

All Change for Regulation

Postal Regulation in the UK has not worked. Who says so? No other than Ofcom, who took over the mantle of UK postal regulator from Postcomm on 1st October 2011. Ofcom bases this view on the fact that Postcomm used price control as its regulatory model and this resulted in removing Royal Mail's flexibility to adjust to changes in demand at a time when it was struggling to improve efficiency in a declining market. Ofcom also believes price control has not served consumers well, with Royal Mail applying for price increases above the level of inflation, e.g. its application in November 2010 for additional flexibility to increase its prices to stem losses. Given the risk to the Universal Service Obligation (USO), Postcomm had no choice but to grant Royal Mail's request which resulted in price rises averaging 12% in 2011/12. Ofcom believes if the price control policy continues it would see further special requests from Royal Mail to increase prices beyond inflation. It is therefore setting a much different course for regulation in the future.

So how does Ofcom plan to regulate in future? Its primary duty is to secure the provision of a universal postal service, i.e. to protect the USO. In doing so it believes that Royal Mail must be financially sustainable and be able to enjoy a commercial rate of return on its activities. At the same time, it expects Royal Mail to become efficient within a reasonable timescale and to sustain a good level of efficiency into the future. It recognises that this will be tough in a declining market and it is the uncertainty over future mail volume that has led Ofcom to the view that it should not set a traditional price control up front. It believes that to do so could cause a regulatory error which might damage Royal Mail's finances and, with it, the USO. It is therefore proposing to grant Royal Mail more commercial freedom for a period of seven years by allowing it to determine price levels against a background of electronic substitution and access competition. At the same time it expects Royal Mail to address its inefficiency which it believes it will better be able to do with a period of regulatory stability.

However, Ofcom also realises that **a number of safeguards must be put in place** to ensure consumers and competitors receive a reasonable level of protection. It is therefore planning to introduce safeguards in the following three areas:-

- effective monitoring of performance, including scope for re-regulation if the incentives to deliver greater efficiency are demonstrably failing;
- ensuring that a basic universal service is available to all and affordable by all;
- the discipline of competition and innovation.

So how will these safeguards work? Firstly, by monitoring Royal Mail's quality of service performance and its pricing and profitability, Ofcom could intervene should service deteriorate or excessive profits be achieved. Secondly, by regarding the 2nd class service as the basic universal service, particularly for vulnerable customers, it proposes to set a standard price limit within the range of 45p – 55p over the next 7 years (the precise figure will be dependant on the level of inflation during that period). Thirdly, it will not regulate access prices nor price headroom (the minimum difference between the access and the retail price that is the basis of the business model of many of Royal Mail's competitors).

Ofcom's proposals are currently out for consultation to the industry, with a response required by early January 2012. This is clearly a much different approach to regulation than Postcomm, although in fairness, Postcomm was also moving towards a lighter touch during the last year. At one level there is logic in allowing Royal Mail to set its own prices if one sees electronic media as its main competitive threat. Effectively, Ofcom are saying that it is difficult to estimate accurately how the market will change over the next seven years and is saying to Royal Mail – 'you make the judgement' and if you put prices up too much you may suffer even greater losses of market share than are currently predicted.

The setting of a price control for 2nd class mail does give a level of protection for those least able to afford to post. However, there are a number of companies who rely on 1st class mail to operate their businesses, e.g. internet retailers such as Photobox, whilst a number also offer the service as an enhanced delivery option, e.g. Amazon. As internet retailing is one of the few growth areas in the mail market Royal Mail will need to be careful in how it sets prices in this area.

In addition, many consumers may use 1st class mail when they need an item to be delivered the following day. For consumers and businesses alike the other advantage of 1st class mail is that it provides (virtually) a defined delivery day and as such is often used for sending birthday cards and other communications which need to be delivered on a specific day. Posting 2nd class means delivery within three days but the letter could be delivered in 2 or 3 days depending on the distance it travels. Perhaps an option Ofcom might have considered as part of this change might have been to ask Royal Mail to enhance its 2nd class service to a two day delivery system to give customers the option of a cheaper defined delivery day service (albeit two days instead of next day).

A further aspect of 1st class is that it has no real competition at an affordable level as most access mail is delivered two days after posting.

As far as Royal Mail's competitors are concerned, the removal of the access pricing and headroom regulation places a greater risk on their business models. Any significant move to end-to-end competition also looks unlikely unless Royal Mail increase their prices significantly and with a cap on 2nd class prices this makes it even more unlikely, particularly in a declining mail market .

Finally, Ofcom's hope is that Royal Mail's future pricing strategy will not only be determined by revenue generation but also by improving efficiency. Whether this will be the case remains to be seen and, if not, what real incentives are there in the proposal (other than the threat of future intervention). As mail volumes have fallen Royal Mail's unit costs have increased and this trend will need to be reversed if prices are to be contained.

In conclusion, Ofcom have set out a very clear strategy for the future with the survival and sustainability of the USO at its centre. Will the strategy of giving Royal Mail more commercial freedom achieve this objective or will it see a downward spiral of above inflation price rises that accelerate the fall in mail volumes with customers paying higher prices and competition diminishing due to lower margins? If this approach fails then we could be seeing a real risk of Royal Mail's six day collection and delivery service (which is at the heart of the USO) coming under real threat as it already has in a number of other countries.