



Royal Mail, Licensed Postal Operators,
Postwatch, Trade Associations and other
interested parties

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Dear Colleague,

REGULATORY FRAMEWORK FOR POSTAL SERVICES FROM 2010

Introduction

1. Postcomm is considering how, and to what extent, it should regulate Royal Mail from 2010 onwards, when its current price control is due to be replaced.
2. We want to begin by taking a “top down” approach, based on what we have learned from our Strategy Review, before focusing on detail later on in the process. Most specifically, we want to consider whether adopting a different approach could allow a significant reduction in the scope of regulation, whilst maintaining sufficient protection for customers and operators in those areas where Royal Mail has substantial and enduring market power.
3. This letter sets out a number of possible approaches and seeks stakeholder feedback on the advantages and disadvantages of each of them. Also we would like to hear your views as to what other measures might be needed to ensure that a proposed approach would be effective. We will also be mindful of any developments from the Government review of liberalisation of the postal market in taking our own thinking forward on the appropriate regulatory framework.

Focus for future price regulation

4. The key issues that we have identified as needing to be addressing through regulation in the future, in addition to ensuring the provision of a universal postal service, are:
 - o Protecting customers’ interests (e.g. to prevent service degradation, unjustified price rises, etc). Some products offered by Royal Mail are facing an increasing degree of competition, diminishing Royal Mail’s ability to increase prices without risking customers switching to alternative postal service providers or other media. Some other of Royal

Mail's products, however, do not yet face any competition from other mail operators. Customers of these, less competitive, products will need to be safeguarded against excessive prices and/or cuts in service quality;

- Avoiding distortions to the development of effective competition. Most users have so far benefitted from competition only through the mechanism of downstream access. The growth of competition from alternative delivery networks has been limited. In pursuing its statutory duty to further the interests of users of postal services, wherever possible by promoting effective competition, Postcomm wants to ensure that it facilitates all potential forms of effective competition;
- Margin squeeze on access operators. Currently, Royal Mail is subject to a headroom constraint, preventing it from reducing the margin between its bulk retail and equivalent access prices. Without any price or headroom regulation, there is the potential for upstream margin squeeze in those parts of the market where competition has already developed (i.e. collection, sortation and trunking);
- Pricing flexibility for Royal Mail. The headroom control (described above) was introduced to prevent upstream margin squeeze. However, it is a relatively rigid approach to margin squeeze and does not allow Royal Mail to reflect upstream efficiency gains in its retail prices; and
- Royal Mail's efficiency. Under the current price control, Royal Mail has been set a minimum target for improvements in efficiency. In order to make this level of efficiency improvement, Royal Mail would need (and was expected) to transform its business and control its costs (without degrading service quality). Royal Mail's current plans do not appear to be aimed at achieving the minimum efficiency improvements expected under the current price control.

Possible scenarios for regulation

5. In order to further our thinking on a regulatory framework that would address the above issues most effectively, Postcomm has developed a number of scenarios (i.e. potential regulatory frameworks) that could be established from 2010. These are detailed in Annex 1. They are not specific policy options, more a range of possible outcomes that are designed to assist policy development.
6. The scenarios range from a similar approach to that taken under the current price control through to a framework that would include controlling only a stamped product (with everything else, including access, being regulated through Postcomm's *ex post* competition powers (i.e. Conditions 10 and 11 in Royal Mail's licence). The latter option is, in effect, the approach that has been advocated by Royal Mail in its recently published response to our August 2007 consultation document on *Postcomm's Strategy Review – The Postal Market 2010 and Beyond Emerging Themes*.
7. Other potential scenarios set out in Annex 1 include an *ex ante* price control of access and the possibility of wholesale equivalence (which is described in more

detail in Annex 2). Wholesale equivalence has been adopted as part of Ofcom's approach to regulating BT. Early indications are that it has been effective in ensuring that BT does not favour its own business over competing operators, when supplying similar services to both.

8. Measures such as wholesale equivalence could lead to a step change in deregulation whilst maintaining sufficient protection for customers and competing operators.
9. However, Postcomm considers that some of the proposed scenarios could require other key safeguards to be put in place before they could be implemented effectively. For instance, some scenarios might not be effective unless they are supported by further developments in Royal Mail's cost transparency. A robust and stable approach on cost allocation by Royal Mail would, for example, be crucial if a lighter touch approach to upstream headroom regulation is to be adopted. In the absence of greater cost transparency under a lighter regulatory approach, there would be insufficient confidence in the cost data used by Royal Mail to support price changes and by Postcomm in any subsequent investigations.
10. It is very important that, in responding to this industry letter, you are as specific as possible in spelling out any pre-conditions that would need to be in place before you could be confident in the effectiveness of a particular scenario.

Next steps

11. Postcomm would like to receive comments on the various scenarios in Annex 1. In addition, we would like responses to the following questions:

Which of the scenarios outlined in Annex 1 do you believe would be the most appropriate approach to regulating Royal Mail from 2010 onwards, and why? We would like to reduce the scope of regulation to the maximum extent possible and so we are unlikely to be receptive to a scenario that maintains tight regulation without there being a very strong justification for so doing.

What other measures (for example, greater Royal Mail cost transparency) would need to be put in place for your preferred scenario to be an effective approach to regulation?

Would any of the scenarios be likely to favour or encourage one type of competition more than another (i.e. end-to-end competition or access)?

12. Responses to this initial consultation should be sent to Postcomm by Friday 14 March 2008. Postcomm would prefer to make public the responses it receives to this consultation document. If you do not want all or part of your response to this document to be read by anyone outside Postcomm, please ensure that your response clearly indicates which parts are confidential.
13. Following this consultation, Postcomm will carefully consider responses, before publishing initial proposals for changes to the regulatory framework around June 2008.

14. In addition to this consultation, Postcomm is also carrying out the following pieces of work that will also help inform the future regulatory framework from 2010 onwards:
- A consultation on how effectively current access arrangements, as established under Condition 9 of Royal Mail's licence are working; and
 - Consideration of consumers' future needs from a universal service to inform how it should evolve in response to changes to the technical, economic and social environment.
15. More details of these other pieces of work are set out in Postcomm's Forward Work Plan, which will shortly be published, for consultation, on our website at www.psc.gov.uk.

Yours sincerely



Sarah Chambers
Chief Executive

ANNEX 1 – POTENTIAL SCENARIOS FOR FUTURE PRICE REGULATION

Scenario	Advantages	Disadvantages	Approx % of RM revenues subject to price control
<p>Scenario 1: “Current approach”</p> <ul style="list-style-type: none"> ○ Competition test in specific segments: <ul style="list-style-type: none"> ▪ Similar to current control but removing Mailsort 2 and bulk packet services (e.g. Packetsort) ▪ Remove third class products (competition with other media) and all other pre-sorted bulk mail? ○ Assumes no change to current approach on cost transparency and ring-fencing/wholesale issues 	<ul style="list-style-type: none"> ○ Existing degree of protection for customers and operators ○ Explicit headroom regulation for access competitors 	<ul style="list-style-type: none"> ○ Leaves problem of how to control price of existing access products (which facilitate competition with Mailsort 2) ○ Scope of price regulation still high ○ Potentially discourages end-to-end competition 	<p style="text-align: center;">77%</p> <p>(Removing all pre-sorted bulk mail would leave around 50% regulated.)</p>
<p>Scenario 2: “Benchmark regulation”</p> <ul style="list-style-type: none"> ○ A stamped mail service price controlled (i.e. first or second class standard tariff) ○ Downstream access price controlled by Postcomm taking a judgement on Royal Mail’s costs (i.e. controlling access prices in a similar way to other products) ○ Pre-sorted bulk mail and metered/PPI not price controlled 	<ul style="list-style-type: none"> ○ Focuses only on the key current <i>products</i> where Royal Mail has enduring market power (i.e. the top (stamps) and bottom (access) of the price range) ○ These benchmarks influence pricing behaviour of all products priced in between these points ○ Reduces scope of regulation ○ Protects residential customers ○ Access price regulation could be scaled back to rural areas if end-to-end takes off in urban areas 	<ul style="list-style-type: none"> ○ Would require high level of confidence (for example, through cost transparency) in ability to prevent access margin squeeze (i.e. to ensure no cross subsidy from delivery to upstream activities) 	<p style="text-align: center;">20-30%*</p> <p>*Depending on whether first or second class is in price control. Will grow as access volumes increase.</p>

Scenario	Advantages	Disadvantages	Approx % of RM revenues subject to price control
<p><u>Scenario 3: “Wholesale equivalence with price caps”</u></p> <ul style="list-style-type: none"> ○ A stamped mail service price controlled (first <u>or</u> second class standard tariff) ○ Wholesale equivalence in delivery along with a price control on delivery activities 	<ul style="list-style-type: none"> ○ Protects residential customers and access operators ○ Could help avoid margin squeeze ○ Allows Royal Mail some flexibility upstream 	<ul style="list-style-type: none"> ○ Scope of price regulation still relatively high given delivery activities such a high % of value chain ○ Could discourage end-to-end competition 	<p>70-72%*</p> <p>*Depending on whether first or second class is in price control</p>
<p><u>Scenario 4: “Wholesale equivalence with no price caps”</u></p> <ul style="list-style-type: none"> ○ A stamped mail service price controlled (first <u>or</u> second class standard tariff) ○ Wholesale equivalence in delivery (but no price control on delivery) 	<ul style="list-style-type: none"> ○ Protects residential customers ○ Could help avoid margin squeeze ○ Does not distort end-to-end competition (but VAT distortion remains) 	<ul style="list-style-type: none"> ○ Risk is rising access prices and therefore bulk mail prices, relying on competition developing in delivery in the medium-longer term 	<p>15-20%*</p> <p>*Depending on whether first or second class is in price control</p>
<p><u>Scenario 5: “Stamp price regulation”</u></p> <ul style="list-style-type: none"> ○ A stamped mail service price controlled (first <u>or</u> second class standard tariff) ○ Ex post control of other products, including access prices (i.e. through Condition 11 of Royal Mail’s licence) 	<ul style="list-style-type: none"> ○ Protects residential customers ○ Allows Royal Mail pricing flexibility ○ Does not distort end-to-end competition (but VAT distortion remains) 	<ul style="list-style-type: none"> ○ Requires quick and effective investigation of anti-competitive complaints by Postcomm 	<p>15-20%*</p> <p>*Depending on whether first or second class is in price control</p>

ANNEX 2 – WHAT WHOLESALE EQUIVALENCE MIGHT MEAN FOR ROYAL MAIL

What wholesale equivalence might mean in broad terms

- Wholesale equivalence would mean that different divisions of Royal Mail:
 - are offered exactly the same set of products (for example, to the delivery network)
 - receive the same terms and conditions (relating to operational aspects), including price and service levels
 - use the same set of systems and processes to request new access products
 - have the same level of access to information on products, services, and systems relating to the delivery network (e.g. in the development of new products to be offered by Royal Mail 'delivery') as other postal operators.

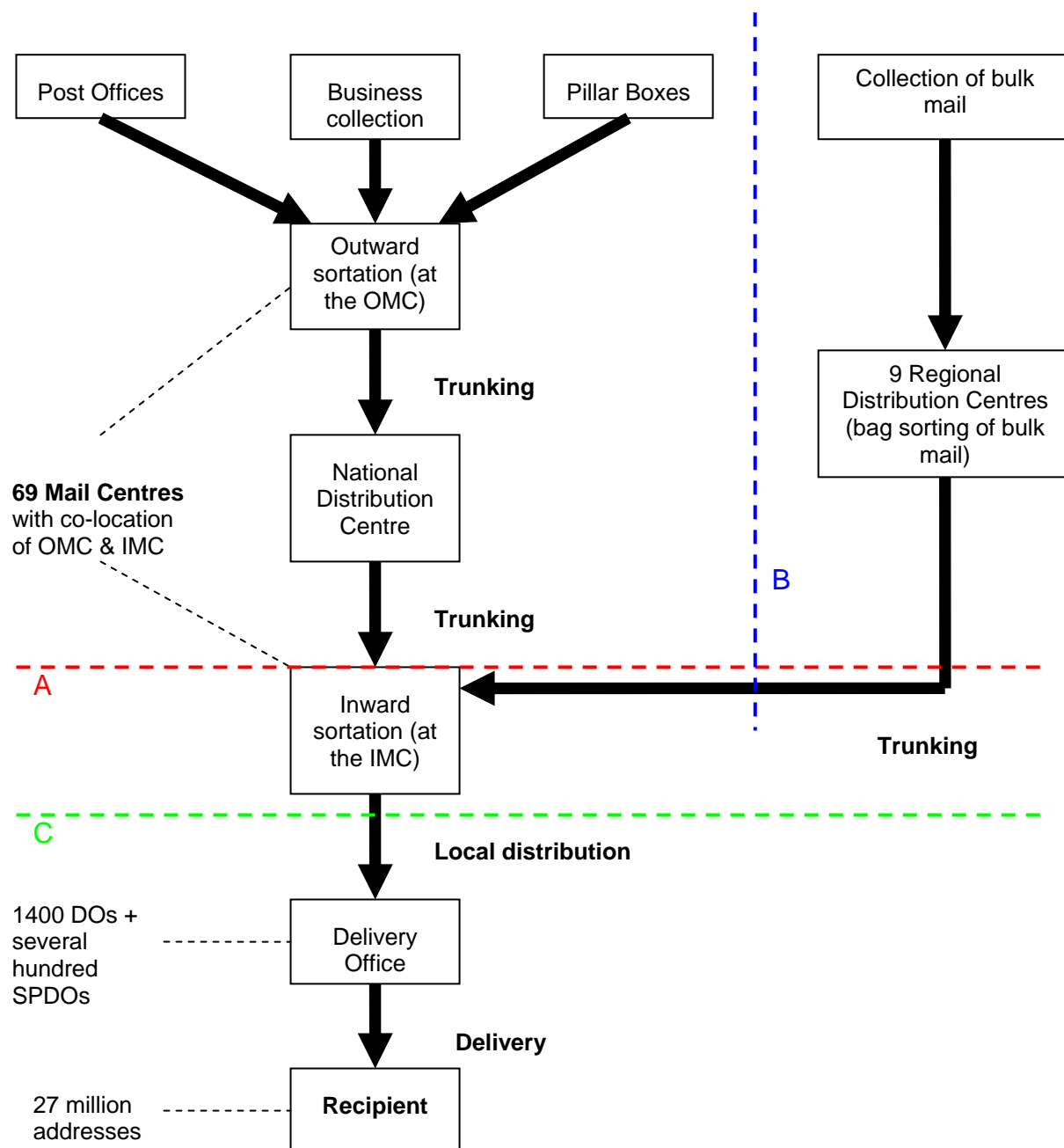
- Wholesale equivalence would probably be accompanied by separation of Royal Mail into two or more distinct business units. A split might occur around the inward mail centre (perhaps between mail centres and delivery offices) or between Royal Mail's network of regional distribution centres and the mail centre network.

- This would then be accompanied by a licence obligation on Royal Mail to provide equivalence of wholesale service offering to its separate divisions and to third parties (i.e. operators and customers).

- Although wholesale equivalence does not necessarily require ring-fencing of specific parts of Royal Mail's business, it is unlikely to effectively address issues of discrimination without further structural changes made to Royal Mail. These would probably include:
 - a 'downstream' or 'operations' business clearly separate from Royal Mail's other business units, with:
 - separate staff, management and remuneration incentives. If financial incentives are offered to the workforce of the downstream business, these should be tied to the performance of the downstream business as opposed to Royal Mail group performance;
 - specific obligations with respect to commercial and customer confidentiality; and
 - clear financial transparency. This would require the downstream business to prepare its own set of financial statements.

- A crucial consideration relating to the introduction of wholesale equivalence is which parts of Royal Mail's business should be captured by a new licence obligation and what this would mean for the appropriate structure of Royal Mail. For example, if equivalence is required in the service offering for use of the downstream network, what would the appropriate point of separation be in Royal

Mail's network and what are the implications of this? The diagram below provides three possible scenarios (A, B and C).



- In the diagram above, the dotted lines demonstrate three different options for where a 'split' might occur:
 - A: at the inward mail centre (IMC)
 - B: between the network of regional distribution centres and the mail centre network
 - C: between the inward mail centres and delivery offices
- Under each scenario, the division of Royal Mail providing delivery services would be required to offer equivalent access to both the rest of Royal Mail and alternative operators and customers. This would include equivalent price (e.g.

around 13p) and non-price terms and conditions. To help ensure this was the case, it would also be important to have separate staff, with different management and remuneration incentives. If the downstream unit has any incentive (financial or otherwise) to offer more favourable terms to the upstream part of Royal Mail, then there is a risk that the approach would not be successful.

- An important consideration under any of the approaches outlined above would be certain operational implications, for example:
 - ensuring that universal service mail has access to slots at the mail centre or delivery office;
 - the potential requirement to revenue protect universal mail twice (upstream and downstream) which may be difficult for first class mail given the greater time pressure; and
 - the (limited) use of delivery offices for collections.
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