

Postal Regulation
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UK Mail Response to OFCOM's Call For Input: Review of postal regulation – pricing and affordability

Please find below UK Mail's response to your Call For Input regarding regulation of Royal Mail pricing. UK Mail is happy for this response to be published.

Price Controls for USO Services

As a downstream access mail operator, UK Mail is not best placed to comment on Ofcom's proposals for reviewing stamped mail price regulation, except where those plans might have a positive or adverse impact on downstream access mail prices. We do however take the view that the second class safeguarding cap has been the only part of Ofcom's regulatory regime that has applied any downward pressure on any parts of Royal Mail's pricing, and so has been the only lever Ofcom has had to influence its statutory obligation to ensure Royal Mail delivers an efficient postal service. We would therefore be very concerned if Ofcom were to replace the second class safeguarding cap that applies to all second class stamped mail with a discount scheme that might only protect the prices of a smaller proportion (either through specified recipients or vulnerable senders) and effectively remove price control from other users who then continue to receive an inefficient service at ever higher prices. We would therefore expect Ofcom to introduce a more active form of efficiency regulation than their historic pattern of monitoring and reporting that Royal Mail continue to fail to meet efficiency targets whilst taking no action to intervene.

Price Controls for Access Services

UK Mail is better placed to comment on the access price remedies discussed in Chapter 5. UK Mail has long argued that the margin squeeze test adopted by Ofcom is entirely ineffective and massively flawed. The test is designed to prevent unfair competition between Royal Mail and access operators on specific bulk mail services (Mailsort 2 for Standard access and Mailsort 1 for Priority access). However as Royal Mail has very little volume in either of these bulk mail services it is very easy for Royal Mail to increase these relative to other services without consequence to their bulk mail revenues, but so that the price differential between access mail relative to non-bulk mail is reduced. This effect enables Royal Mail to sell their business unsorted mail services at a price that an efficient competitor could not match, especially for the larger mailers receiving the higher volume related discounts from Royal Mail, and so forecloses the market to downstream access operators for customers sending higher volumes of unsorted mail. We do not believe Ofcom's implied test of downstream access operators losing volumes to Royal Mail is the appropriate test when operators have not had chance to win this volume in the first place. UK Mail is therefore pleased Ofcom plans to look at this area in more detail.

As well as preventing access to certain parts of the mail market for downstream access operators, we can see no mechanism under the current regime that would prevent Royal Mail increasing bulk mail prices above unsorted prices, and with this increasing access prices to do the same. Driving mail back into unsorted services might be

advantageous to Royal Mail but would result in an inherently less efficient postal service for users. It would not only damage the market for downstream access mail operators but also for mail producers (i.e. mailing houses) who enable efficient mail services through presortation within their production processes.

UK Mail is pleased Ofcom is considering alternative forms of price control, and as above, consider this an absolute necessity if they are to entertain the removal of the second class safeguarding cap. Current price controls have not driven Royal Mail to improve efficiency and whilst Ofcom have repeatedly argued that this is a Royal Mail shareholder duty, it is evident that this consistently is not achieved. It will always be easier for Royal Mail shareholders to improve margins whilst not having to invest in efficiency improvements than it is to do so with the additional investment risk, and so passing on costs to customers will always be a more attractive option.

UK Mail wants to see Ofcom deliver on all their obligations of an effective, efficient and sustainable postal service. That means a service with a respectable quality of service, at an affordable price to both social and business users, delivered through an efficient network. Over recent years none of these objectives have been achieved. Reports from the pilots for the alternate day delivery model suggest the levels of savings envisaged by Royal Mail and Ofcom, which were fundamental to customer agreement to accept a reduction in the service specification to put Royal Mail on a more sustainable footing, are now unlikely to be achieved. UK Mail believe Ofcom must learn from this experience and ensure it has more levers to manage Royal Mail rather than fewer. Ofcom may not choose to apply all those levers in an aggressive manner, but should have sufficient controls to shape Royal Mail behaviour and enforce the hitting of targets.

Ofcom has proposed a number of possible price controls. Although Ofcom seems to be presenting them as alternatives, UK Mail's view would be that only the pre-authorisation option could be effective in isolation, and even then only because the market would expect Ofcom to be applying the other controls as part of their authorisation.

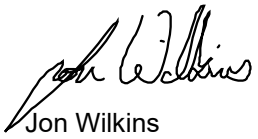
UK Mail believes the most appropriate controls would be a cost based charge control along with quality of service targets coupled to punitive penalties for failing to achieve those targets. We are very disappointed to read that having contributed to the funding of projects for Ofcom to build their own cost models for the Royal Mail operations that Ofcom considers further models would be needed to enable this form of control. We also believe that Ofcom's tariffs for failing to achieve targets are too low by approximately a factor of ten (based on Ofcom's own estimates of how much Royal Mail can save through not delivering to every address as part of the research for the new alternate day delivery model) for this to be effective.

We do not see that a profit cap in isolation would create downward pressure on prices to improve efficiency, and so costs would continue to rise and just push prices up whilst almost protecting Royal Mail margins. Alongside the current quality of service regime where customers can probably expect four more years before Ofcom tariffs reach the level that would make Royal Mail decide delivering on quality was a worthwhile investment this seems another ineffective price control in isolation. However, it could be a sensible safeguard to prevent excessive pricing alongside the outcome incentives.

Outcome incentives, where Royal Mail's pricing options were defined by achievement of quality of service targets, do seem to provide a mechanism to encourage Royal Mail to improve service performance and prevent users from continuing to have to pay higher prices for a worse service. Constraints on price increases are likely to deliver a more significant impact on Royal Mail revenues than Ofcom tariffs, and so will focus Royal Mail on investing in service performance. Allowing Royal Mail to achieve above inflation price increases when service performance is achieved, but no increase where performance is substandard, provides the opportunity for them to also invest back into efficiency programmes once customers are receiving the services they expect. The risk of this model is that if Royal Mail does start to perform then repeated above inflation increases starts to result in excessive pricing, and so a profitability cap as a secondary safeguard would seem a sensible protection.

The big advantage of the outcome incentives model is that it drives Royal Mail behaviour whilst allowing Ofcom to continue to take a largely passive role in Royal Mail regulation. Royal Mail retains commercial freedom whilst working within a framework which delivers the effects that users would expect from a competitive market; where Royal Mail can't continue to charge more for an ever worsening service.

We would be delighted to expand on any of the access pricing related topics as you conduct your reviews.

A handwritten signature in black ink, appearing to read "Jon Wilkins". The signature is written in a cursive style with a prominent initial "J".

Jon Wilkins
Director of DSA Mail