



Annex 7 - Access

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Section 1

Introduction

- 1.1 In March 2011, Postcomm consulted on its access review¹. The access review provided a background to access, considered the role of access competition in the UK and provided Postcomm's initial views on how access should be regulated under a new regulatory framework from 2012.
- 1.2 The document specifically considered the likely impact of the Postal Services Bill 2010. Although at that point the Bill had not yet been enacted, Postcomm believed that it was appropriate to have close regard to the framework of the Bill in setting out its proposals given the timing of the anticipated changes in legislation. The relevant sections of the Postal Services Act that deal with access (section 38 and Schedule 3 of the Act) are unchanged from the version of the Bill on the basis of which Postcomm set out its proposals.
- 1.3 In the document, Postcomm addressed the following questions:
- Should Ofcom impose an access condition requiring Royal Mail to grant access to its network?
 - If Ofcom imposed an access condition requiring Royal Mail to grant access to its network, what should its role be in setting the terms and conditions of access?
 - What is meant by ensuring 'equivalence' and how should equivalence between Royal Mail and access operators be ensured?
 - How should disputes over the terms of access be resolved and what is the role of Ofcom?
 - How should Ofcom consider whether it is necessary for Royal Mail (and potentially other operators) to offer access to elements of postal infrastructure and is there a current need for such access?
- 1.4 Within Postcomm's consultation on the need for ex ante regulation of Royal Mail beyond 2012², it also consulted on the following:
- Are regulatory safeguards required to address the risk of Royal Mail engaging in a price or margin squeeze and what are the options for addressing any such risks?
 - Is there a need for zonal access price regulation and what are the potential options?
- 1.5 In this document Ofcom sets out the responses to Postcomm's consultations and we provide our proposals regarding the need for the regulation of access and the appropriate form of any such regulation. We have primarily focussed on the areas which we consider need to be addressed as a minimum alongside our proposals for

¹ Postcomm, The building blocks for a sustainable postal service – Access Review 2012 – Initial Proposals, March 2011.

² Postcomm, The building blocks for a sustainable postal service – Initial proposals for regulatory safeguards, April 2011.

the regulatory framework. Therefore, we have focussed on the case for imposing a USP access condition for participation in the retail D+2 and later than D+2 Letters and Large Letters markets.

- 1.6 Further proposals on more detailed aspects of implementation of our proposals for the regulation of access will be addressed within a supplementary consultation which we intend to publish later this year. In addition, other aspects of the regulation of access, such as the prohibition on Royal Mail obtaining an unfair commercial advantage in Condition 10 of its licence (now replaced by Initial Condition USPA 3), including the undertakings Royal Mail gave relating to the 'ring-fencing' of Royal Mail Wholesale³, will fall within the scope of the review of regulatory conditions that will be conducted later this year.
- 1.7 The proposals we make in this document should be considered in the context of our other proposals in relation to the wider regulatory framework that we have published alongside this document.
- 1.8 To be clear, although Ofcom has taken regard of evidence provided in response to Postcomm's consultation, the views expressed in this document are Ofcom's.

³ Postcomm, Condition 10 of Royal Mail's Licence: Prohibition against Obtaining Unfair Commercial Advantage, A Complaint about Royal Mail's Offer of Zonal Downstream Access, Second Report and Decision of the Postal Services Commission, July 2006.

Section 2

Obligation on Royal Mail to offer access to the postal network

- 2.1 Under the Act, Ofcom may impose a USP access condition i.e. a condition requiring the universal service provider to give access to its postal network to other operators or users of postal services.
- 2.2 The legal tests that Ofcom must meet in order to impose such a condition are set out in sections 3 and 9 of the consultation document.
- 2.3 In this document we have focussed on the assessment of whether Royal Mail should be required to offer access to the postal network for participation in the retail D+2 and later than D+2 Letters and Large Letters markets. Over 99% of current access volumes relate to these markets whereby access users inject items into Royal Mail's network at the Inward Mail Centre ('IMC').
- 2.4 Ofcom notes that access operators have indicated a desire to compete with Royal Mail by gaining access in order to participate in a number of markets, including:
- the retail D+1 Letters and Large Letters markets;
 - Packets markets; and
 - response service markets through extraction services.
- 2.5 In assessing the need for a USP access condition requiring Royal Mail to offer access for participation in these markets, the same legal tests as referred to above will need to be applied. Before Ofcom undertakes an assessment of whether the tests are met, it expects to receive detailed evidence from access seekers supporting the case for imposing a USP access condition. As part of this, Ofcom would expect to receive the following information:
- The access seeker's business case for the proposed form of access;
 - A description of the perceived operational requirements of the proposed form of access; and
 - An assessment of how the form of access meets the tests set out in the Act. In addition, an assessment of how this form of access will be consistent with Ofcom's primary duty to secure the provision of the universal postal service.

Postcomm's consultation

- 2.6 In March, Postcomm indicated that the process for imposing a mandatory requirement to offer access was likely to involve imposing an obligation, via a USP access condition, on Royal Mail to grant access to a specific point or parts of the network (as opposed to a general obligation to grant access to all parts of Royal Mail's postal network).

- 2.7 Postcomm indicated that the first step in imposing a USP access condition would be to assess the extent to which the criteria for imposing a USP access condition under the Act (at the time the Postal Services Bill) might be met at different points in the network.
- 2.8 As part of this work, Postcomm undertook a preliminary assessment of whether the criteria for obliging Royal Mail to offer access for participation in the retail D+2 and later than D+2 Letters and Large Letters markets were met as a matter of principle. Postcomm did not assess in detail the specific obligations that ought to be included in a USP condition.
- 2.9 Postcomm considered that the three tests as set out in the Act and paragraph 2.1 above, for imposing a USP access condition requiring Royal Mail to offer access to its network for the purposes of participating in the relevant retail markets for D+2 and later than D+2 Letters and Large Letters market, were satisfied.
- 2.10 In relation to promoting efficiency it considered that competition from access would incentivise Royal Mail (and other operators) to improve the efficiency of their upstream networks. Indeed, Postcomm noted that access operators had already been able to provide flexibility to customers in terms of collection times and customer service and that had in turn encouraged Royal Mail to improve its efficiency and customer service in this respect.
- 2.11 In relation to promoting effective competition, Postcomm observed the evidence of its analysis of postal markets and noted Royal Mail's market power in the relevant wholesale markets for D+2 and later than D+2 Letters and Large Letters. It considered that given the barriers to entry of a legal, economic and strategic nature in the downstream network and the uncertainty over future volumes there was unlikely to be entry on a meaningful scale to provide a viable alternative for the majority of mailers to Royal Mail's downstream sortation and delivery in the medium term. Given this view, Postcomm concluded that competition from entrants at the retail level was only likely to be feasible on any meaningful scale through participation in upstream activities and that access offered the best prospect for encouraging effective and sustainable competition in the relevant D+2 and later than D+2 Letters and Large Letters markets.
- 2.12 Postcomm noted that access operators had already invested in their own upstream networks to provide a D+2 and later than D+2 service for Letters and Large Letters and were already processing over half of all business mail items for these formats before injecting them into Royal Mail's downstream network for final sortation and delivery. Effective, sustainable competition in the upstream activities of collection, outward sortation and trunking was only likely to be possible if other operators had access to Royal Mail's downstream network on appropriate terms.
- 2.13 Postcomm considered that access conferred significant benefits to the users of postal services through greater choice of postal operators leading to improvements in customer service, quality and lower prices. Furthermore, it considered that lower prices were likely to have helped to maintain volumes in comparison with faster declines in other mail segments in recent years and this would have helped to sustain the universal service, with Royal Mail retaining over 80% of the revenue from these services.
- 2.14 Postcomm therefore considered that the tests in section 38(4) of the Act for the imposition of a USP access condition for access to Royal Mail's downstream network

for retail providers of Letters and Large Letters services in the D+2 and later than D+2 markets were met.

- 2.15 Having assessed whether a USP condition was justified, Postcomm considered the appropriate point in Royal Mail's network at which access should be granted and considered that the five factors set out in section 38(8) of the Act and paragraph 2.3 above were relevant to the assessment. In particular, Postcomm considered the appropriate point of access with reference to issues such as the feasibility of granting access at a particular point, the investment made by the universal service provider and the extent to which alternative facilities could be installed or used that would make that point of access unnecessary.
- 2.16 Postcomm considered that accessing Royal Mail's network at the Inward Mail Centre ('IMC') was an appropriate point of access. This recognised that downstream access users currently injected items for final delivery at the IMC and was therefore shown to be feasible. Postcomm also observed that accepting and sorting mail at the IMC provided greater scope for Royal Mail to retain the benefits of existing scale economies than if mail was sorted at other points of the network, say further downstream at the Delivery Office, which handles a lower volume of mail.
- 2.17 Postcomm considered two other points of access to the network for the purposes of participating in the retail D+2 and later than D+2 Letters and Large Letters markets – at the Delivery Office and the Outward Mail Centre ('OMC') (or outward Regional Distribution Centre ('RDC')).
- 2.18 In relation to Delivery Offices, Postcomm noted the smaller scale of the premises compared to IMCs and considered these to be less suited to accepting and processing mail from other operators. It also recognised that accepting mail from other operators at the Delivery Office could remove the efficiency benefits that Royal Mail expects to derive from its investment in walk-sequencing machines as part of Royal Mail's overall transformation plan. Royal Mail plans to install over half of its walk-sequencing machines in Delivery Offices and Mail Preparation Units ('MPUs') with the remaining machines installed in Mail Centres.
- 2.19 Postcomm's initial view was that it was unclear whether it would be appropriate to require access to the Delivery Office for the purposes of participating in the relevant D+2 and later markets. It also argued that there was not a strong case for obliging Royal Mail to offer access at the OMC or outward RDC for participating in the relevant D+2 and later markets due to the relatively low barriers for operators seeking to provide an upstream network capable of offering customers a D+2 and later service.
- 2.20 Postcomm considered the extent to which the criteria for imposing a USP access condition was met in relation to participating in the retail markets for D+1 Letters and Large Letters. Postcomm considered that, in relation to promoting effective competition, promoting efficiency and conferring significant benefits to users, a similar set of arguments apply as in relation to the analysis on the D+2 and later than D+2 Letters and Large Letters markets. Indeed, it argued that the barriers to entry for establishing a D+1 network are likely to be greater than for establishing a D+2 and later than D+2 network.
- 2.21 In relation to the appropriate point of access in Royal Mail's network to participate in the D+1 market for Letters and Large Letters, Postcomm noted that, although the existing point of access was at the IMC, a number of operators had experienced difficulties in meeting the required access slots. Therefore, Postcomm suggested and

sought views on whether it might be more feasible to require access at an alternative point in the network, such as the outward RDC or OMC, or whether an alternative approach involving changing the specifications for the current access product (for example, by modifying access slot times) might be feasible.

Responses to Postcomm's consultation

- 2.22 Royal Mail argued that it was not appropriate for network access to be mandated but rather, Royal Mail should be free to determine the circumstances under which it would offer access based on the assessment of whether it is in the interests of sustaining the universal service.
- 2.23 Royal Mail argued that, with regard to the question of determining the circumstances under which Royal Mail would choose to provide access to its network, there was a contradiction within Postcomm's document. In particular, it argued that Postcomm made statements that access competition was beneficial to sustaining the universal services, yet at the same time, believed that it was necessary to mandate access, rather than allowing Royal Mail to determine under what circumstances access should be offered. Royal Mail argued that it was clearly in its interest to ensure the financial sustainability of the universal service. Therefore, if the provision of access supported this objective, Royal Mail would welcome economically efficient access, even in the absence of access being mandated.
- 2.24 Royal Mail provided three main reasons for not imposing an obligation to provide access:
- the economic rationale for mandating access in network industries did not apply to post;
 - it should not be obliged to offer access, since as long as access supported the financial sustainability of the universal service, it would have an incentive to continue to do so; and
 - access was not required to promote competition in the D+2 and later markets, as end-to-end competition would have developed in the absence of access competition.
- 2.25 Royal Mail argued that the rationale for imposing network access under competition law as a means of overcoming an economic bottleneck which impedes the development of competition did not apply to postal markets since none of Royal Mail's assets was inherently non-replicable. Further, there was no evidence to suggest that Royal Mail had any 'essential facilities' from a competition law perspective and these facts were supported by evidence of the presence of end-to-end competition in other countries. Royal Mail also argued that Royal Mail's downstream facilities were replicable on an incremental basis and therefore were not essential facilities.
- 2.26 Royal Mail accepted that the introduction of upstream competition into certain D+2 and later retail markets through access might have delivered some operational efficiency through other operators being incentivised to achieve lower operating and other costs. However, it argued that although there might be some instances where the presence of upstream competition had stimulated efficiency savings by Royal Mail these were limited (not least because the headroom regime itself had distorted Royal Mail's incentives to improve efficiency). Royal Mail also noted that access competition had resulted in some inefficiency through increasing transactional costs

from Royal Mail transacting with multiple operators and through the presence of stranded costs where it was unable to remove assets in response to upstream volume declines due to competition.

- 2.27 Further to arguing that the Letters⁴ delivery markets, when considered on a localised and/or a limited day delivery basis, were not necessarily natural monopolies, Royal Mail considered why end-to-end competition had not developed to any significant extent in the UK (i.e. it considered a counterfactual case without an access regime). Royal Mail considered that the access regime itself had impacted on the incentives for end-to-end competition in the UK. It contrasted this with the experience in the Germany, Netherlands, Spain and Sweden where some end-to-end competition had developed (with the exception of Germany) without an ex ante regulatory regime that governed access.
- 2.28 Royal Mail argued that there were a number of important features that were relevant to this issue: the headroom control that gave greater certainty to access operators; low capital requirements based on entry models that had leveraged existing parcel networks; and any scale economy issues which might deter entry were made largely redundant by the incremental nature of upstream entry. Royal Mail argued that these factors in combination had meant that when entrants had evaluated the options for entering the market in the UK they had chosen access rather than establishing an end-to-end network. In short, Royal Mail argued that, had the access regime not existed in its current state, some form of entry would have occurred.
- 2.29 Royal Mail presented a scenario that examined the level of sunk costs that would be expected from a hypothetical operator that is seeking to establish a delivery network in Birmingham. Royal Mail estimated the level of sunk costs for the hypothetical operator would be around [£Xm] and compared this against the incremental costs that the hypothetical operator would face if access prices increased by [X]. In summary, Royal Mail argued that since the extent of sunk costs would be less than the increase that the hypothetical operator would face if access prices increased by [X] this demonstrated the conditions for by-pass entry in a local area.
- 2.30 Royal Mail also considered a further counterfactual case where access is not mandated. Royal Mail suggested that, in the absence of a mandated access regime, it would continue to provide access in circumstances under which it helped to sustain the universal service and was in its commercial interests and that its intention is to continue to provide access at the IMC.
- 2.31 Royal Mail argued that in relation to conferring significant benefits to postal users it was not clear that access had resulted in lower prices compared to a counterfactual of end-to-end competition developing. It argued that it did not follow that access had resulted in improvements in quality of service for customers since there was no independent measure of quality of service and that competitors used different approaches to measuring quality of service that made comparisons difficult. In addition, it argued that the introduction of access had not resulted in any material innovation in the market with access operators almost exclusively offering imitations of Royal Mail's own services.
- 2.32 Notwithstanding Royal Mail's other arguments regarding it not being appropriate to mandate access to the network, it suggested that the only logical point for widespread access given how the market had developed was at the IMC since this

⁴ Although Royal Mail uses the term 'letters' we assume that Royal Mail is also referring to the Large Letter format.

had been shown to be feasible and was unlikely to require any material investment by Royal Mail over and above that already planned to support existing and forecast access volumes. Royal Mail questioned why access should be required at Delivery Offices to secure competition given the growth of competition to date through access at the IMC. It also claimed that access at the Delivery Office would incur additional costs and result in inefficiencies.

- 2.33 Other operators and respondents generally agreed with Postcomm's initial view that the criteria for obliging Royal Mail to offer access to participate in the retail D+2 and later than D+2 Letters and Large Letters market were met. There was also a broad consensus that the IMC was an appropriate point of access. However, a number of respondents suggested that access to other points of the network could also satisfy the criteria set out in the Act. For example, two customer groups argued that no part of the network should be precluded from access on fair and reasonable terms.
- 2.34 A number of respondents also raised the benefits that could be gained from obliging Royal Mail to offer access at the Delivery Office. For example, one operator argued that access at the Delivery Office might be useful for smaller delivery companies. Another operator believed that the concept of access direct to Delivery Offices should be explored to determine the feasibility on the basis of national or zonal access options or a configuration of both, which might open new opportunities for direct injection to some or all Delivery Offices.
- 2.35 One operator argued that Postcomm had been too general in its view of access at the Delivery Office and that for some larger Delivery Offices access was likely to be feasible and might encourage the development of local/regional competition. It also argued that, where walk-sequencing machines were not located at the IMC, but further downstream, only allowing access at the IMC would remove the prospect of an accessor undertaking further sortation before handing the mail items over to Royal Mail.

Ofcom's analysis

- 2.36 As described above, under the Act, Ofcom may only impose a USP access condition requiring Royal Mail to offer access to a point of its network, where the relevant legal tests set out in the Act are met.
- 2.37 We set out below our analysis in light of the responses to Postcomm's consultation. A full assessment of whether the various tests for imposing a USP access condition are met is set out in Section 9 of the consultation document. Ofcom's power to impose a USP access condition is also subject to its primary duty to secure the provision of the universal service.
- 2.38 Our consultation published alongside this document proposes that the continuation of access competition is likely to be consistent with our primary duty. In particular, access competition is an important component of competition which will provide incentives for the provision of the universal service to be financially sustainable, without threatening the financial sustainability of the universal service.

Promoting efficiency

- 2.39 Royal Mail raised a number of challenges to Postcomm's preliminary assessment for imposing a USP access condition for the purposes of participating in the retail D+2 and later than D+2 letters and large letters markets that are particularly pertinent to

the criteria of 'promoting efficiency' in the Act. As set out above, the main focus of Royal Mail's arguments centred on the following issues:

- The rigid nature of the existing structure of headroom control has distorted Royal Mail's incentive to make efficiency savings upstream since these cannot be passed on to its retail customers due to the level of the headroom control being fixed and not directly variable with costs;
- Access competition results in Royal Mail incurring transactional costs; and
- The risk of stranded costs from Royal Mail being unable to remove certain upstream activities in response to losing upstream volumes.

- 2.40 We consider that our proposals for regulating price squeeze, set out in Section 7 of this document, will address the concerns raised by Royal Mail relating to the existing headroom control potentially distorting incentives. We believe that our proposals will provide Royal Mail with greater ability to benefit from efficiency gains by allowing it to respond effectively to competition, and so adjust prices (and thereby margins) accordingly. By benefiting from such gains, this may incentivise Royal Mail to make further efficiency savings that can be passed on to customers and thereby provide the correct incentives to the market in the long-term.
- 2.41 We accept that Royal Mail will incur transactional costs from being required to interact with multiple operators due to providing access to its network and this will impact on efficiency. We have considered the scale of transaction costs based on evidence provided by Royal Mail. Such costs include those related to the need to operate duplicate sales channels, and the need to run parallel processes for access. In some cases, these may in part be offset by avoided costs from lower retail volumes, and also the benefits of receiving larger quantities of mail from a single customer.
- 2.42 Furthermore, our analysis indicates that the impact is not material given the scale of access. Access operators now handle seven billion items, and our analysis suggests that the costs incurred by Royal Mail Wholesale equate to less than [8] pence per item. The information provided by Royal Mail as part of its response to Postcomm's March consultation appears to confirm this view. We also consider that some of the cost incurred by Royal Mail Wholesale is likely to relate to costs that have been avoided by Royal Mail's retail activities and therefore do not fully represent additional costs to Royal Mail.
- 2.43 Royal Mail highlighted the risks of stranded costs. We agree that such risks exist, and would be taken into account in assessing the impact on the universal service.
- 2.44 However, we consider that stranded costs would occur in the absence of an access regime under the counterfactual put forward by Royal Mail of end-to-end competition being present (or if access is being offered on a voluntary basis) as volumes are lost to other operators. Furthermore, we also believe that the risks raised by Royal Mail are common to all firms that face competition and are subject to a changing market.
- 2.45 Our analysis of Royal Mail's modernisation programme provides some support for the proposition that access competition has incentivised Royal Mail to improve its efficiency upstream and that this will have helped to off-set the incremental costs of an access regime. This analysis indicates that those parts of the delivery network that are subject to competitive pressures from access have modernised more rapidly than other parts of the network. Specifically, our analysis suggests that Royal Mail is

making relatively good progress against certain aspects of its Business Plan, whereby improvements in the efficiency of its Mail Centres have so far been achieved at a faster rate than within Delivery Offices.

- 2.46 On balance, we consider that the risks of stranded costs and transaction costs relating to access are likely to be outweighed by the provision of incentives for efficiency. We consider that the former can be addressed by the provision of an appropriate approach to the test for price squeeze under regulation or competition law. Such an approach should be designed to ensure that Royal Mail can set access prices at a level which reduces these risks, assuming it responds to competition by efficiently re-optimising its network.
- 2.47 We therefore consider that an access condition is consistent with promoting efficiency.

Promoting effective competition

- 2.48 Royal Mail raises a number of issues with Postcomm's preliminary assessment that are pertinent to meeting the criteria of 'promoting effective competition'.
- 2.49 Royal Mail argued that without an inherent 'bottleneck' in the postal network that precluded the development of end-to-end competition there should be no requirement to mandate access. In addition, it argued that, in the context of competition law, 'bottlenecks' are typically assessed with reference to essential facilities and that essential facilities are not present in the postal network.
- 2.50 We agree with Royal Mail in so far as they state that the rationale for a requirement to mandate access is to overcome economic bottlenecks. Indeed that is consistent with the statements made by BIS⁵ when the Postal Services Bill 2010 was laid before Parliament that the Bill seeks to ensure that competitor access, and the terms on which such access is offered, to Royal Mail's services can only be required at economic bottlenecks where access would encourage competition, promote efficiency and be of significant benefit to users.
- 2.51 However, we do not consider that the Act requires Ofcom to prove that a point of the postal network is an essential facility before being able to require Royal Mail to offer access to its network. The relevant tests for determining whether an access obligation may be imposed are those set out in the Act. We therefore consider that Royal Mail is seeking to set too high a threshold in this regard. As previously stated we consider that Postcomm's preliminary assessment of whether access is necessary to participate in the retail D+2 and later than D+2 Letters and Large Letters markets is based on the correct set of criteria and using the appropriate threshold for assessing whether the criteria are met under the Act.
- 2.52 Royal Mail raises a number of other challenges to Postcomm's preliminary assessment that need to be addressed. Key amongst these is consideration of the correct counterfactual that would exist in the absence of an access regime.
- 2.53 In its response to Postcomm's Access Review, Royal Mail argued that on a localised level (or a limited day delivery basis) the downstream network and delivery is not characterised by economic bottlenecks. It supported this with evidence of the

⁵ "Delivering for the future: A universal mail service and community post offices in the Digital Age " October 2010, <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/d/10-1206-delivering-universal-mail-service-community-post-offices.pdf>

development of end-to-end competition in other European countries. We assume Royal Mail refers to regional operators providing delivery for local customers sending mail within the same local area ('local-to-local') since this is typical of the form of competition in Germany, Spain and the Netherlands.

- 2.54 Royal Mail argues that the access regime itself has impacted on the incentives of end-to-end competition developing and that when an operator considers whether to enter the market through either using access or investing in an end-to-end network, the access option is more attractive from a profitability perspective (even though some form of end-to-end entry would be viable for firms). As supportive analysis, Royal Mail provides a hypothetical scenario that estimates the level of sunk costs that would be incurred by an access operator with aspirations to roll-out a delivery network in Birmingham and argues that given a 10% increase in access prices above the competitive level the conditions for end-to-end are likely to be created.
- 2.55 In summary, Royal Mail contends that, in the absence of the access regime, end-to-end competition would have developed i.e. the access regime has stifled the development of end-to-end entry.
- 2.56 We do not agree with Royal Mail: rather than access competition stifling the development of end-to-end entry, we consider access competition to be an important component in facilitating end-to-end competition. In our view, in the absence of an access regime, end-to-end competition would not be likely to develop to any material extent. This reflects two connected impacts of the access regime:
- It allows an access operator to build customer volumes, 'know-how' and brand ahead of the investment and expansion into end-to-end services; and
 - The most likely business model of delivery for an entrant within the foreseeable future is likely to arise from an operator who is able to convey both access items and end-to-end volumes. Without access volumes an end-to-end entrant will face additional barriers to offering an end-to-end service.
- 2.57 We consider that significant barriers to entry exist in developing a delivery network. These predominantly relate to Royal Mail's economies of scope and scale advantages that are likely to limit the extent of end-to-end competition. The scale advantages relate to the economic characteristics of providing delivery and the relatively fixed cost of being required to travel a fixed distance on a delivery route that does not vary with the volume of items delivered (although we recognise that an operator may be able to reduce Royal Mail's scale advantages by delivering on fewer days).
- 2.58 Royal Mail has provided evidence of the extent of sunk costs that might be incurred by a hypothetical operator that is seeking to develop a delivery network. However, although Royal Mail's analysis suggests that sunk costs are not significant and by inference would not provide a barrier to entry, Royal Mail does not assess the underlying cost comparison for the hypothetical operator when competing against Royal Mail (which will benefit from economies of scale advantages). In particular, Royal Mail's analysis does not take into consideration the relevant impact on the unit costs of a potential end-to-end entrant of the additional volumes which an entrant would be able to achieve as a result of the presence of access competition.
- 2.59 Given the high proportion of fixed costs in delivery, a regional competitor is likely to face a cost disadvantage to Royal Mail in a particular geographic area given Royal Mail's ability to deliver volumes that originate from all other areas. Evidence suggests

that around [X]% of mail items in the UK are sent local-to-local. However, this is likely to vary according to type of customer. For example, a local council is likely to have a greater proportion of mail that is local-to-local, whereas a large national mailer, such as a utility company, is likely to have a far lower proportion of mail that is local-to-local because of its national customer base.

- 2.60 Although Royal Mail points towards the development of end-to-end-competition in other countries, the evidence relating to international markets where end-to-end competition has occurred indicates that there exists a greater proportion of mail which can be delivered by a local-to-local competitor. This means that the cost disadvantage faced by other operators is likely to be lower (relative to an operator with the ability to deliver on a national basis) than if they looked to develop similar business models in the UK.
- 2.61 In addition, we believe that the cost disadvantage faced by a local-to-local operator will be increased further still since it is likely to focus on the largest local customers only whereas Royal Mail will have volumes relating to all customers.
- 2.62 It could be argued that competitors could establish business models that focus on delivery within a specific geographic area but also including volumes that originate from outside that area. This would allow an operator to compete on a more comparable basis with Royal Mail, increase delivery volumes and reduce the fixed cost per unit of mail delivered. However, in the absence of an access regime, this would mean that large mailers with a national posting profile, such as a national bank, would need to separate mail between Royal Mail (for geographic areas where no delivery competition has developed) and each of the competing operators that are able to offer delivery services in specific geographic regions.
- 2.63 Although such a process is possible, we consider that it has clear disadvantages. The process would incur additional transactional costs and is a more complex process than that which exists presently. Therefore, although large customers could in theory multi-source their mailing, for large bulk mailings of either transactional mail or direct mail, we believe that they would have a strong preference to send items with a single provider and not split the mailing between different delivery areas. In addition, large customers may also be reluctant to hand over mail for delivery to relatively small delivery operators that do not have the same brand and reputation as Royal Mail (and some of the more established access operators).
- 2.64 In light of these considerations, we believe that an operator that was seeking to provide a delivery service would need to collect all items from a large customer (or customers) and deliver the items where it had established a delivery network and use access to deliver the remaining items. This means that an operator would need to rely on access to Royal Mail's network.
- 2.65 Therefore, we consider that mandated access to Royal Mail's network will play a key role in facilitating effective end-to-end competition. First, it allows an operator to deliver items that originate from outside a local area, thereby increasing delivery volumes (beyond local-to-local only) and improving the economies of scale for an operator.⁶ Second, without access, a large customer with a national profile of mail would be required to separate mail between geographic regions based on whether another operator to Royal Mail was active (and competitive). This would incur

⁶ In addition to improving economies of scale and scope in delivery, an operator will also be able to use machines that are currently used for the outward sort activity for the inward sort activity.

transactional costs and reduce its incentive to use a competing postal operator to Royal Mail.

- 2.66 In summary, we do not accept Royal Mail's argument that the access regime stifles end-to-entry but consider access is likely to be necessary for an entrant that is seeking to provide a delivery service.
- 2.67 Royal Mail suggests that, in the absence of Ofcom establishing a USP access condition at the IMC, it would continue to provide access (on a voluntary basis) at the IMC subject to ensuring that the terms and conditions of access, including price, enable Royal Mail to earn a commercial rate of return. This provides a further alternative counterfactual scenario to a mandated access regime.
- 2.68 In assessing this we note two key issues. First, Postcomm's analysis of markets concluded that Royal Mail has market power in the downstream Letters and Large Letters wholesale markets⁷. Since Royal Mail is a vertically integrated operator (that is active in retail markets and the wholesale downstream markets), it would have the incentive and ability to abuse its market power downstream by favouring its own retail operations when providing access to its network. Second, in the absence of mandating access and establishing a USP access condition, Ofcom would need to rely on ex post Competition Act powers were an allegation of anti-competitive behaviour to be raised.
- 2.69 We consider that, although an ex post approach could be adopted to address the risk of Royal Mail abusing its market power downstream, competition law enforcement may not be the most effective tool for addressing the issues that would be likely to arise. In particular, there is a risk that, even if an abuse were ultimately found by Ofcom following an investigation using Ofcom's Competition Act enforcement powers, the length of time it would take to conduct that investigation and establish the infringement could result in a competitor being forced to exit the market in the intervening period. Therefore, we are concerned that relying on ex post safeguards alone could lead to the risk of irreversible and permanent damage to access competition.
- 2.70 Furthermore, without imposing a USP condition, Ofcom would be unable to impose a number of additional constraints that the Act envisages may be included in a USP access condition. These include the following important potential safeguards:
- An effective dispute resolution process;
 - The ability to set price regulation, if necessary; and
 - The ability to impose publication, accounting separation and cost orientation requirements, if necessary.
- 2.71 On balance, our analysis indicates that an access condition will be consistent with the promotion of effective competition, including access competition, in the D+2 and later markets for Letters and Large Letters.

⁷ Postcomm, Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets - Decision Document, November 2010.

Conferring significant benefits on the users of postal services

- 2.72 In relation to the criterion of conferring significant benefits to the users of postal services, Royal Mail raises the issue of whether there are benefits from access compared to a counterfactual case of no mandated access, where it argues that some end-to-end competition will develop. We have set out our analysis on the role of access in developing competition earlier in this section and explained why we have concerns over the counterfactual case Royal Mail is postulating.
- 2.73 We agree with the view previously expressed by Postcomm that access has benefitted customers through lower prices, better terms and improved customer service.
- 2.74 Although Royal Mail argues that access has not resulted in any material innovation, we consider that this overlooks the benefits to customers with respect to improved customer service and more flexible collection times. We consider that the impact of access competition needs to be assessed in the context of the proportion of the network within which access operators compete. In that context, we consider that some innovation has been delivered:
- Access operators have launched day certain⁸ and hybrid mail services (e.g. UK Mail's 'imail' service) which have extended the services available to customers; and
 - Access operators have delivered alternative approaches to meeting customer needs, including the provision of additional management information to customers.
- 2.75 Our view that access has benefitted users of postal services was also supported by the Hooper Review's findings which affirmed that "*Large businesses have greater choice, lower prices and better assurance about quality of service. We believe that, over time, these benefits will be extended to smaller businesses*"⁹. We also note that in response to Postcomm's March document, Consumer Focus had also agreed that access had conferred significant benefits on users "*both in terms of price and quality*".

Identifying the appropriate point of access

- 2.76 Notwithstanding Royal Mail's general argument that Ofcom should not establish a USP access condition for the purposes of participating in the retail D+2 and later than D+2 Letters and Large Letters market, it did agree that, if access is mandated, the IMC was the most logical point of the network.
- 2.77 There was broad agreement from other respondents that the IMC was an appropriate point of access in Royal Mail's network. Ofcom also considers that, for the reasons outlined in Postcomm's March consultation document, the IMC is an appropriate point for an access user to access Royal Mail's network for the purposes of participating in the retail D+2 and later than D+2 Letters and Large Letters markets.

⁸ Access operators provide their customers with a day certain D+2 delivery or D+3 delivery. These services can be compared to Royal Mail's Second Class service offering that does not provide a day certain delivery but a delivery by day D+3 (i.e. the day of delivery is not certain).

⁹ Modernise or Decline: Policies to maintain the universal postal service in the United Kingdom, 16 December 2008, Cm 7529.

- 2.78 One operator raised concerns over Postcomm appearing to have rejected the appropriateness of access at other points of the Royal Mail's network (other than the IMC) such as at the Delivery Office and Mail Preparation Units (MPUs) since these may house walk-sequencing machines and therefore excluding access from such points would reduce the amount of value that an access user could otherwise provide. We consider that the operator makes a valid argument and that this could become an issue in the future. However, whether access should be given to the Delivery Office will be dependent on the completion of Royal Mail's transformation plan. Although we are not ruling out mandating access at alternative points to the IMC in the future, we would need to consider the case in more detail based on evidence provided by the access user relating to why access at an alternative point meets the criteria set out in the Act. In this regard, evidence would be needed relating to how obliging Royal Mail to offer access at alternative points in the network satisfies the tests set out in the Act.

Section 3

Setting the terms and conditions of access

3.1 The Act provides a framework for imposing certain types of obligation in USP access conditions as well as a power to specify or describe terms and conditions that Royal Mail must include in the terms and conditions that it offers access operators. Beyond that, it is left to Ofcom to determine the precise content of the obligations to be included in the condition as well as, more generally, the extent to which it is appropriate to become more involved in setting the detailed terms and conditions of access.

Postcomm's consultation

3.2 In Postcomm's March access review consultation document, it outlined that it had not had a significant involvement in directly setting the terms and conditions of access services (other than through the regulation of prices). Instead, the development of access services had largely been through bilateral negotiations between Royal Mail and access seekers facilitated by Condition 9 of Royal Mail's licence. However, Postcomm recognised that there had been two occasions where it was likely to have influenced the terms of access.

- Prior to the first access agreement eventually being entered into by Royal Mail and UK Mail, Postcomm published a notice of a direction to Royal Mail on downstream access. The notice provided Postcomm's views on Royal Mail's and UK Mail's position following failure to reach agreement over a number of price and operational terms of access. Following the notice, Royal Mail and UK Mail renewed negotiations and agreed the terms of access without Postcomm needing to make a formal determination.
- Postcomm played a significant role in facilitating an agreement between Royal Mail and access users in relation to revising the zonal structure of zonal access agreements from a five zone pricing structure to a four zone structure in May 2009.

3.3 In its March consultation document, Postcomm considered three broad options for the regulator's role in setting the terms and conditions of access. These were:

- Option 1: Limited involvement for the regulator in setting the terms and conditions of access unless requested to make a determination i.e. in the event that access negotiations are unsuccessful and it is approached to intervene.
- Option 2: As a development of option 1, the regulator providing a framework on the basis of which negotiations can take place between Royal Mail and third parties, by providing clear guidance on how it might determine the terms of access in the event that a dispute is referred to it.
- Option 3: A more prescriptive approach in setting some or all the terms and conditions for access either through directly stipulating particular terms or conditions as part of a USP access condition or by requiring adherence to an access code.

- 3.4 Based on an initial assessment, Postcomm proposed that the regulator should provide a framework within which negotiations could take place between postal users and Royal Mail in developing access (option 2). Postcomm believed that option 2 would give access users (and Royal Mail) sufficient freedom and flexibility to develop access services whilst providing knowledge of how the regulator would be likely to act in the event that commercial negotiations were unsuccessful.
- 3.5 Postcomm considered that a prescriptive access code that set out all the terms and conditions on which access should be provided would be disproportionate, although suggested that there might be a case for a more limited code or guidelines around the procedure for seeking access and on some 'core' terms.
- 3.6 Under the preferred option (option 2), Postcomm considered that there was a case for Royal Mail Wholesale to have alternatives to the approach of annual pricing and to seek to negotiate different terms with access customers providing it complied with its no undue preference and no undue discrimination obligations. In this context, Postcomm indicated that further consideration would be needed on how any future price controls might be applied and whether any controls should only apply to standard services or to baskets of comparable services, including individually negotiated contracts.
- 3.7 In the absence of an access code, Postcomm also sought views on the obligation on Royal Mail to publish all the terms and conditions of access. Postcomm sought views on the following options:
- A requirement for Royal Mail to notify all access agreements to Ofcom without an obligation to publish agreements;
 - A requirement for Royal Mail to notify all access agreements to Ofcom with an additional obligation on Royal Mail to publish a standard access contract only, from which variations could be agreed without the obligation to publish terms and conditions; or
 - Placing an obligation on Royal Mail to notify Ofcom and publish the terms and conditions for all access agreements.
- 3.8 Postcomm did not express a preference for any of the above options.

Responses to Postcomm's consultation

- 3.9 Royal Mail did not believe that access to its network should be mandated and, consequently, did not believe that there was any need for a regulator to set an access framework or access code. In an environment under which access was not mandated, Royal Mail proposed to put forward its own Access Framework, consistent with an ex post (competition law) approach.
- 3.10 Although Royal Mail did not support Postcomm's option 2, it noted that if such a framework were to be put in place, care must be taken to balance the objective of providing a degree of clarity to relevant parties against the benefits that come from allowing unfettered commercial negotiations. In particular, the regulator would need to be pragmatic about the extent of any clarity that can realistically be achieved through the provision of guidance.
- 3.11 Royal Mail indicated that its existing user guides and contracts with access operators exhibit most of the features of an access framework. Any areas remaining would be

covered in its proposed Access Framework that would provide transparency to customers and an overarching set of principles relating to:

- The proposed pricing methodology and approach
- The outline process for reviewing any new access requests including timescales
- Eligibility
- How the rules of discrimination are applied
- Dispute resolution

- 3.12 Whilst Royal Mail acknowledged that without mandated access, the parties had no contractual recourse to the regulator on dispute resolution, it believed that this would lead to greater incentive on these parties to reach a commercial agreement with recourse to the Centre for Dispute Resolution (CEDR) Model Mediation Procedure. Royal Mail argued that, if access was mandated, an operator had the right to refer every commercial decision to the regulator and that this could lead to the regulator being inundated with vexatious referrals in the hope that the regulator would enforce a binding agreement rather than genuinely negotiating in good faith.
- 3.13 Most respondents believed that option 2 was the most appropriate option for the regulator's role in setting terms and conditions.
- 3.14 However, two respondents highlighted the need for potentially greater regulatory intervention in setting the terms and conditions. For example, one operator argued that there was need for rigorous regulatory involvement in access terms since Royal Mail's market power downstream was so great – and Royal Mail Wholesale's lack of incentive to act independently of Royal Mail Group – was such that refusal or delay to provide terms acted as a barrier to customer choice, investment and innovation. The MCF suggested that muscular intervention was needed on access issues, although did not believe there should be a prescriptive access code.
- 3.15 One operator raised a concern about the extent to which access agreements were truly negotiated with Royal Mail on 'commercial terms'. It argued that once an agreement had been made between one customer and Royal Mail then that agreement set the precedent for all succeeding agreements, which would differ only in minor details. Therefore, it argued that the process for negotiation between the first customer and Royal Mail excluded other potential customers and led to suboptimal outcomes. The operator argued that this process needed to be re-thought and that the use of access codes should be considered.
- 3.16 Another operator suggested that further consideration could be given to a hybrid of option 2 and option 3, with more work on a non-prescriptive access code. It argued that although in principle an access code was a good thing it believed that it should be drawn up by access users and Royal Mail.

Ofcom's analysis

- 3.17 Ofcom believes that commercial negotiations between Royal Mail and access operators should provide the basis for agreeing the terms and conditions of access. This is consistent with our view that regulation should only be applied where necessary. Given this view and the development of access competition since 2006, we do not consider that a prescriptive access code, whereby Ofcom stipulates the

specific terms and conditions of access, is a proportionate response to the concerns that have been raised in response to Postcomm's March consultation.

- 3.18 We recognise that Royal Mail's existing access user guides and contracts with access operators address many of the areas that will be of importance in a future Access Framework. We also consider that an Access Framework developed by Royal Mail could in theory play a key role in reducing or even eliminating Ofcom's role in setting the terms and conditions of access. However, to date Royal Mail has not come forward with detailed proposals on the form of an Access Framework and therefore at this stage it is difficult for Ofcom to comment on the appropriateness of such a framework in the abstract.
- 3.19 Furthermore, Ofcom would expect significant industry involvement in the development of such an Access Framework. In this context, we recognise that access users may have significant concerns about agreeing to a framework where Ofcom does not play any role in setting the terms and conditions of access. Therefore it could take some time before Royal Mail was able to gain broad agreement on the scope and detail of such a framework.
- 3.20 Notwithstanding the above, we do not rule out the future possibility of an Access Framework developed by Royal Mail removing the need for Ofcom to intervene in setting the terms and conditions of access. However, at this time, and given Royal Mail's negotiating and market power, we do not consider it appropriate to rely solely on Royal Mail in this regard now.
- 3.21 In terms of Ofcom's role in setting the terms and conditions of access, the Act permits Ofcom to include in a USP access condition a provision requiring the terms and conditions on which Royal Mail is willing to offer access to include such terms and conditions as may be specified or described in the condition¹⁰.
- 3.22 We have already indicated that we do not consider it appropriate to adopt a prescriptive approach and set out specific terms and conditions that Royal Mail should be required to offer access operators. An alternative approach would be to include a more general requirement in the USP access condition that the terms and conditions for access (including prices) to be offered by Royal Mail should be "fair and reasonable". This approach would give Royal Mail greater flexibility to negotiate the terms and conditions of access with access users.
- 3.23 In addition to imposing a general obligation for terms and conditions to be fair and reasonable, we propose providing guidance in line with Postcomm's option 2. This guidance would provide an indication as to how Ofcom would approach assessing whether terms and conditions were fair and reasonable in the event that a dispute was referred to us once commercial negotiations had failed. It might also address issues regarding the process of seeking access. Noting the preference of some stakeholders for a more prescriptive approach, we recognise that there may be certain issues in relation to which it may be appropriate for the guidance to be relatively specific. However, it should be noted that, even where the guidance was specific, its purpose would be to provide an indication as to Ofcom's current view.
- 3.24 We believe such guidance could be provided in a number of ways. First, guidance can be provided by Ofcom in advance of disputes being brought forward by access users (or Royal Mail). However, we recognise Royal Mail's concern that care needs

¹⁰ See Schedule 3, paragraph 2 of the Postal Services Act 2011.

to be taken such that any guidance that is provided does not fetter future commercial negotiations and therefore stifle innovative solutions that are market driven.

- 3.25 Second, over time, guidance could be provided as a result of Ofcom's role in relation to intervening and settling disputes between Royal Mail and access users. Decisions made in this regard will build up a set of precedents that can provide guidance to the industry.
- 3.26 In Table 1, we have identified a number of issues that could be of interest to access users. We have provided a high level assessment of the various options for Ofcom's role in setting the terms and conditions of access. These options represent varying degrees of intervention, ranging from full flexibility whereby Royal Mail sets the terms of access, to guidance by Ofcom that indicates how Ofcom is likely to act in the event that there is a dispute, to Ofcom providing more specific guidance on what it considers would be fair and reasonable terms of access.
- 3.27 As part of this consultation we would like to receive views from interested parties about the key areas that we have set out in Table 1 as well as on Ofcom's initial assessment of the suitability of different levels of guidance, and any suggestions as to the level of detail which the guidance should include. This will help us to understand the areas where guidance is needed and whether that guidance should be specific or more general in nature. We are also interested to receive views on whether we have omitted key areas where guidance would be beneficial (and the reasons for this).
- 3.28 In summary, given Royal Mail's position in the market and its negotiating power, we propose that an obligation be included in the proposed USP access condition, requiring Royal Mail to set the terms and conditions for access (including prices) on a "fair and reasonable" basis. This obligation would be supported by guidance as to Ofcom's approach to assessing what it regards to be fair and reasonable terms.

Table 1

		Assessment		
Issue	Current approach	Flexibility	Guidance	Specific guidance
Application for terms of access	<p>Access seeker required to submit a completed Condition 9 application form.</p> <p>Royal Mail is required to offer the main terms and conditions of access within 3 months.</p>	<p>x</p> <p>Full flexibility would mean that access seekers had no certainty about the process for applying for access and Royal Mail would not have a clear basis for rejecting applications for access that did not provide sufficient information.</p>	<p>✓✓</p> <p>Clear guidance on the information that Royal Mail must receive before advancing an access request is likely to be necessary to ensure certainty for all parties that an access request can be taken forward. Guidance on the time scales for providing the main terms of access would also provide access seekers with more certainty.</p>	<p>✓</p> <p>A regime with more specific identification of an indicative process for application for terms for access would have similar benefits to guidance but could be less flexible if the access regime changes in the future.</p>
Process for price changes	<p>Royal Mail Wholesale sets access prices in advance of Royal Mail setting retail prices. Access prices set annually. Three month advance notification and publication of</p>	<p>x</p> <p>Full flexibility for Royal Mail might result in insufficient notice of access prices for access users and therefore difficulties in adjusting prices to their customers.</p>	<p>✓</p> <p>Guidance might indicate that it would be appropriate for access prices be set annually, but recognise that there may be certain circumstances where Royal Mail changes prices or offers new prices for customers on an ad hoc basis and not simultaneously with its annual price changes.</p>	<p>✓</p> <p>To ensure greater equivalence, Royal Mail should set standard access prices in advance of it setting retail prices.</p> <p>Notice of price changes may need prescriptive regulation to ensure that access users receive sufficient notice of prices.</p>

		Assessment		
Issue	Current approach	Flexibility	Guidance	Specific guidance
	access prices.			
Zonal access (see Section 8) and NGPP	<p>Royal Mail is subject to a number of licence conditions that restrict its ability to change the terms and conditions of zonal access (including pricing).</p> <p>Access users must make all reasonable endeavours to meet a national geographic posting profile when using a national access agreement¹¹.</p>	<p>x</p> <p>Full flexibility for Royal Mail to change zonal access prices and terms could create barriers to entry for operators relying on zonal access to offer regional services as a change could make an existing business model unsustainable.</p>	<p>✓</p> <p>Guidance on how Ofcom is likely to consider a dispute in relation to zonal access may strike the right balance in providing an indication to access seekers as to how Ofcom would address the issues in a dispute whilst allowing Royal Mail to act in a more commercial manner. It may also be more flexible to changing market conditions than more specific guidance.</p>	<p>✓</p> <p>Provides certainty for access users but risks being inflexible to changing market conditions and changes in customer demands.</p>
Surcharging	Reasons for surcharging and level of surcharges	<p>✓</p> <p>Royal Mail should have sufficient flexibility to set</p>	<p>✓</p> <p>Guidance may be necessary on the levels of surcharges and</p>	<p>x</p> <p>Specific guidance may be difficult given the range of</p>

¹¹ Royal Mail Wholesale has consulted on a proposal to replace the “all reasonable endeavours” obligation with a more objective measure (see Changes to the Access National Geographic Posting Profile Definition, 6 October 2009, http://www.royalmailwholesale.com/dsa_docs/NGGP_Changes_Consultation_Paper_Final_Clean_091002.pdf). This would involve Royal Mail stating a clear tolerance to be associated with each zone and imposing surcharges if a customer’s mail profile falls outside the agreed tolerances. Royal Mail’s proposed changes have not yet been adopted. In the event that Royal Mail and access users cannot reach an agreement on the changes to these terms, this is an area where Ofcom is likely to provide guidance.

		Assessment		
Issue	Current approach	Flexibility	Guidance	Specific guidance
	set out in access agreement.	surcharges to address issues of non-compliance with access agreements.	assurance that these are comparable with similar surcharges applied to Royal Mail's retail customers.	circumstances where surcharging might be necessary and/or appropriate.
Operational disputes	Access agreement includes a provision to resolve disputes either through contact with other party or through arbitration process.	✓ Royal Mail should retain the flexibility to resolve disputes through commercial negotiations and an arbitration process.	✓ Guidance may be beneficial in relation to the process that Ofcom would expect parties to follow before approaching it to resolve a dispute. Guidance on how Ofcom may address general operational issues may also be of benefit and could be supplemented with evidence related to previous decisions on disputes.	x Specific guidance is likely to be inappropriate given the variety and number of different operational disputes that may arise.
Forecasting requirements	Access users forecast volumes on a rolling 7 day and 24 hour basis before the actual posting.	✓ Royal Mail should retain the ability to determine the details of its forecasting requirements to maximise operational efficiency.	✓ Guidance could ensure that forecasting requirements for access users are comparable with those that apply to Royal Mail's retail customers.	x Specific guidance may be too inflexible to changes in Royal Mail's operations.
Publication of terms	Royal Mail has regulatory requirement to publish all terms and conditions of access.	x May not provide sufficient transparency to the market.	✓ Guidance may be given on exceptions to publication obligations.	✓ Specific guidance on the publication of standard terms may be necessary.

x – Not suitable; ✓ - Suitable; ✓✓ - Very suitable

Section 4

Principles for addressing issues of non-equivalence

4.1 Areas where there are differences between the terms offered to third parties compared to those offered to Royal Mail's own business in relation to accessing Royal Mail's network are sometimes referred to issues of 'non-equivalence'. In Postcomm's March consultation it outlined what it considered was meant by 'ensuring equivalence', identified a number of broad areas where issues of non-equivalence might arise and provided high level proposals on how issues of non-equivalence could be addressed.

Postcomm's consultation

4.2 Postcomm recognised that the concept of ensuring equivalence could have a number of interpretations. One interpretation could be that terms of access offered to Royal Mail's own business for accessing the network should be identical to those offered to third parties. However, Postcomm recognised that there are likely to be circumstances where it is efficient for Royal Mail to treat its own business differently from third parties. This could be to reflect the operational differences deriving from Royal Mail being a vertically integrated user of the universal service network compared to an access operator that only uses part of the network.

4.3 Postcomm considered that the concept of 'ensuring equivalence' should align with the concept of no undue discrimination or no undue preference. It considered that this approach to ensuring equivalence recognised that there are likely to be occasions where differences between the terms of access offered to Royal Mail and third parties (and potentially between third parties) might be acceptable and that it would not be appropriate for Ofcom to intervene.

4.4 Under the Postal Services Act 2011¹², Ofcom may include a requirement on a person not to discriminate unduly against particular persons, or a particular description of persons, in relation to access matters in a USP access condition. Postcomm considered that this would provide an appropriate basis for addressing issues of non-equivalence.

4.5 Two options for addressing issues of non-equivalence were proposed:

- Option 1: Imposing operational or process changes on Royal Mail
- Option 2: Through a pricing mechanism whereby equivalence is ensured by making adjustments in the relativity of access prices to Royal Mail's retail prices.

4.6 It was proposed that the choice between which option to adopt should be determined on a case-by-case basis with reference to Ofcom's statutory duties. Postcomm recognised that there would be circumstances where addressing issues of non-equivalence via a pricing mechanism was appropriate and other circumstances where seeking an operational change would be a more targeted and proportionate remedy.

¹² Schedule 3, Part 1, paragraph 11.

- 4.7 However, in circumstances where imposing operational or process changes could be readily implemented without having a detrimental impact on Royal Mail's efficiency or on the financial sustainability of the universal service, option 1 was likely to be more appropriate. Postcomm recognised that there could be areas where imposing operational changes could be achieved without incurring significant costs to Royal Mail and might be more transparent than addressing the issue via a pricing mechanism, particularly as that required the regulator to estimate the financial impact of additional accessor costs.
- 4.8 Postcomm also proposed a more general principle that, where an area of non-equivalence was de minimis or immaterial, then no ex ante regulation should be imposed on Royal Mail and Postcomm considered that this principle was consistent with the concept of no undue discrimination and an overall approach to imposing regulation only where it is required.
- 4.9 Postcomm also suggested that there might be a case for introducing an additional reporting requirement on Royal Mail that required it to provide an objective justification for any different criteria that it applied to third parties compared to Royal Mail's own business. For example, Royal Mail could be requested to provide evidence on a regular basis on the steps it has taken to ensure that it is complying with any non-discrimination requirement in a USP access condition.
- 4.10 Finally, Postcomm sought views on the benefits of establishing an independent system as a means of measuring end-to-end quality of service of access mail and the most appropriate way of taking this forward including in terms of management and funding.

Responses to Postcomm's consultation

- 4.11 Respondents were supportive of Postcomm's view that the concept of 'ensuring equivalence' should align with the concepts of no undue discrimination or no undue preference.
- 4.12 Respondents were broadly supportive of the proposal to ensure equivalence through operational or process changes on Royal Mail. They also generally agreed that, where an operational or process change was considered inappropriate, a fully compensating pricing or headroom allowance for access was required.
- 4.13 Royal Mail stated that non-equivalence should be aligned to the concept of undue discrimination under competition law. Where Ofcom identifies undue discrimination with material adverse effects, it should investigate on a case-by-case basis, based on a proper assessment of evidence and taking representations from all concerned parties. It should impose a remedy only where non-equivalence gives rise to undue discrimination. It argued that an operational form of remedy would be preferable where it could be shown that there would be no detrimental impact on its efficiency or on the financial sustainability of the universal service. It stated that if a non-discrimination provision is inserted into an access USP condition, there would not be a need for Royal Mail to provide additional forms of reporting to the regulator.
- 4.14 One operator stated that, only if the operational changes are not deemed correct, then the pricing mechanism should apply as it otherwise does not require the necessary accounting separation and transfer prices to be established and operating. It identified the requirement for detailed traffic forecasting and booking access slots, penalties for late arrival, revenue protection, product and IT development as likely equivalence issues. Another operator identified zonal access, NGPP surcharges as

additional issues where there is lack of equivalence. It required equivalent access services to be made available on all services, and especially for new services. According to the operator, the pricing mechanism, applying an additional element to the transfer price, was appropriate where operational changes were not required. Furthermore, it argued that if better equivalence could be achieved by relaxing downstream access obligations, this should always be explored.

- 4.15 One respondent recommended that Royal Mail be able to exercise its discretion to choose to make process and operational changes or accept pricing changes, as it felt appropriate.
- 4.16 Three respondents supported the imposition of an additional reporting requirement on Royal Mail to provide evidence of compliance with its non-discrimination obligations under a USP access condition or its existing licence condition. It was suggested that the report should be externally audited.
- 4.17 Consumer Focus supported the implementation of a quality metric by Royal Mail for measurement of access mail to ensure equivalence.
- 4.18 Royal Mail proposed an independent industry-funded measure of end-to-end quality of service. It suggested that Ofcom should take the lead in implementing such a measure. However, one operator did not support the proposal on the basis that it was unnecessary; Royal Mail was not the relevant authority to measure the quality which other operators provide to their customers; and that the additional costs involved would be passed on to Royal Mail's access customers in the form of access charges. It suggested that end-to-end quality measurement should be left to the market.

Ofcom's analysis

- 4.19 In the March consultation, Postcomm proposed that 'ensuring equivalence' should align with the concept of no undue discrimination or no undue preference. We note that there was broad agreement from respondents to the consultation for this proposal.
- 4.20 Ofcom also considers that it is appropriate that 'ensuring equivalence' should align with the concept of no undue discrimination. This recognises that there are likely to be differences between how an access operator, on the one hand, and Royal Mail, on the other, accesses Royal Mail's network due to the vertically integrated structure of Royal Mail. In some cases the differences are likely to be justifiable. Furthermore, in some cases the differences might be immaterial in relation to the ability of access operators to compete against Royal Mail. Therefore, in those cases, ensuring that all the terms of access are identical for Royal Mail and for access operators would not provide any benefits. Moreover, it would result in unnecessary inefficiencies in Royal Mail that would conflict with its ability to provide the universal service.
- 4.21 Therefore, we consider that it would be appropriate to include a non-discrimination obligation in the USP access condition¹³ against which any allegations that differences in operational terms are important can be assessed with reference to the impact on competition.
- 4.22 We note that there was broad agreement from respondents to address issues of non-equivalence through either operational changes or a pricing mechanism. Ofcom

¹³ Schedule 3, paragraph 11 of the Postal Services Act 2011 permits Ofcom to include a non-discrimination provision in a USP access condition.

agrees with the principle of addressing issues of non-equivalence via either of these options and that the choice of option will need to be made on a case by case basis. However, where imposing operational or process changes can be achieved without having an undue impact on Royal Mail's efficiency or threatening its ability to provide the universal service this is likely to be the most appropriate option that gives assurance to access operators.

- 4.23 Ofcom has yet to examine in detail areas where access operators believe that issues of non-equivalence are present and evidence presented to Postcomm did not imply that immediate regulatory action was required. As part of this consultation we would encourage operators if they see fit to provide further evidence regarding the specific areas that are of the most concern. This will allow Ofcom to prioritise its future work in this area.
- 4.24 We set out above our proposals for Ofcom's role in setting the terms and conditions and more specifically our proposals for providing guidance on specific matters that may arise between Royal Mail and access users. We consider issues relating to dispute resolution below. We recognise that concerns over the non-equivalence of the terms and conditions of access could be a key area where Ofcom is requested to intervene.
- 4.25 In the event that an access user approaches Ofcom to intervene in a non-equivalence matter, we believe that this could be addressed in the following ways:
- No action required – either because there is no evidence of discrimination or because the issue of non-equivalence is immaterial;
 - Operational change appropriate – Seek to impose an operational change on Royal Mail through taking enforcement action under Schedule 7 of the Act for a breach of the non-discrimination obligation in the USP access condition, or through handling a dispute under the dispute resolution procedure under Schedule 3 of the Act.
 - Price change appropriate – Ofcom would take account of any cost differential in the transfer price/margin squeeze control under the proposed interim arrangements or in the transfer price alone under a future monitoring regime (see further Section 7 below) and competition law.
- 4.26 As part of its March consultation, Postcomm considered whether there was a case for requiring Royal Mail to report on a regular basis on the steps it had taken to ensure that it was complying with a non-discrimination obligation in a USP access condition. We note a number of respondents supported the introduction of such an additional reporting requirement. However, Ofcom questions the necessity of introducing further regulatory obligations on Royal Mail and the value that this would provide to access operators and the market. In particular, we are concerned that such a reporting requirement would become a routine 'tick-box' exercise and would not provide the relevant information to either the regulator or access operators on specific issues that are important at a particular time.
- 4.27 Ofcom believes that it should seek information on issues of non-equivalence as they arise and using its information gathering powers. This avoids imposing an obligation on Royal Mail to provide a routine report that may have little real value. Furthermore, more specific questions relating to issues of non-equivalence are likely to be better addressed via tailored ad hoc information requests by Ofcom.

- 4.28 There appears to be a mixed response on the need for a quality of service metric for access mail from respondents. We believe that a quality of service metric could be of benefit to customers. However, the need for a metric should be customer driven. Therefore, we believe the postal industry should seek to reach an agreed position on a quality of service metric and the development of such a system. Consequently, we do not believe that it is appropriate for Ofcom to intervene in this matter at this time.
- 4.29 In summary, our proposal is that issues of equivalence should be addressed by reference to the concept of no undue discrimination. We therefore propose including a requirement that Royal Mail should not discriminate unduly against any particular persons or against a description of persons in relation to access matters in the proposed USP access condition.

Section 5

Process for addressing disputes

5.1 As a result of discussions with interested parties in preparation for the March consultation document, Postcomm noted that there appeared to be a general reluctance to approach the regulator to intervene in matters relating to access. In light of this, Postcomm considered that a process should be established for addressing disputes arising out of failure to agree access or regarding the terms and conditions of access or issues of non-equivalence.

Postcomm's consultation

5.2 In its March document, Postcomm noted that the Postal Services Bill, as it was then, gave Ofcom the power to resolve disputes, including to make a declaration as to the rights and obligations of the parties to the dispute, directions fixing the terms and conditions of transactions, directions requiring the payment of money by way of adjustment for over or under payment, as well as directions as to which party is to pay the cost of proceedings.

5.3 Postcomm also set out the key stages that it envisaged an effective and transparent dispute resolution procedure would involve. This included:

- Making a dispute referral and an initial screening phase including scrutiny of the evidence provided by the parties;
- Initial consideration of the dispute and whether it was appropriate for the regulator to handle the dispute;
- A detailed examination phase and recognition that it was increasingly common for a regulator to set an administrative timetable for the process and its various stages.

5.4 Postcomm believed that the dispute resolution guidelines published by Ofcom would provide an appropriate basis for handling disputes subject to any relevant differences in the underlying legislative regime. Postcomm advised interested parties to refer to Ofcom's proposed Dispute Resolution Guidelines for a comprehensive description of the dispute handling process that was likely to be adopted.

Responses to Postcomm's consultation

5.5 Respondents broadly supported Postcomm's proposal to adopt Ofcom's new dispute resolution guidelines for access disputes to ensure speedy and effective dispute resolution procedure – as this would promote effective competition, efficiency and user benefits. One respondent believed that Postcomm's existing dispute resolution approach was only effective for resolving major access disputes as opposed to tactical access disputes and that disputes over existing terms should also be open to review by the regulator.

5.6 In line with its argument that access should not be mandated, Royal Mail proposed to maintain the current access dispute resolution process as it argued that it had worked successfully to date. This consists of a combination of Royal Mail internal escalation processes and a set of provisions contained in the access contracts

(including independent mediation). This would be supplemented by the proposed Access Framework which provides the overarching principles for: pricing methodology and approach, an outline of the process of reviewing new access requests including timescales, eligibility, application of rules of non-discrimination, dispute resolution process including escalation etc.

- 5.7 In relation to Ofcom's proposed dispute resolution process, Royal Mail recommended the need for the early provision of complete and accurate draft information requests to support Ofcom's decision making. It also suggested providing for some time (around 3 days) for factual accuracy checks in advance of the final dispute determination by Ofcom. Royal Mail acknowledged that, without mandated access, parties would have no contractual recourse for dispute resolution. However it considered that this would lead to greater incentives on parties to reach commercial agreements, with recourse to alternative dispute resolution mechanism (CEDR) if necessary. It would also prevent a situation where the regulator is "inundated with vexatious referrals" requiring the regulator to enforce a binding access contract.
- 5.8 Consumer Focus suggested that the regulator should provide a decision-making framework which maximised certainty, transparency and produced timely decisions. It required the publication of guidelines to ensure the adoption of Ofcom's dispute resolution procedures. One operator believed that Ofcom should apply the four month timetable set out in its existing dispute resolution procedure for resolving access disputes.
- 5.9 One operator required dispute resolution mechanisms to apply to new product development and to existing terms, since the existing regime only permitted the review of disputes where there was no commercial agreement.

Ofcom's analysis

- 5.10 If Ofcom decides to impose a USP access condition then operators will be able to refer access disputes to Ofcom in accordance with the provisions set out in Schedule 3 of the Act. As these provisions apply in any event, we do not consider it necessary to make further provision in regulatory conditions in this regard.
- 5.11 In terms of process, we propose adopting the dispute resolution process that has been established by Ofcom for the communications sector, subject to recognising any appropriate differences such as where the Communications Act and the Postal Services Act impose different legal requirements. In due course, we will provide further guidance on these differences.

Section 6

Access to elements of postal infrastructure

- 6.1 Under the Act, Ofcom may impose a general access condition on a particular postal operator (or operators) requiring them to grant access to its postal infrastructure or any service within the scope of the universal postal service which it provides or to maintain a separation for accounting purposes between such different matters relating to such access¹⁴.
- 6.2 Ofcom may only impose a general access condition where it appears to them that the condition is necessary for either or both of the following purposes:
- Protecting the interests of the users of postal services; and
 - Promoting effective competition.
- 6.3 The Act reflects the obligation imposed on Member States under Article 11a of the 3rd Postal Services Directive¹⁵ to mandate such access.
- 6.4 Examples of what is envisaged by 'elements of postal infrastructure of services within the scope of the universal service' as set out in Article 11a of the 3rd Postal Services Directive include the 'postcode system, address database, post office boxes, delivery boxes, information on change of address, re-direction service and return to sender'.
- 6.5 In the March document, Postcomm considered whether it was necessary to oblige Royal Mail (and potentially other operators) to offer access to elements of postal infrastructure or services within the scope of the universal service under the then Bill.

Postcomm's consultation

- 6.6 In the March consultation, it was explained that the consideration of whether mandating access to an element of postal infrastructure or a service within the scope of the universal service is necessary should involve an assessment of whether either or both of the two tests referred to above, namely that access would protect the interests of users and/or that it would promote effective competition, are met.
- 6.7 In addition the Act sets out a further five factors (as set out in paragraph 2.3) that Ofcom must consider in deciding what obligations to impose in a general access condition.
- 6.8 Postcomm noted that requiring access to elements of postal infrastructure was geared more towards the smooth functioning of a multi-operator postal market as it appeared to focus more on issues of interoperability.
- 6.9 Postcomm considered whether there was a present need to impose a general access condition in relation to six elements of infrastructure or services within the scope of

¹⁴ Section 50 of the Postal Services Act 2011.

¹⁵ Directive 2008/06/EC of the European Parliament and of the Council of 20 February 2008 amending Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services.

the universal service: the Postcode Address File, PO Boxes, delivery boxes, information on change of address and redirections services, return to sender services and Post Office Counters.

- 6.10 Its preliminary view was that market circumstances in the UK were such that there was no immediate or current need, and in relation to the Postcode Address File, there were separate statutory and regulatory provisions. It argued that the central purpose of a general access condition appeared to be to ensure interoperability in a multi-operator environment. Although this type of access was relevant and important where postal operators provided end-to-end services, there was currently extremely limited provision of such services in the UK. Furthermore, it did not appear that the lack of end-to-end competition was because of the lack of access to postal infrastructure services either in a particular case or cumulatively. Indeed it argued that far more significant barriers were likely to exist.

Responses to Postcomm's consultation

- 6.11 Royal Mail agreed with Postcomm's view that there was no current need to provide access to elements of infrastructure on the basis that there had been little development of end to end competition and so, a general access condition was not required at this time. It suggested that there was no evidence to indicate that lack of access to these had, either individually or cumulatively, given rise to any material entry barrier to operators seeking to provide end to end competition or that these could be deemed "essential facilities".
- 6.12 Other respondents disagreed with Postcomm's view on the basis that there was a huge end to end market for packet and parcel services. They raised concerns that Postcomm's view could potentially provide a poor investment signal to the future development of end to end networks for postal services more generally. They recommended that the regulator should require access to the elements of postal infrastructure such as PAF, PO Boxes and redirections data on acceptable commercial terms. It was argued that this would become increasingly important with the growth of end to end competition.
- 6.13 Two operators suggested that the regulator should review any constraints imposed which could impact the ability of access operators to compete and commercial solutions should be encouraged. One of these operators recommended that Ofcom should adopt the terms of access to redirections data as part of its initial conditions project.

Ofcom's analysis

- 6.14 We agree with Postcomm's analysis that the central purpose of a general access condition is to ensure the interoperability in a multi-operator environment and that this type of access would be important where postal operators look to provide end-to-end services.
- 6.15 The Act sets out clear criteria that need to be satisfied before access can be mandated to elements of postal infrastructure. These relate to protecting the interests of users and promoting effective competition. Given the limited provision of end-to-end postal services in the UK we do not believe that the case for mandating access to elements of postal infrastructure would currently satisfy the criterion to protect the interests of users. Furthermore, we do not believe that a lack of access is currently a significant barrier to effective competition and that there are far more significant

barriers to entry relating to the end-to-end competition developing. Therefore, we do not believe that the criterion to promote effective competition is satisfied either.

- 6.16 We note the concerns raised by some respondents regarding the existence of end-to-end competition in some of the Packets markets. However, we have not been given sufficient evidence at present of a specific need to mandate access to a particular element of postal infrastructure or a service within the scope of the universal postal service. Whilst some respondents identified elements of infrastructure to which access should be mandated, they did not provide sufficient (or in some cases any) explanation of why access to those elements was necessary. In advance of mandating access to any elements of postal infrastructure we would need to receive further evidence from potential users that demonstrates how providing access to that particular postal infrastructure or service within the scope of the universal postal service would satisfy the criteria set out in the Act.
- 6.17 We recognise that circumstances might change in the future, and in the event that this is the case and/or a postal user approaches Ofcom with evidence that access to an element of postal infrastructure or service within the scope of the universal postal service meets the criteria set out in the Act we would consider the case at that time.

Section 7

Preventing price squeeze

- 7.1 Under the Act, Ofcom has the power to impose ex ante controls on access pricing, but may only do so where it appears to Ofcom that such a condition is necessary to prevent the universal service provider from setting excessive prices or engaging in a price squeeze between retail and access prices¹⁶.
- 7.2 In April 2011, as part of its initial proposals on regulatory safeguards consultation¹⁷, Postcomm considered whether safeguards were required from 2012 to address the risk of Royal Mail setting excessive prices and engaging in a price or margin squeeze. It proposed a set of options to mitigate the risk of price squeeze. These are further discussed below.
- 7.3 As regards imposing a price control to address the risk of excessive pricing, Postcomm's April 2011 consultation proposed that no price control should be applied to access products if there was no price control on universal service products. It set out various options in the event that a price control was imposed on universal service products, including no direct price control of wholesale services, controlling wholesale product prices together with a separate retail universal services price control and a combined price control for universal and access products.
- 7.4 As discussed in Section 6 of the consultation document, we do not consider that it is necessary to impose on Royal Mail a price control to address the risk of excessive pricing. We therefore focus below on the need to impose price controls to prevent a price squeeze.

Postcomm's consultation

- 7.5 Postcomm noted that the combination of Royal Mail's market power both in the wholesale (downstream) markets and retail markets and its vertically integrated structure provided it with the ability and incentive to squeeze the margin of retail competitors using its downstream access products.
- 7.6 However, Postcomm recognised that, while Royal Mail retains market power in the retail pre-sorted and high volume unsorted Letters and Large Letters markets, it had also observed substantial entry into those markets and therefore needed to consider the extent and nature of any constraint placed on Royal Mail to address the risk of price squeeze. Postcomm noted that other operators had costs that were comparable to, and indeed might be lower than, Royal Mail's and have gained significant market share. Postcomm considered that in this context, the approach to controlling headroom (i.e. controlling the difference between retail prices and access prices in order to ensure an appropriate margin to enable access competitors to compete), ought to change to reflect the growth in competition.
- 7.7 Postcomm identified four broad options that could be adopted to prevent or mitigate the risk of Royal Mail engaging in margin squeeze. These were:

¹⁶ See Section 38 and Part 1 of Schedule 3 of the Postal Services Act 2011.

¹⁷ The building blocks for a sustainable postal service, Initial proposals for regulatory safeguards, April 2011.

- Option 1: Ex post – Deregulate with no ex ante control of minimum headroom, relying instead on the application of general competition law.
- Option 2: Ex ante – Royal Mail would be able to set individual retail and access prices at its discretion subject to maintaining a minimum price differential between its own retail and access services corresponding to an estimate of upstream LRIC, or other appropriate cost measure. This estimate would be derived subject to principles and guidance provided by the regulator on how such an estimate of upstream LRIC should be derived for regulatory scrutiny, and the extent to which it should be disclosed. Compliance would be monitored and action taken ex post if price squeeze was suspected.
- Option 3: Ex ante – Royal Mail would be able to set prices subject to general pricing boundaries, for example including the point at which a reduction to the retail price would be considered to be squeezing the wholesale margin and a basket approach as proposed for 2011-12 in Postcomm’s November 2010 document. The overall headroom for the basket would be set by the regulator.
- Option 4: Ex ante – Royal Mail would be required to set prices subject to specific pricing boundaries that maintained stated minimum levels of headroom, with reference to the level of FAC, set by the regulator between specific retail and access product price points (point by point approach) as currently in place.

7.8 Based on an initial assessment of the options, Postcomm considered that efficient entry should continue to have some protection from Royal Mail engaging in margin squeeze, but that Royal Mail should have substantially greater flexibility to compete than under the existing headroom control. In the foreseeable future, Postcomm considered that its vision for regulation most closely accorded with option 2. This would allow Royal Mail to set access prices subject to maintaining a price differential between retail and access services based on guidance and principles set by the regulator based on the definition of incremental costs for upstream services.

7.9 In relation to Postcomm’s preferred measure of the headroom that Royal Mail should maintain, Postcomm recognised the role of LRIC in assessing the risk of margin squeeze (and in supporting the 2012 regulatory framework). However, in the absence of robust estimates of LRIC, alternative measures, such as those based on FAC costs would need to be considered.

7.10 Therefore, given the uncertainties over the development of robust LRIC data, Postcomm indicated that it might be necessary to consider an interim approach as a stepping stone to the preferred regulatory solution. One potential approach suggested for an interim regime (which was broadly comparable to Postcomm’s 2011-12 minded to decision) was as follows:

- A basket for headroom across Second and Third Class Mailsort and Walksort products only;
- The level of the basket to be set to reflect relevant FAC costs;
- Price point headroom to be reduced to a proportion of the average basket level indicative of LRIC.

7.11 Finally, Postcomm recognised that, given the level of uncertainty around the timing and production of robust LRIC data, and the potential size of any change, a glide path from the current approach to regulating headroom to its preferred long-term

approach might be needed to reflect the on-going changes to the regulatory framework as they were successfully implemented. This could be both in terms of moving from a point-to-point headroom control to ex ante principles, and also in moving from an FAC-based measure to LRIC.

Responses to Postcomm's consultation

- 7.12 Royal Mail argued that the existing headroom regime had created distortions that had given rise to economic costs. In summary, Royal Mail raised three main concerns with the existing approach to regulating access headroom. First, the fixed percentage margin (that was in place until May 2011) undermined the incentive for Royal Mail to pass on any upstream cost efficiencies into lower retail prices since this would in turn lead to lower wholesale prices to upstream rivals. This reduced both the incentive to realise upstream efficiencies, and potentially, the intensity of upstream price competition, which was detrimental to customers. Second, Royal Mail argued that historically access prices had been set at too low a level and as a result the headroom regime could have led to inefficient levels of entry by access operators. Third, the level at which access prices had been set, and the fixed headroom may have undermined the incentives for alternative forms of competition.
- 7.13 In accordance with Royal Mail's overall response to matters relating to access, it argued that a competition law approach for addressing the risk of margin squeeze was proportionate to the issues that were now present in the market in which it operated.
- 7.14 CWU argued that the access market had been created and sustained by regulation based on inaccurate costing assumptions and that this balance needed to be redressed. It therefore supported the full removal of access headroom regulation.
- 7.15 Other respondents argued that a headroom control should be maintained. A few respondents suggested that, alongside any move towards ex post regulation, Postcomm should expect Royal Mail to commit to 'voluntary undertakings' in respect of its existing licence conditions in relation to protecting against price or margin squeeze between retail and corresponding access prices.
- 7.16 An operator and the MCF argued that a headroom control was essential and that without it ex post enforcement would be too late to adequately protect competition (which the operator argued was fragile). The operator also argued that FAC should be used as the cost standard within a point-to-point control and that a basket control would allow too much flexibility to Royal Mail to eliminate upstream competition. The operator raised concerns over the use of LRIC in a headroom control since data were not sufficiently robust nor was it clear how LRIC would be calculated.
- 7.17 One operator considered that option 1 (no ex ante control) was too risky and that an ex ante control was necessary. It did not consider that the conditions necessary to adopt option 2 were currently present. The same operator strongly believed that if a basket approach was to be taken then that must be a basket 'across products' and not a basket 'across customers' since the nature and state of competition in the UK meant that a low number of large customers are crucial to a competitor's business. Furthermore, a basket approach required clear obligations to be placed on Royal Mail on it to show that its proposed pricing met the required level overall and to report regularly that its revenue in practice did cover that level.
- 7.18 In the absence of LRIC data, the operator broadly agreed with Postcomm's suggested interim headroom control. It also believed that moving to Postcomm's

preferred long-term approach as early as April 2012 would mean a significant change in the market when other associated safeguards were not in place and therefore agreed that a glide-path to the long-term preferred solution should be considered.

- 7.19 Consumer Focus supported either ex ante pricing boundaries (option 3) or retaining the current headroom control (option 4) recognising that, although the latter was more prescriptive, it remained the safest option for the time being.

Ofcom's analysis

- 7.20 Royal Mail argued that, rather than an ex ante headroom control, a competition law approach under which no regulatory obligation would be imposed was proportionate to the issues now present in the markets in which it operated.
- 7.21 We recognise that an approach that relies only on competition law can offer a number of benefits. In certain circumstances, it can provide a more proportionate approach to addressing concerns over anti-competitive behaviour. It can also avoid imposing regulation that is unnecessary or inflexible to changing market conditions.
- 7.22 In relation to Royal Mail setting prices, such an approach would provide it with the greatest commercial flexibility to set prices that reflect customers' willingness to pay in order to recover the costs of providing the universal service. This is because its pricing would not be constrained by ex ante regulation (as would be the case under option 3) that sets parameters on prices in advance of it being demonstrated that Royal Mail has abused its position in the market. Under competition law, the generally accepted cost measure for considering whether there is a margin squeeze is LRIC. This is likely to provide more flexibility for Royal Mail to recover its costs in aggregate by allowing it to set prices and so vary contributions to common costs across products than if required to maintain headroom with reference to its Fully Allocated Costs on a product by product basis (as under the existing headroom control).
- 7.23 However, Ofcom is concerned that reliance on competition law alone (option 1), in the absence of other established regulatory safeguards, is unlikely to be sufficient to address the risk to competition (and the associated customer impact) from Royal Mail engaging in a price squeeze in the relevant retail markets.
- 7.24 As Postcomm outlined in its April document, a competition law approach is likely to be most suitable where there is not a clear dominant player in the market. Royal Mail's dominant position in the downstream wholesale market (in addition to its vertically integrated nature) provides it with the incentive and ability to use its position in the downstream wholesale market to favour its own retail business. Furthermore, we consider that, in the absence of some form of margin squeeze control in a USP access condition, Royal Mail might impose a margin squeeze with adverse consequences for the users of postal services.
- 7.25 A pure competition law approach could be adopted to address the risk of Royal Mail engaging in margin squeeze, as there is precedent as to how competition law would be applied in the context of an integrated network such as Royal Mail. However we recognise the concern raised by some respondents relating to the length of time that such investigations can take which could mean that, even in the event that an infringement finding is made, competitors may have by then been forced to exit the market. In such circumstances there could be irreversible and permanent damage to competition that Ofcom is unable to remedy in the same way that it could recover the loss of customer welfare in the event that Royal Mail engaged in excessive prices to

retail customers. Indeed, we consider that the case for adopting a competition law approach alone to control the maximum prices paid by customers is less risky than that of controlling against a margin squeeze. This is because in the event that Royal Mail excessively increased prices to end customers, Ofcom could choose to re-introduce an ex ante price control that sought to recover this revenue for customers over the period of a control through ensuring that prices over time including the control period were not excessive.

- 7.26 Notwithstanding the above, Ofcom is aware that access competition has grown significantly since Postcomm introduced an ex ante headroom control in 2006. In addition it agrees with Postcomm that the regulation of access headroom must reflect the changes in competitive conditions. As part of this Royal Mail should be afforded more flexibility to price services than under the existing headroom control. Here we recognise the specific concern raised by Royal Mail regarding the existing headroom control and the potential problem of a fixed headroom regime undermining the incentives on Royal Mail to fully realise upstream efficiencies since these cannot be passed on to retail customers. However, we do not fully accept all of Royal Mail's arguments relating to access headroom and have responded to Royal Mail's concerns that the access regime has distorted alternative forms of competition earlier in this document.
- 7.27 Our preferred approach to regulation, as summarised in the main document, is to monitor Royal Mail's costs and revenues to assess the impact of its pricing on competition (as opposed to imposing ex ante controls on Royal Mail's pricing). We consider that a monitoring regime can in principle be used to assess the impact of Royal Mail's pricing to ensure that no price squeeze will occur.
- 7.28 However, we recognise that, given the permanent harm that could occur to competition from margin squeeze, even over the relatively short-term, the mechanism for monitoring Royal Mail's headroom must allow any potential issues of margin squeeze to be addressed swiftly. Therefore, we consider that it is important to provide certainty to Royal Mail and other market participants about the form of test that we will be expecting Royal Mail to meet.
- 7.29 We believe that setting prices with reference to LRIC costs provides the correct signals for entry and investment in the market. Therefore in the long-term, we believe that Royal Mail should set its prices with reference to LRIC costs such that a minimum of LRIC margin is maintained between the access price and the equivalent retail price and that compliance is monitored by Ofcom through the regular provision of information from Royal Mail.
- 7.30 We note that one operator and the MCF argued that FAC was a more appropriate cost measure. However, as explained in Postcomm's April document, although setting the level of headroom based on FAC can be consistent with promoting competition during the early stages of entry in a market by ensuring that all services contribute to the shared costs of the network, using FAC raises two primary issues.
- 7.31 First, FAC can provide the incorrect signal for market entry and using a measure of incremental cost (based on Royal Mail's costs) of providing upstream services better ensures that only operators that are equally or more efficient than Royal Mail at providing upstream services are able to sustain market share. Second, it may be more appropriate (and efficient) to vary upstream contributions to common cost recovery on a commercial basis which more reflects customers' willingness to pay and/or allows Royal Mail to better respond to competitors that have more flexibility in how prices are set. Otherwise, using FAC on a product basis could have an adverse

impact on the financeability of the universal service if setting the price differential between retail and access prices at FAC results in Royal Mail losing retail volumes (which might not be the case under a more flexible pricing structure), and thereby losing contribution to the shared costs of the universal service (i.e. costs that it will be unable to avoid or necessarily recover in access prices).

- 7.32 We note that one operator and the MCF indicated that the existing 'point to point' control (option 4) was the preferred option for regulating headroom in the future. However, Ofcom is concerned that a point to point control may not provide sufficient flexibility for Royal Mail to compete in a similar manner to other operators nor adjust prices in response to efficiency improvements or changes in market conditions.
- 7.33 We believe that setting a margin squeeze control in the long-term with reference to the level of FAC or on a point to point basis will not reflect the development of competition since 2006 nor allow Royal Mail to compete on a similar commercial basis with other operators. This will be detrimental to promoting effective competition and conferring benefits to customers.
- 7.34 However, we recognise that robust LRIC information is not currently available, nor likely to be available, to inform the level of a margin squeeze control for 2012 in order to allow us to implement our preferred long-term vision for regulating access headroom. In addition, we also recognise that there are a number of assumptions that can be used to estimate LRIC that affect the level of costs and therefore guidance is likely to be needed to ensure that the form of LRIC that is developed to mitigate the risks of margin squeeze is consistent with all our statutory duties.
- 7.35 Whilst robust data are not yet available, our analysis of Royal Mail's costs, together with previous analysis provided by Royal Mail, indicates that an approach comparable to competition law is likely to result in lower margins than FAC, and significantly lower margins than those currently offered by Royal Mail. This suggests that there may be large changes to competitive conditions following such a change in regulation. In this context, the risk of regulatory failure can be high, as a large structural change can disrupt market conditions and be difficult for operators to respond to efficiently.
- 7.36 Furthermore, before relying on a monitoring regime subject to ex ante guidance (i.e. option 2), Ofcom would need to be satisfied that its other regulatory safeguards relating to cost transparency and accounting separation had been successfully implemented.
- 7.37 Given the above, we consider that an interim safeguard will be needed in the intervening period before robust LRIC data are developed and we are satisfied that our other regulatory safeguards are satisfactorily implemented. This can also act as a glide path between the current form of regulation and an approach more consistent with competition law.
- 7.38 We therefore propose to impose a margin squeeze control on Royal Mail in relation to access pricing which is broadly consistent with the principle of monitoring, but with additional safeguards requiring Royal Mail to provide evidence to us that it expects to meet specified tests. We expect that margin squeeze control to remain in place at least until Royal Mail's work on LRIC and regulatory reporting is sufficiently developed. In the absence of Royal Mail providing this evidence, we may consider action to impose formal quantified price controls. A formal control could impose ex ante requirements on Royal Mail more comparable to a traditional price control regime.

- 7.39 We consider below the design of the control that we are proposing, and in particular:
- its scope;
 - its structure and level;
 - its duration; and
 - how it is envisaged to work in practice

Scope

- 7.40 In its April document, Postcomm proposed a headroom basket across Mailsort second and third class products and Walksort.
- 7.41 Ofcom's first consideration has been whether the scope of the existing headroom basket (including Second Class Mailsort and Walksort products only) is appropriate or whether it should be extended as Postcomm proposed in its April consultation to include third class products, or indeed extended still further to include products within the high volume unsorted Letters and Large Letters markets where other operators have gained significant market share.
- 7.42 Our view is that the interim margin squeeze control should not be extended beyond its current scope (i.e. it should include Mailsort and Walksort Second Class products only).
- 7.43 We have come to this view for the following reasons. First, Ofcom believes that it should only intervene in the market where necessary and that evidence of entry in the market by access operators suggests that the existing scope of the headroom control has provided a sufficient safeguard for other operators to compete in the market against Royal Mail's Second Class presorted products, third class presorted products and in relation to services that fall within the high volume unsorted Letters and Large Letters markets. Therefore, extending the control beyond its existing scope, given the development of access operators and their ability to compete for services beyond the scope of those included in the existing control, would appear to be disproportionate and unnecessary.
- 7.44 Second, we consider that interim margin squeeze control should provide an appropriate step in a glide-path between the existing headroom control and our preferred long-term vision of how the risk of margin squeeze should be addressed in the future. As explained earlier, we believe that the margin squeeze control should be replaced in the long-term by an approach more consistent with competition law, which is likely to use LRIC as the relevant cost measure. We believe that it would be inconsistent to require Royal Mail potentially to adjust prices for services not currently within the scope of the control for the period of interim margin squeeze control to meet the requirements of an ex ante control based on costs other than LRIC.
- 7.45 We consider that maintaining the scope of the control to include Mailsort and Walksort Second Class products only provides a clearer glide-path to our long-term vision for regulating access and will reduce potential short term price variability for Royal Mail that could result from obliging Royal Mail to bring a wider set of services within the scope of a margin squeeze control.

Structure and level

7.46 In its April document, Postcomm proposed that Royal Mail be required to recover FAC across a basket of products with a further 'price point' headroom control relating to individual products at a proportion of FAC.

7.47 We propose that a set of adjustments be made to Royal Mail's relevant upstream FAC costs for the purposes of calculating relevant costs for a margin squeeze basket. We propose:

- Upstream FAC is calculated as the end-to-end FAC less the equivalent access FAC (including wholesale costs)¹⁸. In calculating relevant FAC, we propose:
- Excluding a set of costs that is non-incremental to upstream activities. We believe this will provide an appropriate step in moving the margin squeeze control closer to our long-term vision of the level being based on LRIC. More specifically, we propose:
 - To exclude the allocation of central overhead costs from Royal Mail's upstream FAC (estimated to be around 5%-10% for 2010/11)
 - To exclude exceptional costs from Royal Mail's upstream FAC
- Including an adjustment to FAC for a reasonable rate of return at 5-10% of revenue;
- Where there is evidence of issues of non-equivalence that cannot be addressed through operational changes, Ofcom will consider making further adjustments to the upstream FAC.
 - At this stage, we do not have sufficient evidence of issues of non-equivalence that result in material cost differences that require such further adjustments. However, this is an area where we are seeking evidence and will give further consideration ahead of our final decision. One area which we will need to keep under review relates to the differences in VAT status between Royal Mail and access operators.

7.48 In addition to the margin squeeze test described above, we propose to establish a price point control for individual contracts. We believe that it is appropriate to establish such a control, at least while our proposed control remains in place, since relying on the margin squeeze basket alone would enable Royal Mail to price at levels for individual contracts below LRIC whilst maintaining the minimum average price (and thereby meeting its margin squeeze basket obligation). Although Ofcom could investigate this behaviour under ex post competition law powers, for the reasons set out earlier we are concerned that this leaves a risk of targeted pricing which could result in the permanent exit of competitors from the market. Similarly, for the reasons set out earlier, we would first expect to have robust LRIC estimates

¹⁸ Under this approach, the direct costs of Royal Mail Wholesale are included in access costs and by virtue reduce the minimum level of costs that Royal Mail must recover to meet the requirements of the margin squeeze control. We consider that currently the direct costs of Royal Mail Wholesale are broadly efficient costs but would consider whether this approach remained appropriate if such costs were to increase sharply.

before removing all safeguards as to how Royal Mail sets its prices for individual contracts.

- 7.49 As noted in Annex 6, Royal Mail's overheads accounted for around 25% of FAC in 2010-11 and these would not generally be expected to vary with individual contracts relevant for contract-level LRIC estimates. Furthermore, some direct costs cannot be varied in response to smaller, contract-level, volume variations. However, contract-level LRIC estimates are likely to exceed the shorter-run cost variability levels that Royal Mail has assumed in its Restructuring Plan, as costs can be varied more in response to demand changes in the longer term.
- 7.50 We consider that a safeguard set at 50% of adjusted FAC for individual contracts strikes an appropriate balance between allowing Royal Mail the ability to compete for individual customers whilst also providing the necessary protection to other operators during the period of the control.

Duration

- 7.51 In relation to the appropriate duration of a control, we recognise that we will need to balance the certainty that a longer control provides to the market with the risk of maintaining a control that does not provide sufficient flexibility to Royal Mail and/or provides the incorrect investment signals to entrants or prospective entrants to the market. Ofcom has considered the following two broad options:
- Option A: Control to remain for a fixed period that accords with the length that Ofcom proposes to set for other aspects of Royal Mail's price regulation in advance of a future review. This is currently proposed to be of seven years (as set out in Section 6 of the consultation document).
 - Option B: Control to remain for a shorter period with a commitment to review the need for the existing control and the availability of robust LRIC information. Ofcom would expect to undertake a review within 18 to 24 months, subject to the provision of appropriate data. We believe this provides a realistic time for Royal Mail to develop LRIC estimates that would support Ofcom's preferred long-term aim for controlling the risk of margin squeeze.

An assessment of each option is provided in Table 2.

Table 2

Option	Advantages	Disadvantages
A: Medium-term control consistent with approach to price regulation	<p>Provides greatest certainty to the market.</p> <p>Provides greatest protection to access operators.</p>	<p>Reduces the incentives on Royal Mail to develop LRIC estimates and implement other regulatory safeguards to a sufficient standard.</p> <p>Risks providing incorrect investment and pricing signals to the market.</p> <p>Could fail to provide the appropriate level of flexibility for Royal Mail to compete in a market where other operators have an increasing presence.</p>

<p>B: Review within 18 – 24 months</p>	<p>Allows Ofcom to review the margin squeeze control at a specific point in the future taking into account the progress of Royal Mail in providing LRIC information, implementing regulatory safeguards and other changes in the market over the interim period.</p> <p>Incentivises Royal Mail to progress LRIC work and implement other regulatory safeguards successfully. Provides signal to the market and to potential investors that Ofcom intends to review the margin squeeze control.</p> <p>Mitigates the alleged risks of price shocks in the market by providing a 'glide-path' between the existing control and our preferred long-term vision of using LRIC.</p>	<p>Since the margin squeeze control is subject to change after an interim period this may cause uncertainty in the market for competitors (and customers).</p>
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7.52 On balance, we believe that option B is the most appropriate and that the regime should be reviewed within 18 to 24 months, with the expectation of moving to a monitoring regime by 2014-15, subject to the provision of the appropriate data, that is more comparable with competition law principles and LRIC based costs. We believe that this would allow sufficient time for Royal Mail and/or Ofcom to develop LRIC information that could be used to inform regulation.

Proposed approach

7.53 In summary, Ofcom's proposed approach for the margin squeeze control is as follows:

Table 3

	Form	Scope	Structure	Level
<p>Margin squeeze Basket</p>	<p>USP access condition requiring Royal Mail to demonstrate having a reasonable expectation of meeting the requirements of the margin squeeze control</p>	<p>Mailsort/Walksort Second Class products only</p> <p>Letters and Large Letters only</p>	<p>Single basket</p>	<p>Relevant upstream costs.</p> <p>Upstream FAC (adjusted as follows):</p> <p>Less: Allocation of central overheads</p> <p>Add: Reasonable rate of return</p>

				Add: costs of non-equivalence (if necessary)
Margin squeeze price point control	USP access condition requiring Royal Mail to demonstrate having a reasonable expectation of meeting the requirements of the margin squeeze control	Mailsort/Walksort Second Class only Letters and Large Letters only	Related to individual prices	50% of relevant upstream cost

- 7.54 Ofcom will be working on the detail of how the interim control will be implemented in advance of April 2012. One issue that will need to be finalised in advance of 2012, and on which we would like to hear views from stakeholders, relates to the period of costs and revenues that Royal Mail should be required to use to demonstrate compliance with the control.
- 7.55 As part of the margin squeeze control, we propose that Royal Mail should be required to provide quarterly information that will enable Ofcom to monitor the relevant costs for the relevant period with revenues for that period. We expect to impose this obligation as part of a USP access condition.
- 7.56 Under our proposal Royal Mail would set its prices at the beginning of a period with reference to a forecast of costs and volumes for that period. In setting prices and providing quarterly information, Royal Mail would be required to have a reasonable expectation of the product costs, product revenues and volumes (to demonstrate compliance with the margin squeeze basket) for the forthcoming period.
- 7.57 We recognise that the reliance on forecasts of the relevant period's costs, volumes and revenues as a proxy for actual costs and revenues in the period is subject to a margin of error. This could result in Royal Mail not maintaining the minimum level of headroom over the relevant period and thereby failing to meet the requirements of the margin squeeze control.
- 7.58 However, we consider that this risk is likely to be manageable for the following reasons. First, Royal Mail has significant expertise and capability to model future costs and revenues and will be able to forecast costs and revenues for the next period to a high degree of accuracy. Furthermore, the risk of non-compliance being undetected or of Royal Mail exploiting the potential opportunity to "game" the control by underestimating costs over estimating revenues will be limited by the provision of quarterly cost information to Ofcom (as part of its regulatory financial reporting obligations) that can be used by Ofcom on a frequent basis to assess Royal Mail's compliance with the margin squeeze control. Therefore, although under the proposed approach Royal Mail would be comparing a forecast of the costs and revenues for the relevant period, we would expect that these closely accord with the actual costs and revenues that it will incur and receive in the period.

- 7.59 As part of this consultation we would like to receive views from stakeholders regarding our proposed approach to controlling the risk of margin squeeze including our proposed approach to monitoring Royal Mail's compliance with the control.

Section 8

Zonal access

- 8.1 Royal Mail offers two types of pricing structure for access – a national access agreement and a zonal access agreement. Under a national access agreement, access charges are geographically uniform and are based on the assumption that a customer’s daily postings are reflective of a typical daily Royal Mail mix of mailing items in the UK and so do not have a disproportionate amount of mail for geographic areas with a high cost to serve, nor a disproportionate amount of mail generated locally for local delivery. Access operators who use these arrangements must undertake “all reasonable endeavours”¹⁹ to ensure that the mail they present meets the National Geographic Posting Profile (‘NGPP’). This is known as the NGPP condition.
- 8.2 Under a zonal access agreement the price of sending an item of mail depends on the destination of the mail items and its zonal delivery classification. When introduced in October 2004, Royal Mail allocated each postcode sector to one of five price delivery zones. This was revised in May 2009 to allocate each of the postcode sectors to one of four zones – London, urban, suburban and rural. Under a zonal access agreement users are not subject to the NGPP condition.

Postcomm’s consultation

- 8.3 In the April consultation, Postcomm summarised the current approach to controlling zonal access that is set out in the Initial Conditions. The current approach mainly involves pricing requirements and/or requirements to publish or provide information. These include the following:
- The weighted average zonal access price must be equal to the national access price (with the ability to offer a small discount). This is intended to prevent Royal Mail from raising or lowering national access prices without also raising or lowering the weighted average zonal price and thereby prevent Royal Mail from unduly discriminating against a class of customer whilst also affording degree of protection against margin squeeze on zonal prices.
 - Differences of zonal prices in the first year of implementation of the new zonal structure (2009) were based on relative differences in FAC costs between each zone. In subsequent years changes to those implementation prices could only be made to make prices more cost reflective and subject to a rebalancing cap of 3%.
 - The existing licence places limits on Royal Mail’s ability to change the allocation of postcode sectors between zones.
 - There is a requirement for Royal Mail to publish and/or provide to Postcomm additional audited information in relation to zonal access pricing.
- 8.4 Postcomm considered there to be a number of arguments that could be put forward for regulating zonal access pricing:
- To prevent a margin squeeze

¹⁹ As noted in footnote 13 above, Royal Mail Wholesale has consulted on a proposal to replace the “all reasonable endeavours” obligation with a more objective measure.

- To prevent excessive pricing
- To prevent discrimination against access operators and specifically access operators which are also seeking to develop end-to-end networks

8.5 Postcomm set out two broad options for controlling zonal access prices from 2012, but recognised that, although only two options were put forwards as part of its consultation, there could be others that fall within between the limits defined by these two broad options.

- Option 1 – Remove the existing pricing requirements in the licence or modify some or all of them – allowing Royal Mail greater commercial freedom to set zonal access prices; or
- Option 2 – Roll forwards the existing pricing requirements as in Royal Mail's current licence – without any change.

Responses to Postcomm's consultation

8.6 One operator argued for Postcomm to review the pricing structure used in zonal access which it believed was impracticable for manually sorted mail. It argued that the aim of the pricing structure was to prevent cream-skimming by delivery competitors. Given the absence of delivery competition, the structure's use of measures such as business and dwelling density within postcode sectors as proxies for delivery cost (the sectors are then grouped into pricing zones), was not economically effective, and only added unnecessary cost for customers using it.

8.7 Another operator found the obligation on retail customers to apply a zonal identifier to each item to be being costly and ineffective, and unnecessary as it would not satisfy Royal Mail's stated objective of revenue protection. It suggested that equivalence could be achieved by removing this obligation.

Ofcom's analysis

8.8 We consider that there are a number of potential risks relating to zonal access, these are as follows:

- The risk of zonal prices not being cost orientated and thereby sending the wrong signals to competition in the market;
- The risk that Royal Mail may decide to increase the price of access in a particular zone in order to discourage access competition in that zone. In such circumstances, the corresponding retail price (which could well still be set on a uniform national basis) would not rise to reflect the change in the underlying zonal access price, thereby potentially giving rise to a price squeeze in that particular zone;
- If end-to-end entry is more likely to develop on a zonal rather than a national basis, the risk of Royal Mail setting zonal prices too low (specifically in zones where there is a threat of delivery competition) at a level that may not be cost-orientated. Therefore, to ensure that access costs overall are recovered, Royal Mail may have an additional incentive to increase prices in zones where end-to-end competition is less likely;

- The risk of Royal Mail unduly discriminating between zonal access, national access and retail customers; and
 - The risks of Royal Mail frequently changing the structure of zonal access or moving postcode sectors between zones. This may be of concern in circumstances where it creates a barrier to entry through creating uncertainty for access operators and prospective end-to-end competition (in addition to being inconvenient for customers).
- 8.9 We consider that access competition is likely to play a role in promoting end-to-end competition (as set out earlier in this document). As Postcomm noted in its initial proposals on regulatory safeguards consultation in April 2011, zonal access can play a particular role in promoting end-to-end competition by allowing operators (and customers) with a specific regional posting profile to benefit from access. This could promote end-to-end competition where an operator is seeking to provide a delivery service in a specific geographic region whilst using access for the delivery of its items on a national basis.
- 8.10 Ofcom could remove all regulation in relation to zonal access and rely on its ex post enforcement powers under competition law. This would provide Royal Mail with a high degree of flexibility to set zonal prices and terms. However, given the risks set out above, we have concerns that, in the absence of any controls relating to zonal access, Royal Mail would be able, should it so wish, to either alter prices or change the structure of zones to provide a barrier to entry for any potential end-to-end entrants. In addition, Royal Mail could also make zonal access less effective as a form of upstream competition.
- 8.11 Therefore, for the reasons given above, we consider that additional safeguards beyond the application and enforcement of competition law are needed. Furthermore, given the risks relating to zonal access that we have identified above, we consider that the tests in the Postal Services Act 2011 for imposing a price control would likely to be met²⁰.
- 8.12 We consider that the existing ex ante regulation provides a set of safeguards that mitigate the risks outlined above. Furthermore, we recognise that this regulation was introduced as recently as 2009 and that changes to these safeguards may cause uncertainty in the market. However, we also consider that some elements of the existing regulation are unduly restrictive and a more flexible approach could be introduced that adequately mitigates the risks identified by Ofcom whilst allowing Royal Mail greater freedom to price on a cost reflective basis.
- 8.13 Under our proposals, we would monitor zonal costs and pricing. As explained earlier, we propose to include an obligation for Royal Mail to set the terms and conditions for access (including prices) on a “fair and reasonable” basis. That obligation would be supported by guidance providing an explanation of how Ofcom would assess whether terms and conditions were fair and reasonable. That guidance would also cover matters relating to zonal costs and pricing and in particular the need for prices to be cost oriented.
- 8.14 As discussed in more detail in Section 8 of the consultation document and Annex 6, we are proposing that Royal Mail should be required to document its zonal costing

²⁰ Under section 38(5) of the Postal Services Act 2011, Ofcom may not impose any price controls on a universal service provider in a USP access condition unless it appears to them that the provider concerned might otherwise charge excessive prices or impose a price squeeze.

estimates in an expanded Costing Manual from 2012-13, and that these costing estimates should comply with zonal costing rules set out in the Regulatory Accounting Guidelines, a draft of which has been included with this consultation.

8.15 In addition to providing guidance on the need for prices to be cost oriented, we consider that guidance would be likely to cover the following areas:

- Changing the structure of zones
- Moving postcode sectors between zones
- Maintaining equivalence and cost orientation with other prices (e.g. national access prices)

8.16 In relation to setting the terms and conditions of zonal access, Ofcom would expect in the first instance for Royal Mail to seek to agree changes in relation to zonal access contracts with its customers. Where these could not be agreed or where an access user had justifiable concerns about the changes being made, then it could approach Ofcom to intervene subject to our dispute resolution process. In relation to the areas set out above, Table 4 below provides an illustration of the broad guidance that could be given by Ofcom.

Table 4

Area	Illustration of the guidance
Changing the structure of zones	<p>In the event that a dispute is brought to Ofcom, evidence should be provided by Royal Mail on the following:</p> <ul style="list-style-type: none"> • The improvement in the cost orientation of the zonal pricing structure • The commercial benefit of the proposed change • The customer benefit of the proposed change. As part of this regard would need to be given to the frequency of the change in zonal pricing structure • The cost orientation of prices in relation to the national access price
Moving postcode sectors between zones	<p>In the event that a dispute is brought to Ofcom, evidence should be provided by Royal Mail on the following:</p> <ul style="list-style-type: none"> • The improvement in the cost orientation of the zonal pricing structure
Equivalence and cost orientation with other prices	<p>In the event that a dispute is brought to Ofcom, evidence should be provided by Royal Mail on the following:</p> <ul style="list-style-type: none"> • The improvement in the cost orientation of the zonal pricing structure • The cost orientation of prices in relation to the national access price

- 8.17 One operator argued that the non-price terms for zonal access make it impracticable for manually sorted mail. We believe that the operator was referring to the need for each zonal access item to include a 'zonal indicator' denoting the zone of delivery. Royal Mail uses this information for its revenue protection activities. Where items are machine sorted the information can be printed on each item during the sorting process by the access operator, mailing house or customer. However, where the item is not machineable (and needs to be manually sorted) printing the zonal indicator on each item of mail is more onerous and will incur a higher cost for the access operator.
- 8.18 We recognise the importance of Royal Mail's revenue protection processes. We also believe that where Royal Mail incurs costs due to access users not meeting reasonable operational terms then Royal Mail should be able to pass on these costs to the customer as cost orientated surcharges.
- 8.19 However, we also are aware that in relation to the national access agreement, for assessing whether a customer is meeting the National Geographic Posting Profile obligation, Royal Mail carries out its revenue protection checks through sampling the customers' mail items. Furthermore, a customer is not required to include a zonal indicator on each item of mail. We believe that Royal Mail could in principle offer similar terms to zonal access users. This could allow access users with manually sorted items to take advantage of the benefits of zonal access.
- 8.20 Notwithstanding the above, where there is an additional operational cost to Royal Mail from an access user not providing a zonal access indicator on each item of mail, either because the customer is unable to provide a zonal indicator or chooses not to on each item of mail, Royal Mail should in principle be able to reflect this in the price to the customer.