

REDACTED PUBLIC DOMAIN VERSION



Royal Mail's vision for a future regulatory approach

Delivering benefits to all

June 2011

Executive summary

Introduction

1. The time is right to change the existing regulatory structure. The Postal Services Bill, including the provision for Ofcom to become the regulator, alongside the Government commitment to a new regulatory approach, provides a framework for change. Any significant changes to the regulatory structure would not impact on the one-price-goes anywhere, six-days-a-week universal service, which is enshrined in the Postal Services Bill.
2. The universal service for post in the UK is under serious threat. Richard Hooper's independent review of postal services in 2008 found that, without serious action, Royal Mail would not survive in its current form. His report recommended the introduction of private capital, the resolution of the pension deficit and the reduction of the burden of regulation.
3. The new coalition Government asked Richard Hooper to update his review in June 2010. The update report published in September 2010 confirmed the original conclusions of the Hooper Report. It also emphasised the case for urgent action. We welcome the determination and speed of action the Coalition Government has demonstrated to address the situation. It tabled the Postal Services Bill only a month after taking power.
4. The Secretary of State has subsequently stated his belief that we require a "comprehensive reassessment of the regulatory regime for postal services" following the progress of the Postal Services Bill through Parliament. This Bill will transfer postal services regulation from Postcomm to Ofcom, which regulates other parts of the communications market.
5. Given the emergence and continued growth of competition from alternative forms of communication, driven by e-substitution, the change of regulator is welcome – rightly placing post within the broader communications sector. But it must be accompanied by a fundamental change of approach. Simply switching the regulator from Postcomm to Ofcom will not sustain the universal service.
6. Royal Mail will continue to face significant regulation even if ex ante price, product and conduct regulation is removed, namely:
 - the minimum service and quality level for universal postal service provision in the UK is specified in primary legislation and can only be changed by Parliament;

- there is specific sectoral regulation for post, which provides broad powers for regulatory intervention and information gathering; and
 - like any other business we must comply with general competition law.
7. All of these constraints will remain following the passage of the Postal Services Bill, irrespective of whether Royal Mail faces ex ante price, product and conduct regulation.
8. At a time when there are more alternatives to physical mail than ever – when UK consumers are offered up to £50 per year by large mail senders to switch to paperless communication – it does not make sense to continue to treat Royal Mail like a water, gas, electricity or telecommunications network provider, price controlling our activities as if we were a natural monopoly from which consumers need additional regulatory protections. A change of regulatory approach is essential to preserve the universal service.
9. This document sets out the context, vision, and rationale for deregulating the postal service. The current regulatory approach has not secured the financial stability of the universal service. Regulation must keep pace with the rapid and unprecedented decline in postal markets. Competition law alone would effectively regulate Royal Mail within the framework of the Bill. Royal Mail’s vision to secure the future of the universal service is:
- a sustainable and self-financing universal service which can earn a reasonable commercial return;
 - complete removal of forward-looking regulation on Royal Mail’s prices, products and conduct;
 - access not mandated but negotiated on commercial terms; and
 - the provision of information to demonstrate that Royal Mail is treating consumers and customers fairly.

The current regulatory approach has failed to secure the Universal Service

10. The primary duty of the regulator is to ensure the provision and financeability of the universal service. The specifications of the universal service are defined by European law, which guarantees a minimum service and quality level for postal services, including the daily collection and delivery of mail. The UK Government has set minimum standards based on the European Directive. The Postal Services Bill enshrines these requirements in UK law. It mandates Ofcom with the duty of securing the sustainability and efficiency of the universal service and of ensuring that Royal Mail can earn a reasonable commercial return on all the costs involved in providing the universal service.

11. Royal Mail is balance sheet insolvent and cash flow negative. It requires a fundamental change of regulatory approach together with the Government's plans for pension deficit relief, balance sheet restructuring and the company's own plans for continued modernisation to secure the viability of Royal Mail and the financial sustainability of the universal service.
12. Royal Mail has been obliged to operate since 2001 under a regulatory regime which was designed around the needs of highly capital intensive natural monopolies such as gas, water, and electricity. This regime was introduced when the postal market was still growing and the universal service could cover its costs. This form of regulation is not, and never has been, appropriate for a contestable sector such as postal services.
13. This regulatory approach went significantly beyond the requirements imposed by the European Postal Services Directive and the Postal Services Act 2000. Royal Mail is constrained by a broad and stringent set of rules governing every part of its operations – pricing, product introduction, customer and competitor communications, quality of service targets and information provision. The regime mandates access with a price mechanism that guarantees a price advantage to Royal Mail's competition, generating artificial incentives for upstream entry and restricting Royal Mail's freedom to contract.
14. Royal Mail – the only company that can currently provide the universal postal service in the UK – needs flexibility to price commercially to cover the full cost of universal service activities, allowing it to invest in innovation and modernisation. The revenues generated by the universal postal service in the UK should cover the cost of the activities required to provide it, and allow Royal Mail a reasonable commercial return. This is mandated by the Postal Service Bill. Royal Mail believes that an ex post regulatory approach is the optimal way to ensure that this can be achieved.
15. The regulatory constraints placed on Royal Mail impose significant costs on our business. Current regulation delays our ability to deliver the changes that customers want – like new, simpler products, innovative pricing models appropriate for a digital world, and mobile-to-mail services. The overly burdensome regulatory approach focuses both Royal Mail and its competitors on the regulator and not on customers.

Regulation must keep pace with the rapid and unprecedented decline in postal markets

16. Postal volumes used to grow in line with the economy. Since 2005/06 there has been a rapid decline in demand for postal services due to the rise of alternative forms of communication. As a result, volumes have fallen by more than 20%. These trends are not unique to the UK; they are mirrored in postal businesses across the globe. But they are uncharacteristic of regulated industries – such as water and gas – where demand is strongly correlated with overall economic development. Post can, in almost all circumstances, be substituted by other forms of communication. There are very few “captive” customers of mail.
17. These volume declines are now significant. There is also considerable uncertainty regarding future levels of demand. It is impossible to know how far or how quickly mail volumes will fall. Mail volumes are now over 20% lower than predicted by Postcomm’s consultants at the last price control. For planning purposes we have assumed volumes will fall by over 25% over the next 5 years, a pace of decline consistent with the expectations of many other countries.
18. Volume declines present real challenges to the provision of the universal service. Royal Mail must collect and deliver mail six days a week to c.29 million addresses nationwide. A significant proportion of the cost base that must be funded to meet the requirement of visiting every address every day is fixed regardless of the number of letters sent. As volumes drop, Royal Mail’s average costs rise and its ability to finance the universal service falls. This is exacerbated by the growth in delivery points, which increases the fixed operating costs that we incur to provide the universal service. Between March 2006 and March 2011 the number of delivery points increased by nearly 1 million from 27.9 million to 28.8 million.
19. Royal Mail is not standing still in dealing with the challenges of mails decline. Indeed, it is mid-way through a wide-reaching innovation and modernisation programme.
 - In all areas of the operation, modernisation is being delivered including reductions in the number of Mail Centres, from 64 at the start of 2010/11 to [X] at the end of 2012/13 with plans to reduce to [X].
 - At the end of this year, all of the machines operating in Mail Centres will have been replaced, refurbished or upgraded and over [X] of large letters are now processed through Flat Sorting Machines. In 2009/10 this percentage was 66%.
 - By the end of this year [X] of mail will be walk sequenced to the delivery post person’s walk, compared to 34% at the end of 2010/11.

- In delivery, we plan to implement [~~S~~] revisions by 2012/13, leading to efficiency improvements and changes to the ways of working in all aspects of the delivery operation.
- Royal Mail has also introduced World Class Mail (WCM) into its operations, with the full agreement of the CWU. WCM started in 2008 in three Mail Centres. During 2011/12 WCM roll out will be underway in all of our Mail Centres, and at the end of this year, WCM roll out will be underway at 500 delivery office sites.

20. It is difficult to set meaningful efficiency targets for postal operators. There are a number of complicating factors specific to the postal industry and Royal Mail in particular:

- Unlike in regulated water or electricity companies, in postal services there is no direct and clear link between capital investment and operating cost reductions.
- The combination of falling demand, demand uncertainty and uncertainty as to the variability of operating cost with volume makes it difficult to determine regulated efficiency targets that will deliver the desired incentives to the operator.
- Our operating cost structure – in particular, our high proportion of people-related costs, which are largely invariant with volume – is itself a function of the USO and of wider legacy issues. This complicates any regulatory assessment of what proportion of our costs might be considered “controllable” and over what time period.

21. Ofcom has a duty under the Postal Services Bill to have regard to the need for the provision of the universal service to be efficient. Looking forward, the long term financeability of the universal service depends on Royal Mail continuing to make significant strides in business modernisation. Royal Mail cannot afford to rely on price rises alone. The danger of losing customers from mail makes this strategy unsustainable. Royal Mail has every incentive to be efficient. In current circumstances, the efficiency incentives provided by the market for Royal Mail are stronger than any potential regulatory remedy.

22. Royal Mail believes that its business plan will deliver further productivity and quality improvements at a stretching and ambitious rate. In addition, if the Government’s policy to attract private capital into the business is successful, private sector disciplines will put further emphasis on Royal Mail’s overall efficiency incentives.

23. The postal market is changing at an extraordinary pace. Inflexible and detailed rules-based regulation cannot keep up with rapidly changing customer requirements

and unpredictable mails volumes. The status quo for regulation is not tenable. A fundamentally new approach to postal regulation is required.

24. Royal Mail commissioned KPMG and other external advisors to partner the business in building a robust, independently challenged and evidenced proposition for a new regulatory framework. Our research has looked at the extent and nature of competitive constraints facing Royal Mail, international comparisons of regulatory regimes for postal services, and the costs and benefits of forward looking regulation in the postal context.

Competition law can effectively regulate Royal Mail

25. In light of the scale of change in the market the correct starting point for developing the new approach is to ask whether any regulatory constraints are required – over and above the constraints imposed by general competition law and the framework of the Postal Services Bill.
26. The UK’s competition law regime is regarded as world leading by many commentators. The National Audit Office points out, “ratings in the Global Competition Review (an international journal that annually ranks competition authorities around the world) show that the UK’s Office of Fair Trading and Competition Commission are globally recognised as amongst the leading authorities.”
27. The need to consider the “proportionality” of any regulatory intervention is well established amongst regulators and competition authorities. Both government policy (e.g. the Better Regulation Strategy) and best practices in regulatory economic literature demonstrate that the case for formal forward looking (“ex ante”) regulation needs to be proved, not disproved. This is entirely consistent with the Postal Services Bill. It makes provisions that allow, but do not compel, Ofcom to regulate Royal Mail’s prices.
28. There is firm precedent that three tests must be met before forward looking regulation is justified:
- a firm has to have “significant market power”;
 - there must be a presumption that, in the absence of forward looking regulation, the firm would abuse that market power with detrimental outcomes for consumers or rivals; and
 - it must be demonstrable that competition law cannot adequately deal with these issues.
29. The presence of market power (or even dominance) does not therefore; necessarily lead to the conclusion that ex ante price regulation is appropriate. There are many

real world examples of deregulatory decisions being taken where firms retain market power. Ofgem deregulated British Gas Trading with a market share of 70%. BT's relevant market shares ranged from 45% to 80% at the time at which Ofcom allowed their remaining retail price controls to lapse.

30. A competition law based approach would have a number of advantages. It would reduce the market distortions created by forward-looking regulation. It would substantially reduce the costs of regulation. Competition law offers a means of resolving any anti-competitive behaviour. The threat to Royal Mail of damaging, costly and inconvenient investigation and prosecution under competition law provides a strong deterrent from engaging in anti-competitive behaviour.
31. Unlike most other companies, Royal Mail would be subject to Ofcom's enhanced powers under the Postal Services Bill. Even if current regulatory controls were removed, Ofcom could activate additional tools from the new regulatory framework if it were dissatisfied with Royal Mail's actions at any point. For example, given that Ofcom could, at any point, impose price controls on the universal service, Royal Mail would naturally seek to avoid any increase in regulatory burdens. We would therefore, take care to comply with competition law and regulatory requirements.
32. The fall in postal volumes is fundamentally driven by the ever-increasing use of electronic alternatives to mail. 89% of companies in the UK send electronic invoices – more than any other country in Europe. Central and local government – responsible for over 7% of mail volumes – have been actively shifting mail to online channels for some years, e.g. the 2011 census. There has been significant migration to electronic documentation within the 60% of Royal Mail's volumes that make up the "transactional" mail segment. This comprises large financial institutions or other major players (e.g. utilities, phone companies) who send statements or invoices to their customers. Although, as Postcomm notes, around 70% of users prefer to use post when receiving bank statements, the mood is changing among both banks and customers. Incentives offered to consumers for switching to paperless billing are frequently around £1.25 per bill (e.g. for BT and Virgin Media) and can be as high as £4 per bill (for Sky). That is many multiples of the cost of postage.
33. Large UK banks have managed to transfer between 20% and 60% of their customers to online statements. For example, HBOS, with one of the most successful uptakes of paperless banking, has had over 2 million customers make the switch. Banks expect to generate significant further savings as a result of investments in paperless banking – with targets for future penetration rates being up to 80% of all customers. Royal Mail faces significant price constraints for its large customers.
34. Customers sending smaller amounts of mail also have real choices. The average number of letters sent by social users each year has fallen from almost 70 in 2,000 to just over 53 in 2010. At the same time internet penetration has grown from 26%

of the population to 83%. Royal Mail is becoming a 'niche' player in communications and delivery. By 2008, post accounted for only 2% of personal messaging, with text messages making up 50% and social email making up 9%. Since that time, social networking has had explosive growth and social mail has declined further. Letters – 46p for a first class stamp – compete with emails, text messages, and social communications with a marginal cost close to zero.

35. Royal Mail faces significant competitive constraints. Unlike in water or other utilities, the growth of alternative forms of communication means that there are very few truly “captive” customers. Historically, Postcomm has over-estimated Royal Mail’s market power. Its analysis has been based on historical and static data, which does not reflect recent customer switching behaviour, the future scale and potential for switching, or the pace of change.
36. Royal Mail cannot compromise on quality of service. Customers use post because of its reliability and ability to reach across the country within a day. Keeping collection and delivery standards high encourages people to use mail. If standards slip, customers will be driven away. It is not just Royal Mail that believes this. Private operators across Europe consistently outperform their regulatory targets. On average they deliver higher quality of service (at around 94%) on first class mail equivalents than public posts (~91%).
37. Royal Mail faces the barrier of unknown “tipping points” beyond which customers will switch from mail. When prices reach this tipping point, customers will switch to a different – often electronic – way of communicating. A small number of customers switching could have an enormous effect. KPMG estimates that around 50% of Royal Mail’s volumes are at high risk. These tipping points are hard to forecast in advance. Nor is past switching behaviour (in different times, with different alternatives) a good guide to the future.
38. So even in the absence of forward looking regulation, Royal Mail is very limited in its pricing power. Increasing prices beyond what customers are willing to pay would speed up the decline of mail.

Royal Mail’s vision for the future regulatory model

39. Royal Mail’s vision to secure the future of the universal service is made up of four pillars.
 - a sustainable and self-financing universal service, where the provider can earn a reasonable commercial return;
 - complete removal of forward-looking regulation on Royal Mail’s prices, products and conduct;
 - access not mandated but negotiated on commercial terms; and

- the provision of information to demonstrate that Royal Mail is treating consumers and customers fairly.

A self-financing universal service

40. Under the Postal Services Bill, Ofcom's primary duty is to secure the provision of the universal service. In fulfilling the duty, Ofcom is required to have regard to: "the need for a provision of a universal postal service to be financially sustainable which includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal service."
41. The Bill recognises that the universal service provider is required to perform a set of activities, which drive a set of costs. All of these costs must be recoverable, with a reasonable commercial return, for the universal service to be financeable. Royal Mail views a commercial return for the USO as one where all of the revenues generated from services sold through the use of the USO network are sufficient to cover all the costs associated directly, or in connection with, the activities required to provide the USO, plus a reasonable commercial rate of return. This replaces the historic notion that the universal service is defined by a set of products with their own allocated costs. An activity definition of the universal service is highly appropriate given the changing market and changing customer needs.
42. There are a number of alternatives to self-financing of the universal service. They should be considered as fall backs if the market does not generate enough value to sustain the USO. The alternatives, such as compensation funds and subsidies, could be distortionary. They could impose further costs on both end customers and other postal operators. This should be avoided if possible.
43. The first pillar for the future model is that the universal service should be sustained by ensuring that the revenues generated from services sold through the USO network cover the costs associated with universal service activities, and a reasonable commercial rate of return. Under a competition law regime, Royal Mail would have the freedom to set prices to achieve this consistent with competitive constraints to prevent excessive pricing.

Competition law, rather than forward looking price, product and conduct regulation

44. The rapidly changing pace of postal markets means that forward-looking regulation is both costly and inappropriate. Uncertainties about demand and costs mean that rules-based approaches cannot support the commercial requirements of the market and sustain Royal Mail's financeability while protecting customers.
45. A move to a competition law based regime is consistent with the Government's direction on regulation and regulatory best practice. Royal Mail faces material competitive constraints in the markets in which it operates. The scope for Royal Mail

to engage in anti-competitive behaviour is naturally limited and can be dealt with by competition law.

46. Royal Mail should be able to set both retail and wholesale prices at commercial levels. In the short run it might be the case that the universal service could be financed to some degree by higher prices. However, as competitive constraints are rapidly increasing, in the longer run, financeability will not be achieved without operating cost efficiency. Royal Mail will need to adopt a moderate approach to price rises while aggressively targeting cost efficiencies.

Access should not be mandated but negotiated on commercial terms

47. Royal Mail is required by its licence to offer “access” to its network. Providing access services allows other mail operators to use parts of Royal Mail’s network without buying a normal mail product. For example, to purchase a delivery service so that an operator collecting post from large businesses can secure its delivery throughout the UK without investing in its own delivery network.
48. The access competition that has developed to date is damaging the economics of the universal service. Royal Mail is forced to provide access to operators on an artificial basis. It actually subsidises its competitors’ operations today. That is because it has to keep an artificially wide gap between the prices of its services to end-customers and the prices it charges other mail operators for network access. This approach to access regulation has attracted surplus capacity into the market at a time of declining volumes. Effective competition would have incentivised reduced capacity. Access competitors offer only “copycat” products to Royal Mail. They compete largely on a lower price point supported by the artificial cross-subsidy. No true innovation has resulted from competition in the UK. In a declining market it is unlikely that long run dynamic efficiencies associated with the development of competition will offset the loss of welfare arising from the reduction in Royal Mail’s scale economies in the provision of the universal service.
49. There is no economic justification for mandating access. Nor does the Postal Services Bill require it. End-to-end competition has developed successfully in several other European countries including Germany, the Netherlands, and Sweden. The Dutch regulator OPTA recently suggested that the existence of mandatory access in the UK has actually prevented the development of end-to-end competition to date. There is no mandated access in the Netherlands. Removing the artificial elements of access competition may promote alternative competition where entrants can offer their own delivery services. There are signs that entrants continue to evaluate the business case for launch, as evidenced in TNT’s recent analyst presentation on their strategy for the UK market.
50. There is no good reason to mandate that Royal Mail should provide access. Some forms of network access are likely to help sustain the universal service by keeping volumes within the delivery network. For these access volumes it is clearly in Royal

Mail's interest to provide access. But, as Postcomm acknowledges, only at prices where "Royal Mail [is] financially no worse off".

51. Under the approach we are proposing, Royal Mail would negotiate with other mail operators in good faith for access to the network. Such negotiations would be supported by the effective bipartite disputes process already in place. This process has led parties to date to resolve any issues without relying on outside intervention. It has led to flexible, rigorous commercial negotiations.

Information safeguards to demonstrate that customers are protected

52. We recognise that Royal Mail's proposals for deregulation mark a ground-breaking change. Stakeholders may express concerns with regard to our proposal to move to a competition law led approach. For example, they may argue that it could be hard to ascertain the financeability and efficiency of the USO based on standard statutory accounts, that competition law, which represents an "after the event" form of intervention, may be too slow to identify and remedy anti-competitive behaviours, that competition law is not traditionally regarded as well suited to monitoring or incentivising efficiency, or that absence of forward looking regulation might lead to deteriorations in Royal Mail's quality of service, which would be detrimental to consumers.
53. While these are natural concerns for stakeholders to have in the face of change, they are unfounded. Competition law will not be the only safeguard for consumers and customers. Royal Mail is fundamentally constrained by the above competitive forces and the range of alternatives to mail. Regulatory intervention is not the right solution.
54. To support the transition to a deregulated environment RM has identified the provision of transparency safeguards as a core element of our proposals. While Royal Mail already publishes significant information including regulatory financial statements – well ahead of most other UK companies – we intend to enhance our transparency by updating our marginal costing data – including developing a measure of long run average incremental cost. This, in combination with a range of other financial, performance and modernisation data, will inform our business decisions. We will be preparing specific financial statements to demonstrate how the cost of the universal service is being covered.
55. The Government has signalled the need for better regulation. This response is entirely consistent with that. It will ensure that Ofcom is provided with sufficient data and information to enable it to take an ex post regulatory approach cutting the need for costly and disproportionate interventions. For example, this information will demonstrate the financeability of the universal service and that Royal Mail will not act anti-competitively when setting prices and negotiating with access customers.

Benefits of Royal Mail's proposals

56. Consumers, large and small business customers, competitors, regulators and Royal Mail itself all gain under our proposed new regulatory approach.
57. The universal service with collection and delivery 6 days a week and a high level of service should become sustainable in the long term. There would then be no need to use the alternative funding mechanisms for the universal service which are available in the Postal Services Bill, such as the levy on other mail companies or direct government subsidy. Consumers and customers will benefit from the reduction of regulatory bureaucracy (in the form of notification and consultation requirements) which slows Royal Mail in innovating services, products and arrangements to meet customers' needs.
58. Fair prices for "access" services will increase the likelihood of effective competition throughout the postal network. Competitors could make profits as they collect, process and deliver mail, leading to alternative forms of competition. The removal of regulatory distortions should allow true signals as to the underlying value of markets, allowing new forms of sustainable competition to open up.
59. Ofcom will benefit from being able to deliver an approach which, for the first time, provides a real solution to the challenges facing the sector. The key regulatory objectives of financeability, efficiency and sustainability will be achieved in a less costly way.
60. Our postal workers will benefit from having an employer that will be able to respond directly to the challenges it faces in a commercial way, forcing it to improve the working environment to allow productivity improvements to be implemented on the ground.

Summary

61. In summary, Royal Mail operates under significant competitive constraints where consumers have real choice. We have every incentive to price competitively and to continue to drive efficiency. There is no basis for ex ante price and product regulation.
62. Royal Mail's vision is to secure a sustainable and self-financing universal service, complete removal of forward-looking price, product and conduct regulation, an end to mandated access arrangements, and disclosure of information to demonstrate that Royal Mail is treating consumers and customers fairly.
63. This vision rests on a number of supporting arguments. The current regulatory regime has failed to sustain the universal service and imposes disproportionate and extraordinary rules on Royal Mail's conduct. Forward looking regulation is costly and too rigid for a dynamic and declining market. The universal service obligation, alongside a unique set of market conditions, drives strong incentives to maximise volume and efficiency. There is little evidence of significant risk of detriment to consumers and the economy under a deregulated regime given competitive constraints and the increasing number of alternatives to mail. The obligations placed on Royal Mail by UK competition law – buttressed with Royal Mail's proposals on disclosure of information – should protect consumers and customers from anti-competitive behaviour.
64. Our vision for future regulation is consistent with the commercial realities that now exist in the markets we operate in. Consequently, it is the one most likely to deliver against the objectives set out in the Postal Services Bill. Given the considerable challenges faced in postal markets, the Bill provides a one off opportunity to fundamentally change the regulatory approach whilst securing an injection of private capital into Royal Mail.
65. The remainder of our response document is structured as follows:
 - first, we set out the shortcomings of the current regulatory model;
 - second, we explore the overall trends in the postal market and the need for a move to ex post regulation;
 - third, we explain why ex post competition law approach would effectively regulate Royal Mail; and
 - last, we set out Royal Mail's vision for the future regulatory regime, and the benefits it will bring to.

66. Royal Mail proposes a bold change for the industry. But it is the best solution to maintaining the relevance of mail and sustaining an efficient, innovative universal service for the future. Change is overdue.