



**Consumer
Focus**
Campaigning for a fair deal

**Consumer Focus response to
Postcomm's consultation on *The
building blocks for a sustainable
postal service – Initial proposals
for regulatory safeguards*
May 2011**

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

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Summary

Royal Mail's current licence includes controls on approximately 80% of its prices. The intention of this was to promote efficiency whilst managing the risks to Royal Mail; this intention has not been achieved. The current price control has been rolled over for 2010-11 and 2011-12 with some initial deregulation. There is an urgent need for a wider review of the regulatory framework, hence this consultation on whether there is a need for price regulation, and we expect Ofcom to consult on its final proposals in autumn 2011.

The options presented by Postcomm present a greater or lesser risk to consumers, competitors, Royal Mail and the wider operation of the postal market. Our views on these options will therefore be informed by our views of these risks, based on such evidence as is available. We will also ask Postcomm for as much clarity as possible around the mechanisms for each option as this will influence their ultimate success or failure.

Please note that this is very much a preliminary response to these issues. The very tight deadline set out in the consultation combined with its publication during the response period for three other consultations means that we have not had the time to consider Postcomm's proposals in the way we would wish. We therefore present our initial thoughts in this document and will seek to respond more fully when future opportunities present themselves.

To regulate or not?

Q2 Should ex post competition law be used as an alternative to the current ex ante regulatory framework?

Ex post competition law is considered sufficient to deal with competition problems in some circumstances. However, relying on ex post regulation means that action is not taken until harm has been done. Where there is a dominant player, the likelihood of abuse could be higher and the consequences of harm might be irreversible. The test under competition law might be different to that under ex ante regulation, where the regulator is subject to a number of duties (i.e. a higher headroom might be set), and the reduced speed of implementing measures ex post could make it more difficult to prevent permanent damage. Ex post measures can lead to a protracted period during which cases tested under competition law come to fruition; meanwhile any harm continues unchecked and consumers continue to be disadvantaged. This could be particularly damaging as most of Royal Mail's competitors are small and could not survive anti-competitive measures.

A price control on postal products is not as certain a regulatory solution as in other monopoly-dominated markets. Postcomm notes two arguments for why regulation might be unnecessary: Royal Mail has incentives to reduce costs without raising prices significantly, and Ofcom has competition law powers that Postcomm does not possess. It is also right to note that regulating is not a risk-free option, and we believe that price controls are very much a second-best to genuine competition. However, there is no real end-to-end competition for postal services and almost no competition at all for residents and SMEs. We simply do not have enough information to be able to support rapid moves to de-regulate either the universal service or the access regime. Royal Mail is a soon-to-be privatised monopoly provider of essential communications and logistics services; a move to ex post regulation is a step into the unknown.

One 'unknown' concerns Ofcom's use of its competition powers, which will be extended to cover its new remit for postal services. Ofgem, Ofwat, Ofcom and the Office of Rail Regulation all have competition enforcement powers under the Competition Act 1998 and the Enterprise Act 2002. These sectoral regulators all have the power to impose fines of up

to 10% of turnover for abuse of dominance, and Ofcom has made 23 determinations using these powers (although all concluded non-infringement). They also have the power to make market investigation references to the Competition Commission as the statutory referral body. The Government's 2001 White Paper 'A World Class Competition Regime' did not comment on the expected use of these powers. However, Ofgem, Ofwat, Ofcom and the ORR have collectively made only one market investigation reference to the Competition Commission since 2002. In 2010 the National Audit Office carried out a review of the UK's competition landscape and concluded that the Government should evaluate the appropriateness of the incentives for regulators to use their competition powers. In particular, they stated that:

'Regulators are not making Market Investigation References to the Competition Commission to the extent envisaged in the planning assumptions.'¹

It is therefore possible that Ofcom's powers to make market investigation references might not be sufficient to deter anti-competitive behaviour, particularly as Royal Mail is the effective monopoly provider of both retail and delivery services for residential and SME consumers. More widely, most postal consumers spend relatively little on postal services and might not think ex post action worth taking.

This point undermines the argument that Royal Mail faces pressures not to raise prices. These pressures are stronger in certain parts of the market, namely those that are more price-sensitive and that benefit from greater competition. These do not include residents or SMEs. There is little disincentive for Royal Mail not to increase prices substantially for its captive customers (i.e. those using products such as First Class for which there is no competition) without some form of ex ante regulation to prevent this. Postcomm's recent retail market analysis concludes that non-postal alternatives (i.e. e-substitution) exert only a limited constraint on the price of retail mail services, and are therefore unlikely to add pressure on Royal Mail's pricing decisions. Consumer Focus has a particular concern for the needs of vulnerable groups, and it is vital that the potential impact of deregulation on these consumers is carefully considered before any changes are made.

Another potential argument for retaining a price control system is to encourage Royal Mail to become more efficient by including efficiency incentives in the price control setup. However, Postcomm has noted that the existing incentives (which assume that Royal Mail will achieve 3% efficiency each year) have not served to make Royal Mail more efficient (it achieved 0.6% efficiency in 2008²). This demonstrates that in this case utilising ex ante regulation as a proxy for effective competition is not ideal, although it should be noted that there is no evidence that the price control regime led to the continued inefficiency. We instead believe that the privatisation of Royal Mail permitted under the Postal Services Bill, which could introduce an equity investor with an interest in margins and who is not easily swayed by political arguments, is more likely to succeed in this regard.

Finally, there is an issue around the timing of the current debate given the sweeping changes to the postal sector envisaged under the Postal Services Bill. It seems unwise to consider major changes to the regulatory safeguards regime when Ofcom is shortly to take on responsibility for postal regulation. The risks inherent in deregulation are only likely to be exacerbated in this transitional period. Another clause in the Bill will allow for the privatisation of Royal Mail. Any private sector investor in Royal Mail is likely to favour minimal regulation at the point of sale in order to maximise market share, revenues and

¹ National Audit Office, *Review of the UK's Competition Landscape*, March 2010

² *The independent review of the postal services sector. Second submission by Postcomm, the industry regulator*, May 2008

profits, mirroring the stance that Royal Mail has already openly adopted. These obvious benefits for investors, Royal Mail (and the Treasury) are not necessarily benefits for Royal Mail's captive customers.

Options for universal service price regulation

Q9 Do you consider that an ex ante price control on universal services is required to protect customers from unreasonably high prices by Royal Mail and provide greater certainty over future prices?

Q10 Do you consider that an option whereby only Second Class stamp products are price controlled could be appropriate?

Q11 Do you consider that single piece Meter and PPI products should be included in the scope of any universal service price control? Do you consider any competitive distortion would be created if there was different regulation between the Meter and PPI payment channels?

Q12 Do you agree with our options for providing incentives on Royal Mail to meet quality of service targets? If so, which option do you consider would be most appropriate?

Postcomm is consulting on whether it needs to control the price of universal services and, if so, which option is most appropriate.

1. No regulation
2. Regulate 2nd class stamps only
3. Regulate a basket of products

Our arguments above about the risks inherent in a rapid move to ex post regulation underpin our responses to Postcomm's proposed options for regulating the universal service, access and headroom. We believe the option for no regulation of the universal service (Option 1) is inappropriate at this moment in time; the risk here is that Royal Mail will seek to implement excessive price rises and/or reductions in related Quality of Service standards for those consumers who currently benefit least from competition i.e. residents and SMEs.

Postcomm's market analysis, which concludes that Royal Mail has market power in every retail market, provides clear support for the case for continued regulation of these markets.

We are also concerned that the option to regulate 2nd Class stamps only (Option 2) could bring with it unintended consequences. While we understand the rationale behind including this option, to provide a 'backstop' regulated service while minimising the regulatory burden on Royal Mail, Postcomm itself acknowledges that there is no foreseeable prospect of competition for stamp products and that the different types of stamp mail are not sufficiently close substitutes to exert adequate constraint on Royal Mail's pricing behaviour.

We believe the safest option at this time is for continued regulation of a basket of products (Option 3) as this acknowledges that universal service consumers have little choice but to use Royal Mail. This would not only prevent opportunism in the form of short-term steep price rises (which would both immediately disadvantage particularly vulnerable consumers and potentially damage the long-term future of the USO) but would increase price stability which is particularly important to SMEs, which are not able to absorb price rises unlike larger businesses. The current system of regulation is one we understand, including its faults, and it is likely to be easier to rectify these faults than to take a leap of faith on a completely new form of regulation of the postal market.

We will be in a position to respond more fully when we have further details of the regulator's analysis and proposals for universal service regulation. If it decides determines that some

form of price control for universal services is appropriate it is important that prices are not set below costs, as this would increase the possibility of competitive distortion. This of course presupposes that the regulator has sufficient information about Royal Mail's costs via increased cost transparency and accounting separation. On the issue of Meter and PPI please see our response to Postcomm's proposals on single piece products contained in *The building blocks for a sustainable postal service – Proposals to remove bulk products from the universal service and clarify the status of other universal service products*. In our response we agree with Postcomm's proposal to include PPI mail alongside metered and stamped mail as single piece products within Condition 2 of Royal Mail's licence, with the associated service standards and protections this brings.

Turning to the proposals for quality of service and its relationship to any future price control mechanism, Postcomm has set out four options:

1. Remove the C-factor mechanism
2. Retain the C-factor mechanism in its current form
3. Consider making changes to the structure of the C-factor mechanism
 - a. A positive C-factor mechanism
 - b. Different minimum and maximum levels of financial exposure
 - c. A different deadband for the C-factor
 - d. Different coverage of the C-factor for different products/services
 - e. Different levels of financial exposure for each product and standardised measure
4. A new form of quality of service incentive mechanism that is specified in advance but does not rely on price cap adjustment or price control

Currently, consumers have two main mechanisms by which they can receive financial compensation for poor service: indirect nationwide compensation comes via automatic implementation of the C-factor across Basket A products when service targets are missed, and direct consumer compensation comes via Royal Mail's retail compensation schemes. There is a balance to be struck between these two compensation routes. The C-factor scheme has the benefit of incentivising good service-wide performance and providing group compensation but does not address any detriment suffered by individual consumers. Retail compensation provides targeted redress but does not necessarily encourage Royal Mail to address wider problems and puts the onus on individual consumers to submit claims for each issue. This route is of course highly dependent on the efficacy of Royal Mail's complaint procedures (which are currently under review) and it is particularly problematic for vulnerable consumers.

Of the four options proposed for future quality of service mechanisms, Consumer Focus cannot support option 1 to remove the C-factor. Post is a widely-used, nationwide service provided by an effective monopoly for residents and SMEs whose ongoing effective provision is critical for the economic development and social wellbeing of the country. It is a service that, while inexpensive per unit, is used regularly (if not daily) by the majority of consumers who should be compensated if Royal Mail performs poorly. If the quality of service mechanism is removed Royal Mail's market power will allow it to reduce its performance to below what would be provided in a competitive environment. This case seems so clear that we agree with Postcomm's position that the issue is not whether to retain the quality of service incentive mechanism but rather how the mechanism should be applied.

Over the coming months prior to the full consultation on the new price control regime Consumer Focus will therefore give careful consideration to the most appropriate quality of service mechanisms. This includes assessment of continuing with the current arrangements, proposed in option 2. For example, the regulator needs to review the effectiveness of the current C-factor scheme given the exemptions Royal Mail has secured for poor performance attributed to bad weather and industrial action. A complementary alternative that could be implemented is for the regulator to regulate Royal Mail's retail compensation scheme directly to help ensure that those individuals most directly affected by poor performance are directly compensated.

We will also consider whether any of the changes to the C-factor set out above would be beneficial for consumers. For example, it is unlikely that we would support a positive C-factor designed to reward Royal Mail financially for exceeding its targets as we do not believe consumers would value this above smaller price rises. Our joint research with Postcomm into consumers' needs from the universal service³ indicates that consumers would prefer to see a reduction in First Class quality of service than a substantial price rise. Allowing Royal Mail to increase prices beyond those agreed in the price control in response to above target performance also runs the risk of gold-plating the universal service.

One issue we would like to raise at this stage is the products included in the quality of service mechanism. For example, Postcomm is consulting on whether to include Redirections in Condition 2 of Royal Mail's licence to formalise its status as a universal service product (see *The building blocks for a sustainable postal service – Proposals to remove bulk products from the universal service and clarify the status of other universal service products*). Alongside this it has proposed retaining the current retail compensation mechanism under which items that arrive more than six working days after the due date are treated as delayed. However, we believe Postcomm should take the opportunity to consider also including it in Condition 4 i.e. adding it to the list of scheduled services to which quality of service targets apply. Redirections exemplifies the debate around indirect and direct mechanisms for compensating consumers affected by Royal Mail's poor performance. On the one hand direct compensation (retail compensation) is appropriate because this is an expensive service that is not used as widely used as, for example, First Class. However, most consumers will probably use this service at some point, and its effective operation is very important due to the associated security issues and its ongoing provision over an extended period of time (potentially two years). The large number of complaints Royal Mail receives about Redirections (approximately 100,000 in 2009-10) demonstrates that it is often not operating effectively for consumers, and as mentioned above there is no compensation available for service failure: the only way that consumers can be compensated for poor service is via a claim for each and every delayed item. One way to incentivise Royal Mail to make service-wide improvements is to include Redirections in the quality of service alongside First Class, Second Class etc.

Option 4 has been proposed under a scenario in which there is no price control imposed on Royal Mail. The C-factor goes hand-in-hand with a price control regime and so this would no longer be an option for enforcing quality of service standards but an alternative would be to extend the system of investigations and financial sanctions available to the regulator should Royal Mail fail to meet specified targets. However, our concern with relying on this method rather than compensation linked to a price control is that any money collected via fines does not go to postal consumers but rather to the Treasury. Therefore although this method provides incentives for Royal Mail to meet its quality targets consumers do not receive even the indirect recompense that a C-factor system provides.

³ *Residential customer needs from a sustainable universal postal service in the UK*, November 2010

Options for access price regulation

Q14 Do you agree that we have identified the principal options for addressing the risk of price or margin squeeze? Do you agree with our proposal that the preferred option should be option 2 – ex ante monitoring of upstream margins?

Postcomm is consulting on whether it needs to control the price of access products and, if so, which option is most appropriate.

1. No control (control universal services only)
2. Separately control universal and access services
3. Combined control on universal and access service

A further option is for additional safeguards (e.g. sub-cap on 2nd class stamp).

The choice of options for access regulation has consequences for both consumers (Option 3) and competitors (Option 1). The risk from a combined control on universal and access services (Option 3) is that Royal Mail could rebalance its prices by increasing universal service prices for captive consumers in order to decrease bulk mail prices for captive customers. The risk from no control of access prices is that this would reduce competition from alternative postal operators as Royal Mail could seek to decrease headroom or increase wholesale prices. Ultimately, which option is most appropriate will also depend on Royal Mail's progress on cost transparency and further information about Ofcom's use of its competition powers. We again support the safest option of separate control of universal and access services (Option 2); this is most similar to the current control and, as Postcomm acknowledges, is likely to be the most effective at preventing excessive universal service and wholesale prices.

Options for headroom regulation

Q18 Do you consider that it is appropriate to impose an ex ante access control to prevent the excessive pricing of wholesale products (i.e. inward sortation and delivery activities)?

Postcomm is consulting on whether it needs to control headroom, if so, which option is most appropriate.

1. Ex post
2. Publish ex ante pricing guidance
3. Set ex ante pricing boundaries
4. Retain current headroom control

Turning to the four options for headroom regulation, once again we would not support a move to ex post regulation (Option 1) as this would remove the incentives on Royal Mail to efficiently allow competitors access to its network. Postcomm's preferred option is to publish ex ante pricing guidance (Option 2), but until the relevant regulatory safeguards are in place we believe this option remains too risky. We support either ex ante pricing boundaries (Option 3) or retaining the current headroom control (Option 4); the latter is more prescriptive and intrusive but remains the safest option for the time being.



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For more information contact Natasha Dare on 020 7799 8054 or at natasha.dare@consumerfocus.org.uk

www.consumerfocus.org.uk

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From a telephone, call 18002 020 7799 7900

Consumer Focus

Fleetbank House
Salisbury Square
London EC4Y 8JX

t 020 7799 7900

f 020 7799 7901

e contact@consumerfocus.org.uk

Media Team: 020 7799 8004 / 8005 / 8006

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