ROYAL MAIL GROUP LIMITED

Response to Ofcom's consultation
"End to end competition in the postal sector, Draft guidance on Ofcom's approach"

Foreword

Royal Mail welcomes Ofcom's consultation on its approach to regulatory intervention to safeguard provision of the universal postal service from the impact of direct delivery competition.

Ofcom's statement that direct delivery competition poses a number of risks to universal service provision and its statement that it will, when necessary, initiate regulatory intervention to protect the universal service are important clarifications for all industry stakeholders.

Greater regulatory clarity is now needed

In March 2012, Ofcom noted: "The sustainability of the UK's universal postal service in the UK is at severe risk." This was a result of Royal Mail's fragile financial position. This, in turn, was driven by an outdated regulatory regime, substantial competition from a highly competitive upstream mails market and rapid e-substitution.

Royal Mail is concerned that Ofcom has not yet taken sufficient action to protect the universal service, its primary and most important statutory duty to postal customers and consumers in the face of direct delivery competitors. The draft guidance does not provide the degree of regulatory certainty that is now necessary. In particular, clear guidance is needed for all industry stakeholders on how it will use its powers to protect provision of the universal service, specifically:

- what constitutes harm to the financial sustainability of the universal service;
- the level of harm that would trigger regulatory intervention;
- and the type of regulatory intervention Ofcom would take to protect the universal service in certain predefined circumstance

Royal Mail's detailed response to Ofcom's consultation identifies areas where greater clarity is required in the final guidance to be published later this year.

If competition is allowed to develop unchecked and Royal Mail is impacted by falling revenues and a diminishing profit pool in the already declining letters market, there is a risk that some customers and ultimately the taxpayer may have to finance the increased cost of maintaining the universal service specification. The burden of cost would also fall unequally between customer groups. Bigger companies may benefit from direct delivery competition, particularly in urban areas. By Contrast, small and medium sized businesses and individuals – especially those in rural areas – may well be disadvantaged.

The UK already has a highly competitive postal market

Unlike any other European country, the UK has a highly competitive upstream postal market, a regulatory regime which mandates that Royal Mail provides access to its downstream network and unfettered direct delivery competition. The UK was the only country in Europe where the regulator set a fixed margin between access and retail prices. This led to the rapid development of competition and significant loss of market share for the incumbent. Upstream competitors now carry more than 45% of inland addressed mail, including over 70% of business mail in the UK.

In other European countries, such as the Netherlands, where direct delivery competitors have c.16% market share, there is no upstream competition and in member states where access is required the universal service providers set the price. A consequence of the UK's regulatory framework is that Royal Mail handles a significantly lower proportion of the overall business mail post bag than any other European universal service provider. This gives established access mail providers the considerable advantage of being able to roll out a direct delivery network far more quickly thanks to existing customer relationships. This poses considerable challenges to maintaining the financial sustainability of the universal service.

As the provider of the Universal Service Obligation (USO) and all the detailed requirements that go with it, Royal Mail sees significant benefits in retaining a skilled and committed workforce. Nonetheless, in response to increasingly competitive market conditions, Royal Mail has been working hard to modernise operational processes, optimise the network, manage costs and drive efficiency. This has included the reduction in the number of employees in UKPIL of c23,000 – a difficult and painful process - and the closure of 23 mail centres, which is 1/3 of our mail centre estate and in the reported business[1] have reduced costs in real terms by £1bn[2] since 2007/8.

Under the new regulatory framework, introduced in April 2012, Royal Mail is using its new, *and more appropriate*, commercial freedoms to price its services to better reflect the costs of their provision. As a result, Royal Mail Group's finances have begun to strengthen, as shown in our half-yearly results.

Unfettered direct delivery competition risks undermining the provision of an affordable universal service

Royal Mail welcomes competition on a level playing field. We have a track record of competing effectively in the highly competitive parcels market both in the UK and in Europe. The UK was one of the first EU countries to see major liberalisation of its postal markets. But the universal service obligation, with its requirement for a high quality, nationwide, six-day-a-week delivery and collection service, at uniform and affordable prices, inevitably creates an opportunity for distortive "cherry-picking". Typically, this entails focusing on high density, urban areas. This is because the USO means Royal Mail must operate a high-fixed cost network. Those high fixed costs mean relatively small changes in Royal Mail's revenues and/or costs have a major impact on the financial sustainability of the universal service.

[1] The business entity defined by Ofcom as providing the universal service
[2] 2007/08 prices, nominal costs deflated by RPI, operating costs pre exceptionals and modernisation costs

Ofcom must be mindful that the combination of unfettered direct delivery competition, mandated and highly competitive access competition and a letters market in structural decline means that the financial sustainability of the universal service can be quickly undermined. Timely and effective regulatory intervention to protect the universal postal service is therefore crucial.

The Postal Services Act 2011 (the "PSA") requires that the financial sustainability of the universal service includes 'a reasonable commercial rate of return for its provider on all of the cost of its provision'.[3] Royal Mail believes that we must be able to earn a sustainable central case rate of return of at least 8-10% EBIT margin (in the medium to long-term)[4]. This range represents a reasonable commercial return, as required by the PSA. It is informed by benchmarking of Royal Mail's relevant peer group of other major European privatised postal operators.[5]

Regulatory certainty is critical to Royal Mail's financial sustainability. It is particularly important in supporting informed investment decisions necessary to maintain the universal service network and the Company's ongoing operational transformation e.g. in the parcels market.

Government policy recognises that private sector investment is essential to enable Royal Mail to adapt its network to meet changing customer demands. Given Government's clear policy to maintain the current specification of the universal service – and Ofcom's primary duty to secure its provision – certainty from Ofcom is important for Royal Mail and its stakeholders. It is also important that other operators engaged in or considering launching direct delivery services are aware of the circumstances in which Ofcom will intervene and the types of regulatory interventions it will make, before they commit to investment.

Ofcom's own research, published in its Review of Postal Users' Needs (Oct 2012), shows 9 out of 10 consumers believe the universal service, as currently provided, meets their needs. Further, more recent polling, commissioned by Royal Mail from Ipsos MORI, shows that a similarly significant majority of consumers would be concerned were unfettered direct delivery competition to lead to its erosion:

- over 8 out of 10 consumers would be concerned if the loss of business from Royal Mail to competitors impacted our ability to deliver the universal service at the current level;
- 87 per cent of consumers believe direct delivery competitors should be required to deliver to all parts of the UK; and
- 82 per cent of consumers think direct delivery competitors should be required to publish quarterly service quality results like Royal Mail.

Competition can bring benefits. But it will equally undermine the provision of an affordable universal service where competitors are not required to operate on a level playing field. This is the case today. The current lack of clarity from Ofcom on how it will secure the

[3] Ofcom (March 2012), Securing the Universal Postal Service, Decision on the new regulatory framework, p43, para 5.2.

[4] This refers to an 8-10% EBIT margin at the level of UKPIL which will in turn require that the Reported Business entity, as defined by Ofcom, would need to be earning an EBIT margin at the upper end of Ofcom's 5-10% range.

[5] Deutsche Post, PostNL and Austria Post.

universal service is making it harder to achieve a level playing field. Royal Mail believes it is inconsistent with Ofcom's primary duty under the PSA.

The current level of direct delivery does not *yet* present an immediate threat to the viability of the universal service. However, if competition is allowed to develop unchecked, and there is at least one significant competitor with publicly stated intentions in this area, then an affordable universal service will be under threat. The prospect of Royal Mail Group securing access to private capital, on reasonable terms, could become more uncertain. There is also the risk that customers, and ultimately taxpayers, could be adversely impacted by the increased cost of financing the universal service from a diminishing revenue pool. This arises due to the unavoidable link between the reduced revenues available to the universal service if there is unfettered direct delivery competition and the predominantly fixed costs associated with delivering the universal service. The burden of cost would also fall unequally between customer groups. Bigger companies may benefit particularly in urban areas while by contrast, individuals and small and medium sized businesses especially those in rural areas – may well be disadvantaged.

Royal Mail is calling on Ofcom to provide greater clarity on the scope for regulatory intervention

Royal Mail believes Ofcom has a duty to set out for the market now the regulatory interventions it will initiate to secure the universal service. As a minimum, we believe Ofcom must immediately impose conditions on all direct delivery entrants to establish the appropriate degree of market transparency on their operations – specifically:

- direct delivery competitors must be required to demonstrate that, within a reasonable period of time, for example 2 years, the services they are providing are profitable in their own right, at commercial levels, and are not being cross subsidised from other operations (in or outside of the UK); and
- direct delivery competitors must be obliged to publish regularly defined performance information that is collected and verified independently.

Royal Mail is calling on Ofcom to make the clarifications and changes set out in the rest of this submission and to finalise its guidance swiftly so that there is regulatory certainty for all stakeholders. These are summarised in paragraph 1.11 below.

Ofcom's guidance should include a public commitment that when direct delivery competitors achieve a 2% market share (equivalent to a material revenue dilution of 1% for the universal service provider) it will trigger an immediate regulatory review, with the view to initiating subsequent regulatory intervention. Regulatory intervention must take the form of preventative action to ensure Royal Mail can earn a reasonable commercial rate of return and is not subject to any undue dilution of its ability to earn a commercial rate of return on all of the costs of providing the universal service.

The types of regulatory interventions necessary to secure the financial sustainability of the universal service could include the following conditions for direct delivery entrants:

- Delivering letters and parcels a minimum of 4 days per week to every delivery point in their geographic area of operation; and

- Covering rural and urban addresses and reaching 80% of national coverage within 5 years. This is already a legal requirement on direct delivery competitors in Belgium.

The postal market is fast moving and dynamic. Past experience has shown that fundamental changes in the structure of the postal market can happen quickly. For example, following the introduction of access competition, Royal Mail lost around half its business mail to new upstream competitors within five years. Is it therefore essential Ofcom establishes a transparent framework that will support timely and effective regulatory intervention to protect the provision of an affordable universal service.

1. Executive Summary

1.1 Royal Mail welcomes Ofcom's consultation on its proposed approach to assessing the need for regulatory intervention to safeguard the provision of the universal postal service (referred to as the "**universal service**") from the impact of direct delivery competition (the "**consultation**"). Of particular importance is Ofcom's acknowledgement that direct delivery competition poses a number of risks to the provision of the universal service, and confirmation that it will, when necessary, initiate regulatory intervention to protect the universal service. However, Royal Mail believes the draft guidance lacks sufficient clarity to provide the necessary degree of regulatory certainty needed by all stakeholders.

1.2 The universal service has been under threat in recent years as a result of the fragility of Royal Mail's financial position. Whilst the finances of Royal Mail have begun to strengthen, as shown in our half-yearly results, the "Reported Business"[6] is still not earning a reasonable commercial rate of return.

1.3 Royal Mail has long maintained that the unique combination of unfettered direct delivery competition, mandated and highly competitive access competition and a letters market in structural decline means that the financial sustainability of the universal service can be quickly undermined. Ofcom acknowledges that the financial sustainability of the universal service needs to include 'a reasonable commercial rate of return for its provider'[7]. Royal Mail believes if it is unable to earn a sustainable rate of return in the medium to long-term of at least 8-10% EBIT[8] it will not earn a reasonable commercial rate of return, in line with its peer group of other major European privatised postal operators.[9]

1.4 Ofcom's primary statutory duty includes the requirement to ensure that the universal service is financially sustainable and that Royal Mail, as the designated universal service provider, can earn a reasonable commercial rate of return on all of the costs of its provision. By definition, a reasonable commercial rate of return must be attractive to a commercial investor in light of the level of risk faced by the company irrespective of whether a company is owned by the private or public sector. To be clear, Royal Mail is not arguing that Ofcom's objective is, or should be, to ensure Royal Mail is privatised.

[6] The business entity defined by Ofcom as providing the universal service, i.e. both regulated and unregulated products that depend on the core universal service activities for their efficient provision, including all universal service products, retail bulk mail products and access products.

[7] Ofcom (March 2012), Securing the Universal Postal Service, Decision on the new regulatory framework, p43, para 5.2.

[8] This refers to an 8-10% EBIT margin at the level of UKPIL which will in turn require that the Reported Business entity, as defined by Ofcom, would need to be earning an EBIT margin at the upper end of Ofcom's 5-10% range.

[9] Deutsche Post, PostNL and Austria Post.

Competition without appropriate regulatory safeguards poses a serious threat to the financial sustainability of the universal service

1.5 Royal Mail welcomes fair competition; such competition is a characteristic of all well-functioning markets and it will be essential if mail is to remain relevant as a significant communications channel in a world of rapidly growing mobile and internet e-communication. However, the universal service obligation, with its requirement for a high quality, nationwide, six-days-a-week delivery and collection service, at uniform and affordable prices, inevitably creates an opportunity for distortive "cherry-picking".

1.6 Royal Mail has always maintained that direct delivery competition without appropriate regulatory safeguards poses a serious threat to financial sustainability of the universal service in the UK. It risks significantly accelerating the decline in mail volumes flowing through the universal service network, and will undermine Royal Mail's ability to earn revenues necessary to cover the costs of providing the universal service, continuing to deliver to 29m addresses six days a week at affordable prices, while making a reasonable commercial rate of return.

1.7 Direct delivery competitors are capable of undermining the financial sustainability of the universal service if they are permitted to target only high profit, dense delivery, areas of the country and/or by delivering fewer times per week than the universal service provider. Under these circumstances, Royal Mail will be left with significantly lower mail volumes yet it will still face a requirement to operate a national network capable of delivering six days per week to every address, nationwide at uniform and affordable prices. The reality in a market in structural decline is that the universal service provider would never be able to compete on operating costs with non-universal service competitors due to the high fixed cost nature of the network required to deliver the universal service.

1.8 The threat posed by unfettered direct delivery competition in the UK is compounded by the fact that, unlike any other EU member states, in the UK there is a well-developed access regime. This permits Royal Mail's competitors to inject mail into our network for final sortation and delivery. The previous regulatory regime for access artificially restricted Royal Mail's ability to compete and was unique to the UK. This has resulted in Royal Mail losing over 45% of UK addressed inland mail volume to its upstream competitors (equivalent to over 70% of business mail volumes). The development of a vibrant upstream market provides access operators with the ability to rapidly transfer a significant volume of mail into their own direct delivery networks as they already have established relationships with end customers. This significant reduction in mail handled through the universal service network undermines the economies of scale which the universal service has historically enjoyed and leads to a higher unit cost for mail items which remain in the network. This is an inevitable outcome due to the substantially fixed cost nature associated with providing a one-price-goes-anywhere service at high quality specification.

Regulatory certainty is important for all industry participants

1.9 Given the Government's clear policy to maintain the current specification of the universal service – and Ofcom's primary duty to secure its provision – it is important for all industry participants that there is certainty and clarity as to Ofcom's approach to using its regulatory powers. It is important that operators engaged in, or considering launching, direct delivery services are aware of the circumstances in which Ofcom will intervene and the types of regulatory interventions Ofcom can make in practice, before they commit potentially substantial investments. Similarly, regulatory certainty is particularly important if Royal Mail is to make informed investment decisions to maintain and modify the universal service. Royal Mail must have the ability to earn a commercial rate of return if it is to invest on a rationale economic basis in adapting its network to meet the changing needs of customers.

Royal Mail's key requests

1.10 Royal Mail regards the draft guidance set out in the consultation as a step in the right direction and welcomes the fact that the approach is broadly consistent with the framework developed and proposed by Royal Mail and Oxera. Ofcom should finalise and publish its guidance swiftly so that there is regulatory certainty for all stakeholders. That said, we have a fundamental concern that the draft guidance is too high level to provide the degree of regulatory certainty that is necessary for all industry stakeholders: Royal Mail, competitors, customers and potential providers of capital.

1.11 Royal Mail urges Ofcom not only to provide further clarity on the basis for regulatory intervention, but also to set out a clear view on what form and level of competition it considers to be consistent with the provision of a financially sustainable universal service. In particular, Royal Mail believes that Ofcom should amend its guidance to clarify a number of specific areas, as follows

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1. Ofcom's approach to assessing whether the provision of the universal service is financially sustainable should better reflect market conditions:

   - Royal Mail proposes that, in line with Ofcom's March 2012 decision on the regulatory framework, the EBIT margin must include the restructuring and redundancy costs associated with transforming our network.
   - Ofcom should reconsider the use of a wide 5-10% range and instead set a point estimate target for the commercial rate of return that is commensurate with the level of risks faced by a company in Royal Mail's position. This is precisely what Ofcom set out to achieve when defining the new regulatory framework for Royal Mail and would be entirely consistent with Ofcom's duty to ensure the universal service is financially sustainable. Royal Mail believes this target rate of return should be set, at the top end of of Ofcom's 5-10% range and in line with Ofcom's initial view expressed in the October 2011 consultation.
   - Royal Mail considers that if Ofcom wishes to apply the 'fair bet' principle in the postal sector, it must first choose a point estimate target for the commercial rate of return commensurate with the risks faced by a

company in Royal Mail's position (i.e, within the 8-10% EBIT margin range) and, second, commit to intervening in order to discharge its primary duty if returns fall (or are forecast to fall) on a non-transient basis below this target as a result of direct delivery competition (or other factors outside of Royal Mail's control).

2. Ofcom's approach to assessing efficiency and the presumption of perverse incentives:

   - Ofcom's approach should recognise that Royal Mail faces strong efficiency incentives from a wide variety of sources and there is no evidence that early intervention would lead to perverse incentives.
   - Royal Mail requests that Ofcom initiates and concludes its efficiency review in the early part of 2013 to ensure that it is not a barrier to swift and decisive action on direct delivery.

3. The need to include a probability framework in Ofcom's assessment of the impact of direct delivery on the finances of the universal service:

   - Royal Mail urges Ofcom to use a medium to long term probabilistic approach to assessing whether direct delivery will undermine the financial sustainability of the universal service.

4. The need for greater clarity on the timing of intervention with a clear trigger point for initiating a review on whether regulatory action is required:

   - Royal Mail urges Ofcom to set out clearly the level at which it will initiate a review of the need for intervention in the direct delivery mail market. The level should be clearly defined and we propose it should be a market share figure for an entrant, based on total inland addressed mail market. Royal Mail believes that the trigger point to initiate a review is when entrants achieve a 2% market share.

5. The types of regulatory intervention that Ofcom may consider:

   - Royal Mail believes that the types of regulatory interventions necessary to impose on direct delivery entrants to secure the financial sustainability of the universal service include:
     - Delivering letters and parcels a minimum of 4 days per week to every delivery point in their geographic area of operation.
     - Covering rural and urban addresses and reaching 80% of national coverage within 5 years. This is already a legal requirement on direct delivery competitors in Belgium.
     - Further quality of service targets and publication obligations to increase transparency and help postal users make better informed choices.
   - In practice, combination of these (and potentially other) requirements may be needed to secure the universal service.

1.12 In addition, Royal Mail calls on Ofcom to impose immediately certain transparency conditions on all direct delivery entrants to require them to:

- demonstrate that, within a reasonable period of time, the services they are providing are profitable in their own right, at commercial levels, and are not being cross subsidised from other operations (in or outside of the UK); and

- publish regularly defined performance information that is collected and verified independently.

2. Ofcom's approach to assessing whether the provision of the universal service is financially sustainable should better reflect market conditions

2.1. We welcome Ofcom's statement that the assessment of the financial sustainability of the universal service should take account of all the costs and revenues of both the regulated and un-regulated services that depend on the core universal service activities for their provision – in other words that the assessment will be undertaken with reference to Royal Mail's 'Reported Business' as defined by Ofcom. We also support the proposal that financial sustainability is assessed in terms of Royal Mail's ability to earn a reasonable commercial rate of return, expressed as an EBIT margin on the Reported Business.

2.2. However, we have a number of comments regarding the way in which the test should be undertaken in practice so that it better reflects the market reality. Royal Mail is calling on Ofcom to reflect these comments in its final guidance. There are three key areas, summarised below and discussed in further detail in the subsequent section:

a. Financial sustainability should be assessed against Royal Mail's EBIT margin *including the restructuring and redundancy costs associated with modernising our network.*

b. The lower end of Ofcom's proposed EBIT range is not consistent with a reasonable commercial rate of return for a company with Royal Mail's risk profile. Ofcom must reconsider the use of such a broad (5-10%) EBIT margin range – commensurate with the level of risks faced by the business. Royal Mail believes this target must be at least 8-10% EBIT margin in the medium to long term[10], i.e. at the top end of Ofcom's 5-10% EBIT margin range.

c. The proposal to use a broad EBIT range of 5-10%, along-side the "fair-bet" principle, results in an unduly onerous burden on Royal Mail and is inconsistent with Ofcom's duties in the postal sector as set out in the PSA. In order to discharge its primary duty to secure the financeability of the USO, Ofcom must commit to intervening if returns fall (or are forecast to fall), below a specified target level of return – on a non-transient basis – as a result of direct delivery competition (or other factors outside of Royal Mail's control). Applying the 'fair bet' principle, has less direct relevance and must be adapted when assessing the scope for returns in the context of a competitive framework.

a. Financial sustainability should be assessed against Royal Mail's EBIT margin including all ongoing transformation costs.

2.3 Royal Mail welcomes Ofcom's approach of using an EBIT margin for assessing financial sustainability of the universal service provider. However, we believe that further clarity is required as to the intended treatment of transformation costs.

[10] See footnote 7

2.4 In its October 2012 consultation on draft guidance, Ofcom states the EBIT margin will be *'calculated on a pre-exceptional basis, although where exceptional items may be expected to recur each year, we [Ofcom] will consider withholding these costs on a case by case basis.*[11] Royal Mail believes this wording may lead to ambiguity in the market on how transformation costs will be treated by Ofcom. Further scope for confusion is created elsewhere in the October 2012 consultation where Ofcom quotes the profit for Royal Mail's Reported Business of £151 million (equivalent to a 2.3% EBIT margin) in 2011-12[12]. These figures exclude *all* transformation costs and are likely to be interpreted by readers of this document as indicating that Ofcom will disregard *all* Royal Mail's exceptional expenses. Royal Mail does not believe this is Ofcom's intended position and is urging the regulator to clarify its position on the treatment of exceptional expenses. When reporting our results externally Royal Mail focuses on our EBIT margin post transformation costs.

2.5 Royal Mail believes that the right approach to the treatment of transformation costs is that set out by Ofcom in it regulatory decision document in March 2012. This clearly identified the proposed approach on treatment of transformation expenses for the purposes of calculating the appropriate EBIT margin: 'Where we discuss Royal Mail's EBIT margin, our intention is that this refers to a pre-exceptional measure of profitability. However we will determine the exceptional nature of items on a case by case basis. For example, ***we would not expect restructuring or redundancy costs, which are likely to recur year on year, to be included in exceptional items'***[13]. (emphasis added)

2.6 Ofcom must therefore provide clear guidance, as it did in its March 2012 document, that the EBIT margin range should be calculated on a measure of profitability which includes the restructuring and redundancy costs associated with Royal Mail's transformation programme. This approach would be consistent with how we report our published profit margins to the external market.

- *Royal Mail proposes that, in line with Ofcom's March 2012 decision on the regulatory framework, the EBIT margin must include the restructuring and redundancy costs associated with modernising our network.*

b. The lower end of Ofcom's EBIT range is not consistent with a reasonable commercial rate of return for a company with Royal Mail's risk profile

2.7 In the October 2012 consultation, Ofcom repeats the points it made in its March 2012 Decision that financial sustainability should take into account both the need to make a reasonable commercial rate of return, and the level of risk associated with providing the universal service.[14] While Royal Mail does not disagree with these statements, we believe that Ofcom should be clearer in its final guidance that for a company with Royal Mail's risk profile a return at the lower end of the 5 – 10% EBIT margin range would not be a reasonable commercial rate of return.

[11] Consultation p21, footnote 21
[12] Consultation, p.10, footnote 13
[13] Ofcom, Securing the Universal Postal Service, Decision on the new regulatory framework, section 5 footnote 69
[14] Ofcom (2012), 'End-to-end competition in the postal sector: Draft guidance on Ofcom's approach', October 31st, p.21, paragraph 6.9.

2.8 We note that Ofcom recognised in its October 2011 consultation document that, relative to other postal operators, Royal Mail faces a higher degree of exposure to a range of risks, and that a reasonable commercial rate of return for Royal Mail would be towards the top end of the 5-10% EBIT margin range:

> 'While a certain element of judgement is necessary, these risks all point towards Royal Mail being assumed to need to earn a level of return towards the top half of the 5% to 10% range on the activities required for the provision of the universal service…
>
> On this basis, we have assumed a base case for an indicative return of **8% margin** on these activities when considering our options for the future regulatory framework.' [15] (emphasis added)

2.9 However, in its March 2012 decision document, rather than narrowing the indicative range for the EBIT margin required by Royal Mail, Ofcom reverted to a very broad EBIT range of 5-10%. This approach is contrary to standard regulatory precedent and accepted best practice where regulators initially consult on a broad cost of capital range and then settle on a point estimate in final regulatory decisions.

2.10 As a result of its approach to describing the required commercial rate of return for Royal Mail there is a contradiction between Ofcom's statements in October 2011 that Royal Mail is exposed to higher risks than other postal operators and as such that the likely required rate of return would be in the top half of a 5-10% EBIT margin range — and Ofcom's conclusion in the March 2012 decision document (reiterated in the October 2012 consultation) that a rate of return falling anywhere in the range of 5–10% would provide reasonable commercial levels of return commensurate with the level of risk within the business. This problem is exacerbated by Ofcom's use of the fair bet principle discussed further in the following section.

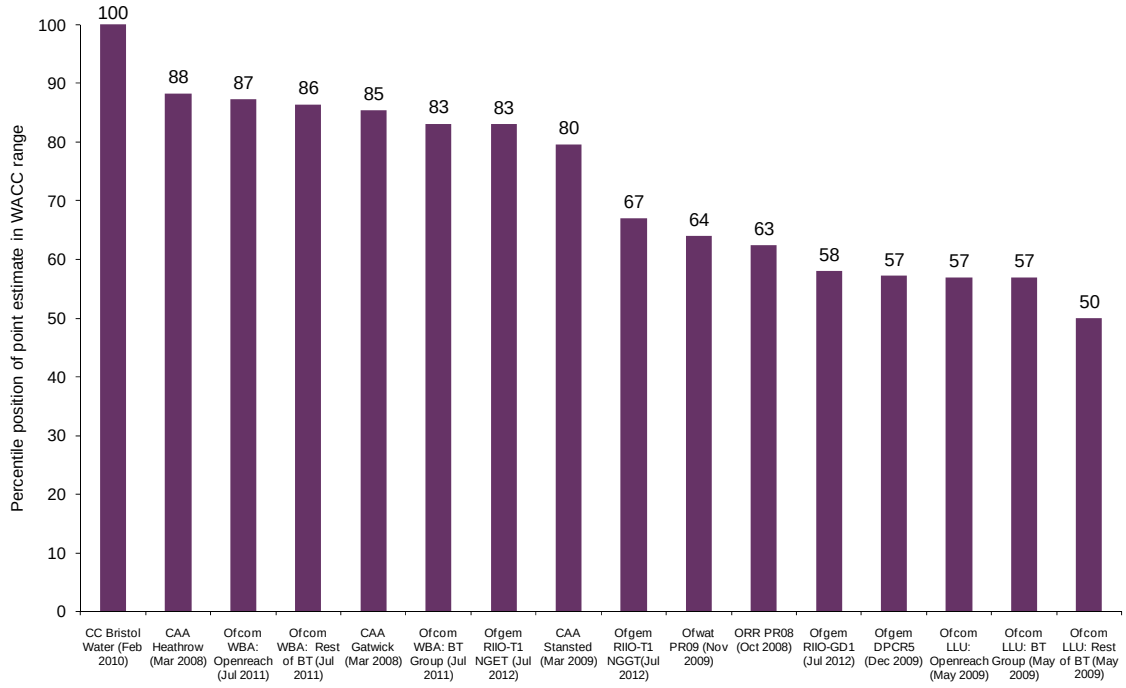
2.11 In October 2012, Royal Mail provided Ofcom with evidence—including a submission by Oxera (the "Oxera Submission") — which demonstrated that Royal Mail's risk exposure may be significantly greater than that of other privatised postal operators who provide the universal service under the EU Postal Services Directive and clearly indicated that the relevant benchmark for a reasonable commercial rate of return would be at the top end, if not above, Ofcom's proposed 5–10% EBIT range, for at least the current seven-year period during which Royal Mail is designated as the universal service provider.

2.12 Furthermore, even without taking into account the specific business risks to which Royal Mail is exposed, there would be a strong case to select a point estimate at the top of Ofcom's 5–10% range. This approach would be in line with the established best practice approach used by most other UK economic regulators when determining the appropriate rate for the allowed cost of capital in setting

[15] Ofcom (2011), 'Securing the Universal Postal Service: Proposals for the future framework of economic regulation', p. 48, paragraphs 5.82-5.83.

regulated price controls. As can be seen in Figure 1 below, having defined a range for the cost of capital, all regulators ultimately chose a point estimate above the 50th percentile—indeed, a majority of the estimates lie at the top end of the cost of capital range.

Figure 1 Position of point estimate in the cost of capital range by various UK economic regulators



Source: Oxera analysis, based on a review of public domain regulatory decisions.

2.13 While it could be argued that the context in which those decisions were made is different from the objective that Ofcom is aiming to fulfil in relation to the postal sector, the economic rationale behind those decisions is equally applicable in this case, namely, that the risks of setting a rate of return that is too low (e.g. under-investment, financial distress) far outweigh those of setting a rate of return that is too high (e.g. excess returns and higher prices).[16]

2.14 As explained in the following section, the use of a target level of return instead of a broad range would be consistent with the 'fair bet' principle, which Ofcom applies in the telecommunications sector to regulate BT and is now planning to adopt in the postal sector.

2.15 Further insight into the appropriate level of return which would be judged to be a 'commercial rate of return' can be gleamed from the financial markets. Royal Mail believe that a commercial rate of return must be consistent with an ability to

[16] See, for example, Competition Commission (2007), 'BAA Ltd—A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)', presented to the CAA, September 28th, paragraphs 150–152, Appendix F; and Ofcom (2011), 'WBA Charge Control Statement', July, paragraphs 6.85–86.

achieve an investment grade credit rating as this is an indicator of whether a company may be able to access the capital markets at reasonable rates. Royal Mail believe that when setting the EBIT margin range Ofcom should be heavily influenced by the rates of return achieved by other major privatised European postal operators who provide a universal service.

2.16 We therefore view the most relevant comparators to our UK PIL division to include Deutsche Post's Mail division, Austrian Post and PostNL, because of their privatised nature, lack of government support/influence, business mix, scale and reach. In our January 2012 submission we provided Ofcom with evidence of the historic rates of return achieved by this peer group[17]. On the bases of this data on relevant peer group rate we argued that a reasonable commercial rate of return should be an EBIT margin at the top end of Ofcom's proposed range, if not above. We have provided, further evidence in the table below, demonstrating that the relevant peer group has achieved historic rates of return in the range 7 – 10% which is at the top end of Ofcom's range.

Summary EBIT Margin for Peers

	Year End	FY11A	5y Avg
Deutsche Post (Mail Division)	Dec	7.9%	6.8%
Austrian Post	Dec	7.2%	10.9%
PostNL	Dec	9.7%	12.9%

Source: based on publicly available financial reports, compiled for Royal Mail by Barclays

- *Based on this evidence, Royal Mail believes that Ofcom should reconsider the use of a wide 5-10% range and instead set a point estimate target for the commercial rate of return that is commensurate with the level of risks faced by a company in Royal Mail's position. This is precisely what Ofcom set out to achieve when defining the new regulatory framework for Royal Mail[18] and would be entirely consistent with Ofcom's duty to ensure the universal service is financially sustainable. Royal Mail believes this target rate of return should be set, at the top end of Ofcom's 5-10% range and in line with Ofcom's initial view expressed in the October 2011 consultation.*

c. *When applying the 'fair bet' principle in the postal sector in a manner that is consistent with its primary duty to secure the provision of the universal service, Ofcom must commit to intervening in the market if returns are forecast to fall below a target commercial rate of return on a non transient basis.*

[17] In Royal Mail's response to Ofcom's consultation, Securing the Universal Postal Service Proposals, for the future framework of economic regulation, 20 October 2011.

[18] Paragraph 5.46 of the March 2012 statement reads: "... given the level of risk faced by Royal Mail, a financially sustainable universal service goes hand in hand with the operator earning a reasonable commercial rate of return that is commensurate with this level of risk".

2.17 Ofcom has, in the context of the telecoms sector, relied on the concept of the "fair bet" in order to address the potential for perverse incentives. As explained in the consultation document, the "fair bet" principle seeks to ensure that a regulated entity has sufficient *opportunity* to earn a specified level of return without *guaranteeing* that return. If a firm under- or out-performs the target return, Ofcom does not automatically intervene ex post to compensate for under-performance or claw back excess returns. Ofcom has recently provided the following explanation for its approach in the telecoms sector:

> *We set charge controls according to the 'fair bet' and 'no retrospection' principles. This means that BT is allowed the opportunity to recover expected costs on a forward-looking basis, but is not provided with certainty that actual costs will be recovered. The "fair bet" principle means that prices are set to cover the expected value of costs, and BT has opportunities for over- or under-recovery of costs which are symmetric. If the actual costs turn out to be higher or lower than the forecast figures, then the gain or loss is kept by BT. This is known as the "no retrospection" principle and is fundamental to incentives to productive efficiency.*[19]

2.18 Royal Mail agrees that the 'fair bet' principle may have a useful role to play in the design of the regulatory framework for Royal Mail, just as it does in the regulatory regimes of most other utility sectors in the UK economy. We understand that Ofcom cannot guarantee Royal Mail a particular level of return, and also recognise the strong incentive properties that such an approach embeds in regulated industries.

2.19 However, Royal Mail does not consider that the 'fair bet' principle as applied in the telecoms sector can legitimately be applied to the postal sector **without modification**, given the significant differences between the regulatory regimes applying in the sectors. As described in the quote above, the 'fair bet' principle in the telecoms context rules out any intervention from Ofcom even in situations where returns would fall persistently (ie, on a non-transient basis) below the target rate of return set for BT. Transposed to the postal sector, this principle would be inconsistent with Ofcom's primary duty to secure the provision of a universal service on a financially sustainable basis. Ofcom does not have any such duty in the telecoms sector.

2.20 We note that Ofcom acknowledges this important distinction in paragraph 6.25 of the consultation document, where it states that the 'fair bet' principle may have to be adapted to take account of its duty to secure the provision of the universal service which means that, in practice, not all of the risk of adverse outcomes should be borne by Royal Mail. We consider this essential.

2.21 Ofcom seeks to justify its adaptation of the 'fair bet' principle in paragraph 6.26 on the basis that, because its benchmark for financial sustainability of the universal service is a range of 5-10% EBIT margin, the lower end of this range already accounts for Royal Mail bearing some downside risk. This position results in

[19] Ofcom (2012), 'Charge control review for LLU and WLR services: Annexes', March 7th, p.12, footnote 54.

significant uncertainty on the threshold for intervention that Ofcom will apply. The approach adopted with BT is different to the approach being adopted for Royal Mail. Ofcom applies the 'fair bet' principle in telecoms based on a point estimate of the cost of capital and using a specific efficiency target which is considered achieveable.

2.22 It is not clear to us what Ofcom considers the relationship between the 5-10% EBIT margin and the 'fair bet' principle to be. One potential interpretation of paragraphs 6.25-6.26 of the consultation is that, even if returns were to fall below the 5% threshold, the 'fair bet' principle would dictate that Ofcom may still decide not to intervene. If this interpretation is correct, in effect, the lower limit of the range becomes the allowed return with the application of the fair bet principle being applied to the 5% EBIT margin, based on the Ofcom EBIT margin range.

2.23 If this is Ofcom's intended approach, then Royal Mail strongly opposes it. This approach would amount to a double-counting of the 'fair bet' principle; once in the setting of a margin as a range rather than a fixed target margin (which means Royal Mail already bears some risk of adverse outcomes), and secondly, in the refusal to intervene if returns fall below the lower end of that range. This approach would also be inconsistent with the regulatory framework set out in Ofcom's *Decision on the New Regulatory Framework, Securing the Universal Postal Service* of March 2012 (the "March 2012 Decision"), which stated that if returns were to fall below the 5-10% range, "Ofcom may need to reconsider the regulatory framework".[20]

2.24 An alternative interpretation of paragraphs 6.25-6.26 is that the 5-10% EBIT range already embodies the 'fair bet' principle in terms that Ofcom does not guarantee Royal Mail any particular level of return within it; e.g. Ofcom would not claw back returns at the upper end of the range nor would it intervene if returns fell towards the lower end of the range. On this interpretation, based on the low end of the range Ofcom has identified, if returns did fall below 5% this would indicate that Royal Mail had borne more downside risk than would be consistent with the financial sustainability of the universal service, and Ofcom would intervene.

2.25 It is not clear which of these approaches Ofcom envisages adopting. Royal Mail believes that only the latter interpretation potentially is consistent with Ofcom's primary duty to secure the financial sustainability of the universal service (although, as has been explained above, Royal Mail considers that we must be able to earn a sustainable central case rate of return of at least 8-10% EBIT margin in the medium to long term as this represents a reasonable rate of commercial return for Royal Mail). Given the lack of clarity in the consultation, Royal Mail urges Ofcom to publish clearer guidance on how it envisages that the 5-10% EBIT margin range and the 'fair bet' principle will be factored into its decision to take regulatory action.

2.26 Ultimately, however, Royal Mail does not believe the 'fair bet' principle can be applied alongside such a broad range (5-10% EBIT margin) for the reasonable commercial rate of return. All industry stakeholders, not least Royal Mail, require an unambiguous target level of return reflecting the appropriate commercial rate

[20] Paragraph 7.51.

of return consistent with the financial sustainability of the universal service with a reasonable expectation of being able to achieve this return.

2.27 Royal Mail believes Ofcom must clearly articulate this EBIT target in their final guidance. Royal Mail does not believe an EBIT margin at the lower end of Ofcom's 5-10% range is consistent with a commercial rate of return for a business with Royal Mail's risk profile. As such any target must be at the top end of Ofcom's range – if not above it.

2.28 If returns in any given year fall (or are forecast to fall) temporarily below the target commercial rate of return, Royal Mail accepts that an application of the 'fair bet' principle may dictate that Ofcom will not necessarily intervene to remedy this situation. However, if returns fell below this target rate for a sustained, non-transient period, then Royal Mail believes Ofcom must intervene to protect the USO. This type of modification to the 'fair bet' principle as applied in the telecoms sector, is both necessary and justifiable in light of the specific duties that Ofcom has in the postal sector in relation to securing provision of the universal service.

2.29 In summary, Ofcom's approach is not proportionate for a company that has highly volatile revenues and is currently operating well below the level consistent with a reasonable commercial rate of return. This is particularly important in the context of Ofcom's duty to ensure the financial sustainability of the universal service. The PSA establishes the financial sustainability of the universal service in terms of the universal service provider is having the ability to earn a reasonable commercial rate of return. We believe this requirement must logically extend to Royal Mail being able to achieve access both to debt and equity markets on reasonable commercial terms. The lower end of Ofcom's range, either on its own or when combined with the "fair bet" principle is out of line with returns earned by Royal Mail's relevant peer group of privatised European universal service providers. A broad EBIT margin range of 5 – 10% with a "fair bet" principle applied over the whole range does not provide either debt or equity investors with sufficient certainty on how Ofcom will act if direct delivery gains momentum.

- *Royal Mail considers that if Ofcom wishes to apply the 'fair bet' principle in the postal sector, it must first choose a point estimate target for the commercial rate of return commensurate with the risks faced by a company in Royal Mail's position (i.e, within the 8-10% EBIT margin range) and, second, commit to intervening in order to discharge its primary duty if returns fall (or are forecast to fall) on a non-transient basis below this target as a result of direct delivery competition (or other factors outside of Royal Mail's control).*

3 Royal Mail faces strong efficiency incentives from a wide variety of sources and there is no evidence that early intervention would lead to perverse incentives.

3.1 A key consideration reflected in the consultation is Ofcom's assessment of the relationship between the likelihood, timing and form of regulatory intervention in respect of direct delivery, Royal Mail's incentives to become more efficient and the risk that early intervention by Ofcom would create perverse incentives for Royal Mail. Royal Mail has experienced competition from a variety of sources, both from the internet (e-substitution) and from other physical sources (upstream mail providers). Royal Mail has been and continues to respond to these competitive pressures by modernising our network, including large scale redundancy programmes.

3.2 Royal Mail recognises that, in performing its primary duty under Section 29 of the Postal Services Act, Ofcom is required to have regard to 'the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times'. Royal Mail recognises that in performing its duties Ofcom must review the level of cost reduction in Royal Mail's strategic plan to gain confidence that the plan moves the business to a reasonable level of efficiency. To that end Royal Mail has been pro-actively engaging with Ofcom to explain the detailed underpinning assumptions of its cost reduction forecast and the significant external independent scrutiny to which its assumptions have been subjected. Therefore, we do not believe that concerns over efficiency should be used as a barrier to regulatory action relating to direct delivery competition. For the avoidance of doubt, we do not expect regulatory intervention by Ofcom in respect of direct delivery competition to be a substitute for improving Royal Mail's own efficiency. Royal Mail is highly incentivised to reduce costs and has a proven track record on cost reduction.

3.3 Ofcom must be careful not to exaggerate the efficiency incentives arising from direct delivery competition or to materially underestimate the incentives already existing on Royal Mail to become more efficient. The incremental incentives for Royal Mail to become more efficient by responding to delivery competition are likely to be highly marginal when viewed in the light of existing incentives Royal Mail already faces.

3.4 Absent direct delivery competition, Royal Mail already has very considerable incentives to become more efficient because of the degree of competition in letters upstream, parcels end to end competition and e-substitution. There is the need to attract private capital, both to sustain the universal service and in furtherance of stated Government policy. We need to respond to existing competition by reducing costs. Indeed, Ofcom has recognised these incentives when it stated that *"Royal Mail has inherent efficiency incentives, given its financial position and the ongoing decline in market volumes"*[21]. Such incentives will remain whether or not Ofcom sets out a framework for intervention, or does in fact intervene, under Section 42. The key drivers for delivering cost savings are not the result of the threat of delivery competition.

3.5 Royal Mail has been facing up to the challenges of competition for many years principally in response to e-substitution and the introduction of upstream competition as a result of the access regime in the UK. The availability of alternative media for advertising and communications has driven a material structural decline in the letters market, and this has forced Royal Mail to focus on all available cost reduction opportunities. This, when combined with the 'going concern' issues faced by the company over the last few years, has given management every possible incentive to reduce costs and improve efficiency.

3.6 As Ofcom is aware, Royal Mail is already engaged in an extensive transformation programme aimed at rationalising the business and making it more efficient. This process commenced well in advance of the prospect of delivery competition, but this process takes time and carries inherent execution risk.

3.7 Royal Mail has a clear track record of delivering cost savings. For example, the Reported Business (the entity defined by Ofcom as providing the universal service) achieved £1 bn[22] of real cost savings over the period March 2008 to March 2012. This includes closing the defined benefit pension scheme in 2008 to new employees, and changing the terms of the pension scheme from final salary to career average. Over the same time period Royal Mail has also exited [✂] employees in its operations.

3.8 Royal Mail has responded to increased competition and the decline in letter volume through rationalising and modernising its mails network. By March 2012, we had closed 16 mail centres[23], rolled out over [✂] new or refurbished machines, with over [✂] of all outward letters automated and over [✂] of all letters sequenced to delivery point. To date in 2012/13, Royal Mail has closed a further 7 mail centres.

3.9 Royal Mail's business plan demonstrates further productivity improvements and cost savings based on a detailed review of what we believe is a challenging yet achievable forecast. Our assessment of the appropriate level of hours reduction is based on a detailed bottom up exercise to understand the impact of letters volume decline and parcels growth on the network. This analysis focuses on "workload"[24] enabling the work required to handle different types of mails items to be appropriately considered. Royal Mail has engaged leading international industrial engineering experts to help with this assessment. This analysis has been reviewed by senior executives, who have then assessed the appropriate level of hours reduction in light of this information, business expertise, the need to balance rapid cost reduction, the need to manage the industrial relationships environment with the need to continue to deliver the universal service to required service levels..

3.10 Our business plan has been subject to significant external validation; [✂] undertook a review of the business plan on behalf of the Shareholder Executive,

[22] See footnote 2
[23] Gross closures
24 Workload is defined as the 'should take time' for a given task and is measured in standard hours. It forms the basis for determining how much manpower is required to process a given amount of work. Standard time is the amount of time required to carry out a task at Standard Performance which is defined as the pace a qualified worker, conversant with the task, will be able to maintain under proper conditions, throughout the normal working day, without undue fatigue, providing they take the appropriate amount of rest.

while Royal Mail engaged [✂] to review the operational cost base. [✂] found, as set out in their report which has been shared with Ofcom, that in relation to [✂]

3.11 Royal Mail, like any commercial organisation, is constantly focused on improving our performance. For example:

1. We undertake an annual budget round, setting challenging performance targets. The targets are set in conjunction with our shareholder and profit targets form the bases for staff bonuses, including the executive team bonuses. There is a focus on both the short and medium term for senior managers through the Long Term Incentive Performance (LTIP) bonus;
2. We produce detailed monthly management packs comparing actual performance against budget for discussion at board and shareholder level (these packs are also shared with Ofcom); and
3. Management incentives are tied directly to profit growth and cost performance. Bonuses are based on a balanced scorecard including both financial and non financial targets. The bonus targets are included within the monthly management information packs provided to Ofcom.

3.12 In short, Royal Mail considers that it is already doing as much as it reasonably can to become more efficient: attempts to cut costs more rapidly would incur significant risk of industrial action and consequent execution risk to Royal Mail's ability to deliver the transformation programme. In the past 12 months alone, Royal Mail has seen transformation-related industrial action in more than [✂] separate locations.

3.13 Royal Mail recognises Ofcom's need for confidence that the efficiency savings in the plan are reasonable. Royal Mail is actively engaging with Ofcom on our strategic plan; we have held a number of meetings and workshops with Ofcom staff to discuss the strategic plan, and have provided access to both [✂] report and to key members of the [✂] team and provided the full forecasting model suite. We have adopted an open book policy to ensure Ofcom has sufficient information with which to undertake its efficiency assessment.

3.14 We note the comment in the consultation that Ofcom 'intends to undertake work to determine how to assess what constitutes a reasonable rate of efficiency improvement by Royal Mail'. We look forward to continuing our engagement with Ofcom on these topics, but we consider it very important not to overstate the importance of direct delivery competition as a driver of efficiency for Royal Mail. There is no need for the regulator to commit to a major or lengthy review of Royal Mail's cost reduction forecasts. Royal Mail already faces powerful incentives to improve efficiency (including from other forms of competition) and it is acting on those incentives. Ofcom must quickly conclude its own efficiency review of Royal Mail's cost forecasts, which it is well positioned to do given the extensive information and engagement Ofcom staff have received from Royal Mail, and remove this as an obstacle to regulatory action.

- *Ofcom's approach should recognise that Royal Mail faces strong efficiency incentives from a wide variety of sources and there is no evidence that early intervention would lead to perverse incentives.*

- *Royal Mail requests that Ofcom initiates and concludes its efficiency review in the early part of 2013 to ensure that it is not a barrier to swift and decisive action on direct delivery.*

4 Royal Mail believes a probabilistic framework, as developed by Oxera, is the appropriate approach for assessing the impact of direct delivery on the financial sustainability of the universal service provider. This approach enables a medium to long term view to be taken, isolates the impact of other factors and ensures efficiency is appropriately considered in the assessment.

4.1 Royal Mail notes that Ofcom's consultation document refers to the ability for the regulator to take prospective action to mitigate the potential for harm occurring to the financial sustainability of the universal service at a point in the future. However this concept, and the framework for decision taking in relation to it is not well developed in the consultation document by Ofcom. Royal Mail urges Ofcom to provide greater clarity in its final guidance on how it will assess the prospect of harm from direct delivery competition – and the consequent need for regulatory action. Royal Mail believes Ofcom must be explicit that its intention is to adopt a probabilistic framework as set out by Royal Mail in our 1 October 2012 submission.

4.2 Royal Mail believes that adopting a probabilistic framework in order to determine action by identifying the most likely outcome on the basis of a balance of probabilities is critical to ensuring that Ofcom does not set too high a hurdle for:

i) establishing evidence of the causal relationship between direct delivery competition and a threat to the financial sustainability of the universal service; and

ii) assessing the prospect of harm to the universal service.

i) Establishing evidence of the causal relationship between direct delivery competition and a threat to the financial sustainability of the universal service

4.3 Ofcom's consultation document suggests that it is necessary to isolate the impact of direct delivery on the financial projections for the company. For example in paragraph 5.5 Ofcom states that 'In assessing the impact of delivery competition on the provision of the universal service, we would start by considering the counterfactual – i.e. the expected financial position of Royal Mail in the absence of end-to-end competition. Any assessment of the financial impact of competition would then be compared to this counterfactual. This would allow us to take into account the fact that end-to-end competition will not be the only factor affecting the universal service during this period and so allows us to isolate the incremental impact of end-to-end competition'.

4.4 In paragraph 6.28, Ofcom expands on this to say 'we would need to establish the level of control that Royal Mail has over each of the factors identified as contributing to its poor financial performance The central distinction would be between those factors that are largely within Royal Mail's control and those factors that are not. As a general rule, if Royal Mail's poor financial performance was primarily the result of factors that are within its own control, then there would be a substantially weaker case for intervention than if its performance was due to factors that are mainly outside of its control".

4.5 Royal Mail welcomes this approach, but urges greater clarity on how Ofcom will apply this in practice, including an acknowledgement of the need to apply this approach in a flexible and pragmatic manner. It is appropriate to compare Royal Mail's actual financial position and performance in the presence of existing and likely delivery competition, with a counterfactual of no such competition. However, if in constructing the counterfactual Ofcom took account only of impacts on Royal Mail's performance that could be shown to be wholly or exclusively attributable to delivery competition, that would result in an unrealistic assessment: the relevant markets are subject to a multitude of inter-related dynamics that make it impossible in practice to isolate with certainty specific impacts as being exclusively the result of delivery competition. For example, there are inter-relationships between mail volume losses due to e-substitution and direct delivery, economic factors, and the commercial responses of all mail operators to such losses.

4.6 Royal Mail therefore believes a probabilistic approach provides the most appropriate tool set for assessing the causal relationship between direct delivery competition and the financial sustainability of the universal service. This approach enables various factors to be assessed using a range of sensitivities rather than having to generate a narrow range of scenarios. Put another way, given the inter-related nature of the variables, an approach that required Royal Mail (or Ofcom) to be required to demonstrate beyond a reasonable range that a particular impact was the result of direct delivery and no other factor, would impose an impossible hurdle and would be unrealistic and disproportionate.

4.7 A probabilistic framework allows for a more pragmatic and reasonable assessment of the impact of direct delivery – namely to establish what the most likely outcome is including assessment of various commercial responses. This framework is consistent with the use of a fair bet principle, with the requirement that Royal Mail should be able, more than 50% of times, to earn an EBIT rate of return which is at least 8% in the medium to long term. This appears to be consistent with Ofcom's statement at paragraph 6.29 of the consultation regarding the difficulty in assessing the impact of individual factors on changes in Royal Mail's finances.

ii) Assessing the prospect of harm to the universal service

4.8 It is also important that Ofcom does not set the standard of proof too high. Oxera's analysis modelled the potential impact of direct delivery entry over time, projecting the pace and scale of entry on a forward-looking basis, it forecast the extent to which, on a 'balance of probabilities' direct delivery entry would permanently and irreversibly lower the expected level of return that Royal Mail would be able to make on its universal service below the level of a reasonable commercial rate of return.

4.9 The analysis undertaken by Oxera goes significantly further than simply undertaking 'sensitivity analysis' of a few parameters to test the robustness of the results. It involved modelling a variety of risks faced by the business in the round, taking a view on the overall range of outcomes, and measuring on a probabilistic basis whether financial harm to the universal service was more likely than not (e.g. whether there is a higher than 50% probability of returns falling below reasonable commercial levels) as a result of direct delivery entry.

4.10 Royal Mail believes that clarity on how Ofcom intends to implement a probabilistic framework to assess the financial sustainability of the universal service is required to provide a satisfactory level of regulatory certainty. This approach would also be in line with how a commercial investor would assess the expected returns from an investment in Royal Mail, both of which are critical in the context of the Government's planned privatisation of Royal Mail.

4.11 The use of a probability framework also enables an assessment of the probability of harm to the universal service. Such an approach also possesses the benefit of being consistent with the concept of identifying a clear trigger for regulatory intervention, in the form of an immediate review of the current facts, as the basis for regulatory action (see Section 4 below).

- *Royal Mail urges Ofcom to use a medium to long term probabilistic approach to assessing whether direct delivery will undermine the financial sustainability of the universal service.*

5 Ofcom must set out a clear plan for intervention, identifying the trigger point for when it will initiate a review. This will provide a clear signal to the market regarding Ofcom's approach to intervention reducing the risk of inefficient investment.

5.1 Given the potential for a significant time period to elapse between the initiation of a review and an eventual intervention, it is essential that Ofcom provides much greater clarity on the circumstances in which it will initiate a review and how the assessment will be undertaken. This is critical for the industry; lack of clarity will lead to distorted incentives for investment both in Royal Mail and in other postal operators.

a. Greater clarity on the trigger for regulatory intervention is essential: intervention too late will undermine the provision of the universal service

5.2 As set out in Ofcom's consultation document:

1. The objective of the Third Postal Directive is to create a single market for postal services in the EU, whilst ensuring a high quality universal service; and

2. Ofcom's primary duty under Section 29 of the PSA is to secure the provision of a universal service and, in doing so, to have regard to the need for the provision of that universal service to be financially sustainable, a requirement that expressly includes the need for the Universal Service Provider to make a reasonable commercial rate of return.

5.3 As explained above and acknowledged by Ofcom in the consultation, new delivery competitors are capable of undermining the financial sustainability of universal service provision if they are permitted to "cherry pick", for example by delivering only in the most profitable areas of the country and/or fewer times per week than the universal service provider. It is therefore imperative, if Ofcom is to satisfy its duties under the PSA, that the guidance provides for Ofcom to commence a review of the need for regulatory intervention quickly in response to material changes to the level of delivery competition. Without this, there is a real risk that Royal Mail's ability to continue to provide a sufficiently high quality universal service on a sustainable basis will be permanently and irreparably undermined. Before intervention can occur Ofcom must initiate and conclude a review into whether intervention is required. During this time period, there will be no constraint on direct delivery operators continuing to roll out their operations at speed given the low barriers to entry in the market. Hence the hurdle for initiating a review must be set at a level which enables swift and timely intervention.

5.4 A further consideration on the timing of intervention must be a recognition that Royal Mail is already operating at a level of financial performance well below that consistent with a financially sustainable universal service and has done so in nine out of the last ten years (assessed using the lower bound of Ofcom's reasonable commercial return range). In other words, the starting point matters: the impact of end-to-end entry in the case of a company which already has a healthy financial position and can withstand relatively large shocks, is fundamentally different to that

of a company which is operating at a loss (or, at best, a very small profit), and therefore has a considerably reduced ability to withstand shocks.

b. It is imperative that Ofcom set out a clear and appropriate threshold for initiating a review to provide clarity to the market

5.5 Ofcom has outlined broad conditions under which it would initiate a review, which are all effectively dependent on Ofcom seeing evidence of a material increase in actual direct delivery roll-out, or likely scale of such roll-out, or a material impact on the finances of the universal service.

5.6 While we agree with this general approach, Ofcom must provide greater transparency on when a review would be initiated. In other words, Ofcom does not identify clear, unambiguous thresholds which would lead it to apply its framework described in the draft guidelines. Absent these thresholds, it is unclear when Ofcom would be satisfied that it ought to apply the framework presented in the consultation document.

5.7 We suggest that Ofcom adopt a clear trigger upon which it will initiate a review. Our proposed approach to this trigger is set our below. However, we emphasise that we do not suggest this trigger for a review is exclusive. There may be circumstances in which the threshold suggested below is not satisfied, but in which Ofcom considers it is appropriate to initiate a review in light of an assessment using the factors set out in paragraph 4.26 of the consultation. However, certainty requires that Ofcom sets out a threshold upon which it is committed to initiating a review, whilst not being restricted to initiating a review only in those circumstances.

5.8 We therefore suggest that Ofcom should provide clear guidance on:

1. What it considers constitutes a material impact on financial sustainability of the universal service at both current and future profit levels; and
2. An assessment of the ability (given the current scale of entry) of direct delivery entrants to achieve further roll out of services and attain a scale that could ultimately threaten the sustainability of the universal service.

5.9 The first step is to define what constitutes a material impact on the financial sustainability of the universal service. Financial sustainability will be impacted by changes in profit levels which will be caused by changes in revenue or cost. We believe that the materiality level should be informed by the approach that independent auditors would adopt. Auditors typically consider a 5% change in profits as material and a ½ to 1% change in revenue as material. The International Federation of Accountants has suggested rules of thumb for cut-off values for assessing materiality, while recognising that materiality decisions should not be based solely on them. The cut-off values include[25]:

- 5% pre-tax profit from continuing operations, or 0.5% of total revenues for a profit-oriented entity;

[25] The International Federation of Accountants (2004), 'Materiality in the identification and evaluation of misstatements', International Auditing Standard No. 320.

- 0.5% of total expenses or total revenues for a not-for-profit entity; and
- 0.5% of net asset value for an entity in the mutual fund industry.

5.10 Indeed, these ranges are consistent with the approach that Ofcom itself has adopted in relation to Royal Mail's costing system and regulatory accounts. In that context, Ofcom have adopted a 1% materiality threshold for changes in the costing methodology[26] and a 5% materiality threshold when assessing the materiality of profit impacts.[27]

5.11 Royal Mail's profit levels have historically been small and volatile. Therefore, we propose that Ofcom should set a threshold for review based on revenue and in Royal Mail's view a 1% materiality threshold on revenue is appropriate. To provide clear market signals, we suggest that the trigger for a review should be defined as a market share for the direct delivery competitor expressed as a proportion of the overall addressed inland mail market. This approach will enable a direct delivery entrant to assess, based on its own business plans, when its planned market share would trigger a review by Ofcom.

5.12 Royal Mail estimates that a 1% loss of revenue to Royal Mail would translate approximately to a 2% market share for an entrant (based on addressed inland mail market). We have calculated this estimate based on 200 monte carlo runs through Royal Mail's Strategic Pricing and Competitive Entry (SPACE) model. These monte carlo runs vary a number of key parameters such as entrant costs, pace of roll out, entrants service quality and size of mail market (e.g. GDP, e-substitution, etc.)[28].

5.13 Our modelling predicts that in areas where a competitor operates a successful business model they will gain [✂] of the addressed inland mail market in the area they have entered over the medium to long term.

5.14 It is essential that Ofcom initiates a review at the appropriate time. An early review is essential given the potential speed of roll out by competitors. Competitors have low barriers to entry in the direct delivery market. Only low levels of capital investment are required. Direct delivery competitors do not have to provide a mail network that can collect and deliver six days a week, at a uniform price and with high quality of service targets leading to a business model with high variable costs. Once a competitor has been able to develop a successful model in a particular locale they will be able to roll this out quickly to other similar areas. Hence, the pace of roll out and the impact on the finances of the universal service may increase exponentially.

5.15 Ofcom should also be mindful of the impact of early or late invention in the market. The risks to the universal service from early or late intervention are not symmetric. Delaying a review incurs a real risk of encouraging further inefficient competition

[26] Ofcom (2012), 'Securing the Universal Postal Service, decision on the new regulatory framework' para 11.57.
[27] Ibid para 11.94.
[28] We have also undertaken a high level cross check using the results from the monte carlo runs to estimate when the EBIT margin for the universal service provider falls below the bottom end of Ofcom's reasonable rate of return range. This suggests that initiating a review at a 2% market share rate for entrants is appropriate given the likely pace of roll out by entrants.

which would risk undermining the sustainability of the universal service even more. Ofcom expresses concern in its consultation that if it intervenes too early it will weaken the incentives created by competition. We believe this concern is over-stated, as discussed in section 2 above: Royal Mail already has strong incentives to drive cost efficiency, in particular as a result of e-substitution and significant upstream competition (resulting from the access regime in the UK) and the need to deliver a strong track record on cost reduction for its owners.

5.16 In summary, the trigger for initiating a review must be set at a level that takes into account Royal Mail's starting position and the large impact that even modest losses in market share can have on the profitability of the USO (due to the fact that low barriers to entry mean that alternative mail networks can be swiftly rolled out), as well as the time required to undertake the analysis and to make and implement a finding. It is important to remember that the triggering of a review does not mean that Ofcom is committed to intervening.

- *Royal Mail urges Ofcom to set out clearly the level at which it will initiate a review of the need for intervention in the direct delivery mail market. The level should be clearly defined and we propose it should be a market share figure for an entrant, based on total inland addressed mail market. Royal Mail believes that the trigger point to initiate a review is when entrants achieve a 2% market share.*

6 Types of regulatory intervention

6.1 In order to provide regulatory certainty, it is important that Ofcom sets in place now the appropriate oversight and transparency regime to monitor the progress of direct delivery entrants.

6.2 Royal Mail is concerned that there is a risk that a direct delivery entrant may be prepared to sustain losses in that sector of the UK market for wider strategic objectives. This risk may arise where a potential entrant in the direct delivery sector has a dominant position in other markets, enabling it to cross subsidise its direct delivery operation in the UK. However, in any event, if a new entrant were to offer services at a price which over a sustained period would not cover their costs of operating a direct delivery service this could fundamentally undermine the provision of the universal service. We therefore believe that is it imperative Ofcom requires that direct delivery entrants' revenue in that sector to more than cover their costs of operation in that sector within a reasonable period of time, for example 2 years, so that their service cannot be positioned as a loss leader.

6.3 Hence, as a minimum, Royal Mail believes that Ofcom must immediately impose the following conditions on all direct delivery entrants to create the appropriate degree of market transparency and ongoing regulatory oversight on their operations:

- direct delivery competitors should be required to demonstrate that the services they are providing are profitable in their own right, at commercial levels, and are not being cross subsidised; and
- direct delivery competitors should be obliged to publish regular defined performance information that is collected and verified independently.

6.4 We believe that in addition to these conditions it is important that the guidance published by Ofcom sets out clearly the types of regulatory intervention that Ofcom would consider taking in the event that it concludes that direct delivery competition threatens the provision of the universal service and the circumstances in which Ofcom would consider exercising its different powers.

6.5 In its consultation document, Ofcom sets out a range of options open to it to safeguard the universal service, namely:

- Impose general universal service conditions ("GUSCs") under Section 42 PSA;
- Establish a universal service compensation fund;
- Modify the access obligations on Royal Mail;
- Require direct delivery operators to offer access to their own delivery networks; and/or
- Competitive tendering of the provision of the universal service.

6.6 As acknowledged by Ofcom, some of these options are unlikely to be possible within a short timeframe and therefore may not be appropriate to address the threat posed by direct delivery competition, which is likely to require more urgent

intervention by Ofcom. Royal Mail agrees with Ofcom that the most appropriate intervention in the short term is likely to be to impose GUSCs.

6.7 Section 42 PSA is drafted in broad terms and therefore there are a wide range of GUSCs that Ofcom could potentially impose in order to level the playing field between Royal Mail and direct delivery operators and, hence, address the threat posed by direct delivery competition to the provision of the universal service.

6.8 In our submission to Ofcom dated 1 October 2012, we set out a list of possible types of obligations that Ofcom might consider imposing on direct delivery operators. The most effective obligations in terms of rebalancing the position of Royal Mail and direct delivery operators are likely to fall into the following categories:

a) Conditions related to the frequency of service;

b) Conditions related to geographic coverage; and

c) Conditions related to quality of service.

6.9 We note that Ofcom's consultation document refers to the first two categories of conditions, but does not make any reference to conditions related to quality of service. We believe that Ofcom must provide a clear signal to the market in relation to the full extent of the intervention options open to it.

6.10 We set out below an indication of the guidance that we believe Ofcom should provide in respect of any potential intervention.

a. Conditions related to the frequency of service

6.11 The universal service provider is obliged to collect and deliver mail six days per week. If a direct delivery entrant delivers only two or possibly three days per week, it can operate at a much lower cost and, hence, charge lower prices potentially threatening the sustainability of the universal service. Ofcom has the ability to require direct delivery operators to deliver a certain number of days, up to a minimum of five days a week. Ofcom should provide further clarity on the likely minimum number of days it would require competitors to deliver.

6.12 Royal Mail believes that Ofcom should impose a requirement to deliver a minimum of 4 days per week to every delivery point in their geographic area of operation in order to create a more level-playing field for competition.

6.13 We note that there is precedent in Europe to obligations as to the frequency of service as demonstrated by the regimes in both Belgium and Finland.

b. Conditions related to geographic coverage

6.14 As the designated universal service provider, Royal Mail is obliged to collect and deliver mail throughout the whole of the UK, including to high cost and less profitable areas. In contrast, direct delivery operators are currently able to 'cherry pick' the most profitable areas. Ofcom has the ability to require a delivery operator to deliver to all of the addresses within the particular geographic area in which they operate, including a mix of rural and urban areas. Royal Mail believes Ofcom

should impose a requirement that any entrant that achieves a 2% market share must be required to cover rural delivery points as well as urban and to achieve 80% national geographic coverage within 5 years.

6.15 This is in line with the requirement in Belgium where any direct delivery entrant must cover 80% of the national geography within a period of 5 years as well as being required to offer a uniform delivery price for the designated 80% of the country.

c. Conditions related to quality of service

6.16 The universal service provider is obliged to publish information as to its quality of service, whereas no such obligation currently applies to direct delivery operators. The universal service provider also has high quality of service targets that it must achieve. Such quality of service targets and publication obligations increase transparency and can help postal users make better informed choices. Ofcom has the ability to require delivery competitors to publish quality of service information or impose minimum quality of service standards. We suggest that Ofcom requires direct delivery entrants to publish quarterly information on their quality of service, and this information should be independently verified.

6.17 In practice, we believe Ofcom is likely to consider it appropriate to impose a combination of the above (and potentially other) requirements, including those set out in our submission of 1 October 2012.

7 Conclusion

7.1 We welcome Ofcom's consultation on draft guidance and believe this is an important first step in developing the appropriate framework for Ofcom to intervene in the postal market when there is potential for the financially sustainability of the universal service to be undermined. We believe that transparency to consumers and other postal operators on the status of the roll out of competition is essential to ensure direct delivery competition develops in a way which is beneficial to all postal users. Therefore we propose that Ofcom commits to monitor the market and to the provision of quarterly public updates on the level of market share, geographic coverage and achieved quality of service by direct delivery competitors and annual published profitability statements on individual direct delivery operations in a similar way that Royal Mail is required to publish profitability statements for its downstream operation.

7.2 In addition, as set out in this response, we believe Ofcom must provide significantly greater clarity on:

- the trigger for reviewing the need for regulatory intervention consistent with our proposal;
- their planned assessment of the financial sustainability of the universal service; and
- the regulatory conditions which they would expect to impose on delivery competitor where the financial sustainability of the universal service is threatened.