

Securing the universal postal service: The future framework for economic regulation

Philip Groves, Ofcom
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Overview

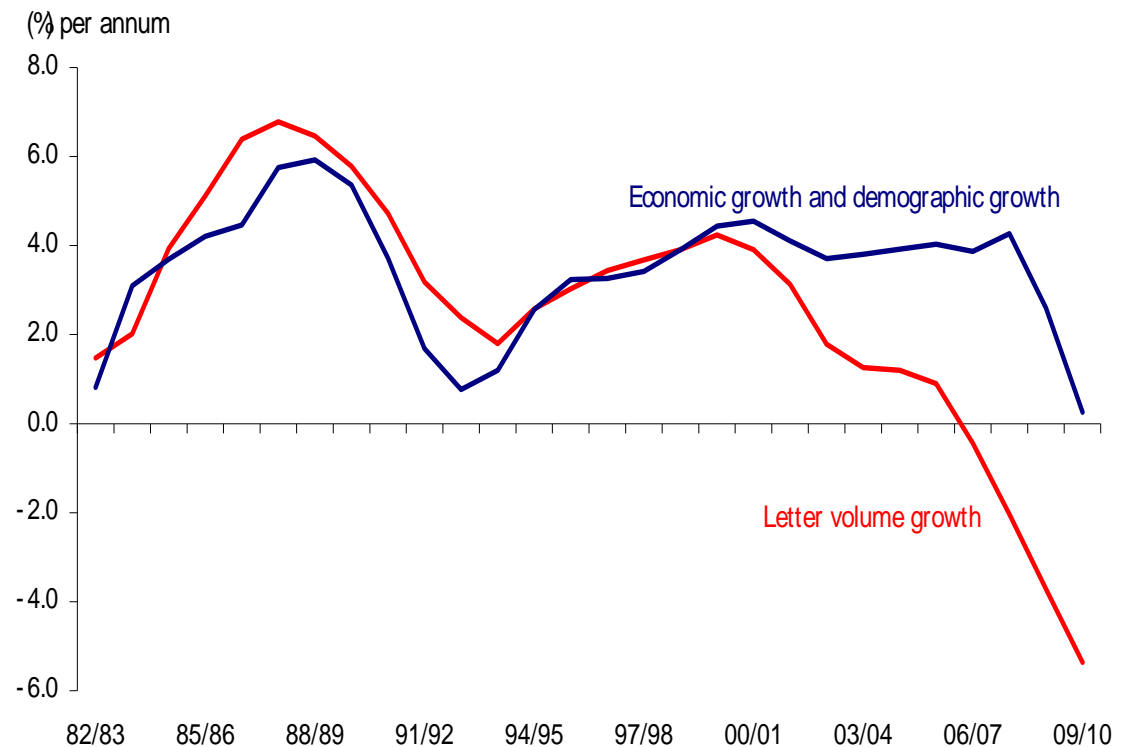
- Why is the universal service under threat?
- Ofcom's focus and priorities
- The universal service in the UK
- The regulatory model needs radical reform
- Ofcom's proposed approach

A challenging market context



- Delivered mail has fallen 25% since 2006
- Royal Mail delivered 84m letters a day in 2006 but 62m in 2010
- Access has grown rapidly but RM still delivers 99% of all mail
- Product mix change (“down-trading”) responsible for a 10% revenue decline
- Packets and parcels growth has not offset letters decline

Royal Mail performance (Hooper Report 2010)



Note: Data refers to three year moving average annual growth rates
Source: Economics Forecasting, Group Regulation

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Ofcom's focus and priorities

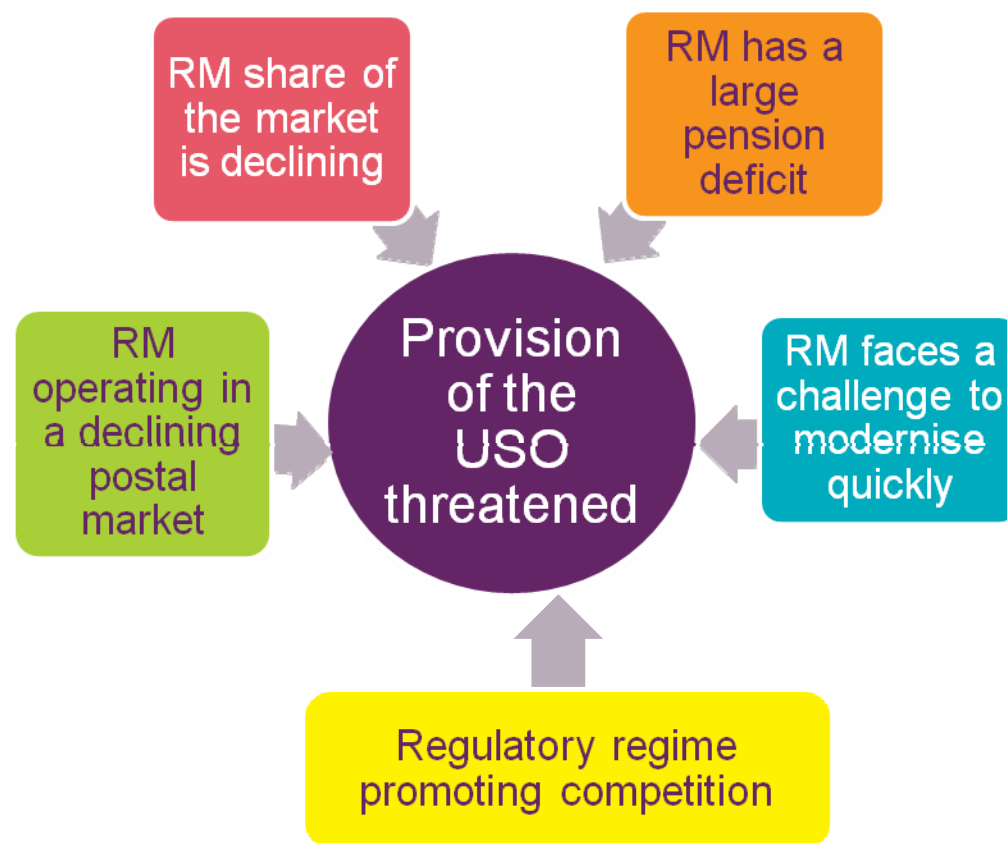
- **The Postal Services Act 2011 made Ofcom the relevant NRA and gave Ofcom the clear priority of securing a financially sustainable universal service**
- We will aim to do this by ensuring:
 - Clear service obligations are set for Royal Mail
 - Royal Mail has commercial flexibility to deal with a very challenging market environment
 - The regulatory regime provides real incentives for Royal Mail to improve efficiency levels

The circumstances are extremely challenging

- Universal service is loss-making
- Public sector owned and operated company
- Market is declining

Hooper made three main proposals:

- 1.Privatisation** – to bring in capital and experience to drive modernisation
- 2.Pensions** – addressing the pension deficit by moving it to the Treasury
- 3.Regulation** – moving regulatory responsibility to Ofcom



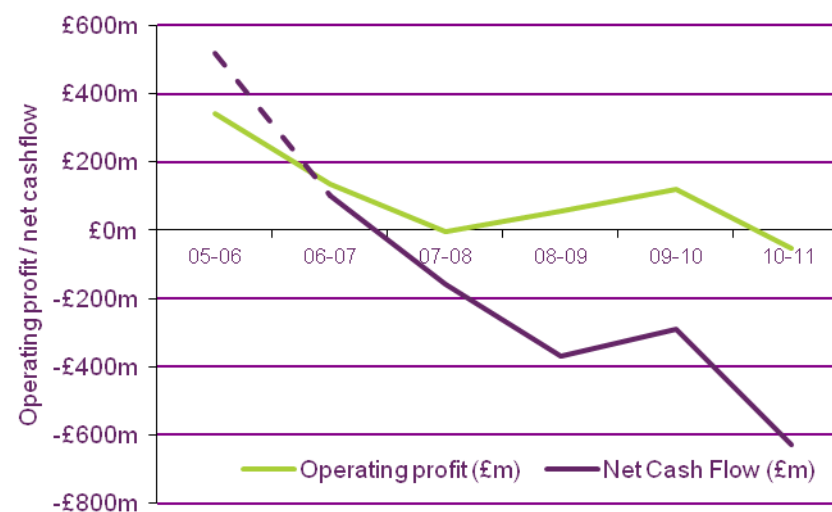
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The UK universal service is fairly high and is in real difficulty

- The universal service is set at the high end (6 day delivery, 93% D+1, 98.5% D+2)
- This is no longer financially sustainable under current framework
- Royal Mail is making a financial loss and struggling to strip out costs from its network
- There is no appetite for continued tax payer funded model – State aid application aims to restructure Royal Mail's £1.7bn debt

Royal Mail performance 2005/06 to 2010/11

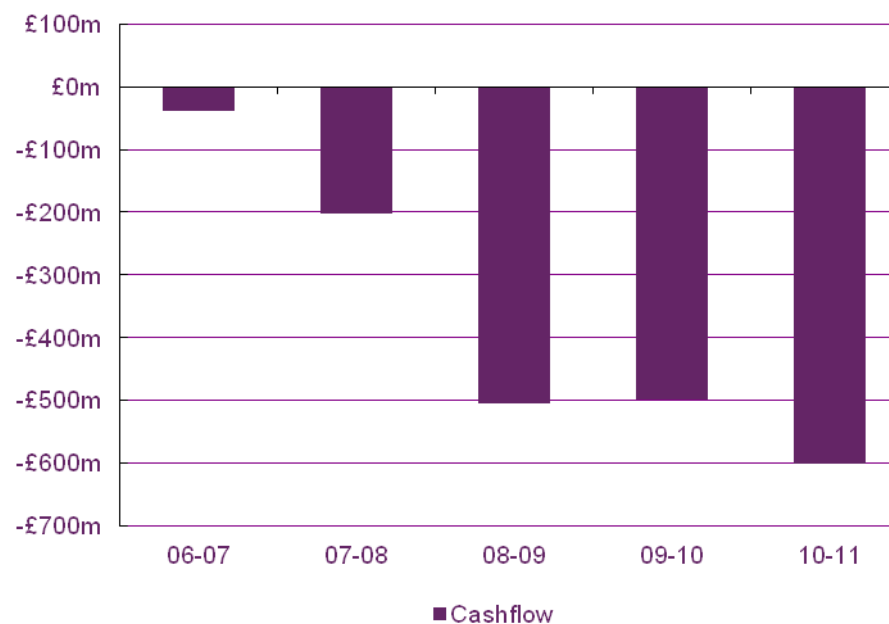


Cash flow includes pension deficit payments and modernisation costs

Royal Mail is spending more than it receives

- Forecasting Royal Mail cash flow has proved to be difficult
- Since 2006, Royal Mail's cash flows have been £3bn less than anticipated

Royal Mail's cash flow 2006/07 to 2010/11

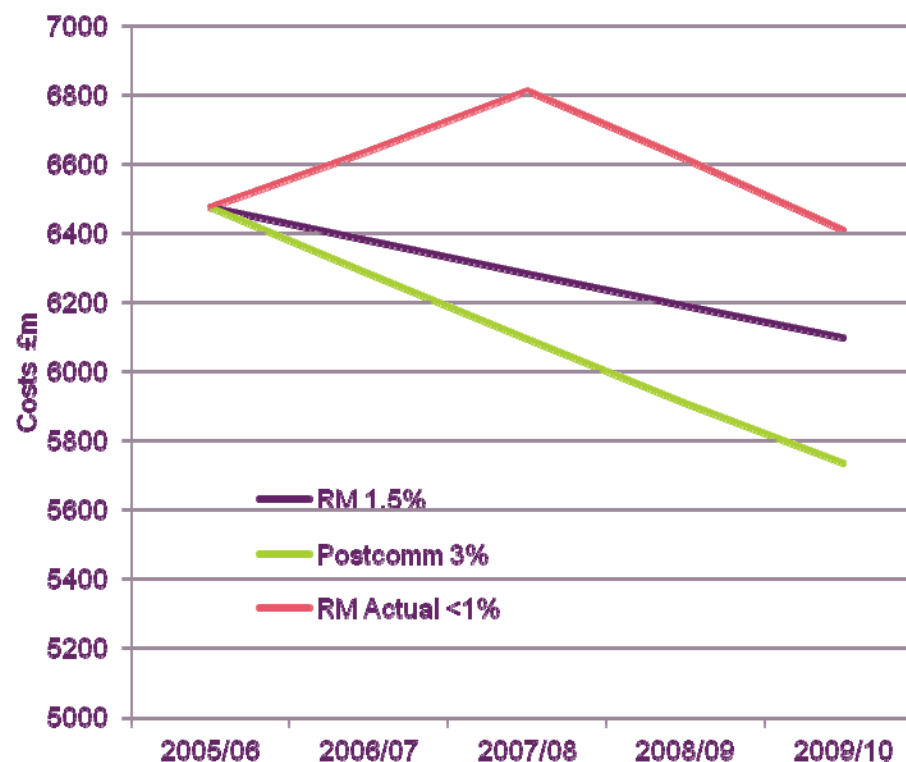


N.B. includes annual cost of servicing pension deficit

Royal Mail has struggled to strip out costs from a largely fixed cost network

- Since 2006 capital investment including modernisation (but not redundancy) has been around £1.6bn
- Royal Mail must convert expenditure and cost savings into real efficiency improvements
- The total workforce has fallen by 20,000 since 2007, but unit costs have increased

Royal Mail efficiency



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Features of current regulation

- Price control of around 85% of Royal Mail's revenues
- Direct regulation of access prices
- Royal Mail's commercial freedom to change products and prices constrained by prior notification and publication requirements

The conventional approach to regulation is not appropriate

- Price controls are usually applied to stop private operators from earning excessive profits while driving efficiencies.
- Price control regulation has failed in post:
 - Patterns of demand are insufficiently predictable
 - Incentive mechanisms have not worked: efficiency improvements proved very challenging
 - Royal Mail were highly constrained while facing a rapidly changing market



The regulatory settlement needs to be re-drawn

The regulatory challenge:

- In the short-term the universal service must be returned to a sustainable basis
- Royal Mail needs to make a commercial return and become more efficient
- Competition should be efficient and not undermine the universal service

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Our proposals are fundamentally deregulatory...

- Change from licence obligations to general authorisation model
- Removal of vast majority of retail and wholesale price controls
- Removal of direct regulation of access pricing
- Removal of the requirement for Royal Mail to maintain a guaranteed margin for access operators; known as access headroom
- Consultation on product and service commercial freedom for Royal Mail before the end of the year
- At same time, as the designated universal service provider, Royal Mail will be obliged to meet the universal service requirements

Average household expenditure on postal services is very low compared to other services

	Weekly expenditure (£)	% of average weekly expenditure
Telephone	10.80	2.4%
Electricity	10.20	2.2%
Gas	9.70	2.1%
Water	6.50	1.4%
TV & internet	5.90	1.3%
Postal services	0.40	0.1%

Source: ONS family spending 2009

Data is from most recent ONS family spending report – electricity and gas prices are now significantly higher

Safeguard 1 – Ensuring that a basic universal service product is available to all

- A safeguard price cap for Second Class stamp prices
 - The product particularly relied on by vulnerable consumers
 - Consistent with substantial flexibility for Royal Mail
- Strikes a balance between safeguarding consumers, and ensuring the USO is sustainable
- Consulting on a range of 45p – 55p (inflation linked)
- Possibility of reassessing in two years in light of any relevant changes in the market and evidence on affordability

Safeguard 2 – Effective monitoring of Royal Mail's performance

- We will monitor Royal Mail's performance to ensure that:
 - The universal service is restored to viability
 - The universal service's quality of service obligations are met
 - Royal Mail becomes more efficient over time and consumers share the benefits
 - Prices do not become unaffordable for vulnerable consumers



Safeguard 3 – Competition within the mail market

Competition can help make Royal Mail more efficient and provide choice and innovation for customers

Access

- Mandating access to Royal Mail's network to ensure established benefits remain
- Removing headroom control for 'margin squeeze' test protection for access competitors

End-to-end

- Case-by-case consideration of any proposals for end-to-end services
- Balancing benefits with risks to financeability of the universal service



Next steps – our timeline

October 2011 – Final proposals on a future framework for economic regulation



Late 2011 – Consultation about product and service commercial freedom for Royal Mail



Early 2012 – Decision about the economic framework



Spring 2012 – Economic framework takes effect

A phased approach

