



Postcomm Consultation

**Laying the foundations for a sustainable
postal service**

Royal Mail's Response

August 2010

Executive Summary

1 Context and the need for change

Royal Mail is honoured to provide the universal service which the UK Government wants for its citizens. A new regulatory framework for the mails market is critical to the financial sustainability of the universal service and the future success of the industry.

The current framework and price control date back to 2006, and were predicated on volume growth. Whilst successful in stimulating competition, they have not worked in terms of allowing Royal Mail to compete effectively, on a level playing field, in the competitive parts of the market. Nor have they protected the universal service adequately in the context of an overall decline in the market.

The industry has effectively experienced a two year delay in the development of a new regulatory framework due to the timing of the original Hooper report and the 2009 Postal Services Bill. This has resulted in significant uncertainty for the industry at a time of rapid market change which has impacted investment decisions across the market.

Given this context Royal Mail welcomes Postcomm's acknowledgement that establishing a new regulatory framework is now essential. Both Royal Mail and the industry need a step change in regulation to reflect the current reality of the market. However, Postcomm's proposals set out in its May consultation are neither sufficiently radical nor fast given the market conditions. Bolder action is required, including in 2011, as a precursor to a new framework encompassing much broader deregulation in 2012 to secure the future of the universal service and Royal Mail. More radical regulatory reform is also essential to facilitate an injection of private capital into the business inline with Government policy in the Queen's Speech.

Royal Mail is now modernising its business as fast as possible to improve efficiency and protect the universal service with a real track record emerging. For example, Royal Mail now walksorts mail to a similar level as other international players and is implementing walk sequencing twice as fast as any other player; it is investing in new services, and in the last 2 years has removed some 12,000 people as a result of its modernisation programme.

It is continuing to implement world class mail standards across the remaining mail centres with leading working practices and cost structures. The pay and modernisation agreement, endorsed by the CWU leadership and members in 2010, will facilitate completion of this phase of modernisation over the next 2-3 years.

However the market dynamics are changing fast:

- Overall market declines are accelerating with mails volumes down 7% in 2009/10 compared with 3% in 2007/8. This reflects a structural shift in the industry driven by the switch to electronic forms of communications.
- Continuing rapid growth in access continues with c.7bn items currently forecast by the end of this year.
- The recessionary impact on customer buying patterns is increasing downtrading from premium to more standard services.

Royal Mail's revenues are therefore coming under increasing pressure due to the declining market, intensifying competition and heavy ex-ante regulation in now competitive segments of the market.

- The parcels market is competitive in many market segments and competition is now increasing at lower weights and volumes; without the removal of heavy ex-ante regulation where there is real competition, Royal Mail will not be able to compete and will lose market share.
- Royal Mail has experienced a rapid loss of market share for bulk mail – a share now standing at some 40% for deferred services – driven by access headroom regulation which has given new entrants to the market a guaranteed minimum upstream margin to compete for and prevented Royal Mail from competing effectively, however low its upstream costs are.

Under the current price control and set of access prices, Royal Mail is in effect subsidising new players into the upstream market to the order of c. £100m per annum. This is because the access prices do not cover fully allocated costs (and any increase in those prices would result in an increase in retail prices due to the headroom requirements, making those retail bulk mail products even less competitive).

With the build up of significant competitor upstream sorted bulk mail volumes, the conditions are also increasingly economic for another player to deliver in dense areas on a partial number of days per week basis: were this to happen at scale, the profitability of Royal Mail would be quickly impacted through competitor cherry picking of the high volume profitable routes.

In recent years Royal Mail has preserved operating profits through real cost reductions. However, the continued structural decline in the UK mail is market means that less cash is being generated from operating activities and there is considerable uncertainty over this going forward.

The further downturn and uncertainty in the mails market means that – without appropriate mitigating action – Royal Mail faces the prospect of cash headroom reaching a level which could represent a risk to a business of this scale and with our cash outgoings. The financial health of Royal Mail and the Universal Service are intimately linked, and so urgent action is now required to safeguard the progress of on-going modernisation, the financial sustainability of Royal Mail and

therefore the Universal Service. The business is currently looking at a package of measures to safeguard the future of Royal Mail and the Universal Service which includes additional earned revenues in 2011/12. Further discussion would be necessary to discuss the precise mechanism for bringing forward price increases and increase the earned revenues to safeguard the progress of on-going modernisation, the financial sustainability of Royal Mail and therefore the Universal Service.

2 The universal service

Royal Mail is honoured to provide the universal service the UK Government wants for its citizens. It is at the heart of what Royal Mail does and, as part of its commitment to the universal service's sustainability, Royal Mail is modernising its business as fast as it can.

Royal Mail believes that the universal service, and the appropriate regulatory framework to ensure its sustainability, should be at the heart of the regulatory framework, consistent with the regulator's primary duty to ensure the provision and financing of the universal service. It needs to feature much more strongly in Postcomm's proposals for the new regulatory framework from 2012. The current set of proposals makes only passing reference to the universal service, its cost and financing.

Consistent with the Postal Services Directive, Royal Mail seeks to ensure that its universal service obligations can be self-financed through the pricing of universal services. However, Royal Mail cannot reasonably be expected to continue to subsidise competition through an inappropriate access headroom mechanism nor should it be required to fund the universal service through its non-USO services in competitive markets by an excessive allocation of universal service costs to competitive products or profits.

If Royal Mail is not allowed to compete fairly in competitive markets and is forced out of these competitive markets, then the core universal services will have to bear more of the costs. Royal Mail currently estimates that the cost of providing the universal service as a stand-alone network (i.e. if there were no non-USO services contributing to the network costs) is around £4bn compared with the £3.2bn of cost which is allocated to universal service products within the reported Regulatory Accounts. As Postcomm's primary duty is to ensure the provision of the universal service, its financing must be of utmost priority to it in setting the regulatory framework within which Royal Mail must operate. Failure to do so will imply the regulator is not focussing on its primary duty.

Royal Mail recognises the importance of Postcomm's USO work elements – Customer Needs Research, Affordability and the Net Cost of the USO – and urges Postcomm to consult in November 2010 on a fuller coherent approach to the universal service and how it will be financed.

3 The cornerstones of a new regulatory framework from 2012

Given the structural changes in the industry, a radical overhaul of the regulatory framework is required for 2012. This would secure the future of the universal service, establish efficient competition in the industry and drive innovation for sending customers to improve the attractiveness of mail. Royal Mail has a clear vision for a new regulatory framework for 2012 and believes that the cornerstones of this regulatory framework should be set in Government policy for the sector.

These include:

- Reliance on general competition law to control any improper market behaviour, rather than detailed unique ex-ante controls, to reflect the speed of change in the market and allow the emergence of a fair and level playing field for competition;
- The targeting of ex ante regulation and price control where there is no or very little competition with rapid deregulation of all other products where there is real competition. This would include deregulation in business parcels where there is already significant competition and in upstream mail markets and the limiting of price controls to stamp and meter products used mainly by consumers and small businesses.
- The removal of access headroom: given the competitive nature of the bulk mail markets, access headroom is not required and destroys Royal Mail's ability to compete. Its removal would also allow fair downstream access prices to rise to a level which is cost reflective - removing the headroom control would facilitate the entry of fair competition into the market;
- Access to be charged at appropriate commercial rates, which allow Royal Mail to make a profit and which provide for access to Royal Mail's downstream network focussed at the inward mail centre before the delivery operation. The regulator should not be able to impose access at any point to Royal Mail's network;
- A regulatory regime in which prices are not constrained by artificial mechanisms in market segments where competition could emerge - e.g. lightweight packets and delivery;
- Ensuring all market players have the same merits-based right of appeal against regulatory decisions, i.e. not simply the right of judicial review;
- Safeguards for the universal service for as long as it is Government policy to require it - through a requirement for performance and delivery obligations on end-to-end operators to ensure a level playing field;

- Finally Royal Mail believes it would be appropriate to move to a regulatory framework based around an ex-post return on the universal service activities, which would replace the current ex-ante RPI-X regulatory framework.

A new regulatory framework is required not only to provide certainty for all stakeholders but it is also critical to Government's objective of bringing an injection of private capital in to Royal Mail – itself a requirement for a pensions solution – which will bring much needed relief to Royal Mail's financial position and underpin the business as an investable proposition.

4 Postcomm's proposals for 2011/12

Postcomm's stated proposals to apply from 2011 are a first step towards a new and fit for purpose regulatory framework. However the proposals do not go far enough, or quickly enough. The level of deregulation and changes to the access regime – which has destroyed Royal Mail's bulk upstream business while subsidising competitors – are but small, incremental steps.

In light of the rapid market developments and the need for Royal Mail, given the declining market and intensifying competition, to invest further in cost reduction and business transformation, it is absolutely critical that real, substantial and bold steps are implemented for 2011. Royal Mail is requesting specifically that the control for 2011/12 encompasses:

- A rollover of the existing price control volume and pension adjuster mechanisms, the setting of a volume adjuster for 2011/12, and adjustments to revenue recovery factors for baskets A and B (specific proposals on the level of allowed revenue are being finalised);
- Deregulation of packets down to 750g in 'deferred' services; of high volume customers sending over 100,000 items pa down to 500g and; of all deferred premium services at all weights. Royal Mail recognises that, at present, competition is less well developed at lower weights. However, given that the regulator will set a price control to take effect in 7 months time, which must remain fit for purpose for the subsequent 12 months at least, it is essential that Postcomm takes a forward-looking view to ensure that the regulatory framework reflects market realities. Royal Mail would therefore urge the regulator, when making decisions on regulatory safeguards and scope for deregulation, to go far further in terms of deregulating beyond 750g; towards and potentially below 500g for deferred vanilla products. Royal Mail has increasing evidence set out in Annex 2 of its response that competition is increasing at weights of 500g;
- Reduction in access headroom further than proposed in Annex 4 of Postcomm's consultation document, to be reduced significantly below 3p based on the latest 2009/10 Royal Mail costs and the rate of market share loss, as a precursor to its complete removal beyond 2012. Royal Mail's

evidence leads to a conclusion that the upstream deferred bulk presort and unsorted mail markets are now effectively competitive, and by 2012 Royal Mail believes there should be no regulation applied to such bulk mail. [X]. Royal Mail's proposal is therefore that headroom should be reduced significantly below 3p, for 2011/12, to better reflect Royal Mail's upstream costs as provided to Postcomm, as a precursor to full deregulation in 2012. Even at these levels Royal Mail would expect to continue to lose volume to other upstream players;

- In the context of these changes Royal Mail confirms that in 2011, it is willing, in principle, to adopt Postcomm's proposal to set wholesale prices first i.e. adopt option (iv) in Postcomm's proposals – although the tight timeline to implement for April 2011 means Royal Mail needs to understand and agree the proposals to change the licence in early September to enable implementation.

Royal Mail accepts the importance of and need for greater cost transparency, and the principle of accounting separation which reflects how its business operates. Royal Mail is committed to continue to work with the regulator on improved cost transparency, developing costing in line with the level 1, 2 and 3 principles (with some proposed amendments discussed later in our response to annex 3).

Royal Mail accepts in principle working with Postcomm towards developing, for reporting, accounts where this is linked to a clear timetable for regulatory reform and rapid deregulation for different parts of the business by 2012 including the removal of the access headroom control and the reform of the access regime. On this basis Royal Mail will work through the issues and principles with Postcomm in order to develop the approach for a set of proforma accounts that reflect the reality of the business, not a theoretical construct. The feasibility of creating meaningful separate accounts between regulated and non regulated parts of the business will clearly be dependent on the speed at which deregulation and reform of the access regime is secured.

5 Ensuring change is achieved from April 2011

Royal Mail is committed to working with the regulator to achieve the regulatory objectives and a set of proposals for 2011 as quickly as possible.

Whilst the allowed revenues must be explicitly set by Postcomm for 2011-12 (and Royal Mail will shortly be submitting proposals to Postcomm as to the level that is needed in order to enable Royal Mail to optimise prices to fund ongoing acceleration of modernisation and cost reduction), this alone will not be sufficient. The set of additional funding proposals together with more far reaching deregulation in 2011, represent important steps towards a fundamentally new framework that must come into place in 2012.

Royal Mail is concerned that with the introduction of the new Postal Services Bill there may be disruption to Postcomm's consultation approach and the work

required to agree a set of changes for 2011. This would not only be detrimental to the viability of the universal service and Royal Mail but also damaging for the market to have a further delay to progress in transforming the regulatory framework and regime.

Royal Mail's Proposals for 2011

A summary is set out below of Royal Mail's proposals for changes to the control from April 2011. It should be noted that Royal Mail considers these represent an essential but incremental step to much fuller deregulation in 2012.

Issue	Royal Mail Proposals
Additional allowed revenue	Setting of an allowed revenue for 2011 requires: <ul style="list-style-type: none"> • the volume adjuster mechanism to be extended to 2011-12 as proposed by Postcomm • volume adjustment (G) factor to be determined by Postcomm, or similar amendment • some technical amendments to the formulae to make the price control fully effective
De-regulation	<u>Packets and parcels:</u> <ul style="list-style-type: none"> • Full deregulation (i.e. removal of Licence Condition 7, and 21) for all premium deferred packets at all weights • Full deregulation of vanilla deferred packets above 750g for all contract sizes • Full deregulation of vanilla deferred packets above 500g for contracts of 100,000 and above, given the fast evolution of the marketplace • Even at this level, incremental revenue deregulated is less than 15% of Royal Mail's fulfilment revenues • Royal Mail's preferred position would be deregulation to 500g where we already see increased competition and this would deregulate a further [3<] of revenue <u>Bulk Mail:</u> <ul style="list-style-type: none"> • Pre-sorted D+2 recognised as effectively competitive market but retained in Licence Condition 21 price control for 2011/12 as a transition to full deregulation in 2012 • High volume, unsorted, D+2 recognised as effectively competitive but retained in price control as a transition to full deregulation in 2012, but meanwhile withdrawal of Licence Condition 7 for this market
Condition 7	For services in markets with effective competition there should be no requirement for notification or publication. <ul style="list-style-type: none"> • For Basket A+B services, notification 3 months in advance with publication 4 -6 weeks in advance • For services in headroom Basket C, new services and variants notification to Postcomm only 3 months in advance
Headroom	<ul style="list-style-type: none"> • Reduction of headroom, significantly below Postcomm's proposed 3p for Letter format, to better reflect Royal Mail's 2009/10 Revenue Derived Traffic costs as provided to Postcomm • Headroom basket as proposed does not provide any significant flexibility; Royal Mail's suggested changes (detailed in Annex 4) are essential to bring about meaningful change to the status quo
Wholesale led control	Option 4 (Wholesale led control for 2011) subject to resolution of a number of technical issues and early receipt of necessary draft licence modifications
Cost transparency	<u>Costing Methodology:</u> <ul style="list-style-type: none"> • Implement Level 1, Level 2 and Level 3 for April 2011 to give Postcomm costing transparency including the development of a full draft of the level 3 costing manual by October 2010 • Proposed amendments on change control and materiality, to ensure an appropriate and manageable process that can change as the business changes. Postcomm's proposal for option 2 for change control is without comparable precedent, and goes beyond reasonable regulatory requirements, giving the regulator inappropriate control over costing • Where agreement for change is required by Royal Mail and Postcomm that there is an appropriate process to ensure that a conclusion can be reached in a timely manner <u>Accounting Separation:</u> <ul style="list-style-type: none"> • Acceptance of the principle where it is clearly linked to a timetable for rapid deregulation for access regime and reform.

6 Structure of Response to Postcomm's consultation

The remainder of Royal Mail's response is set out in 5 annexes which provide detailed evidence and supporting arguments in addressing Postcomm's consultation questions:

- Annex 1 – Royal Mail's response on the USO workstream
- Annex 2 – Royal Mail's response on Market Definition
- Annex 3 – Royal Mail's response on Cost Transparency
- Annex 4 – Royal Mail's response on the Regulatory Regime for 2011/12
- Annex 5 – Royal Mail's response on Supplementary Licence Amendments 2011/12