

# **GIVING CUSTOMERS CHOICE: A FULLY OPEN POSTAL SERVICES MARKET**

A decision document

18 February 2005

## Summary

### Introduction

- S.1. Postal services play a vital role in modern commercial and social life, providing channels of communication between individuals, businesses, organisations and government. Last year, over 20 billion postal items were mailed by customers, generating revenues for Royal Mail Group of around £6 billion.
- S.2. Currently, a significant proportion of the postal services market is already open to competition. This includes mailings of over 4,000 items, all mail collected by a consolidator that is handed over to Royal Mail for final delivery, and all mail over 100g in weight (falling to 50g as of 1 January 2006, as required by the European Postal Services Directive).
- S.3. In discharging its duties, 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".*
- S.4. Postcomm believes that a successful Royal Mail, the UK's only universal service provider, is central to the delivery of this vision. Also, given the economic and social importance of the postal industry, a competitive market should encourage innovation and benefit postal users. Postcomm was very pleased, therefore, that in response to Postcomm's September 2004 proposals to bring forward market opening, Royal Mail said that it welcomed competition. Postwatch, representing business and social customers also supported Postcomm's position.

### The date of market opening

- S.5. Having consulted extensively with stakeholders, Postcomm has decided to bring forward the date for full market opening from 1 April 2007 to 1 January 2006, as proposed in September 2004.

- S.6. Postcomm has decided to do this in a single step, giving Royal Mail a nine month extension to the present phase of market opening which was due to end on 31 March 2005. This means that, from 1 January 2006, no part of the postal market will be reserved to Royal Mail alone.
- S.7. As the risks of market opening now appear lower than first thought, the risks of moving to full market opening in one step also appear lower. Moving straight to market opening is a pragmatic step that avoids a further, intermediate stage, which now appears unnecessary. It will also allow Postcomm to better allocate resources to other priority areas, such as minimising other barriers to entry or finalising Royal Mail's next price control.
- S.8. It will take time to put in place a framework more tailored to a fully open market, including a new licensing regime and common operational procedures. In its September 2004 document, Postcomm proposed not to go straight to full market opening on 1 April 2005 (i.e. when the second stage of market opening was due). Instead, as the European Postal Services Directive requires a reduction in the reserved area to 50g on 1 January 2006, Postcomm considers it appropriate to adopt the same date for implementing its decision to fully open the market, and is satisfied there are already sufficient safeguards available.
- S.9. Advanced full market opening should 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 fallen some way short of its agreed targets, although it is now showing signs of improvement. 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.10. The stimulus of full market opening should better incentivise Royal Mail to face some longer-term challenges to its ability to provide the universal service in a rapidly evolving market place, such as threats from alternative media (e.g. electronic substitution). It is equally important that Royal Mail identifies and embraces new opportunities from such developments to ensure continued healthy growth within the core postal market.

- S.11. Royal Mail must also increase its efficiency and flexibility, which are key drivers to the achievement of Postcomm's vision for the market (and the health of the universal service, which is a key element of that vision). 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.
- S.12. A large scale effective competitive challenge to Royal Mail is likely to take some time to develop, but bringing forward full market opening is likely to accelerate certain operators' investment plans for entering the market, offering customers greater choice.
- S.13. Postcomm hopes that full market opening will encourage new innovative services, offering greater 'value added'. Postcomm also expects niche operators to enter the market, serving smaller local or sector-specific markets. Although the results of liberalisation of postal services in other countries have been mixed, there is evidence that competition has benefited many users through innovation, improved standards of service, falling real prices and greater efficiency.

#### **Other barriers to entry**

- S.14. 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 (for example in delivery) and Royal Mail's VAT exempt status.
- S.15. Other barriers to entry also need to be considered systematically, and addressed in the most appropriate way. However, in Postcomm's view, this need not delay the decision on market opening. Full market opening is only one (albeit a significant one) of a series of steps needed to set the framework for effective competition. In March of this year, Postcomm plans to issue a decision on the matters raised for consultation in the Competitive Market Review.

## Issues related to market opening

S.16. Aside from addressing barriers to entry, full market opening will influence Postcomm's work and priorities in the following areas:

- Licensing, mail integrity and common operational procedures. Postcomm shares the view of many stakeholders that measures more tailored to a fully open market than those currently in place should be introduced by 1 January 2006. Postcomm wants the regime to have a 'light touch', whilst safeguarding mail integrity. Postcomm is working with industry towards this goal and believes it is achievable by 1 January 2006, although Postcomm is satisfied that adequate fall-back measures are already available;
- Royal Mail's pricing flexibility. As it responds to the pressures of competition, Royal Mail will no doubt seek to move its prices more into line with costs. In principle, Postcomm supports moves to make Royal Mail's pricing structure more efficient, subject to adequate safeguards for postal users and new entrants;
- Raising customer awareness and market confidence. Postcomm is keen to develop its stakeholder relations to ensure it understands how competition is evolving. Postcomm will continue to monitor the universal service, Royal Mail's performance and the market closely; and
- Complaints against a Royal Mail behaving anti-competitively. Experience of newly liberalised markets suggests that the incumbent seeks to both pre-empt and respond to entry, and rarely remains passive. Postcomm expects most of these moves will be within the general cut and thrust of commercial business. However, provisions exist both within Royal Mail's licence and general competition law to prohibit behaviour that is anti-competitive (e.g. predatory or unduly discriminatory pricing). Postcomm published its first decision on an investigation into anti-competitive behaviour in January 2005 (catalogue promotions).

## **Safeguarding the universal service**

- S.17. Following a careful re-evaluation of the risks and opportunities in light of stakeholder responses to the September 2004 proposals and its own analysis of ongoing trends, Postcomm's view continues to be that the best long-term universal service safeguard is to ensure that Royal Mail is efficient and customer focussed, through the stimulus of competition. This will help Royal Mail to withstand the threats from, for example, e-substitution and the potential risks of reduced growth in mail volumes. Postcomm's previous consultations have highlighted the risks that a continued monopoly might have on Royal Mail's business and its customers.
- S.18. In Postcomm's view, these market opening proposals will not jeopardise 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, Royal Mail made a profit from operations of £348 million (before pension deficit payments and exceptional costs) on price controlled products (6% margin on turnover). Royal Mail also continues to supply over 99% of licensed postal services in the UK.
- S.19. 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 Royal Mail's financial strength by making efficiencies through three major initiatives: Single Daily Delivery, the Transport Review and the Mail Centre Review. It will also help make Royal Mail's 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 offset by price rises for captive customers. Royal Mail is also now seeing opportunities in offering access which allows it to retain (downstream) volumes. This should also help sustain the provision of the universal service.

## **Definition of the bulk mail element of the universal service**

- S.20. In the September proposals for market opening, Postcomm also considered the definition of the bulk mail element of the universal service. Postcomm proposed to define only Mailsort 1400 (first and second class) as a universal service, with all other bulk mail services being considered as within the scope of the universal service. Postcomm also proposed to consider access as only within the scope of the universal service.
- S.21. Defining a product as a universal service requires Royal Mail to continue to provide it at a uniform geographic price. Defining a product as only being within the scope of the universal service allows Royal Mail to de-average prices geographically. However, through Condition 19, Postcomm can still require Royal Mail to continue to provide a product that is only considered to be within the scope of the universal service through other licence conditions.
- S.22. The responses to the proposal on bulk mail made it quite clear that this was a complex issue. For example, the issue of access and the bulk mail element of the universal service are linked very closely to the complaint by the Licensed Consolidators about Royal Mail's zonally-priced access contract.
- S.23. Postcomm recognises the link between market opening and the definition of the universal service (and the impact this has on the amount of pricing flexibility Royal Mail is subsequently allowed) and aims to achieve a balanced package that allows Royal Mail the appropriate degree of pricing flexibility. Postcomm considers that in a fully competitive marketplace, Royal Mail should have a higher degree of flexibility. However, we do not yet have a competitive market and therefore Postcomm is working towards an appropriate transition path.
- S.24. Postcomm's assessment of the impact of competition on Royal Mail following full market opening essentially assumes the status quo in terms of geographic uniformity of pricing for bulk mail tariffs. Therefore, Postcomm is confident that, whatever the outcome of its consultation on the bulk mail element of the universal service, Royal Mail will continue to be able to provide the universal service in a fully open market.

S.25. Postcomm expects to issue a decision on the definition of the bulk mail element of the universal service either in March (with the decision on the issues raised in the Competitive Market Review), or in May (with the next set of price control proposals).

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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 function 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". This consists of the delivery and collection at least once every working day of mail (up to 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 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 the provision of the universal service, Postcomm recognises that it will need to regulate the activities of Royal Mail and others.
- 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;
  - in March 2003, Postcomm put in place a price control and service quality package for Royal Mail to last until 1 April 2006;
  - 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;
  - 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 comprise Royal Mail’s universal service obligation.

### ***Postcomm’s Forward Work Plan***

- 1.9. Postcomm’s Forward Work Plan (FWP), 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.

- 1.10. Postcomm is currently consulting on its 2005/6 FWP. To successfully achieve its vision, Postcomm sees the key challenges as ensuring:
- o that liberalisation will deliver real benefit to all postal users, and not just large business mailers;
  - o barriers to competition are kept as low as possible;
  - o new operators “stay the course” and provide a real competitive challenge to Royal Mail;
  - o Royal Mail’s response to competition is positive (i.e. becoming more responsive to customers, more efficient and more innovative); and
  - o customer interests are protected by price and quality controls in advance of real and sustainable competition.

**Process**

- 1.11. Postcomm has based its decision on market opening on the outcome of an extensive consultation exercise. In particular:
- o in January 2004, Postcomm issued its “Market Report”, setting out how the market was developing, and explaining current trends. This document consulted on the main barriers to entry that may be impeding competition and innovation;
  - o on 5 May 2004, Postcomm issued a consultation letter to stakeholders on its Competitive Market Review. Among the main issues raised were potential options for further market opening. Postcomm complemented this consultation by meeting with many stakeholders (including Royal Mail, Postwatch, operators, customers and the unions) to listen to their views;
  - o in the first quarter of 2004 Postcomm conducted an extensive market research survey of business customers (with the consultant, Roland Berger) to listen to their views on competition and how it should be progressed;
  - o 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 at that time) 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 the Board of Royal Mail Group to discuss its work programme. A similar event was held with Postwatch's Council in June 2004;
- Postcomm has conducted a detailed review of how competition has progressed to date, assessed barriers to entry and the prospects for further competition (the Competitive Market Review);
- on 30 September 2004, Postcomm discussed its market opening proposals with Postwatch's Personal & Small Business Mail Users Group;
- on 26 October 2004, Postcomm discussed its market opening proposals with a large group of operators and major customers at a forum specifically organised for this issue in Birmingham;
- it has taken into account the responses to its consultation on the Competitive Market Review (published on 20 September 2004) where relevant to this decision. The deadline for responses was 20 December 2004; and
- Postcomm has carefully considered the responses to its consultation on the revised proposals for market opening published on 20 September 2004. The deadline for responses was 20 December 2004.

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

1.12. Chapter 2 of this document summarises Postcomm's original proposals and details Postcomm's decision on the date for market opening. Chapter 3 considers the implications of this decision for other key areas (such as licensing and cost reflective pricing).

- 1.13. Annex 1 contains a summary of respondents' views on the proposals on advanced market opening published in September 2004. Annex 2 contains Postcomm's financial analysis of the potential impact of further market opening on Royal Mail.

***Purpose of this document***

- 1.14. 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.
- 1.15. In September 2004, Postcomm consulted on proposals to revise the market opening timetable, forgo the second interim phase of market opening, and bring forward the date of full market opening to 1 January 2006. This document considers the responses to this consultation and sets out Postcomm's decision on the subject.
- 1.16. If you would like clarification of any points raised in this document please contact Matthew Ward (on 020 7593 2117 or at [matthew.ward@psc.gov.uk](mailto:matthew.ward@psc.gov.uk)) or Pav Dhesi (on 020 7593 2120 or at [pav.dhesi@psc.gov.uk](mailto:pav.dhesi@psc.gov.uk)). Postcomm is always happy to meet with stakeholders to discuss its policies and listen to stakeholders' views.

## **2. Decision on Advanced Market Opening**

### ***Introduction***

2.1. This chapter sets out Postcomm's decision to introduce full market opening, in one step, earlier than planned, on 1 January 2006. Postcomm originally proposed advanced market opening for a number of reasons, outlined below. It received support from the majority of respondents.

### ***Postcomm's September 2004 proposals***

#### **Market opening**

- 2.2. In September 2004, Postcomm proposed to bring forward full market opening which was originally planned for 2007, following an interim step from the current position on 1 April 2005. Postcomm considered that there were strong reasons for speeding up the liberalisation of postal services and proposed to bring forward full market opening to 1 January 2006. There would be no intermediate step before that date.
- 2.3. As discussed in the consultation documents to this process and in the Competitive Market Review proposals, there are, of course, a number of other significant barriers to entry. Postcomm is seeking to identify the most appropriate approach to addressing these barriers to entry in its Competitive Market Review.

#### **Licensing**

- 2.4. In addition to full market opening, Postcomm considered a number of related issues that would need to be addressed in preparation for full market opening. Postcomm proposed to review its licensing process to ensure mail integrity in a fully open market through "light touch" licensing arrangements. A consultation on licensing was published on 30 November 2004<sup>1</sup>.

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<sup>1</sup> "Licences under the Postal Services Act 2000: Licensing Framework in a Fully Open Market – A Consultation Document", November 2004.

## **Universal service**

- 2.5. As always, Postcomm's proposals are designed to ensure the continued provision of the universal service. All public tariffs (including stamps) would continue to be provided by Royal Mail at a geographically uniform and affordable rate.
- 2.6. Postcomm also proposed to clarify which of Royal Mail's bulk mail products fulfil its obligation to provide a generic bulk mail universal service. Postcomm proposed that Mailsort 1400 (first and second class), currently the most widely used (non-third class) bulk mail product, would be best suited for this purpose. Other bulk mail products which do not comprise the generic bulk mail universal service would continue to be regulated through Royal Mail's price control and service standard regulation, ensuring that customers using these products remain protected and that these products continue to be provided. Postcomm is currently considering whether or not to include access products as part of Royal Mail's next price control.

### ***Positive effect of competition on Royal Mail, the market and postal users***

- 2.7. Postcomm continues to hold the view that market opening will sharpen the incentives on Royal Mail to improve its customer focus and quality of service (both in terms of measured targets and other aspects such as account handling etc). The threat of competition in postal services should also benefit Royal Mail when responding to competition from other forms of advertising media.
- 2.8. Stakeholders and customers will be well aware of Royal Mail's recent quality of service problems<sup>2</sup>. However, these are slowly improving and, in Postcomm's view, this can in part be attributed to the threat of competition.

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<sup>2</sup> Royal Mail's quality of service deteriorated significantly in the final half of 2003/04, which resulted in Royal Mail announcing in May 2004 (and again in August 2004, with respect to the first quarter of 2004/05) that it had failed to meet all 15 of its quality of service targets for the year. Recent figures, however, suggest an improvement in Royal Mail's quality of service.

- 2.9. While competition develops, the threat of regulatory measures such as compensation, financial penalties and enforcement action are likely to continue to be vitally important in ensuring quality of service targets are met. However, Postcomm considers that further opening the market will increase the incentives for Royal Mail to improve its service standards – not just those measured targets, but also aspects such as account handling etc. Postcomm does not consider that competition will be detrimental to service standards, as argued by some respondents.
- 2.10. Postcomm hopes that full market opening will encourage new innovative services, offering greater ‘value added’. Postcomm also expects niche operators to enter the market, serving smaller local or sector-specific markets as has happened elsewhere in the world.
- 2.11. These views were supported by Postwatch and other customers (such as WWAV Rapp Collins). The European Express Association (EEA) also supported the view that full market opening should bring about further competition and innovation, encouraging new operators to maintain and increase their commitment and investment in the UK postal market.
- 2.12. The two operators that responded to the consultation (TPG and Special Mail Services (SMS)) welcomed the proposals to bring forward full market opening. Intellect, an industry body representing the hi-tech industries, also supported this view.
- 2.13. Royal Mail also said it welcomed competition. However, it said market opening was not needed to increase its resolve to make further efficiencies or introduce greater innovation. Meanwhile, the unions argued that what Royal Mail needed was a period of stability during which it could make the necessary improvements to quality of service.
- 2.14. In Postcomm’s opinion, it is competition that will drive improvements in quality of service and innovation. Thus far, the evidence points to it having been predominantly the threat of competition rather than the existence of competition itself that has helped this process. Now, the emergence of effective competition is what is needed to bring further positive change.

2.15. Full market opening will bring new opportunities for operators, without the need for the regulator to decide which segments of the market should be open to competition, in Postcomm's view improving the likelihood of credible and sustainable competition.

***Effective competition will take time***

2.16. Since 2002, it has become clear that effective, sustainable competition will take time to develop. Competitors have taken just 0.3% of Royal Mail's volume<sup>3</sup> since competition was first introduced into the licensed area, although operators, such as DX Services, are carrying millions of items each year as part of their document exchange service.

2.17. Market share is not the sole indicator of competition. Other measures such as customer awareness, the nature and scale of barriers to entry, and (potentially) Royal Mail's behaviour should also be considered. On all measures, and on the basis of its extensive consultation, Postcomm can only conclude that competition is still very much in its infancy.

2.18. As highlighted by operators (TPG and SMS), and by Postwatch and some customers, the legal barrier reserving certain segments of the postal market to Royal Mail is not the only barrier to entry. Royal Mail's VAT exempt status puts it in a favourable position when offering services to customers that are also VAT exempt, since other non-public postal operators have to charge VAT to these customers (who cannot in turn recover that VAT).

2.19. Royal Mail also enjoys huge scale, which enables it to perform certain activities at a much lower unit cost than its competitors. This is most keenly felt in final delivery, which is why Postcomm has taken the approach it has to downstream access.

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<sup>3</sup> In the licensed area (i.e. the letter market for items costing below £1 and weighing less than 350g).

2.20. In view of the nature and scale of these barriers, which tilt the playing field in favour of Royal Mail, Postcomm considers that it is imperative that the legal barrier to entry (i.e. Royal Mail's continued monopoly over the part of the market originally reserved to Royal Mail) be removed as soon as possible. Through the Competitive Market Review, Postcomm is considering the most appropriate approach to addressing the other barriers to entry. However, Postcomm considers that whatever action it may take or encourage others to take in respect of these entry barriers, effective competition is still likely to take some time to develop.

### ***International experience***

- 2.21. The European Postal Services Directive requires that the reserved area be reduced from below 100g (or below 3 times the basic first class tariff) to below 50g (and below 2½ times the basic first class tariff) on 1 January 2006. A European Commission report is planned for 2006 which will assess, for each Member State, the impact on the universal service of opening up postal services to competition in 2009. The earliest date proposed for market opening throughout the European Union is, however, 1 January 2009.
- 2.22. Some countries have taken steps to introduce competition more quickly. Sweden has fully opened up postal services to competition. The Netherlands has liberalised both direct mail and all letters weighing more than 100g and, along with Germany, is considering opening up its postal market fully in 2007, ahead of the rest of Europe.
- 2.23. Although the benefits of liberalisation have varied and must be considered in context, there is certainly evidence that competition has benefited many users through innovation, improved standards of service, falling real prices and greater efficiency.

### ***The universal service is secure***

- 2.24. Following a careful re-evaluation of the risks and opportunities, and in the light of the results of its extensive consultation exercise, Postcomm's view continues to be that the best long-term universal service safeguard is to ensure that Royal Mail is efficient and customer focussed, through the stimulus of competition. This will help Royal Mail to withstand the threats from, for example, e-substitution and the potential risks of reduced growth in mail volumes.
- 2.25. In Postcomm's view, these market opening proposals will not jeopardise 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 £348 million (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 for which a licence is required.
- 2.26. 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 Royal Mail's 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 Royal Mail 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 captive customers.
- 2.27. Another important development that provides Postcomm with greater assurance that Royal Mail has more resilience 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.

- 2.28. As an additional safeguard, Postcomm always has a duty to have regard to the need to ensure that Royal Mail has sufficient revenue to fund its universal service obligation. Postcomm is currently considering its approach to Royal Mail's next price control (which will take effect from April 2006) and this duty will be a key factor in determining the revenues Postcomm considers Royal Mail should be allowed to recoup.
- 2.29. Also, as part of its September 2004 market opening proposals, Postcomm made an estimate of the future profit of that part of Royal Mail's business that provides the universal service (i.e. that part of the business that Postcomm is required by law to ensure continues to be provided). In its response, Royal Mail made a number of criticisms. Most notably, it did not accept that the universal service can necessarily be financed in a fully liberalised postal market. Postcomm has reviewed its projections carefully in the light of Royal Mail's response, but has concluded that full market opening on 1 January 2006 does not pose a risk to the universal service (as currently defined). This analysis, along with Royal Mail's comments, is contained in Annex 2.
- 2.30. Postcomm's analysis for the original market opening timetable suggested that continued inefficiency and a poor quality of service was a very real risk to the universal service, encouraging users to switch to alternative media.

### ***A single step to market opening on 1 January 2006***

- 2.31. Moving to full market opening in two further steps would require the regulator to determine the next 'tranche' of the market that is to be opened. In addition, such a move would only leave unopened the 'tranche' of the market that is likely to be the least attractive to competitors.
- 2.32. As the risks of market opening now appear lower than first thought, the risks of moving to full market opening in one step also appear lower. Moving straight to market opening is a pragmatic step that avoids a further stage, which now appears to be unnecessary, and allows Postcomm to better allocate resources to other priority areas, such as minimising other barriers to entry.

- 2.33. Time will be required to put in place a suitable framework for a liberalised market, such as a more appropriate licensing regime, common operational procedures, etc. Therefore, in September 2004 Postcomm proposed not to go straight to full market opening on 1 April 2005. A date after 1 April 2005 will also give Royal Mail a little more time in which to prepare for a fully open market, allowing it to consolidate and build upon some of the recent efficiency improvements it has made.
- 2.34. On 1 January 2006, the European Postal Services Directive<sup>4</sup> requires a reduction in the reserved area to 50g. Taking into account the factors set out above, and in order to strike a balance between the benefits of early market opening and the interests of all parties concerned who need time to prepare, Postcomm considers this to be the most appropriate date to open the market fully.
- 2.35. Other than objections to the general principle of advanced market opening (considered below) no respondents appeared to disagree with the date of 1 January 2006. Only Postwatch suggested an alternative (of 1 April 2006, the date of the new price control) if more time were needed to set up an appropriate framework. Postcomm does not consider this extra time necessary.

### ***Opposition to advanced market opening***

- 2.36. Some respondents were opposed to full market opening. The Communications Workers Union (CWU), Amicus/CMA, and the South Eastern Region of the Trades Union Congress (SERTUC) all opposed advanced market opening, as did the Periodical Publishers Association (PPA).

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<sup>4</sup> EC Postal Services Directive (97/67/EC) as amended by Directive (2002/39/EC).

### **Why progress more quickly than the rest of Europe?**

2.37. The unions were concerned about why Postcomm considered it necessary to move more quickly than the rest of Europe. Postcomm is charged with furthering the interests of UK postal users, and considers that the benefits of competition in UK postal services (as discussed earlier) substantially outweigh the possible risks of anti-competitive behaviour by European operators entering the UK market, or the lack of opportunities that a slower European timetable affords Royal Mail. Postcomm also believes that there are suitable mechanisms in place to address the former through UK and EC competition law. Therefore, in Postcomm's view, it is not necessary to wait for other European markets to open up to competition and deny UK consumers the benefits of competition.

### **Competition could undermine the universal service**

2.38. The unions were also concerned that Royal Mail's business is based on a complex system of cross subsidies. They considered that competitors with no universal service obligation would simply target the more profitable routes. This would weaken Royal Mail, depriving it of profit needed to subsidise more expensive routes.

2.39. The universal service only requires geographic cross subsidies. Postcomm accepts that there is likely to be a certain amount of cross subsidising of routes, but considers that Royal Mail's scale gives it a huge advantage over competitors entering the market. Postcomm has put in place resources to deal with future Royal Mail proposals to rebalance and restructure tariffs (to deal with other cross subsidies) and has also allowed Royal Mail some scope to rebalance prices under the current price control.

### **There is a risk of anti-competitive behaviour by Royal Mail**

2.40. The PPA expressed a concern that there was a risk of Royal Mail engaging in anti-competitive practices, and that the market should not be fully opened until appropriate safeguards are put in place. Postcomm is aware of the risk of anti-competitive behaviour, and considers that the potential impact of such behaviour at this very early stage in the introduction of competition could well have a disproportionate effect.

- 2.41. However, Postcomm considers that the relevant conditions of Royal Mail's licence (primarily Condition 11, though Conditions 9 and 10 are also important) are already in place to be used should Royal Mail act anti-competitively. In addition, Royal Mail is subject to the provisions of the Competition Act 1998 and Articles 81 and 82 EC Treaty.
- 2.42. In the proposals contained in the Competitive Market Review, also published in September 2004, Postcomm outlined a process that it proposes to use when dealing with anti-competitive complaints. This process has already been used when dealing with the catalogue complaint<sup>5</sup> on which Postcomm recently reached a decision. It is also being used in the recent complaint from the licensed operators on zonal access<sup>6</sup>.
- 2.43. Finally, Postcomm has agreed a Memorandum of Understanding (MoU) with the Office of Fair Trading (OFT) which should provide for closer working and cooperation between the two organisations in all cases, whether it proved more appropriate to proceed under the licence, or under more general competition legislation. As set out in the MoU, Postcomm would liaise very closely with the OFT on anti-competitive complaints.

### **Summary**

- 2.44. 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 are likely to continue to prevent operators from gaining a foothold and expanding their businesses. These have the effect of tilting the playing field in Royal Mail's favour and include Royal Mail's economies of scale (for example in delivery) and Royal Mail's VAT exempt status.
- 2.45. Other barriers to entry also need to be considered systematically, and addressed in the most appropriate way. However, in Postcomm's view, this need not delay the decision on market opening. Full market opening is only one of a series of steps needed to set the framework for effective competition. Postcomm plans to issue a decision, in March of this year, on these other issues, as set out in the Competitive Market Review.

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<sup>5</sup> "Investigation into Royal Mail's Catalogue and Advertising Promotion Scheme - Decision of the Postal Services Commission", January 2005.

<sup>6</sup> "Licensed Operators' Complaint about Royal Mail's Zonal Pricing for Access", January 2005.

### 3. Market Opening: Implications and Related Issues

#### ***Introduction***

- 3.1. In the September 2004 proposals, Postcomm identified a number of other workstreams that it considered needed to be completed before it opened the postal services market to full competition on 1 January 2006. These were: the universal service definition for bulk mail services, the licensing regime, provisions for mail integrity, and agreement over common operational procedures. In addition, Royal Mail has argued that it must be able to make adjustments to the structure of its prices to bring them more into line with costs, enabling it to compete more effectively. These issues are dealt with below.
- 3.2. Also, in September 2004, Postcomm issued the market opening proposals alongside its Competitive Market Review. Postcomm's plans with respect to the proposals in the Competitive Market Review are also set out below.

#### ***Definition of the universal service***

##### **September proposal**

- 3.3. In June 2004, Postcomm proposed that the 'non-bulk' element of the universal service should continue to be defined as all the products (of that nature) that Royal Mail was providing<sup>7</sup>. In September 2004, Postcomm proposed that as of 1 April 2006 the bulk mail element of the universal service be satisfied by Royal Mail continuing to provide Mailsort 1400 (first and second class), and that other bulk mail services (such as Cleanmail, Mailsort 120 and 700, and Walksort) be considered as *within the scope* of the universal service.

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<sup>7</sup> "Decision document: The UK's universal postal service", June 2004.

- 3.4. Defining a product as a universal service requires Royal Mail to continue to provide it at a uniform geographic price. Defining a product as within the scope of the universal service allows Royal Mail to de-average prices geographically. However, Postcomm can still require Royal Mail to continue to provide a product that is only considered within the scope of the universal service through other licence conditions (such as Condition 19).
- 3.5. Postcomm also proposed that access be considered as within the scope of the universal service (but not as a universal service itself).
- 3.6. Of all the issues from the September proposals on market opening and the Competitive Market Review, it is clear that the definition of the universal service is the most complex. For example, the issue of access and the universal service is linked very closely to the complaint by the Licensed Consolidators about Royal Mail's zonally-priced access contract. A summary of respondents' views on the definition of the bulk element of the universal service is contained within Annex 1.
- 3.7. Respondents had very differing views on what should be defined as the bulk mail element of the universal service. Postcomm also received new information that it had not previously been able to take into account, such as the types of customer that typically use different Mailsort products. In view of this, Postcomm proposes to take more time to conduct further analysis on this issue. Postcomm expects to issue a decision on this element of the definition of the universal service either in March (with the decision on the issues arising in the Competitive Market Review) or in May (with the next set of price control proposals).
- 3.8. Postcomm recognises the link between market opening and the definition of the universal service, and the impact this has on the amount of pricing flexibility Royal Mail is subsequently allowed. Postcomm considers that in a fully competitive marketplace, Royal Mail should have a higher degree of flexibility. However, we are not at that stage yet and the question of transition is more complicated. It can, nevertheless, be said that a more competitive market should result in greater pricing flexibility, rather than the other way round.

3.9. Postcomm's assessment of the impact of competition on Royal Mail does not assume any increase in pricing flexibility. Therefore, Postcomm is confident that, whatever the outcome of its consultation on the bulk element of the universal service Royal Mail will continue to be able to provide the universal service within the context of a fully open market.

### ***Licensing and mail integrity***

3.10. Most respondents supported Postcomm's decision to review its licensing procedures (as summarised in Annex 1).

3.11. Those supporting the idea included most customers and operators. They believed that a light touch regime was necessary to prevent the licensing regime becoming a barrier to entry itself. Respondents also agreed on the importance of processes and procedures being in place to ensure mail integrity, as failings by any operator in this regard could have serious implications for the industry as a whole.

3.12. Postwatch considered that although some regulatory oversight of new entrants was necessary, there was no need for licences (other than Royal Mail's) to specify quality of service targets or compensation arrangements. These should be up to the individual operator involved, on the basis that customers could choose between new operators.

3.13. The CWU and Amicus/CMA said that Royal Mail should be treated fairly in comparison with any other operator. They were also concerned that a 'light touch' approach, as advocated by Postcomm in September 2004, would not be sufficient to prevent rogue operators taking advantage of a liberalised market. They wanted Postcomm to include the following licence requirements: financial viability (e.g. through a bank bond), security of mail, quality of service standards, compensation arrangements, common operational procedures, and the means for Postcomm to revoke any licence at short notice.

3.14. Royal Mail supported the need for operators to be required to provide a bank (or similar) guarantee, and the principle of the need for a supplier of last resort.

- 3.15. Postcomm will consider these views (and those expressed in the response on the licensing consultation) carefully as part of its review of the licensing regime. Postcomm is confident that there is sufficient time between now and 1 January 2006 to decide upon and implement changes to the licensing regime. However, in a worst case scenario, if this is not possible, it is considered that the current approach to licensing could be continued in the interim (and would operate adequately). This may have resource implications for Postcomm, but it need not delay full market opening.
- 3.16. Similarly, Postcomm is confident that there is sufficient time between now and 1 January 2006 to decide upon and implement a revised approach to ensuring mail integrity. However, in a worst case scenario, there are procedures currently in place which can continue for the medium term in the absence of any industry standard. These procedures, which form part of Postcomm's current licensing regime, involve operators proposing mail integrity procedures which must be agreed by Postcomm before a licence is issued. Postcomm has already successfully pursued a number of individuals who have committed offences under the Postal Services Act 2000.

### ***Common operational procedures***

- 3.17. Most respondents supported Postcomm's proposals to develop an industry-wide set of common operational procedures. This was seen as crucial for the smooth running of a liberalised market.
- 3.18. Royal Mail was also keen to ensure that this was not just limited to its own network (i.e. Royal Mail should be allowed to make use of other operators' networks) and that it should not be required to perform any functions for other operators at a loss.
- 3.19. The Mail Users Association (MUA) was keen to see a clear timetable for the achievement of industry-wide common operational procedures.
- 3.20. Postcomm will consider these views (and those expressed in the response on the licensing consultation) carefully as part of its work on common operational procedures. It agrees that this is a key workstream to be completed in advance of market opening and is confident that it can be achieved.

3.21. However, there are risks to any timetable and, if common operational procedures cannot be agreed by 1 January 2006, Postcomm proposes to use Freepost as a fall back. Currently some operators are using Freepost as a means of ensuring that misdirected mail is returned to the sender via the correct operator. This is not a long term solution, but Postcomm considers that it will be sufficient as an interim solution if absolutely necessary.

### ***Cost reflective pricing***

3.22. Royal Mail has argued that, as competition develops, it must be allowed to make its prices more cost reflective. Otherwise, it argues, Postcomm risks encouraging inefficient entry, made possible only as a result of there being too wide a gap between price and cost.

3.23. Other operators, such as TPG, are also concerned about this issue, as Royal Mail offering services at a price below cost will act as a barrier to entry and prevent significant competition developing.

3.24. Postcomm is also concerned about the issue of cost reflective pricing. Indeed the European Postal Services Directive requires that prices be “geared to costs”. Postcomm therefore proposes to devote greater resources to this issue in 2005/06. Postcomm expects Royal Mail to come forward with more proposals directed at this objective, such as size based pricing, which Postcomm will deal with as expeditiously as possible. Also, Postcomm proposes to take a more proactive view on the relative prices of some of Royal Mail’s services, in consultation with stakeholders. In all cases, careful consideration will be given to managing the transition from one pricing structure to another in order to protect customers’ interests.

### ***Competitive Market Review***

3.25. In September 2004, Postcomm published its Competitive Market Review. The document set out Postcomm’s view of the market, an assessment of the major barriers to entry that currently exist, and Postcomm’s proposed approach to addressing these barriers. The deadline for responses to the matters raised for further consultation was 20 December 2004 and a number of stakeholders have responded.

- 3.26. Clearly, some of the issues in the Competitive Market Review overlap with those in market opening, albeit that the two consultations are ultimately concerned with different policy decisions. Postcomm has taken into account responses to the Competitive Market Review where relevant, along with all other data and analysis collected in that exercise, in the formulation of its decision on market opening.
- 3.27. Postcomm plans to issue a decision on the proposals contained in the Competitive Market Review in March of this year.

## **Annex 1 – Summary of respondents' views**

### ***Introduction***

- A1.1. Postcomm received 15 responses to its September 2004 consultation on market opening (compared 1,935 letters, postcards, petitions, etc we received to our first round of consultations on market opening in 2001).
- A1.2. The responses are summarised below, by topic. The full version of all responses can be found on Postcomm's website ([www.psc.gov.uk](http://www.psc.gov.uk)). Postcomm would like to thank all stakeholders who responded to this consultation.

### ***Summary of responses***

- A1.3. The responses summarised below indicate that full market opening is no longer as controversial as it once was. Royal Mail welcomed competition and seemed indifferent on the date. Apart from the unions and the Periodical Publishers Association (PPA), most other respondents welcomed earlier market opening, but were concerned about making it work in practice (e.g. issues such as licensing, mail integrity and common operational procedures).
- A1.4. It was clear that by far the most complex issue was the definition of the universal service in relation to bulk mail and access. Almost all respondents provided a view on this.

### ***Responses on market opening***

- A1.5. The majority of respondents (ten) supported bringing forward market opening to 1 January 2006. Operators and operator associations welcomed Postcomm's proposal to accelerate market liberalisation. SMS (Special Mail Services) perceived the original timetable as being unduly influenced by Royal Mail's interests and it hoped the new measures marked a turning point in changing Royal Mail's behaviour. The EEA (European Express Association) believed this proposal would increase innovation and competition and also send an important signal of support for the European Union's long-term goal to create a dynamic delivery sector in Europe.

- A1.6. Both TPG and SMS believed, however, it would still be difficult for competitors to enter the market to any significant extent due to Royal Mail continuing to enjoy special privileges, particularly its VAT exemption. Another impediment TPG mentioned was certain Royal Mail prices, which it believed did not cover costs.
- A1.7. Customers (WWAV Rapp Collins) and the majority of customer groups and bodies (Direct Marketing Association (DMA), Mail Users Association (MUA) and Postwatch) also supported the proposal. They argued that the existing strategy has resulted in only minimal market development, and that the absence of significant competition has been due to a number of significant barriers to entry, the most significant of which was Royal Mail's VAT exempt status. They further believed that full market opening would act as a spur to Royal Mail to provide customers with more choice, innovative products and services, and would force quality of service improvements. It would also give new entrants an incentive to maintain and increase their commitment to investment in the postal market.
- A1.8. The DMA indicated support for 1 January 2006, as this would coincide with the next step of European liberalisation. Customers and customer groups also believed this measure was necessary to ensure the industry was competitive and innovative enough to compete against other advertising media. Furthermore, they did not believe full market opening would affect Royal Mail's ability to provide a universal service.
- A1.9. Postwatch believed 1 January 2006 was a sensible compromise between stepping up competitive pressure while also allowing sufficient time to consult on any necessary modifications to the licensing regime. However, it also thought 1 April 2006, when the new price control is due to come into force, was an acceptable alternative for full market opening.

A1.10. Intellect supported the proposal though it believed barriers to entry would remain high in the form of Royal Mail's VAT exemption, customer inertia, Royal Mail's brand and the ubiquity of the daily delivery service. Postmasternetwork also fully supported the proposal for market opening and believed there would be opportunities for sub-postmasters to benefit, but Postcomm would need to press Post Office Ltd to allow sub-postmasters freedom to work in this area.

A1.11. Royal Mail said it welcomed the introduction of competition in the market. Though it did not indicate either support or opposition to bringing forward market opening to 1 January 2006, it outlined a number of concerns. It said that in a fully liberalised market Royal Mail must have the commercial freedom to compete effectively, to allow it to provide a universal service while generating a commercial return for its shareholder.

Fundamentally, it argued prices must be rebalanced to ensure that in a competitive market there were minimal cross subsidies that would encourage inefficient entry and undermine the universal service. Royal Mail also requested details of how any proposed universal fund might operate.

A1.12. Royal Mail believed the proposals in the document reflected a false sense of security arising from Postcomm's analysis of the market as set out in the Competitive Market Review and Postcomm's analysis of competition in Sweden and New Zealand. All responses to the Competitive Market Review (including Royal Mail's) can be found on Postcomm's website.

A1.13. Royal Mail argued that customers are sensitive to price and that significant volumes could switch to entrants. It argued international experience has shown that market opening encourages lots of small operators, and the risk of these entrants destabilising the market is high (as observed in Sweden). It further argued that significant academic literature highlighted the potential problems ahead in ensuring the provision of the universal service in the longer term, and this should not be overlooked. Royal Mail also argued that its VAT exempt status is less of a barrier to entry than considered by Postcomm to be the case.

A1.14. With respect to the impact analysis contained in the Annex to the September 2004 proposals, Royal Mail said the assessment was only for the short term and the assumptions underlying the analysis had not been shared with Royal Mail, so it felt it was not able to comment on the reasonableness of the analysis or its conclusions and asked Postcomm to share this information with them. Royal Mail argued the results were not consistent with the conclusions from Royal Mail's own modelling where the impact on contribution is significantly more adverse. Royal Mail did not accept, on the basis of the information that Postcomm has placed in the public domain, that the universal service can necessarily be financed in a fully liberalised market.

A1.15. Royal Mail said earlier market opening would not change its resolve to improve efficiency and it welcomed the emphasis on the need for innovation. However, it considered Postcomm had thus far limited Royal Mail's innovation by the lack of speed in dealing with the size based pricing issue, and requiring Royal Mail to provide products that are deemed by Royal Mail to be outside the universal service. It argued for greater scope to change non-price terms, in order to facilitate innovation and benefit customers overall. There should also be stronger incentives for investment in the price control.

A1.16. Four respondents indicated they were against the proposal to fully open the market from 1 January 2006. These included the Communications Workers Union (CWU), Amicus/CMA, SERTUC (Southern and Eastern Regional Council of the Trades Union Congress) and the PPA (Periodical Publishers Association).

A1.17. The CWU, Amicus/CMA and SERTUC argued that if liberalisation must take place it should not exceed the requirements set out in European legislation, and they urged Postcomm to withdraw its proposal. They were concerned this would allow European operators to gain a foothold in the UK market without reciprocal opportunities to make gains in the European market. They believed this proposal would merely increase the pressure on Royal Mail at a time when it already faced substantial challenges.

A1.18. The CWU, Amicus/CMA and SERTUC also argued that Postcomm was ignoring the fact that Royal Mail's business is based on a complex system of cross subsidies that support the geographically uniform tariff. Competitors with no universal service obligation are likely to target the more profitable routes, leaving Royal Mail to provide the more expensive services. This proposal would financially weaken Royal Mail and jeopardise the universal service. They argued it was too early to gauge the impact of changes already taking place in the market, particularly the impact of recently negotiated access arrangements, and the issuing of seven long-term licences. They believed a period of stability was now required, during which Royal Mail could address a wide range of issues, including securing long term improvements to customer service. They also did not believe that improvements in quality of service and customer focus would result from bringing forward market opening. It may, they argued, have the opposite effect. They argued that a greater onus on Royal Mail to perform competitively would place Royal Mail under greater pressure at a time when its quality of service standards had performed poorly. This proposal, they argued, was likely to lead to a further decline in service standards resulting in heavier financial penalties, at a time when Royal Mail had only recently improved its financial situation.

A1.19. Furthermore, the unions did not believe it was possible to draw reliable lessons from the experience in New Zealand and Sweden, saying they were two much smaller countries in terms of population, and major cities, and had much smaller economies than the UK. They also believed that both countries' regulatory bodies had not aggressively promoted competition.

A1.20. The PPA did not support the proposal, arguing that Postcomm had not made a sufficiently strong case for bringing forward market opening citing Postcomm's own concerns that there was a lack of robust cost allocation data, there was a prospect of existing and ongoing anti-competitive behaviour by Royal Mail, and there was a lack of common operational procedures. The PPA believed any proposal to introduce further competition must be accompanied by proper analysis of Royal Mail's needs, both for working and investment capital to support its existing and future obligations. The PPA therefore believed full market opening should remain at 1 January 2007, allowing sufficient time for competition to develop, and for Postcomm to focus on establishing sufficient checks and balances for Royal Mail to be cost efficient, quality driven, and competitively focused.

***Proposal for reviewing licensing and other implications of market opening***

A1.21. Many respondents stated that they planned to communicate their views on licensing to Postcomm as part of Postcomm's specific consultation on licensing.

A1.22. However, a number of respondents supported the proposal to review the licensing regime. Royal Mail supported the need for licensing of other operators as a means of ensuring mail integrity and supported the proposal for all operators being required to provide a bank, or similar, guarantee and the principle of the need for a supplier of last resort.

A1.23. The CWU and Amicus/CMA said Royal Mail must be treated fairly in comparison to any private operator, and Postcomm must act firmly to prevent large numbers of small scale entrants being introduced to the market. They were concerned that a light-touch approach advocated by Postcomm would not be sufficient to prevent rogue operators from taking advantage of a liberalised market. This, they argued could potentially damage the reputation of all postal services, and customers could switch to other media, leading to the decline of the postal industry and the demise of the universal service. Amicus/CMA feared Royal Mail would be left to pick up the pieces in the event of unscrupulous practices such as dumping of unprofitable mail on the network. They both wanted Postcomm to ensure the following licence requirements: financial viability which could be in the form of bank bonds to guarantee delivery of mail already in the pipeline, security of mail including vetting of employees such as criminal record checking, the same quality of service standards for all operators, compensation arrangements, common operational procedures to provide accountability between different operators, and the means to quickly revoke licences in the event of malpractice.

A1.24. Postwatch agreed there must be some regulatory oversight of new entrants, particularly to ensure mail integrity. It did not, however, believe that it was appropriate to stipulate either quality of service targets or compensation schemes for new entrants on the basis that customers should be able to choose between operators, including Royal Mail, on the basis of different price and quality levels. TPG commented that to encourage innovation, Postcomm should keep open the possibility of granting other types of licences on an ad hoc basis.

A1.25. The DMA, MUA and SMS emphasised the need for a light touch approach and were concerned the licensing regime could become a barrier to market entry. They all supported a registration process in a fully competitive market, believing the market itself will determine and evolve the standards for mail integrity. If a new operator fails to meet customers' standards for mail integrity, it will lose that business.

A1.26. The MUA, however, said that where there is no effective competition, licensing would be necessary to facilitate competition and innovation, to protect the interests of consumers. It also supported the establishment of a code of practice with which licensed operators must comply. However once there is sufficient competition, a less formal registration system is all that will be required. SMS did not believe market exit should be a concern, given entry and exit is natural in an open market and, in its belief, the licensing regime already provides customer protection in the event of an operator leaving the market. It asked Postcomm to note that an extensive number of companies in the express service market carry valuable items, and that this industry is unregulated. It also suggested that Postcomm take a close look at the licensing regime in countries such as Germany, Sweden and New Zealand, arguing none of these countries has experienced a collapse in confidence even though they have licensing regimes far less regulated than what is proposed by Postcomm.

***Proposal for raising market awareness***

A1.27. Postwatch agreed work is required to raise levels of awareness of alternative services provided by other operators and said it would co-operate with Postcomm in helping to raise awareness. SMS also supported this proposal, and asked if it was possible for operators to participate in Postcomm's regional road-shows.

A1.28. The DMA said that while Postcomm's proposals for market awareness are well intentioned, Postcomm's resources would be better spent resolving barriers to entry like Royal Mail's VAT exemption.

A1.29. Royal Mail said it did not believe that there was currently a low level of awareness of the market opening programme in the postal industry.

### ***Proposal for raising the priority of common operational procedures***

A1.30. Four respondents (Royal Mail, DMA, MUA and PPA) all said they welcomed the development of an industry code of practice for common operational procedures. Royal Mail believed that this is important to maintain integrity and commercial confidence in the postal market and to have clear and precise rules and operations for all licensees. Royal Mail said it should not be expected to do work for other operators at a loss and other operators should be prepared to conform to reasonable rules for use of the network used to meet the universal service obligation. As a potential further development in a competitive market, common operational procedures should not just be limited to the use of Royal Mail's network but be extended to the use by Royal Mail of other networks.

A1.31. The MUA said it was reassured to see Postcomm's stated commitment to a full review of common operational procedures and access pricing. It said there must be an agreed action plan for common operational procedures with clear and achievable goals and key milestones as part of any proposal for earlier liberalisation. The DMA said Postcomm must take the lead on this issue to ensure there is clear guidance and protocols are in place to facilitate the quick movement of mail.

### ***Process for dealing with requests from Royal Mail to move some of its prices more closely into line with costs***

A1.32. The majority of respondents indicated support for the principle of bringing Royal Mail's prices more in line with costs. However, they believed it was important to better understand Royal Mail's costs and make this as transparent as possible before considering any price rebalancing. This would ensure that any decisions are taken on the basis of robust data.

A1.33. Royal Mail said there was a need for greater clarity with regard to the process and expectations for how Postcomm would review future applications for price rebalancing and restructuring.

A1.34. SMS was concerned about the reliability of Royal Mail's costing system and its ability to allocate costs accurately. The costs that need to be reflected are those of an efficient operator that is meeting the needs of the market. In the case of major price adjustments SMS believed that it was essential for Postcomm to undertake full cost/benefit analysis, considering all the additional costs incurred by the mailing industry. The PPA also said that transparency in Royal Mail's cost allocation system is critical, and that action was needed to address this question.

A1.35. TPG and the MUA expressed concern about the motives behind price rebalancing. The MUA said it supported the principle of cost reflective pricing provided cost data is transparent. However it was concerned about the use of rebalancing for anti-competitive reasons. With respect to payment channel discounts, some MUA members believed that the proposals could be interpreted as having anti-competitive motives, particularly in light of the fact Royal Mail had not chosen to better align their prices to costs for second class metered/PPI mail streams.

A1.36. The DMA said that with respect to size based pricing, unless Postcomm was convinced by rigorous analysis that it is more cost reflective, it should not be progressed further. With respect to payment channel changes, the DMA supported this provided it does reflect costs of an efficient operation. Intellect also indicated strong support for a price differential between metered mail and PPI.

A1.37. Amicus/CMA said it recognised the need for Royal Mail to be able to rebalance its prices, but strongly opposed the proposal for charging customers different prices depending on how they pay for their post. Amicus/CMA believed this would be a first step towards undermining the uniform geographic tariff.

## ***Responses on the universal service***

### **Bulk mail**

- A1.38. Amicus/CMA, DMA, Intellect, Postwatch, MUA and SMS believed it was necessary to have bulk mail products defined as universal services. However a number were concerned that considering just Mailsort 1400 (first and second class) as a universal service would not be enough to protect small and medium sized users. They also advocated keeping Mailsort 120 and Cleanmail as universal service bulk mail products. These respondents argued most Cleanmail users and Mailsort 120 customers would be unable to meet the thresholds for Mailsort 1400.
- A1.39. SMS believed Cleanmail customers would not be able to provide Royal Mail with destination details for mail carried under this tariff and so it would not be possible for this product to be subject to geographically de-averaged pricing.
- A1.40. The MUA believed that excluding Cleanmail and Mailsort 120 products from the universal service obligation would result in these users switching to alternative media. Postwatch argued that restricting the bulk mail element to Mailsort 1400 allowed Royal Mail too large a degree of pricing flexibility in a market with only limited competition and significant barriers to entry. It believed Royal Mail was attempting to move customers away from Mailsort 1400 and take up other bulk mail services. If this continued, Mailsort 1400 might not constitute a significant generic bulk mail offering.
- A1.41. The DMA, MUA, Intellect believed the universal service should only be changed when sufficient competition developed within the market (including sub-markets). The DMA, MUA, and Intellect believed this should be linked to when Royal Mail's market share had fallen to an agreed level.

A1.42. A number of respondents (Intellect, MUA, and Postwatch) believed all products should remain within the universal service until the next review was undertaken. Postwatch argued that if full market opening did go ahead on 1 January 2006, Postcomm should conduct a further review (probably in early 2007) once the level and nature of early competitive entry becomes apparent. The MUA believed products falling within the scope of the universal service should receive uniform geographic pricing mandates until such time as sufficient competition had entered the market for Royal Mail to make a viable case for needing to move to geographic pricing.

A1.43. Amicus/CMA believed there should be no narrowing of the universal service without a clear and common understanding of what constitutes the universal service and the principles behind it. It believed this was fundamental in the run up to a liberalised market. It believed any narrowing of the universal service would lead to increased prices for social and small business users. Rebalancing the tariff would also reduce the range of products covered by the universal service, and reduce services available to individual and small businesses.

A1.44. The PPA said members generally supported Royal Mail as the supplier of first choice and would be concerned at any threat to Royal Mail's ability to provide a universal service at a fair price, and consistent and acceptable standards of service.

A1.45. Three respondents (Royal Mail, CWU and TPG) believed that no bulk mail product should be defined as a universal service. Royal Mail believed that all bulk mail services should be outside the universal service and argued that the case presented by Postcomm for the inclusion of Mailsort 1400 (first and second class) did not stand up to scrutiny. It said the universal service is closely related to the groups identified in the Postal Services Act 2000. These groups included individuals who are disabled or chronically sick, of pensionable age, or residing in rural areas. These groups are not the senders of bulk mail. Royal Mail believed first class prepaid mail, available to everyone, drives the costs of the universal service by requiring an extensive upstream network and an every door, every day delivery capability. Consistent with this view, it could be argued that the coverage of the universal service should be limited to first class prepaid mail only. It also argued the retention of one bulk mail service at a geographically uniform price (that is not cost reflective) while all other services are more cost reflective, may result in switching between bulk mail services to take advantage of arbitrage opportunities arising from distortions of the uniform tariff. This, Royal Mail argued, would increase the uncertainty of volumes and revenues for Royal Mail's planning and operations, and is an argument put forward by Postcomm in favour of a single set of access prices in the September 2004 proposals. Royal Mail also did not consider that Mailsort 1400 (first and second class) would necessarily provide assurance to smaller bulk mail users.

A1.46. The CWU similarly supported the removal of bulk mail products from the universal service. It argued bulk mail products are used solely by large customers, and these customers are certain to have access to the widest range of competitor products and services in a liberalised market. A competitive market would necessitate greater pricing flexibility in relation to these bulk mail products. It also believed Condition 19 of Royal Mail's licence would ensure that it is required to continue to provide all bulk mail services, even if these services no longer form part of the universal service.

A1.47. TPG also believed it was unnecessary to include bulk mail products within the universal service. It believed Royal Mail would provide these services voluntarily and at a discount in order to attract important mail volumes. It believed competition would control the upper level of prices. If Postcomm does include bulk mail services within the universal service, TPG did not understand why Mailsort 1400 (first and second class) services should be treated differently from Mailsort 120 and Mailsort 700 services. It argued if Royal Mail provided Mailsort 1 & 2 (120 and 700) services on a non uniform tariff, would this not amount to discrimination against those using a single item tariff (i.e. 1st and 2nd class services), given they would not get a lower price for certain areas?

### **Access**

A1.48. Though respondents indicated support for the principle of pricing that was more cost reflective, a number of respondents expressed concern about the introduction of zonal pricing. Many respondents believed it was important both to understand Royal Mail's cost allocation, and to make this as transparent as possible, before considering de-averaged pricing. They also believed it was important to assess the impact of de-averaged pricing on customers and competition.

A1.49. TPG believed Postcomm should focus on controlling zonal pricing, to ensure that it did not impede competition, rather than artificially including bulk mail within the universal service. It believed Royal Mail's introduction of zonal pricing was a direct assault on new competition in the provision of upstream consolidation services. TPG believed if zonal pricing and other access proposals were left uncontrolled, there would be no competition. TPG argued Royal Mail's ability to offer access prices without any prior review by Postcomm is being used to destabilise the market, with the effect of dissuading customers from choosing to use the services of rival operators. It believed Postcomm needed to have ex ante control of access and new services pricing to prevent this.

A1.50. SMS said Postcomm must be convinced about the reliability of Royal Mail's costing data before contemplating a relaxation of the requirement for geographic uniform pricing. It saw no reason why any of these products should be subject to geographically de-averaged pricing. It argued that even the use of access products by operators was only an example of worksharing, and that there was no justification for discriminating against access operators. There was, it argued, no fundamental difference between the activities of a consolidator and those of a mailing house.

A1.51. Small business users represented by Postwatch's Personal & Small Business Mail Users Group were concerned that geographical pricing of Cleanmail would be detrimental, in particular for those businesses based in rural areas.

A1.52. The PPA also expressed concern about the difficulty of introducing geographical pricing for certain user groups, but accepted that this might be appropriate as part of a system of improved cost reflectivity in prices, provided that it did not prejudice the universal service.

A1.53. The DMA said pricing flexibility was merited if it reflected an efficient operation and gave some benefit to customers. Geographic pricing must be directly linked to costs. Controls must be in place to ensure Royal Mail does not use geographic access pricing with direct customers, as a means of restricting competitors who use Royal Mail's network, through an access arrangement. The necessary licence provisions must be used by Postcomm to ensure Royal Mail does not abuse its pricing flexibility or abuse its position with respect to products defined outside the universal service.

A1.54. The MUA said its members understood Royal Mail's desire to be able to price more flexibly in order to respond to developments in the market and act in a commercial manner. However MUA members were generally of the view that in what is presently an all but captive market, the disadvantages are likely to outweigh the benefits. This was however very dependent on individual companies' geographic profiles. It said Postcomm should also be mindful of the administrative burden, mail acceptance procedures, and overall complexity of manifesting and rating the mail, that zonal prices could place on customers.

A1.55. Intellect said that in the absence of an access code, the price of access products should be controlled for the foreseeable future with a market share limitation on this requirement, to give Royal Mail some protection in the future from new competitors selling under the access price.

A1.56. WWAV Rapp Collins said that, if Royal Mail is to compete effectively not just with other postal operators but also with other media channels, it should have the discretion to have zonal pricing. It said Postcomm should appreciate that price flexibility is the key to mail competing against rival media, and bulk mail is key to the development of the postal services market and to the continued prosperity of Royal Mail. It must be appreciated that direct mail is just one option for clients within a direct marketing environment. Cost efficiency is a key factor. The key to the development of the market will be how Postcomm strikes the balance between allowing price flexibility and avoiding unfair discrimination and predatory pricing.

A1.57. Royal Mail said there was a need for greater clarity with regard to the process and expectations for how Postcomm will review future applications for price rebalancing and restructuring. Royal Mail argued it may not have much price flexibility even when a product is removed from the universal service, because of restrictions in its licence (notably the restriction on changes to non-price terms in Condition 19(1) and Postcomm's process for changes to pricing structures in Condition 19(12)). Royal Mail believed changes to the licence would be needed to remove the regulation restricting changes to non-price terms. Royal Mail also argued that its licence covered services that are not part of the universal service, and that it considered that there was nothing in the European Postal Services Directive or the Postal Service Act 2000 that required Royal Mail to continue providing these services.

## Annex 2 – Financial Implications of Market Opening for Royal Mail

### *Introduction*

A2.1. Postcomm has a statutory duty to act in the manner it considers best calculated to ensure the continued provision of a universal service. As part of its September 2004 proposals, Postcomm modelled the impact of full market opening on 1 January 2006 on Royal Mail's business. This analysis supported the proposal to open the postal services market to competition on 1 January 2006. Postcomm's central estimate is detailed below in Table A2.1.

Table A2.1: Postcomm's Original Central Forecast (for profit from operations for universal service products) as published in September 2004

| £m in 2003/4 prices | Contribution from Royal Mail end-to-end volume | Contribution from access volume | Royal Mail's imputed fixed costs | Forecast profit from operations |
|---------------------|--|---------------------------------|----------------------------------|---------------------------------|
| 2004/5              | 2,343  | 20                              | (2,043)                          | 329                             |
| 2005/6              | 2,319  | 30                              | (2,014)                          | 335                             |
| 2006/7              | 2,271  | 53                              | (1,994)                          | 330                             |
| 2007/8              | 2,212  | 80                              | (1,974)                          | 318                             |
| 2008/9              | 2,129  | 120                             | (1,954)                          | 295                             |
| 2009/10             | 2,011  | 179                             | (1,935)                          | 255                             |
| 2010/11             | 1,980  | 193                             | (1,915)                          | 258                             |

Source: Postcomm

### ***Royal Mail's response***

A2.2. Royal Mail's response to Postcomm's market opening proposals made four principal points, which Postcomm deals with in turn:

- Postcomm only modelled the short term
- Royal Mail's model shows a far more negative financial impact
- Postcomm did not publish enough detail
- Postcomm should have presented a number of scenarios

#### **Postcomm only modelled the short term**

A2.3. Postcomm modelled the effect of market opening up to and including 2010/11 (i.e. to 31 March 2011). This is a period of seven years beyond 2003/4 and is, in Postcomm's view, a reasonable time horizon. It includes the remainder of the current price control and the maximum possible period of the next price control (which at five years from 2006 is the longest price control Postcomm has proposed).

A2.4. To look beyond 2010/11 (which is two price controls away) would be of limited use for the purposes of this exercise, and the accuracy of any forecasts would decline significantly that far into the future. Each price control review seeks to ensure that Royal Mail can finance the provision of its universal service obligation. Postcomm therefore believes that it has modelled a sufficiently long period of time.

#### **Royal Mail's model shows a far more negative impact**

A2.5. Royal Mail has shared, with Postcomm, its economic models for competitive entry, as part of the current price control review. However, the reason that Royal Mail is forecasting a more pessimistic effect from market opening, is that it believes that it will lose significantly more mail volume to competitors than Postcomm believes will be the case.

- A2.6. Postcomm has assessed Royal Mail's models for forecasting competitive entry on a number of occasions, for a range of regulatory decisions. Postcomm is of the view that Royal Mail has consistently over-estimated the impact of competition on its mail volumes when providing forecasts to Postcomm. To date, Royal Mail has lost very little mail to competitors. In addition the overall mail market has continued to show reasonable levels of growth. Postcomm considers it likely (based on nine months of actual data recently provided by Royal Mail) that 2004/5 will continue this trend, with between 2% and 3% growth in Royal Mail's volumes.
- A2.7. Postcomm engaged the economic consultancy Frontier Economics to forecast the financial effect on Royal Mail of fully opening the UK mail market to competition. Frontier's model has taken a different approach to forecasting competitive entry to that of Royal Mail. Frontier has focussed its analysis on the switching behaviour of Royal Mail's largest 100 customers, which account for around 50% of Royal Mail's mail volumes, and mail volume that appears to be attractive to competitors of Royal Mail.
- A2.8. Furthermore, Frontier's analysis takes a less disaggregated view of the extent to which Royal Mail's volumes can be competed for by new entrants. Royal Mail continues to believe that competition will happen at a very disaggregated level, with competitors offering to take only very selective parts of a customer's mail, where they are best able to compete effectively with Royal Mail. Frontier believes that it is unlikely that postal users will be prepared to segregate their mail to that degree (i.e. based on a range of factors, including the origination point, delivery point, format of mail and ability of items to be machine sorted). Frontier's analysis suggests that postal users will be prepared to switch parts of their mail to an alternative mail provider, but effectively at a higher level of aggregation. For example, Frontier believes that it would be reasonable to expect postal users to split their mail by product (e.g. giving a competitor all of its Mailsort 1400 mail) and even by product and by weight (e.g. giving a competitor all of its heavy Mailsort 1400 mail).

A2.9. Postcomm has asked Frontier to revisit its market entry analysis in light of the more accurate forecasts for 2004/5 actual mail volumes now available, and the release of revised models Postcomm has recently received from Royal Mail as part of the price control review. The outcome of this review is shown in Table A2.2.

Table A2.2: Postcomm’s Revised Central Forecast (for profit from operations for universal service products)

| £m in 2003/4 prices | Contribution from Royal Mail end-to-end volume | Contribution from access volume | Royal Mail’s imputed fixed costs | Forecast profit from operations |
|---------------------|--|---------------------------------|----------------------------------|---------------------------------|
| 2004/5              | 2,386  | 4                               | 2,034                            | 356                             |
| 2005/6              | 2,310  | 30                              | 2,014                            | 326                             |
| 2006/7              | 2,262  | 53                              | 1,994                            | 322                             |
| 2007/8              | 2,204  | 80                              | 1,974                            | 310                             |
| 2008/9              | 2,121  | 120                             | 1,954                            | 287                             |
| 2009/10             | 2,004  | 179                             | 1,935                            | 247                             |
| 2010/11             | 1,973  | 193                             | 1,915                            | 250                             |

Source: Postcomm

A2.10. There is an element of uncertainty surrounding all projections, but Postcomm still considers that Frontier’s assumptions and analysis are the most plausible, and has continued to use these forecasts (which are slightly modified versions of those published in September 2004 to reflect more up to date data) for its analysis of its market opening decision.

### **- Interaction with price control review**

A2.11. LECG, the economics consultancy, is currently performing a review of Royal Mail's efficiency as part of Postcomm's work to set a new control on some of Royal Mail's prices from April 2006. In financially modelling the impact of market opening on Royal Mail, Postcomm has made some assumptions (e.g. on the level of efficiency that Royal Mail can achieve) that will be revisited as part of LECG's work.

A2.12. The current model (used for market opening purposes) makes very conservative (i.e. low compared to that which has been achieved by Royal Mail during the current price control period) assumptions of the rate at which Royal Mail can improve its efficiency (i.e. 1% per annum). If Royal Mail is able to achieve better annual efficiencies than 1% per annum, as has been the case in recent years, this will lead to higher operating profits. This means that, in this respect, Postcomm's analysis of Royal Mail's profit from operations for present purposes might be considered to be conservative.

A2.13. Clearly the biggest and most important impact of Postcomm's decision to fully open the UK postal market to competition is the extent of the loss of mail volume from Royal Mail to competitors. Postcomm has used the economic consultancy Frontier Economics to estimate the extent of competitive entry. Frontier's work (above) forecasts a significantly lower level of competitive entry to that forecast by Royal Mail. As part of the price control review, Frontier will continue to refine its forecasting techniques.

### **- Financial impact of Royal Mail losing mail to competitors**

A2.14. 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.

A2.15. On average, for every item Royal Mail loses to end-to-end competitors, it incurs a loss of approximately 12p of contribution towards its fixed costs (although no costs are fixed for ever). For an item lost to a consolidator, around 6p of contribution is lost.

- A2.16. In forecasting the financial impact on Royal Mail of it losing mail volume to competitors Postcomm has made very conservative estimates (of only 1% per annum) of the extent to which Royal Mail will be able to reduce its fixed costs. If Royal Mail is able to reduce its fixed costs by more than 1% per annum, this will lead to higher operating profits for the regulated business.
- A2.17. Postcomm has a statutory duty to have regard to the need to ensure that Royal Mail is able to finance its universal service obligations. As part of the current price control review, and in consultation with stakeholders, Postcomm will set a control on Royal Mail's price controlled products (probably via an RPI – X mechanism) to seek to ensure that Royal Mail will be able to finance its universal service obligations.
- A2.18. To this extent, even if Postcomm were to accept Royal Mail's more pessimistic view of the extent to which it will lose mail volumes to competitors, Postcomm will seek to ensure, via the price control review, that Royal Mail will still be able to finance its universal service obligations.

**Postcomm has not published enough detail**

- A2.19. Royal Mail, in its response to Postcomm's market opening consultation, contended that Postcomm did not publish enough detail or behind its projections in its September 2004 consultation document on market opening or share its models with Royal Mail.
- A2.20. Postcomm always has to balance the requirement to disclose details of its analysis with the desire of Royal Mail to protect its commercial interests. Postcomm is content that the level of detail in its contribution analysis of full market opening was sufficient for Royal Mail to understand Postcomm's view that Royal Mail would be able to finance its universal service obligations.

**Postcomm did not present a number of different scenarios**

- A2.21. Royal Mail expressed a desire for Postcomm to publish a number of different scenarios alongside its central forecast for the profit from operations for the universal service obligation part of its business.

A2.22. Postcomm has taken the opportunity to use more accurate actual data for 2004/5 but is still content to use Frontier's original forecasts for years beyond 2004/5. In effect Postcomm still stands by its central forecast of loss of mail to competitors, as presented in the consultation document. In testing the sensitivity of Royal Mail's profit from operations for this scope of its business, Postcomm has flexed upwards and downwards its central forecast of the extent of competitive entry by 50%. The results of this analysis are shown in Tables A2.3 and A2.4. Under both scenarios, Postcomm's modelling indicates that Royal Mail would still be able to finance its universal service obligations.

Table A2.3: Postcomm's Central Forecast, Flexed for 50% Higher Competitive Entry (for profit from operations for universal service products)

| £m in 2003/4 prices | Contribution from Royal Mail end-to-end volume | Contribution from access volume | Royal Mail's imputed fixed costs | Forecast profit from operations |
|---------------------|--|---------------------------------|----------------------------------|---------------------------------|
| 2004/5              | 2,386  | 4                               | 2,034                            | 356                             |
| 2005/6              | 2,277  | 45                              | 2,014                            | 308                             |
| 2006/7              | 2,205  | 80                              | 1,994                            | 291                             |
| 2007/8              | 2,118  | 120                             | 1,974                            | 264                             |
| 2008/9              | 1,994  | 180                             | 1,954                            | 219                             |
| 2009/10             | 1,818  | 268                             | 1,935                            | 151                             |
| 2010/11             | 1,771  | 289                             | 1,915                            | 145                             |

Source: Postcomm

Table A2.4: Postcomm's Central Forecast, Flexed for 50% Lower Competitive Entry (for profit from operations for universal service products)

| £m in 2003/4 prices | Contribution from Royal Mail end-to-end volume | Contribution from access volume | Royal Mail's imputed fixed costs | Forecast profit from operations |
|---------------------|--|---------------------------------|----------------------------------|---------------------------------|
| 2004/5              | 2,386  | 4                               | 2,034                            | 356                             |
| 2005/6              | 2,343  | 15                              | 2,014                            | 344                             |
| 2006/7              | 2,319  | 27                              | 1,994                            | 352                             |
| 2007/8              | 2,290  | 40                              | 1,974                            | 356                             |
| 2008/9              | 2,249  | 60                              | 1,954                            | 354                             |
| 2009/10             | 2,190  | 89                              | 1,935                            | 344                             |
| 2010/11             | 2,174  | 96                              | 1,915                            | 355                             |

Source: Postcomm

A2.23. Tables A2.3 and A2.4 show a forecast of Royal Mail's profit from operations. This however, is before additional payments that will be required to be made to address Royal Mail's pension deficit. In setting the level of the next price control, Postcomm will take into account the size of such deficit payments. The analysis presented here is considered robust for the purposes of reaching a decision on market opening.

### **Conclusion**

A2.24. The forecasts and analysis presented here suggest that Royal Mail will be able to finance its universal service obligations when the UK postal market is fully open to competition. Furthermore, even if Postcomm's forecast of competitive entry were increased by 50%, Postcomm believes that Royal Mail would still be able to finance its universal service obligations up to and including 2010/11. Postcomm considers the biggest risk to the universal service to be a fall in volumes resulting from a lack of customer focus and innovation on the part of Royal Mail.