Briefing for analysts: The regulatory framework for postal services

18 July 2013
Agenda

Welcome and introduction
Ed Richards, Chief Executive

New legislative and regulatory approach
Stuart McIntosh, Group Director, Competition

The regulatory framework
Chris Rowsell, Competition Policy Director

Questions & answers
Ed Richards
Introduction

Ed Richards,
Chief Executive
About Ofcom

• Who are we?

• Our regulatory principles include:
  – intervening when markets alone cannot achieve public policy goals;
  – operating with a bias against intervention;
  – evidence-based, proportionate, consistent, accountable and transparent decisions;
  – always seek the least intrusive regulatory mechanisms; and
  – consult widely and assess the impact of regulatory action

• Our approach to regulation includes:
  – a willingness to deregulate as well as regulate;
  – allowing companies to make a return;
  – allow any outperformance to be retained within a control period; and
  – a recognition of the importance of stability and predictability
Ofcom as the postal regulator

• The need for postal regulatory reform has been clear for some time:
  – 2008/2010 Hooper Reports
  – Postal Service Act 2011

• The new framework is aligned with our regulatory principles:
  – Ensures **sustainability** of the universal service obligation;
  – Fundamentally **deregulatory**, representing a change in regime;
  – Provides **commercial freedom** and the **ability to earn a return**; and
  – Provides **stability and predictability** over a 7-year period
The new legislative and regulatory approach

Stuart McIntosh,
Group Director, Competition
Postal Services Act 2011 implemented the key recommendations of the Hooper reports

- Allowing for the introduction of private sector capital into Royal Mail
- Transferring Royal Mail’s historic pension deficit to Government
- Transferring regulatory responsibility from Postcomm to Ofcom

It also replaced the previous licensing regime with a general authorisation regime
Our duties with respect to the postal sector

• Our primary duty is to carry out our functions in a way that we consider will secure the provision of a universal postal service

• In doing so, we must have regard to the need for such provision:
  – to be financially sustainable (including the need for the universal service to earn a reasonable commercial rate of return); and
  – to become efficient before the end of a reasonable period, and for it to continue to be efficient

• We have a general duty to further the interests of citizens and consumers, where appropriate by promoting competition

• In the event of conflict with our general duties when exercising our postal functions, our primary duty to secure the universal postal service takes precedence
Implementing a new regulatory framework

• Volumes were declining rapidly

• Royal Mail’s financial position was not sustainable

• The regulatory framework was not flexible enough for Royal Mail to react quickly to structural changes in the market
  – 80% of Royal Mail’s revenues were price controlled
  – Intrusive and detailed regulation
The new deregulatory 7-year regime is designed to support sustainability of universal service

- We put the framework in place for seven years to give Royal Mail regulatory certainty and stability
- Removed the vast majority of retail and wholesale price controls
- Removed the requirement for Royal Mail to maintain a guaranteed margin between its retail and access prices (known as access headroom)
- Provided greater commercial and operational freedom for Royal Mail
But with key safeguards

- A safeguard cap on Second Class stamped letters and parcels up to 2kg

- Effective monitoring of Royal Mail’s performance

- Competition within the mail market
The regulatory framework in more detail

Chris Rowsell
Competition Policy Director
The universal service
The Act sets the minimum requirements for the universal service

- Six days per week delivery and collection of letters
- Five days per week delivery and collection of parcels
- Affordable and geographically uniform prices
- Registered and insured services
- Free services for the blind and some legislative petitions/addresses

These minimum requirements can only be changed by the Government, following a vote in both Houses of Parliament
Ofcom specified key characteristics of the universal service

<table>
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<tr>
<th>RM product</th>
<th>Speed</th>
<th>Quality target</th>
<th>RM weight limit</th>
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<tbody>
<tr>
<td>First Class</td>
<td>D+1</td>
<td>93%</td>
<td>Up to 20kg</td>
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<tr>
<td>Second Class</td>
<td>D+3</td>
<td>98.5%</td>
<td>Up to 20kg</td>
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<td>1pm D+1</td>
<td>99%</td>
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<td>85%</td>
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<td></td>
<td>ROW: D+5</td>
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<td>N/A</td>
<td>Up to 2kg</td>
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<td>ROW: D+12-72</td>
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</tr>
<tr>
<td>Items for the blind</td>
<td>D+1</td>
<td>N/A</td>
<td>Up to 7kg</td>
</tr>
</tbody>
</table>

Other elements of the universal service:

- Redirections
- Keepsafe
- Poste Restante
- Certificate of posting
- Certain free legislative petitions and addresses
The postal market is currently meeting the ‘reasonable needs of users’

• The Act required us to carry out a review of the reasonable needs of users by end-March 2013

• This review found that different users rely on post to varying degrees, and needs are evolving

• We have recently improved the regulation of the post box network. There must now be a postbox within 0.5 miles of 98% of addresses
Universal service products must be affordable

• The Act requires that all universal service products are affordable

• In March 2012 we removed the vast majority of price controls, but kept a second class products safeguard cap over the seven years
  – For standard second class letters this cap was set at 55p in 2012, increasing by CPI each year
  – For larger letters and parcels (up to 2 kg) there is a basket control allowing price increases of up to 53%, again linked to CPI

• In 2013 we concluded that universal postal services are affordable for almost all residential consumers and small businesses
Financial sustainability
Approach to defining financial sustainability

- Relevant entity defined by those products that use the universal service network
- Universal service network largely based around people
- Operating costs are therefore significantly higher than the value of tangible assets
- Return on sales more relevant measure than a return on capital
A reasonable commercial rate of return

• We consider this to mean an EBIT margin in the range of 5-10% – based on returns of comparator companies; analysis of different approaches to measuring financeability; and Royal Mail’s risk profile

• This is an indicative range of what earnings we consider will represent a reasonable commercial rate of return over the duration of the regulatory framework

• **It does not** represent a cap on earnings
Operational freedom
Greater operational freedom for Royal Mail

• Reduced the notice period for changes to price and non-price terms for universal services to one month

• Removed the need for pre-approval for changes to non-price terms for universal services

• Removed the requirement for notification and advance publication of changes to Royal Mail’s retail non-universal services

• Approved Royal Mail’s proposal to allow it to deliver parcels to neighbours when recipients are not home
Competition
Competition in the postal sector – End-to-end

• The Third Postal Services Directive required all EU markets to be fully opened to competition and operators do not require regulatory approval to enter the market.

• Ofcom has a duty to promote competition where appropriate but in relation to post our primary duty to secure the provision of a financially sustainable universal postal service takes priority where there is a conflict:
  – Ofcom has the powers to impose obligations to address prospective threats to the universal service.

• In April 2012, TNT Post UK began delivery services in West London. It subsequently expanded its services to cover Central, South East and South West London.
We have published guidance on our approach to end-to-end competition

• 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 anticipate Royal Mail’s returns will fall below the range 5% to 10% EBIT margin on a sustained basis, we would expect to intervene unless we conclude that this is due to Royal Mail failing to take appropriate steps to respond to the challenge posed by competition, such as failing to improve its efficiency levels

• Potential options for intervention include:
  – Requiring a new entrant to deliver more days per week or over a minimum geographic area
  – Establishing a universal service compensation fund

• We will initiate a review of the need for intervention by the end of 2015 at the latest if the monitoring regime has not already lead to a full review
Competition in the Postal Sector – Access

- Access mail – i.e. where a postal operator collects mail from customers and hands it over to Royal Mail for delivery – makes up 46% of mail volumes in the UK. However, Royal Mail retains between 85-95% of revenue for these products.

- Access had led to bulk mail users receiving significant price savings benefiting those companies and their customers.

- Royal Mail has to offer access on fair and reasonable terms to its Inward Mail Centres for D+2 letters and large letters, but has greater commercial freedom to negotiate price, terms and conditions.

- We have replaced the fixed margin (headroom) with an ex ante margin squeeze test.
Current or planned Ofcom work
Current or planned Ofcom work

• Statement on our strategic review of Postcode Address File

• Two studies on efficiency:
  – Pros and cons of different approaches to measuring postal operator efficiency
  – Study on international postal operator efficiency

• Monitoring of Royal Mail and compliance reviews

• Mail integrity and interoperability obligations

• Exceptions policy for deliveries and collections
Questions
Speaker biographies
Ed Richards

Ed Richards is the Chief Executive of Ofcom, appointed in October 2006. Previously Ed was Chief Operating Officer, responsible for Strategy, Market Research, Finance, HR and other functions.

Strategy responsibilities included Ofcom’s strategic thinking on the communications sector and covering economic issues and consumer policy.

Ed was previously Senior Policy Advisor to the Prime Minister (Tony Blair) for Media, telecoms, the internet and e govt and Controller of Corporate Strategy at the BBC.

He has also worked in consulting at London Economics Ltd, for Gordon Brown MP, for the N.C.U. and began his career as a researcher with Diverse Production Ltd where he worked on programmes for Channel 4.

Ed is currently a Director of Thames Water Utilities Limited, a Director of Donmar Warehouse, a Governor of The London School of Economics & Political Science.
Stuart McIntosh joined Ofcom as Group Director, Competition in January 2008 and was appointed to the Ofcom Board in July 2008.

The Competition Group undertakes much of the economic and competition analysis undertaken by Ofcom in regulating the sectors for which it is responsible including telecommunications, broadcasting and Post.

Prior to joining Ofcom, Stuart was a Strategy partner in IBM’s communications practice in the US.

Before that Stuart held senior positions in PWC, where he led PwC’s Telecoms Consulting Practices (in both the UK and the US) and Adventis, a boutique strategy consultancy. Stuart began his career as an Economist in the UK’s Government Economic Service. He also worked for BT for a period of 4 years where he held the position of Head of Business Economics.

Stuart holds degrees in economics from the London School of Economics.
Chris Rowsell is currently a Competition Policy Director in Ofcom's Competition Group, leading work on postal regulation.

Chris Rowsell joined Oftel (the previous telecommunications regulator) in 1999 and transferred to Ofcom as part of the 2003 merger. During this time Chris has worked, among other things, on quality of service and price comparison websites for both fixed and mobile telcos; the establishment of consumer codes of practice and the telecoms ombudsman; several market reviews and price controls; online copyright infringement; and regulatory financial reporting.

Prior to joining Oftel, Chris wrote for Which? magazine as their senior researcher for technology and communications.
Annex
Key publications

• All documents are available on our website
  http://stakeholders.ofcom.org.uk/post/

• Decision on the new regulatory framework (March 2012)
  http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-
  regulatory-conditions/statement/statement.pdf

• Review of postal users’ needs (March 2013)
  http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-
  needs/statement/statement1.pdf

• Guidance on Ofcom’s approach to assessing the impact of end-to-end
  competition on the universal service (March 2013)
  http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-
  guidance/statement/E2E_Guidance.pdf