

# **A REVISED MARKET OPENING TIMETABLE**

**PROPOSALS FOR CONSULTATION**

**September 2004**

## KEY PROPOSALS

This document sets out Postcomm's proposal to revise its timetable for market opening.

- Postcomm proposes to bring forward full market opening from 1 April 2007 to 1 January 2006. There will be no intermediate step before that date.
- Postcomm will review its licensing process later this year to ensure mail integrity in a fully open market through "light touch" licensing arrangements.
- Postcomm's proposals are designed to ensure the continued provision of the universal service. All public tariffs (including stamps) will continue to be provided by Royal Mail at a geographically uniform and affordable rate.
- Postcomm proposes to clarify which of Royal Mail's bulk mail products fulfil its obligation to provide a generic bulk mail universal service. Postcomm proposes that Mailsort 1400 (first and second class), currently the most widely used (non-third class) bulk mail product, is best suited for this purpose. Other bulk mail products, including access services, which do not comprise the generic bulk mail universal service, will continue to be regulated.
- Postcomm would like to hear stakeholders' views on these key proposals by Monday 20 December 2004. Postcomm expects to make a final decision in early 2005.

## Summary

### **Accelerated market liberalisation**

- S.1 Postal services play a vital role in modern commercial and social life, providing communications between individuals, businesses, organisations and government. Last year, over 20bn postal items were mailed by customers, generating revenues for Royal Mail of around £6bn.
- S.2 Postcomm's vision for the market is "a range of reliable, innovative and efficient postal services, including the universal postal service, valued by customers, and delivered through a competitive market". Postcomm believes that a successful Royal Mail, the UK's only universal service provider, is central to the delivery of this vision. Given the economic and social importance of the postal industry, a competitive market should encourage innovation and benefit postal users.
- S.3 To help achieve its vision, this document consults on Postcomm's proposal to bring forward the date for full market opening from 1 April 2007 to 1 January 2006. Postcomm proposes to do this in a single step, which also gives Royal Mail a nine month extension to the present phase of market opening.
- S.4 From 1 January 2006, which is also the date when the European Postal Services Directive reduces the reserved area from 100g to 50g, reputable, rival operators to Royal Mail will be able to operate anywhere within the UK postal services market.
- S.5 Postcomm considers that, as competition develops, it is important that Royal Mail and postal users have clarity over which particular products are classified as universal services and therefore have to be provided by Royal Mail on a daily basis to all users at a geographically uniform and affordable price. In addition to a universal service including all the stamped and other products used by the general public and the majority of small businesses, Postcomm also considers that it should include a generic bulk mail product for Royal Mail's larger business mailers. The product that Postcomm considers most fulfils the characteristics of the universal service for bulk mailers is Mailsort 1400 (first and second class), presently the most used (non-third class) bulk mail product. This proposal seeks a

balance between providing a safeguard for bulk mailers, whilst affording Royal Mail some pricing flexibility in order to respond to competition and the developing commercial environment in which the Government, as its shareholder, would like Royal Mail to operate.

### **Reasons for bringing forward market opening**

#### **a) Positive effect on Royal Mail, the market and postal users**

- S.6 Earlier full market opening is likely to contribute positively towards sharpening the incentives on Royal Mail to improve its quality of service performance and customer focus. Regrettably, Royal Mail's quality of service has been poor of late, when compared to its agreed targets. This has adversely affected many users, from large businesses who wish to reach every address in the UK, to small businesses who rely on the post for their cash flow, to residential customers for whom the reliability of personal correspondence is paramount.
- S.7 Postcomm is committed to doing all it can to ensure that Royal Mail improves its poor performance and restores public confidence. This includes introducing competition and choice for customers. This is something that Postwatch, the independent customer watchdog for postal services, has called for in response to Royal Mail's quality of service failings. Pending the development of effective competition, Postcomm will need to rely on regulatory measures such as compensation, the price control, enforcement action and financial penalties.
- S.8 Although a large scale effective competitive challenge to Royal Mail is likely to take some time to develop, bringing forward full market opening may accelerate certain operators' investment plans for entering the market and offering customers choice.
- S.9 International experience shows that full market opening is also likely to encourage some small scale niche operators, such as local delivery operators serving the needs of small businesses and their local communities.

- S.10 There is also scope for innovative entry in the early stages of market opening. Offering different products, higher quality of service standards, or “add-ons” such as “track and trace”, could well offer significant opportunities. UK Mail, for example, is now offering a two-day time certain product, utilising its landmark agreement on downstream access with Royal Mail.
- S.11 Full market opening should, in due course, help to provide customers with choice, which will make Royal Mail more responsive to their needs. Postcomm believes competition is the best mechanism for ensuring that Royal Mail improves its customer focus. The removal of monopoly privileges will help Royal Mail drive through this change at all levels of its business.
- S.12 The stimulus of full market opening should help Royal Mail better face some longer-term challenges from a rapidly evolving market place. It is important that it defends its business and its ability to provide a universal service against threats from alternative media (e.g. electronic substitution). It is equally important that Royal Mail identifies and embraces opportunities from such developments to ensure continued healthy growth within the core postal market.
- S.13 Royal Mail must also become more efficient and flexible, which is a key driver to the achievement of Postcomm’s vision for the market. Postcomm believes that the most powerful incentive for this change is the belief on the part of Royal Mail that it will face effective competition over time.

**b) Effective competition will take time**

- S.14 Since 2002, Postcomm (with the industry) has developed a more informed understanding of how competition might develop within the market. The main change since 2002 is the realisation that entry into the market is much more challenging than was previously anticipated. Competitors have taken just 0.3% of the market and Royal Mail’s volumes have grown. Postcomm recognises that market shares are only one indicator of competition. Postcomm’s Competitive Market Review document, published alongside this document, examines other indicators of competition such as customer awareness, barriers to entry and Royal

Mail's behaviour. These all point to a similar conclusion that competition has been slow to develop and will take more time to materialise than many commentators had previously thought.

- S.15 Full market opening, though a necessary step for effective competition, is unlikely to be sufficient in itself. This is because of significant barriers to entry that prevent operators from gaining a foothold and expanding their businesses. These include Royal Mail's economies of scale (especially from delivery), derived from handling over 80m items per day, and its daily delivery network to all the UK's 27m residential and commercial addresses. This keeps Royal Mail's unit costs very low (and hence some prices) compared to new entrants, despite inefficiencies within its operations. Other barriers include customer inertia and Royal Mail's VAT exempt status, which may effectively distort pricing in up to half of the market in its favour.
- S.16 These barriers have been compounded over the past couple of years by the uncertainty caused by the considerable delay in Royal Mail agreeing terms with other operators over downstream access to its delivery network.
- S.17 Full market opening is, therefore, one of a series of steps needed to set the framework for effective competition. Other barriers to entry also need to be addressed in a systematic and orderly way. These proposals signal that Postcomm is doing all it can to identify and remove those barriers that are under its control, in order to secure a genuinely level playing field.

**c) The universal service is secure**

- S.18 Following a careful re-evaluation of the risks and opportunities, Postcomm's view continues to be that the best long-term universal service safeguard is to ensure Royal Mail is efficient and customer focussed, through the stimulus of competition. This will help Royal Mail to withstand the threats from e-substitution and the potential risks of reduced growth in mail volumes.
- S.19 These market opening proposals will not affect Royal Mail's ability to continue to provide an affordable universal service. Since Postcomm's original market

opening timetable was established in 2002, the company has significantly improved its financial position. In 2003/04, it made a profit from operations of £348m (before pension deficit payments and exceptional costs) on price controlled products (6% margin on turnover). Royal Mail also continues to supply over 99% of postal services.

S.20 There are other changes that are strengthening Royal Mail's business. Its "Renewal Plan" is scheduled to be completed in the next six months. It will improve its financial strength by making efficiencies following three major initiatives: Single Daily Delivery, the Transport Review and the Mail Centre Review. It will also help make the business more flexible and better able to deal with potential, unexpected shocks (such as a fall in mail volumes) than was the case in the past, when adverse events that increased costs were usually cushioned with price rises for monopoly customers.

S.21 Another important development that provides Postcomm with greater assurance that Royal Mail is now stronger to face a liberalised environment is the agreements that have been entered into for third-party access to Royal Mail's network. Royal Mail is now offering access prices at which it expects to make a profit.

S.22 Since 2002, Postcomm has provided more clarity on what is meant by the universal service in terms of the many public and business products that Royal Mail offers. In 2002, nearly all of Royal Mail's regulated products were considered as comprising the universal service because it had previously been undefined. However, following Postcomm's consultations and assessment on the scope of universal service for non-bulk mail (June 2004) and bulk mail (see below) this figure will fall to around 64% of its volumes (excluding Mailsort 3). This gives Royal Mail more pricing flexibility than was previously the case.

S.23 As an additional safeguard, Postcomm always has a duty to allow Royal Mail sufficient revenues to fund its universal service obligation. Indeed, although some customers in the short-term may not directly benefit by having a wide range of choice of alternative operators, they will indirectly benefit owing to Royal Mail's

improved efficiency, innovation and customer service. In particular, all postal users should benefit from Royal Mail having sharper incentives to improve its quality of service performance. Postcomm is currently consulting on its approach to the 2006 price control in parallel with these proposals (a consultation document has been published at the same time as this document).

S.24 Finally, Postcomm notes from international experience that in countries that have fully liberalised their postal markets, such as Sweden and New Zealand, the incumbent has been able to maintain and improve its universal service. This is against the background of more competitive prices, more choice and improved quality of service. Indeed, Postcomm has been told by these incumbents that full market liberalisation was significantly beneficial to their businesses in terms of a change in mindset and focus on the customer and innovation.

#### **A single step to full market opening**

S.25 There will be no intermediate step in market opening before 1 January 2006. This also gives Royal Mail a nine month extension to the first phase of market liberalisation. This recognises that removing the partial monopoly privilege currently afforded to Royal Mail for the delivery of non-bulk mail (a step originally planned for April 2005) would not lead immediately to effective competitive pressure. Barriers to entry are more significant than previously thought.

S.26 Recent experience has shown that the risks for Royal Mail from market opening appear to be lower than first thought. Phase 1 of market opening has led to little market entry. Achieving full market opening in a single step represents a pragmatic proposal for the removal of the remaining monopoly barrier. It also avoids the regulator defining, in an artificial way, a part of the market where competitors can enter in a second interim phase. This leaves the market to determine which business models are viable and, therefore, which customer groups are to benefit most from competition.

S.27 In addition, bringing full market opening forward in a single step enables Postcomm to better focus on tackling the remaining barriers to entry and to take other action to further the interests of postal users.

### **Why 1 January 2006?**

S.28 Postcomm fully supports the European Commission's policy of progressively opening the European postal market. On 1 January 2006, the reserved area, as defined by the European Postal Services Directive, will be reduced to 50g in all member states. This date is, therefore, considered an appropriate moment for Postcomm to not only meet the minimum requirements of the Directive, but to exceed them and bring about full market opening in UK postal services, by making the two changes together. There would be little point in having two further steps only nine months apart.

S.29 This decision reflects Postcomm's assessment that the advantages to postal users and to the market of the removal of the last monopoly privilege justifies moving faster than the minimum requirement of the Directive. Postcomm notes that The Netherlands and Germany would appear to share this view as they are also proposing to go further than the minimum requirement (outside the EU, Norway has also proposed to fully liberalise in 2007). Furthermore, Postcomm takes the view that there is no reason to wait for the Netherlands and Germany who say they are waiting on the UK and each other before taking the final step to full market opening.

### **Postcomm will seek to ensure the market is not abused**

S.30 All operators seeking to enter the market from 1 January 2006 will continue to require a licence from Postcomm. Postcomm intends to review its licensing regime in advance of full market opening to ensure that it will achieve two important objectives. The first objective is to ensure that customers and postal users have confidence in the operators that provide their postal services (i.e. mail integrity). The second objective is to ensure that the licensing regime is "light-touch" and does not itself act as a barrier to entry.

S.31 Postcomm will publish in November 2004 its first consultation document on the licensing regime and how it will achieve its objectives of safeguarding mail integrity and being “light touch”. Postcomm will also work closely with Postwatch to monitor mail integrity.

**Royal Mail should have some flexibility to respond to competitive pressures**

S.32 As the postal sector becomes more competitive, Postcomm considers that Royal Mail should have some flexibility to be able to respond to competitive developments, encourage efficient posting methods by its customers, and to respond to demands from its shareholder to act in a commercial manner. Consistent with these aims, Royal Mail would like to be able to align some of its prices more closely with its costs, and Postcomm broadly supports the principle of more cost reflective pricing. Postcomm is keen to ensure that the pace of transition is carefully planned and that adequate safeguards are in place to protect postal users and other operators.

S.33 A key constraint on Royal Mail is the number and types of products that are classified by Postcomm as “universal services”. These services must be priced on a geographically uniform basis.

S.34 There will be no change to the definition of the universal service for public and social users. Stamps and other tariffs used by the general public and the vast majority of small businesses will continue to be provided at a geographically uniform and affordable price.

S.35 Postcomm does not accept Royal Mail’s view that all bulk mail products should be removed from the universal service definition. Postcomm believes that smaller bulk mail customers in particular should enjoy the continued assurance of purchasing a bulk mail service that is a universal service. In its June 2004 decision document on the scope of the universal service, Postcomm decided that at least one generic bulk mail product, available to large mailers, should be considered within the universal service. This would be in addition to the public

tariffs and other products (such as franked and metered mail) typically used by small and medium sized businesses.

- S.36 Postcomm proposes that, as of 1 April 2006, the most commonly used (non-third class) bulk mail product (Mailsort 1400, first and second class) should be classified as the generic bulk mail universal service. It accounted for over 50% of all (first and second class) bulk mail volume in 2003/04 that fulfils the current universal service definition. Royal Mail must, therefore, continue to price this product on a geographically uniform basis. Removing other bulk mail products from the universal service will require a licence modification, and this date has been chosen to coincide with the new price control in April 2006, allowing Postcomm to make both licence modifications at the same time.
- S.37 Other existing bulk mail products will continue to be regulated. This means that Royal Mail must continue to provide these products. It will have the discretion to price them on a non-geographically uniform basis subject to certain safeguards for customers and other operators.
- S.38 In practice, the existence of Mailsort 1400 (first and second class) as the bulk mail universal service will limit the extent to which Royal Mail can de-average prices. Customers will also be protected by Royal Mail's price control. This will ensure that for a national average posting, the cost to the mailer will not change (apart from price rises permitted under the current price control). It will also ensure that under the current regime (that extends until April 2006) no price for an existing product can rise by more than RPI + 1½% in any year. Operators will be protected by the provisions of Royal Mail's licence, that prohibit it from certain anti-competitive pricing practices, and by general competition law.
- S.39 Postcomm notes that under the current legislative framework, access offered to rival operators cannot be classified as universal services. Only services offered to mailing customers can be considered as universal services. For simplicity (and to prevent distortions and market confusion) Postcomm proposes that direct access for customers should be brought into line with access for operators and not

classified as a universal service. This will take effect from the date of Postcomm's decision, expected in early 2005.

S.40 At present, access products are outside the price control. As part of its review of the price control arrangements that should run from 1 April 2006, Postcomm will consider whether it is necessary to bring access within the scope of the price control. This review will also consider whether access services should be controlled through a separate price control.

S.41 To better understand and assess tariff structure changes, Postcomm will undertake a review of Royal Mail's cost allocation.

### **Postcomm's consultation**

S.42 Postcomm would like to thank stakeholders who have so far contributed towards this review. Postcomm now invites views from stakeholders on the specific policy proposals contained in this document. Responses can be sent by post, e-mail or fax and should reach Postcomm by no later than Monday 20 December 2004. Postcomm will be pleased to meet with stakeholders to discuss their views in advance of this deadline for formal representations. Full contact details can be found in Chapter 1. Postcomm expects to publish a decision in early 2005.

# Risk assessment

## Introduction

S.43 Postcomm believes that in making any major regulatory decision, it should assess the risks inherent in its actions, including the risk of not taking any action. This is consistent with its approach to market opening in 2002 and regulatory best practice.

## **Risk that too much competition might undermine an affordable universal service?**

S.44 Postcomm continues to believe that the best long term safeguard for the universal service is an efficient, innovative and customer focussed Royal Mail and the best environment to encourage this is a competitive market rather than a monopoly.

S.45 Postcomm recognises that competition, under certain circumstances, could cause problems for Royal Mail's ability to be able to provide services that it might seek to avoid if it were free from all constraints. Postcomm notes Royal Mail's concern that some aspects of its tariff structure are not well aligned with its costs (e.g. the geographically uniform tariff). This may pose risks based on unsustainable arbitrage opportunities (called "cream skimming" by Royal Mail). There are a number of reasons why Postcomm considers this risk to be even less than when it concluded its original full market opening timetable in 2002:

- barriers to entry, such as Royal Mail's scale, brand loyalty and VAT exemption (see Postcomm's Competitive Market Review, published alongside this document, for details) are significant;
- Royal Mail is seeking a greater degree of pricing flexibility. This includes clarifying those products that are included and excluded from the uniform pricing constraint as well as other pricing initiatives (see Chapter 4);

- Royal Mail has now negotiated commercial agreements with three other operators to have access to its local delivery network. This reinforces Royal Mail's competitive position;
- Royal Mail's regulatory accounts (based on the company's allocation of costs) show that, on average, it makes a loss on the part of the market that is not yet opened to competition, which may dissuade some operators from entering the market; and
- Postcomm's financial analysis of the impact of competition on Royal Mail's business further supports this view (see Annex 1) as does international experience from those countries that have fully liberalised their markets, such as Sweden and New Zealand.

S.46 Clearly, there is always some degree of uncertainty over how the market will develop, and Postcomm has identified a number of potential risks. If any of these risks do materialise, then Postcomm believes it has adequate mitigation measures available (see Chapter 2).

S.47 Postcomm will continue to monitor the market closely in order to ensure the universal service is maintained and strengthened.

#### **Risk of too little competition to change Royal Mail's behaviour?**

S.48 Against the background of Royal Mail's current poor quality of service performance against its agreed targets, Postcomm is concerned that this is currently the most pressing risk facing the regulatory regime. As mentioned above, Postcomm's Competitive Market Review suggests that barriers to entry are more significant than were appreciated at the time of Postcomm's original market opening timetable in 2002.

S.49 Postcomm is committed to periodic Competitive Market Reviews in order to assess whether the situation has changed and to inform regulatory action to improve the prospects for competition to further postal users' interests. This will

also address the risk that there is uncertainty about how the market will develop in the medium to longer term.

- S.50 To ensure the market prepares for 1 January 2006, Postcomm will undertake an extensive market awareness campaign with operators and customers.

**Risk that unscrupulous entrants might bring the market into disrepute?**

- S.51 In fully opening the market, opportunities will arise for small scale local and niche operators. Although Postcomm expects that most of these operators will add to the entrepreneurial spirit of the market and generate real customer benefits, Postcomm believes it ought to be vigilant to any activity that might cause postal users distress and bring the market into disrepute. To help mitigate this risk, Postcomm is reviewing the licensing framework, focusing on mail integrity whilst ensuring the regime is “light touch” to facilitate entry and innovation. Postcomm will publish its first document on its licensing framework review in November 2004.

**Risk of delays to interoperability issues?**

- S.52 Arrangements are needed among operators to underpin a multi-operator environment, e.g. redirection of letters that have inadvertently been posted into another operator’s network.
- S.53 In proposing to bring forward the date for full market opening, Postcomm is concerned by the slow pace of progress from the industry in putting in place measures to ensure “interoperability”. Postcomm will mitigate this risk by focusing more on this area. Postcomm will also consider using its powers against any operator who it believes is not conducting negotiations on this issue in good faith and thus undermining Postcomm’s ability to ensure suitable and timely arrangements are put in place to protect customers.

## **Risk that Royal Mail might overload the regulator with pricing and other proposals?**

- S.54 Postcomm notes Royal Mail's concern that some of its prices are not well aligned with its costs. Postcomm is currently considering three of Royal Mail's main strategies for better aligning its price control costs. These are Size Based Pricing, geographic pricing (for non-universal services, see Chapter 4) and discounts for customers using metered and franked mail.
- S.55 In general, Postcomm supports the principle of improved cost-reflective pricing. It will help Royal Mail compete better in a competitive market, encourage customers to use more efficient mailing methods, and help Royal Mail respond to demands from its shareholder to act in a commercial manner. That said, Postcomm has to be assured that adequate safeguards are in place to protect customers and the universal service (in addition to operators that could be adversely affected by potentially anti-competitive pricing).
- S.56 Postcomm is currently reviewing Royal Mail's cost allocation approach, primarily for the purpose of the price control review and to assess the justification for Size Based Pricing, as it is not yet convinced that Royal Mail's cost allocation is sufficiently robust to provide a basis for such major decisions. More generally, a review will also enable Postcomm to take a more informed view of those areas where prices do not reflect costs and to respond more quickly to "rebalancing" requests from Royal Mail.
- S.57 Equally important, Postcomm will need to be able to respond to complaints from other interested stakeholders about Royal Mail's pricing. Therefore, Postcomm's approach (and resource effort) to assessing proposals for price changes cannot be driven just by Royal Mail's agenda. Regarding individual re-pricing reviews, the nature, magnitude and sensitivity of the proposal would dictate the level of analysis and type of process.
- S.58 Notwithstanding the need to make the analysis and process proportionate to the specific proposal, in each case Postcomm would require a detailed proposal for

any price restructuring. Once Postcomm is satisfied that the proposal is of sufficient quality, it would review the evidence submitted by Royal Mail. Following that, there would be a full and proper consultation with all industry stakeholders, including Postwatch, before any decision could be taken.

S.59 Postcomm has limited resources and must ensure that, to fulfil its duties, it properly prioritises its work to greatest benefit. With work on the major initiatives under way, and with the major review of its price control ongoing, Postcomm would look to Royal Mail to explain how any additional proposals are likely to lead to a proper discharge of Postcomm's duties, and why action is required at the present time. Postcomm may have to refuse to prioritise a proposal from Royal Mail if it cannot make a convincing case.

**Risk that Royal Mail might foreclose the market through anti-competitive behaviour?**

S.60 Postcomm recognises that Royal Mail will "fight for every letter" and much of this activity will be within the general cut and thrust of business. However, given Royal Mail's market position, Postcomm is keen to ensure Royal Mail does not abuse its market power and foreclose the market before competition has had a chance to gain a foothold.

S.61 Postcomm will work closely with operators (e.g. through its Operators Advisory Group) to monitor any concerns about Royal Mail's behaviour.

S.62 Postcomm will use its powers under Royal Mail's licence if it believes that Royal Mail has acted in an anti-competitive way. It will also work closely with the Office of Fair Trading (OFT) to ensure that Royal Mail does not breach the prohibitions of general competition law, in particular, the Competition Act 1998 and Articles 81 and 82 of the EC treaty.

**Risk that pending effective competition, Royal Mail's efficiency may not improve significantly?**

S.63 Improving Royal Mail's efficiency is key to achieving Postcomm's vision. Postcomm recognises that if effective competitive pressure will take time to materialise, it will need to set incentive based regulation as a substitute, recognising the unique ownership structure of Royal Mail, as a wholly government owned public limited company. Postcomm will aim to mitigate these risks with its detailed review of Royal Mail's price control for the arrangements that will apply from 1 April 2006. For details of Postcomm's approach, please see the consultation document on Royal Mail's price control that is published alongside this document.

**Risk that Royal Mail fails to improve its service quality?**

S.64 Postcomm recognises Royal Mail's quality of service is a key area of concern to many customers. In addition to fully opening the market to competition, Postcomm is taking a number of steps to mitigate this risk. These include:

- o ongoing monitoring and enforcement of current quality of service standards. Postcomm is currently considering whether enforcement action should be taken in respect of the failures in Royal Mail's quality of service for 2003/04. This follows an enforcement order and financial penalty of £7.5m imposed on Royal Mail for failures in relation to Printed Postage Impressions (PPI) and Response Services in 2002/03;
- o compensation. Under its licence, Royal Mail has a scheme to compensate customers for delay to first and second class retail and business services, Mailsort 3, Special Delivery and Standard Parcels. Compensation paid for service failures in 2003/04 will amount to at least £50m. Postcomm will review the compensation scheme in early 2005; and
- o "C-factor". This mechanism provides for adjustment to the allowed revenue in the price control where Royal Mail fails its non-bulk mail quality targets. Postcomm will be reviewing this mechanism as part of the next price control

to see whether it should be changed, or expanded to take account of bulk mail services.

S.65 In June 2004, Postwatch, Royal Mail and Postcomm jointly commissioned research by MORI to better understand the needs and expectations of Royal Mail's customers in relation to quality of service standards. The objective of the research was to:

- o establish customer requirements of a universal postal service in terms of speed of delivery, reliability and security; and
- o assess customer expectations of quality over the period of the next price control.

S.66 This research is set out in detail in a consultation document that will shortly be published by Postwatch (available at [www.postwatch.co.uk](http://www.postwatch.co.uk)). It seeks the views of the industry, major stakeholders and customer groups on the appropriate quality of service measures. This will allow Postwatch and Royal Mail to discuss how the quality of service measures should be developed to complement Postcomm's review of Royal Mail's price and service regulation from 1 April 2006.

**Risk that competition has very different impacts on various customer groups?**

S.67 Competition by its nature will not affect all customers and postal users in the same way. Certain postal users, such as large customers with purchasing power, will find their choice in terms of price and quality offers is more varied than the choice open to customers who post a single mail item. This is not surprising given that business customers account for about 86% of all mail posted in the UK. International experience supports this and shows that bulk mailers have experienced significant price reductions from competition. Operators are also keen to develop innovative products and services more tailored to these customers' needs and requirements (e.g. track and trace arrangements and customer database management).

- S.68 However, Royal Mail's universal service network is used by large and small customers alike. Therefore, even those customers that will not get an effective alternative choice to Royal Mail in the short-term, such as residential customers, will nonetheless benefit as Royal Mail improves its overall quality of service in the face of potential competition for some of its large customers.
- S.69 This will be particularly important for those parts of the market such as small and medium sized businesses (who rely on the post for cash flow) and residential customers (who tend to value reliability above all else). This is one reason why Postwatch, the statutory body responsible for promoting the interests of all postal users, has consistently supported full market opening.
- S.70 In the past, Royal Mail has criticised liberalisation because it may lead to greater pricing differentials between residential and large bulk mailers. Some movement in relative prices might be benign, given that Royal Mail wants to move its prices more into line with its costs and research suggests that residential customers are more concerned with reliability and quality of service than price. Sharp increases in the basic public tariffs are not a direct response to competition. Postcomm notes that this has not been the case in New Zealand.
- S.71 In any event, Postcomm will ensure that those postal users that do not fully benefit from a competitive market will have their interests protected from regulation, most notably they will always have available a universal service at an affordable "one price goes anywhere" price. Postcomm helps to ensure this through Royal Mail's price control and service quality regulation. The present price control, for example, ensures that average prices fall in real terms, i.e. postal prices rise by less than inflation in the wider economy.

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# 1. Introduction

## *Postcomm's statutory duties*

- 1.1 Before the Postal Services Act 2000 was enacted, Royal Mail Group plc, formerly The Post Office, had the exclusive privilege of a monopoly in the provision of postal services within the UK for items weighing less than 350g and costing less than £1 to convey. The changes introduced by the Postal Services Act 2000 (the "Act"), established Royal Mail as the successor to the Post Office and Postcomm as the sector regulator with duties in relation to the universal service, consumers and competition. Postcomm's main power is the issuing of licences to operators within the former monopoly area.
- 1.2 Postcomm's universal service duty is to exercise its functions in the manner it considers best calculated to ensure the provision of a "universal postal service" (UPS). This consists of the delivery and collection at least once every working day of mail (not exceeding 20kg in weight) and the provision of a registered postal service, all at affordable prices that are geographically uniform throughout the UK.
- 1.3 Subject to this, Postcomm is charged with furthering the interests of users of postal services wherever appropriate by promoting effective competition between postal operators. In doing so, Postcomm must have regard to the interests of those who are disabled or chronically sick, are of pensionable age, are on low incomes, or reside in rural areas.
- 1.4 Subject to both the duties above, Postcomm has a further duty to exercise its functions in a manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.
- 1.5 Finally, in performing all its duties, Postcomm must have regard to the need to ensure that licence holders are able to finance the activities authorised or required by their licences.

## ***Postcomm's vision and regulatory strategy***

1.6 Postcomm's vision for the postal services market, in the discharge of its duties is:

"A range of reliable, efficient and innovative postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market."

1.7 Postcomm's strategy for achieving this vision recognises that regulation will need to evolve over time. Postcomm believes that its duties will be best discharged by encouraging a dynamic and competitive market that stimulates innovation and customer focus on the part of postal operators. In the short-term, when competition is not sufficiently developed to protect postal users' interests and provision of the universal service, Postcomm recognises that it will need to regulate the activities of Royal Mail.

1.8 Postcomm has put in place a number of key regulatory policies to implement this strategy:

- in March 2001, Postcomm granted the first licence under the Act to Royal Mail;
- in May 2002, Postcomm announced a market opening programme, which is summarised in Chapter 2 and reviewed as the subject of this document<sup>1</sup>;
- in March 2003, Postcomm put in place a price control and service quality package for Royal Mail to last until 1 April 2006<sup>2</sup>;
- in October 2003, Postcomm established compensation arrangements in Royal Mail's licence, which require it to reimburse business customers for a proportion of their bills if its quality of service performance is below target;

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<sup>1</sup> "Promoting Effective Competition in UK Postal Services", Postcomm, May 2002.

<sup>2</sup> "2006 Royal Mail Price and Service Quality Review", Consultation on Principles, Postcomm, March 2004.

- Postcomm's work on establishing third-party access arrangements to Royal Mail's network included Royal Mail agreeing commercial terms with UK Mail on 12 February 2004 and subsequently with TNT Post Group (TPG) on 7 April and Deutsche Post World Wide (DPWW) on 16 April; and
- Postcomm has sought to provide greater clarity on the scope of the universal service in terms of the products that Royal Mail provides. In June 2004 Postcomm published a decision document establishing the non-bulk products and services that comprised Royal Mail's universal service obligation<sup>3</sup>.

1.9 Postcomm's Forward Work Plan, which can be found on its website ([www.psc.gov.uk](http://www.psc.gov.uk)), gives details of its duties, functions, objectives and work plan.

### ***Purpose of this document***

1.10 Postcomm's 2002 market opening timetable provided for a review towards the end of "Phase I" (1 January 2003 to 31 March 2005) of the arrangements that should be put in place to give effect to "Phase II" (1 April 2005 to 31 March 2007). At the time, Phase II was designed to open a further 30% of the market by revenue to competition in April 2005, before full market opening in 2007.

1.11 This document reassesses this approach and sets out Postcomm's proposals on how best to open the market, consistent with ensuring the continued provision of a universal service. Postcomm recognises that in opening the market to competition, clarity is required on exactly what bulk mail products (including access) should be classified as universal service products. This document also sets out Postcomm's proposals on this issue.

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<sup>3</sup> "The UK's Universal Postal Service", Postcomm, June 2004.

### ***Structure of this document***

1.12 Chapter 2 reviews the original market opening timetable and sets out Postcomm's revised proposals for further market opening. Chapter 3 sets out Postcomm's response to several issues arising from full market opening such as the licensing policy and raising market awareness. Chapter 4 sets out Postcomm's proposals on the particular bulk mail products that should be classified as universal services.

1.13 Annex 1 contains a summary of Postcomm's financial analysis of the potential impact of further market opening on Royal Mail.

### ***Process***

1.14 Postcomm has based its proposals in this document on a wide number of inputs. These include:

- in January 2004, Postcomm issued its "Market Report", setting out how the market was developing and explaining current trends<sup>4</sup>. This document consulted on the main barriers to entry that may be impeding competition and innovation;
- on 5 May 2004, Postcomm issued a consultation letter to stakeholders for its Competitive Market Review (CMR)<sup>5</sup>. Among the main issues raised were potential options for further market opening. Postcomm complemented this consultation by meeting with many interested stakeholders (including Royal Mail, Postwatch, operators, customers and the unions) to listen to their views;

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<sup>4</sup> "The UK Letters Market 2000 – 2003", Postcomm, January 2004.

<sup>5</sup> "Competitive Market Review – Stakeholder Letter", Postcomm, May 2004.

- in the first quarter of 2004 an extensive market research survey (conducted with the consultant, Roland Berger) of business customers to listen to their views on competition and how it should be progressed<sup>6</sup>;
- on 9 June 2004, Postcomm presented its views on competition to stakeholders at its London Forum event. Postcomm also continues to undertake a series of regional "roadshows" and since January 2004 has been to Belfast, Edinburgh and Builth Wells (Wales);
- in April 2004, Postcomm discussed market opening with the Operators Advisory Group (OAG). This group of operators (not including Royal Mail) was set up for Postcomm to better understand how operators view the prospects for competition and innovation in the market and what barriers they have to overcome;
- in May 2004, Postcomm met with the Board of Royal Mail Group to discuss its work programme. A similar event was held with Postwatch's Council in June 2004; and
- a detailed review of how competition has progressed to date, barriers to entry and the prospects for further competition. Much of the detailed analysis is contained in Postcomm's parallel publication to this document: "Competitive Market Review"<sup>7</sup>.

### ***How to respond***

1.15 Postcomm invites views from stakeholders on the policy proposals contained in this document. Responses can be sent by post, e-mail or fax and should reach Postcomm by no later than Monday 20 December 2004. Responses should be sent to:

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<sup>6</sup> "Monitoring Developments in the Postal Market – Market Survey", April 2004, Roland Berger. This is available on Postcomm's website: [www.psc.gov.uk](http://www.psc.gov.uk).

<sup>7</sup> "Competitive Market Review –Proposals for Consultation", September 2004.

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- 1.16 If you would like clarification of any points raised in this document please contact Matthew Ward or Pav Dhesi (on 020 7593 2120 or at [pav.dhesi@psc.gov.uk](mailto:pav.dhesi@psc.gov.uk)).
- 1.17 Postcomm is always happy to meet with stakeholders to discuss its policies and listen to stakeholders' views.
- 1.18 Following consideration of responses to this document, Postcomm expects to issue a decision document in early 2005.

### ***Confidentiality of responses***

- 1.19 Postcomm wishes to make public the responses it receives to this consultation document. If you do not want all or part of your response to this document to be read by anyone outside Postcomm, please ensure that your response is clearly indicated as confidential.

## 2. Review of Postcomm's market opening timetable

### *Introduction*

2.1 This chapter reviews Postcomm's 2002 market opening timetable. In the light of new information and experience available to Postcomm, it considers the merits of an intermediate step before full market opening and the most appropriate date for full market opening.

Postcomm welcomes views from stakeholders on its proposal to fully open the UK market to competition from 1 January 2006 (with no intermediate step between 1 April 2005 and 31 December 2005).

### *Postcomm's 2002 market opening proposals*

2.2 In 2002, Postcomm established a three-phase approach to opening the then "reserved area"<sup>8</sup>, to competition consisting of:

- "Phase I": 1 January 2003 to 31 March 2005. Operators could apply for three categories of licence to operate within the reserved area. First, operators could apply to convey "bulk mail" defined as any mailing of more than 4,000 identical format items from a single site in the UK. This opened about 30% of the market by revenue to competitors. Second, operators could apply for a consolidation licence to collect and sort mail and inject it into Royal Mail's network for delivery (but not other operators' networks). Third, licences were offered for so-called 'defined activities' such as enhanced document exchange and tracked business-to-business services. In

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<sup>8</sup> In 2002, the "reserved area" consisted of items weighing below 350g or costing less than £1 in postage. Postal services for items costing or weighing more than these thresholds have been open to competition since 1981.

addition, on 1 January 2003, the reserved area was reduced to items below 100g, in line with the European Postal Services Directive<sup>9</sup>.

- “Phase II”: 1 April 2005 to 31 March 2007. It was intended that the bulk mail volume threshold would be adjusted to open up a further 30% of the market by revenue. A review (the subject of this document) would take place before the end of Phase I to inform how this could be achieved; and
- “Phase III”: 1 April 2007. All remaining restrictions on market entry would be abolished and the market would be fully opened to competition. Consolidators would be able to inject mail into non-Royal Mail networks.

2.3 Postcomm’s 2002 proposals indicated that Phase II of market opening would involve a reduction in the bulk mail threshold. In a consultation letter issued on 5 May 2004, Postcomm proposed to reconsider the approach of reducing the bulk mail threshold and consider a number of alternatives. These were combinations of the following:

- competition by customer type. For example, mailers posting more than a particular volume or operating in a defined segment such as business-to-business (B2B);
- competition by product type. For example, direct mailers or other ‘types’ of mail; and
- full opening of the market to competition ahead of 1 April 2007. This could be achieved in one step or with an intermediate step.

### ***Stakeholders’ views on options for further market opening***

2.4 Royal Mail said that Postcomm should continue to follow its previously announced three-phase strategy and reduce the bulk mail threshold in 2005 to open 60% of the market by revenue. Royal Mail noted that due to changes in its

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<sup>9</sup> EC Postal Services Directive (97/67/EC) as amended by Directive (2002/39/EC).

product mix, the current 4,000 items per mailing threshold opened up more than the intended 30% of the market by revenue. Royal Mail also argued that much more of the market was already open to competition. This was because downstream access effectively liberalised the whole market to consolidators. Royal Mail did not indicate what volume threshold would be consistent with opening up 60% of the bulk mail market by revenue.

- 2.5 Royal Mail did not support alternative options to reducing the bulk mail threshold. It argued that opening the B2B segment in Phase II would have a disproportionate effect on its profitability. It also argued against full market opening ahead of April 2007 stating that changing the programme would reduce confidence in regulatory decisions and potentially increase the risk to the universal service (Royal Mail did not quantify this risk).
- 2.6 A number of other operators supported bringing forward full market opening. This was on the basis of both the lack of entry to date and barriers to entry, which the industry now understood to be more significant than at the time of Postcomm's original decision. Full market opening would give operators much more flexibility to enter the market without arbitrary regulatory restrictions on their business models and it would give a clear signal to the market and to Royal Mail that the postal market was now liberalised. All these operators, however, suggested that for the pace of competition to increase, full market opening must be complemented by a programme that removes the other barriers to entry.
- 2.7 Two licensed operators said that Postcomm should stick to the existing timetable and reduce the bulk mail threshold in April 2005 (one saying it should be reduced to 1,000 items per mailing and the other operator saying it should be reduced to 2,000 items per mailing). They argued that the impact of access arrangements was yet to be seen. More importantly, however, they were concerned that unscrupulous operators would enter the market and that stories of mail integrity mishaps could damage the market's reputation for all operators.

- 2.8 Postwatch believed that bringing forward full market opening to the earliest possible date, 1 April 2005, should be considered, given the slow pace of entry to date and Royal Mail's VAT exemption which is unlikely to be resolved soon.
- 2.9 Large customers were in favour of bringing forward market opening. One customer argued that this was necessary to allow the market to compete with the threat of other advertising media. Many customers believed that full market opening would send a powerful signal to Royal Mail, at all levels, to improve its performance. The majority of customers (both large and small) believed that full market opening by itself would make no significant difference, due to other barriers to entry such as Royal Mail's scale and the ubiquity of its daily delivery network, Royal Mail's VAT exemption and its brand.
- 2.10 A number of customers said that if Postcomm did decide to continue with the bulk mail threshold reduction, the revised volume per mailing should be set at 1,000. It was noted that this was the same level as Royal Mail's lowest bulk mail entry volume on its Cleanmail product.
- 2.11 Some large customers also argued that the present restriction requiring mail to be posted from a single site in the same format should be removed as it acts as a barrier to potential users, especially multi-site users.
- 2.12 Only one customer indicated support for competition by product category, arguing that Phase II should open the direct mail market segment to competition.
- 2.13 The Communication Workers Union (CWU) observed that access arrangements had only been reached with three major operators – UK Mail, Deutsche Post and TPG Post UK – in recent months. It therefore felt that it would be unwise to introduce a further wave of competition activity before the impact of these agreements could be properly assessed. It therefore opposed bringing forward full market opening. Both the CWU and Amicus argued that liberalisation should not exceed the requirements of the European Postal Services Directive.

2.14 Two equipment suppliers to the industry supported earlier full market opening, given the slow pace of competition to date and its limited prospects given Royal Mail's VAT advantage. However, one supplier said that more time was required to assess the impact of long term licensing and the development of the access arrangements. Another supplier believed that lowering the bulk mail threshold to 500 items per mailing could encourage Royal Mail to begin to consider small and medium sized customers.

### ***Reconsidering the original market opening timetable***

#### **Postcomm's objectives for the market opening review**

2.15 In conducting its review of market opening, Postcomm has had in mind the same objectives it set out for its original review. Postcomm believes these are still relevant. These are:

- ensuring the provision of the universal service;
- promoting effective competition;
- encouraging efficiency and economy;
- objectivity and transparency; and
- proportionality.

#### **Rationale for a broader review than just reducing the bulk mail threshold**

2.16 Postcomm, in devising its 2002 market opening timetable, wanted to ensure that there was an orderly transition to a competitive market. Its three phase timetable was essentially put in place because of significant uncertainty about how the market would develop. The significance of other barriers to entry was not well understood by the industry, given the market had long been subject to Royal Mail's monopoly. The pace of competitive entry was unknown. Royal Mail suggested that barriers were very low and that significant amounts of "cream skimming" entry would occur.

2.17 The National Audit Office (NAO) encapsulated the uncertainties Postcomm faced at the time in its report on Postcomm's activities<sup>10</sup>. It said that there were two main risks arising from the liberalisation programme. The first risk was that too much competition could undermine Royal Mail and its ability to ensure the continued provision of a universal service. The second risk was that too little competition would develop and that this would fail to put adequate pressure on Royal Mail to improve its performance and customer focus.

(a) Greater clarity over the risks of the intensity of competition

2.18 Postcomm's CMR, and responses to the CMR letter sent out on 5 May, suggest that one of the two risks identified by the NAO has predominated over the past two years and is likely to persist in the near future: the risk of too little competition to improve Royal Mail's performance and customer focus. This is supported by Royal Mail's recent under-performance against its quality of service targets. In addition, Royal Mail has lost just 0.3% of the market. It has experienced healthy volume growth throughout the period, which has helped to improve its financial position significantly and hence the security of the universal service.

2.19 The CMR assesses other indicators of competition which support this view. An important indicator is the significance of barriers to entry. Postcomm believes that certain barriers are at present having a major effect on the short-term prospects for operators gaining a foothold in the market and expanding their businesses. These include Royal Mail's economies of scale, derived from handling over 80m items per day and its national delivery coverage. This keeps its unit costs very low compared to new entrants, despite inefficiencies within its operations. Postcomm also notes the comment from some rival operators that Royal Mail charges some of the lowest postal prices in Europe. Other barriers include Royal Mail's VAT exempt status, which may effectively distort pricing in up to half the market in its favour.

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<sup>10</sup> "Opening the Post: Postcomm and postal services – the risks and opportunities", NAO, January 2002.

2.20 Postcomm recognises that these barriers have been compounded over the past couple of years by the uncertainty caused by the considerable delay in Royal Mail and UK Mail agreeing terms for third party access to Royal Mail's network, which took two years. This created uncertainty not only for potential upstream operators but also for potential end-to-end operators, who wanted to assess whether they should develop delivery networks or use Royal Mail's downstream network.

2.21 On top of these barriers, rival operators also need to overcome quite a high degree of inertia on the part of customers. Customers, despite being disadvantaged by Royal Mail's recent quality of service performance, have a strong affinity with Royal Mail's brand, ubiquity and general service specification. This is demonstrated by the results of the Roland Berger customer survey, which highlighted customers' inertia and lack of desire to switch operators. However, many interviewees, responsible for the procurement of postal services, may have had little experience of the benefits of switching provider.

(b) Royal Mail and its universal service are more robust to the challenge of competition

2.22 Royal Mail is now in a much stronger financial position than it was in 2002. In 2003/04, it made a profit from operations of £348m (before pension deficit payments and exceptional costs) in the price controlled area, a 6% operating margin on turnover, and £220m overall (for the total Royal Mail Holdings). Royal Mail's stronger financial position suggests a reduced risk to the universal service. This is supported by analysis that Postcomm has undertaken (set out in Annex 1).

2.23 Royal Mail is also strengthening its business in other ways. Its "Renewal Plan" is scheduled to be completed by the end of this financial year. This is designed to make the business stronger for future challenges. It is undertaking three major initiatives to improve flexibility and efficiency. These are Single Daily Delivery, the Transport Review, and the Mail Centre Review. These are designed to make it more efficient and flexible to future change.

2.24 Royal Mail's agreement of terms for third-party access will further strengthen its business. The commercial agreement with UK Mail in February 2004 has since become a benchmark for subsequent agreements with DPWW and TPG. This will help strengthen its competitive position in the delivery market. Inward sortation and delivery account for nearly half of all costs and access will help Royal Mail retain volumes in a competitive market and reinforce employment opportunities in this labour intensive part of its business.

2.25 These changes in circumstances that have happened since the last market opening review mean that Postcomm has had to take a fresh look at the options for market opening from 1 April 2005. Not to do so would be irrational and would jeopardise the proper discharge of Postcomm's statutory duties.

### **Identification and assessment of options for the next phase of market opening**

#### *(i) Current position*

2.26 At present, the market that is effectively reserved for Royal Mail is for end-to-end letters under 100g (and, in value terms, three times the basic first class tariff) that comprise mailings of less than 4,000 identical format items from a single site (i.e. not bulk mail). From 1 January 2006, the European Postal Services Directive will further reduce the weight and price thresholds to 50g (and, in value terms, 2½ times the basic first class tariff). Within this segment, it is still possible for mail to be consolidated and injected into Royal Mail's network using the access arrangements (effectively, the whole market has been liberalised for access). Operators can also apply for defined activity licences. Examples include enhanced document exchange and tracked business-to-business services.

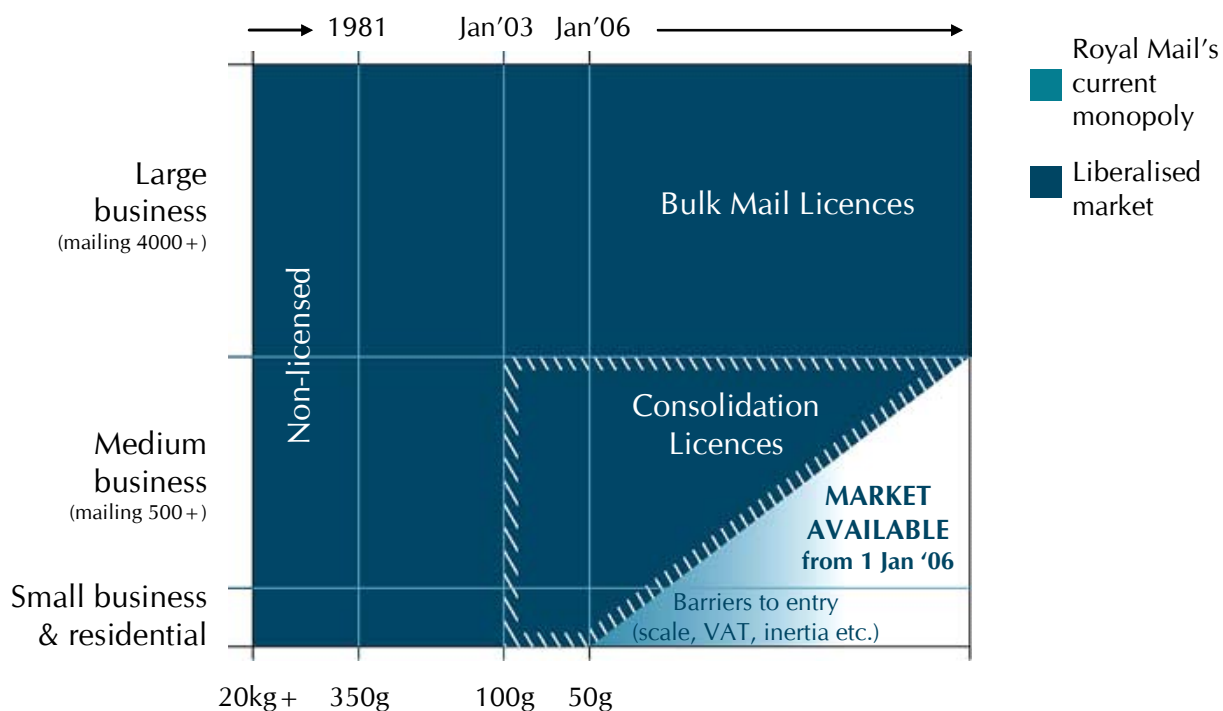
2.27 Chart 2.1 illustrates these market segments. A total of 59% by revenue of the 0-350g end-to-end market will already be open to competition from 1 January 2006 as a result of:

- o the reduction in the reserved area from 350g to 100g (21%) and the further reduction from 100g to 50g from 1 January 2005 (6%); and

- o Postcomm's decision to open bulk mailings in excess of 4,000 items (32%).

2.28 Within the remaining 41% of revenues, it is still possible for operators to undertake consolidation activities and inject mail into Royal Mail's network through the access arrangements. It is also possible for operators to apply for defined activity licences.

Chart 2.1: Market opening 'tranches'



1. The licensed area (0-350g) represents approximate revenues of around £4.6bn.
2. Reserved area reduced to 350g/£1 in 1981.
3. Bulk mail opened to competition in 2003.
4. Consolidation opened to competition in 2003 (it applies to the whole market but Chart 2.1 highlights that it applies to the part of the market that has not yet been opened to competition).
5. Reserved area reduced to 100g in 2003.
6. Reserved area to be reduced to 50g in 2006.

Source: Postcomm

(ii) *Reducing the bulk mail threshold*

2.29 At present bulk mail is defined as any mailing of an identical format posted from a single site in excess of 4,000 items. To open 60% of the bulk mail market by

revenue to competition by reducing the volume threshold would imply a volume of between 500 items and 1,000 items per mailing.

2.30 Postcomm is concerned that this would not achieve anything substantive in terms of promoting effective competition or efficiency and economy. Bulk mailers at present use Royal Mail's pre-sort tariffs, and the minimum entry volume for Mailsort is 4,000 items (1,000 packets) with most mailers posting well in excess of that level.

2.31 Research on customer posting profiles undertaken by Roland Berger for Postcomm suggests that reducing the bulk mail threshold in this way is unlikely to make any difference to competition as most of this market is still dominated by business-to-consumer (B2C) mailings. This segment of the market requires extensive networks and economies of scale. To be able to effectively compete for these mailings, operators would need to be able to assure customers that they could reach every household in the country on a reasonably frequent basis. It is also the market segment where VAT exempt customers tend to be concentrated. These customers include some large mailers, such as financial institutions, some charities and some government departments. The CMR presents analysis which suggests that up to 50% of the total market could be distorted due to Royal Mail's VAT exemption.

2.32 In terms of Postcomm's stated objectives, this approach is unlikely to further the objectives for effective competition and efficiency and could lead to a significant amount of regulatory resources being diverted into activities such as enforcement, with little benefit to postal users.

(iii) *By sector, e.g. business-to-business (B2B)*

2.33 Opening the B2B market is an alternative. It represents about 25% of the market by revenue. Postcomm considers that this approach has merit over reducing the bulk mail threshold in terms of the objective of promoting effective competition. Business-to-business (end-to-end) networks tend to require less economies of scale and can be built in high volume areas such as financial districts and city centres. Some operators could leverage their present activities to expand into this segment.

2.34 Opening up this segment, however, could draw the industry into a very complex exercise of defining and enforcing the boundaries of this segment. It would also create a 'patchwork' of opportunities for operators, which could be confusing and hinder their chances of securing customers' accounts. It would, therefore, not promote objectivity and transparency and would involve a disproportionate amount of limited regulatory resources that could yield greater benefits for postal users by being deployed on other activities.

(iv) *Following the European timetable*

2.35 Postcomm does not accept the argument put forward by the unions that market opening in the UK should take place along the same timetable as the European Postal Services Directive (in effect later than 1 April 2007). In 2002, Postcomm concluded that its duty in respect of the universal service was best discharged by introducing competition. This conclusion has been supported by events since then, with Royal Mail becoming more financially secure as it reforms itself in preparation for the prospect of competition.

2.36 There is no definitive timetable for full market opening across Europe (it is subject to a review in 2006). To follow the plans set out in the European Postal Services Directive would relieve Royal Mail of the competitive pressure that would be the main driver of its commitment to become more efficient and customer focussed. This would not represent a proper discharge of Postcomm's duties or serve the best interests of postal users. Experience from other regulated sectors has suggested that moving ahead of the rest of Europe has delivered real benefits to UK customers.

2.37 Following this approach would therefore neither further the objectives of promoting effective competition nor encouraging efficiency and economy. It would also be disproportionate, given that no convincing case has been demonstrated to suggest that continuing monopoly privilege is required to safeguard the universal service. Indeed, by discouraging efficiency and innovation, this approach could undermine Royal Mail's efforts to strengthen its universal service network.

(v) *Removing the remaining monopoly in a single step*

- 2.38 Postcomm believes that a single step towards full market opening has several advantages over the other options in terms of the objectives for the review. Completely eliminating the partial monopoly of Royal Mail is the option most consistent with promoting effective competition and encouraging efficiency and economy. However, as Postcomm recognises from experience to date, this option by itself is not likely to have an immediate or significant effect on competition. The reasons for opening up the market in two phases rather than one are, as a consequence, no longer valid.
- 2.39 By removing artificial boundaries to operators' business plans, this option also ranks highly in terms of furthering objectivity and transparency. Moving straight to full market opening in one step avoids the regulator defining, in an artificial way, parts of the market where competitors can enter. This leaves the market to define which business models are viable and which customer groups are most likely to benefit from competition.
- 2.40 This option is also a proportionate measure. It has become apparent that Royal Mail's monopoly does not need to be protected in order for it to provide a universal service (see below). In terms of Postcomm's limited regulatory resources, it is also a proportionate measure because it saves two phases and enables Postcomm to prioritise its resources on other important activities, for example addressing other barriers to entry, improving Royal Mail's quality of service, gaining a better understanding of Royal Mail's price-cost relationships, dealing with anti-competitive complaints and ensuring the market infrastructure is in place for full market opening (e.g. establishing mail integrity and interoperability arrangements, etc).
- 2.41 For these reasons, Postcomm believes that the option best calculated to achieve its objectives is to move to full market opening in a single step.

## **Accelerated market liberalisation**

2.42 On the basis that there should be a single step towards full market opening, Postcomm has considered a number of potential dates.

(i) *1 April 2005*

2.43 Postcomm understands certain stakeholders' desire to move to full market opening from 1 April 2005. However, Postcomm recognises that this is just six months away and it would give the industry (including Royal Mail, customers and operators) insufficient time to prepare for a fully open market. Postcomm also needs to ensure that it develops a suitable licensing regime for full market opening.

2.44 Overall, Postcomm believes that this option would create too much risk, with insufficient time to put in place appropriate mitigation measures.

(ii) *1 April 2007*

2.45 Postcomm notes that some stakeholders such as Royal Mail and the unions would prefer Postcomm to keep to its original date for full market opening (if not later). However, Postcomm believes that this option, especially when coupled with no intermediate step, carries too much risk in terms of losing the momentum for change within Royal Mail. It is also significantly disproportionate because no pressing need has been demonstrated as to why Royal Mail should gain an extension of two years to Phase I of market liberalisation.

2.46 Although competition has been slow to develop (and there is no reason to suggest that the incremental effect of full market opening will cause it to change in nature significantly in the short-term) there are no strong reasons to suggest that a delay to market opening would affect positively the behaviour and performance of Royal Mail and strengthen its commercial incentives and ability to provide a universal service. Therefore, Postcomm no longer sees any convincing reason to delay for a further two years removing the distortion and barrier to entry caused by the remaining monopoly.

2.47 Postcomm notes the suggestion by the unions that a decision on full market opening should be delayed until the effects of access are understood. However, Postcomm does not believe uncertainty about how access will develop should delay market opening. First, Royal Mail has now accepted that access can make a profitable contribution to its business and that it is a strategic advantage to maintain its competitive position in delivery. Second, consolidation is already fully open to competition (provided consolidators hand all mail over to Royal Mail). For Royal Mail, it is important that it believes delivery competition will and can happen, otherwise it will have reduced incentives to develop an access regime with prices that attract operators to use its network, in preference to establishing their own networks.

*(iii) A date before 1 April 2007*

2.48 On 1 January 2006, the reserved area, as provided by the European Postal Services Directive, will be reduced to 50g. This date therefore seems an appropriate moment for Postcomm to not only meet the minimum requirements of the European Postal Services Directive, but to exceed them and bring about full market opening in UK postal services, making the two changes at the same time. This is because Postcomm considers that the advantages to postal users and the market of the removal of the last monopoly protection justify moving faster than the minimum requirement of the European Postal Services Directive.

2.49 The intervening months between the decision and the opening date will give Postcomm the necessary time to put in place the appropriate licensing regime for a fully open market and to consider other issues that might flow from full market opening, such as demands from Royal Mail to move some prices more closely into line with costs, or complaints from operators about potential anti-competitive behaviour by Royal Mail.

2.50 1 January 2006 will give Royal Mail the advantage of a further nine months when there is no increase in the scope of the competitive market. This should allow Royal Mail to consolidate and build upon some of the recent changes that are designed to improve efficiency and stabilise its network.

2.51 Postcomm also proposes from 1 January 2006 to remove the present restriction in consolidators' licences that prevents them from giving mail to non-Royal Mail delivery networks.

### **Safeguards for the universal service**

2.52 Postcomm is required by law to exercise its functions in the manner it considers best calculated to ensure the provision of a universal postal service.

2.53 Postcomm continues to believe that the best long term safeguard for the universal service is an efficient, innovative and customer focussed Royal Mail and the best environment to encourage this is a competitive market rather than a monopoly. Experience to date supports Postcomm's view that competition creates the best incentives to ensure achievement of these objectives. Mail volumes are under threat from e-substitution, as the electronic transfer of information increases in importance, and other forms of advertising media become more attractive. However, e-business provides many offsetting growth opportunities for Royal Mail. Fulfilment of internet transactions should provide a growing source of revenue in a relatively high margin part of the market. Also, the technology now exists, and is being exploited by certain other postal operators, to offer value added services and to integrate postal services more closely with customer databases and other media management systems.

2.54 Postcomm recognises that competition under certain circumstances could cause problems for Royal Mail's ability to be able to provide services that it would avoid if it were free from all constraints. Postcomm notes Royal Mail's concern that some aspects of its pricing structure are not well aligned with its costs (e.g. the geographically uniform tariff).

2.55 This may pose risks based on unsustainable arbitrage opportunities (called "cream skimming" by Royal Mail). There are a number of reasons why Postcomm considers this risk to be even less than when it concluded its original full market opening timetable in 2002:

- barriers to entry are significant, such as Royal Mail's scale, brand loyalty and VAT exemption (see Postcomm's Competitive Market Review, published alongside this document, for details);
- Royal Mail is seeking a greater degree of pricing flexibility. This includes clarifying those products that are included and excluded from the uniform pricing constraint (as a result of being considered universal services or not), as well as other pricing initiatives (see Chapter 4);
- Royal Mail has now agreed commercial arrangements for three other operators to have access to its local delivery network. Royal Mail expects to make a profit from this activity and encourage some operators to use its delivery network rather than establish their own rival networks. This reinforces Royal Mail's competitive position;
- Postcomm notes that Royal Mail is in much improved financial health, and is therefore now better able to withstand threats to its business, as compared with 2002, when Postcomm initially formulated its market opening strategy. In 2003/04, Royal Mail made a profit from operations (excluding pension deficit payments and exceptional costs) of £348m on its price controlled business, an improvement of £219m on 2002/03. The wider Royal Mail Holdings (encompassing all of Royal Mail's businesses) made a profit from operations of £220m in 2003/04. All this is before Royal Mail's "Renewal Plan" is due to be completed (by the end of this financial year), which should improve its finances further; and
- Royal Mail's regulatory accounts (based on the company's allocation of costs) show that, on average, it makes a loss on the part of the market that is not yet opened to end-to-end competition, which may dissuade some operators from entering the market.

2.56 Postcomm's financial analysis of the impact of competition on Royal Mail's business further supports this view (see Annex 1) as does international experience

from those countries that have fully liberalised their markets, such as Sweden and New Zealand.

- 2.57 Clearly, there is always some degree of uncertainty over how the market will develop, and Postcomm has identified a number of potential risks. If these risks did materialise, then Postcomm believes it has adequate mitigation measures available.
- 2.58 First, Postcomm has a statutory duty to ensure the continued provision of an affordable universal service. The principal way in which it discharges this duty is by ensuring that a universal service requirement is central to Royal Mail's licence obligations.
- 2.59 Second, Postcomm can, if necessary, through the price control, allow Royal Mail controlled price rises to enable it to fund its universal service obligation. Postcomm will ensure that adequate safeguards are in place to ensure that low prices for some customers are not unfairly subsidised by more "captive" customers. Postcomm is currently consulting on the level and structure of the 2006 price control.
- 2.60 Third, in order to ensure that unscrupulous operators do not abuse a liberalised market, Postcomm will be reviewing its licensing process. The objective of the review will be to introduce a regime that ensures mail integrity and interoperability but is as "light touch" as possible (a consultation is planned for November 2004).
- 2.61 Finally, as a last resort, there is the possibility under the European Postal Services Directive of introducing a "support fund" (though this would require primary legislation in the UK). As new entrants grow in scale, they would increase their contribution into the fund, which would compensate the universal service provider, Royal Mail, for the costs of meeting its universal service obligation. Postcomm currently considers that there is no need for such a fund and that introducing one at the current time could lead to market distortions if Royal Mail believed parts of its business would be assisted financially by other operators.

Postcomm believes that there are other sufficient safeguards which should make it unlikely that a legislative change to introduce such a fund is required.

### **Summary**

2.62 Circumstances have changed substantially since Postcomm established its original market opening timetable in 2002. Royal Mail is financially stronger and carrying higher volumes. Entrants have struggled to gain a foothold in the market due to some significant barriers to entry: the strength of which were not fully appreciated in 2002. Rather than too much competition, the reality is that more entry is needed to promote effective competition. This will improve the prospects for the continued provision of an affordable universal service. It will also help to promote innovation, customer choice and an improvement in Royal Mail's quality of service performance.

2.63 Subject to responses to this consultation, Postcomm proposes to bring full market opening forward to 1 January 2006, with no intermediate step. This will add nine extra months to the present market opening phase, in which Royal Mail can prepare itself for the change.

2.64 By itself, bringing forward full market opening will not be sufficient to facilitate effective competition: more work is required on removing the other barriers to entry. However, it is another step forward and will help to incentivise Royal Mail to innovate and improve customer service.

### 3. Licensing and other implications of full market opening

#### *Introduction*

- 3.1 Full market opening has a number of implications. These concern the nature of the licensing framework, raising market awareness, developing arrangements for interoperability, and dealing with proposals from Royal Mail to align its prices closer to its costs. This chapter sets out how Postcomm will tackle these issues.

Postcomm welcomes views from stakeholders on its proposals for reviewing the licensing regime, raising market awareness, raising the priority of interoperability issues and the process for dealing with requests from Royal Mail to move some of its prices more closely into line with its costs.

#### *Licensing policy*

##### **Stakeholders' views**

- 3.2 Royal Mail has claimed that full market opening would encourage significant small scale local entry (and exit) and, therefore, adequate measures would be needed to ensure that mail integrity was respected, otherwise unscrupulous operators could damage the reputation of the whole market and the liberalisation process. Postcomm would need to continue to regulate the activities of operators.
- 3.3 Some other operators argued that licensing should be removed completely when the market was fully opened. These operators argued that the market would quickly establish the necessary standards for mail integrity and that serious operators would either comply or improve on these standards, whilst operators not complying with this would quickly be eliminated from the market. Therefore the licensing system could be removed and replaced with a less formal "registration" system.
- 3.4 A number of operators (particularly those already licensed by Postcomm) were concerned that a registration system without formal licensing would lead to a flood of less able operators entering the market. In such an eventuality, mail

integrity mishaps would damage the whole industry's reputation, and what little volume private operators had gained would return to Royal Mail or be lost to alternative media. The consensus of these operators was that licensing should be used to ensure mail integrity, but that once there was sufficient competition and confidence in the market, licensing could be removed.

- 3.5 Postwatch argued that licensing should continue in order to be able to gather information about operators' activities including monitoring required for mail integrity checks.
- 3.6 Some customers, particularly some larger customers, argued that a licensing regime would not be necessary in a liberalised market, because any agreement signed with an operator would include the necessary service standards and those operators not complying with these standards would quickly be eliminated from the market. However, the majority of customers said that licensing would need to be maintained to ensure mail integrity, quality of service, and to ensure that rogue operators did not enter the market, thereby reducing confidence in postal services.
- 3.7 The unions believed that all operators should have comparable terms in their licences. For example, all operators should have the same quality of service and compensation arrangements.
- 3.8 One equipment supplier believed that the best solution would be a system where companies were required to have a licence once they reached a certain turnover. Another supplier supported the maintenance of a licensing regime to give Postcomm the necessary controls on mail integrity.

### **Postcomm's response**

- 3.9 Postcomm recognises the concerns of many stakeholders that full market opening should not be abused by unscrupulous operators whose activities could cause distress to postal users and reputational damage to the whole market. Postcomm is therefore keen to review its licensing policy to ensure that arrangements are in

place to facilitate entry, innovation and entrepreneurial activity, whilst ensuring that mail integrity is a priority.

- 3.10 Postcomm does not believe at this time that no regulatory oversight of market participants would help further the interests of postal users in accordance with its duties. Customers must have confidence in mail integrity and therefore Postcomm proposes that licensing will continue to be the means of entry into the market, although operators will be free to provide any services they wish. In the longer term Postcomm will review the continued need for licensing, but while there is no effective competition in the market, Postcomm sees licensing as necessary to facilitate competition and innovation and to protect the interests of consumers<sup>11</sup>.
- 3.11 The first objective of the licensing regime will be to ensure that customers and postal users have confidence in the operators providing their postal services in terms of mail integrity. The second will be that that the licensing regime is “light-touch” and does not act as a further barrier to competitive and innovative entry. To achieve this, Postcomm proposes to work with the industry to establish a code of practice with which all licensed operators will be required to comply.
- 3.12 Postcomm proposes that all operators should be required to provide a bank, or similar, guarantee, so that in the event that an operator goes out of business, measures are in place to ensure that all the mail on hand can be delivered with no or very little customer inconvenience. Postcomm proposes to review licence application fees and annual fees (potentially increasing them).
- 3.13 Postcomm will issue a consultation on its licensing policy review in November 2004, which will cover these issues in greater detail. Following consideration of responses, Postcomm expects to issue its decision regarding its licensing policy around April 2005.

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<sup>11</sup> Ultimately, any decision to suspend the requirement for a licence under section 6 of the Postal Services Act 2000 rests with the Secretary of State, although on Postcomm’s recommendation (Section 7 of the Postal Services Act 2000).

3.14 Once the licensing policy is established, Postcomm intends to grant licences in advance of 1 January 2006 to ensure that operators can operate from that date.

### ***Market awareness***

#### **Stakeholders' views**

3.15 Postcomm has previously said that in assessing the degree of competition it is important to understand customers' attitudes to competition, their awareness of rival offers and whether they have an effective choice<sup>12</sup>.

3.16 In November 2003, Postcomm commissioned consultants, Roland Berger, to conduct a detailed survey of non-residential customers to identify their needs experiences, and likely future switching behaviour in a competitive market. Non-residential customers were the focus of this research as they comprise around 86% of all mail volumes.

3.17 Details of the Roland Berger research are set out in the Competitive Market Review document. The important result to note in the context of Postcomm's market opening proposals is that customers were generally not well informed or aware of potential new operators or the liberalisation process of the market. However, many interviewees, who are responsible for the procurement of postal services, may have had little experience of the benefits of switching provider that similar customers have experienced elsewhere in the world.

#### **Postcomm's response**

3.18 Postcomm recognises that there is currently a low level of awareness of the market opening programme amongst the wider postal industry and its customers. Postcomm believes that for market opening and competition to be successful it should try to increase the level of awareness, especially with larger customers.

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<sup>12</sup> "Assessing Competition in Postal Services: Postcomm's Proposed Criteria", Postcomm, November 2003.

3.19 This may happen as a matter of course as operators and customers start to seek out opportunities for better value for money or innovative solutions: knowledge of the benefits could then spread across the industry, reinforcing customers' confidence. However, Postcomm believes that in the early stages of the market's development there is a role for it in raising the level of awareness of market opening, especially with respect to the opportunities that could result from full market opening on 1 January 2006.

3.20 Postcomm will try and achieve this by:

- the publication of a readily available and 'easy read' brochure for stakeholders, setting out Postcomm's role and its regulatory strategy. The brochure will provide an overview to this document, the CMR and the price control consultation, and set out Postcomm's main initiatives over the next couple of years;
- editorial pieces in targeted trade magazines;
- investing more time and resources in proactive consultation with stakeholders. This will include meetings with stakeholder groups, such as the Operators Advisory Group and customer groups. Postcomm is particularly keen to raise the awareness of the larger customers;
- continuing with its regional "roadshows" (e.g. the North West roadshow, in November 2004); and
- participating in industry conferences.

3.21 Postcomm will also keep abreast of the attitudes and level of customer awareness by undertaking further market research.

## ***Market infrastructure development***

### **Stakeholders' views**

3.22 Some operators have made informal representations to Postcomm expressing concern about the relatively slow pace of progress within the industry towards establishing practical protocols for a multi-operator environment.

### **Postcomm's response**

3.23 Bringing forward full market opening makes it even more urgent that arrangements be developed for interoperability, mail redirection and the Postcode Address File (PAF). Postcomm is working with Royal Mail and the wider postal industry to develop fair and practical arrangements for sharing the advantages of the established postal infrastructure, in particular:

- repatriating other operator mail (that has been re-posted into the Royal Mail system) with the correct carrier; and
- developing an effective and secure industry system for mail redirection (redirections).

3.24 Postcomm is also reviewing the management structure of the PAF to ensure it remains appropriate as market conditions change and postal competition develops<sup>13</sup>.

3.25 Postcomm is giving priority to this work and expects to publish its proposals for the future management of the PAF before the end of 2004 and to consult on an industry code of practice for interoperability in the Spring of 2005.

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<sup>13</sup> "Royal Mail's management of the PAF", Postcomm, June 2004.

## ***Royal Mail's pricing strategy***

### **Stakeholders' views**

- 3.26 Royal Mail has argued that some of its prices are not aligned with the costs of handling mail. It would like to address this situation to meet a number of aims. These include: ensuring that it can effectively compete in a liberalised market; performing as a commercial enterprise in line with its shareholder's objectives; and encouraging its customers to make efficient mailing decisions.
- 3.27 Whilst not opposing more freedom for Royal Mail in principle, some operators have expressed concern from time to time that Royal Mail could act to foreclose the market by altering its prices for attractive customers in a way that prevents rivals from establishing a foothold.

### **Postcomm's response**

- 3.28 Postcomm considers that as the postal sector becomes more competitive Royal Mail should be allowed an appropriate amount of flexibility to respond to competitive developments and to act in a more commercial manner. Consistent with these aims, Postcomm, in general, supports the principle of more cost reflective pricing.
- 3.29 However, Postcomm is keen to ensure that the pace of this transition is carefully planned and that adequate safeguards are in place to protect captive postal users and other operators.
- 3.30 Postcomm is currently considering a number of initiatives from Royal Mail in terms of its pricing strategies. These include:
- *Size Based Pricing.* Royal Mail has announced that it would like to change its pricing structure from one primarily based on the weight of an item to one primarily based on the format (and, to a lesser extent, the weight) of the item. This is potentially the largest change to Royal Mail's pricing structure in many years. Postcomm launched a major consultation on this subject in

April 2004 and is currently considering responses, in order to propose a way forward<sup>14</sup>. Postcomm expects to issue a further consultation in due course and expects that, if approved, the earliest date Size Based Pricing could be introduced is 1 April 2006, when the new price control arrangements are due to begin;

- *Geographic Pricing.* Currently, Royal Mail prices all its main inland letter products, including access, on a geographically uniform basis (except Presstream). Royal Mail would like the discretion to price some bulk services (including access) on a non-geographically uniform basis to be able to respond to competition and better align its prices with its costs. This would affect only the largest business (and access operator) customers and will not affect the basic public service which will continue to be priced on a universal “one price goes anywhere” basis. Postcomm’s proposals on the scope of the universal service are set out in Chapter 4; and
- *Payment channel discounts.* Royal Mail has said that its costs vary significantly by payment channel. However, it currently charges the same price regardless of whether a customer uses a stamp, a meter or Postage Paid Impression (PPI). In future, Royal Mail would like to bring such prices more closely into line with costs. This would effectively involve discounts for users of meters and PPIs on the basis that these channels are cheaper to service than stamps (for example, Royal Mail pays agents 5% to sell stamps on its behalf).

3.31 Postcomm is currently reviewing Royal Mail’s cost allocation system, primarily for the purpose of the price control review and to assess the justification for Size Based Pricing, as it is not yet convinced that Royal Mail’s cost allocation is sufficiently robust to provide a basis for major price rebalancing decisions.

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<sup>14</sup> “Royal Mail’s Proposal to Introduce Size Based Pricing”, Postcomm, April 2004.

- 3.32 More generally, a review of Royal Mail's costing systems will also enable Postcomm to take a more informed view of those areas where prices do not reflect costs and to respond more quickly to 'rebalancing' requests from Royal Mail. Equally as important, Postcomm will also need to be able to respond to complaints from other interested stakeholders about Royal Mail's pricing. Therefore, Postcomm's approach (and resource effort) to assessing proposals for price changes cannot be driven just by Royal Mail's agenda.
- 3.33 Regarding individual re-pricing reviews, the nature, magnitude and sensitivity of the proposal would dictate the level of analysis and type of process. For example, the analysis and process required for Size Based Pricing might be more resource intensive than for payment channel discounts.
- 3.34 In each case, however, Postcomm would require a detailed proposal for any pricing restructuring. Once Postcomm is satisfied that the proposal is of sufficient quality, it would review the evidence submitted by Royal Mail. Following that, there would be a full and proper consultation with all industry stakeholders, including Postwatch, before any decision could be taken.
- 3.35 Postcomm needs to ensure that Royal Mail does not abuse its pricing flexibility to foreclose the market to competition. Royal Mail is subject to general EC and UK competition law and Condition 11 of its licence, which prohibit certain distortive commercial activities, such as predatory pricing and forms of discrimination. Postcomm would not approve any restructuring of prices that could be considered to be anti-competitive.

### **Summary**

- 3.36 Postcomm intends to review its licensing policy for full market opening. The review will pursue two objectives. First, Postcomm wants to encourage competitive and innovative entry from as wide a range of operators as possible and therefore arrangements should be "light touch". Second, Postcomm wants to ensure that mail integrity is given priority in the new arrangements.

- 3.37 Postcomm will step up its efforts to raise the level of market awareness of liberalisation and the revised full market opening date of 1 January 2006. Interoperability will be given renewed priority now that the proposed date for full market opening has been brought forward.
- 3.38 Postcomm expects that Royal Mail will seek to re-align prices with costs as competition develops. Postcomm supports this general principle, subject to (i) certain safeguards to protect customers and other operators and (ii) a degree of confidence being established in the relevant cost data.

## 4. Royal Mail's universal service obligation for bulk mail

### *Introduction*

- 4.1 Postcomm's June 2004 decision document on the scope of the universal service said that Royal Mail's universal service should contain one generic bulk mail service. Postcomm said that the final decision on which bulk mail service should fulfil this requirement would be made alongside its proposals on further market opening and its Competitive Market Review. This chapter sets out Postcomm's proposals on this issue.
- 4.2 These proposals do not affect the universal service available to the public: that is the public tariff "one price stamp goes anywhere" service. The decision in June confirmed that this will continue.

Postcomm invites views from stakeholders on its proposals to define Mailsort 1400 (first and second class) as the generic universal service product for bulk mailers and to allow, subject to safeguards, Royal Mail some geographic pricing flexibility on other bulk mail products (including access products).

### *Stakeholders' views*

- 4.3 Stakeholders' views on what Royal Mail product(s) should comprise its bulk universal service were set out in Postcomm's June 2004 decision document on the scope of the universal service. In brief:
- o Royal Mail argued that all bulk mail products (including access) should be excluded from the definition of universal service. It argued that these products were used by its largest customers who would be well served by competition. It also suggested that the purpose of the universal service was to protect vulnerable customers such as those using the public tariff and small businesses. Royal Mail wanted to ensure that for its very largest customers, it could have the discretion to price on a non-geographically uniform basis (also known as 'zonal pricing'). This is currently its practice

for Presstream, which is aimed at periodicals and other publications. Its aim is that prices better reflect the costs of local delivery. It has argued that pricing flexibility is required for it to respond to the twin pressures of a more competitive market and a more commercially orientated shareholder. One other operator supported this approach;

- Postwatch and some customer groups argued that all products should remain within the universal service on the basis that competition was not yet established and unlikely to be so for some time. Postwatch was concerned that Royal Mail would abuse its pricing flexibility and lower prices excessively in those parts of the market where competition might develop, such as delivery in city centres. There was also a concern that Royal Mail might seek to withdraw certain services or alter the qualification criteria; and
- One trade association representing large customers said that Mailsort 1400, Mailsort 120 and Cleanmail should be considered as universal services on the basis that they represented 'entry level' bulk mail services.

### ***Universal service and bulk mail***

- 4.4 In further opening up the postal services market to competition, Postcomm recognises that it should allow Royal Mail some pricing flexibility to respond to competition and the new commercial environment. Postcomm notes that bulk mail products are only purchased by approximately the largest 4,000 customers who, in the longer term, are likely to be among the biggest beneficiaries of competition (experience in countries that have fully opened their postal markets supports this premise).
- 4.5 Removing a number of bulk mail services from the universal service would allow Royal Mail, if it so chooses, to geographically de-average prices for those services (subject to certain safeguards). However, it does not allow Royal Mail to cease offering any of the bulk mail services. Royal Mail will continue to be required to provide all bulk mail services under Condition 19 of its licence.

- 4.6 Greater cost reflective pricing should help safeguard against competition being established on the basis of unsustainable arbitrage against Royal Mail's geographically uniform tariff, rather than real efficiency, customer service and innovation.
- 4.7 However, Postcomm has some sympathy with Postwatch's view that even after the market has been fully opened, it will take time for competition to become established and so choice for customers will initially be limited.
- 4.8 Postcomm believes it must make a pragmatic judgement that tries to balance the views expressed by Royal Mail and Postwatch. A balance needs to be struck between allowing Royal Mail some commercial flexibility and ensuring that change occurs in an orderly and measured way. Postcomm also recognises that competition is not yet sufficiently established to justify Royal Mail having the degree of pricing freedom it has requested for all its bulk mail services. Postcomm therefore maintains its position that at least one product available to bulk mail users should remain classified as a universal service product. At present, Postcomm sees merit in there continuing to be a significant universal service offering for bulk mailings, ensuring some protection for smaller bulk mail users.
- 4.9 As explained in the next section, if the universal service contains a significant generic bulk mail offering then under the statutory framework Postcomm will continue to be able to regulate other bulk mail services. This will mean Royal Mail will not be able to withdraw these services without Postcomm's approval, and that such services can be subject to a price control and other licence obligations, such as standards of service (see below).

#### **Categorising Royal Mail's bulk mail products in relation to the universal service**

- 4.10 Each of Royal Mail's bulk (and access) products falls into one of three categories. As depicted in Table 4.1, a service can be classified:

- as a universal service,
- as a service that is not specifically a universal service but is substantially similar to a universal service, and therefore is within the “scope” of the universal service, or
- as being outside the “scope” of the universal service

Table 4.1: Universal service “categories”

1. Universal service
2. <u>Substantially similar</u> to a universal service (i.e. within the “scope” of the universal service)
3. <u>Outside the scope</u> of the universal service

Source: Postcomm

4.11 Postcomm considers it is required to licence activities in categories 1 and 2 (when performed by operators) in order to protect the universal service. In order to do this, Postcomm can:

- decide which services fall into category 1; and
- do this while taking into account which services would then fall into category 2.

4.12 Postcomm, however, bears in mind that:

- services in category 2 should be “substantially similar” to a service in category 1 (or to a part of such a service); and that
- for a service to be in category 1 it must be provided by the operator directly to the postal user/sender (i.e. not access, which is provided to operators such as UK Mail).

4.13 The category into which each of Royal Mail’s services falls has an impact on the powers Postcomm has over the service, as detailed in Table 4.2.

Table 4.2: Summary of Postcomm’s powers over Royal Mail in relation to various categories of products

Categories for products	Activities can be licensed	Required to provide service	Uniform geographic pricing mandated	Subject to C11 or C19*
1. Universal service	√	√	√	√
2. Substantially similar to a universal service	√	√	X <sup>2</sup>	√
3. Outside the scope of the universal service	X	√ <sup>1</sup>	X <sup>2</sup>	√

Notes:

\* Condition 11 of Royal Mail’s licence relates to controls against anti-competitive behaviour. Condition 19 relates to the price control.

<sup>1</sup> Postcomm can require operators within the licensed area to provide these services. However, it is unlikely we would extend this to operators other than Royal Mail, which do not have a dominant market position.

<sup>2</sup> Geographic uniformity could potentially be mandated if Postcomm believed that not doing so could be unduly discriminatory.

Source: Postcomm

### **Royal Mail’s bulk mail products**

4.14 Bulk mail products (including Mailsort, Walksort, etc) are in reality only used for around the largest 4,000 mailing customers. These customers tend to send letters to all regions within the UK or within defined geographic regions (e.g. local councils and regional utilities).

4.15 In reviewing the “status” of various mail products, Postcomm has considered whether the qualification criteria of certain products makes them suitable for

being classed as the 'generic bulk mail product' which remains classified as a universal service. All bulk mail products have some form of qualification criteria.

- Mailsort 120 (sorted 120 ways) applies only to mailings of items below 100g. These must be of regular sized letters, correctly addressed with machine readable font or bar-coded address. The minimum posting is 4,000 items.
- Mailsort 700 requires a minimum posting of 10,000 bar-coded letters, which weigh less than 100g.
- Mailsort 1400 (sorted 1,400 ways, to delivery office level) requires a high degree of sortation, but mail can be any weight up to the universal service limit of 2kg, and can be non-machine-sortable. Mailsort 1400 also caters for irregular sizes. The minimum posting is 4,000 items (or 2,000 if the mailing is within the same postcode area) or 1,000 packets.
- Walksort postings must hit at least one out of every ten addresses in the area covered by the mailing.
- Packetpost is for customers posting packages regularly. Only packets over 60g and subject to certain dimension restrictions are eligible. The minimum posting is 5,000 packets per year.
- Flatsort is for customers sending items over 100g and for either A4 or B4 size. Items must be sorted into eight geographic areas. This service is only available for third class delivery (D + 7).
- Cleanmail requires all mail to be optical character readable (OCR) or bar-coded. The minimum posting is 1,000 items.

- 4.16 Mailsort 3 tariffs have a seven working day delivery target (which is outside the five day maximum for universal services<sup>15</sup>). Therefore, for the Mailsort tariffs, only first class (D + 1) and second class (D + 3) are considered eligible for classification as universal services. This also excludes Flatsort, which has a seven day delivery specification.
- 4.17 Mailsort 1400 first and second class products are currently by far the most widely-used of all Royal Mail's (non-third class) bulk mail products. Together they accounted for around 50% of bulk mail volume in 2002/03 (see Table 4.3). They enable customers to post any item (including irregularly shaped items), at any weight (up to the universal service limit) to anywhere. These products would therefore appear to be the products most compatible with the universal service. The only restrictions are the high degree of sortation and minimum volume. However, the fact that so many customers are currently using Mailsort 1400 suggests that this is not unduly burdensome. Subject to the qualifications above, this product appears to be the closest to being available to "everyone, for everything, everywhere" – the general characteristics of the universal service that Postcomm identified in its June 2004 decision document.
- 4.18 It should be noted, however, that Royal Mail wants customers to move away from Mailsort 1400 over time, and to facilitate this it may continue to alter the relative prices of Mailsort 1400 and Mailsort 120. This is designed to encourage greater efficiency by encouraging customers to barcode letters or post mailings of machinable dimensions.

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<sup>15</sup> This requirement comes from service standards required by the European Postal Services Directive.

4.19 Table 4.3 shows the relative volumes of Royal Mail's bulk mail services.

Table 4.3: Mailsort volumes in 2002/03

	Mail Volume (m)	% of Current Definition of USO Bulk Mail	% of Total Bulk Mail (including 3c)	% of Total Price Control Mail (20,447 m items <sup>3</sup> )
Mailsort 120 (1c/2c)	77	1.7%	0.8%	0.4%
Mailsort 700 (1c/2c)	616	13.3%	6.6%	2.9%
Mailsort 1400 (1c/2c)	2,464	53.3%	26.5%	11.8%
Cleanmail	540	11.7%	5.8%	2.6%
Walksort	528	11.4%	5.7%	2.5%
Packetpost	393	8.5%	4.2%	1.9%
Total	4,618	100%	49.6% <sup>1</sup>	22.1% <sup>2</sup>

Notes:

1. The remainder of total bulk mail comprises Mailsort 700 3 and Mailsort 1400 3.
2. The remainder of total mail comprises standard tariff (1c and 2c), Airmail, Special Delivery Services, Presstream, Response Services, Redirections, Standard Parcels, Recorded Fees, Free Services and Surface Mail (outgoing).
3. Revenue equated volumes (source Royal Mail).

Source: Postcomm, derived from Royal Mail information

## **Mailsort 1400**

- 4.20 Considering Mailsort 1400 (first and second class) to be the generic bulk mail product that meets Royal Mail's universal service obligations would mean Royal Mail would not be able to geographically de-average Mailsort 1400 prices. This product will continue to provide the option of an affordable geographically uniform price for those customers that do not wish to pay different prices for different delivery areas.
- 4.21 Postcomm has been advised by legal counsel that moving all other bulk mail to category 2 in Table 4.1 does not pose undue risk to Postcomm's licensing powers. This is because other bulk mail products requiring pre-sortation and using the same network are substantially similar to Mailsort 1400 or other universal services. This means that Postcomm can continue to license operators that provide bulk mail services, something it needs to have the power to do if it is to be able to take effective action in order to ensure the continued provision of the universal service.

## **Safeguards in relation to bulk mail**

- 4.22 Mailsort 1400 is only one of a number of bulk mail services. It accounts for a large proportion of Mailsort volumes. Postcomm, therefore, considers this proposal a measured response to the need to find a pragmatic balance between granting Royal Mail greater flexibility, whilst ensuring postal users' interests are protected. The proposal will enable the practical effects of the policy to be evaluated and understood without taking too large a step at this early stage.
- 4.23 For current customers of other bulk mail services, there are safeguards to ensure that Royal Mail does not abuse its pricing flexibility. The current price control caps average price increases by RPI-1%. Therefore, the average national price will decrease in real terms at least until the end of the current price control period (31 March 2006). There are also 'supplementary thresholds' built into the current price control of RPI + 1½% each year for any individual price increase for existing

products. Increases above this level require Postcomm's approval. Service standards and regulation of Royal Mail's quality of service will continue to apply.

- 4.24 The existence of Mailsort 1400 (first and second class) as a universal service (i.e. that must be priced on a geographically uniform basis) should also act as a ceiling to any price rises for non-universal bulk mail services. If Royal Mail was to increase any prices to above that of Mailsort 1400, then most customers could simply switch service.
- 4.25 Postcomm's proposal enables Postcomm to continue licensing bulk mail services (both by Royal Mail and new entrants) with a view to protecting the universal service and facilitating competition. This will help protect the integrity of the market by reducing the chances of it being brought into disrepute and help ensure that common rules on interoperability are adopted.
- 4.26 In addition, Postcomm has the following safeguards built into Royal Mail's licence:
- o Condition 7 (notice and publication of terms). This licence condition ensures that the terms are transparent; and
  - o Condition 11 (promotion of competition). This licence condition prohibits Royal Mail (in the absence of established competition and a need to do so to ensure the universal service) from setting terms for many of its services that are unduly discriminatory, unduly preferential or predatory, excessive, or unduly restrictive.

### **The universal service definition will evolve**

- 4.27 The universal service definition must be dynamic. As technology develops or as customers' needs change, the universal service may need to evolve. For the present, Postcomm considers that the bulk element of the universal service must be available for pre-sorted items:
- o not necessarily machine sortable;

- up to 2kg;
- with addresses that are not necessarily bar-coded or typed; and
- for any format.

4.28 Postcomm considers that Mailsort 1400 (first and second class) currently meets these requirements. Therefore, Postcomm considers that Mailsort 1400 will be the service that meets Royal Mail's universal service requirements (with other bulk mail services moving to within the scope of the universal service). Postcomm would therefore need to scrutinise carefully any proposal from Royal Mail to alter the dimensions or qualification criteria of this product, which could deliberately or inadvertently make this product less accessible and universal in nature.

4.29 Such a move will require a licence modification. On 1 April 2006, Postcomm will be introducing a new price control for Royal Mail, which will also require a licence modification. Therefore, Postcomm proposes that this decision become effective as of 1 April 2006, allowing both licence modifications to be made at the same time.

4.30 If market developments, over time, alter the soundness of this conclusion, then Postcomm can alter its determination of the products that should be classified as universal services. This is not a step Postcomm would take lightly, especially if it meant reversing a decision Royal Mail had taken to price a particular product on a zonal basis. However, this safeguard exists and Postcomm would be prepared to use it if it was the best way of ensuring customers continue to benefit from an affordable universal service priced on a uniform basis.

### ***Universal service and access***

4.31 Royal Mail has said that it intends to develop prices for access seekers to its network that are based on local delivery costs and not being geographically uniform. Access seekers are typically rival postal operators, though it is also possible for large customers to use access themselves.

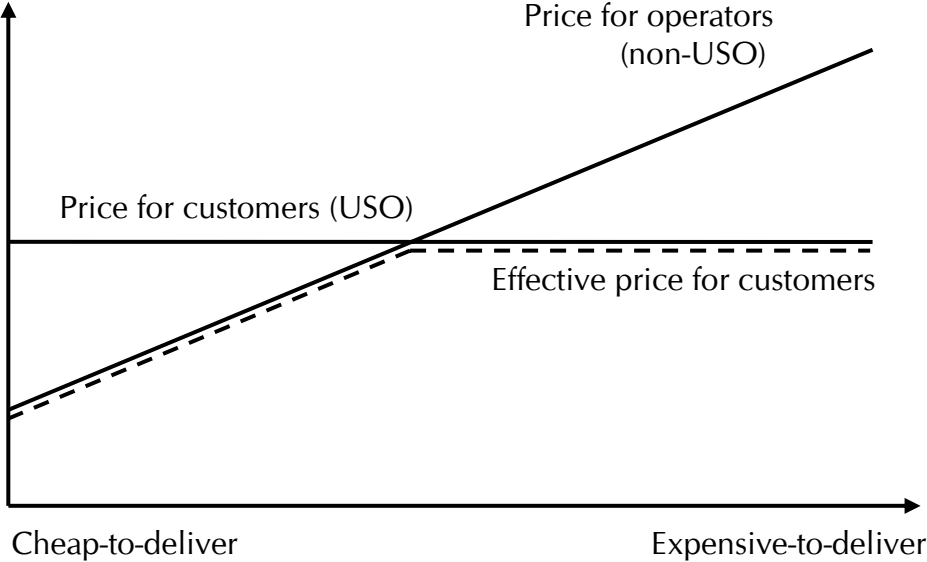
- 4.32 Royal Mail wants to reflect local delivery costs, to prevent other operators from using a nationally averaged price for accessing only the expensive-to-deliver areas and thus enjoying an unfair commercial advantage at Royal Mail's customers' expense. It also wants the flexibility to move prices more into line with costs in lower cost areas, which should encourage operators that cannot match its downstream costs to use its network for delivery rather than establish their own networks.
- 4.33 In practice, what Royal Mail intends to do is to 'de-average' the prices that were established with the UK Mail access agreement.
- 4.34 The link between bulk mail pricing and access pricing is very important. New operators using access are most likely to be competing against Royal Mail's bulk mail services, and so a decision on how to treat access must be made whilst considering any decision on bulk mail products.

### **Assessment**

- 4.35 Two types of access are available. Access can be provided to licensed operators (such as UK Mail) or directly to customers (e.g. a bank). Access used by operators such as UK Mail cannot be classified as a universal service. This is because the Act must be interpreted consistently with the European Postal Services Directive. The Directive requires that "users" have the right to a universal service. "Users" are defined only as senders or addressees of mail, and not operators. Therefore, the use of access by, say, a financial institution could be classified as a universal service but the use of access by an operator such as UK Mail could not be said to be a universal service.
- 4.36 Defining access to customers as a "universal service" (i.e. category one in table 4.1) and access to operators as "substantially similar to a universal service" (i.e. category two in table 4.1) could allow for two concurrent pricing structures:
- o geographically averaged access prices for customers; and
  - o geographically de-averaged access prices for operators.

4.37 As shown in the Chart 4.1 below, two separate pricing structures for access pricing would appear to be neither compatible nor sustainable. Senders of mail could pass cheap-to-deliver mail via an operator, and arrange for expensive-to-deliver mail to be carried to Royal Mail itself. This is simple arbitrage, and could force up the access prices or potentially make access loss-making.

Chart 4.1: Distortions caused by inconsistent access prices for operators and customers



Source: Postcomm

4.38 Postcomm recognises the long-term benefits of greater cost reflective pricing. Such an approach to pricing should ensure that competition only develops when it is more efficient than Royal Mail, helping to promote efficiency which is a key element of Postcomm’s vision.

4.39 Postcomm therefore proposes that access (to both customers and operators) should not be considered as a universal service, but substantially similar to a universal service (and, therefore, within the scope of the universal service). As well as ensuring that two incompatible pricing structures for access do not develop, this proposal is also broadly consistent with Postcomm’s proposal on

bulk mail services, which aims to allow Royal Mail some geographic pricing flexibility.

4.40 Postcomm proposes that this should come into effect from the time of its decision document on these issues due to be published in early 2005.

4.41 Postcomm recognises that some operators may seek to arbitrage between the de-averaged access prices and comparable bulk mail prices. However, this risk is limited because in practice the comparable bulk mail products will be at a margin to the averaged access price and most likely at a margin above price bands that Royal Mail might adopt for its zonal access prices. In other words, Royal Mail will need to consider this in setting the level of its de-averaged access prices and it has an incentive not to set prices at a level that would encourage such arbitrage.

#### **Safeguards in relation to access**

4.42 While Postcomm generally supports the principle of cost reflective pricing, there is a risk that Royal Mail could forestall competition by making the access price too low in cheap-to-deliver areas (where its scale advantage is proportionately not as large) and compensate this with too high an access price in expensive-to-deliver areas where its scale advantage is effectively much larger. Therefore, Postcomm is concerned that it must have sufficient safeguards in place.

4.43 In relation to bulk mail two such safeguards exist already in Royal Mail's licence: Condition 7 (notice and publication of terms); and Condition 11 (promotion of competition).

4.44 Postcomm is taking further steps. It recognises that understanding Royal Mail's cost allocation is critical. Postcomm is currently undertaking an extensive review of Royal Mail's costing methodology which will enable it to respond more quickly to complaints. Postcomm would not expect any of the access prices to be either excessive (i.e. in the case of delivery of mail to expensive areas) or predatory (i.e. foreclosing delivery in cheaper urban areas). Postcomm believes that such an

approach is appropriate for the short-term in order for it to be able to discharge its duty to promote effective competition.

4.45 Postcomm is keen to ensure Royal Mail does not abuse any flexibility and therefore would expect changes to occur slowly over time as the market develops and not in a dramatic step change.

4.46 In addition, Postcomm is currently consulting on its proposal to include access within the scope of the price control (as a “new product” introduced in February 2004, it is currently not included within the control). When judging access against Postcomm’s proposed competitiveness criteria, there would appear to be a strong case for considering access as part of the price control. If this were the case, then (for example, under the current form of the price control) Postcomm would restrict the basic national average access price to RPI-1% and increases in de-averaged access prices in high cost areas to RPI + 1½ %.

### **Summary**

4.47 Postcomm considers that, as the postal sector is opened to competition, Royal Mail should have some pricing flexibility. Postcomm is keen to ensure that the pace of this transition is carefully planned and that adequate safeguards are in place for the universal service and to protect postal users and other operators.

4.48 Postcomm does not accept Royal Mail’s proposal to remove all bulk mail (including access) products from the universal service as being consistent with this approach. Postcomm proposes that, from 1 January 2006, the most commonly used (non-third class) bulk mail product (Mailsort 1400, first and second class) should remain within the universal service and, therefore, will remain priced on a geographically uniform basis. Other bulk mail products must continue to be provided but could be priced on a non-uniform basis. Customers of existing products will be protected by Royal Mail’s price control and service standard regulation.

- 4.49 Following the conclusion to this consultation, early in 2005, Postcomm further proposes that access for customers should be brought into line with access for operators and not classified as a universal service.
- 4.50 Postcomm has safeguards in place, to ensure that Royal Mail does not abuse this pricing flexibility. For bulk mail services, Postcomm has the safeguard of the price control, along with Conditions 7 and 11 and general competition law. Postcomm will also consider whether to bring access within the scope of the price control from April 2006.

## **Annex 1 – Impact analysis**

### **Introduction**

- A1.1 As part of a decision as to whether to bring forward the date of full market opening, Postcomm has a statutory duty to have regard to Royal Mail's ability to finance its licensed activities and the universal service. Postcomm has therefore re-assessed (in conjunction with consultants Frontier Economics) the impact of competition on Royal Mail's volumes and revenues. In doing so, Postcomm has also tried to assess the incremental impact of its revised market opening timetable compared to its original approach.
- A1.2 This analysis supports the view that, under reasonable assumptions, competition will not threaten Royal Mail's ability to finance its licensed activities. It also suggests that the quantitative effect of Postcomm's revised market opening timetable (compared to the original 2002 timetable) will be negligible on Royal Mail's business.
- A1.3 Postcomm recognises the limitations of economic analysis that tries to predict entry and Royal Mail's reaction to competition. Given the nature of this work, it should not be seen as deterministic, but rather as supportive analysis to complement Postcomm's wider assessment coming out of its consultations, other evidence and judgements.

### **Outline of approach to determine the impact of accelerated market opening**

- A1.4 Postcomm's analysis adopts a three part process. The first part assesses the volume impact of competitive entry under the original three phased approach to market opening. The second part assesses the volume impact of competitive entry from the earlier date for full market opening of 1 January 2006. The third

part calculates the incremental impact in terms of both volumes and contribution on Royal Mail from this accelerated market opening<sup>16</sup>.

### **Environmental factors have improved**

- A1.5 Royal Mail's finances have improved significantly from the time that Postcomm's original market opening strategy was originally devised. At that time, Royal Mail had not secured financing for its Renewal Plan from its shareholder, nor had it agreed the current, three year, price control with Postcomm.
- A1.6 The division of Royal Mail that provides the universal service has seen a sharp turnaround in its financial performance over the last year, mainly driven by the price increases from the first year of the present price control, together with approximately 2% mail volume growth. According to Royal Mail, the universal service products made last year (2003/04) a profit from operations<sup>17</sup> before pension deficits and exceptional costs, of £322m compared with £78m in 2002/03.
- A1.7 The prospects for continued profitability are good. First, competitive entry is limited and market volumes continue to rise. Second, as the effects of Royal Mail's "Renewal Plan" feed through to its finances, Postcomm expects to see efficiency improvements translate into higher profitability. These major efficiency and change programmes include the Single Daily Delivery, Transport Review and the Mail Centre Review.
- A1.8 In 2000/01, Postcomm undertook a detailed assessment into the financial impact of competition on Royal Mail's business. This supported the decision to fully open the market. In 2000, Postcomm set the date for full market opening (judged, at the time, to be best from 1 April 2007).

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<sup>16</sup> Contribution is defined as a surplus generated by prices in excess of directly attributable costs that can be used to finance common costs, overheads and profit.

<sup>17</sup> Royal Mail's preferred measure of underlying profit.

A1.9 The major 'change factors' since this analysis was carried out suggest that Royal Mail's financial outlook has improved. In addition to the factors mentioned above, there is now a downstream access regime which Postcomm expects will help to protect Royal Mail from losing some volumes to end-to-end rivals. This was not apparent in 2000/01, and as such was not taken into account in Postcomm's earlier work. Postcomm is also now proposing that not all of Royal Mail's products are universal services, unlike the previous assessment, in which nearly all products (except Presstream) were assumed to be universal services and therefore subject to the uniform pricing constraint. It reduces the base of products that must be protected to around 64% of Royal Mail's total volumes. Greater pricing freedom will help Royal Mail's ability to compete with competitors entering the market in cheap-to-deliver areas, where it could afford to offer its products at lower prices than the geographic average.

#### **Context for analysis**

A1.10 Any attempt to forecast future mail volumes in a quantitative way is subject to a high degree of uncertainty. The market is evolving and some of the changes – both positive and negative – are difficult to assess (e.g. the risks and opportunities of e-commerce).

#### **Forecast financial impact of accelerated market opening**

A1.11 In the past, Royal Mail's forecasts submitted to Postcomm for work on market opening and the price control have exhibited a significant negative deviation compared with actual outcomes. These forecasts turned out to be very pessimistic. For example, for market opening Royal Mail predicted that by now it would have lost around 10% of the regulated market when, in fact, it has lost just 0.3%, and its volumes continue to rise, driven by strong growth in direct mail and the economy more generally. The difference between forecast volumes and experience is also a reason why Royal Mail has managed to out perform its price control.

A1.12 Postcomm has been concerned that Royal Mail has an incentive at the time of major regulatory reviews to provide pessimistic volume projections. Postcomm also notes that some stakeholders have expressed concern about the credibility of Royal Mail's forecasts, including Postwatch and the CWU. Postcomm has therefore tried to develop an independent assessment to inform its view.

A1.13 Postcomm recognises, however, that it is not realistic, nor desirable, for it to determine definitively how competition will impact on the universal service solely on the basis of economic analysis. Ultimately, Postcomm will have to make a judgement on the basis of the best available evidence and the risks identified from any action (or inaction). The analysis in this Annex should, therefore, be seen as providing Postcomm with a degree of assurance rather than as a deterministic forecast outcome.

A1.14 Postcomm will also fundamentally revisit this analysis in the context of its price control review of Royal Mail's regulated products.

(i) *Volumes*

A1.15 Frontier Economics assisted Postcomm in analysing competitive entry in Royal Mail's price controlled business. A summary of this analysis is shown below. This analysis assumes a full market opening date of 1 January 2006, where customers are able to split their mailings by product.

A1.16 The main results show that:

- initially, there is little competitor end-to-end volume. This is forecast at around 40m items in 2004/05;
- access volume initially outweighs competitor end-to-end volume in the ratio of approximately 8:1;
- the overall letters market continues to grow at approximately 1-2% per annum;
- by 2010/11, there could be as many as 3bn items of access mail; and

- by 2010/11, Royal Mail will retain around 91% market share (assuming that an access letter is counted as one half letter won by competitors in the upstream part of the network only).

A1.17 Postcomm notes that these market shares are pessimistic for Royal Mail when compared to international experience of liberalisation in Sweden and New Zealand where the incumbent has retained a greater share of the market.

A1.18 All of the analysis on the impact of bringing forward the date for full market opening to 1 January 2006 assumes quite conservative market growth, at around 1-2%. Postcomm will revisit this and other assumptions underlying this analysis as part of the next price control review and in light of more up to date actual data, especially the extent of access and end-to-end entry.

A1.19 Table A1.1 highlights the extent to which the end-to-end market was considered open in the original three phased market opening strategy. A particular segment is considered to be closed (i.e. 0%), open (i.e. 100%) or only partially open as a result of access (e.g. 25%).

Table A1.1: Extent of market open to competition for selected products, under three phase market opening<sup>18</sup>

End-to-end market (Bulk Licences)	2004/05		2005/06		2006/07		Beyond 2006/07	
	0-50g	51-100g	0-50g	51-100g	0-50g	51-100g	0-50g	51-100g
Stamped	0%	0%	0%	25%	0%	100%	100%	100%
Metered/franked	0%	0%	0%	25%	0%	100%	100%	100%
PPI 1c/2c (< 1,000 items per mailing)	0%	0%	0%	25%	0%	100%	100%	100%
PPI 1c/2c (> 1,000, < 4,000 items per mailing)	0%	0%	100%	100%	100%	100%	100%	100%
Response Service 1c/2c	0%	0%	0%	0%	0%	100%	100%	100%

Source: Postcomm

A1.20 Table A1.2 highlights the extent to which the end-to-end market is considered open with full market opening on 1 January 2006.

<sup>18</sup> The restrictions on Stamped, Metered, Franked and PPI products are eased on 1 January 2006, three quarters into the 2005/06 financial year, leaving 25% of the year unrestricted.

Table A1.2: Extent of market open to competition for selected products, under 1 January 2006 full market opening<sup>19</sup>

End-to-end market (Bulk Licences)	2004/05		2005/06		2006/07		Beyond 2006/07	
	0-50g	51-100g	0-50g	51-100g	0-50g	51-100g	0-50g	51-100g
Stamped	0%	0%	25%	25%	100%	100%	100%	100%
Metered / Franked	0%	0%	25%	25%	100%	100%	100%	100%
PPI 1c/2c ( < 1,000 items per mailing)	0%	0%	25%	25%	100%	100%	100%	100%
PPI 1c/2c ( > 1,000, < 4,000 items per mailing)	0%	0%	25%	25%	100%	100%	100%	100%
Response Services 1c/2c	0%	0%	25%	25%	100%	100%	100%	100%

Source: Postcomm

A1.21 Products not shown in the tables, are unaffected by the proposal to revise the timetable for market opening.

A1.22 As can be seen by comparing the shaded areas in the two tables above, bringing forward the date of full market opening to 1 January 2006 (with no intermediate step in April 2005) accelerates market opening for stamped, metered, franked, PPI and mailings of Response Services that are fewer than 1,000 items per mailing. It does, however, slow down market opening for mailings of PPI that

<sup>19</sup> Market opening at 1 January 2006 leaves 25% of the 2005/06 financial year unrestricted.

are greater than 1,000 but fewer than 4,000 items (recognising the elimination of the intermediate step from Postcomm's revised timetable).

A1.23 The analysis identified the interaction between the counterbalancing effects of bringing forward market opening for some parts of the market, but slowing it down for other parts. Indeed in aggregate, Frontier Economics' projections showed no impact on Royal Mail's volumes (within the margin of error of the forecasts) from competitive entry comparing Postcomm's three stage market opening strategy, to full market opening on 1 January 2006.

(ii) *Contribution Analysis*

A1.24 Frontier Economics' analysis forecast no significant incremental loss of volume as a result of full market opening on 1 January 2006, (with no intermediate step component) to Postcomm's original timetable. This translates into no significant loss of contribution for Royal Mail.

**Financing the universal service**

A1.25 Although Postcomm will take a more detailed look at mail volume projections up to 2011 as part of the 2006 price control review, it is keen now to look beyond the date of full market opening to assure itself that the universal service can be sustained on an ongoing basis. This section discusses this analysis.

A1.26 For each item of mail that Royal Mail loses, it foregoes the revenue for the item. However this is partly mitigated by Royal Mail not having to pay for the variable costs of conveying the item. The difference between the loss of unit revenue and the variable cost for the loss of a mail item is known as its 'contribution'. Contribution is required to recover the fixed costs of the network and other overheads, including profit.

A1.27 The analysis that Postcomm undertook to support its observations on UK Mail's access agreement with Royal Mail suggests that for a typical mail item in the 0-50g weight range (the part of the market that is currently open to competition), Royal Mail makes an average of approximately 12p contribution.

A1.28 This work also indicated that for a typical access item, Royal Mail made approximately 6p contribution in 2003/04. This means that, if Royal Mail lost an item of end-to-end mail to an access user such as UK Mail, the net effect to Royal Mail would be a loss of approximately 6p of contribution (12p for end-to-end minus 6p won back as access).

A1.29 Furthermore, by analysing Royal Mail's 2003/04 financial and regulatory accounts, it is possible to impute Royal Mail's fixed costs (using Royal Mail's estimate of the share of its costs that are fixed at around 40%) for the part of Royal Mail that provides the universal service, as being approximately £2bn per year.

A1.30 By combining Frontier Economics' projected volumes for competitive entry with this estimate of fixed costs and the contributions per item described above, it is possible to forecast future profits for Royal Mail's universal service business. Postcomm's forecast assumes that the current price control format (RPI – 1%) continues, mail volumes for the entire market grow by 1% per annum and that Royal Mail can capture 1% per annum improvements in its productivity (i.e. a 1% reduction in real terms per year). The analysis does not, however, take account of further opportunities for growth, efficiencies above 1% in real terms per year, changes in product mix, and further reductions in Royal Mail's fixed costs. It also does not factor in the effect on entry from the fact that Royal Mail generally makes a loss in this segment of the market or the reduction in the volumes that will, from 1 April 2006, be classified as universal services. Therefore, it is to some extent a conservative view.

A1.31 Table A1.3 brings together the volume and contribution analysis to estimate the forecast profit from operations (excluding pensions deficit payments and exceptional costs) for Royal Mail's universal service business in the period up to and including 2010/11, the latest date that is likely to be included in the next price control. It shows that Royal Mail should make a profit throughout the period. The forecast is based on Frontier and Postcomm's volume projections and assumes competitive entry at the product level for each customer.

Table A1.3: Forecast Royal Mail profit from operations for universal service products<sup>20</sup> with 1 January 2006 as full market opening

(£m 2003/04)	Contribution from Royal Mail end-to-end volume	Contribution from access volume	Royal Mail's imputed fixed costs <sup>21</sup>	Forecast profit from operations <sup>22</sup>
2004/05	2,343	20	(2,034)	329
2005/06	2,319	30	(2,014)	335
2006/07	2,271	53	(1,994)	330
2007/08	2,212	80	(1,974)	318
2008/09	2,129	120	(1,954)	295
2009/10	2,011	179	(1,935)	255
2010/11	1,980	193	(1,915)	258

Source: Postcomm, derived from Royal Mail information

A1.32 Postcomm is principally concerned at this stage about Royal Mail's ability to finance the universal service up to the end of the current price control, which is due to run until 31 March 2006. After this date, and as part of the current review of Royal Mail's prices, we will be able to consider Royal Mail's prices and finances again.

<sup>20</sup> Assumes the current definition of the universal service.

<sup>21</sup> Assumed to also fall by 1% due to efficiency savings.

<sup>22</sup> This is for the part of Royal Mail's business that is currently price controlled.

A1.33 As with Postcomm's previous work, the two single most important determinants of whether Royal Mail succeeds in the future are whether it: (a) innovates in order to grow the market and defend/exploit opportunities; and (b) focuses on becoming more efficient and flexible to change. Postcomm would argue that the best stimulus to ensure these aims are met is through competition.

A1.34 Although Postcomm's volume analysis suggests that bringing forward market opening may not initially make that much difference to the extent of competitive entry, it should act as a strong discipline and focus for the management of Royal Mail to become more innovative and efficient, sooner than might otherwise have been the case. Indeed, some senior managers from Royal Mail have said that they need competition in order to do this and drive the "right behaviour throughout the entire organisation"<sup>23</sup>.

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<sup>23</sup> Adam Crozier, at Postcomm's London Forum, 9 June 2004.