BRIEFING FOR ANALYSTS:  
THE REGULATORY FRAMEWORK  
FOR POSTAL SERVICES  

Thursday, 18 July 2013  

INTRODUCTION  

Ed Richards  
Chief Executive  

Good afternoon, everybody, and thank you for coming. My name is Ed Richards  
and, for those of you who don’t know me, I am Chief Executive of Ofcom. To my left here  
are Stuart McIntosh, Group Director of our Competition team, and Chris Rowsell, who is one  
of our Competition Policy Directors, who leads in this area.  

This afternoon, I shall say a few words by way of introduction. Stuart will then talk  
about the overall legislative and regulatory approach and Chris will talk about the regulatory  
framework in a little more detail. We will then have some Q&A.  

Let me say a couple of things by way of introduction. First, I think it would be helpful  
to get the housekeeping issues out of the way. If you could keep the Q&A until the end, that  
would be much easier for everybody. If you are on the webcast, because we are webcasting  
this, you can submit a question at analyst.relations@ofcom.org.uk so please feel free to do  
that. We will make all of this available on the website as soon as we can after the event.  
The last thing to say is that because we are webcasting this, if you have a mobile phone  
please could you turn it off if you have not already done so. Thank you.  

About Ofcom  

First, a word about us, for those of you who don’t know us. Some of you will and  
some of you will not. We regulate the whole of the communications sector where it is  
formally regulated, so that means the whole of telecommunications, both mobile and fixed. It  
means the media, television and radio, and it means some aspects around the edges of  
those regulated areas which I think are well known. It also means all of spectrum, as one of  
the inputs to some of those services. It now, of course, means post as well, which is the  
subject for today, and we will come on to that in greater detail.  

For those of you who don’t know us, this is the kind of event we do reasonably  
routinely for the sectors that we have regulated for a great many years – for telecoms and  
media in particular. We don’t have a fixed schedule for them but we do them in light of what
is going on but, typically, we would expect to do one session of this kind at least once and possibly twice a year, depending on the level of activity and depending on the level of interest. This is therefore not a special event, unique to post or unique to Royal Mail and the present circumstances, but it is something that we have done on and off for the last 10 years, and which we would expect to continue to do in the coming years in relation to postal services.

Let me talk first about a couple of areas by way of introduction. The first is our regulatory principles and the second is how that and those ideas manifest themselves in terms of our approach to regulation. We have set out the regulatory principles there [on slide]: I will not read them out individually because you can read them yourselves, but let me just highlight a couple of them.

Perhaps the middle one is worth emphasising, particularly for those who have not come across us before. We try to do everything we can by using a very strong evidence base. We are quite analytical as an organisation and we don’t take decisions in the absence of evidence as well as argument. We have to be, and we try very strongly to be, proportionate in what we do. We try to be consistent. We are accountable in all sorts of different ways and we also try to be transparent in the decisions that we make. We are not in any way interested in making clever or surprising decisions but we are trying to set out arguments, set out evidence and set out reasoning which can be challenged, discussed, debated and through which we can then make sure that everybody understands what we are trying to do and why we are trying to do it. That is our objective and that is the approach that we try to take in everything we do. That is also why you will see that one of the other regulatory principles is to consult widely and to assess the impact of regulatory action. Those are the kinds of things we try to do whenever we are making a decision.

Just to highlight some of the areas in which that manifests itself, which perhaps are not always where people assume a regulator might be, although it is certainly where we are. It means that we are as interested in deregulation as we are in regulation. We don’t sit in here thinking about how we can find another 10 ways to regulate things. We are asking ourselves what is in the public interest, what is our role in relation to our duties and whether we need to regulate. We also ask ourselves whether we can deregulate and, as you already know, in this area, there has been substantial deregulation which we can talk about in some more detail. That is the frame of mind that we will bring to questions in this area as we have done in other areas.

We want to see companies make a return. We are not interested in pinning companies down to the bare minimum and we are not interested in taking an approach there
which is inconsistent with economically sustainable, competitive businesses, and that inherently means making a return. We will allow, and have a very clear record of ensuring that we set up the right incentive mechanisms. We will set a control or an approach for a period and that, in a sense, is the regulatory compact at a point in time. If a company, or companies, out-perform that within that control period, then that is what we want to encourage. We want to see an incentive there to do better, to out-perform, to drive efficiency and so on and so forth. We are relaxed about that and indeed that is exactly the kind of incentive that we want to see working.

It is also important to emphasise our recognition of the importance of stability and predictability. Many of the industries and many of the companies with which we work have very long-term horizons. This varies of course, but you will all know about the major network investments being made in both mobile and fixed in the telecommunications sector. This is the kind of environment which requires clarity, which requires predictability and requires stability. These are some of the things that are right at the heart of the way we think about how we do regulation across the board in our area of responsibility.

**Ofcom as the postal regulator**

Let’s just recap at the highest level, before I hand over to Stuart. As you will all know, the argument for a change in the regulatory environment for post has been made over a great many years. It became extremely clear in the context of the two reports – particularly the original report by Richard Hooper which made that argument very, very strongly. Many of you will know that Richard Hooper was of course a deputy chairman here for some years and so his report in that area did not come as a surprise to us and, indeed, it didn’t come as a surprise to us that subsequently the regulatory responsibilities were transferred to us. The arguments made are well-rehearsed and I won’t go through them myself in detail but perhaps instead I will pick up how that legislative framework coincides and is consistent with our own regulatory principles.

There are just four highlights where I think we are very strongly aligned.

- The first is where there is a clear intention to ensure the sustainability of the USO.
- Secondly, where there is a fundamental and strong sense of the opportunity for deregulation, with the challenge to present a change in the regime.
- The third is the idea of greater commercial freedom and that ability to earn an economic return.
- Fourth, it is to underline the attraction of stability and predictability. One of the things we have done, as I hope many of you will know, is to set a seven year period, which
is an unusually long period for a regulatory settlement. The purpose behind that is of course to ensure stability, predictability and also for an extended period in which there is an opportunity to out-perform a given settlement. That is an important feature of what we have done and Stuart and Chris will talk about that in greater detail.

With that, let me hand over to Stuart.

THE NEW LEGISLATIVE AND REGULATORY APPROACH

Stuart McIntosh
Group Director, Competition

Good afternoon, ladies and gentlemen. I am very pleased to have the opportunity to speak to you and, for those of you for whom it is your first time at Ofcom, very much to welcome you.

As Ed has said, I would like to provide an overview in terms of the legislative framework and the regulatory framework for post. Chris will talk about that in a little greater detail. If you will excuse the pun, 27 March 2012 was something of a red-letter day for us: that was the day on which we published our statement, securing the universal postal service. That really set out the foundations of the new regulatory framework for post and, if you have not yet had the opportunity to look at that document, I suggest that it is probably a very good starting point because it is a very substantive document with a discussion of the issues in post and setting out that framework that we anticipated taking forward.

We actually assumed responsibility for regulating post in October 2011 and so, in a sense, we had been on the job for six months at that point. However, it is probably important that you appreciate that we had worked very closely with the previous regulator, Postcomm, for a period of about a year leading up to the transition of those regulatory powers. That was obviously intended to make sure that there was a smooth and effective transition and also that we were in a good position to understand the market and the regulatory issues in post as we looked at what changes needed to be made in the regulatory framework. Our framework is not simply the product of a few months’ work but rather it is quite a considered piece of work stretching over a year or more.
Postal Services Act 2011 implemented the key recommendations of the Hooper reports

The changes in the regulatory framework really flowed from the Postal Services Act which was enacted in 2011. As I think you will be familiar with, there were three big provisions in that Act. One was to allow for the introduction of private sector capital into Royal Mail – something which is a very live and topical issue at the moment. Second, was transferring the responsibility for Royal Mail’s historic pension deficit to Government, which has now happened. Third, as Ed mentioned, it involved transferring responsibility for the regulation of the postal sector from Postcomm to Ofcom. In effect, many of the people from Postcomm integrated into Ofcom but the actual formal responsibility moved over to Ofcom, as I said, at the beginning of October 2011.

The final point to note is that the regime changed from one based on licences to a general authorisations regime, whereby any party who wishes to do so, can enter into the provision and delivery of postal services. It moved away from one where there is a very, very detailed, quite prescriptive licence that applied to Royal Mail, as well as there being some licences which applied to other parties in the sector.

The Act set out in quite specific details what our responsibilities are as a regulator. For those of you who follow regulation I think you will be aware of this but we regulators are the creatures of statute: we can only do what we are allowed to do in the statutory framework given our duty. That is a very important starting point for us, as we think about our duties and responsibilities, and what powers and tools we have to do our job as a regulator. It is probably quite important that, if you want to understand the regulatory environment, that you look at the Act.

Our duties with respect to the postal sector

Our primary duty is very, very clear. It is to carry out our functions and our activities in a way that we consider will secure the provision of a universal postal service. In doing that, however, we do have other duties. In particular, we have a duty to make sure that the provision of that universal postal service should be financially sustainable, That includes the need for the provider of that universal service to be able to earn a reasonable commercial rate of return on its activities, but also that it be provided efficiently and that it be brought to an appropriate level of efficiency within a reasonable period and for that to continue to be the case. That is the primary focus and it is very important that you understand that our duties in respect of the sector all stem from that duty in respect of the universal postal service.

Our general duty, as Ofcom, is to further the interests of consumers and citizens, where appropriate, by promoting competition. That duty applies also to our activities in the
postal sector. However, the Postal Services Act makes it very clear that, insofar as there is a conflict between those duties, our duties in respect of Post will take precedence.

**Implementing a new regulatory framework**

If we look at the challenge of implementing or devising a new regulatory framework, there are a number of things which became very clear to us as we investigated and sought to understand the sector and we began to work with our colleagues in Postcomm. Again, I suspect that many of you have been following the postal sector and the logistics sector for a number of years and some of this will be quite familiar to you. It is things like the structural changes in the way that people are using the postal service. Mail volumes, and particularly traditional letter volumes, peaked around 2006 in the UK and have been in decline subsequently, in large measure because of what is going on in some of the other sectors that we regulate, with the move towards the use of mobile phones, the move towards texting, the move towards email and so forth. That structural trend, in terms of what is happening to mail volumes, is set to continue. By around the time we took over, mail volumes had declined about 25 per cent from that peak and was yet at a point where the growth in the parcel volumes was not quite beginning to counterbalance that.

Secondly, partly because of those structural changes in the market but also, I have to say, because of the regulatory arrangements that applied up to that point, Royal Mail was in quite a challenging financial position, certainly at the time when we took over responsibility for regulation. Given those structural trends, it seemed to us relatively evident that changes needed to be made in the regulatory environment, in order to allow the company to be able to respond to those. That is referred to in the next point.

Despite these quite significant changes in the market, with the shift from letters to the growth in parcels, there was a fairly traditional regulatory model applied to Royal Mail at that time. Somewhere in the region of 80 per cent of Royal Mail’s overall revenues were subject to direct price regulation of one form or another. There was also quite intrusive involvement in the management of the company and, for about a year before we assumed regulatory responsibility for Post, I and several others of the Ofcom Board members served as members of the Postcomm Commission. That, again, was allow us to gain a good understanding as to issues in the industry and how the sector was regulated at that point. One of the things I was quite struck by was - given that regulatory environment - the degree to which many issues which you would ordinarily consider to be issues for the management of the companies in question to deal with as a matter of routine were finding their way to the regulator. We found that that was quite an interesting contrast with our experience in other sectors.
In light of this, and obviously with a great deal of further detailed work that we did in the year leading up to the time when we assumed responsibility, we came to the conclusion that quite a radical change was required in the way that the postal sector is regulated. This echoes very strongly some of the comments that Ed made in his introduction. We are not a regulator who seeks to regulate things for the sake of it but we try to understand what the issues are and the extent to which the market or other means will address those issues, and then to understand, if there is a need for regulation, what is the focus and targeted regulatory intervention that is appropriate.

The new deregulatory 7-year regime is designed to support sustainability of universal service

Given the circumstances as we found them, and as we expected them to unfold in the coming years, we concluded that in light of our responsibility and duty with regard to the universal postal service, there was a need to provide clarity and stability to the industry generally in the regulatory regime. We decided therefore that the new regime should run for a period of seven years, which is quite long in relation to some of the other precedents. In telecommunications, for example, the regulatory framework there particularly when it comes to things like charge controls, in the early days of regulation they started off at five years and migrated to four and are now at three. We felt that, given the specific circumstances of Post, there was a need for a longer period of regulatory certainty and stability and thus we opted for seven years.

Second, we removed the vast majority of the regulatory controls that applied to Royal Mail’s pricing, be those retail controls or wholesale and, in particular, the prices set for access to Royal Mail’s network. Related to access, we removed the headroom control, which set a guaranteed margin between Royal Mail’s retail price and the access price paid by other companies to access the Royal Mail market.

Finally, we enacted a number of measures to provide the company with more flexibility. You will remember that I was talking a moment ago about the extent to which the old licensing regime inevitably led to the regulator being involved in a number of company issues. We thought that much of that could be stripped back and so one of the other things we did was specifically to address those issues as well.
But with key safeguards

In making those changes, however, we felt it was very important to put a key few safeguards in place. In particular, we wanted to make sure that there was a core letter service which was available to all consumers in the UK at a guaranteed, affordable price. We determined that that was likely to be 55 pence for each second class stamped letter and we set that as a cap on the price. We then also decided that that should be indexed relative to the CPI over the seven year period. You will probably have seen some details in relation to that. We applied a similar control in respect of small packets and parcels of weight up to 2kg.

Secondly, we put in place what we believe to be a very effective monitoring regime to make sure that we understand that Royal Mail is delivering the universal service, so that we understand that the quality of service targets are being met, and so that we understand that the mail services are being provided six days per week around the country, as is required. It is also so that we understand what is happening to the financial sustainability of the universal postal service and, as you will remember, that is one of our subsidiary and very important duties, and it is also so that we also understand what is happening to efficiency and productivity over time. Chris will talk in a little more detail about how we are doing that in practice.

The third thing we did was to provide for continued competition in the mail market. We continued an obligation which had been imposed under Postcomm, whereby Royal Mail is required to provide access to its inward mail centres, for companies who want to access its delivery network for bulk mail. However, as I mentioned earlier, we took away the controls which had applied to the setting of that price.

With that providing an overall framework, I will now ask Chris to talk you through some of the details.

THE REGULATORY FRAMEWORK IN MORE DETAIL

Chris Rowsell
Competition Policy Director

I will take you through a little more detail on, particularly, the universal service, and then on how we have approached assessing financial sustainability of Royal Mail. The operational freedoms and the changes we have made in that area; what we are doing around competition and our approach in that area, and our current and planned works, which give you an update of where we are.
The universal service

On the universal service, this is very much at the heart of the Postal Services Act and at the heart of Ofcom’s duties with regard to postal regulation. The Act will refer continuously to the universal service provider and to the universal service and, essentially, it is our duty to ensure that the universal postal service is delivered.

The Act sets the minimum requirements for the universal service

What is that? The Act sets out what it refers to as the minimum requirements for the universal service:

- Letters must be delivered and collected six days per week.
- Parcels must be delivered and collected five days per week.
- The prices for universal service products must be affordable and geographically uniform, which means that the same price goes anywhere in the country.
- There must be registered and insured services, and
- There must be certain free services for the blind or partially sighted and some legislative petitions and addresses.

It is very important that these minimum requirements – some of these are back-stopped by the European Directive and so, for example, affordability is something that is set out in the underlying European Directives, that require all member states to be consistent with that obligation. Some others, such as for example the six days per week, can only be changed by Government following a vote in both Houses of Parliament. None of these issues that I have just talked about here can be changed at the discretion of Ofcom.

Ofcom specified key characteristics of the universal service

Through a mechanism called the Universal Postal Service Order, we have specified the key characteristics of the universal service. I will not go through this slide in great detail but, as an example, one of the ways we have described the obligation to deliver and collect mail items is to say that users’ needs suggest and history suggest that there needs to be a first class service. This is the D+1, which will be delivered the day after you post it, and that should have a quality of service target of 93 per cent of items should arrive the next day. There is also a need for a second class service and for that we have kept with existing targets and existing performance levels of D+3, i.e., it should arrive within three days of posting, at a target of 98.5 per cent. You will see some of the other issues there on this slide. In the interests of clarity there, we are talking about the European and Rest of World,
where we are talking about those international services. At the bottom of the slide, there are some of the smaller elements of the universal service that make everything else work.

**The postal market is currently meeting the ‘reasonable needs of users’**

The Act required us to carry out what it described as a review of users’ needs within 18 months of taking over responsibility for postal regulation. We completed this at the end of March this year and this says that, where we define those aspects of the universal service within our discretion, that has to be based on what users need from the service and the extent to which those needs are reasonable. When we first took over regulation and moved into the generational authorisation regime, we essentially rolled over the existing universal service into the new regulatory framework.

What we found in this review, which was one of the most extensive pieces of research Ofcom has carried out, is that the postal market is currently meeting the reasonable needs of users and we concluded that there was no need for us to make any changes to the universal service as it was currently defined. However, what the review also clearly indicates is that different users rely on postal services to differing degrees and that these needs are evolving. This is something we will have to keep an eye on.

Another aspect we have recently carried out is looking at the postbox network. This was essentially a piece of regulatory tidying up. There was a condition that did not fulfil the purpose for which it was intended and we have introduced a new condition which now says that there must be a postbox within 0.5 miles, half a mile, of 98 per cent of the addresses within the UK.

**Universal service products must be affordable**

As I mentioned earlier, a key characteristic of the universal service, established in both the European Directives and then of course in the Postal Services Act, is that all universal service products must be affordable. As Stuart mentioned, when we removed the vast majority of price controls back in March 2012, we kept a safeguard cap on second class products. The way this works is that for the standard letter this was set at 55p in March 2012 and that can increase by CPI each year. At the time of making the decision, the second class stamp for a standard letter was 36p and Royal Mail has now increased that to 50p. This year, there was no increase on that price.

For larger letters and packets, it is a basket of products for large letters and parcels up to 2kg and this allows price increases of up to 53 per cent, again linked to CPI over the period of a seven year control. Those of you who are good at mental arithmetic may have
worked out that 53 per cent is the same proportion as the increase from the 36p second class stamp, pre- the removal of price controls, and the 55p safeguarded cap.

In 2013, earlier this year, we concluded another piece of research where we went out and asked the question, what does affordability mean for postal services? Previously, this had been addressed by looking just at levels of overall spend, being very low for residential consumers, or comparisons with the cost of a coffee or a Mars bar, and sending a stamp. We felt that we needed to look at this in greater detail and we published a research report earlier this year which used a number of approaches – both qualitative and statistical – to try to understand better what affordability meant to consumers and to businesses. We concluded that all of the universal postal services are affordable for almost all residential consumers and small businesses.

**Financial sustainability**

Let me now move on to the question of financial sustainability. As Stuart mentioned earlier, it is part of our duties to ensure that the designated universal service provider is able to make a reasonable commercial rate of return and that is how financial sustainability should be measured.

**Approach to defining financial sustainability**

Here, we have identified the entity to which that test applies. As I am sure you know, you have Royal Mail Group, which has activities that clearly have nothing to do with the universal service – for example, GLS, at the bottom of this slide, does not even operate in the UK. Similarly, Parcel Force competes with other express parcels operators and again is not part of the universal service. What we have here is the entity we have defined as the reported business, and this is essentially the business that rests on the universal service network – what I think Royal Mail sometimes calls its core network. This includes the postmen and women in the mail centres and the delivery offices, routings, and carrying mail door-to-door – essentially, people in red polo shirts.

This universal service network is largely based around people and, as such, its operating costs are significantly higher than the value of its tangible assets. That is why, in thinking about financial sustainability rather than the return on capital approaches we would use in other regulated sectors, we consider that a return on sales is a more relevant measure.

**A reasonable commercial rate of return**

In our March 2012 document, we set out what we thought a reasonable commercial rate of return might be. We based this on returns of comparator companies, both within and
without the postal sector. There were analyses of different approaches to measuring finance-ability, and looking at Royal Mail’s risk profile. We considered that, on this basis, an EBIT margin of five to 10 per cent represented a reasonable commercial rate of return over the duration of the regulatory framework. Just to be very clear, this is not, and does not represent, a cap on earnings, but this is a view as to what a reasonable commercial rate of return for this defined entity, the reported business, would be.

Operational freedom

I will touch briefly on some of the operational freedoms that we have discussed. Stuart mentioned that, when we took responsibility for postal services, we found that there was a great deal of very detailed regulation and a great deal of to-and-fro engagement between the regulator and Royal Mail.

Greater operational freedom for Royal Mail

One of the key things we did was to reduce the notice period for changes to price and non-price terms from three months down to one month, to allow Royal Mail to be more flexible in pricing approaches.

We removed the need for pre-approval for changes to non-price terms to universal services. The way this regime had worked is that, if Royal Mail wanted to make a change to a universal service contract term that was not wholly in the benefit of all consumers, they had to come to the regulator and involve consumer focus in essentially what became a public negotiation and consultation on what this term should be. We have introduced a rule saying that Royal Mail’s universal service terms and conditions must be fair and reasonable and it is up to Royal Mail to put the changes through to its terms and conditions to reflect its business and what it thinks will be good for customers.

We have also removed the requirement for notification and advanced publication for Royal Mail’s non-universal service products. Its non-universal service products are products that are out there in the commercial market and it is up to Royal Mail to engage with its customers and agree reasonable terms and conditions there. We feel that we have no locus over those.

We also subsequently approved Royal Mail’s proposal to allow it to deliver parcels to neighbours when recipients were not at home, in what is called their ‘deliver to neighbour’ process. This essentially allows Royal Mail, when delivering parcels, to carry out exactly the same kind of activity as all the other parcel operators. It was a quirk of the regulatory regime which prohibited Royal Mail from doing this.

Competition
Now let me move on to competition, and our approach to competition.

**Competition in the postal sector – end-to-end**

The Third Postal Services Directive, which came fully into force across all member states earlier this year, but for the UK and other major European countries came into force a year earlier, this requires all EU markets to be fully opened to competition and operators do not require, as a result of that, prior regulatory approval to enter a market. However, what is also very clear from the Postal Services Act is that Ofcom has a duty to promote competition, as Stuart already mentioned. What is all very clear from the Postal Services Act is that, in relation to post, our primary duty is to secure the provision of a financially sustainable universal postal service, and that this takes priority over our more general duties towards competition, where there is a conflict, with regard to postal services. We have the power to impose conditions to address prospective threats to the universal service. In April 2012, shortly after we published our new regulatory framework, TNT Post UK began delivery services in West London and subsequently has expanded its services to cover Central London, South East London and South West London.

**We have published guidance on our approach to end-to-end competition**

We published in March this year guidance on our approach to end-to-end competition. We have said very clearly that we will carry out a full review, if we think there is a threat to the financial sustainability of the universal postal service. If we think that Royal Mail’s returns are likely to fall below the five to 10 per cent EBIT margin on a sustained basis, we would expect to intervene, unless we concluded that this was due to the Royal Mail failing to take appropriate steps to respond to competition.

The kind of responses we might think about taking would be efficiency changes and reacting to consumer demand. If we felt it was necessary to intervene, there would be a number of options but the two clearest ones, as we identified in our March guidance, is that we could require a new entrant to deliver more days per week than they were currently planning to do, or over a wider geographic area, to level the playing field between the universal service provider and a new entrant. Alternatively, it is also possible that a universal service fund could be established, although that would require a level of secondary legislation to be put into place and therefore would inevitably be a more time-consuming option.

We have also said that we will initiate a review of this subject, of the need for intervention, with regard to end-to-end competition, by the end of 2015 at the latest, if the monitoring regime has not already led to a full review. We will come back and take another look at this in 2015 if we have not had to do so previously.
**Competition in the postal sector – access**

To move on to access – access mail, i.e, where a postal operator collects mail from, generally, large bulk mailers and hands it over to Royal Mail for the last step of delivery – this makes up 46 per cent of current mail volumes in the UK. However, it is worth noting that Royal Mail retains 85 to 95 per cent of the revenue for these services. Access has led to bulk mail users receiving significant price savings, benefiting both those customers and subsequently their end users as well. For example, the reduction in the cost of banks sending bulk mail presumably led to many banks not pushing further down the online route, or enabled them still to offer paper statements.

We require Royal Mail to offer access on fair and reasonable terms to its inward mail centres, for D+2 letters and large letters, where they have far greater commercial freedom to negotiate price and terms and conditions. Royal Mail recently re-negotiated its access contracts earlier this year with the access operators. A process that we understand was completed successfully and was one in which we did not have to get involved in.

We have also replaced the fixed margin (headroom), which was a fixed limit on where Royal Mail was allowed to price its retail bulk services against its access prices. We have removed that and replaced it with a more flexible ex-ante margin squeeze test.

**Current or planned Ofcom work**

I will now just touch on some of our current or planned work.

**Current or planned Ofcom work (2)**

We will be publishing imminently a statement on our strategic review of the Postcode Address File, which is obviously a very important aspect. There was a recent government announcement on this issue, which took forward many of the proposals that we had made in the consultation document we had published earlier this year. In our statement, we will essentially be tying up that process and setting out clearly what our expectation is, as a regulator, from the PAF area in the future.

We will also be publishing two studies on efficiency later this year. These are consultancy reports rather than policy documents or consultations or decisions. One is on the pros and cons of different approaches to measuring postal operator efficiency. The other is a study on the efficiency programmes that have been carried out by other European postal operators over the past 10 years or so, so that we have a better understanding of these questions.
We will also be publishing our annual monitoring report on the performance of the market and the performance of Royal Mail, and Royal Mail’s compliance with its regulatory obligations, later this year.

Two projects we currently have ongoing are on mail integrity and inter-operability, about how postal operators should engage with each other. These are two fairly low-profile projects, which are important in how the market works but we are expecting to use the same approach as we used when setting out the new regulatory regime in taking these issues forward.

There will then also be the exceptions policy for deliveries and collections: these are vis à vis how Royal Mail can deal with situations where it is impossible to deliver the universal service in particular areas, and how those are noted and understood.

Thank you very much.

Ed Richards: Thank you very much, Chris. We will stay here for questions. I will just make a couple of quick points before we take questions. All the documentation that we have produced here, needless to say, is available on the website and it is very easily accessible. If you haven’t already found those documents, then that is where they all are. If you could just tell us who you are and where you are from, that would be very helpful. Otherwise, we are happy to answer any questions that we can today.

Question & Answer Session

Mark McVicar (Nomura): A couple of questions please. First of all, when you set the elements of the regulatory regime that you set around, or you deregulated quite a lot of the elements, how closely did you look at the international comparisons that are available in Germany, Holland and other countries?

Ed Richards: Let me say something first. The most important thing to say is that we came to this very fresh. We did not have any history on it and there was some overlap which Stuart described with Postcomm. When we came to it, one of the reasons why we were intrigued and interested by the whole area is that we came to it fresh and we said: how do we see this market, how do we see the circumstances that we understand, what are our duties and how have they changed, and what is the position in the UK? As I am sure my colleagues will say, we looked carefully at some international benchmarks but
what you also find is, as one always finds in telecoms, media and so on, you have to understand the specific circumstances of the market you are dealing with. That is, ultimately, where we would end up.

**Stuart McIntosh:** I want to say two or three things. We did look at other markets to understand how the postal sector was both developing and how we were regulating those sectors. We are also part of a network called the European Regulators Group for Post. That was very helpful to us as far as understanding some of the structural trends, because some of those are common from one market to the next. However, it is also the case that some of the history in the UK is quite specific to the UK.

For example, if you look at the access regime which is applied here, there are similarities in a number of other countries in Europe but they have not gone anywhere like as far. Therefore, we were very keen to understand some of the structural things which are common across all markets, but we were also very keen to make sure that we understood the specifics of the way the market was evolving here, not simply the access regime.

If you look at people’s spending habits on line in the UK, they are quite different from the rest of Europe, so we have done some contrasting and comparing. We have also spent some time in other countries to understand some of the more interesting features of those but we have been mindful of the need to try to make sure that what we have come up with here addresses the issues and the challenges which are specific to the UK, as well as reflecting the broader industry themes.

**Mark McVicar:** Thank you. The other question I have for now is about how Ofcom would relate to and/or work with the EU. If the EU were to decide, either in the UK or generally, that its directive had not created enough competition and they want to start legislating at EU level to create more competition, how would you fit into that process and how much of it would have to be a statutory intervention rather than a regulatory intervention, if that is the right way of putting it?

**Ed Richards:** It is quite straightforward to answer that. We have a very similar situation in telecoms, where there is European level legislation and there is UK legislation. As you may know, we are very closely involved in everything that happens in the telecoms world at the European level, and we would expect to do exactly the same in postal services. Therefore, we would expect to be very close to any development or thinking of that kind, we would expect the Commission to talk to us and we would expect to talk to the Commission by our own initiative. In any evolution of that thinking, we would want to be right at the heart of it by bringing our own understanding of the UK market and the objectives of the UK market, in the first instance, but applying that in a broader European context. That is
exactly what we do in the sectors that we have regulated for some years, and I do not believe there would be any difference here.

**Stuart McIntosh:** It is the case that the European Commission, generally, is very interested in the approach that we take to regulation and, as we have been thinking about this framework, we have had direct discussions with them. We know the officials who are responsible for the sector in Brussels quite well. Equally, the broad European industry grouping of regulators which is one which is very actively supported by the European Commission and they are very closely involved in it. Therefore, in addition to the regular ongoing contacts that take place with the people in Brussels, there is a network which comes together two or three times a year involving the Commission, so there is a lot of dialogue going on and a lot of shared thinking and understanding regarding the issues in the industry and what may evolve in the future.

**Mark McVicar:** Just a small point of clarification. When you look at and define rate of return with Royal Mail, how do you treat what they call their “transformation costs”: are they just treated as any other costs and, therefore, you are looking at their EBIT post those; or do you assume that one day those transformation costs will fall out?

**Stuart McIntosh:** Chris may want to pick up on the detail. Inevitably, we had to look closely at this but the fortunate thing is that we can look at both. We can understand it both with and without, and we can understand the extent to which there are particular peaks, which may truly be exceptional and unlikely to be repeated, as opposed to those costs which happen every year, because every business has to reinvent itself the whole time. Fortunately, the visibility is there so that we can understand what is going on under the hood and we shall make judgments as appropriate depending on the circumstances when we need to conduct those sort of investigations.

**Penny Butcher (Morgan Stanley):** I noted in one of the slides when you were speaking of how you assess the returns as Royal Mail being a sort of people business and, therefore, a return on sales is more important than a return on capital measures. My perception is, however, that Royal Mail needs to do a lot of investment in its assets, modernise facilities and perhaps adapt to the e-commerce market which its peers are doing. That, to me, seems like a lot of capex-focused investment and in other areas such as airports there is an understanding that there needs to be a return on capex consideration too for modernisation projects. Have you looked into that at all, do you see any restrictions or how to incentivise that perhaps?
Chris Rowsell: It is important to remember what we are doing when we are setting out this indicative range of 5-10% EBIT margin. We are not setting a price control for Royal Mail. We are setting what we expect a reasonable return for this company would be and what would be consistent with the concept of financial sustainability and reasonable commercial rates of return. We would note, however, that even allowing for those kinds of capital, it is not to say that Royal Mail has no capital investment or that it may not need greater capital investment. The Government has been very clear that access to private capital is something that Royal Mail needs in order to adapt to the future. What we are saying is that, taking all those things into account, the EBIT margin seems to be a reasonable way of us measuring it over that time period.

Stuart McIntosh: One detail I would add is that, in setting the range, we looked at a number of alternative measures and a more cost of capital type approach, or a weighted average cost of capital was in that thinking as well, and it was very much within the range we were looking at. It was not as though it was going to take us out of it one way or the other. We felt that these different measures all pointed towards that relatively broad range.

Chris Rowsell: There is a table in our March 2012 document that sets out the indicative ranges of about 10 different approaches to how one could measure financeability for Royal Mail, if you are interested in looking at the ways we have approached it and the kind of numbers that each of the methodologies was producing.

Ed Richards: I have two points to add to that. First, I want to underline the point that all of those calculations are not ceilings. As I mentioned at the start, companies can outperform what we expect and, as long as it is within the period of control, that is fine. The other point is that, if the business changed and we took the view that there was a better or alternative way of making that assessment in the future, we would do that. That is a judgment that we would make in light of the evidence. The approach we have taken at the moment is the one we judge to be the right one at this point in time, or at the point in time when we set it, but, clearly, that could change and we would be open to arguments about that in the future.

Robin Byrne (Cantor Fitzgerald): I have a point of clarification as a first question. Slide 18 – can you tell us what is the value of the universal service, is it all that £7.2 billion or less? Is it everything inside the box?

Chris Rowsell: Inside the purple box is what Royal Mail refers to as its UK parcels, international and letters division. Within that, we have identified this sub-part of that
unit which is the reported business. Therefore, the £6.8 billion reflects those revenues using the universal service network. That includes, for example, access mail and bulk mail, which, while being outside the universal service, Royal Mail is obliged to carry, so these are products that use the same network.

**Robin Byde:** Can you put a number on the universal service?

**Ed Richards:** Do you mean the cost of the universal service? You are going to have to be more precise.

**Robin Byde:** What is the monetary value? If I look at that box and at the £7.2 billion and the reported business, within that reported business what would you say is the universal service in financial terms as a value?

**Chris Rowsell:** Parcel Force is not part of the universal service.

**Robin Byde:** Yes, sure.

**Ed Richards:** I am still not absolutely sure that I know what you mean.

**Ed Richards:** Do you mean, if we were to identify exclusively the cost of providing the specified universal service, what would it be? Is that what you mean?

**Robin Byde:** Yes.

**Stuart McIntosh:** I believe it is correct to say, although I stand to be corrected, that we have not quite looked at it in the way you have framed the question. What we have said is that there is a network that supports the universal service. There is a bunch of products and services that go over that network, some of which are formally part of the universal service products, and some of which are not. However, the economics of the whole thing is one entity. In looking at financial sustainability, we are looking at financial sustainability in relation to all of the products that go across that network, which supports the delivery of the universal service. From a revenue perspective, it may include some items which strictly are not actually part of the universal service but which make a contribution to the economic viability of the service.

**Ed Richards:** Exactly, so we do not think about it in quite the way you are inviting us to, which is because of the nature of the network.

**Robin Byde:** So you can’t answer the question to which I am applying my 5-10% return on sales number?

**Stuart McIntosh:** We are applying it to the £6.8 billion.
Ed Richards: Those are the products that are relevant to the universal service network, but you are asking a slightly different question which is a subset of that, and that is now how we think about it. We think about the EBIT margin on the overall business.

Stuart McIntosh: We may be at one in that you are trying to find out what is the number to which I might apply my 5-10%, is that right?

Robin Bye: Yes.

Stuart McIntosh: By the sound of it, it is £6.8 billion.

Ed Richards: We can pick that up afterwards but we have more or less come to the point.

Damian Brewer (RBC Capital Markets): I have three sub-questions, I guess. I am interested in ensuring the sustainability of the USO. Given the breadth of the 5-10% indicative return on sales central margin, at what point do you start considering the tipping point on that when you would intervene? That is a pretty broad range and you could argue that perhaps 9% is below the top end of that but you are still well above the 5%.

Secondly, when you review that, or when you will review that, how do you partial out other externalities to the business over which it may not have control and over which the regulatory position does not have control either? It may be things like fuel costs or whatever rather than competitive effects.

Finally, when you assess that, you do a review and you have TNT Post UK in its position, and perhaps it is the same size or bigger, do you assess that on a whole network basis on the effect of the margin, or on the effect of the margin on the local network basis? The two would have very different outcomes. On a whole network basis, a small incursion may not be noticeable but on the profitability of a certain city, it may be very noticeable. Therefore, the third question is how do you assess that?

Ed Richards: The overarching question is how are we going to think about the sustainability question in relation to the USO in the context of the indicators that we have set out?

Damian Brewer: Whether it is a network or a localised issue.

Stuart McIntosh: We shall try to answer your questions as best we can. When we set the range at 5-10%, it was at a time when Royal Mail’s margin was probably zero or very close to that. However, that range reflected what we thought was appropriate as far as returns looking at a whole range of other operators. We have not set it as a cap, so
it is not like a charge control where we set a charge control say for BT and they simply cannot go above it. If, during the period of this control, Royal Mail are very successful in growing their business, particularly the parcels business is very successful in improving its productivity, and it is pushing out the top of this range and goes over it, we are saying at the moment it is unlikely that we would choose to intervene. The incentive properties in this regime are meant to be about them being innovative, making sure the universal service is sustainable and making sure that they become more productive.

You know many of the other mail markets in the UK, and pushing way above this range, particularly given that would depend probably on quite a lot of success in parcels, means it is a very competitive market. Therefore, the constraints may well be market constraints rather than regulatory constraints.

Where we get a little worried is if we felt that it was at or above the top of this range, and that was all happening through price increases but there was no evidence of improvement in productivity and efficiency. We have signalled this and the company sees the continuing scope for productivity improvements.

If I have understood your question correctly, when it comes to how we look at other things such as fuel costs and all the rest of it that may be external to all of this. We are not looking at it in quite that way. To some extent, that is the company’s issue to manage these things and to respond to changes in its input prices in a way it thinks is appropriate, so that they can minimise their costs and maximise their revenue opportunities.

**Chris Rowsell:** The approach we have said we shall take in assessing the impact of end-to-end competition is the impact on the 5-10%, the financial sustainability of the reported business, this entity of the universal service network. So we said we are looking at a whole network basis. What is important to note about the approach to end-to-end is we are not saying that we shall take a static or historic look at this and spot that there has been a problem of the sustainability of the universal service. We are taking a perspective look, so looking forward using the full extent of our information-gathering powers both for Royal Mail and its competitors, so that we have the best oversight in the market as to what is happening with all the different players looking forward. We are then applying our modelling and understanding of these businesses to understand if we predict that there will be a problem in the future based on current trends and how things are developing.

What we have said on the test for intervention is that we would look at whether there are things within Royal Mail’s control that it has either not been able to improve, or just has not done so. However, we would not hold them responsible for things that are outside their control. Therefore, we are saying that we would attempt to split factors into exogenous and
endogenous. I am sure you know that there is a grey area there to which Stuart alluded earlier. There are things you can do to hedge against fuel price increases but, if fuel prices have gone up for everybody over a long period of time, there are elements that are endogenous and elements that are exogenous.

**Ed Richards:** We have to come back to the fact that our primary duty is to ensure the universal service is sustainable, so we need to keep that in mind. However, after that we can be as clear as we can possibly be about the kind of approaches we can take, which we are trying to be in the documents and we are doing so today. As your question rather perfectly illuminates, there are many areas of discretion and judgment and there will always be some uncertainty about exactly what is cause and what is effect, and unpicking those different things. Therefore, we are going to have to reserve a little bit of judgment relating to that and, again, it is illuminated by your 5-10% - is it at 9% or at 8%? It depends what the trajectory is, it depends what we have seen in the previous period and have we seen precipitous declines that have led to a dramatic change, or have we seen a very gradual – is there a plan in place to fix it? The truth is, as we all know, that there are so many different variables in there that, ultimately, we shall have to exercise some judgment in those circumstances.

It is not a situation that we hope to see or, indeed, expect to see. What we expect to see is the commercial freedom that we have given, the deregulation in pricing that we have given, the opportunities of mechanisation, productivity gains and so on. We expect to see these things come through and, in the context of that seven-year period, we want to see a healthy mail market with credible, sensible, good economic returns, out-performance on offer if that is achieved, and the USO being sustainable on that basis. That is the scenario we are looking at and that is the one we expect to unfold.

**Joel Spungin (Bank of America Merrill Lynch):** Forgive me if this is a simplistic question but can you talk me through what an *ex ante* margin squeeze test is and how it works in practice?

**Ed Richards:** We love questions like that! Chris, do you want to go first?

**Chris Rowsell:** The products in which we are interested here are whether when Royal Mail is signing contracts, is offering retail bulk mail services, the relationship of that price to the access price, and that they are not using their position having 99.9% of the delivery market for letters to margin squeeze its access competitors. What we have said is that, if you take the upstream costs, i.e. the element that is common to both the access operator, essentially the collection of mail from businesses and the first stage of trunking to
the inward mail centre, Royal Mail must cover for all its activities the fully allocated cost of that. However, on an individual contract, they are allowed to price as low as 50% of FAC of that contract, as long as the overall product group accounts balance to FAC. We are quite clear that 50% of FAC tends to be a proxy for long-run incremental cost, which is usually the kind of test that one would apply.

Joel Spungin: Sorry, what is FAC?

Chris Rowsell: Fully allocated cost.

Ed Richards: I am not sure at what level your question was. We can give you a lot more detail like that and that is set out in the document. Another way of putting it is that *ex ante* means before the event, not after the event. So we set some guidance in advance, and the margin squeeze means that another operator has a fair chance of competing in the downstream market when you are facing a vertically integrated Royal Mail. It is as simple as that. And the detail of how that operates resides in the kind of territory that Chris has set out but which we have set out in detail in the documents.

Susanna Invernizzi (Barclays Capital): Going back to the 5-10% range, if we had to run with the contrary of what we said so far as a worst case scenario, so that unfortunately because of a decline in letter volumes, inefficiencies and so on, margins drop below 5%. You mentioned a potential reason for intervention. I wonder whether you can elaborate particularly on the possibility of a universal service compensation fund?

Ed Richards: First, we shall be monitoring this and it is very closely related to the primary duty to secure the universal service obligation. Before we talk about the universal service compensation fund. As Chris mentioned when he introduced this subject, that is a more complex and longer-term set of questions. Therefore, it is probably not where we would start in those circumstances. It depends on the circumstances and on the speed of change and so on. It is an important tool that is available to us but, if we need to do something in a shorter timeframe, we would be more likely to look at the other set of issues around obligations on new entrants. Do you want to say something about the compensation fund?

Chris Rowsell: The Act clearly allows for a compensation fund to be established and there are a number of steps that the Act sets out that must be completed before that happens. From now until 2016, the start of that process would require a direction from the Secretary of State, and also the establishment of a universal service fund would require a piece of secondary legislation by the Secretary of State to put that in place. There
is a role described for Ofcom in understanding the need for it, how it would be designed and developed, the cost that needs to be met by such a universal service fund.

**Ed Richards:** In essence, we would be identifying the underlying cost of provision and then we would establish a fund which all operators would have to pay into, and that would be distributed on the basis. So you can see that it would involve not only those ministerial and legislative interventions but it would also require a very substantial body of analysis on all of which we would consult, and much of which would be arguable in one way or another. We can get there in the end and it may be something that one day we have to do and it is a good thing to have in the background but, as I said, it is probably not where we would start. It certainly is not where we would start if we felt that, for whatever reason, there was a need to act to secure the viability of the universal service in the short term. We would look to the other measures, which would have a much more immediate effect. Therefore, it is good from our perspective, because we have that longer-term, intellectually purer answer but we have other tools in the locker which we can use to address issues in the short term. I believe we feel comfortable with that set of options and we think about them roughly in the relation I have tried to describe.

**John Woodman (Goldman Sachs):** I have a slightly specific question. I understand that Royal Mail now has the ability to cancel access contracts with 12 months’ notice. I want to understand how that reconciles to their obligation to provide access to anyone who requests it?

**Chris Rowsell:** It allows Royal Mail to establish new contracts and new terms and conditions with its customers, otherwise you could have an accretion of some people remaining on a contract from a decade ago, for example, that they have refused to get off because it was particularly advantageous to them. Therefore, it does not remove Royal Mail’s obligation to offer access as we have set out in the regulatory conditions. However, it enables Royal Mail to have some control over the process of renegotiating new terms and conditions.

**Ed Richards:** It is an important change that we made. As I recall when we inherited this area, there appeared to be this unusual situation in which contracts which had been struck under a particular previous regulatory regime were, in some ways, infinite or could be there in perpetuity unless the customer decided that they wished to change them. That is clearly wholly unreasonable on Royal Mail. Both sides of a bargain of that kind need to be able to renegotiate it at a sensible point, and we changed that, which is one aspect of
what we would call greater commercial freedom for Royal Mail but, to be honest, it is uncontroversial for anybody thinking about it sensibly.

**Stuart McIntosh:** What is interesting is that there was quite an extensive programme of renegotiation of the access contracts and, while I am sure it was a sharply contested set of discussions between the various parties, it did not end up coming to us as it could have done. This was quite encouraging as it meant that the industry was able to reach, it would appear, a sensible set of conclusions.

**John Woodman:** So as long as Royal Mail offered reasonable terms, unless someone came to you with a complaint, you would not get involved?

**Ed Richards:** That is right and, prior to that, it was a one-way bet for the other companies. Everybody knows which way one-way bets end up and, when we looked at it, we were surprised by it, we were not even convinced it was legal, to be honest, and it certainly wasn’t sensible. So that has gone and now we have a situation whereby they do the commercial negotiation in the way you would expect conventional companies to do it, as happens every day out in the market and, if there is a genuine problem of failure to agree and there is a dispute over what is fair and reasonable, they can bring it to us. However, as Stuart noted, we were very pleased that did not happen, which was a very good start.

That is what we find, for example, in telecoms quite often. Sometimes we get disputes and have to deal with them, which we do as quickly as we can, so it can happen but many times, even though you have a regulatory backdrop, two companies can sort out a sensible deal, which seems to be what has happened this time.

**Chris Rowsell:** This is quite a good example of that, because our understanding is that, in the renegotiation of a contract, the way this termination right for Royal Mail, which applies also to changes to contract terms, was put into the contract, Royal Mail, to allay some of the concerns of the access operators, said that, if someone were to bring a regulatory dispute to Ofcom about the subject or about the notice, they would stop the clock for the period of that dispute being resolved. That, again, is not something we were involved in; that was Royal Mail engaging with its customers to make sure it gained greater commercial freedom but not giving everything away.

**Joshua Goldman (Davy):** I have a very simple question. On the ability to raise stamp prices in line with CPI, is that cumulative so that, if Royal Mail decides not to do it one year, can they then carry it over?

**Ed Richards:** Yes.
Andy Jones (RBC): I have a point going back to the margin squeeze test question. How do you manage the cost allocation issues there, because, in some cases, the inward and the outward mail centres are in the same building, the staff use the same canteen and the same car-park: there is scope for artistic licence with cost allocation? How do you judge what their fully allocated cost is on a forward-looking basis, is it forward-looking, does it change every year, does it account for modernisation etc.?

Chris Rowsell: I shall give you a very short answer. We have set out in great detail the regulatory reporting requirements for Royal Mail and a large regulatory accounting guidance that they are required to follow when producing the regulatory accounts. We receive regular reports from Royal Mail on their various parts of the reported business, including this area, so cost statements and profit statements. I shall drift into far too much detail again if I go any further but there are dozens and dozens of pages.

Ed Richards: Again, it is worth saying that this is probably a little more novel in this area but it is something that we have been doing for years with telecoms and what happens in other sectors. There is a learning process as you go through it and some of those questions, as you imply, are debatable and arguable, we take a view and we listen to arguments on both sides and that will evolve over time. I believe we are in the right place at the moment and that is set out in considerable detail but no doubt people will give us a view on those matters in the future.

Mark McVicar (Nomura): With apologies, one last question. I know you are going to be setting out a paper on efficiency of postal operators in general but, at the highest level, what sort of elements of efficiency or measures of efficiency do you think you will be using, or do you use elsewhere as a benchmark?

Ed Richards: How are we thinking about efficiency.

Chris Rowsell: There are two papers, again consultants’ reports, that we shall publish later this year. One looks at the pros and cons of different methodologies, those used by other regulators in other sectors, or those used by other regulators particularly in the postal sector. The second piece goes into more detail on some ideas, for example looking at case studies of other European postal incumbents.

What is important for us to understand is the degree to which Royal Mail is meeting the changing market and the steps it is taking. We shall look at the bottom line but also at how their own processes for modernisation and cost savings are performing in taking this
into account. Again, we are not setting an efficiency target, we do not set and have no intention of setting a target for Royal Mail’s efficiency. This is something that we need to understand more in order to be able to assess and to fulfil our duty towards ensuring the financial sustainability of the universal postal service.

**Ed Richards:** We are very reasonable people you see. Let us link it back to that issue of pricing freedom and efficiency. We have not deregulated in the expectation that Royal Mail would not increase prices and, indeed, they have increased prices, so we expect revenue to rise, we expect there to be a response to that, we expect pricing freedom to manifest itself in price increases. Equally, we are here to guard the interest of the consumer as well, so what we want to see alongside that is progress on efficiency and productivity. That does not mean we shall crawl all over every detail but we would expect to see progress on both of those.

If the economics improve which they have done, and we expect them to improve further, some of that will be through price rises but we would also expect to see some efficiency and productivity gains. I believe that is a very reasonable approach from our perspective, given our duties in relation to consumers as well as the universal service and the sustainability of that from an economic perspective. That is how the two mesh together and we shall take an overview of that in a sensible, balanced and considered way during the period of the seven years.

**Are there any other questions? Any from the website?** [No further questions] Thank you all very much for coming, do get in touch again with us if you want to clarify anything else.

- *Ends* -