



Securing the Universal Postal Service

Decision on the new regulatory framework

Statement

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Section 1

Summary

- 1.1 In October 2011, the Postal Services Act 2011 (“the Act”) came into force and Ofcom gained the responsibility and powers to regulate postal services. In the same month we published a consultation (“the October consultation”). Our principal duty under the Act is to secure the provision of a universal postal service. With that duty in mind, the October consultation proposed a major change in the regulation of the sector. In broad terms, it proposed to grant Royal Mail pricing freedom coupled with key safeguards to ensure that it would have strong incentives to improve efficiency and to protect vulnerable consumers.
- 1.2 In December 2011, we consulted on the range of regulatory conditions that apply to either Royal Mail or other postal operators operating in the UK (“the December consultation”). This consultation proposed to simplify the overall structure of regulation affecting more technical and operational areas. We also proposed to grant Royal Mail further commercial and operational freedoms so that it could adapt to the considerable challenges facing the market.
- 1.3 We received 72 and 28 responses to the October and December consultations respectively, which we have fully considered in reaching our decisions. We have also had regard to the House of Commons Business Innovation and Skills Committee’s report on stamp prices, which was published in March¹. This document sets out our conclusions on the proposals set out in the October and December consultations.
- 1.4 Taken together this statement sets out the basis for a new regulatory framework in the postal sector.

Background

- 1.5 The postal sector remains essential to the UK economy. In 2010-11, 16 billion Letters were delivered to 28.8 million addresses². Royal Mail was responsible for delivering 99% of these.
- 1.6 Central to the role that post plays in society is the universal service obligation. This requires Royal Mail to deliver and collect Letters six days a week, and that prices for services that are part of the universal service must be affordable and uniform throughout the UK.
- 1.7 Nonetheless, the sector faces major challenges. The volume of mail in the UK has fallen by over a quarter since 2006. The revenue loss due to this volume decline has been compounded by customers moving away from higher value traditional products (such as First and Second Class mail) and towards lower value services, such as bulk mail (post sent in high volume typically by business customers). Together these factors have meant that Royal Mail’s revenues have fallen by more than 35% over the same period.
- 1.8 As a result, the sustainability of the universal service has come under severe pressure. Royal Mail’s immediate financial position is weak. Its most recent financial

¹ House of Commons Business, Innovation and Skills Committee, Stamp prices, Fifteenth Report of Session 2010-12, March 2012

² Royal Mail’s 2010-11 annual report

results showed a loss of over £100 million on revenues of about £7 billion and a significantly worse cash flow position as it invests in modernisation.

- 1.9 These challenges were set out in the two reports undertaken on behalf of the Government by Richard Hooper³. These argued that the status quo was not tenable and recommended that Royal Mail needed to be opened to private investment; that the pension deficit needed to be moved to the Treasury; and that responsibility for regulating post should be transferred to Ofcom.
- 1.10 The challenges are set to continue. Mail volumes are likely to continue to decline as more customers switch to electronic alternatives. While mail will continue to play an essential role within the wider communications landscape, it has yet to reach a new steady state; and the future remains highly uncertain.
- 1.11 As volumes have dropped, Royal Mail's average costs have increased. Unless Royal Mail can deliver efficiency gains that exceed the effect of volume decline, it will have to rely on increasing prices, which in turn is likely to exacerbate the decline in demand, further increasing unit costs, and putting additional upward pressure on prices.
- 1.12 There is an immediate risk to the universal service given Royal Mail's financial position, which is likely to mean that there will need to be price increases in the short term. However, beyond that, it is clear that unless Royal Mail can improve efficiency, declining volumes will translate into higher prices, and this may send the postal sector into a spiral of decline.

Ofcom's duties

- 1.13 Ofcom's primary duty under the Act is to carry out our functions in relation to post in a way that we consider will secure the provision of the universal postal service. In discharging our duties in relation to the provision of the universal service, the Act also requires us to have regard to the need for the provision of a universal postal service:
 - To be financially sustainable, including the need for a reasonable commercial rate of return for any universal service provider; and
 - To become efficient within a reasonable time, and then remain so.
- 1.14 Ofcom's principal duty under the Communications Act 2003 ("the 2003 Act") is to further the interests of citizens and consumers, where appropriate by promoting competition. This duty, together with our general duties under the 2003 Act, also applies when we carry out our functions in relation to post. The 2003 Act also provides that, where we are carrying out our functions in relation to postal services, in the case of a conflict between our duty to secure the provision of the universal postal service and our general duties under the 2003 Act, our duty to the universal service takes precedence.
- 1.15 The Act also changes the scope of the regulator's duties compared to the previous postal legislation, the Postal Services Act 2000 ("the 2000 Act"). It replaced the previous licensing regime with a general authorisation to provide postal services, subject to conditions imposed by Ofcom. The new Act is clear that the primary focus of regulation should be on the provision of the universal service, and where Ofcom

³ R, Hooper (2008): Modernise or Decline; R. Hooper (2010): Saving the Royal Mail's Universal Service in a Digital Age.

considers it appropriate, on providing access for other operators to Royal Mail's delivery network.

Overall conclusions

- 1.16 This statement sets out Ofcom's conclusions and decisions in relation to a range of issues. At its heart, however, are the following:
- A commitment to the continued provision of the universal postal service.
 - Granting Royal Mail sufficient pricing flexibility to ensure that it can continue to provide these services on a sustainable basis.
 - An effective and ongoing monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels and pricing.
 - To put in place a safeguard cap to ensure that vulnerable consumers remain able to access a basic universal service.
 - Granting further commercial and operational freedoms to Royal Mail so that it is better able to respond to customer requirements, and adapt to the challenging environment.
 - To ensure that the benefits of competition are maintained in a manner that supports the universal service.
 - To require Royal Mail to provide detailed financial information to Ofcom, to a sufficient level to enable us to carry out our regulatory duties.

Preserving the universal service

- 1.17 Recognising the centrality of the universal service to the role of post within society, as reflected in our duties under the Act, we are preserving all substantive elements of the universal service. This means that Royal Mail will continue to be obliged to supply services with the current key attributes.
- 1.18 Under the Act, we are required to undertake a Review of User Needs by April 2013, which we have commenced. The Government has also given a commitment not to change the minimum requirements of the universal service for the term of this Parliament. We are, however, now changing the terms on which the universal service is specified, so that it is based on the key features of the services (such as a requirement for Royal Mail to offer a service that aims to deliver Letters the next working day after posting rather than by reference to specific named Royal Mail products (such as a "First Class Service"). We believe that this approach is required under the new Act, and is also more transparent and flexible.

Pricing flexibility

- 1.19 In the October consultation, we proposed to move away from the traditional approach to regulating Royal Mail based on price controls. Underlying this proposal was a view that a price control-based approach would not be effective in the unique circumstances currently facing the market. This was for the following reasons:

- In a highly uncertain market environment, where the level and pattern of demand is unclear, it is not feasible to predict accurately whether a given price trajectory would be adequate to ensure the provision of the universal service is financially sustainable.
 - The mechanism for instilling efficiency incentives under an RPI – X formula does not work effectively in circumstances where Royal Mail is struggling financially and Ofcom has a primary duty in relation to the continued provision of the universal service.
 - A price control reduces Royal Mail's flexibility to adapt to ongoing changes in the market and its operating environment.
- 1.20 We recognised, however, that removing price controls alone would come with serious risks. Most significant, is the risk that Royal Mail does not take on the challenge of improving efficiency, and relies solely on pricing to return itself to profitability. This would run the risk of prices rising to a point where they become unaffordable to vulnerable consumers, who would then no longer have access to the universal service. It might also precipitate a more rapid decline in the mail market. For these reasons, we argued that, together with moving away from a price control-based approach to regulation, vital safeguards needed to be put in place to ensure that Royal Mail delivered on our regulatory objectives.
- 1.21 The majority of respondents accepted the analysis we presented of the effects of the current price regulation. It was widely accepted that the challenges currently facing Royal Mail are unique, and that the past approach to regulation had not worked. Despite this, however, many respondents expressed concerns about removing price controls on Royal Mail. These centred in the main on the concerns set out above: that Royal Mail needed to improve efficiency rather than raise its prices; and there was a risk it would raise prices excessively, thus driving away demand and hastening the long term decline of the universal service.
- 1.22 We recognise and agree that the regulatory framework must provide strong incentives for Royal Mail to improve efficiency, rather than rely on pricing flexibility alone. This does not, however, imply that a price control-based approach is necessarily appropriate. Indeed, having reviewed the responses to the consultation, our conclusion is that such an approach would provide poorer incentives than an approach based on price flexibility coupled with key safeguards.
- 1.23 The lesson from recent experience is that a price control-based approach has demonstrably failed to deliver on the required regulatory objectives specified at the time. In particular, the experience since 2006 is that price controls have:
- not been effective in ensuring that Royal Mail improved efficiency – Royal Mail missed its own targets for efficiency improvements, as well as those assumed by Postcomm in setting the control;
 - not protected consumers against price rises – as over the period Royal Mail applied for further price increases due to its financial position; and
 - resulted in a position where the universal service was approaching a point where it was no longer financially sustainable.
- 1.24 The fundamental circumstances have not, in our view, changed. Moreover, in these circumstances, we consider that there are real benefits to be gained from giving

Royal Mail additional pricing flexibility. Royal Mail will be able to adapt readily to the changing market circumstances. In our view Royal Mail is necessarily better positioned than the regulator to take commercial decisions that are in its interests.

- 1.25 The recent report into stamp prices by the BIS Select Committee agreed with this conclusion. It stated:

“Although we heard arguments in favour of retaining price controls, no persuasive case was made that continuing with lengthy price determination procedures was a practical means of supporting Royal Mail’s business.”⁴

- 1.26 Pricing flexibility must, however, be accompanied by robust targeted regulatory safeguards to ensure that Royal Mail uses its commercial freedoms to act in a way that is consistent with the regulatory goals. In our view the main concerns of stakeholders can be addressed by ensuring that these safeguards are fit for purpose, as discussed below.
- 1.27 Overall, therefore we have determined that the new regulatory framework will be based on granting Royal Mail commercial freedom by not imposing a traditional price control, but will be subject to critical safeguards, which are discussed next.

Effective and ongoing monitoring

- 1.28 In granting Royal Mail pricing flexibility, it is in our view essential to ensure that this is used in a way that accords with our regulatory objectives in respect of the universal service. While in the short term we expect that Royal Mail will need to improve the viability of the universal service through price rises, beyond that, it must also rely on efficiency improvements. Moreover, it must continue to deliver and sustain the service quality it provides in relation to the universal service.
- 1.29 In the October consultation, we set out the view that it was important for Royal Mail to be given a sufficient period of regulatory certainty so that the management of the company could focus on the operational challenges facing the business in an environment of regulatory stability. We, therefore, proposed that the new regime last for seven years.
- 1.30 A number of respondents expressed concerns about granting Royal Mail pricing freedom for this period of time. Many of these argued that an interim review would be beneficial at some point within this period to ensure that Royal Mail was acting in accordance with the regulatory objectives and to the benefit of the market.
- 1.31 We recognise the validity of these points. We are of the view that pricing flexibility can only be granted to Royal Mail if it is accompanied by a suitably robust regime that monitors and assesses its performance in relation to the universal service. If Royal Mail uses this freedom to act in ways that do not support the regulatory objectives, then we need to be in a position to intervene as appropriate.
- 1.32 Given this, rather than specify a single given point within the period for a review to take place, we believe that on-going monitoring provides a better means of addressing the core concerns. Reflecting the importance of this issue, we intend to set in place an effective monitoring regime that would allow us to recognise potential problems at an early juncture. This will also provide an additional incentive for Royal

⁴ Paragraph 23

Mail to use its regulatory freedom to support the sustainability of the universal service.

- 1.33 We consider that with this on-going and robust monitoring regime in place, it is appropriate to grant Royal Mail pricing flexibility for seven years to give a sufficient period of regulatory stability for the management of Royal Mail fully to address the challenges facing the business.
- 1.34 We will, therefore, publish an annual statement, supported by market, financial and operational analysis, setting out how the regulatory framework (and hence, Ofcom) is fulfilling its objective of securing the provision of the universal service.
- 1.35 Here in this document, we set out the basis of the monitoring regime. Within this, the most important metrics are:
- **Quality of Service** – Royal Mail will be required to provide the universal service to the specified standard and we will regularly monitor service quality to ensure that this is the case.
 - **Efficiency** – we expect Royal Mail to improve efficiency levels and to sustain such improvements thereafter. While there are many ways to measure efficiency, our focus will be on the level of costs. It would not be in keeping with our regulatory objectives if Royal Mail were to return to a position of sustained profitability, but had done so solely as a result of price rises, and not cost reduction. Conversely, a situation where Royal Mail is able to demonstrate a healthy level of profitability that has been driven by cost savings or business improvements would be consistent with our regulatory objectives, and would not warrant our intervention.
 - **Affordability** – if prices rise to a point that they give rise to affordability issues, particularly for vulnerable consumers, then there would be a need to re-intervene. Below, we set out our conclusions on the need for a cap on Second Class stamp prices, and our related proposals in this regard to safeguard the needs of vulnerable consumers.

Ensuring vulnerable consumers are protected

- 1.36 Ofcom has a duty to ensure that the universal service remains affordable. While household spending on post remains low, at around 50p a week⁵, we are concerned about the impact on vulnerable consumers such as those on low incomes and the elderly. It is also worth recognising the point raised by the BIS Select Committee that for such consumers the pressures may be particularly felt at certain times of the year when postal expenditure is higher, in particular at Christmas.
- 1.37 To address this, in the October consultation we proposed a safeguard cap on Second Class stamps for standard Letters so that a basic universal service product remained accessible to all, including the vulnerable.
- 1.38 We received a significant number of responses; particularly in relation to the level of the cap for Second Class stamp Letters and whether the cap should be extended to other Second Class formats and universal service products.

⁵ Office for National Statistics, Family Spending: A report on the 2010 Living Costs and Food Survey, 2011.

- 1.39 In relation to the level of the cap for Second Class Letters, we were particularly interested in any evidence provided that showed that the range that was proposed for the safeguard cap (45p – 55p) would generate affordability issues. While we were provided with some evidence as to the impact of price rises on customers, no parties provided us with evidence that indicated that there would be specific affordability issues at any particular level within our proposed range. Given this, and recognising the benefits of giving Royal Mail pricing flexibility in the current circumstances, we are therefore setting the safeguard cap for standard Letters at 55p.
- 1.40 In light of responses and the fact that the cap is intended to protect vulnerable consumers, we have also decided that the consumer prices index (CPI), and not the retail prices index (RPI) should be used for future increases in the safeguard cap. This is because the CPI is used as the basis for indexing benefits payments.
- 1.41 A number of respondents, including Consumer Focus, argued that the scope of the cap should be extended to include larger items sent by Second Class stamps. We have considered these arguments carefully. Specifically, we note that although vulnerable consumers send fewer Large Letters and packets, they are similarly reliant on Royal Mail when sending these larger items, as when sending standard Letters. It is also clear that the opportunities to substitute between the different formats and weight steps are generally very limited, so that a constraint on Letters alone is unlikely to provide protection on the prices of other formats within the Second Class stamp product.
- 1.42 We have also considered whether there is any competition for residential and small business customers for different weight steps and formats, which offers customers a choice. Our analysis shows that there is modest competition between 1kg and 2kg, but that there are competitive choices above 2kg.
- 1.43 For these reasons, we are persuaded that, while the safeguard cap should be set at the top of our proposed range, 55p, its scope should be extended to include Large Letters and packets up to 2kg. This extension in scope will provide an important further level of protection for vulnerable consumers. Our assessment is that this extension will not have a material impact on Royal Mail's commercial flexibility, in that the safeguard cap will still potentially apply to only a small proportion of its revenues, and permit considerable pricing freedom.
- 1.44 We intend to consult on the level and structure of the extended cap alongside the associated regulatory conditions in the coming weeks. It is our intention to put in place the necessary regulatory condition setting the cap by August this year and for the cap for Large Letters and packets to come into effect in April 2013. Royal Mail's pricing decisions for 2012 will therefore not be constrained by this extension. However, given the information provided to us by Royal Mail in respect of its indicative pricing intentions for these products for 2012-13 and the range of prices on which we intend to consult, we do not consider the level of the extended cap is likely to be inconsistent with Royal Mail's current intentions for pricing for these services.

Giving Royal Mail Greater Operational Freedom

- 1.45 Under the previous regulatory regime, Royal Mail was subject to a number of conditions that constrained its relationship with its customers. We have reviewed these conditions in light of market circumstances, and more significantly, the new legislative framework applying to postal regulation. This framework has replaced the previous licensed-based approach to regulation with one based on general

authorisations; and has also confined the core scope of regulation to the universal service and access.

- 1.46 Given this, and taking account of the consultation responses, we have concluded that it is appropriate to implement the proposals in our December consultation to lift or reduce Royal Mail's price and non-price notification requirements.
- 1.47 This means there will no longer be any publication or advance notification requirements for changes to the price and non-price terms of Royal Mail's retail non-universal services. In addition, the minimum publication and advance notification requirements for services that fall within the universal service will be reduced to one month.
- 1.48 There will also be no prior approval process for changes to the non-price terms of universal services (but any changes made to these terms will have to be fair and reasonable). As long as the services retain the service elements specified in the universal service order, Royal Mail will have flexibility to adapt the detailed specification of its services. This will mean that it is free to innovate and bring products to market quickly, while at the same time ensuring that the essential characteristics of the universal service are maintained. These changes should help to give Royal Mail greater commercial flexibility to innovate and respond to its challenging market environment.

Competition

- 1.49 Access competition – where a postal operator collects mail from customers and then accesses Royal Mail's delivery network for the mail to be delivered to the final recipient – is the main form of competition in the UK at present. We are implementing the key access proposals set out in our October and December consultations, to maintain access competition given the benefits it can bring such as lower prices to consumers.
- 1.50 As a result of the condition that we are imposing, Royal Mail will have to grant access at inward mail centres for the provision of retail D+2 and later than D+2 Letters and Large Letters services. While we will not directly be regulating the price of access (so that Royal Mail can set its prices in a way that cover the costs of the network), we will ensure, by means of an ex ante margin squeeze test, that the difference between its access price and the equivalent retail price is consistent with principles that will provide for effective competition between Royal Mail and access operators.
- 1.51 We are also giving Royal Mail and access operators' greater flexibility to negotiate the terms and conditions of access agreements, and we are implementing the dispute resolution process set out in the Act to address areas relating to access where they are not able to reach commercial agreement.
- 1.52 End-to-end competition – where a postal operator not only collects the mail from the customer but also delivers it to the recipient (by-passing Royal Mail's network entirely) – has no significant presence in the UK. There is, however, the clear prospect of it developing in the future. Through this statement, we are implementing a notification condition requiring operators who intend to enter (or grow) a competing Letters delivery service to inform us of their plans three months in advance. This information will allow us to assess the potential impact of end-to-end competition on the provision of the universal service.

- 1.53 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.
- 1.54 This document explains our powers to take action in respect to end-to-end competition if it is necessary to do so to secure the ongoing provision of the universal service. The notification process provides a means of providing Ofcom with advanced warning of an operator's plans to enter the market or expand. It does not, however, provide Ofcom with the power to approve or reject the operator's plans prior to their implementation.
- 1.55 Ofcom's powers to act in relation to end-to-end competition stem from our ongoing duty to act in a way that we consider will secure the provision of a universal postal service. If there is a demonstrable threat to that provision, Ofcom has the power to impose general universal service conditions on end-to-end operators. Furthermore, Ofcom's duty to carry out its functions to secure the provision of the universal service is ongoing, and so the assessment of its provision must be both ongoing and forward looking.

Regulatory accounting

- 1.56 We are also setting in place the conditions required for us to gain the financial information we need from Royal Mail in order to fulfil our duties. The regulatory financial reporting requirements will provide us with sufficient information to understand and monitor the financial sustainability and efficiency of the provision of the universal service. It will also inform our understanding of how costs and revenues are allocated across different parts of the business and the relative profitability of different products.

Other changes

- 1.57 Finally, we have implemented⁶ the (mostly minor) proposals set out in our December consultation on changes to the majority of other regulatory conditions so that they remain fit for purpose. These include the other designated universal service provider conditions (applying to Royal Mail) as well as the consumer protection conditions, the essential condition and the time-limited transitory conditions which apply to either Royal Mail and/or other postal operators.

Implementation

- 1.58 Our regulatory changes come into effect on 27 March 2012 and will apply to Royal Mail and (where relevant) to other postal operators from that date.
- 1.59 Taken together, these changes constitute a new approach to the regulation of the postal sector. They encompass the measures we consider necessary and

⁶ The only key proposal which we have not implemented at this stage is the removal of consumer protection condition 1.2(b). We will retain this requirement pending a review of the Postal Common Operational Procedures Code and Mail Integrity Code – see Section 12 in this statement.

appropriate to secure our duties under the Act, and in particular the provision of a universal postal service. We recognise that these changes will, across the piece, give significantly more regulatory and commercial freedom to Royal Mail. Our assessment is that this is necessary in order to meet the challenges facing the universal service, now and in the foreseeable future. Our expectation is that Royal Mail will use this greater flexibility to secure the long term sustainability of the universal service in a manner that responds to its customers' needs.

- 1.60 In light of these changes to provide greater freedom for Royal Mail, and the associated risks this could entail, we will keep a close watch on developments through our monitoring regime and through engagement with stakeholders. If Royal Mail does not act as we expect it to, we note we would, as necessary, be open to revisiting our decision to lift the majority of regulatory requirements in this market.

Section 2

Introduction

Scope of this statement

- 2.1 The postal sector is essential to the UK economy and consumers also place a high value on a functioning and high quality postal service. The universal service obligation underpins the universal service and requires Royal Mail, as the universal service provider, to deliver and collect Letters six days a week at an affordable and uniform price throughout the UK.
- 2.2 Responsibility for postal regulation was transferred from Postcomm to Ofcom on 1 October 2011 through the Postal Services Act 2011 (“the Act”). Our primary duty under the Act is to carry out our functions in relation to post in a way which we consider will secure the provision of a universal postal service.
- 2.3 The approach to regulation adopted by Postcomm was based on price controls – similar to those used in most other utility sectors. In normal circumstances this approach is an effective means of preventing private operators from earning excessive profits, thereby providing incentives for firms to reduce costs, while at the same time protecting consumers from excessive prices. It is an approach that is widely used by regulators, including Ofcom, to regulate private operators with significant market power.
- 2.4 In the October consultation, we set out the significant challenges that Royal Mail has faced in recent years. When the last full price control was implemented by Postcomm in 2006, market volumes were expected to broadly flat for the period of the control. Instead, UK market volumes have fallen by over 25% as consumers have moved away from traditional mail and towards digital means of communication. As volumes have dropped, Royal Mail’s average unit costs have increased. Furthermore, there have been substantial changes in product mix, with customers tending to move away from higher value traditional products (such as First and Second Class mail) and towards lower value services such as bulk mail (post sent in high volume typically by major business customers). Although the price control included a mechanism to allow Royal Mail additional revenue if its volumes were lower than expected, this was not sufficient to compensate it for the volume decline experienced and the loss in revenue due to mix factors.
- 2.5 Within this context of a declining postal market, the current “traditional” price control has not been successful in incentivising efficiency improvements and securing the provision of the universal service. In fact, the provision of the universal service is threatened by Royal Mail’s immediate financial position, with the part of Royal Mail responsible for delivering the universal service making a loss of £120m⁷ in 2010-11. This is despite price increases in November 2010 in excess of those consistent with the price control (which were permitted by Postcomm in light of its primary duty to secure the provision of the universal service following a request by Royal Mail).
- 2.6 The limited success of the current price control is attributable to a range of factors, including: the highly uncertain market conditions (aggravated by the longer than

⁷ UK Letters, Parcels and International (UKLPI), previously Letters, Parcelforce, Corporate and Group Property

expected price control⁸); Royal Mail's limited flexibility to reduce its costs in line with the declining volumes and the delays in completing a price control review due to the regulatory uncertainty from the Hooper review and the first Postal Services Bill.

- 2.7 However, as well as the immediate financial threat to the universal service (given Royal Mail's financial position), it is likely that the market will continue to face uncertainty and challenge. Mail volumes, in particular, are expected to continue to decline worldwide, with Letter volumes possibly declining by between 25% and 40% over the next five years⁹. Unless Royal Mail can deliver efficiency gains that exceed the effect of this volume decline, it will have to rely on increasing prices, which in turn is likely to suppress demand, further increasing unit costs, and putting further upward pressure on prices. This could potentially lock the postal sector and the universal service into a spiral of decline.
- 2.8 In light of this, the risks to the universal service are considerable, and it has therefore been necessary to consider more fundamental solutions to ensure that we meet our primary duty in the current circumstances. As part of a programme of work we have undertaken a series of consultations to determine the regulatory framework that should be in place for the postal sector to ensure we meet our statutory duties and in particular secure the provision of the universal service.
- 2.9 We set out our proposals for the future regulatory framework in two key consultations published in October and December 2011:
- *'Securing the Universal Postal Service (Proposals for the future framework for economic regulation)'* on 20 October 2011- ("the October consultation") – which primarily focused on our proposed approach to regulating Royal Mail and its pricing;
 - *'Review of Regulatory Conditions'* published on 13 December 2011 – ("the December consultation") – which presented our proposals for revising all the regulatory conditions relevant to the postal sector.
- 2.10 Common to both consultations were proposals intended to give Royal Mail more commercial flexibility by ensuring regulation is targeted where it is needed to secure the provision of the universal service. This included removing unnecessary regulation while at the same time, protecting consumers and, where appropriate, promoting effective competition through use of safeguards, such as appropriate monitoring mechanisms. The key topics covered in both these consultations are noted, in turn, below.

Securing the universal postal service – the October consultation

- 2.11 The October consultation set out our proposals to secure the provision of the universal service, given the challenging market conditions and Royal Mail's financial

⁸ Postcomm's review on Royal Mail's price control for 2010 was delayed following the recommendation by the Independent Review Panel, led by Richard Hooper CBE published in 2008: *Modernise or Decline* (updated in 2010: *Saving the Royal Mail's Universal Service in a Digital Age*) to among other measures transfer regulatory responsibility to Ofcom. Given the deferral of the first Postal Services Bill in 2009, Postcomm rolled over the price control in 2010-11 and again in 2011-12 with some amendments to give additional flexibility to Royal Mail and implement additional price increases given Royal Mail's financial position.

⁹ Figure cited in R.Hooper (2010): *Saving the Royal Mail's Universal Service in a Digital Age*, <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/s/10-1143-saving-royal-mail-universal-postal-service>

position. In this context, we set out that fulfilling the primary duty of safeguarding the universal service implied providing:

- *Royal Mail with the opportunity to return the universal service to sustainability* – Royal Mail is the only company at present capable of delivering the universal service in the UK and unless it can be made viable, the universal service is at risk in the near term; and
- *strong incentives to improve efficiency and innovation and counteract the longer-term threat to the universal service* – unless it is able to improve efficiency, Royal Mail will be forced to rely solely on price increases to cover its costs, which could lead to a spiral of declining volumes.

2.12 Specifically we set out our proposals to:

- a) Remove the significant majority of retail and wholesale price controls to give Royal Mail greater commercial freedom to determine the most appropriate way to raise its revenues and secure the financial sustainability of the universal service;
- b) Implement an effective monitoring regime which includes scope for re-regulation if the incentives to deliver greater efficiency are demonstrably failing;
- c) Ensure that a basic universal service is available to all and affordable by all (through a safeguard cap on Second Class Letters¹⁰);
- d) Incentivise the discipline of competition and innovation through:
 - imposing an access condition on Royal Mail to oblige it to grant access at inward mail centres (IMC); and
 - implementing a margin squeeze test that ensures the difference between the access price and retail price is kept at a level that allows efficient access competitors to compete effectively.
- e) Leave the new economic framework in place for seven years (unless fundamental concerns arise through the monitoring regime); and
- f) Require Royal Mail to regularly provide regulatory financial reports to allow us to assess the financial sustainability of the universal service and effectively monitor its behaviour given the proposed substantial removal of regulatory safeguards.

Reviewing the regulatory conditions – the December consultation

2.13 Amongst other things, the Act replaced the existing licensing regime in the postal sector with a general authorisation regime. This means that persons may provide postal services without the need for any licence or authorisation but that the provision of those services by postal operators may be subject to regulatory conditions that Ofcom may impose under Part 3 of the Act¹¹. In light of this, the Act required Ofcom to transpose the existing licences into regulatory conditions under a general

¹⁰ “Letters” means any item up to length 240mm, width 165mm, thickness 5mm, and weighing no more than 100g.

¹¹ The types of conditions we can impose are those in sections 36, 38, 39, 41, 42, 48-51 of the Act.

authorisation regime. The first regulatory conditions – ‘initial conditions’ – are very similar to the conditions contained in the previous licences¹² imposed by Postcomm.

2.14 The fundamental aim of our December consultation was to ensure these regulatory conditions remained fit for purpose and consistent with our wider objectives (set out in the October consultation) – taking account of the need to ensure the viability of the universal service and market developments.

2.15 The review was wide-ranging in scope, covering the following areas:

- proposing the first UPSO and related changes to DUSP conditions given we have to describe the services which make up the universal service (and so move away from the current approach which lists a set of Royal Mail’s product names);
- ensuring Royal Mail’s performance targets are maintained for universal services to avoid the risk of quality of service being reduced;
- the advance notification and publication requirements for the price and non-price terms of Royal Mail’s services;
- setting out the changes to the conditions required to implement the October consultation proposals, including the Second Class stamp safeguard cap; the access requirements; and the revised approach to accounting and financial reporting¹³;
- proposing a new notification condition on other postal operators for potential end-to-end entry or growth into a (competing) Letters delivery service¹⁴; and
- considering whether to retain any aspects of the five transitory conditions, which are due to expire at the end of March 2012.

2.16 We reviewed all 21 initial conditions¹⁵, plus the transitory conditions, and we proposed to change most of them (as well as to add the new end-to-end ‘notification’ condition).

One statement covering our regulatory approach and conditions

2.17 This document contains our decisions in relation to the proposals set out in both the October and December consultations. In reaching the conclusions in this document, we have considered fully the 72 responses to the October consultation and the 28 responses to the December consultation.

2.18 In addition, we have taken into account the report on stamp prices published by the Business, Innovation and Skills Committee¹⁶ on 2 March 2012 following a short investigation. This report set out the BIS Select Committee’s views on:

- the current regulatory framework and the proposed removal of price controls;

¹² Previously, operators needed a licence or authorisation in order to provide postal services.

¹³ Subject to responses to the October consultation.

¹⁴ We were directed by the Secretary of State to put this condition in place by 1 April 2012.

¹⁵ See paragraph 3.24 of this statement for more detail on which operator(s) these conditions apply to.

¹⁶ House of Commons Business, Innovation and Skills Committee, Stamp prices, Fifteenth Report of Session 2010-12, March 2012.

<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmbis/1841/184102.htm>

- future stamp pricing;
 - the importance of efficiency savings; and
 - the choice of inflation measure.
- 2.19 We also note the recent decision by the European Commission to approve the UK plans to provide pension relief (by removing the historic pension deficit) and restructuring aid to Royal Mail Group¹⁷.
- 2.20 We have consolidated our conclusions into one document given the close linkages between the content of the two consultations and since our decisions on both of them shape our making of regulatory conditions under Part 3 of the Act.
- 2.21 We believe a combined statement will provide clarity on the overall regulatory framework to stakeholders - as it presents our approach to regulating the postal sector as well as the new regulatory conditions (to implement that approach) which will apply to Royal Mail and where, relevant, to other postal operators.

Outline of the rest of this document

- 2.22 Our conclusions are set out in the remainder of this document as follows:
- **Section 3 – Legal framework** – summarises the key features of the legal framework relevant to the decisions set out in this statement.
 - **Section 4 – The universal postal service** - sets out our approach to the first Universal Postal Service Order;
 - **Section 5 – Financially sustainable universal service** – sets out our approach to measuring the financeability of the universal service;
 - **Section 6 – Securing the provision of the universal service – commercial freedom** - sets out our decisions in relation to the regulation of Royal Mail's prices and the other safeguards that will be implemented to protect consumers and ensure Royal Mail is addressing the efficiency challenge. This section also sets out our decisions on the notification and publication requirements for price and non-price terms for both universal and non-universal services;
 - **Section 7 – Monitoring regime** – sets out the key features of the monitoring regime;
 - **Section 8 – Safeguard cap** – sets out our decision in relation to the scope, form, structure and level of the safeguard cap;
 - **Section 9 – End-to-end competition** – sets our decision in relation to the notification condition for end-to-end entry or expansion;
 - **Section 10 – Access competition** - sets out our decision on the safeguards that we are implementing to protect access competition implemented via a universal service provider ('USP') access condition;

¹⁷ 21st March 2012

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/260&format=HTML&aged=0&language=EN&guiLanguage=en>

- **Section 11 – Regulatory Financial reporting** – sets out our decisions for a new regulatory financial reporting framework for Royal Mail;
- **Section 12 – Other regulatory conditions** - sets out our decisions on and our conclusions to most¹⁸ of the designated universal service provider ('DUSP') conditions which relate to Royal Mail's provision of the universal postal service ; our approach to the consumer protection conditions (which vary in terms of their coverage, applying to all postal operators, all regulated postal operators - 'RPOs' – or just to Royal Mail); the one essential condition (which applies to RPOs); and our handling of the cessation of the transitory conditions; and
- **Section 13 – Legal thresholds** – sets out our analysis of how the various conditions that we are imposing meet the various requirements set out in the Act relating to the imposition of regulatory conditions.

2.23 The Annexes to this document are as follows:

- **Annex 1** is a table listing the respondents to our consultations.
- **Annex 2** is a table of the new condition numbers (including a comparison back to the transitional and licensed based regimes);
- **Annex 3** – Regulatory financial reporting – sets out our conclusions for a new regulatory financial reporting framework for Royal Mail (including the objectives behind the framework, the reporting requirements necessary to meet those objectives and the implementation of requirements via a direction and regulatory condition).
- **Annex 4** – USP Access Condition – detailed drafting comments on the USP access condition.
- **Annex 5** – is our regulatory impact assessment for the first universal postal service Order.
- **Annex 6** – is the text of the first universal postal service Order.
- **Annex 7** – is the notification of the DUSP conditions.
- **Annex 8** – is the notification of the consumer protection conditions.
- **Annex 9** – is the notification of the USP access condition.
- **Annex 10** – is the notification of the USP accounting condition.
- **Annex 11** – is the direction under the proposed USP accounting condition.
- **Annex 12** – is the notification of the end-to-end notification condition.
- **Annex 13** – is the notification of the essential condition.
- **Annex 14** – is our notification of revocation and amendment of regulatory conditions imposed from 1 October 2011.

¹⁸ One of the DUSP conditions is discussed in Section 6.

- **Annex 15** – is out notice on the proposed changes to 'Postal Common Operational Procedures Code Agreement ('PCOPA').

Section 3

Legal framework

Introduction

- 3.1 The framework for our assessment of any regulatory safeguards applicable to postal services is set out in the Act, which received Royal Assent on 13 June 2011. One of the Act's main purposes is to make provision for a new regulatory framework for the postal services sector, including transferring regulatory responsibility from Postcomm to Ofcom.
- 3.2 This framework is set out in Part 3 of the Act, which came into force on 1 October 2011. Its provisions also give effect to Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008, which amends Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services.
- 3.3 The Act also replaced the existing licensing regime in the postal sector with a general authorisation regime. This means that persons may provide postal services without the need for any licence or authorisation but that the provision of those services by postal operators may be subject to regulatory conditions that Ofcom may impose under Part 3 of the Act¹⁹.
- 3.4 This section summarises the key features of the regulatory framework relevant to the decisions set out in this statement.

Duty to secure provision of a universal postal service

- 3.5 Section 29(1) of the Act provides that Ofcom must carry out its functions in relation to postal services²⁰ in a way that it considers will secure the provision of a universal postal service. Section 29(2) of the Act provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1) of the Act.
- 3.6 Section 30(1) of the Act requires Ofcom to make a universal postal service order setting out a description of the services that Ofcom considers should be provided in the United Kingdom as a universal postal service, and the standards with which those services are to comply.
- 3.7 The universal postal service must, as a minimum, include each of the services set out in section 31 of the Act. Those services are known as the 'minimum requirements' and comprise (in summary):
- at least one delivery of Letters every Monday to Saturday, and at least one delivery of other postal packets every Monday to Friday;

¹⁹ The types of conditions we can impose are those in sections 36, 38, 39, 41, 42, 48-51 of the Act.

²⁰ The expression 'postal services' is defined in section 27(1) 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.

- at least one collection of Letters every Monday to Saturday, and at least one collection of other postal packets every Monday to Friday;
- a service of conveying postal packets from one place to another by post at affordable, geographically uniform prices through the UK;
- a registered items service at affordable, geographically uniform prices through the UK;
- an insured items service at affordable, geographically uniform prices through the UK;
- the provision of certain free services to the blind/partially sighted; and
- the free conveyance of certain legislative petitions and addresses.

Financially sustainable and efficient provision of the universal service

- 3.8 Section 29(3) of the Act provides that, in performing our duty under section 29(1), we must have regard to the need for the provision of a universal postal service to be:
- financially sustainable; and
 - efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 3.9 The concept of ‘financially sustainable’ is not exhaustively defined. However, section 29(4) of the Act states that it includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.
- 3.10 We note in this regard that in a letter dated 15 April 2011 to Ofcom and Postcomm²¹, the Secretary of State set out the government’s view that the words ‘reasonable’ and ‘commercial’ in section 29(4) seek simply to ensure clarity that, where Ofcom deems it appropriate, it should take into account private sector international operators in the postal market, their respective levels of efficiency and the different markets they are operating in, as well as regulated commercial companies in other regulated sectors.

The duty to secure the provision of sufficient access points

- 3.11 Section 29(6) of the Act provides that Ofcom’s duty under section 29(1) includes a duty to carry out its functions in relation to postal services in a way that Ofcom considers will secure the provision of sufficient access points to meet the reasonable needs of users of the universal postal service. This duty is subject to any direction by the Secretary of State for Ofcom to take, or refrain from taking, specified action. No such direction has to date been given to Ofcom.
- 3.12 The term ‘access point’ is defined at section 29(11) of the Act as meaning any box, receptacle or other facility provided for the purpose of receiving postal packets, or any class of postal packets, for onwards transmission by post.

²¹ The letter is published on BIS’ website at: <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/p/11-874-postal-regulatory-framework-letter-to-ofcom-postcomm> .

General duties

- 3.13 Section 3 of the Communications Act 2003 (the “2003 Act”) provides that it shall be our principal duty, in carrying out our functions, to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
- 3.14 This principal duty applies also to functions carried out by us in relation to postal services.²² Section 3(6A) of the 2003 Act provides that the duty in section 29(1) of the Act takes priority over our general duties in the 2003 Act in the case of conflict between the two where we are carrying out our functions in relation to postal services.
- 3.15 In performing our general duties, we are also required under section 3(4) of the 2003 Act to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations appear potentially relevant, including:
- the desirability of promoting competition in relevant markets;
 - the desirability of encouraging investment and innovation in relevant markets;
 - the vulnerability of children and of others whose circumstances appear to Ofcom to put them in need of special protection;
 - the needs of persons with disabilities, of the elderly and of those on low incomes;
 - the opinions of consumers in relevant markets and of members of the public generally;
 - the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas; and
 - the extent to which, in the circumstances of the case, the furthering or securing of the matters mentioned in section 3(1) is reasonably practicable.
- 3.16 Section 3(5) of the 2003 Act provides that in performing our duty to further the interests of consumers²³, we must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.
- 3.17 Pursuant to section 3(3) of the 2003 Act, in performing our general duties, we must have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice.

²² Section 1(1) refers to such functions as may be conferred on Ofcom by or under any enactment. The reference to ‘communications matters’ in section 3(1) also refers generally to matters in relation to which we have functions, and similarly the reference to ‘relevant markets’ means markets for any of the services, facilities, apparatus or directories in relation to which we have functions: section 3(14) of the 2003 Act.

²³ Under section 405 of the 2003 Act as amended, references to consumers in a market for a service include, where the service is a postal service, addressees.

- 3.18 In this regard, we note Ofcom's general regulatory principles²⁴ including in particular the following in the present context:
- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
 - seeking the least intrusive regulatory mechanisms to achieve our policy objectives; and
 - consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.
- 3.19 We also note the Secretary of State's letter referred to above, in which he stresses the need for the universal service provider to have commercial flexibility, where appropriate, to react to market dynamics in pricing and product innovation. He also urges Ofcom to reflect that its regulatory decisions retain sufficient flexibility and adjustment mechanisms to allow for rapid change helping to secure the future of the universal postal service, while providing appropriate incentives for Royal Mail to improve its efficiency over time.
- 3.20 Finally, we have an ongoing duty under section 6 of the 2003 Act to keep the carrying out of our functions under review with a view to ensuring that regulation by Ofcom does not involve the imposition of burdens which are unnecessary or the maintenance of burdens which have become unnecessary.
- 3.21 Under the Act, Ofcom can potentially impose different types of condition on different types of postal operator. The different types of condition that we have decided to impose are described in the sections that follow

The initial conditions

- 3.22 Under the transitional provisions set out in the Act²⁵ Ofcom was, in effect, required to transpose the existing regulatory conditions which were contained in postal operators' licences into conditions under a general authorisation regime and to apply these from 1 October 2011. For the transitional period, these conditions ('the initial conditions') had to be substantially similar to the conditions previously contained in licences, except where we considered that a condition was no longer necessary²⁶.
- 3.23 On 29 September 2011, we issued our statement on the transitional regulatory regime²⁷. This included our transposition of the existing postal licence conditions into initial conditions to apply under the general authorisation regime as well as our provisional designation of Royal Mail as the universal service provider.
- 3.24 This regime took effect from 1 October 2011 and consisted of the following conditions:
- One essential condition ('E1') which applied to regulated postal operators ('RPOs') and nine consumer protection conditions (CP 1-9) whose requirements

²⁴ <http://www.ofcom.org.uk/about/sdrp/>

²⁵ Under Part 3 and Schedule 9 of the Act.

²⁶ Apart from consumer protection conditions.

²⁷ Ofcom, Postal regulation: Transition to the new regulatory framework, Update statement, October 2011. See <http://stakeholders.ofcom.org.uk/consultations/postal-regulation/update-statement/>

vary in terms of their coverage, applying either to all postal operators, all RPOs or just to Royal Mail;

- Eleven conditions which apply to Royal Mail as the USP – six designated USP conditions ('DUSP 1-6'), four access conditions ('USPA 1-4') and one accounting condition ('ACC 1'); and
- Five transitory (i.e. time-limited) conditions – four on the universal service provider ('T 1-4') and one on RPOs ('T 5').

3.25 In our December consultation, we considered whether these conditions need to be amended, deleted or whether new conditions should be introduced. We set out our final decisions in this regard in the remaining sections of this statement.

Legal tests

General test for imposing regulatory conditions

3.26 Schedule 6 to the Act provides that we may impose a regulatory condition²⁸ only if we are satisfied that the condition:

- is objectively justifiable;
- does not discriminate unduly against particular persons or a particular description of persons;
- is proportionate to what it is intended to achieve; and
- is transparent in relation to what it is intended to achieve.

3.27 Individual regulatory conditions provided for in the Act go on to set out specific tests which we must be satisfied are met before they can be imposed. We consider each of these, where relevant, in Section 13 where we set out our conclusions on the package of measures which in our view best meets our statutory duties.

General impact assessment

3.28 The analysis presented in the whole of this document represents an impact assessment, as defined in section 7 of the 2003 Act.

3.29 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the 2003 Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach

²⁸ The expression 'regulatory condition' is defined in section 28(2) of the Act as including a designated USP condition and a USP access condition; that definition applies to Schedule 6 by virtue of sections 53 and 63 of the Act, when read together.

to impact assessments, see our guidelines, '*Better policy-making: Ofcom's approach to impact assessment*'.²⁹

- 3.30 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

Equality impact assessment

- 3.31 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation;
- advance equality of opportunity between different groups; and
- foster good relations between different groups,

in relation to the following protected characteristics: age; disability; gender re-assignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation.

- 3.32 Such equality impact assessments ("EIAs") also assist us in making sure that we are meeting our principal duty under section 3 of the 2003 Act discussed above.
- 3.33 We have therefore considered what (if any) impact the decisions in this statement may have on equality. We do not consider the impact of the decisions in this statement to be to the detriment of any group within society. In particular we have addressed in Section 8 the specific issue of whether additional safeguards are required for vulnerable consumers.
- 3.34 We have therefore not carried out separate EIAs in relation to race or gender equality, or equality schemes under the Northern Ireland and Disability Equality Schemes.

²⁹ http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

Section 4

The universal postal service

Introduction

- 4.1 As noted in Section 3, our primary duty under the Act is to secure the provision of a universal postal service. This has driven our overall work in setting the new regulatory framework. In addition, we noted – in both the October and December consultations – our commitment that “the scope of the universal service will remain unchanged from the present scope”, until we have assessed the needs of users.
- 4.2 In this section, we define the universal service and, in particular, we discuss the conclusions to our proposals for:
- Making the Universal Postal Service Order (UPSO or Order) which for the first time would contain a description of the services which we consider are key components of the current universal postal service in the UK;
 - Specifying a *reasonable* duration period for Redirections, Keepsafe and Poste Restante in the Order;
 - The potential inclusion of Redelivery and Return to Sender within the universal service; and
 - Lifting the requirement to provide Return to Sender free of charge.
- 4.3 We discuss the designated universal service provider (DUSP) conditions relating to the obligation on Royal Mail to provide the universal postal service (and access points³⁰) and to meet universal service quality of service standards in Section 12. The DUSP condition relating to provision of information to users is discussed within Section 6.

Our focus on securing the universal postal service

The current universal postal service

- 4.4 We described the current universal service in paragraphs 4.1 to 4.3 of our December consultation. The minimum requirements of the universal postal service are set out in section 31 of the Act³¹, which themselves implement the requirements of the EU Postal Services Directive³² and Parliament's decision on what must be provided.
- 4.5 The initial DUSP condition 1 (now superseded by this decision) listed the following products³³ that Royal Mail had to provide in order to discharge its universal service obligation:

30 Most commonly provided by Royal Mail in the form of post boxes and through post offices.

³¹ For the full minimum requirements, see paragraph 4.2 of our December consultation.

³² Directive 97/67/EC as amended by Directive 2002/39/EC and http://ec.europa.eu/internal_market/post/legislation_en.htm#proposal.

³³ Royal Mail's website describes their products - see <http://www.royalmail.com/>. Redirections, Keepsafe, Recorded Signed For, Certificate of Posting and Poste Restante are also described in

- First class stamped, single piece PPI³⁴ and meter³⁵ mail;
- Second Class stamped, single piece PPI and meter mail;
- Standard Parcels;
- Stamp, PPI and metered Airmail;
- Stamp, PPI and metered Surface Mail;
- Incoming services for Letters posted outside the UK³⁶;
- Special Delivery Next Day (when not sold on account);
- International Signed For (when sold with single piece Airmail and Surface Mail services);
- Redirections;
- Keepsafe;
- Recorded Signed For;
- Certificate of Posting;
- Poste Restante; and
- Petitions and addresses.

4.6 In addition DUSP 1 required one delivery to every home or premises and one collection from access points used in the provision of the universal service of relevant postal packets³⁷ every working day. DUSP 2 covered the provision of free services for the blind and partially sighted. The quality of service targets which are associated with universal services are discussed in Section 12.

Review of user needs

4.7 In our consultation, we explained that section 30 of the Act requires us to “carry out an assessment of the extent to which the market for the provision of postal services in the United Kingdom is meeting the reasonable needs of the users of those services” before making or modifying a universal postal service order (UPSO or

Table 5, page 55 of the Postcomm 2011 decision on the universal service available at <http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf>.

³⁴ Printed Postage Impression (PPI), a method of payment or payment channel for Royal Mail services whereby postage is pre-printed on envelopes, labels or wrappers and requires the customer to have an account with Royal Mail

³⁵ Meter or franked, a method of payment or payment channel for Royal Mail services where customers pre-pay for postage and apply an impression to the envelope, label or wrapper using a franking machine licensed by Royal Mail.

³⁶ Includes a requirement to use reasonable endeavours to establish delivery arrangements with postal operators in countries outside the UK.

³⁷ Under Section 27(2) of the Act, ‘postal packet’ means a letter, parcel, packet or other article transmissible by post.

Order). While this obligation does not apply for making the first Order, the Act requires us to conduct such a review within 18 months of vesting (by 1 April 2013).

- 4.8 While this was not within the scope of our October or December consultations, we have started a project to fulfil our obligation to review user needs and will undertake this during 2012 and the early part of 2013. Our work includes a comprehensive programme of consumer research, direct engagement with stakeholders and public consultation. We will conclude the review by 31 March 2013 and will publish our conclusions on the extent to which the reasonable needs of users are being met.

Our proposals

We proposed to move to a description of universal services

- 4.9 The Act requires Ofcom to make an Order³⁸ to set out:
- A description of the services that it considers should be provided in the UK as a universal postal service; and
 - The standards with which those services are to comply.
- 4.10 As the Act is clear that we need to move to a *description* of services, we therefore proposed in our December consultation to set out, in the Order, a description of the characteristics of the universal services, rather than a list of Royal Mail's product names.
- 4.11 In proposing this change we set out our intention to retain all the essential features of the current universal service – and the importance of preserving this, pending the review of user needs by March 2013. We noted that the minimum requirements of the universal service could not, in any event, be changed without approval from Parliament. We specifically asked respondents for their views on any areas where our proposals would not achieve our aim of maintaining the key features of the current universal service.
- 4.12 In summary we proposed that the following characteristics should be specified: *Definition of the product; Delivery and collections six days a week for letters, five for packets; Universal access; Uniform and affordable prices; Single piece, where applicable; Speed and associated quality of service targets; Dimensions and weight; and Tracking (in relation to the registered and insured product).*
- 4.13 We proposed not to specify the prices of the services in the Order except where there are existing requirements to provide free services, nor the format of the items. We consulted on our approach to the pricing of universal service products in our October consultation and our conclusions on this are set out in Sections 6 and 8 of this statement. We also proposed not to specify requirements imposed on customers by Royal Mail, as these relate to practical and operational issues.
- 4.14 In addition, we proposed not to include compensation and times of collection and delivery in the universal service products characteristics, as we have required compensation as part of the Consumer Protection conditions, and have retained the

³⁸ An Order under section 30 of the Act is a type of statutory instrument. Under section 63 of the Act and section 403 of the Communications Act, we must consult before making it but it is not laid before Parliament.

requirement on Royal Mail to notify us of the collection and delivery times and any changes to these in the DUSP condition (see Annex 7).

Our assessment of stakeholder responses

- 4.15 Most respondents to our December consultation provided feedback on our proposal for the Order. We received many comments and there were several themes that emerged from respondents' feedback. We discuss these and our analysis of these responses, in turn, below.
- 4.16 Overall, we note that stakeholder feedback was positive, with many respondents - including both industry and user groups³⁹ - supporting the move to a description of the universal postal service and, in general, our identification of the core characteristics of the universal service. On that basis we note, upfront, that we have adopted our characteristics-based description of the universal service in the Order.
- 4.17 A number of respondents raised issues in relation to the content of the Order, rather than its form, in effect opening a debate in relation to our policy of retaining the essential features of the universal service until our review of user needs.
- 4.18 While we welcome and acknowledge the points stakeholders have made, we believe we have received no compelling evidence about the needs of users which indicates that we should make changes prior to our completing our review, as discussed above. We will however consider the points made about what the universal service should include as part of our review of user needs – and so we encourage stakeholders to engage with us further during that review over 2012-13.
- 4.19 We address specific comments below.

Alleged over-specification of the universal service in the Order

- 4.20 A number of respondents argued that some of our characteristics went beyond the minimum requirements in the Act or the Directive:
- On speed of delivery, the Mail Competition Forum (MCF), TNT Post UK (TNT) and UK Mail noted that First Class (D+1⁴⁰) and Second Class (D+3) were not legal requirements. TNT argued that including a D+1 service in the universal service supported the claim that access should be provided to the Outward Mail Centre on fair and reasonable terms. DX Group also believed that the Order should not include the names of Royal Mail products, for instance the terms Priority and Standard would be a better description than First and Second Class;
 - DX Group, the MCF, Royal Mail, TNT and UK Mail all argued that the Order should require registered and insured services, rather than Special Delivery, as the Order should not replicate the current Royal Mail products. The MCF and UK Mail believed that this conflated registered and insured services and formalised Royal Mail's commercial decision to combine both as part of the Special Delivery Next Day product. Another user group, the Direct Marketing Association (DMA), considered that the requirements of the universal service were for registered and

³⁹ Organisations representing smaller users (Consumer Focus, FSB, Archbishops' Council), one individual, three business customers, Royal Mail, some access operators (MCF, UK Mail, another access operator), Intellect and CWU.

⁴⁰ A D+X postal service is a service with a specification for delivery to be X days after collection from the originating customer or access point.

insured services, and that the characteristics should be as broad as possible to allow flexibility. Royal Mail wanted it to be clarified that “special delivery services” did not refer to its Special Delivery products and that the definition should be based on the minimum characteristics of a registered and insured service;

- Royal Mail argued specifically against the inclusion of an express product and a delivery time guarantee for Special Delivery Next Day (SDND), as this was not required by the Directive and would place a further requirement on Royal Mail than was currently the case. Royal Mail also said that the target delivery time of 1pm is unnecessary and that requiring it changed the current universal service;
- The DMA, another user group, the MCF and four operators (DX Group, ONEPOST, TNT and UK Mail) questioned the inclusion of tracking as a characteristic of the universal service;
- DX Group objected to the inclusion of proof of delivery on anything other than the registered mail service; and
- Royal Mail considered that our list of characteristics should refer to “key attributes” rather than “product definitions”.

4.21 In addition, two access operators believed that the delivery and collection requirements should be reviewed and reduced.

4.22 In contrast, Consumer Focus, the Federation of Small Businesses (FSB), the Archbishops’ Council (of the Church of England), the Communication Workers Union (CWU), Intellect, three customers and one individual either agreed with the characteristics we proposed, or suggested additions. In particular, Consumer Focus considered that “the correct characteristics have been identified to cover existing services” and strongly agreed with our proposal to maintain the existing characteristics of the universal service pending the review of user needs.

4.23 In response, we note that our proposal to move to a description of characteristics of the universal service, in addition to implementing the Act, seeks to preserve the essential features of the current universal service, while defining the universal service more clearly and flexibly. We consider that our proposals achieve this policy.

4.24 The Act requires minimum requirements, whereas the Order can go beyond this to take into account the needs of users. As the current universal service fundamentally goes beyond the minimum requirements of the Act and the Directive, so does the universal service we described in the Order.

4.25 We consider that any material change to the current universal service is only appropriate after a process of gathering evidence as to whether users’ needs are met. As expressed by Consumer Focus, “any change to the universal service should be made on evidence of changing consumer need”. The move to a first Order based on characteristics is intended to be a change in how the service is described, rather than what is being described, in so far as we aim to replicate the essential characteristics of the current universal service.

4.26 We have received no evidence that persuaded us that the needs of users require changes to the universal service, including the removal of tracking in relation to insured and registered products. However, we recognise respondents have raised issues of substance as to what should properly be considered to be part of the universal service. These issues are relevant to the review of user needs, as the

review is best placed to consider whether the current service meets the needs of postal users.

- 4.27 Therefore, at present we will not be removing requirements for First and Second class services (though we have now termed these *priority* and *standard* services – see next paragraph), tracking in relation to the registered and insured product, (special) delivery next day by 1pm, and proof of delivery on priority and standard services (which is a characteristic of Recorded Signed For) in this Order. We have also clarified that tracking is only required in relation to the registered and insured products.
- 4.28 However, we agree that we should refer to “key attributes” rather than product definitions. We also recognise that First and Second Class and Special Delivery are terms which relate to Royal Mail’s commercial products. Therefore, we have amended the Order to refer to Priority and Standard services and Registered and Insured services, respectively. We have also amended the Order to refer to Retention services rather than Royal Mail’s product name Keepsafe.
- 4.29 As to reviewing the collection and delivery obligations, only Parliament can change the minimum requirements of the universal service specified by the Act, including the number of days a week post must be collected and delivered. The Government has indicated that it has no intention to seek to change the minimum requirements during this Parliament⁴¹.
- 4.30 In relation to the point made by TNT, we discuss the obligation on Royal Mail to offer access to its postal network and to elements of postal infrastructure in Section 10 of this statement.

Single piece, meter⁴² and PPI⁴³ products

- 4.31 A few respondents raised issues relating to meter and PPI payment channels for single piece items. TNT, ONEPOST and another access operator queried the inclusion of the meter payment channel (or discounted items) in the universal service, with ONEPOST believing that the definition of single piece excludes meter mail as it is a presentation discount. Another operator considered that meter and PPI are channels for volume discount. DX Group argued that meter and PPI are different products, not payment channels for the same underlying services. Another postal operator considered that those using a meter machine should not be excluded. Intellect believed that payment channels should be clearly specified as a primary characteristic of the universal service.
- 4.32 Two respondents informally queried the specific wording in our definition of single piece⁴⁴.

⁴¹ For instance Baroness Wilcox stated that “As I said during Committee, and as my colleague the Minister for Postal Affairs has said in the other place, the Government have no intention of reducing the minimum requirements of the universal service during this Parliament.” House of Lords, 17 May 2011, Hansard vol.727, col. 1319 -

<http://www.publications.parliament.uk/pa/ld201011/ldhansrd/text/110517-0002.htm#11051758000723>

⁴² Meter or franked, a method of payment or payment channel for Royal Mail services where customers pre-pay for postage and apply an impression to the envelope, label or wrapper using a franking machine licensed by Royal Mail.

⁴³ Printed Postage Impression (PPI), a method of payment or payment channel for Royal Mail services whereby postage is pre-printed on envelopes, labels or wrappers and requires the customer to have an account with Royal Mail.

- 4.33 While we acknowledge these points, we would note that First and Second Class meter services are currently part of the universal service. Payment channels are characteristics specified in the Order, with Royal Mail required to provide a meter payment channel for Priority and Standard services.
- 4.34 In its decision on the universal service in August 2011⁴⁵, Postcomm clarified that First and Second Class services paid for by PPI would be part of the universal service provided that they met the definition of single piece services. Universal services are now defined by characteristics, including the requirement to be single piece. Therefore Royal Mail needs to demonstrate that priority and standard items paid for by PPI meet the characteristics of the universal service for these items to be included within the universal service.
- 4.35 In addition, we do not consider that our definition of single piece excludes meter mail on the grounds that the franking impression to show the postage value is a presentation discount. We do not consider that it constitutes “*markings which facilitate the use of machines to sort postal packets*” as it does not aid in the sortation of mail. Postcomm clarified in its August 2011 decision on the universal service its definition of presentation discount:
- “Presentation of mail” includes presortation by geographic zones to which the mail is intended to be delivered, and/or the positioning of text on the envelope, font or bar codes using approved Optical Character Recognition (OCR) fonts, or machine readable barcodes (Customer Bar Code, CBC), so that it is easier for sorting machines to read.
 - Formal “presentation of mail” does not refer or relate to the location at which the mail is posted, whether the mail is posted in pouches or, when preparing the mail for posting, whether the mail is posted face up, or posted by class of products (i.e. priority or non-priority). Formal presentation of mail also does not include the price differences related to the size of the postal item under “Pricing in Proportion”.
- 4.36 We also do not consider that meter and PPI are a channel for volume discount in relation to single piece items, as there is no minimum volume requirement to send a meter or PPI standard tariff item. While there is a minimum spend for account customers, as long as they reach this spend across the range of products used, they can send a single PPI standard tariff item. This was discussed in the abovementioned Postcomm 2011 decision on the universal service.
- 4.37 We do recognise that there is an argument that PPI and meter items are different services rather than PPI and meter being two different payment channels for the same underlying services. However, this issue was explicitly considered by Postcomm in 2011 and we do not propose to re-open this question for the first Order, which simply aims to replicate the current essential features of the universal service. (although we may consider this issue further under our review of user needs).

⁴⁴ Our original definition was that a single piece service “means a postal service whose price (on average for each postal packet) is not subject to any discounts related to number of postal packets sent in connection with the person who paid for the service, the positioning of text on the postal packet, the use of markings which facilitate the use of machines to sort postal packets or the pre-sortation into geographical areas for delivery”. The meaning of “on average for each postal packet” was questioned.

⁴⁵ Postcomm, *The building blocks for a sustainable postal service, Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document*, August 2011, <http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf>

- 4.38 We have also taken account of stakeholder responses on our definition of single piece and have decided to amend our definition in the Order to make it more transparent. Finally, to provide clarity we have specified that we do not consider that response services are single piece items (last bullet point below). Our definition is now as follows (changes are marked in bold):

*“a postal service for **the conveyance of an individual postal packet to the addressee, for which the price per postal packet is not subject to any discounts related to—***

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

Scope for additional features and VAT

- 4.39 We noted in the December consultation document⁴⁶ that Royal Mail’s universal service products could have additional features, in addition to the characteristics we set out in the Order. DX Group, MCF, TNT and UK Mail highlighted the potential VAT implications of allowing these ‘additional features’. They considered that it could unfairly extend the scope of its current VAT exemption by allowing ‘bolted-on’ product features to qualify for universal service status and become VAT exempt. DX Group asked Ofcom to clarify whether such additional features would be part of the universal service. TNT highlighted more generally that the VAT exemption creates a competitive distortion.
- 4.40 In response, we note that while VAT considerations are for Her Majesty’s Revenue and Customs (HMRC), we consider this potential issue is limited in scope because bulk mail products cannot qualify for universal service status, given that the Order requires only single piece services.
- 4.41 We remain of the view that Royal Mail should have commercial flexibility to make changes to the products it provides to fulfil its universal service obligations, as long as the essential characteristics of the service described in the Order are maintained.
- 4.42 However, we would also clarify that this does not mean that Royal Mail can change the current scope of the universal service. In particular we do not believe that Royal Mail should extend significantly the range of products provided to meet the universal service characteristics. We have therefore amended the Order to make this clear; in particular we have specified that the priority and standard single piece services do not include tracking features.
- 4.43 We believe that this will limit the potential scope for Royal Mail to increase the number of universal service products while still allowing it to make changes to service

⁴⁶ At paragraph 4.22

features and terms and conditions (e.g. reasonable payment methods in addition to stamp and meter, retention periods for products.)

- 4.44 In relation to the point made by TNT about the impact of VAT rules more generally, we have no vires to determine VAT policy, which is a matter for HMRC.

“Fair and reasonable” terms and conditions

- 4.45 A number of respondents questioned the meaning of “fair and reasonable” as we specified that these requirements would apply to the terms and conditions of universal services. They called for guidance on how Ofcom would approach determining whether a non-price term was fair or reasonable. This issue related mostly to our proposal that we should not impose prior approval requirements for changes to the non-price terms of universal services and our proposals on compensation, which we discuss in Sections 6 (and 12) below. However, because the concept of fair and reasonable applies to the universal service terms and conditions, we have discussed our approach to it within this section.
- 4.46 First of all, we note that we are specifying in the Order the essential characteristics of the universal service. Royal Mail has to meet these requirements as set out in the DUSP conditions. This includes detailed requirements, such as quality of service targets, or service features such as tracking. Therefore, this will provide protection for users on the key characteristics of universal service products specified in the Order and should reduce the impact of any potential change that Royal Mail decides to make to any subsidiary terms and conditions.
- 4.47 Furthermore, we consider it is unnecessary and impractical to set out specific guidance on how we would assess whether terms and conditions are not fair and reasonable – as that will depend on the circumstances of the case. There are lessons from the telecoms sector which can be applied to the concept of fair and reasonable in the postal sector, and it is also well used in consumer law⁴⁷.
- 4.48 While we do not propose to provide specific guidance, we note that we can investigate (and intervene) in appropriate cases where we consider that terms and conditions may not be fair and reasonable. In assessing what is “fair and reasonable” we will of course have to act within the framework of our statutory duties in relation to post, in particular ensuring the provision of a universal postal service (having regard to its sustainability and efficiency) and securing the provision of sufficient access points. If we find that terms and conditions are not fair and reasonable, we may have recourse to the remedies specified in Schedule 7 of the Act, which include notifications to make changes and penalties.
- 4.49 We note that the requirement for the non-price terms of universal services to be fair and reasonable is now included in the DUSP conditions within Annex 7 (and in relation to the consumer protection condition on compensation within Annex 8). We believe it will help to protect consumers of universal services given we have decided to give Royal Mail more commercial flexibility by removing the prior approval process for changes to the non-price terms of universal services (as discussed in Section 6).

⁴⁷ For instance in relation to regulations such as The Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). For regulators’ guidance, see for instance the OFT “Unfair contract terms guidance” at http://www.ofcom.gov.uk/shared_ofcom/reports/unfair_contract_terms/ofcom311.pdf Ofcom “Guidance on unfair terms in contracts for communications services” at <http://stakeholders.ofcom.org.uk/binaries/consultations/addcharges/statement/Guidance.pdf>

Suggestions for additional changes to universal services

4.50 A few respondents highlighted areas where they felt there could be further changes to the universal services or Ofcom could extend regulation in relation to the universal service. For example:

- Consumer Focus suggested that the different features of Certificate of Posting, Recorded Signed For and Special Delivery need to be separated out so that consumers are able to choose only those options that they need;
- The Ofcom Advisory Committee for Scotland suggested that Ofcom should impose a requirement to notify customers if delivery times are not going to be consistent; and
- The CWU said that collection and delivery times should be included in the universal service.

4.51 As noted above, it is our intention to preserve the essential features of the current universal service, while defining the universal service more clearly and more flexibly. Postcomm reviewed specific elements of the universal service between February and August 2011. We have not yet carried out our review of user needs, and therefore we lack up to date evidence of the costs and benefits of changing the requirements in the ways suggested. Accordingly, we do not consider it appropriate to make these changes to the universal service at this point. However, we would welcome evidence and contributions on the scope of the universal service as part of our review of user needs, which can consider issues such as collection and delivery times – and again, encourage stakeholders to engage with us on that review later this year.

Other comments

4.52 Some respondents raised additional questions:

- The FSB asked for a specific small business test to ensure that the universal service is meeting the requirements of small businesses across the UK.
- UK Mail considered that changes to the format of Royal Mail's products are major changes which should be communicated and consulted upon. It asked for the previous licence requirements on Royal Mail to show the impact of format changes to be retained.

4.53 In response to these comments, we note:

- Ofcom has a duty to secure the provision of the universal service. In doing so, we will therefore consider the needs of all users of the universal service, including small businesses.
- Changes to the format of items will be subject to the same notification periods as other non-price terms and conditions for universal and access services. In relation to universal services, Royal Mail must ensure that the terms and conditions are fair and reasonable. As discussed in Section 6 below, we expect that, in practice, Royal Mail may give a longer notice period than one month for some material changes in order to meet the needs of its customers.

- 4.54 In addition, Royal Mail proposed various detailed changes to the drafting of the Order, and we have made some changes where appropriate. We explain below those changes which go beyond very minor corrections or clarifications.
- 4.55 Royal Mail was concerned that the definition of “working day” meant that routing time requirements could be read as requiring deliveries on days when no delivery was required, either by Royal Mail in the UK or by other countries’ universal service providers. We have amended the definition of “routing time” to make it clear that where delivery would fall on a day where no delivery is required, the requirement is met if delivery takes place the next day on which delivery is required. We have reflected these changes in the drafting of the DUSP condition, in particular the quality of service reporting requirements.
- 4.56 The existence of international services means that the proposed definition of “public holiday”, which was principally derived from the 2000 Act and was focused on UK holidays, was not appropriate either. Parliament did not consider it necessary to define “public holidays” for the UK, and we do not consider that there is any reason to depart from that approach for other countries. We have provided for Ofcom to issue directions in exceptional circumstances where specified days may be treated as public holidays.
- 4.57 In addition, the following changes were suggested by Royal Mail:
- a) Ofcom should specify “postal address” instead of “homes and premises” in the Order and DUSP 1 condition, and generally that there should be a requirement that addresses should be full and accurate. We consider that “homes and addresses” is more appropriate as it repeats the wording used in the Act. We also consider that Royal Mail should make reasonable efforts to deliver the mail. We have deleted the requirement for postal packets to be “legibly addressed” as we consider it follows from the Directive that postal packets must be addressed.
 - b) The definition of “proof of delivery” should be changed to include evidence of an electronic scan as an alternative to the copy of a signature. We consider that it is important to provide proof from the recipient that the packet has been delivered to the right address or the right addressee. However, we recognise that technology may evolve over time. We have therefore changed the definition to include copy of signature or other confirmation of receipt from the recipient.
 - c) The definition of “tracking facility” should be changed to reflect the fact that tracking is only possible at specific points in the network. We do not consider the change necessary, as there is no suggestion in our definition that tracking needs to be continuous.
 - d) All the exceptions provided for in section 33 of the Act should be repeated in the Order – these include the public holiday exceptions and the exceptions for collections and deliveries in exceptional circumstances. We have decided not to include the exceptions in the Order as we consider it sufficient for these to be provided for in the DUSP condition.
- 4.58 In addition, in the course of reviewing the draft Order in light of consultation responses, we identified that a further change is required to the definition of “insured item” in order to ensure that we did not exceed our powers by requiring less than the minimum requirements of the Act. We have amended it to read: “an item the value of which has been declared to a universal service provider and of which, in the event of its theft or loss or damage in the course of its conveyance by post, that universal

service provider has agreed to pay to the sender the declared value or such lesser sum as is consistent with the provision of the service at affordable prices.”

- 4.59 We have also clarified the drafting of the definition of “partially sighted” for the purposes of the provision of free services for the blind.

Amendment to reflect section 33(1) of the Act

- 4.60 We have also made one further change to the scope of the insured and registered services that must be provided: having reviewed the drafting of section 33(1) of the Act, we consider that we do not have the power to limit the provision of insured and registered services only to postal packets up to 10 kilograms, but are instead required to ensure that insured and registered services are available for postal packets up to 20 kilograms. We acknowledge that this is a change from the current scope of the universal service that Royal Mail is required to provide⁴⁸; however it is a change that results from the drafting of the primary legislation. We do not consider that the Act imposes any specific requirements relating to routing times or other standards in relation to such services, and we have therefore ensured that such requirements remain limited to postal packets up to 10 kilograms. We have amended the Order accordingly.

Our decision

- 4.61 We have decided to make an Order which now describes the universal postal service by specifying its core features (the Order is in Annex 6).
- 4.62 We have also made amendments to our proposed Order following our analysis of stakeholder feedback (as discussed above).
- 4.63 In the remainder of this section, we discuss our conclusions on two further proposals related to the Order:
- Specifying *reasonable* duration in the Order for Redirections, Keepsafe and Poste Restante; and
 - Potentially including Redelivery and Return to Sender within the universal service.
- 4.64 We also discuss the decision on our proposal to lift the requirement to provide the Return to Sender free of charge.

Redirections, Keepsafe and Poste Restante

- 4.65 In our December consultation we noted *Redirections*⁴⁹, *Keepsafe*⁵⁰ and *Poste Restante*⁵¹ are all Royal Mail services which can be used for a specific period of time, rather than being a “one-off” service.

⁴⁸ We also do not consider this amendment will result in a significant burden on Royal Mail.

⁴⁹ Redirect mail from an old address to another address.

⁵⁰ A service which holds UK customers' mail at their local delivery office while they are away, and then delivers it on their return.

⁵¹ Mail redirected to a chosen post office.

Our proposal

- 4.66 We considered that duration was an essential characteristic of these products, but proposed that the Order should simply require a “reasonable” duration period (rather than us specifying the period as we considered this may be overly prescriptive).
- 4.67 We considered our approach would mean customers would continue to enjoy the benefits of the services, as Royal Mail would have to provide them for a reasonable period, but would give it some flexibility on the period of time for which the services are offered.

Responses to consultation

- 4.68 Stakeholders generally supported this proposal. TNT stated that the lack of *Redirections* and *Poste Restante* data hampered delivery competition in this area⁵². One large customer said that a reasonable period should be long enough to capture those customers, who for some time, will continue to write to old addresses and another stakeholder felt that “reasonable” should be clearly defined.

Our assessment and our decision

- 4.69 As there was general support for our proposal, there is no reason for us to reconsider our original rationale and we have therefore specified a reasonable duration for redirections, retention services and *Poste Restante* in the Order.
- 4.70 We address the concept of “reasonableness” in relation to the requirement for universal service terms and conditions to be fair and reasonable above⁵³.

Redelivery and Return to Sender

- 4.71 Royal Mail’s redelivery service for parcels, Special Delivery Next Day and Recorded Signed For means that a packet can be delivered to a local post office for collection by the customer, redelivered to another address within the same postcode, or redelivered another day to the original address.
- 4.72 Collection from the delivery office (“caller’s service”⁵⁴) is also available. While redelivery and caller’s service are two distinct alternatives, for the purposes of our discussion, we included caller’s service in redelivery. Redelivery and collection from the delivery office are not currently mandatory for Royal Mail to provide.
- 4.73 The return to sender service is where the customer receives a Letter with the correct address but addressed to the wrong person, writes “return to sender” or “not known at this address” and puts it back in a post box or post office. Where it is able to identify the address of the sender, Royal Mail then delivers it back to the sender⁵⁵.

⁵² Ofcom discusses the obligation on Royal Mail to offer access to its postal network and to elements of postal infrastructure in Section 10

⁵³ Paragraphs 4.45-4.49

⁵⁴ See Royal Mail’s website for more information:

<http://www.royalmail.com/sites/default/files/docs/pdf/Callers%20Service%20Web%20December%2010.pdf>

⁵⁵ For more information on how Royal Mail deals with items which need to be returned see

<http://www2.royalmail.com/customer-service/safe-and-sound>,
<http://www2.royalmail.com/customer-service/getting-other-peoples-mail> and

Our proposal

- 4.74 Neither redelivery nor return to sender would have been required to be provided in the new regime if we did not actively decide that they were part of the terms of the universal service and therefore should be provided.
- 4.75 We invited respondents' views as to whether we should or should not include these products as part of the universal postal service.

Our assessment of stakeholder responses

Redelivery

- 4.76 Overall, respondents agreed that redelivery should be specified as a characteristic of universal services. However Royal Mail did not agree that redelivery was a core characteristic of the universal service. It believed that mandating redelivery would limit innovation for customers and operational flexibility for Royal Mail. In addition, a couple of respondents, DMA and another user group, considered that redelivery did not be a characteristic of the universal service because most of the time Royal Mail was operating in a competitive environment, and therefore needed to provide a competitive service.
- 4.77 TNT questioned whether delivery to another address, such as delivery to neighbour, should be included in the universal service, in cases where the sender has requested this service. In addition, Royal Mail commented that customers' requirements might change, and therefore it may want to change the way it dealt with undelivered items. Royal Mail gave the examples of Lockerbox, Local Collect and delivery to neighbour, and argued that "regulation should not prevent RM from innovating to meet customer needs" in the way it enabled customers to take possession of their postal items.
- 4.78 We continue to believe that redelivery (and caller's office or collection of undeliverable items) should be included in the universal service as a core characteristic of the universal service. We consider that delivery implies that the item has been transferred to the intended address, and that this is not achieved if there has not been some reasonable effort to ensure that the item reaches the addressee. In addition, redelivery is an important aspect of the service for customers in that it enables those who are not available or present at the time of delivery to obtain their item.
- 4.79 We recognised in our December consultation that there was a risk that this would constrain Royal Mail's flexibility. We consider that the Order gives Royal Mail the flexibility of providing a choice of different services, but not all of them, and it does not limit its ability to offer other ways in which customers can take possession of their items. In the "redelivery" part of our specification of delivery, we also note we have added "collection points approved by Ofcom" to the list of possible places to which Royal Mail may bring a postal packet for collection by the addressee following an attempted delivery.
- 4.80 In relation to redelivery and the collection of postal items from Royal Mail, we agree with Royal Mail that it is important to meet the needs of customers as they evolve. The Act requires delivery to every home or premises or to delivery points approved by Ofcom. We have therefore redrafted the Order to enable alternative delivery

<http://www2.royalmail.com/customer-service/personal-customers/missed-deliveries/what-happens-dont-pick-item>.

points requested by the addressee (such as secure boxes) or approved by Ofcom (such as delivery to neighbour).

- 4.81 This is simply an enabling measure. In relation to delivery to neighbour, this is currently being trialled by Royal Mail which will report to us later in the year. The Order requires Ofcom to approve alternative delivery points, which would include delivery to neighbour. To give such an approval, we would need to follow the process set out in Schedule 6 of the Act, which means that a consultation on delivery to neighbour would be necessary before determining whether it could be allowed to be an alternative delivery point.
- 4.82 Furthermore, while it is true that in some respects Royal Mail operates in a competitive environment, this competition typically concerns the sender of the postal item rather than the recipient. In relation to redelivery (or collection), we consider that universal service users are entitled to a way of receiving or collecting packet items, even if the sender has elected not to choose this service, as a reasonable attempt at redelivery (and collection) should be part of the delivery service.

Return to sender (RTS)

- 4.83 Overall, we note that respondents agreed that RTS should be specified as a characteristic of universal services. The only exception was Royal Mail, which considered RTS to be only an operational matter and also argued that its inclusion in the universal service might hamper new, innovative ways of providing this service.
- 4.84 Although Royal Mail argued that RTS should not be part of the universal service characteristics, we do not consider that it provided sufficient evidence for us to change our view that there should be a requirement to provide RTS for universal services.

Our decision

- 4.85 We have determined that Redelivery and RTS should be included in the universal service (and therefore be required in relation to universal service products).

‘Free of charge’ RTS

- 4.86 Under the transitory (time-limited) condition 4, there is a requirement to provide RTS free of charge as part of a regulated product.

Our proposal

- 4.87 We made a proposal in our December consultation to lift the current requirement to provide return to sender free of charge in order to provide Royal Mail with more flexibility consistent with our decision on pricing flexibility set out in Section 6.

Our assessment of stakeholder responses

- 4.88 All but three respondents who responded to this question (Consumer Focus, a business customer and one individual) disagreed with our proposal that Royal Mail be allowed to charge for RTS for non-universal services⁵⁶. We note that most of these respondents believed that RTS should apply to bulk mail (as well as being

⁵⁶While Consumer Focus agreed with our approach it highlighted the significant implications arising from our proposal and cautioned us to research fully these complex issues before making a final decision.

provided free of charge). Only a few respondents explicitly raised concerns on our proposal with regard to universal service users.

- 4.89 We discuss below our response to the issues raised - on requiring RTS for non-universal services; on a possible charge for RTS in relation to non-universal services; and on lifting the requirement to provide RTS free of charge for universal services.

Issues raised in relation to non-universal services

Requiring RTS for non-universal services

- 4.90 Firstly, we note that we proposed the inclusion of RTS for universal service on the basis that we consider it is an important characteristic of universal services. It is not currently treated as a standalone part of the universal service as defined in DUSP 1.
- 4.91 We do not consider that it would be appropriate to extend the universal service requirements to require RTS for bulk mail (as a consumer protection condition) or for it to be provided free of charge for bulk mail customers, as part of this review.
- 4.92 Bulk mail is not part of the universal service. As a matter of principle we do not believe that products provided in conjunction with bulk mail should become part of the universal service without a proper review of the needs of users to identify whether these characteristics should be specified in the Order and an associated DUSP condition. As an example, we do not believe that tracking, or proof of delivery, should be required for bulk services, unless there is a case for tracking or proof of delivery to become stand-alone requirements (in relation to all services) of the universal service.

Possibility of a return to sender charge for non-universal services

- 4.93 We note that respondents who supported RTS service being provided free of charge for bulk mail highlighted the importance of RTS, essentially to maintain accurate mailing lists and provide reassurance that a confidential or valuable piece of mail has been delivered (or can be returned). The DMA, another user group, ONEPOST and some members of the Strategic Mailing Partnership (SMP) also highlighted the negative environmental impact of inaccurate addressing and the potential reputational damage to direct marketing mail more generally. The key concern of respondents was that introducing a charge would deter senders from purchasing this service, as a result of which they would not receive such aforementioned benefits.
- 4.94 Nevertheless, we consider it should be a commercial decision for Royal Mail whether to provide the RTS service for bulk services. The benefits of RTS suggest likely demand, and therefore that Royal Mail has an incentive to continue to provide this service. Furthermore, a charge may provide an additional incentive on senders to keep information as up to date as possible. It will also mean that those customers who do not regularly update their mailing lists will have to pay the appropriate cost of providing the RTS service (i.e. the principle of cost causation would apply). Bulk mailers should be responsible for Royal Mail incurring additional cost in returning their undeliverable items and we can see no good reason why Royal Mail should not be able to charge them.
- 4.95 We acknowledge the comments made that RTS provides reassurance if a postal item has confidential or valuable content. However, proof of delivery may be requested as part of both standard and priority services. Our approach does not change the

current situation where the only product providing sufficient compensation and proof of delivery for valuable contents is Special Delivery⁵⁷.

- 4.96 We also note that a few respondents believed that the cost of RTS was already included in the price of the item and that this should continue to be the case. One of these stakeholders (CWU) added that allowing RTS to be priced separately could be seen asking customers “to pay again for the service”. In response (and in relation to non-universal services) we note in Section 6 that we will monitor both non-universal service prices as a whole and access prices. This will include monitoring of prices for RTS if Royal Mail introduces a separate charge for this service.

Issues raised in relation to universal services

- 4.97 As noted above, the concerns of respondents in relation to charging focused mostly on RTS for bulk mailers. Only two respondents directly raised the issue of charging from the point of view of universal service users: Consumer Focus and the Archbishops’ Council (of the Church of England). In addition, Royal Mail raised an issue around pricing flexibility / uniform pricing of RTS for universal services.
- 4.98 Consumer Focus agreed with our proposal in principle but cautioned us to consider the complex issues involved, in particular in relation to receivers’ data accuracy and confidentiality, before reaching our decision. We do not believe that we need to delay our decision, for the reasons set out above, and because we consider that mail recipients have other ways of dealing with mail intended to reach a previous occupant at their address should they wish to do so⁵⁸.
- 4.99 In addition, we expect Royal Mail to behave responsibly in considering any potential charges for universal service users. We recognise that, should any charging mechanism ever be introduced by Royal Mail for residential customers⁵⁹ - in line with our approach to pricing discussed in Section 6 – Royal Mail is best placed to determine how it should be implemented taking into account users’ needs⁶⁰. Non-price terms and conditions for RTS must, as with other characteristics of the universal service, be fair and reasonable.
- 4.100 Again, in response to the general comment that the cost of RTS is already implicit within the price of services, we note that universal services must be affordable and cost-orientated. So if Royal Mail was to introduce a separate charge for universal service users of the RTS service, we will assess whether this service is affordable and cost oriented alongside other universal services in our monitoring regime. We would also expect Royal Mail to provide us with information on the costs of the RTS service separately.
- 4.101 We note that Royal Mail considered it should have further pricing flexibility in relation to RTS by arguing that we should not require RTS for universal services to be

⁵⁷ Maximum current level of compensation for standard and priority services is 100 First Class stamps (£46).

⁵⁸ Recipients of mail can continue to return mail delivered to a previous occupier, and Royal Mail will deal with this mail appropriately even where a RTS service has not been purchased. There are also other means by which recipients can ensure they are removed from incorrect mailing lists or, to raise a separate but related issue, register that they do not wish receive unwanted mail. They can contact the sender of the mail or the direct marketer directly. In relation to unwanted direct mail, they can also register with the Mailing Preference Service - www.mpsonline.org.uk.

⁵⁹ And we would also note that the vast majority of RTS mail is bulk mail and therefore the financial impact of any move by Royal Mail to introduce charging for RTS mail would be borne by bulk mailers.

⁶⁰ We are also willing to take representations on this as part of our review of user needs.

uniformly priced. In principle, we disagree that RTS should not be uniformly priced geographically. Uniform pricing is a key requirement of the universal service which we believe should continue to apply to all end-to-end services, as is currently the case, unless we are provided with relevant evidence on users' needs. However, within the constraints of uniform, affordable and cost-orientated prices for universal services, we agree that Royal Mail should have pricing flexibility and note that there is no requirement that, for instance, the same price should apply to different levels of service.

- 4.102 In addition, the Archbishops' Council believed that RTS should be free to recipients. We agree in principle but do not consider that RTS is likely to be paid for by recipients – it is more likely that the original user, the sender, would be expected to pay for a return of the sent items either at the point of first dispatch or on receipt.
- 4.103 The Archbishops' Council also believed that RTS should remain free of charge for those receiving items that are correctly addressed but which Royal Mail has not been able to deliver. In relation to items which could not be delivered by Royal Mail, we have already mandated a way for recipients to obtain their items, either via redelivery or via collection from Royal Mail.
- 4.104 The Archbishops' Council also raised the issue of mis-delivered mail. Mis-delivered mail, where Royal Mail has incorrectly delivered the mail to a different address, is not part of RTS – and we expect Royal Mail to continue to deliver the item to the right address free of charge if the item is returned to the post box as incorrectly delivered (as this is a failure of Royal Mail to deliver the mail correctly in the first place⁶¹).

Our decision

- 4.105 We have decided remove the requirement for Royal Mail to provide RTS free of charge for its universal service products. We will also not mandate Royal Mail to provide RTS free of charge in relation to non-universal services.

Other issues raised in relation to RTS

- 4.106 Finally, we discuss below our response to some more generic issues which stakeholders raised on RTS.
- 4.107 Some respondents considered that RTS might be the only way for a sender to establish that an address was inaccurate, with one operator highlighting that the only other alternative was a tracked service. However, as with the current situation, the only guarantee of delivery (and thus knowing an address is inaccurate) is to purchase a Special Delivery or Tracked product⁶². This will remain the same under our decisions. In addition, as mentioned above, Royal Mail is likely to continue to offer RTS.
- 4.108 Finally, there were also queries raised in relation to: who would pay in relation to access mail; what Royal Mail would do with undelivered mail (or the risk to Royal Mail of accumulating a large number of items) and how RTS would be audited. Some

⁶¹We have not required unofficial redirections to be provided or to be provided free of charge, as we have included official redirections in the Order.

⁶²Senders cannot assume, or be confident, that if an item is not returned to them via RTS, then it must have been delivered to the addressee. This is because many recipients do not use the RTS service e.g. for items sent to previous occupants at their address or mis-delivered to them, and some of these items are destroyed.

respondents offered alternative solutions, specifically requiring this service under a CP or access condition, and mandating return addresses for all mail⁶³.

4.109 In answer to these other points, we consider that:

- The process for potentially charging for RTS for access mail is a matter for senders, operators and Royal Mail;
- We expect Royal Mail to continue to make reasonable efforts to find the rightful recipient of universal service items and sender (where they have put a return address on the envelope), although if Royal Mail is unsuccessful e.g. due to the lack of a return address, it is right that Royal Mail deals with the item appropriately (which may mean the item is ultimately destroyed). In relation to non-universal service items, Royal Mail and the sender can agree what should happen to mail returned to the postal network, including whether or not the sender would benefit from purchasing a return to sender service;
- An auditing process for RTS for universal services is not necessary or proportionate at this stage, given, first, the small volumes involved and secondly, the limited harm to users if an item is not returned, given that customers can use alternative products if they want assurance of delivery; and
- It would be difficult to *require* all senders, including residential users, to provide a readable RTS address with their mail, especially as in many cases senders post their items without having had the opportunity to be informed of such a requirement.

Summary of our decisions

4.110 In summary, in this section we have proceeded with our proposals to:

- i) Maintain the features that customers currently expect from universal service products and ensure that the universal service will remain essentially the same as now, pending the review of user needs;
- ii) Define the universal service by describing its characteristics in the first UPSO;
- iii) Specify a reasonable duration period for redirections, retention services and Poste Restante in the Order;
- iv) Include Redelivery and Return to Sender in the universal service; and
- v) Remove the requirement to provide Return to Sender free of charge.

4.111 We have attached our Regulatory Impact Assessment (RIA) at Annex 5, which explains our reasoning for making the first Order (in Annex 6) describing the existing universal service in a manner which retains the essential features of current universal service products (and which includes Redelivery and Return to Sender) - as well as the impacts of these decisions. We are requiring Royal Mail to provide this universal service via the condition discussed in Section 12 and contained in Annex 7.

⁶³One stakeholder asked about the rate of returned mail over the last ten years. Trends on RTS volumes are not available in the public domain, but again we note that RTS forms a small amount of mail volumes.

Section 5

Financially sustainable universal service

Introduction

- 5.1 Having set out our description of the universal service and the subsequent obligations of provision on Royal Mail in the previous section, we now set out our decision on the approach to the financeability of the universal service.
- 5.2 This section considers each of the relevant elements of our primary duty (to secure the provision of the universal service) including:
- The need for the provision of the universal service to be financially sustainable, noting that Royal Mail is the only operator currently capable of providing the universal service, and the specific risks it faces.
 - The need for the financial sustainability of the universal service to include a reasonable commercial rate of return for its provider, Royal Mail, based on market evidence and regulatory precedent.
 - The need for the provision of the universal service to be efficient, after a reasonable period, and to remain so, including the need for the regulatory framework to provide appropriate incentives for efficiency.
- 5.3 We set out below a summary of Ofcom's proposals in October consultation, a review of responses received and analysis of the additional evidence we have gathered since our proposal was published. In addition we describe the further work we have done, and set out our final decision.
- 5.4 On this basis, we present our decision on:
- The scope of the universal service network to be considered when assessing financeability;
 - The way in which we measure financeability; and
 - The range associated with a reasonable commercial rate of return for Royal Mail.
- 5.5 This section should be read in conjunction with section 6 where we set out how this approach to financeability will work in an environment in which Royal Mail is given greater commercial freedom.

Financial sustainability

Our proposals

- 5.6 In our October consultation, we set out our views on the concept of financial sustainability. We stated that it should take into account both: 1) the need for the universal service provider to be able to earn a reasonable commercial rate of return (on expenditure incurred in, or in connection with, the provision of the universal service); and 2) the level of risk in providing the universal service.

- 5.7 In addition, we stated that the financial sustainability of the universal service was linked to the financial position of Royal Mail as the universal service provider (for the foreseeable future). On this basis, we set out how these requirements could be assessed in the context of Royal Mail's current and expected future financial position.
- 5.8 In considering the financial sustainability of the universal service and taking account of the risks faced by Royal Mail, we also analysed the projections in Royal Mail's restructuring plan. We noted that such projections were inherently uncertain and each of the key assumptions (e.g. market growth, efficiency gains, marginality, etc) was difficult to predict.
- 5.9 On this basis we recognised that when the individual sources of uncertainty combine, Royal Mail faces significant risks to both its revenue and cost outlook. Our sensitivity analysis demonstrated that deviations from Royal Mail's plan could have major implications for the financeability of the universal service, and the scope of uncertainty for Royal Mail extends beyond risks which it can manage efficiently itself. One-off shocks to the market could also have a major impact on Royal Mail's financial performance and sustainability of the universal service.
- 5.10 We provisionally concluded that these issues represented tangible risks to the financeability and future provision of the universal service and that our regulatory framework would need to take account of these risks.

Summary of responses

- 5.11 Responses were received from eight stakeholders on this issue, including: Royal Mail, UK Mail, ONEPOST and one other access operator; a large customer; Citizens Advice Scotland; and two individuals. All agreed that the universal service plays a critical role in the cohesion of society and that a financially sustainable universal service was therefore fundamentally important.
- 5.12 Royal Mail argued that in determining how the universal service should be sustained (both in terms of securing its financeability and efficiency) it was necessary first to consider how the universal service is defined. It considered that all revenues and costs of products which use the universal service network should be included within the assessment of a financially sustainable universal service. This, it added, should include both universal service and non universal service products that use the universal service network.
- 5.13 On this basis, Royal Mail argued that the boundaries of the regulated business represented by activities of the former Letters & Wholesale divisions were too broad as they included activities and products that do not use the universal service network, for example: stamps (philatelic) and collectibles; Mailrooms, Relay; Sameday; and Warehouse and Data products. It identified the revenue and costs associated with these non-universal service network products as broadly neutral⁶⁴. Similarly, it explained that there are products which have historically been defined as non mails which use the universal service network. These are, internal charges for Post Office (POL) and Parcelforce, and addressed mail centres (AMC).
- 5.14 Using this approach to revenue and costs, based on 2010-11 information, Royal Mail has calculated that products and services which use the universal service network generated £6.4bn revenue and £6.7bn costs during that financial year. It advised Ofcom that as part of its business structure re-organisation and review of financial

⁶⁴ Using Activity Based Costing (ABC) costing allocation methodology.

reporting, it would in future be relatively straight forward for it to identify the non-universal service products from its general ledger.

- 5.15 The CWU welcomed our proposal that all costs and revenues associated with the upstream and downstream activities in the former Letters business unit would be assessed under the scope of a financially sustainable universal service and therefore allowed to earn a commercial rate of return. However, it considered that Royal Mail's ability to provide a universal service is dependent on a national integrated network, and that all mail passing through the network benefits from the existence of the universal service.
- 5.16 ONEPOST stressed the importance of establishing the boundaries and defining exactly what the universal service included. It argued that without a clear definition it would not be possible to understand cost allocations or arrive at a consistent view of the cost of providing the universal service. Further, ONEPOST added that cost allocations between parts of Royal Mail have not been consistent in the past, so establishing the boundaries would allow direct comparisons to be made year on year. Moreover, it expressed concern that in its assessment of financial sustainability and the associated risks, Ofcom had not given enough importance to the issue of price increases accelerating the rate of e-substitution, and the subsequent impact on Royal Mail's profitability and ability to sustain the universal service.
- 5.17 UK Mail agreed that the universal service network was the relevant business entity that Ofcom should consider when carrying out its duty with regard to financial sustainability. It noted that extending this scope would be inappropriate as it would introduce business activities which did not use the universal service network.

Our assessment

- 5.18 Having considered the views of respondents, we agree with the overriding view that it is appropriate for the activities undertaken for the purpose of, or in connection with, the provision of universal service, to cover their costs and earn a reasonable rate of return. Further, we consider that such activities encompass a sub-set of the costs and revenues (and associated assets and liabilities) of Royal Mail Group Limited (RMG) which are required for the efficient provision of the universal service. This means that they should also include all revenues and costs of those unregulated products which depend on these activities.
- 5.19 In our consultation, we proposed that these revenues and costs are best represented by those of the "Mails" and "Non-Mails" products which were formerly provided by the integrated upstream and downstream network activities within the Letters division of RMG and on which Royal Mail has provided regulatory reports to Ofcom. Since recent internal restructuring, this business activity is now managed by Royal Mail's new, expanded UK Letters, Parcels and International (UKLPI) division.
- 5.20 We consider that the scope of a financially sustainable universal service, as set out in our October consultation, is broadly consistent with Royal Mail's position that *"all of the revenue and costs of products which use the universal service network should be considered in an assessment of the financial sustainability of the universal service, including a commercial rate of return"*⁶⁵.
- 5.21 We agree with Royal Mail's argument that there may be some adjustments which may be appropriate to make in order to better match the universal service network.

⁶⁵ Royal Mail response, "USO network definition", 5 January 2012.

Specifically, we generally agree that some but not all shared costs between Mails and Non-Mails products are directly associated with the provision of the universal service. In particular we accept that costs associated with non-network products such as Stamps and Collectibles have very limited connection with the costs directly associated with universal service provision. In our monitoring regime, we will consider the need for any such adjustments in assessing the actual financial performance of Royal Mail over time. However we do not consider that the adjustments are necessary to effectively monitor Royal Mail over the forthcoming regulatory period.

- 5.22 The scope of the universal service entity on which we proposed to focus our monitoring is set out in more detail in our regulatory financial reporting section⁶⁶, where we explain what the exact composition of the Reported Business should be. There, we have considered the relevant products and services Royal Mail has advised Ofcom should be excluded from the scope of the universal service network. As set out above, this can be expected to have little impact on the measurement of the financial sustainability of the universal service. To the extent that the effect of adjustments relating to these products becomes material in the future, we may reconsider our position and the need to review the most appropriate scope of the universal service network.

A reasonable commercial rate of return

Our proposals

- 5.23 In the October consultation we explained that the Act requires Ofcom to have regard to the need for the universal service provider to earn a “reasonable commercial rate of return”. We explained that whilst the Act did not provide further guidance on what was meant by a reasonable commercial rate of return, we could draw on significant regulatory precedent in allowing regulated companies to earn and retain a profit (variously described as the allowed profit or allowed return). However, we also explained that in the context of the new proposed regulatory framework, having a specific target for the rate of return was less relevant.
- 5.24 We therefore considered what might be a reasonable level of return for the provision of the universal service, and how it might change in relation to the risks facing Royal Mail. In doing so we considered:
- the level of return under different approaches to measuring financeability;
 - market evidence as to the returns achieved by comparable companies;
 - the risks and uncertainties about both Royal Mail's plans for modernisation and restructuring in the context of a declining market; and
 - the impact of the government's intention to privatise Royal Mail.
- 5.25 Having assessed each of these issues in turn we provisionally concluded that:
- An approach such as a return on sales would be more relevant than a return on capital, given Royal Mail's universal service network is largely based around people, and these operating costs are significantly higher than the value of its tangible assets.

⁶⁶ See Section 11

- An EBIT operating margin was an appropriate proxy for operating cash generation, as the operating cash flow and EBIT are projected to become broadly comparable towards the end of Royal Mail's plan.
- A range of 5% to 10% EBIT⁶⁷ margin might represent a reasonable commercial rate of return for Royal Mail.

5.26 At the time, the analysis provided to us both by our advisers, Cambridge Economics Policy Associates (CEPA), and by Royal Mail, indicated that this proposed level of return of 5% to 10% EBIT, represented a realistic target for Royal Mail in seeking to achieve financing for the wider borrowing entity (Royal Mail Group Limited) on reasonable commercial terms. We further recognised that the actual level would be likely to be impacted by the form of financing, including the form of any privatisation, and the level of diversification within the wider Royal Mail Group.

Summary of responses

- 5.27 Most respondents who commented on this issue agreed that Royal Mail should be allowed to earn a reasonable commercial rate of return on the provision of the universal service. Further they agreed that a return on sales approach as measured by an EBIT margin was an appropriate approach for Royal Mail due to its high proportion of people costs. However, of greater contention, was what specific range of return should apply for Royal Mail.
- 5.28 In responding to Ofcom's consultation, Royal Mail argued that the level of implied margin was too low for a business such as Royal Mail to incentivise private sector investment, and thus would jeopardise the long term efficiency gains that would be associated with such investment.
- 5.29 Royal Mail stated that a lack of track record, coupled with the perceived risks to the business, meant that an external investor would likely require a margin in the range of 10 – 14% by 2015-16. It supported this with comparator analysis, using the historic observed returns of other private sector European universal service providers. Royal Mail identified the relevant comparator companies as European privatised postal operators. The evidence provided demonstrated that a 10 – 14% EBIT margin range was consistent with historic returns achieved by these operators during and after their respective modernisation phases between 2000 and 2010.
- 5.30 The CWU agreed that it was important to ensure an appropriate commercial rate of return for the universal service. Moreover, it agreed that calculating a rate of return based on tangible net assets was not appropriate for Royal Mail given its costs are largely people based. The CWU considered that the proposed approach would give Royal Mail more flexibility and allow it to function in a similar way to comparable companies.
- 5.31 The CWU also agreed with the proposed range of return, explaining that it considered the higher end of the 5% to 10% range would give Royal Mail greater commercial flexibility. Citing CEPA's example of Post NL being allowed a return of 10%, and given it is considered a successful postal operator, the CWU argued that it would therefore be equally appropriate to allow a similar level of return to Royal Mail. It stated that it was reasonable that Royal Mail should aim to make returns in line with the highest performing comparators. The CWU further noted that allowing Royal Mail

⁶⁷ Earnings before interest and tax

to earn a return of up to 10% did not necessarily mean it would be able to do so without regulator intervention.

- 5.32 An access operator, ONEPOST, stated that a rate of return of around 8% appears generous compared to other postal operators, but accepted that Royal Mail has to attract investment and given its past performance in delivering profit and modernisation the business could be considered high risk and therefore justify a higher rate of return.
- 5.33 UK Mail however argued that the commercial rate of return proposed for universal service provision should be closer to a 5% – 6% EBIT margin. It explained that this was more consistent with returns earned by UK comparator companies and disagreed with the approach to CEPA's analysis of including a number of overseas comparators, believing the UK comparators would be more appropriate for use in such analysis. UK Mail added that if a reasonable view of the EBIT margin was at a higher level, it would impose "too high a requirement for over-stretching efficiency improvements and/or market-crushing price increases".

Our assessment

- 5.34 Respondents' comments all broadly agreed that the financial sustainability of the universal service needs to include a reasonable commercial rate of return for its provider, Royal Mail. As we set out in the October consultation, Royal Mail faces significant risks related to its provision of the universal service, and in doing so needs to be incentivised accordingly.
- 5.35 On this basis, we do not agree with UK Mail's argument to exclude other overseas universal service providers from our benchmarking analysis. As explained in the October consultation, and supported by CEPA's analysis, Royal Mail, as the only universal service provider and national end-to-end operator in the UK, does not have any direct UK comparators. We therefore remain of the view that the scope of our original analysis is appropriate, namely that such European operators should be included within our benchmarking analysis, in order to provide a fully representative EBIT margin range against which to assess Royal Mail. We recognise concerns around the ability to read across directly between different national operators. However we consider that we have taken this into account by selecting a wide range of different comparators.
- 5.36 We have also analysed the information provided by Royal Mail in support of its proposal for a higher EBIT margin. Whilst the comparator companies used in such analysis is far narrower in scope than our own, the examples used have been included in our assessment. We therefore agree that these are part of the relevant comparator group which such benchmarking analysis should use.
- 5.37 However, we do not agree with the conclusions Royal Mail drew from its analysis. Royal Mail explained that since it is in the middle of modernisation, the relevant time period of its analysis concentrates on 2000 to 2010, being the time period when such overseas comparator companies were implementing their own modernisation plans. We consider that this time period is inconsistent with current postal market conditions.
- 5.38 In particular we note that the early part of this period represented a relative period of growth in the mail market with stable, if not increasing, volumes. This no doubt contributed to the margins these companies were able to earn at the time. Given the current market, in which the established trend is now declining volumes, we do not

agree with Royal Mail's proposed period in which to benchmark our analysis. Instead, we consider that the relevant period of our benchmarking analysis should concentrate on the period no earlier than 2005 onwards where the most recent and indeed relevant trend in earnings for postal operators applies under current prevailing market conditions.

- 5.39 We also note that analysis of the other operators used by Royal Mail in its analysis indicates that current and future expectations of profitability for the same comparators are lower, at around 7% – 9% EBIT margin to 2013. However Royal Mail does include such forecasts in its calculated margin range. We do not agree this is consistent with current capital market process or credit rating agencies, which not only look at historic performance, but also attach weighting to future earnings expectations. We note that when we apply the short term forecasts of 2011 to 2013 for the comparators to Royal Mail's existing analysis of 2000 to 2010, the range falls to around 10% – 12%. This falls further to approximately 8% – 11% when historic data before 2005 is excluded.
- 5.40 Furthermore, we also now have 2011 profitability data on the relevant European competitors. This latest data suggests a downward trend in EBIT margins, at least across the three main comparators that Royal Mail has identified, consistent with the 8% – 11% range over the 2005-2013 period. Table 1 below, shows an extended range of indicators for EBIT margin outcomes, constructed using these different measures.

Table 1: Indicated EBIT constructed using different measures⁶⁸

EBIT Measures	EBIT Margin Range (%)	
	Low	High
EBIT margin - Comparators (inter-quartile range)	5.6	7.7
Return on Capital - Infrastructure	4.4	5.8
EBIT margin - Rating agencies (investment grade used in post)	8.0	12.0
Ofcom Analysis of Royal Mail Comparator calculation - 2005 to 2013E	8	11
Return on Capital - Logistics	6.5	7.3
Return on fixed assets - rating agencies	6	8
EBIT margin - Rating agencies (investment grade used in post for higher risk business)	12	16

⁶⁸ Source: Ofcom analysis, CEPA Financeability report 2011, Royal Mail analysis (consultation response, "Rate of return – Annex A", 5 January 2012.

Royal Mail comparator calculation - 2000 to 2010	10	14
Range	5%-12%	6%-16%

- 5.41 This provides a range of potential outcomes, most of which still reside within or close to our original EBIT margin range as set out in our October consultation. However, for the reasons described above, we consider that the measures which provide the highest results, and specifically those above our indicative range, are least consistent with the aim of our analysis, which is to derive an indicative return for Royal Mail to achieve financial sustainability over the forthcoming regulatory period. We have therefore concluded that the range of 5% – 10% remains the most appropriate range to use in assessing medium-term financial sustainability⁶⁹.
- 5.42 We acknowledge Royal Mail's argument that, at least in the short term, its lack of financial track record coupled with the risks to the business, may require it to seek to earn a level of return above the 5% – 10% range. As stated in the October consultation, our 5% – 10% range is an indicative range for returns consistent with the financial sustainability of the universal service. It does not however represent an implied cap on earnings. We discuss this further in Section 7 in the context of the use of this range within the monitoring regime.
- 5.43 We also acknowledge the arguments proposed by the CWU and UK Mail that the actual figure could be towards the higher or lower end of the range. At present we consider that there are different and potentially valid arguments for using different points in the range. We will consider this further under our monitoring regime as discussed in Section 7.

Update on Royal Mail's financial position

- 5.44 Since our October consultation we have not received any further information to suggest we should materially alter our position on Royal Mail's projected revenue and costs underpinned by its Restructuring plan. We note that Royal Mail's performance in 2011-12⁷⁰ has benefited from near term improvements in its cash flow position, largely driven by further asset disposals and working capital improvements. We also note that revenues have improved as prices rose by over 10% in April 2011 for most customers, but there has been relatively stable observed rate of volume decline. This might, however, represent a "lag" effect, where customers take time to respond to price rises. Nevertheless, Royal Mail Group's cashflow position for the first six months of 2011-12 has improved by over £300m, which is likely to provide further support to the short term financial sustainability of the universal service.
- 5.45 We have therefore updated our analysis and financial projections to take into account recent near term improvements in Royal Mail's financial position. Despite this short term improvement in financial performance, our analysis still indicates that Royal Mail's ability to achieve its plan is subject to significant risks. In particular, the

⁶⁹ Where we discuss Royal Mail's EBIT margin, our intention is that this refers to a pre-exceptional measure of profitability. However, we will determine the exceptional nature of items on a case by case basis. For example, we would not expect restructuring or redundancy costs, which are likely to recur year on year, to be included in exceptional items.

⁷⁰ [http://www.royalmailgroup.com/sites/default/files/Interims%202011-12%20\(final\).pdf](http://www.royalmailgroup.com/sites/default/files/Interims%202011-12%20(final).pdf)

analysis outlined in the October consultation of the potential variations in margin over the plan period under our modelled scenarios, demonstrated that margins could be up to 10% above or below Royal Mail's plan. Such effects would materially outweigh any short term variations observed to date.

- 5.46 As stated in the October consultation, given the level of risk faced by Royal Mail, a financially sustainable universal service goes hand in hand with the operator earning a reasonable commercial rate of return that is commensurate with this level of risk. Adverse changes in Royal Mail's underlying plan assumptions could, absent mitigating actions, result in disproportionately large effects on its profitability. This reinforces the need for Royal Mail to have the flexibility to respond to changing market circumstances.

Summary of our decisions

- 5.47 In summary, therefore, having performed further analysis as described above and considered all the responses to the consultation, we believe the following conclusions are consistent with securing a financially sustainable universal service, under Royal Mail's new regulatory framework:

- The activities undertaken for the purpose of, or in connection with, the provision of the universal service define the appropriate boundaries of the business relevant to our duty in relation to financial sustainability.
- 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. While a certain element of judgement is necessary, we consider this should bring it more in line with its peers and more likely to be consistent with encouraging investment in the network.
- However, our 5% to 10% range is an indicative range of where we think earnings can go over the duration of the regulatory framework, and does not represent a cap on earnings. We remain mindful that short term financing requirements may necessitate a deviation around any indicative range. Going forward, we will continue to monitor the underlying factors contributing to Royal Mail's earnings, and whether these are largely underpinned by improved operational performance and efficiency gains, or whether they are more generally driven by price rises.

Section 6

Securing the provision of the universal service – commercial freedom

Introduction

- 6.1 In the previous two sections we have defined the universal service and set out what a financially sustainable universal service means. In this section we outline our decision on the approach to regulation, taking into account these definitions.
- 6.2 The October and December consultation documents set out our proposed approach to the regulation of the postal markets in order to secure the provision of the universal postal service. This new approach was in response to the market context of declining volumes and changes in the mix of mail, both of which have resulted in a significant reduction in Royal Mail's revenues. The impact of these declining revenues and Royal Mail's inability to reduce costs in line with the pace of volume decline threatens to undermine the sustainability of the universal postal service.
- 6.3 We proposed giving Royal Mail significantly more commercial flexibility to allow it to determine the best way to meet the significant financial challenges facing it now and in the future. This included both:
- **pricing flexibility**, by moving away from a price control based approach for a period of seven years; and
 - **operational flexibility**, by reducing the notification and publication and pre-approval requirements for product changes and new services.
- 6.4 Alongside the commercial freedom we propose to provide through this additional flexibility granted to Royal Mail, we proposed implementing safeguards to protect vulnerable consumers, incentivise efficiency, support competition and monitor the impact of the proposed new regulatory regime.
- 6.5 This section sets out the responses to our proposals, our analysis of the views and evidence provided and our decision on these issues. It should be read in conjunction with Section 7 setting out the detailed proposals for a safeguard cap for vulnerable consumers, Sections 8 and 9 on end-to-end and access competition, Section 11 on our Regulatory Reporting proposals and Section 12 for our decision on quality of service targets for universal and non-universal services.

Our overall approach to pricing freedom

Our proposals

- 6.6 Given the context of Royal Mail's financial position and the declining market discussed in Section 5, we proposed that general price regulation of Royal Mail's postal services should be removed, as long as the following safeguards were in place:
- Monitoring of Royal Mail's performance;

- A safeguard cap to protect vulnerable consumers; and
 - Competition within the mail market.
- 6.7 The proposal to remove the significant majority of price regulation was based on a number of arguments. We considered that:
- A price control is unlikely to be effective in the current context, given the level of uncertainty within the postal market, and the very high sensitivity of Royal Mail's profitability to changes in the assumptions used in setting a price control;
 - Royal Mail has inherent efficiency incentives, given its financial position and the ongoing decline in market volumes;
 - Whilst prices are likely to rise under our proposed regime, Royal Mail has a commercial incentive to ensure that such price rises do not significantly accelerate market decline and therefore threaten the viability of the universal service; and
 - A monitoring regime would be the most effective mechanism for ensuring that Royal Mail did not seek to return to profitability through price rises alone, i.e. without also improving efficiency.
- 6.8 We therefore proposed that a price control would not be appropriate or effective in the current context and would be unlikely to provide strong efficiency incentives in and of itself. Rather, we considered that Royal Mail would have inherent efficiency incentives. We concluded that we should remove price regulation in light of the prevailing market circumstances and because Royal Mail would retain incentives to become efficient, not just to increase prices.

Responses to consultation

Overall approach

- 6.9 The majority of respondents to our October consultation document addressed, at least in some way, the question of whether a price control was appropriate.
- 6.10 Royal Mail, the majority of other postal operators, Unite, some individuals and some large customers agreed with our overall approach. These respondents largely agreed with our assumptions as set out above and therefore agreed that an approach which removed the majority of price controls would be most effective in securing the universal service.
- 6.11 A number of the respondents highlighted that they felt the current approach to regulation had failed and was a factor in Royal Mail's current weak financial position. The CWU also agreed with our overall assessment of the current approach, but considered some form of price regulation was still likely to be required to ensure prices remained affordable.
- 6.12 In contrast, all the user groups and consumer groups which expressed an opinion, eight customers, two access operators and the majority of individuals argued that a price control would represent more effective price regulation.

6.13 These respondents disagreed with some of the various assumptions that we made in coming to our proposals. We consider these arguments below primarily within the following categories:

- Whether an ex ante price control can be viable in creating efficiency incentives in the specific circumstances facing Royal Mail;
- Whether our proposed approach will provide efficiency incentives; and
- The impact of giving additional commercial flexibility to Royal Mail.

Can an ex ante price control be viable in creating efficiency incentives in the specific circumstances facing Royal Mail?

- 6.14 A number of respondents including Consumer Focus, the DMA, the Professional Publishers Association (PPA) and another user group all argued that a price control was appropriate and could be made to work. In particular, Consumer Focus undertook an independent analysis of Royal Mail's finances under certain modelling assumptions, including a price control based on RPI. This analysis showed that cost control and efficiency could have a significant impact on Royal Mail's financial position. For example, its modelling showed that Royal Mail could earn a significant margin by improving efficiency by 5% per annum while maintaining prices at their current level.
- 6.15 The DMA and another user group provided an example of how a price control could be made effective through allowing Royal Mail significant pricing flexibility and the ability to return to Ofcom for further price rises if necessary, but without the significant uncertainty that a fully deregulatory approach could imply. UK Mail and another access operator proposed that the level of price rises could be linked to cost reduction. Laithwaites Wine proposed that an RPI (or RPI+) control could be the default with further rises only by exception. Postaf suggested that a glidepath approach should be taken in respect of any significant changes to regulation.
- 6.16 Other respondents argued that international precedent demonstrated that a price control could work. Consumer Focus gave examples of other privatised postal operators who were profitable in spite of a price control. A number of respondents specifically referred to the constraints on USPS' prices, and the DMA argued that other countries had not seen price rises for business mail comparable to those imposed by Royal Mail in 2011-12.
- 6.17 The CWU, Unite, TNT and a number of individuals agreed that the current control had not worked, and concluded that a fundamentally different approach was required. The CWU argued that whilst a price control comparable to the current form of regulation would not work, a looser price control would still be appropriate to ensure affordability for small businesses. Other respondents, including Unite, agreed with the approach of removing price controls as a consequence of the circumstances facing Royal Mail.
- 6.18 Royal Mail agreed with our analysis that a price control could not be effective at present. It argued that a price cap would remove the flexibility that it needs to respond to changing market conditions.
- 6.19 The BIS Select Committee also agreed with our overall approach. It agreed that "no persuasive case was made that continuing with lengthy price determination procedures was a practical future means of supporting Royal Mail's business."

Will our proposed approach provide efficiency incentives?

- 6.20 A number of respondents argued that intrinsic efficiency incentives for Royal Mail were likely to be weak. Some responses, including Consumer Focus, concluded that these incentives would in practice be further weakened by our proposed approach to regulation. Consumer Focus argued that our proposals came from giving insufficient weight to the risk of efficiency failure which they saw as the key risk, rather than market uncertainty.
- 6.21 The DMA and another user group argued that efficiency incentives were inherently weak for companies with a monopoly position, and that in the absence of price regulation, these would be even weaker. The Postal Trade Association (Postaf) was concerned that since Royal Mail had required the detail of its proposed efficiency improvements to remain confidential, this demonstrated that the market could have little confidence in its commitment to achieving such efficiencies. The Mail Users' Association (MUA) stated that its members did not consider that Royal Mail would make efficiencies at a commercially acceptable speed.
- 6.22 Some respondents were concerned that removing price controls would weaken efficiency incentives as Royal Mail would resort to price rises to offset shortfalls in cost reduction. Laithwaites Wine noted that in the past customers have had to fund efficiency failures through price rises. Other customers agreed that the proposals could potentially be effective, but that this would only be the case with clear measurable efficiency targets to provide incentives.
- 6.23 Royal Mail and the CWU agreed that there were inherent efficiency incentives. Both argued that we should not give too much weight to the specific forecasts for cost reduction in Royal Mail's plans, as these plans would need to develop over time.

The impact of giving additional commercial flexibility to Royal Mail

- 6.24 A number of respondents considered that the risk of regulatory error was higher with the proposed approach of removing price controls than under a traditional price control. In particular, many of these respondents considered that Royal Mail's pricing would be likely to threaten the sustainability of the universal service. A number of user groups claimed that Royal Mail's past performance demonstrated that it did not understand the needs of its customers and Ofcom could not reliably assume that Royal Mail would act in a commercial manner. SLG Economics, Secured Mail, the PPA and MUA argued that price rises could result in a 'spiral' of increasing volume decline.
- 6.25 The BIS Select Committee noted that the scale of price rises indicated by Ofcom's range (up to 53%), if implemented by Royal Mail, particularly given the uncertainties in the market, could well lead to significant volume decline. They were concerned about the potential presence of a tipping point, and urged consideration by Royal Mail of more modest price rises. A number of respondents including the GCA and CWU raised concerns about the impact on affordability of our proposals, and the potential for significant price rises more generally.
- 6.26 A number of user groups and customers also provided evidence of how recent price increases impacted their volumes in practice, stating that they were already reducing or would reduce their use of mail. For example, the PPA gave information about usage patterns for both small and large publishers. Some of these publishers had already closed the print element of several of their magazines and noted their plans to further reduce their use of mail for all titles, with several titles being transferred

entirely to other media. One publisher noted that price increases of the scale experienced in 2011 would speed up their commitment to online projects.

- 6.27 Customers also argued that Royal Mail had demonstrated a lack of understanding of price elasticity and how customers respond to price changes. They gave examples of their ability to reduce mail by more than the rate of price increases, subject to a lag effect which was likely to have given the impression of a slower rate of decline from the price increases in 2011-12. The MUA argued that this lag effect was due to the complexity of decision making processes for introducing alternatives to mail.
- 6.28 In addition to the concerns expressed about the impact of commercial flexibility which could result in price increases, a number of customers and user groups also referred in this context to Royal Mail's actual non-price behaviour. Postaf argued that the proposed flexibility required trust and confidence by customers in Royal Mail, and that this had been lacking in recent times.
- 6.29 In this context, the MUA and a number of large customers referred to current disputes with Royal Mail due to the fact that it had recently significantly increased the amount of surcharging of its customers for not meeting product specifications. Another customer criticised Royal Mail's approach to Advertising Mail, arguing that its standards were inconsistent with wider industry practice. The SMP raised concerns about the adverse impact on the mail industry of introducing charging for returning undeliverable or incorrectly addressed mail to the sender.
- 6.30 Customers also argued that Royal Mail's product range and commercial strategy were focussed on its operational needs rather than customers' needs, and that as a result, demand for mail would fall as it became less attractive relative to other media. They expressed their view that that in turn may result in an overall increase in the cost of producing mail. An example that access operators and other users have raised with us concerns Royal Mail's recent consultation in respect of "Delivered by Royal Mail" as imposing unnecessary costs on industry and reducing the attractiveness of direct mail. They considered the effect of this initiative would be to reduce the overall demand for Royal Mail's services.
- 6.31 In addition, the DMA noted that terms for retail customers should meet the same test in respect of being 'fair and reasonable' as wholesale customers. Other respondents including Intellect stated that the specification of products need to be reconsidered to reflect customer needs. The MUA and PPA considered that a dispute resolution process was required to address operational issues.
- 6.32 A number of user groups and an individual also argued that these concerns were underlined by the lack of appropriate incentives on Royal Mail's senior management. Their responses indicated that a management team whose focus was largely around privatisation would have short-term incentives which would be likely to lead to a decline in mail. In the medium-term, such pricing behaviour would be likely to threaten the provision of the universal service, which could lead to the need for Ofcom to intervene.
- 6.33 The MUA claimed that Royal Mail had indicated it was set to increase prices further as it had not seen the reduction in mail volumes expected in response to its 2011-12 price increases. The DMA and another user group reiterated their response to Postcomm's consultation in November 2010 on the 2011-12 price increases⁷¹ noting that there would be a lag of potentially 12-18 months before mail could be switched

⁷¹ <http://stakeholders.ofcom.org.uk/binaries/post/1162.pdf>

to digital alternatives (or even 4-6 years if more structural changes were required). They were concerned that Royal Mail's management did not appear to understand or be concerned about this customer response and complaints to the regulator had been ineffective.

- 6.34 On this same issue SLG Economics suggested that Ofcom's universal service duty meant that we should intervene in relation to the management incentives for Royal Mail's senior management, to seek to ensure that these were aligned with our duty to secure the provision of the universal service.
- 6.35 UK Mail and the Scottish Churches Rural Group both considered that price controls should remain until monitoring was in place, robust and consistent, further research on affordability and monitoring has been conducted, and the required information has been published.
- 6.36 Finally, a number of individual respondents considered that Royal Mail's quality of service was poor and getting worse. In this context the respondents did not consider that it would be appropriate to allow prices to rise until Royal Mail had resolved these issues.

Our assessment

Can an ex ante price control be viable in creating efficiency incentives in the specific circumstances facing Royal Mail?

- 6.37 Our starting point in considering the most appropriate regulatory framework for Royal Mail has been the creation of a regulatory environment in which efficiency incentives are most effective. We have considered carefully the responses which suggest that a price control could be viable and would encourage efficiency. We fully agree that efficiency improvements are an essential input to the success of the regulatory framework and to secure the provision of the universal service. These responses argue that, under certain conditions, a price control can be the most effective way of both protecting customers and promoting efficiency. However, as discussed below, we are not persuaded that these conditions exist at present. The current price control was intended to protect customers and promote efficiency, but the overall conclusion from that period is that the price control has not been effective in respect of either aim.
- 6.38 In practice since the start of the current price control period, many factors have diverged from expectations, most of them causing concern:
 - There have been sharp price increases for most customers. Prices rose at above the rate assumed in the price control due to the volume adjuster, and then the level of the price control was re-opened twice with significant price rises in 2011-12;
 - Royal Mail's finances have become weak and unsustainable. Cash flow has been around £3 billion below forecast, and has been significantly negative for the last three years, despite the price control including adjustment mechanisms which were intended to mitigate the risks faced by Royal Mail; and
 - Efficiency performance has been consistently below the assumptions made by Postcomm and also below Royal Mail's own plans.

- 6.39 We recognise and acknowledge the points made by respondents highlighting the benefits of price control regulation more generally. Our October consultation document also highlighted the potential benefits of a price control. An RPI-X price control, as we use for instance in controlling some of BT's wholesale prices, is a well-established and effective mechanism for providing network operators with an incentive to manage their costs to become more profitable and protect customers from monopoly prices. A price cap can be designed to ensure that all cost reductions over and above that assumed by the 'X' during the price control period are retained by the regulated company as profit. Indeed, Consumer Focus' analysis shows that, under a fixed set of assumptions for all other factors, what could be considered a small outperformance in Royal Mail's cost reduction assumptions would result in it making significant profits even under a price control.
- 6.40 We also noted in our October consultation document that the aim of a price control was to ensure that private operators were not able to make excessive profits and to provide efficiency incentives in markets where competition was not sufficient to restrain pricing. Royal Mail is not making excessive profits, rather in recent years, it has incurred losses on the universal service network, and its plan indicates that it may not achieve cash flows consistent with the returns we determined were appropriate in Section 5 for some time. We cannot therefore safely assume that the same approach as we use in other sectors will be appropriate for regulating Royal Mail.
- 6.41 Our October consultation document considered the wider risks faced by Royal Mail and the implications for the effectiveness of a price control. Royal Mail faces significant risks in managing its network. Small changes in the underlying assumptions of a price control can have very significant impacts on its profitability.
- 6.42 As a result we outlined that it is not realistic to expect to be able to impose a medium-term price control which would be robust and provide efficiency incentives. We pointed to the current price control as evidence that a detailed price control had not been effective in ensuring significant improvements in efficiency, and had also not been robust. Royal Mail's financial position means that a future price control would have to address the need to return to financeability as well as all the same challenges around volume and mix risk, a realistic target for efficiency within a universal service network and understanding the elasticity impact of recent price rises.
- 6.43 Consumer Focus proposed that, with moderate improvements in efficiency, Royal Mail could become profitable, and argued that the uncertainty over the price control assumptions could be addressed through adjustment mechanisms. In fact, the current price control included a number of adjustment mechanisms designed to reduce the impact of variance from the price control assumptions but these were only partially successful in mitigating the risks faced by Royal Mail. We considered the effectiveness of adjustment mechanisms in coming to our proposals in October. Our view is that they cannot be expected to work in the future, in particular:
- adjustment mechanisms can only be partially effective as there are inevitable time lags between the impact on Royal Mail and the timing of any change to the price control;
 - some risks, such as an adverse impact of a change in the mix of mail, cannot be fully addressed by adjustment mechanisms as they are difficult to measure within a price control formula; and

- the complexity of a price control including such mechanisms inevitably creates unintended consequences, and potentially perverse incentives where adjustment mechanisms could run the risk of overcompensating for the risks identified.
- 6.44 We recognise that it is possible that price regulation could form part of an effective regulatory regime in the future. To some extent this may be determined by the evidence of whether Royal Mail responds positively to the incentives provided by a more deregulatory regime.
- 6.45 Our assessment of the evidence provided is that it does not change our conclusion that a standard 'RPI-X' price control is not likely to meet our primary duty in the current circumstances. It is likely that such a control would need to be set at a high level to address the risks faced by Royal Mail, and could therefore result in significant profits for moderate efficiency improvements. Therefore, it is likely that it would still result in significant price rises. For example, the DMA's response proposes a backstop price increase of 5-10% above RPI. Such a backstop level could instead become the actual price path as it would be 'approved' by the regulator.
- 6.46 In addition, if Royal Mail underperformed against the expected outcomes, whether due to factors within or outside its control, it is very likely that we would still need to consider re-opening the control due to our primary duty of securing the provision of the universal service. This would therefore provide poor efficiency incentives, as Royal Mail would expect that its prices would be adjusted to reflect any actual efficiency improvements achieved. Given the many factors that could impact Royal Mail's overall performance, there is a reasonable risk that any control would need to be re-opened which would reduce the certainty of future prices that a price control should provide to the market. Indeed the central mechanism by which RPI-X provides efficiency incentives would potentially be undermined.
- 6.47 Therefore any price control, whether long-term or short-term, would be likely to have an effect more comparable to a rate of return control, at least under the scenario where market conditions and Royal Mail's finances remain difficult. Our view is that such a control would not be likely to provide strong efficiency incentives, as the benefits of efficiency improvements would be transferred to customers in the form of lower prices. A rate of return control would be the preferred option only if efficiency incentives were a low priority, or if inherent efficiency incentives were likely to be weak regardless of our approach to regulation.
- 6.48 We have also looked at what lessons can be learned from international comparisons, including those countries referred to by Consumer Focus. Our review indicates that there is no clear picture. Customers in a number of countries have faced and are facing significant price rises. In the majority of countries, volumes are declining and the profits of postal operators are falling.
- 6.49 We also recognise that international precedent tends to point to a different approach to regulation. However it is also the case that the presence of regulation has not stopped many international operators having to increase prices, or facing reduced profits. In the case of USPS which was raised by a number of respondents, price rises are low but it has recently announced losses of \$3.3 billion for the last quarter. We do not consider that this is a sustainable model for the UK.
- 6.50 Overall, we consider that, whilst international precedent can provide context for our decisions, our approach relates to the specific circumstances faced by Royal Mail at present, and this will necessarily be different to the approach that would be taken in other countries where the incumbent postal operator faces different financial

positions. Consumer Focus' analysis showed that its comparable operators were all profitable.

- 6.51 As part of our monitoring regime, we will consider evidence from international comparisons, but our current view is that this will only be able to provide context for our review, rather than specific benchmarks or evidence for appropriate levels of efficiency improvements or price rises.
- 6.52 In summary, our review has highlighted that there are many scenarios, including those in place in some other countries, in which a price control may be effective, and may provide strong efficiency incentives. However, none of the arguments presented have changed our view that a future price control for Royal Mail would have significant risks, potentially comparable to the risks that arose within the current price control. Some of the options proposed by respondents would provide high returns for low risk. We continue to take the position that such a price control would be unlikely to provide strong efficiency incentives.

Will our proposed regime provide efficiency incentives?

- 6.53 We recognised and highlighted in our October consultation document that efficiency incentives were a critical part of securing the provision of the universal service. We outlined why we concluded that efficiency incentives would be provided by our proposed regulatory framework.
- 6.54 We consider that the ongoing volume decline and likely limits on the pace at which prices can rise without triggering further reductions in volume (and potentially making price increases unprofitable) will result in Royal Mail facing significant pressure to reduce its costs to contain the need for price rises. It is clear that Royal Mail currently recognises the clear imperative to reduce costs and improve efficiency. Our regulatory framework must provide the incentives for the modernisation programme and cost reduction to continue and to be implemented effectively.
- 6.55 Given the wider considerations and Royal Mail's financial position, we consider that there should be inherent efficiency incentives as long as the regulatory framework does not distort the effectiveness of those incentives. A framework which constrains profits and focuses on form of price regulation rather than the underlying operational performance is most likely to have such an effect.
- 6.56 In addition, our and Royal Mail's advisers have indicated the Government's current intention to privatise Royal Mail is likely to provide immediate incentives to management to demonstrate a track record of achieving efficiency improvements. We therefore continue to expect that Royal Mail's management should have inherent efficiency incentives over the period of our proposed regulatory framework.
- 6.57 We nevertheless recognise, and were also clear in our proposals, that there is a risk that Royal Mail will seek to increase prices and improve its profitability without making appreciable efficiency improvements. Whilst profits would be lower than in the scenario where Royal Mail achieves significant efficiency improvements, they could be sufficient to reward investment and the risks for the shareholder of achieving those profits could be lower, particularly if volumes decline at a slower rate than expected (or there is a longer than expected lag in volume decline).
- 6.58 We have concluded that to ensure that this is not the case we will need to implement safeguards that are robust to this risk. The ability to operate the network efficiently, combined with appropriate pricing flexibility, is what will secure the provision of the

universal service in the medium term. We are proposing that a thorough monitoring regime (discussed in Section 7) will be in place through the regulatory period, including an assessment of the pace of cost reduction, and that this will provide strong incentives on Royal Mail.

- 6.59 If Royal Mail does not respond to those incentives, we will consider the need to re-regulate, and if it shows a track record of consistently increasing prices and not improving efficiency, it is likely that more intrusive regulation will have to be considered.
- 6.60 We therefore do not agree with Consumer Focus that we have given insufficient weight to the need to improve efficiency in coming to our proposals. Indeed, it is as a result of the weight which we put on efficiency incentives that we are adopting this approach. Our approach is designed to provide significant pressure on Royal Mail to improve efficiency. Our conclusion is that, given the need to also give weight to financeability, particularly in the short term, an approach based on pricing flexibility is best calculated to ensure that those efficiency incentives are credible and effective.
- 6.61 We note the concerns raised by two respondents that the monitoring regime should be in place and shown to be effective before price controls are removed. We discuss in Section 7 below the monitoring regime in detail. Our view is that our work on regulatory reporting as outlined in Section 11 and the extensive analysis we have performed of Royal Mail's modernisation programme mean that we will be able to monitor Royal Mail's efficiency effectively throughout the period of our proposed regulatory framework. We discuss this further below.
- 6.62 We note concerns about affordability raised by respondents. We took particular account of the risks to affordability in concluding on the need for a safeguard cap. Our approach to monitoring affordability and our decision on the safeguard cap are set out in Sections 7 and 8.
- 6.63 We also note the concerns around quality of service. As with efficiency, we consider that maintaining quality of service is an essential part of the regulatory framework. We discuss our approach to quality of service further in Section 12.

The impact of giving additional commercial flexibility to Royal Mail

- 6.64 Our overall approach to the regulatory framework is intended to give more commercial flexibility to Royal Mail. It faces significant challenges in responding to changes in the demand for mail, especially as a result of switching to electronic alternatives. This is difficult to do in a heavily regulated environment. Both the Act and our proposals are intended to reduce the regulatory burden on Royal Mail, in order to help it and the postal market as a whole to be better positioned in addressing the challenge of falling demand and the trend of switching to electronic alternatives.
- 6.65 Our starting point is that we are not and will not be in a better position than Royal Mail to determine its optimal commercial strategy. The aim of our proposals is to ensure that Royal Mail has the incentives to act in a commercial manner, to respond to customer needs and thereby to optimise the use of mail, with the potential to maximise the chance that the provision of the universal service can be financed. Only Royal Mail can deliver the commercial strategy that will achieve this. We would fully expect Royal Mail's commercial strategy to take into account the risks around the future level of demand as raised by respondents and by the BIS Select Committee.

- 6.66 At the same time, Royal Mail remains the only provider of mail services for many customers, including residential customers, and we have to ensure that such customers who do not have competitive alternatives are appropriately protected.
- 6.67 Royal Mail has acknowledged that in the past it has been slow or not able to respond adequately to customer needs, but has argued that this is due to regulatory intervention (such as the advance notification requirements and the complex nature of the current regulatory framework which Royal Mail has argued provides a barrier or a disincentive to innovation). As such, some customers have in principle been supportive of greater commercial flexibility for Royal Mail, particularly large customers with specific needs who would like to have the ability to negotiate individual terms with Royal Mail.
- 6.68 By contrast many other customers have been concerned at Royal Mail's perceived lack of understanding or concern for its customers' needs and its overall infrastructure for managing customers. They are concerned that commercial freedom will result in higher prices. Royal Mail has recently announced wholesale prices and provisional retail prices for 2012-13 which indicate price rises of 10%-15% for most customers.
- 6.69 Customers are also concerned about changes to non-price terms that add additional cost to their process and the removal of current protections (e.g. advance notification requirements for changes to presentation requirements). Many of the responses in respect of "Delivered by Royal Mail" and surcharging claim that Royal Mail's commercial behaviour is resulting in higher costs for its customers, and that Royal Mail has not shown its customers that it has taken the customer impact of its proposed changes sufficiently into account. Similar concerns have been raised in respect of the design of product specification. These respondents suggest that as a result of this behaviour some customers increasingly do not trust Royal Mail, and consider that there is a risk it will use its commercial freedom in a way which may undermine the use of mail.
- 6.70 This risk clearly needs careful consideration as it has been raised by a significant number of large customers. It is clear that some customers fear that in the short-term deregulation will drive up prices and force them away from mail. The challenge from the majority of customers and user groups is that there is a need to retain pricing and other regulatory requirements on Royal Mail to ensure its financial sustainability, rather than rely on the strategy that would be employed by Royal Mail if it were given commercial freedom. The DMA characterised this as "protecting Royal Mail from itself". Customers have given specific examples to demonstrate that, in some cases, price rises are likely to be inconsistent with delivering increased revenue, because of the impact they claim it is likely to have on their use of mail.
- 6.71 The evidence provided by customers also shows the disparate nature of Royal Mail's customer base. Our analysis of data discussed in Section 8 below shows that many of its business customers spend very little on post. However, some customers' business models are more reliant on post because the delivery of many physical items cannot be replicated by electronic means. These customers' profits are impacted to a greater extent by the cost of postal services. The nature of competition in their end markets will affect whether they are able to pass price rises on, or whether price rises will result in their business in some extreme cases no longer being viable, as argued by some respondents.
- 6.72 These different types of customers are likely to have very different levels of short- and medium-term price elasticity. Ofcom cannot precisely estimate these complex

relationships with individual customers, and in any event they are not likely to be constant over time. However, we can see that there is clear evidence that customer needs and preferences are likely to be very different. It is therefore imperative that we provide Royal Mail with the commercial flexibility and appropriate incentives to be able to better address these customer needs.

- 6.73 There is some evidence that Royal Mail is seeking to base its pricing decisions on such a commercial strategy. For example, we have seen in recent years that Royal Mail has introduced a significant and growing discount for advertising customers, to limit the real price rises faced by such customers. This appears to be a clear attempt to address the different demand elasticity of different customer groups.
- 6.74 Nevertheless, responses indicate that some other customers may also be more price elastic than has potentially been assumed by Royal Mail in its pricing strategy. These customers may not be price elastic in the traditional sense (particularly in the short term), but may have more opportunity to switch away from mail altogether over time if postal price increases are too high and encourage them to make the necessary investments to switch to non-postal alternatives. We would expect that Royal Mail would have regard to this risk within its pricing models and commercial strategy.
- 6.75 Royal Mail has a very wide customer base, with many different needs from the postal service. We would therefore envisage that a Royal Mail with the incentive and ability to take better account of customer needs would start to change its behaviour, but that it is likely there would be a transitional period whilst it adjusts to the new regulatory framework.
- 6.76 In summary, we recognise customers' concerns about the risks around Royal Mail's behaviour during this interim period, but we do not consider that it indicates that the correct response is to extend the scope of regulation which in practice may have contributed to some of the problems raised by respondents regarding Royal Mail's previous commercial behaviour. We consider that our decision to set up a monitoring regime to examine the impact of the changes is an appropriate way to regulate Royal Mail's pricing (and non pricing) behaviour.
- 6.77 As discussed in Section 7 below, as part of the monitoring regime we propose to include ongoing dialogue with customers to discuss the effectiveness of the new regulatory regime, in order to understand the impact of commercial flexibility on the market. As discussed below, we consider that the effectiveness of this regime needs to be considered in the round. If the evidence is that the regime is leading to perverse behaviour which could undermine the universal service, then we will consider our potential response, which could include proposing price regulation or changes to non-price regulation in the future.
- 6.78 In the interim period we acknowledge the concerns raised by the PPA and MUA that there may be benefit in having an independent dispute resolution process for customers or customer groups. Such a process could support industry resolution of the non-price issues discussed above. We consider this specifically in the context of access in Section 10 below, but highlight that we would equally consider whether such a mechanism could be used to address comparable issues that may arise for retail customers.
- 6.79 In response to the point raised by SLG Economics regarding regulatory intervention in management incentives, we do not consider that we are better placed than Royal Mail's Board and shareholder to determine an appropriate remuneration strategy for its executives. In the medium-term, the interests of the Board and shareholder should

be for Royal Mail to be successful, and therefore for the universal service to be financeable. This includes the need not to set prices which will result in significant levels of volume decline, and which could therefore undermine the viability of the universal service.

- 6.80 Nevertheless, it is conceivable that there could be a divergence of incentives between Royal Mail's corporate objectives and the medium-term sustainability of the universal service. We expect that these would be identified over time through our monitoring regime. We will consider Royal Mail's overall incentive structure as part of our monitoring regime and if necessary maintain ongoing dialogue with Royal Mail to gain assurance that these risks are being addressed in the appropriate manner.

Our decision

- 6.81 There are a number of risks to the sustainability of the universal service. As argued by customers, price rises may undermine the universal service in the longer term. Equally, if Royal Mail is unable to become efficient, this would also undermine the sustainability of the universal service and we consider that improvements in efficiency are vital to secure the provision of the universal service beyond the forthcoming regulatory period. However, in the short-term, there is a clear risk to the universal service if Royal Mail is not able to cover the costs of its provision. The postal market remains highly uncertain, and a small change in the assumptions within Royal Mail's plan may result in the universal service remaining financially unsustainable.
- 6.82 In general therefore we consider price rises are likely to occur under any scenario. Inevitably price rises will result in some customers reducing their use of mail, although the full implications of the scale of price rises implemented in 2011-12 (and those provisionally announced for 2012-13) are not yet well understood. Royal Mail has undertaken some analysis of how customers are likely to respond to price rises in this environment. Our engagement with stakeholders indicates that in some cases Royal Mail is engaging actively with its customers, but that the majority of those customers and user groups who have engaged with our consultation do not feel that Royal Mail is sufficiently focussed on the needs of its customers. We consider that this engagement should be expected to improve under our proposed framework, and we will assess this as part of the monitoring regime and any future review of the effectiveness of the regulatory framework.
- 6.83 Our analysis concluded that, given the current circumstances an effective monitoring regime, should be able to provide stronger efficiency incentives than ex ante price control regulation, and offers a significantly lower risk of regulatory error. Along with customers, we would expect to see that Royal Mail uses this additional commercial freedom to better respond to its customers' needs. However, our modelling suggests that price increases are likely to be required regardless of the regulatory regime. Overall we consider that in this complex and evolving market, Royal Mail is in a better position to determine the price increases required than Ofcom would be in setting a detailed price control.
- 6.84 We have therefore concluded that the most effective mechanism to address these risks remains pricing flexibility, with key safeguards including a monitoring regime. We outline below our proposals for safeguards, including further detail about how we propose to implement a monitoring regime to address the concerns raised by respondents.

Operational flexibility – increased freedom to determine and agree terms and conditions

- 6.85 In the December consultation document on the review of regulatory conditions, we set out some proposals on the provision of information to users which were intended to give Royal Mail additional commercial flexibility while providing sufficient protection for users. This included proposals for changes to the information and prior approval Royal Mail is required to provide/obtain in the following areas:
- a) The advance notification and publication requirements for changes to the price and non-price terms of Royal Mail's universal services (these are currently contained in initial consumer protection condition 4⁷²);
 - b) The prior approval process for changes to the non-price terms for universal services. This requirement is within transitory condition 4⁷³; and
 - c) The publication and advance notification requirements for Royal Mail's retail non-universal services (these are also currently contained in initial consumer protection condition 4⁷⁴).
- 6.86 As discussed in Section 3, we have different powers to regulate universal and non-universal services. For example, if we were to impose a requirement on Royal Mail to give advance notice of price and non-price changes for universal services this could be implemented through a designated universal service provider condition. However, if we were to impose a similar requirement for non-universal service products, this would need to be implemented through a consumer protection condition. These conditions have different purposes and different legal tests that need to be met before a condition can be imposed. We have therefore considered the publication and advance notification requirements for universal and non-universal services separately below. In addition, we discuss the requirement for an approval process for changes to Royal Mail's universal services.

Advance publication and notification requirements for price terms for Royal Mail's universal services

Our proposals

- 6.87 We considered that, given the lack of competition for universal services, it was essential that the standard terms and conditions and prices be published to ensure that all customers can access these products.
- 6.88 We also proposed to reduce the advance publication and notification requirements for changes to the price and non-price terms for Royal Mail's universal services from the current three months to one month. We noted that, given the low average household spend on postal services, residential customers are unlikely to need

⁷² See paragraph 5.86-5.88 of our December consultation for more details.

⁷³ It is transitory condition clause 4.3, under which Royal Mail must apply to Ofcom if it wishes to make non-beneficial non-price changes to regulated services. This includes all price controlled services, miscellaneous services (such as redirections) and non-priced services (such as services for the blind). Ofcom can then, after consultation, direct Royal Mail not to make its proposed changes.

⁷⁴ See paragraph 5.117-5.118 of our December consultation for more details.

significant notice of price changes and one month is often used in other industries as the minimum notice period to protect consumers⁷⁵.

- 6.89 However, we recognised that both price and non-price changes can have more of an impact on small and medium sized businesses that use universal services. We considered that, as most businesses operate on a one month billing cycle, they would also require a minimum of one month's notice to pass any price increase on to their customers. We proposed that one month would be an appropriate balance between the need to give additional commercial flexibility to Royal Mail and allow smaller businesses time to change their prices and/or budgets. We also noted that we would expect Royal Mail to give more notice for changes that would have a significant impact on its customers (particularly non-price changes).

Responses to consultation

- 6.90 The majority of stakeholders who responded on this issue disagreed with the proposal to reduce the advance notification period for universal services to one month. This included six user groups, five access operators, two large customers and the MCF. Royal Mail, the CWU and Consumer Focus agreed with the proposal.
- 6.91 A number of respondents expressed concern that if the notification period were reduced to one month, this would impact businesses ability to plan effectively. They considered that one month did not give businesses sufficient time to determine whether to absorb or pass on the increased postal costs and implement any decision.
- 6.92 The Forum of Private Business noted that even minor price increases could have a big impact for small businesses and budgeting was especially important given the difficult economic climate. The FSB also expressed a concern that if the notice period were reduced to one month, Royal Mail would be able to increase its prices more frequently which would be likely to act as a barrier to growth for small businesses. An access operator was also concerned that a reduction in the notice period would result in more price changes within a financial year which could potentially unsettle and undermine what was already a fragile postal market.
- 6.93 A number of stakeholders noted that meter manufacturers could not implement a price change in one month using the current technology. Intellect pointed out that the current contracts between Royal Mail and meter manufacturers require Royal Mail to give three months' notice of price changes and it considered Ofcom should be clear that where contractual arrangements exist these take precedence over any regulatory requirement. The MCF and an access operator also noted that business users would have terms with their customers that required them to give more than one month's notice of price changes.
- 6.94 In addition, some respondents commented on the notice period required for non-price changes. User groups were particularly concerned if small businesses were only to receive one month's notice for more fundamental non-price changes as they considered this could involve significant changes in customers' processes (e.g. if changes to IT systems were required).
- 6.95 One access operator noted that universal services are used by both small and large businesses and it was therefore important to consider the impact of a reduced notice period for all business customers.

⁷⁵ For example, it is the notice that telecommunications providers are required to give for materially adverse changes.

- 6.96 The MCF and an access operator considered that neither Ofcom nor Royal Mail had substantiated the claim that the current three month notification requirement had reduced Royal Mail's ability to respond to its customers. One access operator considered that Royal Mail must know the prices it was planning to put in place much longer than one month in advance and it should be required to give the maximum notice to its customers. Another access operator considered that if Ofcom believed that Royal Mail would continue to give three months' notice for price changes there was no valid reason to reduce the current notice period.
- 6.97 The majority of respondents who disagreed with this proposal considered that the notice period for both price and non-price changes should remain at three months. For example, two user groups considered that the three months' notice period was necessary as the regulatory framework should allow for the worst case scenario in respect of how long would be needed for some changes. The Forum of Private Business considered that business customers should be given at least two month's notice of price and non-price changes.
- 6.98 The CWU supported the proposal to reduce the notice period for price and non-price changes to universal services to one month as it considered the current requirement unnecessarily restricted Royal Mail's commercial flexibility. The CWU believed that one month was a reasonable balance between the needs of universal service customers and giving Royal Mail more flexibility.
- 6.99 Consumer Focus considered that the reduction of the advance notice period to one month was acceptable for residential customers as long as the requirement to consult and approve non-price changes to these services was retained (discussed further below). However, it stressed that any reduction in the notice period should be accompanied by Royal Mail communicating effectively and any changes should receive sufficient publicity through a variety of printed and electronic methods.
- 6.100 Royal Mail welcomed and supported the proposal to reduce the universal service notification period for price and non-price changes to one month as it considered this would provide suitable notice for customers and was more in line with other regulated sectors. It noted that business customers did not receive longer than one month's notice for price changes from other regulated suppliers (such as gas and electricity) and they would also have no protection against immediate price increases from a number of unregulated suppliers. Royal Mail considered that, as expenditure on mail would only make up a small percentage of total outgoings for the majority of businesses, it was difficult to justify a longer notice period for universal services. In addition, it believed that a longer notification period would disadvantage customers as it would delay the introduction of product changes.
- 6.101 Royal Mail also noted that as the core characteristics of the universal service would be set and that any changes to these products needed to be fair and reasonable, non-price changes would not have a detrimental effect on customers. It also considered that many of the universal services are basic products and changes were therefore likely to be relatively rare. In addition, Royal Mail commented that when making changes it would consider the needs of its customers and would look to provide more than one month's notice where it deemed that this was required. It also committed to putting in place an appropriate communications plan to ensure its customers were prepared for any changes that would have a major impact. Royal Mail considered that it would not be proportionate for Ofcom to mandate a longer notification period for unusual circumstances such as this.

Our assessment

- 6.102 We remain of the view that it is essential that up-to-date price and non-price terms are published for universal services and no respondent disagreed with this position. As set out in Section 3, any DUSP condition will need to be objectively justifiable, not unduly discriminatory, proportionate and transparent (this is discussed further in Section 13). Our approach in determining the appropriate safeguards that should be in place is therefore to consider the notice that is required by customers, taking into account the appropriate balance between protecting customers and ensuring Royal Mail has sufficient commercial flexibility rather than attempting to justify the changes to current arrangements.
- 6.103 In assessing the appropriate advance notification period, we have considered the needs of the different customers that use universal service products. In general universal services are used by residential customers and small to medium size businesses. However, as noted by one access operator, many large customers use universal service products for some of their mail. Nevertheless universal services are likely to make up a small percentage of large customers' volumes and therefore overall postage costs, given the significant discounts that Royal Mail has put in place for higher volume products. In addition, they are likely to be able to access other operators for the majority of their mail volumes. We have therefore focussed our analysis on the needs of residential and small to medium sized business customers.

Residential customers

- 6.104 We consider that residential customers would benefit from some notice of price changes to allow them to purchase stamps in advance to mitigate the impact of price increases to an extent. In addition, we considered that residential customers might need some notice for some non-price changes that impact how they send mail. No respondent disagreed with this view and our conclusion that one month's notice is consistent with other industries' minimum notice periods to protect consumers and would be sufficient for residential consumers.
- 6.105 We note Consumer Focus' suggestion that the notice period should be accompanied by an effective communications plan. In its response, Royal Mail committed to putting an appropriate communication process in place to give publicity to any changes that would have a significant impact on its customers. We consider that, as there is now a requirement for all universal service terms and conditions to be fair and reasonable (as discussed in Section 4), there is no need to put any additional requirements on Royal Mail to ensure publicity for its changes.

Small business customers

- 6.106 We have concentrated our analysis on the notice required by small business customers and how this should be balanced against the need to ensure Royal Mail has commercial flexibility to change its prices and products and better meet customers' needs. Respondents highlighted the impact that notice of price changes can have on businesses' ability to budget appropriately and/or pass the increased costs onto their customers. We acknowledge the impact that price increases can have for businesses particularly where postage costs make up a higher proportion of total costs and that businesses are likely to require notice to communicate and implement price changes to their customers.
- 6.107 We set out in the December consultation our view that most businesses operate on a one month billing process and are therefore likely to require a minimum of one

month's notice to pass on any price increases to their customers (if they are able to do so). However, as pointed out by Royal Mail, businesses would be unlikely to receive more than one month's notice of price changes for other regulated services and will also not have any regulated notice period for price changes to any other inputs. Given the comparatively low spend on postal services by most businesses who predominantly use universal services, we do not consider there is sufficient justification to require Royal Mail to give longer than a month's notice of price changes for these customers.

- 6.108 We also note the concerns expressed by the FSB and an access operator in relation to Royal Mail increasing its prices more frequently in response to a reduction in the advance notice period for price changes. There are significant logistical challenges involved in changing prices and as such we would not expect that it would want or need to implement frequent universal service price increases. In addition, it is in Royal Mail's interests to better meet the needs of its customers and frequent price changes may have a destabilising effect on the market.
- 6.109 With regard to the contracts for the minimum notice period to be provided to meter manufacturers, this contractual arrangement would not be impacted by our decision to reduce the minimum notice period for universal service price changes to one month. Our decisions set out in this document are designed to encourage Royal Mail to negotiate mutually beneficial terms with its customers.
- 6.110 Some business customers may also have contractual arrangements in place that require them to give more than one month's notice to their customers for price changes. While we recognise this is likely to be the case (although potentially more of an issue in relation to non-universal service prices), it is not practicable to put regulation in place to meet the contractual arrangements of all of Royal Mail's customers. As discussed above, postal prices are only one input cost for businesses (and in many cases a relatively minor cost) and as such we do not consider it would be proportionate to require greater notice for these costs than for other input costs.
- 6.111 We also acknowledge stakeholder concerns about the impact of some non-price changes where it is likely that customers will need more than one month's notice. As noted by Royal Mail, given that the key features of the universal service will be set out in the order and most universal services do not have detailed presentation or sortation requirements, it is unlikely that the majority of non-price changes will have a significant impact on business customers. We do not consider that it would be proportionate to cater for the worst case scenario in determining the length of notice Royal Mail would be required to give for any non-price change (as suggested by some respondents). Therefore we remain of the view that one month would be sufficient for all but a minority of non-price changes and that it is appropriate that Royal Mail be required to give this length of advance notice as a minimum requirement.
- 6.112 However, as noted above in relation to residential customers, this would be the minimum required notice and we would expect that Royal Mail would look to better understand the needs of its customers and provide for those customers who require a longer notice period. In its response to this consultation, Royal Mail indicated it would give a longer notice period where it considered this to be required. We would expect this consideration to take into account the reasonable needs of its customers.

Our decision

- 6.113 Taking into account the responses received to the consultation and the other safeguards that will be in place for universal service customers, we have decided to require Royal Mail to give one month's notice of price and non-price changes to universal services. However, as noted in the December consultation, this required notice period should be considered a minimum and we would expect Royal Mail to give more notice to its customers where this is required to meet the reasonable needs of universal service customers. The requirement is within the new DUSP condition within Annex 7.

Prior approval for changes to the non-price terms for universal services

Our proposals

- 6.114 We proposed removing the prior approval process for changes to the non-price terms of Royal Mail's universal services. As discussed in Section 4, Royal Mail will be required to provide the key characteristics of the universal service and the terms and conditions for universal services will need to be fair and reasonable. Customers and other operators would be able to complain to Ofcom if they considered any changes made by Royal Mail were not fair or reasonable.

Responses to consultation

- 6.115 The majority of stakeholders who responded to this question were concerned about the impact of removing the prior approval process for non-beneficial changes to universal services. For example, one customer argued that Royal Mail had a history of being inwardly and operationally focussed and as such there needed to be a prior approval process to prevent unfair and unreasonable changes being made. It proposed the establishment of an industry operational forum to increase mutual understanding of capabilities and aspirations.
- 6.116 Two user groups considered that the pre-approval requirement needed to remain to protect customers from Royal Mail abusing its monopoly position. Another user group considered that it might be advisable to have a "heavy hand on the tiller" in the first year or two of the new regulatory regime. An access operator agreed with this proposal as long as the three month advance notice requirement remained to give customers time to understand the impact of the changes and discuss with Royal Mail if required. If the advance notice period were reduced to one month it considered that the approval process should remain, so that the impact of the change could be fully assessed (prior to implementation).
- 6.117 In particular, Consumer Focus strongly disagreed with this proposal. It considered that the current pre-approval process that included constructive engagement gave consumers an opportunity to inform Royal Mail if they consider the changes were unreasonable. It did not have any faith that Royal Mail would make changes in the public interest if the pre-approval process were removed and considered the process would be less effective if consumers had to complain after the fact and Royal Mail potentially then had to roll-back the changes.
- 6.118 To support its position Consumer Focus provided examples of two recent changes to terms and conditions that Royal Mail was proposing to make which benefited from the current constructive engagement process. This included the delivery to neighbour trial where Consumer Focus argued that Royal Mail had not fully considered the implications of its proposal for senders and receivers of mail, and as a result it made

changes to its trial on the basis of Postcomm's consultation⁷⁶. It also cited the example of compensation claim times, where due to Consumer Focus concerns, Postcomm required Royal Mail to extend the length of period in which consumers could complain.

- 6.119 Much of the concern expressed related to the reliance on the requirement that non-price terms for universal services are fair and reasonable. A user group considered that fair and reasonable was a vague term and businesses needed greater guidance on what this would cover and how it would be measured and enforced. It considered that businesses would make commercial decisions on the basis of what this term meant and therefore clarity was important. Another user group considered fair and reasonable to be too open to interpretation and this was a concern given the importance of the issue to customers. It noted that one party's interpretation of what was fair and reasonable was not likely to correspond to the views of the other party. The user group also considered that to reassure the market Ofcom should publish a formalised grievance procedure which sets out process and potential outcomes where parties considered terms and conditions to be unfair and/or unreasonable (similar to what is proposed for access).
- 6.120 Royal Mail welcomed and supported this proposal. It considered that, as the key characteristics are set out in the DUSP condition, there would be little room for it to make any non-price changes apart from adding innovative new attributes.

Our assessment

- 6.121 We acknowledge the concerns expressed by Consumer Focus, user groups and customers about non-price changes that Royal Mail could make to its universal services. However, as set out in the December consultation, the key characteristics of these products will be set out in the universal postal service order and Royal Mail will be unable to change these aspects of the services.
- 6.122 In addition, there is also now a requirement within the new DUSP condition that the terms and conditions for universal services are fair and reasonable. We consider that the combination of these two requirements will be sufficient to ensure Royal Mail focuses on understanding the needs of its customers and ensure that any changes to its universal services are considered fair and reasonable.
- 6.123 Therefore, given the safeguards that will already be in place for universal services, we do not consider that it would be proportionate to add an additional approval step in the process for making changes to services. This would be likely to add time and complexity to the process of introducing new products into the market and disadvantage Royal Mail and potentially some customers by delaying fair and reasonable changes. In addition, it may also result in perverse incentives for Royal Mail to propose a negotiating position rather than what it would ultimately like to implement. It may also focus Royal Mail's attention on engagement with Ofcom and Consumer Focus rather than its customers.
- 6.124 However, Royal Mail will have the obligation to ensure that its non-price terms for universal services are fair and reasonable and should be incentivised to consider the needs of its customers before making any changes to the terms and conditions of universal services. We recommend that where customers are likely to have concerns

⁷⁶ Postcomm consultation on Royal Mail's application to run a Delivery to Neighbour Trial, July 2011, <http://stakeholders.ofcom.org.uk/binaries/post/1995.pdf>

about such changes to terms, Royal Mail should seek evidence of the impact on customers in developing its proposals.

- 6.125 Fair and reasonable is context specific i.e it will depend on the circumstances of the case. However, it is used in many regulatory frameworks and Ofcom has experience in its application in other sectors. To a certain degree it requires the exercise of regulatory judgement. We also explain our view on this in paragraphs 4.46 – 4.48 in this statement.

Our decision

- 6.126 Given that the key characteristics of the universal service will be fixed, and terms and conditions need to be fair and reasonable, we have decided not to impose a pre-approval process for other changes to non-price terms.
- 6.127 We would expect that Royal Mail will look to better understand the needs of its customers and take these into account when making changes to non-price terms, given the need to ensure that terms and conditions remain fair and reasonable.

Publication and advance notification requirements for Royal Mail's retail non-universal services

Our proposals

- 6.128 In our December consultation, we proposed no longer to require Royal Mail to publish or give advance notice of prices and terms and conditions for its retail non-universal services. This included the notification and publication of the terms of bespoke retail contracts. We considered that, as Royal Mail would be required to give ten weeks' notice of price and non-price changes to standard access products and that there was a significant level of competition for the majority of non-universal services, it would be incentivised to give sufficient notice to its retail customers. We also proposed to monitor Royal Mail's performance in this area under the monitoring regime, in particular for the retail non-universal service customers who do not have a choice of operator.

Responses to consultation

- 6.129 The majority of stakeholders who commented on this issue disagreed with our proposal to remove the existing requirements relating to the publication and advance notice of price and non-price terms for non-universal services. This included five user groups, five access operators, one customer and the MCF. Royal Mail and one customer supported the proposal.
- 6.130 The majority of respondents considered the current three month notification and publication requirements should remain. Specifically, respondents highlighted the following issues with a reduction in the advance notice of price changes:
- a) Budgeting and business plans are set far in advance creating a risk that volumes sent will be reduced in proportion to the price increase (particularly a concern for publishers with annual subscriptions);
 - b) There are existing contractual arrangements with end customers which include three months' notice of price changes;

- c) Direct marketing campaigns can take up to three months to send the mailing and any price change within this period may impact the return on investment for the campaign and/or result in lower volumes; and
 - d) Customers need some time to understand the price changes in order to determine and implement their response (given Royal Mail's complicated product portfolio).
- 6.131 In addition, respondents highlighted the issues with no or limited advance notice of non-price changes. This included the potential impact on direct marketing campaigns that were already in progress, IT, operations or infrastructure changes, time lag for suppliers and the time involved in implementing process changes and training staff.
- 6.132 Two user groups considered that Ofcom's proposals that gave Royal Mail commercial freedom both in terms of pricing and the advance notification of prices and changes to specifications would create uncertainty. A number of respondents were concerned that this might incentivise customers to move away from mail altogether due to the lack of predictability.
- 6.133 Respondents were also not convinced by Ofcom's argument that Royal Mail would have a commercial incentive to continue to provide sufficient notice to customers and compete with access operators given its market power. For example, one access operator considered that Royal Mail would take a short term approach which would in the long term be detrimental to both customers and the postal market. In addition, two user groups did not believe that Royal Mail understood the complexity of the processes that were involved in the production and use of bulk mail. They cited the example of Royal Mail attempting to introduce the printing of "delivered by Royal Mail" on Letters without adequate consultation and notice. A customer also pointed to the example of Royal Mail's retail zonal pricing application and considered the length of the notice period should depend on the complexity of the change required.
- 6.134 One user group provided a quote from a large customer:
- "Given the ever increasing ability to gauge the effectiveness of Pay per Click advertising online, with incredible accuracy and level of detail, it would seem perverse of Royal Mail to make their own medium even less accurately predictable, and thus discourage the use of the one form of mailing that, it would appear, is subsidising their service, namely Direct Marketing."
- 6.135 One user group considered that a more gradual approach that included safeguards such as prior notification would give Royal Mail time to adapt to its new commercial freedom (including the responsibilities that come with this) and provide some stability and reassurance to bulk mail users.
- 6.136 Similar to the point made above in relation to universal services, some respondents considered that the regulatory framework should cater to the worst case scenario. The FSB noted that the removal of the advance notification requirements would disproportionately impact small businesses as they would not be able to absorb costs as easily as larger businesses. Consumer Focus was also concerned about the impact of these proposals on small to medium sized businesses, particularly those in rural areas that had no choice but to use Royal Mail.
- 6.137 The MCF and access operators were concerned about the removal of the requirement to notify and publish details of bespoke retail contracts and the impact that this would have on the ability of other operators to identify and complain about

anti-competitive behaviour by Royal Mail. They considered that the regulatory financial reporting requirements would not offer sufficient protection. UK Mail was concerned about the impact of this proposal in conjunction with the significant changes proposed to the regulation of margin squeeze.

- 6.138 Royal Mail welcomed the proposal to remove the notification and publication requirements for non-universal services. It considered that there was extensive competition in the retail bulk mail market and these requirements had restricted its ability to compete in this market. Royal Mail argued it was vital that it was able to compete in this market on a level playing field with other operators.
- 6.139 Royal Mail set out that to retain or regain retail customers it would need to understand its customers' needs and be professional in its dealings with them. It outlined the steps it was taking to understand customer views on a regular basis and ensure it had an effective communications plan in place.
- 6.140 Royal Mail noted that it "has every incentive to manage its customers commercially, communicate with them effectively and give them reasonable notice as otherwise it will lose business."⁷⁷ It noted that its contracts stipulated a minimum of 30 days' notice for price and non-beneficial non-price changes and committed where possible to give customers notice well in advance of this.

Our assessment

- 6.141 As set out in Section 3 and the December consultation, our primary duty is to carry out our functions to secure the provision of the universal service. To do this we proposed and have confirmed in this document a number of measures to give Royal Mail more commercial flexibility, particularly for non-universal service products. There is no regulatory requirement on Royal Mail to continue to provide non-universal services and under the Act we are not able to implement a price cap on these services.
- 6.142 Therefore, our starting point in considering whether Royal Mail should be subject to a regulatory requirement to publish and provide advance notice of price and non-price changes for non-universal services was that it would seem inconsistent given the implications of the Act for our powers to regulate non-universal services more generally. In addition, we have taken an approach, where possible, to give Royal Mail more commercial flexibility to better meet the needs of its customers. This includes the flexibility to offer bespoke contracts (which it could be argued Royal Mail was disincentivised to offer by the previous regulatory regime) to better meet the needs of its customers and more generally to be able to compete on the merits with access operators.
- 6.143 However, as noted by a stakeholder, non-universal service bulk mail products are essential to support the financial provision of the universal service. As such we recognise that it is important to take into account the needs of these customers and the impact of our proposals on this market.
- 6.144 We acknowledge the points raised by stakeholders above in relation to the importance of advance notice for both price and non-price changes to non-universal service customers. Customers have repeatedly responded to Postcomm consultations on this issue setting out the impact on their business if Royal Mail does not give sufficient notice of its changes. We have therefore assessed whether Royal

⁷⁷ Royal Mail response, Section 2. Consumer protection and essential conditions

Mail is likely to provide this notice to its customers and the extent of competition for these products.

- 6.145 A number of respondents challenged our assumption in the December consultation that Royal Mail would be likely to act in a commercial manner and have pointed out specific examples to show that Royal Mail did not fully understand its customers' needs or give sufficient notice of changes (for example, the proposal to print "Delivered by Royal Mail" on the envelope). However, we do not consider that historical performance will necessarily be the best predictor to how Royal Mail will act in the future. It is possible that because the minimum notice periods were set out in the regulatory framework, Royal Mail focussed on this rather than better understanding the types of notice periods its customers need.
- 6.146 In addition, for many of the non-price changes implemented over the period of the current regulatory framework, it would have been beneficial for customers to have implemented these immediately. The regulatory framework might also have disincentivised Royal Mail from negotiating individual arrangements for its customers given the notice period that was required for any bespoke contracts and the no undue discrimination requirements of Royal Mail's licence. Royal Mail will be likely to be incentivised to negotiate minimum notice periods with its customers in the future to the extent that advance notice of price and non-price changes are important for customers.
- 6.147 We note the work that Royal Mail is currently doing to better understand its customers' needs and align management bonuses with customer satisfaction scores (among other indicators). It also has a minimum of one month's notice for price and non-beneficial non-price changes in place in its bulk mail contracts.
- 6.148 We also note Royal Mail's commitment to giving its customers additional notice where possible. For example, Royal Mail has given its retail business mail customers approximately six weeks' notice of its intended prices for the 2012-13 financial year. While this may not be considered sufficient notice by many customers, it does show its intent to continue publishing standard prices in advance even where there is a level of uncertainty over the future regulatory framework (i.e. due to the publication of the decisions on the future economic framework set out in this statement).
- 6.149 In addition, as set out in Section 10, Royal Mail will be required to give ten weeks' notice of standard price and non-price changes for access products (unless otherwise agreed by the parties) and an appropriate notice for non-price changes for access products. There is a significant level of competition for many of Royal Mail's retail non-universal services as a consequence of these access products. We therefore consider that, if advance notice of the price and non-price changes is important to customers (for the reasons set out above), other operators will give sufficient notice and Royal Mail will be likely to have the incentive to give sufficient notice in order for it to be competitive and retain/regain customers.
- 6.150 However, we recognise that some retail non-universal service customers do not currently have any choice of operator and this is not likely to change in the medium term. We consider that as these customers are generally using comparable business mail products they are also likely to benefit in practice from the advance notice that Royal Mail is incentivised to give in the more competitive parts of the market.
- 6.151 Given the importance of bulk mail services to the universal service, we are intending to look at the impact of the change in regulation on these customers and the market as a whole under the monitoring regime (discussed further above). In addition, we

will monitor the impact of the removal of the publication and advance notification requirements for non-universal services to ensure that Royal Mail is acting appropriately and determine if there is a need to intervene and impose a consumer protection condition.

- 6.152 We also note the concerns expressed by the MCF and access operators about the publication of details of bespoke retail contracts. However, most companies do not have sight of the prices and terms and conditions of their competitors' individually negotiated contracts. It is likely that customers will give some idea of the terms of contracts Royal Mail is offering to other postal operators during a competitive negotiation process (and vice versa). Previous analysis by Ofcom has indicated that price publication can reduce the level of competition in the market, as other operators have full transparency of the incumbent's prices.
- 6.153 As set out in Section 10, Royal Mail will be required to provide certain details of retail contracts that fall within the scope of the margin squeeze test to Ofcom which should enable faster investigation of any issues raised. We therefore do not consider that any additional protection is required or appropriate given our statutory duties.

Our decision

- 6.154 We have decided to remove the publication and advance notification requirements for Royal Mail's retail non-universal services, other than as required to demonstrate compliance with the margin squeeze test as discussed in section 10 below. We expect that Royal Mail will continue to provide sufficient notice to its customers and intend to monitor this alongside the other areas within the monitoring safeguard.

Safeguards to protect customers and consumers

- 6.155 This section sets out the response to our overall proposals for the protection of customers and consumers in the absence of price regulation, our analysis of those responses and our decision on this.
- 6.156 The detailed proposals on these safeguards are set out in Sections 7 - 10 below.

Our proposals

- 6.157 We set out in the October consultation document that, despite our proposal that a traditional price control is not appropriate in the current circumstances, the risks that led us to consider a price control remain (despite Royal Mail's claims that its behaviour is constrained and so all ex ante regulation is unnecessary⁷⁸). In particular, we recognise the implications of the following risks:
- a) Royal Mail might have the incentive and ability to increase prices instead of taking on the efficiency challenge, and might do so in a way that results in a long term detriment to the universal service;
 - b) Vulnerable consumers in particular might potentially be adversely affected by price increases; and

⁷⁸ Royal Mail argued that it was constrained by competition from non-postal alternatives, uncertainty about the location of tipping points, the threat of end-to-end competition, and the threat of regulation (paragraph 6.63 of the October consultation).

c) Royal Mail will have the incentive and ability to make competition more difficult⁷⁹.

6.158 We argued that these risks are significant and imply that commercial freedom cannot be permitted without sufficiently strong safeguards. With the right safeguards in place, however, we considered that the risks would be manageable. As a result we proposed that if price controls were to be removed, we would introduce key regulatory safeguards in the following areas:

- a) Monitoring and potential for re-regulation;
- b) Ensuring that a basic universal service is available to all; and
- c) Competition and innovation.

Responses to consultation

6.159 The majority of respondents from all categories agreed that regulatory safeguards were needed if greater commercial freedom were to be provided. The Scottish Churches Committee argued that these three safeguards should be kept under close review and appropriate action should be taken should the safeguards appear insufficient to ensure the provision of the universal service and the protection of vulnerable consumers.

6.160 The DMA and another user group argued that the proposals did not include safeguards for businesses (including small businesses) and considered that these were necessary.

6.161 Royal Mail recognised the need for Ofcom to put safeguards in place to ensure that universal services remained affordable and considered the threat of re-regulation was credible. However, while it recognised that Ofcom would need to monitor to understand whether re-regulation was required, it considered that the proposed monitoring regime was disproportionate and not sufficiently targeted. It considered that the case to support the imposition of a safeguard cap was not strong and it did not believe it was necessary to mandate access. Royal Mail's specific concerns about the proposed safeguards are discussed in the relevant sections below.

Our assessment

6.162 We agree that it is important to monitor closely how Royal Mail reacts to the additional commercial flexibility set out in our proposals, and there needs to be a credible threat of re-regulation. Only if strong safeguards are in place, can pricing freedom be granted. However, it is important to consider all aspects of the regulatory framework in the round and the general circumstances under which we may consider further regulatory intervention are discussed in the section on monitoring below.

6.163 We also consider that our proposed safeguards will provide some protection for businesses. Many businesses use non-universal services such as bulk mail where there is more competition and these businesses therefore have a greater choice of alternatives to Royal Mail. As a result, the regulatory safeguards around competition (in particular the mandating of access and the margin squeeze control) discussed in Section 10 plus the monitoring regime will provide some protection for these

⁷⁹ Discussed further in paragraphs 6.64 to 6.75 of the October consultation <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>

businesses. Our expectation is that the prices paid for all services that use the universal service network should cover the costs of the network, including a reasonable rate of return, and therefore all users of the universal service network will benefit from the monitoring of returns across the network.

- 6.164 Smaller businesses which may not have a large enough mailing profile to use bulk mail services and so rely on universal services will also receive some protection through the monitoring regime (particularly around universal service prices) and potentially, depending on usage, the safeguard cap. Previous analysis by Postcomm and Consumer Focus has shown that the majority of small businesses continue to use Second Class stamps. This is discussed further in Section 8.

Our decision

- 6.165 No stakeholder disagreed with the need to put safeguards in place to secure the provision of the universal service and protect customers (including where appropriate addressing issues relating to effective competition) or proposed any new safeguards.
- 6.166 Those who disagreed with our approach largely argued that the impact of our safeguards needed to be wider. These included those who felt the monitoring regime needed to be more explicit, those who considered a tighter or more extensive safeguard cap would be appropriate. We consider these arguments in the context of our proposals on the specific safeguards in Sections 7-10.
- 6.167 Royal Mail, whilst disagreeing that our safeguards were necessary, did not provide any new evidence that our specific safeguards would undermine the viability of the universal service. As discussed above, our view is that a fundamental weakening of the safeguards, which would be the implication of agreeing with all of Royal Mail's proposals, would mean that our overall approach to pricing freedom would no longer be appropriate. We also take account of Royal Mail's full responses on each of the safeguards in Sections 7-10 below.
- 6.168 We have therefore concluded that it remains appropriate to put key safeguards in place to mitigate and monitor the impact of the removal of traditional price controls. This includes:
- a) Monitoring and the threat of re-regulation (details of the monitoring regime are discussed in Section 7);
 - b) Ensuring that a basic universal service is available to all (discussed in Section 8); and
 - c) Safeguards to protect competition and incentivise innovation (set out in Sections 9 and 10).
- 6.169 We now discuss the duration for this regulatory framework, including the safeguards.

Duration of the framework

Our proposals

- 6.170 In our consultation we considered that the optimum length of time before we review the framework would need to:
- provide sufficient efficiency incentives;

- provide sufficient certainty for Royal Mail (including any potential investor) over the future regulatory framework;
- address the risk of Royal Mail increasing prices rather than targeting efficiency improvements; and
- allow the benefits of a financially sustainable universal service to be shared with customers.

6.171 We noted that these objectives were similar to the questions considered when setting the duration of a price control in the electronic communications sector, where we have in the past preferred durations of four years (now typically three due to EU requirements). We consider that this provides a reasonable balance between keeping prices in line with costs and providing incentives to reduce costs. We stated however that these were designed for companies in relatively good financial health, possibly already making strong profits.

6.172 We also set out our view that setting an indefinite duration would provide greater certainty to Royal Mail (and any potential investor) over the future regulatory framework. However, we did not consider this appropriate due to Royal Mail's potential ability and incentive to make excessive profits in the future, together with the level of uncertainty about the future of the postal market.

6.173 On balance we considered the period should be sufficiently long to allow Royal Mail to return to viability but short enough not to allow it to take unreasonable advantage of the situation. We proposed a duration of seven years, but that we would leave open the possibility of reassessing the level of the safeguard cap in about two years' time. We also noted we could take regulatory action sooner if we considered it necessary to secure our statutory duties.

Responses to consultation

6.174 A number of respondents, including some operators, user groups and customers, argued that the duration of the economic framework was too long. This group included some that accepted the principle of deregulation. The arguments were generally based on market context – given the uncertainty over the future direction of the postal industry it was not considered likely that any regulatory framework would be robust for seven years. Many respondents considered three years an appropriate duration, and some respondents referred to the fact that Ofcom uses three year periods in other price controls.

6.175 Consumer Focus was concerned that any relaxation of controls over a long period would substantially weaken incentives for cost restraint and efficiency. It preferred a five year RPI-based price control. The BIS Select Committee recommended that five years would be a more suitable duration and would provide greater incentives for rapid progress with efficiency measures.

6.176 Some respondents, including some customers and user groups, also proposed having an interim review after around three years (or after privatisation), the scope of which could be defined in advance and which would not trigger changes if the new regulatory approach had been effective. UK Mail and another access operator argued that our duration appeared to be linked to the timetable for privatisation.

6.177 Some other customers supported our proposed timeframe. Two operators considered the duration acceptable with some caveats, e.g. provided the monitoring

mechanisms and processes for intervention were robust. Royal Mail considered seven years a minimum, emphasising the need for greater regulatory certainty, particularly if the Government were to be successful in attracting private investment.

Our assessment

Why a shorter period could be more appropriate

- 6.178 As noted, we currently use three (previously four)⁸⁰ year periods in the electronic communications sector, such as for RPI-X price controls in accordance with EU law. Respondents thought that such a period would also be appropriate for post, and we agree that there is nothing fundamental in Royal Mail's business that would prevent them from achieving efficiencies over such a timeframe.
- 6.179 Such a period would also provide us and other industry participants with the opportunity to reassess the performance of the new regulatory framework – and the impact of continuing changes in the market – in the near future.
- 6.180 We agree that there are a number of reasons why uncertainty in the market and over Royal Mail's behaviour could indicate the need for a shorter period prior to a review. As discussed below, we need to offset these against the need to provide efficiency incentives. Our view is that an effective monitoring regime, as described above, should be able to address the same concerns as those which indicate the need for a shorter regulatory period.

Impact of Royal Mail's financial position

- 6.181 Given the current state of its finances, and our analysis of its Restructuring Plan, we consider that the cumulative cash flow generated by Royal Mail may remain weak even if it achieves efficiencies, through at least the first three years of the next regulatory period. A shorter period therefore might not provide enough time for Royal Mail to redress this situation and then to make a reasonable return on any efficiencies it made during the period. This might distort its incentives.
- 6.182 Further, if we were to implement a three year duration prior to a formal review (as favoured by the majority of respondents) the review might take place shortly after all or part of Royal Mail has been sold. This could under some circumstances result in a potential barrier to investment in Royal Mail, due to the uncertainty a review could create, and this would be likely to again reduce efficiency incentives over the course of any period of uncertainty. This could occur regardless of whether or not the review subsequently proposed significant changes.

A longer control is therefore more likely to be consistent with efficiency incentives

- 6.183 A longer period is more likely to strike an appropriate balance between incentives to pursue short term price increases and short to medium term efficiency improvements. This would in our view be in the best interests of consumers, Royal Mail and the universal service.
- 6.184 In the absence of medium-term regulatory certainty, there is a significant risk of Royal Mail focussing on price increases which can be made quickly and may be

⁸⁰ Up to 2009 Ofcom and (OfTel previously) had used 4 years, but an update to EU legislation in respect of the electronic communications sector mandated the requirement for triennial market reviews.

preferable to seeking efficiency improvements. This may be particularly the case if Royal Mail believes that efficiencies are likely to be returned to customers at the time of a future review and in the context of the very significant challenges it faces to achieve modernisation.

- 6.185 A longer regulatory period will also make it clear that it is for Royal Mail to consider the impact of price increases on volumes, as it will have to manage that risk in the medium term. A longer period will avoid creating the risk that could arise under a shorter period that the impact of price increases on volumes could be perceived as an issue to be managed by Ofcom as part of the next regulatory review. These issues will arise regardless of the timing of any introduction of private capital to Royal Mail.
- 6.186 We recognise that a five year period as proposed by Consumer Focus and the BIS Select Committee could allow the above to occur, with some time left before the next review. However such a review, if it were to be an extensive review of regulation, would then need to be started in around three years time, and there is therefore a risk that incentives for perverse behaviour might be created if, following a return to profitability, Royal Mail immediately started positioning itself for the next review, rather than focussing on efficiency and longer term sustainability. On balance we consider that there is a risk that five years would therefore be too short a period for the incentives within our proposed regulatory framework to work effectively.

Monitoring regime and the issue of an interim review

- 6.187 The monitoring regime we are putting in place (which we noted earlier in this section was generally supported by stakeholders) will mean that we will monitor, analyse and publish data on Royal Mail's performance each year. This will put us in a strong position to ascertain whether there is a need to intervene if it appears that the objectives of the regulatory framework are not being met. If this were to be the case we would undertake a review to formally consider whether changes to the regulatory framework should occur.
- 6.188 Initiating a review as a result of analysis undertaken in the monitoring regime would be likely to have the same effect as conducting the interim review that some stakeholders have suggested. It should also be able to address the risks which many respondents have stated in coming to the conclusion that a shorter review period is required. We consider this flexibility in conducting an interim review – i.e. if our monitoring regime suggests that it is necessary – is preferable to setting the date for an interim review in advance. The latter could result in the review not being held at the right time (e.g. straight after the injection of private capital) and could encourage the sorts of perverse incentives noted above in the lead up to a review.
- 6.189 We also note that we are leaving open the possibility of reassessment of the safeguard cap in two to three years (see Section 8).

Our decision

- 6.190 We therefore consider that a period of seven years, supported by annual analysis and data provision including the provision of an annual report on the effectiveness of the regime, would provide greater certainty of the regulatory framework for Royal Mail, potential investors and other stakeholders. We consider that this would better encourage efficiency incentives and allow the benefits of a financially sustainable universal service to be shared with customers. We will keep under regular review the

need for an interim review of the regulatory framework, taking into account the evidence from our monitoring regime.

Summary of our decisions

6.191 In respect of price regulation, we have decided to remove all price controls generally for universal services, with key safeguards, comprising;

- A monitoring regime, described in more detail in section 7;
- A cap on the price of Second Class stamps to protect vulnerable consumers, described in more detail in section 8; and
- Competition and innovation, described in more detail in sections 9 and 10.

6.192 We have decided to reduce pre-notification and publication requirements for Royal Mail to provide it with operational flexibility, specifically;

- For universal services, Royal Mail will have to publish both price and non-price changes with a minimum one month's notice; and
- For retail non-universal services, there will be no formal requirements on Royal Mail in respect of pre-notification or publication.

6.193 We have also decided to remove the prior approval process for changes to the non-price terms of Royal Mail's universal services.

6.194 In addition, we have decided that the framework will be in place for seven years.

Section 7

Monitoring regime

Introduction

- 7.1 Section 6 discusses our proposals to give Royal Mail additional commercial freedom through removing traditional price controls, subject to a number of safeguards being in place. One such safeguard is the introduction of a monitoring regime to understand the impact of the regulatory framework on the provision of a sustainable universal service. In designing the monitoring regime, we have had regard to the wider aims of the regulatory framework, in particular the overall aim to secure the provision of the universal service.
- 7.2 This section sets out our decision on the approach to the monitoring regime. We set out below a summary of our proposals discussed in the October consultation, a review of responses received, and our assessment of the issues raised. On this basis, we present our decision on how the monitoring regime will work; what we will monitor; the information that will be provided throughout the regime; and the role of regulatory review/intervention.
- 7.3 It is important to consider the combined impact of all the safeguards that are being put in place to protect customers in the absence of a comprehensive price control. Therefore this section should be read in conjunction with Section 8 which sets out our view of the safeguard cap for vulnerable consumers, and Sections 9 and 10 which discuss end-to-end and access competition respectively. In addition, Section 11 summarises the regulatory financial information that Royal Mail will be required to provide to support the safeguards we are putting in place, and Section 12 discusses our decision on quality of service targets for universal and non-universal services.

Our proposals

- 7.4 In the October consultation⁸¹, we argued that in order to assess whether the proposed regulatory approach to give Royal Mail increased commercial freedom was working, we would need to have sufficient information and confidence in this information to enable us to identify any issues, investigate, and propose any further regulatory action that may be required.
- 7.5 As a result, one of the key safeguards we proposed was to monitor particular measures and information to determine the impact of the change in regulatory framework and to allow us to assess whether there is a need to intervene to protect the universal service, customers or competition.
- 7.6 In particular, we were concerned about an outcome which undermined the delivery and/or sustainability of the universal service. We set out that the information we would require for effective monitoring would broadly fall into the following four areas:
- a) **Financial performance** - monitor operating margins and returns on capital, both at an absolute level and between products and/or markets, and cash flow to allow us to assess Royal Mail's performance, and in particular any consumer protection concerns that may arise.

⁸¹ The full discussion of the monitoring regime is set out in paragraphs 6.81 to 6.93 of the October consultation.

- b) **Operational performance** – monitor Royal Mail's performance against its own efficiency targets (e.g. its modernisation/restructuring plan and/or internal targets) and quality of service targets (including reasons for variances, to prevent Royal Mail from reducing costs through quality degradation).
 - c) **Customers/Consumers** – monitor universal service prices since Royal Mail would have the ability to significantly increase prices to customers and consumers. Overall price and revenue increases would need to be considered in conjunction with the monitoring of profit margins and efficiency, to provide a complete view of Royal Mail's performance and to identify any risks to the universal service.
 - d) **Competition** – monitor access prices and changes to access prices, transfer charging and cost allocation.
- 7.7 Our intention was that the combination of these areas of monitoring should result in a robust regulatory framework which would provide appropriate incentives for Royal Mail to support the efficient provision of the universal service. We also expected that the monitoring framework could support the postal market itself, through providing relevant information to the market about Royal Mail's performance and the impact of the regulatory framework on customers.

Responses to consultation

- 7.8 The majority of respondents across all categories considered that if traditional price controls were removed, then monitoring would be essential to ensure the postal market worked well and protected the universal service.
- 7.9 Royal Mail recognised and supported significant elements of Ofcom's proposals for greater reporting and monitoring, stating that certain financial information would be critical to enable Ofcom to fulfil its statutory duties. It also agreed with the principle that the information provided should be relevant, reliable and timely.
- 7.10 Many respondents also provided more detailed views on the proposed monitoring regime, which have been grouped into the following areas:
- a) How we will be monitoring;
 - b) What we will be monitoring;
 - c) Publication of information/data; and
 - d) Regulatory review/re-opening the regulatory regime.

How we will be monitoring

- 7.11 Some individuals, user groups and large customers considered that Ofcom should provide further information about how the monitoring regime would work. In particular, there were concerns that we had not set out in detail what we would monitor and the data that would be collected, the circumstances/thresholds under which we would intervene, what the intervention would be, and the timescale for any such intervention.
- 7.12 Royal Mail argued that, in order for Ofcom to understand the financeability and efficiency of the universal service, the basis for the monitoring regime should be the

reports its Board and Executive team use to run the business. It therefore proposed to provide the confidential “Management Accounts” and KPI performance pack⁸².

- 7.13 The DMA and another user group considered that there should be a requirement in the monitoring regime for Royal Mail to gain approval from the regulator for price increases above a certain level. They considered this should include a regulatory requirement for Royal Mail to consult industry participants on its proposed pricing plans. The DMA also considered that there should be regular meetings between Royal Mail, mail users, trade associations and consumer groups hosted by Ofcom as part of the monitoring regime (as it did not consider it likely without it being a statutory requirement) to discuss pricing issues and the impact on the market.
- 7.14 Finally, Postaf argued that industry participants do not have the necessary resources or expertise to respond to issues after the event. Therefore, it considered they would need to rely on Ofcom to identify and respond to issues caused by Royal Mail exercising its market power.

What we will be monitoring

- 7.15 The MUA and PPA noted that the industry did not have access to Royal Mail’s commercially confidential information such as its business plan, and therefore Ofcom was best placed to determine the specific areas that should be monitored to ensure Royal Mail achieved appropriate targets and efficiency gains.
- 7.16 The majority of respondents who commented on this issue agreed with the four areas we identified in the October consultation (namely financial performance, operating performance, consumers/customers and competition).

a) Monitoring financial performance

- 7.17 The majority of respondents explicitly agreed that it was important in securing the long term sustainability of the universal service to monitor Royal Mail’s financial performance and understand its profitability.
- 7.18 A number of respondents including Intellect and one large customer noted the importance of detailed financial information on the profit and cash contributions for different product groups to gain a better understanding of the finances of the universal service, including its profitability, and to prevent unfair subsidies being introduced.⁸³

b) Monitoring operating performance

- 7.19 As noted above, one of the main concerns about price deregulation was that Royal Mail would increase prices rather than reduce its costs, and several respondents raised this as an issue. Respondents were therefore concerned that Royal Mail’s actual efficiency improvements were monitored effectively, in order to ensure that the

⁸² This would be in addition to the regulatory financial reporting requirements. Royal Mail made several comments in relation to the regulatory financial reporting proposals, arguing that elements were not proportionate, transparent or targeted, and these responses are considered in Section 11 and Annex 3.

⁸³ For example, it argued that if Royal Mail took a short term view that transactional mail was price inelastic and would disappear at some stage, they might try to maximise this income stream at the same time as subsidising direct mail volumes which were price elastic, even though the demise of the former was not a given, but would in fact be affected by price.

incentives on Royal Mail to become efficient were robust, and Ofcom could identify if Royal Mail was not responding to the efficiency challenge.

- 7.20 Royal Mail argued that any assessment of efficiency improvements should take into account other issues that might affect its costs such as changes in the mix of mail and increases in the number of delivery points⁸⁴.
- 7.21 Some respondents argued that we should set out in advance the year-on-year efficiency gains we expect Royal Mail to deliver. A number of other respondents including large customers, the MUA, the PPA, and Consumer Focus considered that Ofcom should benchmark Royal Mail's operating performance against other national postal operators (e.g. European counterparts) and even other network industries.
- 7.22 Conversely, the CWU welcomed the proposal not to implement explicit efficiency targets as it argued that those set by Postcomm for the current price control had proven to be unachievable. In particular, it argued that efficiency was more complicated than simply meeting targets and it would like to see an open debate about the meaning of efficiency in Royal Mail.
- 7.23 In addition to efficiency, many respondents including UK Mail, large customers, Which? and Age UK also agreed that monitoring must include measurement and reporting of Royal Mail's service performance for universal service and access products as there was a risk of a degradation in quality of service alongside price increases. In particular, this was considered to be a concern if Royal Mail had an incentive to increase prices and/or degrade quality rather than improve efficiency. This was especially the case for universal service products where it was considered domestic consumers were unlikely to benefit from increased competition in the near future.

c) Monitoring the impact on customers and consumers

- 7.24 Which? considered that Ofcom should be attentive to market developments and responsive where Royal Mail's conduct might harm the interests of consumers. As well as monitoring quality of service (discussed above), some respondents including the CWU, the BIS Select Committee and Consumer Focus also considered that the monitoring regime should ensure that universal services remained affordable. Vulnerable consumers, small businesses and rural customers were all identified by various respondents as particular areas of focus when considering affordability.
- 7.25 The detailed comments made by respondents that relate to our approach to affordability for universal services (including packets) and whether current prices are affordable are discussed as part of the safeguard cap in Section 8. Here we focus on the responses which directly relate to the role of affordability within the monitoring regime.
- 7.26 As a result of its concerns around affordability, the CWU considered that Ofcom should fully assess the impact of price rises on domestic consumers and small businesses on an annual basis to ensure universal service products remained affordable. The CWU believed that this would still enable price rises but could better ensure that the interests of customers dependent on the universal service were protected. Similarly, the BIS Select Committee argued that the consequences of price increases for vulnerable consumers should remain a priority for Ofcom, and the regulatory model should include the ability to re-open this issue if need be.

⁸⁴ It also noted that it was developing proposals for the measurement and monitoring of efficiency.

- 7.27 The Scottish Churches Rural Group considered that we should not move to a monitoring regime until further research had been undertaken on affordability.

d) Monitoring the impact on competition

- 7.28 Many respondents including access operators, user groups and large customers (including TNT, DMA, UK Mail) agreed that competition needed to form part of the monitoring regime if greater commercial freedom was to be given to Royal Mail. In particular, one respondent argued that the regime should be used to support competition (including packets) and the market as a whole, whereas it considered the proposed regime would only monitor Royal Mail's ability to fund the universal service and preserve downstream access. There was a general view that Royal Mail would have strong incentives to act anti-competitively.
- 7.29 Secured Mail argued that despite competition being one of the key safeguards, there was a real risk that competition law and the regulatory conditions aimed at preventing anti-competitive behaviour (such as the proposed ex ante margin squeeze regime) would be slow, unwieldy and ineffective, potentially leading to market exit before any remedy was effective. It therefore argued that there was a real risk that Royal Mail would increase barriers to entry.
- 7.30 It was suggested by several respondents including access operators and large customers (including TNT, DMA and UK Mail) that monitoring must include the identification of a range of scenarios of anti-competitive behaviour, and include effective and prompt measures to prevent and address these. Such scenarios identified were:
- a) Setting prices to hinder upstream competition;
 - b) Setting final delivery prices which are not based on a fair allocation of costs;
 - c) Frequent and unpredictable movement of underlying costs and related prices;
 - d) Failure to achieve equivalence between Royal Mail retail and access operators;
 - e) Different and unjustified pricing to similar customers;
 - f) Excessive and discriminatory pricing for non-universal services;
 - g) General abusive, damaging or exploitative behaviour from Royal Mail;
 - h) Imposition of unfair or unreasonable terms on customers; and
 - i) Anti-competitive cross-subsidy from captive parts of the market to the competitive areas e.g. to damage competition in the packets market.

Publication of information

- 7.31 Many of the respondents across all categories (except Royal Mail) asked for more data to be in the public domain. While many of these responses relate directly to the publication of regulatory financial reporting data (and so are discussed in Section 11), several respondents considered there was a lack of detail in relation to the monitoring regime proposals more widely, including what form of 'performance scorecard' Ofcom intended to publish.

- 7.32 Some respondents (including Postaf, MUA, and Intellect) considered it important that clear and granular data (including financial information) be made available to stakeholders. They also considered that Ofcom should establish an appropriate reporting regime to stakeholders alongside the monitoring regime to increase industry understanding and confidence. In addition, some respondents considered it was appropriate to provide a breakdown of the profitability of the universal service to allow key stakeholders to understand decisions being taken in relation to it. Postaf proposed two objectives for such a regime:
- a) To help overcome the historical lack of trust and confidence in Royal Mail by reporting with the maximum disclosure possible; and
 - b) Provide regular feedback to stakeholders on Ofcom's performance in regulating a dominant market supplier.

Regulatory review / re-opening the regulatory regime

- 7.33 The BIS Select Committee explicitly agreed with Ofcom that it should retain the ability to step in and reregulate prices if a failure to deliver efficiency savings resulted in additional significant price rises.
- 7.34 TNT was concerned about the proposed reliance on the threat of re-regulation to constrain Royal Mail's behaviour and questioned whether this threat would be sufficiently strong. It argued that given Ofcom's comments on the suitability of the price control, it was not clear what type of re-regulation might be appropriate or even whether regulation could be re-introduced given our primary duty. TNT also considered that this approach did not provide market certainty, particularly if it might affect investment decisions.⁸⁵
- 7.35 A number of respondents (including Secured Mail, MCF, SLG Economics, and the MUA) considered that we should put in place and publish thresholds or triggers for when regulatory action was appropriate. Some, including the MCF and an access operator, recommended the use of 'warning signs' (orange lights) and 'calls to action' (red lights), based on key thresholds for particular elements, ratios etc⁸⁶. To do this, they proposed that we could set a range of monitoring thresholds and regularly report on whether any had been breached by Royal Mail and if so, the action it had taken or was proposing to take to reassure customers and competitors that the problem would be corrected. One large customer and a user group considered trigger events for an interim review should be used, and could include significant variations from Royal Mail's projections for volumes and revenues to allow for a timely re-evaluation of changing market circumstances.

Our assessment

- 7.36 We consider that monitoring will be an essential safeguard within the regulatory regime to manage the risks associated with the removal of a price control and allow us to fulfil our statutory duties, to ultimately ensure the delivery of a universal postal service. This is a view reflected in many responses. In particular, monitoring will enable us to recognise potential problems and investigate as appropriate, but still

⁸⁵ Royal Mail stated that for the threat of re-regulation to be credible Ofcom would need to monitor its performance.

⁸⁶ E.g. to assess efficiency improvements, Ofcom might start to be concerned (orange) if cost reduction were less than X% of product costs and consider the need for a regulatory review if they were less than Y% of product costs.

allow Royal Mail the flexibility to address the challenges facing the business. Therefore we intend to set in place a comprehensive, detailed and regular monitoring regime, which we now discuss.

How we will be monitoring

- 7.37 A frequent request made in responses was for greater clarity as to how we will actually monitor these areas. Taking into account our analysis of Royal Mail's plan, the aims and risks of our proposed regulatory regime and the views of respondents, we have concluded that the following approach is the most appropriate to support the provision of a sustainable universal service.
- 7.38 As identified in the October consultation and discussed in 7.10 above, we consider there are four key areas of risk associated with removing the majority of price controls which may undermine the provision of the universal service, and therefore will need to form part of our monitoring regime. These are:
- a) Financial performance;
 - b) Operating performance;
 - c) Customers and consumers; and
 - d) Competition.
- 7.39 The detailed consideration of these areas and the particular aspects we will be monitoring for are set out below. However, it is useful to first set out the process by which we will monitor before discussing the detailed areas of consideration.
- 7.40 We intend to conduct regular internal Ofcom analysis and review of the data and indicators that relate to each of the four areas, in order to allow timely identification of potential areas of concern. The output of this ongoing analysis will be kept under regular review by Ofcom through provision of data to the internal governance bodies on a regular basis. To do this, we will largely use the data we receive as part of the regulatory financial reporting requirements. This data will be provided on a monthly, quarterly and/or annual basis (see Section 11 for detailed description of the data that will be provided).
- 7.41 Stakeholders will also hold a range of market specific information as part of their own business-as-usual processes which will be important in understanding the market context (as well as the Royal Mail/universal service specific data). Therefore many stakeholders are likely to be in a position to provide evidence to be used as part of the monitoring regime which can inform our analysis, particularly if they identify potential concerns with how the regime is operating.
- 7.42 We will be able to seek the views of stakeholders throughout the monitoring regime (without immediately having to undertake a full regulatory review, discussed further below) to understand the issues and key drivers⁸⁷. As part of this, we encourage stakeholders to engage with Ofcom and Royal Mail to exchange views on market developments, and this could potentially be through industry meetings hosted by us as suggested by one respondent (subject to demand from stakeholders). How this

⁸⁷ As well as the provision of information more informally through discussions, stakeholders will also be able to raise concerns more formally (for example, through the dispute or Competition Act 1998 routes), although these processes are distinct from the monitoring regime and as such have their own framework.

stakeholder engagement will take place can be considered further after this statement, but we do not consider it necessary to make this a statutory requirement at this stage.

- 7.43 Our view is that to be effective, this will need to be a holistic analysis taking into account a range of indicators and data (and their impact on the provision of the universal service) over time. If we were to consider any indicator in isolation this might be misleading, due to the interactions between the measures. For example, significant cost savings might be considered positive for the provision of the universal service if viewed in isolation, but if they were as a result of severe quality of service degradation, this might raise concerns. Conversely, a significant increase in profitability above what would be considered a reasonable rate of return (as discussed in Section 5) might raise concerns if considered in isolation. However, if this were due to a significant reduction in costs (and was therefore a reward for such efficiency gains), then this could still be consistent with our regulatory duties in the short term. Therefore in order to effectively monitor market developments and Royal Mail's performance, it will be necessary to take all relevant factors into account to get a complete picture, and for this analysis to be regularly carried out over time.
- 7.44 Relevant, reliable and timely information (including financial data) is vitally important for the monitoring regime to be effective. We welcome the provision of internal data used by Royal Mail to run its business, and agree these will provide a useful supplement to the other data sources we will rely on to understand Royal Mail's financial and operating performance. However, as Ofcom will have some different concerns to Royal Mail's management and Board, this information is unlikely to be sufficient on its own to support the monitoring regime. The requirements of the regulatory financial reporting are set out in Section 11.
- 7.45 Regarding some respondents' views about using the monitoring regime to limit Royal Mail's pricing freedom, we consider this could undermine one of the key objectives of removing the substantial majority of price regulation i.e. that Royal Mail rather than Ofcom is better placed to determine how and what price increases should be applied. The respondents' proposal would involve Ofcom acting as a gatekeeper for Royal Mail's pricing decisions, which would likely reduce Royal Mail's responsiveness to market changes and might distort its incentives and behaviour⁸⁸. At the same time an apparently generous maximum price rise could have the effect of becoming a loose price control, with the perception of such price rises having 'regulatory approval'. Instead, we consider the other elements of the regulatory regime (including competition, the safeguard cap and monitoring) will provide sufficient protection for customers without the need for the monitoring regime to place a direct limit on Royal Mail's commercial flexibility.
- 7.46 Finally, we acknowledge the specific concern that many stakeholders will rely on the regulator to identify and respond to many issues due to information asymmetry and the lack of internal resources/expertise. This is in part why we proposed such an active role for Ofcom in the monitoring regime to allow us to identify concerns and react as considered appropriate (notwithstanding the potential role for some stakeholders in providing information and evidence to support the monitoring regime as necessary).

⁸⁸ For example, this could incentivise frequent but unpredictable price increases just below the cap to avoid regulatory review/industry consultation, which could reduce market certainty.

What we will be monitoring

- 7.47 As set out above, the main reason to remove traditional price controls, subject to appropriate safeguards, is to provide Royal Mail with the commercial flexibility to address its financial position and therefore ensure the sustainability of the universal service (in line with our primary duty). In light of this, we are not intending to use the monitoring regime to assess or opine on the appropriateness of every decision Royal Mail makes, but to allow us to monitor and understand a range of indicators that will affect the provision of the universal service over time (focused around the four key areas of financial performance, operating performance, customers and competition).
- 7.48 However, in granting Royal Mail pricing flexibility, it is in our view essential to ensure that this is used in a way that accords with our regulatory objectives in respect of the universal service. While in the short term we expect that Royal Mail will need to improve the viability of the universal service through price rises, beyond that, it must also rely on efficiency improvements. Moreover, it must continue to deliver and sustain the service quality it provides in relation to the universal service. Therefore, an outcome which undermined the provision of the universal postal service would raise concerns, and so if fundamental concerns arise, we may consider additional regulatory intervention (discussed further below).
- 7.49 We now discuss stakeholders' responses that relate to the specific details of the four key areas of concern that underlie the provision of a sustainable universal service, and set out the range of data we will be regularly analysing (including some of the potential issues we will be seeking to identify, should they arise) as part of the monitoring regime.

Monitoring financial performance

- 7.50 We think it will be important to monitor Royal Mail's overall financial performance, particularly in relation to any short-term behaviour that may threaten the long term sustainability of the universal service, and this was agreed by many stakeholders. To do this, we will monitor a range of financial performance measures that will highlight significant deviations relative to expected outcomes that could potentially threaten the universal service. This includes data such as Royal Mail's overall revenues, costs, volumes, operating profits and cash flows.
- 7.51 In relation to profitability, Section 5 sets out our approach to an indicative EBIT margin range for Royal Mail, based on a review of market, comparator and Royal Mail specific data. Under this approach there are clear principles which set out the level of return that we would expect in order for Royal Mail to be financeable. Comparing Royal Mail's performance to this will give us some understanding of where Royal Mail's finances point us in terms of the implications of our regulatory regime, which will supplement and help inform the analysis in the monitoring regime. These are:
- Within the indicative EBIT margin range (assumed to be 5% – 10%), Royal Mail's return would be broadly consistent with comparators in other markets, and would only be likely to raise concerns if this appeared to be driven by price rises and/or quality of service degradation and/or weak efficiency improvements. Therefore the monitoring regime will need to consider all of these areas, discussed further below.
 - As set out in Section 5, there are a range of reasons why the return may increase above the benchmark range, including some which are consistent with the long

terms sustainability of the universal service and some which are not. Therefore, amongst all the factors that will be monitored, there would be particular focus on understanding if such a return was being achieved through cost savings over time, or only through significant price increases and/or quality of service degradation.

- If the return was to decrease below the range, the universal service would not be financially sustainable in the short-term. It is possible that a failure to improve efficiency (and/or resolve its capital restructuring) in a declining mail market in which price rises cannot compensate for falling volumes might push Royal Mail towards and below this lower boundary. If this level persists then Ofcom may need to reconsider the regulatory framework. Therefore as part of the monitoring regime we will need to consider whether such a return is the result of failure to achieve sufficient efficiency gains or whether there are wider considerations (for example, the burden imposed by the universal service).

7.52 Therefore, it is clear from this than when monitoring financial performance it will be particularly important to consider quality of service, efficiency and absolute price levels. Each of these is discussed further below.

7.53 As such analysis of financial metrics will be a key part of the holistic approach to monitoring over time as its insight when considered in isolation is potentially limited (or even misleading) due to the interactions with the other areas we will be monitoring.

7.54 We consider that the regulatory financial reporting requirements⁸⁹ will provide sufficiently granular data to enable us to understand the contributions of different groups of products to the common costs of the activities undertaken for, or in connection with, the provision of the universal service (and the profitability of the universal service itself) that will in turn enable us to identify potential areas of concern.

Monitoring operating performance

7.55 We have previously set out the importance for the long term sustainability of the universal service of Royal Mail achieving significant efficiency gains, and we therefore consider that operating performance is an important element to the monitoring regime. This was a view supported by many respondents. As is the case with all elements of the monitoring regime, we will be able to act if Royal Mail fails to respond sufficiently to the efficiency challenges it faces over time (see the discussion of regulatory review below). As such, we will be regularly monitoring key cost data to determine if these efficiency challenges are being adequately addressed.

7.56 We will be focusing on cost reduction when considering the operating performance of Royal Mail as this is a key objective of the regulatory regime (i.e. not the detail underlying the costs such as headcount etc). Costs will need to be considered over time (to allow efficiency gains to be realised), and in conjunction with a range of other factors (such as quality of service, as we acknowledge the risk Royal Mail could degrade quality in order to reduce costs rather than improve efficiency).

7.57 Although the primary focus will be on costs (using data provided as part of regulatory financial reporting), we agree with Royal Mail's response that mix and other factors may affect efficiency and so this may require additional information around the

⁸⁹ E.g. the product profitability statements - see full discussion of reporting requirements in Section 11.

factors which underlie changes to costs to enable understanding of the financial results (as discussed in Chapter 5). There are a range of factors we may need to consider to help understand and interpret operating performance, such as changes to volumes and mix, modernisation investment, and overall internal targets/modernisation plan (particularly in the short term).

- 7.58 While we might need to understand such operational factors underlying cost savings, our focus will be on the efficient provision of the universal service (i.e. costs), rather than the appropriateness or otherwise of the methods to achieve those savings. This is not least because we consider that Royal Mail should be better placed than Ofcom to identify the drivers for efficiency gains and ensure their timely implementation, particularly given that Royal Mail should already have sufficient efficiency incentives (as discussed above).
- 7.59 As such, we do not consider that it is currently appropriate for us to comment further on Royal Mail's approach to improving efficiency or the targets it is setting itself. Similarly, we do not consider it necessary at this stage to set out our own efficiency targets. We also do not consider that it is necessary in the short term to benchmark Royal Mail against other universal service providers as country specific variables make precise quantitative comparisons difficult and less meaningful (for example some other operators are at very different stages of their modernisation plans).
- 7.60 However if over time the monitoring regime identifies potential concerns about operational efficiency, we could, if it was considered necessary and appropriate in the future, include our own analysis (such as qualitative international comparisons) to inform our own view of what a 'good' outcome for operating performance might look like.
- 7.61 We also recognise the concern that in order to improve its financial position, Royal Mail may seek to degrade quality of service rather than improve efficiency. Quality of service will form a key part of the monitoring regime for universal services. As set out in Section 12 we will continue to set quality of service targets for universal services, and Royal Mail's achievements against these will be reported publically as well as being monitored internally by Ofcom as part of the monitoring regime. If Royal Mail fails to meet these targets, we can launch an investigation and take action for breach of a regulatory condition. We also set out in Section 10 that we will continue to require transparent reporting of quality of service for access services.

Monitoring impact on customers and consumers

- 7.62 The main concerns raised for consumers are regular, significant price increases and quality of service degradation. As well as issues in their own right, these would be of particular concern for us if they also occurred in lieu of increased efficiency. Both of these scenarios could undermine the provision of a universal postal service. As a result, both pricing for universal services and quality of service will form a key part of the monitoring regime.
- 7.63 The European Directive and the Act both require the provision of universal postal services at affordable prices. In the October consultation, we relied on the evidence set out in Postcomm's discussion paper on affordability⁹⁰ which concluded that as the

⁹⁰ The building blocks for a sustainable postal service: Universal service - Discussion paper on affordability. February 2011. <http://stakeholders.ofcom.org.uk/binaries/post/1809.pdf>

average household only spent 40p⁹¹ per week on postal services, universal postal prices are affordable for residential customers now and for the foreseeable future. We also considered that while the issue of affordability is more complicated for small businesses, it was our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses⁹².

- 7.64 We set out our full analysis and assessment of the affordability of universal services in Section 8 as part of our discussion of the safeguard cap. In summary, in light of responses to the October consultation and the previous analysis, we do not consider that current prices raise affordability concerns for small business or residential customers⁹³. Therefore we do not consider that affordability acts as a barrier to our proposed regulatory regime (particularly in light of the safeguard cap which provides additional ex ante protection for vulnerable consumers). However, going forward, we are going to be monitoring prices and will look to further understand consumer behaviour in relation to the use of postal services. This will include further consideration of our approach to affordability and whether future changes to prices of universal services continue to be affordable, as considered appropriate and necessary.
- 7.65 As well as affordability, we will also be considering the extent to which prices reflect the costs of providing universal service and access products (as set out in the October consultation). We consider that the data to be collected as part of the regulatory financial reporting will enable us to monitor the extent to which pricing reflects this requirement. We also intend to consider this area further to ensure pricing takes account of the costs of providing the service into the future.
- 7.66 The importance of quality of service and the interactions with the other areas we are monitoring are discussed above. However, as well as any formal quality of service targets, changes to the non-price terms in general for universal services will also be important to customers. Therefore, we will also consider non-price changes for universal services as part of the monitoring regime, on the basis of the requirement for all universal service terms and conditions to be fair and reasonable (as discussed in Section 4). In addition, we note that changes to non-price (as well as price) terms for universal services will be subject to the one month notification requirement (set out in Section 6).
- 7.67 Changes to non-price (and indeed price) terms for non-universal services may also be relevant to the extent that they have the potential to undermine the universal service (for example, through short term behaviour discussed in Section 6). This is due to the relevance of non-universal services to the sustainability of the universal service given the contribution made by all products (i.e. not just universal services) to the common costs of the network⁹⁴. Therefore while our duty relates to the provision of a universal postal service, non-universal service products (such as bulk mail) are important to support the financial provision of the universal service. As such we

⁹¹ As set out in Section 8, the 2011 ONS report found that on average consumers spent 50p per week on postal products.

⁹² Paragraph 6.955 of the October consultation

⁹³ We recognise the concerns raised by respondents about affordability for rural customers, but given the geographically uniform pricing requirement for universal services, we consider that affordability for rural customers is largely in line with those of small businesses and/or residential customers more generally (including vulnerable consumers). Therefore for ease, we refer to residential customers, vulnerable consumers, and small businesses.

⁹⁴ This is in part linked to the discussion of cross-subsidisation and assessing the relative contributions of product groups to the common costs of the network, set out below under "Competition".

recognise that it is important to take into account the needs of these customers and the impact of our proposals on market confidence to the extent they may affect the provision of the universal service (as discussed in Section 6).

- 7.68 As part of the monitoring regime, we will therefore review price and non-price changes for universal services over time (including the impact this has on volumes), with particular regard to affordability and the costs of provision. We may also consider price and non-price terms for non-universal services (as considered necessary and appropriate), to the extent these may have an impact on the long term sustainability of the universal service. This will all be considered in the round alongside the financial, operational and competition metrics.

Monitoring impact on competition

- 7.69 As discussed in Sections 9 and 10, effective and efficient competition can generate benefits, and so where monitoring can usefully and meaningfully contribute to this (and therefore the postal market more widely) it should do so. The October consultation⁹⁵ proposed to monitor access prices and changes to access prices, transfer charging, and cost allocation. All of these areas are important not only for competition reasons in the market as a whole, but also for the sustainable provision of a universal service given the contribution of all products (not just universal services, e.g. bulk mail) to the common costs of the network.
- 7.70 This monitoring combined with our decision on mandating access for retail D+2 and later Letter and Large Letter services at the Inward Mail Centre, the ex ante margin squeeze test and the ten-week notice period for access price changes (and appropriate notice period for non-price changes) discussed in Section 10 largely address the majority of the access-related competition concerns raised by respondents⁹⁶. Further, the dispute resolution process will provide a route for access operators to raise complaints, for example if they are concerned about unfair or unreasonable access terms.
- 7.71 In addition to this, monitoring will also need to consider the relative extent to which different sets of products are contributing to the costs of the activities required for the provision of the universal service. This will enable us to understand the extent to which high margins for products where competition is limited are being used to anti-competitively cross-subsidise low prices where Royal Mail does face competition (a concern raised by several respondents). As well as universal services and access, the monitoring of relative cost contributions will also include non-universal service retail products at an aggregate level, as considered appropriate⁹⁷. For this, we will use the data to be provided as part of regulatory financial reporting, including the product profitability statements.
- 7.72 For these areas that will form part of our ongoing monitoring regime, we will have regular oversight of financial data to inform our view, which will better enable us to respond should we identify a potential concern.

⁹⁵ Paragraph 6.89 of the October consultation

⁹⁶ For example, non-equivalence on price terms, margin squeeze, unreasonable/variable cost allocation etc

⁹⁷ This is not just for competition reasons as described above, but also to the extent that short term behaviour in relation to non-universal services has the potential to undermine the sustainability of the universal service itself (given their contribution to the common costs of the network). This is discussed further above in relation to the impact on customers.

- 7.73 As set out in the December consultation⁹⁸, there is no regulatory requirement on Royal Mail to continue to provide any non-universal services and under the Act Ofcom is not able to implement a price cap on these services. In light of this, it would seem inconsistent to place these services under the active monitoring regime from the perspective of customer protection. Further, this consultation⁹⁹ considered that many retail non-universal service customers have a choice of operator, which should provide some protection for retail non-universal service customers.¹⁰⁰
- 7.74 Equally, a monitoring regime cannot be implemented with the intention of imposing ex ante regulation on these services on the basis of a 'risk' of anti-competitive activity. This is because it is clear that the Act is not intended to provide us with the power to impose extensive ex ante regulation of non-universal services. However, as with other industries, these services are subject to competition law, and as such, stakeholders can raise a complaint under the Competition Act if they consider competition law has been breached (subject to meeting the requirements of Ofcom's guidelines¹⁰¹). Therefore, should any such issue occur, they would most likely be addressed on a case by case basis through this mechanism, taking into account all relevant evidence, including any evidence gathered through the monitoring regime.

Publication of information

- 7.75 We consider that it is important for there to be sufficient transparency of the monitoring regime and that key pieces of data/information are also made public, as raised by several respondents. This is not only to increase trust and confidence in the monitoring regime, but also to help industry identify particular issues if concerns are raised by their own market knowledge. As such, a large amount of information on postal services will be publicly available given the reporting and monitoring arrangements we are putting in place:
- a) Each year going forward, we will set out in our annual report our view on how the regulatory regime is working to secure our duties, and this statement will be informed by the analysis in our ongoing monitoring regime. This is in line with the legal requirement in the Office of Communications Act 2002 (as amended by the 2011 Act) for us to include in our annual report a statement about Ofcom's performance in relation to our duty to secure the provision of a universal postal service.
 - b) We have also concluded that it is appropriate to publish key postal market data in an annual market context update, which we expect to include key market developments and relevant financial and operating metrics (subject to commercial confidentiality). This is to increase transparency of data to stakeholders and to help build confidence in Royal Mail and the monitoring regime – it is not intended to be a market or regulatory review and so we do not consider it would raise regulatory certainty concerns.
 - c) A range of financial data will be publicly available due to the regulatory financial reporting requirements, discussed further in Section 11; and

⁹⁸ Paragraph 5.122, the December consultation

⁹⁹ Paragraph 1.15, the December consultation

¹⁰⁰ Nonetheless, as discussed in Section 9 below, we will also monitor the development of end-to-end competition and its effect on the financial sustainability of the universal service.

¹⁰¹ Guidance on submitting competition complaints to Ofcom is set out in the Draft Enforcement Guidelines, 31st October 2011. <http://stakeholders.ofcom.org.uk/binaries/consultations/draft-enforcement-guidelines/summary/condoc.pdf>

- d) Universal service pricing and non-price terms will be publicly available through the price and non-price notification and publication requirements (discussed in Section 6).

7.76 This data and information is all in addition to the business as usual provision of industry data by Ofcom through the Communications Market Report. This will provide general postal market data (as it does for all the sectors we regulate), including a summary of developments in the postal market and key pieces of data such as industry volumes and customer data (including quality of service for universal services). Some international data will also be provided through the International Communications Market Report.

Regulatory review / re-opening the regulatory regime

- 7.77 As set out above, we will be monitoring a range of data and indicators in combination¹⁰² through the monitoring regime to understand market developments and Royal Mail's performance in delivering a sustainable universal service. Importantly, we are not seeking to use the monitoring regime as a de facto control on Royal Mail's behaviour (as discussed above), but instead as a mechanism to identify significant concerns given our duties (and so understand if regulatory action might be required). As such, we would generally expect the default position to be regulatory observation and understanding for the duration of the monitoring regime.
- 7.78 Crucially, however, this is subject to two high level variables: Royal Mail's behaviour and significant unanticipated market challenges. In relation to the former, Royal Mail's response to the increased commercial flexibility will be a major factor in the role of the monitoring regime due to the associated risks of removing price controls that the safeguards are designed to address. For example, we may be concerned if the monitoring regime revealed persistent negative performance in at least one indicator (discussed further above e.g. profit, cost levels, progress in modernisation, price levels and quality) over time without sufficient mitigating factors/explanation. Therefore if Royal Mail uses its commercial freedom to act in a way that does not support the regulatory objectives and so may undermine the provision of the universal service, then we need to be in a position to intervene as appropriate.
- 7.79 In relation to the latter, the postal market has experienced fast paced changes, and this is expected to continue in the future. If broader market conditions (e.g. factors outside of Royal Mail's direct control) turn out to be significantly more challenging than currently anticipated, the provision of the universal postal service could still be under threat even if Royal Mail responds to the increased flexibility appropriately (and in a manner consistent with our regulatory objectives). As a result, regulatory intervention within the seven years may be necessary to help address this.
- 7.80 Therefore whether it is a result of Royal Mail's behaviour or severe unanticipated market challenges, we consider that throughout the duration of this regulatory regime we will maintain the ability to intervene and conduct a regulatory review if the monitoring regime identifies fundamental and persistent concerns that undermine our duties in relation to post.
- 7.81 While we will be in a position to intervene at any point during the seven year duration, we fully recognise the impact this may have on regulatory certainty and the complexity and interactions underlying all the data we will be monitoring (as

¹⁰² This is particularly important given the interactions between the different measures, such as between profitability and costs, prices, and volumes.

discussed above). As such, on identification of a persistent concern(s) which may threaten the sustainability of the universal service, we would expect to initiate a dialogue with Royal Mail and stakeholders to further understand the concerns and to assess whether regulatory intervention and review was indeed necessary.

- 7.82 As well as interactions between the data, it is important to note that a potential threat in one area or period of time does not automatically mean that there is a fundamental risk to the provision of the universal service, particularly in light of Royal Mail's current financial position. This is because detailed consideration of the indicators in the short term may show variability and potential areas of concern, but short term adjustments are likely to be necessary during the transition process in the interest of the longer term sustainability of the universal service given other developments and future expectations¹⁰³. Therefore it will be important to assess some performance indicators over time (particularly in the short term) to fully understand their impact.
- 7.83 This is an example of where seeking the views of stakeholders can add important context. However, this would not limit our discretion to intervene in the short term if we identified a significant and immediate issue in relation to Royal Mail's behaviour (such as significant delays in modernisation or making a material change to operations which would undermine Royal Mail's ability to meet quality of service requirements) or the market conditions that undermine the universal service.
- 7.84 If the analysis in the monitoring regime and subsequent engagement with industry indicated a need for regulatory review and intervention, this could lead to intervention (in relation to price and/or non-price regulation) ranging from a modification to the existing regulatory regime to a full review/re-opening of the regime (including the specification of the universal service), as was considered necessary and appropriate. However, the form and timing of any intervention would very much depend on the circumstances, and as such would be considered on a case by case basis taking into account the views of stakeholders as appropriate. By initiating dialogue before launching a review, this would not only reduce uncertainty, but would also enable us to actively seek and understand the views of stakeholders.
- 7.85 We note the concern raised by respondents about the credibility of the threat of future regulatory intervention, particularly in response to adverse behaviour by Royal Mail in light of its increased flexibility. As set out above, Ofcom will be taking an active role through the monitoring regime. It is in part because of this and the retained ability to intervene that we do not consider the threat of re-regulation to be a weak constraint on Royal Mail's behaviour. While we currently consider the removal of price controls to be the most appropriate approach to meet our duties, this does not mean there are no alternative approaches to regulation that could be used under a different context or if Royal Mail does not respond appropriately to the increased commercial flexibility.
- 7.86 The impact of possible future re-regulation is further supported by Royal Mail's own incentives. Royal Mail's response to our consultation made it clear that it has a strong preference not to be regulated. It is inevitable that there will be some costs to any regulated company of regulation. We consider that there will be significant incentives on Royal Mail to act in a manner that ensures a deregulatory regime continues. We recognise that such incentives could be outweighed by commercial considerations, which is part of the rationale for the monitoring regime being defined in such a way

¹⁰³ For example increased costs in one period may raise concerns, but if they have been incurred in order to realise future efficiency savings they are not necessarily inconsistent with the long term sustainability of the universal service.

as to regularly monitor and allow intervention if necessary in a timely manner, as discussed above. Therefore the threat of intervention and re-regulation is a very real one.

- 7.87 Whilst the potential to intervene as a result of Royal Mail's behaviour or market conditions may reduce regulatory certainty, we consider that our proposed approach to monitoring ensures sufficient engagement with stakeholders that if a regulatory review was considered necessary at some point in the future it would not be unexpected and would be likely to be after other less intrusive measures had been considered.
- 7.88 Whilst the previous discussion of areas to be monitored provides some guidance on the sort of scenarios that may raise concerns in the future, we consider it inappropriate and potentially damaging to provide a more definitive view of when we would intervene at this stage. This is not least because the active, ongoing nature of the monitoring regime described above makes the need for explicit trigger points for regulatory review unnecessary, particularly given the breadth of indicators to be analysed. In particular, we will be reviewing the data regularly so we will not need to wait for a particular trigger to be breached before we identify (and can therefore investigate) a potential area of concern.
- 7.89 In addition to not considering explicit triggers to be necessary given our overall approach, we have also identified the following issues with setting them as part of the monitoring regime to trigger regulatory review:
- a) **Difficulty in setting clear, measurable and meaningful thresholds** – this is because of the significant interactions between the different measures that, if considered in isolation using a traffic light system such as the one proposed by some respondents, might raise concerns but when considered in the context of other developments and future expectations it may be consistent with our regulatory duties. The use of formal, quantitative triggers could therefore lead to inappropriate regulatory intervention (or regulatory uncertainty due to the perceived risks of a regulatory review).
 - b) **It may lead to perverse incentives on Royal Mail** - and it is likely to be difficult to balance the incentives created when defining explicit triggers. In one extreme, we could set a tight threshold to provide maximum protection for consumers, but this would reduce Royal Mail's commercial freedom and potentially act like an implicit control in its own right. In the opposite extreme, setting the thresholds too loosely might provide Royal Mail with an explicit incentive to take an easier approach and sit just below all the thresholds which could be perceived as 'regulatory acceptance' of a particular performance level.
 - c) **Limit our regulatory discretion and responsiveness to changes in the future** – this is because it is unlikely that we could foresee all market developments and potential concerns, particularly given the fast changing market environment. For example, if we were reliant on a breach of a particular trigger before we could investigate a potential issue further, this may make the monitoring regime unresponsive.
 - d) **May inappropriately limit Royal Mail's commercial decision making** - it is likely that setting explicit triggers would also complicate Royal Mail's decision making process in order to balance the impact across the triggers, even though there might be legitimate reasons for some of the thresholds to be exceeded from time to time.

- 7.90 Therefore we consider that explicit thresholds are not necessary to trigger a regulatory review given the active monitoring regime. In addition, we consider that these interactions and definition difficulties mean that it is not possible to set meaningful explicit thresholds that are internally consistent for all possible negative states of the world for all the individual indicators we are monitoring. This is why we propose to consider all of the relevant factors in combination through the monitoring regime.
- 7.91 Such an approach will provide us with a greater level of discretion, allowing us to regularly review the performance of Royal Mail as a whole while taking into account a range of factors without relying on a particular trigger being breached before a regulatory review can occur. However, while this may help address many of the concerns of an explicit monitoring approach, we recognise this could increase regulatory uncertainty. In order to minimise this, we have indicated the measures we will be considering above, and will be providing a statement in the annual report setting out our view of how the overall regulatory regime is working to achieve our duties.

Our decision

- 7.92 In granting Royal Mail pricing flexibility, it is essential to ensure that this is used in a way that accords with our regulatory objectives in respect of the universal service. Given this, we consider it is appropriate to implement a monitoring regime to help manage the risks associated with the removal of price controls as well as to increase transparency, and regulatory and market certainty. We intend to set in place a comprehensive, detailed and regular monitoring regime that will enable us to recognise potential problems and investigate as appropriate, but still allow Royal Mail the flexibility to fully address the challenges facing the business.
- 7.93 As a result of this regime, we will be able to monitor particular measures and information to determine the impact of the change in regulatory framework and whether our key duties with respect to the universal postal service are being met. The monitoring regime will encompass a range of different measures, but in particular we need to ensure that:
- a) **Quality of Service** – Royal Mail provides the universal service to the minimum required quality of service levels;
 - b) **Efficiency** – Royal Mail improves its efficiency levels and sustains such improvements thereafter¹⁰⁴; and
 - c) **Affordability** – prices for universal services remain affordable, particularly for vulnerable consumers.
- 7.94 The main features of the monitoring regime will be:

¹⁰⁴ While in the short term we expect that Royal Mail will need to improve the viability of the universal service through price rises, it would not be in keeping with our regulatory objectives if it were to return to a position of sustained profitability, solely as a result of price rises rather than cost reduction. Conversely, a situation where Royal Mail is able to demonstrate a healthy level of profitability that has been driven by cost savings or business improvements would be consistent with our regulatory objective, and would not warrant our intervention

- Regular internal review by Ofcom (including through our internal governance process) of data and indicators around financial performance, operating performance, consumers and competition.
- A role for industry stakeholders to provide market specific information, identify any concerns with how the regime is operating, and engage with Ofcom and Royal Mail to exchange views on market developments.
- The ability to conduct a review of the regulatory framework and intervene if there are persistent concerns that our duties in relation to post will not be met.
- Annual external statement setting out our view on how the regime is meeting our duty to secure the provision of a universal service in the annual report;
- Transparency of data through:
 - External publication of some annual financial data through regulatory financial reporting proposals (see Section 11);
 - Prices and non-price terms for universal services made publicly available due to notification requirements;
 - Summary of developments in the postal market in our annual Communications Market Report (and international data through our annual International Communications Market Report); and
 - Additional key postal market data (subject to confidentiality) published in an annual market context update to increase transparency of data to stakeholders.

Section 8

Safeguard cap

Introduction

- 8.1 Section 6 discusses our decision to give Royal Mail additional commercial freedom through removing some of the current regulatory safeguards. This includes removing traditional price controls as, given the current circumstances facing Royal Mail and the market in general, we consider that such controls would not be likely to secure the provision of the universal service. Section 6 also sets out the views of stakeholders in respect of our proposals and our decision to implement the proposal to remove traditional price controls subject to a number of safeguards being in place. One such safeguard is the implementation of a safeguard cap for vulnerable consumers to ensure that a basic universal service product is available to all.
- 8.2 This section discusses the detailed aspects of such a cap to protect vulnerable consumers, including respondents' views on the scope, level, structure and form of the control. We have also taken into account the report from the BIS Select Committee on stamp prices. In addition, we set out our analysis of the arguments raised and our decision in relation to the detailed aspects of this safeguard. We have not repeated the argument and analysis considered in Section 6 on whether or not a more comprehensive price control should be in place.
- 8.3 It is important to consider the combined impact of all the safeguards that are being put in place to protect customers in the absence of a comprehensive price control. Therefore this section should be read in conjunction with Section 7 which sets out our decision on the monitoring regime, and Sections 9 and 10 which discuss end-to-end and access competition respectively. In addition, Section 11 summarises the regulatory financial information that Royal Mail will be required to provide to support the safeguards we are putting in place.

Our proposals

- 8.4 The October consultation set out our proposal to impose a safeguard price cap on a product to ensure that a basic universal service is available to all and protect vulnerable consumers from ongoing price increases. In addition, to ensure that the wider financeability and/or efficiency incentives are not affected, we looked to minimise the impact of the cap on Royal Mail's wider pricing freedom and considered that Royal Mail should be allowed to make a reasonable commercial rate of return on the safeguarded product.
- 8.5 In terms of the scope of the safeguard cap, we consulted on four options:
- First Class stamps (all weights);
 - Second Class stamps (all weights);
 - Second Class stamps for standard Letters; and
 - Both First and Second Class stamps (all weights).

- 8.6 We noted that research undertaken by Postcomm and Consumer Focus¹⁰⁵ showed that most consumers did not need their mail to arrive the next day and set out our assumption that the majority of First Class customers would be able to switch to the Second Class stamp product for at least some of their Letter mail. In addition, we noted that Large Letter and packet products are little used by stamp customers and this is particularly the case for vulnerable consumers and as such we did not have any evidence at the time to support the extension of the cap beyond the standard Letter format.
- 8.7 Therefore, given the evidence on the usage of stamp products and the need to give Royal Mail more commercial flexibility to secure the provision of the universal service, we proposed limiting the scope of the safeguard cap to Second Class Letters. We noted that we would welcome engagement on this issue with consumer groups and in particular evidence of the use of and reliance on Royal Mail's Large Letter and packet products.
- 8.8 We considered the level of the safeguard cap in the context of the likely requirement that certain prices would need to materially increase in the short term to ensure Royal Mail could cover its costs and earn a reasonable commercial return. We proposed that the cap on Second Class Letters should be set between 45p and 55p in 2012-13 and that this should increase by RPI over time. We also left open the possibility of reassessing the level of the safeguard cap in about two years' time in light of any relevant changes in the market and consumer spending patterns.

Responses to consultation

- 8.9 As discussed in Section 6, many stakeholders expressed concern about the removal of price controls given the lack of competition for the majority of universal services. However, the significant majority of stakeholders supported the concept of imposing other safeguards if the proposal to remove traditional price controls was implemented. For example two respondents considered safeguards were necessary to protect consumers from Royal Mail abusing its monopoly power.
- 8.10 Apart from Royal Mail, almost all respondents supported the proposal to impose a safeguard cap to protect vulnerable consumers. For example, one user group noted that regulating the price of the most commonly used consumer products was in line with the US and other European countries. Age UK thought that controlling Second Class stamp prices was a reasonable compromise between full deregulation and ensuring that postal prices remain affordable for all customers.
- 8.11 Other respondents' comments could be categorised into the following areas that have been discussed in turn below:
- Affordability of universal services (for both residential and small business customers);
 - Safeguard cap for Second Class stamp Letters, including the:
 - level of the cap; and
 - structure of the cap.

¹⁰⁵ Postcomm and Consumer Focus, Residential customer needs from a sustainable universal service in the UK, November 2010.

- Extension of the safeguard cap – in particular whether it should be extended to other Second Class stamp formats, First Class stamps and other universal services.
- 8.12 Consumer Focus undertook some research¹⁰⁶ to explore the reactions of domestic consumers to potential stamp price increases. This included whether they would move from First Class to Second Class products and away from post altogether in response to potential price increases. The results of this research have been discussed in relation to the relevant areas below.

Affordability of universal services

Affordability for consumers

- 8.13 Royal Mail considered that empirical evidence showed that there would need to be a substantial increase in the price of Second Class stamps before any affordability issues would be raised, even for vulnerable consumers. It based this analysis on the price increases that would be needed for household expenditure on post to be equivalent to certain discretionary items (such as alcohol, gambling or takeaways) and other utilities. Royal Mail found that the safeguard cap would have to be set at a level at least five or six times higher than that proposed before affordability might become an issue. It therefore did not consider there was any justification for Ofcom to impose a price cap on any universal service product.
- 8.14 In addition, Royal Mail set out its plans to put a targeted discount in place for vulnerable consumers during the heavy usage period of November and December 2012 when it estimates that around a third of social mail is sent¹⁰⁷. It considered this would provide an additional safeguard for vulnerable consumers as any stamps bought at this discounted rate would be able to be used at any time.
- 8.15 A number of stakeholders commented on the analysis Postcomm and Ofcom have undertaken to understand the affordability of universal services. The CWU recognised that determining a definition of affordability for postal services is not straightforward. However, it noted that Ofcom had not set out what proportion of household spending postal services would need to make up before they ceased to be affordable and was concerned that the description set out by Ofcom would not rule out very significant price increases. One access operator questioned what the top end of an affordable price would be and considered that bulk mail prices should not increase as any further declines in these products will have an adverse impact on universal service prices. The Archbishops' Council of the Church of England considered it was essential that a clear definition of "affordable" was provided.
- 8.16 While the BIS Select Committee acknowledged that some increase in stamp prices was appropriate, it was concerned about the impact that price increases would have on vulnerable consumers and small businesses. It disagreed with the approach to assessing affordability by comparing postal prices (and total postal expenditure) with other household expenditure and encouraged Ofcom to consider alternative measures of affordability (such as the ability for vulnerable households to switch resources from spending on things like food budgets to spending on mail). The BIS

¹⁰⁶ Consumer Focus report on potential impacts of stamp price increases on consumers, January 2012. This research was based on two stated preference consumer surveys: an online survey with 2,020 respondents; and 212 face-to-face interviews of vulnerable consumers who had low internet use.

¹⁰⁷ Royal Mail did not indicate whether it would continue such a scheme beyond Christmas 2012.

Select Committee suggested that the pressing issue should be whether vulnerable consumers have extra money to spend on stamps at periods of peak spending.

- 8.17 The BIS Select Committee welcomed Royal Mail's plan to hold stamp prices at their 2011 level for vulnerable consumers for the 2012 Christmas period¹⁰⁸. However, it was concerned about the practicalities of introducing this targeted discount. The BIS Select Committee also considered that any plan to selectively discount at Christmas did not detract from the need for Ofcom to collect data on the actual effects of price increases for vulnerable consumers. It considered that the impact of price increases for vulnerable consumers should remain a priority for Ofcom and the regulatory model needed to include an ability to re-open the issue if required.

Affordability for small businesses

- 8.18 A number of stakeholders also commented on the issue of affordability for other universal service customers. The CWU considered that all domestic and small business customers would continue to need some protection from Royal Mail charging high prices and that their needs were distinct from residential consumers (including posting profiles and sensitivity to pricing). The FSB considered that Ofcom should also ensure that the key services purchased by small businesses remained affordable. UK Mail considered that Ofcom had not adequately explained why such a large price increase was required and the basis on which it was assumed that prices would remain affordable at this level.
- 8.19 A number of respondents disagreed with Ofcom's hypothesis that if universal service prices were affordable for consumers, they would also be affordable for small businesses. The CWU noted that small businesses were dependent on stamped mail (and therefore Royal Mail) and as such changes in stamp prices could have a significant impact on business models and viability. The FSB noted that small businesses were likely to use more diverse Royal Mail services on a more frequent basis than residential consumers.
- 8.20 Intellect, the MUA and CWU believed that Ofcom should also consider small businesses within its definition of vulnerable consumers when determining any safeguards that should be in place to protect these customers. TNT noted that the test for imposing price controls on universal services should be whether they are "affordable for all users".
- 8.21 As noted above the BIS Select Committee was also concerned about the impact of price increases on small businesses, particularly in the current economic climate. It considered that Ofcom's position that affordability for small businesses is the same issue as for consumers was entirely the wrong starting point for assessing the diverse needs of small to medium businesses that often operate on tight margins. The BIS Select Committee recommended that Ofcom and Royal Mail reconsider the available evidence and that Royal Mail should look to set pricing structures that nurture and grow its small business customer base.

¹⁰⁸ Royal Mail evidence provided to the BIS Select Committee, 28 February 2012, see <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmbis/uc1841-ii/uc184101.htm>.

Safeguard cap for Second Class stamp Letters

Level of the safeguard cap

- 8.22 There was a range of responses to our proposal to set the level of the safeguard cap for Second Class stamp Letters between 45p and 55p. A number of respondents recognised the need for an increase in the price of mail products and supported different points within the proposed range. For example, Age UK considered that the price of Second Class Letters should be set at no more than 45p as this was already a substantial increase on current prices and it considered anything higher would be unacceptable. It suspected that older consumers spent more on postal services than the 40p average household weekly expenditure as, for example, they had a significantly higher use of cheques as a payment method and would therefore be disproportionately impacted by price increases.
- 8.23 ONEPOST and Laithwaites Wine noted that research had indicated that customers would pay around this level for a Second Class Letter, although they believed there appeared to be a psychological threshold of 50p. However, they observed that this was a minimum 25% increase which they considered was generous and particularly generous in comparison to other regulated postal operators (noting in particular that USPS was limited to a 2.1% increase).
- 8.24 Royal Mail considered that the level of the cap for Second Class Letters should be set at no less than the top end of the range (i.e. 55p) and inflation linked for the period of the control. It noted that a cap at this level would give it the pricing freedom it needed to respond to adverse changes in market conditions by re-optimising pricing and a lower cap would be likely to constrain its pricing freedom in the medium term. Royal Mail also noted that limiting price increases to no more than RPI was very restrictive and it was therefore important that it had some pricing flexibility built into the level at which the cap is initially set.
- 8.25 As discussed above, Royal Mail believed that there was no risk that universal services would become unaffordable without significant price increases and as such greater emphasis should be placed on giving it additional pricing freedom. It noted that it did not intend to set the price for Second Class Letters to this level in 2012-13 but considered that the higher cap was important to give medium term pricing flexibility as the level would be fixed (in real terms) for seven years.
- 8.26 Royal Mail also considered that, as the Directive requires all universal service prices to be affordable, it was appropriate to compare its prices with other EU countries. It noted that its prices for Second Class stamps were low in comparison to other European countries and that many of these countries had prices at or above the upper bound of the proposed range and some countries did not even offer a Second Class service.
- 8.27 TNT considered that the affordable level of the price cap should be based on research of users' needs but noted that the proposed range did not appear to be unaffordable when looking at the total household spend on postal services.
- 8.28 The DMA and one user group supported this proposal for the level of the safeguard cap as long as it did not distort the market and result in further large price increases for other Second Class products (such as bulk mail). ONEPOST, Laithwaites Wine and Lakeland Ltd were also concerned that the level of the price control for Second Class stamps would be seen as the benchmark for bulk mail prices and noted the impact that price increases may have on volumes in this market (particularly for direct

mail). Lakeland Ltd considered it was essential that pricing for business mail products is independent from changes to the public tariff (universal service products).

- 8.29 A number of customers and user groups objected to the proposed level of the cap for Second Class Letters arguing that the proposed price increase was too large or even in some cases that the current price was too high. For example, the Scottish Churches Rural Group felt that the price needed to be frozen at current levels or there was a danger that Second Class volumes would collapse. A large customer considered that an increase in the price of Second Class Letters to 45p was unreasonably high. The Greeting Card Association was concerned about the impact on the Christmas card market as the average price of a boxed Christmas card is 22p compared to the proposed 45p to 55p cost of a Second Class stamp.
- 8.30 A number of businesses and user associations observed that postage costs for small businesses had increased considerably over the rate of inflation in recent years. They noted the significant impact that postage price increases have on small businesses and considered that further increases would be likely to further exacerbate volume declines. One individual customer considered the Second Class Letter product was currently overpriced and if this very large price increase were implemented it would discriminate against small businesses (particularly in rural areas) and customers who did not have access to broadband.
- 8.31 As noted in Section 6, Consumer Focus' modelling suggested that Royal Mail could achieve reasonable margins by reducing its costs without increasing prices. It was concerned that price increases of the level proposed would increase volume decline, result in financial indiscipline in Royal Mail and adversely impact consumers and small businesses. Consumer Focus also considered that Ofcom had not presented detailed financial analysis of market trends or Royal Mail's future costs and revenues to justify that such large price increases were necessary or that they would set positive efficiency incentives.
- 8.32 In its research, Consumer Focus found that vulnerable consumers with low web use tend to maintain their use of mail products even when faced with significant price increases (which may be due to the lack of alternatives). On this basis, Consumer Focus considered that these consumers are more likely to be affected by significant price rises. On the other hand, it noted that consumers with internet access (even those on low incomes) are much more price sensitive, and are more likely to abandon Royal Mail services entirely when prices reach a certain point. It was therefore concerned that as consumers with web access switched away from mail, vulnerable consumers could be faced with even higher prices to sustain the universal service in the face of these lost volumes.
- 8.33 UK Mail did not consider that Ofcom had outlined its rationale for setting the proposed level of the cap between 45p and 55p. An access operator considered that prices should only be set once product profitability statements based on LRIC costs have been produced and audited. It considered the level of the cap should be set annually and until there was published data on profitability based on LRIC costs it could not support a proposal for such significant price increases.
- 8.34 TNT was also concerned about the issue of discrimination as it believed that retail and wholesale bulk mail prices had in theory been set until now as a discount to the stamp price on the basis of work-share and avoided costs. It considered that this relationship had broken down over time as Royal Mail claimed that stamp prices did not cover the cost of providing the services. TNT considered that it would be useful if

Ofcom provided some guidance on the correlation between single item and bulk mail prices.

- 8.35 A number of customers believed that rather than increasing prices the universal service should be reviewed. One individual considered that there should only be one class of mail.
- 8.36 In addition to its concerns about affordability (discussed above), the BIS Select Committee considered that Royal Mail will need to *“have very careful regard to the possibility of a tipping point affecting volumes”*. It did not believe that the current economic climate would sustain a 53% price increase if Royal Mail was to set its prices at the top end of the proposed range of the safeguard cap. The Committee recommended *“serious consideration of a more modest increase”*.

Structure of the safeguard cap

- 8.37 UK Mail, Which? and Postaf disagreed with the proposal to link the price of the safeguard cap to RPI. They noted that CPI was the Government's preferred inflation measure and was linked to a range of social security payments. Which? noted that RPI was generally higher than CPI and considered there was evidence that there would be greater divergence between these measures in the future.
- 8.38 Postaf and Which? believed that the proposal to link the level of the safeguard cap to RPI was not based on a sound methodological or policy basis and would result in higher price increases than if CPI was used. Which? considered that the current explanation that RPI had traditionally been used by sectoral economic regulators was not a sufficient justification. Postaf considered that while it might only be a small incremental difference, it would nonetheless make a difference for vulnerable consumers.
- 8.39 UK Mail, Which? and Postaf therefore considered that, if the purpose of the control were to ensure a basic universal service is affordable for vulnerable consumers, then the safeguard cap should be linked to CPI rather than RPI. The BIS Select Committee agreed with this view and recommended that Ofcom give serious consideration to using CPI rather than RPI as its inflation measure.

Extension of the safeguard cap

- 8.40 A number of respondents considered that the scope of the safeguard cap should be wider than Second Class standard Letters and should instead include additional products or formats given the lack of competition and choice for the significant majority of universal service products.

Extension of the safeguard cap to Second Class Large Letters¹⁰⁹ and packets

- 8.41 To inform its views on the scope of the safeguard cap, Consumer Focus undertook some research in December 2011 on the potential impacts of stamp prices on consumers. This research found that 35% of consumers claim to send at least one parcel or package and 15% claim to send at least one Large Letter per month. However, vulnerable and low internet usage consumers claim to send fewer packets and Large Letters (14% and 8% respectively). Consumer Focus also found that the insensitivity to price increases of vulnerable consumers with low internet usage

¹⁰⁹ “Large Letters” means any item larger than a Letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.

extended across all formats and products. It was concerned that these consumers would be left to bear the price increases as consumers with online alternatives are more likely to switch away from mail.

- 8.42 Consumer Focus also considered Royal Mail's services were important in ensuring that packages get delivered to rural areas. It considered that this was particularly important given the current trend of increased electronic fulfilment,
- 8.43 Therefore Consumer Focus recommended that the safeguard cap should be extended to Large Letters and packets to protect vulnerable and in particular low internet usage customers. The Archbishops' Council of the Church of England similarly considered that the price cap should be extended to all Second Class services.
- 8.44 UK Mail questioned why the safeguard cap was limited to Letters. It considered that all formats were important to residential and small business customers. One individual considered that to protect vulnerable consumers from excessive pricing it would be necessary also to control Second Class Large Letters and packets. It believed these formats were not substitutable either with each other or the Letter product that Ofcom proposes to implement a cap on.
- 8.45 Royal Mail believed that as Letters account for almost 90% of Second Class stamp volumes it would not be proportionate regulation to extend the cap to other formats. It did not believe that a broader cap would be necessary to meet Ofcom's objectives for the safeguard cap.
- 8.46 In particular, Royal Mail was concerned about the extension of the cap to its Standard Parcels product. It noted that on average UK adults only send one Standard Parcel every seven years. In addition, Royal Mail provided data from its consumer panel survey which showed that only a small group of vulnerable consumers used Second Class packet and parcel products and that even heavy users of the Standard Parcel product would not spend more than 2% of their annual income on packet and parcel products. It noted that this would be unlikely to be considered unaffordable given that a household needs to be spending more than 10% of their income before the Government considers them to be in "fuel poverty". In addition, Royal Mail considered it could be argued that expenditure on Standard Parcels is discretionary.
- 8.47 Royal Mail also noted that consumer choice of which provider to use to send packets and parcels was increasing. It considered this included the use of consolidation websites which enable customers to compare and purchase from different parcel services such as Hermes, City Link, TNT and Collect+. Royal Mail noted that the Parcel2Go website and Collect+ (which uses a network of shops for posting and collection) provide 3-5 day delivery service at comparable prices to its Standard Parcels product.
- 8.48 In addition, Royal Mail noted that in any event the Directive and PSA 2011 obliged it to provide a parcel service up to 20kg¹¹⁰ at an affordable price. It also noted that the Directive explicitly recognised that the prices for the universal services should take account of the cost of providing the service. Royal Mail noted that as the product was currently loss making, if a cap were applied it would need to allow for significant price

¹¹⁰ Directive requires Member States to ensure users have access to a range of postal services at affordable prices, including parcels up to 10kg. This can be increased to 20kg at the discretion of Member States and this higher level has been reflected in the PSA 2011.

increases to ensure the costs were covered and Royal Mail could earn a reasonable commercial rate of return.

- 8.49 One individual considered that a Second Class service with more additional features (such as signed for) should be price controlled. It considered that this should include standards, monitoring and penalties if these standards were not met. However, the individual believed that Royal Mail should have commercial freedom in the pricing for “premier class” offerings.

First Class stamps

- 8.50 In addition, Consumer Focus, Intellect, Postaf, MUA, PPA, TNT, the Greeting Card Association, one access operator and one small customer considered that First Class services should also be included in the scope of the safeguard cap. The Greeting Card Association noted that, apart from at Christmas, Second Class mail is not generally seen as a viable alternative to First Class for sending cards.
- 8.51 Consumer Focus’ research provided evidence that most vulnerable consumers use First Class stamps. In contrast to the Postcomm research undertaken in 2009, it found that 60-65% of respondents reported that most or all of the First Class mail they sent needed to reach its destination the next working day. However, for all formats customers rated price as more important than speed and this differential was higher for Large Letters and packets.
- 8.52 Consumer Focus’ survey also found that the rate of switching declines at higher prices for First Class products suggesting there is a core of consumers (i.e. 5 – 20%) who will not move away from this class of products. It noted that it did not appear there was a similar pattern of declining switching rates for higher Second Class prices. Consumer Focus therefore concluded that First Class is still considered a vital service by many consumers and, given the lack of price sensitivity for First Class Large Letters (under 100g) and packets (indicating that vulnerable and low web users are less able to switch from these services), Ofcom should consider this further.
- 8.53 Intellect did not consider that only controlling Second Class stamps would be a sufficient safeguard for small businesses as there was virtually no competition to act as a constraint to Royal Mail increasing its prices. It was concerned that meter customers would have to pay higher prices or revert to the loss making stamp channel which is inefficient from a customer point of view. Intellect was also concerned that the proposal could lead to excessive increases in First Class prices which would have serious and lasting effects for small business users and increase switching from First Class to Second Class products. It noted that meter customers are significant users of single piece First Class items and the universal service depends on both First and Second Class services.
- 8.54 Intellect considered these services should not be considered in isolation as if the price of one is capped this could significantly impact the behaviour of customers with regards to the other class. It also believed that to avoid switching between the classes, Ofcom should also cap First Class services. Postaf also considered that removing price caps for First Class products was a step too far at present and Ofcom should initially control the prices of both First and Second Class products.
- 8.55 The MUA and PPA considered the safeguard cap should apply to all weights of both First and Second Class stamps. They were concerned that Royal Mail would increase the price of First Class services to such an extent that downtrading to

Second Class reached a point where Royal Mail could argue for it to be removed from the universal service. The MUA did not consider that this would be in the interests of the mail market and believed that Ofcom needs to consider the consequences of social and small business customers being forced to switch to Second Class due to an increased price differential.

- 8.56 TNT was also not convinced there was a clear case for the removal of the cap on First Class stamps noting that as long as this product remained in the universal service, it also needed to be affordable. It noted that First Class was more frequently used by single piece customers and it was not clear what measures Ofcom would use to ensure prices for this service were set at an affordable level. TNT also considered that it would be important to mandate access to allow upstream competition for First Class services, if it was not included in the safeguard cap. It believed a threat of entry for these services (through access) would act as a constraint on Royal Mail's prices.
- 8.57 One access operator considered that removal of price controls for next day delivery services would not provide sufficient protection for rural customers and this may result in a two tier postal service.

Other universal service products

- 8.58 In addition, a number of respondents argued for the inclusion of other universal service products in the safeguard cap. For example, TNT questioned whether there should be a cap in all areas where there was emerging or no competition. It noted that Royal Mail had significant market power in consumer to consumer segments but that the competition law test of excessive pricing was different to the affordability test under the Directive. TNT therefore considered that Ofcom should consider also capping all formats of the domestic and international single item services. It noted that while it would be appropriate to increase domestic services by RPI, as international services were driven by agreements and treaties this would need to be taken into account when setting the level for these products.
- 8.59 Another access operator considered that all universal service products should be in the safeguard cap including non-tracked parcels up to 20kg and outbound international mail.
- 8.60 TNT was also concerned that Royal Mail would charge captive customers prices that would allow it to cross subsidise the prices for non-captive bulk mail customers. It noted that while some degree of cross subsidisation was permitted, it would not be acceptable if the prices for single piece mail were excessive. TNT considered that to minimise this risk, it was essential that proper cost allocation and equivalence on transfer pricing were in place and that a cap on affordability would also be appropriate.

Structure of any extended safeguard cap

- 8.61 Royal Mail was also concerned that the weight step nature of the Standard Parcels products could result in "multi-point price caps" being imposed. It noted that the Standard Parcel product currently has six pricing points based on weight and believed that Ofcom might need to apply a price cap to each of these points or a basket of points. Royal Mail considered such regulation would tie it to the current weight based pricing structure even if consumer and business requirements and/or competitive actions would suggest a different approach.

Our assessment

8.62 As discussed in Section 6, we considered in our October consultation that one of the key safeguards that should be in place if traditional prices controls were removed was that a basic universal service product should be available to all. The 2003 Act sets out that Ofcom must, in performing its duties, have regard to the needs of persons with disabilities, of the elderly and those on low incomes¹¹¹. We considered that if the safeguard cap ensured that a universal service product was affordable to vulnerable consumers (as defined above), it would also be affordable to all residential consumers and small to medium businesses that were reliant on universal services and Royal Mail to provide their postal services.

8.63 The objectives of the safeguard cap were to:

- Ensure a basic affordable universal service product is available to all;
- Protect vulnerable consumers from ongoing price increases;
- Allow Royal Mail to make a reasonable commercial rate of return on the safeguarded product; and
- Minimise the effect of the safeguard cap on Royal Mail's pricing freedom so as to avoid a material effect on wider financeability and/or efficiency incentives.

8.64 To respond to stakeholder concerns and assess the additional evidence provided, we have first considered the issue of the affordability for consumers and small businesses. We then discuss the imposition of a safeguard cap on Second Class stamp Letters and finally whether the cap should be extended to other formats or universal service products.

Affordability of universal services

Affordability for consumers

8.65 As mentioned above, there is a requirement in both the Directive and the Act that all universal services are affordable (as noted by TNT). In practice we are therefore concerned that all universal services remain affordable. Section 7 sets out our intention to monitor the prices of universal services to ensure they remain affordable and take into account of the cost of providing the service¹¹².

8.66 It is difficult to measure affordability for a low cost and infrequently used service such as postal products. In the past Postcomm has considered this holistically in relation to the weekly spend on postal services as a whole and how this compares to the cost of other communication services and total household expenditure¹¹³.

8.67 Since we set out our proposals in October, the Office for National Statistics (ONS) has published its 2011 family spending report¹¹⁴. This survey confirmed that postal

¹¹¹ Communications Act 2003, Section 3(4)(i)

¹¹² Under section 36(5) of the Act, prices must take into account the costs of providing the service or part of the service. Under Article 12 of the Directive, prices must be oriented to cost.

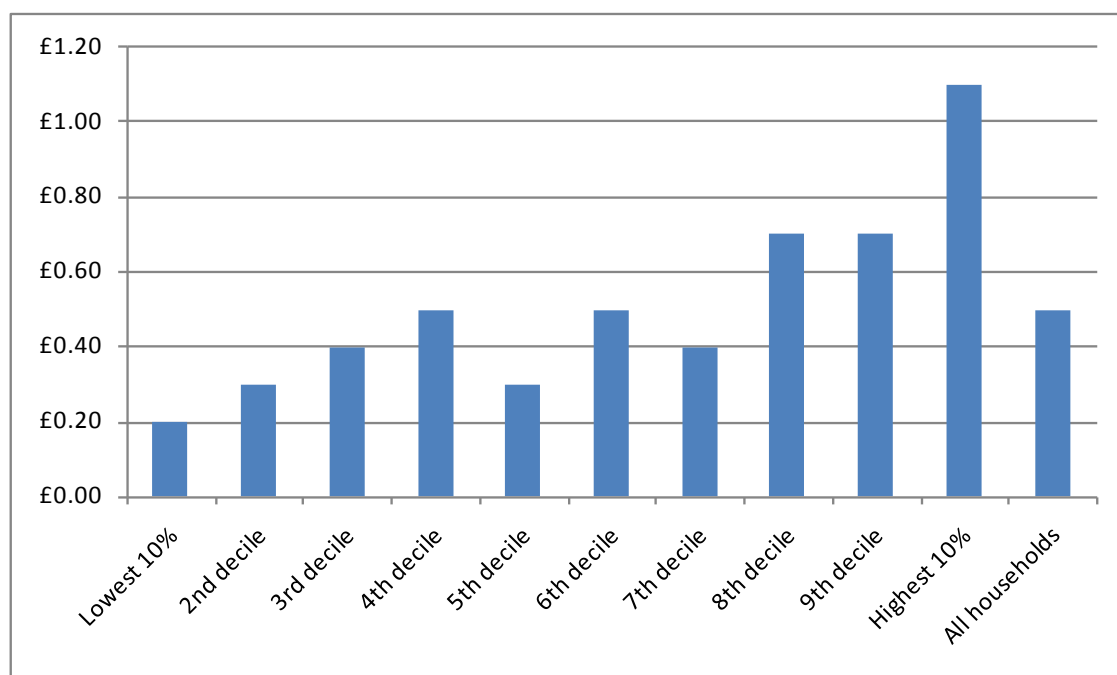
¹¹³ Postcomm, The building blocks for a sustainable postal service, Universal Service: Discussion paper on affordability, February 2011. See <http://stakeholders.ofcom.org.uk/binaries/post/1809.pdf>.

¹¹⁴ Office for National Statistics, Family Spending: A report on the 2010 Living Costs and Food Survey, 2011.

expenditure for residential consumers is low with an average household spend of 50p on postal services per week. This equates to just 0.11% of total average household spend¹¹⁵.

- 8.68 As with the 2010 report, and consistent with research Postcomm, Ofcom and Consumer Focus have undertaken in the past few years, in general as income¹¹⁶ increases, consumer spend on postal products also increases (see Figure 1 below).

Figure 1: Expenditure on postal services by income decile



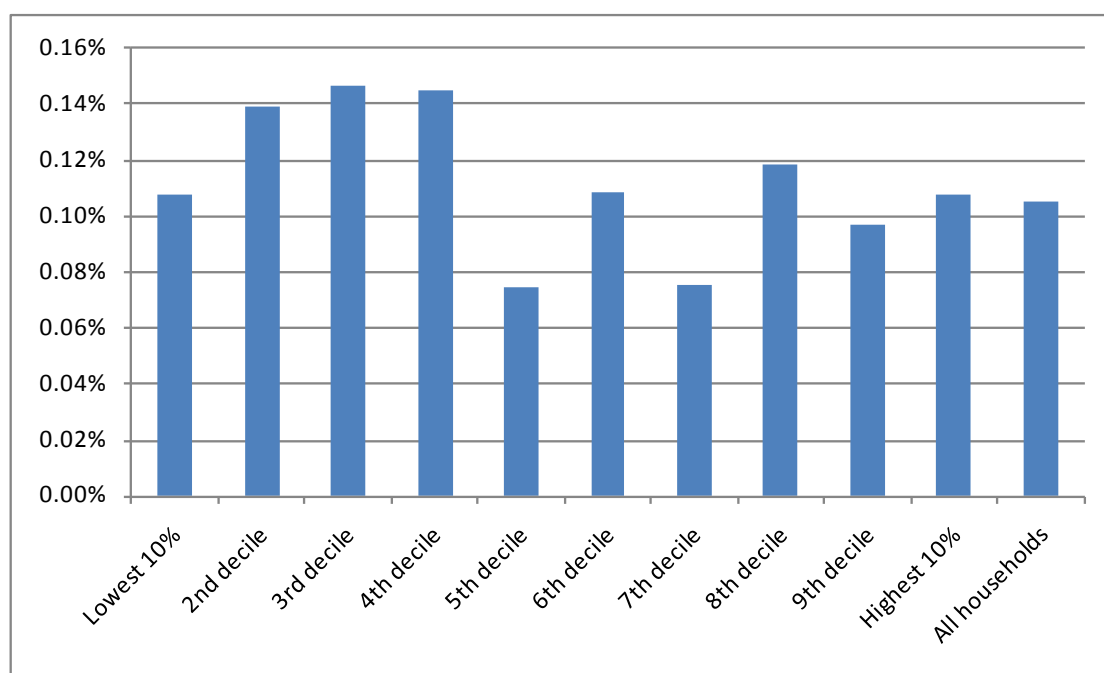
Source: ONS 2010 Living Costs and Food Survey

- 8.69 When consumer expenditure is assessed in the context of total weekly expenditure the lowest and highest deciles spend a similar proportion on postal services. As illustrated by Figure 2, there is some variability in consumers' average weekly expenditure on post. However, even for these deciles, postal expenditure remains a very small proportion of total household outgoings.

¹¹⁵ Total weekly household expenditure included the following COICOP categories: transport; housing, fuel and power (including net rent); recreation and culture; food and non-alcoholic drinks; restaurants and hotels; miscellaneous goods and services; household goods and services; clothing and footwear; communication; alcoholic drinks; tobacco and narcotics and education and health. Housing costs exclude non-consumption expenditure, such as mortgage interest, mortgage capital repayments, mortgage protection premiums, council tax and domestic rates.

¹¹⁶ Social Grade has been used as a proxy for income levels within this research as these are correlated and approximately half of respondents did not give details of their income levels. We have considered that socio-economic group DE are low income consumers.

Figure 2: Postal services as a proportion of household expenditure by income decile



Source: ONS 2010 Living Costs and Food Survey

- 8.70 There was less variation in the ONS report in postal services expenditure in relation to age. Consumers over 75 spent on average 60p per week on postal services compared to an average of 50p per week in the 30 to 74 age brackets. Younger consumers spend on average 40p per week.
- 8.71 This research on actual expenditure undertaken by ONS supports some research reporting claimed behaviour undertaken by Ofcom through an omnibus survey in December 2011¹¹⁷. This showed that on average consumers estimated that they send 3.2 Letters per month, those on low incomes¹¹⁸ and over 65 estimated that they send 2.5 and 4.1 Letters per month respectively. This would equate to an average expenditure of 32p per week on Letters, with consumers on low incomes and over 65 spending 25p and 41p respectively¹¹⁹.
- 8.72 However, as noted by the CWU, even if there were tenfold increases in postal prices, spend on post would only equate to 1% of total household expenditure (assuming consumers do not send less mail as a result of the price increases). The CWU questioned what proportion of total expenditure postal services would need to make up before Ofcom would consider postal prices were unaffordable.
- 8.73 There is no universally accepted approach to measuring or defining affordability. Whilst we acknowledge there are potentially many alternative ways to assess affordability for both residential customers and small and medium businesses, the

¹¹⁷ Ofcom carried out research as part of GfK NOP's face to face omnibus in December 2011. A battery of questions about usage and attitudes were asked to those who had any responsibility for opening or sending mail (94% of the total sample).

¹¹⁸ Social Grade has been used as a proxy for income levels within this research as these are correlated and approximately half of respondents did not give details of their income levels. We have considered that socio-economic group DE are low income consumers.

¹¹⁹ Based on an estimate of 75% of Letters sent by consumers are First Class (using Ofcom's omnibus data).

analysis in the October consultation focused on the approach adopted by Postcomm in its discussion paper (average weekly household expenditure). In addition, to this we have assessed a range of available evidence to determine whether the current prices and proposed range for the level of the cap for Second Class stamps would be affordable. This includes the total proportion of household expenditure on postal services as set out above, consumer behaviour when purchasing postal services and consumers' views from some qualitative research undertaken by Postcomm.

- 8.74 For example, the omnibus research undertaken by Ofcom also showed that most consumers claimed to use First Class services more often than Second Class¹²⁰. This is consistent with research undertaken by Postcomm and Consumer Focus in 2010¹²¹ where 66% of consumers said they used First Class most or all of the time compared to 26% for Second Class mail. However, about half of the respondents agreed that the mail they send First Class did not need to arrive the next day.
- 8.75 The Ofcom omnibus research also showed similar results for low income consumers who claimed to use First Class rather than Second Class mail more often. However, it found that those over 75 claimed to use Second Class more than younger people (although they were still more likely to send more First Class than Second Class mail). These conclusions were supported by the Postcomm and Consumer Focus research. This research also found that 57% of vulnerable consumers agreed with the statement that they would only use First Class if the item needed to arrive the next day.
- 8.76 Consumers' (including vulnerable consumers') more frequent use of First Class rather than Second Class, even when speed of delivery is not a paramount concern, suggests that they are not particularly sensitive to the current prices and differentials between classes. This may also mean that affordability is not currently an issue.
- 8.77 In the recent Ofcom omnibus research, when asked what the price of stamps were, 41% of consumers said that they couldn't give an estimate of the price of First Class stamps and 56% could not estimate the price of Second Class stamps. Only 9% and 6% of consumers correctly stated the price of First Class and Second Class stamps respectively. This low price awareness may also point to the fact that affordability of stamp products is not currently an issue for consumers.
- 8.78 Furthermore, in qualitative research undertaken by Postcomm in 2010, most customers (both residential and small businesses) felt that postal services are affordable. Most customers' immediate reactions to this topic were that they could not imagine anyone being unable to afford a price of a stamp. This research highlighted that stamp prices are very low when compared to their total household expenditure, and people have difficulty relating to a situation where they would not be able to spare that much money¹²².
- 8.79 It could be argued that the fact that lower income consumers send less mail could indicate there is a link between price, income and the number of mail items sent. However, low income consumers also receive significantly less mail than other

¹²⁰ 67% of consumers claimed to use First Class to send Letters 'more often' compared to 16% for Second Class.

¹²¹ Postcomm and Consumer Focus, Residential customer needs from a sustainable universal service in the UK, November 2010.

¹²² Findings of 'Affordability' of postal services, Postcomm Customer Interest Forum, November 2010. See <http://stakeholders.ofcom.org.uk/binaries/post/1797.pdf>.

groups¹²³. It is therefore possible that lower income consumers have fewer transactions that need to rely on this type of communication.

- 8.80 We note the views expressed by the BIS Select Committee that affordability should be assessed in relation to whether vulnerable consumers can afford to spend additional money on stamps at periods of peak spending. In relation to post this will be Christmas, and Royal Mail has estimated that approximately one third of all social mail is sent at this time. Given the nature of the mail sent at Christmas, it is more likely to be able to be posted sufficiently in advance for consumers to take advantage of the Second Class service.
- 8.81 We have therefore assessed the average additional cost to consumers if Royal Mail was to be able to set the price at the top end of the proposed range i.e. 55p (if it considered this was appropriate). The omnibus research undertaken by Ofcom found that on average vulnerable consumers sent 30 Letters per year. Using Royal Mail's estimation of the total proportion of volumes sent at Christmas, this would mean that on average vulnerable consumers are sending around ten Letters at Christmas. This would equate to an additional expenditure of less than £2.
- 8.82 While this figure is likely to be overstated in relation to the average vulnerable consumer (as consumers generally over state usage in self-reported surveys), we recognise that it is likely that some vulnerable consumers send comparatively more mail at Christmas and will therefore be disproportionately impacted by the price increase. We therefore welcome Royal Mail's commitment to discount Second Class stamp prices for vulnerable consumers in November and December 2012. As set out in Section 7, we will also endeavour to understand and gather further evidence on the affordability of postal products for vulnerable consumers, in general and at peak times such as Christmas, to determine whether there is a need for further regulatory intervention.
- 8.83 On the basis of the evidence available (including the responses to consultation), we have concluded that the current and proposed price ranges for Second Class stamps are likely to be affordable for vulnerable consumers. However, given the importance of ensuring that universal services remain affordable over time (particularly for the universal service products which are not included in the safeguard cap), we will be monitoring Royal Mail's future prices. As set out in Section 7, we will consider the approach that should be used to assess affordability as well as whether future universal service prices are affordable.

Affordability for small businesses

- 8.84 A number of respondents disagreed with our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses. In addition, the BIS Select Committee noted that many small to medium businesses were struggling with pressures on their costs from a number of areas in the current economic climate and postal price increases might cause them difficulty. It strongly recommended that both Ofcom and Royal Mail review the evidence on this issue.
- 8.85 We fully recognise the different needs and market conditions facing small businesses compared to residential customers. Postcomm and Consumer Focus undertook

¹²³ Ofcom omnibus research – on average consumers receive 8.5 items per week but low income consumers receive 7.4 on average.

some research in 2010¹²⁴ to understand the needs of business and residential users from the universal service. This research found that 58% of businesses claimed to use stamps as their main method of payment with 29% using meters for the majority of their mail. However, 72% of businesses noted that they used stamps for some of their mail which shows the importance of this payment channel for business customers. In addition, approximately half of businesses claimed to use First Class all or most of the time but consistent with the previous research only 55% said that all or most of their mail needed to arrive the next day. This suggests that some businesses will be able to switch at least some of their mail to Second Class services if the price of First Class increases significantly in relation to Second Class.

- 8.86 While the majority of businesses claimed to send all or almost all of their mail with Royal Mail, the businesses who claimed they were now sending less mail than three years ago (approximately one third) say they are communicating differently with their customers. All businesses have increasingly been using online alternatives to physical mail over the last few years. This is particularly true for larger businesses.
- 8.87 In addition, this research also found that businesses spend on postal services is correlated to the size of the business (based on the number of employees). It also found that businesses in rural areas are more likely to use mail than those in urban or suburban areas but they are also more likely to be in the lowest expenditure category of £1 to £25 per month (47%)¹²⁵. Table 2 below shows the average monthly mail spend for the different categories of company size.

Table 2: Monthly mail spend by establishment size

	Total (460)	1 – 10 (153)	11 – 50 (106)	51 – 249 (108)	250+ (93)
£1 - £25	35%	38%	18%	16%	3%
£26 - £100	36%	37%	37%	13%	10%
£101 - £500	19%	17%	29%	31%	24%
£501+	10%	8%	16%	39%	63%
Mean	£344	£294	£390	£806	£4, 768
Median	£37.50	£37.50	£75	£350	£2,812
Mode	£7.50	£7.50	£75	£750	£3,500

¹²⁴ Postcomm and Consumer Focus research into the needs of business customers, 2010, <http://www.consumerfocus.org.uk/files/2010/11/Business-report.pdf>. This comprised telephone interviews with 460 businesses, which to be eligible, had to spend at least £1 a month on postal services and not use any bulk products.

¹²⁵ This may be related to size as one third of rural companies surveyed were sole traders compared to 16% of urban and 11% of suburban companies. These companies tend to spend low amounts of post and in rural areas, 50% spend £1 – £25 on post (compared to 46% and 41% in urban and suburban areas). However, where 100% of such companies spend less than £100 a month in urban and suburban areas, 18% of rural sole traders spend £101 - £500 a month.

- 8.88 Table 2 shows that 71% of businesses within the survey claimed to spend less than £100 per month on postage. This would suggest that for the significant majority of small businesses postal expenditure is a minor proportion of their overall costs. Even if Second Class stamp prices were to increase to the top of the proposed range (53%), over 70% of businesses would still be spending less than £153 per month on postage.
- 8.89 Smaller businesses that are more reliant on post, in general, have other alternatives to using stamp products and to this extent will not be affected by stamp price rises to the same degree. Franking machines are a low cost alternative which are used by many businesses, and are widely available for very small businesses at £20 to £30 per month. Royal Mail offers significant discounts of around 20% for customers who use a meter to pay for their mail and this is likely to increase in 2012-13. Therefore businesses spending as little as £100 to £200 per month on mail could benefit from using a meter to pay for their mail rather than stamps.
- 8.90 In part, the differences between residential consumers and small businesses (and in particular the potentially greater choice of substitutes to stamps and/or Royal Mail available to small businesses sending more mail) formed the basis of our hypothesis that prices are likely to be affordable for small businesses. However, in addition to seeking views around affordability for residential consumers, we actively sought views from stakeholders to further understand the challenges of small businesses and whether this hypothesis was correct. No respondent suggested that current prices were not affordable or were close to reaching affordability limits. Equally no respondent provided evidence of the affordable price levels for either residential or small business customers.
- 8.91 In light of the evidence available we therefore do not consider that the current price of 36p or the proposed prices for Second Class stamp Letters of 45p to 55p are likely to be unaffordable for small business users. We also do not consider that it would be appropriate to extend the scope of the safeguard cap for vulnerable consumers to include small businesses. As noted above all universal service products are required to be affordable and we will be considering the issue of affordability further for both residential and small business customers under the monitoring regime. However, any cap that limits the prices Royal Mail charges for Second Class stamps will also benefit the small business customers who use these services (and will in all likelihood act as an overall cap to other payment methods).

Safeguard cap for Second Class stamp Letters

- 8.92 As set out above, the October consultation proposed a safeguard cap on Second Class Letters with a range in the level of the cap between 45p and 55p. We also asked respondents for their views on whether the scope of the cap should be extended to other Second Class formats. Aside from Royal Mail no respondents disagreed with our proposal to place a cap on Second Class stamp Letters (although a significant number of respondents considered that other universal services should also be included in the scope of the cap, which is discussed further below). In this sub-section, we therefore discuss the level and form (including the measure of inflation index) of the cap for Second Class stamp Letters. The possible extension of the cap to other Second Class formats is discussed further below.

Level of the safeguard cap

- 8.93 As discussed in Section 6, we have decided to remove traditional price controls and instead impose a safeguard cap to protect vulnerable consumers. The decision to

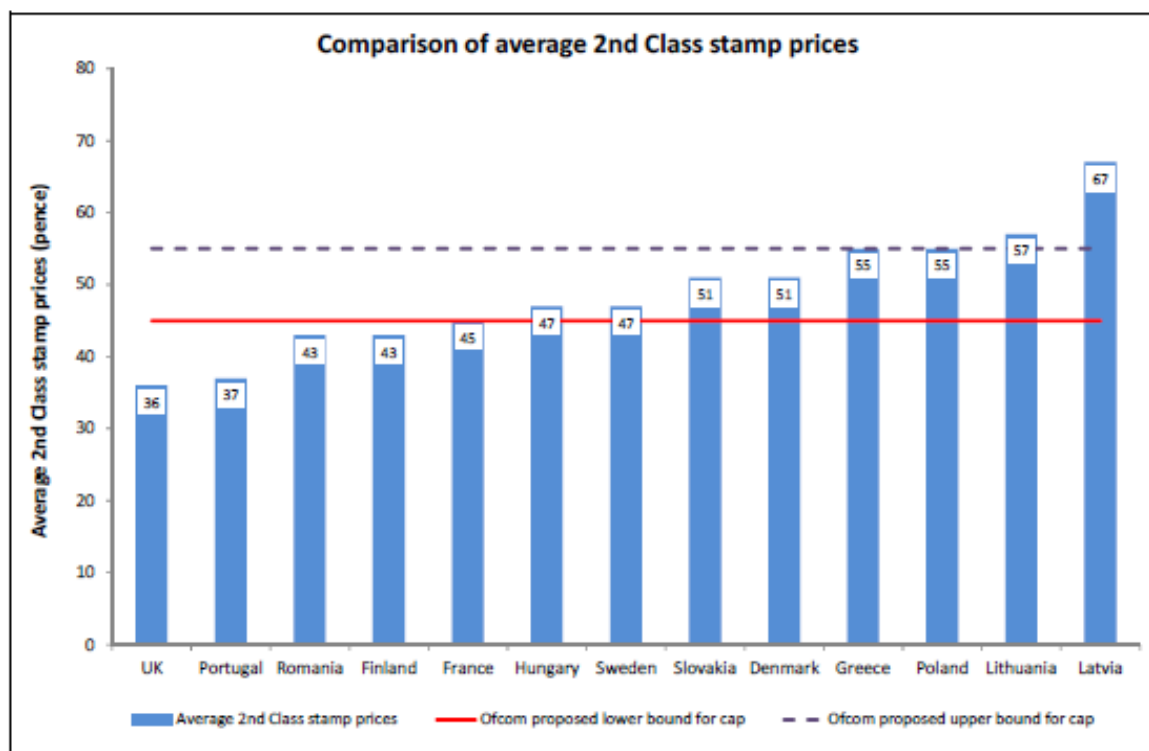
remove price controls is due in part to the difficulties that are involved in forecasting Royal Mail's future revenues and costs given the current uncertainty within the market. Therefore the safeguard cap is not intended, in and of itself, solely to provide efficiency incentives to Royal Mail. It is also not intended to impose a significant constraint on Royal Mail's pricing flexibility for any other universal services.

- 8.94 Instead the key objective of the safeguard cap is to ensure that a basic affordable universal service product is available to all and in particular vulnerable consumers. The October consultation also set out that material price increases are likely to be required in certain areas in the short term to ensure Royal Mail can cover the costs of the universal service network and earn a reasonable commercial rate of return. The proposed range for the level of the safeguard cap for Second Class Letters of 45p to 55p was intended to be an appropriate compromise between these two competing objectives.
- 8.95 A number of respondents have argued that the level of the cap for Second Class Letters should be significantly lower than the bottom of the range proposed by Ofcom. As set out above universal services must be affordable and in particular we were concerned that a basic affordable universal service is available to all. If there were affordability concerns, we could minimise the impact of price increases on universal service customers, and vulnerable consumers in particular, by setting the level of the cap at 45p. This approach would be likely to be appropriate if we were concerned that this level of the cap was approaching the affordability threshold for vulnerable consumers. However, as set out above, there has been no evidence provided which indicates that the proposed range of levels for the safeguard cap are unaffordable for vulnerable consumers.
- 8.96 In considering the appropriate level of the safeguard cap within the range consulted on, we have also considered the objectives of the regulatory framework. As discussed in Section 6, the overall approach of the regulatory framework is to provide more pricing freedom for Royal Mail to allow the universal service to become financially sustainable. Therefore, absent any concerns that the range of prices are (or would become unaffordable), we were pre-disposed to set the cap at the top end of the proposed range to give more weight to financeability concerns.
- 8.97 Royal Mail noted in its response to the consultation that the price of a Second Class Letter also provides a reasonable constraint on First Class prices. We have also undertaken some analysis on the impact of the cap on Second Class Letters on First Class prices. This indicated that, using a range of data including Royal Mail's model elasticities and also survey data, it may not be profitable for Royal Mail to have a price differential between its First and Second Class stamp Letter products greater than 15p to 25p in the short to medium term. Therefore we consider it is possible that Second Class prices could constrain First Class prices to some extent.
- 8.98 We have also considered how Royal Mail's Second Class Letter prices compare to international comparators. Figure 3 below illustrates Royal Mail's analysis of the current European Second Class stamp prices up to 100g¹²⁶. This shows that Royal Mail's current price for Second Class stamp Letters is low in comparison to other countries. In addition, while the top end of the proposed range would put it at the higher end of the current prices (if Royal Mail were to increase the price to the level

¹²⁶ Royal Mail's analysis includes more than one price for many of the other countries that have higher prices for standard Letters above 20g or 50g, which increases the average price indicated for these countries. However, the overall picture is broadly consistent with a graph showing the lowest price (0 – 20g) only.

of the cap immediately), as this cap would be in place for up to seven years, it would be unlikely that Royal Mail's prices would remain at the higher end of comparable European Second Class stamp prices over time.

Figure 3: European comparison of Second Class stamp Letter prices



Source: Royal Mail, 2011

8.99 In considering the level of the cap, it is also important to consider its duration. While we have set out our intention to review the level of the cap in two to three years' time if necessary, the aim of the cap is to prevent further real price increases over the control period. We would therefore be unlikely to intervene and change the level of the cap unless there were concerns about affordability for universal service customers or Royal Mail's ability to finance the universal service.

8.100 We accept that any increase in price is likely to have an adverse impact on the volumes for Second Class Letters and potentially total mail volumes. However, as set out in Section 6, one of the key aims of the economic framework is to give Royal Mail additional commercial flexibility in determining the appropriate price differential between its products. This will be subject to competition law (including excessive pricing provisions) and the requirements of the Act and the Directive that universal service prices are affordable and set in relation to cost¹²⁷.

8.101 However, in determining if Royal Mail's prices for universal services are cost oriented, we consider it is important to take into account the specific features of Royal Mail's network. As the postal industry is a network business, the costs of individual services depend on the scale and type of other services delivered over the same network. For example, if there was a significantly lower volume of business mail, the average cost of all mail products would increase.

¹²⁷ We will further examine the requirements of the Act and Directive under the monitoring regime, as considered necessary.

- 8.102 Therefore the financial sustainability of the universal service requires Royal Mail to set prices across its different mail products in a manner that maximises overall mail volumes. This in turn should help contain costs and prices for all mail users, but it does also mean that the reported accounting margins and profitability across mail services will vary, again possibly significantly. As noted above, we consider that Royal Mail is in the best position to determine the appropriate relative prices for its products to ensure that it can cover the costs of the universal service network.
- 8.103 As discussed above, we do not consider that small businesses constitute vulnerable consumers. However, as the Second Class stamp product is used by both residential and business customers, they will also benefit from the protection that it will provide. In addition, under the Act Royal Mail is required to provide universal services at a uniform price across the UK. We do not therefore consider that our proposals will have a disproportionate impact on rural businesses or residential users.
- 8.104 The Greeting Card Association was concerned about the impact of the proposed price increases on the Christmas card market. As discussed above, Royal Mail has estimated that approximately one third of all social mail is sent in November and December and it is also possible that the elderly, in particular, send proportionately more mail at Christmas. However, we note Royal Mail's stated intention to offer a discount to vulnerable consumers for November and December 2012 and keep Second Class Letter prices at current levels. We consider that this will mitigate to an extent the impact of the potential price increases on vulnerable consumers and the Christmas card market.
- 8.105 TNT set out its concern that Royal Mail would earn sufficient margin through the proposed cap for Second Class Letters to allow it to cross-subsidise into more competitive parts of the market. In addition to the analysis set out above, the monitoring regime (and our ongoing ability to use the Competition Act) will also consider the implications of the profitability of different groups of Royal Mail's services. In any case we consider that we have sufficient information provided by the regulatory financial reports to support this analysis and address the concerns raised by TNT and the other access operator. However, in any event, Second Class Letters make up less than 5% of Royal Mail's revenues (so the opportunities for cross-subsidisation are limited).
- 8.106 As mentioned by a number of respondents, we are currently undertaking a review of user needs from the universal service. It is possible that this will have an impact on the required attributes and therefore the future costs of the universal service. As noted in the October consultation, if we consider it necessary we will review the level of the safeguard cap in two to three years' time to ensure that it remains appropriate.
- 8.107 Taking the available evidence in the round and, in particular, given that it does not appear to show that 55p for Second Class stamps is close to the level of affordable postal prices for vulnerable consumers and that this price for Second Class stamps would not be out of step with other European countries, we consider it is appropriate to give more weight to allowing Royal Mail greater commercial flexibility. We have consequently determined that the level of the safeguard cap for Second Class stamp Letters should be set at 55p.

Structure of the safeguard cap

- 8.108 We set out in the October consultation that the structure of the cap should be a simple cap on the level of the Second Class Letter price of between 45p and 55p

which should then be linked to inflation for the duration of the regulatory period¹²⁸. As we were only proposing to control one price point (Second Class stamp Letters), this cap would be simple to implement and easy for all stakeholders to understand.

- 8.109 We continue to believe that this type of control is appropriate for the Second Class Letter stamp product. Consumers use significantly more Second Class Letters than any other Second Class format or price point and when Second Class stamp prices are discussed is the most commonly referred to price. There is therefore benefit in putting in place a cap that allows customers to easily predict future (maximum) prices. We will therefore implement a standalone cap on Second Class Letters as proposed in the October consultation.
- 8.110 As noted in the December consultation on the review of regulatory conditions, this is a simple cap on the maximum price that Royal Mail can charge for this product. If Royal Mail chooses to offer discounts to this price (for example, its proposed Christmas discount for vulnerable consumers), this will not impact the requirement to charge no more than 55p at all other times and to all other customers.

Inflation index

- 8.111 We note the arguments raised by a number of stakeholders (including the BIS Select Committee) over our proposal to use RPI as the measure of inflation to increase the level of the safeguard cap over time. As noted by these stakeholders, CPI is now the inflation index used by the Government to maintain in real terms the level of public sector pensions and most benefits, as it excludes mortgage payments and is therefore considered to be a better measure of the costs incurred by vulnerable consumers.
- 8.112 The majority of regulators in the UK (including Ofcom) have traditionally used RPI for linking charge controls to inflation. This approach has been reviewed by a number of regulators in recent years as part of their charge control reviews. We note that the Competition Commission observed in 2007¹²⁹ that the value of retaining RPI has been that precedent favoured it and that “*significant cost items of regulated companies, such as index-linked bonds which are used to calculate the cost of capital and wage settlements, are generally linked to RPI*”.
- 8.113 However, as discussed above, the main rationale for the safeguard cap is to protect vulnerable consumers and ensure that a basic affordable universal service product is available for all. Given that the safeguard cap is intended to protect vulnerable consumers and many of these consumers’ incomes are derived (at least in part) from Government pensions or benefits, we agree that it would be consistent to use CPI as the inflation measure. We have therefore decided that annual increases in the safeguard cap on standard Second Class Letters should be linked to CPI rather than RPI.
- 8.114 Royal Mail suggested that the inflation measure should be floored at zero so that it would not have to decrease its prices in the unlikely event that the inflation index became negative. We do not consider this is appropriate or necessary as the level of

¹²⁸ As discussed in the section on the level of the control we also allowed for a review to the level of the control in 2-3 years if this became necessary due to affordability concerns or significant changes in the market.

¹²⁹ Competition Commission, “BAA Ltd.: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)”, 28 September 2007, para 3.21, page 24, http://webarchive.nationalarchives.gov.uk/20111108202701/http://competition-commission.org.uk/rep_pub/reports/2007/fulltext/532.pdf.

the cap is based predominantly on the affordability of stamps for vulnerable consumers rather than being linked closely to Royal Mail's costs. We have previously indicated that we will reassess the level of the cap if there are significant market changes over the period of the control (which would include if costs were out of line with the level of the cap). In any event, we note that our decision to adopt CPI as the relevant inflationary index means that a situation of negative inflation is even less likely. We have therefore decided not to amend the formula for the safeguard cap as proposed by Royal Mail.

- 8.115 The DUSP condition 2 which sets out Royal Mail's obligations with regards to the cap for Second Class Letters is contained in Annex 7.

Extension of the safeguard cap

- 8.116 We proposed in the October consultation that the scope of the safeguard cap should be Second Class Letters and specifically invited engagement from consumer groups on whether or not the cap should be extended to other Second Class formats (including Standard Parcels). In the meantime both Ofcom and Consumer Focus have undertaken some research on what postal products consumers and in particular vulnerable consumers use.
- 8.117 Stakeholder responses to this question can be categorised into three areas including whether the safeguard cap should be extended to other Second Class formats, First Class stamps and other universal service products. We discuss these areas separately below.

Extension of the safeguard cap to Second Class Large Letters and packets

- 8.118 A number of respondents considered that the safeguard cap should be extended to Second Class Large Letters and packets. Royal Mail's Second Class stamp product includes Large Letters up to 750g and packets up to 1kg. In addition, the universal service Standard Parcel product provides a Second Class service for packets and parcels up to 20kg.
- 8.119 We accept the argument put forward that there is no chain of substitution between these formats and the Letter product that we proposed to be within the scope of the safeguard cap. This means that in general senders of Large Letter and in particular packet products will not be able to switch to the Letter product if the prices for the bigger formats significantly increase. In addition, given the nature of the type of items that are sent using these formats, there is generally less opportunity for consumers to switch to electronic alternatives (apart from for certain items such as CDs and DVDs which make up a minority of physical items sent).
- 8.120 There is therefore a strong logical argument for including these formats in the safeguard cap. The main argument for not extending the cap to these formats (as expressed by Royal Mail) is about materiality and proportionality, given that close to 90% of Second Class volumes are Letters. As discussed above in relation to setting the level, this needs to be considered in the context of the trade-off between giving Royal Mail sufficient commercial flexibility to secure the provision of the universal service and ensuring that vulnerable consumers have a basic affordable universal service product.
- 8.121 Any extension to the cap would directly impact less than an additional 5% of Royal Mail's total revenue from the regulated business. Given the impact of substitution from First Class products, Royal Mail has argued that it would also impact its pricing

flexibility for the equivalent First Class stamp products (around 10% of total revenue). Whilst we do not expect the cap to constrain Royal Mail's prices, if the impact of the cap were that Royal Mail increased the margin between First and Second Class, we accept that there could be some substitution. For example, the evidence shows that it would not be profitable for there to be more than a 15p to 25p differential between First and Second Class Letter prices in the short term¹³⁰. If we were to extrapolate that to Large Letters and packets it would be a differential of around 25% to 45%. Current price differentials for weight steps up to 1kg are between 14% to 19%¹³¹. This may suggest that the impact of any price cap on Second Class Large Letters and packets on First Class prices might be lower than for Letters.

- 8.122 To better understand vulnerable consumers' usage of these formats we have undertaken some further research into residential consumers' use of stamp products since the publication of the October consultation¹³². In addition, Consumer Focus has also undertaken some new research into the potential impacts of stamp price increases on consumers¹³³. In its response to the consultation Royal Mail also provided usage data from its consumer panel survey.
- 8.123 While these different pieces of consumer research involve different questions and survey methodologies, there are some common themes. For example, it is clear that consumers send significantly less Large Letters and packets and parcels than they do Letters. The survey results are broadly consistent with each other showing that consumers claim that approximately nine out of ten items sent are Letters. In addition, these surveys have also consistently found that vulnerable consumers overall send fewer Large Letters and packets than other consumers. For example, Consumer Focus found that people without internet access, older consumers or those of a lower social class were less likely to send parcels than the UK online average.
- 8.124 However, Ofcom's consumer omnibus research found that there were different patterns of usage of postal services for different types of vulnerable consumers. For example, while low income consumers are more likely to say they never send any parcels (40% for DE compared to 29% and 19% for C1C2 and AB respectively), they also proportionally send fewer Letters than other consumers¹³⁴ (so their proportional spending patterns are consistent with the average). On the other hand consumers who are 65 or older claim to send a high volume of Letters but relatively few parcels giving them a significantly different mailing profile to other consumers. This is consistent with the findings from Consumer Focus' research.
- 8.125 While consumers (and in particular vulnerable consumers) send significantly fewer Large Letters¹³⁵ and packets than Letters, given the higher cost of these products, they comprise a larger proportion of total expenditure on postal services. We have estimated, based on Ofcom omnibus survey data and Royal Mail's volumes for

¹³⁰ Based on self-reported behaviour survey data and Royal Mail's estimates of cross-price elasticities.

¹³¹ 1kg – 2kg the differentials in prices get higher as there are four weight steps for First Class stamps while Standard Parcels only has one.

¹³² Ofcom omnibus survey, December 2011

¹³³ Consumer Focus report on potential impacts of stamp price increases on consumers, January 2012. See <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/ConsumerFocusreport.pdf>

¹³⁴ 40% of those in DE social grades either 'don't send Letters' or 'don't always send Letters' each month compared to 31% in C1C2 and 20% in AB.

¹³⁵ The omnibus research did not directly ask respondents their usage of Large Letters but about 9% claimed to have used large stamps which we have assumed covers both Large Letters and packets.

different formats and weight steps, that Large Letters and packets make up 54% of total consumer expenditure on post and 52% of vulnerable consumers total spend on post. Therefore given the actual spend on Large Letter and packets, we consider that the rationale for imposing a cap on Second Class Letters is also valid for Large Letters and packets.

- 8.126 We have also assessed the level of competition for these formats as we consider that, if there are competitive options for some consumers for certain formats and/or weight ranges, this would be likely to constrain Royal Mail's prices for all consumers, given its universal service obligations. For example, if there was sufficient competition in urban areas to constrain Royal Mail's universal service prices to customers in that area, its geographically uniform pricing requirement would mean that all consumers would benefit from the competition through lower prices.
- 8.127 Analysis undertaken by Postcomm in its market review showed that for Large Letter formats there is virtually no competition or prospect of competition for consumers (similar to its conclusion on the Letter format)¹³⁶. This is supported by the minimal Large Letter delivery volumes operators report to Ofcom¹³⁷. This is also true for some of the packet weight steps (particularly the lower weights) although our more recent analysis has shown there is competition emerging for certain weight steps within the packet and parcel format.
- 8.128 We have therefore concluded that it is appropriate to extend the cap to the Large Letter format and in principle to the packet format given the actual average consumer spend on these formats and the lack of alternative providers. Given this conclusion and the segments of the market where competition is emerging, we consider the options for the extension of the cap to be:
- Second Class Large Letters and packets up to 1kg (Second Class stamps only);
 - Second Class Large Letters and packets up to 2kg (including the less than 2kg weight step for Standard Parcels); and
 - Second Class Large Letters and packets up to 20kg (including the Standard Parcel product).
- 8.129 In assessing these options we have considered both the consumer spend on these weight steps and the actual and potential development of competition.
- 8.130 Consumer (and in particular vulnerable consumer) usage of the different formats and weight steps shows significant variations. Broadly speaking as weight increases usage drops. Table 3 below sets out the average volumes and spend that all consumers and vulnerable consumers claim to send for the different packet weight steps (based on Ofcom's consumer omnibus data).

¹³⁶ Postcomm laying the foundations for a sustainable postal service. Annex 1: Analysis of Markets, Decision document, November 2010.
<http://webarchive.nationalarchives.gov.uk/20111027102050/http://www.psc.gov.uk/documents/1158.pdf>

¹³⁷ All operators are required to report delivered volumes to Ofcom on a regular basis

Table 3: Estimated average annual volumes and spend on Letters and packets¹³⁸

Format and weight step	All residential consumers			Vulnerable consumers		
	Average Annual volume	Average Annual spend	% Spend	Average Annual volume	Average Annual spend	% Spend
Letters	38.4	£16.7	46%	30.0	£13	48%
Large Letters	2.6	£2.0	6%	1.9	£1	5%
Packets 0-1kg	4.4	£11.3	31%	3.2	£8.4	30%
Packets 1-2kg	0.6	£3.2	9%	0.4	£2.4	9%
Packets 2kg+	0.3	£3.0	8%	0.2	£2.2	8%
Total	46.3	£36.3	100%	35.7	£27.5	100%

Source: Ofcom analysis of survey data

- 8.131 Royal Mail's actual volumes indicate that consumers appear to be overstating the number of items they send in a year within self-reported survey data. However, a conservative approach to estimating volumes of mail using the self-reported volume of packets sent from Ofcom's omnibus research indicates that less than half of vulnerable consumers send a 1-2kg packet every year. In addition, less than one in five vulnerable consumers sends a packet/parcel heavier than 2kg every year. This is consistent with Royal Mail's evidence that customers send a Standard Parcel on average once every seven years. However, we recognise that it is likely there are some vulnerable consumers who send significantly more packets and parcels than the average and would be disproportionately impacted if these weight steps were not included in the scope of the safeguard cap.
- 8.132 We have therefore also taken into account the competitive options for different packet weights. Table 4 below sets out some of the competitive options that are available to consumers sending packets and parcels. This shows that as weight increases there are more options for residential consumers where other operators can compete on prices that are broadly comparable to Royal Mail's Second Class stamp prices. This competition is strongest for weights greater than 2kg. As noted above, while these competitive options are not likely to be available to all consumers or at prices competitive with Royal Mail's products, if they constrain Royal Mail's prices in one geographic area or type of customer (such as internet based customers), all universal service customers will benefit from that constraint (due to the geographically uniform pricing requirement).

¹³⁸ Estimates based on Ofcom omnibus research, December 2011 (unpublished) of self-reported sending of parcels of any size combined with Royal Mail data on consumers' use of different packet and parcel weights. Based on 2011-12 prices.

Table 4: Competitive analysis for packet and parcel products by weight step

Operator	Service standard	<1kg	<2kg	<5kg	<10kg	Comments
RM – Standard Parcels	72 hours, non-tracked	£3.15	£4.41	£7.62	£13.61	Geographically uniform
RM – Parcelforce	48 hours fully tracked and guaranteed	£10.79	£10.79	£13.19	£16.79	Geographically uniform
Hermes	3-5 days, tracked	£3.30	£4.19	£5.99	£7.14	Pick up and drop off at residential addresses £1.99 extra for IM/HS/ZE remote locations
Collect +	3-5 days, tracked	£3.99	£3.99	£4.99	£6.99	Pick up and drop off at residential addresses
UPS (via Interparcel)	1-2 days, tracked	£8.39	£8.39	£8.39	£8.39	Most of UK mainland
DHL collect point	1-2 days, tracked	£12.95	£14.95	£16.95	£17.95	Drop off to DHL collection points - non-geographic pricing

Source: Ofcom research

8.133 In addition, in Ofcom's omnibus we also asked residential consumers whether they use alternatives to Royal Mail when sending packets and parcels. 16% of the respondents who send packets and parcels claimed to have used another operator for some of their items. Among those who used other operators, the most common competitive options claimed to have been used were at the more expensive end of the options set out in the table above¹³⁹. It is therefore likely that many consumers either value the specific features of the products offered by other postal operators (for example tracking or speed of delivery or convenience/ease of use) or they are not aware of all the available alternative prices and options for sending packets and parcels.

8.134 We consider that, while imposing a price cap on packets up to 20kg would be comprehensive, it would be unlikely to be proportionate given the very low usage of these weight steps by vulnerable consumers and the level of competition for these weight steps. However, the level of competition below 2kg is more ambiguous. There is evidence that some other operators can and do compete with Royal Mail on price in this weight range. However, evidence suggests that awareness and/or use of these competitive options is currently relatively low.

¹³⁹ For example, 37% of those respondents who claimed to use other operators had used DHL's collect point product.

8.135 We have also considered the impact a safeguard cap for Second Class packets might have on the growth area of electronic fulfilment. We assessed the potential impact given the current pricing differentials between bulk Large Letters, bulk untracked products, bulk tracked products and express services and the Second Class stamp prices.

- Bulk Large Letters – Royal Mail's Mailsort 1400 product offers significant sortation and volume discounts to the standard stamp price. For a Second Class Large Letter under 100g that meets the required minimum volume and sortation level¹⁴⁰, the current price is 30.7p which is a significant discount to the equivalent stamp price of 58p.
- Bulk untracked packets - Royal Mail's largest business packet revenues come from bulk untracked products. These products are currently priced at a significant discount to stamp prices (£1.45 for 500g packets¹⁴¹ compared to £2.61 for the equivalent stamp price).
- Bulk tracked packets - the majority of other operators compete for tracked services. Royal Mail launched a tracked service in 2008 and its volumes have grown significantly over the last three years, though are still small as a percentage of total packets volumes. These products are not a direct substitute for untracked services, as they include premium features (such as tracking and insurance) which are more suitable to higher-value e-commerce items. They are already priced at a significant premium to the equivalent untracked services (price of £2.76) and this does not appear to be linked in any way to the untracked single piece stamp price.
- Express services – Royal Mail's Special Delivery service includes tracking, insurance, and a 1pm guaranteed delivery time. The prices are not closely linked to the price of bulk untracked or tracked services. For example the price of business mail Special Delivery services is currently £5.38 which is nearly twice the price of the bulk tracked product.

8.136 We therefore consider that a cap on Second Class stamp Large Letters and packets would not constrain to any material extent Royal Mail's pricing on other single piece or bulk Large Letter and packet business products (given the differential in prices that currently exists).

8.137 We have therefore decided that the scope of the safeguard cap should be extended to Second Class Large Letter and packet products up to 2kg. We consider that this is the point above which competition is more effective. Given the changes in this market for consumers over the last few years, we would expect the scope of regulation to shrink over time and there is the potential for revisiting the scope of the cap in the future to reduce it in line with growing competition.

8.138 We have set out below our current views on the appropriate form and structure of this control. We intend to issue a short consultation on the appropriate level of this cap in the coming weeks. This will include the formal consultation on the designated universal service provider condition required to implement our decision to extend the safeguard cap to these formats and weight steps. We expect to publish our final decision on this issue in summer 2012.

¹⁴⁰ To use the Mailsort 1400 prices, customers must send a minimum of 1000 Large Letter items.

¹⁴¹ Based on a customer sending 5000 items per annum of an average weight of 500g with a service standard of 2-3 days.

- 8.139 Given that we consider it appropriate to consult on the level of this extended cap and the need to avoid impacting Royal Mail's ability to set its prices for 2012, it is intended that this cap for the Second Class stamp Large Letter and packet formats will apply from April 2013. This extension of the cap will therefore not constrain Royal Mail's pricing decisions for these formats in 2012. Our decision set out above for the level of the safeguard cap for the Letter format will however apply as proposed from April 2012.
- 8.140 As discussed in relation to the level of the cap for Second Class stamp Letters, an important objective of imposing a safeguard cap is to minimise its impact on Royal Mail's pricing freedom and the wider financeability and efficiency incentives. Given that we are looking to set a cap that will in real terms potentially be in place for seven years (although as set out above we will review the level of the cap in two to three years, if required), it is not intended that this cap will constrain Royal Mail's pricing freedom in the short term. In assessing the level of the basket for these formats, we are likely to take as a starting point, subject to consultation, the level of pricing flexibility that Royal Mail has been given in relation to Second Class Letters. Given the information provided to us by Royal Mail in respect of its indicative pricing intentions for these products for 2012-13, and the range of prices on which we intend to consult, we do not consider the level of the extended cap is likely to be inconsistent with Royal Mail's current intentions for pricing these services.

First Class stamps

- 8.141 In the October consultation, we specifically considered whether it would be appropriate to put in place a safeguard cap for First Class stamp products either instead of or as well as Second Class stamps. We considered that the Second Class service was more appropriate to price cap than First Class as:
- Vulnerable consumers were more likely to use this service (in comparison to other consumers);
 - While the majority of consumers and vulnerable consumers still predominantly use the First Class service, most of their mail does not need to be sent First Class (so a Second Class service would meet the majority of their needs); and
 - The impact on Royal Mail's pricing flexibility if First Class products were controlled would be material (particularly if this was in conjunction with Second Class).
- 8.142 A number of respondents (Consumer Focus, CWU, other operators and a number of customers and individuals) proposed that First Class stamps should also be included in the scope of the control. The focus of these responses was around the principle that many customers had no choice but to use First Class stamps. For example, Consumer Focus noted that most consumers (including vulnerable consumers) predominately use First Class stamp products.
- 8.143 However, putting a price cap on First and Second Class products would involve directly controlling nearly 20% of Royal Mail's total revenues. This would be likely indirectly to affect Royal Mail's pricing freedom for non-universal services and could compromise the wider financeability and efficiency incentives we consider will be created by not imposing a traditional price control. This is contrary to our objectives of the safeguard cap which include minimising the impact of the cap on Royal Mail's pricing flexibility.

- 8.144 While in the more recent research undertaken by Consumer Focus, consumers have claimed that more of their mail needs to reach its destination the next day, this does not appear to be backed up by their responses to other questions. Consumer Focus found that nearly 50% of all mail was personal communications and another 37% is general correspondence. It is likely that many of these items could be sent two to three days in advance if customers are incentivised to do so. Therefore we do not consider that including both First and Second Class products in the safeguard cap is necessary or appropriate.

Other universal service products

- 8.145 Some respondents sought to make a case for the inclusion of all universal service products within the scope of the safeguard cap, given the lack of competition for the significant majority of these services. However, as discussed in Section 6, we do not consider that a more comprehensive price control is appropriate given the current circumstances. Including other universal service products such as single piece International products in the scope of the safeguard cap (as was suggested by TNT) does not meet our intention or objectives for implementing the safeguard cap. In addition, we do not have any evidence that vulnerable consumers use these other universal service products on a regular basis.
- 8.146 In light of our duties we will however monitor the prices of these products to assess on an ongoing basis whether they remain affordable.

Structure of the safeguard cap

- 8.147 In the December consultation we set out our proposed structure if the safeguard cap were extended to include Large Letters and packets. This involved imposing a simple weighted average basket based on actual volumes for these additional price points, which would also be linked to inflation. This basket would be weighted by actual volumes to ensure that the impact on consumers (on average) was no more than what was allowed by the cap.
- 8.148 We do not currently consider there is any need to restrict Royal Mail's pricing flexibility any further within this basket. As previously discussed there is no chain of substitution between these products and as such we currently consider there is no need to place further restrictions on the prices Royal Mail can charge for individual price points (i.e. we do not currently propose to implement any sub-caps within the basket).
- 8.149 We note Royal Mail's concerns over the restriction to its pricing flexibility if multi price point caps were imposed (in particular on Standard Parcels). As set out above, it is currently our intention that the safeguard cap will require Royal Mail to charge no more than the average price across the basket for the range of products contained within it, and it will therefore have flexibility to change the relative prices of its products should this be required in relation to the needs of its customers or market or competitive changes.
- 8.150 We will set out our full proposals in this regard in the consultation document referred to above, on the level of the safeguard cap on Large Letters and packets up to 2kg which we intend to publish shortly.

Our decision

- 8.151 We have fully considered the additional evidence provided by stakeholders in their responses to consultation and, in particular, the research of potential impacts of stamp price increases on consumers provided by Consumer Focus. In addition, we have taken into account the findings of the BIS Select Committee in its report on stamp prices. We have therefore decided to:
- impose a safeguard cap on Second Class stamp Letters;
 - set the level of this safeguard cap at 55p for 2012-13; and
 - increase the cap at CPI thereafter (for the duration of the control).
- 8.152 We have also decided that it would be appropriate to extend the scope of the safeguard cap to Second Class Large Letters and packets up to 2kg. The form and level of the condition for the extension of the cap to these additional formats will be subject to consultation in the coming weeks. However, as set out above, in the first instance we would look to set the level of this basket based on a similar approach as that used in determining the range for Second Class Letters to minimise the effect of the safeguard cap on Royal Mail's pricing freedom. We do not intend to set caps on individual prices. Therefore, we do not expect that this will have a real constraining impact on Royal Mail's pricing flexibility in the short-term.

Section 9

End-to-end competition

Introduction

- 9.1 In Section 6 we set out our conclusion that Royal Mail should have greater commercial flexibility subject to key regulatory safeguards. Competition was one of these safeguards. In this section we set out our considerations and decisions with regard to end-to-end competition. Our consideration of access competition is set out in the next section (Section 10).
- 9.2 End-to-end competition is where operators other than the incumbent universal service provider collect, process and deliver mail direct to the recipient, without the need to use the incumbent's network. In the UK, other operators have been able to compete by providing these services since 2006, when the postal market was fully liberalised. End-to-end competition does not currently have a significant presence in the UK, and, alternative suppliers deliver less than 1% of Letters and Large Letters. The end-to-end competition that has developed so far in the UK has been in limited geographic areas only and/or for certain higher-value products, such as packets and parcels at higher weights or with premium elements, document exchange services and local delivery operations that tend to be limited in scale.
- 9.3 Section 41 of the Act gives Ofcom a power to impose a notification condition, following a direction from the Secretary of State, on every person providing or intending to provide a service within the scope of the universal postal service. Such a condition may require such persons to provide advance notice of their intention either (i) to provide a Letters business on a specified scale (whether or not the person is currently providing a Letters business or any other postal service), or (ii) where the person is already providing a Letters business on a specified scale, to expand the business by a specified extent. On 1 October 2011 the Secretary of State issued a direction to Ofcom, requiring us to impose such a condition by 1 April 2012.¹⁴²
- 9.4 In this section we set out our decisions to:
- Find an appropriate balance between our primary duty to secure the provision of a universal postal service and our duty to promote competition;
 - Impose a notification condition along the lines on which we consulted in December; and
 - Continue to monitor the market and initiate a review that will assess the evidence and the necessity and appropriateness of any regulatory intervention.

Our proposals

Potential benefits and costs of end-to-end competition

- 9.5 In the October consultation we recognised that by providing a competing service to Royal Mail's delivery operations, end-to-end competition potentially provides powerful incentives on Royal Mail to reduce its costs across the full length of the value chain.

¹⁴² <http://www.bis.gov.uk/policies/business-sectors/postal-services/postal-services-acts>

However, we also recognised that it poses a greater threat to the sustainability of the universal service by removing proportionately greater amounts of revenue from Royal Mail.

- 9.6 We stated that while end-to-end competition is the main model of competition in other countries, and appears to coexist with a healthy universal service and an efficient incumbent operator, in the current UK circumstances, in particular in light of Royal Mail's current financial position, we needed to recognise the associated risk to the provision of the universal service.
- 9.7 In particular, we noted that end-to-end competition could contribute to the sustainability of the universal service by providing incentives for Royal Mail to improve its efficiency within the delivery network; and increase the potential for innovation, lower prices and improved customer service.
- 9.8 Whilst offering potential benefits, end-to-end competition can have a significant cost for the universal service provider. In particular Royal Mail would be exposed to volume and revenue reductions not just from the declining market but also from competition. This effect could be potentially exacerbated by the fact that access providers currently handle over 40% of Letter volumes potentially leading to rapid growth if those operators chose to adopt an end-to-end model. If Royal Mail was unable to react effectively to such competitive pressures it could lose revenues and volumes to such an extent that it endangered the provision of the universal service. Also, Royal Mail's obligation to deliver universal service items everywhere at the same price creates an implicit cross subsidy between cheaper to serve areas and more expensive to serve areas which creates opportunities for arbitrage (sometimes called 'cherry-picking').
- 9.9 Therefore, we proposed to assess any actual or planned end-to-end competition notified to us on a case-by-case basis. We said that we would do so in the light of the potential impact on the provision of the universal service, in order to decide whether it would be appropriate to impose further regulatory conditions on operators in order to secure provision of the universal service, in accordance with our primary duty under the Act.

We proposed a notification condition on end-to-end entry or expansion

- 9.10 In proposing our end-to-end notification condition, we stressed it was not an approval process and so would not prevent a person/postal operator from providing services. The condition provides for a process to alert us to an instance of material end-to-end entry or growth of a competing Letters delivery service, which we can then use to develop an understanding of the impact of that competing service on the provision of the universal service.
- 9.11 We proposed requirements in the notification condition which we felt were simple to implement and understand, capable of being predicted relatively easily by the new entrant, that would inform us of any significant planned entry or growth (and allow us sufficient time to understand the plans), but equally would not lead to us being inundated with notifications about plans which would have an immaterial impact on Royal Mail's ability to provide the universal service and achieve financial sustainability.
- 9.12 We therefore proposed to require three months' advance notification to Ofcom if the operator was - in the quarter following the notification period –planning to:

- a) enter the market and deliver more than 2.5 million Letters in the UK; or
 - b) increase the volume of Letters they were carrying by more than 2.5 million.
- 9.13 Our proposed condition also included the basic set of information a notifying postal operator (or potential operator) should initially provide to us – including their name and address; the volume of Letters they forecast they will deliver in the quarter following the notification period; the planned delivery areas and the forecasted Letter delivery volumes in each of these areas; and if relevant, the date at which they plan to start delivering in each of these areas.
- 9.14 We also noted we would assess any potential entry or growth notified to us under this condition on a case-by-case basis to determine whether we should consider taking any regulatory steps to secure the provision of the universal service in accordance with our duties under the Act. In order to provide some clarity and certainty, we set out the process we expected to follow, namely:
- To acknowledge receipt of a notification within five working days – and tell the operator around this time that we may (i) request more information on its plans and (ii) collect information from other relevant parties;
 - Within a month of receiving a notification, tell the notifying operator whether we considered further analysis to be necessary (and if we believed that more analysis was required, we would inform them of its likely timetable); and
 - If following our analysis, we considered that we should impose any regulatory conditions in order to secure the provision of the universal postal service, we would consult on any such condition for a period of at least one month as required by the Act.

Responses to consultation

- 9.15 In response to the October consultation, Royal Mail, the CWU and two groups representing users (Scottish Churches Rural Group and the Methodist Church in Scotland) argued against the introduction of end-to-end competition. On the other hand, several respondents – including Consumer Focus, TNT, UK Mail and the DMA – supported the development of end-to-end competition.
- 9.16 With regard to the proposals for the notification condition and associated process in the December consultation, there was near consensus amongst respondents that greater certainty and clarity on the potential future regulation of end-to-end competition would be beneficial. Most respondents on this point were content with both the thresholds and timescales in the draft notification condition.
- 9.17 There was however disagreement amongst respondents in relation to the implications for potential future regulation. Some thought clarity was necessary because of the potential detriment to the universal service and others thought the lack of clarity undermined the potential for benefits from competition and the likelihood of entry.
- 9.18 Royal Mail stated that end-to-end competition is the single biggest factor that will affect the financeability and sustainability of the universal service. It noted that the economics of the universal service could be rapidly undermined if end-to-end competitors were permitted to cherry pick the most profitable mail volumes, leaving Royal Mail to deliver the least profitable mail six days a week. It also noted that the

scale of upstream volume processed by access operators means that entry could lead to greater market penetration than seen in other European Member States, where access volumes are low or non-existent.

- 9.19 Royal Mail said that Ofcom needs to be much clearer to the market on the process it will use to assess the risks to the universal service, how it will impose conditions on prospective entrants and what those conditions will be. It believed that the three month notification period set out in the proposed notification condition was appropriate if Ofcom provides clarity upfront on these issues, but that otherwise in its view six months would be more appropriate.
- 9.20 Royal Mail also maintained that it is essential that Ofcom substantiates how its proposed process for assessing entry would safeguard against any detriment to the universal service occurring. In addition, it said Ofcom should not wait until delivery competition is up and running at scale before taking action and that where Ofcom concludes that some form of action is required, this should take effect from the moment deliveries start or the volume increases, rather than after the event.
- 9.21 The CWU stated that Royal Mail could not withstand the loss of delivery market share and this would threaten the viability of the universal service. The CWU urged Ofcom to further clarify its position, and if necessary impose further regulation on new end-to-end operators. The CWU was particularly concerned that the model of end-to-end competition that develops may not be a single large entrant but rather a proliferation of small operators or an operator targeting business mail only in a specific geographical area. It noted that this could also undermine the universal service.
- 9.22 Which? said that it was not clear how end-to-end competition would operate efficiently or effectively in consumers' interests. It believed it was important that any competitive process for a utility service (such as post) is properly implemented to empower and protect consumers. Additionally, it considered that Ofcom should be prepared actively to use its sectoral, competition and consumer enforcement powers to intervene where conduct or other failings undermine benefits for consumers.
- 9.23 The DMA and another user group welcomed the potential increase in end-to-end competition as they considered that this would provide the best incentives on Royal Mail to reduce cost, improve efficiency, innovate and become more customer focussed. These responses stated that end-to-end competition would also provide an alternative to Royal Mail in the event of industrial action, which would dilute the impact of such action and prevent switching to other channels.
- 9.24 TNT (which has publicly announced its intention to offer end-to-end services in the future) hoped that the requirement on all operators to notify Ofcom with plans for commencement or expansion of delivery operations will not impose an undue regulatory obligation on postal operators. TNT noted that although Ofcom's primary duty is to secure the provision of the universal service, imposing regulation in a way that may hinder end-to-end competition is subject to a number of statutory constraints which it believes would make such regulation unlawful.
- 9.25 UK Mail (which has also announced plans to offer end-to-end services) agreed with the potential benefits of end-to-end competition that we had set out. Whilst it recognised the risk of cherry-picking, it noted that end-to-end competition would be in bulk mail which is not part of the universal service and therefore Royal Mail could

price zonally.¹⁴³ With regard to the proposed notification condition, UK Mail referred to the notification process imposing “planning blight” on the development of competitive final delivery of mail in the UK. It said an operator will not know what conditions it will be subject to (or if it will be subject to none) before it has begun its new or expanded delivery operation.

- 9.26 ONEPOST agreed with Ofcom’s proposals regarding the notification process but suggested there should be more detail about the timescales involved as an operator deciding to invest in an end-to-end operation needs to be able to have a better idea of exactly how long the process will take so that they can plan their investment and internal approvals around it.
- 9.27 Consumer Focus stated it believes that competition in the postal market provides benefits for consumers and customers, both through promoting efficiency at Royal Mail and in offering greater choice. It also stated it did not consider Ofcom has the power under EU rules to block end-to-end operators in the postal market and that any attempt by Ofcom to restrict or use authorisations of end-to-end entrants as a form of restrictive licensing would foster significant regulatory uncertainty and would run the risk of being counter to EU rules.
- 9.28 Consumer Focus considered the notification process will act as a disincentive for end-to-end entry by creating sufficient uncertainty to deter entry into the market. It said Ofcom should work closely with potential entrants to reduce the level of market uncertainty that the imposition of the notification condition poses by, for example, clearly defining the circumstances under which regulatory conditions will be imposed, working closely with potential end-to-end operators in order to discuss regulatory concerns and providing a clear indication as early in the process as feasible as to whether the potential entrant will be subject to regulatory conditions. However, Consumer Focus supported Ofcom’s recognition of the importance of confidentiality when handling commercially sensitive information as part of the notification process.

Our assessment

- 9.29 The issues raised by the responses to the consultations fall into three broad areas. First, the impact of end-to-end competition, and whether it will have a negative or positive effect on the UK’s universal postal service. Second, how the notification process would work. Third, the desire for greater certainty regarding the regulatory framework for end-to-end competition and, in particular, the circumstances in which Ofcom would impose general universal service conditions and what form these obligations would take.
- 9.30 We consider these issues further below.

The impact of competition

- 9.31 We note that the responses fell into two broad groups. Royal Mail, the CWU and some consumer groups argued that the development of end-to-end competition would harm the universal postal service and was unlikely to bring benefits. Most other postal operators (including TNT and UK Mail, both of whom have announced plans to offer end-to-end services) and Consumer Focus argued that end-to-end competition would be positive for the universal postal service by maintaining mail

¹⁴³ Zonal pricing is where the operator charges different prices for delivery to different parts of the country, generally in order to reflect the different cost of delivering to different areas. Zonal pricing is not permitted for universal service products, which have to be priced on a geographic uniform basis,

volumes, providing greater choice and lower average prices for customers, and also provide greater incentives for Royal Mail to cut costs.

- 9.32 These two positions are diametrically opposed to each other, but taken together are consistent with our position in the October consultation. That is, we considered it possible to hypothesise scenarios in which end-to-end competition has either positive or negative implications for the sustainability of the universal service. We consider that none of the information presented by stakeholders to this point presents an overwhelming case for a conclusion one way or the other.

The notification process

- 9.33 There were few responses directly on the notification condition itself. Most respondents seemed content with the threshold of the delivery of 2.5 million new Letters per quarter (either by entry or growth) and the three-month time period. Similarly the process we outlined for handling notifications attracted little comment.
- 9.34 We acknowledge the CWU's view that multiple small postal operators or intense geographic competition could in theory pose a threat comparable to that of a single large entrant. However, we consider that the notification condition addresses a particular circumstance or set of circumstances, namely the entry or growth by one or more postal operators of significant Letters businesses. Setting the threshold lower or adding more complicated triggers risks, in our view, undermining the efficacy of the process. In any event, our duty to secure the provision of the universal service is not dependent on the notification process and we will take into account other sources of information in securing our ongoing duty to exercise our functions in a way that we consider will secure the provision of a universal postal service.
- 9.35 One area that attracted comment was the confidentiality of notifications, with Consumer Focus supporting the view they should be confidential, but UK Mail expressing concerns that we could not guarantee confidentiality. Implicit in several responses were concerns about the transparency of the process.
- 9.36 As noted in the December consultation, we consider that the content of any notification should be confidential. It may be necessary in some cases to seek information from other operators, including possibly Royal Mail, in order to assess the likely impact of proposed entry or expansion on the provision of the universal service. We do not however consider that this necessarily means that we would need to disclose the identity of the party that had notified us. We recognise however, that our need to seek information from third parties may effectively mean that the fact that a notification has been made to us becomes public, if on an anonymous basis. We do not believe this in any case to be a significant concern in a context where the two main potential entrants have publicly announced in the last few months their intention to begin delivery in specific geographic areas.
- 9.37 Royal Mail's comments about the need to extend the notification period to six months unless there is certainty about the imposition of conditions, in our view misunderstands the role of the notification condition and our powers to impose general universal service conditions. Royal Mail appears to suggest that the notice period acts as a barrier to providing services until Ofcom has reached a decision. It is important to note that a notification condition does not give Ofcom the power to accept / reject an operator's proposals. It is not akin to an authorisation process but simply a system of advanced notification. We discuss our powers to impose general universal service conditions below.

Uncertainty regarding the imposition of general universal service conditions

- 9.38 Several respondents said that we should provide greater certainty and clarity regarding what obligations we might place on end-to-end competitors. Any assessment of the impact of end-to-end competition on the provision of the universal service would depend on the individual facts of each case, and as such, we consider that there are limits to the extent to which we can provide such guidance, whilst still ensuring that we do not fetter our discretion in relation to any future regulatory action that we might consider taking.
- 9.39 We have however set out below a summary of our statutory powers and duties in this regard, the statutory tests for imposing certain obligations in conditions, and our current views on how we are likely to assess whether it is necessary to impose conditions as a result of end-to-end competition.
- 9.40 Before doing so, we consider that it is useful to recognise that the Act replaced the previous individual licensing regime with a system of general authorisation. This means that anyone is permitted to provide postal services provided that they comply with conditions imposed by Ofcom. As set out above, we have decided to impose a notification condition in relation to certain end-to-end competition. Against this background, the notification condition acts as a means of advanced warning of market entry for Ofcom; it does not provide Ofcom with a power to approve/reject plans for market entry or expansion. Also, the existence of the notification condition or any particular notification made under it are not necessary for Ofcom to assess the impact of end-to-end competition on the universal service or to consider the imposition of conditions: Ofcom has an ongoing duty to act in a way that we consider will secure the provision of a universal postal service.
- 9.41 It is in our view also important to recognise that there are no powers in the Act for Ofcom to "block" end-to-end entry.

Our main relevant statutory powers and duties in this context

- 9.42 To the extent that an operator or operators have entered the market and are providing a service within the scope of the universal postal service¹⁴⁴, Ofcom has the power (but not a duty) to impose on them general universal service conditions pursuant to section 42 of the Act.
- 9.43 General universal service conditions would apply to every postal operator providing a service within the scope of the universal service, or every postal operator providing a service of a description specified in the condition.
- 9.44 A general universal service condition may (amongst other things) contain such obligations as Ofcom considers necessary to impose for, or in connection with, securing the provision of a universal postal service in accordance with the standards set out in the universal postal service order. The Act limits the scope of those obligations, by preventing us from replicating the USP conditions imposed on the designated universal service provider. Specifically, Ofcom cannot impose conditions under section 42 requiring a postal operator to:

¹⁴⁴ For example, the delivery of bulk mail by an end-to-end operator would be within the scope of the universal service.

- deliver or collect Letters or other postal packets as set out in section 31 of the Act (section 31 prescribes the minimum list of services that must be included in the universal postal service),
 - to provide a service throughout the UK, or
 - to provide a service at an affordable price in accordance with a public tariff uniform throughout the UK.
- 9.45 In accordance with Schedule 6 of the Act, any condition that Ofcom intends to impose (including general universal service conditions under section 42 of the Act) must be objectively justifiable, not unduly discriminatory, proportionate to what it is intended to achieve, and transparent.
- 9.46 When imposing conditions, Ofcom must act consistent with its general statutory duties. Under section 3 of the 2003 Act, Ofcom has duties to (a) further the interests of citizens in relation to communications matters; and (b) to further the interests of consumers in relevant markets, where appropriate by promoting competition. However, in the event of a conflict, Ofcom's general duties under the 2003 Act must give way to its primary duty to secure the provision of the universal postal service under the Act (see section 6A 2003 Act).

Tests for intervention

- 9.47 As set out above, any obligation contained in a general universal service condition must in our view be necessary to impose for, or in connection with, securing the provision of the universal service in accordance with the standards set out in the universal postal service order. We do not have powers to impose a general universal service condition for any other purpose.
- 9.48 In order to impose such an obligation, the Act effectively requires us to identify the likely risk to Royal Mail's ability to continue to provide the universal service in accordance with the standards set out in the order. The Act makes it clear that any obligation contained in a general universal service condition would need to be capable of addressing that identified perceived risk, and be necessary to do so. Whether an obligation is necessary, objectively justifiable, and proportionate will inevitably depend on the individual circumstances of each case. We note in this regard that the necessity requirement contrasts with the requirements relating to the imposition of some other conditions under the Act, such as for example the imposition of a USP access condition, which Ofcom may impose if it considers that the condition is appropriate for the purposes specified in section 38 of the Act.

How we are likely to assess whether it is necessary to impose conditions as a result of end-to-end competition

- 9.49 Ofcom will assess the likely impact on the universal service of any end-to-end competition that is either notified via the notification condition or comes to our attention from any other source. We will take into account any factors that we consider to be relevant, such as:
- The size and projected growth of end-to-end competition (individually or, if relevant, in aggregate);
 - The particular business plan(s) of the end-to-end competitor(s), including types of service offered, frequency of delivery, geographic scope, prices, etc;

- The likely direct impact of end-to-end competition on Royal Mail's revenues, future cash-flows and unit costs;
- Royal Mail's wider financial position;
- The nature and effect of existing regulation and any ongoing regulatory processes;
- Any benefits that may result from end-to-end competition, including efficiency incentives; and
- The market context.

9.50 We consider that it is likely also to be necessary to carry out sensitivity analysis to ensure that any assessment we undertake is robust to changes in assumptions, given, for example, the historic volatility of the postal services market and the fact that any such assessment will be forward-looking in nature.

Summary

9.51 Therefore, we consider that it is clear that Ofcom has power to impose general universal service conditions where there is a demonstrable threat to the provision of the universal service. Furthermore, Ofcom's duty to carry out its functions to secure the provision of a universal service is an ongoing duty, and so Ofcom must assess the provision of a universal service on an ongoing and forward looking basis. However, none of the evidence or analysis presented to us so far suggests to us that we should put in place conditions on a precautionary basis.

9.52 Given that (1) we must consider the potential impact on the universal service on an ongoing and forward-looking basis, (2) the need for the imposition of any regulatory conditions, including general universal service conditions, to be based on evidence as to why they are (amongst other things) objectively justifiable and proportionate and (3) the wide range of factors that we would need to take into account in reaching any assessment which would in large part depend on the individual facts of each case, it is not possible for us to set out the precise circumstances in which we will or will not impose general universal service conditions in the future.

Our decision

9.53 Given our primary duty to secure the provision of a universal postal service (as set out above), we recognise the need to find an appropriate balance between that duty and our duty to promote competition. Prior to considering the need for regulation, we will therefore consider the benefits of competition, and whether competition is likely to conflict with our duty to secure the provision of a universal postal service.

9.54 We have decided to impose a notification condition along the lines on which we consulted. The final text of the condition is set out in Annex 12. We consider that such a condition will provide us with timely notice of any new end-to-end competitors and assist us in assessing any impacts on the provision of the universal service.

9.55 We will continue to monitor the market and if we consider there have been any significant developments we will initiate a review that will assess the evidence and the necessity and appropriateness of any regulatory intervention.

Section 10

Access competition

Introduction

- 10.1 Section 6 sets out the importance of key regulatory safeguards, including competition, given our decision to remove traditional price controls. Section 9 discussed our approach to end-to-end competition and this section sets out our considerations in relation to competitors' accessing Royal Mail's network.
- 10.2 In October consultation we set out our proposals for the regulation of access to Royal Mail's network and the appropriate form of any such regulation. In setting out our proposals, we also took into account the responses to two earlier consultations that Postcomm had carried out:
- In March 2011, Postcomm consulted on its access review¹⁴⁵ which set out the background to access, considered the role of access competition in the UK and provided Postcomm's initial views on how access should be regulated under a new regulatory regime from 2012; and
 - In April 2011, Postcomm consulted on the need for ex ante regulation of Royal Mail beyond 2012 as part of its initial proposals on regulatory safeguards consultation¹⁴⁶, including in particular whether regulatory safeguards were required to address the risk of Royal Mail engaging in a margin squeeze (including options for addressing such risks). It also consulted on whether there was a need for zonal access price regulation.
- 10.3 In our October consultation, we primarily focussed on the key areas that we considered needed to be addressed as part of our proposals for a new regulatory framework. More specifically we focussed on the following:
- Whether Royal Mail should be required to offer access to the postal network for participation in the retail D+2 and later than D+2 Letters and Large Letters markets¹⁴⁷;
 - Ofcom's role in setting the terms and conditions of access in these markets and whether it should specify or describe the terms and conditions that Royal Mail must offer access operators;
 - The principles for addressing issues of non-equivalence;
 - A process for addressing disputes;
 - Whether Ofcom should impose a general access condition on a particular postal operator (or operators) requiring them to grant access to its postal infrastructure;

¹⁴⁵ Postcomm, The building blocks for a sustainable postal service, Access Review 2012 – Initial Proposals, March 2011.

¹⁴⁶ Postcomm, The building blocks for a sustainable postal service, Initial proposals for regulatory safeguards, April 2011.

¹⁴⁷ Markets for D+2 and later than D+2 services are those where the suppliers of retail services aim to ensure that the mail is delivered in a minimum of two working days after collection.

- Whether to impose regulation to address the risk of Royal Mail engaging in price squeeze; and
 - Whether to impose regulation relating to zonal access.
- 10.4 In December 2011, we published a consultation that set out how our proposals from October would be reflected in a USP access condition. In addition, the consultation made certain supplementary proposals which set out more detailed aspects of the implementation of the proposed new access framework.
- 10.5 This section responds to the key points made by stakeholders to both our October and December consultations on access and sets out our final decisions for regulating access from April 2012.
- 10.6 In this section, references to draft USPA provisions are to provisions contained in the draft USP access condition that was published in our December consultation. References to revised USPA provisions are to the provisions in the USP access condition that is being imposed on Royal Mail and that is set out in Annex 9.

Obligation on Royal Mail to offer access to its network – D+2 and later than D+2 Letter and Large Letter services

Our proposals

- 10.7 In our October consultation we considered that the tests in the Act that must be satisfied in order for a universal service provider to be required to give access to its postal network were met in relation to obliging Royal Mail to offer access for participation in the retail D+2 and later than D+2 Letters and Large Letters markets.
- 10.8 Under the Act, Ofcom may not impose a condition requiring access to the universal service provider's network unless it appears to it that a condition is appropriate for each of the following purposes:
- Promoting efficiency;
 - Promoting effective competition; and
 - Conferring significant benefits on the users of postal services.
- 10.9 In relation to promoting efficiency, we considered that competition from access would incentivise Royal Mail (and other operators) to improve the efficiency of their networks. We considered that the approach that Royal Mail had adopted in its modernisation programme provided some support for this proposition as those parts of Royal Mail's network that were subject to competitive pressures from access had modernised more rapidly than other parts of the network.
- 10.10 In relation to promoting effective competition, we noted that prior to the launch of access, Royal Mail faced little or no competition in the relevant markets. However, since launch, access had grown rapidly. We also noted that, although the initial pace of growth of access had been facilitated by the headroom regime, over half of the items handled by access operators in 2010-11 had previously been sent via services of Royal Mail that were not subject to any headroom control.

- 10.11 In relation to conferring significant benefits to users, we considered that competition provided incentives on Royal Mail to operate more effectively in dealing with customers. We also noted that access competition had led to large bulk mail customers receiving significant price savings from access operators in the provision of upstream activities and that competition had now led to small customers receiving price savings.
- 10.12 Royal Mail had provided three main reasons against imposing an obligation on it to provide access in its prior response to Postcomm's March consultation:
- The economic rationale for mandating access in network industries as a means for overcoming an economic bottleneck that impeded the development of competition did not apply to post since none of Royal Mail's assets were inherently non-replicable. Further, Royal Mail argued that there was no evidence to suggest that Royal Mail had any 'essential facilities' from a competition law perspective and these facts were supported by evidence of the presence of end-to-end competition in other countries.
 - Access was not required to promote competition in the D+2 and later markets and the access regime itself had impacted on the incentives for end-to-end competition. In short, Royal Mail argued that, had the access regime not existed in its current state, some form of end-to-end entry would have already occurred.
 - Royal Mail should not be obliged to offer access, since as long as access supported the financial sustainability of the universal service, it would have an incentive to continue to do so.
- 10.13 In our October consultation, we responded to Royal Mail's main arguments against mandating access to its network. We did not consider that the Act required Ofcom to prove a point of the postal network was an 'essential facility' before requiring Royal Mail to offer access to its network and therefore Royal Mail had set too high a threshold in this regard. The relevant tests for determining whether an access obligation should be imposed were those set out in the Act.
- 10.14 We considered that significant barriers to entry existed in developing a delivery network that predominantly related to Royal Mail's economies of scope and scale advantages that were likely to limit the extent of end-to-end competition.
- 10.15 We did not fully agree with Royal Mail's contention that in the absence of the access regime, end-to-end competition would have developed. We considered that access was likely to be an important component in facilitating end-to-end competition. First, we considered that access allowed operators to build volumes, 'know-how' and brand ahead of potential investment into end-to-end services.
- 10.16 Second, we considered that, given the high proportion of fixed costs in delivery, a regional competitor (which was a more likely form of entry than a national competitor offering delivery services) was likely to face a cost disadvantage relative to Royal Mail in a particular geographic area given Royal Mail's ability to deliver volumes that originated from all areas.
- 10.17 We set out our view that, in order to overcome the cost disadvantage, an entrant could establish a business model that focussed on delivery within a specific geographic area that also included the delivery of volumes originating from outside that area. However, in the absence of an access regime, we believed that this would mean large mailers with a national profile (which were most likely to be targeted by

operators) would need to separate their mail between Royal Mail (for geographic areas where no competition had developed) and the competing operator that was able to offer a delivery service in a specific geographic region. We considered that, although such a process was possible, it would incur additional transactional costs for customers.

- 10.18 In light of this, we considered that an operator seeking to provide a delivery service would be likely to need to collect all items from a customer and deliver those items where it had developed a delivery network and use access to Royal Mail's network to deliver the remaining items. Therefore, we considered that mandated access to Royal Mail's network would play a key role in facilitating end-to-end competition.
- 10.19 We considered that although an ex post approach could be adopted to address the risk of Royal Mail abusing its market power downstream, competition law enforcement might not be the most effective tool for addressing the issues that would be likely to arise and that relying on ex post safeguards alone could lead to the risk of irreversible and permanent damage to access competition.
- 10.20 When deciding what obligations should be imposed in a USP access condition, the Act requires that Ofcom must in particular take into account five factors. The five factors are as follows:
- the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed access unnecessary;
 - the feasibility of giving the proposed access;
 - the investment made by Royal Mail in relation to the matters in respect of which access is proposed;
 - the need to secure effective competition in the long-term; and
 - any rights to intellectual property that are relevant to the proposal.
- 10.21 In our October consultation, we considered that these five factors indicated that the appropriate point of access for participation in the retail D+2 and later than D+2 Letters and Large Letters markets was at the Inward Mail Centre ('IMC'). In reaching this view we recognised that downstream access users currently inject items at this point (access at the IMC for participating in the D+2 and later than D+2 Letters and Large Letters market accounts for over 99% of access items and over 97% of access revenues) and this demonstrated that it was feasible.
- 10.22 The October consultation proposed that access at the IMC for participating in the retail D+2 and later than D+2 Letters and Large Letters markets was consistent with Ofcom's primary duty to secure the provision of a universal postal service. Our analysis indicated that in the long-run a significant proportion of upstream costs should be avoidable. Therefore, if in the long-run the price paid by access operators was comparable to Royal Mail's retail price less an appropriate measure of incremental costs, Royal Mail should be indifferent to offering access and the provision of access should not be inconsistent with safeguarding the provision of the universal service. We recognised that the existing headroom regime, and the prices which were set as a result of that regime, might have resulted in an adverse impact on Royal Mail's finances. However, we considered that these adverse impacts were not due to access per se but rather the price at which access was offered.

- 10.23 Although we did not rule out mandating access at alternative points to the IMC in the future, we considered that further evidence would need to be provided by the access seeker regarding why such an alternative point of the network met the criteria in the Act.
- 10.24 In our December consultation, we proposed to establish a USP access condition¹⁴⁸ that required Royal Mail to offer access at the IMC for the provision of D+2 and later than D+2 Letters and Large Letters services. We also consulted on a draft of the USP access condition as part of the December consultation.

Responses to consultation

- 10.25 Royal Mail maintained its position that that it did not believe it necessary for Ofcom to mandate access to its network and that mandated access did not satisfy the tests set out in the Act. It referred to its position as set out in a previous submission to both Ofcom and Postcomm which was considered by Ofcom in our October consultation (see paragraphs 10.12 – 10.19 above).
- 10.26 Royal Mail did not provide further evidence in relation to mandating access at the IMC for the purposes of participating in the D+2 and later than D+2 Letters and Large Letters markets in response to Ofcom's initial proposals. However, Royal Mail argued that if Ofcom were to mandate access to Royal Mail's network then it should be at the IMC since this was where it and other operators had already invested in facilities and processes to facilitate access. Given this, Royal Mail's subsequent evidence focussed on why mandated access should not be widened to other points of its network or for the provision of other services.
- 10.27 The CWU and some individual respondents supported the full deregulation of downstream access. Otherwise there was broad agreement from stakeholders regarding Ofcom's proposals to require Royal Mail to offer access to its network at the IMC for the provision of D+2 and later than D+2 Letters and Large Letters services.
- 10.28 A number of access operators argued that Ofcom should widen the scope of mandated access to include other forms of access such as access for packet items and for the purposes of participating in the D+1 markets. This is discussed further in paragraphs 10.195 – 10.222.

Our assessment

- 10.29 As noted above, Ofcom had already taken account of the arguments provided by Royal Mail against mandating access at the IMC for the purposes of participating in the retail D+2 and later than D+2 Letters and Large Letters markets as part of our analysis to support our October proposals.
- 10.30 Although the CWU and some individuals supported the full deregulation of downstream access, their responses did not provide further explanation, beyond that considered as part of our initial proposals, relating to why access at the IMC for the purposes of participating in the retail D+2 and later than D+2 Letters and Large Letters markets did not satisfy the tests in the Act.

¹⁴⁸ USP conditions, including USP access conditions, are those which are applied to the Universal Service Provider.

10.31 Based on our analysis within our October proposals and the evidence provided we consider that access at the IMC for participating in the retail D+2 and later Letters and Large Letters markets satisfies the tests set out in the Act and is consistent with our primary duty to secure the provision of a universal service.

10.32 We discuss the obligation on Royal Mail to offer other forms of access below.

Our decision

10.33 Our final decision is to establish a USP access condition that requires Royal Mail to offer access at the IMC for the provision of D+2 and later than D+2 Letters and Large Letters services. An explanation of how our decision to impose a USP access condition for these purposes meets the various requirements set out in the Act is set out in Section 13 below.

10.34 The USP access condition that we have decided to impose is set out at Annex 9. The detail of what will be included in the USP access condition is discussed below. In addition, certain more detailed drafting comments that we received on the draft USP access condition set out in our December consultation are addressed separately in Annex 4.

Setting the terms and conditions of access - General

10.35 The Act provides a framework for imposing certain types of obligation in access conditions as well as power to specify or describe terms and conditions that Royal Mail must include in the terms and conditions that it offers access users. Beyond that, it is left to Ofcom to determine the precise content of the obligations to be included in the condition as well as, more generally, the extent to which it is appropriate to become more involved in setting the detailed terms and conditions of access.

Our proposals

10.36 In our October consultation, we proposed that commercial negotiations between Royal Mail and access operators should provide the basis for agreeing the terms and conditions of access. Therefore, although we recognised that the Act permitted Ofcom to include in a USP access condition a provision requiring Royal Mail to offer access on the terms and conditions as may be specified by Ofcom, we did not believe that such a prescriptive approach was appropriate.

10.37 Instead, we proposed that the USP access condition should include a more general requirement that the terms and conditions of access (including prices) offered by Royal Mail should be “fair and reasonable”.

10.38 In addition, in our December consultation we identified a limited set of areas that we considered key to the effectiveness of the access regime and where we proposed that additional regulatory requirements should be included in the USP access condition. These related to the process for postal operators and users of postal services to request access contracts or variations to existing contracts, notification and publication requirements and information relating to quality of service.

10.39 We also considered whether there was a role for Ofcom to publish guidance to supplement the USP access condition that provided an explanation as to how Ofcom would approach assessing whether the terms of access had been offered on a fair and reasonable basis. As part of the October consultation, we set out a number of

potential areas where guidance could be provided and sought views from interested parties regarding whether there were any key issues where guidance was needed.

Process for requesting access contracts and variations to existing contracts

10.40 We proposed that the USP access condition should include a requirement for Royal Mail to adopt a reasonable, transparent and timely process for postal operators and users of postal services to make requests for access contracts (or variations to existing access contracts). In this regard, we proposed that Royal Mail should publish a Statement of Process within three months of the USP access condition being imposed, having first consulted with the industry and Ofcom. We expected that this process would be followed in the future, subject only to a right for Ofcom to direct Royal Mail to change the terms of the statement of process or the manner in which they applied. We proposed that, in developing the Statement of Process, Royal Mail should address the following:

- How access requests should be made;
- The basic information that is required from an access seeker to progress an access request and an appropriate means of providing such information; and
- A set of timescales in which Royal Mail will handle requests for access (or variations to existing contracts).

Publication and notification

10.41 In relation to publication and notification requirements, we recognised that currently all access contracts are substantially the same. However, in the future, the industry might wish to achieve greater flexibility to negotiate individual access agreements where different postal operators or users were in different positions and/or had different needs. We identified that one way that this might be achieved could be through Royal Mail providing all customers with a standard set of terms and conditions of access, but being free to negotiate aspects of the contracts with individual access customers.

10.42 Therefore, we proposed to set regulatory obligations relating to the notification and publication of standard terms and conditions only. For individually negotiated terms and conditions, publication requirements would not apply and the period for implementing the changes to the terms and conditions would be expected to be agreed as part of the negotiation process.

10.43 We also recognised that there could be circumstances under the current contractual arrangements where it would be unfeasible (or difficult) for Royal Mail to make changes to the standard terms and conditions because it could not make the changes unilaterally and it was unable to agree the changes with all customers. We suggested that one option that could be taken forward by the industry was for Royal Mail to have the ability to make unilateral changes to more, or all, standard terms and conditions. We recognised that the feasibility and acceptability of such an option would be dependent on Royal Mail providing sufficient notice in relation to changing the terms and conditions as appropriate for the purposes of allowing access operators to manage the changes or bring a dispute in the event that they disagreed with the change being proposed.

10.44 In summary, we proposed that, for standard terms and conditions, the USP access condition would require Royal Mail to provide sufficient notice of changes to terms and conditions to access operators as follows:

- Ten weeks' prior publication and notification of standard price terms (unless otherwise agreed);
- Ten weeks' prior publication of standard non-price terms (unless a shorter notification period agreed, in which case, consistent with the shorter period);
- A transparent process for prior notification of those non-price changes that do not require the prior consent of the access operator, with periods sufficient to allow operators to manage the impact of such changes; and
- No requirements around notification or publication for individually negotiated terms.

Quality of service

10.45 In relation to quality of service, we proposed that the USP access condition should include a requirement for Royal Mail to provide access users with quality of service information based on a fair and reasonable system of monitoring quality of service. However, we did not propose to set quality of service levels as part of the USP access condition.

10.46 Although we recognised that end-to-end quality of service information could be of benefit to customers, we considered that the demand for such information should be customer led and that, if there were a genuine demand from customers, the industry should endeavour to reach an agreement regarding how that customer demand could most appropriately be satisfied.

Responses to consultation

10.47 Royal Mail was supportive of the principle that the terms and conditions of access should be set on a "fair and reasonable" basis. It argued that if there were a regulatory role, then it should be limited to providing broad guidelines on what constitutes: (a) "fair and reasonable"; and (b) an appropriate process for the principles and broad timescales to be adopted. Royal Mail argued that the guidelines should not include interventions, either explicit or implicit, in specifying contractual terms and conditions.

10.48 There was broad agreement from access operators in relation to the USP access condition including an obligation for Royal Mail to offer access terms on a "fair and reasonable" basis with the support of specific guidance on how "fair and reasonable" should be interpreted. Access operators also requested that it should be clear that the "fair and reasonable" obligation should apply to access agreements that already exist at the time that the USP access condition is imposed and not just to any new access agreements.

10.49 A number of access operators highlighted areas where they believed Ofcom should provide specific guidance on the interpretation of "fair and reasonable". These included areas such as zonal pricing and forecasting requirements. TNT suggested that Ofcom should provide guidance on Royal Mail's retail pricing behaviour. One area that was repeatedly raised by both access operators and customers was the desire for guidance in relation to surcharging and reversions.

Process for requesting access contracts and variations to existing contracts

- 10.50 Royal Mail agreed with the principle of providing a reasonable, transparent and timely process through which postal operators and other customers could apply for new access contracts or variations to existing agreements and was content to publish a Statement of Process following consultation with the industry.
- 10.51 Two access operators expressed concerns over our proposals for Royal Mail to publish a Statement of Process following consultation. UK Mail believed that Ofcom should retain a role in both the development of the process and its subsequent application, and that Royal Mail should be required to agree with Ofcom both how the consultation should take place and the resulting Statement of Process. TNT suggested that the duty for Royal Mail to consult to change the process for agreeing access terms (or variations to terms) was insufficient and argued that a change to the process should be subject to agreement through consensus through a duly established group representing all access customers who wished to attend.
- 10.52 TNT raised a concern that the proposed USP access condition did not specify timings by which Royal Mail was required to seek further information in relation to an access request and that minor modifications in an access request could result in the three-month period by which Royal Mail was required to provide the terms of access starting again.

Publication and notification

- 10.53 Royal Mail agreed with Ofcom's proposals relating to the requirement to notify and publish standard terms and conditions including the ten week notification period.
- 10.54 A number of access operators (and the MCF) argued that Royal Mail should not be allowed to negotiate bespoke (or non-standard) access agreements and/or that these remain unpublished. Access operators were concerned about the risk to competition that might arise due to Royal Mail discriminating against or in favour of certain access operators, for example by offering targeted discounts, such as volume discounts. Examples of the possible adverse impacts of Royal Mail not publishing such contracts included:
- Preference in access terms towards operators not seeking to extend their networks into end-to-end as a means of creating a barrier to delivery competition; and
 - Preference towards large operators with the effect of embedding a small number of competitors and restricting innovation and further competition.
- 10.55 A number of access operators raised a concern over Royal Mail having greater power to make more unilateral changes to the terms and conditions of access.

Quality of service

- 10.56 Whilst Royal Mail already measured its quality of service and published its results, it believed that there were significant benefits from implementing an industry-wide scheme. Royal Mail argued that this would be intended to provide customers with the same level of quality of service information for each operator (including access operators) and thereby provide customers with information regarding the quality of service of access operators in relation to upstream activities (i.e. in advance of items being injected into Royal Mail's network). Royal Mail argued that Ofcom should

introduce an industry-wide, industry-funded monitoring process with the results published quarterly.

- 10.57 A large customer also suggested that there needed to be an independent and consistent system of monitoring Royal Mail's quality of service, both for Royal Mail's wholesale and retail services, and that it would be beneficial for this to be extended to other operators. The MUA expressed support for Ofcom to take responsibility for ensuring that end-to-end quality of service metrics for access operators were properly monitored and reported.
- 10.58 UK Mail supported the requirement for Royal Mail to monitor the quality of service of the delivery of access items. However, it was uncertain whether there was support for a wider requirement that included the monitoring of the quality of service of all access operators.
- 10.59 A number of access operators have expressed opposition to the relatively recent introduction by Royal Mail of its own system that measures the quality of service of access operators. One access operator has expressed a specific concern to Ofcom relating to the accuracy of Royal Mail's results given its view that the system does not satisfactorily reflect the operational characteristics of mail being sent via access operators.

Our assessment

- 10.60 Ofcom continues to consider that commercial negotiations between Royal Mail and access operators should as a matter of principle provide the basis for agreeing the terms and conditions of access. We also continue to consider that this would be best achieved through a requirement in the USP access condition that the terms and conditions of access offered by Royal Mail should be "fair and reasonable".
- 10.61 For the avoidance of doubt, we consider that the fair and reasonable requirement in the USP access condition would apply to both existing access agreements and future access agreements. We have therefore made this clear in the drafting of the USP access condition by including a separate requirement for fair and reasonable terms, conditions and charges which are stated to apply to any 'existing' D+2 and later Access Contract as well as to D+2 and later access that is provided in accordance with the requirement to provide D+2 Access on reasonable request (revised USPA 3).
- 10.62 In relation to Ofcom providing guidance to supplement the USP access condition, Royal Mail has argued that Ofcom should limit itself to providing broad guidelines relating to principles and processes and that the guidelines should not specify terms and conditions. As indicated in our October consultation, we do not consider it appropriate to adopt a prescriptive approach in guidance by setting out specific terms and conditions that Royal Mail should be required to offer access operators as guidance should not stifle commercial negotiations and innovative solutions.
- 10.63 As previously explained, we consider that commercial negotiations between Royal Mail and access operators should provide the basis for agreeing the terms of access. Therefore as a general principle we consider that any guidance should typically be at a relatively high level, and be subject to the specific circumstances. However, notwithstanding this, we also recognise that in some cases, more detailed guidance may be appropriate. For example, we note that for some issues (e.g. surcharging and reversions) a number of access operators have specifically requested that guidance is given which could suggest that for specific issues more detail will be necessary.

- 10.64 In our December consultation, we proposed that a guidance document would be published in draft in March 2012. We continue to believe that guidance published by Ofcom that indicates how Ofcom would assess whether the terms and conditions of access were fair and reasonable (in the event that a dispute was referred to us once commercial negotiations had failed) would support commercial negotiations between parties and have a valuable role to play within the new regulatory framework for access. However, we now consider that it would be more appropriate to provide comprehensive guidance after our proposals for regulating access have had time to become established. We believe that this will allow stakeholders to better identify issues on the basis of how the new regulatory framework for access is operating in practice. Therefore, instead of publishing a separate document comprising guidance immediately, we intend to publish guidance in the future in light of the evidence received regarding the new access regime.
- 10.65 Notwithstanding our decision not to publish a separate document comprising guidance immediately, we recognise that respondents have identified a number of areas where they believe some initial guidance would be helpful. Therefore, in this document, we provide views on the following issues where we believe that it would be of benefit to provide our views immediately and in advance of receiving evidence regarding the operation of the new access regime: surcharging and reversions (paragraphs 10.66 to 10.67), measuring end-to-end quality of service (paragraphs 10.82 to 10.84), zonal access (paragraph 10.153) and alternative dispute resolution mechanisms (paragraphs 10.189 to 10.193).
- 10.66 As noted above, one key area on which a number of respondents have requested guidance has been in relation to how “fair and reasonable” should be interpreted with regards to surcharging (including zonal surcharging) and reversions. We believe that it could be beneficial to provide an indication, at this stage, of some of the high level principles that we would be likely to take into account and apply to the particular facts of any dispute that was referred to us (and accepted by us).
- 10.67 We consider that a ‘fair and reasonable’ approach to surcharges may, alongside any other relevant factors, include reference to the principles of transparency and proportionality.
- Transparency: What are the terms and conditions including any specifications and criteria? Are these set out in a clear and transparent manner? If different or additional charges apply under variable circumstances, are these stated clearly? If there is a process for addressing issues of non compliance with the terms and conditions, is this process known to all the parties and does it operate in a transparent manner?
 - Proportionality: If action is taken for non compliance with terms and conditions, including criteria and specifications, is this applied consistently and fairly? If there are additional charges, what explanation has been given for these, and is there, where appropriate, a clear rationale (and potentially supporting evidence) for those charges? Is the level of those charges proportionate and do these have regard to the additional costs incurred by Royal Mail?
- 10.68 TNT suggested that Ofcom should provide guidance in relation to Royal Mail’s retail pricing behaviour. We do not consider that guidance in relation to Royal Mail’s retail pricing, given the other regulatory safeguards that we have set out in this document, is either necessary or proportionate. However, we will have additional regulatory oversight of Royal Mail’s retail pricing behaviour by virtue of the specific requirement that we have imposed on Royal Mail to provide details to Ofcom of bespoke (i.e. off

price list) bulk mail contracts for services within the scope of the control for the purposes of demonstrating compliance with the margin squeeze test in accordance with revised USPA 6.7. This is discussed in paragraph 10.143 below.

Process for requesting access contracts and variations to existing contracts

- 10.69 Royal Mail has indicated that it will consult with the industry regarding the process for agreeing new access contracts and variations to existing agreements. We continue to believe that Royal Mail, through consultation with the industry, is well placed to develop the specific details of this process, subject to the high level obligations that we have proposed in the USP access obligation and subject also to Ofcom's right to direct Royal Mail to change the terms of the statement of process or the manner in which they are to be applied. In accordance with our initial proposals set out in our December consultation, we expect that Royal Mail's existing process for agreeing the terms of access would apply in the interim period until the Statement of Process is established.
- 10.70 We note the concerns expressed by operators relating to Royal Mail's ability to change the Statement of Process in the future without industry agreement or regulatory involvement from Ofcom. However, in establishing a Statement of Process or agreeing future changes we expect Royal Mail to take its access customers' views into account and to consult with those customers before adopting the statement of process or making changes to it. Where access operators (or users) are unsatisfied with the consultation process or any prospective change to the Statement of Process they will be able to bring these concerns to Ofcom. As stated above, the USP access condition provides Ofcom with the right to direct Royal Mail to change the terms of the Statement of Process.
- 10.71 We would expect the Statement of Process to set out timings by which Royal Mail expects to process access requests and would capture cases where further information is required. In addition, we would also expect that the Statement of Process would have regard to the complexity of the access request when setting the timings for offering the terms of access. However, we do not believe that we should specify details of the process such as the timings of the different stages in the USP access condition.
- 10.72 TNT raised specific concerns about Royal Mail's ability to use the provision in draft USPA 3.4 enabling it to treat modifications of requests for access or variations to existing access as a new request as a means to introduce significant delay into the process. We consider that this is an issue that should be addressed in the Statement of Process. We would expect the Statement of Process to provide some clarity as to the circumstances in which a modification to a request would result in the request being treated as a new request and, in particular, to make it clear that minor modifications to a request would not provide a basis for treating a request as a new request.

Publication and notification

- 10.73 There was broad agreement with our proposals relating to the notification and publication of the standard terms and conditions of access. However, we note that access operators (and the MCF) raised concerns over the proposal to allow Royal Mail and other operators to negotiate bespoke terms (or non-standard terms) and that these would not be captured by notification or publication obligations.

- 10.74 As set out in our December consultation, all access contracts are at the moment substantially the same and there are only a limited number of provisions that have been individually negotiated. In our proposals, we have sought to recognise that, in the future, the industry might want to achieve greater flexibility to negotiate individual agreements that are better suited to individual requirements (provided that Royal Mail continues to treat like customers alike). We believe that, with sufficient regulatory safeguards, greater flexibility to negotiate more individual terms and conditions could provide more choice and benefits to customers.
- 10.75 We consider that the existing publication and notification obligations may have stifled the incentive for access operators and Royal Mail to seek a greater number of individually negotiated provisions to date and that a publication obligation going forwards would continue to reduce the incentive to innovate.
- 10.76 In response to the concerns raised by some operators that such negotiation, including bespoke arrangements for discounts, could have an adverse impact on competition, we note that Royal Mail will be subject to the requirement not to show undue discrimination or preference between operators in negotiating terms. We discuss our decision in respect of non-equivalence in 10.156 below.
- 10.77 Notwithstanding the above, we also recognise the concerns from access operators that, without transparency as to the terms and conditions offered by Royal Mail to other access operators, there is a risk that Royal Mail might be able to behave in an unduly discriminatory manner. We accept that such an outcome is possible, and will therefore assess developments in the access market as part of our monitoring regime discussed in Section 7. Should this indicate any potential concerns, we will consider the need to request further information. Beyond this, monitoring, and our powers to investigate any complaints about anti-competitive behaviour, we do not consider that there is any further need to regulate any contracts negotiated commercially on an ex ante basis.
- 10.78 In relation to the concern over allowing Royal Mail a greater ability to revise the terms and conditions of access unilaterally, we believe that it is worth clarifying our proposals. We recognise that under the existing form of access agreement there are a number of terms and conditions that Royal Mail cannot change without the consent of access customers. We believe that in the past there have been occasions where Royal Mail has sought to make changes to specific terms and conditions for all access customers but has failed to reach agreement with all customers. The failure to reach agreement with all customers has made it unfeasible (or difficult) to make changes to the contracts of those customers that have informally agreed to the changes.
- 10.79 We are not seeking to require any modifications to the contracts to allow Royal Mail greater scope to make unilateral changes to the terms and conditions of those contracts. Our proposals merely recognise a possible scenario that would involve Royal Mail being able to negotiate a greater number of unilateral changes to access agreements provided it could agree a sufficient period of notice with access customers. The appropriate period of notice would need both to allow access customers to manage the changes and/or bring a dispute to Ofcom if they disagreed with the changes being proposed by Royal Mail.
- 10.80 However, we recognise that access operators may not wish to agree such a change to the existing access agreement, in which case the existing terms and conditions would remain in place. Ultimately, we have only suggested an alternative approach

that might be suitable in the future, but recognise that this would require a change to the contractual arrangements between Royal Mail and access operators.

Quality of service

- 10.81 We did not receive any opposition to our proposal to include a requirement in the USP access condition for Royal Mail to monitor the quality of service of access and provide the results of this to access users. We continue to consider this to be an important requirement to place on Royal Mail.
- 10.82 We also continue to believe that end-to-end quality of service information could be of benefit to customers and we support the provision of information that allows customers to make more informed choices. Of those sending customers that expressed an opinion, there appeared to be support for such a system.
- 10.83 We are aware that Royal Mail Wholesale has introduced its own system to measure the quality of service of access items from the point that the customer sends the item to the point that they are received in Royal Mail's network. Some customers and users have indicated their support in principle for such a system. We are also aware that access operators have raised some concerns over this system. Given those concerns, we consider that it should be in their interests to engage with Royal Mail to seek to establish a system that they believe better meets the requirements of their customers. Therefore, we reiterate our view that the industry should take the lead in developing an independent, transparent and consistent system to monitor quality of service that meets the needs of customers, and that access operators should work with Royal Mail to overcome any concerns that they have with the system proposed by Royal Mail Wholesale.
- 10.84 If access operators and Royal Mail Wholesale are unable to resolve these differences, this could be an area where we might need to resolve a dispute or give more formal guidance in due course. However, on the whole we consider that that this would be less effective than an industry led solution.

Our decision

10.85 Our final decision is as follows:

- The USP access condition will include a requirement for Royal Mail to offer the terms and conditions of access on a "fair and reasonable" basis. The USP access condition will be amended to make it clear that this requirement applies to both new and existing agreements that fall within the scope of the USP access condition.
- The USP access condition will include a requirement for Royal Mail to adopt a reasonable, transparent and timely process for postal operators and users of postal services to make requests for access contracts (or variations to existing access contracts) i.e. a Statement of Process¹⁴⁹.
- For standard terms and conditions, the USP access condition will require Royal Mail to provide sufficient notice of changes to terms and conditions to access operators as follows:

¹⁴⁹ The Statement of Process relates to services within the scope of the USPA condition only. We discuss the process for agreeing the terms for other forms of access later in this section.

- Ten weeks' prior publication and notification of standard price terms (unless otherwise agreed);
- Ten weeks' prior publication of standard non-price terms (unless a shorter notification period is agreed, in which case, consistent with shorter period); and
- A transparent process for prior notification of those non-price changes that do not require the prior consent of the access operator, with periods sufficient to allow operators to manage the impact of such changes).
- The USP access condition will include a requirement for Royal Mail to provide access users with quality of service information for its downstream access services from the point of entry at the IMC based on a fair and reasonable system of monitoring.

10.86 The legal basis for imposing the USP access condition and the various provisions contained in it is set out in Section 13 below.

Pricing of access

10.87 Under the Act, Ofcom has the power to impose ex ante controls on access pricing, but may only do so where it appears to Ofcom that such a condition is necessary to prevent the universal service provider from setting excessive prices or engaging in a price squeeze between retail and access prices.

10.88 In our October consultation we explained that we did not consider that it was appropriate to impose on Royal Mail a price control to address the risk of excessive pricing and we outlined our provisional conclusions in Section 6 of the October consultation. However, we were concerned about a risk of price squeeze. We provided proposals in relation to preventing price squeeze and zonal access.

Our proposals

Margin squeeze control – Form, scope and level

10.89 In our October consultation we explained that our preferred long-term approach to addressing the risk of price squeeze was to monitor Royal Mail's costs and revenues to assess the impact of its pricing on competition (as opposed to imposing an ex ante control on Royal Mail's pricing). In addition, in relation to setting prices we considered that LRIC costs provided the correct signals for entry in the market and that Royal Mail should set its prices to maintain a minimum LRIC margin between its access prices and the equivalent retail prices (subject to guidance from the regulator regarding the derivation of LRIC costs).

10.90 We recognised that robust LRIC information was not currently available and that, before relying on a monitoring regime, we would need to be satisfied that our other regulatory safeguards relating to cost transparency and accounting separation had been successfully implemented. In light of this we proposed to impose an ex ante margin squeeze control in relation to access pricing that was broadly consistent with the principle of monitoring but with additional safeguards requiring Royal Mail to provide evidence to Ofcom to demonstrate how it was meeting specified tests in the control.

- 10.91 More specifically we proposed that, in relation to Second Class Mailsort and Walksort Letter and Large Letter products only, the margin squeeze control be comprised of two elements: (a) a margin squeeze 'basket'; and (b) a 'price point' control.
- 10.92 In relation to the margin squeeze basket, we proposed that Royal Mail should be required to recover a minimum level of upstream relevant costs through its revenues across the basket of products within the scope of the control. We proposed that Royal Mail's relevant upstream costs be based on Royal Mail's upstream Fully Allocated Costs (FAC) costs with adjustments. More specifically, we proposed that:
- Upstream FAC should be calculated as Royal Mail's end-to-end FAC less the equivalent access FAC (including Royal Mail Wholesale costs). In calculating relevant upstream FAC we proposed to:
 - Exclude a set of specified costs that are non-incremental to upstream activities – an allocation of central overhead costs from Royal Mail's upstream FAC (estimated to be between 5%-10% of FAC)¹⁵⁰; and
 - Include an adjustment to FAC for a reasonable rate of return (estimated to be between 5%-10% of revenue)¹⁵¹.
- 10.93 We proposed to consider further adjustments to the above to reflect equivalence differences between Royal Mail's retail and wholesale services¹⁵². We proposed that should Royal Mail or an access operator approach Ofcom with an area of non-equivalence which we considered required an adjustment, Ofcom would be able to direct that this would be included in the calculation. However, unless and until such evidence was provided, the level of equivalence differences would be zero.
- 10.94 For the 'price point' control, we proposed that Royal Mail be required to demonstrate having a reasonable expectation of recovering a minimum of 50% of relevant upstream FAC for individual contracts and proposed that this would apply to each individual price point that is offered by Royal Mail for services within the scope of the margin squeeze control.

Margin squeeze control – Compliance and future review

- 10.95 We proposed that compliance with the margin squeeze control would be with reference to actual costs and revenues which meant that Royal Mail could not be certain of recovering relevant upstream costs at the time of setting prices at the start of a year (since price setting would be based on forward looking costs and revenues). Therefore, in demonstrating compliance with the margin squeeze control, we proposed that Royal Mail would be required to provide a forecast of the forthcoming period's costs, volumes and revenues. We proposed that the information would be provided on a quarterly basis. We proposed that the test would be applied on an annual basis, to avoid the impact of seasonality, but there should be compliance reporting on a quarterly basis.

¹⁵⁰ In our December document, we confirmed that no adjustment would be required for 'exceptional' costs since using a FAC measure excludes such costs.

¹⁵¹ In our December document, we indicated that, given that the above adjustments were expected to net to zero, they were assumed to be equal within the access condition, and no specific adjustment would be made to either.

¹⁵² In this context, these are areas where there are differences between the terms of access offered to third parties compared to those offered to Royal Mail's own business in relation to accessing Royal Mail's postal network.

- 10.96 In our December consultation we set out our proposals for how the requirements of the margin squeeze control would be implemented in the USP access condition. We proposed that the regime should be reviewed within 18 to 24 months, with the expectation of moving to a monitoring regime by 2014-15, that would be more comparable with competition law principles and LRIC based costs.

Zonal access pricing

- 10.97 In relation to zonal access, we proposed to remove the existing ex ante regulation. Instead, we proposed to rely on the USP access obligation for Royal Mail to set the terms and conditions for access (including prices) on a “fair and reasonable” basis and monitor zonal costs and pricing. We also proposed to provide guidance explaining how Ofcom would assess whether the terms and conditions of access were fair and reasonable. We indicated that the guidance would cover matters relating to zonal costs and prices and in particular the need for prices to be cost oriented.

Responses to consultation

- 10.98 Royal Mail questioned the justification for imposing a margin squeeze control. It believed that competition law enforcement was sufficient to ensure effective competition in the bulk mail market and that an ex ante margin squeeze control was unnecessary.

Margin squeeze control – Form, scope and level

- 10.99 Royal Mail welcomed Ofcom’s proposals to remove the existing access headroom control. However, it raised a number of specific concerns with our proposals.
- 10.100 Although Royal Mail recognised the need for Ofcom to monitor its prices and costs in the upstream market, for a transitional period, before moving to a competition law approach when robust LRIC data were available, Royal Mail considered that the transitional stage must allow it to compete effectively in the market. In this context, Royal Mail believed that Ofcom’s proposals requiring Royal Mail to recover FAC on average under the margin squeeze price control (the basket element), unnecessarily restricted its pricing flexibility. Royal Mail contended that, should Ofcom decide to impose such a control, this should recognise the rapid development of competition in the upstream market and must strike the right balance between ensuring that efficient upstream rivals could compete with it, while not limiting its ability to compete. Royal Mail noted that the application of VAT to bulk mail products would further erode its position in the bulk mail market (as access operators would be likely to be able to offer their customers a VAT free-route to using wholesale services, due to VAT not being charged on access services).
- 10.101 Royal Mail argued that Ofcom’s proposals did not strike the right balance, in part because they failed to make adequate adjustments to Royal Mail’s FAC to place it on an equal footing with its rivals. Therefore, it argued that appropriate adjustments should be made to the proposed margin squeeze control. In summary these were as follows:
- Adjustments should be made to Royal Mail’s FAC to recognise the historic sunk costs which Royal Mail had incurred due to its role as the universal service provider and its historic monopoly in the provision of bulk mail services.

- The adjusted FAC in the control should be a proxy for the avoidable costs in the relevant period rather than long-run incremental costs (i.e. comparable to average avoidable costs (AAC) over the relevant period).
- Adjustments should be made to the basket level by reducing the reasonable rate of return. This was because Ofcom's estimate of the margin that upstream rivals needed to remain commercially viable was too high (both reflecting lower capital intensity for upstream activities and a lower cost of capital). Rather than the Ofcom estimate of 5-10%, Royal Mail analysis suggested that a figure between 4-7% was more appropriate.

10.102 Royal Mail argued that the individual contract level control (price point control) should be removed, since the actual costs of serving individual contracts might be significantly different to those that Ofcom proposed to use in the individual contract level control. Furthermore, it contended that the proposed basket control offered sufficient protection against the risk of margin squeeze, and therefore the price point control risked distorting competition.

10.103 Although access operators agreed with the need for a margin squeeze control, a number of concerns were raised regarding Ofcom's proposals. First, there was a concern that the proposed margin squeeze control would significantly degrade the protection to access operators that was modified by Postcomm in April 2011.

10.104 Second, a number of operators raised concerns over the scope of services to be included in the margin squeeze control and it was suggested that without protection extending to other products there was a possibility that competition would be limited to those products within the scope and any further development of competition would be stifled. Operators were concerned that the scope of the margin squeeze control did not extend to packet services. TNT suggested that Third Class Mailsort, Mailsort Light and high volume unsorted services should also be included within the scope of the control because of the risk of Royal Mail pricing at a level that did not recover upstream LRIC costs and because detection of such behaviour would be difficult in the absence of readily available LRIC data.

10.105 TNT highlighted various areas of non-equivalence that might be recognised through adjustments to the level of relevant upstream costs in the margin squeeze control. These included additional accessor costs from the alleged lack of flexibility in access times at mail centres, forecasting requirements and access surcharges in relation to issues of non-compliance.

10.106 In relation to the price point control, access operators raised concerns over the minimum level of cost that Ofcom proposed Royal Mail should be required to recover on individual contracts. Some access operators did not consider that 50% of relevant FAC was a reasonable proxy for contract level LRIC. UK Mail was concerned over the analysis that had been used to determine the 50% figure. The MCF argued that a higher figure would be more appropriate (both to reflect an element of caution and to be more closely aligned with the 60% proxy for LRIC that had previously been proposed by Postcomm). TNT suggested that Ofcom should use 70% of relevant FAC as a more reasonable estimate of LRIC.

Margin squeeze control – Compliance and future review

10.107 Royal Mail argued that Ofcom should exercise discretion when deciding on the application and enforcement of the margin squeeze control. Royal Mail proposed that the control should be used as an initial screen and considered alongside a careful yet

pragmatic assessment of the effects of any alleged anti-competitive behaviour, including, where appropriate, consideration of rivals' costs.

- 10.108 TNT suggested that Royal Mail should be obliged to comply with the margin squeeze control for each individual three-month period (as opposed to the proposed period of a year) or that Ofcom should publish a report on a quarterly basis that outlined whether Royal Mail had complied with the margin squeeze test for the previous three-month period. TNT also argued that compliance with the control should be based on an absolute test of Royal Mail recovering relevant upstream costs in the period as opposed to having a 'reasonable expectation' of recovering relevant upstream costs.
- 10.109 TNT sought clarification on whether customer specific costs would be used in the price point control (given the reference to 'individual contracts' in the draft USP access condition) and questioned whether such information was available.
- 10.110 Access operators also sought further information on how Ofcom intended to ensure that Royal Mail complied with the control and how Ofcom would intervene, and how swiftly this might happen, if Royal Mail were non-compliant with the control or were deemed unlikely to be compliant over the period of the control. TNT suggested that, in the event that Royal Mail did not recover relevant upstream costs in a period, it should be obliged to 'claw back' the shortfall in the subsequent period.
- 10.111 Consumer Focus recognised the importance of effective measures to counteract the risk of margin squeeze. However, it raised concerns about any plans to move to competition law within a short period as it considered that ex post enforcement might be insufficient to protect competing operators to Royal Mail.
- 10.112 Access operators raised concerns over the future use of LRIC information (in the context of a future monitoring regime based on competition law principles). More specifically there were doubts over whether reliable upstream data could ever be produced and whether the market would have sufficient insight into the LRIC data. It was also alleged that only Royal Mail would be able to survive by recovering LRIC costs only over a period of time since it had an economies of scope advantage compared to other access operators and was therefore able to recover its common costs over a wider set of services.

Zonal access

- 10.113 In relation to our proposals for zonal access, TNT argued that zonal pricing was now the predominant form of access pricing since the majority of access volumes were posted using the national access agreement with a surcharge mechanism based on the proportion of mail falling into the four access zones. It considered the degree of regulatory attention paid to zonal pricing should reflect this fundamental change in the basis of pricing. It argued that regulatory certainty was crucial for potential investors in end-to-end networks regarding zonal prices being cost oriented and thereby avoiding market uncertainty. TNT was also concerned that guidance would not be sufficient to ensure that zonal structures and pricing were set appropriately and recommended that prior assessment and approval be required by Ofcom before material changes were made to zonal access.
- 10.114 TNT suggested areas where it considered that guidance and related approval would be needed. This included the frequency with which postcode sectors could be reclassified and a restriction on the total number of zones. It also suggested rules

relating to the price of each zone being above FAC and the prohibition on Royal Mail offering bespoke zonal terms and conditions.

Our assessment

10.115 Royal Mail believed that in principle competition law would be sufficient to safeguard competition and an ex ante control was not necessary. However, as set out in our October consultation, Ofcom is concerned that at this stage, given the current limitations in Royal Mail's incremental and avoidable cost data, reliance on competition law alone, in the absence of other established regulatory safeguards, is unlikely to be sufficient to address the risk to competition (and the associated customer impact) from Royal Mail engaging in a price squeeze in the relevant retail markets.

10.116 We recognise that the application of VAT to bulk mail products could erode Royal Mail's position in the bulk mail market in relation to those customers that have VAT exempt status (e.g. financial institutions and charities). However, we are also aware that for a significant part of the market, customers are not VAT exempt, and therefore the risk of Royal Mail engaging in a price squeeze remains.

Margin squeeze control – Form, scope and level

10.117 In principle our preference would be in the longer term to address issues of margin squeeze on an ex post basis whereby Royal Mail's costs and revenues are also assessed with reference to the potential effects on competition (as opposed to imposing ex ante controls on Royal Mail's pricing). We also believe that Royal Mail setting prices with reference to LRIC costs will provide the correct signals for entry and investment in the market. However, we believe that LRIC estimates should be derived subject to principles and guidance provided by Ofcom.

10.118 Our proposals for a margin squeeze control have sought to recognise that robust LRIC data are not yet available and therefore moving to our preferred long-term approach is currently too risky.

10.119 Therefore, we continue to believe that in principle our margin squeeze proposals that establish an ex ante control from April 2012 with the aim of moving to a monitoring regime by 2014-15 relying on ex post enforcement provides an appropriate glidepath between the existing regime and our preferred long-term approach for preventing price squeeze based on ex post competition law powers.

10.120 Although Royal Mail accepted that a transitional approach would be needed in the absence of LRIC data being available, it argued that Ofcom's proposed control, where the margin was set with reference to Royal Mail's FAC costs, unnecessarily restricted Royal Mail's pricing.

10.121 Royal Mail argued that adjustments should be made to reflect legacy issues relating to its network including the obligation to provide the universal service and the existing headroom control (that has resulted in a decline in volumes that has been more rapid than its ability to reconfigure its network and remove costs) which could have resulted in FAC being above incremental costs for the relevant services. However, we consider that, given the absence of robust LRIC information, a measure of readily available, robust, actual cost information based on FAC costs should be used as part of the margin squeeze control. This not only accords with our proposals to establish a glidepath between the existing regulatory regime and our long-term preferred

approach to preventing margin squeeze but also provides a clearer incentive for Royal Mail to improve its efficiency in the relevant upstream activities.

- 10.122 Royal Mail argued that FAC should be adjusted to average avoidable cost (AAC). We consider that using a cost standard of AAC with reference to the duration of the period of the control (interpreted to mean over 18-24 months up until the proposed review as set out in our October consultation) is inappropriate. First, as discussed above, Royal Mail does not have robust cost information relating to AAC. Second, a cost standard of AAC with reference to a period of 18-24 months is likely to result in a cost level that is lower than a reasonable measure of LRIC. This is therefore likely to be inconsistent with our preferred long-term approach (and result in a cost level that is below that of the long-run costs of other efficient competing operators).
- 10.123 Royal Mail has provided extensive arguments relating to a reasonable rate of return for the upstream activities of other access operators. These focus on two key issues. First, the lower capital intensity of upstream activities compared to downstream activities (or the activities of an integrated operator), and second, the alleged lower cost of capital for upstream activities relative to either downstream activities or those of Royal Mail's integrated business.
- 10.124 We recognise that upstream activities could be less capital intensive than downstream activities and that this could therefore support the case to reduce the reasonable rate of return in relation to the level of relevant upstream costs. However, our assessment of Royal Mail's analysis, where it examined UK Mail's capital intensity and returns, is that it is likely to understate the capital intensity of UK Mail, as it is based on end-to-end revenues and costs, rather than being based on upstream revenues and costs alone. Second, we consider that Royal Mail's estimate of an upstream operator's asset beta is likely to be too low as it is based upon UK Mail's performance, which formed an outlier in our wider capital market analysis. This was potentially because of its low trading volume. It would therefore skew Royal Mail's estimate of the cost of capital downwards.
- 10.125 On balance we consider that any differential between the costs excluded from upstream costs as a result of excluding general overheads, and the return on capital for upstream activities is likely to be very small and not material in the context of the calculation of the overall upstream revenues and costs for the purposes of the margin squeeze test.
- 10.126 Royal Mail also argued that the proposed 'price point' control should be removed. However, for the reasons set out in our October consultation, we believe that a 'price point' control set at a proportion of relevant upstream costs is appropriate given the risks of Royal Mail pricing below LRIC on individual contracts.
- 10.127 Some access operators believed that our proposals degraded the existing headroom control and were concerned that the scope of the control did not include a wider set of services. As explained in our October consultation, our proposals for preventing price squeeze have sought to reflect the changes that have occurred in the market since 2006 where access competition has grown significantly. Given the changes in competitive conditions since 2006, we consider that Royal Mail should be afforded more flexibility to price services than it has under the existing headroom control. Therefore, we consider that rather than 'degrading' the existing control, our proposals better reflect the competitive environment and are more proportionate to furthering our statutory duties.

- 10.128 Given the current competitive conditions, we do not consider that it is proportionate to extend the scope of the margin squeeze control, beyond those services in the existing control, to include Third Class Mailsort products or high volume unsorted products. Our evidence suggests that the proposed scope, which accords with the existing control, has provided the basis for access operators to extend their offerings to compete with both Third Class Mailsort and increasingly high volume unsorted products. We therefore consider that expanding the scope of the control given the growth in access competition would be disproportionate and inconsistent with our intention that the margin squeeze control represents a glidepath between the existing regime and our long-term preferred approach for preventing price squeeze which is based on ex post competition law principles.
- 10.129 Notwithstanding this, we recognise that access operators have raised concerns around the scope of the control particularly given Royal Mail's proposals to re-brand its bulk mail products and introduce an 'economy' D+4 service that will effectively replace Mailsort 3 services. Access operators have voiced concerns over the prospect of the re-branding allowing Royal Mail to offer substantially similar services to Mailsort 2 services that fall outside the scope of the margin squeeze control¹⁵³.
- 10.130 In response to these concerns we consider that it is worth stressing that Royal Mail will need to ensure that all of its pricing remains compliant with competition law, whether or not it is covered by the scope of the ex ante control which we are imposing. In addition, Ofcom will closely monitor developments in the bulk mail market (both pricing and volume changes) and will consider widening the scope of the control if it appears that Royal Mail's rebranded D+4 service is substantially similar to Second Class Mailsort.
- 10.131 In the context of the margin squeeze control, we proposed in October to make adjustments to reflect equivalence differences. However, we have now defined the adjustments that we intend to make as those adjustments to relevant upstream costs (as directed by Ofcom) that address differences between Royal Mail's upstream operations and the access operators with regards to accessing Royal Mail's network.
- 10.132 This is because we believe that the concept of 'ensuring equivalence' should align with the concept of no undue discrimination, whereas we consider that in the context of our margin squeeze control there could also be circumstances where there are differences between the terms of access between Royal Mail and third parties that, although are not unduly discriminatory, may require adjustments to reflect the terms of access. For example, there may be circumstances where Royal Mail is required to impose different operational terms of access between itself and third parties to meet its universal service obligations, that although are not unduly discriminatory, may need to be reflected as adjustments in the relevant upstream costs as part of the margin squeeze control. Therefore, we have revised the drafting of USPA 5 (now USPA 6) to recognise this consideration. The revised condition includes replacing the reference of 'Equivalence Differences' to 'Directed Adjustments'.¹⁵⁴
- 10.133 Although a number of issues of non-equivalence have been highlighted as areas that could support adjustments to the level of relevant upstream costs in the margin squeeze control, the evidence provided to Ofcom and previously to Postcomm has

¹⁵³ Operators have also raised more general concerns relating to Royal Mail's flexibility to offer other discounts such as Tailor Made Incentives (TMIs).

¹⁵⁴ We note Royal Mail's suggestion that as part of the definition of "Equivalence Differences" in draft USPA 1.3(h) Ofcom should articulate what is meant by the concept of 'non-equivalence'. However, the revised drafting of USPA 6 means that the definition is unnecessary.

not been sufficient to indicate that these result in material cost differences to convince us that adjustments are needed to the level of relevant upstream costs in the margin squeeze control. Therefore, at this point, we do not propose to make any adjustments to relevant upstream costs for the purposes of addressing issues of non-equivalence.

10.134 Access operators have also raised concerns over the proportion of relevant upstream costs that Royal Mail is required to recover on individual contracts as part of the 'price point' element of our proposals. We have proposed that Royal Mail should recover 50% of relevant upstream costs whilst access operators have argued that Royal Mail should be required to recover a higher proportion of relevant upstream costs as a more reasonable approximation of contract LRIC. TNT suggested that the proportion should be as high as 70%.

10.135 We note that we do not have actual data regarding Royal Mail's LRIC costs that are derived from a LRIC model and therefore there is a degree of judgement around the precise level of contract LRIC costs. However, in developing our proposals, we have considered a range of evidence regarding what might be an appropriate proxy for contract LRIC. Furthermore, our analysis indicates that 50% of FAC falls within the middle of the range of these estimates. Therefore, we are satisfied that in the context of our overall proposals for preventing margin squeeze and based on the evidence available, our proposal to require Royal Mail to recover 50% of relevant upstream costs provides a balanced approach to protecting competition, affording Royal Mail an appropriate level of price flexibility and providing a glidepath between the current regulation and our preferred long-term approach.

10.136 By way of clarification, for the purposes of complying with the 'price point' control on individual contracts, Royal Mail is expected to recover 50% of relevant upstream costs where those relevant costs relate to the average cost of that service (at that specific price point) as defined in its costing system. This means that Royal Mail will not be able to use customer specific costs (assuming these were to be available) for the purposes of demonstrating compliance with the control.

Margin squeeze control – Compliance and future review

10.137 Royal Mail has suggested that Ofcom should exercise discretion when applying and interpreting the margin squeeze control and that this should include an assessment of the competitive harm of Royal Mail's pricing behaviour. Under our proposed margin squeeze test, the competitive harm from Royal Mail's pricing behaviour will not be a factor that Ofcom considers in assessing whether Royal Mail has or has not complied with the control. As explained in our October consultation (Annex 7, paragraph 7.28), given the permanent harm that could occur to competition from margin squeeze, even over the relatively short-term, we believe that it is important to provide certainty to Royal Mail and other market participants about the form of control that Royal Mail will be expected to meet. We consider that including an assessment of competitive harm directly within the ex ante margin squeeze control would result in too high a level of uncertainty regarding Royal Mail's pricing obligations and would not provide a sufficient level of assurance to the market of mitigating the competitive risks from Royal Mail engaging in a margin squeeze.

10.138 Having considered the responses to the consultation, we believe that our proposed margin squeeze control provides sufficient clarity regarding the parameters of Royal Mail's pricing behaviour in the context of addressing the risks of a margin squeeze. Notwithstanding this, and in the event that Royal Mail did not comply with the margin squeeze control, one of the issues that Ofcom would be likely to consider in deciding

what response was appropriate would be the impact of Royal Mail's pricing on competition and customers¹⁵⁵. We discuss the application of our proposed margin squeeze control below in reference to other respondents' questions and concerns regarding the detail of the control.

- 10.139 TNT suggested that the relevant period over which Royal Mail's compliance with the control is measured should be three months (or that Ofcom should issue a quarterly report on whether Royal Mail was meeting the tests in the control). For the reasons set out in December 2011, we remain of the view that the relevant period of the control should be one year. We consider that a one-year period will avoid the impact of seasonality on revenues and/or fluctuations in costs, which a three month period may not be able to avoid.
- 10.140 TNT argued that compliance with the margin squeeze control should be based on an absolute test of Royal Mail recovering relevant upstream costs rather than it having a 'reasonable expectation' of recovering relevant upstream costs. We do not consider this to be appropriate. We believe that Royal Mail should set its prices with reference to the costs it reasonably expects to incur for the forthcoming period (rather than setting prices on a backward looking basis). We believe this is more comparable with the behaviour of its competitors; it is more appropriate given the competitive environment; and accords with our view that the margin squeeze control is a step in a glidepath to moving to a control based on ex post competition law principles. Royal Mail will be required to set prices based on a forecast of revenues and costs (which will be subject to margin of error) and may result in over recovery or under recovery of relevant upstream costs. Notwithstanding the above, we believe that the risks of our approach can be mitigated through regular monitoring and we provide further detail on how we intend to monitor Royal Mail's compliance with the control below.
- 10.141 A number of respondents requested further detail regarding the practicalities of our proposed margin squeeze control including how Ofcom would monitor Royal Mail's compliance with the control and intervene if it appeared that Royal Mail was non-compliant. We note these concerns and have sought to provide clarity within USPA 6 of the information that Royal Mail will be expected to provide to demonstrate compliance.
- 10.142 Under the requirements of the revised USPA 6, we expect Royal Mail to demonstrate compliance with the ex ante margin squeeze control by providing a forecast of its costs, volumes and revenues for each quarter of the relevant period of the control (i.e. one year). The forecast will be provided at the start of the period of the control.¹⁵⁶ Throughout the year, and at the end of each quarter during the period of the control, Royal Mail would be expected to provide quarterly compliance reports that provide actual cost, volume and revenue information. For the avoidance of doubt, under our margin squeeze control, Royal Mail is able to change prices throughout the year and is not restricted to setting prices at the start of the relevant period only. We have made a revision to draft USPA 5.6 (revised USPA 6.6) to clarify this point.
- 10.143 As part of the quarterly compliance reports we will also require Royal Mail to provide specific information on bespoke bulk retail contracts that are agreed (or are materially

¹⁵⁵ Indeed, as set out in our October document (section 7), our assessment as to whether Royal Mail should be required to offer access to its network for the purposes of participating in the D+2 and later than D+2 Letters and Large Letters markets involved considering the role of access in promoting efficiency, promoting effective competition and conferring significant benefits on users.

¹⁵⁶ For reasons of practicability, in the first relevant period of the control, Royal Mail should demonstrate its compliance as soon as is reasonably possible, and no later than 1 May 2012.

amended) during the previous quarter for services within the scope of the control. Under this requirement, which is set out in revised USPA 6, Royal Mail will be required to provide the following information about each such contract:

- price;
- volume;
- length of the contract; and
- date that the contract was signed (or most recently materially amended).

10.144 We intend to keep the requirement relating to the provision of information on bespoke retail contracts under review. If necessary, we would consider revising the requirement in the future to ensure that it is both proportionate and effective in enabling Ofcom to monitor compliance with the margin squeeze control.

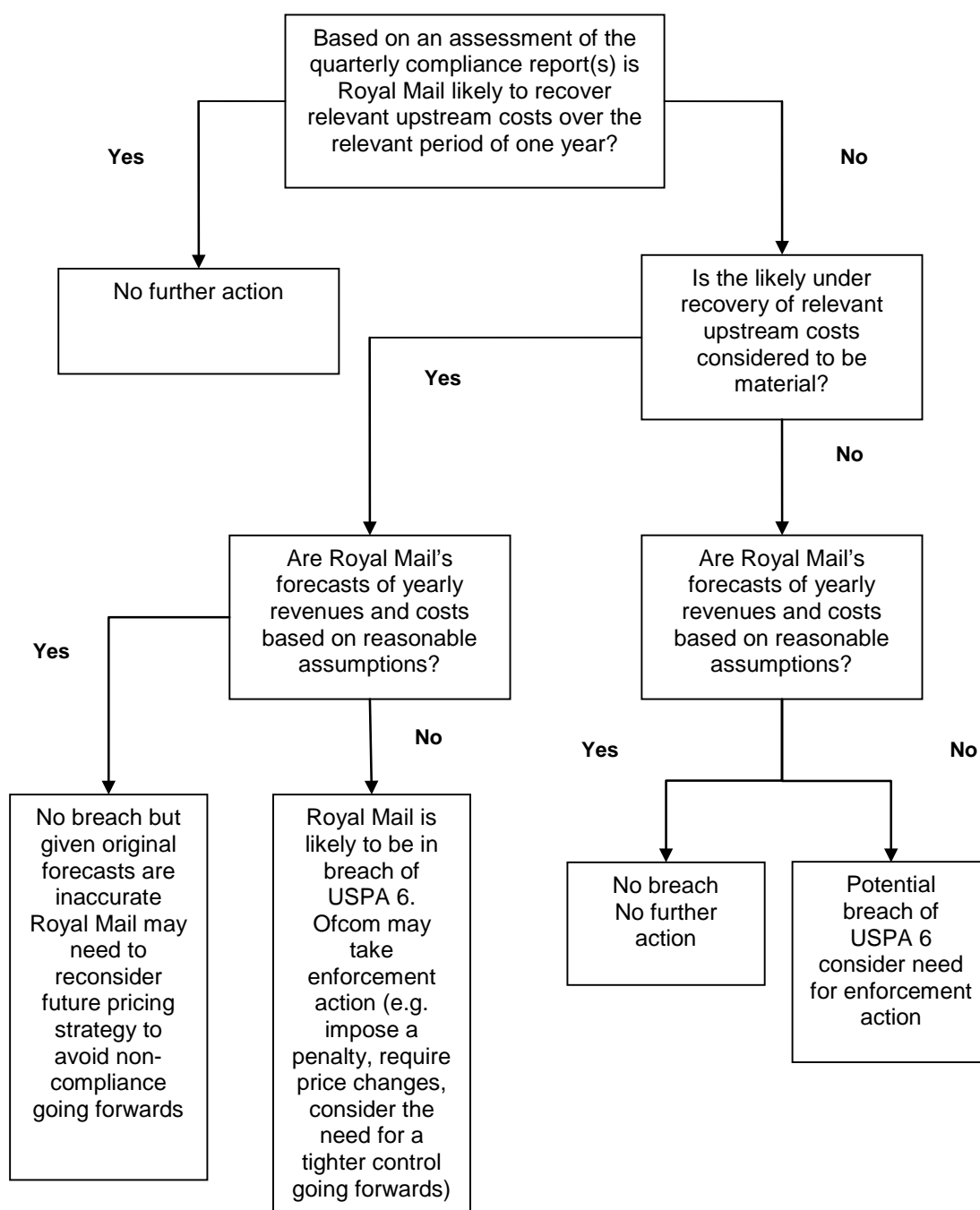
10.145 Ofcom intends to monitor Royal Mail's compliance with the margin squeeze control on a quarterly basis with the information provided by Royal Mail's quarterly compliance reports. However, to be clear, compliance with the margin squeeze control will be assessed with reference to the relevant period of one year. We consider that monitoring in this way will allow Ofcom to intervene promptly during the relevant period if it is considered that Royal Mail is unlikely to recover relevant upstream costs in accordance with its regulatory obligations (e.g. in the event that actual cost and revenue data differ significantly from those forecast).

10.146 As explained in December 2011, we recognise that unforeseeable changes in volumes and costs could result in Royal Mail not recovering its relevant upstream costs in the relevant period of the control. Under such circumstances and, in assessing whether Royal Mail had met the requirements of the control, Ofcom would be likely to consider the assumptions that Royal Mail had used in its forecasts of meeting the requirements of the control and how reasonable these were. Ofcom would only be likely to intervene if it concluded that Royal Mail's assumptions were unreasonable, although as outlined below, it is feasible that we could consider whether Royal Mail was proposing to amend its approach to contract pricing to address any material divergences.

10.147 We note that TNT suggested that Royal Mail should be obliged to 'claw back' revenue in the event that it did not comply with the control (although this was in the context of an absolute margin squeeze test being set rather than one based on 'reasonable expectations' of recovering relevant upstream costs). We do not consider that it is necessary to set a specific mechanism in the USP access condition regarding the actions that Ofcom would take in the event that Royal Mail was non-compliant with its margin squeeze obligations. We believe that a number of approaches might be taken by Ofcom as part of enforcement action (including imposing price changes) but the most appropriate choice would be dependent on the circumstances of the case and therefore should be assessed at that time.

10.148 Figure 4 provides a simplified illustration of the approach that Ofcom is likely to follow in each quarter when assessing whether Royal Mail is likely to comply with the margin squeeze control and whether, and how, Ofcom might intervene depending on that assessment.

Figure 4: Illustration of approach to assessing compliance



10.149 Concerns were also raised about using LRIC costs as part of Ofcom's preferred long-term approach to preventing margin squeeze. These concerns related to the level of Royal Mail's LRIC costs (and thereby the level of costs that other operators would need to compete against), the reliability of LRIC estimates and the transparency of those costs.

10.150 We recognise that estimating LRIC costs is complex and a number of issues will need to be considered by Ofcom. However, in principle we consider that in the long-term any margin squeeze test should be set with reference to LRIC costs, such that, a minimum of LRIC margin is maintained between the access price and the

equivalent retail price and that compliance is monitored by Ofcom through provision of regular information.

10.151 As set out in October, Ofcom will only move to such a margin squeeze control following completion of a review and after consultation. We will endeavour to review the margin squeeze control in around 18-24 months. However, we stress that a key input that will enable a review of the margin squeeze control (with the aim of moving to a regime aligned with competition law principles) is the availability of robust LRIC data from Royal Mail. In this regard we note that Royal Mail's progress in deriving LRIC data has been slower than originally indicated to Ofcom.

10.152 Under the Act, Ofcom must identify the form of access to which a USP access condition relates before it can impose an ex ante control on the pricing of that form of access. In our October consultation, we did not propose to establish a USP access condition in relation to packet items and therefore the proposed scope of the margin squeeze control did not include packet items. We discuss below the obligation on Royal Mail to offer other forms of access, beyond that at the IMC for participation in the D+2 and later than D+2 Letters and Large Letters markets.

Zonal access

10.153 We continue to believe that our proposals for Royal Mail to set the terms and conditions of access on a "fair and reasonable" basis will provide a more flexible approach to the existing ex ante regulation whilst maintaining a sufficient level of protection to customers and competition. We also continue to believe that guidance could play a role but that the provision of a separate document comprising guidance by Ofcom would be more appropriate following a period where the new access regime has time to become established and there is evidence on its effectiveness. Notwithstanding this, we recognise that some clarity on zonal pricing is important. We believe that it would be useful to provide an indication of the issues that Ofcom may have regard to when considering whether the terms (or a proposed change in terms) for zonal access are fair and reasonable. We consider that in setting zonal access terms, Royal Mail should:

- take into account the alignment of zonal prices with Royal Mail's costs. Furthermore, in moving geographic areas (e.g. postcode sectors, postcode areas) between zones, Royal Mail should take into account the alignment of prices and costs. Zonal costs should be derived in accordance with Royal Mail's Regulatory Financial Reporting obligations;
- seek to ensure that the weighted average of zonal access prices is broadly comparable to the national access price; and
- take into account the frequency of implementing changes to the terms of zonal access (including moving geographic areas between zones and revising the zonal structure) as well as the transactional costs for access users (and customers) of implementing the changes. Regard should be given to minimising such transactional costs for access users.

Our decision

10.154 Our final decision is as follows:

- To establish a USP access condition that requires Royal Mail to have a reasonable expectation of recovering a minimum level of upstream relevant costs

across a basket of products within the scope of the control over the relevant period of the control.

- Relevant upstream costs are calculated as Royal Mail's end-to-end FAC less equivalent access FAC (including Royal Mail Wholesale costs)
- The scope of the control will be Second Class Mailsort and Walksort Letter and Large Letter services (and any current, new or successor retail services that are substantially similar)
- The relevant period of the control is a year (being the year that broadly aligns with Royal Mail's financial year)
- To establish a USP access condition that requires Royal Mail to have a reasonable expectation of recovering a minimum of 50% of relevant upstream costs for individual price points offered for services within the scope of the control.
- To require Royal Mail to provide information on a quarterly basis that allows Ofcom to monitor compliance with Royal Mail's ex ante margin squeeze requirements. This will include the requirement to disclose to Ofcom the details of bespoke 'retail' contracts for services within the scope of the margin squeeze control.

10.155 An explanation of how our decision to impose a margin squeeze control meets the various requirements set out in the Act is set out in Section 13 below.

Addressing issues of non-equivalence

10.156 Areas where there are differences between the terms of access offered to third parties compared to those offered to Royal Mail's own business in relation to accessing Royal Mail's postal network are sometimes referred to as issues of 'non-equivalence'.

Our proposals

10.157 We proposed that ensuring equivalence would align with the concept of no undue discrimination or no undue preference. Therefore, we proposed that the USP access condition should include a requirement that Royal Mail should not unduly discriminate against any particular persons or against a description of persons in relation to access matters.

10.158 In our October consultation, we proposed to address issues of non-equivalence either through seeking to impose an operational change on Royal Mail or through taking account of any cost differential that results from the issue of non-equivalence in the transfer price as part of the margin squeeze control arrangements or in the transfer price under a future monitoring regime.

10.159 Beyond the requirement not to unduly discriminate, we did not propose that any particular area of non-equivalence needed to be specifically addressed in the USP access condition. The draft USP access condition was published in December 2011.

10.160 We considered that the dispute resolution process, discussed below, might provide an appropriate means for access operators to seek to resolve concerns over potential issues of non-equivalence. In addition, there could also be circumstances

where Ofcom might consider enforcement action against Royal Mail for breach of the non-discrimination obligation in the USP access condition.

'Ring-fencing' of Royal Mail Wholesale

10.161 In our December consultation, we considered that the need to ensure that Royal Mail maintained a ring-fence¹⁵⁷ around Royal Mail Wholesale (as originally agreed as undertakings between Royal Mail and Postcomm) was important under a new regulatory regime. We also recognised that access operators would be unable to agree such 'ring-fencing' arrangements as part of the terms and conditions of access. Therefore we proposed a continuation of those elements of initial condition USPA 3 that prohibited Royal Mail from obtaining any unfair commercial advantage for itself or any other party in connection with the provision of access to its postal network.

Responses to consultation

10.162 Royal Mail agreed with our proposal that equivalence should align with the concept of no undue discrimination or no undue preference. However, Royal Mail questioned the need to impose this obligation in a USP access condition since it considered that the concepts were already covered by competition law and were therefore unnecessary.

10.163 Other respondents typically supported Ofcom's proposals for addressing issues of non-equivalence.

10.164 Consumer Focus welcomed Ofcom's emphasis on the importance of no undue discrimination between providers and our insertion of a no undue discrimination obligation in the USP access condition since that would help to safeguard third party access competition.

10.165 UK Mail argued that Ofcom's proposals should be supported by a mechanism to ensure that Royal Mail actively monitors its compliance with the no undue discrimination obligation and that this could be achieved through a reporting obligation on Royal Mail's compliance.

'Ring-fencing' of Royal Mail Wholesale

10.166 Royal Mail questioned the legal basis of draft USPA 4.3. This provision requires Royal Mail to conduct its business in the manner best calculated to prevent it from obtaining any unfair commercial advantage for itself or any other party in connection with the provision of the access to its postal network.

10.167 Royal Mail argued that the legal basis for the condition was not clear since there was nothing in Part 1 of Schedule 3 to the Act that gave Ofcom the power to impose such a condition. It argued that the condition was onerous and unworkable since the wording "the manner best calculated" meant that there was only one way in which Royal Mail could structure and organise its business to comply with the condition. In addition, Royal Mail argued that the condition was disproportionate as it went beyond what was necessary to protect access customers and to ensure fair competition (through competition law as well as regulatory measures such as draft USPA 4.1, 4.2 and 4.4). It also argued that it was contrary to Ofcom's preference for seeking the

¹⁵⁷ Ring-fencing is a general term used to describe the regulatory controls that are applied to different parts of an integrated business to address potential risks to competition, for example, to prevent the flows of information between different parts of a business.

least intrusive regulatory mechanisms. Finally, by way of clarification, Royal Mail contended that it did not give undertakings to Postcomm to ring-fence Royal Mail Wholesale but had already voluntarily put in place measures and so undertakings were unnecessary.

- 10.168 UK Mail was concerned that the existing undertakings by Royal Mail to 'ring-fence' Royal Mail Wholesale had been significantly eroded by Royal Mail's organisational changes in October 2011, which saw it replaced as a team within the Regulated and Consumer business unit.

Our assessment

- 10.169 We consider that, although respondents raised some specific points relating to our proposals, there was a broad agreement to align the concept of non-equivalence with that of no undue discrimination. There was also a broad agreement that issues of non-equivalence should be addressed through Ofcom imposing operational changes to Royal Mail and/or through a pricing mechanism.
- 10.170 Royal Mail argued that Ofcom should not include a requirement not to unduly discriminate in the USP access condition since the proposed conditions – draft USPA 4.1, 4.2 and 4.4 mirror competition law requirements and therefore these conditions were redundant. We recognise that issues of no undue discrimination can be investigated under competition law on an ex post basis. However, the Act specifically provides that an access condition may include a no undue discrimination provision.¹⁵⁸ We consider that it is appropriate to include a specific ex ante prohibition of undue discrimination as this will give us a regulatory basis for taking enforcement action against undue discrimination in addition to our powers to investigate under the Competition Act 1998.
- 10.171 For the reasons set out in October, Ofcom does not believe that it is appropriate to impose a requirement on Royal Mail to report on a regular basis the steps it has taken to ensure that it has complied with the non-discrimination obligation to the USP access condition. We do not consider that we have received sufficient evidence to revise this view.

'Ring-fencing' of Royal Mail Wholesale

- 10.172 Royal Mail has sought to argue that the requirement not to obtain any unfair commercial advantage in draft USPA 4.3 does not have a legal basis in Part 1 of Schedule 3. We disagree with that analysis since the list of provisions that may be included in access conditions that is set out in Part 1 of Schedule 3 is not an exhaustive list of the provisions that may be included in access conditions.
- 10.173 However we note Royal Mail's argument that the condition was disproportionate. We consider that there are unlikely to be circumstances where an attempt by Royal Mail to obtain an unfair commercial advantage would not be caught by the other regulatory measures set out in revised USPA 5 (i.e. the prohibition against undue discrimination set out in revised USPA 5.1 and revised USPA 5.2 and the restrictions on the use of information set out in revised USPA 5.3 and 5.4). We agree with this position and have therefore decided to remove draft USPA 4.3 from the USP access condition as we consider that the remaining provisions are sufficient.

¹⁵⁸ See paragraph 11 of Part 1 of Schedule 3 of the Postal Services Act 2011.

10.174 We note that one operator has argued that Royal Mail's ring-fencing obligations have been significantly eroded by Royal Mail's recent organisational changes. Although we have not received any evidence to demonstrate specific factors as to how Royal Mail's restructuring has resulted in an erosion of suitable ring-fencing measures, we intend to seek further evidence from Royal Mail over the coming months regarding its recent organisation change. We will review its compliance measures in relation to ensuring an appropriate level of 'ring-fencing' between its wholesale division and its retail division(s) in order to consider the appropriateness of these measures in light of the new regulatory obligations that are being imposed on Royal Mail under the USP access condition.

Our decision

10.175 Our final decision is as follows:

- The USP access condition will include a requirement that Royal Mail does not unduly discriminate, as set out in Annex 9.
- Issues of non-equivalence will be addressed either through seeking to impose an operational change on Royal Mail or through taking account of any cost differential that results from the issue of non-equivalence in the transfer price as part of the margin squeeze control arrangements or in the transfer price under our proposed financial regulatory reporting, undertaken within the framework set out in Section 11.

10.176 The legal basis for imposing the USP access condition, including the non-discrimination provision, is set out in Section 13 below.

Regulatory disputes

Our proposals

10.177 In our October consultation, we proposed to adopt the dispute resolution process for access that had been previously established by Ofcom for the communications sector in its Dispute Resolution Guidelines.¹⁵⁹ This was subject to recognising any appropriate differences such as where the 2003 Act and the Act impose any different legal requirements on stakeholders or Ofcom.

10.178 In light of those differences, we stated that we would consider the need to publish a further document that identified, more specifically, the parts of Ofcom's existing Dispute Resolution Guidelines that would be different for postal access disputes.

10.179 We proposed that an access user would be able to refer an access dispute to Ofcom in accordance with the provisions set out in Schedule 3 of the Act. Since those provisions applied in any event, we did not consider that it was necessary to make further provision in the USP access condition in this regard.

Responses to consultation

10.180 Respondents were broadly supportive of Ofcom using the existing Dispute Resolution Guidelines as established in the communication sector.

¹⁵⁹ Ofcom, Dispute Resolution Guidelines – Ofcom's guidelines for the handling of regulatory disputes, 7 June 2011 [http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/Dispute Resolution Statement.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/Dispute%20Resolution%20Statement.pdf)

10.181 Notwithstanding the above, Royal Mail believed that it was essential that all contractual dispute resolution processes should be allowed to fully run their course before the regulator intervened (and that this aim should form part of the wording of the Guidelines). Royal Mail also raised concerns around limiting the timescales for the resolution of disputes to four months given that this was not a statutory obligation and could unnecessarily restrict the provision of evidence.

10.182 A number of respondents (both access operators and customers) suggested that there should be a role for an independent adjudication body, in addition to Ofcom's proposed Dispute Resolution Process.

10.183 TNT suggested that such an adjudication body would be more effective in dealing with operational disputes, with Ofcom's Dispute Resolution process being more appropriate for addressing disputes of a 'strategic' nature. TNT argued that there may be a number of issues which could not be resolved through commercial negotiation or by mediation (since, under the existing terms of the access agreement, mediation requires the consent of both Royal Mail and the access operator or user). Given this, the only options would be to refer the dispute to Ofcom or take the matter to arbitration. TNT argued that arbitration was unsatisfactory where there was an on-going commercial relationship since it was adversarial and that it was formal, expensive, inflexible and time consuming. TNT suggested that a neutral third party adjudicator should have the ability to issue a binding decision and that neither party should have the right not to submit to the process (except where the matter was considered strategic and where Ofcom had decided to resolve the dispute). In this context ONEPOST referred to OTA2, which it regarded as performing a similar role in the telecommunications sector.

10.184 Royal Mail believed that it would be wholly inappropriate and disproportionate for regulation to impose third party dispute resolution requirements upon Royal Mail. It believed that, if parties had failed to resolve a contractual dispute over access after exhausting contractual resolution provisions, then cases should be resolved through arbitration, as was the norm in such situations.

Our assessment

10.185 Royal Mail was supportive of our proposals to use the existing Dispute Resolution Guidelines established in the communications sector, however, it stressed the importance of access customers allowing contractual dispute processes to fully run their course before seeking intervention by the regulator. Ofcom's view is that parties should first seek to settle matters between themselves before referring disputes to us. Indeed, as set out in our Dispute Resolution Guidelines, we would "*expect to see evidence that the Parties have made reasonable endeavours to enter into good faith negotiations in order to seek to resolve their differences before referring the matter to Ofcom*".

10.186 We are aware that the Act does not impose a requirement to resolve disputes within four months. We also recognise that to resolve a dispute Ofcom will need to obtain the necessary information from all parties involved. However, we recognise the importance of resolving disputes in a timely manner and therefore will endeavour to resolve disputes within four months. In this context we would seek and expect to receive evidence on a timely basis.

10.187 In our December consultation, we noted a possible need to publish a further document that identified, more specifically, the parts of Ofcom's existing Dispute Resolution Guidelines that would be different for postal access disputes. We have

decided that such a document would provide useful clarity to parties considering bringing such disputes and therefore intend shortly to publish a supplement to Ofcom's Dispute Resolution Guidelines for these purposes.

- 10.188 The evidence provided to Ofcom indicates that, in the majority of cases, problems in relation to access agreements are dealt with during the normal course of business between Royal Mail and access customers. However, where this is not the case and disputes arise, it is clear that some access customers consider that the existing provisions for dispute resolution in the current contract have a number of shortcomings.
- 10.189 Access operators and customers have provided examples of disputes which they consider cannot suitably be addressed by the current Royal Mail dispute resolution options, which include the options of mediation (by mutual consent) and arbitration. They suggest that evidence indicates that, in the context of the postal industry, the latter is expensive given the typical size of disputes and is only likely to be suitable for certain limited cases.
- 10.190 We understand in this context the reasons why a number of respondents have indicated their support for an independent body to deal with disputes as an Alternative Dispute Resolution ('ADR') mechanism. These respondents have indicated that adjudication would be more cost-effective and appropriate than arbitration (which is currently offered by existing access agreements) for the scale of disputes which normally arise between Royal Mail and access operators and could also be more appropriate (in some circumstances) to Ofcom's Dispute Resolution Process. This could be done in a manner consistent with telecommunications where our Dispute Resolution guidelines indicate we may require parties to use ADR before we are able to take forward a dispute.
- 10.191 As previously discussed, a number of access operators (and customers) have raised concerns over Royal Mail's terms and conditions (or Royal Mail's interpretation of the terms and conditions) relating to the reversion of mail items (and the associated surcharging policy) for failing to meet mail presentation requirements. We have also been made aware of examples of specific commercial disputes between Royal Mail and its wholesale customers. Although we believe that these and similar operational issues could be brought to Ofcom under our Dispute Resolution Process, we also recognise that at least some of these issues may also be suited to being dealt with by an independent dispute resolution body, particularly where those disputes that are relatively small scale and relate to operational issues rather than regulatory matters).
- 10.192 In light of this, we consider that an alternative dispute process, possibly including an adjudication role, could have merit. We are aware that operators are exploring options to develop a more effective operational dispute resolution mechanism and would encourage the industry to engage in this process and work towards improving the existing dispute provisions for matters that are more operational in nature. We also note Royal Mail's position in its response that regulation should not be imposed to require such a mechanism. We agree at this stage that regulation is not the best way to develop an ADR process which can work effectively for the industry. However, if access operators and Royal Mail are unable to agree such a process, we would have the powers to resolve disagreement and if necessary impose a solution where that was in accordance with our duties.
- 10.193 In supporting such an independent adjudications office, a number of respondents have referred to the Office of the Telecommunications Adjudicator (OTA) as a comparable body in the telecoms sector. The context under which the OTA was set

up was different and very specific to the circumstances of the creation of BT Openreach. It is not clear that they apply here, and that the type of issues which could arise in post cannot be addressed by Ofcom's Dispute Resolution process, or, if appropriate, ADR. We will keep this under review based on ongoing review of the effectiveness of these processes.

Our decision

10.194 Our final decision is as follows:

- To adopt Ofcom's established dispute resolution process for postal access disputes as set out in Ofcom's Dispute Resolution Guidelines. This will be subject to recognising any appropriate differences such as where the 2003 Act and the Act impose any different legal requirements.

Obligation on Royal Mail to offer access – Other forms of access to the network or access to elements of postal infrastructure

Our proposals

10.195 In our October consultation, we focussed on assessing whether Royal Mail should be obliged to offer access for participation in the retail D+2 and later than D+2 Letters and Large Letters markets. We proposed that Royal Mail should be obliged to offer access at the IMC for the purposes of providing D+2 and later than D+2 Letters and Large Letters services only.

10.196 We did not propose that Royal Mail should be obliged to offer access to its network for other forms of access (i.e. to other points in Royal Mail's network or for other services).

10.197 In addition, we considered whether Ofcom should impose a general access condition requiring Royal Mail to grant access to its postal infrastructure or a service within the scope of the universal service which it provides. Under the Act, Ofcom may only impose a general access condition where it appears that the condition is necessary for either or both of the following purposes:

- Protecting the interests of the users of postal services; and
- Promoting effective competition.

10.198 Ofcom considered that the central purpose of a general access condition was to ensure interoperability in a multi-operator environment and that this type of access would be important where postal operators provided end-to-end services. However, given the limited provision of end-to-end postal services in the UK to date, we did not consider that the case for mandating access to elements of postal infrastructure currently satisfied either of the tests set out in the Act. We therefore did not propose to mandate access to any element of postal infrastructure or a service within the scope of the universal service.

10.199 We did however, recognise that circumstances might change in the future, and in the event that this was the case and/or evidence was brought forward to that effect, Ofcom would consider the position at that time.

Responses to consultation

- 10.200 Royal Mail argued that mandated access should not be further widened to any other points of Royal Mail's network or any services other than D+2 and later Letters and Large Letters markets.
- 10.201 Royal Mail argued that mandating access at points downstream of the IMC, such as at the Delivery Office, would have significant downsides and would not meet the tests for mandating access that are set out in the Act. In summary, Royal Mail argued that access at points downstream of the IMC would introduce additional inefficiency and unnecessary costs into Royal Mail's network.
- 10.202 In relation to mandating access to Royal Mail's network to allow other operators to extract items, Royal Mail argued that this would allow competitors to target specific streams of mail via 'cream skimming', would significantly undermine its ability to finance the universal service and would exceed the intention and requirements of any access regime.

Packets access

- 10.203 Royal Mail did not regard that mandation of access packets was necessary to promote competition in the deferred packets markets. Royal Mail referred to Postcomm's market analysis that concluded that there was effective (end-to-end) competition in the packets market at heavier weights and also developing competition even at relatively low weights for the very largest customers. However, Royal Mail noted that the fact that access for packets was not mandated would not preclude it from offering such access where it was viable and allowed a reasonable commercial return.
- 10.204 A number of respondents (including access operators and Consumer Focus) raised concerns regarding Ofcom's proposal only to mandate access at the IMC for participation in the D+2 and later Letters and Large Letters markets and argued that this should be extended. There was particular concern that the scope of the obligation did not extend to packet items.
- 10.205 Access operators argued that mandated access for packets, where there was no, or limited, delivery competition was needed. Respondents referred to Postcomm's market analysis that concluded that there was no downstream competition for packets below 500g and only emerging competition in certain sectors for packets below 2kg.
- 10.206 Respondents argued that recent developments had increased the importance of access packets to access operators. UK Mail highlighted the strong growth in access packet volumes that had increased by up to 42% in the year to October 2011, whilst overall access volumes had only increased by 5.5%. UK Mail argued that the growth in volumes was because of three factors which had enabled the realistic use of access-based services for packets. These were (a) changes to access agreements to allow mixed-weight packets; (b) changes to access agreements to allow packets up to 5kg; and (c) changes in Royal Mail's pricing of access packets and the minimum headroom for packets.
- 10.207 TNT was concerned that, without mandated access for packets, there would be no ex ante margin squeeze control, and that issues of margin squeeze would need to be addressed ex post under competition law which was considered to be time consuming and potentially ineffective. UK Mail was also concerned that denying

customers (who also use access for posting Letters and Large Letters) the ability to send packets via access would result in highly disruptive requirements for separation of items.

Access for participating in D+1 services

10.208 Royal Mail argued that access for D+1 Letters and Large Letter services would provide a clear commercial opportunity for access operators to cherry pick the most profitable First Class customers i.e. those that are cheapest to serve, which Royal Mail could not compete against given its geographically uniform pricing obligation. Royal Mail argued that this would threaten the viability of the universal service.

10.209 UK Mail argued that, by excluding D+1 services from the scope of mandated access, Ofcom had excluded the existing Premium Access service (where items are injected at the IMC) from its proposals. This was despite Premium Access providing access based competition in the D+1 markets where Royal Mail has significant market power. UK Mail also noted Postcomm's initial view that a similar set of arguments for mandating access for D+2 services was likely to apply to D+1 services. TNT suggested that Ofcom should also mandate access at the Outward Mail Centre (OMC) for participation in the D+1 markets.

Access to elements of postal infrastructure

10.210 UK Mail was concerned with Ofcom's proposal not to mandate access to some elements of postal infrastructure, specifically to PO Boxes. It argued that its significant business in the collection and delivery of packets was materially constrained by not being able to accept customers' items that are addressed to PO Boxes (since it cannot know the location of the PO Box or may not have access to the PO Box). UK Mail argued that this had effectively foreclosed competition to delivery of PO Box addressed items. TNT indicated that access should be required to redirections data (and poste restante information).

Our assessment

10.211 Our assessment of whether Royal Mail should be required to offer access to the postal network focussed on D+2 and later than D+2 Letter and Large Letter services. Our proposals that oblige Royal Mail to offer access at the IMC recognised the importance of this form of access to customers and competitors since it currently accounts for over 99% of all access volumes (and over 97% of access revenues). As set out above, the Act sets out three tests which must be satisfied in order for a universal service provider to be required to give access to its postal network. Ofcom may not impose a condition requiring such access unless it appears to it that a condition is appropriate for each of the following purposes:

- Promoting efficiency;
- Promoting effective competition; and
- Conferring significant benefits on the users of postal services.

10.212 In our October consultation, we noted that, before Ofcom undertakes an assessment of whether the tests in the Act are met, it would expect to receive detailed evidence from access seekers supporting the case for imposing a USP access condition. As part of this, Ofcom would expect to receive the following information:

- The access seeker's business case for the proposed form of access;
- A description of the perceived operational requirements of the proposed form of access; and
- An assessment of how the form of access meets the tests set out in the Act and how the form of access is consistent with Ofcom's primary duty to secure the provision of the universal service.

10.213 At this point in time, we do not believe that we have received sufficient information along the lines set out in the preceding paragraph that would allow us to progress an assessment of whether the tests in the Act are met in relation to imposing access beyond that at the IMC for the purposes of participating in the D+2 and later than D+2 Letters and Large Letters services.

10.214 However, on the basis of the evidence that we do have, we note that Royal Mail currently offers both a D+1 access service and an access packets service and we would expect that Royal Mail will continue to offer these services and we will monitor the basis on which it does so.

10.215 We also note that evidence in relation to access packets and D+1 access, indicates that both volume and revenue are relatively low. We note that volumes of access packets have recently grown, but overall remain low and are estimated to remain low for the forthcoming year.¹⁶⁰

10.216 Given the fact that a D+1 access service and an access packets service are currently being offered and that the take up of these services is currently low, we are not persuaded of the need to consider mandating access at this stage. However, if Royal Mail were to seek to stop providing access for these services (or not offer access on a fair and reasonable basis) or if the demand for these services increased, Ofcom might need to reconsider the evidence available at that time and accordingly whether it might be appropriate to impose a further USP access condition.

10.217 Therefore, although we are not mandating other forms of access beyond the D+2 and later than D+2 Letters and Large Letters markets, this by no means implies that this is the only type of access that Royal Mail may offer, nor does it mean that we have discounted that in the future other forms of access should be mandated.

10.218 It should be noted that the Statement of Process for agreeing new terms of access or variations to existing access agreements will only apply to those services where access has been mandated. Ofcom does not have the legal vires to require Royal Mail to establish a process for negotiating the terms of access (or agreeing variations to existing terms) for forms of access that are not required by regulation. We would, however, encourage Royal Mail to follow clear and transparent processes for considering such requests for access for new forms of access or variations to existing terms that are broadly comparable to those that apply under the Statement of Process.

10.219 UK Mail argued that the existence of end-to-end competition for packets was constrained by a lack of access to PO Boxes. We also note a similar concern by TNT relating to lack of access to redirections data. However, we do not consider that we have a sufficient level of evidence explaining why access to PO Boxes (or other

¹⁶⁰ Based on current trends, we estimate that access packets will account for less than 1% of total access volumes over the forthcoming year.

elements of postal infrastructure) meets either, or both, of the tests set out in the Act for mandating access (i.e. protecting the interests of postal users and/or promoting effective competition). We have not therefore imposed a general access condition requiring access to PO Boxes or other elements of postal infrastructure.

10.220 We also believe that, before Ofcom considers imposing an obligation on Royal Mail to offer access to an element of postal infrastructure, we would need at least to see that an operator had sought to agree such access through commercial negotiations.

10.221 Notwithstanding our decision not to impose a general access condition requiring Royal Mail to offer access to PO Boxes (or other elements of postal infrastructure), we recognise that there is a case for mandating access to infrastructure in order to promote interoperability of postal networks, and that there is a clear intention within the Directive and the Act for such access to be granted where necessary. Where access cannot be agreed through commercial negotiations and Ofcom is approached to mandate access, it would need to consider evidence regarding whether that form of access was necessary to protect the interests of postal users and/or promote effective competition. In relation to the latter, Ofcom would be likely to consider the evidence regarding whether access was necessary to overcome a barrier to entry in the market.

10.222 Were either, or both, of the tests in the Act satisfied, in deciding what obligations should be imposed in a general access condition, the Act requires that Ofcom must in particular take into account the five factors set out in paragraph 10.20.

10.223 Our decision therefore is that we do not propose to impose any further access conditions at this stage. However, we will consider future evidence in relation to the need for general access conditions on a case by case basis.

Summary of our decisions

10.224 In this section we provided our final decisions relating to the need to regulate access and the appropriate form of that regulation.

10.225 We have decided to establish a USP access condition that requires Royal Mail to offer access at the IMC for the provision of D+2 and later than D+2 Letters and Large Letters services only. In relation to this form of access we have decided:

- To require Royal Mail to offer the terms and conditions of access on a “fair and reasonable” basis.
- To require Royal Mail to adopt a reasonable, transparent and timely process for postal operators and users of postal services to make requests for access contracts (or variations to existing access contracts).
- To require Royal Mail to provide ten weeks’ prior publication and notification of standard price terms (unless otherwise agreed).
- To require Royal Mail to provide ten weeks’ prior publication of standard non-price terms (unless a shorter notification period is agreed, in which case, consistent with the shorter period).
- To require Royal Mail to adopt a transparent process for the prior notification of those non-price changes that do not require the prior consent of the access operator (with notice periods sufficient to manage the impact of such changes).

- To require Royal Mail to provide access users with quality of service information for its access services based on a fair and reasonable system of monitoring.
- To establish an ex ante margin squeeze control that requires Royal Mail to have a reasonable expectation of recovering relevant upstream costs across a basket of products within the scope of the control and 50% of relevant upstream costs on a price point basis for services within the scope of the control.
- To require Royal Mail to provide quarterly information to allow Ofcom to monitor Royal Mail's compliance with the ex ante margin squeeze control.
- To require Royal Mail not to unduly discriminate against any particular persons or against a description of persons in relation to access matters.
- To adopt the dispute resolution process for access previously established for the communications sector in its Dispute Resolution Guidelines subject to recognising any appropriate differences in legal requirements.

Section 11

Regulatory financial reporting

Introduction

- 11.1 Section 7 of this statement sets out our detailed proposals on how we intend to monitor Royal Mail, given the significant commercial freedom that we have decided is appropriate to give Royal Mail in the current context. This section sets out the information Royal Mail will be required to give to Ofcom to support the monitoring regime.
- 11.2 In our October consultation document, we set out our proposals for Royal Mail's regulatory financial reporting requirements. In particular, we discussed our objectives for regulatory financial reporting obligations from 2012 onwards. These objectives took account of the need to ensure that our statutory duties (especially our primary duty to secure the provision of a universal postal service) are secured in light of our other proposals for a new regulatory framework for the postal sector.
- 11.3 In December 2011, we published a separate consultation setting out the proposed detailed legal instruments to implement our October policy proposals, namely the texts of our proposed USP accounting condition, together with our proposed direction under that condition to impose more detailed regulatory financial reporting obligations in the Regulatory Accounting Guidelines (RAG).
- 11.4 This section sets out our conclusions on our main proposals concerning the regulatory financial reporting framework. We also summarise our consideration of the key points raised by stakeholders in their responses to both consultations. We provide further details of these matters in Annex 3.
- 11.5 Our conclusions mean, in essence, that we have decided that it is necessary to impose on Royal Mail our proposed USP accounting condition (USPAC) and the direction containing the RAG, with some modifications. We address in Section 13 of this statement why we consider that these measures are likely to best meet our statutory duties and the legal tests referred to in Section 3 of this Statement, particularly in light of the objectives for regulatory financial reporting obligations we set out in the October consultation.
- 11.6 Those objectives, in summary, are:
- the need to monitor the financial sustainability of universal service provision;
 - the need to monitor the efficiency of universal service provision;
 - the need to understand how costs and revenues are apportioned to different products and activities; and
 - the need to monitor the relative profitability of different product groups sharing activities and costs.

Overview

- 11.7 In the October and December consultations, we proposed to build on the existing regulatory financial reporting framework by requiring enhanced reporting from 2012-13. We proposed, in particular, that Royal Mail's regulatory financial reports should be required at three levels, namely:
- the **Relevant Group** – encompassing Royal Mail Group Ltd (RMG) and all persons (corporate and unincorporate) included in the statutory consolidated accounts of Royal Mail Holdings plc (RMH plc), excluding RMH plc itself and Post Office Ltd (POL) and its subsidiary and associated undertakings – which raises external finance in connection with the provision of the universal service;
 - the **Reported Business** – encompassing the activities and services the attributable costs of which are included in the Costing Manual; and
 - **separated reporting elements** within the Reported Business, where we proposed financial statements for four Financial Reporting Entities (FREs) described in the consultation, including separate profitability statements for product groups within the Reported Business.
- 11.8 Respondents generally supported our proposals. The key points raised – particularly by Royal Mail - were:
- a potential opportunity to narrow the **scope of the Reported Business** in 2012-13 to Mails products only;
 - the need where possible to **avoid duplication of information** already produced by Royal Mail for business management purposes;
 - the limited regulatory value of some financial information being provided on a **quarterly financial reporting** cycle; and
 - the risks associated with the **disclosure** of quarterly financial information and some separated financial reports of the Reported Business.
- 11.9 We have decided not to change substantively the scope of the Reported Business. However, we have clarified in the USPAC that the scope of the Reported Business should be defined by the most up to date costing methodology, as documented in the most recent version of the Costing Manual. This approach ensures that the scope remains consistent with Royal Mail's costing methodology which continues to evolve to take account of operational changes, and to incorporate zonal costing.
- 11.10 We have also made some additional minor modifications to our October consultation proposals in order to address the concerns raised in the three other main areas mentioned above.

- 11.11 We have decided to impose the regulatory financial reporting obligations in the USPAC and the RAG, published at Annexes 10 and 11, to this Statement.¹⁶¹ The main reports which we require from Royal Mail are summarised in the Table 5 at the end of this section. The table also explains the key changes to our October proposals.
- 11.12 As the table shows, we have amended our requirements for the format of some of the information to be provided by Royal Mail. Generally, these reports follow relevant financial reporting cycles within a financial year but, in the case of the Strategic Business Plan and cash flow projections, full updates (beyond the requirements of annual budgeting) are not necessarily produced in this way. We have therefore reflected this in the modifications we have made to the obligations imposed on Royal Mail also to provide us with updates as and when they are available to its own Board.
- 11.13 The table also indicates that we have decided not to proceed with our proposed requirement for a quarterly allocation of exceptional costs to and within the Reported Business. Royal Mail indicated that it does not prepare such allocations, and we now consider that, at this stage, it is not sufficiently important to impose such a requirement to further our understanding of quarterly financial performance variations. However, we have made certain modifications to the scope of confidential product profitability reporting that Royal Mail will be required to provide, to align it with the final scope of our other economic regulatory decisions.
- 11.14 Finally, as noted in the table, we have decided to review at a later date the requirement for Royal Mail to publish quarterly information, and annual results for the FREs and non-Mails. Royal Mail expressed significant concerns over the publication of such information, and we now consider that, at this stage, it is not sufficiently important to impose such a publication to achieve our objectives set out above.
- 11.15 On 2 March, the Business, Innovation and Skills Committee published a report on stamp prices which stated that: *“alongside removal of price controls Royal Mail will need, rapidly, to get a much clearer grasp of the costs and profitability of its product lines. As Royal Mail’s financial reporting regulator, Ofcom must ensure that this happens”*.
- 11.16 We consider that the reporting requirements set out in this section and explained in more detail in Annex 3 will provide the necessary understanding of costs and profitability of Royal Mail’s products. Specifically, we consider that the requirements for reporting at the level of the Reported Business in general and the different product profitability statements in particular will enable us to understand and monitor the allocation of costs and revenues and relative profitability of different products.

Reporting of the Relevant Group and Reported Business

Our proposals

- 11.17 In our October consultation, we proposed that Royal Mail should provide us with three types of reports in relation to the financial performance of the Relevant Group:

¹⁶¹ For the avoidance of doubt, Royal Mail will continue to be subject to the financial reporting obligations set out in Acc 1.1 to Acc 1.28 for the financial year beginning 28 March 2011 as set out in our notice of regulatory conditions and direction, published at Annex 2 to Ofcom’s Statement ‘Postal regulation: Transition to the new regulatory framework’, 29 September 2011.

- audited annual financial statements (income statement, balance sheet and cash flow) of historic performance;
 - quarterly updates of its cash flow projections for the following two years (i.e. eight quarters); and
 - annual updates of its Strategic Business Plan, in similar form to the plan which we reviewed for the purposes of developing our October consultation proposals.
- 11.18 We proposed that the information should cover the Relevant Group as it is the entity which raises external finance, for which financing costs (such as interest) are relevant. We proposed that the historic statements (and supporting information) should be published but the projections should be provided to us in confidence.
- 11.19 This information would enable us both to assess the historic and projected financeability of the Relevant Group, as the legal entity with the obligation to provide the universal service, and to assess Royal Mail's medium term plans for the business in the context of a glide path to the efficient provision of the universal service over a reasonable period. We noted that the current financial position of the business meant that monitoring the projected cash position via quarterly updates was particularly important at this stage.
- 11.20 Within the Relevant Group, Royal Mail reports the activities of its UK Letters, Parcels and International (UKLPI) division for internal management and statutory reporting purposes. This division is not a legal entity and includes both activities associated with universal service provision and others which are not (such as those provided under the Parcelforce Worldwide brand).
- 11.21 We therefore proposed to continue to define a narrower entity for regulatory financial reporting purposes – the Reported Business – on the same basis as existing regulatory financial reporting.
- 11.22 This entity includes all activities the direct costs of which are included in the methodology which Royal Mail is required to use to generate Fully Allocated Cost (FAC) estimates for regulatory financial reporting purposes, changes to which are subject to regulatory oversight under the cost transparency framework previously introduced by Postcomm for 2011-12.
- 11.23 As with UKLPI, the Reported Business is not a legal entity as such and so it does not raise external finance. We therefore proposed to require audited annual regulatory financial statements (and supporting information) to be produced for it on a pre-finance basis. These statements, which we proposed would continue to be published, would enable us to monitor the overall return being made by the activities undertaken for, or in connection with, universal service provision – via profitability at EBIT level, and return on capital employed, and to monitor the relative contribution of operating cash from these activities to the overall financeability of the Relevant Group.

Responses to consultation

- 11.24 There was general agreement to our proposals in relation to annual reporting of historic financial performance at the level of the Relevant Group and the Reported Business, and for the need for Royal Mail also to provide information on projections at the level of the Relevant Group. There was also agreement that the audited information on historic performance should be published, but the projections should not be.

- 11.25 Apart from Royal Mail, the main comments were in relation to the detail of the reporting requirements. Some respondents noted that the integrated nature of Royal Mail's operations, and the common ownership and control of activities outside of the Relevant Group and Reported Business, required regulatory transparency over transfer pricing and allocation assumptions across these boundaries.
- 11.26 In addition, Royal Mail noted that it already prepared regular updates on its forward cash position for its own Board and suggested providing these to us, to avoid the risks of duplication. It noted that the minimum time horizon it considered to be appropriate for this purpose was six, not eight, quarters. Royal Mail also pointed out that, apart from annual budgets, updates to the content of its Strategic Business Plan are unlikely to be undertaken within an annual cycle, and proposed that the updates provided to Ofcom in these areas should be those it undertook for its own Board.
- 11.27 Finally, Royal Mail proposed removing non-Mails products from the scope of the Reported Business on the grounds that these did not require the activities of the core universal service network for their provision.

Our assessment

- 11.28 Since we published our proposals, Royal Mail has confirmed that it still faces challenges to the efficient and financially sustainable provision of the universal service. Given the consultation responses, we therefore consider our October proposals for the level of regulatory financial reporting to monitor the overall efficiency and financeability of universal service provision are necessary to achieve our objectives for regulatory financial reporting.
- 11.29 We agree that this will require an appropriate level of supporting detail, in order to understand how costs and revenues are shared within the wider RMG group of companies. Hence, as set out in Annex 3, we have therefore decided to impose obligations for the reporting of the transfer pricing and cost allocations concerned in the RAG, which are enforceable under the USPAC.
- 11.30 We agree, however, with Royal Mail's proposals to use, where possible, the information in reports which it expects to produce for internal management purposes for regulatory financial reporting, to avoid unnecessary duplication. Nevertheless, we consider it necessary to impose additional detailed requirements to provide the transparency and comparability of reporting over time that we consider are required to achieve our objectives for regulatory financial reporting.
- 11.31 We have therefore decided to adopt reporting formats for regulatory reporting which align with Royal Mail's proposals where possible, but to require regular reporting in addition to *ad hoc* updates to projections following Board approval. However, we now consider that the effectiveness of achieving our aims would not be jeopardised by limiting the need for Royal Mail to prepare quarterly cash projections to six future quarters, as Royal Mail does itself.
- 11.32 Although Royal Mail proposed to remove non-Mails products from the scope of the Reported Business, it did not propose to change its own costing system for the purpose. This could make it difficult for us to understand the impact, if any, that changes in the direct costs concerned would have on the FAC of Mails products.
- 11.33 We therefore consider that it is appropriate, at this stage, to leave the scope of the Reported Business unchanged. However, we remain open to a review of this matter later, particularly if Royal Mail can provide evidence that the activities concerned are

not connected with the efficient and financially sustainable provision of the universal service, and that their accounting treatment can be alternatively provided for in the regulatory financial reporting framework.

Our decisions

11.34 We have decided to require Royal Mail to:

- publish full audited annual financial statements, with appropriate supporting information, for the Relevant Group (RMG Limited excluding POL and its subsidiary undertakings) and the Reported Business;
- deliver to Ofcom, on a confidential basis, quarterly updates to the cash flow projections of the Relevant Group following their approval by its Board; and
- deliver to Ofcom, on a confidential basis, annual updates to its budget and *ad hoc* updates to its Strategic Business Plan following their approval by its Board, together with annual confirmation of the existing Strategic Business plan.

Product costing for the Reported Business

Our proposals

- 11.35 As noted above, we proposed in our October consultation to continue to define the scope of the Reported Business with reference to Royal Mail's existing FAC product costing methodology, which is already used for audited regulatory financial reporting. We also proposed to continue the requirement for Royal Mail to provide us with advance notification of proposed material changes to this costing methodology (subject to the existing 1% materiality threshold), but not to continue the requirement for prior Ofcom approval of changes that were compliant with the regulatory costing rules.
- 11.36 Consistent with this proposal, we proposed to leave most of the existing regulatory rules applied to FAC product costing unchanged, including the scope of cost types covered by the costing methodology, and the basis of traffic data used to attribute and allocate costs to products within it.
- 11.37 However, we did propose to refine the basis on which general overheads – accounting for under 10% of total FAC - are allocated within this costing methodology. At present, these are allocated, along with overheads specific to each part of the pipeline, in proportion to direct costs. We proposed that, in future, they should be allocated in proportion to the sum of direct costs and pipeline overheads, which is closer to the basis indicated in the Postal Services Directive. However, our assessments show that this would currently have only limited impact on FAC estimates. We have therefore decided not to require changes to the costing system for the time being.
- 11.38 We also proposed to review the detailed formats in which some of the confidential documentation of the costing methodology is currently provided to Ofcom (under the initial conditions) in the Technical Appendices of the Costing Manual, to ensure we were able to monitor the evolution of future changes to FAC estimates on a timely basis.
- 11.39 In our October consultation, we also proposed to extend the existing scope of regulatory financial reporting for FAC products to include zonal costing. In particular,

we proposed additional regulatory rules to cover the identification of geographically-specific costs for that purpose, and to extend the scope of documentation in the Costing Manual of the existing FAC product costing methodology to encompass the associated zonal costing methodology that complied with our proposed rules.

- 11.40 Those rules, which we set out in detail in our December consultation, included requirements to ensure zonal and national costs could be reconciled and that zonal differentials were reviewed at least annually, with any estimated zonal cost differentials that were estimated using regression techniques being supported by appropriate econometric analysis, and the number of zones for cost reporting purposes remaining at no more than the existing four zones for this new regulatory financial reporting framework.
- 11.41 In our October consultation, we explained that it was premature to consider including rules for deriving LRIC estimates for regulatory reporting purposes, given Royal Mail's progress to that point in deriving such estimates. Instead, we proposed that we would consult further on the basis of LRIC estimation for regulatory reporting purposes once further work had been undertaken by Royal Mail.

Responses to consultation

- 11.42 Most respondents supported our proposals for FAC product cost reporting at the national level and to extend a comparable reporting framework to zonal costing, which is relevant for zonal access pricing. UK Mail expressed caution over implementing further changes to the overhead allocation methodology at this stage, while TNT argued against too many boundaries for zonal costing.
- 11.43 Royal Mail argued that our proposed refinement of the allocation of general overheads was unnecessary given the level of detail already used in the costing methodology for overhead allocation, and indicated that its existing system could not accommodate the change without excessive manual intervention. It also proposed that the documentation of the detail of the methodology in the Technical Appendices could be simplified, to reduce the costs of their preparation. It argued that separate rules for zonal costing were unnecessary, as the national costing rules were also sufficient for zonal costing.
- 11.44 Respondents generally agreed that it was premature for us to set out rules for LRIC estimation as part of the regulatory financial reporting framework, although the CWU encouraged Royal Mail to continue to work with us on this area, to support a future move to LRIC based regulation.

Our assessment

- 11.45 Since our consultation proposals, Royal Mail proposed some updates to the quarterly costs for 2011-12. These changes included more up to date estimates of input costs, confirmation of the completed implementation of Royal Mail's existing Undertakings aimed at bringing its costing system into compliance with the existing regulatory costing rules, and some amendments to reflect recent changes in its product portfolio.
- 11.46 However these proposals also included some proposed changes in the basis of costing, as set out in the latest update to the published part of Royal Mail's Costing

Manual¹⁶². Under the existing accounting condition (the initial conditions), Royal Mail must seek our approval to make material compliant methodology changes to its costing methodology for regulatory financial reporting purposes.

- 11.47 We have reviewed these proposed changes and provisionally consider them to be consistent with the existing regulatory costing principles in the current accounting condition (the initial conditions). As required under this condition, we shall shortly commence the required one month's statutory consultation over the changes and subject to responses to that consultation, anticipate confirming our approval to them in May.
- 11.48 Royal Mail is also required to document the details of these changes in the confidential Technical Appendices of the Costing Manual. Royal Mail has confirmed in writing that they will provide us with Technical Appendices, consistent with the changes concerned, in May covering the third and fourth quarters of 2011-12¹⁶³.
- 11.49 This latest version of the Costing Manual, setting out the application of the costing methodology for the third and fourth quarters of 2011-12 is then expected to be fully compliant with the existing regulatory financial reporting requirements. It will therefore represent a suitable starting point both for defining the scope of the Reported Business and for our reviewing further changes in the costing methodology under our proposed framework from 2012-13.
- 11.50 Nevertheless, the recent review work confirmed the value of the existing process, whereby we can review changes to the costing methodology on a quarterly basis. We have therefore decided to require Royal Mail to continue providing us with the Technical Appendices on a quarterly basis, to pre-notify material changes to the costing methodology, and to update the published part of the Costing Manual where appropriate. To facilitate this quarterly monitoring process, we have refined and extended the detailed formats of some of the Technical Appendices. The details are set out in Appendix 4 to Annex 3.
- 11.51 We note that Royal Mail's concern over the additional costs of implementing a change to the rule for allocating general overheads at this stage. As we indicated in our October consultation, the cost-effective timing of this change could be dependent on when Royal Mail upgrades its legacy costing system. However, we would not wish the implementation of our proposal to be delayed indefinitely, and we have decided to set a deadline of 2014-15 for its implementation.
- 11.52 In relation to zonal costing, Royal Mail is currently required (under Condition USPA 4.5) to confirm that updated zonal access prices are no less cost reflective from one year to the next. We have reviewed the zonal cost estimates Royal Mail has used to satisfy this requirement in relation to its notified zonal access prices for 2012-13, based on 2010-11 costing information. Relative to these cost estimates, Royal Mail's audit report confirmed the 2012-13 prices were no less cost-reflective than the 2011-12 prices, although the same test could not be applied for the previous year.
- 11.53 The existing zonal costing methodology is therefore a suitable starting point for the future regulatory financial reporting framework in this area, but we remain of the view

¹⁶² [http://www.royalmailgroup.com/sites/default/files/Costing%20Manual%20%20v2011-3V\(625KB\).pdf](http://www.royalmailgroup.com/sites/default/files/Costing%20Manual%20%20v2011-3V(625KB).pdf)

¹⁶³ Royal Mail will be publishing a letter to this effect on its website:
<http://www.royalmailgroup.com/how-were-regulated/regulation-framework>

that zonal FAC product costing should, from 2012-13, be subject to regulatory oversight to the framework in place for national FAC product costing.

- 11.54 In this respect, we also continue to consider additional rules will be necessary for the geographically-specific aspects of zonal FAC product costing, particularly as the relevant costing methodology is currently applied using both outputs from the national FAC product costing methodology and other inputs including the results of an econometric regression at postcode sector level, which depend on sampled traffic volumes at this level.
- 11.55 We have therefore decided to retain these additional zonal costing rules, and associated documentation requirements, along the lines set out in our December consultation, but with some modifications to allow Royal Mail to refine its methodology when the available data permits it. However, we expect Royal Mail to consult over any proposed zonal boundary changes for cost reporting purposes. We have also accepted its proposal that it completes the documentation of the methodology in the first part of 2012-13 once it has confirmed the compliance of its current methodology with the new rules that we are putting in place.
- 11.56 Since our consultation, Royal Mail has made more progress in developing the capability to derive LRIC estimates, but does not expect to provide us with estimates to review until later in 2012-13. We therefore continue to consider that regulatory financial reporting requirements should be based on FAC estimates at this stage.

Our decisions

11.57 We have decided to require Royal Mail to:

- continue to prepare FAC national product cost estimates on a quarterly basis from its costing system, notifying Ofcom seven days in advance of any proposed material compliant changes to the costing methodology, with the existing 1% materiality threshold remaining;
- produce consistent zonal cost estimates, reviewed at least once a year, using specific zonal costing rules, and will document the methodology in the Costing Manual as set out in our October consultation (Royal Mail is expected to consult before any changes to zonal costing boundaries are made); and
- continue to publish an up-to-date Costing Manual documenting its FAC product costing methodology, and continue to provide Ofcom with quarterly Technical Appendices, with the changes in format in 2012-13 set out in Appendix 4 to Annex 3.

Separated reports for the Reported Business

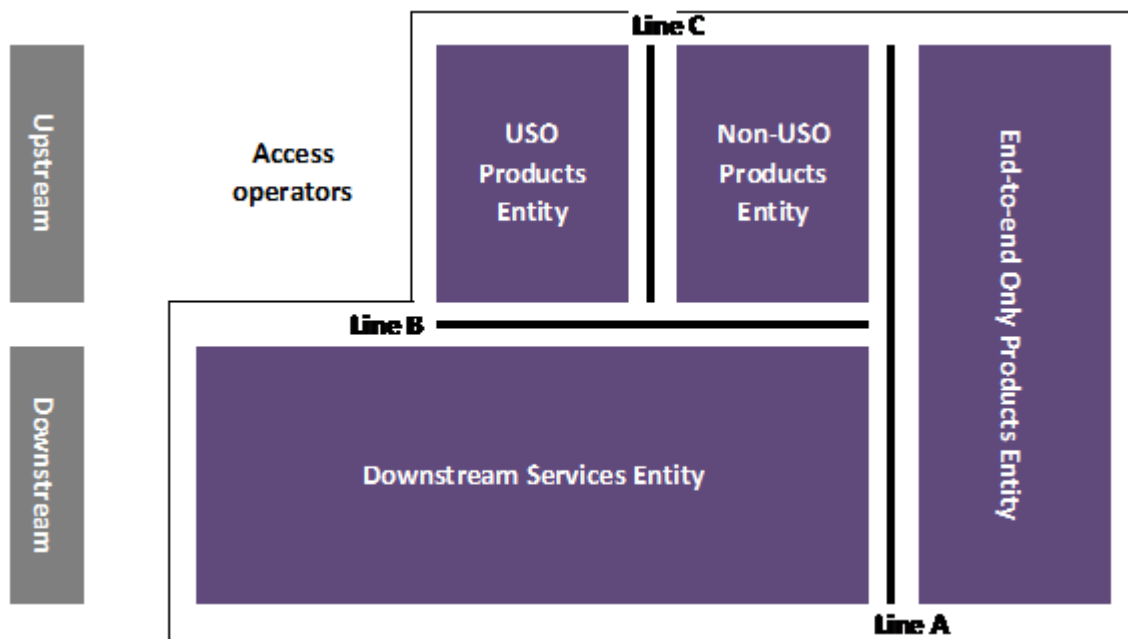
Our proposals

- 11.58 In addition to financial statements for the Reported Business as a whole, we proposed that Royal Mail must prepare and maintain:
- income statements, capital employed statements, and cash flow statements for four component FREs within the Reported Business;
 - income statements splitting the profits of the Reported Business between universal service, other Mails and non-Mails products; and

- product profitability statements for defined product groups within these FREs which shared similar market and/or regulatory conditions.

11.59 The main purpose of the proposed reporting for the FREs, the scope of which is illustrated below, was to enable us to understand the relative overall contributions being made by different components of the integrated Reported Business to the profitability and financial sustainability of activities undertaken for, or in connection with, the provision of the universal service.

Figure 5: The Four FREs



11.60 For that purpose, we proposed that Royal Mail must produce and publish financial statements in the format proposed for the overall Reported Business – covering profit before interest and tax, and supporting statements of capital employed and operating cash flow, and associated supporting information. As with the statements for the Reported Business as a whole, we proposed that all of the annual FRE statements must be audited.

11.61 Where Royal Mail's own retail products used services provided by activities the costs of which were reported in another FRE, we proposed rules for transfer pricing. These rules required transfer prices to be based on the market prices of equivalent services where these were sufficiently robust, and a 10% mark-up on FAC where they were not.

11.62 We also proposed that Royal Mail must prepare and publish similar income statements covering the aggregate end-to-end profitability of its universal service, other Mails and non-Mails products within the Reported Business, to identify the respective contributions being made by these broader product groups.

11.63 We explained in the October consultation that we needed to understand in detail the relative profitability of different product groups within the Reported Business. We therefore proposed that Royal Mail must provide a series of more disaggregated product profitability statements. Those statements, which are already produced for a

range of products and product groups, would simply compare revenues with FAC product costs from the costing system. Since a number of the products are sold in, or affect, competitive markets, we proposed that Royal Mail should only continue to publish a limited number of these statements, with the remainder provided to us to support our monitoring regime.

Responses to consultation

- 11.64 Most respondents supported our proposals for separated reporting. Some respondents said that information on the different contributions being made by different products to the funding of the universal service activities was essential to enable us to achieve our regulatory duties.
- 11.65 Royal Mail accepted the need for product profitability reporting, and for a published split of the aggregate profitability of the universal service products. However, it considered that our proposals for FRE reporting to be unnecessary, as they provided little useful additional regulatory information, and required arbitrary splits of the costs and revenues of an integrated network business, which would be costly to prepare and audit. It considered that if transfer prices were to be prepared for downstream services, those relevant to its retail D+1 products should reflect the market prices for its premium access products, a position with which the MCF and some individual operators agreed.
- 11.66 It also considered that publication of separated accounting information, beyond the basic split of universal service profitability, would risk the provision of misleading information to the market, encouraging inefficient competition and unfairly tilting the competitive playing field. We discuss our decisions on disclosure later in this section.

Our assessment

- 11.67 We have set out in earlier sections of this Statement our view that both access and end-to-end competition have important roles to play in supporting the efficient provision of the universal service. We therefore continue to consider that regulatory financial reporting information on the relative financial performance of Royal Mail's different activities within the Reported Business, supporting its universal service, retail bulk mail, access and other products, is important for the effectiveness of our wider monitoring framework.
- 11.68 To effectively achieve our objectives for regulatory financial reporting, we consider it necessary to require Royal Mail to provide annual audited reports to us on the financial performance of the four FREs as set out in our October consultation. On the basis of work we have undertaken to derive illustrative statements, we consider that the effort required for Royal Mail to prepare these should be relatively limited.
- 11.69 We note that the basis of costing and asset allocation will be internally consistent with the FAC product costing system which Royal Mail has been adopting for regulatory reporting for some time.
- 11.70 However, given Royal Mail's as well as other operators' responses, we have modified the transfer pricing rules to allow premium access prices as the basis for downstream services for Royal Mail's retail D+1 products, providing there is sufficient evidence of the relevant access products' suitability for this purpose.
- 11.71 We also agree with Royal Mail and other respondents that it is important to maintain reporting on the end-to-end profitability (before interest and tax) of the universal

service products. However, we accept Royal Mail's proposal that more disaggregated reporting, below the FRE level, should not involve an allocation of exceptional costs, so that non-Mails profitability should only be reported at FAC level.

11.72 We also explained in the consultation that our proposed product profitability statements would have a complementary role, namely to help us understand the relative performance of different groups of products subject to distinct market and regulatory conditions. With the finalisation of the scope of the universal service, and the regulatory safeguards relevant to these and other products within the Reported Business for 2012 and onwards, we have reviewed and updated the detailed specification of the associated product profitability statements which Royal Mail will be required to provide to us for this period.

Our decisions

11.73 We have decided to require Royal Mail for each of the four FREs to:

- prepare, maintain and deliver to Ofcom audited annual income statements, capital employed statements and annual cash flow statements using the pro-formas prescribed by the RAG;
- prepare, maintain, deliver to Ofcom (confidential information) and publish (non-confidential information) annual reconciliations of the quarterly information with the annual information in the income statements using the pro-formas prescribed by the RAG;
- comply for that purpose with the detailed rules in the RAG, including transfer pricing rules on which we consulted, except that transfer prices for downstream services used by Royal Mail's D+1 retail products can be based on premium access prices where sufficient information on equivalent products is available;
- provide and publish an audited split of the annual income statement for the Reported Business between universal service and other products; and
- provide a total of 32 audited annual product profitability statements, disaggregating the profitability of the FREs to FAC level.

Quarterly and monthly financial reporting

Our proposals

11.74 In our October consultation, in addition to the audited annual statements discussed above, we also proposed that Royal Mail must provide the following unaudited information:

- quarterly income statements for the Reported Business and its component FREs, with additional splits for the profitability of the universal service, other Mail and non-Mails products;
- quarterly product profitability statements; and
- monthly information on revenue, volume and cost trends.

11.75 The main information sources for the proposed quarterly statements would be Royal Mail's revenue accounts and FAC product costing system, although the income

statements would also require allocations of exceptional costs. The monthly information was proposed to be in line with previous regulatory reporting, drawing on internal management information.

- 11.76 We proposed these supplementary reports to provide us with up to date information on the financial results and position of the Reported Business. As discussed in Section 5 of this statement, our analysis suggested that both the conditions in the wider postal market and Royal Mail's own business remained vulnerable to rapid change, the financial consequences of which would not be reflected on a timely basis via annual financial reporting.

Responses to consultation

- 11.77 Although our proposals for quarterly financial reporting represented an extension to the existing framework, most respondents did not comment on the specific proposals. In general, they considered that Ofcom should define the details of the reports which it needed to perform its regulatory functions.
- 11.78 Royal Mail accepted the need for confidential quarterly reporting of product profitability to Ofcom. However, it considered that reporting quarterly profits after the allocation of exceptional costs was unnecessary, had no regulatory precedent, and would involve additional cost in that it was not already undertaken by the business. It also strongly objected to the publication of quarterly financial information, which it considered would be too unreliable for the market. We discuss our decisions on disclosure later in this section.
- 11.79 In respect of monthly information, Royal Mail proposed to provide us with the reporting packs which it produces for its UKLPI division for internal management purposes, to avoid duplication of information.

Our assessment

- 11.80 As noted above, since we published our consultation proposals, Royal Mail has revised its quarterly FAC product costs for 2011-12, and we have taken these revisions into consideration in finalising our regulatory framework proposals. In our view, they further illustrate the need for us to maintain an up to date awareness both of the evolving product costs and the underlying business activities concerned, and of their impact on the profitability of different elements of the Reported Business.
- 11.81 In addition, Royal Mail has also announced new structures and levels for its access and retail prices in the intervening period, and has altered its product portfolio. This illustrates the extent to which Royal Mail's commercial responses to changing market and regulatory conditions continue to evolve. We consider that there is a need for us to receive quarterly and monthly updates of financial performance to support our monitoring framework.
- 11.82 We therefore consider it necessary to implement our October proposals for quarterly financial reporting, except that these reports need not include an allocation of exceptional costs to the Reported Business. We accept that Royal Mail does not analyse these costs quarterly and that the key within-year variations are still captured by reporting to FAC level.
- 11.83 In relation to monthly reporting, we consider that Royal Mail's proposal to provide us with the relevant information in the format of the packs provided to its own management is sensible, because it avoids unnecessary duplication and will provide

us with the requisite level of detail and context to understand monthly changes in the business. However, as with the provision of projected information, we have specified the required formats in the RAG to provide transparency and consistency for the relevant regulatory reporting requirements.

Our decisions

11.84 We have decided to require Royal Mail to provide:

- unaudited quarterly profitability statements to FAC level for the four FREs, the split between universal service, other Mails and non-Mails products, and the 32 product groups defined for annual reporting;
- monthly information on revenues, volumes and costs in a format consistent with its current management information.

Documentation and assurance

Our proposals

11.85 We proposed that Royal Mail must document the detailed methodology used for regulatory financial reporting to comply with the RAG (other than for FAC product costing, set out in the Costing Manual discussed above) in a new Accounting Methodology Manual, and that it would pre-notify us of material changes to this methodology. We proposed a materiality threshold of 3% for this purpose.

11.86 In our October consultation, we proposed a strengthening of the existing assurance arrangements in two key dimensions:

- first, external auditors would need to report to both Royal Mail and Ofcom, under a tri-partite arrangement similar to the one in place for BT's regulatory financial reporting; and
- second, the nature of the audit opinion should, after a transitional period including 2012-13, move from the current "properly prepared" basis to the more demanding "fairly presents" basis used for Royal Mail's statutory accounts.

Responses to our proposals

11.87 While respondents generally agreed that it was essential that Ofcom had assurance over the annual regulatory financial reports it received, only Royal Mail addressed these proposals in detail.

11.88 Royal Mail did not raise objections to our proposed tri-partite audit arrangement in principle but, based on discussions with its existing auditors, did express significant concerns with the practicality of our proposal for a move to a "fairly presents" opinion, with particular reference to our separated accounting proposals. In this area, it suggested that such an opinion might need to be so heavily qualified as to obviate its usefulness, given the various assumptions that would need to be made and the inadequate level of data available to support them.

11.89 More generally, Royal Mail argued that even the existing "properly prepared" opinion would be more expensive to secure for the form of separated financial reporting we proposed, particularly in relation to the application of a pre-set materiality threshold

which could require the review a large number of changes to provide the requisite assurance.

Our assessment

- 11.90 We noted in the October consultation that previous restatements of Royal Mail's accounts and qualifications of the audit opinion on previous regulatory financial statements underlined the importance of improved assurance over regulatory financial reporting.
- 11.91 This underpinned our proposals for a more detailed RAG, as a basis for the preparation for regulatory financial statements, and for our closer involvement in the audit process via the proposed tri-partite arrangement, and pre-notification of material methodology changes, documented in the Costing and Accounting Methodology Manuals.
- 11.92 Based on the consultation responses, we consider that tri-partite arrangements are necessary to effectively achieve our objectives for regulatory financial reporting, by providing the higher level of assurance required. We accept Royal Mail's argument that the proposed form of the RAG and the supporting Accounting Methodology Manual should themselves provide a clearer basis for an audit opinion of the "properly prepared" form, and that accordingly the assurance of the regulatory financial statements for 2012-13 will be enhanced.
- 11.93 We also accept Royal Mail's argument that some details of the new reporting framework need to be confirmed before any move to a "fairly presents" opinion can be fully evaluated. We have decided that a finalised Accounting Methodology Manual should be in place before the 2012-13 financial statements are audited, and we will review the future move to a "fairly presents" opinion in the light of this progress.
- 11.94 In the meantime, however, we consider a pre-set materiality threshold to be appropriate, to provide additional clarity for the tri-partite assurance of a pre-notification regime of the form to be put in place. We accept that to an extent such a pre-set threshold could risk avoidable increases in review and audit activity. To help mitigate this risk, we have adjusted the materiality threshold to the 5% level used by BT for regulatory financial reporting and Royal Mail for assessing the materiality of profit impacts for audit purposes.

Our decisions

- 11.95 We have decided to require Royal Mail to:
- enter into audit arrangements with Ofcom (effectively a tri-partite agreement) for its annual regulatory financial statements under the USPAC;
 - secure that audit opinions for those statements are given on the basis that the statements have been properly prepared in accordance with the requirements prescribed by the RAG; and
 - secure compliance with, and pre-notified changes to, the methodology in the Accounting Methodology Manual will be subject to a materiality threshold of 5%.

Disclosure

Our proposals

11.96 In the October consultation, we proposed that Royal Mail must publish some, but not all, of the reports produced under the regulatory financial reporting framework. Specifically, we proposed that it must publish:

- audited annual financial statements, and associated supporting information, for the Relevant Group and Reported Business as a whole;
- audited annual financial statements for the four FREs and the audited annual income statements splitting the profitability of the Reported Business between universal service, other Mails and non-Mails products;
- unaudited quarterly income statements for the four FREs, and those splitting the profitability of the Reported Business between universal service, other Mail and non-Mails products;
- three of the product profitability statements – for the access, PAF and Relay product groups; and
- the Costing Manuals and its updates with the existing published scope, including the supplemental material setting out the zonal costing methodology.

11.97 In combination, we considered that publication of this information would provide the market with relevant information to assess the effectiveness of our monitoring framework and other regulatory safeguards, and where appropriate support our regulatory activities.

11.98 However, we recognised that a balance needed to be struck in relation to disclosure of commercially confidential information, which could risk harming effective competition and undermining the efficient and financially sustainable provision of the universal service. We therefore proposed that the information on financial projections, most of the product profitability statements, and the detailed information in the Technical Appendices of the Costing Manual should all remain confidential to Ofcom. We did not propose that the Accounting Methodology Manual should be published, but only that Royal Mail must disclose the Accounting Methodology Manual to us.

Responses to consultation

11.99 Most respondents supported the publication of regulatory financial reports, to provide the market and other stakeholders with assurance over the effectiveness of the new regulatory framework. A number of the respondents highlighted the importance of this in the context of our proposed move away from a price control approach to regulation, and removal of pre-notification and publication requirements for universal services.

11.100 Some respondents drew particular attention to the need to understand the relative profitability of universal service products, such as stamped mail, in comparison to the profitability of products for business customers, such as bulk mail and access to ensure there is no anti-competitive subsidisation.

- 11.101 Nevertheless, a number of respondents also recognised that the publication of too much detailed financial information would risk undermining Royal Mail's commercial position in a competitive market, and that it was appropriate for us to guard against these risks. Most respondents felt that, in striking this balance, we should use our discretion based on our access to the full set of information concerned.
- 11.102 However, Royal Mail felt strongly that our proposals went too far and that it should not be required to publish some of the information we had proposed. In particular, while it accepted the proposals to publish annual audited results for the Relevant Group and Reported Business, the aggregate profitability of the universal service products and the Costing Manual, it argued against the publication of other results for the Reported Business.
- 11.103 In this respect, Royal Mail's arguments focused on the relative benefits and risks of publication. On the one hand, it considered that separated results required a range of arbitrary assumptions that did not reflect the integrated nature of the Reported Business, and hence provided limited useful information to the market.
- 11.104 On the other hand, it considered that the publication of details of the financial performance of component parts of its business would significantly increase the risks of inefficient competition, encouraging "cherry picking" entry that would not support the efficient and financially sustainable provision of the universal service, and unfairly tilting the competitive playing field by requiring greater disclosure obligations than its competitors.
- 11.105 Royal Mail similarly argued that the publication of unaudited quarterly results would provide misleading information to the market, given the seasonal fluctuations in its business and the need to revise cost estimates within-year, and hence would add little regulatory value and create significant costs and risks.

Our assessment

- 11.106 Respondents who discussed publication broadly agreed with most of our proposals. While some respondents argued for as much disclosure as possible, most respondents recognised the risks and accepted the need for us to exercise caution in this area, particularly in relation to new requirements for disaggregated reporting. We have therefore focused our further consideration of these issues on the specific publication proposals where Royal Mail focused its objections to publication – separated and quarterly financial statements.
- 11.107 As noted above, we do not consider the preparation of separated audited annual financial statements for elements of the Reported Business would be arbitrary or necessarily difficult to interpret. Royal Mail has, for example, published the separate end-to-end aggregate profitability of its universal service products for some time and accepts that this should continue. Similarly, it has previously published the profitability (to FAC level) of its access, Relay and PAF product groups, and is due to continue doing this for 2011-12, and respondents confirmed that this existing level of publication would remain valuable for the market in the future.
- 11.108 Nevertheless, we accept that in some areas our regulatory financial reporting proposals introduce new requirements for the first time. In particular, the generation of reports for the four FREs and elements of them will require the new upstream/downstream split of profitability associated with the transfer pricing of downstream services used by many of Royal Mail's retail products. As respondents (including Royal Mail) noted, the selection of appropriate transfer prices will need to

reflect judgements over equivalent market prices for the downstream services concerned. At least in the first year of the enhanced reporting framework, it will be important for us to closely monitor and assess these judgements for regulatory reporting purposes.

11.109 Similarly, in addition to the monthly financial information Royal Mail already provides to us, we are proposing that Royal Mail generates quarterly financial profitability reports, for regulatory monitoring purposes, for the first time. As it noted in its response, the seasonal nature of its business, overlaid with the ongoing changes to the business associated with its modernisation, will mean that quarterly profit results will fluctuate over the year – particularly at the more disaggregated level. The proper understanding of such fluctuations requires access to the range of confidential information which Royal Mail will be required to provide to us, but not publish.

11.110 We are therefore persuaded of real risks associated with requiring publication of new separated and quarterly information, at least covering 2012-13. In parallel, we will be reviewing the form of reports we will ourselves be producing under our monitoring framework. Pending this, we have therefore decided not to require publication of most of the separated financial statements, or unaudited quarterly results.

Our decisions

11.111 We have decided to require Royal Mail to publish:

- the audited annual financial statements for the Relevant Group and Reported Business as a whole;
- the Costing Manual excluding the Technical Appendices, updated for material changes; and
- a split of the audited annual income statement for the Reported Business between universal service and other products, and separate annual audited profitability statements for access, PAF and Relay products.

11.112 We have decided that other financial reports should remain confidential to Ofcom at this stage, and as such Royal Mail is only required to deliver them to us.

Summary of our decisions

11.113 The main reports which we require from Royal Mail are summarised in the table below, which also explains the key changes to our October proposals.

Table 5: Main regulatory financial reports required

Entity	Requirement	Change	Frequency	Audit	Publish
Relevant Group	Consolidated income statement		Annual	Yes	Yes
	Consolidated balance sheet and cash flow statements		Annual	Yes	Yes
	Consolidated cash flow projection statement	Scope and format revised to reflect Royal Mail proposal, and revised implementation timetable	Quarterly	No	No
	Annual budget/Strategic Business Plan updates	Additional provision for ad hoc updates to reflect Royal Mail proposal and revised implementation timetable	Annual	No	No

Entity	Requirement	Change	Frequency	Audit	Publish
Reported Business – As a whole	Annual income statement		Annual	Yes	Yes
	Quarterly income	Quarterly reporting of exceptional costs not required Publication subject to further review	Quarterly & annual reconciliation Annual	No	No
	Annual capital employed and cash flow statements inc. reconciliation to Relevant Group			Yes	Yes
Reported Business – Further detail	Annual product profitability statements	Additional reports to align with other regulatory decisions	Annual	Yes	No, except Access, PAF& Relay
	Quarterly product profitability statements	Additional reports to align with other regulatory decisions	Quarterly	No	No
	Monthly revenue, cost and volume information statement	Scope and format revised to reflect Royal Mail proposal	Monthly	No	No
Reported Business – Separated	Annual income statements – Four FREs	Publication subject to further review	Annual	Yes	No
	Quarterly income statements - Four FREs	Quarterly reporting of exceptional costs not required Publication subject to further review	Quarterly	No	No
	Annual end-to-end income statements (for USO, non-USO and non-Mails)	Publication of non-Mails subject to further review	Annual	Yes	Yes: USO No: non-Mails
	Quarterly end-to-end income statements (for USO, non-USO and non-Mails)	Quarterly reporting of exceptional costs not required Publication subject to further review	Quarterly	No	No
	Capital employed and operating cash flow statements - Four FREs	Publication subject to further review	Annual	Yes	No
Reported Business - Manuals	Costing Manual	Implementation timetable revised & detailed formats clarified	Quarterly	No	Yes (exc. technical apps)
	Accounting Methodology Manual	Implementation timetable revised	Quarterly	No	No

Section 12

Other regulatory conditions

12.1 This section covers:

- i) The designated universal service provider (DUSP) conditions which apply to Royal Mail¹⁶⁴;
- ii) the consumer protection (CP) conditions¹⁶⁵ which vary in their coverage, applying either to all postal operators, all Regulated Postal Operators (RPOs) or just to Royal Mail;
- iii) the essential condition which applies to RPOs; and
- iv) the five transitory conditions (four of these apply only to Royal Mail; the other to RPOs).

12.2 It sets out the conclusions to our proposals for regulatory requirements relating to:

- Royal Mail's obligation to provide a universal service including access points;
- Royal Mail publishing an up to date list of its products that sets out how it meets its universal service obligation;
- Royal Mail's quality of service targets – including its reporting obligations - for its universal services (and for its non-universal services);
- Royal Mail's contingency planning, to ensure the continuity of universal services;
- Royal Mail's compensation arrangements for its universal services;
- Royal Mail and other postal operators' obligations for consumer complaints handling, reporting and redress;
- RPOs measuring and reporting on their contract targets;
- RPOs' obligation to use reasonable endeavours to collect postal packets as agreed with customers and deliver them appropriately within a reasonable time;
- RPOs and the *Postal Common Operational Procedures Code* – which covers measures to handle mis-posted, mis-collected or mis-directed mail;
- RPOs and the *Mail integrity Code* – which covers measures to reduce the risk of loss, theft, damage or interference with mail; and
- Our approach to handling the cessation of the five transitory conditions which are due to expire at the end of March 2012.

¹⁶⁴ Apart from a DUSP condition, relating to the provision of information to users i.e. the publication and advance notification requirements for universal services. This is discussed in Section 6.

¹⁶⁵ Apart from consumer protection condition 4, which is discussed in Section 6.

The DUSP conditions

- 12.3 The DUSP conditions apply to Royal Mail, as the universal service provider, and relate to its provision of the universal postal service.
- 12.4 We explain in more detail in Section 13, the types of DUSP conditions which we can impose under the Act.

Provision of the universal postal service including access points

- 12.5 In Section 4 of this statement we set our decision on making an Order which specifies the universal postal service. However, the first Universal Postal Service Order by itself does not impose a requirement on Royal Mail to provide the universal service. We therefore proposed in our December consultation to require Royal Mail to provide the universal service by imposing a DUSP condition.

Our proposal

- 12.6 The detailed requirements in our proposed DUSP condition largely mapped onto the requirements in the Order. But it was a broader condition that covered requirements for Royal Mail to:
- provide a universal postal service in line with specified characteristics, and which required them to meet specified standards (our approach to these standards is discussed in the subsequent 'ensuring the quality of the universal service' subsection);
 - provide access points to particular criteria; and
 - publish a list of its universal service products, and to notify us and customers of any changes to that list (please see the next subsection for our decision on the notice period required).
- 12.7 We noted in our December consultation that we proposed to retain, in their entirety, the existing requirements for access points. We stated that we would consider the needs of postal users in accessing the universal service as part of our review of user needs - assessing whether the current density requirements are appropriate and, if not, what density requirements should replace them.

Responses to consultation

- 12.8 We asked stakeholders if they agreed with our condition. All respondents agreed with our proposals.
- 12.9 Royal Mail made some comments in relation to the drafting of the DUSP condition which we address further below. The Ofcom Advisory Committee for Scotland, the CWU and Royal Mail commented on the provision of access points. The Ofcom Advisory Committee for Scotland suggested the same type of criteria as currently exist for each postcode district¹⁶⁶ and was concerned about the delay in installing new post boxes in new estates.

¹⁶⁶ They suggested, specifically, that there should be intermediary targets similar to the current density criteria which should apply to each postcode district, as opposed to density criteria applying

- 12.10 The CWU argued that there should not be a reduction in access points. Royal Mail noted that it intended to engage with Ofcom to provide information on access point density and the provision of access points but believed that the drafting of the DUSP condition should allow Ofcom to review the methodology for assessing access points density earlier than the completion of our user needs review.

Our assessment and our decision

- 12.11 As there were no objections to make us reconsider our rationale, we propose to implement our DUSP condition, taking into account changes already discussed earlier in Section 4 in relation to the Order.
- 12.12 We welcome input from the Ofcom Advisory Committee for Scotland, CWU and Royal Mail, and all stakeholders interested in giving information and comments on the provision of access points, to our review of user needs. We continue to consider that a review of access points (post boxes) criteria is best undertaken as part of the wider review of user needs, as it will seek evidence from users.
- 12.13 More specifically, Royal Mail requested a change to the DUSP condition on access points on the grounds that it would provide it with more flexibility. It suggested Ofcom could agree in writing that Royal Mail had met its obligation in respect of the access criteria as an alternative to Royal Mail demonstrating that it had fulfilled its obligation to meet the reasonable needs of users in relation to access points. We consider that this change is unnecessary. It is up to Royal Mail to ensure that it complies with the overall requirement to meet the reasonable needs of users.
- 12.14 In relation to other specific points made by Royal Mail:
- Royal Mail proposed a change to our proposed DUSP 1.4.1, to provide for certain exceptions. However, that clause requires services to be provided every day on which a collection is required by our proposed DUSP 1.3.1. DUSP 1.3.1 is subject to our proposed DUSP 1.3.2 which already sets out all but one of the proposed exceptions. We have revised the definition of “routing time” to provide for the last exception.
 - Royal Mail proposed a series of changes to the definitions in the DUSP conditions relating to overseas (and in particular EU) services. We have not accepted all these suggestions, for the following reasons:
 - The wording in the proposed DUSP condition mostly followed the wording in the Order. There may be good reason for wording to differ between the two, but absent such reasons we consider it appropriate to keep them the same. This ensures transparency.
 - Royal Mail suggested widening the D+3 EU service to cover all territories to which it can currently deliver in a D+3 routing time, rather than just those in the EU (in relation to which EU law also imposes performance targets). We do not consider it necessary to do this. Delivery in D+3 to some Rest of World ('ROW') destinations is to be welcomed and falls within our proposed target routing time for ROW services. However, we do not consider it necessary to specify end-to-end routing times to reflect current practice for every ROW

only each postcode area where the delivery point density is not less than 200 delivery points per square kilometre.

territory when in any event the practical obligation on Royal Mail is to convey the postal packets to a handover point with the relevant overseas operator (rather than all the way to the addressee). Royal Mail's proposal would have incorporated into the DUSP a list of territories which it proposed it should be entitled to amend as appropriate. Such a provision would amount to Royal Mail amending the regulatory conditions applicable to itself, avoiding the processes Ofcom is required by the Act to follow¹⁶⁷.

- The drafting of the Order and DUSP conditions did not require the “EU transfer point” and “ROW transfer point” to be in any particular country or to be in different facilities, so we did not consider there to be a need to amend them to specify which country they are in or to make it clear that they could be in the same place. However, we have changed “transfer point” to “office of exchange” as Royal Mail suggested.

12.15 Finally, we consider it useful to distinguish between European Union services and services to and from other countries, as services to and from the European Union are subject to special requirements under EU law.

12.16 We have clarified DUSP 1.6.2 to more closely reflect the current obligation on Royal Mail to make reasonable endeavours to establish arrangements with overseas operators to provide for both incoming and outgoing international services.

Notification regime for universal service products

12.17 In our December consultation, we also proposed a notification regime for the products (that meet the characteristics) of the universal services which Royal Mail would be required to provide to fulfil the abovementioned DUSP condition.

Our proposal

12.18 We proposed that as part of the DUSP conditions Royal Mail should:

- Publish a list of all the services which it provides as part of the universal service; and
- Update this list when there is a change in the services which it provides as part of the universal service. This includes taking out and replacing a product in the universal service (even if there is no change to the product specification).

12.19 In particular, we invited views as to whether the notification period for changes to the list of universal service products should be one month or three months.

Our assessment of stakeholder responses

12.20 Most respondents, except Royal Mail and Consumer Focus, considered that Royal Mail should provide a three month notice for changes to the list of universal service products. Some respondents noted that there are VAT implications in relation to the universal service status of postal products. Royal Mail believed that there was no benefit to customers if it was to publish this list three months in advance and Consumer Focus considered that one month was sufficient notice for customers.

¹⁶⁷ For the same reason, we did not accept any other changes Royal Mail suggested which would have allowed its opinion to define the scope of the regulatory requirement or any changes which suggested that Ofcom could lift or modify a regulatory condition outside the statutory process.

Our decision

- 12.21 We have decided to implement a notice period of one month, which is consistent with our decision on the minimum advance notice period required on the price and non-price terms of universal services (see Section 6).
- 12.22 In particular, we consider that it would confer no advantage on customers for Royal Mail to be required to publish the list of universal service products three months prior to implementation without Royal Mail also publishing at the same or similar point in time either, confirmation that the new product had identical terms and conditions / prices to the product it was replacing, or details of the revised / new terms and conditions / prices. In the absence of a complete picture, consumers and particularly businesses would be unable to make properly informed decisions as to how to respond to the notification of a change solely in respect of the list of products. For a discussion on the merits of having a one month notification rather than longer period, see Section 6 in this statement.
- 12.23 Overall, we consider that this one month notification requirement (for the list of universal service products) will not be onerous on Royal Mail but that it will provide certainty and transparency benefits for users of universal services – and enable us to establish if changes to that list comply with the characteristics of the universal service

Ensuring the quality of the universal service

- 12.24 In this subsection we discuss the conditions used to ensure the quality of the universal postal service as well as our approach to the quality standards for non-universal services.
- 12.25 Initial condition DUSP 5 currently requires Royal Mail to meet quality of service targets for its universal services and sets out its obligations regarding the measurement of performance against the targets. The condition also includes the reporting and auditing requirements for Royal Mail's quality of service performance.
- 12.26 In addition, part of the initial consumer protection condition 1 (CP 1) places similar obligations to DUSP 5 on Royal Mail with regard to quality standards for non-universal services, a target for universal service collections and how it should report on performance against these standards. These targets cover certain bulk mail products and the percentage of collection points (which currently includes business collections, as well as post offices/post boxes) served each day (CP 1.1).
- 12.27 We discuss our proposals, feedback and our conclusions for the quality of service of universal services, and follow this with a discussion on quality of service for non-universal services.

Our proposals – for universal services

We proposed to maintain the quality of service targets for universal services to ensure service reliability and quality

- 12.28 In our December consultation, we considered that it was important to retain the current quality of service targets for universal services – noting that we would consider the specific level of these targets as part of our comprehensive review of user needs which will be completed by April 2013 – and highlighted the importance of Royal Mail achieving its quality of service targets.

12.29 We discussed the two mechanisms in the current regulatory conditions which incentivise the achievement of quality of service targets:

- a) Royal Mail must use all reasonable endeavours to meet such targets, failing which it can be subject to investigation and enforcement if performance falls below certain levels¹⁶⁸.
- b) The transitory condition which sets the current price control features a quality of service incentive mechanism ('C-factor') whereby, if Royal Mail fails its quality of service targets for some of its retail products and standardised measures¹⁶⁹ (outside a certain deadband), permissible price rises in subsequent years are lower than would otherwise be the case (T4.13)¹⁷⁰.

12.30 We also discussed what we would do if these targets were not achieved in the future given that in our October consultation we proposed to lift price controls, which would (if implemented) result in the cessation of the C-factor mechanism¹⁷¹. We explained that cessation of the C-factor would mean we would rely on our ex post investigation and enforcement powers if Royal Mail failed to meet its quality of service targets in future.

Responses to consultation

12.31 We asked stakeholders if they agreed with our proposed condition which specifies the quality of service targets for universal services. There was general support for the retention of quality of service targets for universal services amongst postal (including access) operators, consumer groups, trade bodies and business customers – of the eleven respondents to this issue, all agreed with the principle that there should be quality of service targets on universal services. Consumer Focus said that there was no evidence to support a reduction in targets or review at this time. The CWU said that quality of service targets for universal services should protect captive customers from deterioration in quality of service performance.

12.32 In addition, Consumer Focus and UK Mail commented on the cessation of the C-factor and the importance for Ofcom to be clear about the enforcement action that it was able to take in the event of Royal Mail failing its quality of service targets for universal services. Similarly, the MUA commented that for universal service customers, there should be more transparency regarding how performance is measured and validated and what sanctions could be imposed for failure. Royal Mail and Consumer Focus also provided feedback on the drafting of the relevant DUSP condition. In particular, Royal Mail noted that the Postcode Area (PCA) target of

¹⁶⁸ Below performance band I in table 1 on page 32 of our consultation.

¹⁶⁹ % of collection points served each day, % of delivery routes completed each day, % of items delivered correctly and a postcode area target which requires Royal Mail to deliver 91.5% of First Class stamped and metered items by the next working day in 118 postcode areas.

¹⁷⁰ The C-factor mechanism came into effect in 2006. Historically, adjustments have been made due to quality of service failures subject to Postcomm's consideration of Royal Mail's applications for exemptions due to force majeure and/or transformation-related industrial action.

¹⁷¹ This subsection also does not consider the compensation customers can get for specific failures – that is discussed later in this Section. Following negotiations with Postcomm, Royal Mail put in place voluntary compensation arrangements for individual items of mail that are lost or damaged and Royal Mail also provides compensation for delay. The arrangements are not automatic and payment is not linked to overall performance against the quality of service targets. Customers must apply for compensation for each item that is lost, damaged or delayed and will only be successful if their application meets the specific criteria set by Royal Mail (for example, the claimant must provide proof of posting and proof of value for items with intrinsic value).

91.5% of First Class mail delivered next day in each PCA (except HS, KW and ZE postcodes) should only apply to stamped and metered single piece mail, not PPI single piece mail.

12.33 A few respondents made general points on quality of service:

- Royal Mail proposed the removal of the quality of service targets for Special Delivery Next Day (SDND) and PCA delivered performance, as well as the current regulatory requirement for a code of practice for identifying significant failures at sub-PCA level. Royal Mail also considered that Royal Mail should appoint the independent auditor to audit its quality of service measurement system instead of Ofcom and noted that an audit statement had never been published and that the current audit should include all targets - not just First class retail performance; and
- Consumer Focus said that the consideration of Royal Mail's applications for adjustments to quality of service results due to force majeure events should be made more transparent and should include public consultation.

12.34 Royal Mail raised a specific point in relation to the quality of service condition drafting. It said that the current regulatory obligation is to use "all reasonable endeavours" to meet the quality of service targets and suggested that the "all reasonable endeavours" requirement should be inserted back into the proposed DUSP 1.7.1. It said that given the possible consequences of failing to comply with the regulatory conditions, setting such a high absolute standard would be disproportionate.

Our assessment

12.35 As we have decided we are no longer to price control Royal Mail's services (except for a safeguard cap on certain services), the C-factor quality of service incentive mechanism which partly links price adjustments to quality of service performance will fall away. Under the new regulatory framework it would be impractical for us to create a price adjustment mechanism similar to the C-factor as we are only capping the price of a limited number of services.

12.36 Therefore, we will rely on our enforcement powers under the Act to address any future issues with Royal Mail's performance. We consider that the risk of investigation and enforcement action will incentivise Royal Mail to meet its quality of service targets for universal services. In deciding whether to take enforcement action in relation to suspected quality of service failures, we may take into consideration any exceptional circumstances e.g. force majeure events which may have had an impact on Royal Mail's performance.

12.37 Royal Mail's quality of service targets for universal services are included in the relevant DUSP condition in Annex 7. Where Royal Mail has not achieved its targets, Ofcom can consider taking action in accordance with Schedule 7 of the Act. We therefore consider that there is clarity regarding the enforcement action that we can take and the sanctions that we can impose.

12.38 With regard to transparency of how quality of service performance for universal services is measured and validated, there are already provisions in the relevant DUSP condition requiring independent measurement and auditing/validation of Royal Mail's quality of service results.

- 12.39 We note Royal Mail's comments on the removal of the "all reasonable endeavours" obligation to meet its quality of service targets. In practice, the removal of that term will not change our approach when considering quality of service failures. As with any breach of a regulatory condition, Ofcom would have to consider the relevant circumstances and reasons for failure before deciding upon the appropriate course of action.
- 12.40 We have noted other comments from Royal Mail and Consumer Focus on the specific drafting of parts of the relevant DUSP condition. We have taken these into account in our revised drafting of the condition.
- 12.41 In particular, in relation to PPI⁴³ single piece mail, a product is only in the universal service if it meets the characteristics specified in the Order. The detailed quality of service targets mandated by DUSP 1 support the Order's requirements. Consequently, we consider that PPI First class and Second class single piece items can only be in the universal service if they are subject to the quality of service targets of 93% of mail delivered next day for First Class and 98.5% of mail delivered within three days for Second Class.
- 12.42 However, in relation to the PCA target, we understand the practical challenge of measuring the PCA target by including PPI single piece mail. Royal Mail raised the point with Postcomm previously that the inclusion of single-piece PPI in the measurement of PCA would result in a disproportionate cost due to having to amend the survey to take account of the different fall to earth of PPI items (compared to stamped and metered items) and also having to approximately double the PPI sample to ensure that the combined stamped, metered and PPI measurement of PCA performance is accurate to an acceptable level.
- 12.43 We do not consider this to be a sensible or necessary use of Royal Mail revenue, particularly since Royal Mail has offered to report on PPI delivered performance by PCA to Ofcom outside of the formal measurement and reporting process. We therefore agree that a pragmatic approach on this occasion is to exclude PPI items from the PCA target. In any event PPI single piece items will still be included in the measurement of the national targets for D+1 and D+3. We have made clear in the table of quality of service targets that the PCA target only relates to stamped and metered single piece items.
- 12.44 With regard to Royal Mail's general points, we do not consider that we should make changes to the current targets on universal services until we have conducted our wider review of user needs. Therefore, the targets for SDND and PCA performance will be retained in the DUSP condition.
- 12.45 In relation to the code of practice for sub-PCA performance, we consider that it is important to retain this regulatory requirement so we can monitor performance at local levels and be satisfied that consistently poor local performance is not being masked by good overall national quality of service performance. We note that the code can be amended by Royal Mail at any time – it was last amended in 2006 following a Royal Mail review in order to align it more closely with its operational practices. We have encouraged Royal Mail to review the code again to ensure that it remains fit for purpose.
- 12.46 In relation to Royal Mail's comment that it should appoint the independent auditor, we have not been able to identify any record that Royal Mail has previously raised the matter of the appointment of the independent auditor either with Postcomm or with Ofcom. Prior to receiving Royal Mail's response to the consultation, we were already

in the process of appointing the independent auditor for the 2012-13 audit which is due to commence from the beginning of the quality of service reporting year on 1 April 2012. To accede to Royal Mail's request we would have had to abandon this process and Royal Mail would have had a matter of days in which to appoint an auditor before the beginning of the new reporting year. We do not consider this would have been appropriate and, Ofcom has therefore appointed the independent auditor for the 2012-13 audit.

- 12.47 However, we note Royal Mail's comments and will consider its request as part of any future review of quality of service measurement. We consider it appropriate for the audit to remain in place for the full year. Given that EN 13850 (the European Standard for the measurement of quality of service)¹⁷² only applies to Royal Mail's First Class retail performance and the target for First Class retail mail is Royal Mail's headline target, the most recent audit covered First Class stamped and metered mail only. We consider that we have discretion as to what targets are included in the audit.
- 12.48 In relation to Consumer Focus' comments on force majeure applications, we are aware that the current process for considering such applications was not set out in Royal Mail's licence and there are no provisions for such applications in the initial conditions. Quality of service standards for universal service providers are subject to a harmonisation obligation in the Directive¹⁷³. Paragraph 4.2.2 of CEN standard 13850 gives national regulatory authorities the discretion whether or not to agree that the relevant quality of service results should be adjusted to allow for exceptional events. It is through this provision that Postcomm has previously considered applications from Royal Mail for adjustments to quality of service due to force majeure. This was outside the scope of our December consultation but we have noted Consumer Focus' comments.

Our decision

- 12.49 Given our analysis of stakeholder feedback, we have retained the current quality of service targets on universal services – and these are set out in the DUSP condition in Annex 7 to this statement.
- 12.50 With the removal of all price controls from Royal Mail (except for a safeguard cap), the C-factor quality of service incentive mechanism has also fallen away. This means that for Royal Mail's quality of service performance in 2011-12¹⁷⁴ and subsequent years, if any action is required due to Royal Mail failing its quality of service targets, then it would be undertaken through enforcement of the relevant regulatory condition and would follow the general procedures in Schedule 7 of the Act.
- 12.51 We consider that this regime should provide sufficient incentive for Royal Mail to meet its targets for universal services but also allows us to take appropriate action where targets are not achieved.

¹⁷² which implements the European Standard - CEN 13850 - for the measurement of the transit time of end-to-end services for single piece priority mail and First Class mail

¹⁷³ Article 20 of the Postal Services Directive as amended,

http://ec.europa.eu/internal_market/post/doc/legislation/2008-06_en.pdf

¹⁷⁴ As the C-factor makes adjustments to prices in the year following the Quality of service failures, the removal of the current price control from 1 April 2012 actually means that C-factor adjustments will not be applied to any failures in the current Quality of service reporting year of April 2011- March 2012.

Our proposal – for non-universal services

We proposed to remove quality of service targets and reporting obligations for non-universal service products

- 12.52 In our December consultation, we also discussed our approach to the current quality of service requirements for non-universal services.
- 12.53 In August 2011 Postcomm confirmed the removal of bulk mail (Mailsort 1400 and Cleanmail) products from the universal service and also confirmed that business collections are not in the universal service.¹⁷⁵
- 12.54 We noted that we were required by the Directive and Act to specify service standards, and the publication of these, with respect to universal services. We are not required to do so for services falling outside the universal service. Accordingly, we proposed that quality of service performance targets and reporting should be limited to universal services and the obligation to meet and report against performance targets for bulk mail services and business collections should be lifted.
- 12.55 This is also consistent with our approach to other areas of regulation to give Royal Mail more commercial freedom e.g. the removal of price controls and requirements to notify changes to non-universal services (confirmed in Section 6 of this document).
- 12.56 More specifically, in relation to the current quality of service targets for non-universal services, we proposed to:
- Remove business collections from the “collection points served each day” target and the collections times reporting requirement so they only relate to collections from public universal service access points and place these requirements (more appropriately) into the DUSP on performance targets to sit alongside the quality of service performance targets for universal services; and
 - Remove bulk quality of service performance targets. Our proposal would also mean that the measurement, reporting and auditing mechanisms associated with these performance targets would not be required for regulatory purposes.
- 12.57 Finally, we also proposed to remove the requirements – in CP 1.9 and CP 1.11 – on Royal Mail to monitor and report on its performance in the provision of access services. However, please also see Section 10 in this statement where we explain our decision in relation to the access condition to include a requirement for Royal Mail to provide access users with quality of service information based on a fair and reasonable system of monitoring quality of service.

Responses to consultation

- 12.58 Business customers, user groups and other postal operators expressed concern in relation to the removal of the performance targets, and more importantly, the reporting of quality of service performance for all non-universal services.
- 12.59 The DMA and another user group said that quality of service reporting for non-universal services should remain as business users would have some reassurance

¹⁷⁵ Postcomm *The building blocks for a sustainable postal service - Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document* August 2011 <http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf>

that they were getting what they were paying for. A business user and a postal operator said that there should be targets for universal services, Mailsort and access services to ensure continued competitive pressure to keep quality of service at high levels. Four postal operators expressed their concerns with removing targets and quality of service measurements from Royal Mail's non-universal services. They wanted transparency of Royal Mail's quality of service performance to ensure continued consumer confidence and usage of mail.

- 12.60 No responses were received in relation to the removal of business collections from the quality of service target for daily collections and reporting of collections times performance.

Our assessment

- 12.61 We recognise the concerns from stakeholders but maintain the view from our December consultation that Royal Mail will still have incentives to offer, maintain (and report against) appropriate quality of service performance targets for its non-universal bulk retail services and business collections as required by its customers. We believe the incentive is provided by Royal Mail's need to offer or maintain services at levels that satisfy customers who might consider switching to alternatives e.g. access-based competitors or non-postal forms of communication.
- 12.62 We expect that users' needs in relation to quality of service for bulk mail (including reporting of quality of service performance) will be met by the market itself in the absence of any regulatory requirements imposed by Ofcom. As 70% of bulk mail is now carried by access operators (who provide services to smaller mailers), we consider competition will provide sufficient protection.
- 12.63 We consider our decision is in line with our removal of regulation from non-universal services and our general approach to give Royal Mail more commercial flexibility to respond to a challenging environment. It would be inconsistent with other areas, where we are simplifying regulation, to continue to require Royal Mail to measure and report on non-universal service quality of service performance¹⁷⁶ on the basis that it may not act in a commercial manner in the future.
- 12.64 We believe that the impact on non-universal service customers should not be significant as the majority of customers have a choice and option to switch to another (upstream or end-to-end) operator for services and therefore Royal Mail is incentivised to meet the needs of these customers.

Our decision

- 12.65 We have therefore removed all reference to quality of service targets and reporting of quality of service performance for Royal Mail's non-universal services.
- 12.66 This means that the regulated targets for Royal Mail's bulk mail services no longer apply and business collections have been removed from the target and measurement of collections performance. As the collections quality of service target and collection times reporting requirement now only relate to collections from universal service access points, we have moved these provisions from the CP condition (CP1.4, 1.7 and 1.10(a)) to the relevant DUSP condition to sit alongside the other quality of

¹⁷⁶ It is also in line with our decision to lift similar reporting requirements for other RPOs' non-universal services, discussed later in this Section.

service performance targets on universal services and reporting and publication requirements.

- 12.67 Royal Mail is now free to set its own quality of service levels for bulk mail and business collections going forward. We believe that Royal Mail will still have incentives to offer and maintain appropriate service levels for these services as required by its customers, despite the removal of the regulatory requirement.

Contingency planning

- 12.68 Initial condition DUSP 4 currently requires Royal Mail to maintain appropriate contingency plans which ensure as far as practical the provision of the universal service without interruption, suspension or restriction of any service in the event of local, regional or national industrial action, emergencies or natural disasters.
- 12.69 Royal Mail must also conduct a review of its contingency plans at least every two years and provide Ofcom with a report on this¹⁷⁷. Should Ofcom be of the view that the contingency plans should be modified in any way, Royal Mail is under a “comply or explain” obligation.
- 12.70 DUSP 4 also requires that Royal Mail must maintain a list showing how it will prioritise its provision of its services in the event of the type of events noted above¹⁷⁸. This essentially specifies how Royal Mail should go about ensuring that it meets its overall obligation to provide universal services (save in cases of emergency or in the case of exceptional circumstances specified by Ofcom). If the priority list is amended, Royal Mail is required to notify Ofcom within one month of the change.

Our proposals

- 12.71 In our December consultation, we set out a provisional view that it would still be appropriate to continue to retain a regulatory obligation requiring Royal Mail to maintain contingency plans in order to ensure the provision of the universal service. This would provide assurance that appropriate planning would be undertaken by Royal Mail in order to meet its obligations and help ensure there is *continuity* in the provision of universal services. We also proposed to reframe the requirement slightly so that Royal Mail would be required to maintain ‘appropriate’ contingency plans.
- 12.72 In addition, we proposed to retain the obligation for Royal Mail to review its contingency plans at least every two years. Given that we could, in future, use our information gathering powers to establish the outcomes of its reviews - and, in addition, take enforcement action (if ever necessary) if the contingency plans were not appropriate - we proposed to delete DUSP 4.5-4.6 as they oblige Royal Mail to send us a report following its biennial review of its contingency plans (and to consider altering its plans following our request).
- 12.73 In line with the clause in the initial condition (DUSP 4.3), we would require Royal Mail to implement its contingency plans in the event of emergencies - and in the event this did not happen, we would expect them to be able to explain why this was the case, taking into account the exact nature of the circumstances.

¹⁷⁷In practice, this biennial review has taken the form of a meeting between Royal Mail and the regulator to discuss any developments in respect of Royal Mail’s contingency plan policy making that Royal Mail considers should be highlighted to the regulator.

¹⁷⁸In practice, this has consisted of Royal Mail maintaining a list and notifying the regulator within one month of any change to the list.

- 12.74 Nevertheless, we also believed Royal Mail should be given some operational flexibility for dealing with different challenges to service continuity. So we proposed that Royal Mail should no longer be required to maintain a list showing how it prioritises its provision of services and the criteria it applies to determine how the provision of services is to be prioritised. As a result, we proposed to delete DUSP 4.2 (on the requirement to maintain a priority list) and also the references in other initial condition DUSP clauses to the priority list.

Responses to consultation

- 12.75 Eleven stakeholders responded on this issue of which eight were supportive while three raised concerns. Royal Mail, Consumer Focus and the Federation of Small Business (FSB) together with five other large mailers were supportive of the proposal with two of the large mailers asking for confirmation that the regulator would monitor Royal Mail's application of its contingency plans and another asking for clarification of the impact of Royal Mail's contingency plans on different classes of mail in terms of additional days to deliver etc.
- 12.76 The MCF, UK Mail and one other access operator did not agree with the proposal. The MCF and UK Mail both said that without the current reporting system Ofcom would not be able to have full confidence that Royal Mail's contingency plans were sufficiently robust to maintain provision of the universal service in the event of strikes, emergencies or natural disasters and suggested it was inappropriate for us to give up our oversight of Royal Mail's contingency plans and instead to rely on ex-post explanation from Royal Mail when provision fails. They felt that, when taken together with our proposal not to oversee Royal Mail's prioritisation of services, we could not have confidence that Royal Mail would not choose to prioritise maintaining bulk services in a competitive market ahead of ensuring provision of the universal service.
- 12.77 An access operator also expressed the concern that our proposal could allow Royal Mail to do as it chose and without the current regulatory oversight, future regulatory action would only result from lengthy and resource intensive investigations.

Our assessment

- 12.78 We note the reservations expressed by the three respondents who disagreed with this proposal but are not persuaded by the arguments made. The level of oversight actually exercised by the previous regulator, Postcomm, in relation to this regulatory issue was, in practice, minimal in respect of proactive assessment and intervention regarding the robustness of Royal Mail's contingency plans. Royal Mail maintains contingency plans for deployment in relation to a large number of potential scenarios potentially affecting well over a thousand Royal Mail sites across the UK and it would not be practical or appropriate for the regulator to assess the robustness of those plans on a statistically significant basis.
- 12.79 In practice, the previous regulator assessed the effectiveness of Royal Mail's contingency plans after they were put in to practice and where the regulator needed to decide whether Royal Mail had used reasonable endeavours to meet its regulatory obligations. Typically, such a scenario arose where Royal Mail requested relief from the impact of a force majeure type event on its achievement of its regulated quality of service targets. In such cases the previous regulator sometimes employed the services of professional logistics consultants to provide expert views as to the effectiveness of Royal Mail's contingency arrangements.

- 12.80 Going forward Royal Mail will continue to be required to meet quality of service targets and we will be able to assess the robustness of Royal Mail's contingency arrangements as and when the need arises in a similar manner to the way Postcomm did.
- 12.81 With regard to the issue of the priority list Ofcom considers that in real time only Royal Mail can be expected to make properly informed decisions on an operational basis regarding what its priorities should be when decisions have to be made as to allocating resource in the most effective way possible.
- 12.82 In certain situations, for example widespread industrial action when mail centres may only be staffed by a small number of managers, it is current practice for Royal Mail to use those managers to process bulk (typically machinable mail) mail rather than stamped and metered mail. This is because a small number of managers can process a large volume of bulk mail but only a very small amount of non machinable mail. By doing this the Royal Mail pipeline can return to normal operation much more quickly after the strike action due to bulk mail volumes being ready for onward travel and the overall result is an improvement in the speed of mail items generally.
- 12.83 We maintain our view from the consultation that removing the requirements on the priority list would not have any material impact on Royal Mail's ability to ensure continuity of services.
- 12.84 Furthermore, if Ofcom decides to investigate any universal service failure it will be able to require Royal Mail, under its information gathering powers, to provide relevant details of how the company dealt with emergencies, industrial action etc and how and in doing so, why Royal Mail chose to prioritise services, on a case by case basis.
- 12.85 We note that under our penalty guidelines, in the calculation of any penalty for breach of a regulatory condition, we would take into account factors including:
- Whether in all the circumstances appropriate steps had been taken by the regulated body to prevent the contravention;
 - The extent to which the contravention occurred intentionally or recklessly, including the extent to which senior management knew, or ought to have known, that a contravention was occurring or would occur; and
 - Whether the contravention in question continued, or timely and effective steps were taken to end it, once the regulated body became aware of it.
- 12.86 We believe that Royal Mail will be appropriately incentivised to meet quality of service targets going forward so that there is no need for the regulator additionally to proactively oversee how the company manages its operational activities.
- 12.87 In summary, we consider that in practice our oversight of the effectiveness of Royal Mail's contingency arrangements and by extension Royal Mail's provision of the universal service will not be diminished by our changes.

Our decision

- 12.88 Further to our consideration of the consultation responses, we confirm that we have made the following changes:

- reframed the requirement slightly so that Royal Mail is required to maintain ‘appropriate’ contingency plans;
- removed the requirement to maintain a priority list and associated references to the priority list; and
- removed the obligation for Royal Mail to send us a report following its biennial review of contingency plans (and to consider altering its plans following an Ofcom request).

12.89 We believe these changes will not materially impact the contingency planning undertaken to ensure continuity of the universal postal service, although there may be a small reduction in the regulatory burden on Royal Mail from our amendments.

The consumer protection conditions and essential condition

12.90 This sub-section covers our approach, in sequence, to the initial consumer protection conditions (CP 1-3 and 5-9¹⁷⁹) the requirements of which vary in terms of their coverage, applying either to all postal operators, all RPOs or just to Royal Mail. We then discuss the one initial essential condition which applies to RPOs.

12.91 Both a consumer protection condition under section 51 of the Act and an essential condition under section 49 of the Act may be imposed on every postal operator or on every postal operator of a specified description¹⁸⁰.

12.92 We discuss, in turn, our proposals for these conditions, stakeholder responses and our conclusions.

Requirements for collecting postal packets ‘as agreed with customers’ and delivering postal packets within a reasonable time

12.93 In Section 6 of our December consultation, we proposed further changes to consumer protection condition 1 (in addition to those which we have discussed in relation to quality standards earlier in this section).

12.94 CP 1.2 placed an obligation on all RPOs in relation to regulated postal services to use reasonable endeavours to:

- a) collect postal packets from their customers as agreed with them; and
- b) deliver appropriately, or procure the delivery of, any postal packets they receive in the course of their business as a postal operator, within a reasonable time.

12.95 In our December consultation we set out a provisional view that universal service customers should be protected by the universal service requirements in relation to delivery and that contractual remedies and competition should help drive RPOs to provide an adequate delivery service in order to retain non-universal service customers.

12.96 In relation to collection, we proposed that contractual remedies should be sufficient to ensure that RPOs provide the required services.

¹⁷⁹ Consumer protection condition 4, which covers the provision of information to users, is discussed in Section 6 of this statement.

¹⁸⁰ See Section 13 for more explanation of the legal basis and potential scope of these conditions.

Our proposal

We proposed CP 1.2 be removed and that we make related amendments to the Postal Common Operational Procedures Code (PCOPC) and Mail Integrity Code (MIC)

- 12.97 In our December consultation, we noted that if CP 1.2 were to be removed, changes might be needed to the PCOPC which is an Annex to initial consumer protection condition 5, and to the MIC (together, “the Codes”) which is an Annex to essential condition 1.
- 12.98 The PCOPC is intended to minimise the risk of mis-posted, mis-directed and mis-collected mail not being repatriated to the correct postal operator, customer or addressee. The Code currently applies to packets weighing no more than 2kg for Royal Mail and those access operators who are also RPOs, and to Letters weighing less than 350g and costing no more than £1 for RPOs not acting in the capacity of an access operator.
- 12.99 The MIC is intended to minimise the exposure to the risk of loss, theft, damage and/or interference in relation to regulated postal packets in the course of collection, conveyance and delivery. It currently applies to RPOs.
- 12.100 We stated there was no logical reason to limit the PCOPC to parcels weighing no more than 2kg under the new regulatory framework or for the PCOPC to be restricted to only RPOs handling access mail rather than any access operator¹⁸¹. We noted that the most likely places for mis-collection, mis-direction or mis-posting to occur are in a multi-operator environment, in particular, where customers use more than one party to send mail. Therefore, it seemed appropriate to require all such operators to also be party to the processes in place for mis-posted, mis-collected or mis-directed code Letters to be repatriated to the correct operator, customer or addressee – and for the PCOPC to continue to apply to RPOs providing regulated postal services.
- 12.101 We also stated that we could see no reason for the MIC to be restricted to only RPOs – especially in a multi-operator environment, where customers use more than one operator and it seemed appropriate to require RPOs and access operators to have processes in place for mail integrity.
- 12.102 In our December consultation we proposed to remove CP 1.2 in conjunction with proposed amendments to the PCOPC and the MIC to ensure that any postal packet¹⁸² sent via Royal Mail or an access party, plus any Letter¹⁸³ sent by an RPO that costs no more than £1 to send or weighs less than 350g, would be covered. We also noted that consequential changes might need to be made to the Postal Common Operational Procedures Agreement (‘PCOPA’) in due course.

¹⁸¹ An access operator is referred to in the Code as an access party.

¹⁸² Postal packets and letters were defined for these purposes in accordance with their definitions in the Act (sections 27(2) and 65(1) respectively), subject to the proviso that they excluded postal packets which are excepted under section 33(1) of the Act and postal packets that contain items which it is reasonable to exclude from carriage by post and which do not comply with conditions reasonably imposed on their carriage by post by reason of their potential harm to health, public security or compliance with law.

¹⁸³ Ibid.

Responses to consultation

- 12.103 In our December consultation we asked if respondents agreed with our proposal to delete the requirement in CP 1.2 and the related changes to the Codes. We received 13 responses to this question, with responses from Royal Mail, the MCF, RPOs, access operators, business mailers, CWU and Consumer Focus.
- 12.104 All the respondents agreed with the proposal to remove CP 1.2 and the majority of respondents agreed with the related proposal to extend the Codes to cover access mail. However, the MCF, UK Mail, DX Group and TNT did not agree the Codes should be extended to access operators. In addition, whilst Royal Mail and CWU agreed with our proposals, Royal Mail questioned certain elements of the condition drafting and CWU considered that the Codes should be extended to cover all end-to-end operators as was an important consumer protection.
- 12.105 Royal Mail recommended that the definition for Royal Mail and access operators' postal packets should be up to the Royal Mail access contract size, and should exclude ParcelForce Worldwide and unaddressed mail, and that the threshold for end-to-end operators should be up to 2kg and less than £5 to better reflect the type of mail which might inadvertently end up in Royal Mail's network. Royal Mail also recommended specific changes to the Codes in relation to the definitions of Code Packet and reporting.
- 12.106 The MCF, UK Mail, and TNT responded that the extension to access operators would place a burden, particularly in relation to reporting. The MCF considered that the extension was unnecessary as incidences relating to repatriation or security of mail would only occur extremely rarely. In addition they stated that access operators were accountable to their customers in the same way as end-to-end operators who are not RPOs and that not all items weighing more than 350g and costing over £1 were tracked. The MCF and UK Mail also considered that mail integrity issues were already dealt with by the offence of interfering with the mail as a postal operator under section 83 of the 2000 Act. The MCF, UK Mail and TNT also recommended specific changes to the Codes in relation to reporting requirements and the Code Identifier.

Our assessment

- 12.107 We consider that the proposal to extend the application of the Codes would bring consistency to the treatment of repatriation of mis-posted, mis-collected and mis-directed packets and security of mail in a multi-operator market, encouraging customer confidence in the mail industry.
- 12.108 Our proposals would also ensure consistency of protection for all items that use Royal Mail's network at any point in its journey, providing consistency of protection for customers whose items are sent through the network either directly with Royal Mail or via access mail. The increasing volumes of access mail (now over 40% of mail) and the multi-operator market increase the importance of the Codes to facilitate network interoperability. Furthermore, as access mail is injected into another network the chance of mail going astray is increased and as access mail is likely to have intrinsically low value, the financial incentive may be reduced for ensuring the security of mail.
- 12.109 In relation to the argument that mail integrity was already sufficiently dealt with by postal operators' duties under section 83 of the 2000 Act, we consider it important to distinguish between the criminal offence under section 83 and the need for operators

to have appropriate preventative policies in place governing their mail operations and the need to manage and reduce the risk of mail being lost, stolen, damaged. Section 49 of the Act clearly foresees the possibility of preventative action in relation to mail integrity issues.

- 12.110 Ofcom therefore provisionally considers that the proposal to remove CP 1.2 and extend the application of the Codes remains valid in principle. However, given the specific issues raised by consultation responses (for example, the reporting requirements and the Code Identifier) and the fact the Codes have been in place since 2005-2006 without formal review, we feel that there is a clear need to review the Codes and our role in the Codes.
- 12.111 We note in this context that access operators have raised concerns that the cost of compliance with the Codes may be material. At the same time, the majority of operators have stated that they are already compliant with the overall principles of the Codes. Small end-to-end operators comply with the Codes, and we see no evidence of extensive costs for those operators. We therefore do not consider in principle that it should be expensive to extend the Codes to access operators. However, carrying out a review will give us the opportunity to take into account the cost of compliance in assessing whether particular provisions remain necessary.
- 12.112 We also consider that it would be inappropriate to extend the application of the Codes before such a review has been completed to avoid exposing operators to unnecessary compliance costs should the review result in regulatory requirements being removed.
- 12.113 However we do believe that it is appropriate to proceed with the removal of the first clause of CP 1.2, which is related to collection. As noted above, this part (a) requires RPOs to collect packets from customers as agreed with them. The wording “as agreed with them” in part (a) implies that this only applies to customers who have a contract with an RPO. We still consider that contractual remedies should be sufficient to ensure that RPOs provide the required services for collection and therefore that CP1.2(a) can be removed before the review of the Codes is complete.
- 12.114 In relation to the detailed points respondents raised on the Codes themselves, these points will be considered as part of a review of the Codes including our role in the governance of these Codes.

Our decision

- 12.115 In light of the above, we have decided to remove CP1.2(a), but retain the requirement in CP1.2(b) and to review the Codes with a view to issuing a consultation setting out the results of the review in 2012. Following that review, and depending on its outcome, we plan to remove CP 1.2(b) and extend the application of the Codes (assuming that we conclude that the Codes are still required broadly in their current form).
- 12.116 We confirm that the reports currently required under the Codes become effective on the making of the regulatory conditions. Therefore, the first reports will be due after March 2013.

Royal Mail's compensation arrangements for universal services

12.117 We explained in detail the current requirements in relation to Royal Mail's compensation arrangements for universal services in paragraphs 6.33 – 6.43 of our December consultation.

12.118 We noted that some of these requirements are set out in particular clauses of CP 1. This includes an obligation for Royal Mail to maintain a 'standards of service compensation scheme' for compensating users of postal services affected by a delay to an individual postal packet. It also includes requirements to publish a report on its operation of this scheme as well as its compensation scheme for loss and damage (and to review the standards of service and the compensation scheme and consider modifications made by Consumer Focus which are in the interest of users).

12.119 In addition, Royal Mail also has compensation arrangements for loss¹⁸⁴ and damage¹⁸⁵ included in its schemes made under section 89 of the 2000 Act and under initial consumer protection condition 2 (CP 2) it is required to meet its obligations under any section 89 schemes¹⁸⁶. The compensation arrangements for universal services that are not in the section 89 schemes - such as Redirections¹⁸⁷ and Keepsafe¹⁸⁸ services - are set out in Royal Mail's specific terms and conditions for those products.

Our proposals

We proposed a requirement to provide reasonable compensation for universal services

12.120 In our December consultation, we made the following proposals for compensation on universal services:

- that we should retain the regulatory requirements on Royal Mail to provide compensation for loss, damage and delay for universal services where compensation is currently provided (including for failures to the Redirections and Keepsafe services and where there has been a failure to obtain proof of delivery for Recorded Signed For and Special Delivery Next Day services); and
- in line with our proposed approach to the non-price terms of universal services discussed in Section 5 of our December consultation, which we have now confirmed in the Section 4 of this document, the compensation provided should be fair and reasonable¹⁸⁹.

¹⁸⁴ <http://www.royalmail.com/customer-service/personal-customers/refunds-and-compensation/lost-item-compensation/lost-items>

¹⁸⁵ <http://www.royalmail.com/customer-service/personal-customers/refunds-and-compensation/damaged-item-compensation/damaged-items>

¹⁸⁶ CP 2 applies to any postal operator making schemes - but currently Royal Mail is the only operator to have created such schemes.

¹⁸⁷

<http://www.royalmail.com/sites/default/files/docs/pdf/Redirections%20Social%20December%202010.pdf>

¹⁸⁸ http://www.royalmail.com/sites/default/files/keepsafe_agreement.pdf

¹⁸⁹ As a consequence of this, the review and modification provisions for any changes to Royal Mail's compensation arrangements for delay, currently in CP1, will fall away.

12.121 In our consultation, we stated that such provisions for compensation are necessary given that universal services are used by residential customers and small business customers who have no realistic alternatives to Royal Mail. The sums involved in the conveyance of single piece post, and for Redirections and Keepsafe services are, for the most part, so small that it is unrealistic to expect that customers would find legal action an effective remedy.

We also proposed a few changes to the reporting requirements on compensation

12.122 Royal Mail's annual report on the operation of its compensation schemes must set out the number of complaints received, incorporating the number of claims for compensation made and the amount of compensation paid. The report is broken down by the ten main causes of the claims. The reports show that loss, damage and delay are always in the top ten main causes of claims¹⁹⁰. Royal Mail must provide data for both the United Kingdom as a whole and also for each postcode area. The annual report must also include a statement of action that Royal Mail intends to take in the following year to address the causes of claims for compensation.

12.123 We proposed the following changes to the current reporting requirements on compensation:

- to remove the reporting requirement for each postcode area because (1) Ofcom has information gathering powers should information be needed on Royal Mail's performance on a case by case basis; and (2) the postcode area level information in the postcode area report does not provide meaningful comparative information about the relative performance of postcode areas nor does it provide a robust indicator of the complaints and compensation claims for each individual postcode area.; and
- to remove the requirement to include a statement of action that Royal Mail intends to take in the following year to address the causes of claims for compensation for the following reasons because (1) we would still receive the annual complaint and compensation figures and we could use our information gathering powers to probe RM's performance, if we became concerned with complaint levels; and (2) loss, damage and delay are likely to be the main causes for compensation claims and most of the actions to address these causes of claims would be covered in the action plan required under the Mail Integrity Code of practice (the essential condition E 1).

Responses to consultation

12.124 We asked stakeholders if they agreed with our proposed requirements for Royal Mail's compensation arrangements for universal services. Royal Mail, the CWU and three business customers agreed with this proposal. Consumer Focus agreed that any compensation arrangements should be fair and reasonable but said that the requirement should also include Redirections and Recorded Signed For as individual services. It also considered that there should be compensation (not just a fee refund) for failure to obtain proof of delivery for services which require a signature on delivery. UK Mail said that Ofcom must retain its existing powers in relation to review and modification of Royal Mail's compensation arrangements for universal services as it considered that retail customers will not be able to challenge whether the terms are fair and reasonable.

¹⁹⁰ http://www.royalmailgroup.com/sites/default/files/docs/files/annex_a_national_summary_2010-11.pdf

12.125 The FSB and one postal operator disagreed with our proposal as it did not include a regulatory requirement on Royal Mail to provide compensation for all users including those using non-universal services. The FSB also sought clarification on Ofcom's definition of a fair and reasonable level for compensation.

12.126 Consumer Focus and UK Mail raised some concerns over the proposal to remove some of the compensation reporting requirements.

Our assessment

12.127 The purpose of our proposals in relation to compensation is to ensure that Royal Mail provides fair and reasonable compensation for those universal services where compensation is currently provided.

12.128 We would note again that the specific details of the compensation arrangements are essentially a commercial matter for Royal Mail. We do not believe it is appropriate to review and modify Royal Mail's compensation arrangements for universal services – which is in line with our decision, discussed in Section 6, on removing the prior approval process for changes to the non-price terms of universal services. However, we are requiring that compensation for the services must be fair and reasonable and our consideration of what is fair and reasonable has been set out in paragraphs 4.46 – 4.48 of this statement. Furthermore, if any person considered that compensation was not being provided consistently with our regulatory requirements, it would be open to them to make a complaint.

12.129 We do not currently regulate the compensation arrangements for non-universal services and did not propose to do so in the December consultation. In Section 6 we confirm that there is no regulatory requirement on Royal Mail to continue to provide non-universal services and under the Act we are not able to implement a price cap on these services – and in effect, confirm our intention to provide Royal Mail with more commercial flexibility in relation to non-universal service products. In line with these decisions, the regulatory requirements for compensation will be restricted to universal services. However, this does not prevent Royal Mail from having compensation arrangements for non-universal services.

12.130 We maintain our view that the reporting of postcode area information and annual statement of action in relation to compensation should cease. As mentioned in the December consultation, the PCA data are not reliable and the statement of actions only provides a snapshot of a point in time and therefore loses its relevance as the year goes on. There will still be regulatory and commercial reasons for Royal Mail to ensure good quality of service and maintain mail integrity. As Royal Mail will still be required to provide reports on the main reasons for complaints and compensation claims, Ofcom as well as Consumer Focus, will be able to use powers to request information if we or Consumer Focus became aware of issues attracting a higher number of complaints and compensation claims than usual.

Our decision

12.131 In light of the above, we have created a single CP condition (CP 4) relating to compensation which replaces CP 1.12-17 and CP 2.

12.132 Furthermore, the compensation provided by the universal service provider (Royal Mail) will have to be fair and reasonable in relation to relevant services¹⁹¹ provided as part of the universal service. As a result, the review and modification provisions for any changes to Royal Mail's compensation arrangements for delay (currently in CP 1) have fallen away.

12.133 In terms of reporting, we have removed the postcode area level element of the annual report currently required by CP 1.16. We have also removed the requirement on Royal Mail to include a statement of action to address the causes of claims for compensation currently in CP 1.16.

12.134 We consider that there will be minimal impacts on stakeholders from our decisions. Royal Mail is only being required to provide fair and reasonable compensation for those universal services for which compensation is currently provided; while senders and recipients benefit from knowing compensation for these services will still be in place.

12.135 While Royal Mail must continue to publish annual, UK-wide reports on the operation of its compensation schemes, its regulatory burden may be reduced as a result of the deleted requirements on postcode area level reporting and the statement of action to address the causes of claims for compensation in the following year.

Schemes related to compensation

12.136 The 2000 Act enabled Royal Mail (as the universal service provider) to make and operate schemes setting out terms and conditions for the provision of universal postal services (in place of contracts), which limit liability, in particular the liability for consequential losses. The purpose of this exclusion of liability was to ensure that the universal service will continue to be provided.

12.137 The Act amended the 2000 Act, in particular by extending the ability to make a scheme to any postal operator rather than just the universal service provider. The Act also adds a new section to the 2000 Act (89A) setting out Ofcom's powers in relation to schemes. In particular, section 89A:

- Requires postal operators to notify Ofcom of proposed schemes and to consult as required by Ofcom; and
- Allows Ofcom to modify schemes by direction, following one month's consultation.

12.138 We have been asked by a stakeholder to confirm the consultation criteria that will apply under section 89A.

12.139 We consider that any postal operator intending to make a scheme should consult for a period of not less than one month with those customers or users likely to be affected by the scheme and with any relevant groups representing such customers or users. We also consider that these criteria should apply to any new scheme proposed from 1 April 2012.

¹⁹¹ Certain services in the universal service are provided free of charge – therefore it would not be relevant for Royal Mail to pay compensation in relation to such services (except for Articles for the Blind which do have existing compensation arrangements for loss, damage and delay).

12.140 For the avoidance of doubt, there is no provision under section 89 or section 89A of the 2000 Act for a postal operator to amend a scheme that it has made, other than by making a new scheme. This is clear from 89(6)(b) which states that a scheme under section 89 may “modify any previous scheme made under this section.” Therefore, any postal operator wanting to change the contents of its scheme is required to make a new scheme under section 89 and follow the requirements of section 89A in doing so.

Measuring and reporting on quality standards by other RPOs

12.141 The initial consumer protection condition 3 (CP 3) currently requires an RPO other than Royal Mail to establish, within three months of starting conveyance of Letters, adequate systems for measuring and recording its performance in achieving its contract targets. In addition, such RPOs must provide Ofcom and Consumer Focus with an annual report in relation to their performance in achieving their contract targets. Ofcom and Consumer Focus may publish these reports after notifying the RPO.

12.142 As the condition relates to *contract* targets, it only applies in those cases where customers have a contract with an RPO. In our December consultation, we noted that most customers using RPOs other than Royal Mail are business customers or those sending higher mail volumes.

Our proposal

We proposed to remove the requirement for other RPOs to measure and report on quality standards as it is no longer required

12.143 We noted in our December consultation that since these regulatory requirements were put in place, competition has developed in several areas of the postal market. As market forces tend to help drive required service levels, we stated that it was in the interest of an RPO voluntarily to measure, record and provide information on performance against contract targets without regulatory intervention (in order to win and retain customers). In the event a customer becomes dissatisfied with an RPO's performance against contract targets, they can choose to switch to another RPO.

12.144 In light of the above we proposed to delete CP 3 in its entirety.

Responses to consultation

12.145 We asked if respondents agreed with our proposal to remove CP 3. We received 11 responses from Royal Mail, postal and access operators, CWU, Consumer Focus and business mailers.

12.146 The majority of respondents agreed with our proposal to remove CP 3 in light of the increased competition in the sector and the incentives for information to be provided by the market.

12.147 However, three respondents (Royal Mail, an RPO and CWU) disagreed with our proposals believing that all RPOs should be required to record and report on performance to ensure customers are properly informed when choosing a mail provider. Royal Mail recommended an Ofcom regulated, industry wide, industry

funded scheme with an independent standardised end-to-end metric to be used by all postal operators¹⁹² with mail volumes above a set threshold.

Our assessment

12.148 As set out in the December consultation, we plan to conduct regular market research in relation to business mailers to help us monitor awareness and use of, and satisfaction with RPOs and Royal Mail. Furthermore, both Ofcom and Consumer Focus have information gathering powers should information be needed on RPO performance.

12.149 We consider that quality of service information could be of benefit to customers and we support the provision of information by the industry that allows customers to make more informed choices between different operators. We note Royal Mail's recommendation for an industry wide scheme. However, we consider that industry should take the lead in developing systems of measuring quality of service that meet the needs of users.

Our decision

12.150 In light of the above, we have decided to remove CP 3.

12.151 We believe the impact on consumers from removing the requirement will be minimal as market forces should ensure RPOs measure and give information to their customers their contract target performance. RPOs may benefit slightly from reduced compliance costs.

Common operational procedures

12.152 The initial consumer protection condition 5 (CP 5) requires RPOs to comply with the Postal Common Operational Procedures Code¹⁹³. The Code is intended to minimise the risk of mis-posted, mis-collected or mis-directed postal packets not being repatriated to the correct RPO, customer or addressee and covers the handling of mis-directed or mis-collected Letters as well as mis-directed complaints and enquiries. CP 5 also requires RPOs to become party to a Postal Common Operational Procedures Agreement (PCOPA¹⁹⁴) which is referenced in CP 5.

12.153 Earlier in this section we set out our decision to retain CP 1.2(b) and to review the PCOPC and issue a consultation on this review in 2012. Following that review, and depending on its outcome, we plan to remove CP 1.2(b) and extend the application of the PCOPC as explained above. In light of that decision, we have not at this stage made any substantive changes to CP 5 or to the PCOPC. Therefore CP 2 (the renumbered replacement for CP 5) is essentially the same as CP 5, subject to formatting changes to bring the condition into line with the other CP conditions.

¹⁹² Excluding express parcels market as such services were highly competitive, contractual and may offer individual the tracking/guarantees with no common measurement system.

¹⁹³ Operators must comply with such a Code *unless* Ofcom otherwise consents. The Code applies in so far it is consistent with or deals with matters not provided for by any Access agreement to which the operator is party - or unless the operator has established alternative arrangements with other regulated postal operators relating to the treatment of mis-directed, mis-posted and mis-collected mail.

¹⁹⁴

<http://webarchive.nationalarchives.gov.uk/20111027102050/http://www.psc.gov.uk/documents/2067.pdf>

12.154 In our December consultation, we noted that some changes had been requested to the PCOPA (by parties to the PCOPA) and that further changes might be needed if the application of the Code were extended. In light of our decision to review the PCOPA before extending its application, we only need to proceed with appropriate, requested changes to the PCOPA to ensure it is up to date¹⁹⁵. The consultation on these changes can be found at Annex 15 and we will directly notify parties to the PCOPA and Consumer Focus in line with the requirement at CP 5.7(a).

Contributions to consumer bodies' expenses

12.155 The initial consumer protection condition 6 (CP 6) sets out how consumer bodies' expenses will be allocated and recovered from RPOs. The precise contributions depend on the level of an RPO's turnover and are allocated to the qualifying consumer expenses of *Consumer Focus* and/or to the Office of Fair Trading's ('OFT') expenses relating to their *Consumer Direct* service which caters for postal service customers.

Our proposal

12.156 The only change we proposed to make to this condition in our December consultation was to remove CP 6.5 to clarify that requests for payments and the actual payments will now be made by/to Ofcom (instead of Postcomm). We also noted that from April 2012, Citizens Advice will provide a telephone and online consumer advice service in place of Consumer Direct. In light of this change in provider, we will eventually need to change the references to the OFT and Consumer Direct. However, we cannot do this until such time as the Act is amended as currently we can only recover consumer body expenses in relation to Consumer Focus or the OFT.

Responses to consultation

12.157 Several respondents provided further comments on this condition. The MCF stated that the expenses of Consumer Direct (and from April, Citizens Advice Consumer Services) are unknown and should be clarified. TNT responded that the Consumer Direct expansion expenses should already have been incurred and therefore references to this in the Condition should be removed.

12.158 Royal Mail queried the proportion of costs it paid towards Consumer Focus and stated that other postal operators should be required to make appropriate contributions to the costs of consumer bodies. Royal Mail recommended that the current threshold for when contributions apply should be lowered and that access turnover should not be excluded from the turnover calculation.

Our assessment and our decision

12.159 We note respondents' comments on this condition. We consider that the expansion costs for Consumer Direct and Consumer Focus are not necessarily one off costs and therefore should remain in the condition. The level of the expenses for Consumer Focus, Consumer Direct (and from April, Citizens Advice Consumer Service) is a matter for them and the proportion attributable to postal services is a matter for the Secretary of State. We note Royal Mail's comments on the current threshold and calculation of turnover and will consider it as part of any future review of the recovery of expenses. The condition is now renumbered as CP 1.

¹⁹⁵ These changes are those we considered following separate requests in December by two parties to the PCOPA – see paragraphs 6.80-6.82 of our December consultation.

Consumer complaints handling and redress

12.160 There are currently three initial consumer protection conditions (7-9) which relate to handling consumer complaints and membership of redress schemes:

- **CP 7** which requires any postal operator to set up and adhere to transparent, simple and inexpensive procedures for dealing with complaints from consumers of postal services. The procedures must facilitate the fair and quick settlement of disputes;
- **CP 8** which sets out further requirements in relation to complaint handling specifically for RPOs providing regulated postal services. For example requiring the publication of an annual consumer complaints report (which includes the number of complaints received and the number resolved each year); and
- **CP 9** which requires an RPO providing regulated postal services to be a member of a qualifying redress scheme. Currently, POSTRS¹⁹⁶ is the only qualifying redress scheme in place.

12.161 In addition, initial condition DUSP 6 requires Royal Mail to publish and provide to Ofcom and Consumer Focus quarterly reports on the number of consumer complaints received and completed.

Our proposals

12.162 In our December consultation, we proposed minor changes:

- to consolidate the consumer protection condition requirements in CP 7-9 into one complaint handling and redress condition;
- to amalgamate DUSP 6 into this merged consumer complaints and redress condition, on the basis that it contained similar requirements to CP 8;
- to deal with a transposition error by specifying in CP 8 and 9 that they apply where postal packets other than Letters are conveyed in the provision of the universal service;
- to change the reference in CP 8.2(i), and the associated definition, from 'Consumer Direct' to 'Citizens Advice Consumer Service' to reflect the fact that from April 2012 Citizens Advice will provide a telephone and online consumer advice service in place of Consumer Direct; and
- we also invited feedback from stakeholders for us to feed into the subsequent review that we are planning for complaints-handling and redress.

Responses to consultation

12.163 Royal Mail supported the merging of the conditions and the change proposed to amend the reference to Citizens Advice Consumer Service.

12.164 Royal Mail provided two initial views for Ofcom to consider as part of its review. It did not consider it necessary to introduce an additional redress scheme or that it would

¹⁹⁶ The Postal Redress Service - <http://www.postrs.org.uk/> . Ofcom approved the provider IDRS Ltd to administer the Postal Redress Service on 1 October 2011.

be appropriate to expand the range of customers who are entitled to refer cases to a redress scheme. It also considered that compulsory adjudication by third parties was not an appropriate mechanism for resolution of commercial contractual disputes between Royal Mail and its business retail customers as it had strong commercial incentive to treat its customers in a fair and reasonable manner.

- 12.165 Consumer Focus strongly supported our intention to review consumer complaint handling. Consumer Focus stated that a review was critical to ensure a robust consumer complaints system is put in place and the review should cover escalation procedures and publicity of the complaints process.

Our assessment and decision

- 12.166 We have corrected the transposition error, replaced the reference to “Consumer Direct” in CP 8.2(i) with “the Citizens Advice Consumer Service” and merged the three CP (7-9) conditions with the quarterly reporting requirement on Royal Mail (under DUSP 6) into one condition – now CP 3¹⁹⁷.
- 12.167 RPOs will need to update their complaints handling procedure to ensure that they refer to the correct consumer advice provider. We recognise that there will be some impact for those RPOs who have printed literature which refers to Consumer Direct. However, as Citizens Advice will continue to use the Consumer Direct telephone number, RPOs can gradually phase out any printed literature which refers to Consumer Direct.
- 12.168 The consolidation of the consumer complaints handling and redress requirements into one condition should also help provide more regulatory clarity to stakeholders.
- 12.169 We note the comments from Royal Mail and Consumer Focus and will consider them as part of our planned review of complaints handling and redress. We discuss wider issues around resolving disputes between Royal Mail and customers within Sections 6 and 10.

The essential condition on Mail Integrity

- 12.170 The initial (and only) essential condition (E 1) requires all RPOs to comply with the MIC, the purpose of which is to minimise the exposure of Code Postal Packets to the risk of loss, theft, damage and/or interference, and maintain and improve their performance in this regard.
- 12.171 The MIC was introduced in 2006 and established minimum common standards for mail integrity for all licensed postal operators. It facilitated consumer understanding of what users of postal services could expect from a postal operator in terms of security of mail entrusted to them.
- 12.172 Earlier in this section we set out our decision to retain CP 1.2(b) and to review the MIC and issue a consultation on this review in 2012. Following that review, and depending on its outcome, we plan to remove CP 1.2(b) and extend the application of the MIC as explained above. In light of that decision, we have not at this stage made any substantive changes to E 1 or to the MIC with the exception of a change that is necessary to address a transposition error that we identified in the course of reviewing this condition. This error had arisen in relation to the definition of “Code

¹⁹⁷ This condition uses a different definition of public holiday to other conditions as it is not affected by delivery or collection exceptions in relation to public holidays.

Postal Packet". Its effect was that postal packets other than Letters¹⁹⁸, conveyed in the provision of the universal service, were not covered by the Mail Integrity Code. Previously, the Code covered all Letters "conveyed pursuant to a licence", which did include universal services postal packets other than Letters.

12.173 We have corrected this by amending the definition of Code Postal Packet to become "a postal packet conveyed in the provision of a regulated postal service or a universal service". As we are correcting an error to re-establish the regulatory regime as it applied before 1 October 2011, we consider the likely impact on postal operators to be negligible. The only other changes we have made are formatting changes to bring E 1 into line with the other conditions.

The transitory conditions

12.174 A transitory condition is one which includes obligations which we would not have the power to impose under Part 3 of the Act. Some of the previous licence conditions were transposed as transitory conditions because they contained a mixture of obligations some of which we would not have the power to impose under Part 3 of the Act, but also some of which we would have the power to impose.

Our proposals

We proposed to allow these time limited conditions to cease

12.175 All five of the current transitory conditions – T 1 to 5 – are time-limited. They would cease to apply from the end of March 2012 if we implemented our proposal to make an Order under section 30 of the Act.¹⁹⁹ Therefore, in our December consultation, we considered whether we should retain any aspects of these transitory conditions beyond this date and our analysis led us to propose that this would not be appropriate.

12.176 We asked for stakeholders' views on the planned cessation of these conditions. We received twelve responses with seven respondents agreeing with our approach – Royal Mail, Consumer Focus, Opus Trust Marketing Limited, two other businesses and two postal operators.

12.177 Four stakeholders, in responding to our general question on the cessation of the transitory conditions – the DMA, one other user group, ONEPOST and another access operator – argued against the removal of the prior approval process for the non-price terms of universal services (which currently sits within T 4). In addition, UK Mail argued that we should retain the requirements contained in T 2 and T 5.

12.178 We have already discussed in Section 6 of this statement our responses to stakeholder feedback on our proposal to lift the prior approval process for the non-price terms of universal services. We explained in that section why we have decided to remove this requirement.

12.179 We therefore focus on UK Mail's comments, as part of our discussion (further below) on our conclusions for all five transitory conditions.

¹⁹⁸ Letters is defined in section 65(1) of the Act.

¹⁹⁹ And as explained in Section 4 of this document, we have decided to proceed to make that Order.

Monitoring Compliance with quality standards

12.180 Transitory condition T 1 requires Royal Mail as the universal service provider to appoint an official to monitor compliance with its quality standards and who is required to report to its board. We did not propose to retain any aspects of this condition because we felt it would be inappropriate to prescribe the detail of how Royal Mail arranges its compliance with quality standards and relationship to its governance structure.

12.181 No stakeholder disagreed with our proposed approach and so we will allow this condition to lapse as planned. This may lift a small regulatory burden on Royal Mail.

Compliance Officer Role and Compliance Reporting

12.182 Transitory condition T 2 requires Royal Mail to employ a 'Compliance Officer' and to consult us on the officer's appointment and to assign a number of compliance related tasks to this officer, including the provision of an annual 'compliance report' to Ofcom.

12.183 One stakeholder – UK Mail – disagreed with its cessation and argued that we should retain the obligations for Royal Mail to appoint a Compliance Officer who reports annually to Ofcom on its activities. It added that "the existence of the Compliance Officer within RM has helped to give compliance with regulatory conditions, competition legislation and commercial agreements (e.g. access agreements) greater awareness than would have been the case had the post not existed". UK Mail also felt that the Officer had instigated a network of compliance managers within Royal Mail and had found the Officer to be a useful point of escalation within Royal Mail.

12.184 One other stakeholder – while not explicitly disagreeing with the condition's cessation – felt there would be an "absence of reporting requirements" which would give Royal Mail the "ability to act in a way that enables them to extend the boundaries".

12.185 In response, we would reiterate that Royal Mail will have to ensure compliance with its regulatory obligations going forward. In order to do so, we expect that it will have to allocate relevant personnel to this task. However, we still believe it would be regulatory micro-management for us to dictate how it arranges this internal task by requiring a specific post/appointment.

12.186 Furthermore we note that we have retained requirements on Royal Mail (sitting in individual conditions) for quarterly and annual reporting on universal service quality standards, quarterly reporting for Royal Mail's consumer complaints and an annual report on its compensation scheme for standards of service. In addition, as with other RPOs, Royal Mail will also continue to have an obligation to provide an annual report on mail integrity and a separate annual report on misdirected / mis-collected mail. These, alongside other means at our disposal – such as our information gathering powers – will help us to monitor its operational performance going forward and we will monitor compliance on an ongoing basis where relevant (making the annual compliance report unnecessary).

12.187 Therefore we will allow T 2 to cease as planned. This may have the effect of removing a regulatory burden from Royal Mail.

Assurance of necessary resources

12.188 Transitory condition T 3 applies to Royal Mail and requires it to provide Ofcom with an assurance from its directors that Royal Mail has access to the necessary resources to provide specified postal services – and to provide certain assurances if it wishes to pay dividends.

12.189 We did not believe it was necessary to keep these requirements since we proposed (and will now require – see Section 11 of this statement) Royal Mail to provide reports and forecasts for the Relevant Group which will allow us to monitor its financial position going forward. No stakeholder disagreed with the cessation of T 3.

Price controlled services, geographic price uniformity, non-priced services and non-price terms of regulated services

12.190 Transitory condition T 4 applies to Royal Mail and covers several different elements including requirements:

- a) to provide the regulated services on as wide a basis (geographically) within the UK as they were provided at end 31 March 2006;
- b) to provide regulated services (other than access services) on terms other than price which are no less beneficial than those terms provided at end 31 March 2006;
- c) to set prices for Controlled Services in such a way that they meet certain conditions; and
- d) to provide some services free of charge – Return to Sender (as part of a regulated service); Certificate of Posting, Poste Restante, Petitions to Parliament and Petitions to Her Majesty the Queen.

12.191 These requirements are no longer required, as a result of our decisions to revise conditions set out elsewhere in this statement and its Annexes.

12.192 In terms of (a), we have now secured this in relation to universal services (as it is in fact currently secured) through the imposition of a DUSP condition which will mean customers must be able to send items to every home and premises in the UK or access the service from access points (post boxes and post offices for packets and registered items, post boxes for Letters). Therefore we consider that the cessation of the transitory requirement will have no impact on the geographical provision of the universal service and, in particular, no impact on the requirement for UK-wide collections and deliveries. The Act does not empower us to require the provision of services that are not universal services.

12.193 We already mentioned further above that we have decided to remove (b) – which relates to the prior approval process for changes to the non-price terms of universal services. We explained the reasons for doing this within Section 6 of this statement.

12.194 Requirement (c) is also no longer relevant as we have now decided to lift most price controls as set out in Section 6 of this document.

12.195 Finally, on (d) free Certificate of Posting, Poste Restante and Petitions are being required via a DUSP condition. In terms of Return to Sender, we explained in Section

4 of this statement why we have decided to proceed with our proposal no longer to require that it is provided free of charge beyond 31 March 2012.

Common operational procedures – use of information

12.196 Transitory condition T 5 applies to all RPOs and not just to Royal Mail. It requires them to refrain from using any information about the business of another postal operator, which it obtains from being party to a common operational procedures agreement, in order to secure an unfair commercial advantage. This condition did not fall within any of the types we could potentially impose under Part 3 of the Act and so we stated that would be appropriate to let it fall away.

12.197 The one stakeholder who commented on this condition - UK Mail - felt that the requirement in T 5 was an important safeguard and argued that as we were intending to change the PCOPC (as a consequence of our proposed removal of CP1.2 we should “make the necessary change to the Code” to ensure the continuing application of the requirement in T 5.

12.198 However, we reiterate that we do not consider that we have the power to impose this requirement via a condition – and further clarify that the Code is (an Annex to and so) part of a regulatory condition.

Our decision

12.199 In summary, we will not create any regulatory requirements corresponding to those contained in any of the transitory conditions. Once we make the universal postal service Order, these requirements will automatically cease to exist.

Summary of our decisions

12.200 To summarise, in terms of the conditions discussed in this section, we have:

- Implemented a condition which requires Royal Mail to provide universal services (and access points);
- Included a requirement for Royal Mail to publish a list of the universal services provided, and notify us and customers of any changes to that list one month in advance;
- Retained the current quality of service targets on universal services;
- Removed all requirements for quality of service targets and reporting of quality of service performance for Royal Mail’s non-universal services.
- Removed requirements from Royal Mail’s contingency planning condition for universal services to maintain a priority list and the need to send us a report following its biennial review of contingency plans;
- Removed CP 1.2(a), retained CP 1.2(b) and noted our intention to review the Postal Common Operational Procedures Code and Mail Integrity Code and issue a consultation on these Codes later in 2012;
- Created a requirement which requires Royal Mail to provide reasonable compensation for loss, damage or delay to customers of universal services (for the services for which Royal Mail currently provides compensation);

- Removed the obligation on other RPOs (i.e. not Royal Mail) to measure and report on their contract targets;
- Merged consumer complaints and redress conditions for postal operators and Royal Mail into one condition, made a minor correction to the newly merged consumer complaints and redress condition and change references from Consumer Direct to Citizens Advice Consumer Service; and
- Allowed all five transitory conditions to cease at the end of March 2012.

12.201 Our notification of the DUSP conditions in this section is available at Annex 7, the CP conditions at Annex 8 and the essential condition at Annex 13. In addition, a table listing the new conditions - and comparing their numbering to related initial conditions - is available at Annex 2.

12.202 We set out in Section 13 how we have met the legal tests for implementing the DUSP conditions, consumer protection conditions and the essential condition.

Section 13

Assessment of Statutory Tests for imposing Regulatory Conditions

- 13.1 In Section 3 we summarised the key features of the legal framework and explained the relevant duties applicable to Ofcom's regulation of the postal sector.
- 13.2 In particular we explained our duty under section 29(1) of the Act to secure the provision of a universal postal service and the need, in performing our duty to have regard to the need for the provision of a universal service to be both:
- Financially sustainable; and
 - Efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 13.3 We have set out in this document a number of decisions to impose regulatory conditions to secure our statutory duties. In this section, we explain why we consider that each of those regulatory conditions satisfies the various requirements set out in the Act relating to the imposition of such conditions.

Summary of regulatory conditions being imposed

- 13.4 In the preceding sections of this statement we have identified a number conditions that we have decided to impose:
- 13.4.1 Regulatory conditions imposed under section 36 of the Act to require the designated universal service provider, Royal Mail, to provide the universal service to the specified standards, and as part of the above condition, a control on the price of Second Class stamps to ensure an affordable service, particularly for vulnerable consumers (the DUSP conditions);
- 13.4.2 Regulatory conditions imposed under section 38 of the Act requiring Royal Mail to provide access to its postal network to other postal operators or users of postal services, and as part of the above condition, a control on the price charged for access to prevent a margin squeeze (the USPA Conditions);
- 13.4.3 Regulatory conditions imposed under section 39 of the Act requiring Royal Mail:
- a) to maintain a separation for accounting purposes between such different matters as Ofcom may direct;
 - b) to comply with rules made by Ofcom in relation to the identification of costs, cost orientation, and the use of cost accounting systems; and
 - c) to secure that its compliance with the above is audited annually (the USPAC Conditions).
- 13.4.4 Regulatory conditions imposed under section 51 of the Act relating to consumer protection matters (the CP Conditions);

- 13.4.5 An essential condition imposed under section 49 of the Act; and
- 13.4.6 A notification condition imposed under section 41 of the Act.
- 13.5 We have set out below our assessment of how these conditions meet the specific legal tests set out in the Act. We also note the requirements set out in Schedule 6 of the Act that we may only impose a regulatory condition if we are satisfied that the condition:
- i) is objectively justifiable;
 - ii) does not discriminate unduly against particular persons or a particular description of persons;
 - iii) is proportionate to what it is intended to achieve; and
 - iv) is transparent in relation to what it is intended to achieve.
- 13.6 We consider that each of the regulatory conditions we have decided to impose meets these criteria, for the reasons set out above in this document, and as described in more detail below in relation to each proposed condition.

Designated USP condition (DUSP Condition)

- 13.7 A DUSP condition may be imposed on a universal service provider. Royal Mail is the designated universal service provider in the UK (the USP).
- 13.8 It may require the universal service provider to one or more of the following:
- Provide a universal service or part of a universal service, throughout the UK or in a specified area of the UK, in accordance with the standards set out in the universal postal service order;
 - Provide access points for the purposes of a universal postal service;
 - Provide specified information to postal operators and users about the universal services it is required to provide; and
 - Do anything else that Ofcom considers appropriate for the purposes of or in consequence of any of the above three obligations.
- 13.9 In particular, a DUSP condition may make provision as to tariffs and may impose performance targets.
- 13.10 Under section 37 of the Act, a DUSP condition must include provision requiring the universal service provider to publish information about the extent to which it is providing specified postal services in accordance with specified standards and to publish annually an independently audited performance report.

Tests for imposing a DUSP condition

- 13.11 A DUSP condition may be imposed only if Ofcom considers it necessary to do so in order to secure the provision of a service of a description set out in the Order in accordance with the standards set out there.

- 13.12 The Directive requires the UK to ensure that the universal service it prescribes is guaranteed and requires steps to be taken to ensure the provision to users of sufficiently detailed and up to date information. Under section 29 of the Act Ofcom is under a duty to secure the provision of the universal postal service.
- 13.13 Section 31 of the Act sets out requirements that must as a minimum be included in a universal postal service. These minimum requirements meet the requirements of the Directive.
- 13.14 The universal service currently comprises services which the market does not independently provide, particularly not throughout the UK at a uniform affordable tariff. We do not consider that absent regulatory intervention the universal service would be provided to the required standards and we therefore consider it necessary to impose a DUSP condition in order to secure the provision of the services set out in the UPSO in accordance with the standards set out there.
- 13.15 We have set out our view in previous sections that absent an obligation to do so, Royal Mail would be left to provide the universal service to the standards required and to implement the universal service order as it determines appropriate. Such an approach while giving Royal Mail maximum freedom would provide no guarantee that the universal service would be provided, nor any guarantee as to the level of pricing of any of its constituent elements. Adopting such an approach would risk Ofcom failing to carry out its functions in a way that it considers will meet its primary duty to secure the provision of a universal postal service, and would risk not providing appropriate protection for customers, in particular vulnerable consumers.
- 13.16 We consider that a DUSP condition as described above meets the relevant tests set out in Schedule 6 of the Act in that it is objectively justifiable, non-discriminatory, proportionate and transparent. We address this in more detail below.

Safeguard price control on Second Class stamps to ensure affordability, in particular for vulnerable consumers

- 13.17 We have decided to include in a DUSP condition a control on the price of Second Class stamps for standard Letters.
- 13.18 As set out above, section 36 of the Act sets out the permitted subject-matter of a DUSP condition, including tariffs to be used for determining prices in accordance with which a universal postal service, or part of a universal service, is provided (section 36(4) of the Act).
- 13.19 Section 36(5) of the Act provides that, in exercising the power conferred by section 36(4), Ofcom must seek to ensure that the prices are affordable; the prices take account of the costs of providing the service or part of a service; and the prices provide incentives to provide the service or part of a service efficiently.
- 13.20 We consider that in order that customers as a whole, and particularly vulnerable consumers, are protected and have access to universal services, it is necessary to impose a DUSP that caps the price of Second Class stamps for standard Letters. We consider that this is consistent with the requirement that where we impose a control on prices, we must seek to ensure that prices are affordable. We also consider that the level at which we have decided to set the cap, in combination with our other decisions to provide more freedom to Royal Mail to set prices generally, takes account of the costs of providing the service and will help to provide incentives to provide the service in an efficient manner.

13.21 In particular, we consider that the safeguard price cap is:

- **Objectively justifiable** because it will ensure that an affordable basic universal service is available to all, including vulnerable consumers;
- **Not unduly discriminatory** because it affects the USP – and there is only one such USP (Royal Mail) in the UK;
- **Proportionate** because it is set at a level which takes account of the needs of vulnerable consumers and what is affordable for them, whilst still ensuring that Royal Mail retains sufficient pricing flexibility to make a reasonable commercial rate of return on the services which are the subject of the control;
- **Transparent** because it is clear as to the maximum charges that Royal Mail is permitted to charge for the relevant services under the cap.

Other elements of the DUSP Condition

13.22 We believe imposing a condition requiring provision of the universal postal service is:

- **Objectively justifiable** because the Act requires us to move to a description-based set of universal services and we have decided that the condition should maintain the features that customers *currently* expect from universal service products. The universal service will therefore remain essentially the same as now. In terms of the new notification process for a list of universal service products, we consider that this is required to provide transparency for users and allow us to ascertain if changes to that list comply with the characteristics of the universal services;
- **Not unduly discriminatory** because the change necessarily affects the USP – and there is only one such USP (Royal Mail) in the UK;
- **Proportionate** because we are not prescribing additional or reduced requirements for the universal services at this stage - only a simple notification process for the list of products which should not be an onerous requirement on Royal Mail; the imposition of a DUSP condition is the least onerous means of securing the provision of these services; and
- **Transparent** because it is clear that the change is intended to define the characteristics of universal services while safeguarding universal service provision in essentially its current form pending a full review.

13.23 We believe imposing performance targets in a DUSP condition is:

- **Objectively justifiable** because we must specify quality standards for universal services. We have retained existing performance targets for universal services and ensure the quality and reliability of these services. The removal of targets for bulk mail and business collections from CP 1 is justified on the basis that these are not universal services – and similarly, moving the quality of service target for 99.9% of collection points to be served each into this DUSP and only including collections from universal service access points within this measurement is justified since business collections are not in the universal service; and
- **Not unduly discriminatory** because the condition affects the USP – and there is only one such USP (Royal Mail) in the UK;

- **Proportionate** because we have not changed the targets for the universal services specified in the condition so this does not constitute an additional burden on Royal Mail. Similarly, universal service consumers will continue to be protected essentially as they are today. In addition, we believe Royal Mail will have incentives to maintain standards for non-universal services absent a regulatory requirement so it is not proportionate to extend this regulatory requirement to those services; and
- **Transparent** because it is clear that we impose performance targets for universal services in order to secure that they are provided to a sufficiently high standard.

13.24 We believe removing the requirements from Royal Mail's contingency planning condition for universal services to maintain a priority list; implement its contingency plans or explain why it had not done so; and to send us a report following its biennial review of contingency plans are:

- **Objectively justifiable** because Royal Mail already has incentives to ensure and prioritise its provision of universal services, and it is important to provide some flexibility to Royal Mail given the relative prioritisation of services may partly depend on the particular nature of the issue causing the contingency plans to be deployed;
- **Not unduly discriminatory** because Royal Mail is the only USP and operator who currently faces this requirement;
- **Proportionate** because Royal Mail already has incentives to ensure and prioritise its provision of universal services in order to **meet its regulatory requirements** as the USP (including related quality of service standards) or risk enforcement action - and so it would not be proportionate to retain this regulation; and
- **Transparent** because it is clear that we are removing an unduly interventionist requirement.

13.25 We believe the condition setting out the requirements on Royal Mail for the provision of information on universal postal services is:

- **Objectively justifiable** because the vast majority of universal service customers have no choice of operator apart from Royal Mail and therefore need to be given up to date information on universal services in order to access the services. Both residential and small business users are likely to require some notice to respond to both price and non-price changes;
- **Not unduly discriminatory** because Royal Mail is the designated universal service provider and is the only operator servicing the vast majority of universal service customers;
- **Proportionate** because it balances the need for residential and small business customers to have notice of price and non-price changes to universal services against Royal Mail's requirement for additional commercial flexibility to respond to market changes and the needs of its customers. The changes to the specification of the universal service and requirement for terms and conditions to be fair and reasonable should provide sufficient protection for customers from unreasonable

changes without an additional and potentially time consuming approval process;
and

- **Transparent** because the requirements are clearly linked to the goal of ensuring customers have sufficiently up-to-date information about universal services.

13.26 We believe the removal of requirements covering publication and also advance notification of changes to the terms of **non**-universal postal services is:

- **Objectively justifiable** given the level of competition for the majority of non-universal services Royal Mail should be incentivised to publish and give sufficient advance notice of any changes if this is important to its customers;
- **Not unduly discriminatory** as Royal Mail is the only operator who currently has requirements to publish prices and terms and conditions;
- **Proportionate** because the market can reasonably be expected to meet customers' needs - and so it would not be proportionate to impose additional regulation; and
- **Transparent** as we have clearly set out our proposal to remove this requirement.

13.27 We consider that the DUSP condition as described above is objectively justifiable: while Ofcom could investigate and after consultation, impose a DUSP condition, if Royal Mail was failing to provide the universal service, any such obligation would take effect after the identified failure to provide the universal service potential had occurred. In order to ensure continued provision of the universal service, it is in our view necessary and justified to require this of Royal Mail by imposing a DUSP condition. The control on Second Class stamp prices would also provide a safeguard to ensure that vulnerable consumers will continue to have access to a basic universal service product without significantly limiting Royal Mail's overall pricing freedom.

13.28 We consider that a DUSP condition as described above is not discriminatory. The Act provides that the provision of the universal service to specified standards can only be required of a universal service provider, and Royal Mail is (and will remain for some time) the only universal service provider. There is therefore no other person on whom such an obligation could be imposed.

13.29 We consider that a DUSP condition as described above is proportionate to what it is intended to achieve. In our view, this is the least onerous obligation needed to secure the provision of the universal service, and the protection that will be afforded to users of the universal service is proportionate to the regulatory burdens that will be imposed on Royal Mail as a result.

13.30 Finally, we consider that the proposed obligation is transparent, for the reasons set out above, and because the DUSP condition is set out in Annex 7 to this statement.

USP access condition

13.31 The Act allows Ofcom to impose USP access conditions on the universal service provider. A USP access condition is a condition that requires a universal service provider to do either or both of the following: (a) give access to its postal network to other postal operators or users of postal services; and (b) maintain a separation for

accounting purposes between such different matters relating to access (including proposed or potential access) to its postal network as Ofcom may direct.²⁰⁰

13.32 Under section 38(4) of the Act, Ofcom may not impose a USP access condition unless it appears to it that the condition is appropriate for each of the following purposes:

- Promoting efficiency;
- Promoting effective competition; and
- Conferring significant benefits on the users of postal services.

13.33 We have set out in this document our decision to impose a USP access condition that requires Royal Mail to offer access for the provision of retail D+2 and later than D+2 Letters and Large Letters services and we explain why we consider that the three criteria for imposing such a condition are met. Our assessment takes into account the analysis that we set out in our October 2011 consultation document²⁰¹ as well as the evidence provided by respondents.

13.34 In summary, we consider that the three criteria are met for the following reasons:

- Promoting efficiency: we consider that access competition has incentivised Royal Mail to improve its efficiency upstream and that it will continue to do so going forward. In this context, we note that Royal Mail's ability to respond to competition may have been weaker under the current "headroom" regime. However, we consider that the regulatory environment that we are proposing will address that concern. We also note that Royal Mail identified various static inefficiencies in its response to Postcomm's March access review consultation. However, we consider that they are outweighed by the dynamic efficiency of competition.
- Promoting effective competition: prior to the launch of access in 2003, Royal Mail faced little or no competition in the relevant D+2 and later than D+2 markets. As a result of Royal Mail granting access, access operators now handle around 40% of total Letter volumes. Not only has access promoted effective competition in the relevant D+2 and later than D+2 markets, but we also consider that access competition provides a platform for the development of end-to-end competition. Indeed, in the absence of an access regime, we consider that end-to-end competition would not be likely to develop to any material extent.
- Conferring significant benefits on the users of postal services: we consider that access has conferred significant benefits to users through lower prices, innovation and improved customer service and that it will continue to do so going forward.

13.35 Section 38(8) of the Act requires that Ofcom must in particular take into account five factors when deciding in a particular case what obligations should be imposed in a USP access condition. The five factors are as follows:

²⁰⁰ See sections 38(1) and (2) of the Act.

²⁰¹ Our October 2011 consultation took into account Postcomm's preliminary assessment of the application of the three criteria in its March access review consultation ('The building blocks for a sustainable postal service – Access Review 2012 Initial Proposals, March 2011) along with the further analysis that we conducted in light of points raised by stakeholders in response to Postcomm's consultation.

- the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed access unnecessary;
- the feasibility of giving the proposed access;
- the investment made by Royal Mail in relation to the matters in respect of which access is proposed;
- the need to secure effective competition in the long term; and
- any rights to intellectual property that are relevant to our proposal.

13.36 We consider that these factors indicate that the appropriate point of access for participation in the relevant D+2 and later than D+2 markets is at the Inward Mail Centre. In reaching this view, we agree with Postcomm's preliminary assessment. Postcomm took into account the fact that downstream access users currently inject items at this point shows that it is feasible and identified various reasons why the mail centre network provides a suitable set of premises for such purposes. Postcomm considered various alternative points of access (the Delivery Office, the Outward Mail Centre and the Outward Regional Distribution Centre) and provisionally concluded that they were not as suitable as the Inward Mail Centre.

13.37 In our October consultation, we also considered the concerns raised by one operator that other points of Royal Mail's network such as the Delivery Office and Mail Preparation Units may represent suitable alternative access points. However, whether it is appropriate to mandate access at these points depends on the completion of Royal Mail's transformation plan. Thus, in October, while we did not exclude mandating access at alternative points to the Inward Mail Centre in the future, we recognised that we would first need more evidence as to why obliging Royal Mail to offer access at these points satisfies the relevant tests in the Act. We did not receive any responses to our October consultation that caused us to change our assessment.

13.38 Ofcom's power to impose a USP access condition is subject to its primary duty to secure the provision of a universal postal service.²⁰² As set out in the relevant section above, we consider that access for the purposes of participating in the relevant D+2 and later than D+2 markets is consistent with our duty to secure the provision of the universal service. That assessment is on the basis that the costs of access competition should be relatively limited for Royal Mail. Access competition should result in avoided costs for Royal Mail's upstream network. Provided that the price paid by access operators reflects Royal Mail's retail price less an appropriate measure of incremental costs, Royal Mail should in theory be indifferent to whether access is offered. In October, we noted Royal Mail's concerns about the risks to the universal service of regulated access. However, given our decision for Royal Mail to be granted pricing freedom on both retail and access prices, we took the view that there should not be an adverse impact on Royal Mail's finances of providing access. Royal Mail did not give us any new evidence in response to our October consultation to alter that view.

²⁰² See section 29(2) of the Act.

- 13.39 Ofcom is permitted to impose price controls as part of a USP access condition²⁰³. However, we can only impose price controls if it appears to us that Royal Mail might otherwise fix and maintain some or all of its prices at an excessively high level with adverse consequences for users of postal services; or might otherwise impose a price squeeze (margin squeeze) with adverse consequences for users of postal services.
- 13.40 For reasons explained further in our October consultation, we have decided only to impose price control measures to address the risk of a price squeeze by Royal Mail against other operators. We consider that the combination of Royal Mail's position in the relevant wholesale (downstream) markets and its vertically integrated structure provide it with both the ability and incentive to squeeze the margin of retail competitors using its downstream access product. We consider that such a price squeeze could give rise to adverse consequences for the users of postal services. We did not receive any responses to our October consultation that caused us to change our assessment of the justification for imposing a price control measure to address the risk of price squeeze.
- 13.41 We have taken into account the Section 38(8) factors in deciding to include a price control obligation in the proposed USP condition. We consider that the investment made by the universal service provider, and the need to secure effective competition are relevant to the decision whether to impose a price control obligation.
- 13.42 We have decided that, in the absence of a price control, competition may not be effective due to Royal Mail's ability to exercise its market power in the wholesale markets. In that context, we have decided to impose a form of control which gives certainty to Royal Mail that it will be able to charge prices to reflect its costs, and therefore which take account of investment in its network. We recognise that the headroom regime that was put in place in 2006 to address the risks of price squeeze prevented Royal Mail from competing effectively. We consider that the price control measures we have decided to put in place will address those concerns. In particular, they will give Royal Mail greater freedom to price services than under the existing headroom control. Our indication that we will endeavour to review the regime within 18-24 months in order to assess whether it is appropriate to move to a monitoring regime based on a margin squeeze test to be set with reference to LRIC costs as set out more fully in the relevant section of this document above, shows that we have considered how best to secure effective competition in the long term.
- 13.43 Section 38(6) of the Act requires that, in imposing price controls in a USP access condition in connection with the giving of access to a universal service provider's postal network, Ofcom must have regard to the costs incurred in the provision of that network. We have decided to impose a margin squeeze test based on what we consider to be an appropriate measure of costs, and therefore having regard to the costs incurred in provision of upstream services.
- 13.44 Section 38(7) of the Act provides that, in imposing price controls in a USP condition, Ofcom may have regard to the prices at which services are available in comparable competitive markets. In Annex 7 of our October consultation we explained that Postcomm had considered the costs of other operators who had entered the retail pre-sorted and high volume unsorted Letters and Large Letters markets. Postcomm noted that other operators had costs that were comparable to, and indeed may be lower than, Royal Mail's and had gained significant market share.

²⁰³ The permitted subject matter of price controls is further set out in paragraphs 3 to 5 of Schedule 3 of the Act.

- 13.45 On the basis of the information set out above, we consider that including a price control to prevent price squeeze in a USP access condition is appropriate and that the tests for imposing such a price control set by the Act are met.
- 13.46 In addition to the specific tests that have been assessed above, Ofcom must also be satisfied that the general tests that are set out in Schedule 6 of the Act for imposing regulatory conditions are also met in relation to the proposal to impose a USP access condition.
- 13.47 We consider that imposing a USP access condition including a margin squeeze price control on access is:
- **Objectively justifiable:** we have explained in the relevant section above and in our October consultation why we consider that imposing a USP condition requiring access at the Inward Mail Centre for the provision of the relevant D+2 and later than D+2 services will provide the basis for securing efficiencies, promoting effective competition and conferring significant benefits on users of postal services in accordance with the criteria set out in section 38(4) of the Act.
 - i) We have explained that access is an important component of competition for post and that it will provide incentives for the provision of the universal service to be financially sustainable, without threatening the sustainability of the universal service. In addition, we have explained the reasons why a price control obligation is necessary in order to protect against the risk of Royal Mail imposing a price squeeze and how such an obligation will give Royal Mail increased commercial freedom in a way that will improve the financial sustainability of the universal service and Royal Mail's ability to respond to competition.
 - ii) Given the significant benefits that providing access to the IMC for participation in the relevant D+2 and later than D+2 markets is expected to deliver, we have considered whether it would be possible to secure the same benefits without imposing a requirement on Royal Mail to offer access. In this context, we note Royal Mail's claims that it would continue to provide access at the Inward Mail Centre in the event that Ofcom did not require it in circumstances in which it helped to sustain the universal service and it was in its commercial interests.
 - iii) However, in our view, regulating access through the imposition of a USP access condition enables us to include safeguards which we consider to be important in the current circumstances and which would not otherwise be present. In particular, by imposing a USP access condition on Royal Mail:
 - operators will be able to use the dispute resolution process outlined by Schedule 3 of the Act;
 - we will be able to impose regulation to protect against excessive pricing or price squeeze if necessary; and
 - we will be able to include other provisions in the USP access condition such as an obligation to set "fair and reasonable" terms and conditions, a requirement to implement a process for requesting access contracts and variations to existing contracts, provisions governing the notification and

publication of terms and conditions, quality of service obligations and a non-discrimination obligation²⁰⁴

- iv) We also note that Royal Mail has proposed developing an access framework on a voluntary basis that will address dispute resolution, principles and criteria for requests for access, pricing principles and guidelines and timescales for responding to requests for access and handling disputes. However, we consider that any move towards a different approach to the regulation of access, such as the voluntary regime that Royal Mail is advocating, could look very different from the current form of access with consequent impacts on customers and competitors. Thus, even if we concluded that a move to such a regime was appropriate, we would wish to ensure that such a move was gradual in order to avoid a risk of regulatory error. While Royal Mail may also have an incentive to make such changes gradually, we consider that there is also a possibility that it may have a different incentive to make changes over a shorter period of time in order to disrupt the market and encourage customers to switch to Royal Mail.
 - v) Given that we are not confident that Royal Mail will have the incentives to offer adequate wholesale products, including appropriate safeguards, to competitors and that we have not seen any evidence that Royal Mail is engaging with access operators to develop an appropriate access framework, we consider that regulation will continue to be necessary if effective and efficient access competition is to continue and that Ofcom has a role to play in ensuring an orderly transition to a future access regime. We therefore consider that the imposition of a USP access condition is objectively justified.
- **Not unduly discriminatory** as it reflects Royal Mail's position as the only postal operator with a downstream delivery network capable of facilitating participation by access operators in the relevant markets;
 - **Proportionate:** we have explained the reasons why regulation will continue to be necessary and why any move to an alternative regime, such as the voluntary access framework that Royal Mail proposed, would need to be implemented gradually. We have also explained why a USP access condition will enable Ofcom to implement important additional safeguards. Indeed, we consider that, without a USP condition, there is a risk of irreversible and permanent damage to the relevant markets. We therefore consider that the condition that we have decided to impose is the minimum necessary in order to safeguard the provision of access and to ensure that the benefits of access competition that we have identified (and that the Act envisages) are capable of being achieved.
 - We also consider that the price control obligation is proportionate, in that the obligation is necessary given the risks that we have identified that Royal Mail might otherwise impose a price squeeze. We also note that the margin squeeze control affords Royal Mail more freedom than under the access headroom control which currently applies. We consider that these measures represent the minimum necessary to ensure that access operators are protected against the risk of price squeeze; and

²⁰⁴ A detailed explanation of these various provisions was set out in our December 2011 consultation. Although we have modified some of the details of how these provisions will work in light of the responses that we received to our December consultation, respondents to the December consultation were broadly supportive of our proposals to include such safeguards in the USP access condition. .

- **Transparent:** we consider that the USP access condition requiring access at the Inward Mail Centre for the purposes of participating in the relevant D+2 and later than D+2 markets clearly sets out Royal Mail's obligations so as to secure maximum transparency possible.

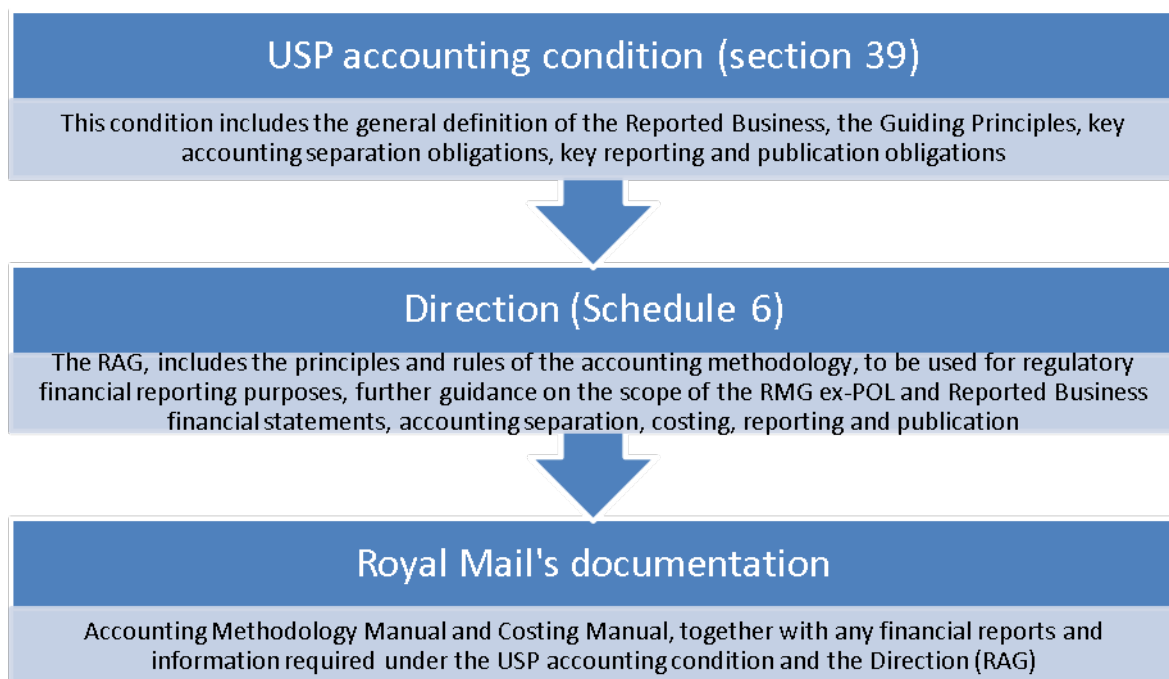
USP accounting (USPAC) condition

- 13.48 We discuss in Section 11 the need for various regulatory financial reporting obligations that we have decided to impose on Royal Mail by means of an USP accounting (USPAC) condition, together with a direction given under powers conferred on Ofcom by that condition to impose detailed requirements and rules in the RAG attached to the direction,
- 13.49 In that section, we summarise our decisions, following our consideration of responses to the consultation, on the main regulatory obligations we have decided to impose on Royal Mail in achieving our objectives for regulatory financial reporting, including to secure our statutory duties. Our more detailed consideration of the responses and related decisions are set out in Annex 3, including our more detailed reasons for our conclusions, which should be read in conjunction with the relevant reasons we set out in the consultation on our associated proposals.
- 13.50 In light of the above, we summarise below why we consider that our decision to impose the USPAC condition set out in the notification published at Annex 10, together with the direction given at Annex 11 imposing the RAG, meet the relevant legal tests and secure or further our statutory duties. This assessment should, however, also be read in light of our overall decisions, considerations and reasoning set out in this Statement.
- 13.51 We have the power under section 39 of the Act to impose a USP accounting condition on Royal Mail as the universal service provider requiring it:
- to maintain a separation for accounting purposes between such different matters as we may direct for such purposes as we may direct, including separation in relation to different services, facilities or products or in relation to services, facilities or products provided in different areas as well as the accounting methods to be used in maintaining the separation;
 - to comply with rules made by us in relation to those matters about the identification of costs and cost orientation, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such accounts and other information relating to anything required to be done by us in this regard;
 - to comply with rules made by Ofcom about the use of cost accounting systems in relation to those matters, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such accounts and other information relating to anything required to be done by Ofcom in this regard; and

- to securing that the universal service provider's compliance with those systems is audited annually by a qualified independent auditor²⁰⁵, including an obligation to meet the costs of the audit.

13.52 Our power to impose a regulatory condition, like the USPAC condition, includes powers to impose obligations also requiring the universal service provider to comply with directions with respect to the matters to which the condition relates, and also powers to impose obligations with respect to those matters framed by reference to, or conditional on, our consent, approval or recommendation.²⁰⁶ In the October consultation, we explained in detail the relationship between the proposed USPAC condition and the RAG. Again, we outline in Figure below the structure and hierarchy of the regulation for regulatory financial reporting that we have decided to impose on Royal Mail.

Figure 6: Structure and hierarchy of regulatory obligations



13.53 We are empowered to impose the USPAC condition if we are satisfied that the general test set out in paragraph 1 of Schedule 6 to the Act is met. A similar test also applies in giving the direction imposing the requirements and rules in the RAG²⁰⁷

13.54 In turning to our assessment of the legal tests, our main decisions set out in this Statement with regard to regulatory financial reporting are, in summary, to require Royal Mail:

- to report separately on the different parts of its business relevant to our regulatory duties;

²⁰⁵ Under section 39, a qualified independent auditor means a person who is eligible for appointment as a statutory auditor under Part 42 of the Companies Act 2006 and, if the appointment were an appointment as a statutory auditor, would not be prohibited from acting by section 1214 of that Act (independence requirement).

²⁰⁶ Paragraph 2 of Schedule 6 to the Act

²⁰⁷ Paragraph 4(2) of Schedule 6 to the Act.

- to further improve the documentation of costing and regulatory accounting more generally;
- to update the form and extent of relevant financial information that is published on a regular basis, and
- to enhance the level of assurance that we can place on the financial information reported for regulatory purposes.

13.55 We are satisfied that the regulatory financial reporting obligations we have imposed on Royal Mail by or under the USPAC condition (including the RAG), including the modifications we have made to our consultation proposals, are:

- **objectively justifiable** as we consider, for reasons explained in the consultation and in this Statement, that these obligations are necessary to effectively achieve the objectives for regulatory financial reporting on which we consulted and that we have decided to pursue as appropriate in light of our overall decisions for the new postal regulation regime. We also consider that these obligations are necessary to ensure that we are able to discharge our duty in section 29 of the Act to carry out our functions in relation to postal services in a way that we consider will secure the provision of a universal postal service, and are consistent with our preferred monitoring regime option for the wider package of regulatory safeguards set out in this consultation.
- i) More specifically, we consider that these obligations are objectively justifiable as they will enable us to:
- monitor the financial sustainability of Royal Mail Group as the universal service provider (having regard to the separate funding and financing of POL), and therefore assist us in securing the provision of the universal postal service;
 - monitor the efficiency and returns made by the Letters business activities of Royal Mail, currently and planned to be used to provide the universal postal service (during the period relevant to the Restructuring Plan on which our reviews of financeability and efficiency in this document have been based);
 - monitor the relative profitability and contributions to overall cash and returns of Royal Mail Group as the universal service provider of different activities within this integrated Letters business, at the level where costs are analysed for regulatory reporting purposes, both to assess the extent to which the pricing of universal services remains cost orientated, and to assess the relative profitability of wholesale and retail services in monitoring for the risk of margin squeeze and assessing their ability to continue to contribute to the funding of universal service activities;
 - monitor the relative profitability of Royal Mail's product groups, including universal service products, using the Letters network and provided to meet the needs of users in different markets, in order to monitor the risk cross-subsidisation and assess the relative cost orientation of the pricing used for products in these different groups; and

- understand the basis by which Royal Mail's shared costs of its integrated universal service network are attributed and allocated for the purpose of relevant regulatory decisions at both national and zonal levels.
- Some specific detailed obligations are also objectively justifiable in discharging our general duties in section 3 of the Communications Act 2003 to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition;
- **not unduly discriminatory** as they aim to address Royal Mail's unique position as the universal service provider and do not impose disclosure requirements which would significantly affect its market position. Some detailed aspects of the obligations (see, in particular, our specification of the detailed accounting lines) also seek to reflect Royal Mail's market power in the respective markets, to which we refer in this Statement;
- **proportionate** in that the obligations are necessary to enable us to discharge our statutory duties and effectively monitor Royal Mail's position and activities. Specifically, we consider that the obligations are the minimum necessary to ensure the successful implementation of our wider package of regulatory safeguards based on monitoring. In our view, these obligations are no more onerous than is required to effectively achieve our objectives for regulatory financial reporting, nor do they produce adverse effects which are disproportionate to those objectives. We set out in Section 11 as well as Annex 3 on regulatory accounting our consideration of issues relating to proportionality in dealing with more detailed aspects of the financial reporting obligations. In so doing, we have also taken into account that Royal Mail needs the ability to adapt the details of its regulatory financial reporting to the changing circumstances of its business, which may potentially continue to be rapid; and
- **transparent** in that we consider it is clear from the wording of the USPAC condition and the RAG what Royal Mail must do and by what timescales. We have made some modifications to our proposals to bring out further clarity to achieve transparency, including to definitional matters. We further consider that the transparency of these obligations is aided by our explanations in this Statement, together with the October consultation.

Consumer protection and essential conditions

- 13.56 Both a consumer protection condition under section 51 of the Act and an essential condition under section 49 of the Act may be imposed on every postal operator or on every postal operator of a specified description.
- 13.57 The Act imposes no specific tests that we must meet in order to be able to impose such conditions, beyond the tests set out in Schedule 6 which apply to the imposition of any regulatory conditions. We consider that the consumer protection conditions and the essential condition that we have decided to impose satisfy those tests, for the reasons set out in this document, and as specifically set out below.
- 13.58 A consumer protection condition is one requiring the operator to:
- Assume specified liability in respect of specified loss of or damage to specified postal packets;

- Establish and maintain procedures, standards and policies with respect to consumer protection matters; and
- Make payments towards the costs of Consumer Focus and Consumer Direct²⁰⁸.

13.59 An essential condition is one containing obligations for or in connection with the following purposes:

- safeguarding confidentiality in connection with the sending, conveyance and delivery of Letters;
- safeguarding security where dangerous goods are transported;
- safeguarding the confidentiality of information conveyed;
- guarding against the theft or loss of or damage to postal packets; and
- securing the delivery of postal packets to the intended addressees.

Tests for imposing consumer protection conditions

13.60 We believe the change to CP 1.2(a) to remove the requirement on RPOs (in relation to regulated postal services) to use reasonable endeavours to collect postal packets as agreed with their customers is:

- **Objectively justifiable** because contractual remedies and market forces should provide the desired levels of collections for customers in the absence of a regulatory requirement. ;
- **Not unduly discriminatory** as the change to CP1.2(a) applies to all RPOs equally;
- **Proportionate** because if the market can reasonably be expected to meet customers' needs it would not be proportionate to impose the requirement at CP 1.2(a); and
- **Transparent** because it is clear that the changes are intended to remove an unnecessary requirement (CP 1.2(a)).

13.61 We believe the requirement for compensation arrangements for universal services is:

- **Objectively justifiable** because in our view compensation is warranted for universal services which are predominantly used by residential customers and small business and these customers need to be protected by way of compensation payable when postal packets are lost, damaged or delayed since they are too small by themselves to be able to negotiate with the USP;
- **Not unduly discriminatory** because the change necessarily affects the USP – and there is only one such USP (Royal Mail) in the UK;
- **Proportionate** because we need to protect senders and recipients of universal services (in relation to compensation for loss, damage and delay), we are only requiring compensation for those universal services for which it is currently

²⁰⁸ The Office of Fair Trading ('OFT') currently funds and manages Consumer Direct.

provided and because we need to ensure compensation is retained for all those services (given they are mainly used by residential customers and small business customers who have no realistic alternatives to Royal Mail or who are unlikely to find legal action an effective remedy); and

- **Transparent** because it is clear that the change is intended to provide regulatory certainty in terms of compensation requirements for universal services.

13.62 We believe deletion of requirements on other RPOs to measure and report on their contract targets is:

- **Objectively justifiable** because competitive drivers should encourage these operators to maintain, monitor and record quality of service absent a regulatory requirement;
- **Not unduly discriminatory** because it applies to RPOs other than Royal Mail and is in line with our approach to remove targets (and reporting on these) for Royal Mail's non-universal services;
- **Proportionate** because the market can reasonably be expected to meet customers' needs – and so it would not be proportionate to impose this regulation; and
- **Transparent** because it is clear that the change is intended to remove an unnecessary requirement.

Notification Condition

13.63 We have decided to impose a notification condition under section 41 of the Act. A notification condition may be imposed on every person providing, or intending to provide, a service within the scope of the universal postal service, or every person providing, or intending to provide, a service within the scope of the universal postal service of a specified description.

13.64 A notification condition is a condition requiring the person to give Ofcom advance notice of the person's intention to provide a Letters business (i.e. a postal service which consists in the delivery of Letters) on a specified scale and, where the person is already providing a Letters business on a specified scale, advance notice of the person's intention to expand the business by a specified extent.

13.65 We set out our reasons for imposing a notification condition in the section on end-to-end competition above.

13.66 We consider the notification condition that we have decided to impose is:

- **Objectively justifiable** because we have been directed to put in place a condition to cover this notification process, and the levels we have decided should trigger the notification requirement are intended to be high enough to avoid the notification of immaterial entry/expansion, but low enough to cover entry/expansion of a scale that, whilst higher than any existing Letter delivery operations in the market, is not likely to be immaterial;
- **Not unduly discriminatory** because it applies to any operator who plans to enter or expand their business (providing a Letters delivery service) above specified thresholds;

- ***Proportionate*** because the thresholds are set at a level which we consider strikes an appropriate balance between the need for us to be notified of material entry whilst not imposing an undue burden on persons/operators; and
- ***Transparent*** because it is clear why this notification is required – that is, to allow us to assess the potential impact of such entry or expansion on universal services.

Annex 1

List of respondents to our consultations

A1.1 There were 72 respondents to the October consultation and 28 respondents to the December consultation. The list below shows whether stakeholders responded to a specific consultation or to both. 'Confidential respondents' refers to those stakeholders who submitted a confidential response or to those who did allow their response to be published (but on an anonymous basis).

Responded to both consultations	Responded to October consultation only	Responded to December consultation only
Consumer Focus	Age UK	Archbishops' Council of the Church of England
Communication Workers Union (CWU)	Alan Reid - MP for Argyll and Bute	MJ Products
Direct Marketing Association (DMA)	Angus MacNeil - MP for Western Isles (Na h-Eileanan an Iar)	Ofcom Advisory Committee for Scotland
DX Group	British Bankers' Association (BBA)	Orkney Community Planning Partnership
Federation of Small Businesses (FSB)	Citizens Advice Scotland	1 individual • Kumar, A
Forum of Private Business	Community and Regional Planning Services	4 confidential respondents - 1 customer and 3 access operators
Intellect	Greeting Card Association	
Mail Competition Forum (MCF)	Laithwaites Wine	
Mail Users' Association (MUA)	Lakeland Ltd	
ONEPOST	Methodist Church in Scotland	
Opus Trust Marketing Ltd	Nationwide Building Society	
Royal Mail	Newhall Publications Ltd	
Secured Mail	PAF Advisory Broad	
Strategic Mailing Partnership (SMP)	Postal Trade Association Forum (Postaf)	
TNT Post UK (TNT)	Professional Publishers Association (PPA)	
UK Mail	Royal National Institute of Blind People (RNIB)	
3 confidential respondents - 1 customer; 1 user group; 1 access operator	Scottish Churches Committee	
	Scottish Churches Rural Group	
	Scottish National Party	
	SLG Economics	
	Unite	
	Which?	
	Yodel	
	10 individuals: • Evans, G • Leftwich, B • Millar, R • Montgomery, J • Peterson, M • Potts, D • Ross, A • Stewart, J • Swatbridge, P • Tinson, L	
	20 confidential respondents - 8 individuals, 10 customers, 1 postal operator and 1 MSP	

Annex 2

New conditions and earlier regimes

Royal Mail licence condition	Standard licence condition	Initial conditions October 2011	Regulatory Conditions April 2012
2	-	DUSP 1	DUSP 1
3	-	DUSP 3	
		DUSP 4	DUSP 1
4	-	DUSP 5	DUSP 1
		(part of) CP 1	CP 4
		CP 2	
		T 1	Lapses
4	2	CP 1.2	CP 5 ²⁰⁹
	2	CP 3	Deleted
5	-	DUSP 6	CP 3
6	-	DUSP 2	DUSP 1
7	-	CP 4	DUSP 1 ²¹⁰
8	3	E 1	E 1
9	-	USPA 1 and 2	USPA
10	-	USPA 3	
11	5	-	-
12	6	-	-
13	-	T 2	Lapses
14	4	CP 5	CP 2
		T5	Lapses
15	-	ACC 1 ²¹¹	USPAC
16	-	T 3	Lapses
17	7	-	-
18	8	-	-
19	-	-	-
20	10	CP 6	CP 1
21	-	T 4	Lapses
		USPA 4	USPA
22	-	Directions to be issued on the Appointed Day	Directions as made on 1 Oct 2011
-	9	-	-
-	11	-	-
-	-	CP 7-9	CP 3
-	-	-	New: safeguard cap – DUSP 2
-	-	-	New: end-to-end notification condition – N 1

²⁰⁹ Contains what was CP 1.2(b) - as CP 1.2(a) has been removed.

²¹⁰ The non-universal services information provision requirement in CP 4 has been deleted. So DUSP 1 contains the CP 4 provision on universal services but at a reduced level (now one month minimum's notice/publication).

²¹¹ ACC 1 applies to the financial year beginning on 28 March 2011 and terminating on the later of the date four months from the end of such financial year or the delivery of the agreed regulatory financial statements.

