

Whistl response to Ofcom's consultation

Royal Mail Access Pricing Review: Proposed amendments to the regulatory framework

This response comprises the following sections:

- General response
- Absence of appropriate cost floor
- Freedom to undermine access price regulation through flexibility to change boundaries
- Discriminatory national access terms
- Analysis of Whistl efficiencies
- Issues raised from the proposals
- Responses to consultation questions
- Suggested amendments to draft USP Access Condition

General response

1. Whistl generally supports the proposals, which provide greater regulatory certainty. Without that certainty, as recognised by OFCOM, there is no prospect for significant investment in competing postal delivery services.
2. Ofcom has recognised there is a unique opportunity for competition in downstream delivery and that Royal Mail has the ability and incentive to undermine that possibility by foreclosing the market from competition (specifically from Whistl). OFCOM has therefore taken the first crucial step in preventing such behaviour by designing regulations aimed at meeting this head on. However OFCOM must complete the task and ensure that its measures go far enough to provide the required level of effective and timely regulatory protection. Unfortunately, the current proposals do not do this, in three key areas:

2.1. Absence of an appropriate cost floor

Whistl strongly believes that allowing Royal Mail to set its prices below cost is a material omission from the proposals. The legal and regulatory decisions on anti-competitive, below-cost pricing show it to be a complex and unsettled area of law.

It is not reasonable, in light of a consistent pattern of anti-competitive behaviour, to assume that Royal Mail would not seek to price below costs, if the short-term profit sacrifice can be recouped later in a restored *de facto* monopoly environment. Such an outcome would not benefit consumers. Competition law provides no regulatory certainty and is not adequate to address the problem in this case.

This should be addressed in the final regulations by including an effective *ex ante* “**Cost floor**” measure which requires Royal Mail's prices to cover costs.

2.2 Freedom to undermine access price regulation through flexibility to change boundaries

Allowing Royal Mail the flexibility to change the geographical boundaries of zones and SSCs within the period regulated by Ofcom's Statement will allow Royal Mail to undermine the structure of the access charges set by Ofcom.

As the building block for the pricing structure [REDACTED], it is crucial that the market has regulatory certainty that the geographical boundaries will not change unexpectedly and in Royal Mail's unfettered discretion. It is not unreasonable in a market with a super dominant provider to expect this degree of regulatory certainty.

2.3 Discriminatory national access terms

OFCOM should not permit different national profiles and surcharging systems to continue where they do not ensure that the prices are cost-based and non-discriminatory. The differing profiles and surcharge mechanisms in the two, current national agreements (NPP1 and NPP2) result in significantly different prices for customers with an identical profile.

3. Royal Mail has taken steps towards achieving greater efficiency but competition from electronic media continues unabated. The need to change is, therefore, unavoidable but much remains to be done if Royal Mail is to match its most efficient EU peers¹. By creating the conditions to enable delivery competition, Royal Mail will face the most effective pressure to adapt. Consumers are the most likely beneficiaries from the resulting price competition, efficiency gains and innovation.

¹ Copenhagen Economics: 'The consumer impact of competition in the UK postal market' pp. 20-23
<http://www.copenhageneconomics.com/Website/Publications/Postal---Delivery.aspx>

Absence of an appropriate cost floor

4. The requirement that the ratio of the four zones' prices must match their cost ratio is appropriate as it prevents increases in 'captive' zones (i.e. zones where delivery competition is unlikely to emerge) to off-set discounts in 'non-captive' zones (i.e. areas where delivery competition already exists or is more likely to develop). It also ensures that zonal access customers pay a fair, but not excessive, price for delivery of their mail in 'captive' zones.
5. The expected response will be for Royal Mail to seek to reduce its costs. This will permit Royal Mail to set lower zonal access prices. This would then feed through to lower national access prices. Retail prices are likely to remain close to access prices and, thus, also reduce. Consumers will benefit.
6. However, even if this is achieved, the proposals only seek to set *relative* pricing levels and not *absolute* pricing levels. This is a serious concern. Having to rely on lengthy, *ex post* competition law measures to challenge anti-competitive pricing affords delivery competitors inadequate protection. Such complaints, even if they are accepted by OFCOM and, thereby, trigger the suspension of the proposed price changes², are extremely disruptive and are likely to delay or halt further investment.
7. In addition, anti-competitive, below-cost pricing is an unsettled and complex area of law. It is therefore very far from certain that competition law could be of *any* assistance. There would, inevitably, be a chilling effect on further investment pending resolution of such an investigation. [REDACTED]
8. Royal Mail has a much clearer commercial and strategic incentive to price below cost than OFCOM suggests. OFCOM has calculated that Royal Mail would need to undergo a profit sacrifice of "over c. £250 million in the first year"³ if it chose to price below FAC in the areas where it fears entry (and would have to make a corresponding reduction in other areas). [REDACTED]
9. Whistl has assessed the impact of different levels of pricing by Royal Mail on the profitability of its roll-out plans at both a national and local level (see Annex A). Overall, Whistl finds that if [REDACTED]
10. The results of Whistl's modelling suggest that: [REDACTED]

² Clause 13.8 of the general terms and conditions of Royal Mail's access services contract provides for the suspension of the notice period in the event that a investigation is opened or an access dispute accepted by a Regulatory Body. However, Royal Mail is consulting the market on the possible remove of this fundamental protection. They are proposing that customers will need to secure 'interim measures' to prevent the changes from coming into effect. If Royal Mail persists with this proposed change, Whistl is likely to submit a formal access dispute to OFCOM.

³ Ofcom consultation, *Royal Mail Access Pricing Review*, paragraph 7.12

11. The cost to Royal Mail of [REDACTED]
12. The clear conclusion is that Royal Mail has a very obvious commercial incentive to [REDACTED]
13. It is therefore critical that, for the regulatory framework to be effective in preventing exclusionary pricing, as an absolute minimum measure OFCOM must impose a further obligation on Royal Mail not to set its prices below cost. For the reasons previously stated [REDACTED] For the reasons previously stated Competition law alone is not adequate in this case.
14. A more detailed analysis, prepared by Frontier Economics, of possible discounting strategies is in Annex A. It shows the impact on Whistl and the cost and benefit to Royal Mail of such a strategy.
15. From a procedural perspective, Whistl recognises that the Ofcom's proposed Statement and revised regulatory conditions cannot include a 'cost floor' provision at this point in the process, as it does not form part of proposals under consultation. Whistl also recognises that it is imperative that this process is not held up by further consultation on this issue. Whistl, therefore, asks that OFCOM undertakes an immediate follow-up exercise in which it consults on and issues proposals for additional regulation to include this extremely important *ex ante* 'cost floor' protection.
16. In the meantime, Whistl considers that it is necessary and proportionate that Ofcom provides an unequivocal statement as to how it will address pricing by Royal Mail that appears to be below FAC.

Freedom to undermine access price regulation through flexibility to change boundaries

17. *Non-London zones*: The density of delivery points and business addresses is the key driver for delivery costs. We fully expect OFCOM to provide regulatory certainty that the zones will continue to be defined along the basis of delivery point density and the conditions in which OFCOM would be willing to consider a change to this fundamental basis for zonal definition. This would provide regulatory stability because the delivery point density in most postcode sectors is unlikely to fluctuate significantly, because it depends on changes in buildings. To that end, it is important that the source of the data which defines the number and type of delivery points is reliable and independently verifiable.
18. *London zones*: The proposed regulations specify the four zones and how they are defined (namely, by reference to delivery point density or, in the case of London, by reference to the amount of mail within the SSC which is delivered within the perimeter of the M25).
19. Royal Mail relies on the Mails Characteristics Survey (MCS) to establish the amount of mail delivered within the M25 perimeter and, therefore, identify the Standard Selection Code areas (SSCs) which are classified as 'London'. All of the postcode sectors within that SSC are automatically classified as 'London' notwithstanding the delivery point density with each postcode sector. Given our own experience of the difference between our actual profile data and sampled data, the robustness of these measurements must be assured.
20. As London is the most expensive zone, classification of an SSC as London has a material impact on the competitive landscape. The scope for changing the classification of SSCs which straddle the M25, based upon MCS data, is an area of serious, potential concern. **[REDACTED]**
21. There is, therefore, a substantial risk in not fixing the London zones for the duration of this price control. There are currently 12 London SSCs. Seven⁴ of them are fully contained within the M25 perimeter and the remaining five⁵ straddle it. As illustrated in the map in Annex B, there are ten⁶ SSCs which cross the M25 perimeter.
22. **[REDACTED]**
23. To give the required level of regulatory certainty, the postcode sectors which make up the London zone need to be defined by reference to the postcodes which make up the current London zone and include any new postcodes (e.g. as a result of new development) which are created within the outer perimeter.

⁴ 360, 369, 370, 374, 375, 377 and 380

⁵ 362, 365, 376, 378 and 384

⁶ 358, 359, 362, 363, 365, 367, 376, 378, 384 and 385

24. *SSC boundaries*: Whistl has a concern about Royal Mail's freedom to set the boundaries of SSCs. [REDACTED]

25. In short, a change in SSCs could have a significantly disruptive impact on Whistl and its customers. To ensure an effective regulatory framework, OFCOM needs to introduce some safeguards which limit the conditions under which SSC boundaries can be changed and to ensure that changes are confined to genuine and essential changes in Royal Mail's operation.

Discriminatory national access terms

26. OFCOM propose that the weighted zonal prices equate to the ‘core’ national access price. We support this very important principle and provide our feedback below on the specific consultation question about the appropriate volumes to be used in the weighting.
27. Whistl has a number of concerns, however, about the proposal to exclude from the ‘core’ national price: profile-related requirements, surcharges and tolerances; an ‘all reasonable endeavours’ provision which, if satisfied, would remove the risk of surcharge; and terms associated with measuring actual geographical posting profile.
28. It is important to appreciate that some of the largest customers hold their own contracts with Royal Mail. These are known as Customer Direct Access or CDA customers ⁷. [REDACTED]
29. Royal Mail is currently inviting comments on a discussion document about, among other things, the removal of the reasonable endeavours provision and replacing it with two formal waivers for non-compliance with profile⁸. We anticipate that the practical effect of the proposed amendment to the clause would make little difference [REDACTED] .
30. Two customers with identical mailing profiles but on NPP1 or NPP2 contracts could face materially different surcharges.
31. We illustrate this below in the relative surcharge calculation, using our own volumes and profile and applying it to the NPP1 and NPP2 contract terms.

[REDACTED]

Naturally, because of the volumes we process under our contract, a CDA customer would pay a fraction of these surcharges. It is, therefore, helpful to consider the surcharge under an NPP1 contract as an additional cost per item. In doing so, it is also important to keep in mind that postal competition is such that contracts are won and lost on price differences of fractions of one pence.

Item surcharge over total volumes (pence)	Item surcharge applied to remaining RM DSA volumes (pence)	Item surcharge applied to Whistl delivered items (pence)
[REDACTED]	[REDACTED]	[REDACTED]

⁷ REDACTED.

⁸ These waivers are where the planned profile is not met due to ‘unplanned changes in volumes’ and ownership or corporate structure changes, neither of which, in Whistl’s view, is a legitimate reason for not applying surcharges. The scope for waivers of profile charges remains largely subjective and, therefore, unfair and unduly discriminatory in that it advantages customers on an NPP1 contract.

32. By proposing to allow the continuation of different types of profile under national contracts – but to exclude them from the calculation of the ‘core charge’ and to permit Royal Mail to include an ‘all reasonable endeavours’ clause (or an equivalent set of ‘waivers’) - OFCOM is also allowing a barrier to switching to continue, the effect of which is to discriminate against those customers who switch volumes to a competing network i.e. do not use Royal Mail on an exclusive basis. We would strongly urge OFCOM to revisit their proposals on this point.
33. Specifically, there should be one profile only in a national contract, based on the NPP2 zonal profile. That is because, if surcharges are based on anything other than zonal charges, there is no assurance that those surcharges will be cost-based (they are not now⁹) and, therefore, there should be a presumption that they will be unduly discriminatory.
34. Where profile-based surcharges are not calculated by using zonal costs (e.g. by reference to SSC profile or urban density profile), customers will be deterred from breaching the NPP1 national profile [REDACTED] in order to avoid paying surcharges (which have no clear cost-basis).
35. [REDACTED]

⁹ For example, if a customer sends insufficient items to urban zones within an SSC, the ‘missing’ items for those urban zones are charged at the rural zone rate.

Analysis of Whistl efficiencies

36. OFCOM correctly concludes that delivery competition will apply pressure on Royal Mail to achieve greater efficiency and that the presence of, and threat of further, competition from more efficient operators will compel Royal Mail to respond by reducing its own costs. Competitive pressure will ensure that the resulting benefits of network cost savings are shared by customers. In this section, we list of the features of our business where we believe we are more efficient than Royal Mail.
37. Royal Mail has a significant advantage in not having to apply 20% VAT on its access prices. Royal Mail has material economies of scale and scope, arising from its position as former monopolist. These elements are described in Annex D.
38. [REDACTED] It is only by being much more efficient than Royal Mail that Whistl will be able to compete profitably.
39. This greater efficiency takes various forms, such as:

Non staff costs

[REDACTED]

Staff costs

[REDACTED]¹⁰

Issues raised from the proposals

40. The proposals themselves raise a number of issues which Whistl would ask OFCOM to take into consideration and incorporate in its final statement and the USP Access Conditions which are finally implemented.

Robust ZCM needed [6.20, 6.23, 6.39, 6.40]

41. For the safeguard to be effective, the underlying zonal cost allocation needs to be accurate. To achieve this there need to be adequate measures to ensure costs are properly allocated to non-captive and captive zones.
42. It is extremely important that the data which are used to set and measure profiles and to define the zones are both accurate and independently verifiable. Our experience of the sampling of our zonal profile is that the results are significantly different from our own zonal data. If similar sampling methodology is used to

¹⁰ Royal Mail's VAT exemption and corresponding limit on the input VAT it can recover, means that this can favour in-house solutions (which are VAT free) even if significantly less efficient than outsourced services which are subject to VAT.

measure Royal Mail's own profile, then this is cause for potential concern and needs to be considered as part of the review of the zonal costing model.

[REDACTED]¹¹ of all bulk mail volumes. Those data should therefore form a significant component of any measurement of Royal Mail's overall zonal profile.

43. The last public data on relative zonal costs were made available in 2009¹². The relevant parts are summarised below. However, the current 'zonal tilt' does not match this.

Zone	Volume	FAC (p)	Zonal change
Urban – A	35.5%	12.83	- 10.3%
Suburban – B	32.1%	14.17	- 0.9%
Rural - C	18.5%	15.82	+ 10.7%
London - D	13.9%	16.34	+ 14.3%

44. It is noted from OFCOM's consultation, that London is still the zone with the highest costs and that urban costs would, upon implementation of the proposals, require an increase in relative urban prices. As important investment and employment decisions will be taken on the basis of the expected level of prices in different zones, it is crucial that the methodology is stable and that prices reflect genuine changes in the underlying operational cost structure.

Barriers to using a zonal contract: zonal indicator

45. The creation of a national and zonal 'pairing' does reduce the scope for discrimination against those operating without a national profile but it will not offer a real alternative to a customer if they are unable, in practice, to transfer to a zonal contract. In practice, operating a zonal contract has one significant, but unnecessary, operational constraint which makes switching problematic and, for some mail flows, unduly expensive. This was initially raised with OFCOM in 2011.
46. The barrier is the requirement that a zonal indicator must be applied to every letter and large letter posted under a zonal contract. Royal Mail has said that this is required for revenue protection purposes but there is no convincing evidence that this is the case. We believe the requirement to be unnecessary and an actual (if not also a deliberate) barrier, for the following reasons:
- 46.1. The requirement is unnecessary for mail destined for a London SSC because that mail can only be for the London zone.
- 46.2. For MailMark mail, the zonal indicator is also superfluous because the barcode includes postcode sector data which can be 'read' by the Royal Mail sorting machinery.

¹¹ [REDACTED].

¹² Changes to Zonal Access Pricing – Proposed Licence Modifications. Postcomm: 20 February 2009 at page 20. <http://stakeholders.ofcom.org.uk/binaries/post/606.pdf>

- 46.3. For all other mail, Royal Mail will have been provided with the zonal data and, when carrying out revenue protection, revenue protection staff can only validate the accuracy of a zonal indicator if they revenue protect the full postcode sector. This would involve reading the full postcode (because only that way can they be sure that the customer had applied the correct zonal indicator and, therefore, reported the correct number of items per zone).
- 46.4. Royal Mail has recognised that there is no need to apply a zonal indicator under NPP2 contracts, even though zonal-based surcharges are calculated by reference to the actual zonal profile. Under those contracts, Royal Mail relies on sampling and is proposing to accept customer zonal data to measure the actual posting profile and, thus, calculate the applicable surcharges.
47. All of the above demonstrates that there is no genuine justification for the need to apply a zonal indicator as there are other, more reliable, means by which to conduct the revenue protection activity.
48. The consequences of not applying a zonal indicator are significant. Royal Mail may either refuse to process the mail or, if it elects to process it, they will apply the price of the most expensive zone in the SSC to the item (i.e. outside London, the rural tariff since there are rural postcode sectors in every non-London SSC). This means that the highest possible price is applied, irrespective of the actual delivery cost to the address in question. This is an excessive penalty for the omission of a zonal indicator which serves no operational function.
49. Applying a zonal indicator to every item is problematic. For some operators, it is said to be the sole reason for not using a zonal contract. The operational barriers of applying a zonal indicator are the following:
- 49.1. Customers will need to amend their mail production systems to apply a zonal indicator to every pre-sorted item. This will involve IT costs and may also require some layout changes, in order to respect clear-zones and other presentation requirements. Details are set out in Annex C.
- 49.2. Operators would need to apply a zonal indicator to every unsorted item. With machine modification (which involves some development cost), this is possible for mechanically sorted mail.
- 49.3. However, for manually sorted mail, this is not operationally possible because the postcode would need to be read and manually entered, a label printed and applied, manually, to the envelope. Given the prohibitive operational costs of this, in reality it means that manually processed mail would be subject to the highest tariff in that SSC, notwithstanding the zonal classification of the postcode sector to which it is addressed. It is, on the other hand, potentially feasible to record and report the zone of an unaddressed item, without also having to apply a label bearing only the zonal indicator.

50. As stated above, there is a requirement to provide the zonal data for every item. We point this out to illustrate that there are other barriers to switching to a zonal contract. However, we also recognise that providing this data is an important requirement to allow Royal Mail to charge the appropriate prices and do not, therefore, do not consider this to be an unnecessary barrier. This can be achieved but does involve IT development for the customer when preparing a pre-sorted mailing and for the operator when presenting a mailing it has mechanically sorted. Not all customers use Whistl's sorting software (which automatically provides this feature) and so, even if the zonal indicator requirement is removed, this would remain a barrier to switching to a zonal contract. For manually sorted mail, an operator must decide if the additional operational costs of providing the data are lower than the costs of declaring the item as Zone Z (and paying the highest, applicable zonal tariff).
51. In order to ensure that OFCOM's proposals work in practice and that zonal equivalent pricing is available in reality (and not just in theory), OFCOM needs to require Royal Mail to remove the requirement for customers to apply a zonal indicator to mail items handed over under a zonal contract.

Timetable for implementation

52. We note that it is proposed that Royal Mail be given six months in which to implement the eventual decision. In practice, because of contractual notice periods, this means that Royal Mail will need to notify the changes significantly earlier.
53. Royal Mail has indicated its intention to introduce its annual Letter and Large Letter access price changes in January (usually the first Monday of January), and is contractually obliged to give at least 70 days' notice of pricing changes, this would mean that they would need to implement the proposals by 23 October.
54. Customers would also need to be notified of any associated contract changes which Royal Mail needed to make. Where the change is required by a regulator, clause 13.2.2 provides that Royal Mail must give 90 days' notice (or such shorter notice as required by OFCOM).
55. We would simply note that this makes the timescales achievable, albeit tight, if Royal Mail intends to introduce the 2016 price changes in January, provided it serves notice by mid July 2015.

Responses to consultation questions

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

The need for intervention is clear. Without setting clearer ex ante rules, which confirm the position we understood OFCOM to have taken in the 27 March 2012 statement, experience has, unfortunately, shown that the scope for significant market disruption is too great. By intervening, OFCOM is creating essential clarity for other operators to make investment decisions. Reliance on ex post measures in this early stage of development of delivery competition offers inadequate protection to competitors and, ultimately, to consumers.

Consultation question 2: Do you [agree] 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?

We agree with the statement that doing nothing is inappropriate, for the reasons stated above. It is clear that the absence of regulatory conditions has permitted Royal Mail to make pricing proposals which would have foreclosed delivery competition had they been implemented. Greater regulatory intervention is essential.

In light of Royal Mail's behaviour, however, it is abundantly clear that competition law is not adequate to prevent Royal Mail from engaging in anti-competitive conduct where they have the ability and incentive to foreclose competition. As set out in detail in Annex A, Royal Mail clearly has both. Whistl strongly urges Ofcom to follow up this access review with a further consultation containing a proposal to impose cost-covering, price floors on Royal Mail.

There is also a strengthening argument that Royal Mail should be subject to a price control, which sets the upper limit on its access prices. Access prices have increased at a significantly faster rate than inflation. If the proposals should prove to be insufficient to ensure the success of delivery competition (and, thus, the efficiency, cost and downward price pressure on Royal Mail), the only means to protect customers will be to impose tight price caps on access prices which drive greater efficiency. This, though, will always be a poor proxy for genuine competition and have not worked previously.

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? If not, please set out your reasons?

It is appropriate to focus on existing zonal definitions and the related costs and prices. When introduced in 2004, zonal prices were specifically intended to offer a pricing solution for those who would not post on a national basis. The costing methodology for zonal pricing has been in place for over a decade and the methodology should be reasonably well embedded. However, the need for a robust

zonal costing model is extremely important, and we have commented on that above (paragraphs 41 – 44).

[REDACTED] To change that underlying basis, after more than ten years, would be extremely disruptive.

When Postcomm analysed Royal Mail's costs, it concluded that pricing on a zonal basis could be cost justified. Indeed, the data published in 2009, demonstrated that the relative FAC of the four zones rank those zones in the order proposed by OFCOM.

We can think of no good reason to adopt a different cost basis. Within those zones, Royal Mail retains the flexibility to alter its prices provided that they are cost justified. As stated above, this relative zonal pricing creates an important incentive for cost saving but we are concerned about the possibility of below-cost pricing, given the potentially damaging effect on delivery competition.

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

The definition of the Zones has been in place for some years **[REDACTED]** As the building block for the pricing structure and proposed regulatory framework, it is extremely important that the market has regulatory certainty that the definitions will not change within the regulated period.

Whistl would strongly advocate that the definition of the London zone be fixed for the duration of the current regulatory framework (i.e. until March 2019). The flexibility around the SSC boundaries is also a concern, as described in more detail above (paragraphs 17 – 25).

Whistl's strongly preferred option is that the definition of zones¹³ should remain fixed. If OFCOM decides to allow possible change, the process for changing the zones needs to ensure that the impact on competition is taken into account. **[REDACTED]**

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

As stated above, requiring that the national pricing terms always have an equivalent zonal pricing framework whereby the weighted average zonal price equals the national price is an extremely important protection. Given Royal Mail's recent attempt to discriminate in favour of customers on a national contract (NPP1), through the offer of differential pricing, this is an important step.

However, continuing to permit tolerances, profiles unrelated to zones, surcharges which are not linked to zonal costs, and subjective compliance obligations (i.e. all reasonable endeavours) could operate to create discrimination.

¹³ Urban, Suburban and Rural to be defined on the existing delivery point / business address density method and London by reference to specific postcodes as currently included within the 12 'London' SSCs.

Whistl would strongly urge OFCOM to require any profiles and surcharges to be based upon an objective assessment based on zones and zonal prices (which, in turn, must be based on zonal costs).

We illustrate the pricing differential under NPP1 and NPP2 contracts, using an identical profile above (paragraphs 26-35).

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

Using a weighted average rule is, in principle, an appropriate way of deriving the national access price. It recognises that the zonal costs, as reflected in the zonal prices, are the fundamental pricing components for all access charges.

Please see our response to question 12 below on the appropriate volumes to use for weighting.

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?

As stated above (paragraphs 26 – 35), we strongly believe that the proposed approach is inadequate, as it can lead to discrimination in favour of customers who use only Royal Mail for final delivery [REDACTED]

We would advocate that the only profile to be used should be the zonal profile as used in NPP2 contracts, which has an underlying cost-justification. The profile and surcharge mechanisms in the NPP1 agreement do not have such a cost-based mechanism.

We would strongly argue for there being a single form of national access contract i.e. the current NPP2 contract. This alone enables a direct comparison with the underlying zonal prices (which, in turn, depend on costs which are to be subject to increased regulatory supervision).

If the unnecessary barriers to using zonal contracts could be removed – most notably the requirement to apply a zonal indicator to every item – there is a powerful argument to say that all access should be on a zonal basis. This would mean that customers would pay for what they mail and there is no need for tolerances.

We strongly believe that, where some customers must pay a cost-based charge which reflects their actual profile (NPP2 or zonal) there is no place for subjective ‘all reasonable endeavours’ provisions as a trigger for profile-related surcharges (nor is there a justification for replacement ‘waivers’ for non-compliance with profile). We will be responding to Royal Mail’s discussion paper to this effect.

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.

We strongly support this proposal. If given the freedom to propose non-Zonal sub-national plans then, based on previous experience, we fully expect that Royal Mail will design them so that they would have the effect of foreclosing the downstream

market to competition, which would cause any a rational downstream competitor to exit. This underpins much of the competition concerns submitted in Whistl's Competition Act complaint to Ofcom.

Given the clearly articulated need for cost-efficiency incentives, it is crucial that the access prices have a direct link to costs.

Providing a zonal contract offers access customers with sufficient flexibility, if they do not wish (or are unable) to post on a nationwide basis. Indeed, zonal pricing was introduced in 2004, ostensibly to meet this very customer demand (from Regional Mail Services). However, we restate the importance of removing the requirement to apply a zonal indicator, which acts as a barrier to the take-up of zonal contracts.

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.

We believe that cost by format is appropriate. Costs of processing different formats differ and so this provides an appropriate level of disaggregation.

[REDACTED]

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

On balance we support the use of the most recent, historic cost data.

The risk of regulatory failure with using forecasts is increased and leads to the potential need for adjustment. This creates regulatory uncertainty.

Where costs are rising, Royal Mail will benefit from a competitive perspective by having a lower, historical cost base (more relevant, of course, if the absolute level of prices needs to cover costs). On the other hand, if Royal Mail is taking out costs, it will experience a time-lag in being able to reduce its costs. In either case, this time-lag will be corrected in time.

This will give Royal Mail an additional incentive not to delay cost-saving measures, so that it might introduce reduced pricing as soon as possible.

We reiterate, though, the importance of a requirement that prices should be required to cover costs. Otherwise, this efficiency incentive is softened if price decreases can take place without the efficiency measures having been taken.

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.

There is a risk of adjustment to the 2013/14 ZCM and so we strongly support the use of the 2012/13 ZCM as the starting point. We note that the ZCM will be reviewed and so, if there are changes which need to be made to ensure that the resulting zonal costs are more accurate, these can be accommodated.

This proposal reduces the risk of regulatory gaming and, thus, provides greater regulatory stability.

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.

The question raised is whether the weighted average of zonal prices should be derived from using (a) access and retail bulk volumes or (b) total mail volumes, including universal service mail.

We would suggest that continued use of access and retail bulk mail volumes is the more reflective of relevant volumes.

However, there is a third possible method, which is to use only access volumes. We note that this has not been advanced as an option to be considered but it may be the most reflective of relevant volumes.

If delivery competition emerges in the way envisaged (i.e. predominantly in London and urban areas), either of the two proposed methods would overstate the proportion of access mail in those zones as compared with a weighting system which relies only on access volumes. This has the following consequences:

- If entry is focused on urban delivery (outside London) then including non-access volumes would use a higher proportion of urban mail delivered by Royal Mail in the weighting, than if only access volumes are used. As this is currently the cheapest zone, using a higher proportion of cheaper, urban mail in the weighting would have the effect of setting the national average price at a lower level.
- If, on the other hand, entry is focused on London delivery, the effect of including non-access mail in the weighting would be to maintain a higher proportion of London mail (the highest price zone) in the calculation and thus have the effect of setting the national average price at a higher level.
- If entry is in both areas, as expected, the effect may balance out, depending on the relative levels of entry, which may vary over time.

Including USO mail would have a further moderating effect on the impact of delivery competition on the components of the weighting and would, therefore, be the least appropriate method.

We do have some concerns about the accuracy of Royal Mail's sampling of zonal volumes (paragraph 42). In the context of measuring our own actual zonal profile, we have exposed material disparities between the Royal Mail sampling result and our own profile which is based on the actual zonal data [REDACTED] Where possible, actual zonal volume data should be used.

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.

We believe that format level volumes are appropriate.

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.

Please see our comments on the timetable at paragraphs 52 - 55. The implementation period needs to take into account the minimum contractual notice periods under the contract.

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?

We agree with this approach. We will provide input during the subsequent review on any additional issues which should be taken into consideration.

One point we would make at this stage is that the effect of volume changes arising from delivery competition should be taken into account as soon as possible, in order to apply the sharpest incentive on Royal Mail to improve its efficiency levels and, thereby, benefit consumers.

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?

Compliance does need to be monitored, given the lack of external transparency of Royal Mail's costs. Without such monitoring, the risk of market disruption is significant.

Providing details of cost ratios to customers will not be instructive, since customers have no way of knowing the underlying cost data and if it has been properly prepared.

We would strongly recommend that the prices be published only once OFCOM has been able to assess compliance with the cost-setting rules in the ZCM and confirm that the prices accurately reflect (and cover) the underlying costs and weighting.

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

As stated in the answer to question 16, Royal Mail should submit the zonal cost data, volumes and proposed prices to OFCOM, before publication.

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

Traditionally, the Crown Dependencies have been treated as a 'domestic' destination, even though each has its own postal provider and separate regulatory regime. Every address in these territories is contained (and maintained) within the Postcode Address File (PAF).

OFCOM can require Royal Mail to provide access for D+2 services to the three islands. IMCs are clearly part of the network used to provide the universal service¹⁴ and, since providing a service to non-UK addresses is part of the universal service obligation and since the 'postal network' includes 'arrangements made with others for the provision of any service', it is (contrary to what is asserted at paragraph 6.46) the case that access *can* be (and is) mandated for D+2 services to the Crown Dependencies. In the USP Access Condition 1.3(f), D+2 Access is defined as 'access to the universal service provider's network at the IMC for the purposes of providing D+2 and later than D+2 Letters and Large Letters services'. The islands are unlike any other non-UK destination in that mail for the islands is not handled by Royal Mail's international network as 'international' mail but is processed through the IMC network. This accords with the view that they are therefore covered by the existing mandate.

We acknowledge that the costs in each Crown Dependency are dependent on local conditions and are not under the control of Royal Mail. However, the combined volumes going to the three islands is 0.28% of Royal Mail's entire volumes and this low volume should be borne in mind when considering the practical consequences (which we outline below) of removing the islands from the access obligation.

From a cost allocation perspective, we would agree that the costs of Jersey Post, Guernsey Post and Isle of Man Post should not be included in the calculation of Royal Mail's zonal costs but cannot believe that this is material.

There has, until now, been equal treatment of retail services, where the Crown Dependencies are treated as domestic destinations. Removing these mail flows from access services, while retaining them within Royal Mail's retail services, would create an undesirable asymmetry and discrimination. Access treatment must, therefore, match the treatment of Royal Mail retail services of these destinations.

As for the amounts charged for these destinations, a price based upon the charges from the three postal operators for delivery in each of the Crown Dependencies, would seem to be a sensible starting point. However, there are practical considerations in treating Crown Dependencies differently and not mandating access for those destinations:

- Many UK businesses have customers in the three islands and produce mailings for the entire PAF addresses. If mail to the islands had to be treated separately, this would involve separate handling and add additional costs. It may not be possible to send these small volumes of mail through retail bulk mail services as these currently require customers to send no fewer than 4,000 items per mailing.
- Customers enjoy having a single postal interface and this may require them to deal with both an access operator and Royal Mail retail.

¹⁴ See definition of postal network s.38(3) Postal Services Act 2011

- If access for the Crown Dependencies does not continue, separate direct arrangements would be required to allow access operators the ability to keep sending their customers' mail to the three islands. This introduces unnecessary inefficiency and operational complexity. Arrangements would also need to be put in place for handling return mail. This may involve a second flight to each of the islands rather than the single flight rotation as currently takes place.
- If the three islands remain an access destination but were subject to a separate price for national access customers, this would require changes to access operators' billing systems to reflect these (small) volumes.
- Sort plans used to produce and sort mail for retail (assuming the same treatment of these destinations applies) and access customers would need to be altered to reflect that the three islands were no longer a domestic destination.
- The three regulators may need to address the issue of postcode ownership in the islands and the regulation of PAF if they were no longer treated as a 'domestic' destination.
- The UK postal industry is already extremely complicated – customers do not need more complication.

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?

Whistl is concerned about the continued availability of an NPP1 contract which has tolerances and surcharges which are unrelated to underlying zonal costs. As stated above (paragraphs 31 – 35) , [REDACTED].

We have outlined in detail (at paragraphs 4 – 16) why Royal Mail should be under an obligation to price its services above cost and have illustrated our serious concerns about a framework which does not include such a protection.

In particular, Whistl strongly believes that allowing Royal Mail to set its prices below cost is a material omission from the proposals. Case law on allegations of anti-competitive below cost pricing is well documented to show it to be a complex and unsettled area of law.

It is not reasonable, in light of a consistent pattern of anti-competitive behaviour, to assume that Royal Mail would not seek to price below costs, if the short-term profit sacrifice can be recouped later in a restored *de facto* monopoly environment. Such an outcome would not benefit consumers. Competition law provides no regulatory certainty and is not adequate to address the problem in this case.

These issues could be addressed in the final regulations by including an effective *ex ante* “**Cost floor**” measure which requires Royal Mail's prices to cover costs [REDACTED].

Allowing Royal Mail the flexibility to change the geographical boundaries of zones and SSCs within the period regulated by Ofcom's Statement provides Royal Mail with the ability to undermine the structure of the access charges set by Ofcom.

As SSCs and the zonal definitions are the building blocks for the Royal Mail pricing structure [REDACTED] it is crucial that the market has regulatory certainty that the geographical boundaries will not change unexpectedly and in Royal Mail's unfettered discretion.

In a consultation dated 16 January 2015, Royal Mail has proposed to remove a very key protection from the access contract. This protection in clause 13.8 provides that proposed unilateral changes which are the subject of a regulatory investigation or access dispute will be suspended pending the outcome of that regulatory process. Instead, they are recommending that changes should come into effect unless interim measures / urgent action is taken by OFCOM (or other regulatory body).

The grant of an interim measures order under competition law has a particularly high threshold test and is, for the most part, untested and unused.¹⁵ [REDACTED] This provides further support for inclusion of an additional *ex ante* Cost floor. This would be a proportionate and necessary regulatory response by OFCOM to the particular issues raised in this case.

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

We agree that regulating the definition of zones and linking relative zonal prices to zonal costs will, potentially, have the impact of reducing the likelihood of targeted discounting in non-captive zones. However, for the reasons stated above (paragraphs 4 – 16), unless this is coupled with an obligation to set prices at a cost-covering level, there is every chance that Royal Mail will seek to exploit this gap in the regulatory framework.

Customers on a zonal charging plan (the number of whom may increase, if Royal Mail reduced the tolerances on NPP2 contracts, as they propose) will, however, be at a disadvantage if they continue to be subject to an obligation to apply a zonal indicator to every item.

Our concerns about the use of an NPP1 contract which is not based on a zonal profile or zonal costs are explained above.

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

We had expressed our deep concerns at Royal Mail's attempt to change zonal prices without underlying cost justification and their intention to discriminate between access customers. We are, therefore, very supportive of the elements of the proposals which address these important concerns.

As stated above, we strongly urge OFCOM to include the additional safeguards we have requested in order to ensure that the regulatory framework operates as intended, that is: to enable competition and investment; to remove the ability of Royal Mail to engage in abusive and discriminatory behaviour and to create genuine efficiency incentives which will benefit consumers.

¹⁵ We understand that Ofcom has never granted a request for interim measures and recently dismissed Virgin Media's request for such a measure.

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.

Please see our detailed comments and drafting suggestions on the section headed “Suggested amendments to draft USP Access Condition”

Question 23:: Which of our proposed two alternative definitions of ‘Relevant Postal Services’ discussed above do you prefer and what are your reasons for your preference?

Please see our comments on Question 12.

Question 24: Do you agree with our proposal to base the concepts related to the concept and definition of ‘Zones’ on Royal Mail’s own methodology (as referred to above)? If not, please explain in detail why.

The current definition of zones has been the basis of zonal pricing since 2010 which followed extensive analysis by Postcomm and input from Whistl. We therefore support the use of Royal Mail’s definition of zones.

Any changes to zones need to be carefully monitored, given the disruptive effect changes could potentially have on investment decisions by Whistl.

The London zone should be defined by reference to the postcodes which currently fall within the 12 SSCs which make up the London zone.

Question 25: Do you have any comments on our proposed new concepts and their definitions discussed in this Annex?

Comments on the concepts are addressed earlier in the paper. In particular, we would point to the risk of Royal Mail being free to re-define zones, the London zone or (save in the case of genuine operational necessity) SSCs.

Question 26: Do you have any comments on our proposed corrections to the USPA Condition discussed in this Annex that are unrelated to our proposed new remedies in USPA 2.1A, USPA 6A and USPA 6B (and their associated new expressions)?

Please see our detailed comments and drafting suggestions on the section headed “Suggested amendments to draft USP Access Condition”

Question 27: Do you agree with our thinking and proposals for the rounding (decimal places) to assess compliance with our proposed new remedies in USPA 6A and USPA 6B? If not, please explain in detail why.

We would prefer that the linkage between costs and prices is as tight as possible. Royal Mail currently sets its zonal prices in its pricing calculator to four decimal places (see NPP Calculator 2014/15 <https://www.royalmailwholesale.com/access-letters-contract/>). For the sake of consistency, we would therefore suggest using four decimal places.

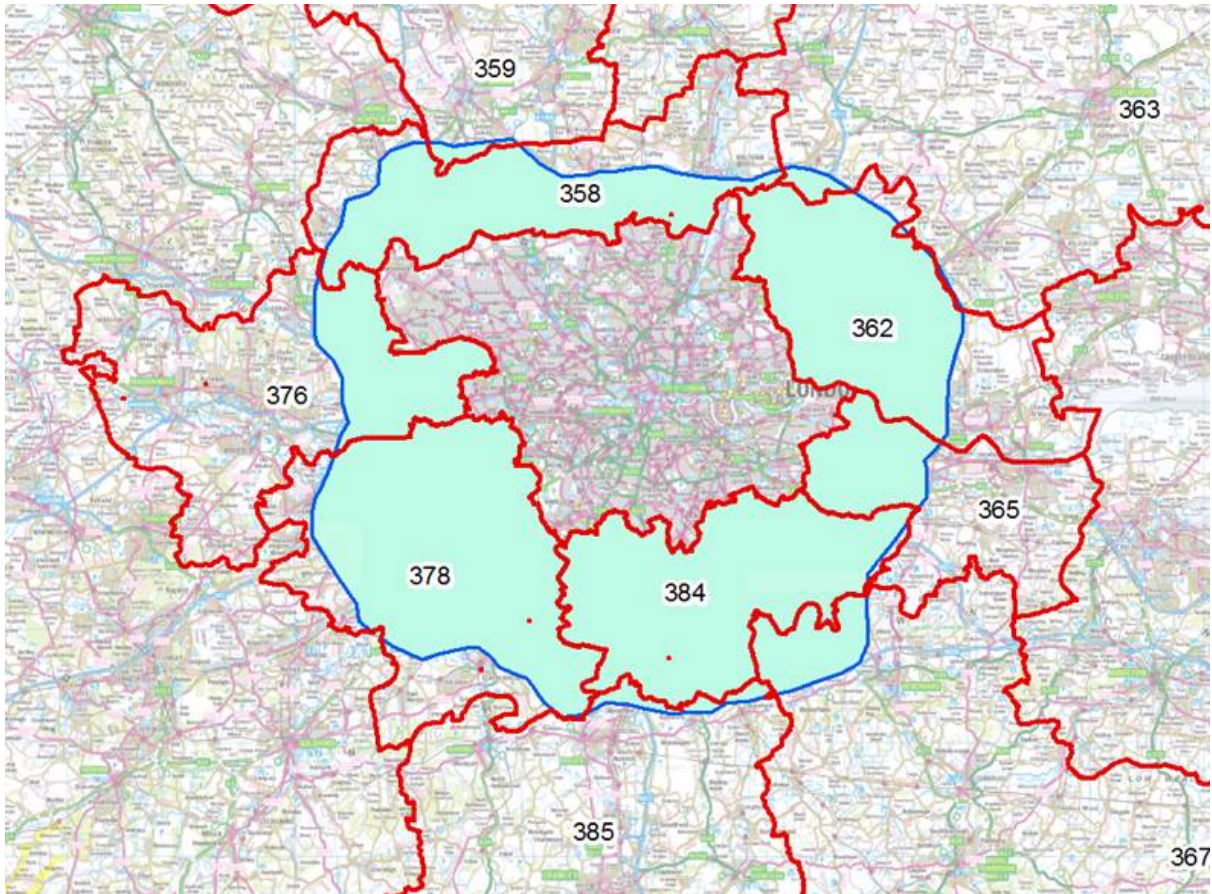
Suggested amendments to draft USP Access Condition

[REDACTED]

ANNEX A

[REDACTED]

ANNEX B
MAP OF LONDON SSCs



ANNEX C

OPERATIONAL BARRIER TO APPLYING ZONAL INDICATOR

Royal Mail Requirements

- Software Sortation using Royal Mail Access Files SORT AZ database to obtain Zonal Indicator for each mail item.
- The word “Zonal” to appear on Customer Final Bag Labels for each Zonal mailing
- Zonal Indicator to appear in the Address Window or Address Carrier either in the Format of Standard Selection Code (SSC) then Zonal Indicator (ZI), Zonal Indicator then SSC or using the word Zone then the Zonal Indicator examples below:

SSCZI

ZISSC

ZONE ZI

What is the Impact of the Change to Zonal requirements on the Mailing Houses?

- Few mailing houses are set up to handle zonal mailings.
- If the Mailing House obtains their sortation software from a third party supplier then they would need to request that the zonal sortation specification is added to their software package, this of course is all dependent upon the software supplier having the zonal product available and if it is not then there would be a lengthy development period before supply. Estimated up to [REDACTED] and annual fee thereafter.
- Inclusion of the zonal indicator in the eye-ball line would not work because it would need to be visible and, therefore, need to be considered part of the address and thus lead to ‘clear zone’ infringement
- Could hamper use of the same address data as appears in the envelope window as is printed in bank giro details, which would require BACS approval
- Sortation software is generally licensed by product so there would be an additional licensing cost for adding a zonal software module to the software package.
- In-house developed sortation software would need to be developed but before this can happen. The Mailing House would need to complete an impact assessment on their existing software and also map out how they could make the required changes. In most cases they would look to recover the cost of development from either a customer or the carrier. Operators who are thought to do all or part of development in-house are responsible for about 70% of mail volumes. The estimated costs for in-house development [REDACTED].
- Mailing Houses would also be required to reconfigure and develop their automated software composition scripts to place the zonal Indicator into the designated area on the mail item. Most Mailing House software platforms consist of a generic platform where a standardised practice takes place and then they link into that generic platform with bespoke composition scripts which are developed only for a certain type of client mailing. Each of the bespoke software scripts would need to be updated to enable the zonal indicator to be placed in the address window of the envelope. There would be literally hundreds of thousands of letter templates which would need to be updated.
- Although phased out by Royal Mail Wholesale, the Access Selection Files for the zonal database used to require monthly updates which in a 24/7 Mailing House production environment caused significant disruption when the sortation software required updating so frequently. If the intention is to reintroduce this requirement and frequency then it could be a further impact to the Mailing Houses.

- On top of the current development that Mailing Houses are completing (e.g. MailMark, End to End), in order to retain the maximum level of postal discount and to prevent themselves from becoming uncompetitive in their sector, adding zonal features to the current Mailmark development would not be a welcome announcement.

ANNEX D

[REDACTED]