



**Consumer
Focus**
Campaigning for a fair deal

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

August 2010

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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.

Key messages

At the outset, we would like to introduce our approach to this regulatory review, and in particular the time period that it covers. We appreciate that the decisions taken following this review will potentially only stand for one year, but we do not believe that such decisions should be taken lightly or without a firm basis, whether for change or maintenance of the status quo in a changing market. This is especially true for some of the more contentious and far-reaching decisions, such as altering the headroom for access prices or instances of substantial deregulation. We would also like to make clear that any views stated in this document might be liable to change over the course of the upcoming year, especially as we receive further information.

In its consultation documents, Postcomm has asked for responses to specific questions on the work it proposes to undertake. Although our response is tailored to answering these questions, underpinning this response are two key messages that encompass wider issues we would like Postcomm to consider. The first message concerns transparency and the use of information. We firmly believe in evidence-based decision-making, which can only be achieved through full knowledge of the markets, organisations, services and consumers involved. While we acknowledge Postcomm's efforts to increase the quantity and quality of information it receives from postal operators, in particular oversight of Royal Mail's costs, we feel that it has proposed several large and rapid changes that are not fully justified by the evidence provided so far. If Postcomm can enforce effective reporting of information this improves the postal sector's confidence in its ability to regulate a market dominated by a former monopoly provider. The provision of adequate information is a prerequisite for increased transparency, which is crucial for Postcomm's analyses of market power and, in turn, for full and fair competition. We will therefore be challenging Postcomm on any decisions that are taken without sufficient evidence.

The second message, which also characterises Consumer Focus's wider approach, is that of effective regulation. The postal sector relies on Postcomm to implement regulation that steers businesses towards providing better products and services for consumers and helps protect vulnerable and disadvantaged consumers. While we believe that inappropriate regulation should be reconsidered it is equally important that any regulation is of high quality, and as mentioned above we do not condone removing regulation without clear evidence for both the reasons why and the likely impact. This review represents an opportunity for Postcomm to ensure that transparency and the effective provision of information are both in place before the start of the full price control, and a

market regulated according to these principles will ultimately benefit consumers of the postal service.

Summary of points raised

- Annex 1: Provision of a universal service

We discuss the joint research we are conducting with Postcomm and emphasise the need for strong regulation in a time of changing consumer needs from the Universal Service Obligation (USO).

- Annex 2: Analysis of markets

We do not have any comments on this section.

- Annex 3: Cost transparency and accounting separation

Cost transparency and accounting separation is vital if Postcomm is to be able to implement a well functioning regulatory framework. Postcomm's work on cost transparency and separated accounts requires the full cooperation of Royal Mail to succeed. Favourable regulatory decisions that involve Royal Mail having greater commercial freedom must only be allowed on the basis of adequate cost transparency and external publication.

Independent auditing of Royal Mail's cost allocation process should ensure external confidence in Royal Mail's cost allocation procedure. However, if accounting separation proves inadequate in promoting Postcomm's regulatory objectives, it will need to consider more intrusive forms of regulatory intervention, such as commercial equivalence.

The pricing of First and Second Class stamp products is very important for us; therefore, having cost (and profitability) transparency of stamped products and metered products is important in ensuring that the prices customers pay reflect correctly allocated costs. Accounting separation between stamped and metered products could go some way to ensuring that consumers as well as competitors to Royal Mail are confident that Royal Mail is not behaving anti-competitively. Postcomm should also consider a line of separation between USO and non-USO products, especially once the scope of the USO has been decided.

- Annex 4: Price control and access

Consumer Focus agrees Postcomm should only aim to regulate ex ante where Royal Mail has market power. However, Postcomm must be absolutely certain about the development of effective competition before removing ex ante regulation.

We present a strong case concluding that Postcomm needs to revisit its proposal to deregulate the B2X (items collected from business premises by an operator) packets and parcels market to 750g. Our concerns are based on the results of Postcomm's own market analysis, and discussions with Royal Mail's competitors and SME representatives.

We recommend that Postcomm rolls over the current scope and level of headroom (option i) with a view to making changes for 2011–12 where it has a better evidence base to make changes.

We think it is appropriate to roll over the current price control in its entirety for 2011–12. Changes that we would like to investigate further would be best suited to a new four to five year price control period. We set out some of the key areas Postcomm should be begin to consider in preparation for the new price control determination set to begin in 2012. These are progress and future scope of efficiency savings, the financial position of the USO and Royal Mail, the level of future pension contributions and application of the pension adjuster and outputs led regulation and quality of service.

We believe that there might be an issue of Royal Mail's pricing flexibility in Basket A having an adverse impact on social customers as Royal Mail's regulatory accounts suggest that we can expect both First and Second Class stamp prices to increase disproportionately in comparison with other mail products in 2011. There is a question around how far stamp prices can rise before they become 'unaffordable' and lead to an increased shift away from stamped mail to electronic forms of communication. Therefore Postcomm should consider for 2012, removing stamped products from Basket A to reduce Royal Mail's pricing flexibility and price controlling these products separately. This should help Postcomm discover what prices would have to be to cover Royal Mail's correctly allocated costs. If the correctly costed price is very high consideration should be given to the degree to which stamp price rises should be phased, have pressure relieved by efficiency savings and, if the evidence suggests, Postcomm should consider alternative funding mechanisms.

Response to consultation questions

Annex 1: Provision of a universal service

Q1. Respondents are invited to comment on the issues discussed.

As an organisation, Consumer Focus always strives to ensure that the consumer interest is understood and represented. In the postal sector the universal service is at the heart of our work and we are therefore involved in two major projects assessing the USO from the point of view of consumers and their changing needs.

The first project consisted of a strategic-level series of roundtable workshops on issues facing the postal sector to which we invited sector experts representing operators, government, regulatory bodies and consumers, including vulnerable consumers. These workshops discussed a wide range of topics, including the future provision of the universal service. The expert opinion and consumer views presented led to the conclusion that the universal service is not under any immediate threat but in the medium term it will need to be reviewed to meet the needs of modern-day consumers.

As mentioned in Annex 1, Consumer Focus is also directly involved in the first workstrand of Postcomm's review of the scope of the universal service. For this we have commissioned joint research with Postcomm to investigate consumers' needs from the universal postal service and the wider communications market. In line with our statutory obligations this research will allow for close scrutiny of the needs of postal consumers, including vulnerable consumers, as well as small and medium-sized enterprises (SMEs).

This research is designed to focus on the needs of consumers, rather than their all-encompassing wants. There is a feeling in the postal sector that the USO as it stands needs updating in the face of volume decline and changing communications methods. Work in this area is timely given the European Commission's concurrent review of the wider European postal service standards. This research will indicate those areas of the USO that are vital for UK consumers, and will allow Consumer Focus to define a baseline service that we think must be provided. This research is due for publication in the autumn, and we will use the findings to feed into Postcomm's ongoing review of the universal service from the point of view of users of the service, providing a solid evidence base for our response to any proposed changes and ensuring that the voice of consumers (particularly vulnerable consumers) is heard.

It is possible that on completion of its review Postcomm will propose a reduction in the USO. However, any review of the USO should be about evolution of the service in response to changing consumer needs, with any changes implemented not just to reduce obligations but rather to refine its scope and ensure the emphasis is on the correct products and services. We would like to stress that any reduction in the USO must go hand-in-hand with regulatory vigilance of Royal Mail in two areas: a rigorous price control to ensure any reduction in the USO is not undertaken in lieu of efficiency, and a requirement for cost transparency to provide the regulator with clarity of avoided costs. Additionally, if Postcomm proposes any changes to the USO it would be sensible for it to take account of the total communications needs of consumers, and the wider context of the changing communications market and Government policy on digital development.

Annex 3: Cost transparency and accounting separation

Q1. Do you think the introduction of Guiding Principles for the Royal Mail product costing process into Royal Mail's licence is an appropriate means of supporting greater transparency of Royal Mail's costs?

It is not for Consumer Focus to comment on and provide suggestions on the detailed technical proposals Postcomm has outlined in this consultation. However, we believe that the cost transparency and accounting separation work that Postcomm is undertaking is absolutely vital if Postcomm is to be able to implement a well-functioning regulatory framework. For example, Postcomm needs to have a good understanding of Royal Mail's cost allocation process to determine efficient access prices to ensure effective competition.

We would note that Postcomm's proposals for cost transparency do seem to have regulatory precedent in other UK utilities and overseas postal regulatory regimes. A cost transparency process of implementing guiding principles, methodological principles, an accounting manual and accompanying change control process have been set up by the Australian regulator (ACCC) in the Australian postal market. As such Postcomm seems to have taken note of best international regulatory practice. We consider the independent auditing of Royal Mail's cost allocation process to be crucial to ensuring external confidence in Royal Mail's cost allocation procedure.

Finally, we would add that if Postcomm's work on cost transparency and separated accounts is to work it will require the full cooperation of Royal Mail; trust between the two parties in the disclosure of information is crucial. Discussions we have had with Postcomm indicate that discussions between it and Royal Mail have been largely encouraging. We hope this will continue. Royal Mail must also be mindful that any favourable regulatory decisions that involve it having greater commercial freedom must only be allowed on the basis of adequate cost transparency and external publication.

Q5. Do you agree that improving the accounting separation of Royal Mail's Letters business is the best way to achieve each of the following key regulatory objectives (in particular in comparison with other potential methods of business separation):

- a) Ensuring sustainable USO operations
- b) Reduced and targeted regulation
- c) Promoting effective and sustainable competition where appropriate

Accounting separation (supported by robust cost transparency) is a minimum requirement for ensuring the achievement of the three regulatory objectives given above. The form of accounting separation also needs to differentiate between the information available solely to the regulator (likely to be commercially sensitive information required to adjudicate between potential instances of anti-competitive behaviour, for example) and the information available to competitors, potential market entrants and other market commentators and participants. The external reporting of accounting information is key to ensuring that market participants, and ultimately consumers, are not commercially disadvantaged by Royal Mail's business actions. Furthermore, reporting and disclosure should allow market participants and potential entrants to identify potentially profitable business opportunities as easily as possible. The proposed consultation on reporting disclosure scheduled for November 2010 will be very important in determining what stakeholders expect to have visibility of in the regulatory accounts.

In the long run accounting separation has not proved sufficient to ensure fair and competitive markets in other regulated utility industries (gas, electricity and telecoms for

example). More intrusive forms of regulatory intervention, such as business separation and ownership divestment, have been implemented by various regulatory authorities. As such, the model of commercial equivalence, previously put forward by UK Mail, represents an interesting model for a regulator trying to ensure free and fair competition in upstream mail services. While Postcomm notes this option and some of the difficulties in its implementation (including the use of common assets in Royal Mail's integrated business model) in the consultation document, we believe that a fuller discussion of the assets and drawbacks of commercial equivalence compared with accounting separation would have been useful. If accounting separation proves inadequate in promoting the three regulatory objectives above, then Postcomm will need to consider more intrusive forms of regulatory intervention.

Q9. To what extent do you agree with our analysis of how the additional types of lines of separation, illustrated by Lines A, B and C in Chapter 5, meet these six criteria?

We believe that all three lines of separation identified by Postcomm are justified by legitimate competitive and/or consumer concerns (especially A and B). Postcomm needs to ensure that cross subsidisation between deregulated products and other products (Line A) and between bulk and non bulk products (Line C) is identified and prohibited ie allocating costs between competitive and non-competitive markets in an anti-competitive manner. Furthermore, the need to ensure that Royal Mail pays the same price for 'downstream access' as upstream operators (Line B) is crucial to ensuring efficient competitive entry in postal services. Visibility of these transfer prices is crucial.

Q10. Are there any other changes in the lines of separation that should be considered, including reducing existing lines of separation currently specified for the regulatory accounts in Royal Mail's licence?

As Consumer Focus has particular interest in promoting the interests of social and SME mail customers, including vulnerable consumers, the pricing of First and Second Class stamp products is very important for us. Royal Mail's regulatory accounts for 2009/10 state that stamped products are highly loss making (making a total loss of £163 million although this is less than the £244 million loss in 2008/09). As such, having cost transparency of stamped products (and metered products as these are contained in Basket A of Royal Mail's price control) is important in ensuring that the prices customers pay are a fair reflection of correctly allocated costs. The work Postcomm is currently undertaking on Long Run Incremental Costs (LRIC) could be particularly helpful in determining whether stamp prices accurately reflect costs. Furthermore, having transparency of the profitability (or not) of stamped products in regulatory accounts is important for consumer confidence in the prices they pay.

We note that the price differential between these two product types has increased sharply in recent years and that Postcomm is currently liaising with Royal Mail to ensure that this price differential is justified. Accounting separation between stamped and metered products could go some way to ensuring that consumers as well as competitors to Royal Mail are confident that Royal Mail is not behaving anti competitively.

Postcomm should also consider a line of separation between USO and non-USO products, especially once the scope of any revisions to the USO has been decided. This again should help prevent any harmful cross subsidisation between captive and non-captive customers.

Q16. Do you agree with our plan and timetable for implementing changes to cost transparency and regulatory accounting separation as set out above?

Yes, although we note that the process depends on the cooperation and trust between Royal Mail and Postcomm.

Annex 4: Price control and access

Q1. Do you agree with our proposals for regulatory safeguards that should apply to products in competitive end to end retail markets?

In line with our theme of effective regulation, Consumer Focus agrees with Postcomm's overriding principle that it should only aim to regulate ex ante where Royal Mail has market power. However, Postcomm must have strong evidence for the development of effective competition in postal market segments before removing ex ante regulation. As such, while we agree with Postcomm's approach to regulating contestable and incontestable markets, as presented in the earlier summary section we do not always agree with every proposal that Postcomm has set out in the consultation. This is because we believe that Postcomm is not always able to provide the empirical evidence necessary to support the changes it proposes to make.

Q2. In particular do you agree that products in competitive end to end retail markets where Royal Mail does not have market power should not be subject to Condition 7?

Consumer Focus agrees in principle with this proposal. However, to mitigate against the possible detriment from removing this protection the publication of Royal Mail's separate regulatory accounts should help provide market participants with confidence that Royal Mail is not behaving in an anti-competitive manner.

Q3. Do you agree with our proposal to reduce the publication notice period for products subject to Condition 7 (including bespoke products) to six weeks?

We believe that this represents a sensible compromise between the needs of consumers, competitors and Royal Mail. It should allow Royal Mail more freedom to tailor its mail products and services to changing consumer preferences while at the same time allowing Postcomm to examine whether proposed products and services might have an anti-competitive effect on the market, thus protecting competitors to Royal Mail and ultimately customers.

Q6. Do you agree with our proposals on regulatory safeguards for Royal Mail's packet and parcel products that fall within markets where Royal Mail does not have market power? If not, please state why and where possible provide evidence to substantiate your view.

and

Q7. Do you agree with our proposal to remove price and headroom controls for packet and parcel products where Royal Mail retains market power, but with a weight above 750g? If not, please state why and where possible provide evidence to substantiate your view.

Postcomm's market analysis included a market study of packets and parcels services which split the market by type of sending customer into B2X (items collected from business premises by an operator), C2X (items collected from consumers) and Y2X (items collected from a collection point such as a Post Office), although they provisionally concluded that C2X and Y2X are in the same market. Postcomm then sub-divided these

markets by weight, volume and delivery speed (express and deferred), presumably at least in part because Royal Mail splits its prices along these lines. This analysis clearly showed that Royal Mail has market power in the entire C2X/Y2X market, and so removal of regulation was not considered in this case. For the B2X market it concluded that Royal Mail is unlikely to have market power for deferred parcels and packets products at weights above 2kg. It did not have enough evidence to reach a firm conclusion between 1kg and 2kg but concluded that below 1kg Royal Mail is likely to have market power.

The conclusions from the packets and parcels market study led Postcomm to consider three options for future regulation of the B2X market. These were 1) to maintain the status quo 2) to remove regulatory safeguards where Royal Mail has no market power (i.e. for express items, deferred products above 2kg, and high volume products 1–2kg), and 3) as option 2 but also to remove price and headroom controls for all deferred items above 750g. It decided that its preferred option was number 3, to deregulate for all deferred parcels and packets weighing more than 750g that are collected from a business premises.

Consumer Focus has strong reservations about this proposal. There are currently price and headroom controls for deferred parcels up to 20kg in weight, and this proposal therefore represents a substantial and rapid deregulation. Postcomm defends this deregulation by claiming that there is some evidence that the weight at which other operators compete with Royal Mail for packets and parcels services has decreased over time. It claims that the reason for the current lack of competition at lower weights is largely due to the price control keeping Royal Mail's prices artificially low, and that if Royal Mail puts up its prices following deregulation it will lose market share to competition. However, this argument could apply to the potential de-regulation of many markets and therefore does not necessarily seem to be a sufficient safeguard against the consumer detriment that would be caused if Royal Mail decided to increase its prices.

Regulation provides an important consumer safeguard where competition does not exist or suffice, and therefore one important piece of evidence for Postcomm to consider before taking the proposed steps is to determine whether competitors would be prepared to enter this market following deregulation. We have held discussions with several of Royal Mail's competitors who have indicated that there are reasons why this is unlikely.

One reason concerns the market study underlying the proposals. As mentioned above, Postcomm sub-divided the markets by weight and volume. Competitors judge that for the foreseeable future Royal Mail will have market power for small, light-weight items because these can be carried by postal delivery workers and put through letterboxes with letter deliveries. The consensus is that the market power weight divide falls at about 1.2–1.5kg, not at 750g. This represents the split between lighter products, those that can 'piggy-back' on Royal Mail's letter delivery infrastructure, and heavier products requiring separate delivery solutions such as vans, when all operators compete equally.

Competing operators also agree that there are additional barriers to competition stemming from Royal Mail's position as monopoly provider in some parts of the market. For example, Royal Mail will maintain its status as the effective monopoly provider of products below 750g, and will be able to leverage its market power for low weights to capture trade for products above 750g. Similarly, although Postcomm characterises business-to-business (B2B) and business-to-consumer (B2C) trade as part of the same B2X market there are doubts about the level of convergence of the two which Postcomm should endeavour to resolve with stakeholders. The issue for competitors is that Royal Mail's dominance for B2C mail will stifle competition for B2B mail. Finally, a logistical problem is that investment in specialised sorting kit is required for small packets, and the capital expenditure for this is unlikely to be justified by the return. Operating costs look similarly prohibitive.

Consumer Focus has explored the impact this proposal will have on SMEs. Eight per cent of SMEs use business collection for parcels and packets¹ and thus fall into the B2X market and will be directly affected by any deregulation. Overall, liberalisation of the postal market has been less effective for SMEs than for larger businesses, with less competition directed at them, and thus fewer options in response to price rises. For example, 84 per cent of SMEs use Royal Mail for sending their parcels and express items, and 28 per cent feel they have little or no choice of service provider². E-substitution is also less prevalent among small businesses, as SMEs tend to send bills and invoices and receive payments through the postal system³. As noted in our roundtable workshops, the lack of competition is particularly acute for rural SMEs, who become captive customers of the universal service provider.

Discussion with representatives of small businesses has indicated that they have suffered from the tough economic conditions of the past couple of years, and although SMEs generally value the services provided by Royal Mail they would not be happy to pay more for these should Royal Mail decide to put prices up following deregulation. SME representatives consider it very unlikely that any competition for the deregulated market will be aimed at them, and rural SMEs in particular are therefore likely to continue to use Royal Mail regardless of potential price rises. They will have to make the choice between either absorbing price rises or passing them onto customers.

In conclusion, option 2 (to remove regulatory safeguards where Royal Mail has no market power) seems to be the most appropriate. This fulfils the aim of both Consumer Focus and Postcomm for regulation to be targeted and effective, and where Royal Mail no longer has market power we agree that there is a case for careful deregulation. However, it is where Postcomm draws the line between competitive and non-competitive markets that gives us cause for concern.

Postcomm's preferred option 3 (to remove price and headroom controls for all deferred items above 750g) does not fulfil our aim that decisions should be based on evidence. Postcomm's own market study on which this decision was based found that Royal Mail has market power below 1kg, and that there was insufficient evidence to judge the level of competition between 1kg and 2kg. Deregulating to below 1kg on the basis that competition should subsequently develop therefore seems very risky, especially in the light of convergent opinions from competitors and SME representatives that competition is unlikely. Our concern is that, following deregulation, Royal Mail will be free to increase prices in the absence of effective competition, and whether consumers are affected directly via retail price increases or indirectly via businesses passing on price rises to consumers, higher postage prices will have to be paid. We hope that Postcomm's stated invitation for input is an indication that it is prepared to re-think this proposal.

Q8. Based on the conclusions of the market study, do you agree that a balanced combination or package of measures is an appropriate regulatory response for pre-sorted bulk mail products given the available evidence?

Indeed, a balanced set of regulatory changes is required based on the evidence available to Postcomm and the market participants. However, we are of the view that the package that Postcomm intends to implement is not the correct one at this time. We elaborate further in the following consultation questions.

¹ Federation of Small Businesses Postal Report 2009

² The FSB-ICM Voice of Small Business Panel: June 2010 Survey

³ Federation of Small Businesses Postal Report 2009

Q9. Do you agree that of the four options considered, option (iv) is the most appropriate based on the problems we have identified and the available evidence? If not, please state why and provide evidence to support your alternative view.

We agree that one element of option iv could be implemented now; the move from retail minus headroom control to a wholesale plus control. However, we do not believe that the case has yet been made or that the time is right to move to average headroom basket and to lower the headroom level. We provide the reasoning for this opinion in subsequent questions.

As such we recommend that Postcomm rolls over the current scope and level of headroom (option i) with a view to making changes for 2012–13 where it has a better evidence base to make the changes it is currently proposing.

Q10. Do you agree that, based on the evidence available, it is appropriate to remove certain pre-sorted bulk mail products from Royal Mail's price control and instead price control their access equivalents? If not, please state why and provide evidence to support your alternative view.

In principle we agree with a move from retail minus to wholesale plus access pricing. We believe that this form of access pricing will help achieve the important principle of equivalence of input (EOI) whereby Royal Mail pays the same price for access to its downstream network as its upstream competitors pay. However, we are of the view that Postcomm is not yet in a position to implement other proposed changes such as the level of headroom and the move to an access basket. As such we would advise Postcomm to refrain from implementing this proposal until 2012.

Q13. Do you agree with our proposals to allow Royal Mail the flexibility to increase the prices for its access products reflective of the reduction in the level of the headroom?

and

Q21. Do you agree that the new form of headroom control should be implemented with a cautious approach to minimise the risk of market disruption as presented in chapter 6?

and

Q22. Do you agree with our proposals for the level of Mailsort 2 and Mailsort 3 headroom controls in 2011–12?

It is Consumer Focus's view that postal liberalisation is good for postal consumers, even small users, as it provides the competitive constraint on Royal Mail to become more efficient thus keeping postal prices for consumers lower than they would otherwise be in the absence of competition. We do not have a preference for any particular type of competition (end to end or access); however, if postal operators are to 'buy' access to any part of Royal Mail's network they must pay an accurate cost based price for it. The price should in no way 'subsidise' either Royal Mail or access operators.

We do not yet believe that Postcomm has the evidence available to make a judgement on the level of headroom ie the price of downstream access. We are aware that Postcomm has completed part of the work required to make a determination on the level of access. However, by its own admission (see *Laying the foundations for a sustainable postal service*, page 11 of Annex 4, for example) it has not yet completed this very important element of its work required to implement a new regulatory framework for 2012.

Postcomm's work so far on the relevant costs required to price downstream access points towards a reduction in the level of headroom. However, some of the analysis Postcomm provides as evidence for its decision to reduce the headroom to 3p on average is inferred from observed competitive dynamics ie not cost based. As such, until Postcomm has completed its analysis of Royal Mail's relevant costs it should make no change to the level of access headroom. We would further question why Postcomm intends to have a lower level of headroom for Mailsort 3 in comparison with Mailsort 2 when the costs involved are substantially similar.

Changes to the level of access headroom, when Postcomm has a full understanding of the relevant costs, should be conservative whether the level of headroom goes up or down. It is important for both customers and competitors that the market is not unnecessarily disturbed by regulatory changes. It is particularly important that the investments made by private enterprises are not rendered immediately unsustainable due to changes in the level of regulatory protection. Time must be given to allow affected parties to adapt to new regulatory conditions or in the most extreme case plan an orderly exit.

Finally, we hope that Postcomm will be able to factor in the current VAT distortion when it is in a position to make changes to the level of headroom. We note the current HMRC consultation on its treatment of VAT and we will respond to that consultation accordingly.

Q15. Do you agree that it would be appropriate to adopt a basket approach to controlling access headroom? If not, please state why and provide evidence to support your alternative view.

In principle an access basket could help encourage more cost-reflective access prices. It will almost certainly allow Royal Mail to better compete in the upstream bulk-mail market. However, there is a risk that the implementation of the basket approach could provide too much pricing flexibility to Royal Mail which could lead to anti-competitive outcomes to the detriment of competitors and ultimately consumers. It is Consumer Focus's view that the basket approach could only operate with the full confidence of market participants and customers if Royal Mail has provided adequate transparency of its costs to Postcomm and adequate disclosure of the profitability of different bulk-mail services in its regulatory accounts. We recommend that Postcomm refrain from moving to the basket approach until its cost transparency and separated accounts work is implemented and completed, hopefully in time for 2012.

Q25. Do you agree that it is appropriate to roll forward the current price control to 2011–12, including the adjustment mechanisms?

We think it is appropriate to roll over the current price control in its entirety for 2011–12. We do not yet have the analysis available in terms of efficiency improvements, for example, to propose changes to the current scope and form of the price control. Changes that we would like to investigate further would be best suited to a new four to five year price control period. We would, however, like to set out some of the key areas Postcomm should begin to consider in preparation for the new price control determination set to begin in 2012. These are:

1. Progress and future scope of efficiency savings

While Postcomm believes that Royal Mail cannot fill the cash outflow gap by efficiency savings alone, we believe that the efficiency savings achieved to date need to be reviewed as a matter of urgency for the proposed price control beginning in 2012. Annex 4 states that the Royal Mail Letters business reduced total costs by approximately £200 million (or three per cent) in 2009–10. Furthermore, total cost reduction for the price

controlled area before exceptional items was equal to £297 million (5.2 per cent) between 2008–09 and 2009–10.

Royal Mail has recently made an outlay of £1.6 billion on capital expenditure to aid modernisation, which could provide substantial returns on investment.

The recent agreement with the Communication Workers Union gives postal workers a generous pay rise of 6.9 per cent over three years. This pay rise indicates that Royal Mail has confidence in its finances, and comes at a time when other public sector and many private sector employees are facing pay freezes, if not cuts and redundancies. It is reasonable to assume that this pay rise equates to additional hundreds of millions of pounds in operating expenditure⁴. We hope that the pay deal will help achieve Royal Mail's goal of introducing more flexible working practices but consumers will be asking at what cost?

Consumer Focus would like to know when, and to what extent, the benefits of these efficiency savings will be passed on to customers.

2. The financial position of the USO and Royal Mail

In 2009/10 Royal Mail made a loss of £8 million after exceptional items (it made a profit before exceptional items) compared with a loss of £191 million in 2008/09 on its provision of the USO. This shows that Royal Mail's financial position is recovering from its recent low in spite of rapid volume decline.

While Royal Mail is experiencing a net cash outflow of over £500 million this is a consequence of high pension contributions (the future of which is uncertain) and capital expenditure which is coming to an end. Royal Mail's cashflow position could change very rapidly depending on government decisions.

3. The level of future pension contributions and application of the pension adjuster

Whether Royal Mail is given financial relief by a potential government takeover of responsibility for the historic pension fund or instead forced to make increased pension contributions will have a large bearing on the level of prices customers will be expected to pay in the future. Postcomm will need to take this into account in its Price Control determination for 2012.

4. Outputs-led regulation and quality of service

Perhaps the most important issue is that the price control determination (allowed revenue, Weighted Average Cost of Capital (WACC), tariff setting etc) is based on the outputs that Royal Mail intends to deliver for its customers. The outputs should be justified by comprehensive market research and be challenged by the regulator and other stakeholders (through appropriate stakeholder engagement). The joint research on the USO should be a useful piece of information in helping to determine what outputs customers want from a national postal service.

More specifically, we agree with Postcomm that the Quality of Service targets should be rolled over for another year. This is because the consumer research necessary for us to recommend changes is not yet available. However, we would note that the Quality of Service targets and C-Factor arrangements should be re-evaluated as part of the Price Control determination for 2012. We are concerned that the current arrangements might not be incentivising Royal Mail to maintain high standards of quality in the event of national industrial action. There might be alternative mechanisms to achieve the quality outputs that customers expect.

⁴ On a conservative assumption of a 0.2 per cent increase in total costs, 60 per cent of which is labour costs

Finally, if wholesale plus access pricing was implemented it might be prudent to introduce quality metrics for access products to help ensure not only price equivalence but also non-price equivalence i.e. quality.

Q26. Do you agree with our proposal in order to make the volume adjuster effective for 2011–12?

It is clear that a proportion of volume decline is outside the control of Royal Mail and that it is difficult for Royal Mail to re-optimize its network completely to remove costs in the face of mail volume decline, particularly in the short run. However, the ability for Royal Mail to shed costs in the short run (short run marginality) needs to be reviewed. It is also worth discussing how much the volume adjuster incentivises Royal Mail to endeavour to increase sales of postal products. However, these discussions are best held during the negotiation of the price control for 2012. Therefore a rollover of the current adjuster seems the most appropriate course of action for 2011–12.

Therefore to allow the rollover to take place Postcomm needs to implement a forecast to make the adjuster function. Postcomm provides two options: one forecast based on the unpublished forecasts produced as part of the last Price Control determination, the other based on last year's volume forecast. Our understanding is that the difference between the two forecasts in terms of the allowed revenue increase equates to a difference between the two options of 0.15 per cent of revenue. As such we accept Postcomm's argument to use the unpublished demand forecast for the roll forward, this being the more consistent approach.

However, we do note that the extra allowed revenue from rolling over the volume adjuster equates to a maximum of £80m allowed revenue (which represents a price increase for customers of two per cent. Of course this doesn't take into account market information Royal Mail will need to take account of in its tariff setting). This represents quite a large amount and the cumulative revenues accrued by Royal Mail as part of this roll forward will need to be evaluated for 2012 in light of changes in Royal Mail's cost base.

Q27. Do you agree that we should roll forward the existing pension adjuster mechanism in the price control for 2011–12 subject to considering the impact of any changes to the funding of the pension scheme?

We believe this is the most sensible action at this time in light of the uncertainty surrounding Royal Mail's pension deficit, the proposed government Bill which might include a measure to place the Royal Mail historic pension fund on the Treasury's books, and ultimately the future level of Royal Mail's pension contribution.

Consumer Focus takes no position on whether the Government should or should not take over responsibility for Royal Mail's pension deficit. However, we would like to highlight the effects on customers in the event that pension contributions increase or decrease.

In *Laying the foundations for a sustainable postal service* Postcomm sets out in Annex 4 what it believes is a realistic scenario for the effect of increased pensions contributions following a possible agreement between the Royal Mail pension trustees and Royal Mail. Under this scenario Royal Mail could make £125 million and £175 million of additional contributions to the pension fund. Under the pensions adjuster 80 per cent of these contributions (between £100 million and £140 million) could be passed on to Royal Mail Letters customers. This equates to an additional three per cent rise in prices for customers. This would represent a large increase for customers and we are unsure whether the market would be able to bear such an increase on top of the other price

increases pencilled in for 2011/12. However, it is our understanding that this scenario looks less likely than it did in the first quarter of 2010.

On the other hand, in the event that the government takes over responsibility of the pension deficit this would provide a very large financial boost to Royal Mail, taking it from a position of negative cash outflow to positive and potentially to very healthy profitability. In this event it is essential that Postcomm ensures that a significant proportion of these financial benefits (the price control (2005–10) currently allows Royal Mail to recover £280 million annually from customers) is given to customers in the form of a lower price level than would otherwise be the case. These benefits could also be passed on in other ways, for example through improved quality of service and a wider range of services and products.

Q28. Do you agree with our proposals for the sub-cap mechanism in 2011–12? If not, please state why and where possible provide evidence to substantiate your view.

We believe that there might be an issue of Royal Mail's pricing flexibility in Basket A having an adverse impact on social customers. Basket A allows Royal Mail to rebalance prices for stamped, metered and Printed Postage Impression (PPI) products so that prices are more aligned with costs. We need to have confidence that Royal Mail properly allocates costs to stamped products (please refer to our answer given to Annex 3 Q10). At present Royal Mail's regulatory accounts suggest that:

- First Class stamp, meter and PPI mail had a positive profit margin of 1.3 per cent for 2009/10 compared with a negative profit margin of (2.4) per cent in 2008/09. Furthermore, Second Class stamp, meter and PPI mail had a negative profit margin of (2.8) per cent in 2009/10 compared with a negative margin of (5.3) per cent in 2008/09. In both price controlled categories margins have either returned to profit or at least led to reduction in losses. This is chiefly due to a 3p tariff increase for First Class stamps, a 2p tariff increase for First Class meter and account mail, a 3p tariff increase for Second Class stamps and 1p tariff increase for Second Class meter and account mail.
- More detailed information is available in the USO performance section of the regulatory accounts. These remove the PPI product from profit/loss calculations and suggest that PPI contributes positively to the profit/loss of items contained in Basket A. First Class stamp and meter mail made a negative margin in 2009/10 of (1.8) per cent, a decrease on the (6.6) per cent margin in 2008/09. Second Class stamp and meter mail made a negative margin of (5.9) per cent in 2009/10 which again represents a decrease on the (9.5) per cent margin in 2008/09. In both cases losses have been reduced although stamped mail made a loss of £163 million in 2009/10 (£244 million in 2008/09) when total losses for stamp and meter mail were £64 million. This suggests that we can expect both First and Second Class stamp prices to increase disproportionately in comparison with other mail products contained in Basket A in 2011 (although this doesn't take into account the price elasticity of stamped products).

The question for consumers and policy makers is (assuming Royal Mail treats the allocation of stamp product costs properly) how far stamp prices can rise before they become 'unaffordable' and lead to an increased shift from stamped mail to electronic forms of communication. However, there is the related issue that for some consumers, moving to electronic communication will not be an option due to lack of availability, affordability of the necessary IT equipment, or lack of confidence and ability to use this technology. Such consumers will face considerable detriment if stamp prices rise significantly. While international comparisons suggest that stamp prices are relatively 'cheap' the losses Royal Mail is making suggest the potential for large price increases. Therefore it might be sensible for Postcomm to consider for 2012:

- Removing stamped products from Basket A to reduce Royal Mail's pricing flexibility and price controlling these products separately ie no sub caps. This should help Postcomm discover what prices would have to be to cover Royal Mail's correctly allocated costs.
- If the correctly costed price is very high consideration should be given to the degree to which stamp price rises should be phased, have pressure relieved by efficiency savings and, if the evidence suggests, Postcomm should consider alternative funding mechanisms.



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

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Published: August 2010

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