The UK postal market: sustainability, efficiency and competition

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2 December 2014
Ofcom’s duties in post

- **Our duty** (Postal Services Act 2011) is to secure a universal postal service
- We must have regard to the need for it:
  - to be **financially sustainable** (including the need for the universal service to earn a reasonable commercial rate of return); and
  - to **become efficient** in a reasonable period, and for it to continue to be efficient

- Third Postal Services Directive requires all EU markets to be open to competition
- Ofcom also has a general duty (Communications Act 2003) to further the interests of citizens and consumers, where appropriate by **promoting competition**
- In the event that we consider there is a conflict with our general duties, our duty to secure the universal postal service takes precedence
What we did in March 2012: a new postal framework

• 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
• Provided greater commercial and operational freedom for Royal Mail
• The framework was put in place for seven years (until 2019) to give regulatory certainty and stability
• Key safeguards:
  – Cap on price of Second Class stamped letters and parcels up to 2kg
  – Effective, ongoing monitoring by Ofcom of Royal Mail’s performance and market conditions (including direct delivery competition)
  – Competition in the mail market
How competition in post works

• ‘Access mail’ has led to substantial competition in bulk mail and savings to businesses which can be passed to consumers

• ‘Direct delivery’ operators also rely on ‘access mail’ to serve the whole country. Without access, no competitor could develop the necessary scale to offer a national service

• Ofcom has ensured that Royal Mail is able to make a fair return on all these services
How competition in letters works

Collect  Initial sort  Final sort  Deliver

Business bulk mail

Direct delivery mail
Access mail

Universal service mail
Royal Mail business mail

Royal Mail network

Competitor network

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What is the current impact of competition?

In 2013/14, Royal Mail delivered 99.4% of total letter volumes, and retained 95.9% of letter revenues. Competitors delivered 0.6%, and took 0.4% of revenues.

Parcels market is more competitive

UK domestic parcel revenue market share

- Royal Mail (including Parcelforce) has 36% of market by revenue
- In 2013/14, Royal Mail and Parcelforce delivered 1.1bn parcels (revenues of £3.2bn)
- Royal Mail’s position is stronger for smaller and non-express parcels
- Some parcels are in the universal postal service but were never part of the monopoly

Source: UBS
Competition and the universal service

• In June 2014, we received a submission from Royal Mail on the threat that it considers direct delivery competition poses to the universal service. We also received submissions from other parties.

• Royal Mail called on Ofcom to bring forward a review and impose conditions on direct delivery competitors.

• In the event, we have undertaken a detailed and forward looking assessment of the potential impact of direct delivery competition on the future financial sustainability of the universal service.

• This was based on an understanding of Royal Mail’s business plan provided to us in July 2014, Whistl’s business plan from December 2013 and market information from other operators.

• We have also considered Royal Mail’s potential commercial responses to direct delivery competition and a range of potential outcomes to allow for uncertainties in the projections.

• This analysis was considered carefully by Ofcom’s Board over recent months.
Review of direct delivery competition

• We have, therefore, carried out a review of the impact of direct delivery competition on the universal service

• On the basis of this review, we are finding at this point in time, direct delivery competition does not pose a threat to the universal service

• However, we consider that there are other issues that may have an impact on the future financial sustainability of the universal service, in addition to direct delivery competition

• We are therefore going to widen our work to consider these other factors, including:
  • The impact of developments in the parcels market
  • Royal Mail’s progress on improving its efficiency

• We will continue to monitor the market and direct delivery competition in particular and can respond swiftly if required
Competition can benefit consumers and the universal service

• As with other businesses, competition in general is central to ensuring that there are incentives for Royal Mail to:
  – Maintain focus on **efficiency** in the delivery of universal services
  – **Constrain pricing**
  – **Innovate** in service delivery

• In parcels, competition has already led to:
  – **Greater choice** for consumers, including introduction of Sunday deliveries and delivery to neighbour
  – **Major changes** to Royal Mail parcel processes

• We expect direct delivery competition to offer similar benefits.
‘Cherry picking’ is more complex than often presented

• Royal Mail states ‘cherry-picking’ entry in high density, low cost areas undermines the cross-subsidies needed to support the universal service.

• **Competitors only entering in certain areas**
  – Zonal pricing means competitors pay a fair and profitable price to Royal Mail for delivering in higher cost areas
  – High-density not always low cost: *London is RM’s highest cost zone*

• **Competitors delivering fewer days per week**
  – Royal Mail is not required to deliver *bulk mail* 6 days per week
  – Royal Mail gets significant cost advantages from using the same network for universal service and bulk mail and could offer a lower frequency bulk mail delivery service if it was commercially attractive

• **Impact on universal service cross-subsidies**
  – Direct delivery competition affects bulk mail not universal service volumes
  – Universal service mail is profitable in its own right
Royal Mail’s access prices

In Jan 2014 Royal Mail announced changes to its access pricing and terms

The changes included:

- A 1.2% price differential between its two national price plans (only one of which is suitable for direct delivery operators)
- Substantial cuts to charges in competitive geographic zones (such as London and urban), and increases in non-competitive zones

- Following a complaint by Whistl, Ofcom opened an investigation into these price changes on 21 February. Royal Mail then suspended the changes

- On 9 April, we announced that investigation would be under the Competition Act, and separately launched a review of regulations on access pricing

- We expect to conclude the investigation in 2015
Royal Mail’s access prices

• **Ofcom’s concern:**
  - Royal Mail has the incentive to price high where there is no competition, and low where there is competition
  - This can **inhibit entry** by direct delivery competitors who partly rely on access services

• **In particular:**
  - Proposed zonal charges would increase prices to operators using access for delivery in suburban and rural areas but delivering themselves in urban areas
  - Proposed national discount appears to give access-only operators a price advantage over ‘direct delivery + access operators’

• **Our priorities on access prices:**
  - Intervene in least intrusive way
  - Ensure RM retains ability for prices to reflect user demand and its own costs
  - Ensure RM has the incentive to compete through innovation and efficiency
  - Allow the potential for effective direct delivery competition
Ofcom proposals on access prices

Our proposals allow Royal Mail the necessary commercial freedom to achieve reasonable returns, while limiting its ability to set prices to deter competition.

• Under the new proposals Royal Mail remains free to set the absolute level of charges separately for each type of product, allowing them to:
  – be able to respond in price to difference in demand;
  – set price to reflect risk and complexity; and
  – maximise their returns subject to demand and competition.

• We propose that for zonal access contracts the differences in charges between zones are aligned with the difference in the costs of delivery in each zone.

• For national average prices we propose that the national access charge for a mailing item equals the weighted average of the zonal access charges for that item.
Next steps

• Now consulting on proposed access price rules
  – Consultation closes on 24 February 2015
  – A statement on our decisions expected in summer 2015

• A further review to understand Royal Mail’s
  – competitiveness in the parcels market
  – progress on improving efficiency

• Continued monitoring of the sector

• Investigation of Whistl complaint (Competition Act case) remains on-going
Thank you

Questions welcome