

## **CWU SUBMISSION TO OFCOM – DRAFT GUIDANCE ON END-TO-END TO COMPETITION IN THE POSTAL SECTOR**

1. The Communication Workers Union (CWU) is the largest union in the communications sector in the UK, representing over 200,000 employees in the postal, telecommunications and financial services industries and is the recognised union for all non-management employee grades in the Royal Mail Group.
2. The CWU welcomes the opportunity to comment on Ofcom's draft guidance on end-to-end competition in the postal sector. Ofcom's consultation document sets out its proposed framework for possible future regulatory action on end-to-end competition in the postal sector. It sets out in detail Ofcom's interpretation of the powers at their disposal, and the steps they propose to undertake in order to decide whether to take further regulatory action.
3. The background for this consultation is the notification condition imposed by Ofcom in March 2012 on potential entrants to the end-to-end market. TNT UK notified Ofcom in summer 2012 of their intention to begin a trial of end-to-end competition in West London. Ofcom decided at the time not to intervene, and published an update in July 2012 setting out that decision. Ofcom at that time committed to producing clearer guidance on what steps they would undertake to decide whether to intervene on end-to-end competition in future, which forms the basis of the current consultation.
4. The CWU believes Ofcom should take a far more robust approach to regulating end-to-end competition than that set out in the draft guidance, in order to protect Royal Mail's ability to deliver the universal service. We believe that Ofcom's duty to ensure the provision of the universal service requires intervention now. Without immediate intervention we believe Ofcom are failing in their primary duty as set out and strengthened in the Postal Services Act 2011.
5. Competition in the end-to-end market inevitably threatens the universal service and could eventually make its provision impossible. There are fundamental tensions between unrestrained competition and the provision of the universal service and the regulator has not shown how the two can successfully coexist. Throughout the debate on postal liberalisation it has been widely recognised that the universal service would need protection from unrestrained competition. It is for this reason that the protection of the universal service is Ofcom's primary duty with regard to post, that UK and European legislation recognises the likely need for intervention to support the universal service, and that even the Hooper report

recognised that Royal Mail must be protected from cherry picking if the universal service is to survive.

6. Our submission sets out the reasons why we disagree with Ofcom's decision not to intervene and again asks the regulator to reconsider its position. Our submission also responds to the specific issues in the proposed framework we believe are of concern.
7. Our principle disagreement with Ofcom's decision not to intervene at this stage is that they are taking a far too relaxed view of the development of end-to-end competition and before they act the universal service will have suffered lasting and irreversible damage.
8. Under the former regulator, competition was introduced with too little regard for the impact on Royal Mail's ability to provide the universal service. The regulatory framework's role in contributing to Royal Mail's perilous financial position is well documented<sup>1</sup>, and we welcomed the new regulator's actions to redress some of those issues in their March 2012 statement, such as Royal Mail's commercial freedom with respect to access pricing.
9. We are however deeply concerned that in its treatment of end-to-end competition, Ofcom's approach appears to repeat that of willingly allowing significant risks to universal service provision to develop unchecked.
10. Ofcom's approach to end-to-end competition risks repeating Postcomm's poor handling of downstream access competition. In the case of downstream access, the regulator refused to intervene for many years over what are now recognised to have been poor pricing structures. Among the reasons given for the regulator for not intervening was a lack of robust information. Whether or not this was the case, the lack of intervention has been shown to have been very damaging. As Ofcom has since noted: "the regulatory formula were proved wrong at a fairly early stage"<sup>2</sup>. Postcomm's response was to tie itself in knots, eventually arguing that it could not intervene as competitors had established their business models based on this flawed pricing structure.
11. We believe Ofcom risk, like Postcomm before, underestimating the financial impact of competition and the speed at which it affects the market, setting in place procedures which are too uncertain and ponderous to adequately respond,

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<sup>1</sup> State aid No SA.31479 (2011/C) – United Kingdom State aid measures to Royal Mail, s. (30) Regulatory Failure, the UK experience, CWU 2012.

[http://www.cwu.org/assets/files/documents/aug\\_12/cwu\\_1343900931\\_CWU\\_Paper\\_to\\_Rutgers\\_Conferen c.pdf](http://www.cwu.org/assets/files/documents/aug_12/cwu_1343900931_CWU_Paper_to_Rutgers_Conferen c.pdf)

<sup>2</sup> Ofcom, Securing the Universal Service: proposals for the future framework for economic regulation (October 2011).

and failing to take advantage of regulatory tools at their disposal. The resulting pressure on the universal service fails to fulfil the primary regulatory duty to ensure its provision.

12. We believe Ofcom should be standing up for the universal service, and taking robust action to ensure its provision is financially sustainable. End-to-end competition without adequate regulatory protection poses a significant threat to the universal service, to which Ofcom should react now.

### **The impact of end-to-end competition**

13. We believe Ofcom underestimate the impact of end-to-end competition on Royal Mail's ability to provide the universal service. Royal Mail's financial position remains fragile, while TNT's plans are for ambitious expansion. We also view Ofcom's expectations of benefits of competition as unrealistic.
14. Royal Mail has begun to restore its financial viability, but still operates at very low margins so that loss of revenue could quickly reverse recent improvements. In the six months to September Royal Mail had an operating margin of 3.3%, up from 0.3% for the year 2011-12<sup>3</sup>. This is still well below the 5-10% level Ofcom believe would represent a reasonable commercial return, and set against the context of continued volume decline shows the fragility of Royal Mail's finances.
15. Whilst we understand that TNT's London trial currently involves delivery of around a relatively modest 200,000 units per week, TNT UK's stated aim is to increase their end-to-end operations to a workforce of approximately 20,000. Evidence from our members in the trial area is that volumes have been materially affected. Loss of revenues on the scale supported by that workforce would have very serious consequences for Royal Mail.
16. In addition to threats to Royal Mail's market share in end-to-end delivery, TNT's trials have the potential to affect downstream access volumes. TNT are a significant user of Royal Mail's final mile delivery network, and their investment in establishing a delivery network will naturally lead to them seeking to transfer final mile deliveries away from Royal Mail.
17. We question Ofcom's views on the potential benefits of increasing end-to-end competition [4.15]. Ofcom contend that increased competition may lead Royal Mail to innovate in its operations, as a means of responding to competition. Whilst this is the standard theoretical position on the advantages of competition, it would be interesting to hear Ofcom's views on what new form of innovation Royal

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<sup>3</sup> Royal Mail Group, Interim Report for the half year ended 23 September 2012 & Royal Mail Holdings Plc Annual Report 2011 -2012

Mail should be investigating in the universal service range of products. Whilst it is clear many elements of the postal market are ripe for innovative practices, for example in fulfilment mail, it is questionable what avenues exist for extensive innovation in universal service letter delivery beyond the modernisation and mechanisation changes already being undertaken by Royal Mail.

### **Inefficient competition – cherry picking**

18. There is an inherent tension between the obligation to provide the universal service and the introduction of competition in those services, which gives rise to the problem of 'cherry picked' competitive entry to the market.
19. One problem with cherry picking entry is the pressure it places on Royal Mail's ability to provide the universal service. Loss of market share in low cost delivery operations increases Royal Mail's average cost. Raising prices to reflect that cost increase will reduce demand for Royal Mail's services and drive users away from post altogether, resulting in falling marginal returns to price increases. This vicious circle of unsustainable cost and price increases is known as the graveyard spiral, and has long been identified as a serious risk to universal service providers<sup>4</sup>.
20. Another issue with cherry picking entry is that entrants to the market are able to undercut Royal Mail without necessarily being more economically efficient. For example, a competitor might have higher unit costs than Royal Mail in the urban area in which they operate, but because Royal Mail's prices need to cover the cross subsidy to more expensive delivery areas, the competitor can charge less. This type of entry does not yield any net utility improvement, and therefore benefits only the competitor company, not consumers.
21. This pressure on the USO highlights the impact its erosion would likely have on rural and hard-to-reach areas. In many cases, Royal Mail's universal service products offer the only remotely affordable option for people living in those areas. Consumer Focus Scotland's recent report 'Effective parcel delivery in the online era' cites consumers buying a £25 mobile phone being charged £45 for delivery, and island inhabitants simply being refused delivery by private operators.
22. The Hooper Report 2010, though written before current end-to-end operations had been set up, considered the issue of cherry picking. At that time, Hooper felt the theoretical possibility of cherry picking had been mitigated by other features

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<sup>4</sup> Panzar, John. 2002. Reconciling Competition, Downstream Access, and Universal Service in Postal Markets; Crew, Michael & Kleindorfer, Paul. 2002. Balancing Access and the Universal Service Obligation.

of the market<sup>5</sup>. Nonetheless, in describing a regulatory framework designed primarily to protect the universal service, Hooper described a framework where: “To protect against the dangers of cherry-picking, the regulator would ensure as level a playing field as possible by not allowing competitors a free run in the more lucrative areas of the market whilst Royal Mail’s hands are tied by the demands of the universal postal service obligation.”<sup>6</sup> Hooper recommended competition be introduced only in so far as the universal service provision was adequately protected<sup>7</sup>. We support this position. It is disappointing and worrying that, nearly three years on from the report, this recommendation has been sidelined.

23. We are deeply concerned that Ofcom’s attempt to balance the tension between the universal service obligation and competition fails to adequately resolve the problem. The model of end-to-end competition facing the UK postal sector is based on cherry picking of profitable parts of the mail market. TNT’s trials have focused exclusively on establishing operations in high density urban areas, where delivery costs are lowest.

24. A number of regulatory options exist to tackle the problem of cherry picking. For example, Ofcom consider the use of service conditions so that entrants are under similar service obligations as the universal service provider. We discuss Ofcom’s proposals on these conditions in more detail below, and express reservations about how effective the relatively weak conditions they propose would be. Similar conditions have been used by other European regulators, for example in Finland and Belgium. We note Ofcom’s involvement in the European Group of Regulators, which is a forum for exchange of information between national regulators at the European level. We urge the regulator to take firm action now.

## **Employment effects and industrial relations**

25. Royal Mail’s end-to-end competitors operate an employment model based on low wages and precarious employment. We are concerned that in the debate on Royal Mail’s efficiency, Ofcom may promote competition based on the erosion of terms and conditions of employment. We believe this would be harmful to the postal industry, as well as to society as a whole.

26. Royal Mail operates an employment model based on a majority full-time workforce, supplemented by part time workers. This allows the business the flexibility to deal with uneven labour demand patterns. The balance of full to part-time employment - 25% part-time employees - forms part of the Business Transformation Agreement 2010, agreed between Royal Mail and the CWU.

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<sup>5</sup> Saving the Royal Mail’s universal postal service in the digital age, Richard Hooper 2010, p.28

<sup>6</sup> *ibid*, p.36

<sup>7</sup> Saving the Royal Mail’s universal postal service in the digital age, Richard Hooper 2010, p.38, 2<sup>nd</sup> bullet.

Wages in Royal Mail reflect the hard work of its employees, and are above the living wage. Royal Mail management continue to seek to maintain a professional workforce providing a quality service. The CWU has demonstrated significant sensitivity to the financial position of the business and is working hard to implement the difficult modernisation programme.

27. In contrast, TNT's business model is for an almost entirely part time workforce, paid below living wages. It appears TNT pay between £6.50 and £7.10 per hour, compared with a living wage of £7.45 to £8.55. This reflects the postal sector in Holland, where TNT are based, and where competition has largely been on terms and conditions of employment, with rival operators such as Sandd using ultra-precarious employment practices such as self-employed delivery workers.
28. The result in Holland has been constant pressure to reduce service levels, by degrading the terms of the universal service. At a European level Dutch operators lead lobbying efforts for reduction in the minimum standards guaranteed by the Directive, for example by reducing the minimum number of delivery days to as few as two or three days a week. We believe fundamentally that worsening terms and conditions reduces quality of service in the postal sector.
29. In addition to the impact on the postal service, this model of employment damages society by replacing decent jobs with precarious employment at wages inadequate to support workers' basic needs. It further risks placing additional burdens on the public purse as a result of loss of income tax revenue and the additional cost of providing income support and other related employment and unemployment benefit payments. We understand that Ofcom's view is that these societal considerations are beyond the scope of their remit, and should be left to the market to decide. We urge Ofcom to take a broader view of the role of the postal service in society, and will continue to make this argument to other relevant stakeholders.
30. Royal Mail is one of the UK's largest employers, with more than 127,000 people in its core letters operations<sup>8</sup>. Only four private UK companies have larger workforces<sup>9</sup>. TNT have repeatedly stated that their intention is to establish a workforce of 20,000 in the UK. This claim is often made to support their presence in the UK market, misleadingly described as job creation. The reality is clearly that in a postal sector experiencing falling volumes and increased mechanisation these jobs can only come at the expense of employment in other operators.
31. The CWU believes strongly in the principle that full time work should provide a basic socially acceptable living standard, and as such support the living wage as

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<sup>8</sup> Royal Mail Holdings plc, Annual Report and Financial Statements 2011-12, p.22

<sup>9</sup> <http://specials.ft.com/ft500/may2001/FT33KQ4NKM.html>

a basic level of pay. The costs to society of in-work poverty are significant, and not justified by additional profits for employers. We do not believe an increase in sub-living wage employment benefits the UK economy or society.<sup>10</sup>

32. The failure to resolve the issue of unfair competition is creating serious tensions in the postal sector. The CWU is considering a full range of options in response to this, including a possible boycott of deliveries of competitors' mail<sup>11</sup>.

### **Ofcom's proposed assessment of the financial impact of end-to-end competition**

33. Section 5 of the consultation document sets out how Ofcom propose to conduct a review of the impact of end-to-end competition, in the eventuality that they considered there was a prima facie risk to universal service provision. Ofcom set out a four-stage process for assessing the financial impact, using commercial information from Royal Mail and the competitor, as well as their own analysis. The assessment would compare Royal Mail's financial position under competition, taking into account a range of potential reactions, with projections of the position were there no competition.
34. There are a number of issues raised by the detail of the procedure Ofcom propose, which are set out below. The fundamental difficulty is the high level of risk involved in Ofcom's assessment. We believe Ofcom ought to be more alert to this risk, giving it more weight in their assessment of whether their actions fulfil their fundamental duty to ensure the provision of the universal service.
35. Were Ofcom to give more weight to the inherent risks involved in their assessment, we believe they would conclude that action was required immediately to ensure the protection of the universal service. We believe the acceptance of the high risk of failure to protect universal service provision is incompatible with Ofcom's primary duty, and risks repeating the mistakes of the former regulator.
36. The principle source of information on which Ofcom propose to make their assessment is commercial information provided by Royal Mail and competitors. In step one Royal Mail's business plan is the starting point for assessment, while step two relies on the business plans of potential end-to-end competitors.
37. In both cases, incentives will exist for the businesses to present commercial information in a way which may influence the regulator. This is acknowledged by

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<sup>10</sup> For further detail on the CWU's views on the living wage see CWU Submission to LPC on Minimum Wage for 2012 - September 2011 , <http://www.cwu.org/other.html>

<sup>11</sup> <http://www.cwu.org/news/archive/cwu-launches-campaign-to-protect-the-post.html>

Ofcom [5.10, 6.20]. We are concerned that Ofcom appear to take the influence of this on their assessment too lightly, for example by describing this risk as a “possibility”. Regulators naturally enter into such situations on a regular basis, but it seems likely competitors would be advantaged in their interactions with Ofcom by having far fewer requirements to share commercial information, and fewer competing incentives to shape the presentation of that information.

38. Better quality commercial information about end-to-end competitors would improve the quality of Ofcom’s assessment. Given the threat posed by end-to-end competition, we believe it would be consistent with Ofcom’s duties for them to begin monitoring far more closely the commercial activity of end-to-end competitors. The proposed ‘spot check’ on competitors plans increases the risk of Ofcom being caught by surprise by the pace of expansion into the market.
39. There are inherently high risks to Ofcom’s approach, regardless of issues around the quality of commercial information. Difficult judgements need to be made throughout the proposed process, which carry high levels of uncertainty, as Ofcom acknowledge. For example, Ofcom would need to form their own view of the extent to which Royal Mail business plans were an accurate predictor of the future [5.7], which retrospective analysis will show has been a poor indicator in the past; competitors business plans are likely to be untested when used to assess the direct impact of competition [5.11]; and analysis of Royal Mail’s potential commercial responses is a highly uncertain exercise given the number of variables affecting the outcome [5.15].

### **Efficiency improvements**

40. In addition to Ofcom’s legal duty to secure universal service provision, the regulator has a duty to make that provision efficient within a reasonable period of time. The consultation document includes the important decision by Ofcom to “...undertake work to determine how to assess what constitutes a reasonable rate of efficiency improvement by Royal Mail.” [6.51].
41. We welcome Ofcom turning their attention to the crucial issue of efficiency. Regulatory decisions need to be based on a better understand Royal Mail’s operations. A thorough and independent assessment of Royal Mail’s performance and relative efficiency is needed.
42. Royal Mail’s employees already provide an efficient and effective service to 29 million homes six days a week. Employees are also working hard to improve this service by adapting to new technology and working practices. Stakeholders need a shared understanding of what can be achieved; efficiency savings cannot be driven poorer terms and conditions for postal workers and by reducing service



standards. Efficiency standards must be underpinned by a fair deal for postal workers and consumers.

43. Ofcom give some indication of the type of work they intend to undertake, while saying they are currently considering its scope. We are told this would not be a detailed assessment of Royal Mail's operations, rather a framework for using different benchmarks to assess efficiency performance over time. Stakeholders are to be able to contribute to this work at some point [6.51].
44. We welcome the opportunity to contribute to this debate as major stakeholders in the postal industry. The CWU has long argued that discussions of Royal Mail's efficiency need to be based on a clear understanding of what efficiency objectives are, and how progress towards them should be measured. We raised our concerns over Ofcom's acceptance of Royal Mail's business plan as a baseline for measuring efficiency in our submission to the regulator in December 2011.
45. As we argued previously, we would like to see an open debate about the meaning of efficiency in Royal Mail. The debate has too often been muddled, with the implication being that employees are not working well enough and that Royal Mail compares unfavourably to its competitors. Employees at Royal Mail are working hard to implement change and are enduring increasing workloads and the strains of a more physical job as the length of deliveries grows. We need to be realistic about what can be achieved and ensure that efficiency projections are valid.
46. Given the importance of the efficiency debate to the tone of the regulatory regime, we are disappointed that Ofcom are only now turning their attention to the question. We would have liked to see this issue considered at the outset, and urge Ofcom to keep an open mind as to the results their assessment may produce.
47. Given the difficulties of measuring Royal Mail's progress on efficiency, and the history of poor quality judgements, we would welcome an independent assessment carried out in consultation with stakeholders.

### **Options for regulatory intervention**

48. In section 7 Ofcom outline the range of regulatory tools available to them in dealing with end-to-end competition, and set out the steps required for their introduction. Two principle tools are identified: the imposition of General Universal Service Conditions (GUSCs) and the establishment of a universal service support fund. Other regulatory options are also considered in less detail.

49. We broadly agree with Ofcom's description of the tools available to them, but believe Ofcom should already be taking the necessary steps to begin using them. Ofcom state that they believe the measures available enable them to intervene in a timely manner to protect the universal service. It is our view that GUSC conditions should be used in the short term to avoid cherry picked entry developing to any greater degree, and in the longer term a universal service support fund should be established to ensure the universal service is able to become financially sustainable, whilst continuing to meet the high standards to which service users are accustomed.

### GUSCs

50. Ofcom may impose GUSCs on competitors providing services which fall within the scope of the universal service, provided these are necessary and proportionate to address a threat to the universal service. GUSCs may prescribe a minimum number of delivery days, or delivery to a minimum geographic area. Other quality of service conditions could also be imposed through GUSCs, although these are not explicitly considered by Ofcom. The Postal Services Act 2011(PSA) restricts the scope of the GUSCs, so that Ofcom may not require competitors to deliver six days a week or throughout the UK, nor require uniform tariffs throughout the UK. GUSCs do not require legislative change, or ministerial approval.

51. We agree with Ofcom that due to the reasonably rapid procedure for their introduction, GUSCs provide the best option for intervention in the short term. As it is our view that end-to-end competition through cherry picking of profitable delivery operations introduces unfair competition which presents a material threat to the universal service, we believe GUSC should be introduced at this stage.

52. GUSCs specifying both minimum delivery days, and a minimum geographic area, would go some way to ensuring competition was on fair terms and reduce cherry picking opportunities. We were disappointed that the PSA limited Ofcom in the scope of GUSCs, as we believe all participants in the delivery of universal service products should operate to the same standard. We would therefore urge Ofcom to consider setting GUSCs to comparably high service standards, at the top of the range considered in the consultation, and including a requirement to deliver to a representative proportion of the population. A mix of these three types of condition would go some way to ensuring a level playing field, and protecting the quality of the postal service.

53. In particular the introduction of a GUSC specifying minimum geographic coverage has the advantage of allowing Royal Mail to use access price negotiations to mitigate unfair competition. We would however be concerned

were Ofcom to rely too heavily on this mechanism, in particular if the condition only specified geographic coverage at the lower end of the range envisaged by Ofcom.

54. It is important to note the link between the level of GUSCs and the range of commercial options available to Royal Mail to respond to end-to-end competition. Ofcom discuss Royal Mail using zonal pricing in access contracts to mitigate cherry picking by end-to-end competitors [5.12]. This response would only achieve the desired effect if the end-to-end operator offered, or was obliged to offer, broad geographic coverage to their customers.
55. Even with the imposition of a geographic GUSC, questions remain about how effective this would be, due to the nature of end-to-end operations envisaged by Royal Mail's competitors. Currently end-to-end competitors target high volume customers, offering deliveries in a small geographic area. There are no public access points to their operation. End-to-end operators would have considerable commercial freedom to target contracts which minimised the likelihood of heavy volumes outside their target delivery area. For example, one current customer is a local authority, who is unlikely to send large volumes outside a restricted geographic area.
56. In addition we believe Ofcom should consider introducing other GUSCs to ensure as level a playing field as possible. For example conditions relating to quality of service, including a specification of maximum delivery delays could reasonably be introduced.

#### Universal service compensation fund

57. The PSA specifically envisages the introduction of a fund through which rival operators in the postal sector compensate Royal Mail for the costs of providing the universal service. As noted by Ofcom a lengthy process is required for its introduction, as well as ministerial approval.
58. We have argued for some time that Ofcom should be seriously considering the introduction of a fund, which offers a long term solution for ensuring the provision of the universal service.
59. We accept that Ofcom require the direction of the Secretary of State in order to begin the process. Ofcom should make clear in their response to this consultation that they would welcome that direction, in order to begin the long overdue review of the net cost of universal service provision. The CWU will continue to make the case for a support fund in our discussions with government.

60. As noted by Ofcom support funds are being established in a number of European countries to ensure the long term viability of the universal service, reflecting the clear intention of the Directive that this should be an option for national regulators. It is particularly telling that Post NL, the parent company of TNT UK, should have applied for such a fund to be established in the Netherlands. We agree with Post NL's view that they should be compensated by competitors for the net costs of providing the Dutch universal service, but believe they should expect the same principles to be applied in those other markets into which they choose to enter.

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