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**Citizens Advice Service (Citizens Advice and Citizens Advice Scotland) response to Ofcom's Review of the regulation of Royal Mail: Discussion document published 17|07|2015**

As the statutory representative for consumers of postal services across England, Wales and Scotland, the Citizens Advice Service welcomes the opportunity to respond to Ofcom's Discussion document on its review of the regulation of Royal Mail.

Given the short timetable for responses and the complex and broad questions raised in the Discussion paper, we base our responses on an indicative analysis in relation to Royal Mail's future financial performance and the contestability of market segments and products.

We make general points in relation to the timing and scope of the Review and then consider each of the questions raised in the Discussion paper.

**General points**

We welcome the opportunity to comment on Ofcom's discussion paper in relation to its review of postal regulation.

***The timing of the review***

Our main concern on reading the document is that Ofcom may use the results of this consultation as part of a process with which it proceeds with unnecessary haste towards evaluation of a new regulatory approach.

In its Discussion paper, Ofcom states that its Review is expected to be completed and any revised regulatory framework put in place during 2016.

We do not consider that this is a realistic timetable for a considered and fundamental Review of regulation of an important communications and distributions market.

Further, we are not convinced of the rationale for such a fast timetable, as our projections suggest that Royal Mail is unlikely either to need to raise prices substantially or to earn significant excess profits on its regulated products within the remaining four years of the current price cap framework.

If the review is intended in some way as a reaction to Royal Mail following Ofcom's initial finding in relation to the separate manner of access pricing proposals then we would consider that such an approach is ill-judged given that it adds uncertainty for all operators.

A compressed timetable for information gathering, analysis and consideration of possible changes to the framework may not allow for strategic and considered decision making and give credence to such criticism.

We note that two of the main players in the postal market have recently complained about a lack of regulatory certainty due to apparent inconsistencies in Ofcom's approach to postal regulation over recent years.

### ***The scope of the review***

We are concerned about the scope of the review being undertaken by Ofcom. We note the following points.

- Any move from a 'light touch' approach to more detailed ex ante regulation should be preceded by detailed and public regulatory studies including, not only studies of efficiency and international and internal benchmarking and of market development, but also competition analysis and consideration of the impacts of the potential development of disruptive models of parcels and e-commerce provision. Where possible, Ofcom should make public the results of such studies and give stakeholders the opportunity to comment upon them.
- In considering its regulation of Royal Mail, Ofcom needs to ensure that it maintains a non-discriminatory approach between postal operators. For example in considering the viability and efficiency of the regulated area, it should not consider potential impacts of developments which lie outside the scope of regulation. If Ofcom concludes that Royal Mail has significant market power in parts of the market and that it is not facing substantial efficiency incentives then it should act accordingly as the economic regulator of the sector to protect consumers and customers from inflated prices and poor value for money.
- We are a little confused about the scope of the consultation questions which range from narrowly drawn price control type questions to more strategic broad issues. If Ofcom wishes to test whether there is significant market power it should perhaps consult upon a fully worked up competition assessment, which could be part of a price control review. We are concerned that the questions, as currently drafted, will not allow Ofcom to receive the types of responses which may provide sufficient understanding as to whether there is a rationale for further regulatory intervention.
- We are, therefore, a little concerned that, following this consultation, Ofcom may use its results to conclude that there are no pressing issues or embark on inappropriate regulatory measures.

- As the representative of consumers of postal services we note that the main focus of consultation questions involve assessments of the contestability of market segments and of efficiency but that there is little consideration of consumer needs and of universal service requirements. Whilst we understand that such considerations may lie elsewhere and may be implicit in Ofcom's regulation, we would expect that these issues need to be revisited before any major changes to the regulation of Royal Mail are proposed.

**Question 1: Do you agree with our view that there is a need to consider the effectiveness of the existing regulatory structure?**

On taking responsibility for postal regulation, Ofcom chose to move towards what could be described as a 'light touch' regulatory approach compared to its predecessor Postcomm. It relaxed the detailed regulatory controls imposed by Postcomm and set a price cap (well above initial price levels) to allow Royal Mail to consolidate its finances and allow for a successful sale of the company.

In the context of the unwinding of the financial crash, it could be argued that this approach, which left consumers and customers facing heavy price rises, was necessary to allow Royal Mail greater pricing flexibility to increase its profitability. However the significant rise in postal prices is likely to have depressed mail volumes and Ofcom agrees that price rises have impacted upon customers and consumers and hit postal volumes.<sup>1</sup>

Given this, it could be argued that the current approach leans towards ensuring Royal Mail's interests are safeguarded, as a provider of the service, compared to promoting those of customers and consumers as senders and receivers of the service.

A 'light touch' approach is a little unusual in the context of economic regulatory precedent in the UK, where regulators have more typically used detailed ex ante regulatory methods to provide proxy commercial discipline where companies enjoy significant market power, and also, perhaps, with Ofcom's approach to other sectors it regulates.

In the context of the UK market Ofcom felt that falling mail volumes (which can create rising average unit costs) and potential end-to-end competition would be enough in the short run, at least, to offset risks that Royal Mail may face insufficient incentives towards cost efficiency. It can be noted that ensuring 'value for money' for customers and consumers could be essential if universal service provision is to be financeable in future.

Other EU countries, whose national strategies for the postal sector have traditionally differed from the UK, have, however, also used more 'light touch' regulatory approaches as part of combination which includes greater end-to-end competition in the mail delivery market and (in theory at least) effective and timely competition law enforcement.

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<sup>1</sup> See Paragraphs 3.7 and 3.21 to 3.23 of Ofcom's "Annual Monitoring Report on the Postal Market 2013-2014".

Whistl's exit from the mail delivery market confirms a comparative lack of competition in mail delivery in the UK, although the company did not ever achieve a significant market share. Further, Ofcom's practice in relation to handling the access pricing competition issue does not provide reassurance that potential competitors can rely on timely competition remedies.

### **The timing of the review and regulatory certainty**

As we noted earlier, we do not consider that there are overwhelming arguments for urgently bringing forward proposals to change the current regulatory framework. Given, this we are concerned, for example, by the possible effects of any such early move on regulatory certainty.

Certainty is important to foster investment in the sector and to provide positive incentives for players in the market. It can be argued that both the sale of Royal Mail and its improved profitability have been achieved, in part, as a result of the certainty set under the current price cap arrangements.

Other aspects of Ofcom's approach appear to have eroded certainty. For example, in considering the development of end-to-end competition in the mail market, Ofcom leant towards an intervention which has arguable legal certainty.<sup>2</sup> Further, whilst it appeared relaxed about how such competition was taking shape in the market, protraction in the manner with which it dealt with competition issues eventually eroded investor confidence.

Therefore, whilst Ofcom argued that it was pro-competitive, in practice its own approaches appear to have made it difficult for market entry to be successfully financed, particularly in the context of mail volume decline and a shrinking window for an entrant to achieve critical mass.

Now, in contrast to this cautious approach to handling end-to-end competition, Ofcom appears to be moving much more quickly to review its regulation. Royal Mail has already complained about the subsequent move towards a quick consultation for this reason.

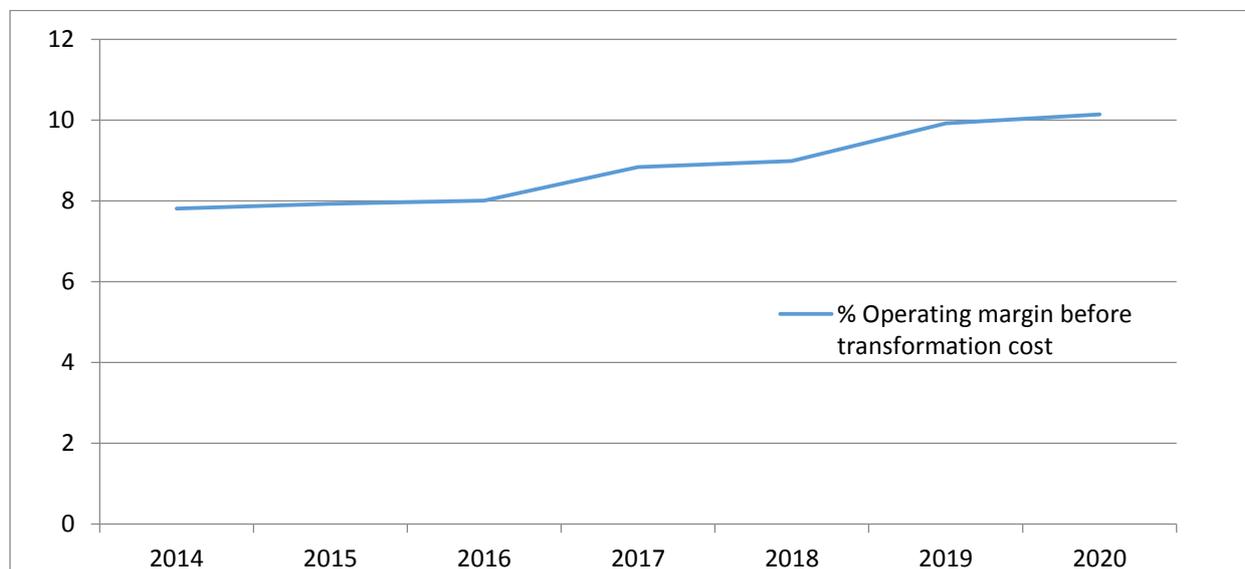
Our analysis of the likely profitability of Royal Mail going forwards does not suggest an urgent need to depart from the current agreed seven year timetable of the price cap. Headline modelling of UK Parcels and Inward Letters' (UKPIL) financial performance suggests that<sup>3</sup> UKPIL will not be making above target margins until towards the end of the current arrangements in 2019.

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<sup>2</sup> There were some concerns about the consistency of Ofcom's approach to imposing licence conditions on end-to-end operators with the European framework for postal services.

<sup>3</sup> These figures are generated by projecting forwards Royal Mail's profitability using the market and business performance assumptions contained in Royal Mail's Annual Report for 2015.

**Figure One: UKPIL operating margins under current market assumptions**



**Source: Citizens Advice based on Royal Mail's Annual report from 2015**

In light of this, and given the significant market uncertainty now being felt due to technology driven disruption in the parcels and packets markets, (See later in this section) we would prefer that Ofcom allowed time for a more considered, detailed and exhaustive review of its current approach before considering changing current arrangements.

### **Accuracy, the time frame for decision making, regulatory conflict and regulatory blight**

We are also concerned that the accelerated timetable for decision making could create risks that future regulation may be based on partial and inaccurate information and that there may be subsequent errors in regulatory judgements.

Ex ante regulation such as price control requires the collection, analysis and handling of significant amounts of business information on issues such as internal benchmarking and efficiency projections, future volumes forecasting, cost allocations and cost modelling, market shares and competition analysis etc. We have some doubts that, unless it devotes substantial additional time and resources to postal issues, Ofcom can effectively collect, handle and analyse all the necessary information and agree data sets and interpretation of data with Royal Mail (for example) within the timetable proposed for the assessment of policy options and consultation of proposed approaches and decisions.

We also note that given the possibly contentious nature of Ofcom's proposals for a new approach we consider that Ofcom may increasingly encounter the types of conflict with Royal Mail which characterised the previous regulatory regime under Postcomm. These may cause further strains on its timetable for decision making.

Further, in light of the accelerated timetable for responses, we are a little concerned that Ofcom may become unreasonable in the (accelerated) timing and quantity of its requests to Royal Mail and other interested parties.

### **The importance of setting positive incentives for market players**

We agree with Ofcom that it is important that the regulatory structure sets commercial incentives for Royal Mail to promote a cost efficient and innovative universal postal service. Consumers and customers should have access to services which provide value for money as well as being affordable.

We share concerns that Royal Mail has mixed incentives towards efficiency and cost restraint under the current arrangements. The business has strong commercial incentives to increase its margins, pay generous Dividends and sustain a high share price to satisfy its owners. Increasing profits through efficiency measures or through cost restraint can present significant business risks in the form of industrial relations problems, whereas increasing margins by raising prices may have more limited downsides at least until the market is saturated.

Therefore, unless there are similar countervailing pressures in terms of increasing competition, market contraction or firm ex ante regulation, it is commercially difficult for Royal Mail's management to prioritise strong efficiency or cost cutting measures.

However, imposition of detailed ex ante regulation can have costs as well as benefits and we would not necessarily like to see a return of very complex price control arrangements. Such arrangements involve debatable analysis whose accuracy depends upon fine projections based on detailed volumes and market share forecasts. Past precedent suggests that it may be difficult to get agreement between key parties over important issues such as cost allocations across products, the flexibility of costs to volumes, and the meaning of efficiency and benchmarking projections.

In light of this, we would encourage Ofcom to think very carefully before making moves in this direction. For example, it may wish to undertake a detailed review of the impacts (costs and benefits) of different regulatory approaches in light of agreed policy objectives for the sector and of the fundamental changes now occurring in the market.

We consider that it could allow more time for such a strategic approach, which may allow for a better evidenced and more strategic policy making, rather than a more rapid move towards new and more detailed regulatory intervention which may then generate its own momentum.

### **Ensuring that approaches fit the developing postal market**

It can be argued that the current regulatory approach is underpinned by the presumption that the universal service postal network will be largely financeable going forward. This

rests upon an implicit assumption that gradually declining mail revenues can be offset by those from growing parcels and packets traffic.

However, it can be argued that the postal sector is at a moment of significant change, where new technology is allowing for rapid innovation. In part this technological change is driven by changing demand as consumers find opportunities to access a wider range of retail solutions online and require delivery solutions tailored to their individual needs.

Consumers are largely benefitting from this change and we consider that competition and innovation are important ingredients of this development. Further, we consider that the increasing power of retailers in the supply of postal services largely increases consumer empowerment and choice, albeit that it adds further complexity in forecasting future trends.

Revision to the types of broad controls used by Postcomm may damage Royal Mail's ability to compete in new markets by tying it to specific product ranges over a number of years, at a time when other players in the parcels market are producing new products much more quickly in response to changing demands.

Whilst we note that Ofcom is undertaking a review of developments in the parcels market, Ofcom could consider revising the scope of its review to assess how its regulation can, or should, take into account potential disruptions due to the impact of technology. Otherwise it is possible that Ofcom may not allow for the effects this disruption may create.

In light of this we consider that it is important that Ofcom maintains a non-discriminatory approach to regulating the market, ensuring that its treatment of the regulated market is self-standing and not compensatory to developments outside the scope of regulation.

### **Dangers of regulatory creep**

There are also dangers that a quick move towards deeper ex ante regulation will create momentum towards ever more detailed intervention.

It can be argued that the experience of price control regulation under Postcomm was that price controls became more and more complex under the glare of requirements to ensure the financial stability of the universal service and political sensitivities about the sector.

In some respects this could appear to be inevitable as the quest for the most scientific price control creates a momentum towards ever greater detail in relation to volume and efficiency projections and the scope of contestability and choice across market segments.

There are also dangers that any new regulatory arrangements such as detailed price controls may run into the types of difficulties created by unpredictability that Postcomm encountered with the onset of the financial crash.

**Question 2: To what extent do you consider Royal Mail's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as substitution**

In answering these questions we caveat that we do not have access to sensitive internal commercial information on issues such as pricing, market trends and efficiency. Given this we can only provide broad brush and intuitive comments.

*Constraints imposed by other postal operators*

Royal Mail has commercial incentives to increase prices most steeply in the parts of the market where it faces the least competition and to reduce or keep constant those in parts of the market which are becoming more contestable.

Contestability is typically assessed by using a SSNIP (Small and significant movement in prices) test to see where an operator has significant market power.

Intuitively we would expect therefore that if Royal Mail is able to raise prices significantly in a market segment then it does not face normal commercial constraints.

Looking at the price movements analysed in Ofcom's latest market review<sup>4</sup> we can see that first and second class stamp and meter prices rise by around fifty percent since 2010-2011.

This suggests strongly that Royal Mail does not face significant commercial constraints for these products.

However, since 2012-2013 the rate of price rises has been much more modest, although it can be argued that this is mainly because the prices have already risen so high and that they have neared the level of the cap.

This could, though provide evidence that Royal Mail considers that it cannot raise prices further without triggering steep volume losses due to electronic substitution or (in the case of direct mail for example) switching to alternative media. Analysis is therefore rather inconclusive depending on the start and end dates of the assessment.

Analysis across weight steps provides similar evidence of a lack of normal commercial constraints until 2012-13.

However, analysis of price movements in the packets and parcels market suggests some internal variance which points to commercial constraints.

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<sup>4</sup> See Figure 5.2, Page 40, in "the Ofcom Annual Monitoring Report on the postal market 2013-2014"

This is shown in broad terms Ofcom market review in Figure 5.3.<sup>5</sup> It shows that previous price rises in the 1<sup>st</sup> class and 2<sup>nd</sup> class 1 to 2kg small parcels stamp services have been reversed.

The report that we commissioned on the impact of competition in the market<sup>6</sup> also suggests that Royal Mail is facing increasing competition in lower weight market segments from operators such as Yodel and Hermes. The movement in prices may reflect this trend and it could be the case that Royal Mail is now beginning to respond on price to this competition following its general increase in prices.

#### *Constraints imposed by electronic substitution*

The analysis of price movements outlined above suggests that Royal Mail has not been significantly constrained in its pricing by electronic substitution until fairly recently.

This may reflect that electronic alternatives are generally considerably cheaper than mail services and it is not usually price which prevents switching to them, but barriers such as the availability of email addresses, concerns over digital security and factors such as the extrinsic value which senders of mail may gain from physical communication.

In relation to electronic substitution PWC in their report for Royal Mail on mail volumes<sup>7</sup> suggested that in many areas of the mail market electronic substitution has already occurred where it is possible.

Areas of the mail market which were now the most likely to be substituted up to 2023 included:

- Government mail;
- B2C mail for example invoicing and insurance;
- B2B transactional mail;
- International letters.

Prices in these areas have risen substantially over the last decade. This does not suggest that electronic substitution has created incentives for Royal Mail to keep prices down.

In one sense it could be argued, reversely, that Royal Mail may seek to extract the most value out of market segments most likely to be substituted before this substitution occurs and to use these profits to best position itself in growing markets.

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<sup>5</sup> Ibid Figure 5.3, Page 41

<sup>6</sup> PLCWW "Report on the Impact of Competition in the postal market on consumers" March 2015

<sup>7</sup> PWC "The outlook for UK mail volumes to 2023"

Nevertheless, as discussed earlier in our response, over the last couple of years we have seen greater price stability. This could reflect that Royal Mail feels that it has increased prices too as high a level as the market will bear (at least for a while).

**Question 3: To what extent do the competitive constraints faced by Royal Mail vary by different types of mail, e.g. for letter services, between advertising mail, transactional mail (mail sent following a consumer's interaction with a company), and publishing mail (such as newsletters and magazines); and for parcel services, between single-piece and bulk parcels?**

Direct mail, of course, is part of the wider advertising market, where there are both substitutes and complements. Overall, it is likely that Royal Mail faces more typical commercial constraints in this area, although general economic growth is particularly important as a driver in relation to volumes trends for these products.

These may be borne out in its pattern of discounts for customers but these are not publicly available.

In relation to transactional mail products we would expect that, as the substitutes may comprise of electronic alternatives the analysis contained in the previous section holds largely true.

In relation to light weight parcels and packets distribution, Royal Mail has traditionally enjoyed market power and we can see this again reflected in the pricing policies which it has pursued.

Growing intensity in competition in these market segments is providing increasing competition for Royal Mail. This is reflected in lower price rises identified earlier for the heavier parcels products. Further, there is some evidence that its network is being bypassed as a default fulfilment of ecommerce both by retailers such as Amazon providing their own distribution and in the growth of locker services. Over time, therefore, we would expect that competitive constraints on Royal Mail's behaviour may grow as the intensity of competition for packets and parcels products grows.

**Question 4: Do you consider that Royal Mail faces appropriate incentives to deliver efficiency improvements?**

Traditional economic regulatory theory would suggest that providers with significant market power do not face sufficient incentives towards efficiency, particularly where active pursuit of cost restraint and efficiency measures may create risks of industrial relations conflicts.

To address this, regulators have traditionally used ex ante regulatory methods such as price controls to protect customers and consumers simulating the effects of normal commercial disciplines on the company.

In setting out its approach to regulating Royal Mail Ofcom deregulated existing price controls and set a price cap to allow the company pricing flexibility below a maximum price set to protect consumers.

Its general approach to its statutory duties could be categorised as “light touch” compared to the much more detailed intervention associated with its predecessor Postcomm. As discussed earlier in this document, “light touch” regulatory approaches rely for their effectiveness upon elements of commercial discipline imposed by competition and where necessary on timely and effective use of competition law.

Ofcom had hoped that the sale of Royal Mail would strengthen incentives at the business towards profit maximisation which, in turn, would push it towards additional cost restraint, particularly in the context of mail volumes decline, which may otherwise act to increase unit costs. Further the potential entry of Whistl into the mail delivery market could impose some commercial constraints on Royal Mail.

However, following the exit of Whistl Ofcom raises the concern that Royal Mail may seek to sustain profitability by increasing prices (rather than becoming more efficient) and that over time this may damage the financial sustainability of universal service provision.

Given the balance of incentives at Royal Mail we agree that this may constitute a significant risk.

Indeed it could be argued that this risk has been expressed in the reality of the market over the last few years as Royal Mail has re-established its finances as the effects of the financial crash have abated. Analysis of the balance of incentives at Royal Mail suggested that it has stronger commercial incentives to use price rises to increase profits rather than to use riskier cost efficiency measures.

In this context it appears counter-intuitive not to apply on Royal Mail the same types of regulatory controls and disciplines which are typically applied to providers of utility services with significant market power.

However, we would expect Ofcom to undertake a detailed and considered analysis of any measures which it may seek to impose.

**Question 5: Do you consider that there are any areas of existing controls on Royal Mail activity where there is the potential for deregulation?**

Ofcom may consider revisiting price caps for parcels and large letters up to 2kg given the greater intensity of competition in the lightweight parcels market, the low margins for other operators, the increasing availability of substitutes to delivery such as lockers services, and the exit of City Link from the market.

We can understand why Ofcom may consider that it should do so, particularly given the arguments made about the possible effects of such a cap in generally dampening down prices and profits in the market.

Of course fierce competition in the parcels distribution market, driven by retailers competing for customers, is beneficial for consumers and has fostered low prices and greater innovation and choice in delivery outcome, helping expand the online retail market. In this respect it can be argued that lifting the cap may have little practical result if Royal Mail is unable to further raise prices significantly due to competitive threat. However, other operators may use Royal Mail's price rises as a signal to increase their own prices to increase margins. In this latter case relaxing the cap would generally increase prices in the market which would not be in the consumer interest.

We note also that current cap already allowed for a substantial price rise until 2019.

Given this we consider that it is important that, before it takes any decision on this issue, Ofcom carefully considers in detail whether and how Royal Mail still enjoys market power in these market segments (ideally through a competition assessment), the effects of lifting the cap on the affordability of services which are important for consumers (for example in having access to retail services), possible competition issues, and the effect that any deregulation may have on Royal Mail's incentives for efficiency.

**Question 6: Do you have any further comments or views (supported by evidence where available) on the issues identified in this discussion paper?**

We have no further comments.



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