



Royal Mail Access Pricing Review

Proposed amendments to the regulatory framework

Consultation

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About this document

The postal sector remains essential to the UK economy, and effective retail competition in post plays a key role in ensuring that postal users and consumers benefit from lower prices, greater choice and innovation.

In recent years we have seen substantial growth in competition through access operations, where operators other than Royal Mail collect, sort and transport mail from bulk senders (such as bank statements, addressed marketing material and local government communications) before handing it to Royal Mail for final delivery.

We have also seen the introduction of end-to-end competition, where operators other than Royal Mail undertake the entire process of collecting, sorting and delivering mail to the intended recipients, which has the potential to extend the benefits of competition to a wider range of postal services. However, end-to-end competition is still in its infancy and represents less than 0.6% of total addressed mail.

Given that end-to-end competition remains reliant on Royal Mail access services to support delivery to those parts of the country where alternative delivery options are not available, we are concerned that Royal Mail has the incentive and ability to seek to disadvantage end-to-end providers and undermine competition in the delivery of bulk mail to the detriment of postal users, and that investment by end-to-end competitors is undermined by uncertainty over the degree to which Royal Mail will act to their disadvantage.

This Consultation sets out our competition concerns in detail. It also sets out our proposed response to those concerns in the form of a draft set of new conditions on Royal Mail's access services, which we consider would prevent Royal Mail from undermining end-to-end competition, while allowing it to continue to compete with end-to-end providers and ensure that it has the potential to receive a fair return from the use of its assets.

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Section 1

Executive summary

The context and scope of this Consultation

- 1.1 In our March 2012 Statement, "*Securing the Universal Postal Service*" we set out our decisions on the new regulatory framework for postal services.¹ This included the imposition of regulation to ensure that the benefits of competition would be maintained in a manner that secures the provision of the universal service.
- 1.2 Our principal duty in carrying out our functions is to further the interests of citizens and of consumers, where appropriate by promoting competition. For postal services, we also have a duty to secure the provision of the universal postal service, to which we must give priority if we consider that there is any conflict with our principal duty. At the time of our 2012 Statement, we did not consider that there was any conflict between these two duties, and as set out in this Consultation, we remain of that view.
- 1.3 We considered at that time that given the challenges Royal Mail faced to ensure it had a financially viable basis for the delivery of its core service,² it was not appropriate to impose a medium-term price control on Royal Mail's retail prices or access services. Instead, we decided to rely on a mixture of constraints, including monitoring and the commercial constraint imposed by:
- 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; and
 - 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).
- 1.4 However, since the March 2012 Statement when we gave Royal Mail commercial freedom, the company has responded by proposing and implementing changes to its contract terms and conditions which we believe could act to discourage and potentially prevent entry and expansion into bulk mail delivery by another operator. This is of concern where such entry could deliver net benefits to consumers.
- 1.5 This Consultation relates to postal services involving the delivery of letters from large organisations (bulk mailers) to individual addressees. In this Consultation, we have set out the changes to Royal Mail's access charges for bulk mail wholesale services (known as D+2 Access), which it has sought to introduce following the March 2012 Statement, and explained how some of these changes raise competition concerns. In essence, we are concerned that Royal Mail's current behaviour could discourage or even prevent competition in bulk mail delivery, leading to reduced pressure on Royal Mail to deliver efficiency improvements and a risk of excessive prices.

¹ Ofcom Statement, "*Securing the Universal Postal Service, Decision on the new regulatory framework*" and Annexes, published 27 March 2012, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>.

² In particular, we noted that Royal Mail faced significant challenges in responding to changes in the demand for mail, especially as a result of switching to electronic alternatives (see, for example, paragraph 6.64 of the March 2012 Statement).

Our duties to secure provision of a universal service and to further the interests of citizens and consumers

- 1.6 We would not consider it appropriate to intervene with respect to end-to-end competition unless we were comfortable that the form of competition supported by our intervention was consistent with our duty under section 29 of the Postal Services Act 2011 (“PSA 2011”) to carry out our functions in a way which will secure the provision of the universal postal service. In performing this duty we must have regard under section 29 to:
- The need for it to be financially sustainable, which includes the need for a reasonable commercial rate of return; and
 - The need for the provision of the universal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient.
- 1.7 We are satisfied on the basis of our assessment set out in the accompanying publication, *Review of End-to-End Competition in the Postal Sector* (“End-to-End Review”), that we do not consider that Royal Mail’s ability to provide the universal service is under threat from end-to-end competition. This Consultation sets out our reasoning that the implementation of our proposals would not change this assessment.
- 1.8 On the other hand, we provisionally consider that there is evidence of a real and current threat to competition, and that if we do not act to modify the existing regulation, the prospect of end-to-end competition will disappear for good, and, with it, one of the key potential drivers of the efficient provision of the universal service in the longer term.
- 1.9 Accordingly, on balance we consider it is appropriate to take steps to seek to ensure that the provision of the universal service becomes and remains efficient and that acting to promote competition would be consistent with this need. We are seeking to promote entry by operators who would put downward pressure on Royal Mail’s retail prices and access charges as a result of genuine competitive advantage. This kind of entry will prevent Royal Mail from charging excessive prices, encourage Royal Mail to reduce its costs and to invest in improving its products and processes, leading to net benefits for postal users, while at the same time minimising the risks of end-to-end competition.
- 1.10 We therefore consider it appropriate to intervene now to preserve the potential for end-to-end competition consistent with and in order to secure the provision of the universal service and promote the interests of citizens and consumers.

Our proposals

Zonal access charges

- 1.11 Certain features of Royal Mail’s recent proposed price changes suggest it could potentially set its zonal access charges in a way that undermines confidence in investment and deters or potentially prevents beneficial localised entry without delivering any benefit to consumers. We consider it has the incentive to do this.

- 1.12 Our objective is to design a remedy that enables Royal Mail to reflect differences in its zonal costs in its zonal charges and does not constrain Royal Mail in determining its absolute return, but at the same time removes the potential for Royal Mail to set charges in a way that can undermine beneficial entry into delivery.
- 1.13 Our preferred approach is to impose on Royal Mail a requirement that, for each mailing item, the ratio of zonal charges must equal the ratio of its unit zonal downstream fully allocated costs by format.³ The key advantage of this remedy is that it allows Royal Mail to determine its overall mark-up and to determine the mark-up on each service separately, preserving desirable commercial flexibility.⁴ It also means an end-to-end entrant would face access charges reflecting Royal Mail's delivery costs in different Zones, reducing the scope for entry to occur in response to an arbitrage opportunity. However, for a given service, it does not allow Royal Mail to set different returns across zones which could potentially be used as a tool to deter entry without delivering any benefit to consumers.
- 1.14 To ensure Royal Mail does not avoid this intervention by creating access services only available in specific zones we would require it to provide, on demand, an offer for every access service for every zone.⁵

National access charges

- 1.15 The majority [80%] of access mail in the UK is carried by Royal Mail under national pricing plans and only a small minority [20%] under zonal pricing plans; Royal Mail is currently required to provide access on fair and reasonable terms and not to unduly discriminate.
- 1.16 Access operators differ from one another e.g. in terms of where the letters are going to (zonally, geographically, business or non-business addressees) and volumes (past and predicted). We consider that Royal Mail has the incentive and ability to use such differences to seek to justify offering differential pricing arrangements between operators on different contracts.
- 1.17 We are concerned that such differentiation could place end-to-end operators at a disadvantage in relation to access operators. This concern is plausible in light of Royal Mail's incentives and observed behaviour.
- 1.18 Were Royal Mail to seek to exploit such differences between operators in the manner suggested above, it would risk undermining the effectiveness of the proposed zonal charging rule as a result of the need for repeated investigation and the uncertainty this would engender.
- 1.19 We consider that the minimum appropriate intervention is to require Royal Mail to derive its national charge for any individual access mailing item directly from its zonal offer. We propose that the national charge must equate to the volume weighted average of the zonal charges for the mailing item.

³ The relevant formats are letters and large letters. Within each format sit many different types of mailing item.

⁴ For example, Royal Mail can take pricing efficiency and cost recovery considerations into account when setting the level of charges for each service. Barcode-based sortation is more efficient than optical reader-based sortation; advertising mail is more price sensitive than transactional mail.

⁵ We note that Royal Mail already publishes charges for all services in all zones.

- 1.20 In order to prevent avoidance of this rule, our proposed modification of the condition would prevent Royal Mail from offering access contracts whose charging was neither national nor zonal.
- 1.21 We publish statutory notifications of our proposed modifications to the regulation in Annex 9, which we propose would take effect six months after the publication of our final Statement, if we decide to proceed with our proposals having considered the responses we receive to this Consultation.
- 1.22 The purpose of this Consultation is to seek input from stakeholders and any other interested parties on our proposals. The deadline for responding to this Consultation is 24 February 2015 and information on how to respond, including our Consultation questions is found in Annexes 1 to 4.

Section 2

Legal framework and Ofcom's duties

Introduction

- 2.1 In this Section, we set out the legal framework and Ofcom's duties relevant for our consideration and assessment of our proposals in order to address the concerns we have in relation to the recent developments affecting access competition, as we discuss in this Consultation.
- 2.2 Ofcom's principal duty under the Communications Act 2003 (the "**CA 2003**") is to further the interests of citizens and of consumers, where appropriate by promoting competition. For postal services, we also have a duty under the PSA 2011 to secure the provision of the universal postal service, to which we must give priority if we consider that there is any conflict with our principal duty. We explain in more detail below how these duties fit together.

Duty to secure provision of a universal postal service

Ofcom's duty under the PSA 2011

- 2.3 Section 29(1) of the PSA 2011 provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service. Section 29(2) provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1). Such conditions include a USP access condition ("**USPA Condition**") under section 38 and a USP accounting condition ("**USPAC Condition**") under section 39, which are two types of regulatory conditions relevant to our proposals in this Consultation.
- 2.4 The universal postal service is a set of services described in an order made by Ofcom.⁶ Retail bulk mail services are not a part of the universal service as described in that Order, but Royal Mail uses the same postal network to deliver bulk mail and the universal postal service.

Financially sustainable and efficient provision of the universal service

- 2.5 Section 29(3) provides that, in performing its duty under section 29(1), Ofcom 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.
- 2.6 Section 29 does not require that Ofcom gives more weight to one of those considerations over the other. We must take them both into account in arriving at a judgment as to how we ought to carry out our functions, including when considering imposing or modifying regulatory conditions.

⁶ The Postal Services (Universal Postal Service) Order 2012, SI 2012/936, as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108 see <http://stakeholder.ofcom.org.uk/post/upso/>.

- 2.7 The concepts of 'financially sustainable' and 'efficient' are not defined in the PSA 2011. As regards the financial sustainability, section 29(4) 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. Whilst the PSA 2011 does not provide further guidance on what is meant by 'a reasonable commercial rate of return', we noted in our March 2012 Statement, "*Securing the Universal Postal Service*" (the "**March 2012 Statement**")⁷ that there is significant regulatory precedent in allowing regulated companies to earn and retain a profit (variously described as the allowed profit or allowed return).
- 2.8 In the March 2012 Statement, we set out our view that an indicative EBIT⁸ 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.⁹ In reaching this view, we noted (among other things) that in a letter dated 15 April 2011 to Ofcom and Postcomm¹⁰, 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.
- 2.9 However, the PSA 2011 gives no express guidance on the meaning of 'efficient'. We consider that this concept is to be aligned with the meaning of economic efficiency, i.e. the use of resources so as to maximize the production of goods and services. Generally, economists identify three¹¹ different types of efficiency:
- productive efficiency – ensuring there is no inefficiency or waste in production so that goods are produced as cheaply as possible, i.e. costs of production are minimised;
 - allocative efficiency – ensuring that the right combinations of goods and services are produced given the tastes and preferences of consumers, i.e. prices are aligned to marginal or incremental costs; and
 - dynamic efficiency – improvements which occur over time as investment and innovation, for example arising from increased competition, result in the development of new goods and services, and technological advances that make the production of current and future goods and services less costly.
- 2.10 Dynamic efficiency can be related back to productive and allocative efficiency, e.g. investment in a process innovation that reduces costs enhances productive efficiency and investment in an innovative new service valued by consumer enhances allocative efficiency. But it is often helpful to identify it as a third type of efficiency,

⁷ Ofcom statement, "*Securing the Universal Postal Service, Decision on the new regulatory framework*" and Annexes, published 27 March 2012, paragraph 5.23, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>.

⁸ "**EBIT**" (earnings before interest and tax) is an accounting and finance measure of a firm's profit that comprises revenue less all the costs of products and services provided before the deduction of interest and tax, also referred to as operating (loss) or profit.

⁹ Paragraph 5.47 of the March 2012 Statement.

¹⁰ The letter is published on BIS' website at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31798/11-874-postal-regulatory-framework-letter-to-ofcom-postcomm.pdf.

¹¹ Productive and allocative efficiency are sometimes collectively referred to as 'static efficiency'.

emphasising the incentives to invest and innovate and the development of competition, even if there is potential for overlap with the other two types of efficiency.

General duties

Ofcom's principal duty under the CA 2003

2.11 Section 3 of the CA 2003 provides that it shall be Ofcom's principal duty, in carrying out its 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.

2.12 Services in relation to which Ofcom has functions include the provision of postal services by postal operators, which may be subject to regulatory conditions that Ofcom may impose on them under the PSA 2011.¹²

2.13 Therefore, this principal duty applies also to functions carried out by Ofcom in relation to postal services. When considering imposing or modifying regulatory conditions in relation to post, Ofcom must have regard to its principal duty.

2.14 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom's general duties in the CA 2003 in the case of conflict between the two where Ofcom is carrying out its functions in relation to postal services. However, if we consider that no conflict arises, Ofcom must carry out our functions in accordance with these general duties and so must further the interests of citizens and of consumers, where appropriate by promoting competition.

2.15 For the reasons set out in section 4 of this Consultation, Ofcom does not consider that there is any conflict between its duty to secure the provision of the universal postal service and its general duties.

2.16 In performing its general duties, Ofcom is also required under section 3(4) of the CA 2003 to have regard to a range of other considerations, which appear to Ofcom 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 needs of persons with disabilities, of the elderly and of those on low incomes;
- 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. Section 3(5) of

¹² Section 1(1) of the CA 2003 refers to such functions as may be conferred on Ofcom by or under any enactment.

the CA 2003 provides that, in performing its duty to further the interests of consumers, Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.

- 2.17 Additionally, pursuant to section 3(3) of the CA 2003, in performing its general duties, Ofcom 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. In this regard, we also note Ofcom's general regulatory principles.¹³
- 2.18 Finally, we have an on-going duty under section 6 of the CA 2003 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.

USPA Condition

Ofcom's powers to impose a USPA Condition

- 2.19 Our proposals in this Consultation involve modifications¹⁴ to the current USPA Condition (see further below).
- 2.20 Pursuant to section 38 of the PSA 2011, Ofcom may impose an USPA Condition on a universal service provider, requiring the provider to do either or both of the following:
- to give access to its postal network to other postal operators or users of postal services, and
 - to 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.
- 2.21 The kind of matters that may be included in a USPA Condition are set out in Schedule 3 to the PSA 2011, including in particular:
- terms of access;
 - price controls, rules made by Ofcom in relation to access matters about the identification of costs and cost orientation, and obligations to adjust prices in accordance with directions given by Ofcom;¹⁵
 - restriction on use of information obtained in connection with giving access;
 - periods of compliance;
 - securing fairness and reasonableness in the way in which requests for access are made and responded to;

¹³ <http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/>

¹⁴ Specifically, the statutory notification published at Annex 9 specifies our proposed modifications to the current USPA Condition.

¹⁵ Ofcom may also include provision requiring the application of presumptions in the fixing and determination of costs and charges for the purposes of such price controls, rules and obligations.

- non-discrimination;
- transparency.

Specific tests for imposing a USPA Condition

2.22 Section 38(4) of the PSA 2011 provides that Ofcom may not impose a USPA Condition unless it appears to it that the USPA Condition is appropriate for each of the following purposes:

- promoting efficiency;
- promoting effective competition, and
- conferring significant benefits on the users of postal services.

2.23 Section 38(8) of the PSA 2011 further provides that, in deciding what obligations to impose in a USPA Condition in a particular case, Ofcom must (in addition to taking into account anything relevant for the purpose of performing their duty under section 29) take into account, in particular, the following factors:

- 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 the universal service provider concerned 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.

2.24 Where Ofcom is considering to impose any price controls on a universal service provider in a USPA Condition, section 38(5) precludes Ofcom from doing so unless it appears to Ofcom that the provider concerned 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 with adverse consequences for users of postal services. Also, in imposing such price controls, Ofcom:

- must have regard to such of the costs incurred in the provision of a universal service provider's postal network, or part of that network, as Ofcom considers appropriate; and
- may have regard to the prices at which services are available in comparable competitive markets, and determine what they consider to represent efficiency by using cost accounting methods.

2.25 Additionally to these specific tests, Ofcom must satisfy the general test for imposing or modifying regulatory conditions, which is discussed below.

The current USPA Condition

2.26 As part of our package of remedies for the new regulatory framework we imposed in 2012, we imposed a USPA Condition¹⁶ on Royal Mail requiring it to offer access (“**D+2 Access**”) at the ‘Inward Mail Centre’¹⁷ (“**IMC**”) for the provision of so-called “**D+2 and later than D+2 Letters and Large Letters services**”¹⁸ only.

2.27 In relation to D+2 Access, we decided in summary¹⁹:

- 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;

¹⁶ See Annex 9 to the March 2012 Statement for the statutory notification imposing the USPA Condition. On 26 February 2013, we published our Statement and Notification to modify USPA 6 in relation to the margin squeeze control imposed on Royal Mail: see http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-margin-squeeze/statement/Statement_on_modification_to_USPA6.pdf (Statement) and http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-margin-squeeze/statement/Change_to_USPA_6_Statutory_Notification.pdf (Notification).

¹⁷ The expression “**IMC**” is defined in USPA 1.3(k) as meaning means the part of the mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre’s catchment area) of mail received from the upstream part of Royal Mail’s network, or from other postal operators, to the final addresses take place. The upstream part of Royal Mail’s network consists of the processes related to collection and distribution of mail.

¹⁸ The expression “**D+2 and later than D+2 Letters and Large Letters services**” is defined in USPA 1.3(h) as meaning retail services that aim to deliver two working days (or later) after collection from the sender, also known as a day C service, or later.

¹⁹ See paragraph 10.225 of the March 2012 Statement.

- to require Royal Mail not to unduly discriminate against any particular persons or against a description of persons in relation to access matters; and
- 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.

USPAC Condition

Ofcom's powers to impose a USPAC Condition

- 2.28 While we are not setting out in this Consultation specific proposals to modify the current USPAC Condition (see further below), this Consultation explains that we expect to make such proposals at a later date (see Section [6] for further details) to ensure that any modified requirements we impose on Royal Mail can be properly enforced and monitored in a practicable and timely manner, by imposing regulatory financial reporting obligations on Royal Mail.
- 2.29 Pursuant to section 39 of the PSA 2011, Ofcom may impose a USPAC Condition on the universal service provider²⁰, requiring the provider to do either or all of the following:
- to maintain a separation for accounting purposes between such different matters as Ofcom may direct for such purposes as it may direct, including requirements about the separation to be maintained in relation to different services, facilities or products or in relation to services, facilities or products provided in different areas, and requirements about the accounting methods to be used in maintaining the separation;
 - to comply with rules made by Ofcom in relation to those matters about the identification of costs and cost orientation, including requirements about the application of presumptions in the fixing and determination of costs and charges for any purpose, and requirements on the provider to publish such accounts and other information relating to anything required to be done as a result of those provisions as Ofcom consider appropriate;
 - to comply with rules made by Ofcom about the use of cost accounting systems in relation to those matters, including requirements about the application of presumptions in the fixing and determination of costs and charges for any purpose, and requirements on the provider to publish such accounts and other information relating to anything required to be done as a result of those provisions as Ofcom consider appropriate; and
 - to secure that its compliance with those systems is audited annually by a qualified independent auditor, including an obligation on the provider to meet the costs of the audit.
- 2.30 Section 39 also provides that, if a USPAC Condition imposes rules on a universal service provider about the use of cost accounting systems, Ofcom may secure that the condition also imposes an obligation on the provider to make arrangements for a description to be made available to the public of the cost accounting system used. If such an obligation is imposed, the description of information to be made available must include details of the main categories under which costs are brought into

²⁰ See footnote 16 above.

account for the purposes of that system, and the rules applied for the purposes of that system with respect to the allocation of costs.

- 2.31 Ofcom's powers to impose a regulatory condition include 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.²¹

Specific tests for imposing a USPAC Condition

- 2.32 In contrast to section 38 of the PSA 2011 (for the USPA Condition), section 39 does not impose on Ofcom any specific tests for imposing a USPAC Condition.

The current USPAC Condition

- 2.33 Our package of remedies for the new regulatory framework we imposed in 2012 also included the imposition of a USPAC Condition.²²

- 2.34 The current USPAC Condition imposes on Royal Mail various regulatory reporting obligations. Those obligations impose several requirements on Royal Mail, such as financial statements and information to be provided by Royal Mail, accounting standards, auditing and publication. Broadly speaking, the condition imposes:

- general obligations (USPAC 1.2);
- obligations relating to the Relevant Group (USPAC 1.3);
- obligations relating to the Reported Business (USPAC 1.4);
- obligations relating to the separated Reported Business (USPAC 1.5);
- obligations relating to the Costing Manual and the Accounting Methodology Manual (USPAC 1.6); and
- obligations to comply with the Guiding Principles etc. (USPAC 1.7).

- 2.35 We also gave a direction²³ that the USPAC Condition shall have effect by reference to Regulatory Accounting Guidelines ("**RAG**") set out in the Schedule to the direction.

- 2.36 In summary, by these requirements under the USPAC Condition, we required Royal Mail:

- to report separately on the different parts of its business relevant to our regulatory duties;

²¹ Paragraph 2 of Schedule 6 to the PSA 2011.

²² See Annex 10 to the March 2012 Statement for the statutory notification imposing the USPAC Condition. It has been modified subsequently: see Ofcom's Statement entitled *Updating the Regulatory Reporting Framework- Statement USP Accounting Condition* (27 January 2014), <http://stakeholders.ofcom.org.uk/consultations/regulatory-reporting-framework/statement/>.

²³ See Annex 11 to the March 2012 Statement for the Direction imposing the requirements and rules in the RAG. It has been modified subsequently: see Annex 2 of Ofcom's statement entitled *Updating the Regulatory Reporting Framework- Statement USP Accounting Condition* (27 January 2014), <http://stakeholders.ofcom.org.uk/consultations/regulatory-reporting-framework/statement/>.

- 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.

General test for imposing regulatory conditions

2.37 Schedule 6 to the PSA 2011 provides that Ofcom may impose or modify a regulatory condition only if it is satisfied that the condition or modification:

- 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.

2.38 We set out our views on the application of this general test, together with the other legal tests and duties referred to above, to our proposals later in this Consultation.

General impact assessment

Assessing different regulatory options

2.39 The analysis presented in the whole of this Consultation represents an impact assessment, as defined in section 7 of the CA 2003.

2.40 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 CA 2003, 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 to impact assessments, see our guidelines, '*Better policy-making: Ofcom's approach to impact assessment*'.²⁴

2.41 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 CA 2003) is secured or furthered by or in relation to what we propose.

Equality impact assessment

2.42 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:

²⁴ <http://www.ofcom.org.uk/about/policies-and-guidelines/better-policy-making-ofcoms-approach-to-impact-assessment/>

- 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.

- 2.43 Such equality impact assessments (“**EIAs**”) also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 discussed above.
- 2.44 We have therefore considered what (if any) impact the proposals in this Consultation may have on equality.
- 2.45 As set out in Section 4, we have identified a risk that, absent intervention, charges for bulk mail sent using so-called “zonal contracts” could be relatively high in rural areas. This may reduce volumes of bulk mail being sent to those areas. Such areas could be disproportionately inhabited by groups with protected characteristics. On the other hand, charges for bulk mail sent using zonal contracts could be relatively low in urban areas (particularly London), which may increase the volumes of mail being sent there. These areas, too, could be disproportionately inhabited by groups with protected characteristics. We consider that any such impact is likely to be very small indeed particularly as only a small proportion of access mail is delivered under zonal contracts. The ultimate benefit or disbenefit to such groups would be impossible to quantify because it would depend on the subjective value they place on receiving such mail.
- 2.46 We have also identified a risk that absent intervention, prices for postal services may be higher than they otherwise would be, which may disproportionately affect groups with protected characteristics if any are more dependent on postal services. Our proposals may, to the extent that they address this issue, indirectly benefit these groups. However, any such benefit is unlikely to be very much greater than it is for the population in general.
- 2.47 Overall, we do not consider that the equality impact of our proposals is likely to be material either way. 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.

Section 3

Background

Introduction

3.1 This Section sets out the background to this Consultation. We describe the value chain for postal services, competition and regulation and how Royal Mail has reacted to the increased pricing freedom it has enjoyed since 2012.

Context of this Consultation

3.2 The market for the delivery of letters in the UK has been in a state of general decline for a number of years, as increased take-up of technologies such as email, social media and text messaging have offered consumers immediate, low-cost alternatives to sending mail.

3.3 Trends in mail volumes differ markedly between letters and parcels. Since 2006, the letters sector – which this Consultation focuses on – has declined significantly, with volumes falling by 6.3% per annum from 2008 to 2013.²⁵ In contrast, the parcels sector is growing, largely due to the increased take-up of online shopping, with volumes increasing by 3.7% per annum over the same period.²⁶

3.4 Total addressed mail volumes fell from 16.1 billion items in 2009-10 to 12.8 billion items in 2013-14.²⁷ In recent years the rate of decline has slowed down; total mail volumes decreased by 3.2% to 12.8 billion items in 2013-14 from 2012-13 compared to a decline of 6.8% between 2010-11 and 2011-12.²⁸ Year on year, bulk mail volumes have declined by 3.3%.²⁹ This volume decline continues to be lower than the overall addressed mail volume decline which would suggest business mail volumes (which include transactional mail) may have been less affected by factors, such as e-substitution, which are contributing to the decline in some other forms of addressed mail³⁰.

3.5 In 2013-14, total mail revenues grew for the third consecutive year, increasing by 1.7% to reach £7.5 billion, with Royal Mail's revenue accounting for the majority of total mail revenues.³¹ However, price increases, including the introduction of size-based pricing for small parcels in April 2013, are responsible for much of the increase in revenue.³²

3.6 Ofcom has designated Royal Mail as the UK's universal service provider ("**USP**") and has imposed upon it regulatory conditions requiring it to provide the universal service.³³ This means that Royal Mail has a number of obligations to deliver a

²⁵ The outlook for mail volumes to 2023, PwC, July 2013, page 7.

²⁶ The outlook for mail volumes to 2023, PwC, July 2013, page 7.

²⁷ Annual Monitoring Update 2013-14, 2 December 2014, <http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/>, figure 6.1.

²⁸ Annual Monitoring Update 2013-14, figure 6.1.

²⁹ Annual Monitoring Update 2013-14, paragraphs 1.7 and 3.25.

³⁰ Annual Monitoring Update 2013-14, paragraph 3.25.

³¹ The 2014 Communications Market Report, Ofcom, Figure 6.7, page 380.

³² Annual Monitoring Update 2013-14, paragraph 3.31.

³³ Ofcom's designation of Royal Mail as the USP is in Annex 1 of Ofcom's Statement *Postal regulation: Transition to the new regulatory framework* dated 29 September 2011, available at:

minimum level of service. In its most basic form, the universal service obligation (“**USO**”) requires Royal Mail to collect and deliver letters six days per week at uniform prices across the UK.

- 3.7 Royal Mail fulfils its USO by providing certain services, including First and Second Class mail up to 20kg, Special Delivery, Signed For and Services for the Blind. However, the universal service, and hence Royal Mail’s USO, does not extend to all types of mail. Bulk mail (large amounts of mail, generally sent by large organisations such as banks, local authorities and charities at a reduced price) is not a part of the universal service. Bulk mail falls into a number of different categories, including transactional mail (mail sent following a consumer’s interaction with a company, such as bank statements and invoices), publishing mail (such as newsletters and magazines), and advertising mail.
- 3.8 Trends in mail volumes and revenues by type of mail and by service type are discussed in more detail in our Annual Monitoring Report.³⁴

The value chain in postal services

- 3.9 As can be seen from Figure 3.1, there are a number of stages to the value chain in postal services. In (broad) summary:
- Mail is collected from post boxes, post offices or, in the case of bulk mailers, the mailer’s premises;
 - Most mail is sorted at the outward mail centre (“**OMC**”) (some mail misses this stage out as the sender arranges for it to be pre-sorted);
 - Mail is transported to the IMC³⁵, where it is sorted again;
 - Then it is transported to the delivery offices, where it is sorted into walks; and
 - Then it is delivered to the recipient’s address.

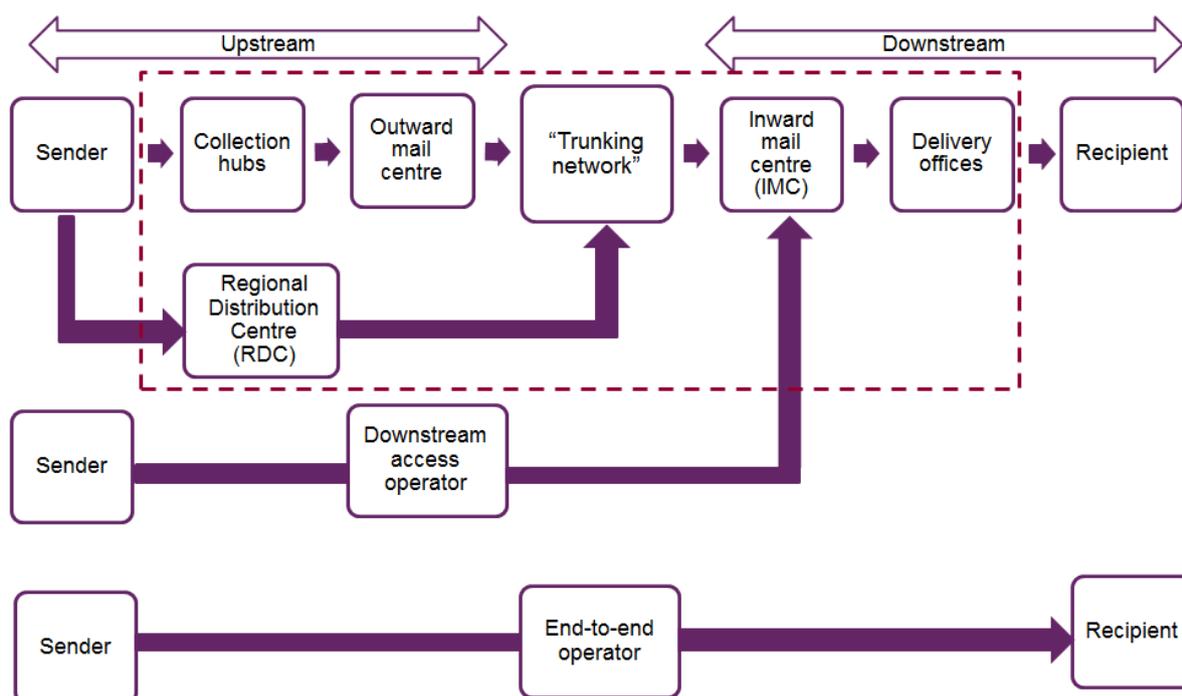
<http://stakeholders.ofcom.org.uk/binaries/consultations/postal-regulation/statement/statement.pdf>.

Ofcom imposed a Designated USP condition on Royal Mail on 27 March 2012, which has been modified on a number of occasions since. See also paragraphs 2.19 to 2.36.

³⁴ Annual Monitoring Report 2013/14 <http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/>

³⁵ As defined in Section 2, footnote 17.

Figure 3.1 Royal Mail's domestic mail pipeline



3.10 The network is divided into two parts. The ‘upstream’ part of the network is where mail is collected, initially sorted (where necessary, unless it has been pre-sorted by the customer) and transported to the IMC (referred to as ‘trunking’). The ‘downstream’ part of the network is where the mail is sorted again and delivered to the end customer. Competition in postal services in the UK covers bulk mail services only. The main form of competition is in the upstream part of the network and is known as ‘access competition’. It usually involves an operator collecting bulk mail from the customer, sorting it (unless the mail has been pre-sorted by the customer) and then transporting it to Royal Mail’s IMCs, where it is handed over to Royal Mail for delivery to the recipient. Royal Mail charges the access operator an access charge for carrying out this delivery.³⁶

3.11 Royal Mail is required to provide access for the delivery of “D+2 and later than D+2 Letters and Large Letters”³⁷ on fair, reasonable and not unduly discriminatory terms.³⁸ The two main access operators are Whistl (formerly TNT Post UK) and UK Mail. Together, they account for the majority [36] of all access volumes.³⁹ There are many smaller access operators, of which Secured Mail is the largest.

3.12 The other form of competition in bulk mail is end-to-end competition, which is where competitors to Royal Mail collect, sort and, importantly, at least in part, deliver bulk mail in their own networks, by-passing Royal Mail’s network entirely. Clearly, an end-to-end postal operator retains the entire per item revenue from those items which it collects and delivers. Thus, full end-to-end service competition leads to a significantly

³⁶ In this Consultation, we use the term “access charge” to refer to Royal Mail’s wholesale charges. This distinguishes them from the retail price charged to the bulk mail sender.

³⁷ As defined in Section 2, footnote 19. The phrase “D+2” relates, broadly to the number of working days after the day (“D”) the mail is posted, before which it is expected to be delivered.

³⁸ USPA3.1 and 5.1, as referred to in Section 2, paragraph 2.31 of this Consultation.

³⁹ Ofcom analysis of operators’ returns.

greater loss of revenue by Royal Mail than access competition.⁴⁰ Put another way, end-to-end operators expose much more of the value chain to competition than access-only operators. As we explained in our 2013 guidance document, *End to end competition in the postal sector* (the “**2013 end-to-end Guidance**”),⁴¹ on a like for like basis, the impact on Royal Mail’s revenues of end-to-end competition is significantly greater than that of access competition, as Royal Mail retains 85% to 90% of the total revenue for access mail but is not involved in any part of the value chain for items processed and delivered directly to the receiving customer by another operator.⁴²

- 3.13 By far the largest end-to-end competitor to Royal Mail is Whistl, which began its own delivery services in April 2012. However, end-to-end competition in the UK remains limited. In 2013, end-to-end operators other than Royal Mail, (of which Whistl is by far the largest), delivered less than 0.6% of total addressed mail.⁴³
- 3.14 There is no national end-to-end network other than that of Royal Mail. Therefore, in order to be able to offer UK-wide services, end-to-end operators are reliant on access to Royal Mail’s network in those areas where they do not have delivery networks of their own.
- 3.15 Access competition in the UK began in 2004 pursuant to what was then Condition 9 (“**C9**”) of Royal Mail’s licence, which required it to negotiate with postal operators and users in good faith with a view to agreeing terms for access to its network.⁴⁴ Although access contracts have changed from time to time since then, some aspects of today’s arrangements can be traced back to these original agreements. In particular, the C9 contracts provided for access either on a national or a zonal basis.
- 3.16 Nationally priced contracts included uniform national prices⁴⁵ but provided that surcharges may be charged if the operator failed to fulfil a national geographic profile requirement. i.e. to match the profile of Royal Mail’s own deliveries. The provision reflected the fact that the cost of delivering to different areas varies. Generally, it is likely to be cheaper to deliver to areas with a high density of delivery points, such as cities and towns, as the amount of time a postal worker needs to travel between delivery points is reduced. Furthermore, mail volumes tend to be higher in urban areas compared with the national average which also tends to lower the average cost per item.⁴⁶ Rural areas, where delivery points are more sparsely distributed, tend to be more costly to serve. A number of other factors also influence delivery costs, including the distance from the delivery office to the delivery destination, the ease of accessing delivery points (e.g. the availability of a lift versus using the stairs), and wages arrangements.

⁴⁰ As we noted in the October 2011 Consultation, paragraph 1.62.

⁴¹ *End to end competition in the postal sector, Final guidance on Ofcom’s approach to assessing the impact of the universal postal service*, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf.

⁴² 2013 end-to-end Guidance, paragraph 3.17.

⁴³ Annual Monitoring Update 2013-14, paragraphs 1.7 and 6.30.

⁴⁴ These contracts have consequently become known as “**C9 contracts**”.

⁴⁵ *The building blocks for a sustainable postal service: Initial proposals for regulatory safeguards – Annex C - Zonal Access*, Postcomm, April 2011, paragraph 1.9 <http://stakeholders.ofcom.org.uk/binaries/post/1890.pdf>.

⁴⁶ *Direct delivery: a threat to the universal service*, regulatory submission provided to Ofcom by Royal Mail on 20 June 2014, page 26, <http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission%20Final%20Version%20for%20Publication.pdf>.

- 3.17 On the other hand, access operators could use a zonal access agreement for mail that did not share Royal Mail's geographic profile. Under the zonal access agreements, the charge for sending an item of mail was different depending on the zonal classification of the mail item's destination. Royal Mail allocated each of the postcode sectors in the UK to a delivery zone and the charge for each mailing was based on the number of items for delivery in each zone multiplied by the charge for each particular item for each zone.⁴⁷
- 3.18 Since 2009, there have been four zones: an **Urban Zone**, **Suburban Zone**, **Rural Zone** and **London Zone** (together, the "**Zones**"). The London Zone was and remains the only geographically contiguous Zone, relating to postcodes within the M25. The other three Zones divided the UK into geographically non-contiguous areas of varying delivery point density and business delivery point density, which are the low-density Rural Zone, mid-density Suburban Zone and high-density Urban Zone. The Zones reflect the broad variation in delivery costs. Royal Mail sets different charges for different Zones relative to the national average charge – we refer to this as the "**Zonal tilt**".
- 3.19 [X] Only a small minority of D+2 Access mail was delivered under the Zonal access agreements in 2013-14.⁴⁸

The March 2012 Statement

- 3.20 When Ofcom took over regulation of the postal industry from the then regulator Postcomm in October 2011, Royal Mail was under serious financial pressure, putting the universal service under threat.⁴⁹
- 3.21 Since 2006, Royal Mail had been subject to a price control on the majority of its services.⁵⁰ The price control had fixed the margin between Royal Mail's access services and its corresponding retail services.⁵¹ However, the assumptions within the price control formula had been proved wrong.⁵² Neither Postcomm nor Royal Mail at the time had accurately predicted the pace of volume decline in a highly uncertain market environment and Royal Mail had lost substantial upstream bulk volumes.⁵³
- 3.22 On 27 March 2012, Ofcom published the March 2012 Statement,⁵⁴ which followed our consultation of the same title, published on 20 October 2011 ("**the October 2011 Consultation**").⁵⁵ The March 2012 Statement introduced a new regulatory framework, which moved away from the traditional approach to regulating Royal Mail

⁴⁷ *The building blocks for a sustainable postal service: Initial proposals for regulatory safeguards – Annex C Zonal Access*, Postcomm, April 2011, paragraph 1.10, <http://stakeholders.ofcom.org.uk/binaries/post/1890.pdf>. In 2004 there were 5 zones but this was reduced to four in 2009.

⁴⁸ Royal Mail in letter of 21 November 2014

⁴⁹ The October 2011 Consultation, paragraph 1.8.

⁵⁰ Royal Mail was subject to a series of price control mechanisms between 2001 and 2011. The price control imposed on Royal Mail in 2006 was the last price control set by Postcomm before Ofcom took over responsibility for the regulation of post.

⁵¹ *Royal Mail's Price and Service Quality Review 2006-2010: Licence Modifications Proposals*, Postcomm, March 2006: <http://stakeholders.ofcom.org.uk/binaries/post/1083.pdf>

⁵² October 2011 Consultation, paragraph 4.27.

⁵³ October 2011 Consultation, paragraph 4.28.

⁵⁴ As defined in paragraph 2.7.

⁵⁵ The October 2011 Consultation,

<http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>

based on price controls and provided Royal Mail with more freedom in relation to the pricing of most of its services. The March 2012 Statement also provided Royal Mail with greater operational flexibility, by reducing the notification and publication and pre-approval requirements for product changes and new services.

- 3.23 Underlying our decision was our recognition that a price control-based approach had failed to achieve the regulatory objectives specified at the time of its introduction in 2006. We noted that price controls had not been effective in ensuring that Royal Mail had improved efficiency, had not protected consumers against price rises, and had resulted in a position where the universal service was approaching a point where it was no longer financially sustainable.⁵⁶
- 3.24 At the heart of our proposals in the March 2012 Statement was our commitment to secure the provision of the universal postal service. Our objectives were to grant Royal Mail sufficient pricing flexibility to ensure it could continue to provide the universal service on a sustainable basis and sufficient commercial freedoms to adapt to the changing market environment. We also aimed to maintain the benefits of competition in supporting the efficient provision of the universal service.⁵⁷
- 3.25 We recognised that removing price controls would come with serious risks. We considered the most significant of these to be the risk that Royal Mail would not take on the challenge of improving efficiency and would rely solely on pricing to return itself to profitability, potentially excluding vulnerable customers and precipitating a more rapid decline in the mail market.⁵⁸ We therefore considered a number of safeguards were appropriate to encourage Royal Mail to improve its efficiency and to prevent it from charging at a monopoly level. These were:
- Capping the price of Second Class Letters at 55p and Large Letters and packets at a 53% increase (to rise in line with CPI) to ensure a basic universal service is available to all;
 - Introducing an effective and ongoing monitoring regime to track Royal Mail's performance (for example on quality of service and affordability of universal service mail, and progress on efficiency), as well as monitoring changes in the postal industry; and
 - Imposing a USPA Condition⁵⁹ requiring Royal Mail to grant access at the IMC for the provision of retail D+2 and later than D+2 Letters and Large Letters.
- 3.26 With regard to access pricing specifically,⁶⁰ we considered that access competition would provide incentives for the provision of the universal service to be financially sustainable and efficient and that, providing that the charges paid by access operators reflected Royal Mail's costs, it would do so without threatening the sustainability of the universal service.⁶¹

⁵⁶ The March 2012 Statement, paragraph 1.23. <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>

⁵⁷ The March 2012 Statement, paragraph 1.16.

⁵⁸ The March 2012 Statement, paragraph 1.20.

⁵⁹ The USPA Condition is discussed in more detailed in paragraphs 2.28 to 2.36.

⁶⁰ At this time, there was no end-to-end competitor of scale in the UK. However, we noted that end-to-end competition could potentially provide both risks and benefits (including incentives to reduce costs, innovate and focus on customer service, as noted in paragraph 1.53 of the March 2012 Statement) to the universal service.

⁶¹ The March 2012 Statement, paragraph 13.38.

- 3.27 We recognised that the headroom regime that was put in place in 2006 prevented Royal Mail from competing effectively.⁶² However, we considered that a price control obligation was appropriate in order to protect against the risk of Royal Mail imposing a margin squeeze.^{63, 64} We aimed to impose a form of control which allowed Royal Mail to charge prices to reflect its costs and investment in its network.⁶⁵ Therefore, although we decided against directly regulating access charges, we relied on an ex ante margin squeeze test to ensure effective competition between Royal Mail and access operators.⁶⁶ Royal Mail was required to maintain a minimum cost-based margin between its retail prices and its access charges.⁶⁷
- 3.28 Royal Mail was also required to offer access for the provision of retail D+2 and later than D+2 Letters and Large Letters services on fair, reasonable and not unduly discriminatory terms.⁶⁸ We did not provide detailed guidance on how we would interpret ‘fair and reasonable’ in the context of any dispute over access charges, as we considered that the provision of a separate guidance document would be more appropriate after the new access regime had time to become established. Nonetheless, we recognised that both access operators and customers had requested specific guidance on how Ofcom would interpret ‘fair and reasonable’ in relation to some key areas, which included surcharges for access and Zonal access pricing. We therefore provided an indication of the high level principles and issues we would be likely to take into account if assessing a dispute in one of these areas.⁶⁹
- 3.29 In relation to surcharges, we said that a ‘fair and reasonable’ approach may, alongside any other relevant factors, include reference to the principles of transparency and proportionality.⁷⁰
- 3.30 In relation to Zonal access charges, we said that Royal Mail should:
- Take into account the alignment of Zonal charges with Royal Mail’s costs;
 - Seek to ensure that the weighted average of Zonal access charges is broadly comparable to the national access charge; 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.⁷¹
- 3.31 Through the March 2012 Statement we also implemented a notification condition requiring operators who intend to introduce (or expand) a competing Letters delivery service to inform us of their plans three months in advance, to allow us to assess the potential impact of end-to-end competition on the provision of the universal service

⁶² The March 2012 Statement, paragraph 13.42.

⁶³ We considered that implementing a margin squeeze test would ensure that the difference between the access charge and the retail price was kept at a level that allowed efficient access competitors to compete effectively.

⁶⁴ The March 2012 Statement, paragraph 13.47.

⁶⁵ The March 2012 Statement, paragraph 13.42.

⁶⁶ The March 2012 Statement, paragraph 1.50.

⁶⁷ USPA 6.1.

⁶⁸ USPA 3.1 and 5.1.

⁶⁹ The March 2012 Statement, paragraph 10.65.

⁷⁰ The March 2012 Statement, paragraph 10.67.

⁷¹ The March 2012 Statement, paragraph 10.153.

on a case-by-case basis. This was in recognition of the potential benefits and risks to the universal service from end-to-end competition.

Whistl's entry into end-to-end delivery services

- 3.32 In April 2012, Whistl started trialling end-to-end deliveries to residential customers in West London. Following this trial, it expanded its end-to-end delivery service to parts of Central, South West and North London, Manchester and Liverpool, delivering bulk mail every other day. This represented the first large-scale introduction of end-to-end competition in the UK. Over the course of 2012 operators other than Royal Mail delivered 18.0 million items⁷², of which Whistl made up the majority [§<].⁷³
- 3.33 In 2013, volumes delivered end-to-end by operators other than Royal Mail more than tripled compared to the previous year, reaching 80 million letters,⁷⁴ again with the large majority delivered by Whistl [§<].⁷⁵ However, end-to-end competition is still in its infancy, and this represents less than 0.6% of total addressed mail.⁷⁶
- 3.34 In contrast, access volumes have grown significantly since 2005 and in 2013-14 access mail as a proportion of total addressed mail was 56%.⁷⁷ Access operators accounted for 7.2 billion items in 2013-14⁷⁸, compared to 5.5 billion items carried end-to-end by Royal Mail.⁷⁹
- 3.35 However, 2013 was the first year in which we recorded a decline in access volumes; in 2013-14 they fell by 1.0% (this decline was at a slower rate than the decline in total mail volumes, so the proportion of access mail continued to rise).⁸⁰ We noted in our 2014 Communications Market Report that the slight decline in access mail represents the maturity of bulk mail delivery, as those senders who are able and willing to send their mail using access services are already doing so.⁸¹

Royal Mail's reaction to pricing freedom

- 3.36 As noted above, our regulatory approach set out in the March 2012 Statement removed the majority of price controls on Royal Mail to allow it the commercial flexibility to manage its revenues to return the universal service to financial sustainability, dependent on a number of safeguards, including the commercial constraint on pricing imposed by competition. Ofcom does not approve Royal Mail's prices – it is up to Royal Mail to comply with applicable laws and regulations. Royal Mail's changes to its access contracts since 2012 are discussed below.

2013 changes to the access contracts

- 3.37 In 2012, after being given increased commercial freedom in the March 2012 Statement, Royal Mail informed us that it was giving consideration to how its access arrangements could be adjusted to reflect the new regulatory environment, including

⁷² The 2014 Communications Market Report, Ofcom, Figure 6.8, page 381.

⁷³ Operator confidential returns.

⁷⁴ Annual Monitoring Update 2013-14, figure 6.1.

⁷⁵ Operator confidential returns

⁷⁶ Annual Monitoring Update 2013-14, paragraphs 1.7 and 6.30.

⁷⁷ Annual Monitoring Update 2013-14, paragraphs 1.7 and 6.9.

⁷⁸ Annual Monitoring Update 2013-14, paragraphs 1.7 and 6.9.

⁷⁹ Annual Monitoring Update 2013-14, figure 6.1. The figures in paragraphs 3.33 and 3.34 relate to total addressed mail.

⁸⁰ Annual Monitoring Update 2013-14, paragraph 6.12.

⁸¹ The 2014 Communications Market Report, Ofcom, page 381.

in response to the challenges posed by end-to-end competition to the financing of the Universal Service.⁸²

- 3.38 Royal Mail proposed new access contracts to reflect the changes to the postal market and its regulation that had occurred since the original C9 access contracts were agreed in 2004.⁸³ It also proposed lower access charges for customers who gave Royal Mail forecasted volume commitments with a national profile over an unspecified period of time.⁸⁴
- 3.39 Following Royal Mail's October 2012 consultation, it introduced new access contracts. However, it decided not to proceed with the proposed introduction of a pricing system rewarding customers forecasting volume commitments. It said that customer feedback revealed that the industry would need more time to implement these proposals due to their complexity.⁸⁵ However, Royal Mail noted that it would continue to work with a view to introducing some form of volume commitment pricing.⁸⁶
- 3.40 The new access contracts, absent any volume commitments, were introduced in 2013 ("**the 2013 access contracts**"). They consisted of two national price plans and one Zonal price plan, the details of which were broadly as follows:
- National Price Plan 1 ("**NPP1**") offered uniform national access charges for each mailing item, independent of the mailing address. This was subject to a number of eligibility and performance requirements measured across individual contiguous postcode areas (known as "standard selection codes" or "**SSCs**" – they broadly correspond to the letters and numbers of a postcode). There are 86 SSCs in the UK.
 - Averaged Price Plan 2 ("**APP2**")⁸⁷ offered a uniform national access charge for each mailing item throughout the UK, independent of the mailing address. As with NPP1, this was subject to a number of eligibility and performance requirements, but under APP2 these were measured across the four Zones.
 - Zonal Price Plan 3 ("**ZPP3**") did not have any relevant eligibility criteria. The ZPP3 tariff contained, for each access service, a separate access charge for each of the four Zones based on a specified variance against the APP2 charge. Under the 2013 access contracts, these access charges were⁸⁸:

⁸² [S&K]

⁸³ Royal Mail Discussion Document: Proposals for the Reform of the Access Contracts, October 2012, paragraph 1.2.

⁸⁴ Royal Mail Discussion Document: Proposals for the Reform of the Access Contracts, October 2012, paragraph 5.15.

⁸⁵ Letter from Royal Mail to its access customers, January 2013, <https://www.royalmailwholesale.com/mint-project/uploads/700293857.pdf>.

⁸⁶ Letter from Royal Mail to its access customers, January 2013, <https://www.royalmailwholesale.com/mint-project/uploads/700293857.pdf>.

⁸⁷ Under the 2013 access contracts, this price plan was known as "National Price Plan 2 (zones)". The name of the price plan was changed by Royal Mail as part of its suite of contract changes in November 2013 and January 2014, which are described in more detail in paragraphs 3.45 to 3.51. As this suite of changes has been suspended by Royal Mail, the name change has not yet come into effect. However, for the avoidance of doubt, we refer exclusively to this price plan as APP2 in the remainder of this Consultation.

⁸⁸ The variances against APP2 here use a weighted average of the Zonal variances illustrated in the first two rows of Figure 3.2.

- Urban Zone: 12.9% lower than the average national price;
 - Suburban Zone: 0.15% higher than the average national price;
 - Rural Zone: 14.12% higher than the average national price; and
 - London Zone: 10.08% higher than the average national price.
- 3.41 The eligibility and performance requirements on the national price plans (NPP1 and APP2) under the 2013 access contracts included requirements for access operators on the national contracts to broadly match Royal Mail's own national delivery profile, within certain tolerances.
- 3.42 These types of requirements are used as gateways (to determine which operators are eligible to be on the plans at all) and as ongoing requirements (to make sure operators pay if they fail to comply with the profile). NPP1 and APP2 have different eligibility/profile requirements. An operator is eligible to use NPP1 if it can prove to Royal Mail's reasonable satisfaction that it has a reasonable likelihood of meeting two benchmarks,⁸⁹ which essentially means that NPP1 customers have to send mail to almost every part of the UK. An operator is eligible to use APP2 if it can prove to Royal Mail's reasonable satisfaction that it is reasonably likely to meet Royal Mail's Zonal Posting Profile,⁹⁰ which requires the operator to balance the level of mail it sends to each of the four Zones. These performance requirements are assessed on an ongoing basis. If the tolerances are breached operators may incur surcharges known as 'profile surcharges'. If an NPP1 or APP2 operator incurs more than a certain level of profile surcharges, Royal Mail is able to require that the operator leaves NPP1 or APP2 and switches to ZPP3.^{91 92}
- 3.43 To encourage operators to adopt the 2013 access contracts, Royal Mail reduced charges by 2.44% compared with the C9 contracts.⁹³ Most operators accepted the new contracts.⁹⁴
- 3.44 The access contracts introduced in 2013 are the access contracts under which most access operators currently operate. Whistl currently operates under ZPP3 and APP2.⁹⁵

The 2013/14 Notices

- 3.45 On 5 November 2013 and 10 January 2014, Royal Mail notified changes to its access contracts to take effect from 31 March 2014 ("**the 2013/14 Notices**").⁹⁶
- 3.46 On 5 November 2013, Royal Mail reduced the tolerances within which an NPP1 or an APP2 customer would be permitted to fail to meet Royal Mail's delivery profile.⁹⁷

⁸⁹ Access Letters Contract (2013), Schedule 3, Option A, paragraph 2.1.

⁹⁰ Access Letters Contract (2013), Schedule 3, Option B, paragraph 2.1.

⁹¹ Access Letters Contract (2013), Schedule 3, Option A, paragraph 11.1.

⁹² Access Letters Contract (2013), Schedule 3, Option B, paragraph 8.1.

⁹³ Royal Mail letter to its access customers, January 2013,

<https://www.royalmailwholesale.com/mint-project/uploads/700293857.pdf>.

⁹⁴ A small number of customers declined to accept the new contract and continued to operate under the C9 contracts.

⁹⁵ Whistl response to question 3 of section 26 notice dated 1 August 2014.

⁹⁶ Royal Mail letter to its access customers, January 2014,

<https://www.royalmailwholesale.com/mint-project/uploads/125713808.pdf>.

- 3.47 The changes notified on 10 January 2014 included the introduction of a price differential between NPP1 and APP2, with APP2 charges increasing by around 1.2% above NPP1 charges.⁹⁸ Royal Mail stated that this differential in access charges reflects the cost benefits to Royal Mail of receiving volume forecasts, which NPP1 customers are required to provide under the 2013/14 Notices but APP2 and ZPP3 customers are not.⁹⁹
- 3.48 On 10 January 2014, a number of changes were also made to the Zonal charges in ZPP3. The Zonal charge is calculated as a specified variance against the APP2 price. The 2013/14 Notices changed the variances, significantly reducing the charges for the Urban and London Zones, while charges for the Suburban and Rural Zones were significantly increased, as shown in Figure 3.2. Royal Mail thus changed the gradient of the Zonal tilt.
- 3.49 As some of the profile surcharges for an operator failing to meet the tolerances on NPP1 are broadly based on the rural variances,¹⁰⁰ any operator on NPP1 failing to meet the new tolerances would incur higher surcharges due to the change in variances for the Rural Zone. Similarly, an operator on APP2 sending excess volumes in Suburban and Rural Zones would face higher surcharges following the changes to the Zonal charges under the 2013/14 Notices.
- 3.50 Price plans NPP1, APP2 and ZPP3 were subject to inflation related increases in 2014 relative to 2013.¹⁰¹

⁹⁷ Access Letters Contract Change Notice: Number 001, 15 November 2013.

<https://www.royalmailwholesale.com/mint-project/uploads/272745243.pdf>.

⁹⁸ Access Letters Contract Change Notices: Numbers 003-005, 10 January 2014.

<https://www.royalmailwholesale.com/mint-project/uploads/815176917.pdf>.

⁹⁹ Royal Mail letter to its access customers, 10 January 2014,

<https://www.royalmailwholesale.com/mint-project/uploads/125713808.pdf>.

¹⁰⁰ Royal Mail Access Letters Contract (2013), Annex A: Calculation of Profile Surcharges,

<https://www.royalmailwholesale.com/mint-project/uploads/438320882.pdf>

¹⁰¹ Royal Mail Wholesale website, Pricing, <https://www.royalmailwholesale.com/download-the-latest-price-lists/>.

Figure 3.2 Royal Mail’s proposed changes to its access charges (percentage change is a variance from APP2 access charges)

	Urban Zone	Suburban Zone	Rural Zone	London Zone
Charge under 2013 access contracts for Letters	-12.9%	+0.3%	+13.9%	+9.9%
Charge under 2013 access contracts for Large Letters	-13.1%	-0.6%	+15.0%	+10.9%
Charge under 2013/14 Notices for Letters	-25%	+10.4%	+44.1%	-25%
Charge under 2013/14 Notices for Large Letters	-25%	+10.4%	+44.1%	-25%

Source: Charges under the 2013 access contracts for Letters and Large Letters: Royal Mail pro-forma letter to customers, <https://www.royalmailwholesale.com/mint-project/uploads/507938298.pdf>.

Source: Charges under the 2013/14 Notices for Letters and Large Letters: Royal Mail Contract Change Notice 003-005, 10 January 2014 <https://www.royalmailwholesale.com/mint-project/uploads/815176917.pdf>

3.51 Royal Mail has chosen to include in its access contract a clause that requires the suspension of any contract change which becomes the subject of an investigation. Following a complaint submitted to Ofcom on behalf of Whistl (the “**Whistl complaint**”)¹⁰² we decided to investigate Royal Mail’s 2013/14 Notices and accordingly Royal Mail has suspended the implementation of the disputed contract changes.¹⁰³ It has not withdrawn the notices, however, it has notified new access prices to be implemented in January 2015..

Scope of this Consultation

3.52 This Consultation considers, on a forward-looking basis, whether the existing regulatory constraints on Royal Mail with respect to its provision of access services remain appropriate and, if not, what changes are required.

3.53 The rest of this Consultation is structured as follows:

- Section 4 sets out the case for intervention in bulk mail delivery, summarising our concerns around Royal Mail’s ability to act to discourage end-to-end competitive entry.
- Section 5 discusses the appropriate intervention to address these concerns and sets out our proposals for Zonal and national price plans.
- Section 6 sets out details of how our proposed remedies would be implemented.

¹⁰² Complaint submitted to Ofcom on behalf of TNT Post UK Limited (“TNT Post”) pursuant to the Universal Service Provider Access (“USPA”) Condition and the Universal Service Provider Accounting Condition (“USPAC”) imposed by Ofcom on Royal Mail Group Limited (“Royal Mail”) under the Postal Services Act 2011 (“PSA”), 28 January 2014.

¹⁰³ Royal Mail press release, ‘Ofcom investigation into Access contract changes’, 9 April 2014 <http://www.royalmailgroup.com/ofcom-investigation-access-contract-changes>.

- Section 7 reviews the efficacy and impact of our proposed intervention set out in Section 5 and Section 6 in the light of the concerns considered in Section 4.

3.54 This Consultation also has a number of annexes, which are structured as follows:

- Annex 1: includes details on how to respond to this Consultation.
- Annex 2: sets out Ofcom's consultation principles, under which this Consultation is being conducted.
- Annex 3: contains a template coversheet for responses to this Consultation.
- Annex 4: lists the Consultation questions.
- Annex 5: sets out the benefits and risks of end-to-end competition in bulk mail delivery.
- Annex 6: sets out detailed drafting issues in relation to Annex 9.
- Annex 7: sets out our sources of evidence used in this Consultation.
- Annex 8: provides a glossary of terms used in this Consultation.
- Annex 9: sets out the legal notification of the modifications we are making to the USPA Condition.

Section 4

The case for intervention

Structure of this section

4.1 In this Section, we briefly summarise again the duties and concerns which have given rise to this Consultation. We identify our concerns about incentives for efficiency and the risk of excessive pricing, and explain why we consider that competition within the existing regulatory framework may not address those concerns.

Summary of our duties and our concerns

4.2 As set out in Section 2, Ofcom's duty under section 29 of the PSA 2011 in relation to postal services is to secure the provision of a universal postal service. In performing our duty, we are required to have regard to:

- The need for the provision of the universal service to be financially sustainable (defined as including the need for a reasonable commercial rate of return); and
- The need for it to be efficient before the end of a reasonable period (which is at Ofcom's discretion) and to remain efficient after that.

4.3 Our principal duty under the CA 2003 is to further the interests of citizens in relation to communications matters and of consumers in relevant markets, where appropriate by promoting competition. (If, in relation to postal services, we consider that our CA 2003 duties conflict with our duty to secure the provision of the universal postal service, our duty to secure the provision of a universal postal service must be given priority.)

4.4 For the reasons we set out below, we do not consider that there is currently a conflict between our general duties under the CA 2003 and our duty to secure the provision of the universal postal service.

4.5 In accordance with our CA 2003 duty, we must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.

4.6 As we explain in Section 3,¹⁰⁴ in the March 2012 Statement we set out our decision to continue to require Royal Mail to offer access services on the basis that access competition would promote efficiency, promote effective competition and confer significant benefits on the users of postal services.

4.7 We decided that Royal Mail should be afforded greater flexibility to negotiate the terms and conditions of access agreements. We considered that competition would serve to (a) drive efficiency improvements by Royal Mail and (b) constrain its dominance at the retail level and therefore its ability to charge excessively high prices.¹⁰⁵ Accordingly, we removed specific charge controls on access services, but set out guidance on how we expected access prices should be related to costs.

¹⁰⁴ See paragraph 3.28.

¹⁰⁵ March 2012 Statement, sections 9 and 10.

- 4.8 Royal Mail has, in successive years, proposed or notified changes to its contract terms and conditions which we consider could act to discourage and potentially prevent entry and expansion into bulk mail delivery.
- 4.9 If competition in delivery does not materialise, Royal Mail will face limited constraints on its retail prices, giving rise to the risk that it will be able to charge excessive prices and will face limited incentives to reduce the costs of operating its delivery network and/or invest in improving its products and processes.
- 4.10 We are concerned that if we do not act now to reduce the risks currently facing a would-be entrant into delivery, we will lose the possibility of competition in delivery for the foreseeable future and with it, the potential for significant benefits to consumers and a key driver of efficiency in the provision of both the universal service and other postal services.

Ofcom's concerns

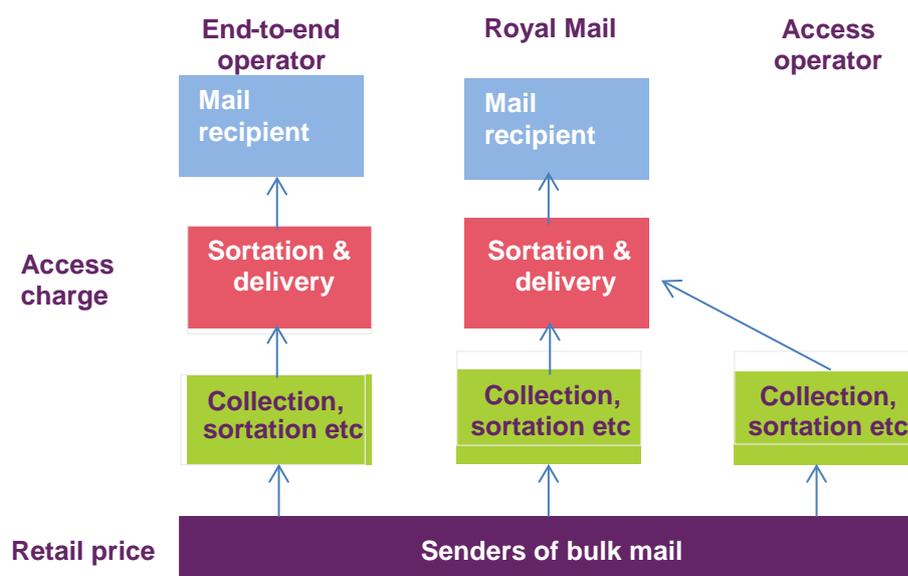
Risk of excessive pricing

- 4.11 While access competition acts to reduce retail prices to some degree, absent end-to-end competition, or the threat of it, there is no significant competitive constraint on the returns Royal Mail might seek on its downstream costs. Put simply, if Royal Mail were a near monopolist in end-to-end bulk mail delivery we would expect prices to be higher than if it faced competition as Royal Mail would have the incentive as well as the ability to price at up to the monopoly level. We consider the monopoly price could be higher than the price charged by Royal Mail today, if the threat of entry and expansion into end-to-end competition that has existed since we removed charge control regulation were to disappear. We discuss the likelihood that the threat of entry will disappear below, and the consequences of that in further detail in Annex 5.
- 4.12 Figure 4.1 is a stylised depiction of the value chain in postal services for the purpose of illustrating the competitive constraint from end-to-end operators.¹⁰⁶ End-to-end operators constrain the final price that Royal Mail and access operators can charge.¹⁰⁷ Absent the constraint from end-to-end operators, Royal Mail could raise final prices relative to a scenario in which it faced end-to-end competition. The constraint that access operators impose on Royal Mail's final prices is limited since Royal Mail could increase access charges, which raises the costs of access operators and ultimately causes the prices that access operators charge to increase.

¹⁰⁶ As explained above, an end-to-end operator will be reliant on Royal Mail for delivery in some areas. However for clarity of exposition, this is not shown in Figure 4.1. Rather this Figure illustrates the supply chain in areas where the end-to-end operator has deployed its own network. In Section 3 we explain the value chain in detail. See paragraphs 3.9 to 3.19.

¹⁰⁷ Particularly given that end-to-end operators expose much more of the value chain to competition than access-only operators do (see paragraph 3.9 to 3.19).

Figure 4.1 The competitive constraint from end-to-end operators



Efficiency

- 4.13 As set out above, we must have regard to the need for the provision of the universal service to become efficient before the end of a reasonable period, and remain so. Efficiency improvements and innovations in the delivery of bulk mail are highly likely to affect the cost of delivering USO mail because Royal Mail uses the same delivery network for both types of mail.
- 4.14 In March 2012, we determined that the price control on Royal Mail which had been in place since 2009 had not succeeded in driving efficiency in Royal Mail. We imposed a USP access condition on Royal Mail, which we considered to be appropriate for promoting efficiency (amongst other things). We also noted that end-to-end competition potentially increases the incentives on Royal Mail to reduce cost, innovate and focus on customer service.
- 4.15 Royal Mail has argued that competition from e-substitution, combined with the disciplines of being a public company, means that it faces strong efficiency incentives already.¹⁰⁸ However, we consider that a monopolist is not incentivised to improve efficiency in the same way that an operator is in a competitive market. We consider Royal Mail would respond to these stronger incentives by realising efficiencies at a faster rate than it would if the threat of end-to-end entry and expansion were to disappear. We set out our detailed consideration of this in Annex 5.
- 4.16 Overall, we are concerned that absent further intervention, the regulatory regime as it may not appropriately incentivise efficiency generally, and also specifically in relation to the provision of the universal service.

Risk to end-to-end competition

- 4.17 Certain forms of end-to-end competition have the potential to deliver significant benefits to consumers, i.e. operators who are able to put downward pressure on

¹⁰⁸ Royal Mail's June 2014 Submission, page 4.

Royal Mail's retail prices and access charges as a result of genuine competitive advantage. We consider that this kind of competition would not only prevent Royal Mail from charging excessive prices, but encourage Royal Mail to reduce its costs and to invest in improving its products and processes, leading to net benefits for postal users. We set out in further detail the benefits of this kind of competition in Annex 5. We refer to entry by any operator who would have this effect on Royal Mail as beneficial entry.

- 4.18 We note here that such an operator need not be as efficient as Royal Mail in entry areas to deliver net benefits to consumers. For example, an operator who can self-supply in entry areas at a cost below Royal Mail's relevant Zonal access charge has the potential to deliver these net benefits to consumers. This will of course include operators with costs as low as Royal Mail's own LRIC in areas it planned to enter (i.e. those operators that are equally efficient as Royal Mail in entry areas, we refer to such an operator in this Consultation as a Locally Equally Efficient Operator ("LEEO") but may also include entrants with a higher cost base who nonetheless have a genuine source of competitive advantage (e.g. the fact they are prepared to accept a lower mark-up over cost).
- 4.19 Whistl is currently the only operator in the UK with plans to roll-out a significant letter delivery network. It has told us that if Royal Mail implements the changes to the structure of access charges and contracts in the 2013/14 Notices, its plans for competing with Royal Mail in downstream letter delivery will no longer be economically viable. Whistl would therefore have to cancel its planned expansion in downstream delivery operations and would probably withdraw from downstream letter delivery entirely.¹⁰⁹ We consider Whistl's claims are plausible, particularly as the 2013/14 Notices [3<].¹¹⁰
- 4.20 We note that Whistl's roll-out of its delivery network has been on hold since the end of Q2 2014, as noted in November 2014 by Post NL, the parent company of Whistl.¹¹¹
- 4.21 Moreover, Whistl's investors have indicated they are not prepared to postpone their investment decision indefinitely while the uncertainty over Royal Mail's access charges remains.¹¹² There is a risk that Whistl will not continue its network rollout and may even exit the downstream market if its backer withdraws.¹¹³ In light of this evidence, we consider that there is a material risk that Whistl will exit end-to-end delivery absent regulatory intervention.
- 4.22 If Whistl exited end-to-end delivery, it is inherently unlikely that any other end-to-end competitor of significant scale would enter. This is because letter volumes are in long-term decline yet require high volumes to realise significant economies of scale. Thus while entry is currently a realistic prospect (as evidenced by Whistl's plans to enter the market), it is likely to represent a time-limited opportunity. In the medium term, the volumes of bulk mail are likely to have declined to a level at which incurring the fixed and sunk costs of entry would no longer be worthwhile. At the same time, the number of potential entrants is small. The exit of Whistl would send a negative message to the industry as a whole, the result being that the postal sector would be

¹⁰⁹ Whistl complaint, paragraph 5.

¹¹⁰ See Figure 4.3.

¹¹¹ Bloomberg transcript of Post NL Q3 2014 *Earnings Call*, page 10.

¹¹² Note of Ofcom meeting with LDC, PostNL and TNT Post UK, 10 July 2014.

¹¹³ Witness Statement of Nicholas Mark Wells, 28 January 2014. See in particular paragraphs 59 to 67.

less attractive to potential entrants. The most plausible entrant other than Whistl – UK Mail – said in 2012 that having explored end-to-end competition, it did not see it as an attractive option to pursue.¹¹⁴

- 4.23 In this regard, we note the following point made in the witness statement of the Chief Executive of Whistl, which accompanied the Whistl complaint:

“It took almost a year to put the deal together with LDC. Any possible alternative investor would be likely to be even more cautious in light of LDC’s withdrawal (and attendant wasted costs). Accordingly, our plans to roll out downstream delivery operations would be, at the very least, long delayed (while we sought an alternative investor), and would probably have to be cancelled entirely. Indeed, it is my belief that if LDC does not invest, finding another investor is likely to be impossible.”¹¹⁵

- 4.24 We therefore consider that there is a strong probability that if we do not act now, the prospect of end-to-end competition is likely to disappear for good. That is, in the absence of modifications to existing access regulation, the risk is that Whistl – the only significant end-to-end operator in the UK – will exit the market in the near future, and that its exit would be irreversible.

Competition within the existing framework

Reliance of end-to-end competitors on access

- 4.25 Royal Mail is the only operator in the postal sector capable of providing daily deliveries to all UK addresses.
- 4.26 Broadly speaking, we can distinguish between two types of mail: USO mail and bulk mail.
- 4.27 There are very strong synergies between the delivery of these two types of mail as the same network can be used to carry both. As a result, the incremental cost to Royal Mail of delivering bulk mail is very low because it does not need to invest in a separate network for the delivery of this mail. Instead, it can make use of the network it is required to have in place for the delivery of USO mail.
- 4.28 Royal Mail also benefits from considerable economies of scale as a result of its incumbency position. There are high fixed costs involved in operating a delivery network and the fact that Royal Mail currently has historically enjoyed a statutory monopoly position in letters delivery, and in 2013-14 continued to deliver more than 99% of addressed letters¹¹⁶, means it can spread these fixed costs over a large volume base.
- 4.29 It is implausible that any operator would be able to provide delivery services itself across the whole of the UK within any normal investment timeframe (or possibly at all). This is because there are some less densely populated areas where an entrant

¹¹⁴ See page of UK Mail’s Report & Accounts 2012, <https://www.ukmail.com/docs/default-source/investor-documents/downloads-reports/annual-interim-reports/annual-report-2012.pdf?sfvrsn=2>.

¹¹⁵ Witness Statement of Nicholas Mark Wells, 28 January 2014, paragraph 61, provided to Ofcom in the context of Whistl’s Complaint.

¹¹⁶ 2013-2014 Annual Monitoring Report, paragraph 6.26

is unlikely to gain sufficient volumes to cover the high fixed costs of rolling out and operating a delivery network (particularly when competing with Royal Mail, which enjoys considerable economies of scope in delivering bulk mail to these areas by virtue of its USO).

- 4.30 At the same time the main organisations that send bulk mail (e.g. banks, utility companies) are likely to send it to addresses across the country. Practically speaking, therefore, any would-be entrant is likely to be dependent on Royal Mail to carry part of its mail, which means that any such entrant requires an access contract with Royal Mail.¹¹⁷
- 4.31 Royal Mail, on the other hand, has a strong incentive to explore options for discouraging end-to-end competition, given that end-to-end operators expose much more of the value chain to competition than access-only operators do (see paragraphs 3.9 to 3.19).
- 4.32 It is also likely to be clear to would-be entrants that Royal Mail is incentivised in this way. Royal Mail has made it clear in public announcements that it considers end-to-end competition to be a threat to the financial sustainability of the universal service, which ideally should be limited or removed by regulator/government intervention.¹¹⁸
- 4.33 In addition to this incentive to discourage entry, Royal Mail also has an ability to change the terms and conditions of its access contracts. End-to-end operators are reliant on Royal Mail's access network in areas of the country where they have not rolled out delivery services. Royal Mail currently has the flexibility to adjust the terms and conditions on which an end-to-end competitor purchases services in these areas in a way that could place the entrant at a competitive disadvantage. In Section 3, we describe Royal Mail's pricing proposals since price controls were removed in 2012. We consider that these have been consistent with the above incentives. Royal Mail has said that "*The Planned changes to Access contracts are an important part of Royal Mail's commercial response to changing market conditions, including the expansion of direct delivery competition*".¹¹⁹
- 4.34 At the same time, the number of potential entrants is small and entry involves high fixed costs. Letter volumes are in long-term decline and so if end-to-end competition is to occur on the kind of scale required to deliver material benefits to consumers and to drive efficiencies in the provision of the universal service and other letters services, we consider that it may need to happen relatively soon.

Concerns regarding the setting of Royal Mail Zonal access charges

- 4.35 The existing structure of Royal Mail's access contracts, in particular the profile requirements, means there is a pre-existing mechanism within which Royal Mail may

¹¹⁷ We note that competition in some other countries has developed differently from the UK, as can be seen from the ERGP report on end-to-end competition: http://ec.europa.eu/internal_market/ergp/docs/documentation/2014/ergp-13-38rev1-report-on-end-2-end-competition-clean-adopted_en.pdf. For example, the Netherlands has very significant end-to-end competition, but no access competition (see page 69 of the report), which stands in marked contrast to the UK (page 89 of the report).

¹¹⁸ See, for example, *Direct delivery: a threat to the universal postal service*, Royal Mail regulatory submission to Ofcom, published 20 June 2014, available at: <http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission%20Final%20Version%20for%20Publication.pdf>.

¹¹⁹ Press release issued by Royal Mail on 9 April 2014, <http://www.royalmailgroup.com/ofcom-investigation-access-contract-changes>.

propose terms which are more likely to apply to access operators that do not offer end-to-end services than for those that do (see paragraph 3.42). An access operator providing end-to-end services is likely to have to use the Zonal pricing plan for a significant proportion of its mail whereas other access operators are more likely to be eligible for a nationally priced plan. This means that changes to Zonal charges may be made which particularly impact on end-to-end operators.

- 4.36 Absent regulatory or competitive constraints and subject to compliance with competition law, Royal Mail is likely to have the ability:
- where an entrant has not rolled out, to set Zonal access charges high (compared with Royal Mail's own costs and its charges in other Zones); and
 - where an entrant has rolled out (or there is a realistic threat that it might), to set Zonal access charges low (compared with Royal Mail's own costs and its charges in other Zones).
- 4.37 In particular, Royal Mail could potentially set access charges as low as its long-run incremental costs (“**LRIC**”) in Zones where entry is likely to occur, and recover all of its fixed and common costs through high charges in other Zones that are less likely to support competition and where an entrant would be reliant on Royal Mail for delivery.¹²⁰ By doing this, Royal Mail could discourage entry into delivery even by a LEEO). Such an operator would not gain any cost advantage through self-supply in this scenario but would incur significant fixed costs of rolling-out and operating a delivery network in entry areas. It would therefore be financially better off remaining reliant on Royal Mail for all of its delivery requirements rather than incurring these fixed costs (i.e. remaining an access operator rather than entering bulk mail delivery).
- 4.38 Royal Mail's likely ability to affect entry by a LEEO illustrates the extent to which Royal Mail can adjust access charges to deter and even prevent competition in delivery. Any conduct which would discourage a LEEO from entering would have an even stronger deterrent effect on a less efficient entrant, who may nonetheless have the potential to provide net benefits to consumers.
- 4.39 Despite the fact that Royal Mail may be able to adjust access charges so as to discourage a LEEO from entering delivery, Royal Mail may be able to do so in a way that does not involve charging below LRIC costs in competitive Zones. Moreover Royal Mail may still be able to recover its costs overall, by setting high charges in the Zones where the end-to-end entrant has not rolled out.
- 4.40 At the same time as potentially discouraging entry by a LEEO, this combination of low charges in some Zones and high charges in others could potentially be structured in a way that largely denies consumers the benefits of lower retail prices. In particular, by raising the charges in some Zones and lowering them in others, the overall 'average' charge need not change.¹²¹ As a result, Royal Mail may be able to discourage entry by a LEEO while keeping charges for operators on national pricing contracts unchanged. Customers of these operators would thus not benefit from lower prices.

¹²⁰ LRIC takes the service in question as the relevant increment of output over which to measure costs. LRIC does not include a contribution to common costs.

¹²¹ As explained in paragraph 3.30, we have previously indicated that Royal Mail should seek to ensure that the weighted average of Zonal access charges is broadly comparable to the national access charge.

4.41 Royal Mail’s potential ability to increase the gradient of the Zonal tilt to the disadvantage of an end-to-end entrant can be seen in its 2013/14 Notices. An example of these charges for Access 70 CBC Letters¹²² is illustrated in Figure 4.2 below. They show that Royal Mail proposed to decrease charges in London and Urban areas where entry was more likely. Figure 4.3 below shows these charges would probably be [redacted]. These proposals would also have increased Royal Mail’s charges in Suburban and Rural Zones, where an end-to-end entrant is more likely to be reliant on Royal Mail for deliveries.

Figure 4.2 Royal Mail access charges for Access 70 CBC Letters¹²³

	London	Urban	Suburban	Rural	National charge ¹²⁴
2013/14 charges (pence per letter)	21.4p	17.0p	19.5p	22.2p	19.5p
Proposed 2014 charges (pence per letter)	15.4p	15.4p	22.6p	29.6p	20.5p

Source: Royal Mail Wholesale website.¹²⁵

Figure 4.3 Royal Mail access charges relative to FAC for Letters and Large Letters by Zone

[redacted] Source: Royal Mail Zonal Costing Model, 2012/13 and Royal Mail presentation to Ofcom on 25 March 2014.

4.42 We are not concerned *per se* that Royal Mail varies access charges between Zones, since delivery costs vary between Zones. It is consistent with the need for the universal service to be provided on a financially sustainable basis, and with our duty to have regard to the need to promote investment and innovation, for Royal Mail to be able to recover its costs.

4.43 Our concern is rather where pricing mechanisms may be used solely or primarily to deter end-to-end entry, and in a way which provides few benefits for consumers. Royal Mail’s response to competition in this instance is not likely to lead to either a focus on improving the efficiency of service (i.e. lower costs), innovation or overall price reductions for many end customers and therefore does not appear to be in the interest of postal users.

Concerns regarding uncertainty

4.44 We have concerns about two sources of uncertainty currently facing access operators, notably the potential for:

- discrimination between different types of operator; and
- very significant year-on-year changes in access charges.

¹²² The 70 refers to the degree of sortation the access operator applies to the mailing items before they are handed over to Royal Mail and CBC refers to Customer Bar Coding.

¹²³ Charges rounded to one decimal place.

¹²⁴ Charge under APP2.

¹²⁵ <https://www.royalmailwholesale.com/download-the-latest-price-lists/>

Discrimination between different types of operator

- 4.45 As explained in paragraph 3.42, the existing structure of Royal Mail's access contracts, in particular the profile requirements means there is a pre-existing mechanism within which Royal Mail may propose terms which are more likely to apply to access operators that do not offer end-to-end services than for those that do. In these circumstances, the scope for differentiation between the terms and conditions offered to different access operators is very broad.
- 4.46 As explained in paragraphs 4.31-4.33, Royal Mail has an incentive to look for ways to set higher access charges for end-to-end operators than for access-only operators. As explained in paragraph 3.47, in the 2013/14 Notices, Royal Mail did give notice of charges which would have treated operators on one of its national access contracts differently from operators on its Zonal contract and other national contract (there was a 1.2% differential in charges between NPP1 as compared to APP2 and ZPP3)¹²⁶ demonstrating the potential ability for Royal Mail to introduce a price differential to the disadvantage of an end-to-end entrant.
- 4.47 Where end-to-end operators have to compete with access-only operators at the retail level on the basis of materially different access charges it would be likely to discourage and potentially prevent entry by an end-to-end operator, even where such entry would be in the interests of consumers.
- 4.48 The USPA Condition currently prohibits undue discrimination in relation to matters connected with access. However, this condition would not necessarily prevent Royal Mail from seeking to set different charges for different operators (as it did in the 2013/14 Notices).¹²⁷ We are concerned that the multiple ways in which it is possible to differentiate between operators of varying sizes and mailing profiles may open up multiple possible ways of setting differential prices, which could result in different prices being available as between access-only and end-to-end operators. This creates uncertainty for access operators particularly given the many sources of potential differentiation between different types of operator, some of which may be a reasonable basis for differentiating charges and others not. Moreover, we are particularly concerned about the potential for delay in resolving that uncertainty given the urgent case for intervention (as discussed below).
- 4.49 As a result, we are concerned that an end-to-end operator currently faces uncertainty over whether they are likely to be able to sustainably procure access services on similar terms to an access-only operator, or whether Royal Mail would be in a position at some point to use differences in characteristics between the different types of operator to offer access on differential terms. This uncertainty is compounded by Royal Mail's establishment of such differentiated offerings in the 2013/14 Notices.

Very significant year-on-year changes in access charges

- 4.50 In addition, as we set out in Section 3, in each of the two years since the March 2012 Statement, following which Royal Mail was given more pricing freedom, Royal Mail has sought to introduce significant revisions to its access contracts and related charges. There have been very material changes from one year to the next in the

¹²⁶ The notices in question are currently the subject of an investigation under the Competition Act so this particular price differential is not discussed further here.

¹²⁷ We have opened an investigation into those notices under the Competition Act 1998 (the Competition Act), which is ongoing.

intended level and structure of Royal Mail's access charges, as well as in the terms on which its access services can be purchased.¹²⁸ We further illustrate this in Figure 4.2 above, which shows Royal Mail Access charges for "Access 70 CBC Letters".

- 4.51 We would expect contracts and prices to evolve over time – indeed, we gave Royal Mail commercial freedom in our March 2012 Statement partly in order to allow this to happen more easily. However, the magnitude of the changes to access charges proposed by Royal Mail has been large, and is more likely to be disruptive in the context of a low margin business where there is little scope to absorb increases in costs. For this reason, and for the reasons set out below, we consider that Royal Mail's proposed and actual changes to its contracts have given rise to considerable uncertainty in the industry as to the nature of access services that will be available and the terms on which they will be provided in anything other than the short term.
- 4.52 This has in turn led to uncertainty over the viability of business models linked to such services. Moreover, there is evidence that such uncertainty risks discouraging investment in alternative postal service models by third parties, which in turn presents a serious risk to sustainable competition (see further below).
- 4.53 The first indications of concern followed proposals by Royal Mail in October 2012 where it suggested that, amongst other measures, customers that met certain national profile commitments and which also committed certain volumes would benefit from lower¹²⁹ access charges for all committed volumes than would be charged on its 'pay as you go' Zonal plan.¹³⁰
- 4.54 While these proposals were not ultimately introduced, raising the possibility led to market uncertainty. Whistl told us that the fact of the proposals had created uncertainty/risk and caused Whistl to suspend its roll-out plans.¹³¹
- 4.55 More recently, in the 2013/14 Notices Royal Mail introduced changes to Zonal charges as set out in Figure 4.2 above. In this context, Whistl said that the uncertainty created by Royal Mail's actions in recent years and its ability to make similar adjustments every year in the future has meant that it is impossible for Whistl to have a stable financial plan for end-to-end roll-out.¹³²
- 4.56 Other operators have told us that changes to the structure of charges, more generally, (even proposed changes) mean that it is difficult for access operators to make long term business plans.¹³³ Postal Group said that business models tend to

¹²⁸ See Figure 3.2 in which we set out the change in Zonal charges following the 2013/14 Notices. These changes were, in the event, suspended.

¹²⁹ As the proposals to introduce lower access charges for committed volumes were not introduced, Royal Mail did not confirm prices. However, in an FAQ document (*FAQs – How the New Model Access Pricing Plans work*), Royal Mail noted that it anticipated the differential to be in the order of 1p – 2p per letter.

¹³⁰ *Proposals for the reform of the access contracts, a customer discussion document*, Royal Mail, October 2012. See, for example, paragraph 5.15.

¹³¹ Whistl slide presentation for Ofcom, 8 November 2012.

¹³² *Anti-competitive implications of Royal Mail's access pricing proposals*, slide 2, Whistl slide presentation, 20 January 2014.

¹³³ Note of meeting between Ofcom and members of the Working Access Group, 26 June 2014. UK Mail said that even the act of Royal Mail publishing the Royal Mail submission was a cause of uncertainty, as was the submission of the Whistl complaint.

reflect Royal Mail's contract structure rather than vice versa, which creates a problem when the contract structures are changed.¹³⁴

- 4.57 In light of the above concerns expressed by postal operators, we are concerned that there is an ongoing potential for uncertainty over the nature of access services that will be available and the terms on which they will be provided. While some uncertainty is to be expected in the market, we are concerned that the scale of such uncertainty is of an order that, absent regulatory intervention, it will undermine investment and competition.
- 4.58 The establishment of alternative postal networks, particularly end-to-end networks, requires substantial investment in systems, logistic centres and staff. The threat of material changes to the terms of access and, importantly, the potential for such changes to lead to access charges that disadvantage end-to-end entry, clearly undermine the business case for such investment.
- 4.59 In circumstances where entry into delivery services is already very challenging, we consider this uncertainty to be a barrier to entry in its own right.

Summary of our concerns

- 4.60 In summary, we are concerned that the existing USPA Condition is not working as we had envisaged in 2012, and may not promote efficiency, promote effective competition, and confer significant benefits on the users of postal services.

The universal service

Securing the universal service

- 4.61 In our March 2012 Statement we secured the provision of the universal service by imposing upon Royal Mail a Designated USP condition which requires it to provide the services. At the same time, we set out our approach to ensuring the sustainability of the universal service. This included the establishment of a detailed monitoring regime in order to monitor developments in the postal sector, including to ensure that Royal Mail used its new pricing and commercial flexibility in a way that accords with our regulatory objectives of achieving a universal service that is both financially sustainable and efficiently delivered.
- 4.62 We expanded on this further in our subsequent statement in 2013 on end-to-end competition in the postal sector (the "**2013 end-to-end Statement**")¹³⁵ and the accompanying **2013 end-to-end Guidance** where we set out the approach and financial analysis we would expect to undertake in establishing the extent to which the finances of the universal service might be affected by the entry or expansion of end-to-end competition. We also set out how, on the basis of this financial analysis, we would form a view as to whether the sustainability of the universal service is likely to be under threat due to end-to-end competition, and whether or not it would be appropriate to intervene..

¹³⁴ Note of meeting between Ofcom and Document Outsourcing, Postal Group and First Scottish on 12 June 2014.

¹³⁵ End-to-end competition in the postal sector: Ofcom's assessment of the responses to the draft guidance on end-to-end competition – Statement, 27 March 2013, <http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/statement.pdf>

- 4.63 In the March 2012 Statement we considered what a reasonable level of return might be given market conditions and the level of risk within Royal Mail's business, and concluded that an indicative EBIT margin range of 5% to 10% was appropriate and consistent with securing a financially sustainable universal service.¹³⁶ We have been clear that this was an exercise of judgment and it would not represent a cap on earnings or an automatic right for Royal Mail to earn a return within this range.¹³⁷
- 4.64 Since Whistl launched end-to-end services in West London in April 2012, as set out in the Review of End-to-End Competition in the Postal Sector, published today (2 December 2014), we have monitored the sector continuously, and over that period have repeatedly concluded that we did not consider it necessary, at that time, to impose any additional regulatory conditions on Whistl to secure the ongoing provision of the universal service.
- 4.65 Royal Mail made a further submission in June 2014 which set out Royal Mail's views on the threat that it considered that end-to-end competition poses to the universal postal service. Royal Mail's key arguments (summarised in more detail in Annex 1 of the Review of End-to-End Competition in the Postal Sector) were:
- the structural decline in letter volumes means the provision of the universal service is already challenged;¹³⁸
 - in light of Whistl's publically stated plans and absent regulatory intervention Royal Mail's ability to reach an EBIT margin within the indicative 5% to 10% range on a sustainable basis in the future would be undermined;¹³⁹
 - the threat to Royal Mail's provision of the universal service is greater than that suggested by Whistl's publicly stated plans;
 - Royal Mail already faces significant efficiency incentives, and end-to-end competition would not provide it with any additional efficiency spur.¹⁴⁰
- 4.66 As set out in the Review of End-to-End Competition in the Postal Sector, we have considered the evidence available to us, including the most recent information from Royal Mail's 2014 business plan, the latest results from our ongoing monitoring programme and Whistl's rollout plans. We have also considered the arguments in Royal Mail's June 2014 submission. We have assessed whether, in light of the evidence, the impact of end-to-end competition from Whistl is likely to pose a threat to the provision by Royal Mail of a financially sustainable and efficient universal postal service. On this basis, we do not consider it necessary at this time to exercise our regulatory powers under the Postal Services Act 2011 to impose regulatory conditions on Whistl in order to secure the ongoing provision of a universal postal service. We do not consider that the provision of the universal postal service is under threat, and as a result we do not consider that the legal tests for imposing such regulatory conditions are met. We have decided we are going to broaden our review of the factors that could materially impact Royal Mail's ability to continue to provide the universal service in the future, and will look at parcels, likely pension cash costs

¹³⁶ March 2012 Statement, paragraph 5.41.

¹³⁷ March 2012 Statement, paragraph 5.34 to 5.43 and March 2013 end-to-end Statement, paragraph 3.9.

¹³⁸ Page i.

¹³⁹ Page v.

¹⁴⁰ Page iv.

and what rate of efficiency improvement Royal Mail should reasonably be able to achieve.

- 4.67 We have separately considered whether there could be a risk to the sustainability of the universal service if the proposals on which we are consulting here result in end-to-end competition being maintained.
- 4.68 As set out in Section 7 paragraphs 7.41-7.43, we do not consider that our proposals will materially impact on the existing roll-out plans of Whistl. Accordingly, as set out in our Review of End-to-End Competition in the Postal Sector, we do not consider that the provision of the universal postal service is under threat, at this time ¹⁴¹.
- 4.69 We are satisfied that we have carried out our functions in such a way as to secure the provision of the universal service to date. As set out in the Review of End-to-End Competition in the Postal Sector we consider that there does not appear to be any immediate threat to the sustainability of the universal service. When looking at the longer term, the potential impact of end-to-end competition needs to be considered in the context of other uncertainties. We recognise that in some scenarios, Royal Mail's profitability could deteriorate to the point where the universal service is not sustainable. However, at this stage it is far from certain that this will be the case and even less certain, if this was the case, that end-to-end competition would be the decisive factor. ¹⁴²
- 4.70 For all these reasons, we do not consider that there is any conflict between our duty to secure the provision of the universal service and our duty to further the interests of citizens and consumers, where appropriate by promoting competition.

Costs and benefits of competition in relation to provision of the universal service

- 4.71 We remain of the view that, as we said in our March 2012 Statement and the 2013 end-to-end Statement, end-to-end competition could potentially provide both costs and benefits to the universal service. ¹⁴³ Therefore, while competition is one possible means of driving efficiency, keeping costs down and securing choice, quality and innovation, considering an intervention in relation to end-to-end competition requires Ofcom carefully to weigh up those costs and benefits.
- 4.72 For the reasons set out below and in detail in Annex 5, we consider competition is generally likely to encourage efficiency improvements and innovation in the delivery of bulk mail services. Further, we consider that acting on these incentives is highly likely to lead to spill-over benefits for the universal service. Efficiency improvements and innovations made in response to competition in the delivery of bulk mail are highly likely to affect the cost of delivering universal service mail because Royal Mail uses the same delivery network for both types of mail.
- 4.73 We recognise there would be some upward pressure on Royal Mail's average costs of delivery, including universal service mail, as a result of loss of volumes to an entrant into delivery. However, as set out below and in more detail in Annex 5, we consider the potential for efficiency gains from competition to be significantly greater.

¹⁴¹ See Review of End-to-End Competition in the Postal Sector paragraph 1.9.

¹⁴² See Review of End-to-End Competition in the Postal Sector paragraph 3.112 – 3.118.

¹⁴³ March 2012 Statement, paragraph 1.53; the same view was expressed in different words in the 2013 end-to-end Guidance, paragraph 1.1.

- 4.74 As a result, we consider end-to-end competition in bulk mail services to be one of the key mechanisms through which we may secure the efficient provision of the universal service (in line with our duties under the PSA 2011).¹⁴⁴ The probable exit of Whistl absent further regulatory intervention would therefore represent the loss of one of the key potential drivers of the efficient provision of the universal service, and (as set out above) we consider this loss would be irreversible.
- 4.75 We cannot rule out there are scenarios in the future where competition in bulk mail delivery could mean the difference between sustainability and unsustainability for the universal service. In this case we may need to consider specific intervention. However, for the time being, we do not consider it likely that such a scenario will arise. In particular, as set out above, we consider that the universal service will continue to be financially viable for the foreseeable future.
- 4.76 It is not possible to state definitively that end-to-end competition in bulk mail delivery would provide a net benefit in relation to the universal service. Both the potential benefits and costs of end-to-end bulk mail competition depend on the extent of roll-out by any entrant (which will in turn depend on the access charges Royal Mail chooses to set) and its ability to win market share, all of which are currently unknown.
- 4.77 However, on balance, in the circumstances, we consider it appropriate to place weight on the need for the universal service to be provided efficiently and therefore the need to preserve the prospect of end-to-end competition, albeit recognising the possibility that such benefits may not materialise until beyond the timeframe for which we are in a position to foresee the overall financial position of the universal service.
- 4.78 We do not consider that in so doing, we are creating a risk to the ongoing provision of the universal service. Ofcom monitors the sector continuously. We consider that we are in a position to identify and react to any emerging threat to the universal service promptly.
- 4.79 In addition, there are in our view a number of other factors likely to have a greater impact than end-to-end competition on Royal Mail's overall profitability in the long term that are currently uncertain (most notably the impact of competition in parcels and future pension costs). It is important that Ofcom understands these effects in order to secure the universal service in accordance with our primary duty, so we intend to review these factors over the next year.

The benefits and risks of competition more generally

- 4.80 As set out in Section 2, Ofcom has a general duty under section 3 of the CA 2003 to further the interests of consumers (including in markets relating to postal services) by promoting competition where appropriate.
- 4.81 We set out a detailed assessment of the benefits and risks of competition in Annex 5. In doing so, we distinguish between the direct effects on the bulk mail delivery market and the indirect effects on related services, notably universal service mail.
- 4.82 Compared to a counterfactual in which Royal Mail is a near monopoly supplier of bulk mail delivery, end-to-end competition has the potential to encourage Royal Mail to set prices which are more closely aligned to its costs and to provide stronger incentives to reduce its costs and invest in the development of new products and/or processes.

¹⁴⁴ A point that we have noted in previous publications. See paragraph 1.61 in the October 2011 Consultation and paragraph 4.40 of the 2013 end-to-end Statement.

We consider that acting on these incentives would be likely to lead to consumer benefits in the form of lower prices and greater choice.

- 4.83 We recognise there are also risks from end-to-end competition, including the potential for duplication of fixed costs to lead to an increase in total industry costs and for entry to occur in response to an arbitrage opportunity created by regulation rather than genuine competitiveness.
- 4.84 As we explain in detail in Annex 5, we recognise there is likely to be some duplication of fixed costs associated with end-to-end competition. However, the alternative involves monopoly prices and limited incentives for efficiency improvements. We consider end-to-end competition will act as a strong constraint on prices, expanding the market and creating incentives for Royal Mail to realise efficiencies more quickly than it otherwise would in the absence of such competition, putting downward pressure on industry costs and encouraging Royal Mail to pass these benefits onto consumers. We consider that these benefits are likely to outweigh any short term losses of productive efficiency given the importance Royal Mail continues to attach to efficiency improvements in its delivery network and the incentives created by competition to pass the benefits of these improvements onto consumers.
- 4.85 We also consider we can mitigate the extent of any loss of short term efficiency through appropriate regulation. Ensuring would-be entrants face Zonal access charges that reflect Royal Mail's cost of delivery in different Zones will tend to encourage operators to self-supply only in areas where their own costs are relatively low compared with Royal Mail's. This will tend to reduce any adverse impact of entry on industry costs. In any event, we do not consider consumers are likely to be adversely affected by any increase in industry cost as entry will only occur if an operator can offer lower retail prices to consumers by entering delivery. The immediate effect of entry will therefore be to put downward pressure on retail prices—even if total industry costs are higher.
- 4.86 We also recognise the potential for geographic arbitrage opportunities to arise under certain forms of access regulation. For example, requiring Royal Mail to provide access services in all areas at a uniform price could create geographic arbitrage opportunities whereby entrants are able to target cheaper to serve areas, while using Royal Mail's delivery service (at the uniform price) in more costly areas (see paragraphs A5.100-A5.104).
- 4.87 We consider that this type of arbitrage opportunity is mitigated by designing regulation in such a way as to ensure an entrant faces Zonal access charges that reflect Royal Mail's cost of delivery in different Zones. This is because an entrant would need to pay higher charges for Royal Mail's access services if it chose not to enter in areas associated with a higher cost to Royal Mail and would therefore not be able to gain an artificial advantage by selectively entering low cost areas only.
- 4.88 In relation to the benefits and risks for USO mail, we consider end-to-end competition offers significant potential benefits in terms of driving efficiency improvements in the delivery network. This is because in responding to competition in bulk mail delivery, Royal Mail will be incentivised to reduce the costs of operating its delivery network, benefitting USO mail as well as bulk mail. As explained above, we consider these efficiency benefits are likely to outweigh any short term upward pressure on delivery costs resulting from entry. We discuss the risks to the provision of the universal service above.

4.89 These findings are consistent with our assessment of competition set out in the October 2011 Consultation and 2013 end-to-end Statement, which found that end-to-end competition offered significant benefits for efficiency but risked duplication of fixed assets and creating arbitrage opportunities, concluding that the balance of benefits would depend on the type of competition that emerged. We consider we can influence the type of competition that emerges through our design of any regulation and would only introduce regulation that promoted end-to-end competition which led to net benefits for consumers.

Provisional assessment of options for intervention

4.90 We have considered a number of regulatory options for intervention to address the risks of excessive pricing, lack of efficiency incentives, and risk to beneficial end-to-end competition. Below we set a high level assessment of these options and identify our preferred approach. Then, in Section 5 we explore that preferred option in further detail.

4.91 The high level options that we have considered are:

- Relying on existing regulation on Royal Mail,¹⁴⁵;
- Introducing controls on the level of retail prices;
- Introducing controls on the level of wholesale access charges; and
- Limiting the structure of Royal Mail's access charges while leaving it with the freedom to determine the overall level of access charges.

Existing regulation

4.92 As we explain in Section 3, Royal Mail is already subject to a number of regulatory obligations in relation to access provision following the March 2012 Statement. These include requirements that:

- Access should be provided on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct (USPA 3.1);
- Royal Mail shall not unduly discriminate against particular persons or against a particular description of persons in relation to matters connected with D+2 Access (USPA 5.1); and
- Royal Mail may be deemed to have shown undue discrimination if it unfairly favours to a material extent an activity carried on by it so as to place at a competitive disadvantage persons competing with the universal service provider (USPA 5.2).

4.93 However, as explained in paragraphs 4.11 to 4.61, we consider that if we rely solely on the existing regulation governing Royal Mail's access prices, it is unlikely that the above benefits of competition would be realised. In particular:

¹⁴⁵ As set out in Section 2.

- Existing regulation does not directly address our concerns about the potential for Royal Mail to increase the gradient of the Zonal tilt or making significant year on year changes to its access charges; and
- As explained in paragraph 4.48, relying on the existing prohibition on undue discrimination is likely to create uncertainty for access operators.

4.94 As such, we do not consider that the prospect of end-to-end competition arises with sufficient certainty under existing regulation for us to be confident that that prospect will serve to drive efficiency on the part of Royal Mail and limit the risk of excessive pricing. Our provisional view is therefore that doing nothing, beyond enforcing existing regulations, is unlikely to be appropriate to achieve our regulatory objectives.

A retail charge control

4.95 As explained above, we consider that end-to-end competition is likely to constrain Royal Mail's retail prices. An alternative to relying on competition would be to control the level of retail prices for bulk mail directly, through a charge control.

4.96 Price controls are a well-established mechanism for providing network operators with an incentive to manage their costs in order to become more profitable and to protect customers from monopoly prices. In 2006, Postcomm introduced price controls that fixed the margin between Royal Mail's access products and its corresponding retail products. However, in the March 2012 Statement we found that these price controls had not achieved the regulatory objectives specified at the time of their introduction and as a result removed most of the price controls from Royal Mail.¹⁴⁶ In brief, the price controls had:

- Not been effective in ensuring that Royal Mail improved efficiency;
- Not protected consumers against price rises;
- Resulted in a position where the universal service was approaching a point where it was no longer financially sustainable; and
- Reduced Royal Mail's flexibility to respond to competition and volume decline.

4.97 We consider that retail price controls on bulk mail would experience similar issues (although we accept that they would limit the extent to which bulk mail customers experienced price rises). The risk is that such controls would not be effective in encouraging Royal Mail to improve its efficiency and they would also reduce Royal Mail's flexibility to respond to changes in its costs and in consumer preferences. As in the March 2012 Statement, our preference remains to rely on competition (rather than retail price controls) to drive efficiency improvements and constrain Royal Mail's ability to charge excessive retail prices.

A wholesale charge control

4.98 Controls on the level of wholesale charges can be used to support the emergence of retail competition, by controlling the price that retail competitors pay for key inputs. We use them, for example, in controlling some of BT's wholesale prices.

¹⁴⁶ March 2012 Statement, paragraph 1.23.

4.99 The concerns we have identified above in relation to Royal Mail's behaviour relates to the setting of access charges and terms and conditions that apply to access contracts. In particular, we have identified that Royal Mail's current charging flexibility allows it to set Zonal access charges in a manner that could potentially deter end-to-end competition.

4.100 In light of this, we have considered whether it would be appropriate to control Royal Mail's wholesale access charges by setting a minimum or maximum Zonal charge by reference to Royal Mail's Zonal costs. The aim of these options would be to limit Royal Mail's charging flexibility:

- In the case of a minimum charge, to prevent Royal Mail from setting charges at a low level in zones where significant entry is planned; or
- In the case of a maximum charge, to prevent Royal Mail from setting charges at a high level in zones where an end-to-end entrant remains largely reliant on Royal Mail to deliver items.

4.101 Our concern with these options is that Royal Mail may retain sufficient charging flexibility to deter entry/expansion by end-to-end operators. For example, in the case of a minimum charge Royal Mail would be able to increase Zonal charges (in a way that does not reflect underlying costs) in the zones where an entrant remains reliant on Royal Mail to deliver. In the case of maximum charges, Royal Mail would be able to reduce charges in zones where the entrant plans to roll out a delivery operation. Therefore we consider that individually these options are unlikely to be sufficient to allow beneficial entry and for this reason are unlikely to maximise the incentives for Royal Mail to improve its efficiency.

4.102 We can also envisage practical issues with these options in determining how and at what level to set the minimum or maximum charge. We have particular concerns around setting a maximum charge in an environment where the volume of letters may be difficult to forecast due to structural decline and the possible impact of entry in the bulk mail delivery market. These challenges may make it difficult to set a maximum charge while also giving Royal Mail an opportunity to recover its costs because it is difficult to predict precisely how costs will vary as volumes fall.¹⁴⁷

4.103 For these reasons we do not prefer these options.

4.104 We have also considered a report Whistl submitted to us commissioned from Frontier Economics (the "**Frontier Report**") that provided its views on designing a zonal access charging regime.¹⁴⁸ Fundamentally, the Frontier Report suggested that Royal Mail should be required to set cost-based access charges. The report suggested that access charges should initially be set using a standalone cost ("**SAC**") approach. Using a SAC approach, access charges would be allocated a relatively large share of common costs, resulting in relatively high access charges. In arguing for a SAC approach Frontier Economics noted that this would allow entry by a rival offering only postal delivery services, and hence removes Royal Mail's economies of scope advantage from offering USO and retail services in addition to access.¹⁴⁹ It noted that

¹⁴⁷ Royal Mail currently offers a wide variety of bulk mail services, depending on the particular characteristics of the letter being posted. Given the obstacles to setting maximum or minimum access charges for a large number of individual services, a more practical and proportionate option might be to apply any control to a basket of different services.

¹⁴⁸ *Designing a zonal pricing access regime*, Frontier Economics, September 2014.

¹⁴⁹ In assessing the advantage enjoyed by Royal Mail, Frontier also estimated the magnitude of the impact of Royal Mail's VAT exemption (which assists it in competing for some bulk mail customers

in the short term a SAC approach will result in an over-recovery of common costs, assuming that other (non-access) services are recovered on a fully allocated cost (“FAC”) basis. For this reason it suggested that as entry becomes established the zonal charges should be placed on a glide path to FAC, which is considered to be the minimum level of cost allocation required to ensure adequate recovery of common costs.¹⁵⁰

4.105 The Frontier Report appears to propose we should simultaneously set both a minimum and maximum charge i.e. that access should not be set above or below SAC (or ultimately FAC). This avoids part of the concern we have identified above in relation to a minimum and maximum charges i.e. Royal Mail retaining sufficient charging flexibility to deter beneficial entry. However, in doing so it puts a significantly greater restriction on Royal Mail’s commercial flexibility. We are concerned that this would limit Royal Mail’s flexibility to respond to competition and volume decline.¹⁵¹ It would also suffer the practical issues described in paragraph 4.102.

4.106 Moreover, we have several specific concerns about requiring Royal Mail to set access charges at the level of SAC (even if this were only a temporary measure).

- As pointed out by Frontier, a SAC approach implies over recovery of costs. While this may be beneficial to encourage entry, it could encourage entry by operators who are sufficiently less efficient than Royal Mail that their entry would not be in the interests of consumers. It may also result in higher prices which would be detrimental to postal customers;
- We do not consider it appropriate for access prices to be set at SAC to facilitate entry. For example, Whistl was proposing to roll out a delivery network in some areas based on Royal Mail’s 2013 charges. The evidence we have suggests that these charges were significantly lower than Royal Mail’s SAC;¹⁵² and
- A further consideration is how long the SAC standard should be adopted for before ultimately moving to FAC. If it was adopted for a short period then it is likely that only operators already considering an end-to-end operation i.e. Whistl would be able to take advantage of it. If we extended the period then other operators may be able to consider entry, however, this would increase the time that Royal Mail was constrained in setting charges at SAC and increase the possible detriment to postal customers through higher prices.

and disadvantages it in competing for others). Frontier also estimated the scale of the disadvantage Royal Mail enjoys as a result of delivering six days per week (as part of its USO obligations), which it considered went beyond bulk mail customers’ requirements.

¹⁵⁰ The difference between the SAC and FAC approach arises due to the different treatment of common costs. Common costs arise from the provision of a group of services but are not incremental to the provision of any individual service. Under a SAC standard access charges would be set assuming that all common costs associated with the access product are assigned to the access product. Under a FAC standard access charges would be set assuming that common costs are allocated between access products and all other products sharing those common costs on the basis of some allocation mechanism.

¹⁵¹ Similar to the concerns raised in paragraph 1.23 of the March 2012 Statement and summarised in paragraph 4.96.

¹⁵² We do not have information on Royal Mail’s SAC by zone. Royal Mail has provided information on its Zonal distributed SAC (DSAC - which we would expect to be lower than SAC) in a presentation to Ofcom on 25 March 2014. The DSAC figures were significantly higher than Royal Mail’s average Zonal charges in 2013/14. Royal Mail response to Q3.2 of section 55 notice dated 2 June 2014.

4.107 In light of the above, our provisional conclusion is that a control on the overall maximum and/or minimum level of access charges would not be an objectively justifiable or proportionate means of intervening to support the intentions of our March 2012 Statement. However, if any regulation that we do decide to impose proves to be ineffective, we might need to reassess the case for directly controlling Royal Mail's charges.

A control on the structure of Royal Mail's access charges

4.108 We have considered whether to address our competition concerns through regulating the structure of Royal Mail's Zonal access charges, while leaving it the commercial freedom to decide the overall level of the charges. We consider that the structure of Zonal charges should reflect the underlying pattern of Zonal costs. We set out in Sections 5 and 6 the detail of our proposals to control the relationship between Zonal charges and Zonal costs, while giving Royal Mail freedom to determine the overall level of charges. We set out in Section 7 how our proposals deal with our competition concerns.

4.109 We consider that this approach has a number of advantages. First, unlike under charge controls, Royal Mail would retain commercial flexibility to set the absolute level of charges. This means that Royal Mail would have the opportunity to set access charges taking into consideration the potential for efficiency improvements, cost recovery and its chosen rate of return. We believe that this commercial flexibility is particularly important to adapt to changing market circumstances and for the financial sustainability of the USO.

4.110 Second, we consider that this option can be designed to achieve our objective of encouraging beneficial entry rather than entry based on arbitrage opportunity (see paragraphs 7.44-7.45). An entrant can only gain an artificial advantage by entering in selected areas if it is able to obtain access services in non-entry areas at subsidised prices (e.g. because access was subject to a uniform price requirement). Under our proposals, an entrant will face Zonal charges that reflect the costs incurred by Royal Mail when providing access services in different Zones (see paragraphs 5.21-5.22). Therefore, an entrant has to pay higher charges for Royal Mail's access services if it chooses not to enter in areas associated with a higher cost to Royal Mail.

4.111 As a result, entry would only be a profitable strategy under our proposals if an operator is able to self-supply in entry areas at a cost which is below the relevant Zonal access charge. This limits entry to those operators who have a genuine source of competitive advantage over Royal Mail in the areas they choose to enter, either in terms of the cost of self-supplying delivery, the mark-up they are prepared to accept on their own delivery services or both.

4.112 Third, this option is consistent with the guidance that we provided in the March 2012 Statement. As noted in paragraph 3.30, our guidance in relation to Zonal access charges was that Royal Mail should take into account the alignment of its Zonal charges with its costs.

4.113 We recognise that this option would impose some further restrictions on Royal Mail's charging flexibility and may create some extra costs or administrative burden. However, we do not see these as major concerns for Royal Mail in light of our proposed approach (we set out the impact on Royal Mail from our proposals in detail in Section 7). We take the cost of intervention for Royal Mail into consideration while setting out the details of our proposal in the following Sections.

4.114 In summary, we consider that this option has attractive features. In particular, since it allows Royal Mail flexibility (in particular, to determine the level of its access charges) while still having the potential to address our competition concerns, this option is likely to represent a more proportionate way of meeting our regulatory objectives. Accordingly in Sections 5 and 6 we explore the design of this option in further detail before then assessing its impact overall in Section 7.

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

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

Section 5

Further detail on our proposals

Introduction and objective

5.1 In this Section we set out our detailed proposals to address the concerns identified in Section 4. In summary we are concerned that:

- Royal Mail has the flexibility to structure its access charges so as to set relatively high charges (by comparison with its own costs) in areas where entry is unlikely while setting relatively low charges in areas open to competition. In doing so it can deter beneficial entry in bulk mail delivery;
- There are two sources of uncertainty facing a would-be entrant in bulk mail delivery that have the potential to undermine beneficial entry:
 - An entrant into bulk mail delivery faces uncertainty over whether they will be able to procure access services on similar terms to access-only operators, or whether Royal Mail would be in a position at some point to use differences in characteristics between the different types of operator to offer access on discriminatory terms; and
 - By introducing significant year-on-year revisions to the structure of its access contracts and related charges, Royal Mail may create uncertainty that has the potential to undermine beneficial entry.

5.2 Having considered a number of options for addressing these concerns, in Section 4 we provisionally conclude that our preferred approach is to introduce a USPA Condition that constrains the structure of Royal Mail's access charges while leaving it with the freedom to determine the overall level of access charges. In this Section we consider in further detail how this proposed remedy would be designed. The overarching objective of our proposals is to address the concerns set out in Section 4 and to encourage beneficial entry. As set out in paragraph 4.17, beneficial entry is that which puts downward pressure on Royal Mail's retail prices and access charges as a result of genuine competitive advantage. This kind of entry will prevent Royal Mail from charging excessive prices, encourage Royal Mail to reduce its costs and to invest in improving its products and processes, leading to net benefits for postal users. We set out in further detail the benefits of this kind of competition in Annex 5.

5.3 In achieving these objectives we also need to meet our duties under the PSA 2011. Our duty is to carry out our functions in a way we consider will secure the provision of the universal postal service. The PSA 2011 requires us to have regard to the need for the provision of the universal service:

- To be financially sustainable, including the need for a reasonable commercial rate for return; and
- To become efficient within a reasonable time, and then remain so.

5.4 In this respect we want to ensure that any regulation we impose secures the provision of the universal service by providing Royal Mail with an opportunity to recover its costs and earn a commercial rate of return. In addition, we want to provide it with the right incentives to improve efficiency.

- 5.5 We are also mindful of our objectives and decisions in the March 2012 Statement, in which we decided to remove certain regulation to give Royal Mail greater commercial flexibility to meet the significant challenges it faces 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.
- 5.6 Therefore, in keeping with our policy position in 2012, we want to impose the minimum possible constraint on Royal Mail's commercial freedom to secure our objectives set out above.
- 5.7 The remainder of this Section is structured as follows:
- we consider how a control on the structure of sub-national (as opposed to a national) charges is appropriate to address our concern relating to the structure of access charges across different areas. We discuss the design of this control first.
 - we then consider how we address our concern related to uncertainty around the possibility for discrimination between operators on different access contracts. In order to address this we consider that it is appropriate to link the charges in national access contracts to the charges in Zonal access contracts.
 - Finally we set out our provisional conclusions.
- 5.8 We consider that the package of remedies we are proposing will also address the second part of our second concern in paragraph 5.1 with respect to year on year variation. We discuss this further in Section 7 where we discuss whether the proposals meet our objectives.

Proposals for sub-national charges

The appropriate basis to differentiate costs geographically

- 5.9 As noted above, we are concerned that Royal Mail may structure its sub-national access charges in a way that prevents beneficial entry. In order to address this concern, we consider it appropriate to control the way that Royal Mail charges in sub-national geographic areas.
- 5.10 In considering an appropriate intervention, we have first considered to what geographic areas our control on the structure of Royal Mail's charges should apply (e.g. to the Zones identified by Royal Mail or to some other geographic unit). In approaching this question we have considered the geographic basis on which Royal Mail's costs vary.
- 5.11 As explained in paragraph 3.16, delivery costs vary depending on the features of a particular area. Key drivers of the per item delivery cost are the density of delivery points and the number of items delivered per point. A number of other factors also influence delivery costs including wage variations.

- 5.12 For the purposes of setting regulation, we consider it is appropriate to aggregate areas with similar delivery costs. Setting regulation on this basis:
- Helps to provide a potential entrant with a consistent basis on which to make its entry decisions, improving the efficiency of signals sent by access charges regarding the areas where entry should occur. For example, if the cost of delivery is the same in two different areas and Royal Mail were to set different access charges in each area, it would send different signals to potential entrants regarding the desirability of entry into those areas;
 - Mitigates the risk of an end-to-end entrant gaining an artificial competitive advantage;¹⁵³ and
 - Is practicable. Since it would not be practicable to consider differences in delivery costs at a very granular level, we therefore need to consider an appropriate way to aggregate geographic localities with similar delivery costs.
- 5.13 There are a number of possible candidates for geographic areas – we could look for example at coverage of individual delivery offices or SSCs. However, in light of the urgency of the need to intervene and the practicability and cost implications of what we do, we consider it more appropriate to use geographic cost information that already exists rather than to require new bottom up modelling.
- 5.14 Royal Mail produces geographic cost information at a Zonal level and there are currently four Zones: London, Urban, Suburban and Rural. The Zones are designed broadly to reflect differences in geographic delivery costs, thus we consider them to be appropriate for our purposes. In particular, each postcode sector is allocated to a Zone based on business address density and delivery point density in the sector (variables that are likely to be key drivers of delivery costs).¹⁵⁴ London is distinguished from the other Zones, which may reflect the fact that Royal Mail incurs higher costs (e.g. wages) in the capital.¹⁵⁵
- 5.15 We consider that using Zones to distinguish delivery costs geographically has a number of further advantages:
- They are already a feature in access pricing and are understood by Royal Mail and access operators;
 - There is a tractable number of Zones (having many Zones could complicate access charging); and
 - Using Zones avoids the creation of a new onerous burden on Royal Mail because a Zonal costing model already exists.

¹⁵³ To illustrate, suppose regulation required Royal Mail's charges to be set on a basis that aggregated geographic areas that had very different costs to serve. Setting the same access charge across that area would potentially allow an end-to-end entrant to undercut Royal Mail's access charges in the cheaper to serve parts of that area, even if the entrant's costs in delivering to those parts were higher than those of Royal Mail.

¹⁵⁴ The postcode sector means the first part of the postcode before the space and the start of the second part of the postcode ie the first three, four or five alphanumeric digits of an outward postcode, which is used to identify a geographical area for mailing items to be delivered. For example, NE1 4 is a postcode sector.

¹⁵⁵ The London Zone is defined according to whether SSCs sit (largely) within the M25. This Zone is not defined according to delivery point density.

- 5.16 Currently Royal Mail is able to change the number and definition of the Zones. If we use Zones as part of the USPA Condition, this flexibility will be lost. Specifying Zones as part of the USPA Condition has both advantages and disadvantages. From Royal Mail's point of view, there is a potential disadvantage because it might wish to change the definition of the Zones for independent commercial reasons. However, the risk of constraining Royal Mail's freedom in this respect is justified in our view by the greater risk that it would wish to adjust the Zones to undermine the control.
- 5.17 From other operators' point of view, changing the number/definition of Zones could be disruptive and make business planning difficult, so on balance this is likely to be an advantage.
- 5.18 In light of this we propose for the time being to largely adopt the methodology Royal Mail currently uses to define Zones as set out in section 8.4 of Royal Mail's ABC Costing Manual.^{156,157} This sets out how postcode sectors are allocated to each of the London, Urban, Suburban and Rural Zones (in addition also defining the number of Zones). However, we set out in Section 6 our reasons for believing it appropriate to review the Zonal costing methodology after this review of access pricing, and it may be appropriate to consider as a part of that work whether any refinements to this methodology are appropriate.
- 5.19 We recognise that there may be legitimate business reasons why the number or definition of Zones needs to change from time to time as the market evolves (although we would expect this to be infrequent) and therefore it may not be appropriate to fix the number and definition of Zones permanently. In the event that Royal Mail considers that a change to the number or definition of Zones is appropriate it should notify the proposed change to us. We would then consult on whether we should make the required changes to the USPA Condition and USPAC Condition. Royal Mail would also need to adapt its Zonal costing model to incorporate any changes (including producing cost information for any new Zones).
- 5.20 Our proposed definitions of the Zones are in the draft legal instrument at Annex 9. More discussion of the way in which we have drafted the instrument to define Zones is in Annex 6.

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

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

¹⁵⁶ See ABC Costing Manual 2014-15, September 2014, available at

http://www.royalmailgroup.com/sites/default/files/Costing_Manual_%202015-1.pdf .

¹⁵⁷ The exception to this is the treatment of the Crown Dependencies. Currently we understand the ABC cost manual provides that costs associated with the Crown Dependencies are allocated to the Rural Zone. As Royal Mail is not the end-to-end provider of D+2 Access mail originating in the UK to parties in the Crown Dependencies we propose that these costs should be excluded for the purpose of our proposals. See further paragraphs 6.45-6.51.

Proposed approach: ratio of Zonal charges equals the ratio of Zonal costs

Overview of our proposed approach

- 5.21 As explained in Section 4, we are concerned that Royal Mail could increase the gradient of the Zonal tilt in a way that prevents beneficial entry. It could set Zonal charges close to LRIC where entry could potentially occur and recover all of its fixed and common costs through high charges in Zones where entry is unlikely. Accordingly we are proposing to require Royal Mail to link its charges across different Zones in a way that reflects differences in the underlying cost of delivery, while preventing a highly tilted pattern of charges that poses a particular risk to end-to-end competition.
- 5.22 Specifically, our preferred option is a proposal whereby, for each D+2 Letter and Large Letter Access service, the ratio of Royal Mail’s charges across Zones is required to equal the ratio of unit delivery costs across Zones. Under this proposal we would only stipulate the relationship between charges across Zones – we would not be setting maximum or minimum absolute charges.
- 5.23 We have considered how this option would be designed in practice. In summary, we propose:
- Each individual access mailing item would be mapped to its format type (i.e. whether it is a letter or large letter).
 - Royal Mail’s Zonal Costing Model (“**ZCM**”) would be used to estimate FAC of delivery, for each Zone, for each format type. Royal Mail already prepares this model and uses it to produce these outputs. (We set out at 6.21 the further steps we would require to ensure the outputs of the model are robust.)
 - We would require the ratio of Zonal charges for each individual mailing item to equal the ratio of Zonal FACs for the relevant format.
- 5.24 In the example below we provide a simple illustration of how the proposal would work. In this simplified example we have four Zones (1, 2, 3 and 4) and three mailing items (X, Y and Z). The three mailing items all sit within the same format type, and thus have the same format level FAC – see Figure 5.1.

Figure 5.1: Illustrative Zonal format FAC

Zone		1	2	3	4
FAC at format level	X	10p	12p	14p	16p
	Y				
	Z				
FAC ratio (relative to FAC in Zone 1)	X	1	1.2	1.4	1.6
	Y				
	Z				

- 5.25 In Figure 5.2 we illustrate Zonal charges for the three mailing items consistent with our proposals. In each case the ratio of Zonal charges equals the Zonal FAC ratio in Figure 5.1 above. The absolute level of charges varies by mailing item.

Figure 5.2: Illustrative Zonal charges consistent with our proposal

Zone	1	2	3	4
X	20p	24p	28p	32p
Y	15p	18p	21p	24p
Z	10p	12p	14p	16p
Ratio of charges (relative to Zone 1)	1	1.2	1.4	1.6

- 5.26 This rule would apply, broadly, to every distinct service that Royal Mail offers on a Zonal basis. Here, we consider a distinct ‘service’ to be essentially every permutation of letter or large letter-type, including handling characteristic combinations, for example size, weight, degree of sortation and whether the mail is presented in trays or bags, which affects or may affect the charge per item carried. We also consider it to encompass each permutation of the applicable terms and conditions of carriage, so the conveyance of a particular letter type under terms and conditions that include e.g. different payment terms, minimum requirements or rebate provisions would be a different service from the same letter type carried under terms and conditions that do not.
- 5.27 To illustrate, consider a standard “Access 70 letter” that is presented to Royal Mail in bags.¹⁵⁸ If, hypothetically, Royal Mail wanted to offer a discount to operators meeting certain environmental standards then this would mean there were two distinct services: (i) a standard Access 70 letter presented to Royal Mail in bags by operators meeting those environmental standards; and (ii) a standard Access 70 letter presented to Royal Mail in bags by operators not meeting those environmental standards.¹⁵⁹ The access charge for these two services could differ but each service would need to comply with our Zonal ratio rule.
- 5.28 The only types of terms and conditions that we would exclude from this would be the terms and conditions that are by definition only applicable to national contracts, i.e.:
- Profile-related requirements (e.g. requirements that mean that only persons with a particular profile are allowed to be on a particular contract and requirements to match a given profile);
 - Profile-related surcharges and tolerances; and
 - Terms and conditions associated with ascertaining the volumes of items handed over to Royal Mail according to the geographic destination to which the items are delivered.
- 5.29 The rule would apply to what we consider to be the ‘core’ charge for a service. That is, the effective contractual charge, which would exclude surcharges/compensation payable by the access operator/Royal Mail for a breach of contractual terms and conditions, i.e. by way of liquidated damages. Such surcharges must by definition reasonably reflect the loss expected to be caused from the breach of the contractual terms, so there is little scope for them to undermine the objective of our proposed regulation.

¹⁵⁸ 70 refers to the degree of sortation the access operator applies to the mailing items before they are handed over to Royal Mail.

¹⁵⁹ Introducing such a discount might double the overall number of services offered by Royal Mail i.e. the original services if the environmental standards are met and if they are not met.

- 5.30 It would also exclude any charges made for hire or maintenance of equipment (e.g. hire of 'Yorks'¹⁶⁰) as these are separate products and services that do not, in themselves, include the conveyance of mail. Charges intrinsically linked to the conveyance of bulk mail would be captured – for example, the extra sorting involved for those mailings that have not been pre-sorted by the access operator and the different handling processes required depending on whether mail is presented in bags or trays.
- 5.31 An effect of this rule would be to make it impossible for Royal Mail to offer any charging variations that were not linked to the per item charge set for the service concerned. For example, it would be inconsistent with the rule for Royal Mail to offer a discount in relation to a minimum volume of items being sent to one particular city or a lump sum rebate in exchange for a minimum spend by the access operator. We do not consider this to be an onerous restriction for Royal Mail. It does not currently offer any such charging variations. Moreover, such variations are particularly likely to raise concerns about the impact on an end-to-end entrant.

Making services available on a Zonally-charged basis

- 5.32 This proposed regulation of Zonal charges is only meaningful where services are offered on a Zonally-charged basis. We have therefore considered whether there is any risk that potential entrants could (reasonably) believe that Royal Mail would not make the necessary services available on a Zonally charged basis.
- 5.33 An existing regulation, USPA 2.1, requires access to be offered on reasonable request in writing. Its provision must be on fair and reasonable terms, conditions and charges and it may not unduly discriminate in relation to matters connected with this access.
- 5.34 However, practically speaking there are today a number of important differences between Royal Mail's national and Zonal price plans. The two current national plans are associated with different eligibility requirements, tolerances, and profile surcharges from one another, while the national and the Zonal plans differ from one another in these respects (which arguably follow from the fact of having national contracts at all) and also in respect of mail marking requirements.¹⁶¹ In addition, amongst Royal Mail's now-suspended changes to its plans was a forecasting obligation that was only created in relation to NPP1.
- 5.35 This history shows there is scope for various differences between plans to exist which Royal Mail must have regarded as duly discriminatory. We take no view on whether or not this is correct in relation to the current differences between the plans, but we consider that in order for our proposed regulation to work, it must be clear on its face that Royal Mail must create a Zonal service equivalent for every national priced service it offers. This means that while Royal Mail may innovate as it wishes in terms of the services available, it must make such innovations available on a Zonally priced plan too.
- 5.36 We therefore propose to amend the existing USPA 2 to make it clear that, without prejudice to the generality of USPA 2.1, where Royal Mail offers a D+2 access service under a national contract it must offer the same D+2 access service under a Zonal contract. A Zonal contract is one:

¹⁶⁰ 'York' is a Royal Mail term for a wheeled container.

¹⁶¹ Mailing items using the Zonal contract must carry the Zonal indicator relevant to the postcode sector of the corresponding address on the envelope.

- Which does not contain any profile commitments or localised volume requirements whatsoever (with the exception of minimum posting requirements¹⁶²);
 - In which services are available throughout all four Zones; and
 - In which a single charge per service is offered for each of the four Zones (the charge may differ between the Zones).
- 5.37 The first provision here, that of preventing profile commitments or localised volume requirements, is appropriate because the essence of the obligation to make services available on a Zonally priced basis is that this should be (as Royal Mail describes the current ZPP3 price plan), “pay-as-you-go”, which means that ongoing profile-based commitments and eligibility requirements based on past mailing profiles are unnecessary.
- 5.38 It follows from the second and third provisions here that Royal Mail would not be able to avoid our proposed rule on Zonal pricing by offering effectively the same (or very similar) services limited to particular Zones or other locations (e.g. “London-only letters”), but setting high charges relative to its costs in some Zones and low charges relative to its costs in others. We do not consider this likely to be in any way harmful to Royal Mail’s ability to make appropriate commercial choices. It does not currently offer any geographically limited services, and its scope to create new types of service and recover its costs in relation to them appropriately in each Zone would, as set out above, be unrestricted.
- 5.39 We discuss a number of detailed implementation points relating to the proposed Zonal remedy in Section 6.
- 5.40 More detail on the precise drafting of this obligation is set out in Annex 6.

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

National charges

The proposed relationship between Zonal and national charges

- 5.41 Our second concern in paragraph 5.1 relates to an entrant into bulk mail delivery facing uncertainty over whether they will be able to procure access services on similar terms to access-only operators, or whether Royal Mail would be in a position at some point to offer access on differential terms to the detriment of the entrant. The majority of access mail today is carried pursuant to contracts that are nationally rather than Zonally priced.¹⁶³ We are proposing to link charges in all national contracts to Zonal charges.
- 5.42 We have previously indicated that such linkages should exist. In the March 2012 Statement, in the context of a discussion of Royal Mail’s obligation to set “fair and reasonable” access terms, we said that in setting Zonal access terms, Royal Mail should “seek to ensure that the weighted average of Zonal access prices is broadly

¹⁶² We are proposing that “Minimum Posting Requirements” should mean terms or conditions under a D+2 Contract requiring that a D+2 Access Operator hand over during any period a minimum amount of Mailing Items to the universal service provider for delivery, which minimum amount applies in relation to any geographic area that is not smaller than the United Kingdom.

¹⁶³ See paragraph 1.15.

comparable to the national access price”.¹⁶⁴ However, in the light of the concerns expressed in Section 4, we consider that there is a need to tighten the existing condition to ensure that our broad policy (which has not changed since 2012) is met.

- 5.43 We propose that the national access charge for any given mailing item must equal the volume weighted average of Zonal access charges for that mailing item. We refer to this as the ‘weighted average rule’.
- 5.44 Under our proposal, Royal Mail would continue to retain flexibility over the overall level of Zonal and national access charges and the return that it earns, subject to compliance with our proposed Zonal remedy and the margin squeeze test currently in place. In particular, Royal Mail would retain the commercial flexibility to keep its national access charge at the prevailing level or change it as a response to end-to-end competition.
- 5.45 The weighted average rule would apply to each individual service, where services are defined in the same way as under our proposals for Zonal charges. To illustrate, in paragraph 5.27 we gave the example of the following two services: (i) a standard 70 letter presented to Royal Mail in bags by operators meeting those environmental standards; and (ii) a standard 70 letter presented to Royal Mail in bags by operators not meeting those environmental standards. For each of these services there would be a separate national charge derived from the Zonal charges.¹⁶⁵ Since discounts give rise to separate services, our weighted average rule has the effect of requiring those discounts to be available at both the national and the Zonal level.
- 5.46 The weighted average rule would apply to the relationship between national and Zonal ‘core’ charges – we explain what we mean by core charges in paragraph 5.29. In particular, that definition excludes surcharges related to the profile of mail that an operator passes to Royal Mail. Accordingly we discuss below whether separate regulation is appropriate to constrain the way in which Royal Mail exercises its freedom over tolerances and profile surcharges.
- 5.47 We discuss the appropriate volumes to use as weights in the weighted average rule in paragraphs 6.26 to 6.36.

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

Mailing profile requirements, tolerances and profile surcharges

- 5.48 The majority of mail is currently sent subject to national price plans under which one charge is offered no matter where in the UK the mailing item needs to be delivered.¹⁶⁶ We recognise that such plans may offer commercial advantages to access operators – in particular, there is no requirement to add a Zonal indicator to the envelope and there may be a greater degree of certainty than when the operator must pay different charges per item to send mail to the different Zones.
- 5.49 However, such charging creates a risk for Royal Mail in that access operators may send proportionately more mail to higher-cost areas than Royal Mail planned for in compiling its one charge. Therefore, as discussed in Section 3, these plans are

¹⁶⁴ March 2012 Statement, paragraph 10.153.

¹⁶⁵ Equally the national charge along with the weighting information could be used to derive the Zonal charges.

¹⁶⁶ See paragraph 1.15.

associated with measures allow Royal Mail to recover its costs in the event of significant deviations from the typical national mailing profile, i.e. eligibility requirements and profile surcharges. Profile surcharges are currently applied subject to 'tolerances' i.e. amounts by which the access operator's mailing profile may deviate from the typical profile before any extra charges are levied. We recognise that, to the extent that national contracts exist, it is appropriate for Royal Mail to protect itself against atypical mailing profiles to the extent necessary to recover its costs appropriately.

- 5.50 Nevertheless, in theory, tolerances and profile surcharges (with or without contractual eligibility criteria) could be used to favour some operators over others. For example, having larger tolerances on one national contract (which an end-to-end operator is unable to qualify for) would allow operators on that contract to send a greater proportion of mail to relatively expensive areas at the national average charge, conferring a competitive advantage on them when competing with an end-to-end operator at the retail level.
- 5.51 A related mechanism that could advantage some operators over others is manipulating the required mailing profile. Royal Mail could potentially require a mailing profile that suits some operators better than others, which in turn could affect contract eligibility and the level of profile surcharges. This mechanism could be used to push certain operators towards less favourable contracts.
- 5.52 Royal Mail is currently required to provide D+2 Access on fair and reasonable terms, conditions and charges (USPA 3.1) and not to unduly discriminate against a person in relation to D+2 Access (USPA 5.1). USPA 5.1 also prohibits Royal Mail from discriminating unduly between two access operators. We have considered whether this existing regulation is sufficient or whether to further intervene to address the concerns outlined above. For example, we could prohibit the use of tolerances, so that any deviation from the national mailing profile results in a surcharge. Alternatively we could specify a maximum tolerance, so that operators with a significantly different mail profile to Royal Mail that breach those tolerances would incur a surcharge. We could also specify the level of profile surcharges, to ensure that they are not unduly harsh or lenient.
- 5.53 Intervening in these ways would lessen the scope for Royal Mail to use tolerances and profile surcharges in a way that discriminates between operators. As a result, it would support the emergence of beneficial end-to-end competition.
- 5.54 However prohibiting the use of tolerances is likely to be highly disruptive. It would impact every operator currently on a national pricing plan, which would be almost all the operators in the sector. This could cause access operators to incur additional costs because they may need to manage their mailing profile more precisely and expend greater resources reconciling invoices from Royal Mail.
- 5.55 Specifying maximum tolerances (relative to a mailing profile) and/or the level of profile surcharges in an ex ante regulatory condition is not straightforward. There are a number of different ways that tolerances could be specified. For example, currently Royal Mail specifies tolerances in terms of the Zonal mail profile under APP2 and in terms of the mail profile delivered to different SSCs under NPP1. Determining the basis on which tolerances should be specified (e.g. Zones or SSCs) potentially restricts Royal Mail's flexibility when designing its national contracts. Moreover calculating an appropriate maximum for those tolerances and associated surcharges would add to the complexity of our proposals.

- 5.56 We have weighed up the benefits and drawbacks of adopting a more interventionist stance on mailing profiles, tolerances and profile surcharges. On balance, we do not consider tolerances to be a major concern at this time. The national plans (NPP1 and APP2) may, in principle, allow operators with somewhat skewed profiles (relative to the mailing profile underpinning the national contract) to pay the national price.
- 5.57 Moreover, Whistl initially proposed to roll-out end-to-end services on the basis of access terms which included eligibility requirements, tolerances and profile surcharges. We therefore do not consider that the achievement of our regulatory objective necessarily requires us to introduce further regulatory requirements at this time.¹⁶⁷
- 5.58 Accordingly we do not propose to introduce additional regulation of Royal Mail's mailing profile requirements, tolerances and any associated profile surcharges/rebates at this time. Rather we propose to continue to rely on the existing USPA Conditions (particularly USPA 3.1 and USPA 5.1) to ensure that these are set on a fair, reasonable and non-discriminatory basis.¹⁶⁸
- 5.59 In addition to contract tolerances, Royal Mail has also included in its NPP1 price plan a requirement to use "all reasonable endeavours" to meet profile requirements such that surcharges are not necessarily payable if the profile is not met. As with tolerances, such clauses must be fair and reasonable and their inclusion and application must not be unduly discriminatory.
- 5.60 In summary, we are not proposing to introduce additional regulation in relation to mailing profile requirements, tolerances and profile surcharges at this time. However, it is an area we will keep under review and may revisit in the future if there are developments that concern us.

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

Other non-Zonal contracts

- 5.61 Currently Royal Mail offers either national or Zonal price plans, and we have described above the relationship between the charges for these price plans. It is possible to envisage other types of access pricing plans, for example, sub-national plans where an average charge is offered for a particular region(s) of the UK.
- 5.62 Were Royal Mail to offer sub-national plans we would need to ensure that the relationship between the charges under any sub-national plan and any Zonal plan satisfied the principles (in relation to national contracts) that we have set out above. In particular, the sub-national average charge for any given service would need to reflect the underlying volume weighted Zonal charge. If this were not the case Royal Mail could potentially undermine our proposed regulation.
- 5.63 Our understanding is that the current Zonal plan (ZPP3) essentially meets the needs of operators that do not wish to be on a national plan (indeed, we understand that it

¹⁶⁷ In this Consultation we have not assessed whether Royal Mail's current mailing profile requirements, tolerances and/or surcharges are compliant with its existing regulatory obligations.

¹⁶⁸ For the avoidance of doubt, we consider that the prohibition in USPA 5.1 on undue discrimination applies to undue discrimination between operators on different national/Zonal contracts (as well as between Royal Mail and other operators).

originally arose in response to a request from a postal operator operating on a sub-national basis).¹⁶⁹ As far as we are aware, access operators have not sought sub-national plans (outside the Zonal plans) with an average charge to date, even though we note there may be advantages in having a specified average charge and associated terms around mailing profile requirements.

- 5.64 Further, our proposals regarding Zonal and national charges are based on existing and well understood costing models and we have defined the rules for Royal Mail's Zonal Costing Methodology in the RAG (though this is subject to further review following the access pricing Statement).¹⁷⁰
- 5.65 While we could construct, in principle, regulations for new forms of sub-national contracts we do not consider that we would (absent a review of the costing methodology) be able to ensure that the methodology is robust. Accordingly, we would be concerned that such developments would introduce additional scope for uncertainty over Royal Mail's ability to discriminate.
- 5.66 In light of this, we consider it appropriate to prohibit Royal Mail from unilaterally introducing a sub-national plan. Should it wish to do so, we would consider its proposals (including the underlying modelling data) and would then consult on whether we should make the required changes to the USPA Condition and USPAC Condition.
- 5.67 While this prevents Royal Mail from introducing a sub-national plan without prior approval from us, in light of the apparent lack of demand for such a plan currently we do not consider that this will have a significant impact on either Royal Mail or access operators¹⁷¹.

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

Provisional conclusions

- 5.68 In this Section we have described the structure of our proposed Zonal and national remedies. In summary, our proposals are:
- To introduce a rule that requires, for every service, that the ratio of Zonal charges equals the ratio of Zonal costs;
 - To require that a Zonally-priced service be offered for every service which is available priced on a national basis; and
 - To require that the weighted average of the Zonal charges for each service equals any national charge; and
 - To prohibit services being offered on a basis that is neither Zonal nor national.

¹⁶⁹ *The building blocks for a sustainable postal service – Initial proposals for regulatory safeguards*, Annex C – Zonal access, April 2011, paragraph 1.10, <http://stakeholders.ofcom.org.uk/binaries/post/1890.pdf>.

¹⁷⁰ See paragraphs 6.39-6.40.

¹⁷¹ In light of this restriction we have modified the regulations with respect to Standard Terms and Conditions' (USPA 1.3 (kkk)) to refer specifically to zonal and national contracts only.

- 5.69 In Section 6 we discuss detailed points around implementation, in Section 7 we discuss whether our proposals will achieve our objectives and set out further the impact of our proposals.

Section 6

Implementation and other issues

Introduction and objective

- 6.1 In Section 5 we describe the broad structure of our proposed remedies. In this Section, we discuss a series of individual issues that we have considered in the construction of the proposed new regulations (we have also set out a detailed discussion of drafting issues in Annex 6). We discuss detailed issues around the implementation of the proposed Zonal and national remedies, including:
- The appropriate cost standard to measure the ratio of Zonal costs;
 - Whether we should use historic or forecast data;
 - The appropriate ZCM to use if our proposals are implemented; and
 - The appropriate volumes to use as weightings in the national weighted average rule.
- 6.2 We also discuss the period in which we propose that the new regulations should come into force and the implications of our proposals for future work by Ofcom.
- 6.3 Finally, we address how our regulations apply in relation to access services for delivery to the Crown Dependencies.

Implementation of the Zonal remedy

Use of FAC to measure the ratio of Zonal costs

- 6.4 We have considered whether using a LRIC or a FAC standard would be the most appropriate cost standard when calculating the ratio of Zonal costs. Our main concern is that a consistent standard is used across the Zones, so that Royal Mail cannot potentially pick and choose a cost standard to create a charging structure that would disadvantage an end-to-end entrant. In light of this, we have considered which standard represents the most practicable and objectively justifiable approach.
- 6.5 Royal Mail currently produces LRIC data by service in its LRIC model. We conducted an initial review of Royal Mail's LRIC model in September 2013 and had significant concerns about the methodology in a number of areas, including increment structure and calculations. This was communicated to Royal Mail at the time. We have not subsequently received a new model which is substantially different from the 2013 version.
- 6.6 We also observe that the current LRIC methodology does not provide Zonal absolute LRICs or LRIC differentials that reflect Royal Mail's actual costs. Royal Mail's estimates of Zonal LRIC are in fact based on FAC differentials from the ZCM.
- 6.7 On the other hand, the ZCM is produced in accordance with a Zonal costing methodology defined by Ofcom in the RAG. We reviewed the methodology for the 2011/12 ZCM when we were developing the Zonal costing rules in the RAG. We also have a change control process in place, whereby Royal Mail has to inform us of any

changes to Zonal costing methodologies in advance and Royal Mail has not notified us of any changes so far. Therefore, we expect the methodology used to construct the 2012/13 ZCM to be materially the same as for the 2011/12 ZCM and fit for purpose. Given our concerns about the LRIC model above, we therefore consider it preferable to use FAC information from the ZCM. In particular, this option is capable of implementation quickly, which is required if the regulation is to be effective in practice.¹⁷² It also may be implemented without imposing significant new accounting burdens on Royal Mail, as the model is already available and used to produce Zonal FACs.

- 6.8 FAC information from the ZCM is only available by format (i.e. by letters and large letters) and not by individual service. Using format level FAC rather than service level FAC could have drawbacks if the Zonal FAC ratio across the Zones varies significantly across services (in this case using format FAC information means the charges for individual services would be less reflective of differences in Zonal costs). We are not able to verify whether this is the case since information on service level FAC is not currently available. However, we are not aware of any reasons why Zonal FAC ratios would be materially different at a service level compared to format level.
- 6.9 Accordingly, we consider it reasonable (and pragmatic) to use the format level FACs to derive the ratio of charges for each service.

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

Use of historic versus forecast data

- 6.10 Royal Mail currently uses historic data in the ZCM. As an example, for access charges notified in January 2014 to apply for the year 2014/15, Royal Mail used the Zonal model on the basis of September 2013 Zonal definitions and March 2013 volume data. This is referred to as the 2012/13 ZCM and it reflects volumes and costs from that financial year.
- 6.11 In considering our proposed Zonal and national remedies, we have looked at the benefits of using forecast data versus historic data. If competitors enter or expand in the delivery of bulk mail, the total and Zonal volumes of access mail may change year on year. The volumes and costs in the ZCM used to set forward looking charges would however reflect a snapshot of data that is two years old. As the ZCM uses historic data it may not reflect the current unit costs because the latest volume data is not taken account of.
- 6.12 An alternative to using historic costs and volumes would be to use forecast data. However, the data would be estimated and subject to forecast error. We have two options if we use forecasts: we could either introduce a mechanism to 'correct' for non-compliance if actual unit costs differed from the forecast; or we could rely on Royal Mail's reasonable expectations at the time when the forecast was provided. Both of these options have disadvantages. The use of a correction mechanism would reduce certainty as access charges would be subject to change. It would also be potentially cumbersome and expensive to administer if access charges are adjusted retrospectively once actual unit costs are known. As to Royal Mail's expectations, we currently rely on its forecasts as part of the margin squeeze condition. However, as access mailing volumes are volatile and difficult to predict at present, it would be

¹⁷² As we explain in Section 4, we consider there is a strong probability that if we do not act now to amend the access regulations, the prospect of end-to-end competition is likely to disappear for good.

difficult to ensure reliability of forecasts in this case. Relying on Royal Mail's forecasts also creates incentives for Royal Mail to make forecasts that act in its favour.

- 6.13 We therefore propose to use historic cost and volume information from the ZCM on the basis that it is easier to monitor and it is appropriate for the purpose of the remedy. It is also readily available without need for further modelling by us or Royal Mail.
- 6.14 It is not clear whether the use of historic cost data works for or against Royal Mail. The use of historic data might be advantageous to Royal Mail if entry/expansion by a competitor causes a reduction in Royal Mail's delivery volumes, as this may cause its unit FACs to increase in areas where it faces competition. (In this case, the use of historical rather than current information means Royal Mail would be able to set relatively lower charges in areas where it faces competition). On the other hand, if Royal Mail is able to reduce its unit costs in areas where it faces competition (relative to areas where it does not) the change in relative costs would not be reflected in the ratio of charges until the following year. This could be a disadvantage as Royal Mail will only be able to reflect such a change through an overall reduction in charges rather than targeted reductions of charges in the specific Zones where lower unit costs were achieved. On balance, however, we consider that such lags in the structure of the control do not materially undermine the purpose of the control. In the medium term Royal Mail would still have to align its charge structure with its cost structure and it would have an incentive to reduce costs (particularly in competitive areas).
- 6.15 We have explored the extent of the distortion if historical costs and volumes are used to calculate unit cost ratios when there is a new entrant in the market and therefore Royal Mail loses volumes. We adjusted the 2012/13 ZCM to reflect the Zonal volumes that Royal Mail is likely to achieve following end-to-end entry in 2015/16. We also made some simplified marginality assumptions to model Zonal costs in 2015/16. We then compared the ratio of Zonal costs in the 2012/13 ZCM with our modelled output for 2015/16.
- 6.16 Our analysis shows that the distortion from using historic costs and volumes is not significant, with the difference in Zonal cost ratios ranging from 0.1% in the Urban Zone to 4.2% in the London Zone.¹⁷³ This is not considerably different from the changes in Zonal cost ratios that were observed in the normal course of business from 2011/12 to 2012/13.

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

Appropriate ZCM to use if our proposals are implemented

- 6.17 Having proposed that historic FAC data is appropriate, it broadly follows that Royal Mail should use the outputs of the latest available ZCM to set Zonal charges.
- 6.18 The current Zonal costing rules in the RAG were developed in the context of the access pricing requirements which we put in place in March 2012 and in particular

¹⁷³ Ofcom analysis carried out using Royal Mail's 2012/13 ZCM. We ran the model to estimate the impact on zonal unit costs from changes in volumes in 2015/16. We used Whistl's forecast of its volume roll out to estimate the volumes that Royal Mail is likely to retain in 2015/16. We then compared the difference in the resulting zonal cost and charge ratios across the different volume scenarios. In our modelling of costs we used simplified marginality assumptions.

our expectation that Royal Mail should take into account the alignment of Zonal access charges with Royal Mail's costs, and that Zonal costs should be derived in accordance with the USPAC Condition¹⁷⁴ and the RAG. We considered the Zonal costing rules in the RAG to be adequate for this purpose, given that we did not specify a direct relationship between costs and charges in that regulatory framework.

- 6.19 However, our current proposals include stricter requirements on how Royal Mail must set its national and Zonal access charges with a direct relationship between the ratios of Zonal access charges and the ratios of unit FAC output from the Zonal model for letters and large letters. In light of this, if our proposals are implemented, we consider it is appropriate to review the Zonal costing methodology and consider whether any changes are required to the USPA Condition, in order to ensure that the USP Condition and the RAG are fit for this new purpose.
- 6.20 We are concerned in particular that the existing rules give Royal Mail a broad discretion to change the methodology through which the ZCM is produced, and that in circumstances where access charges is based upon it this gives rise to a risk that it may be adjusted, for example with the intention to reduce unit costs and therefore charges in the London Zone.
- 6.21 Ideally, we would review the rules in advance of setting the remedy. However, in our view it is not possible to do so in the context of the need to act in a sufficiently timely manner to ensure that the prospect of end-to-end competition in the sector does not disappear for good. Therefore, we propose that we will review the Zonal costing methodology in the RAG following the access pricing Statement with a view to Royal Mail reflecting the updated methodology in the 2014/15 ZCM. We set out below our views on what this review should cover.
- 6.22 This issue does not cause any immediate difficulties in relation to implementing our proposals, because Royal Mail has not had an incentive to change the outputs of its ZCM to date, and we consider the versions of it we have received to date to be sufficiently robust (see paragraph 6.7).
- 6.23 Royal Mail usually produces the ZCM in January. We expect that our Statement will be published in Q2 2015 and therefore Royal Mail will most likely have already produced the 2013/14 ZCM. However, at the time of producing the 2013/14 ZCM Royal Mail will of course be aware of the proposals in this consultation and potentially have an incentive to change the ZCM methodologies in order to produce Zonal costs that are favourable to it. It only has to give Ofcom seven days' notice if it chooses to do this.
- 6.24 The most recent ZCM at the time of this Consultation is the 2012/13 ZCM, which, as we note above, is generally fit for purpose. We have compared the Zonal ratios based on ZCMs that Royal Mail produced in 2010/11, 2011/12 and 2012/13 and note that there is not a significant difference in the Zonal ratios between the models, ranging from [3<]. On this basis we do not expect that a ZCM produced in 2013/14 on the basis of the same methodologies would have significantly different Zonal costs.
- 6.25 We therefore propose that for the time being our regulatory condition should require Royal Mail to use the 2012/13 ZCM, subject to a power for Ofcom to specify by direction that a different model be used. We set out below the further work we

¹⁷⁴ As defined at paragraph 2.3 and discussed at paragraphs 2.28 to 2.36.

propose to do in this regard to ensure that for subsequent years a robust model will be available.

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

Implementation of the national remedy

Appropriate volumes to use as ‘weights’

- 6.26 We set out in Section 4 our concern that an entrant into delivery currently faces uncertainty over whether they are likely to be able sustainably to procure access services on similar terms to an access-only operator. In light of this we consider it appropriate to tighten the link between Zonal and national charges through the weighted average rule (see paragraphs 5.41 to 5.47). For the same reason, we consider it appropriate to set out the volumes to use as weights in the weighted average rule i.e. to avoid the potential for Royal Mail to seek to use this as a means to discriminate and the associated uncertainty this might cause.
- 6.27 We have identified two options for the volume weights:
- Option 1 - using Royal Mail’s access and retail bulk addressed letter and large letter mail volumes;¹⁷⁵ or
 - Option 2 - using total addressed letter and large letter mail volumes (including access, retail bulk mail and USO volumes).
- 6.28 We note that there is no formal definition of Royal Mail’s retail bulk volumes in the contract but we take it to mean all mail which processed through the USO downstream network which is neither provided as a USO service nor on behalf of access operators.
- 6.29 Royal Mail currently uses access and retail bulk addressed mail volumes to determine the mailing profiles used to assess tolerances and surcharges under the national price plans.¹⁷⁶ Therefore Option 1 has the advantage that the volumes underpinning national average charges and the current contractual mailing profiles in national contracts would be consistent.¹⁷⁷ Consistency between the volumes used for the weighted average rule and the mailing profiles in national price plans helps to address our concerns about discrimination.¹⁷⁸ Our proposals concern access charges used for bulk mail delivery, and under Option 1 the volumes used to derive the national average charges would also reflect the bulk mail that Royal Mail delivers.
- 6.30 However, in reality at present, Royal Mail delivers access, retail bulk and USO mail at the same time, and therefore the delivery costs that Royal Mail incurs (and that are

¹⁷⁵ When considering the volumes to use as weights we are using letter and large letter volumes only (i.e. excluding parcels) because our proposed interventions relate to letters and large letters only.

¹⁷⁶ Royal Mail Access Letters Contract, Schedule 1, see definition of ‘National Spread Benchmark’ (NPP1) and ‘Royal Mail Zonal Posting Profile’ (APP2). Available at <https://www.royalmailwholesale.com/mint-project/uploads/438320882.pdf> .

¹⁷⁷ We note that Royal Mail could change the mailing profiles in its national pricing plans in the future.

¹⁷⁸ This means that an operator that exactly matches the mailing profile under APP2 would pay the same overall charge under either ZPP3 or APP2. This may not be the case if the volumes used for the weighted average rule differ from the mailing profile in APP2.

reflected in the ZCM and the Zonal charges ratio rule we are proposing) reflect the costs of delivering total addressed volumes. This may suggest it is more appropriate for the national average charge to be derived using total addressed mail volumes (Option 2).

- 6.31 We anticipate that our proposals will result in greater end-to-end rollout which means that Royal Mail is likely to lose some access volumes, and this loss is likely to be uneven across the four Zones. As a result, over time the access mail that Royal Mail delivers may become proportionately greater in the Rural and Sub-urban Zones than it is currently. This means that an access operator with a profile that is more reflective of the overall national mailing profile may find the national charge calculated using Option 1 to be unattractive.¹⁷⁹ As access mail forms a lesser proportion of the volume under Option 2, this would be mitigated. Option 2 may also lead to a less volatile Zonal distribution of mail over time. These reasons suggest it may be more appropriate to use total addressed volumes (Option 2).
- 6.32 We consider that both options are likely to be practicable and would involve a similar administrative burden for Royal Mail (i.e. Royal Mail should have available Zonal volumes for total addressed mail, and separately access and retail bulk mail).
- 6.33 In weighing up the options we can see pros and cons of each and do not at present favour one option over the other. Our draft regulatory condition in Annex 9 contains alternative definitions of “Relevant Postal Services” reflecting each approach (see also the discussion in paragraph A6.30-A6.37 where we discuss the definition of “Relevant Postal Services”).
- 6.34 We would therefore welcome stakeholder views on the appropriate volumes to use as weights. In coming to a decision on the appropriate option we will be particularly mindful of the impact on competition, and we are interested in views on whether one option would confer a competitive advantage on a particular set of operator(s).

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

- 6.35 We have further considered whether to use volumes at the individual service level or more aggregated format level. In principle, it would be most accurate to use the zonal access volumes for each service type. However, this would mean Royal Mail would need to have information on these volumes of each service in each Zone. This could be difficult to achieve because most access mail is currently sent under the national price plans so actual volumes at a zonal level are unlikely to be readily available. Royal Mail could seek to gather this information by sampling. However, given the large number of different services (some with very low volumes) it is likely to be difficult and costly to generate robust information.
- 6.36 What is readily available is the total addressed volume information at a format level (i.e. for letters and separately, large letters). Royal Mail already compiles this information for each Zone and uses it in the ZCM in the calculation of costs. Furthermore, it has the advantage of being simple and practicable to use and consistent with the zonal cost estimates. Accordingly, we do not consider that a

¹⁷⁹ This would occur if access volumes are lost in the low cost/charge zones meaning the national charge calculated using the weighted average rule places greater weight on high cost/high charge Zones. However this need not necessarily be the case – [X] so loss of volumes in this Zone might make Royal Mail’s national charge more attractive. Moreover, Royal Mail could mitigate this concern by varying its national price plans (e.g. to introduce rebates as well as surcharges, for operators that diverge from its mailing profile).

requirement to determine zonal volumes at a product level would be proportionate and we propose that the volumes used should be at a format level.

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

Period of bringing into force

- 6.37 We note that the proposed Zonal remedy and national remedy may require Royal Mail to make changes to its access contracts. Our understanding is that Royal Mail needs to give 70 days' notice for any such changes, after it has had time to consider what to do and take proposals through its internal governance. We also note that Royal Mail is likely to need to make some changes to its systems and processes, e.g. to ensure compliance with the rules.
- 6.38 In light of this, we propose that the legal instrument implementing these changes will come into force six months after the publication of the final Statement.

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

Review of USPAC Condition

- 6.39 As we note above, assuming we adopt the proposals upon which we are consulting now, we propose to commence a review of the Zonal costing methodology following our Statement. The review will consider in particular the extent to which the existing Zonal costing methodology and associated survey evidence is robust and suitable for the purpose of our Zonal access charging rules.
- 6.40 We will also consider the merits of the following further potential regulatory interventions:
- We will consider whether to make express a requirement for Royal Mail to produce its ZCM by 30 November each year; and
 - Given that the ZCM will be of greater importance than in the past, we will consider introducing an audit of the ZCM to provide an opinion as to whether the ZCM has been prepared in accordance with the rules contained in the RAG. This would give Ofcom and other stakeholders assurance that Royal Mail is compliant with the rules in the RAG and is using appropriate methodologies.

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

Monitoring of compliance options

- 6.41 Our proposed regulation does not include provisions specifically for compliance monitoring. We would expect Royal Mail to structure its charges in line with the regulation and it would, of course, always be open to Ofcom, on an ad hoc basis, to seek specific information regarding compliance.

- 6.42 However, we are conscious that stakeholders take comfort from compliance processes, which can contribute to confidence in the regulation put in place and hence a reduction in uncertainty. Accordingly, we invite stakeholder views as to the need for and value of a compliance regime beyond ad hoc monitoring by Ofcom. We would also welcome consideration as to the form of any such regime.
- 6.43 Options might range from a requirement on Royal Mail to publish sufficient information to allow compliance checks by its customers (e.g. zonal cost ratios and relative volumes) up to complete formal compliance statements.
- 6.44 We would need to consider the cost and proportionality of options against the identified value to stakeholders. In the event that there is an argument for further compliance monitoring measures it is our intention at this time to consider this as part of the review of the USPAC Condition which we propose to undertake following the conclusion of this review.

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

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

The treatment of D+2 Access mail destined for the Crown Dependencies

- 6.45 Royal Mail's current access contracts include the provision of access services for the Crown Dependencies (the Channel Islands and the Isle of Man), and its ABC Costing Manual (2014) provides that its costs associated with the Crown Dependencies are to be allocated to the Rural Zone.¹⁸⁰
- 6.46 However, the obligation on Royal Mail to provide access defines such access by reference to the delivery of D+2 mail to the IMC. Given that Royal Mail is not the end-to-end provider of D+2 mail originating in the UK to parties in the Crown Dependencies we do not consider that any location in the UK could be considered to be a IMC with respect to such mail. Therefore, we do not consider that the Crown Dependencies currently fall within the scope of Royal Mail's access obligations.
- 6.47 It is not obvious to us that it would be appropriate for us to impose an obligation on Royal Mail to accept such mail as part of its access services (though, of course, it is free to continue to do so).
- 6.48 It follows that the downstream cost for the Crown Dependencies currently included in Royal Mail's calculation of the Rural Zone should be excluded from the costs used in the assessment of the relative cost of the Zones as part of our proposed new Zonal charging conditions set out in Annex 9. This exclusion is set out in USPA1.3(w). This

¹⁸⁰ This is in accordance with the 2009 Postcomm decision, *Changes to zonal access pricing by Royal Mail – licence modifications, A decision by the Postal Services Commission*, 14 May 2009, <http://stakeholders.ofcom.org.uk/binaries/post/604.pdf>.

would replace the decision of Postcomm in 2009 for such costs related to the Crown Dependencies to be included in the Rural Zone Royal Mail's cost modelling.¹⁸¹

- 6.49 Notwithstanding the above, we are open to representations from stakeholders as to the impact on competition of Royal Mail withdrawing the onward forwarding of Crown Dependencies mail from its access contracts.
- 6.50 In the event that such representations lead us to the conclusion that such exclusion would materially undermine the effectiveness of the access conditions in supporting access and end-to-end competition then it might be appropriate specifically to include such a service and its associated costs in the access conditions.
- 6.51 We will consider whether any change is needed in respect of the treatment of the costs of Crown Dependencies in more detail when conducting our review of the ZCM following the access pricing Statement.

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

Modifications to the existing requirement to publish and notify charges, terms and conditions

- 6.52 Royal Mail is currently required under the USPA Condition to publish and notify its charges, terms and conditions relating to D+2 Access.
- 6.53 As we explain in Section 5, we are proposing to require that Royal Mail offers a Zonally-priced service for every service which is available priced on a national basis.¹⁸² A consequence of this is that we propose to require Royal Mail to provide D+2 Access under either two forms of contract: a national access contract or a Zonal access contract.
- 6.54 In light of these proposed modifications, we consider that it is appropriate to modify the USPA Condition to ensure that Royal Mail remains subject to the requirement to publish and notify charges, terms and conditions in respect of national access contracts and Zonal access contracts. More detail on the precise drafting of this obligation is set out in Annex 6.

Detailed drafting issues

- 6.55 Annex 6 sets out a number of detailed drafting issues in respect of our proposed modifications to the USPA Condition. The purpose of this Annex is to explain our thinking on certain detailed concepts and their definitions, mainly related to the concept and definition of 'Zones', that we propose to use for the purposes of our proposed remedies discussed in Sections 4 to 7.

¹⁸¹ Note that we do not consider it necessary for our proposed condition to spell out, in relation to volumes, that mail to these islands should be excluded. Since the Crown Dependencies are not a part of the UK, our proposed definition of "Zone C (Rural)" means that they are not caught to begin with.

¹⁸² See paragraphs 5.32 to 5.40

Section 7

Provisional conclusions

- 7.1 In this Section we review the efficacy of our proposed intervention set out in Section 5 and Section 6 in the light of the concerns considered in Section 4. We also assess further the impact of our proposals as a whole in the context of our duties.
- 7.2 We provisionally conclude that the proposed interventions address the concerns identified that:
- Royal Mail has the flexibility to structure its access charges so as to set relatively high charges (by comparison with its own costs) in areas where entry is unlikely while setting relatively low charges in areas open to competition. In doing so it can deter beneficial entry in bulk mail delivery;
 - There are two sources of uncertainty facing a would-be entrant in bulk mail delivery that have the potential to undermine beneficial entry:
 - An entrant into bulk mail delivery faces uncertainty over whether they will be able to procure access services on similar terms to access-only operators, or whether Royal Mail would be in a position at some point to use differences in characteristics between the different types of operator to offer access on discriminatory terms; and
 - By introducing significant year-on-year revisions to the structure of its access contracts and related charges, Royal Mail may create uncertainty that has the potential to undermine beneficial entry.
- 7.3 We also provisionally conclude that the net impact of our proposed intervention is positive for postal users. Competition of the form it allows will provide appropriate constraints on Royal Mail's pricing in the wholesale and retail markets and encourage Royal Mail to improve its service efficiency locally and nationally.
- 7.4 Further, while we cannot rule out that there are scenarios in the future where competition in bulk mail delivery could mean the difference between sustainability and unsustainability for the USO, we do not consider that at this time the current proposals present a material threat to Royal Mail's sustainable provision of the USO.
- 7.5 Finally, we have considered the proportionality of our proposed interventions and provisionally conclude that they are proportionate. Royal Mail would retain appropriate commercial freedom to respond to broader market challenges and opportunities, while its ability to construct contracts which undermine competitive entry is limited.
- 7.6 This Section is structured as follows:
- First we consider whether the proposals meet our objectives;
 - We then consider the impact of our proposals; and
 - Finally, we set out our provisional conclusions.

Will our proposals achieve the objectives?

7.7 In summary, our proposals are:

- To introduce a rule that requires, for every service, the ratio of Zonal charges to equal the ratio of Zonal costs;
- To require that a Zonally-priced service to be offered for every service which is available priced on a national basis;
- To require that the weighted average of the Zonal charges for each service equals any national charge; and
- To prohibit services being offered on a basis that is neither Zonal nor national.

7.8 As set out in Section 5, the overarching objective of our proposals is to address the concerns set out in Section 4 (summarised at paragraph 7.2 above) and to encourage beneficial entry, while taking into account our duties and being mindful of the policy position in the March 2012 Statement (see paragraphs 5.3-5.6).

Our concern about Zonal charges

7.9 Our first concern set out in paragraph 7.2 is that Royal Mail has the potential flexibility to structure its access charges so as to set relatively high charges (by comparison with its own costs) in areas where entry is unlikely while setting relatively low charges in areas where competition is more likely. This risks deterring beneficial entry. Our proposals would require Royal Mail to set a pattern of Zonal charges that reflects the underlying costs. This is consistent with the guidance we provided in the March 2012 Statement¹⁸³ and would prevent Royal Mail from increasing the gradient of the Zonal tilt in a way that could deter entry.

7.10 The relative difference in access charges across Zones would thus reflect the relative difference in FAC. This means Royal Mail would not be able to selectively reduce charges in some Zones while setting high charges in others. For example, if Royal Mail wishes to set charges in the Rural and Suburban Zones that are considerably above its FAC (including a commercial rate of return) then it will also be required to set charges considerably above its FAC in the London and Urban Zones, where it faces the threat of entry.¹⁸⁴ Such a practice may give entrants the opportunity to roll out their own end-to-end delivery networks in these Zones.

7.11 Our proposals do not place any requirements around the absolute level of charges (they simply requires that the ratio of charges across Zones reflects the FAC ratio). We recognise that Royal Mail could respond by setting low absolute charges across all services in all Zones (with a corresponding low national average charge) with the aim of driving out end-to-end entry by making it considerably less profitable in comparison with access. While the entrant would be able to take advantage of lower charges in the areas where it is reliant on Royal Mail for delivery, it may find that it is difficult to compete in the entry areas (i.e. where it rolls out an end-to-end operation). This would require some short term profit sacrifice from Royal Mail but, in the longer

¹⁸³ We stated that Royal Mail should seek to ensure that the weighted average of zonal access charges is broadly comparable to the national access charge. March 2012 Statement, paragraph 10.153.

¹⁸⁴ See paragraph 7.22, bullet one.

term, free from competition in bulk delivery, it could raise charges (potentially to monopoly levels).

- 7.12 Under our proposals, if Royal Mail were to reduce Zonal charges below the level of FAC in Zones where it faces the risk of entry, it will also need to reduce charges below FAC in other Zones and make a corresponding reduction in the national charge. Royal Mail may wish to do so to protect its current volumes in the face of end-to-end competition. From our calculations¹⁸⁵ it appears that for the strategy to be effective the profit sacrifice on the part of Royal Mail to execute it is likely to be significant (over c.£250m in the first year). Such a strategy would have a major impact on Royal Mail, with the potential for the Reported Business to become loss making (the profit sacrifice is likely to be approximately the same as Royal Mail's profit before tax). Such conduct could also raise concerns under competition law. We therefore consider that there is low risk of Royal Mail pricing significantly below its fully allocated costs across the board.
- 7.13 We recognise that, in practice, a competitor may not have exactly the same service mix as Royal Mail. We have considered whether Royal Mail might be able to exploit differences between its own and an entrant's service mix. For example, Royal Mail could decrease charges for the services where the entrant has a significant presence (making it more difficult for the entrant to win customers) while maintaining higher charges on other services (to reduce the profit sacrifice that this strategy entails). Alternatively, Royal Mail could increase charges for only those access services that are predominantly purchased by the entrant.
- 7.14 While theoretically possible, in reality it is unlikely that Royal Mail and an entrant would have a significantly different service mix, so there is likely to be a limited opportunity for Royal Mail to exploit this opportunity to its advantage. We have looked at Royal Mail and Whistl's current service mixes for access mail and consider these to be broadly similar for the main service types.¹⁸⁶ Nevertheless it is possible that the service mixes would diverge in the future. In light of this we are not proposing any specific rules to address this issue at this stage, but we would monitor the effectiveness of our proposals in the future.
- 7.15 In summary, our provisional conclusion is that our proposals are likely to address the first concern set out in paragraph 7.2 and give beneficial end-to-end operators the opportunity to enter into bulk mail delivery.

Our concerns about uncertainty

- 7.16 Our second concern in paragraph 7.2 was that there are two sources of uncertainty currently facing a would-be entrant to delivery that potentially undermine beneficial competitive entry, notably the potential for:

¹⁸⁵ We estimated potential profit loss that Royal Mail would face in 2015/16, under our proposals, if it adopted the average charges in the Urban or London Zones that it announced in the 2013/14 Notices. We modelled the 2015/16 scenario assuming that Royal Mail is able to adopt either the Urban or the London charge to the level planned in the 2013/14 Notices (with an inflation assumption). We compared the results with our estimate of the zonal charges that Royal Mail could adopt in 2015/16 within the constraints of our proposed remedy, based on its current (2013/14) national average charges. The zonal costs and cost elasticity (marginality) assumptions we used in modelling both scenarios are Ofcom estimates based on the 2012/13 ZCM.

¹⁸⁶ Royal Mail response to question 3 of s.55 notice dated 2 June 2014. Whistl response to question 1 of section 55 notice dated 22 August 2014. Whistl and Royal Mail do not use exactly the same naming convention for each service type. We have mapped the service types where necessary.

- Royal Mail, at some point, to use differences in characteristics between the different types of operator to offer access on discriminatory terms; and
- Very significant year-on-year revisions to Royal Mail's access contracts and related charges.

7.17 With respect to the first source of uncertainty we consider that our intervention will substantially reduce the risk that Royal Mail could design its contracts to discriminate in its charges between different types of operator. We propose to require national and Zonal charges to be linked via the weighted average rule. As well as aligning core charges between Zonal and national contracts, this rule also aligns core charges between different national contracts.¹⁸⁷ We recognise that the operation of mailing profile requirements, tolerances and profile surcharges may mean that the position of an operator under a national contract is not exactly the same as the position of that operator under a Zonal contract but for the reasons set out in paragraphs 5.48 to 5.61 we are not proposing to introduce additional regulation of this at this time. Nevertheless this is an area we will keep under review and may revisit in the future if there are developments that concern us.

7.18 With respect to the second source of uncertainty, while it would not be appropriate to try and eliminate all uncertainty, we are concerned that some of the changes (for example the increase in the gradient of the Zonal tilt in the 2013/14 Notices) were aimed at discouraging entry in bulk mail delivery rather than reflecting market evolution or innovation. Given our proposal that the ratio of Zonal charges must reflect the ratio of Zonal costs and the weighted average rule, we consider that Royal Mail is less likely to introduce such significant swings in charges in the future. This is for a number of reasons:

- Our proposals link the structure of access charges more closely to the structure of costs. We consider it unlikely that the ratio of Zonal costs will change very significantly year by year.
- Further, if Royal Mail decides to change the level of the Zonal charges it will also need to change the level of the national charges (since we are proposing that the national charge equals the weighted average Zonal charge). This is likely to discourage Royal Mail from making significant changes to Zonal charges.

7.19 Therefore our proposals will give access operators greater certainty over the structure of Royal Mail's charges and the relationship between the charges under different contracts. Our provisional conclusion is that our proposals directly address the first concern about uncertainty set out in paragraph 7.2 and indirectly mitigate the second concern about uncertainty.

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

¹⁸⁷ Since charges in every national contract have to equal the weighted average of Zonal charges, this also implies, for a given service, that charges in every national contract have to be the same.

Impact of our proposals

- 7.20 In this sub-section we consider further the impact of our Zonal pricing proposals and the proposed weighted average rule on consumers, Royal Mail and other postal operators. Before discussing the impact on these stakeholders we first consider whether our proposals will lead to entry.
- 7.21 An operator looking to enter bulk mail delivery faces a choice – it can either chose to roll out its own network to serve a location or purchase downstream access from Royal Mail. In general, we would expect an entrant to self-supply delivery services where the costs of doing so are less than the downstream access charges it would otherwise incur.
- 7.22 For a prospective entrant, a key input to any decision to enter bulk delivery is therefore Royal Mail's access charges. We do not know how Royal Mail will alter its access charges in response to our proposals - which will depend on its commercial strategy. However, we do consider that our proposals are likely to support beneficial entry:
- If Royal Mail continues to keep the national access charges broadly unchanged (or increases them) under our proposals then, relative to the current situation, we estimate that the average Zonal charges in the London and Urban Zones would be higher, with the average charge in the Suburban and Rural Zones lower.¹⁸⁸ Relative to the current situation this would tend to encourage entry in the London and Urban Zones, and discourage entry in Suburban and Rural Zones though there are variable impacts at the SSC level. On balance, compared to the situation prior to the 2013/14 Notices,¹⁸⁹ in this scenario the impact is likely to be slightly more favourable for entry though it is questionable that Whistl is in a position to take advantage of this in the short term. In particular, we note that Whistl's roll-out plans are focused on the Urban and London Zones.¹⁹⁰
 - We note that Royal Mail may re-optimize its national charges in response to our proposals. Royal Mail may respond by reducing its national and (necessarily) its Zonal charges with the aim of making the case for entry/expansion less compelling (because it is relatively cheaper to use Royal Mail's access service compared to rolling out a delivery network). While this is possible, we discuss at paragraph 7.12 that reducing charges to the extent that entry is no longer profitable would entail significant profit sacrifice by Royal Mail, and may also raise concerns around compliance with competition law.
- 7.23 Overall, we therefore consider that our proposals are likely to lead to entry/expansion in end-to-end. Further, for the reasons described below we consider that entry under our proposals will likely lead to lower retail prices and will occur as a result of genuine competitive advantage, and therefore represents beneficial entry.

¹⁸⁸ Royal Mail generally increased the national average charges in the access pricing notification that came into force on 31 March 2014. Royal Mail also proposes to increase access prices in its proposed prices for 2015/16 that come into force in January 2015.

¹⁸⁹ On which basis Whistl planned to extend its delivery network roll out to a number of additional locations in the UK.

¹⁹⁰ Whistl response to question 12 of section 55 Notice dated 10 July 2014.

Impact of proposals on consumers

Impact on retail prices

7.24 We consider that competition as a result of entry means that Royal Mail is likely to face greater constraints on its retail prices than it would operating as a near monopolist in bulk mail delivery, and as a result senders of bulk mail are likely to benefit from lower retail prices. Ultimately we consider that these benefits will be passed through to consumers more generally e.g. they may benefit from greater use of bulk mail, and to the extent that bulk mail customers benefit from lower prices for sending letters, they may pass this through to consumers in the form of lower prices for their services. We consider that the potential for lower retail prices is a significant benefit to consumers from entry. See also paragraph A5.109.

Impact on efficiency

- 7.25 As discussed in Annex 5 (paragraphs A5.26 to A5.76), we consider that competitive pressure arising from end-to-end entry/expansion will encourage Royal Mail to become more efficient and reduce costs. This will arise for bulk mail (where Royal Mail faces direct competition) but also for USO mail because this shares the same distribution network. We would expect this to benefit consumers to the extent that these cost reductions are reflected in lower retail prices.
- 7.26 We note that Royal Mail has stated that it is already doing everything it can to improve efficiency and that competition does not contribute to the already strong incentives on Royal Mail to seek greater efficiency across its business. However, we consider that competition, including the threat of entry and expansion in bulk mail delivery, is a central part of what currently contributes to the incentives for Royal Mail to improve its efficiency. If the threat of entry and expansion in bulk mail delivery were to disappear completely, any impetus this threat currently provides to efficiency would lessen. The reduced constraint on retail price if this threat of entry were to disappear may also lead to lower incentives for efficiency relative to current levels. As a result, we consider incentives for productive efficiency would be stronger under competition than they would be if the threat of end-to-end entry were to disappear. (see paragraph A5.63).
- 7.27 We noted in Annex 5 that a possible drawback of competition was the duplication of delivery networks. The duplication of fixed costs could lead to an increase in the total industry costs for delivery of a given volume of mail. However, we noted that other factors may mitigate this effect. We consider that competition will increase the incentives for efficiency and cost reduction – which, over the longer term, could counterbalance the cost increase due to duplication of fixed costs. In addition, we noted that prices are likely to be lower and volumes higher in light of competition – so total costs are likely to be spread over a larger volume base relative to the counterfactual.
- 7.28 We consider that our proposals will reduce the scope for efficiency loss through duplication of fixed costs because the pattern of Zonal charges will be linked to the pattern of Zonal costs. As noted above, an entrant will only enter where its own delivery costs are lower than Royal Mail's charges. We consider that our proposals will only encourage entry in areas where an entrant can self-supply at a relatively low cost compared to Royal Mail.
- 7.29 Overall, we consider that entry will only occur if an entrant can self-supply in the areas it chooses to enter and offer a lower price to customers at the retail level. The

immediate effect of entry will therefore be to put downward pressure on retail prices (to the benefit of consumers) - even if total industry costs are higher.

Impact on innovation

- 7.30 As discussed in paragraphs A5.66-5.76, consumers may also benefit from dynamic efficiency through product or process innovation. Competition acts as a spur to both types of innovation because it enables operators to improve their position relative to their rivals.
- 7.31 Product innovation relates to the range and quality of goods/services offered, whether they are new or improved versions of the existing goods/services. Improved choice allows consumers to better match their preferences with expenditure, which means that consumers are more likely to be able to select a product that offers the right balance between price and quality for them. This is likely to have a positive impact on consumer welfare.
- 7.32 Process innovation relates to the implementation of new or improved production processes in terms of the delivery network or technology used. An example of this could be investing into the new sorting machines which have higher levels of efficiency, or replacing manual tasks with automated processes which reduce the transit time and costs of delivery. Process innovation can yield significant cost savings for postal operators (and potentially subsequent benefits to consumers to the extent that this is reflected in lower retail prices).
- 7.33 Overall, we consider there is potential for dynamic efficiency improvements in bulk mail delivery to lead to benefits for consumers.

Impact of changes to Zonal charges

- 7.34 As noted above, we consider that entry will result in lower national retail prices for bulk mail services. The majority of bulk mail customers currently require a delivery service on a national basis. However, some customers are focussed on particular Zones. Relative to the 2013/14 Notices, there may be a differential impact for such customers. For example, in the 2013/14 Notices the charge for the Rural Zone would have increased. Some Zonal access operators operating in Northern Ireland and Scotland have noted that as the balance of mail in those areas is more heavily biased to the Rural Zone, the effect of the 2013/14 Notices would be substantially to increase the cost of mail delivery to these regions. They have suggested that this could lead to postal users choosing to focus direct mail operations in the Suburban and Urban Zones and exclude delivery to households in the Rural Zone.¹⁹¹ [3<].
- 7.35 On the other hand, under the 2013/14 Notices charges in the London and Urban zones would have been relatively lower. This might have benefitted consumers in these Zones who might have received more bulk mail [3<].
- 7.36 However, given that only a minority of mail is sent under the Zonal contract the overall impact is likely to be small in any case. As explained in Section 2, we do not consider that the equality impact of our proposals is likely to be material either way.

¹⁹¹ [3<]

Impact of proposals on Royal Mail

Impact on Royal Mail profitability

- 7.37 As noted above, Royal Mail's response to our proposals (i.e. how it sets retail prices and access charges) will depend significantly on the commercial strategy it adopts. We consider that our proposals are likely to put downward pressure on retail prices and, indirectly, on access charges as a result of greater end-to-end competition.¹⁹²
- 7.38 As noted above, we anticipate that entry/expansion will occur and therefore Royal Mail is likely to lose some bulk mail volumes. Given that mail delivery is characterised by economies of scale, this is likely to increase Royal Mail's average costs.
- 7.39 The combination of lower retail prices and access charges, and increased average costs will reduce Royal Mail's profitability, all else being equal.
- 7.40 While recognising this negative impact on Royal Mail, we consider that the dynamic benefits of competition (in particular the incentives created for Royal Mail to realise efficiency improvements and to pass these benefits onto consumers) justify our proposed intervention. In particular, we note that in the absence of any intervention Whistl may exit bulk mail delivery entirely, meaning that even the limited delivery competition that Royal Mail faces would no longer be present. Over the longer term, the loss of profits that would be likely to result from entry would create a strong incentive for Royal Mail to realise efficiencies in its delivery network, with resulting benefits for consumers of the universal service as well as bulk mail.

Impact on the universal service

- 7.41 We have today published our decision on end-to-end competition in the postal sector. We have therefore considered what the likely impact of these proposals would be on the level and scope of end-to-end competition in relation to that decision.
- 7.42 We find it very difficult to predict with any certainty or accuracy what Royal Mail might do in setting its access prices, if following consultation, the current proposals were imposed. We consider in paragraph 7.22 the possible charging strategies that Royal Mail might adopt. However, London is Royal Mail's most expensive zone to deliver in but is not currently the highest charge zone, so it is likely that Royal Mail will need to increase the charge in London relative to the national average access charge (there are no current or proposed requirements on Royal Mail in relation to setting the level of the national average charge). Therefore, on an equivalent basis, this may make entry into London SSCs relatively more attractive than the current charges and Royal Mail's charges in the 2013/2014 Notices. Urban zonal charges are likely to increase relative to the national average charge and Suburban and Rural prices would be likely to decrease relatively.
- 7.43 However, we do not expect that this will have a significant impact on Whistl's current rollout plan. It is already planning [redacted] and most other SSCs will have a mixture of urban, suburban and rural zones so, if Royal Mail maintained its current margin, the impact of these proposals is likely to be mixed depending on the number and type of the different delivery points in the individual SSCs. We consider, under this scenario, that Whistl [redacted].

¹⁹² In order to lower retail prices Royal Mail will ultimately need to lower access charges to avoid failing the margin squeeze test.

Potential for arbitrage opportunities

- 7.44 We recognise that different Zones have different costs, and that entry is likely to occur in selected areas only. We have considered whether this creates the opportunity for arbitrage because an entrant can roll out delivery services in low costs areas only, and rely on Royal Mail to deliver in other areas. We recognise the potential for such arbitrage to have a negative impact on Royal Mail if, for example, it were effectively subsidising entry by inefficient operator.
- 7.45 We consider that our proposals will reduce the scope for this type of arbitrage opportunity to arise because they would ensure an entrant faces access charges linked to Royal Mail's cost of delivery in areas where it does not enter. This means that, under our proposals, an entrant would not be able to gain an artificial cost advantage in areas where it relies on Royal Mail for delivery. Although our proposals would potentially allow for entry that is less efficient than Royal Mail, such entry will only be able occur if the entrant is prepared to accept a lower mark-up than Royal Mail. We consider this a source of genuine competitive advantage with the potential to offer benefits to consumers. We discuss arbitrage opportunities further in paragraphs A5.91 to A5.108.

Reduction in charging flexibility

- 7.46 Our proposals would limit Royal Mail's charging flexibility to some degree. Overall, Royal Mail would retain the freedom to choose the level of retail prices and access charges. However, it would have less freedom with respect to the structure of Zonal charges. In particular, Royal Mail would not be able to target reductions in access charges specifically at Zones where entry/expansion is likely (unless this reflects underlying reductions in the costs in these Zones).
- 7.47 We recognise that the price elasticity of demand¹⁹³ is likely to differ across mail services¹⁹⁴ and that it may be economically efficient to set charges that reflect this. We consider that our proposals provide Royal Mail with the flexibility to do this – it can set the charges for different services at different levels (as illustrated in the example in Figure 5.2 in Section 5), subject to the ratio of charges across Zones being equal to the ratio of service level costs across Zones. We consider that our proposals do not place any significant constraint on Royal Mail's ability to set different charges across services.
- 7.48 The proposal does limit Royal Mail's charging flexibility across Zones. In theory, this type of flexibility may be beneficial if the elasticity of demand for sending bulk mail varied significantly by Zone. Put another way, this would mean that, in response to a given percentage price change, the percentage change in demand for sending bulk mail differed significantly across Zones.
- 7.49 We are not aware of any evidence that the elasticity of demand varies across Zones. For some mail types e.g. transactional¹⁹⁵, fulfilment¹⁹⁶ and publications¹⁹⁷ mail we

¹⁹³ The price elasticity of demand is a measure used to show the responsiveness, or elasticity, of the quantity demanded of a good or service to a change in its price. More precisely, it gives the percentage change in quantity demanded in response to a one percent change in price (holding constant all the other determinants of demand, such as income).

¹⁹⁴ For example, the price elasticity of demand for advertising mail is likely to be greater than that for transactional mail.

¹⁹⁵ Transactional mail is communication between companies or between companies and individual relating to the ongoing provision of goods or services e.g. monthly bank statements, bills sent by utility companies.

consider that the elasticity of demand is likely to be relatively constant across Zones. This is because we consider it likely that end consumers expect to receive these types of mail, irrespective of the Zone they are located in.

- 7.50 It is possible that, in the case of advertising¹⁹⁸ mail, the elasticity of demand could vary by Zone. In this case the sender of the mail has greater discretion as to where to target mailings. For example, in response to an increase in the price of mailing, an advertiser may decide to focus its attention on Zones that have a higher response rate on average. The response is likely to vary according to the sender, making it difficult to predict the market level effect. We are not aware that Royal Mail varies its charges to reflect differences in the elasticity of demand across Zones currently, so we do not think that removing this flexibility will result in a loss of benefits. Overall, we consider that predicting the difference in the elasticity of demand across Zones is likely to be difficult and it is not clear that providing additional Zonal charging flexibility is likely to increase economic efficiency.
- 7.51 We are proposing to tighten the link between the Zonal and national access charges (i.e. the national average charge must equal the weighted average Zonal charge). We do not think this will have a significant impact on Royal Mail (given Royal Mail should already seek to ensure this is broadly the case).

Compliance costs

- 7.52 We consider that our proposals would not necessarily require Royal Mail to materially alter or withdraw any of its existing access contracts (including the older C9 contracts still in existence). This should minimise the level of disruption for Royal Mail.
- 7.53 We recognise that our proposals will increase the regulatory compliance costs on Royal Mail. For example, Royal Mail will need to establish new processes regarding its ZCM and charge setting. However, we have designed the remedies with practical considerations in mind to minimise the burden on Royal Mail. In particular, the cost information we propose to use is already produced by Royal Mail's ZCM. The mechanism to demonstrate compliance is also simple and clear (once the ratio of FACs is produced it is simple to check whether Zonal charges are compliant at the point the charges are published).

Impact of proposals on other postal operators

- 7.54 As noted above, overall we consider that our proposals will increase the competitive pressure on Royal Mail which will ultimately put downward pressure on retail prices and average access charges. However, it is possible that access charges in some Zones will increase – for example [3<].
- 7.55 The overall impact is likely to differ between postal operators:
- End-to-end operators are likely to benefit from our proposals. They are less likely to face action that disadvantages them (for example targeted increases/decreases in Zonal charges according to where entry/expansion is

¹⁹⁶ Fulfilment mail is letters and large letters which deliver a tangible item that a customer has requested e.g. mail order CDs and books.

¹⁹⁷ Publications mail is printed publications published as part of a series and circulated less than daily but more than twice a year e.g. academic journals.

¹⁹⁸ Addressed advertising mail e.g. direct mail.

likely to occur). This means entry is more likely to be commercially viable – indeed in the counterfactual there is a significant risk that no end-to-end competition emerges.

- Access operators are likely to face greater competitive pressures arising from the downward pressure on retail prices. To some extent this may be offset by reduced access charges.
- Access operators on ZPP3 may face different access charges relative to the current situation depending on which Zones they focus on.¹⁹⁹
- [§<].

7.56 We consider that our proposals will provide greater certainty regarding charges for postal operators on the Zonal charging plan. The proposed weighted average rule should allow operators using Zonal contracts to feel more confident that they are not disadvantaged compared to operators using national contracts. Our proposed Zonal remedy will require that the structure of Zonal charges is more reflective of the underlying costs. This will not prevent Royal Mail from changing the level of charges each year, but it will prevent it from changing the underlying structure which can disrupt access operator business models.²⁰⁰ Greater certainty will give these operators more confidence to make investments and may lead to scope for greater innovation.

7.57 We consider that our proposals would not necessarily require Royal Mail to materially alter or withdraw any of its existing access contracts (including the older C9 contracts still in existence). This should minimise the cost of the changes for access operators.

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

Notice of proposal to modify the USPA Condition

7.58 Annex 9 contains our formal notice of our proposal to modify the existing USPA Condition and provides the text of the condition as we propose to modify it. Based on all the reasoning set out in this Consultation, we are consulting on our view that this proposed modification to the USPA Condition is appropriate for promoting and securing effective competition, including in the long term.

7.59 Specifically, for the reasons set out in Section 4 and Annex 5, we are consulting on our view that intervening to promote competition in the circumstances is necessary (to prevent irreversible exit) and is appropriate and proportionate for:

- Promoting efficiency;

¹⁹⁹ As explained in paragraph 1.15, only a small minority of D+2 Access mail was delivered under the Zonal access agreements in 2013-14.

²⁰⁰ In meetings with Ofcom, access operators noted that significant changes to the structure of Zonal charges had made business planning very difficult, and potentially previously profitable business models would no longer be viable. File note of 12 June 2014 meeting between Ofcom and Document Outsourcing, Postal Group and First Scottish. First Scottish and Postal Group said that the increased gradient of the Zonal tilt in the 2013/14 Notices, if implemented, would have a serious adverse effect on their businesses, possibly causing them to exit altogether.

- Preventing Royal Mail from increasing and maintaining its prices at an excessively high level (which would have adverse consequences for postal users); and
- Conferring significant benefits on the users of postal services in the form of better prices, more choice, the potential for more innovation and improvements in quality.

7.60 In light of the reasoning set out throughout paragraphs 7.7 to 7.57 we are consulting on our view that our proposal is the most appropriate for achieving this end, and is more appropriate than the other options we have considered in that:

- It is objectively justifiable and feasible to implement: it is practicable, logical, evidence-based and consistent with our duties.
- It is proportionate in that it:
 - As set out in paragraphs 7.7 to 7.57, it would be effective to achieve our objectives (appropriate);
 - Is no more onerous than is required to achieve that aim, our having considered other ways of so doing as set out throughout Sections 4 to 6 (necessary);
 - Is the least onerous of the ways we have considered that would be effective; and
 - Would not, our having considered its impact on all those affected, produce adverse effects which are disproportionate to the aim pursued.

7.61 As noted in paragraph 4.29 we do not consider it is economically viable for potential end-to-end entrants to install or use alternative facilities that would make the proposed access unnecessary. On the other hand, as explained above, our proposals would not prevent Royal Mail from setting charges at the level it considers appropriate to reflect the investment made by it in its network. We do not consider any rights to intellectual property are relevant to the proposal.

7.62 As to the test of transparency our proposals directly and transparently set out the pricing mechanism we consider is required to promote competition and we are consulting now on their precise wording. As to undue discrimination, our proposals do involve treating Royal Mail differently from others. Specifically in relation to the postal sector, they would restrict Royal Mail's charging freedom by comparison with other operators and in relation to its customers. More generally in relation to other enterprises, our proposals go beyond generally applicable competition laws to seek to promote competition. However, we consider that this discrimination is "due" in light of all the reasoning set out in Sections 4 to 7.

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

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