



**Consumer
Focus**
Campaigning for a fair deal

**Consumer Focus response
to Postcomm's consultation
*Laying the foundations for
a sustainable postal service***

January 2011

We welcome the opportunity to comment on Postcomm's consultation on its new regulatory framework for the postal services market entitled *Laying the foundations for a sustainable postal service*.

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and for postal consumers in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

Our comments on Postcomm's regulatory review are made from the perspective of our experience of championing consumers' interests in private and public sectors, with a particular focus on the interests of consumers in markets such as post that are 'designated' by Government as requiring additional consumer advocacy. We work to secure fairer markets, greater value for money and improved customer service. We have a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Summary of points raised

- It is very difficult for us to come to a judgement on whether the application should be accepted as we do not have much of the detailed information and analysis available to us. Postcomm, by having access to this information, is best placed to decide whether the application should or should not be accepted
- However, we do accept that there are limited alternatives available to Royal Mail to tackle their current financial difficulties
- If Postcomm decides to accept Royal Mail's application for additional revenue it must ensure that incentives to become a more efficient postal operator are preserved
- We have also taken the opportunity to comment on the proposed licence amendments

Response to consultation questions

Annex 3: Price control and access

Q1. Do you agree with the basis upon which we propose to assess Royal Mail's application?

We broadly agree with the basis upon which Postcomm intends to assess Royal Mail's application. However, we have some reservations about the weighting Postcomm is giving to ensuring the application encourages efficiency and economy on the part of postal operators, in particular Royal Mail (see below for further elaboration).

Q2. Do you agree with the overall proposal that the application should be granted to allow Royal Mail additional revenue for 2011–12, subject to confirming its potential medium term effects?

Consumer Focus believes that postal consumers value the continued provision of the universal service obligation (USO). Thus there is a requirement to fund this service. It is claimed throughout Annex 3 that Royal Mail needs this additional revenue so it will be in a position to fund the investment/modernisation required to sustain the universal service (in accordance with its business plan). Postcomm, to its credit, has made clear that additional revenue should be granted to sustain the USO and not be granted just to improve Royal Mail's financial position in isolation.

However, it is very difficult for us to make a judgement about whether the revenue is needed now and whether a slowdown in investment/modernisation will lead to risks in the continuing provision of the universal service. This is mainly because we have had next to no oversight of, or engagement with, Royal Mail's business plan. We understand the argument that a failure to modernise now when competition (be it from postal operators or e-substitution) in the postal and wider communications market is intensifying could lead to Royal Mail becoming even less competitive on costs. However, in the absence of information (particularly related to the strategic business plan) it is unclear to us that a slowdown in investment/modernisation will put the universal service at risk. Furthermore, Postcomm claims that there is clear evidence that [continued] investment is likely to have longer term benefits for users of mail. Again, there is no information to substantiate this claim in the consultation documents.

In the absence of such basic information it is very difficult for Consumer Focus to judge whether the acceptance of the current business plan and modernisation or a slowdown in the plan is the best way to safeguard the USO. As it would seem Postcomm is the only party (except Royal Mail) with a good understanding of Royal Mail's business plan the regulator is best placed to make this judgement. However, if Royal Mail is allowed to raise additional revenue from its customers it must demonstrate how this revenue is required to ensure the provision of the USO (potentially by publishing a publicly available version of its strategic business plan).

If Postcomm decides to allow Royal Mail to raise the additional revenue it is requesting we would want to ensure that Postcomm makes this decision taking account of the following key points:

Throughout the consultation documents Postcomm places a very high priority on ensuring the provision of the USO. While we think that Postcomm is correct to do this we are concerned that in doing this it might be placing too little regard on another one of Postcomm's duties: to encourage efficiency and economy on the part of postal operators.¹ The elasticity effects noted in the consultation documents show the importance of driving efficiency and innovation; price rises alone will be insufficient in the long run to sustain the USO.

In Annex 3 there are statements that point to the failure of Royal Mail to modernise and drive increased efficiency. For example:

- 'Modernisation has taken longer for Royal Mail to implement than it originally intended'
- 'Costs are 1% above budget (a forecast), which Royal Mail attributed to the longer than expected time to reach agreement with the CWU on the modernisation programme'²

We believe that if Royal Mail is to be granted additional revenue it needs to be on the basis of preserving incentives for Royal Mail to drive efficiencies and modernise business operations. While it can be argued that there are strong incentives to modernise (competitive pressure, e-substitution) it can also be argued that a dangerous precedent is being set i.e. if Royal Mail fails to modernise and gets into financial difficulty it will be bailed out by its customers. To sum up we believe that there is the possibility of moral hazard. As such Postcomm must provide reassurances to the market that it will regulate Royal Mail with one of its key objectives being to incentivise Royal Mail to be a more

¹ See Section 5 of the Postal Services Act (2000)

² We also note that Postcomm estimated in 2008 that Royal Mail would achieve an increase in efficiency of 0.6 per cent compared with a target of 3 per cent per annum. See *The independent review of the postal services sector*, Second submission by Postcomm, the industry regulator (15 May 2008) p124

efficient postal operator. Such a commitment could be made as part of the 2012 price control determination.

Finally, we absolutely support the clawback principle if Postcomm decides to accept the application. It is our view that consumers will have provided the finance and borne the risk to fund Royal Mail's investment. Consumers should therefore expect to receive a fair share of any financial benefits that flow from this investment (be it from making an adjustment to Royal Mail's RAB (Regulatory Asset Base) as part of the 2012 price control determination or some other method).

Q3. If so, do you agree with the proposal to effect the price changes in 2011–12 required to achieve this level of additional allowed revenue through an X factor adjustment for Baskets B and C? Do you think that Postcomm should allow Royal Mail to increase price by approximately 7% as requested, or that different level for these baskets would be more appropriate?

We agree with Postcomm that Royal Mail is best placed to target any price changes; the regulatory risk of Postcomm deciding where price increases should fall is high. However, we want any price change proposals to be subject to ex post analysis by Postcomm to determine whether price increases are broadly justified by underlying costs (potentially as part of the 2012 price control determination). For example, Postcomm states that it has no evidence to suggest that the indicative price increases will significantly increase any misalignment of costs that currently exists. However, we believe what is required is evidence that the increase in prices are related to correctly allocated costs.

Furthermore, Postcomm needs to be fairly confident that by allowing price increases for some customers and products this will allow Royal Mail to recoup its allowed revenue (minus demand effects). As such it is important that Postcomm takes into account the views of the customers who will be directly affected by these price increases and the subsequent ability of Royal Mail to recover its allowed revenue. Royal Mail must also demonstrate it has engaged effectively with these customers.

If following consultation Postcomm decides to allow a smaller price increase applied to all Royal Mail's customer base (as discussed on page 17 of Annex 3) Consumer Focus thinks that Postcomm should consider the same issues (cost reflectivity, demand effect etc) for these customers as well. We note that Basket A customers can expect to see price rises of 10 per cent for 2011/12. Analysis of the ability of these customers to bear increased prices is essential before permitting further price increases for these customers. If Postcomm decides to impose additional price rises on Basket A customers it should ensure that prices (as might be set by the allowed revenue) do not contradict the findings from its upcoming work on the affordability of postal services.

Q4. Are there any other solutions Postcomm should consider in order to address the near term financial weakness identified in Royal Mail's application?

Royal Mail has explained to us that the additional revenue it wishes to collect directly from customers is part of a package of measures to plug the shortfall in its headroom position. We want to ensure that consumers' exposure to Royal Mail's failure to modernise is kept to a minimum. We understand that other contributions to the headroom position include a reduction in headcount, a squeeze on supplier contracts and the disposal of assets. From the data Royal Mail has provided to us it seems that these other measures are contributing the bulk of Royal Mail's efforts to improve its current financial position. We would urge Postcomm (which has greater access to Royal Mail's financial data and business plan) to confirm that customers will only be asked to contribute what is necessary to secure the financial position of the USO should it accept Royal Mail's application. To help provide assurance to consumers that this is the case Postcomm

should consider publishing data which shows the amount customers will be paying (if the request is accepted) to help alleviate Royal Mail's short-term financial position (this could potentially involve a percentage figure of the total funding required to address Royal Mail's headroom position).

Q5. Do you agree with our proposed responses to Royal Mail's requests for licence modifications in respect of zonal access pricing?

We agree with Postcomm's decision on this matter. The risk to the continuing development of competition of allowing Royal Mail greater pricing flexibility for zonal prices is too great. The future of zonal pricing is best decided as part of the review of the zonal pricing structure in July 2011.

Annex 3 Supplementary paper – Draft licence modifications

The proposed draft licence modifications would appear to be appropriate considering the decisions Postcomm has taken in its 'minded to' decisions and provides guidance on how Postcomm would propose to implement those decisions and proposals.

We note that Postcomm will be consulting formally under section 14 of the Postal Services Act 2000 after all the relevant final decisions relating to the matters set out in Annex 3 have been made and we will respond in more detail when this consultation is issued.

There are significant changes proposed for Condition 7. This condition specifically indicates when the licensee shall submit or notify Postcomm and the Council (currently Consumer Focus) with information to users of postal services. Due to the uncertainty of the future of Consumer Focus it may have been more appropriate to either delay making these changes or discuss the issues with Citizens Advice and Citizens Advice Scotland (who are expected to replace Consumer Focus) because they may have alternative information requirements. Therefore, we strongly recommend that Postcomm discuss with Citizens Advice and Citizens Advice Scotland their future information requirements.

Before the formal consultation is issued Consumer Focus will decide internally whether there is still a requirement for us to receive all of the information that the licensee will have to provide.



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