2006

COMPETITIVE MARKET REVIEW + BUSINESS CUSTOMER SURVEY

SUMMARY DOCUMENT

POSTCOMM

THE UK MAIL MARKET 2005/06

A summary of two market reports by Postcomm, the independent regulator of UK postal services.

This summary highlights the main findings of two reports: Postcomm's *Competitive Market Review 2006*, which looks at the state of the mail market in the UK, and the final report of *The 2006 Business Customer Survey*, a document based on market research prepared for Postcomm by NERA Economic Consulting and Accent.

Postcomm prepares and commissions these reports as part of its monitoring of the UK postal market. It is important that Postcomm has a detailed knowledge of the market and how it might develop in order to inform its regulatory decisions. For the first time these reports cover a period of full postal competition.

The summary deals with the main findings of each report separately.

REVIEW OF THE COMPETITIVE MARKET

Market size and Royal Mail's share

The UK addressed mail market regulated by Postcomm (for letters weighing up to 350g and costing less than £1) was worth £4.65 billion in 2005/06. Following several years of growth, 2005/06 saw a slight fall in addressed mail volumes to 20.3 billion items, a drop of 1.1 per cent on the previous year.

Royal Mail retains 97 per cent market share in the regulated addressed letters market.

Figure 1 Addressed letters market (0-350g <£1) 2005/06 market share by volume

	2004/05	2005/06
Royal Mail[24]	99.6%	97.0%
Alternative providers Access	0.2%	1.3%
Customer Direct Access	0.0%	1.5%
Alternative providers E2E	0.2%	0.2%
Total	**100%**	**100%**

Source: Postcomm

Access arrangements

Royal Mail carries some mail for its competitors under so-called access agreements, in which its rivals collect and pre-sort mail from their customers and transport it to Royal Mail for final delivery by Royal Mail postmen and women. Royal Mail charges a fee for this service – around 13p for a typical letter weighing less than 60 grams. Some major customers, such as large banks, have negotiated their own access arrangements with Royal Mail, known as customer direct access.

Royal Mail made 1.2 billion access deliveries in 2005/06, compared to 87 million the previous year. In the five months to August 2006, access volumes have continued to grow, and latest figures show that access accounted for 10.5 per cent of Royal Mail's total letters volume.

Figure 2 Addressed inland letters market 2005/06 (licensed area 0-350g <£1) by volume

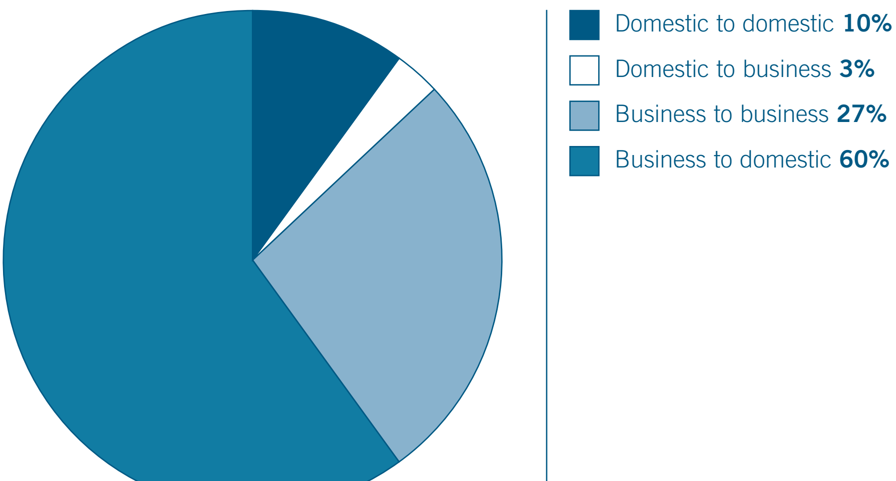
	Total volumes 2004/05 (millions)	Total volumes 2005/06 (millions)	Volume growth
Royal Mail E2E[37]	20,409	19,110	(6.4%)
Total alternative provider Access	79	539	>100%
Customer Direct Access (CDA)	8	618	>100%
Total Access	87	1,157	>100%
Total alternative provider E2E	40	39	(2.5%)
Total	**20,536**	**20,306**	**(1.1%)**

Source: Postcomm with data from Royal Mail

The make-up of the market

Businesses generate 87 per cent of mail in the UK market, with domestic mail accounting for only 13 per cent. Mail sent from businesses to customers is the largest segment, making up 60 per cent of mail volumes. The largest 500 companies account for 50 per cent of mail volumes, making the UK postal market highly concentrated.

Figure 3 Mail flows (domestic v. business customers)



Source: Royal Mail

Domestic customers influence the market by the extent to which they respond to business initiatives. At the moment banks and utilities are encouraging customers to accept statements and bills on-line to reduce costs. Business to business mail has been subject to slightly higher levels of electronic substitution as businesses move towards electronic banking, billing and invoicing and the email of marketing information to other businesses.

Market sectors

Businesses in the financial services sector are estimated to produce 4.3 billion items of transactional mail each year. Up to 70 per cent of this is regular scheduled mailings, making this sector an attractive market for new operators wanting to build consistent volume in their network.

A potential barrier to entry in financial services for competitive mail carriers is that financial institutions are exempt from VAT. This means they are unable to reclaim VAT charged by Royal Mail's competitors, while Royal Mail itself is exempt from charging VAT. This gives operators an approximate 13 per cent price disadvantage against Royal Mail.

The distortion created by Royal Mail's VAT exemption has meant that a number of financial service institutions have used direct customer access agreements, rather than using alternative operators, to avoid paying VAT.

Home shopping has seen continued growth driven by internet sales. Fulfilment traffic is growing and is expected to drive market innovation as customers demand new services and e-tailers provide tailored delivery services. In contrast to internet sales, traditional mail order business fell by £282 million last year.

The UK government sector makes up about 10 per cent of the UK mail market. It is focusing increasingly on improving efficiency and is expected to explore competitive mail offerings.

Central government spent £257 million on postal services in 2004/05, and 90 per cent of this was concentrated among the top eight spending departments. The National Audit Office estimates that government could save £8.5 million annually by 2008/09 by switching to alternative postal suppliers.

Mail applications

Despite an overall increase in spend on advertising, direct mail volumes, which fell by 0.4 per cent in 2004, dropped by a further 5.3 per cent in 2005. According to a recent report by Neilsen Media Research, overall spend on direct mail in the 12 months to June 2006 is down 6 per cent to £1.87 billion. Volumes have also seen a drop of 7 per cent to 3.4 billion items.

Financial services institutions are the largest users of direct mail (around 30 per cent by volume) and some of the overall decline may be due to a switch by financial services towards retaining existing customers rather than acquiring new ones.

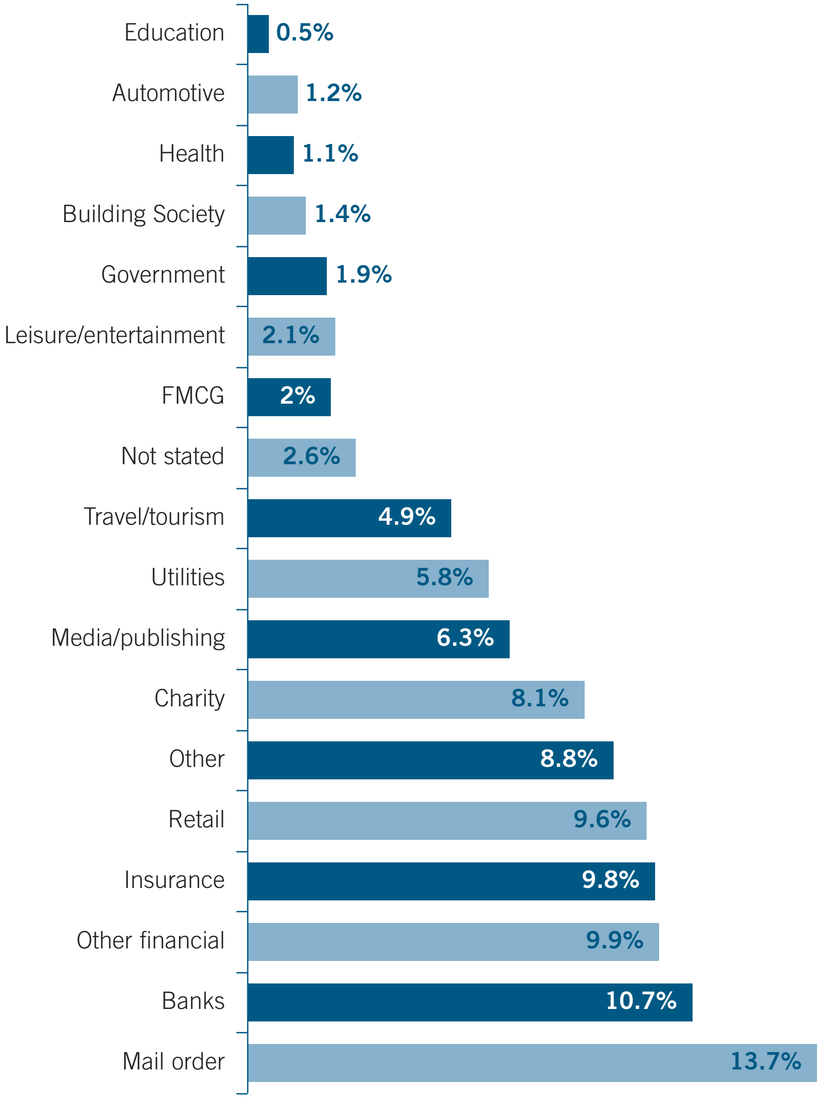
Mail order direct mail volumes also fell in 2005/06.

Figure 4 Direct Mail Volumes and share of advertising spend

	Direct mail volume (number of items million)	Growth %	Direct mail share of advertising spend
1998	4014	NA	NA
1999	4345	8.2	NA
2000	4664	7.3	12.0
2001	4939	5.9	13.5
2002	5233	5.9	14.2
2003	5438	3.9	14.3
2004	5418	(0.4)	13.4
2005	5134	(5.3)	12.5

Source: Direct Mail Information Service/Royal Mail

Figure 5 Percentage of direct mail sent in the UK by industry sector



Source: Royal Mail Consumer Panel, 2004/Direct Mail Information Service

Royal Mail's service quality

In 2005/06 Royal Mail met its licence conditions for end-to-end transit times for all products except first and second class Response Services. There was a substantial improvement towards meeting its postcode area delivery targets, although these were not reached in all areas.

Competition

As of September 2006, Postcomm had issued 17 licences to postal operators in addition to Royal Mail.

New operators have tended to enter the market through access agreements, targeting large regular mailers in order to build volume and customer relationships.

Having targeted many of the key high volume transactional mailers, access providers are beginning to explore the unsorted mail market by offering mail consolidation and sortation. A few access operators are investing in sorting equipment to expand their customer base to include smaller business customers and those that cannot or do not want to sort their own mail.

Competition in downstream access may encourage operators to win volumes of downstream access traffic that they can eventually carry through their own end-to-end network. Up to now end-to-end competition has been slow to develop, due mainly to the difficulty of competing with Royal Mail's economies of scale.

THE CUSTOMER'S VIEW

2006 Business Customer Survey

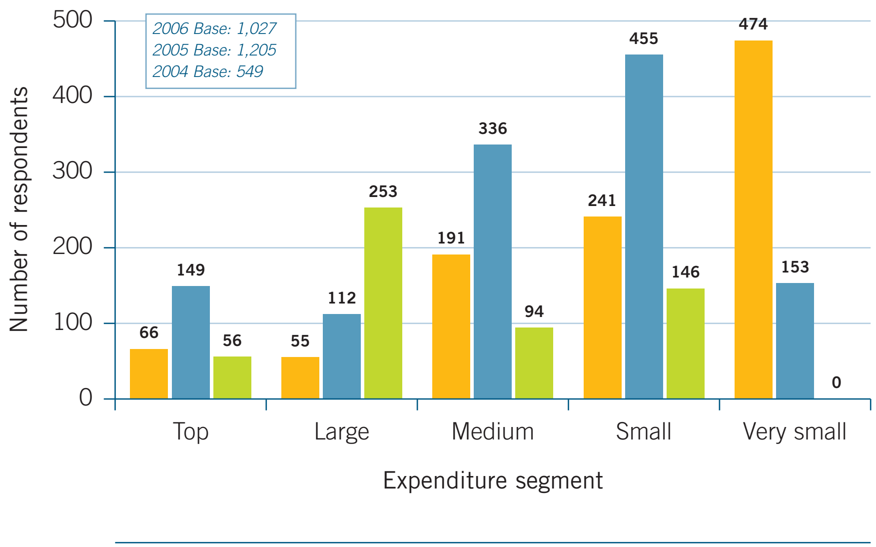
Since full market opening on 1 January 2006, competition and choice has been available to all businesses and this year's survey contains the views of companies of all sizes. Previous business customer surveys have concentrated on larger mailers because until 2006 only the bulk mail market was liberalised.

Postcomm is attempting to engage views of the entire population of business customers. This impacts some of the trend data in this year's survey, in that smaller mailers appear to be less aware of the competitive marketplace and less inclined to switch suppliers.

Who took part

Information in this survey came from 1,213 companies. Of these, based on annual expenditure on mail, 66 were classified as top mailers, 55 as large mailers, 191 as medium mailers 241 as small mailers and 474 as very small mailers*.

Figure 6 Distribution of survey respondents by expenditure segment, 2004, 2005 and 2006



Source: NERA and Accent, BCS 2005

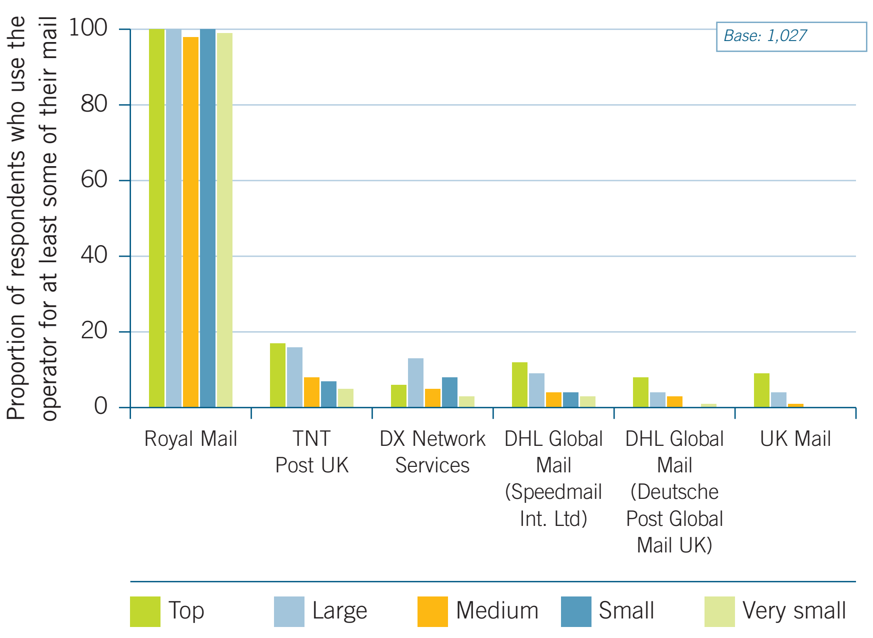
* Respondents who did not know their expenditure on postage account for the difference between the sum of respondents in each category compared to the full sample.

Quick facts

- Financial services firms are the biggest mailers
- Royal Mail is the main service provider to business customers, serving 99 per cent of firms, as in 2005.
- Of customers that have switched, nearly all continue to use Royal Mail for most of their mail. Typically competitors are handling around 10 per cent of their customers' mail.
- Perceptions of service quality were consistently high for Royal Mail and its main competitors.

Although starting from a very low base, competitive operators appear to be expanding their customer base in 2006. Twice as many businesses have switched to Royal Mail's top three competitors compared to 2005, while the proportion of businesses using other competitors was four times higher than last year (6.7 per cent compared with 1.4 per cent). Switching levels are much higher among large mailers than among small mailers.

Figure 7 Distribution of users of mail operators by expenditure segment, 2006

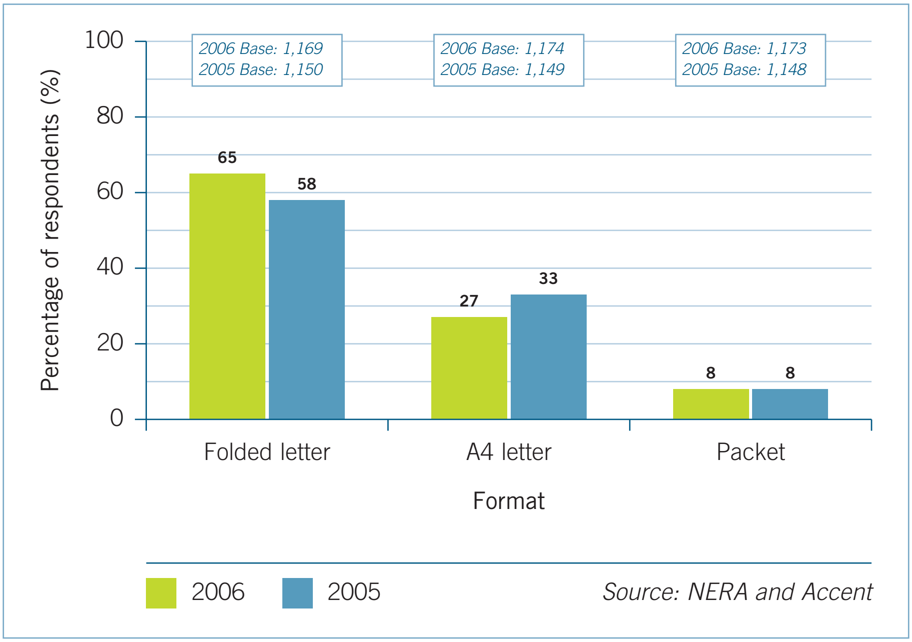


Source: NERA and Accent, BCS 2005

Format changes

There was a shift during the year from the A4 format to folded letter as business customers prepared for Royal Mail's introduction of Pricing in Proportion in August 2006.

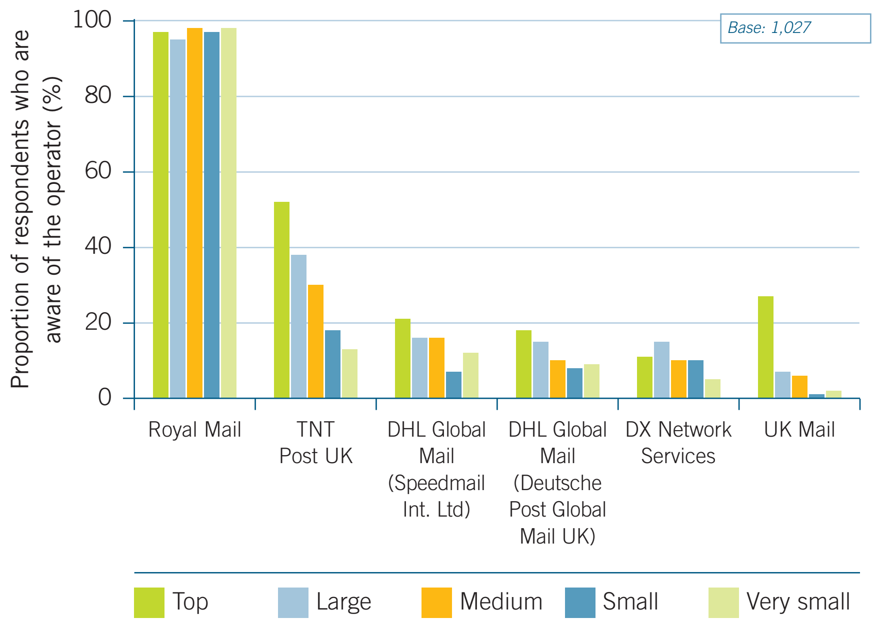
Figure 8 Dimensions and size of items sent by businesses, 2005 and 2006



Switching behaviour

Respondents who said they would be willing to switch to a new mail provider fell from 64 per cent last year to 54 per cent in 2006. The results suggest that firms – particularly small firms – may be less aware of alternative mail providers.

Figure 9 Awareness of operators by expenditure segment, 2006



Source: NERA and Accent

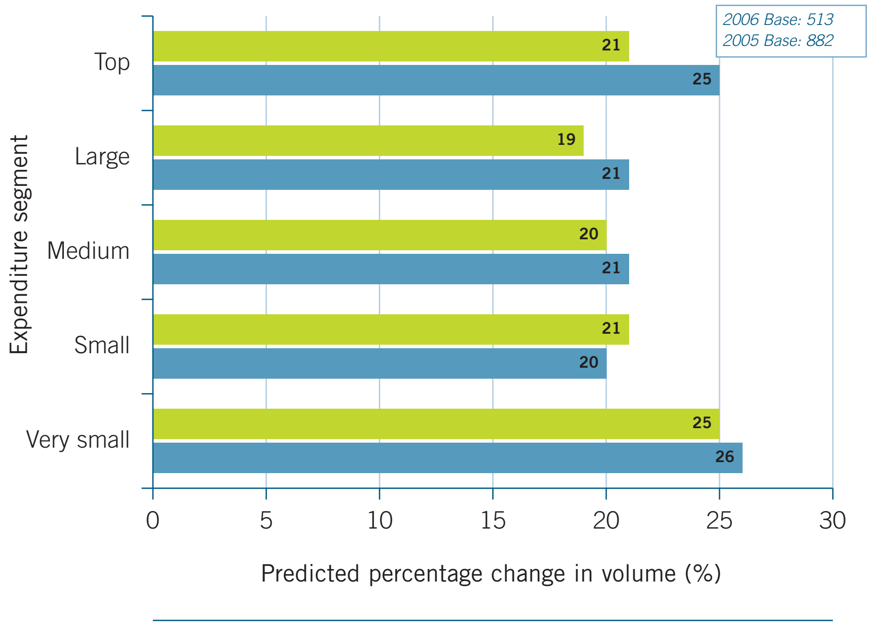
A higher proportion of respondents this year had concerns about confidence in switching operators. The problem most cited was reliance/trust. Most respondents strongly agreed that they would be willing to switch when they knew that operators were providing services to other major businesses.

More than half the respondents said they were would be willing to switch for a discount as small as 5 per cent – although this was a smaller proportion than last year.

There was more switching to other forms of media compared with 2005, with 52 per cent reporting a change (compared with 39 per cent in 2005). Most of these had switched to email. Internal mail was the type most likely to have been affected, followed by direct mail.

Even with higher levels of electronic substitution, businesses expected continued strong growth in mail volumes over the next five years (19-24 per cent). This is despite the small decline in actual mail volumes recorded in 2005/06 compared with the previous year.

Figure 10 Predicted change in volume of mail sent over the next five years, by size segment, 2005 and 2006



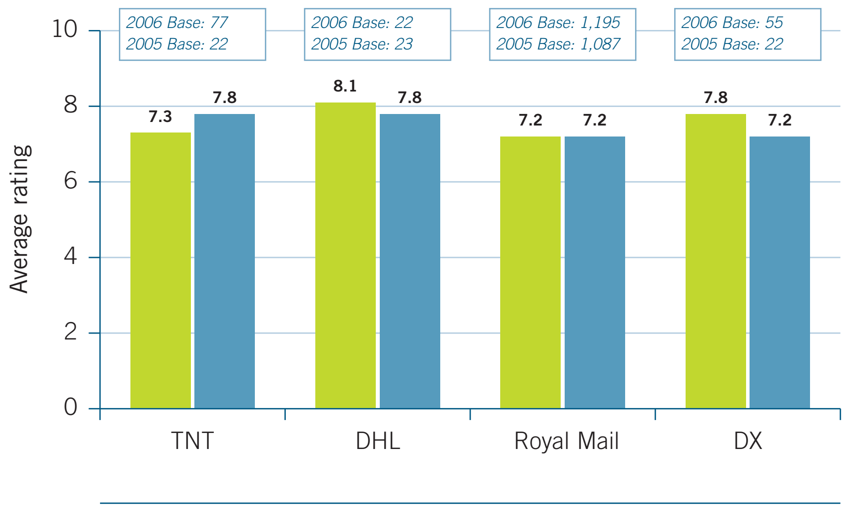
Source: NERA and Accent, BCS 2005

Royal Mail and other operators

Perceptions of quality were consistently high for Royal Mail and its main competitors. The reduction in willingness to switch this year may be more to do with trust and awareness of alternative operators rather than concerns about their service quality.

The rating of Royal Mail's quality of service this year remains the same as in 2005. Its three main competitors, TNT, DHL and DX, scored slightly higher than Royal Mail overall.

Figure 11 Business views of overall operator service quality, 2006 (Average ratings where 1 is very low and 10 is very high)



Source: NERA and Accent, BCS 2005

Royal Mail scored highly on collection reliability and trustworthiness of operator, however, it scored less well on delivery timing, reliability and on levels of lost mail.

Views on full opening of the market

Competition is perceived to have contributed towards lower prices, greater choice and better quality of service from Royal Mail.

- 20 per cent of respondents believed that their mail prices had reduced significantly
- 38 per cent believed that the choice of service available to them had improved
- 34 per cent believed Royal Mail's service quality had improved.

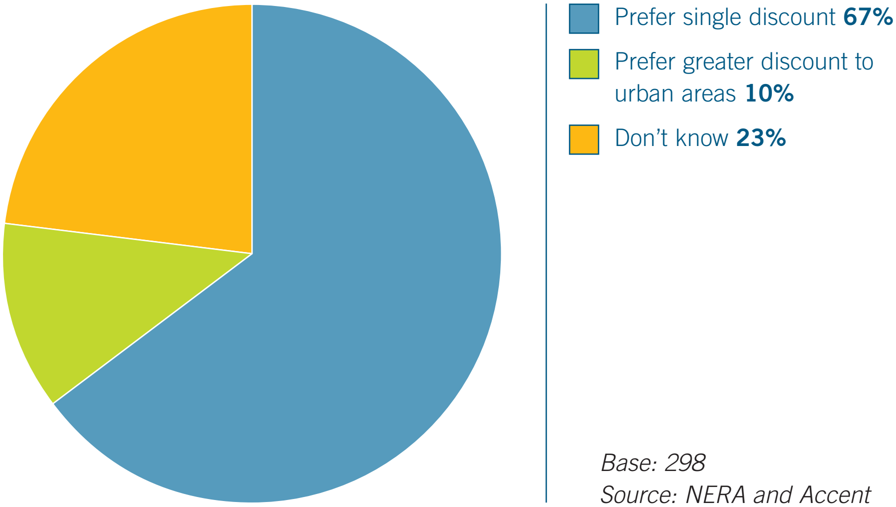
Zonal pricing

Compared to 2005, a higher proportion of business support the principle of geographically-differentiated prices (52 per cent compared with 36 per cent). Support was highest among the smaller mailers. The larger number of small mailers in this year's survey at least partially explains this increase.

Respondents did not think that zonal pricing would significantly affect their mailing behaviour in the short term. Most business said they would send the same amount of mail to rural areas if prices rose by 5 per cent or 10 per cent. In both price scenarios, most businesses said they would seek an alternative provider rather than send less mail. Only 9 per cent said they would send less mail with a 5 per cent price increase.

However, while most respondents agreed with zonal pricing in principle, when asked about the actual pricing structure, it appears that there is less support for complex price differentials, and 67 per cent of respondents would prefer to receive an averaged single discount. This reflects the fact that small mailers will have had limited experience with geographically differentiated pricing and its practical implications.

Figure 12 Business views on differentiated discounts between urban and rural areas for bulk mail, 2006



Base: 298
Source: NERA and Accent

The average percentage of mail sent to rural areas was 24 per cent.

Access vs end-to-end

As in 2005, businesses showed a strong preference for using a single supplier for the entire postal process and they tend to prefer that provider to be Royal Mail. However there is some support for alternative end-to-end suppliers and those providing niche services.

A majority of respondents were in favour of more access products being available and see a role for Postcomm in controlling access prices.

Views on Postcomm

There is limited awareness of Postcomm's regulatory functions among small business mailers, while larger business customers appear relatively well informed about Postcomm. This underpins the importance of the work Postcomm is doing to raise awareness among SMEs and to seek views of smaller businesses on its future regulatory strategy.

This publication can also be viewed on Postcomm's website at www.psc.gov.uk

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