



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Royal Mail's Price Control from April 2010 (Tariff 2010) – Proposals by the Postal Services Commission

October 2009

About Consumer Focus

Consumer Focus campaigns for a fair deal for consumers. We do this through research, policy, analysis, lobbying and by working with policy makers, providers and others who can make a difference to consumers' lives. We have a special remit to represent the interests of disadvantaged and vulnerable consumers.

Gavin Knott
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Dear Gavin

**Royal Mail's Price Control from April 2010 (Tariff 2010) –
Proposals by the Postal Services Commission**

1. The proposals set out in Postcomm's consultation document would be to permit – but not require – Royal Mail to make some increase in prices. Price increases are never welcome to consumers or to Consumer Focus; most especially when the economy is in recession, the Royal Mail Letters business is in industrial relations crisis and the postal service is not always meeting customers' expectations. Domestic consumers may not have a choice of postal provider but, in many instances, they have a choice of delivery mechanism and, if postal prices are increased, there is a risk of even faster e-substitution than is already the case, something Royal Mail should be wary of.
2. Nevertheless, Consumer Focus believes that the maintenance of the Universal Service Obligation (USO) should be the main objective of a customer orientated postal market. We therefore think it is correct that the regulator makes the maintenance of the USO the main priority behind the changes proposed in the consultation document. It is clear to us that the provision of the USO is best borne by a large, efficient network, where the costs are necessarily sunk. The only organisation at present in a position to deliver the USO is Royal Mail. To provide this service Royal Mail needs to be able to make a reasonable return to allow it to cover its fixed costs and also to invest in the business to deliver its transformation programme. This may require price increases to maintain the service in the short run.
3. The evidence presented by Postcomm in the consultation document states that due to a combination of rapid mail volumes decline and an inability on the part of Royal Mail to transform its business fast enough Royal Mail is faced with a substantial revenue shortfall. This picture is reinforced by Royal Mail's regulatory accounts for 2008/09¹. These figures show that Royal Mail made an operating loss before exceptional items on their USO business totalling £108m in that year. Furthermore, first class stamp and meter mail made a loss totalling £82m and second class stamp and meter mail made a loss totalling £69m. It is also stated in the consultation document that Royal Mail does not believe that the business will be cash generative for at least three years.

¹ Regulatory Financial Statements, Royal Mail Group Ltd (2008-09)

4. Consumer Focus has identified three main reasons for Royal Mail's financial predicament:
- Firstly, it is clear that when the price control was first drawn it was not predicted that there would be such a large scale reduction in mail volumes caused by the e-substitution effect (this trend has been further compounded by the economic slump). In fact the 2006-10 price control regime predicted that mail volumes would increase slightly. Mechanisms to share the risk of mail volume fluctuations (and changes in pension payments for that matter), known as the 'adjusters', between consumers and Royal Mail have not been adequate to stem the cash outflow Royal Mail has and will continue to experience.
 - Secondly, Royal Mail, while having clear financial incentives to become more efficient, has, it would appear, not been able to transform its business fast enough, especially in light of rapid mail volumes decline which has driven up unit costs. This makes it even more difficult for Royal Mail to transform its business, especially in the short term. The latest efficiency figures available to Consumer Focus show that although Royal Mail was able to achieve unit cost reductions of 2.7 per cent during the Renewal Period (2002/05)², for 2007/10 Postcomm estimate that Royal Mail will achieve an increase in efficiency of 0.6 per cent compared with a target of 3 per cent per annum³. However, we understand there is some disagreement between Postcomm and Royal Mail about the 'correct' methodology for the calculation of efficiency improvements. We note that Postcomm, having access to the latest data, takes the view that there 'are some encouraging signs that the transformation programme is starting to result in efficiency improvements'⁴.
 - Finally, the Government's decision to postpone the Postal Services Bill has undoubtedly created a period of regulatory 'limbo' for the postal market. The Hooper Report and the Postal Services Bill would have provided the regulatory framework, as well as the investment and pension relief, to safeguard the USO. The issues of mail volume decline and a rapidly changing postal market would have benefited from a longer and more comprehensive consultation process conducted by Ofcom. This would have included a market review of the communications industry as a whole (including telecommunications and the Internet), a more detailed and transparent cost allocation system in Royal Mail, and a review of the access regime. These measures would have preceded a more orthodox four or five year price cap regime. This would have given Royal Mail and its customers greater certainty about future prices and services as well as allowing Royal Mail a more stable environment to transform its business than the current one year interim price control period on which we are currently being consulted. Unfortunately, the measures contained in the Postal Services Bill do not appear to be an option for the foreseeable future.

² LECG: Future Efficient Costs of Royal Mail's Regulated Mail Activities 2006.

³ The independent review of the postal services sector, Second submission by Postcomm, the industry regulator (15 May 2008) p124

⁴ Royal Mail's Price Control from April 2010 (Tariff 2010), proposals by the Postal Services Commission (28 September 2009) p2.

5. Whatever the reasons for Royal Mail's predicament there is a need to provide some relief to the Universal Postal Operator so it can ensure the maintenance of the USO. In any event, taking no action now would eventually lead to higher prices in the future. Due to the reasons given above and the time restrictions involved, Consumer Focus believes that short term, low risk changes to the Price Control are necessary to safeguard the provision of the USO.

Postcomm's proposals

6. The proposals put forward by Postcomm will:
 - set the retail price index to be non-negative.
 - make changes to the sub-caps to provide scope to recover the allowed revenue
7. The main impacts of these proposals will be to:
 - enable Royal Mail to earn additional revenue of approximately £100m to finance the universal postal service in 2010/11
 - allow Royal Mail to increase first and second class stamp prices by a maximum of 3p and 2p respectively in 2010/11 (the price of a first class stamp could reach 42p and the price of a second class stamp could reach 32p)
8. Having evaluated the two proposals Postcomm intends to implement, Consumer Focus is rather more sympathetic towards the mechanism to prohibit RPI in the RPI-X framework falling below zero. It is undoubtedly the case that Royal Mail's input costs are 'sticky' (difficult to reduce in the short run), since most of their costs are labour. It is also the case that in a one-year interim price control extension it will be impossible for Royal Mail to offset gains and losses in different years as the price cap will only run between April 2010 and March 2011. For these reasons we agree with Postcomm that requiring Royal Mail to absorb an increase in uncontrollable costs of this size is not compatible with maintaining the secure provision of the USO.
9. Consumer Focus is less inclined in principle to support Postcomm's amendment to the 'sub-cap' mechanism. We are less sympathetic to this type of modification as it will allow Royal Mail the possibility to price discriminate between different customers to an unacceptable extent. We would be particularly concerned if prices were rapidly increased for Basket A (Captive customers) products such as first and second class stamps. We also note that the linkage between Royal Mail's ability to rebalance prices within baskets and the need to improve cost reflectivity has been removed. While we do not believe that the removal of this linkage will materially affect consumers (due to the narrowing of rebalancing thresholds) we hope that the opportunity to discuss the merits and drawbacks of cost reflective pricing will still be considered as part of the next price control consultation.
10. Despite our misgivings, Consumer Focus notes that although the change to this mechanism will allow Royal Mail to recover an additional £70m in revenue on price controlled products, this figure is modest compared with the £1bn loss of revenues Royal Mail experienced between April 2006 and April 2009.
11. Furthermore, Royal Mail will still experience a cash outflow for 2010/11. We draw comfort from Royal Mail's past use of changes to the sub cap mechanism in 2008 when Royal Mail did not put up first and second class prices by the full allowed amount (although prices increased by a large amount for Large Letters and Special Delivery).

12. Consumer Focus recognises that, in making these proposals, Postcomm is carrying out its statutory duties and not actually recommending price increases and that, in seeking this flexibility, Royal Mail is not yet committed to specific price increases. For this reason we would call on Royal Mail to show restraint when considering such increases and to be mindful of the possibility that customers may simply 'downtrade' to cheaper postal products or use other methods of communication.
13. If Royal Mail is given and chooses to exercise this flexibility, it will need to demonstrate to customers that the service for which it charging is consistently meeting all standards, that a new, more constructive era of industrial relations has been negotiated, and that a credible, well-funded modernisation programme will be delivered. Furthermore Royal Mail should explain to customers how its prices compare with a fair basket of other postal incumbents in other countries. It has a major 'selling' job to do, although we are encouraged by Royal Mail's assurance that they will only apply the additional flexibility given to them in exceptional circumstances. Consumer Focus would welcome discussions with Royal Mail as to what situations would be considered exceptional.
14. On balance, Consumer Focus believes the amendments Postcomm has recommended represent a fair sharing between Royal Mail and its customers of the short-term burden in ensuring the secure maintenance of the USO. It should also be noted that not to change the current arrangements will allow Royal Mail even greater flexibility to increase prices than implementing the new amendments. Under current arrangements following Postcomm's 'Interim Review' in 2008, the price control allowed Royal Mail a higher sub-cap of 8.5 per cent (where price increases were cost reflective) for a proportion of Basket A products and all Basket B products. Postcomm's proposal will mean a lower sub-cap of 3 per cent (although on certain products an increase of up to 4.9 per cent above the average is allowed due to complexity of the price control formula) which will provide Royal Mail with less pricing flexibility than under the present rules.
15. In any case continual interim, piecemeal price control extensions cannot continue indefinitely. Such an approach will fail to provide necessary security and comfort to consumers about the prices they pay, or the stable environment required to transform Royal Mail's business.

Future actions

16. It is essential that Royal Mail is not bound by the decision it makes with regard to these price control amendments. The changes here represent short-term changes in response to a special set of circumstances currently affecting the postal market in order to protect the USO. They do not represent the basis, or a template, for the negotiation of a four or five year price cap regime that will look to provide a realistic assessment of the future progress of the postal market. This is not due to be reviewed until 2010/11. The negotiation of the new Price Control will require extensive consultation and deliberation by Royal Mail, Postcomm and interested parties. There will also have to a review of the Quality of Service regime and C-Factor arrangements among others. This detailed analysis is understandably absent from the current consultation process.
17. Postcomm should begin consulting as soon as possible on a new four or five year price control framework. Traditional price cap regulation in the form of RPI-X cannot function effectively over short-time scales. Only over a long timescale can customers have certainty about the prices they will pay and Royal Mail has the conditions conducive to increase efficiency.

18. Such a new price control will need to be preceded by a market review of the communications industry as a whole, including telecommunications and the Internet (as well as the logistics market), a more detailed and transparent cost allocation system in Royal Mail, and a review of the access regime. All this will represent a major regulatory challenge which is fundamentally undermined by the uncertainty around the regulatory framework for post. The Government needs to make clear its intentions in respect of the future of the Postal Services Bill and most especially its proposal to transfer Postcomm's responsibilities to Ofcom. Furthermore the Government needs to make clear how it intends to exercise its responsibilities as the sole shareholder in Royal Mail, especially as regards funding and delivery of the transformation plan, and tackling the large and rising pension deficit.
19. More needs to be done in terms of developing the regulatory framework to provide greater incentives on Royal Mail to become more efficient, especially in light of the increased unit costs it is currently experiencing. Postcomm must learn any applicable lessons from Ofgem's current review of the RPI-X approach (RPI-X@20⁵) which represents new, innovative thinking on regulatory approaches to monopoly businesses. Consumer Focus is engaging with the Ofgem consultation process, especially the area of consumer engagement and would look to encourage any mechanisms or approaches we believe can improve the current price cap regulation applied to Royal Mail.
20. Furthermore, Ofgem has recently released the initial proposals for Electricity Distribution Price Control Review 5⁶ and outlines the allowed revenues for the 14 network operators for the period 2010 to 2015. Electricity distribution costs have, on average, been rising since 2005, largely to fund the replacement of assets installed in the 1950s and 1960s, and to maintain network reliability. During this price control Ofgem has placed a strong emphasis on providing incentives based on outputs on the companies to improve efficiency and keep price rises to a minimum. In addition there is a focus to make sure network operators can afford to invest in keeping the networks in good working order, while providing good customer service and delivering the networks in a low carbon economy.
21. Ofgem has introduced a range of incentives intended to generate a trade-off between the cost of capital and to provide for shareholders to earn more through outperformance on incentive schemes. In particular they intend to equalise the incentive rate associated with network operating costs and network investment to remove these distortions and introduce a predefined package of output measures associated with network loading and network health by 2015. The Royal Mail price control may benefit from using a similar approach. Consumer Focus will recommend any lessons learned from this consultation period which can be applied to the Universal Postal Operator and would call on Postcomm to do the same.
22. There also needs to be far greater transparency around the efficiencies Royal Mail has already achieved and their operating costs. We will then be in a better position to decide whether proposed allowed revenue increases are due to an intensification of the e-substitution effect or a failure on the part of Royal Mail to transform their business.

⁵ <http://www.ofgem.gov.uk/Networks/rpix20/Pages/RPIX20.aspx>

⁶ <http://www.ofgem.gov.uk/NETWORKS/ELECDIST/PRICECNTRLSDPCR5/Pages/DPCR5.aspx>

23. On a related point we note that Royal Mail has been making methodological changes to its cost allocation which Postcomm is now investigating. Postcomm must ensure that changes to cost allocation methodologies do not allow Royal Mail to cross subsidise different postal products which could disadvantage social consumers.
24. In conclusion, we reiterate that Consumer Focus's main objective is the provision of the USO which meets the needs of mail users. In pursuance of this objective we are prepared to accept the interim amendments Postcomm is proposing even though this will lead to a short-term increase in price for consumers. We also made a similar 'short-term pain' argument when supporting the suspension of the C-Factor and the Bulk Mail Compensation Scheme for 2009-10⁷. However, as in the above consultation, the short-term burden sharing being asked of customers must result in long-term 'gains' for consumers in the form of an efficient, customer focussed USO delivered at an affordable price. To achieve this, Royal Mail must redouble its efforts to transform their business and Postcomm and the Government must put in place the regulatory framework required to deliver this outcome.

I hope these comments are helpful. My colleague, Cem Suleyman, would be pleased to follow them up in person or via telephone or email (0207 799 7932; cem.suleyman@consumerfocus.org.uk).

Yours sincerely



Robert Hammond
Head of Regulated Industries

⁷http://consumerfocus.org.uk/media/viewfile.aspx?filepath=l_20090707102954_e_@@_RESFinancialimplicationsofQoSfailureduetoindustrialaction200910.pdf&filetype=4

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