

Background and Introduction

On 20th October 2011 Ofcom published their consultation document 'Securing the Universal Postal Service' in which they set out their proposals for the regulatory regime for the postal sector from April 2012 when the current regime expires.

Executive Summary

[withheld] recognises the unique role played by Royal Mail in the social letters market. It also however recognises that with a dominant delivery capability, and the likely injection of massive new funding as part of a state aid process, that the company is at risk of abusing its position in the wider packets and parcels market. We therefore welcome much of the proposal from Ofcom and look forwards to helping shape the final framework over the coming weeks.

Our detailed responses are set out in section B, in overview however we would make the following observations

Section A

1. Ofcom does not lay out a view on the products/services it believes are the basis of a universal service. This must be laid out clearly as it forms the basis of the whole document. We believe that there is also potential conflict between the pricing proposals, VAT treatment, and the universal service obligations which have to be resolved at a product level. We also have significant concerns over Royal Mails ability to switch products and services between USO and Non USO in an anti competitive manner.
 - We believe that the USO products should be defined and limited to individuals and small posters who cannot attract major discounts for volume
 - 1st and 2nd class items across all formats up to 5kg, the size at which Royal Mails own delivery methods trolley has been scoped for efficiency at this level.
 - A recorded signed for product (currently marketed by the Royal Mail as Special Delivery)
 - A non-tracked parcel delivery up to 20kgs.

In Royal Mail parlance this would be stamped metered and PPI product plus special delivery and non tracked parcels.

2. All other products and services should be subject to competition law, and where appropriate, equivalence of access rights to the USO delivery network from the inbound mail centre onwards. We also believe that given Royal Mails continued delivery dominance, that Ofcom must put in place defined Access equivalence guidance and pricing positions to ensure that all providers have the same opportunity in the bulk markets as Royal Mail itself. Ofcom should be the final arbiter if Royal Mail abuses its position.
3. This model could dramatically change Royal Mails operational footprint, for example unaddressed mail, and Bulk Mail could be delivered only three days a week enabling vast cost reductions in the RM network and cleaner pricing of the real cost of the USO. This would in time enable Ofcom to run an informed debate on what service the country really wants to pay for.
4. Non USO products must be demonstrably self funding, and not marginally priced to cover the USO network, unless the same price point is on offer to the rest of the carrier market. There must be no cross subsidy.
5. USO products should be allowed to rise by the cost of inflation only, and any further improvement in profit must come from efficiency.
6. The calculation of profit must be based on robustly audited LRIC calculations defined by the industry watchdog.
7. Only once these have been published and agreed should the door be opened to pricing freedom on any USO and non USO service.
8. International products where expressly defined by the UPU, should come under the same controls as USO products.

9. The margin on USO products should be set at the average of the carrier industry in the UK and not at an artificial rate of return beyond that achieved in the free markets. The margin should be on USO defined products only, and not on a wider set of incomes that access that network.
10. Investment plans must be split between USO and Non USO and only those under the USO should be contemplated by the regulator. This for example means that RM cannot fund a roll out of its tracked ambitions from USO profits.
11. Royal Mail has failed to take out costs in line with volume decline and should not be rewarded for its inefficiency.
 - a. Productivity per person, and unit cost per item need to be managed properly for decline. Royal mail has failed to do this in the core network at the speed of volume decline. It should be forced to report such metrics.
 - b. Royal Mails pension is gold plated compared with the industry at large and should not be protected into the future through price increases. Total take home pay inclusive of all benefits is still significantly above the rest of the market. This must be reset as part of any future USO pricing.
12. Royal Mail continues to have an unfair VAT position. Any product outside a narrowly defined USO must have VAT applied.
13. There must be comfort that the agreement between Royal Mail and the Post Office is at the same commercial terms as would be on offer for any other commercial partner. I.E. There should be the same access rights, the same charging structure, and the same quality of service incentives and penalties.
14. Royal mail must structurally separate into a Retail upstream business (including non USO operations), a wholesale/USO product provider and a network provider business of USO services. These must be demonstrably at arm's length from each other and be incentivised for the targets of that business unit not the Royal Mail as a whole.

Section B - Consultation Question Responses

5.1 Do you agree with the assumptions set out in paragraph 5.86 above? If not, please set out your reasons?

- Not entirely.
- It should be the products and not the network that define the boundaries. The network is an operational response to customer requirements both inside the USO, for which you are charged to regulate and outside, for which you are not.
- Agreed there is downside risk beyond the company's ability to manage, that is why given the uncertainty around state aid, economic conditions and technology advancement to name but three that we believe that it would be madness to offer a price position on anything other than a 12 month basis. Similar to that adopted in other regulated markets such as Rail.
- Not necessarily, Royal mails cost base is inefficient, and carries large elements not related to the provision of the USO. For example it's Tracked activity, its international export business, it's unaddressed mail business etc. We believe that segmentation of its business and a real focus on USO efficiency is vital.
- The EBIT range should be in line with the average of the parcels and letters market, but should only be achievable if RM is as efficient and cost controlled as the industry, not through overly large price increases.

6.1 Do you agree with our proposal to impose a regulatory condition on Royal Mail to require it to provide the universal service as set out above? If not, what alternative approach do you suggest?

- Yes but fundamentally Ofcom has to define the USO and its products and services too.

6.2 Do you agree that a price control is not an appropriate option at present for regulating Royal Mail's prices? If not, please explain why and how a price control could be implemented effectively.

- An annually adjusted ex ante price control mechanism for the USO should remain because...
 - a) The level of uncertainty over future volume is so great that fixing prices for the long term is dangerous
 - b) Royal Mail has yet to produce satisfactory financial reports based upon the principles of LRIC and in the format agreed

- c) The last price round appears to have raised RM income well in excess of the level projected, calling into question the forecast accuracy of both RM and the regulator
- Once properly defined, and with adequate safeguards on accounting separation and access equivalence, we believe that ex ante price control over USO and separately access products should be maintained, non USO products should be the subject competition law.

6.3 Do you agree with Ofcom’s proposals to put in place a regulatory safeguard? If not please provide reasons.

- Safeguards are essential not just because of price control but because of Royal Mails near monopoly position in respect of delivery
- The level of safeguard should for example prevent royal mail raising prices more than say 5% above the level of cost reduction it has managed to deliver, should protect consumers by ensuring that USO products and service levels cannot be changed by the business alone, and that there is no cross subsidy between the USO and Non USO product sets. It must also protect equivalence of access both around price and around physical infrastructure and systems.

6.4 Do you agree with Ofcom’s proposals to put in place a monitoring regime? If not please provide reasons.

- Yes

6.5 Do you agree with Ofcom’s proposals for an all index- linked safeguard cap on letters from 45-55p? If not please provide reasons.

- Yes but with significant caveats.
- All products inside your USO definition should be covered by an index linked model
- However the devil here is what is defined as in the USO. We believe in simple terms this should be stamped metered and PPI products both first and second class up to 2kgs.
- A similar safeguard is needed on international export and on no tracked parcels up to 20kgs.
- The price points for these products should only be set once LRIC based product profitability accounts have been produced and audited.
- If there are no controls over 1st class PPI etc then we would argue that the regulator is saying it is not part of the USO and would therefore attract VAT putting prices up by 20%. We would be happy with this as our prices to the market already have VAT charged but suspect that the market would not.

- The market analysis here is from a sending perspective only. Part of the importance of the USO is the receipt anywhere in the UK next day, if this is removed from the price basket, what protection is envisaged for customers who live in rural or remote areas? We may in effect get a two tier postal service. First class to cities, and a lower class offer to rural addresses
- The market cap range is too broad. We would like to see an annual re setting of a cap, which considers the level of progress actually made by Royal mail in its modernisation and does not provide a guaranteed return to include a gold leafed pension provision for its staff.
- The market cap is also lacking in LRIC based evidence of actual profitability and return on sales. Until this is published we cannot support such a proposal.

6.6 Do you agree with Ofcom’s proposal that the approach outlined above remains in place for seven years. If not please provide reasons.

- No we believe that the level of market uncertainty makes such a long period unworkable.
- The lack of firm LRIC data, the lack of State Aid approval, and the current economic environment all point to an annual review mechanism.
- We question the need for such a length from a regulatory rather than investor led position. It is not Ofcom’s role to help Royal Mail gain access to new funding. That is a matter for their shareholder.

7.1 Do you agree with our approach to assessing end to end competition? If not please provide reasons.

- Agreed, although our own analysis suggests that anything other than a niche entry is very unlikely within the next 5 years.

7.2 Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre? If not please provide reasons.

- Broadly yes.
- We would want to see Royal mail upstream retail offer in a separate business unit, and that business unit being subject to the same product and pricing offers available to the market.
- We note the desire to move to LRIC and would not wish to see any radical change around margin squeeze until this system is in place and working.
- The proposal is fairly muted on non price conditions, so for example we would expect equivalence criteria around access times, presentation formats, data transfer, response times to operational queries etc.

7.3 Do you agree with Ofcom's proposals in respect of regulating margin squeeze? If not please provide reasons.

- Again broadly yes
- We note the desire to move to LRIC and would not wish to see any radical change around margin squeeze until this system is in place and working.

7.4 Do you agree with our approach concerning the Terms and Conditions for access? Including the role of equivalence and the regulation of zonal pricing? If not please provide reasons.

- The proposal is fairly muted on non price conditions, so for example we would expect guidance equivalence criteria around access times, presentation formats, data transfer, response times to operational queries etc.
- A full access code structure is in danger of not keeping pace with a rapidly evolving market so we would not like to see this, however
- We would also like to see the formal dispute resolution structure before we accept a guidance rather than imposition route being adopted.

8.1 Do you agree with the objectives for regulatory financial reporting that we have set out above? Please provide details to support your response.

- Yes except for reporting entities.
- The reporting also needs to carefully consider how the other major profits swings in the group are apportioned.
- For example the pricing of the service agreement between Royal Mail and Post Office must be at arm's length.
- The charges for non USO head office activity must be properly allocated to GLS Parcelforce etc.
- The accounting must be based on LRIC and not an internal model
- The costing assumptions must be based upon the current operating procedures, documented and audited
- The reporting entity split is ok but should also have a balancing proof back to total group to demonstrate that only appropriate assets and costs have been allocated. E.g. the treatment of group resources in relation to GLS and Post Office.

8.2 Do you agree that our regulatory financial reporting proposals, set out in this section and the supporting annex, are appropriate and proportionate? Please provide reasons and evidence to support your views.

- Yes provided that non financial equivalence metrics are also reported

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

- Yes

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

- Yes except for reporting entities.
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- The accounting must be based on LRIC and not an internal model
- The costing assumptions must be based upon the current operating procedures, documented and audited
- The reporting entity split is ok but should also have a balancing proof back to total group to demonstrate that only appropriate assets and costs have been allocated. E.g. the treatment of group resources in relation to GLS and Post Office.

We hope that the above helps Ofcom in understanding our views on this consultation and the concerns we have around controls in which the market place is not led and run but the incumbent to meet their own needs and future strategies. We look forward to supporting the changes ahead in a fair and transparent industry which protects the interests of the consumer and enables this industry to become more efficient and cost effective through working partnerships which enable constructive competition to the benefits of all.