



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Ofcom consultation in relation to ‘end-to-end competition in the postal sector’

January 2013

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy-makers to put consumers at the heart of what they do. We tackle the issues that matter to consumers, and give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Following the recent consumer and competition reforms, the Government has asked Consumer Focus to establish a new Regulated Industries Unit by April 2013 to represent consumers' interests in complex, regulated markets sectors. The Citizens Advice service will take on our role in other markets from April 2013.

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Introduction

This document provides the response from Consumer Focus to the consultation about proposals as set out in its document, *End-to-end competition in the postal sector. Draft guidance on Ofcom's approach* of 31 October 2012.

Ofcom's initial assessment of the impact of competition

Ofcom considered the potential impact of competition in the market in July 2012.¹ It took the view that access competition was less likely to impact negatively on Royal Mail's revenues (and so in Ofcom's view limit its ability to finance universal services) than end-to-end competition.

Ofcom considered that end-to-end competition may, according to arguments put forward by Royal Mail, lead to what it terms as 'cherry picking' (exclusively serving the most profitable areas) and may undermine its ability to cross-subsidise loss-making services.

In the July update, Ofcom also considered the potential impact of TNT Post's trial of end-to-end operations in West London and, taking into account the limited scale of these operations, concluded that it was not necessary at this point to impose any regulatory conditions.

Ofcom's proposals

Assessing the need for a review

In assessing whether to undertake a review of the need for intervention, Ofcom would consider whether there is *prima facie* a potential material threat to the universal service from end-to-end competition. This 'threat' could, for example, arise due to several factors including a:

- material increase or notification of a material increase in the level of end-to-end competition
- material change in Ofcom's assessment of the likely scale, timing or certainty of a competitor's plans
- potential material change to the financial sustainability of the universal service which might result from a significant downward shift in revenues for example due to changes in demand or a significant upward shift in the expected level of costs

Assessing the potential financial impact of end-to-end competition

Ofcom proposes to carry out a review of the financial impact of end-to-end competition using four steps:

- **Step one:** Determine what the financial position of the universal service would likely to be in the absence of end-to-end competition. This would allow Ofcom to understand Royal Mail's profitability in the foreseeable future absent of end-to-end competition.

¹ Ofcom, "Update on Ofcom's position on end-to-end competition in the postal sector", 25 July 2012. <http://bit.ly/Rpbe9b>

- **Step two:** Consider the expected direct impact of the loss of business on Royal Mail resulting from end-to-end competition. This would involve reviewing the current and potential activities of competitors and then looking at how this would impact Royal Mail's forecast financial position (determined in Step one).
- **Step three:** Consider the impact of any potential subsequent commercial response(s) from Royal Mail, including improved efficiency. Increased competition might be expected to change Royal Mail's behaviour in relation to its commercial strategy, and its ability to make efficiency savings. The financial analysis would need to be adjusted to take this into account.
- **Step four:** Test whether the universal service is likely to be put at risk allowing for the uncertainties associated with projections.

Basis for assessing financial sustainability

Ofcom states that in considering Royal Mail's ability to finance the universal service it should allow Royal Mail an EBIT margin of 5-10 per cent and set a 'fair bet' principle – in that it should have a reasonable chance of achieving this margin.

Ofcom would use the 'fair bet' principle to assess whether the potential future risks to financing the universal service were from areas which Royal Mail could control – for example its level of efficiency – or were outside its control. In this respect, it notes the potential impact of declines in mail volumes, changes in the product mix and Royal Mail's commercial strategy and efficiency. Ofcom would make an assessment of efficiency and what constitutes an acceptable level of improvement. To this end it intends to undertake work to determine how to assess what constitutes a reasonable rate of efficiency progress.

The scope of the universal service and users' needs

Ofcom is also undertaking a review of the extent to which the provision of postal services in the UK is meeting the reasonable needs of users. The minimum requirements of the universal service can only be changed by a direction from the Secretary of State or through modifications to primary legislation.

General points

In this section we set out our views on how consumers' rights for a universal postal service are affected by competition for postal services. Consumer Focus considers that the safeguarding of the universal postal service is the most important priority for postal consumers.

Competition and the universal service

In general, we consider that the universal postal service is most likely to be financially viable over the long term in a fully competitive postal market.

In the long run, it is the choice of customers and consumers to use the universal service network, and to purchase postal services more generally which will safeguard the financing of the universal service and this positive choice will be most likely to continue under competitive market conditions. Customers and consumers benefit from the additional choice under a competitive environment and the wider economy benefits from the lower prices it generates.

The challenge of competition in markets is a spur to innovation and efficiency and without these incentives it is possible that Royal Mail and other providers will gradually become out of step with the wider economy, and that postal services may be bypassed as a delivery mode of choice.

Competition and the costs of the universal service

Further, we consider that the costs associated with universal service provision are likely to be lower if there is a competitive postal market.

Analysis conducted for Postcomm and the European Commission² concluded that net universal service costs, where they exist, are small in relation to the financial turnover of Universal Service Providers, and that general issues of efficiency and cost control are more important to viability than these burdens.

We see in EU countries such as Sweden, the Netherlands and Germany – where end-to-end competition for mail services has been established – that:

- the universal service been viable without the need for extensive intervention
- its effects on national postal companies (to become more efficient and control wage costs) have outweighed any financial impacts of the competition itself

Indeed where there has been end-to-end competition in these postal markets, national postal companies have been spurred to become much more efficient and to control their costs more aggressively, consequently reducing universal service costs. For example, in the Netherlands Post NL plans to save up to €40 million in 2012 due to its implementation of its Master Plan III programme of part time working and wage controls.

² Postcomm, "An assessment of the costs and benefits of Consignia's current Universal Service Provision: A Discussion Document", June 2001. <http://bit.ly/U4i9cP>
Frontier Economics, "Net costs of elements of the universal service: A Report Prepared for Postcomm", May 2008. <http://bit.ly/VGII7o>
NERA, "Costing and Financing of the Universal Service Obligation in the Postal Sector in the European Union", 1998. <http://bit.ly/XN524r>

Legal obligations to open markets

We also note that the issue of permitting end-to-end competition without restrictions has been settled in the EU through the Community *Framework for postal services*. Under these treaty obligations, the UK has agreed, in common with other EU Member States, to open up its mail market to competition. This is now a legal obligation as well as a benefit for consumers.

We note further that the Community *Framework for postal services* has set out acceptable mechanisms through which Member States can provide for the financing of net universal service costs without distorting the market or limiting competition. Whilst we understand that Ofcom is required to follow the imperatives which it has been set by UK legislation, we would ask Ofcom to provide further clarity as to how its approach also accords with the provisions in the Community legislation.

The Postal Act 2011 and the European Community framework

It can be argued that, if it is interpreted that Ofcom's powers (as set out under the Postal Services Act 2011) allow it to impose General Universal Service Conditions as a means of limiting the scope of end-to-end competition in the market, such a measure to restrict the internal market for postal services would be inconsistent with the UK's legal obligations under the European Community *Framework for postal services*.

The European Community framework for postal services

The European Community *Framework for postal services* is set out under the Postal Directive 2008/06 which amends Directives 2002/39 and 1997/67.

The objectives of European postal policy are to ensure a universal postal service for EU citizens and to complete the internal market for postal services in the context of previous monopoly rights for national post providers.

Under a method of gradual, controlled and harmonised liberalisation, Member States first converted monopoly rights into reserved areas, then reduced the scope of reserved areas and finally under Directive 2008/06 agreed to remove all barriers to competition in their national mail markets to competition.

In this respect the postal sector is now largely within the mainstream of the internal market, where Treaty rules require that the free flow of goods and services is legally guaranteed – except insofar as obligations need to be imposed (consistent with principles of objectivity, proportionality, transparency and non discrimination) to ensure the provision of services of general interest or general economic interest, such as the universal postal service. Under Postal Directive 2008/06 all 27 EU Member States have agreed to fully open their postal markets by end 2012.

Ofcom's powers to restrict competition under EC rules

Under EC rules, Member States have agreed to open up their mail markets to competition and to allow entrants to freely compete with Universal Service Providers.

However, recognising that Universal Service Providers such as Royal Mail may face net costs in providing universal services, the Community legislation has provided for remedies to ensure that universal services can be financed.

Article 7, which is the relevant article of the Postal Directive 2008/06 in this respect, reads as follows:

'Member States shall not grant or maintain in force exclusive or special rights for the establishment and provision of postal services. Member States may finance the provision of universal services in accordance with one or more of the means provided for in paragraphs 2, 3 and 4, or in accordance with any other means compatible with the Treaty.

Paragraph 2): Member States may ensure the provision of universal services by procuring such services in accordance with applicable public procurement rules and regulations including, as provided for in Directive 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services (), competitive dialogue or negotiated procedures with or without publication of a contract notice.*

Paragraph 3): Where a Member State determines that the universal service obligations, as provided for in this Directive, entail a net cost, calculated taking into account Annex I, and represent an unfair financial burden on the universal service provider(s), it may introduce:

- (a) a mechanism to compensate the undertaking(s) concerned from public funds; or*
- (b) a mechanism for the sharing of the net cost of the universal service obligations between providers of services and/or users.*

Paragraph 4): Where the net cost is shared in accordance with Member States may establish a compensation fund which may be funded by service providers and/or users' fees, and is administered for this purpose by a body independent of the beneficiary or beneficiaries Member States may make the granting of authorisations to service providers under Article 9(2) subject to an obligation to make a financial contribution to that fund or to comply with universal service obligations. The universal service obligations of the universal service provider(s) set out in Article 3 may be financed in this manner. Member States shall ensure that the principles of transparency, non-discrimination and proportionality are respected in establishing the compensation fund and when fixing the level of the financial contributions referred to in paragraphs 3 and 4. Decisions taken in accordance with paragraphs 3 and 4 shall be based on objective and verifiable criteria and be made public.'

This suggests that, if Royal Mail is having difficulties in financing its universal service obligations, Ofcom should firstly calculate the net cost of the universal obligations as described in Annex 1 of the Directive and then consider which of the remedies described in Article 7 best fits the Community principles of transparency, objectivity, proportionality, non-discrimination and least market distortion.

Article 7 does not include measures which permit Member States to act in a manner which restricts the rights of operators (including Royal Mail) to compete in the market. Indeed, its purpose is precisely the opposite, to complete the internal market for postal services and to remove barriers to competition.

Ofcom's powers to licence operators under EC rules

The Postal Directives aim also to ensure that EU citizens enjoy a high quality universal postal service. Towards this end Member States can licence operator(s) to provide universal service. Typically these operators have been national posts who have been designated as Universal Service Providers.

Article 9.2 specifies this as follows:

'For services which fall within the scope of the universal service, Member States may introduce authorisation procedures, including individual licences, to the extent necessary in order to guarantee compliance with the essential requirements and to ensure the

provision of the universal service. The granting of authorisations may be made subject to universal service obligations, if necessary and justified, impose requirements concerning the quality, availability and performance of the relevant services, where appropriate, be subject to an obligation to make a financial contribution to the sharing mechanisms referred to in Article 7, if the provision of the universal service entails a net cost and represents an unfair burden on the universal service provider(s), designated in accordance with Article 4, — where appropriate, be subject to an obligation to make a financial contribution to the national regulatory authority's operational costs referred to in Article 22, where appropriate, be made subject to or impose an obligation to respect working conditions laid down by national legislation.

Obligations and requirements referred to in the first indent and in Article 3 may only be imposed on designated universal service providers Except in the case of undertakings that have been designated as universal service providers in accordance with Article 4, authorisations may not: — be limited in number, for the same elements of the universal service or parts of the national territory, impose universal service obligations and, at the same time, financial contributions to a sharing mechanism, — duplicate conditions which are applicable to undertakings by virtue of other, non-sector-specific national legislation, — impose technical or operational conditions other than those necessary to fulfil the obligations of this Directive.'

In essence, Article 9.2 is intended to allow Member States to use licensing to ensure that the designated Universal Service Provider(s) is (or are) obliged to provide the universal service. Such licensing has not been included in Article 7 as a means for providing a safeguard for universal service financing or as a mechanism for restricting competition in the market.

In light of this, and considering the principles of proportionality, transparency, objectivity and non discrimination and that the intention of the Directive 2008/06 was precisely to remove final barriers to the internal market for postal services, we consider that there is, at the least, considerable legal uncertainty that Ofcom could use its licensing powers in the manner and towards the objectives that it proposes.

In this respect we also note that both the examples quoted by Ofcom where similar licence conditions have been imposed (in Finland and Belgium) have led to action by the European Commission and that Finland has now changed these policies. Discussions are ongoing in Belgium.

The scope of Ofcom's powers and its view of market development

We are also concerned that the narrow span of Ofcom's powers, in focusing on the scope of the universal service, is fostering a distorted view of the postal market more generally which over emphasises the importance of traditional mail products. Perversely, while the focus on these products at a time in sustained decline in letters volumes may be understandable, this may underplay more fundamental long term risks to Royal Mail's ability to be the sole Universal Service Provider.

Growing revenues and new players in a healthy postal market

Although the UK postal market is in a state of some dynamism there are clear and predictable market trends.

Letter mail is declining at a fairly constant pace (an underlying trend of 3 to 5 per cent per year – notwithstanding the effects of price rises), While e-commerce traffic (parcels and packets volumes) is rising at over 5 per cent per year although Royal Mail is losing market share in this segment.

Overall the broader postal market is dynamic, healthy and vibrant. It is projected both that advertising mail volumes will recover in the medium term (with the economic cycle) and that e-commerce traffic will continue to rise.

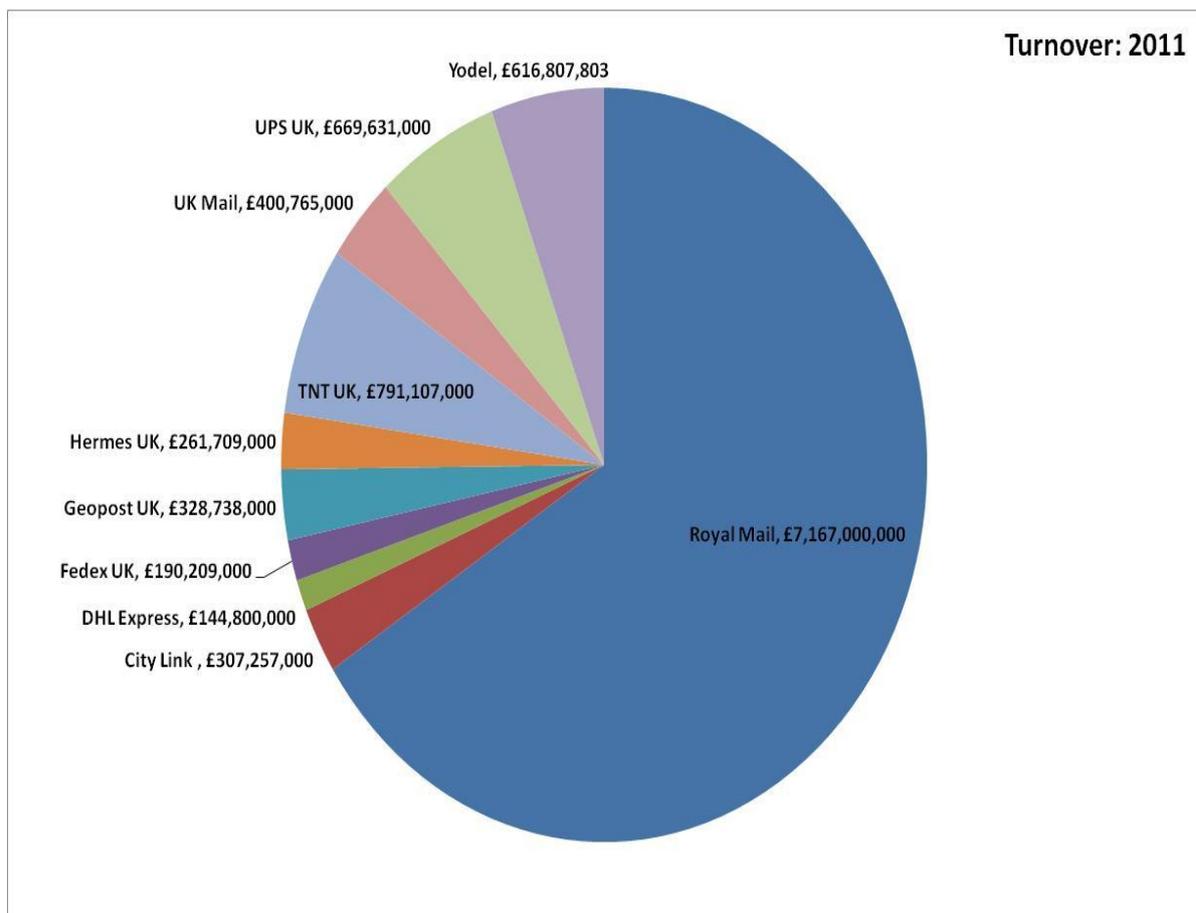
The net effects of technology on the sector continue to be benign with new market growth increasing market revenues while new cost savings available due to new IT systems and new sorting machinery emerge. There has been some electronic substitution of transactional mail but we can expect that net revenues in the sector will grow over time.

End-to-end competition in the UK postal market

This change in the composition of the postal market, with a greater relative importance for packets and parcels, is increasing the intensity of competition faced by Royal Mail and reducing its relative dominance in the market, both in general and in relation to the services within the scope of the universal service.

Indeed, the effects of these changes are that Royal Mail is becoming gradually less preponderant in relation to the market as a whole. This is shown in Figure 1 which considers market shares of operators including postal logistics providers:

Figure 1: UK postal market shares among major operators 2011



Source: ESL UK

We can see from this that an increasing diversity of postal operators are now significant in the market, with traditional players, integrators such as Fedex and UPS, and subsidiaries of national postal companies such as TNT Post UK and DHL Express joined by newer players such as Yodel and Hermes.

In this respect it can be argued that end-to-end competition in the UK postal market has arrived already, is vibrant and healthy, is providing choice and value for key customers such as e-retailers and has the potential to provide similar benefits to consumers.

Postal logistics providers are increasingly offering parcels and packets products which are price and service competitive with those offered by Royal Mail and using national networks. Over time it is possible that these providers could begin also to deliver non time-specific correspondence and marketing from their customers as TNT Post UK has started to do for its access customers.

In light of this market dynamic, where Royal Mail is already facing intense competition in relation to some of its key future market revenues, we consider that it is disproportionate and discriminatory to focus in isolation on the impact of competing providers of end-to-end mail services.

Royal Mail's position in the future market

While we do not consider that the financing of the universal service is necessarily dependent upon Royal Mail's financial success, we do consider that Royal Mail's survival in the market in the long run will depend most upon its success or otherwise in competing in growing market segments, such as e-retail distribution. In this respect it can be argued that it is its performance in market segments which lie outside the Universal Service that will determine its market position. Given this, we highlight the continuing importance of isolating universal service costs and revenues and of a non discriminatory and proportionate regulation to avoid market distortions.

To compete successfully for these markets Royal Mail must be cost efficient and customer responsive. In this respect we are concerned that Ofcom's current approach in seeking to provide assurances that it can restrict the impact of competition and in allowing Royal Mail to raise prices has impaired Royal Mail's incentives to control its costs and become more efficient.

Ofcom has stated in its document that it would consider closely the impact of efficiency incentives on Royal Mail in relation to any intervention it may take and we welcome this emphasis.

However, we remain concerned that by proposing to consider the impact of end-to-end competition on Royal Mail's finances if Royal Mail runs into financial difficulties, Ofcom risks adopting an approach which is potentially anti-competitive and which could weaken efficiency and cost control incentives on Royal Mail and deter investment and innovation in the sector.

While Royal Mail's finances have improved since 2011, its underlying costs have risen despite volume losses and extensive capital expenditure intended to reduce costs. Universal service costs and finances are dependant largely upon the cost and efficiency decisions taken by Royal Mail. Competing operators should not be required to underwrite Royal Mail's profitability in circumstances in which Royal Mail may end up financing the universal service under strain because it may be able to rely on regulatory intervention from Ofcom to restrict the activities of competitors who may have been more disciplined in their approach to costs.

In this respect it is also notable that the target margins foreseen for Royal Mail under Ofcom's approach exceed those which are being achieved by competitors in the e-commerce market.

Ofcom's consultation questions

Ofcom's consultation questions

Section 5: Assessing the potential financial impact of end-to-end competition on the universal service

Question 5.1 Do you have any comments on the approach set out above to assess the financial impact of end-to-end competition on the universal service and/or do you consider that any other approach would be appropriate?

We share Ofcom's aspiration to safeguard the financing of the universal service. However, in light of the broader picture of a market changing from communications to distribution and of an increasing intensity of competition for growing market segments, we are concerned that Ofcom's approach, in focusing on intervening to impose obligations on competing mail delivery operators may not be consistent with the UK's treaty obligations to respect the internal market for postal services or that it represents an appropriate regulation.

The risk is that this approach may be open to some legal challenge and that it may undermine potential investment in the sector both by fostering regulatory uncertainty and potentially by creating a 'no-win' situation for entrants – who may be penalised if they are successful in the market.

While the Community framework *does* allow Member States to safeguard the financing of universal services by:

- tendering out loss-making services
- using State aid to assist Universal Service Providers in relation to the net costs of universal service provision
- sharing out universal service burdens proportionately between operators (measures which are discussed in Ofcom's consultation)

it does *not* allow Member States to restrict competition or to act in a disproportionate or discriminatory manner. We are concerned that any measure which aimed to impose non-trivial universal service burdens or obligations on entrants would be discriminatory and disproportionate and may have the further consequence of limiting the indirect benefits of competition on consumers within the broader postal market.

Section 6: The implications of the analysis of the impact of end-to-end competition

Question 6.1 Do you agree with our approach to assessing the need for intervention in relation to end-to-end competition? Do you consider that any other approach would be appropriate?

In assessing the need for this type of intervention we consider that Ofcom has adopted an approach which could be considered as discriminatory in favouring Royal Mail compared to other market players and which may distort the market.

The method for assessing the need for intervention is based on its approach to BT's broadband network, the 'fair bet' principle, based on whether Royal Mail has sufficient

opportunity to earn a return equivalent to the cost of capital. This is set at between 5-10 per cent of EBIT margin.

While we agree that other postal operators have earned this type of return and that it may be appropriate for Ofcom to set such a target for example in the context of a price control, we do not consider that Ofcom should set such a return for Royal Mail as a regulatory target for intervention in relation to end-to-end competition.

Clearly other operators aim to win market share and to compete successfully and, if they are successful, this may reduce Royal Mail's margins. Indeed, we note that margins in the growing e-commerce market segment for all operators are tight and below the targets set here.

Consumers generally benefit from intense competition which is often present in such new and emerging markets although we recognise that competition built on efficient and sustainable business models is key to securing these consumer benefits over the long term. However there are dangers here that intervention to restrict competition on the basis that Royal Mail does not compete successfully may distort the market in guaranteeing returns for the business and may present perverse incentives for Royal Mail, both in managing for example its wage costs and in pursuing regulatory gaming strategies. Over time such a policy may prevent the efficient working of this (e-commerce) market which is important to the UK's competitive success.

Question 6.2 Do you have any comments on the factors that we would need to take into account when considering the types of intervention that may be suitable?

We consider that Ofcom should reconsider its interpretation of the legal framework as we believe that it is legally uncertain that it can use licensing in the way it proposes to restrict end-to-end competition. In this respect, we note that the examples quoted in the document (Belgium and Finland) where such arrangements have been put in place are both instances where the European Commission has felt the need to write to these Member States to express concern that they were acting outside Treaty rules.

Section 7: Options for regulatory intervention in relation to end-to-end competition

Question 7.1 Do you have any comment on the interventions we have discussed in the draft guidance? Are there any others that may be appropriate? Are there particular circumstances where you consider one potential intervention would be more appropriate than another?

We welcome Ofcom's proposal not to impose access obligations on competitors.

We share Ofcom's aim for a sustainable universal service. Of the types of interventions described by Ofcom for this purpose, we consider that it would be best if it could follow the guidance of the European legislation in this regard, towards one of the options of tendering out of loss making elements, state aid or compensation funding arrangements.

However, we note that Ofcom is precluded immediately from using either public procurement procedures to tender out loss making universal service elements or from setting up a compensation fund for entrants.

Conclusions and recommendations

Our findings

Our main findings in relation to this consultation are as follows:

- There is considerable legal uncertainty in relation to whether Ofcom's proposed approach can be reconciled with the UK's obligations under EC Treaty rules
- There are dangers that Ofcom's proposed approach could set perverse incentives for market players in weakening incentives for efficiency and cost control at Royal Mail and deterring investment by competitors
- In doing so there are risks that Ofcom's policy could run counter to Ofcom's primary duty (to ensure universal service provision) over the medium and longer terms. Evidence from other EU postal markets suggests that end-to-end competition alongside privatisation can be extremely important in cutting costs associated with universal service provision
- There are risks of market distortions and discrimination where competitors operating in one market segment may be penalised by Royal Mail's lack of competitive success in another

Recommendations

In light of these findings we make the following recommendations:

- a. That Ofcom provides greater legal certainty by publishing any legal advice which it has been given in relation to the scope of its powers under European treaty rules.
- b. That Ofcom reconsiders its approach by looking more widely at the positive impact of end-to-end competition on universal service costs in other EU postal markets.
- c. That Ofcom ensures that its 'fair bet' analysis takes account of the particularities of the postal sector by also considering the issue of labour cost restraint at Royal Mail perhaps through a benchmarking of labour costs between operators and across relevant comparators.
- d. That following its review of the needs of users for postal services it considers undertaking a preliminary assessment of whether providing the universal postal service is a net cost to Royal Mail, and if so to consider whether it may be appropriate to consider using remedies such as state aid to assist the business in meeting these net costs.



Consumer Focus response to Ofcom consultation in relation to 'end-to-end competition in the postal sector'

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