

## Post Policy Issues: Ofcom's 2011 Price Control Consultation

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### Background

A 4-year price control was set for 80% of Royal Mail (RM) products by the then-regulator, Postcomm, in 2006. This was rolled-over twice in the light of the 2008 and 2010 Postal Services Bills and the plan to transfer regulatory responsibility to Ofcom. Ofcom assumed regulatory oversight for the postal market on 1 October 2011 and has recently published a consultation on its final proposals for a 7-year pricing regime to come into force in April 2012. This builds on 2 earlier consultations by Postcomm this year.

In response to those documents, Consumer Focus had acknowledged the financial difficulties in which RM found itself and the need for it to be adequately financed to complete its much-needed modernisation programme and deliver on operational efficiencies.

We supported the view that RM should not be constrained by any price control mechanism in the areas of the postal market where there was genuine or emerging competition to RM. However, in areas where RM retained a virtual monopoly, we suggested that caution should be exercised before de-regulating on prices completely. The Ofcom consultation closes on 5 January 2012.

### Ofcom's overarching view on the Price Control

Ofcom is of the view that the previous traditional RPI-x approach to pricing regulation had failed. They cite:

- that the traditional regulatory approach to prevent an operator earning excessive profits and forcing it to reduce its costs has failed in the light of a rapidly changing market where RM has not been in a position to respond quickly enough to volume declines, improve its efficiencies and has actually needed to request price rises above the regulatory formula to stay afloat;
- the declining trend in mail volumes, down 25% since 2006 and projected to decline by a further 25-40% over the next 5 years;
- the higher USO burden on RM to deliver 6 days a week for letters (5 for parcels) than most of its European counterparts and the fact that its 1<sup>st</sup> and 2<sup>nd</sup> class prices are amongst the lowest in Europe;
- its loss of £120mm in 2010-11 and its ever-widening negative cash flow (currently at £600m) due to the pension deficit and funding of its modernisation programme. In its view, Postcomm also failed to anticipate RM's revenue decline, as since the 2006 price control, RM's performance has been £3bn worse than Postcomm had expected<sup>1</sup>;

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<sup>1</sup>Ofcom, "Securing the Universal Postal Service – proposals for the future framework for economic regulation," October 2011, p.4.

- the low use of the postal service as a means of communication – average household spend of 40p/week as opposed to £10.80 for telephone services; but
- acknowledge that mail remains important for businesses for delivering/receiving goods, invoicing and payments, marketing and communicating with suppliers and customers, as well as the fact that residential consumers receive far more mail than they send and still place a high value on the postal service.

Ofcom further recite the key findings from the Hooper report namely that:

- RM needs to be opened up to private investment to fund its modernisation programme and to introduce the rigours of efficiency that a private sector approach could bring;
- the pension deficit needs to be moved to the Treasury. The matter is currently before the EU Commission for sanctioning that it would not amount to a state-aid competition infringement;
- responsibility for regulation should transfer to Ofcom, which has now happened.

### **Ofcom's proposals**

Ofcom does not intend to set a traditional price control on RM but allow it to set its own prices. Its view is that this would allow RM greater commercial freedom to choose the best way to raise revenues to address the financial pressures on the universal service.<sup>2</sup> It also believes that allowing RM a greater freedom will provide it with a more effective route to incentivising efficiency gains. In detail, it proposes to allow RM to set its own prices on:

- First Class deliveries – letters, large letters (A4 in size and up to 750g in weight) and parcels;
- Second Class deliveries – for large letters and parcels up to 1Kg in weight;
- standard parcels;
- business mail – metered or franked mail and pre-printed envelopes; and
- bulk mail – mainly large businesses sending a large volume of post in a single mailing for example, bank statements.

### **Safeguards to protect consumers**

Ofcom proposes a number of significant regulatory safeguards to help ensure that the universal service remains viable and to protect consumers. They include:

#### **1. A cap on Second Class stamps for standard letters**

Ofcom proposes to put a price cap of between 45p and 55p on Second Class stamps for standard letters to protect vulnerable customers from significant price rises. The cap would be indexed in line with inflation. It also proposes to leave open the possibility of reassessing the level of the pricing cap on Second Class stamps in two years, in light of any relevant changes in the market.

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<sup>2</sup> Ofcom, "Securing the Universal Postal Service – proposals for the future framework for economic regulation," October 2011, p.6

## **2. Effective monitoring of Royal Mail's performance**

Ofcom proposes to monitor RM's performance closely, focusing particularly on the provision of universal service, efficiency, profitability and pricing. This would ensure that RM meets its universal service obligations and becomes more efficient over time.

## **3. Require Royal Mail to continue to provide network access to its competitors**

Ofcom state that whilst competition from access operators has driven RM to become more efficient, existing headroom regulations have made it too easy for competitors to undercut RM's prices for their retail products. Ofcom state that if competitors continue to squeeze RM's profits through undercutting their prices then RM's ability to fund the universal service may be threatened.

Ofcom intend to secure competition within the market without impacting Royal Mail's USO funding with the following proposals:

1. imposing an access condition on RM to oblige it to grant access at inward mail centres;
2. not to regulate the price of access, to enable RM to set prices in a way that covers the costs of the network; and
3. ensuring, by means of a 'margin squeeze test', that the difference between the access price and retail price is kept at a level that allows efficient access competitors to compete effectively.<sup>3</sup>

Ofcom also proposes to assess on a case-by-case basis any interest in providing so-called 'end-to-end competition' in the UK, where a postal operator receives the letter and delivers to an address without using RM's network.

### **Consumer Focus initial response to these proposals**

- Consumer Focus recognises the importance of the Universal Service to consumers, particularly vulnerable groups who rely upon the postal service as a vital communication tool. We should welcome the fact that Ofcom recognises the importance of a basic universal service product being available and affordable to all. The question is whether these proposals will allow RM the flexibility to continue to provide the USO or represents an opportunity to raise cash to stem its dire financial situation and thus make it more attractive to a buyer, and whether in the medium to long term this will weaken rather than strengthen the USO. Economic modelling around these proposals is necessary to be able to compare the outcomes against a series of counterfactuals and thus assess the proposals.
- We are concerned that Ofcom proposes to allow RM to set its own efficiency targets. At best it hit a 0.3% efficiency target in one year under the old price control (against a target of 3%). We need to explore the practicalities of linking RM efficiency achievements to its ability to raise prices. There are clear risks to Ofcom allowing Royal Mail to raise its prices without tying this commercial freedom to greater efficiencies.
- Consumer Focus remains concerned that the safeguard cap on the price of Second Class standard mail may be insufficient as it does not cover packets and parcels, the prices of which may be raised significantly to the detriment of all users. We anticipate a significant substitution effect with residential consumers in particular switching from using first to second class post. Ofcom has done no modelling on this effect and is basing its

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<sup>3</sup> Ofcom, "Securing the Universal Postal Service – proposals for the future framework for economic regulation," October 2011, p.9

proposal on existing usage of second class mail (90% of Second Class mail being standard letters).

- If the price of a First Class stamp rises significantly and commercial users (especially SMEs) continue to use this class of mail in order to conduct their business, then we shall need to consider the impact of pass-through costs to residential consumers.
- The Ofcom approach to this price control is predicated upon vigorous monitoring of the market. Whilst it says that it will retain quality of service targets that are “*at the level required and that the service consumers receive is maintained to the required standard*”, we need to be alert that come the review of the USO which Ofcom are about to embark upon, these standards may become eroded, thus devaluing the monitoring process.
- We are further concerned that despite the threat to re-regulate the prices if Ofcom believes RM to be abusing its position, such a decision/action may come too late into the 7-year cycle of the price control or may not come at all. It is easier to de-regulate but harder to re-regulate once that step has been taken.
- Consumer Focus notes that changes to the access headroom may cause problems for competition in the bulk mail and packets and parcels markets, allowing Royal Mail to squeeze out competitors through setting its retail prices so low other access operators cannot compete. Ofcom will need to monitor RM to ensure this does not happen. However this relies upon a new accounting framework that RM has yet to provide. If competition in the mail market disappears, RM’s incentives to make efficiency gains may also vanish, impacting the service provided to consumers.

#### **Next steps**

The Post Team at Consumer Focus propose to undertake the following action in response to Ofcom’s consultation:

- **Provide a Consultation Response**  
A Consultation Response document will be drafted and sent to Ofcom. We expect a draft available from mid-December for sign-off
- **Provide analysis of the market and regulatory context**  
In order to provide a detailed analysis of the complex issues reflected in a price control decision (such as the current and future regulatory landscape, economic factors and future predictions of market change, impact modelling of economic and regulatory issues) Consumer Focus will use the services of external experts on the postal market to analyse these issues in-depth. A tendering process has been concluded and ESL & Network (UK) have been appointed and begun work.
- **Hold a significant stakeholder workshop**  
Consumer Focus is holding a stakeholder workshop on 15th November with consumer representatives, industry experts, large mail user representatives and competitors to RM to discuss the impacts that Ofcom’s proposals will have upon consumers, customers of RM, and competition in the postal market. Ofcom are to give an introductory presentation explaining in more detail its rationale behind the proposals and to field questions from the audience. Ofcom and others have cancelled their own meetings to be able to attend ours and the significance of the workshop can be measured by the wide and lengthy list of those pledging to come.

- **Explore further Consumer/SME Research**

Consumer Focus will investigate the cost of undertaking additional research to assess how the potential price changes under the Ofcom proposals will affect consumer and SME decisions around which mail product they use. The research will attempt to establish whether there is “tipping point” on certain products which will lead to consumers switching to another product. This will enable Consumer Focus to draw conclusions around the price elasticity of key products and therefore which price rises could be unacceptable from a consumer/SME perspective.

### **Action for the Board**

- The Board is asked to endorse CF’s strategy for responding to the Ofcom Price Control consultation.
- The Board is asked to note and consider CF’s concerns around Ofcom’s Price Control decision.

### **Key Questions**

1. Will Ofcom’s proposals enable Royal Mail to continue to deliver the current Universal Service Obligation?
2. Will a protected second class standard letter service offer a sufficient “backstop” service for consumers?
3. Is it acceptable for Royal Mail to be allowed to set its own prices for all other products, including first class stamps?
4. Should Royal mail be allowed to set its own prices and efficiency targets or should they be linked to Regulator set standards that are actually delivered?
5. What will be the impact on Royal Mail’s competitors of removing headroom on access and replacing it with a “margin squeeze” test?