

Royal Mail plc

Response to Ofcom's December 2014 Consultation:

*"Royal Mail Access Pricing Review:
Proposed amendments to the regulatory framework"*

24th February 2015

Public Version

Confidential information which has been redacted from this document is indicated by: [X]



Executive Summary

- I. Ofcom is proposing to impose a new control on the prices Royal Mail can charge for access to its delivery network. Its proposals are designed to encourage direct delivery competition. But they severely restrict Royal Mail's ability to compete and will incentivise inefficient entry. They will encourage the transfer of mail from Royal Mail's network into that of a direct delivery entrant.
- II. In order to be able to recover its costs overall, Royal Mail will be effectively required to tie zonal prices to fully allocated zonal costs. But it will not be able to price in a way which any normal, rational business may wish to and which is recognised as competitive market pricing. Ofcom's rationale in part is that the proposed regulatory intervention will increase Royal Mail's rate of efficiency improvement. But Ofcom has not provided evidence that supports this.
- III. Royal Mail has commissioned research from academic and postal experts, including the Regulatory Policy Institute, and Toulouse University. The analysis in these studies suggests that access pricing proposals of the type proposed would accelerate the risks to the future finances of the Universal Service. The research also suggests that the creation of extensive direct delivery competition will increase total industry costs and extract revenues from the Universal Service network. This means the efficiency gains required to safeguard the Universal Service Obligation (USO) would be unfeasibly high.
- IV. Ofcom's proposed intervention would have a negative impact on the mails market. It would harm access competition. It would harm sending customers, by ultimately reducing the number of access operators and currently benefit just one operator. By severely restricting Royal Mail's ability to compete with 'cherry picking' direct delivery entrants, it will accelerate the existing threat to the future financial sustainability of the Universal Service. Moreover:
 1. **The proposals significantly increase the risk of Ofcom failing to meet its primary duty in postal regulation.** Ofcom's primary duty for postal regulation is to secure the long term provision of the Universal Service. Ofcom is proposing to introduce constraints that will significantly limit Royal Mail's ability to compete. But, it does so without undertaking an adequate risk analysis of the consequences of the proposals for its primary duty. Ofcom itself acknowledges that numerous risks to the Universal Service arise from its proposals but it does not clearly assess or address them. If it implements the proposals, Ofcom will be at material risk of failing to meet its primary duty.
 2. **The proposals represent a materially retrogressive change from the 2012 framework. They would restrict Royal Mail's ability to respond to competition. They would skew the playing field in favour of direct delivery operators.** In 2012, Ofcom gave Royal Mail greater commercial flexibility in pricing for at least seven years to secure the Universal Service. This followed a period where Royal Mail had been balance sheet insolvent, and the Board held 'going concern' determinations at every meeting. Now, less than three years later, Ofcom is proposing to impose rules that would severely constrain Royal Mail's ability to compete. They would skew the playing field in favour of cherry picking direct delivery operators. They would introduce greater fragility into the regulatory framework. The proposals would actively promote entry, even where an entrant is less efficient than Royal Mail. In addition, they would make the current four zone access structure almost immutable, removing Royal Mail's ability to respond to market changes and emerging customer needs. If implemented, the proposals would create a postal access pricing regime that is among the most restrictive in Europe.
 3. **The proposals would put the USO finances at greater risk than now. They would prevent Royal Mail from responding to 'cherry picking' from competitors.** The high and largely fixed costs of the Universal Service network mean that the more items flowing through it, the more sustainable it is. Royal Mail disagrees with Ofcom's conclusions in its end-to-end Statement¹ (and Access Pricing consultation) that the current proposals do not impact Whistl's roll out, and

¹ Ofcom (2014) 'Review of end-to-end competition in the postal market'. Statement from 2 December 2014.

therefore do not threaten the future finances of the Universal Service. Ofcom's proposals would prevent Royal Mail from engaging in price competition in response to 'cherry picking' from competitors. For example, Royal Mail would not be able selectively to reduce access prices in London, where the likelihood of further entry and therefore competition is high. This would accelerate the loss of volumes and revenues from the USO network as direct delivery expands. This is against the backdrop of a network already managing the ongoing structural decline in letter volumes.

4. **The proposals are likely to lead to reduced competition, and reduced choice for customers, in the highly competitive access market.** Competitors to Royal Mail handle c.70% of addressed letters posted by large businesses. Ofcom's proposed intervention would create an artificial source of advantage for Whistl - which already carries over 50% of downstream access mail volumes - to develop an extensive direct delivery network. Access operators without a direct delivery arm could lose major customers. They may then exit the market, which would reduce competition. Customers would then face reduced choice and the prospect of higher prices.

5. **Royal Mail already faces strong incentives to improve its efficiency, to keep prices competitive, and to innovate.** Ofcom has not addressed in its consultation document the extent to which Royal Mail is already incentivised to reduce costs and to innovate. Royal Mail already faces significant competitive pressures from e-substitution - addressed letter volumes are falling at around 4-6% each year. The parcels market is also fiercely competitive and drives cost efficiencies across the network. As a publicly-listed company, our shareholders also expect productivity improvements year on year. Ofcom does not provide evidence that its proposals would create an additional spur to Royal Mail's efficiency drive.

6. **Ofcom's proposals are not based on compelling evidence, nor supported by robust analysis. Ofcom has not carried out a proper impact assessment. Nor has it fully considered other options.** Ofcom's proposals should, at the very least, be paused until its efficiency review has been completed. Ofcom is proposing very intrusive, untested intervention in a fragile declining market. Ofcom requires clear and compelling evidence to justify this radical and intrusive approach and it does not have it:

- To impose a new price control, Ofcom needs to demonstrate that Royal Mail might otherwise maintain some or all of its prices at an excessively high level or engage in a price squeeze. Ofcom has not demonstrated in its consultation document that Royal Mail would do so;
- Ofcom has not properly considered alternatives to its proposals or undertaken cost-benefit analyses of such alternatives;
- Ofcom has not set out sufficient analysis to constitute a proper impact assessment of the proposals it has set out;
- The core rationale for Ofcom's proposals is that Royal Mail will be able to cut its costs sufficiently quickly and deeply to outweigh the inefficiencies and duplication of costs its proposals would introduce;²
- Ofcom does not provide any proper evidence to support these views on efficiency. In fact, it is only just starting its review of what might represent a reasonable rate of efficiency improvement. So, it does not know the level of gains that could reasonably be achievable.

V. Royal Mail believes that Ofcom should not implement any access pricing changes without undertaking a more thorough review. This must include a robust risk assessment of the long term impact of its proposals on the sustainability of the Universal Service and a detailed consideration of other options that are less intrusive and risky. Nevertheless, Royal Mail recognises that these are complex issues.

² For example, the promotion of direct delivery competition will create many more instances where two postal workers, from rival companies, are walking the same streets carrying an ever decreasing number of letters.

We would be keen to discuss further with Ofcom the issues raised in its consultation and in our response. In particular, we would also welcome further dialogue with Ofcom on the need for a comprehensive and robust regulatory framework that would support the Universal Service and at the same time support competition in the fragile and declining letters market.

Chapter 1: Ofcom's proposals would restrict Royal Mail's ability to compete. They would increase total industry costs. They would put the future sustainability of the USO at greater risk than now

- Ofcom's proposals make it harder for Royal Mail to compete with its rivals.
- Ofcom's proposals create a platform for, and encourage, inefficient entry. This effect is likely to grow over time. Even if Royal Mail were able to make significant further cost reductions, the proposals would mean that this simply provides more scope for direct delivery growth. The incentives on Royal Mail are therefore counterproductive.
- Ofcom accepts that its access pricing proposals would increase total industry costs. They would also remove volumes and revenues from the Universal Service network.
- The proposals add to the existing pressures on Universal Service Provider (USP) finances, and pose a serious threat to the future financeability of the USO. They introduce a spiral of volume reductions and price increases.
- It is incumbent upon Ofcom to show that its proposals would not create unmanageable risks for the future finances of the Universal Service. Ofcom's claims as to the net benefits of the proposals are not substantiated by evidence, and run contrary to the existing postal economic literature.

Ofcom's proposals create a platform for inefficient entry

1.1 Ofcom claims – but does not offer sufficient evidence to support – that its proposals are appropriately designed so that inefficient entry will not occur.³ Currently, direct delivery entrants can selectively enter cheap-to-serve urban areas. They can do so without having to meet any quality of service or delivery frequency obligations. Unlike Royal Mail which, contrary to what Ofcom stated in its consultation, does have a regulatory mandate to provide a D+2 access service. Under Ofcom's proposals, entrants would be given an even greater advantage than they already enjoy. The proposals:⁴

- restrict Royal Mail's ability to set prices in response to competitors' entry;
- duplicate costs and actively promote entry (even if inefficient) in a declining market;
- prolong the current zonal structure, and
- enshrine the use of historic models and a backward-looking approach.

1.2 We explore some of the consequences of these features of Ofcom's proposals below.

Ofcom's proposals will prevent Royal Mail from being able to compete effectively in areas where direct delivery entry occurs

1.3 In other network industries, incumbents often price below fully allocated costs (FAC). This is reasonable, economically rational and appropriate. Pricing above average avoidable cost or – more conservatively – long run incremental cost (LRIC) is generally accepted as appropriate. Indeed, Ofcom in its March 2013 statement⁵ recognised this, stating: *“we note that services that share the universal service network could be positively contributing to the universal service as long as they recover at least their incremental costs, and there may therefore be a case to continue these services even if they appear to be loss making on a fully allocated cost basis”*.

³ Ofcom's Access Pricing Review (APR) consultation, December 2014, para 7.45.

⁴ Meaning they can achieve a local cost advantage over the Universal Service Provider (USP).

⁵ End-to-end competition in the postal sector, Ofcom's assessment of the responses to the draft guidance on end-to-end competition, March 2013.

- 1.4 Direct delivery entrants have pricing flexibility – they are therefore allowed to price at their LRIC or lower and to differentiate prices between customers (pricing at marginal cost to some customers while setting higher prices to other customers). This enables them to more easily acquire additional customers whilst still making a profit.
- 1.5 By contrast, under Ofcom’s proposals, Royal Mail would be restricted to setting prices to include a mark-up reflective of the zonal FAC differential. Hence Royal Mail would not practically be able to price to zonal LRIC. The consequence would be that we may not be able to compete effectively on price in those areas where direct delivery entry occurs. Technically, the proposals allow for pricing close to LRIC in a particular zone. But this would need to happen across all zones at the same time (to maintain the zonal FAC ratio). This would imply low prices across the whole network, which poses severe challenges for cost recovery across the network. Ofcom’s proposals materially restrict Royal Mail’s ability to compete on the most important factor, price, in order to try to maintain volumes and revenues, and thereby support the costs of the USO.
- 1.6 In our submission to Ofcom in June 2014, we showed that, based on our modeling, the estimated impact of Whistl’s then stated plans for expansion could reduce Royal Mail’s revenue by over £200m in 2017–18. At the Marketforce conference in October 2014, Whistl announced its roll out plan was being pushed back by two years, with revised target locations. As a result, we now estimate that the impact on Royal Mail’s revenue could be delayed in line with this restated plan. However, as discussed in this document, the roll out could be faster than this.⁷
- 1.7 Irrespective of Whistl’s announcements, the potential speed of direct delivery roll out can be categorised into 3 main scenarios:
1. Slower roll out due to operational challenges, lower local market shares achieved etc.
 2. Roll out as per Whistl’s announced plan
 3. Faster roll out with rapidly increasing market share
- 1.8 We believe that scenarios 1 and 2 are likely to be conservative if Ofcom implements its proposals. The proposals are likely to lead to a large differential between the relevant access price and the entrant’s cost.
- 1.9 This would suggest scenario 3 is more likely. Under this scenario, the financial impact on Royal Mail’s revenues could be much higher than under the other scenarios. This introduces both a greater risk and a greater hazard for the future finances of the USO. Even if Ofcom believes the risk of scenario 3 is relatively low, it needs to consider that, if this scenario were to come to pass, the hazard it creates for the future finances of the USO would be very considerable.
- 1.10 Overall, we recognise that there are numerous different potential scenarios. However, we have not seen Ofcom’s analysis of the impact of its proposals on either Whistl’s roll out plans, or Royal Mail’s finances. As we set out in chapter 4 below, the burden of proof is with Ofcom to show/be satisfied that the primary duty is met. In doing so Ofcom must set out its analysis so as to afford stakeholders an opportunity to properly comment.

The proposed cost standard is at odds with the network economics of the USO

- 1.11 The operational structure of Royal Mail’s delivery network is different from that of a direct delivery entrant which does not have to comply with the requirements of the USO (e.g. 6 days a week, everywhere, overnight, at a 93% service standard). It would be uneconomic for Royal Mail to put in

⁶ Formerly TNT Post UK.

⁷ This assumes Whistl rolls its network out to 42% of delivery points as per its presentation. We assume that Whistl will gain c20% local market share in the areas where it delivers.

place a separate network for delivery of bulk mail, in parallel to the USO network that is already in place. Access mail is delivered by the USO network.

- 1.12 Royal Mail's USO network will have substantially higher fixed costs than any zonal or even national network established by a direct delivery entrant without USO obligations. Royal Mail's FAC for bulk mail delivery incorporate a contribution to fixed costs of the USO network and will therefore be higher than an entrant's FAC. But the incremental costs to Royal Mail of delivering bulk mail are significantly lower than its FAC.
- 1.13 As a result, Ofcom's observation that an entrant having a lower FAC in a particular area would imply an advantage is not justified. The lower cost may result simply because the entrant does not have to deliver the USO.
- 1.14 As noted above, entrants can also price by reference to their LRIC to win business. Royal Mail will in practice be unable to respond; even if it is equally efficient or more efficient than an entrant, because it will effectively have to price at a level closer to its FAC.
- 1.15 Other industries characterised by strong network economics feature a variety of pricing approaches, including marginal cost pricing, for particular services. With its proposals for the postal access market, Ofcom is taking an opposite view; they would prevent such flexibility and limit effective competition.

The proposed cost standard leads to inefficient entry

- 1.16 As set out in its economic analysis of Ofcom's proposals, Oxera concludes that they will introduce a significant distortion to the competitive process. This will have the effect of funding and promoting inefficient levels of end-to-end entry. The main reason is that Ofcom's proposals have the practical effect of imposing a price floor on Royal Mail's access pricing at FAC levels. This would provide entrants with an artificial source of competitive advantage.
- 1.17 The proposals feature a fixed zonal FAC ratio to be applied across all access products. Each product line would therefore require a constant level of mark-up across zones. Royal Mail's competitors would not be constrained to pricing at FAC, or to price on an equivalent basis, both zonally and at a customer level. Indeed, there are good reasons to expect that they would decide not to set their prices on such a basis.
- 1.18 The effect would also become more pronounced over time. As direct delivery grows, Royal Mail's FAC for each zone that experiences entry increases. The same or a similar amount of fixed costs would need to be recovered from reduced volumes. Royal Mail would become progressively less able to compete at both access and retail level even as competitors realise savings due to economies of scale. This is the perverse result of Ofcom's proposals.
- 1.19 Hence while the total revenue that the industry generates from sent mail could fall (to the benefit of mail senders), positive outcomes overall will occur only if this benefit outweighs the associated duplication of cost. The illustration below explains why this is unlikely to be the case.

Ofcom's proposals would accelerate a downward spiral

- 1.20 

Figure 1.1 

1.21  i

- 1.22 If access prices are tied to zonal FACs ratios and updated over time, and Royal Mail chooses to maintain its access margins, the access prices in the areas that have experienced increased competition would need to increase. If Royal Mail wanted to respond to entry by lowering its access price in the zone where entry occurred, it would have to also lower the prices across all other zones. This is likely not to be a feasible commercial strategy, and hence the zonal access price in areas that see direct delivery entry is likely to experience price increases.
- 1.23 This creates an incentive for the direct delivery entrant to roll out further in the zones that have seen the price increases. It is also contrary to the economic principle that Royal Mail should have flexibility to prices to respond to increased competition.
- 1.24 This effect would occur mostly in London and urban areas. And it would become more pronounced over time. The incentives to roll out increase as Royal Mail's unit FACs relative to entrant's costs increase. Eventually, some areas where the entrant's operation was originally less efficient than Royal Mail's operation would also be entered.
- 1.25 As Royal Mail volumes reduce, fixed costs become more pronounced. Because the access prices proposed by Ofcom will have to reflect zonal costs, the higher the unit cost in a given area, the higher Royal Mail's access prices will be for that area. This will likely encourage more switching to the entrant's network, which will benefit from scale economies. This would result in a further reduction in volumes for Royal Mail.
- 1.26 This accelerates a spiral of the type envisaged by Richard Hooper in his 2008 report,⁸ who

⁸ Hooper Report, "Modernise or Decline" December 2008, paragraphs 190-192.

predicted the emergence of “a situation in which competitors take advantage of Royal Mail’s universal service constraint to compete in a way to which Royal Mail is unable to respond. [...] The requirement to charge a uniform price across the country could, in theory, lead to “cherry picking” and a spiral of events in which unit costs rise and the universal service becomes unsustainable.”

A historic zonal cost base reduces incentives on Royal Mail to become more efficient

1.27 Royal Mail believes it would be inappropriate for Ofcom to put in place a difficult and protracted process before a move away from a historic zonal cost model could be effected. This will further exacerbate Royal Mail’s difficulties in competing even where it does drive down costs. This proposal would prevent Royal Mail from benefiting in price terms from improving its relative efficiency and so reduce efficiency incentives. It effectively re-creates something akin to Postcomm’s headroom price control. If implemented, some of the consequences would be:

- Royal Mail has made several key operational changes since 2012-13. None of these would be recognised in the proposed base costs.⁹
- Any future planned productivity improvements – either network-wide or zone-specific – would only be recognised in the cost models if Ofcom allows an update of the cost models and the associated prices. As a result, Royal Mail’s pricing could stay the same despite relative productivity improvements.¹⁰ This would further increase a direct delivery competitor’s price advantage.

1.28 Furthermore, this approach contradicts the approach Ofcom itself uses in the regulatory margin squeeze price control (USPA 6), which is prospective not historic.

Structural decline in letters volumes

1.29 Declining markets do not lend themselves well to the promotion of entry through regulatory support, due to the cost challenges linked with market shrinkage. As we set out in Chapter 2 of our June submission to Ofcom on direct delivery, e-substitution and other drivers have led to a decline of letter volumes over the last decade. This trend will continue.

1.30 Royal Mail continues to transform its operations to address these underlying pressures. Regulatory policy designed to artificially increase the level of direct delivery competition will lead to further unnecessary resource duplication in the labour-intensive delivery segment.

Ofcom justifies its proposals by asserting that Royal Mail’s efficiency performance will be enhanced sufficiently to outweigh the duplication of costs created

1.31 Ofcom has not published the modelling behind its proposals. Royal Mail has, therefore, commissioned Oxera to undertake an indicative assessment of how Ofcom’s proposals may impact industry costs.¹¹ The key results of this analysis are:

- Total industry costs increase as Whistl’s coverage or market share grows
- If Whistl were to reach their stated plans, the increase in total industry cost could be around  ii
- Based on what Royal Mail believes is a more credible roll out plan for Whistl under the access pricing proposals, the total industry cost increase is significantly higher

⁹ The changes took place particularly in London. Notably, this includes the closure of Rathbone Place (West Central Delivery Office) and the South and East London Mail Centres. Furthermore, Royal Mail is also in the process of selling the Nine Elms site for redevelopment that was previously South London Mail Centre. The full market cost for each of these sites will still be included within the 2012-13 ZCM that Ofcom is proposing to use.

¹⁰ For example, if Royal Mail makes a 2% efficiency saving in London in 2015-16, relative to the other 3 zones, it would not be able to reflect this in its future zonal access pricing as Ofcom is proposing to fix the relative cost difference between zones at the 2012-13 level. Ofcom recognises this at para 6.14.

¹¹ See detail of Oxera’s modelling in the Economic Analysis Annex.

- 1.32 Ofcom's central hypothesis is that competition in delivery will provide incentives to improve the efficiency of Royal Mail's delivery operations.¹² Ofcom suggests that these efficiency gains will outweigh the costs associated with resource duplication and losses from the Universal Service network. However, on a relative assessment, it is more likely that the costs attached to Ofcom's proposals would be greater than any realistic assessment of the realisable efficiency gains.
- 1.33 Royal Mail has faced competition from a variety of sources for a significant period of time. That competition is escalating. Royal Mail has faced competition in: bulk letters since 2004; all letters (through e-substitution) since the early 2000s and in the parcels market for many years, with significant new entry into the market in the last five years.
- 1.34 This, combined with pressure from shareholders to bear down on costs wherever possible, means that Royal Mail is already strongly incentivised to improve its efficiency. Ofcom's proposals would not create an additional spur. In fact, as noted above, they could reduce the incentives to achieve efficiency improvements.
- 1.35 Royal Mail has commissioned reviews of these issues from the IDEI at Toulouse University¹³ (the leading European postal economics institute) and Professor George Yarrow of the Regulatory Policy Institute.¹⁴ The analysis within these reviews indicates that:
- where an incumbent is required to deliver a uniform price USO, and;
 - where other operators already control a significant proportion of the access market;
 - a regime designed to promote direct delivery will lead to substantial and predictable static losses, and;
 - it is unlikely that efficiency gains can be sufficient to offset these.
- 1.36 Moreover, Professor Yarrow's paper notes that, in combination, the public policy objective of seeking to introduce competition and the emergence of e-substitution leads to a significantly greater challenge to the sustainability of the provision of the Universal Service. In relation to the access pricing regime, Professor Yarrow's paper notes that ideally this should take account of the cross subsidies that are required for the financing of the one-price-goes-anywhere Universal Service. Further, this raises the issue of the 'degree of fragility' of the regulatory arrangements. As demonstrated by the Californian electricity system in 2001 and the UK and US banking supervision before 2008, 'regulatory fragility' led to economic outcomes that fell very far short of the policy objectives of the regulatory arrangements. Professor Yarrow also observes that, in relation to UK postal regulation today 'the current arrangements give every impression of being fragile'.
- 1.37 This suggests that there needs to be a much more detailed review of all the relevant factors before a reasonable and properly considered decision on the appropriate regulatory framework can be made.

Royal Mail is developing its 2015 Business Plan

- 1.38 This plan will demonstrate the significant cost efficiencies required to address the structural decline in the letters market, increased parcel competition and to meet shareholder expectations. Royal Mail has already announced to the market that it is targeting a flat, or better, underlying UKPIL cost performance in 2015-16. This builds on the half year performance where underlying cost have been held flat.
- 1.39 The new plan sets out the best expectations on efficiency improvements. We believe that Ofcom should review our 2015 Business Plan, and complete its review of what might represent a reasonable rate of efficiency improvement for Royal Mail, before it can be in a position to consider properly options for a comprehensive regulatory framework. We are willing to cooperate fully with Ofcom in achieving that objective.

¹² Ofcom's APR consultation, December 2012, paras 1.9 and 4.72.

¹³ IDEI, *The implications of liberalizing the postal sector on welfare and pricing*, De Donder, Cremer and Rodriguez, February 2015, http://idei.fr/doc/wp/2015/wp_idei_846.pdf

¹⁴ Professor George Yarrow, *Universal Service Obligation in postal services: issues of robustness and fragility in current regulatory arrangements; a discussion paper*, February 2015, www.royalmailgroup.com/regulation/consultations.

Chapter 2: Ofcom's proposals are likely to have an adverse impact on the access market, including reduced choice for customers

- Royal Mail believes that Ofcom's proposals will likely lead to a reduction in competition in the access market.
- Access operators may have to exit the market. This would leave businesses with reduced choice for their mail service provider.
- The proposals may lead to price rises for access operators who do not have a direct delivery arm. These may have to be passed on to customers.

Development of the access market

- 2.1 The regulatory regime put in place by Postcomm promoted the development of access competition. Access now accounts for around 7.1 billion items per year (or 53%) of all addressed letter volumes. Access volumes have continued to grow until very recently. The UK has the most developed access market in Europe.
- 2.2 Access operators compete with one another, and with Royal Mail Retail, for customers' mailings. The largest contracts are won or lost over fractions of a penny per item. Competition in the access market is working effectively.

Royal Mail is already driving innovation in the mails market

- 2.3 Ofcom makes one reference to innovation in its consultation document, referring to "Mailmark". It attributes this development to Royal Mail responding to Whistl. This is not the case. The idea of Royal Mail adding a unique barcode onto a mail item and tracking it through the network began in 2009, well before Whistl had commenced its Direct Delivery operations.
- 2.4 Royal Mail has an on-going innovation programme. For example, we are investing to promote the use of advertising letters. This is to the benefit of the whole industry. E-substitution is the primary driver of innovation in the postal industry. Direct delivery provides no further spur.

Royal Mail is already subject to significant regulation in relation to access

- 2.5 Ofcom is proposing to impose a new control on the prices Royal Mail offers for access to its delivery network. Yet the regime already mandates that Royal Mail provide access to all its inward mail centres on fair, reasonable and not unduly discriminatory terms. Royal Mail is also subject to a regulatory margin squeeze price control on its access and retail prices. The proposed regime would now require Royal Mail to tie its zonal access prices closely to the specific costs it faces in each zone. This would significantly curtail the commercial freedom Royal Mail was given in 2012 to allow it to respond to a changing and declining market.

a) Impact on direct delivery

- 2.6 Ofcom does not provide an analysis of how direct delivery could evolve across the UK.
- 2.7 Whistl is presently the only operator with sufficient scale to operate its own delivery network in selected locations. The next largest carrier is UK Mail, and it has publicly stated that it has no intention to carry out direct delivery in the future.¹⁵

¹⁵ CEO of UK Mail testimony at a Business Select Committee hearing on 26th November 2014 (available online at <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-innovation-and-skills-committee/competition-in-the-uk-postal-sector-and-the-universal-service-obligation/oral/15871.html>). In particular answer to Q4.

- 2.8 A certain level of volume is required in an area for an entrant to run a profitable direct delivery operation. This level varies dramatically from one area to another. In the most urbanised areas, it can be as low as $\frac{1}{3}$ ⁱⁱⁱ local market share. However, in the most rural areas, even $\frac{1}{3}$ ^{iv} market share may not be profitable.
- 2.9 It is theoretically possible to have two or more additional direct delivery operators in the most urbanised areas. There are some smaller direct delivery operators at the local regional level, such as Velopost and CitiPost. But it is highly unlikely that there could be any widespread direct delivery operator other than Whistl.

b) Harming competition in the access market

- 2.10 Royal Mail believes that Ofcom's proposals will likely lead to significant consolidation of the access market. Once an operator combining access and direct delivery achieves a critical level of delivery point coverage, it will be in a position, and indeed incentivised, to offer its customers an aggregate end-to-end price lower than Royal Mail's access price. Whistl has indicated that it would look to offer a discount in areas where it has a direct delivery presence and this would typically be a reduction of 10%¹⁶ in areas where it has a direct delivery presence.
- 2.11 As direct delivery competition grows within particular zones, Royal Mail's unit costs for these areas will increase. Consequently, the zonal prices in these areas are likely to increase. However, due to Ofcom's proposal for the national price to equate to the volume weighted average of the zonal prices, an increase in zonal prices would lead to an increase in the national price plans. These are typically used by operators without a direct delivery operation.
- 2.12 This mechanism puts this group of operators at a further disadvantage compared to their rivals with direct delivery operations. It would not be possible for a company which continued to use Royal Mail for downstream access to compete with Whistl on price. It would be likely that other access operators will lose contracts as a result. They may exit the market, thereby reducing the intensity of access competition, limiting the choice available for customers, and ultimately leading to a likely increase in prices in the medium term.

c) Impact on users of postal services

- 2.13 Table 1 below assesses the likely impact of Ofcom's proposals on different users.

Group:		Impact:
Bulk Mail	Senders	<ul style="list-style-type: none"> Reduced choice of access operators due to access operators being unable to compete and exiting the market Real potential for higher prices in the medium term. Royal Mail will likely have to increase prices to make up the revenue gap resulting from direct delivery
	Receivers	<ul style="list-style-type: none"> Less transparency and more uncertainty over the delivery provider Reduced service quality for items delivered through a direct delivery competitor due to their lower delivery frequency Unlikely to receive any financial benefits (e.g. utility bills unlikely to be lower)
USO mail		<ul style="list-style-type: none"> Royal Mail likely to remain the only operator handling this type of mail Increases in unit costs due to lower volumes of bulk mail

¹⁶ 10% is the figure Whistl (formerly TNT Post UK) used in its first witness statement para 34 in the VAT court proceedings between The Queen on the application of TNT Post UK Limited and The Commissioners for Her Majesty's Revenue and Customs and Royal Mail Group Limited claim no: CO/5302/2011.

- 2.14 Ofcom has not provided an analysis of how its proposals will impact other key stakeholders in the access market, such as intermediaries,¹⁷ which represent almost half of all Royal Mail's access customers. Neither has Ofcom analysed the impact of its proposals on mailing houses, which are an important element of the postal value chain. There is a risk that some mailing houses may not be able to absorb the higher direct delivery prices that Ofcom's proposals may drive.
- 2.15 By making the introduction of sub-national price plans very difficult, Ofcom's proposals also have a strong bias for national operators, at the expense of regional access operators. There is a risk that these regional players will exit the market. Furthermore, the proposals curtail Royal Mail's ability to develop solutions for emerging customer needs. The restriction on new price plans substantially inhibits innovation in the market by Royal Mail's customers. It denies any customer who comes to Royal Mail with a novel request for an Access service or pricing proposal the first mover advantage that they would normally expect to get – as any new business ideas would have to be shared with the whole market in advance. Ofcom has not considered these important issues.

¹⁷ These are large mail producers and specialist print/production houses who offer a one stop shop facility to mail originators.

Chapter 3: Ofcom's proposals represent a materially retrogressive change from its 2012 regulatory framework

- Ofcom's 2012 regulatory framework sought to address significant challenges facing the postal market and gave Royal Mail much-needed new commercial freedoms. Ofcom now proposes to make a fundamental shift from this position and to introduce new price controls.
- The proposed zonal access regime would be more restrictive than under Postcomm – a regulatory regime Ofcom concluded was inappropriate and had failed. It would be one of the most restrictive access pricing regimes in Europe.
- The proposals would put in place a difficult and protracted process in order to move away from the four zone structure that Royal Mail uses for access pricing. This would stifle the ability to make changes to zonal structures that could be more cost-reflective and respond to changing customer needs.
- It appears that Ofcom's proposals are not in line with developments in the rest of Europe. The majority of EU regulation focuses more on the risks that could arise to the sustainability of the USO.

The 2012 regulatory framework

- 3.1 Ofcom's 2012 regulatory framework followed the Hooper reports (2008 and 2010) and the Postal Services Act 2011 (PSA 2011). These identified the changing competitive landscape of the postal market, and the shortcomings of the previous regulatory regime.¹⁸
- 3.2 Ofcom concluded that providing Royal Mail with commercial flexibility was necessary to protect the USO.¹⁹ Ofcom considered that *"there are real benefits to be gained from giving Royal Mail additional pricing flexibility. Royal Mail will be able to adapt readily to the changing market circumstances"*²⁰ It was Ofcom's view that Royal Mail was well placed to take commercial decisions necessary to secure the long term stability of the USO.²¹
- 3.3 Ofcom also concluded that regulatory certainty and stability was needed. It considered it appropriate to grant Royal Mail greater pricing flexibility, including in relation to access pricing, for seven years. Now less than three years later Ofcom has published the current proposals which would rescind those freedoms²² and introduce a more restrictive zonal access pricing constraint than that under Postcomm.
- 3.4 Royal Mail completely refutes Ofcom's suggestion that it would act inappropriately in the absence of these proposals.

¹⁸ Ofcom's 2012 document states *"The challenges [for Royal Mail] are set to continue. Mail volumes are likely to continue to decline as more customers switch to electronic alternatives. While mail will continue to play an essential role within the wider communications landscape, it has yet to reach a new steady state; and the future remains highly uncertain....price control-based approach [had] demonstrably failed to deliver on the required regulatory objectives specified at the time."* Sustainability of the USO paras 1.10 and 1.23.

¹⁹ Ofcom, Securing the Universal Postal Service, paragraph 1.16.

²⁰ *ibid*, Paragraph 1.24.

²¹ *ibid*, Paragraph 1.24 states "Royal Mail is necessarily better positioned than the regulator to take commercial decisions that are in its interests".

²² Paragraph 1.29.

Making use of commercial freedoms

3.5 In line with Ofcom's March 2013²³ guidance, in January 2014, Royal Mail attempted to use the commercial freedoms mentioned above to respond to competition and support the Universal Service.²⁴ The changes to access prices were a reasonable competitive response to market conditions. They were intended to support a financially sustainable Universal Service for the benefit of customers. The changes were never implemented. Following a complaint from Whistl, Ofcom opened an investigation in relation to certain of these changes, and consequently the contested changes were suspended by operation of the relevant contracts in February 2014. Royal Mail believes the complaint is unfounded. In the meantime, Royal Mail has implemented new access pricing for 2015.

Ofcom's proposals represent a fundamental shift from the 2012 regulatory framework

3.6 Ofcom's proposals represent a fundamental shift from its 2012 position. But, there is insufficient evidence and analysis set out in Ofcom's consultation document to support such a change. The existing regulatory controls ensure that access prices are, as required by Ofcom, fair, reasonable and not unduly discriminatory.

3.7 Ofcom does not discuss how Royal Mail's position has so markedly improved since 2012 to mean that its proposals are now appropriate. As set out in Ofcom's latest annual monitoring report, the Reported Business still has a margin below the indicative 5-10%. The range Ofcom stated was necessary for the USO to be financially sustainable.

Ofcom is consulting on creating a zonal access pricing regime more restrictive than that under Postcomm, a regulatory regime Ofcom concluded was inappropriate and had failed.²⁵

3.8 Under Postcomm, Royal Mail was subject to a zonal access price control. This meant relative prices for different zones could change by no more than 3% pa. In 2012, Ofcom (for the reasons set out above) removed this restriction. It instead introduced, *inter alia*, a new regulatory margin squeeze price control.

3.9 Under the proposed regime, Royal Mail would be denied the ability to respond through differentiated pricing to competitive pressures in direct delivery.

²³ Ofcom End-to-end competition in the postal sector. *Final guidance on Ofcom's approach to assessing the impact on the universal postal service*. March 2013.

²⁴ Ofcom's APR consultation, December 2014, paragraph 3.45.

²⁵ Ofcom 'Securing the Universal Postal Service' – decision document, March 2012: "*The lesson from recent experience is that a price control-based approach has demonstrably failed to deliver on the required regulatory objectives specified at the time*".

Table 2: Comparison of Postcomm, Ofcom 2012, and current zonal proposals

	Postcomm Zonal Regime	Ofcom's 2012 Zonal position	Ofcom's 2014 Zonal Proposals
Restrictions on zonal access pricing	Royal Mail can change relative prices for different zones by no more than 3% p.a.	Removed the constraint on the zonal tilt. Subject to prices being cost oriented and fair, reasonable and not unduly discriminatory	Royal Mail required to set zonal access charges in proportion to the corresponding zonal allocation of FAC. Without the 3% margin allowed under Postcomm. Freedom in principle to set the overall level
Restrictions on changes to zonal access pricing	Zones could be changed subject to consultation	Royal Mail to "take into account the frequency of ... revising the zonal structure" Planned guidance was not published by Ofcom	In practice, removes the ability to amend the zonal structure quickly Cost data based on historic 2012-13 zonal costing model
Margin Control	Headroom control. Royal Mail required to keep a fixed pence margin above its access price	Regulatory margin squeeze price control more akin to competition law. Cover upstream FAC for the basket of products and 50% upstream FAC at the individual contract level Intention to move to LRAIC when available	No proposed changes

The proposals and zonal structure would limit Royal Mail's ability to respond to changing customer needs

- 3.10 The current zones emerged from the failed Postcomm regime. This level of detail may have been sufficient to reflect costs when most of the postings were national and Royal Mail was able to reduce the tolerances as requested. But, they are not disaggregated enough to reflect delivery costs fully. It is also not appropriate to make it so difficult to change the existing four zone structure.
- 3.11 Ofcom considers that more disaggregated zones could complicate access charging. But Royal Mail's zonal charging is calculated using an automated IT system, which is easily scalable. Royal Mail does not, therefore, consider that increasing the number of zones would significantly complicate access charging.

Other European regulators do not actively promote direct delivery as proposed by Ofcom

- 3.12 If implemented, the proposals would create a postal access pricing regime that is one of the most restrictive in Europe. Postal markets are declining. It is unsurprising then that in all European countries, the USP has retained the majority of delivery volumes.
- 3.13 Royal Mail is not aware of any other European country that has taken the approach Ofcom is proposing. It appears that other regulators have not implemented similar regulations. In fact, the opposite is more common, the majority of regulation is focused on the risks that could arise to the USO.

Chapter 4: Ofcom's proposals do not satisfy the key legal tests it needs to meet to justify regulatory intervention

- Ofcom's proposals would amount to a price control decision. In order to justify the imposition of a price control, Ofcom needs to demonstrate that Royal Mail would otherwise charge excessive prices or prices leading to a price squeeze. Ofcom has not established that either of these requirements is met.
- In any event, Ofcom has failed to meet the statutory requirements for the imposition or modification of a USPA access condition, or a regulatory condition more generally.
- Ofcom is under a duty to carry out an impact assessment of its proposals, analysing the associated benefits and costs. That assessment should consider viable alternatives to Ofcom's preferred proposal. Ofcom has not met this duty.
- The exercise of Ofcom's regulatory powers is subject always to its primary duty under section 29(1) PSA 2011. But Ofcom's proposals fail to discharge this duty, since implementation of the proposals will risk provision of the Universal Service becoming unsustainable.

Ofcom's proposes a USP access condition containing a price control

- 4.1 Ofcom proposes to exercise its powers under section 38, 53, and Schedule 6 PSA 2011 to amend Royal Mail's USP access conditions to include the following:
1. a requirement that, for each mailing item, the ratio of zonal charges must equal the ratio of Royal Mail's unit zonal downstream FAC by format; and
 2. a requirement that Royal Mail derive its national charge for any individual access mailing item directly from its zonal offer, so that the national charge must equate to the volume weighted average of the zonal charges for the mailing item.
- 4.2 Ofcom's proposals:
- expressly prescribe the **relative level** of Royal Mail's zonal access pricing;
 - effectively determine the **absolute level** of Royal Mail's zonal access prices for the reasons explained in Chapter 1 above – by preventing Royal Mail rationally from setting any of its zonal access charges below its relevant zonal FAC.²⁶
- 4.3 On any view, the proposals concern the “prices that may be charged for the giving of access under an access condition” and would amount to a price control decision as defined in section 59(13)(b), PSA 2011. The upshot is that Ofcom may not implement any price controls (including the proposals) unless it appears to it that the requirements of section 38(5) & (6), PSA 2011 are satisfied.

Ofcom has failed to show its proposals meet the statutory requirements

The Proposals fail to meet the requirements for a price control

- 4.4 When imposing a price control, Ofcom needs to be satisfied that, absent such a measure, Royal Mail might (a) fix and maintain some or all of its prices at an excessively high level with adverse

²⁶ Ofcom recognises this at paragraph 7.12 of the APR consultation, December 2014 “Under our proposals, if Royal Mail were to reduce Zonal charges below the level of FAC in Zones where it faces the risk of entry, it will also need to reduce charges below FAC in other Zones and make a corresponding reduction in the national charge ... From our calculations ... it appears that for the strategy to be effective the profit sacrifice on the part of Royal Mail to execute it is likely to be significant (over c.£250m in the first year). Such a strategy would have a major impact on Royal Mail; with the potential for the Reported Business to become loss making (the profit sacrifice is likely to be approximately the same as Royal Mail's profit before tax).”

consequences for postal users or (b) impose a price squeeze with adverse consequences for postal users: section 38(5), PSA 2011. Ofcom has not identified or sought to rely on any risk of a price squeeze and has failed to demonstrate that there is any risk of excessive access prices absent the proposals.

- 4.5 Ofcom sets out its concerns regarding excessive pricing in paragraphs 4.11 to 4.24 of the Consultation Document. There is no attempt at quantification of the alleged excessive pricing risk. This is just articulated at a very high level with the aid of a simplistic diagram.
- 4.6 While Ofcom acknowledges at paragraph 4.11²⁷ that “access competition acts to reduce retail prices to some degree”, it also asserts that “absent end-to-end competition, or the threat of it, there is no significant competitive constraint on the returns Royal Mail might seek on its downstream costs”. Ofcom states in the same paragraph that “if Royal Mail were a near monopolist in end-to-end bulk mail delivery ... Royal Mail would have the incentive as well as the ability to price at up to the monopoly level”.
- 4.7 This is misconceived. It overlooks the fact that Royal Mail’s ability to charge excessive prices for letter post is constrained by (a) existing regulatory controls, including the requirements in USPA 3 and 5 that prices for access are fair and reasonable, and not unduly discriminatory; and (b) the threat of e-substitution (see Executive Summary and Chapter 1).
- 4.8 Further, Ofcom has failed to identify any cogent or compelling evidence in support of its assertion that “there is a strong probability that if we do not act now the prospect of end-to-end competition is likely to disappear for good”.²⁸
- 4.9 This conclusion appears largely to be based on an unquestioning acceptance of assertions made by Whistl. At paragraphs 4.23 and 4.24 of its consultation,²⁹ Ofcom relies exclusively on an excerpt from the witness statement of Nick Wells, (provided to it in support of a regulatory complaint from Whistl) regarding investment in Whistl’s end-to-end activities in support of the above conclusion.
- 4.10 Royal Mail does not know why Whistl may have had difficulties in persuading an investor to finance its end-to-end activities. It is also not clear to us that Ofcom has tested this evidence from Whistl, or indeed considered evidence from any other sources before reaching its conclusions. This is a particular concern when Whistl plainly has an incentive to overstate the scale of difficulties associated with its end-to-end roll out in order to secure favourable regulatory intervention.

Ofcom has not met the requirements for imposing USP Access conditions

- 4.11 Ofcom’s failure to establish that the proposals meet the requirements of section 38(5) is sufficient to prevent Ofcom from proceeding further with the proposals. However, Ofcom has further failed to establish that the requirements for the imposition of new USP Access conditions (both price controls and other access conditions) specified in section 38(4), PSA 2011 are met. In particular, Ofcom has not shown that its proposals are appropriate for: promoting efficiency, promoting effective competition or conferring significant benefits on the users of postal services.
- 4.12 Ofcom’s proposals do not promote efficiency (as explained in detail in Chapter 1 above).³⁰ At the most basic level, Ofcom cannot conclude that the efficiency benefits associated with the proposals – which it has not assessed³¹ – outweigh their costs – which it has also not assessed. Until its efficiency review has been completed, Ofcom’s cannot have a proper evidential basis for its conclusions about efficiency. Moreover, the conclusion already drawn prejudices that assessment.

²⁷ Ofcom’s APR consultation, December 2014.

²⁸ *ibid*, paragraph 4.24.

²⁹ *ibid*.

³⁰ Chapter 1, “The proposed cost standard leads to inefficient outcomes”.

³¹ Ofcom’s is only just starting its review of what might represent a reasonable rate of efficiency improvement.

- 4.13 Ofcom's proposals are not appropriate for promoting effective competition; in fact, as we set out in Chapter 1, Ofcom's proposals create a platform for inefficient entry.³²
- 4.14 Indeed, Ofcom has proposed a set of regulatory obligations that is inconsistent with these two aims: a price control and effective price floor based on an inappropriate measure of cost, namely FAC that will risk encouraging potentially inefficient entry.
- 4.15 A price control based on FAC is manifestly inappropriate. It is well-established, including in Ofcom's own decisional practice in other regulated sectors, that the appropriate measure of costs for use in price controls and other regulatory interventions is LRIC (as we discuss in Chapter 1).
- 4.16 These proposals are not appropriate for conferring significant benefits on the users of postal services. The analysis set out in Chapter 2 is that the effect of the proposals would be to harm access competition. They will likely lead to significant consolidation in the access market, and place access operators which do not operate direct delivery at a disadvantage,³³ with resultant negative impacts for users of mail services in terms of choice, price, transparency, and quality.³⁴ The proposals may also restrict Royal Mail's own ability to compete at the retail level by virtue of the regulatory margin squeeze price control in USPA 6.
- 4.17 Given these deficiencies, Ofcom cannot credibly claim that its proposals satisfy the basic requirements under Section 38(4) PSA11 for imposing access conditions – i.e. the requirements to promote efficiency, effective competition and confer significant benefits on customers.

Ofcom has not discharged its primary duty

- 4.18 The exercise of Ofcom's regulatory powers in relation to the postal sector is subject always to its primary duty under section 29(1) PSA 2011, namely to secure the provision of the Universal Service as specified from time to time ("**the primary duty**").³⁵ Ofcom is also subject to general duties under section 3(1), Communications Act 2003 (CA 2003) to further the interests of citizens in relation to communications matters and further the interests of consumers by promoting competition ("**the general duties**"). However, section 3(6A), CA 2003 makes clear that Ofcom's section 29(1) primary duty must take priority in the event of any conflict with the general duties.
- 4.19 In securing the provision of the Universal Service, Ofcom is required to have regard for the need for that provision to be financially sustainable and efficient before the end of a reasonable period and thereafter. Ofcom has itself interpreted the need for financial sustainability to mean that a 5% to 10% EBIT margin range is indicative of returns consistent with the financial sustainability of the Universal Service.³⁶ In relation to the requirement to become efficient, Ofcom has reached no conclusion; instead Ofcom has announced that it will aim to conclude its review of Royal mail's efficiency "*by the end of 2015/16*".³⁷
- 4.20 Ofcom states that its proposals will not risk provision of the Universal Service and are therefore consistent with its primary duty, on the basis that:
- in its End-to-End Statement dated 2 December 2014, Ofcom determined that end-to-end competition does not currently pose a threat to the financial sustainability of the Universal Service based on Whistl's current roll out plan.³⁸
 - Ofcom does not consider that its proposals would have a significant impact on Whistl's current roll out plan. Therefore Ofcom considers that its proposals would not pose a threat to the financial sustainability of the Universal Service.³⁹

³² Chapter 1, "Ofcom's proposals create a platform for inefficient entry".

³³ Chapter 2, "Harming competition in the access market".

³⁴ Chapter 2, "Impact on users of postal services".

³⁵ Section 38(8) PSA 2011.

³⁶ End-to-end competition in the postal sector – Ofcom's assessment of the responses to the draft guidance on end-to-end competition, paragraph 3.9; [March 2012 statement], paragraph 5.47.

³⁷ Ofcom, Draft Annual Plan 2015-16, 19 December 2014.

³⁸ Ofcom's APR consultation, December 2014, paragraph 4.66-4.70.

³⁹ *ibid*, paragraph 7.41-7.43.

- 4.21 Ofcom is not justified in reaching this conclusion. The end-to-end statement considers whether the existence of any end-to-end competition would jeopardise the provision of the Universal Service but does not undertake any proper analysis of the impact of these proposals on Royal Mail's ability to compete and to sustain the Universal Service.
- 4.22 Whilst paragraphs 7.41 to 7.43 of the consultation document are prefaced with the statement that "we find it very difficult to predict with any certainty or accuracy what Royal Mail might do in setting its access prices, if following consultation, the current proposals were imposed", Ofcom concludes that "we do not expect that this will have a significant impact on Whistl's current roll out plan". However, that conclusion is incorrect. As Royal Mail notes in Chapter 1, its analysis suggests that Ofcom's proposals will make the acceleration of Whistl's announced roll out more likely.⁴⁰
- 4.23 In any event, Ofcom has failed to recognise that (a) the proposals at least severely risk accelerating Whistl's roll out time table; and (b) whether or not they accelerate Whistl's roll out, for the reasons set out in Chapter 1 Ofcom's proposals would prevent Royal Mail from being able to compete effectively in those areas where direct delivery entry occurs, create a platform for inefficient entry, and ultimately accelerate a downward spiral.
- 4.24 As a result, the gravity of the risk the proposals create is, even on the approach to risk adopted by Ofcom, itself sufficient to put Ofcom in breach of its primary duty were it to take the proposals forward.
- 4.25 Ofcom asserts (for example, at paragraph 7.40)⁴¹ that the risks of the loss of bulk mail volumes as a result of its proposals are outweighed, in particular, by incentives on Royal Mail to realise efficiency improvements and pass these on to consumers.
- 4.26 This assertion is not supported by the evidence. First, Ofcom has only just started its efficiency review and therefore has made no assessment of Royal Mail's current rate of efficiency improvement. It cannot therefore have available the information reasonably required to assess whether promoting direct delivery competition through constraining access prices will drive enough efficiency gains to prevent harm to the future financial sustainability of the Universal Service. Secondly, Ofcom has not sought to analyse the impact of rising unit costs (by reason of loss of volumes to end-to-end competitors) against any putative efficiency gains to assess a net cost position.
- 4.27 Further, as noted below, Ofcom has failed to consider the impact of its proposed changes on Royal Mail's likely returns.

The proposals are not in line with statutory requirements for regulatory conditions and other relevant regulatory principles

- 4.28 Quite apart from and in addition to the primary duty, Ofcom must not impose any regulatory conditions under the PSA 2011 (whether price controls, USP access conditions or otherwise) unless it is satisfied that such conditions are (a) objectively justifiable, (b) not unduly discriminatory, (c) proportionate to their aims and (d) transparent as to what they are intended to achieve: see section 53 and paragraph 1, Schedule 6 to the PSA 2011.
- 4.29 The proposals fail to satisfy these requirements in a number of respects, for example:
- For the reasons set out in Chapters 1, 2 and 3, Ofcom's proposals are not objectively justifiable or proportionate to their aims. In particular, as explained below, Ofcom has not carried out a proper impact assessment of its proposals, including a thorough comparison between a wide range of options, and assessment of the risks and benefits of each (including maintaining

⁴⁰ Chapter 3, "Ofcom proposals will prevent Royal Mail from being able to effectively compete in those areas where Direct Delivery occurs".

⁴¹ Ofcom's APR consultation, December 2014.

the existing status quo) in light of Ofcom's duties. As a result, it is not clear how Ofcom has concluded that its proposals are justifiable or proportionate (see, for example, paragraphs 7.5 and 7.60 of the consultation document).

- Ofcom's proposals are unduly discriminatory, contrary to the requirement in paragraph 1(b), Schedule 6, PSA 2011. Royal Mail's own analysis demonstrates that the proposals function to the benefit of one operator, Whistl, and to the detriment to the ability fairly to compete of both Royal Mail and other access operators, particularly regional operators.⁴²
- Ofcom's proposals are neither transparent on their objectives nor consistent. Ofcom's proposals represent a significant and unjustifiable shift from the regulatory framework established in its March 2012 decision, the material regulatory obligations of which remain unused and tested by Ofcom, to a position that existed before the framework was introduced and which Ofcom itself has stated, failed.⁴³
- In particular, Ofcom's inconsistent regulatory conduct since 2012 has created significant uncertainty for Royal Mail and other postal operators, among others. Ofcom undertook in March 2012 to provide further guidance on access pricing, and at the same time encouraged Royal Mail to respond commercially to "*mitigate the direct impact of increased competition*".⁴⁴ The promised guidance on access pricing never materialised and Ofcom did not establish (and is yet to establish) how it would regulate the market should it assess that direct delivery had increased to a point where the Universal Service was at risk, and stated, in 2012, that "*there are real benefits to be gained from giving Royal Mail additional pricing flexibility*".⁴⁵ Less than just three years later, it is now proposing new restrictive regulations, including further price controls, on access pricing.

In addition to failing to satisfy the conditions under PSA 2011, Ofcom has misinterpreted and given undue priority to section 3(1)(b), CA 2003. First, for the reasons noted in Chapter 1 and 2, the proposals do not promote proper and effective competition, instead they unduly fetter Royal Mail's ability to compete and encourage inefficient entry. Secondly, and in any event, Ofcom has attached an undue prominence to the importance of promoting what it considers to be "*beneficial entry*". The duty established in section 3(1)(b) is to further the interests of consumers by promoting competition "*where appropriate*". Given the impacts on Royal Mail and the risks to the USO engendered by the proposals, it is clear that it is not appropriate to promote competition of this type (as identified by Ofcom) in these circumstances.

Ofcom has failed to conduct a proper impact assessment

- 4.30 As Ofcom acknowledges, it has a duty under Section 7 CA 2003 to carry out an impact assessment in putting forward its proposals. Ofcom appears to consider the analysis in the consultation document as a whole to represent an impact assessment pursuant to Section 7 CA 2003 (see, for example, paragraph 2.39).
- 4.31 However, it is clear that Ofcom has not carried out an adequate impact assessment of its proposals. In particular, Ofcom has not followed its own process for impact assessments in the consultation. Ofcom has not adequately defined its objectives, described appropriate options, or assessed each of the options against its objectives in a comparative fashion⁴⁶
- 4.32 Section 4 is the only part of the consultation where Ofcom mentions any regulatory options other than the proposed approach. In that Section, there is no comparison between the potential

⁴² See Chapter 1, "*Impact on direct delivery*".

⁴³ See Chapter 2, "*Ofcom is consulting on creating an access pricing regime than under Postcomm. A regulatory regime Ofcom concluded was inappropriate and had failed*".

⁴⁴ Ofcom March 2013 Direct Delivery Guidance

⁴⁵ Ofcom March 2012 decision document, paragraph 1.24.

⁴⁶ Paragraphs 2.1 and 3.7 of Ofcom's impact assessment guidance (Better policy-making: Ofcom's approach to impact assessment)

interventions and the eventual proposed approach (or indeed a comparison between ultimately rejected approaches), but instead a cursory overview of the benefits and purported flaws of each of the rejected approaches and the advantages of the chosen option.

- 4.33 A list of strengths and weaknesses of different options is not a substitute for comparing options against one another. The reason for this is that such a list does not give an account of why one particular strength or weakness is grounds for rejecting or accepting a proposed approach.
- 4.34 One key flaw arising out of Ofcom's approach is the fact that retail and a form of wholesale charge control are partially rejected on the basis that they do not offer "*flexibility to respond to competition and volume decline*". However, the proposed approach of controlling Royal Mail's pricing structure within Zones also reduces Royal Mail's ability to respond to competitive pressures within particular areas of high competition. It is therefore unclear why Ofcom believes that two approaches should be rejected as a result of purported pricing inflexibility, when the adopted proposed approach appears to suffer from the same problem.
- 4.35 In making an impact assessment, Ofcom's guidance states that "*(c)osts and benefits should be quantified where possible...where costs and benefits cannot be quantified precisely; [Ofcom] should aim to give broad estimates*" (paragraph 5.30). There is no proper quantification of the risks and benefits of Ofcom's proposals, and in particular, given Ofcom's primary duty in this regard, no attempt at quantification of the harm that will follow to the Universal Service from Ofcom's proposals.
- 4.36 Given these (and other) defects, Ofcom cannot maintain that its proposals are in compliance with the requirements of Section 7 CA 2003 or Ofcom's own guidance. More fundamentally, Ofcom has not quantified or assessed the likely impact of the proposals on Royal Mail's profitability. The consultation makes no attempt to assess the impact of the proposals on Royal Mail's ability to earn that margin Ofcom has itself identified as necessary for financial stability.

Annex 1: Responses to Ofcom's Consultation Questions

This annex provides short answers to Ofcom's specific questions. It should be read in conjunction with the whole of Royal Mail's response, in particular chapters 1-4 of our document and the Economic Analysis Annex.

Consultation question 1: Do you agree with Ofcom's analysis of the case for intervening as proposed in this section?

Royal Mail disagrees with Ofcom's analysis for intervention as proposed. Our response to the consultation sets out our reasons in full.

Ofcom's proposals would restrict Royal Mail's ability to respond to competition and skew the playing field in favour of direct delivery operators.

Royal Mail does not believe Ofcom has provided sufficient evidence to support its proposals. Ofcom's proposals are not based on compelling evidence. Nor are they supported by robust analysis. Ofcom is under a duty to carry out an impact assessment of its proposals. This includes analysing the associated benefits and costs. That assessment should consider viable alternatives to Ofcom's preferred proposal. Ofcom has not carried out such an impact assessment. It therefore cannot be satisfied that the statutory thresholds are met.

Ofcom's proposals represent a materially retrogressive change from the 2012 framework, including the introduction of a new price control. In order to justify the imposition of a price control, Ofcom needs to demonstrate that Royal Mail might otherwise charge excessive prices or prices leading to a price squeeze. Ofcom has not met these requirements. Ofcom has also not met any of its other statutory thresholds for imposing regulatory conditions of this type.

Ofcom's primary duty under the PSA 2011 is to secure the provision of the Universal Service. This includes regard for the need for that provision to be financially sustainable and efficient. But, these proposals fail to discharge this duty. Implementation of the proposals will risk the future sustainability of the Universal Service.

Consultation question 2: Do you think that the options of doing nothing and of imposing a price control on the level of Royal Mail's prices are not appropriate or proportionate [sic]?

Royal Mail presumes that this question intended to say:

Do you [THINK] that the options of doing nothing [OR] imposing a price control on the level of Royal Mail's [ZONAL ACCESS] prices are not appropriate or proportionate?

We answer on this basis.

We do not agree that Ofcom has demonstrated that imposing a price control on Royal Mail's access services is either appropriate or proportionate.

The access market functions well and is highly competitive. It has developed rapidly growing to 7.1 billion items in 2013-14. Three sizeable operators plus Royal Mail, and smaller and niche players, actively compete for volumes.

In 2012, Ofcom gave Royal Mail greater commercial flexibility in pricing – for at least seven years – to secure the Universal Service. Ofcom's proposals represent a fundamental shift from its 2012 position. But, there is not sufficient evidence and little analysis set out in Ofcom's consultation document to support such change.

Ofcom's conclusion that end-to-end competition will drive efficiency, and therefore result in lower prices for customers, assumes a number of market dynamics which may or may not occur. It is incumbent upon Ofcom to show that its proposals would not create unmanageable risks for the future finances of the Universal

Service. Ofcom's claims as to the net benefits of the proposals are not substantiated by evidence. They run contrary to the existing postal economic literature.

Ofcom has not fully considered other options open to it. That should include a full assessment of a "no change" option.

Consultation question 3: Do you agree with our approach to focus on existing Royal Mail zones to develop our response to the threats to end-to-end competition? If not, please set out your reasons?

Royal Mail disagrees with Ofcom's approach to focus on the existing four zones.

The current zones emerged from the failed Postcomm regime. They are not disaggregated enough to reflect delivery costs fully. This level of detail may have been sufficient to reflect costs when most of the postings were national and we were able to reduce tolerances as requested. But, it is less likely to be suitable for an environment with direct delivery.

For further reasons please see our response to question 4 below.

Consultation question 4: Is our proposed approach to the definition of 'Zones' appropriate?

In Annex 9 of this consultation, Ofcom's proposed modification to USPA 1.3 (section ZZZ) defines 'Zones' as:

"Zones" means the following four geographical areas into which the United Kingdom is divided for the purposes of this USPA Condition—

(i) **"Zone A (Urban)"** means the area comprising all —

(1) Geographic Postcode Sectors which —

(A) have both a Business Density of more than 10% and a Delivery Point Density of more than 500; or

(B) have a Delivery Point Density of more than 1,000 (irrespective of the Business Density), but excluding Postcode Sectors falling within the meaning of Zone D (London); and

(2) Non-Geographic Postcode Sectors, but excluding Postcode Sectors falling within the meaning of Zone D (London);

(ii) **"Zone B (Suburban)"** means the area comprising all Geographic Postcode Sectors which have a Delivery Point Density of between —

(1) equal to (or more than) 100; and

(2) no more than 1000,

but excluding Postcode Sectors falling within the meanings of Zone A (Urban) and Zone D (London), respectively;

(iii) **"Zone C (Rural)"** means the area comprising all Geographic Postcode Sectors which have a Delivery Point Density of less than 100, but excluding Postcode Sectors falling within the meanings of Zone A (Urban), Zone B (Suburban) and Zone D (London), respectively;

(iv) **"Zone D (London)"** means the area comprising all Postcode Sectors allocated to one or more London SSCs;

Royal Mail does not consider these definitions are appropriate. Ofcom has not provided any analysis to justify the thresholds between zones.

The zones, as discussed in question 3, are not sufficiently disaggregated to fully reflect differences in delivery cost. The urban definition permits a broad range of areas to be captured within this definition.

For example:

- The Moorfield's area of Liverpool (L2 5) has an equivalent of c.14,000 delivery points per Km² which is c.14x the requirement for the urban zone.
- The Calderstones Park area of Liverpool (L18 3) is also classed as urban, however has an equivalent of just 1,003 delivery points per Km².

This illustrates the very large differences in delivery points per square kilometre which are not captured by the current broad zone definitions. It highlights why disaggregation is essential to fully reflect differences in delivery cost.

There are alternative metrics that Ofcom has not considered that may avoid such discrepancies. For example, using the number of delivery points per kilometre of road length. We believe this, used alongside the existing density metric, could be a more robust measure of delivery cost and should be further considered.

Consultation question 5: Do you agree with our proposals regarding Zonal charges address our competition concerns? If not, please explain why.

Royal Mail disagrees with Ofcom's proposal regarding zonal charges as a means of addressing competition concerns.

The current regulatory regime is interpreted to be characterised by pricing flexibility within the DLRIC-DSAC 'tramlines'. One option for Ofcom would be to make these tramlines clear for all participants and consider how this may address any concerns.

Ofcom is seeking through its proposals to deliberately skew the market in favour of direct delivery competition, by preventing Royal Mail from competing on price. But, Ofcom has not provided analysis on how its proposals will impact other downstream access operators, intermediaries, mailing houses, regional direct delivery operators, indeed the access market as a whole.

Royal Mail believes that Ofcom's proposals are likely to lead to reduced competition, and reduced choice for customers, in the highly competitive access market. Ofcom's proposals create a contrived financial incentive for Whistl to develop an extensive direct delivery network. Access operators without a direct delivery arm could lose major customers. They may then exit the market. Based on this logic, it is difficult to see how the outcome of the proposals leads to a more pro-competitive total market outcome.

Another issue with the proposals concerns a number of Royal Mail's price discounts that are currently applied in absolute terms. Examples include tray discounts or responsible advertising (using recycled discounts). These discounts are not linked with a zone-specific activity. Hence, they should not be subject to a zonal price regulation. Under the current proposals, however, rather than being able to apply a flat discount across all zones, Royal Mail would be forced to differentiate the discount on a zonal basis.

In paragraph 5.30, Ofcom states that "*Charges intrinsically linked to the conveyance of bulk mail would be captured – for example, the extra sorting involved for those mailings that have not been pre-sorted by the access operator and the different handling processes required depending on whether mail is presented in bags or trays*". This overlooks the fact that Royal Mail does not currently offer an access service for non-pre-sorted mail.

Consultation question 6: Do you agree with the proposed weighted average rule? If not, please explain why.

Royal Mail agrees with the proposed weighted average rule. But, importantly, other factors must be taken

into consideration. For example, the 'NPP1' price plan should reflect the cost benefit to Royal Mail of receiving advance information about posting volumes at the local level compared to NPP2 and Zonal price plans.

Consultation question 7: Do you agree with our assessment of and proposed approach towards tolerances and profile surcharges on national contracts? If not what alternative would you propose?

Royal Mail agrees that Ofcom should not introduce additional regulation to mailing profile requirements, tolerances and profile surcharges.

It is important for Royal Mail to retain the flexibility to change profile requirements, tolerances and surcharges to reflect:

- i) changes in customer requirements and posting profiles, and
- ii) changes to measurement methodology and profile changes.

In paragraph 3.46, Ofcom states that *"On 5 November 2013, Royal Mail reduced the tolerances within which an NPP1 or an APP2 customer would be permitted to fail to meet Royal Mail's delivery profile."*

Royal Mail only announced a reduction to the applicable tolerances for APP2 on 5 November 2013. This change was not implemented and the relevant contract change notice is currently suspended as a result of Ofcom's competition law investigation. Royal Mail has also announced a change to the applicable tolerances for NPP1, but this was on 10 January 2014, not 5 November 2013. Again, this change was not implemented and the relevant contract change notice is currently suspended as a result of Ofcom's competition law investigation.

Consultation question 8: Do you agree that it is appropriate to prohibit non-Zonal sub-national pricing plans at this time? If not please state your reasons.

Royal Mail disagrees with Ofcom's proposal to prohibit sub-national pricing plans.

Sub-national plans may address specific customer requirements or, may be needed to address falling volumes in specific areas. For example, volumes in SSC 339 (Derby / Nottingham) have declined steeply even without Direct Delivery competition, and Royal Mail believes that there are operators in the area that would benefit from a price plan more closely tailored to their specific market conditions.

Consultation question 9: Do you agree that the appropriate measure of cost in relation to our proposals is Zonal FAC by format? If not please state your reasons.

Royal Mail does not agree that zonal FAC is the appropriate cost measure. This is explained at length by Oxera in the Economic Annex to our response.

Consultation question 10: Do you agree with our proposal to use historic cost data rather than forecast data? If not please state your reasons.

We do not agree that it is appropriate to use a specific historic zonal cost model version at a point in time.

Royal Mail believes that any framework should be based on the best, most up to date, information available. By proposing the use of historic, out of date, cost data Ofcom is preventing Royal Mail from reflecting any relative efficiency savings in our access pricing.

This will drive artificially high pricing for Royal Mail's access products. It would create an increasing competitive benefit for a direct delivery entrant as Royal Mail becomes more efficient. It will reduce, not enhance, the incentives on Royal Mail to become more efficient.

Royal Mail believes that this contravenes part of Ofcom's primary duty under Section 29 of the Postal Services Act 2011, which is:

“In performing their duty under subsection (1) OFCOM must have regard to —

(b) the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.”

Consultation question 11: Do you agree that we should require Royal Mail to use the 2012-13 ZCM, subject to a power for Ofcom to specify by direction that a different model be used? If not please give your reasons.

As stated in response to question 10, Royal Mail believes that any framework should be based on the best, most up to date, information available. Using historic information has flaws as outlined above.

Royal Mail believes that it would be appropriate for Ofcom to give consideration to the current zonal costing specification, regardless of year, and determine whether it is fit for the purpose it is considering. We believe that as outlined in answer to question 9, FAC is not the appropriate cost benchmark to use.

Consultation question 12: Do you have a view on the appropriate volumes to use as weights in the weighted average rule? Please provide reasons for your view.

In Royal Mail’s view, “*Option 1 – using Royal Mail’s access and retail bulk addressed letter and large letter mail volumes*”, is the most appropriate of the two proposed options.

This option is consistent with the relevant market that access services fall within. The alternative ‘Option 2’ would include USO and Response Service volumes that are not appropriate to be included in Access volumes. However, Royal Mail would suggest that flexibility is maintained for this definition to change as the market develops.

Consultation question 13: Do you agree that it is appropriate to use format level volumes as the weights in the ‘weighted average rule’? If not please give your reasons.

Royal Mail agrees that using the data at format level is simple, practical and consistent with zonal cost estimates. As Ofcom states, using service level volumes would require a difficult, complicated and costly sample to generate robust information.

Consultation question 14: Do you agree with our proposal that the legal instrument implementing our proposed regulatory changes will come into force six months after the publication of the final Statement on this review? If not please give your reasons.

Royal Mail would need the ability to implement any zonal pricing changes required by a shift in regulatory framework at the same time as its tariff. This is due to the linking of national contracts to zonal prices. This means any change to zonal prices could affect the national access price. In turn, this has implications for the regulatory margin squeeze price control and retail prices.

The timeframe for implementation alongside the January 2016 tariff would be August 2015. Should this cut-off date be missed, it would then be August 2016. Implementation would then be in January 2017.

Consultation question 15: Do you agree with the proposed scope of our review of the Zonal costing methodology to take place following the publication of our Statement? Are there any other issues that it would be appropriate to consider as part of the review?

Royal Mail believes that it would be highly inappropriate for Ofcom to impose the proposed framework prior to completing a review of the zonal costing methodology that would underpin it.

As outlined in answer to questions 9 and 11, Royal Mail believes it would be inappropriate for Ofcom to impose a framework based on FAC, and as outlined in answer to Question 4, any review of zonal costing should also include a review of the zonal definitions.

Consultation question 16: Do you consider that there is a need for a structured compliance process with respect to the proposed remedies? If so, why and what would be the value of such a process, if not why not?

Royal Mail does not believe that the proposed remedies are appropriate as set out in answer to question 2. Therefore, an appropriate framework would first need to be defined before it could be determined whether a structured compliance process was required.

Consultation question 17: If we were to establish a compliance process what form should it take?

Not applicable.

Consultation question 18: Do you consider there are reasons we should extend the access obligation to the Crown dependencies? If so please state your reasons.

Royal Mail does not believe that the access obligation should be extended to the crown dependencies; this would represent an unnecessary increase in regulation.

However, since Crown dependencies are currently treated as domestic destinations under our business bulk mail sortation services, Royal Mail believes that so long as this remains the case it is appropriate that their associated costs should be included in the rural zone in the ZCM. This would be consistent with Royal Mail's view on the appropriate volumes to use as weights in the weighted average rule ('Option 1') as outlined in response to Question 12.

Consultation question 19: Do you agree that our proposals are likely to address the concerns we have identified? Are there ways that Royal Mail could take action which would undermine the effectiveness of our proposals?

Royal Mail believes the framework proposed by Ofcom threatens to destabilise the access market. This would result in reduced access competition, reduced customer choice and likely lead to higher prices in the medium term.

The second part of this question is targeted at respondents other than Royal Mail and therefore it is not for us to provide an answer.

Consultation question 20: Do you agree with our assessment of the impact of our proposals? If not, please explain why.

Ofcom has failed to provide an appropriate impact assessment. It has not provided any modelling analysis to demonstrate that outcomes, including outcomes around efficiency, will be realised.

Ofcom's primary duty under the PSA 2011 is to secure the provision of the Universal Service. This includes regard for the need for that provision to be financially sustainable and efficient. But, Ofcom's proposals failure to discharge this duty. Implementation of the proposals will risk provision of the Universal Service becoming unsustainable in the future.

Royal Mail therefore does not agree with Ofcom's assessment.

Consultation question 21: Do you agree with our proposals, if not please explain why?

This question is answered by our consultation response. Royal Mail does not agree with Ofcom's proposals. Nevertheless, we would welcome the opportunity to work with Ofcom to put in place a comprehensive regulatory framework that would support the USO and competition.

Consultation question 22: does the way in which we have drafted the proposed modified access condition appropriately reflect the proposals and in particular do you find it sufficiently clear? In your response, you should suggest alternative wording if you have drafting concerns.

As outlined in the preceding document and question answers, we believe the proposed condition is fundamentally flawed. Therefore, it should not be implemented as drafted.

Question 23: Which of our proposed two alternative definitions of ‘Relevant Postal Services’ discussed above do you prefer and what are your reasons for your preference?

This question is substantially similar to consultation question 12 above. We therefore believe we have already answered this question in our answer to question 12.

Question 24: Do you agree with our proposal to base the concepts related to the concept and definition of ‘Zones’ on Royal Mail’s own methodology (as referred to above)? If not, please explain in detail why.

This question is substantially similar to consultation question 4 above. We therefore believe we have already answered this question in our answer to question 4.

Question 25: Do you have any comments on our proposed new concepts and their definitions discussed in this Annex?

Ofcom Consultation on Access Pricing and Policy Review – Annex 9 Amendments

Clause reference	Comment/query	Proposed change
USPA 1.3 (e)	Fees for Mail Collection of non-compliant items should be excluded. An additional allowance should be made for exclusion of promotions or incentives.	Add an exemption for fees for Mail Collection and any other fees associated with provision of access. Add an exemption for incentives.
USPA 1.3 (o)	It is not clear if this definition means that C9 agreements are a different product or if they will be deemed to be the same? Royal Mail does not see that this definition is sufficiently clear.	Royal Mail has different provisions in the standard C9 agreement in clause 8 (termination rights) and clause 13 (changes). Therefore Royal Mail suggests it is necessary for C9 to be deemed a separate Access Service for this purpose.
USPA 1.3 (q)	Royal Mail believes that this definition is inaccurate. The use of the term postal packets is not relevant to USPA conditions since USPA only relates to Letters and Large Letters.	Amend term ‘Postal Packets’ to ‘Mailing Items’.
USPA 1.3 (r)	The definition of a ‘Delivery Point’ as “any more or premises of any individual or other person in the United Kingdom” is sufficient and Ofcom does not need to reserve right to approve any other delivery point.	Simplify the definition of ‘Delivery Point’ to mean “any home or premises of any individual or other person in the United Kingdom.”

USPA 1.3 (hh)	This definition of IMC activity is inaccurate since final sorting is not necessarily done by machines at mail centres. This activity is also undertaken by machines located in MPUs and by staff in delivery offices.	Simplify the definition of 'IMC' to mean: "The mail centre processing phase in which activities are undertaken to sort mail to the delivery offices served by the given mail centre".
USPA 1.3 (kk) i	The condition as drafted references specific SSCs by number. The numbering of SSCs does not remain static overtime as they denote work plans in mail centres. Each time new work plan is created (about every 12 - 18 months) it prompts a change to the Access Selection Files and new number ranges are created.	Royal Mail suggests that to future-proof the condition SSCs are not explicitly referenced by number as these will become out of date.
USPA 1.3 (kk) ii	This condition is unnecessary as there is already a mechanistic calculation to determine whether an SSC falls within the London zone. Ofcom therefore does not need to reserve any right to direct Royal Mail to override this calculation.	To remove this whole paragraph.
USPA 1.3 (nn)	As drafted this definition of 'Minimum Posting Requirements' is overly restrictive by defining that it applies to any geographic area that is not smaller than the United Kingdom. This would mean that Royal Mail would be unable to offer reduced minimum volume levels for smaller regional access operators.	To remove application to specific geography.
USPA 1.3 (rr)	This definition of 'Postcode Sector' is inaccurate.	Correct definition: "A Postcode Sector means the first two, three, or four alphanumeric digits of an outward Postcode plus the first numeric digit of the inward Postcode which is used to identify a geographical area for Mailing Items to be delivered".
USPA 1.3 (eee)	As outlined in our answer to Consultation Questions 12 and 23, Option 1 is consistent with the relevant market that access services fall within and is therefore the most appropriate of the two options proposed.	Delete Option 2
USPA 1.3 (jjj)	This definition of 'SSC' is inaccurate. It is incorrect to say: i) that an SSC is three digit numeric code ii) that groups of Postcodes belonging to a Postcode Sector only have one Delivery Office.	This definition be amended to state that an SSC: "means a unique three digit numeric code used from time to time, as published in data files (known as the 'Access Selection Files' at the time that USPA 6A enters into force), by the universal service provider".

Question 26: Do you have any comments on our proposed corrections to the USPA Condition discussed in this Annex that are unrelated to our proposed new remedies in USPA 2.1A, USPA 6A and USPA 6B (and their associated new expressions)?

This question is substantially similar to consultation question 25 above. We therefore believe we have already answered this question in our answer to question 25.

Question 27: Do you agree with our thinking and proposals for the rounding (decimal places) to assess compliance with our proposed new remedies in USPA 6A and USPA 6B? If not, please explain in detail why.

Royal Mail agrees with this element of the proposal. The national price in USPA 6B.2 is set to 1 decimal place, but we already quote prices at 3 decimal places.

The most flexible option for Royal Mail would be to have as few decimal places as was practical as it would allow for volume distribution changes over time.

Redactions and Confidentiality

Royal Mail is of the opinion that selected information supplied in this submission is absolutely commercially confidential and that its disclosure in any form would have an extremely prejudicial effect on its commercial interests. Further that there could be no public interest or other argument which could possibly justify the disclosure of the information supplied; in whole or in part, without obtaining Royal Mail's express written consent in advance.

In accordance with Ofcom's request to supply a written explanation as to why any document or information is considered to be confidential we have divided up the reasons for asserting its confidentiality into nine categories.

Category 1: Inside information can be broadly defined as precise, non-public information relating directly or indirectly to the Company which, if made public, would be likely to have a significant effect on the price of the Company's shares.

Category 2: Commercially valuable information, not in the public domain, including but not confined to Royal Mail's market share, costs, volumes, revenues, savings, productivity, margin information (or similar information), or information which could be used to derive such data. Disclosure of this information would mean that Royal Mail's competitors would have access to commercially sensitive data, which would seriously affect Royal Mail's ability to participate successfully in its commercial activities.

Category 3: Third party information - Any disclosure of this information could potentially harm a third party, unless express consent has been obtained by Ofcom from the party in question for publication. See also Category 4 below.

Category 4: Customer information - Disclosure of this business sensitive information might seriously and prejudicially affect Royal Mail's business interests as competitors would unfairly and unnecessarily be given the opportunity to target specific Royal Mail customers. The result could well be a detrimental impact on commercial revenues, which would weaken Royal Mail's ability to compete in a fully liberalised market environment.

Category 5: Correspondence containing individual names- Disclosure of, or even disclosure of the very existence of, correspondence containing individual names, including that of customers, could potentially harm a third party's commercial interest, without Ofcom having first sought and obtained express consent from that party for the particular purpose. Disclosure without consent may also put Royal Mail and its Regulators in breach of Data Protection legislation.

Category 6: Information which sets out specific internal Royal Mail procedures, processes, measures, performance (whether operational, financial, sales or marketing) or speed of potential Royal Mail response. Disclosure of this detailed information could again seriously and prejudicially harm Royal Mail's interests by enabling competitors to bid for traffic against Royal Mail with more than purely normal commercial information (which is already

in the public domain) about a competitor's offering and operation at their disposal. Disclosure of processes and procedures could adversely affect the security of the mail, putting both Royal Mail staff and mail at risk. Information relating to contingency arrangements for dealing with industrial relations could prevent the successful implementation of such arrangements, prolonging disputes and affecting quality of service.

Category 7: Details of Royal Mail's strategic business plans / cases/ potential scenarios and the supporting modelling analysis and rationale for all its future and past activities. Public disclosure of this information which contains, forecasts, strategic business plans, outcomes both actual and anticipated, analysis and intentions would seriously and prejudicially harm Royal Mail's future commercial interests. Such information would obviously be of particular interest to competitors of Royal Mail. One clear serious consequence of putting into the public domain Royal Mail's internal commercial (and sometimes not yet concluded) thinking,

which has been shared with Ofcom in confidence solely in order to explain business rationale, or as required by the regulator and /or to seek guidance from the regulator, would be to weaken Royal Mail's ability to compete in a fully liberalised market environment and to enhance the knowledge of competitors unjustifiably and unreasonably.

Category 8: Details of Royal Mail's labour environment. Disclosure without consent could have a major impact on industrial relations, Royal Mail's relationships and negotiations with the Trade Unions and adversely impact on the transformation programme.

Category 9: Material over which Royal Mail or third parties claim intellectual property rights are confidential as unauthorised disclosure could lead to action.

List of Redactions and Confidentiality Claims:

- i Category 2
- ii Category 2
- iii Category 2
- iv Category 2