

Postcomm's Strategy Review

The Postal Market 2010 and Beyond

Emerging Themes

August 2007

From: Postcomm Commissioners

23 August 2007

Our Emerging thoughts from Postcomm's Strategy Review

A. Introduction

We launched this Strategy Review in May 2006. This was less than six months after the UK mail market had been fully opened to competition and immediately after we had finalised a new Royal Mail price and service quality control package, covering a four year period through to April 2010.

We have often consulted on individual policy initiatives, but the aim of this review has been to make a considered assessment of the likely overall impact of our current package of regulatory initiatives over the longer term. To do so, we have collected evidence and views to inform ourselves about how the mail market is likely to develop in the future. We have then considered the challenges and opportunities that follow from this assessment. We have met a large number of mail senders and recipients to learn about how they have been impacted thus far by the emerging competitive market and how their needs will evolve in the future. The people we have met as mail senders and recipients include parliamentarians, representatives of the commercial sector and the not for profit sectors, and members of the public.

This Strategy Review considers whether Postcomm's current regulatory policies are capable of achieving our objectives in the longer term taking into account the expected changes in the mail, wider communications and distribution markets. Where we do not believe this to be the case we have sought to identify what policy changes might be desirable to ensure that postal users continue to be protected but that all mail operators – and particularly Royal Mail (as the current universal service provider) – have the flexibility to adapt to these important market changes. Our focus, therefore, is on understanding the developing trends in the mail market and their implications for regulatory policy.

The Strategy Review is not intended to consider changes to our regulatory policies that may be needed in the immediate future. These have been examined in a parallel project, the results of which were published on 9 August 2007 under the heading of "Review of Royal Mail's pricing flexibility and the level of access headroom (the 'Interim Review' of the price control)".

This paper sets out the emerging themes from our Strategy Review. We believe there is justification for making some policy adjustments in the medium to long term. However, before developing specific proposals we would like to ensure that there is time for proper assessment and further consultation. In some instances we need more information to validate our

emerging themes, which we hope can be acquired through a further debate with stakeholders and through some targeted research.

We are presenting these emerging themes in a different format from that which is adopted for our typical consultation papers. Following the summary of emerging themes that is set out in Section B, this paper is structured as follows:

- we explain first how the Strategy Review has been conducted and make some comments on the feedback that has been received from our consultations;
- we use this framework to evaluate progress to date on the provision of the universal service, on introducing competition into the mail market and on its benefits for customers; we then put forward our thoughts about likely trends going forward;
- we set the context for presenting our emerging themes by assessing what we believe are the critical external success factors for achieving Postcomm's objectives as determined by our statutory duties; and
- finally we set out our emerging thoughts about changes that could be made to our regulatory policies to reflect appropriately future trends, to secure a universal service that meets the needs of postal users having regard to the costs of its provision, and to provide greater incentives to investment and innovation in the mail market. Such changes will, we believe, increase the probability that Postcomm can achieve its objectives.

In presenting these emerging themes, we set out the key questions on which we are seeking further feedback from stakeholders before we make any policy decisions.

There are three annexes to this document.

The first – **Annex 1** – looks at changes to the UK mail market (and related markets) over recent years and our expectation for how the mail market will develop over the next five years.

Annex 2 looks at how the mail market has developed in some other major countries and identifies some policy options that might be transferable to the UK market.

Annex 3 provides a summary of the responses to Postcomm's consultation document issued at the start of this Strategy Review as well as the feedback that has been received from meetings and road shows that we have hosted in the intervening period.

While we appreciate that the future structure of the Post Office network will be very important to postal users, we are not focusing on this issue as part of the Strategy Review because Postcomm has no direct regulatory locus over the counters network but has the function of advising the Secretary of State. We are, however, currently undertaking research looking at access to postal services which will be published in the autumn. This work will help inform the advice we give to Government on the long term future of access to postal services through the Post Office network.

B. Summary of Emerging Themes

The major emerging theme from our review is that the mail market is changing, as are the wider communications and distribution markets. In response to these changes we believe that the following policy initiatives could be desirable to ensure that we achieve our objectives over the medium to long term. These policy areas, which are discussed in some depth in this paper, are:

The universal service obligation and costs of providing it

1. Given the significant changes that are taking place in the mail market, careful and close consideration needs to be given to the products that are considered universal services. Royal Mail has asked that the present range, which includes some bulk mail products and products used by the public, such as stamps, is limited to only stamps. We are attracted to the principle of giving Royal Mail more commercial flexibility in devising products for the largest mailers. Removing the remaining bulk mail products from the universal service would facilitate this outcome. However, we believe that to manage some potential risks, a phased approach might be an attractive way forward.
2. It is clear that with the advent of many alternative means of communication, the needs of postal users are changing. Consistent with the European Directive's requirement, the universal service should evolve in the light of changing social, economic and technological conditions. We are keen to facilitate a debate about how the universal service should change, in terms of its product coverage and service specification, in the medium to long term. We need to ensure the service remains aligned with changing customer needs and the economic costs of providing it. We will not be proposing any changes without extensive public debate nor will we take initiatives that could threaten the long term health of the mail market.
3. We also have a firm belief, and can point to significant evidence from international comparisons, that competition and a strong internally-financed universal service can co-exist. Indeed, the early experience in the UK is that competition has strengthened the universal service. What is needed urgently is for Royal Mail to place a far greater focus on efficiency and customers accepting the need to pay a fair price for

postal services. We do not consider external financing is needed; this could potentially lead to serious distortions and perverse incentives on Royal Mail's efficiency. However, if it were required or desirable at some point in the future, we believe that it should be based on competitive bidding for the funding to ensure all operators have an opportunity to provide services valued by customers at the most economical cost.

Further steps to promote effective competition

4. We continue to be committed to promoting effective competition in the UK mail market. This is not just because of our statutory duty in relation to consumers and competition. It is also because evidence increasingly supports our contention that competition is absolutely critical to stimulating innovation and better service quality.
5. In promoting competition we have to be sure that we are removing barriers to entry and market distortions and not 'tilting the playing field' in favour of either new entrants or the incumbent. Measures that we believe have merit include making sure that Royal Mail's costs are more transparent and that certain Royal Mail activities that competitors rely on are appropriately 'ring-fenced' from other Royal Mail functions in order to prevent possible anti-competitive behaviour. Ensuring the VAT regime does not continue to unfairly favour Royal Mail is another necessary step towards achieving a genuine 'level playing field'. We also consider there should be a revised licensing framework making it easier for smaller scale and local entrepreneurs to enter the market.

Encouraging a more efficient and innovative Royal Mail

6. Competition in the mail market is benefitting customers but Royal Mail is not responding either as effectively or as quickly as we would have expected to the challenge of competition and changes in the market. Given Royal Mail's current levels of efficiency, long term success requires major initiatives to reduce its cost base and make it more flexible to changing market conditions. Over time, more radical transformation may need to be considered. For example, some other national incumbents have achieved a step change in efficiency and flexibility through such initiatives as a greater amount of contracting out or franchising parts of their operations to third parties. International experience with these policy initiatives has been broadly positive.
7. We also want to consider the alternative ownership and governance structures that have been adopted in some other government-owned and non-privatised regulatory sectors and whether these offer useful insights for the mail industry and its regulation.

Creating the right conditions to enable a further withdrawal of sector specific regulation

8. We have considered carefully whether there are aspects of the current Royal Mail price and service quality control that are restricting Royal Mail's ability to react to competition. Our response to its deteriorating financial situation was published recently (the "Interim Review") and we are proposing to give Royal Mail extra flexibility to align some of its retail prices more closely with costs. We believe that the remaining controls are no more restrictive than Royal Mail's dominance would warrant and that they do not stifle Royal Mail's ability to innovate, which is a vital ingredient to its long term success.
9. This position will change over time if competition can be relied upon to protect the interests of customers. The scope of regulation should therefore be reviewed, with the aim of it reducing over time. In addition, we need to be conscious of potential instances where continued regulation may actually impede or distort the development of competition. Accordingly, there are grounds to believe that we should be in a position to reduce the scope of Royal Mail's price and service quality controls when the present arrangements are intended to expire in April 2010.

Some of these themes – in particular those related to deregulation and the promotion of competition – will be taken forward in our first consultation for the next price control for Royal Mail, due to be published in the first half of 2008. However, we will be initiating discussions immediately with Royal Mail on the issues that we have identified as important factors, such as ring-fencing and greater cost transparency, that we would take into account in endorsing further deregulation. Other policy proposals, on which we believe there needs to be a substantial amount of further work and much public debate, are likely to be taken forward through a separate consultation document later in 2008. Our emerging themes about the universal service fall within this category.

Some of the emerging themes set out in this paper are well developed but others are less so. As would be expected from a review of such complexity and broad scope there are some issues where we need to keep a more open mind at this stage. On these issues, in particular, we would welcome further discussion and information from stakeholders before we articulate a clear way forward. Your responses to the specific questions at the end of this document will help us to achieve this outcome.

Most of the responses to our initial consultation – and those from Royal Mail and its competitors in particular – have been focused almost exclusively on how to secure a bigger slice of the current "mail cake". We want to hear more from stakeholders on the measures that they believe might be taken to increase the value of mail as a communications medium. Competition should have the effect of growing or sustaining the "mail cake" at the expense of other media and distribution methods. It should also encourage mail

operators to participate fully in any new markets that develop from media convergence.

We would like feedback on this document by 26 November 2007 to assist us in developing specific policy proposals.

C. Nature of responses to our Strategy Review

This Strategy Review has been informed by a consultation with all key stakeholders, by a substantial number of bilateral meetings and some targeted research projects. We have taken into careful consideration all the points made, which have helped inform our emerging themes. The key points made by each respondent to our consultation are summarised in Annex 3. Non-confidential responses are published on our website. We want to thank respondents for committing the time to engage with us on this important review.

Royal Mail expressed the view that the current regulatory framework is too restrictive and prevents it from responding commercially to some of the pressure building up against the company. It has asked that regulation be targeted more specifically on the services used by the public and removed from all business mail. It also said it wanted more flexibility to raise stamp prices to allow it cover their full costs. However, Royal Mail's competitors questioned whether our current regulatory tools were sufficient given that Royal Mail is focusing hard on retaining every item of mail and in doing so enjoys considerable advantages from its scale economies in local delivery and the unique privilege of an exemption from applying VAT to its prices. Postwatch and most representatives of business mailers were not supportive of the Royal Mail stance but to a large extent the CWU endorsed it.

As a general observation many responses focused largely on the short term tactical policy initiatives that respondents thought Postcomm ought to be taking. There was less consideration of how the market and regulation ought to evolve post 2010, which was a key focus of this review.

We can understand some stakeholders' concerns about short term issues. Competitors are concerned because competition is in its infancy. Royal Mail is concerned because of its weakening financial position and a recent decline in mail volumes. Some customers are concerned about the limited alternatives to using Royal Mail.

Where the feedback we have received is about the impact of regulation, we are responding quickly through several initiatives. For example, we have recently announced our proposals on requests by Royal Mail for a change to the constraints on its pricing flexibility, on its application to introduce zonal pricing for retail non-universal business mailers, and on its request to suspend financial incentives and customer compensation arrangements in the event that service quality is impacted adversely by industrial action. We have also

responded to a request by Royal Mail, TNT Post and UK Mail for changes to access margins.

We can, therefore, assure stakeholders that Postcomm is looking at both the short term and the longer term issues and is seeking to ensure that one does not prejudice, or detract from, the other. Given the nature of the responses to our first consultation, we hope that the emerging themes set out in this paper will trigger another round of feedback from stakeholders before we decide on long term policy proposals.

D. The impact of competition so far

Postcomm fully liberalised the UK mail market in January 2006, based on the evidence and careful judgement that competition is the best way to ensure that an affordable universal service is delivered and that customers' interests are served. We remain committed to this view. Having conducted a large number of meetings with mail users, and after the completion of our third annual Competitive Market Review (published in November 2006) we can present very clear evidence to the effect that:

Customers have benefitted from the introduction of competition.

- I. Large customers have benefitted directly from our earlier decisions to open the market to competition: new entrants have offered them different services and keener prices. Nearly all the volume captured by new entrants is under access arrangements whereby they hand mail over to Royal Mail for final delivery. Some customers that have not switched supplier have exercised their choice by using Royal Mail's products more effectively, having decided what is best for them.
- II. Small and medium sized businesses are now starting to gain some choice because the new entrants are investing in mail sorting equipment so that they can service customers who post smaller quantities of unsorted mail.
- III. All customers, including social users, have benefitted indirectly because the threat of competition (and regulatory incentives) has spurred Royal Mail to raise its game on quality of service to record levels. This has improved the quality of service of both universal and non-universal products. Royal Mail and its workforce are to be commended for achieving reliability figures that only a few years ago many people thought were impossible.
- IV. We do recognise, however, that in its search for greater commercial focus and efficiency, Royal Mail has made some changes to services that not all of its customers have appreciated (though not specifically part of its universal service obligation). Examples are the move to single daily delivery and some instances of earlier collection and later delivery times.

- V. Although competition has delivered benefits for all customers, we believe more innovation is needed if mail is to continue to be seen as an attractive communications and delivery medium. Also, we note that there is, as yet, no choice of mail supplier for some categories of business customers or for social users. Nor is there any indication that this will change for the better in the foreseeable future unless further measures are taken to facilitate competition.

The universal service remains strong.

- VI. The universal service continues to be internally financed and is earning a modest profit for Royal Mail¹. However, as identified later in this paper, the health of the mail market (in terms of mail volumes) and Royal Mail's financial performance are two key factors that are on a worsening trend and we need to continue to monitor developments very closely.
- VII. There are fewer exceptions to the 'one price goes anywhere' universal service. Before the introduction of Postcomm's delivery exceptions policy on 1 April 2003, there were 4,323 excepted addresses across the UK: this figure had fallen to 2,761 by 2006.
- VIII. Under access competition, more than 70% of the total mailing revenue is still retained by Royal Mail and there is no associated reduction in the volumes that it carries over the final mile. It is in final delivery where Royal Mail says that its fixed costs are highest and where a significant reduction in mail volumes would most challenge the business.
- IX. Royal Mail's regulatory price control contains a number of mechanisms to provide assurance for the financing of the universal service (e.g. Royal Mail's allowed revenues are adjusted if delivered mail volumes are lower than expected when the price control was set).

However, nearly four years since the business mail market was liberalised, Royal Mail still retains a *de facto* monopoly over the final mile.

- X. Royal Mail has been challenged by the rapid growth of upstream competition. Currently nearly one in five items is being collected from customers by a rival operator and handed over to Royal Mail for delivery over the final mile ("access competition")². However, this rapid rate of growth in access volumes now appears to be slowing.

¹ Operating profit (before exceptional items) is £27m, Royal Mail's Regulatory Financial Statement (2006/07).

² Based on access volumes of 344m items in July 2007.

- XI. Less than 1% of addressed mail volumes are currently delivered end-to-end by rival operators³. The volume of mail delivered end-to-end by competitors to Royal Mail in 2006/07 was 10% down compared with the previous year and one operator (Express – a mail operator using its milk doorstep delivery business model) has exited the market. We do not expect Royal Mail's dominance over the final mile to reduce materially over the medium term because it is proving very hard for new operators to compete against Royal Mail's scale economies, the sunk costs of its existing network, and its unique privilege of VAT exemption. Also, there is little scope in the UK to create a rival network for addressed mail around an existing system of frequent delivery of another product to the majority of addresses (as has been done successfully in Germany where most newspapers are sold by subscription and delivered daily to their readers). In the UK unaddressed mail networks are not being leveraged to deliver addressed mail.

Emerging Theme: Liberalisation has made a promising start. It has delivered significant benefits to postal users through choice, better value for money and far better service reliability from Royal Mail. There is no evidence it has thus far undermined the universal service. However, Royal Mail retains a de facto monopoly over the final mile, many customers still have no choice of supplier and the industry is challenged because mail volumes have now started to decline. To sustain a vibrant industry all operators, including Royal Mail, will need to do more to offer postal users innovative, cost efficient and reliable postal services. Regulatory policy should facilitate these outcomes.

E. The future: what contributes to a successful outcome?

At first glance it is easy to point to factors that would suggest that Postcomm's regulatory policies are achieving their objectives.

Competition is providing benefits for customers, mail prices are low by European standards (though this can be a deterrent to some new entrants) and Royal Mail's quality of service is at a record high. The universal service remains profitable and exceptions from it are very few in number.

However, our Strategy Review has a forward looking focus and it must assess the likely impact of changes over the next few years in terms of what customers will need from mail providers and of changes to the mail market itself. Only by understanding how these external environmental factors might impact on the development of the mail market and by assessing the

³ Postcomm is working with Royal Mail and other licensed operators on a definition of mail volume market shares. This is a complex matter, for example Royal Mail argues that self-delivered mail (such as local authority items) should be included in these figures. To date Postcomm's market share figures exclude document exchange mail. There is also difficulty with the treatment of parcels, most of which fell outside Royal Mail's historic monopoly.

challenges and opportunities that these present can we determine how regulation should evolve.

Our vision statement sets out what we are aiming to achieve in the discharge of our statutory duties and it is:

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

After evaluation of the feedback from our first consultation, we have identified what we believe to be the critical external success factors that will be most influential in determining whether or not Postcomm’s vision is realised. These are:

1. A **healthy and innovative mail market** that provides a universal service and meets the needs of users. We consider that this is more likely to be achieved through the progressive introduction of competition in mail rather than by perpetuating Royal Mail’s near monopoly of the letters market.
2. A prompt and **successful transformation of the Royal Mail business**. It needs to be efficient, innovative and responsive to customers, thereby positioning the company better to succeed in the future and to support its current role as the universal service provider.
3. **A willingness on the part of mail users** – both senders and recipients – **to accept** that, as markets evolve, **some changes** may be required to what they have come to expect from the mail service. Although some change will be necessary over time, Postcomm must ensure that postal users, including vulnerable users, continue to benefit from an affordable universal service and that changes are not detrimental to the future health of the mail industry.

Clearly success in these areas depends mainly on the decisions and activities of participants in the market and postal users. However, the regulatory framework can potentially have an impact – for better or worse – on market participants. We also recognise there is considerable uncertainty over the degree and speed with which each of the three critical external success factors can be realised. For these reasons we are keen to continue discussions with all stakeholders to ensure our future policies are as soundly based as possible.

1. A healthy and innovative mail market

The UK postal market is changing and this has implications for all players.

We believe that a healthy and innovative mail market will ensure a strong and affordable universal service. Most respondents to our consultation expect mail to remain a vital communications and distribution channel for commerce, government and the public. Nevertheless, they expect the market to evolve in a way which poses more new opportunities, and also greater challenges, than has been the case in recent years. As the postal market develops we must be alert as to how this may impact on Postcomm's ability to discharge its statutory duties.

Future volume trends

For a long period of time UK mail volume growth tracked very closely the rate of economic growth. This linkage became weaker from 2001 onwards but unlike in some other European countries, mail volumes in the UK continued to grow.

However, over the past 18 months mail volumes have declined. Through our engagement with stakeholders, and monitoring of volume data relating to mail we anticipate that there is a potential spectrum of outcomes in the UK mail market of growth or decline ranging from +1% to -3% per year over the next few years. Predicting mail volumes accurately at this time is more challenging than in the past, when mail volume change mirrored the growth of the economy. The behaviour of mail operators, particularly Royal Mail, can make a considerable difference to where the actual outcome is within this range.

The key trends identified by our customer research over the last 12 to 18 months are:

- people are shifting mail volumes from standard overnight tariffs (e.g. first class) to lower priority tariffs (e.g. second class), suggesting that alternative media such as email could be increasingly being used for some urgent communications;
- the volumes of fulfilment mail⁴ are significantly increasing as the rapid growth in online shopping and ordering fuels growth;
- as a complement to, or substitute for, direct mail, some large users are choosing magazine, radio, television and, increasingly, internet advertising to promote their products and services. In terms of advertising and product promotion – which accounts for around 25% of mail volumes – mail must show its value compared with all

⁴ Fulfilment mail is the delivery of requested goods, including tickets and brochures. This traffic is a combination of volume in the licensed area and parcel and express traffic which falls outside the licensed area.

these other media, most of which have become more price competitive compared with mail in recent years; and

- business customers, who account for over 90% of the mail industry's income, are increasingly requiring mail operators to add value to each item of mail. They are using mail in a more focused way and appear to be growing more resistant to absorbing price rises and to unresponsive customer service and account management.

These developments can be portrayed by a "life cycle" concept for the different types of mail services. Figure 1, below, shows that while the demand for some forms of mail is reducing – and seems likely to continue to reduce over time (e.g. transactional mail⁵) – the demand for other forms of mail is growing (e.g. fulfilment). The numbers on Figure 1 represent Postcomm's current estimate of how the volumes of each type of mail have recently been changing on a yearly basis.

There is clearly a lot of uncertainty surrounding any prediction of mail volumes. Most industry players believe that direct mail volumes fell in 2006/07 compared with the previous year. However, combining Royal Mail's retail bulk mail volumes with access volumes gives an increase of 5.1%⁶ compared to 2005/06⁷. This 5.1% growth figure could be driven by either direct mail or fulfilment mail. Postcomm believes that there may still be opportunities for direct mail volume growth in the future.

What happens to volumes is impacted very considerably by the pricing and other commercial policies of the mail operators, particularly Royal Mail. A pattern of flat to modest decline in mail volumes is, however, reflective of the situation in several international comparators.

An exogenous threat of a sharp decline in mail volumes could arise if there becomes a significant environmental concern over direct mail that leads to the Government requiring an "opt-in" to receiving it, as opposed to electing to opt out, as currently offered under the Mail Preference Service.

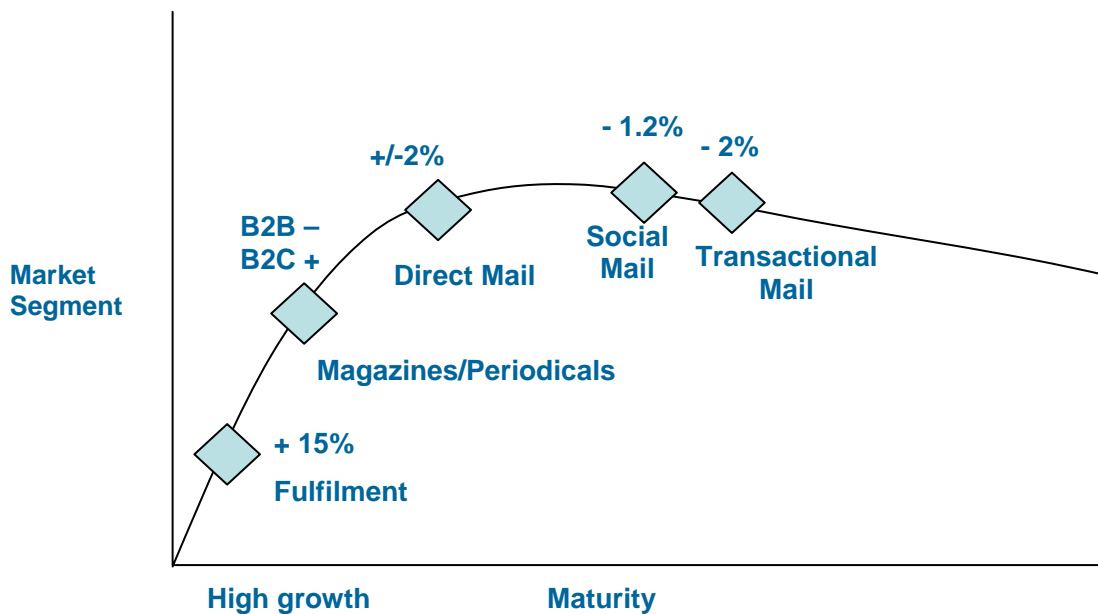
Volumes could also be significantly affected if large users lose confidence in mail as an effective and reliable medium owing to sustained industrial action causing serious interruptions in service.

⁵ Transactional mail tends to be regular, scheduled mail such as bank statements or credit card bills.

⁶ Table 4, p.34 of "Review of Royal Mail's pricing flexibility and the level of access headroom (the 'Interim Review' of the Price Control – Postcomm's Proposals", August 2007.

⁷ Access and Royal Mail's retail bulk mail volumes combined should represent a reasonable basis for year-on-year comparison.

Figure 1: Indicative stages of the life-cycle for different mail services



Impact of other communications media

Going forward, some mail streams are likely to compete increasingly, at least indirectly, with other communications media in a sector where new technologies are bringing about rapid change. The mail market is still a distinct and identifiable market, but in some segments mail will only hold its own against other communications media in the future if it adds value for the customer, whether that be for the sender or the recipient.

This added value might come – from the perspective of the recipient – from the personal nature of mail which is why, for example, people continue to prefer to send very personal correspondence by post (e.g. greetings cards) rather than email and e-cards. From the perspective of business senders, mail will be favoured versus other media if it provides a better return on their investment than can be achieved through communicating with their customers and promoting products in other ways.

For example, a company using direct mail will probably use sophisticated tools to measure the cost per 1,000 responses of each major campaign compared with what they achieve from advertising in business magazines or using internet advertising. Operators can assist customers in maximising the benefits from direct mail compared with other media by providing added value to the service in innovative ways. This has been achieved in Australia through providing mailing list information to customers that can be used to improve the targeting and success of advertising mail. In the Netherlands, Sandd (a competing operator to TNT Post) will print and sort mail for customers as well as delivering it.

Mail operators also need to think innovatively about how they grasp the opportunities posed by the rapid growth in internet shopping and online

commerce. Many customers are familiar with multi-media and expect suppliers to have a joined up approach by integrating physical mail with other media such as press or TV. For example, in the USA there is already evidence that direct mail is a valuable tool for advertisers in driving people to visit their websites.

Capitalising on the unique attributes of mail

The competition from other media should be seen in a positive light because mail has features which can make it increasingly valuable compared to those other media in an online world. All mail operators need to focus their innovation in ways that capitalise on these attributes. Competition need not have negative effects if it exploits the inherent advantages of mail:

- it is personal and can be personalised, and this is valued;
- it can be carefully targeted to customers using good quality mailing lists; and
- it is a reliable and hand delivered service which can reach each of the 27 million addresses in the UK on a daily basis, which is increasingly valued when interaction is increasingly through the screen or the telephone.

We anticipate that mail services will evolve as the needs of users change in response to new technologies. Further changes in the scope of mail services will be required in the future if mail is to retain or build on its success so far, in what is fast becoming an online world. There are examples of other European mail operators adding to their product ranges to take advantage of the e-opportunities and to counter declining demand for their traditional mail products. However, despite the UK's leading position in terms of both broadband penetration and internet advertising we are not yet witnessing similar initiatives in the UK mail market.

Ensuring a healthy mail market may require changes to traditional operating practices

In addition to product innovation we are also seeing, outside the UK, some significant changes in mail operations to improve national operators' efficiency and to take advantage of the services available from third parties. Such changes have kept down the cost of mail and can thereby stimulate market growth.

In Germany, the national operator has contracted out its upstream trunking operations and much of its rural collections and has achieved significant cost savings. In the USA, the US Postal Service (USPS) still retains a monopoly on the delivery end of the mail pipeline but the upstream part of the market is liberalised. This has resulted in the development of significant upstream competition (through 'workshare'). But instead of fighting this competition USPS has taken advantage of the lower cost upstream operators to increase the overall efficiency of its operations and to hold down mail prices, which has helped stimulate a growing mail market.

Other examples are in New Zealand and Australia where both of the national operators have outsourced delivery in rural areas to owner/driver workers, who are also able to deliver other products, and in New Zealand mail for other operators (although not at a higher service quality specification).

The lesson from these markets is that rather than fighting partial or full liberalisation, the incumbent operators have looked for ways of using new entrepreneurial activity to become more efficient and improve the attractiveness of mail as a medium of communication.

Structural changes in the European Postal Market

The changes to the market described above are pertinent not just to the UK but also to most industrialised economies, including those in Europe. They have occurred against the background of moves at the European level to liberalise all postal markets. Although some countries seem inclined to use the maximum time under the European Directive (currently likely to be 2011), others like the UK and Sweden have already fully liberalised their postal markets and Germany and the Netherlands have committed to do so next year.

To position themselves most strongly to face the threats and opportunities from the evolving communications and distribution markets, the most efficient and forward looking operators are looking at 'mail markets' on a pan-European and regional basis, across their national borders. Competition and consolidation has been a key feature in many other liberalised markets such as telecoms, gas and electricity. Although the mail sector is liberalising somewhat later, many believe it can be expected to follow the same trend.

We have also seen some European countries taking the decision either to privatise (Germany and the Netherlands) or to allow minority equity ownership of their national operators (Denmark and Belgium). Where this has happened, the results suggest that forms of non-government ownership structures are better at facilitating transformation and a more agile business model.

We would expect Royal Mail and its shareholder to monitor developments in comparable markets to see if there are lessons for how best to secure the long term health of the UK mail market.

Emerging Theme: For there to be a healthy and sustainable mail market in the long term, mail will need to be competitively priced, to add value to customers and to complement or compete with the wider communications and distribution choices. A lot is being said about the challenges from digital communication but the fact is that mail has some important characteristics, such as personalisation and hand delivery, which valuably differentiates it from other media. With a growing economy, there is no reason why we should resign ourselves to the prospect of a contracting mail market if operators focus on how their

products can add value for users. Therefore, the pace of innovation by operators, especially Royal Mail, is critical to the future of mail.

Implications for regulation:

1. Postcomm needs to be even more alert in evaluating the regulatory framework to ensure that it encourages competition and innovation. It must not unnecessarily constrain operators in responding to the changes that occur now and in the future. This will be the best way of ensuring that regulation supports – as far as it can – the development of a mail market that is attractive to investment, stimulates entrepreneurial activity and is responsive to the needs of customers.

2. The needs of customers are changing. Whilst up to now customers have sought regulation that protects them from price rises, they are now also starting to place a greater priority on more choice and innovation. This might call for an easing of the regulatory restrictions on some parts of Royal Mail's product range. This would allow greater flexibility to meet the needs of customers and also provide greater scope for competition if Royal Mail does not step up to the mark. However, we will need to continue to carefully protect the interests of captive customers.

2. A successful transformation of Royal Mail

The need is urgent

Postcomm has a duty in relation to ensuring the provision of an affordable universal service. At present only Royal Mail has the infrastructure to provide this, as it delivers 99.8% of all addressed letter mail.

After a long period of under-investment, Royal Mail needs to modernise its business to improve its cost efficiency. It now has a £900m credit line from its shareholder, on commercial terms, to enable it to finance its transformation plan. The focus on achieving efficient and sustainable business practices should extend to all elements of costs, including the very significant burden arising from its pension deficit and costly defined benefit pension scheme. Also, if Royal Mail is to adapt successfully to a changing mail industry and to take advantage of the developments in the wider communications and distribution markets, it will need to transform its business across a much wider front. Postcomm should provide a regulatory environment that does not restrict either the scope or pace of such a transformation.

In addition to the protection of the universal service, Postcomm has other duties, the two principal ones being in relation to furthering the interests of postal users wherever appropriate through promoting competition, and to promoting efficiency on the part of postal operators. Therefore, Postcomm sets incentives in a way that is meant to challenge Royal Mail to raise its

game. We monitor its progress according to a number of measures, the most important of which are set out below.

Good progress on service quality and value for money

As stated earlier, we fully commend Royal Mail for the significant improvements in its service quality. For example, first class performance improved from 90.1% in 2003/04 to 94.0% in 2006/07. In 2003/04 Royal Mail failed all its quality targets but in 2006/7 it achieved all but one of its 12 targets (and the 12th was missed by only a small margin). Complaints from the public are down and trust in the service is very high.

Also, compared to international benchmarks, UK postal prices are fairly inexpensive. Nevertheless, the urgent challenge for Royal Mail is to position itself for the changes we have identified in the market which must mean transforming its business. A decline in mail volumes will be arrested only by product innovation and greater efficiency.

Efficiency improvements have not translated into lower costs

In late 2003, Royal Mail implemented some extensive efficiency initiatives as part of a three year programme called the Renewal Plan. The changes included eliminating the second daily delivery, simplifying the upstream transport network and alterations to working practices in Mail Centres. In total, staffing levels were cut by 27,000.

As a result of the Renewal Plan Royal Mail reduced real operating costs per unit by 3% over the period. However, adjusting for the impact of growing mail volumes at that time, these savings were not as significant as might have been expected. The cost savings anticipated from eliminating the second daily delivery to every home and from making the first delivery before 2pm (compared to by 9.30am in urban areas) were more than absorbed by above inflation increases in wages and other employment costs.

Since the Renewal Plan was completed, Royal Mail has continued to seek improvements in labour productivity. However, this has not translated into significantly lower per unit operating costs because of higher wage rates and a substantial increase in the cost of employer contributions to its defined benefit pension scheme. From 2006/07 onwards Royal Mail's has had to pay extra contributions to recover the substantial deficit in its pension fund. The volatility of Royal Mail's pension fund deficit, due to its sensitivity to life expectancy, long term interest rates and bond and equity markets, makes this even more challenging for the company.

The pace of radical transformation has thus far been slow

With this in mind, we have some significant reservations about the effectiveness of Royal Mail's response to date to the challenges it faces:

(i) In May 2006 Postcomm agreed with Royal Mail a price control through to April 2010 to support mechanisation and modernisation of its business. The start of the modernisation programme has been delayed by at least eighteen months. Royal Mail's shareholder proposed the necessary financing package in May 2006 but it was not agreed by the company until February 2007. In the interim most of the important aspects of the transformation programme were put on hold. Since February 2007 negotiations with the unions have further delayed the ordering of machinery to automate and modernise its mail handling. The roll-out of much of this equipment is, therefore, still at least a year away and the installation programme now extends to 2012. As a result we have not seen the efficiencies in the business that we anticipated as part of the price control. We estimate that Royal Mail's unit costs⁸ have reduced by around 1.9% in 2006/07 as compared to the 3% target in the price control.

(ii) Royal Mail's commercial strategy has not evolved to the extent necessary to enable it to address, and potentially benefit from, the challenges and opportunities of a changing market. There have been few changes in its product portfolio since 2003, with Royal Mail launching only a relatively small number of new products to meet the changing needs of customers. Many of the other large international operators have been far more proactive in addressing the threats and opportunities of e-business, especially in the growing fulfilment and unaddressed markets. In the unregulated markets of unaddressed mail and delivery of Internet shopping packets, which have both shown strong growth, Royal Mail has lost share over the past year.

(iii) To date, Royal Mail's reaction to the threat of competition has been principally to alter prices and pricing structures (generally increasing prices where there is no competition from other mail operators and reducing them where it is starting to develop) rather than significantly reducing its costs and inefficiencies. Pricing changes may be necessary but they cannot be a substitute for Royal Mail tackling its cost base and must be done in a manner that is sensitive to customers' ability to pay and their concerns about complex changes and pricing uncertainty.

(iv) Royal Mail believes that its wage rates are 25% higher than the competition but its productivity is 40% lower, largely because of the lack of investment in automation. It says that its costs are only flexible to volume changes after a long time lag, and even then the majority

⁸ Adjusted for the effects of lower total volumes and increased volumes of access mail.

(said to be 60%) of its costs remain fixed. Royal Mail is taking some steps to address its high costs. For example, it announced in February 2007 an intention to consult about closing its final salary pension scheme to new entrants and making changes that will reduce the cost of servicing the current scheme, to take effect from April 2008. It is also resisting calls for above inflation pay rises.

Emerging Theme: Although some progress has been made, Royal Mail is still a long way from achieving its own vision of becoming a modern and efficient operator. We are encouraged by the recent proposals for transformation but the serious delays that have already occurred mean there is now little contingency against any further problems in implementation of the transformation programme.

Implications for regulation:

1. The success of Royal Mail's transformation is in its own hands and those of its shareholder. The role of regulation should be to support Royal Mail's transformation in so far as it furthers the regulator's statutory duties, especially if Royal Mail can deliver enduring customer and efficiency benefits without anti-competitive consequences.
2. If Royal Mail's pension obligation has to be financed through higher regulated prices, we need to consider the likely adverse impact this will have on Royal Mail's competitive situation and the positioning of mail in relation to alternative forms of media.
3. In those parts of the market where competition offers insufficient protection for customers, some continuing price and service regulation will be required. When setting these price limits, we will need to monitor and understand how effective Royal Mail is at becoming more efficient. To the extent that is compatible with our statutory duties, we will ensure that customers are not forced to pay unduly high prices as a result of inefficient practices.
4. Postcomm's approach to incentivising Royal Mail to become more efficient has been through price cap regulation, which is based on the traditional "RPI-X" framework. However, Royal Mail is not a typical regulated company, not least because it is government owned and has a labour intensive, not capital intensive, network. Therefore there is doubt as to whether Royal Mail has the same strong incentives to meet, let alone outperform, the cost projections underlying its price control that privatised and publicly quoted companies do.
5. To inform the next price control and our regulatory policy generally, we will explore whether there are other regulatory initiatives better placed to incentivise the necessary transformation of the business. We also plan to evaluate the potential scope for efficiency and flexibility gains that might be realised by alternative models, such as contracting out or tendering parts of the Royal Mail network.

6. Postcomm is not the only regulator seeking to establish effective, incentive based regulation for a publicly owned or non-privatised company. Other examples include the Water Commission for Scotland (in the case of Scottish Water), Ofwat (Glas Cymru), CAA (National Air Traffic Service) and ORR (with Network Rail). In some of these instances alternative ownership and governance structures – such as mutuals, cooperatives and companies limited by guarantee – have been adopted.

7. We will be looking closely, before we decide the shape of the next price control, at these precedents to see whether there are lessons that can be drawn for the governance and regulation of Royal Mail. In particular we will consider the impact of these alternative structures on securing greater efficiency, better customer focus and a more secure platform for the long term provision of a universal service.

3. Willingness of users to accept change

The last of our critical success factors is a willingness on the part of mail users – both senders and recipients – to accept that some changes may be required to what they have come to expect from the mail service.

It is important to bear in mind that social users of postal services post fewer than 1 in 10 letters. The average spend on postal services per household is about 50 pence per week. Postcomm's market research indicates that postage is affordable, including among vulnerable groups. Although these social users do not contribute a significant amount directly to Royal Mail's and other operators' income, they are the recipients of most of the mail (about 70%). Social users, therefore, value certain aspects of the mail service as recipients but they do not directly pay for them.

We believe that if there is proper consultation with mail users and any changes are implemented smoothly, users will accept necessary changes provided their core needs are met. This was demonstrated by the introduction of single daily delivery in 2004 when Royal Mail took the lead in communicating the imperative for change and the steps that users could take to minimise its impact. We believe that Royal Mail also put in place an effective communication plan for the introduction of Pricing in Proportion.

However, while there appears to be some acceptance of the need for change we must be aware of the impact of any changes which could be perceived as a significant reduction in the value of mail. For example the market research conducted jointly by Postcomm, Postwatch and Royal Mail last year showed that while there is high customer satisfaction for postal services as currently provided there was some reluctance to accept significant change. We also recognise the risk that too many significant changes, which customers regard as a serious degradation of service, could potentially accelerate any move away from mail to other media. However, social senders of mail were much less concerned about price than business mailers.

Emerging Theme: Changes to the specification of the mail services that affect the public have a high profile and need to be handled very carefully and only after full consultation with affected parties. But when the case for change is carefully explained to mail users it may be acceptable to them.

Implications for regulation:

1. We should continue our market research on postal users' needs and the cost of universal service provision in order to ensure we have solid evidence on both demand and supply factors.
2. Subject to ensuring that the universal service is maintained, further carefully managed and communicated changes to uneconomic services may be required, especially if the public's use of mail continues to decline over the longer term. Mail services will need to adapt to retain their competitiveness with other communications and distribution media.

F. Our emerging thoughts on key regulatory issues

1. Future scope of the universal service – further debate and research required

Ensuring the provision of a universal service that meets the needs of postal users, especially vulnerable users, in terms of its nature and quality, is a key element of our strategy because it is central to our statutory duties.

The minimum requirements for the universal service are set out in the Postal Services Act (the "Act"), which in turn, reflects the provisions of the European Postal Service Directive ("the Directive")⁹. While the basic requirements of the universal service are set through the Directive and the Act, certain elements of the universal service, such as its product range, are determined by Postcomm and given effect through Royal Mail's licence. The Directive requires one collection from appropriate access points, one delivery to all addresses every working day in respect of postal items up to 2kgs and packages up to 10kgs, plus a service for registered and insured items. The Act (but not the Directive) further requires geographic price uniformity and requires the delivery of postal packets up to 20kgs.

The universal service was first defined in the UK in 1999 when the Directive was originally implemented. Postcomm subsequently determined the range of Royal Mail products to be provided as universal services. Essentially this

⁹ Directive 97/67/EC (as amended by Directive 2002/39/EC). The Directive is currently being reviewed with the aim of any amendments to it being given effect in individual Member States in or after January 2009. Postcomm does not, at this stage, envisage fundamental changes to the minimum requirements of the universal service to be made in the Directive.

reflected the set of products that Royal Mail then offered at a geographically uniform price. The products provided as universal services were subject to two subsequent reviews by Postcomm in 2004 and 2005. These reviews enabled Postcomm to determine what generic and specific services should be included in the USO and to conclude that certain business mail products could be removed. However, the current product range is still in excess of the minimum requirements set by the Directive and the Act.

Our market research shows that the universal service is valued by postal users and that customers believe the price of stamps is well within the bounds of affordability. However, postal services, including universal postal services, are being used overall to a lesser extent. Analysis of Royal Mail's price elasticities would suggest that further price increases could result in customers reducing their usage of universal services still further.

Therein lies a predicament: should the universal service be maintained at its current broad product scope, especially if it were to become more expensive and then be used less (because even if it remains affordable customers may be unwilling to pay higher prices for it); or should we, in a controlled and careful fashion, change its scope to increase its affordability and usage? The latter option would also provide more flexibility to Royal Mail to adjust its business model to new threats from alternative media and to capture increased efficiencies.

The Directive recognises that the scope and service specification of the universal service should evolve in response to the technical, economic and social environment and to the needs of users. With the emergence of email, text messaging and mobile telephony, technology has changed the economic and social environment. We must have regard to these factors and assess carefully their impact. It would not be a proper discharge of Postcomm's universal service duty to require the postal industry to provide a universal service that was over-specified by reference to users' actual needs and willingness and ability to pay, and thereby unnecessarily costly to provide.

We believe therefore that between now and 2010 it is necessary for us to decide whether – and if so how – the current scope and service specification of the universal service should in due course be changed to meet the evolving needs of postal users. In particular, we must understand better the value to users, and the cost to Royal Mail of providing, those products and service specifications which are in excess of the minimum requirements of the Act and Directive.

It would be short-sighted if, in trying to support service specifications which are out of step with customers' essential needs and their willingness and ability to pay, Royal Mail (or any other universal service provider) had to incur unnecessary costs. The consequence of so doing is that it would have to raise prices to levels at which users might move to alternatives. This in turn would reduce the level of assurance that an operator, such as Royal Mail, would be able to provide the service in the long term on an internally financed basis.

This explains why we endorse strongly the aim of the European Directive that the universal service should be reviewed and allowed to evolve in a dynamic way to reflect the effects of changes in social, technological and economic factors on the needs of users of universal postal services. Although the Act leaves to Postcomm the responsibility for determining the products to be provided as universal services, we shall take carefully into account the views of all stakeholders, including MPs, MSPs and Welsh Assembly members on the socio-economic dimension of the USO.

Our starting point in undertaking such a review of the regulatory specification of the universal service will be to have regard to:

- the future needs of postal users, particularly vulnerable users;
- the net economic burden (or benefit) of providing particular features of the universal service;
- how the service should be financed; and
- whether the service (in whole or in part) could be provided in other ways by either Royal Mail and/or other operators.

The themes which are emerging on this are complex, but key issues are as follows:

Bulk mail

A distinguishing element of the universal service in the UK at the moment is that it is a uniformly priced service: one price goes anywhere. This is a requirement of the Act, but not of the Directive. The inclusion of some bulk mail services in the universal service means that those services, presently Cleanmail and Mailsort 1400¹⁰, are required to be priced on a geographically uniform basis.

Having some bulk services priced on a geographically uniform basis constrains the approaches to the pricing of other bulk mail services offered by Royal Mail and therefore of services provided by other operators. The aim of prices being reflective of costs cannot be fully achieved if the uniform price of the universal service prevents services to areas where costs are particularly high from being priced so as to cover those costs; the reverse is true for areas that are cheaper to serve. We recognise the case for the prices of bulk services being increasingly set by market forces and cost conditions without the regulatory constraint of enforced price uniformity. For this reason, we accept that there might be advantages in bulk services not having to be offered as part of the uniformly priced universal service.

As noted earlier, Royal Mail has suggested that the universal service should be confined to stamped mail. We have reflected on the implications of such a change. Although we see merit in removing the remaining bulk mail services from the universal service in 2010 to afford Royal Mail fuller flexibility for

¹⁰ 1st and 2nd class.

larger customers, there are risks that need to be considered before this step is taken. First there is a risk that customers relying on these remaining universal bulk mail products will be adversely affected by their withdrawal. Secondly, removing bulk mail from the universal service could impact on the current manner in which access is regulated in the UK (because of features of the legislative framework).

To overcome these potential risks, a two-stage approach might be appropriate. As a first step, the uniform tariff constraint for bulk mail might be removed, thereby addressing the issue of pricing flexibility. A natural opportunity to make this change will arise when the Act is modified to give effect to Directive changes. Then consideration could be given to the services being taken out of the universal service at a later date.

Other non-stamped mail

Royal Mail is asking us to withdraw standard tariff franked and PPI mail (postage paid impression) from the universal service, so that it is confined just to standard tariff stamped mail. This poses many difficult issues beyond those described above in relation to bulk mail. It is unlikely, therefore, that we could endorse such a change in the scope of the universal service to take effect as early as April 2010. There are far fewer competitive alternatives to these products. They are used extensively by small and medium sized businesses, many of whom are very reliant on the mail service and greatly value the “one price goes anywhere” attributes of the universal service. We will, however, be undertaking further detailed market research and consultation to consider Royal Mail’s request.

Service specification

Besides reviewing the regulatory specifications of the universal service in terms of particular products, we believe it is also appropriate to consider the merit of changes in the longer term to the broader specification of the universal service.

In comparison with other European countries, the UK has a very highly specified universal service. Most other countries in Europe, for example, have only one class of stamped mail within the universal service; some have five deliveries a week rather than six; many do not require delivery of mail to the front door when it is more than a specified distance from a public road or if there are a number of separate dwellings or offices in the same building.

Part of the reason why Royal Mail’s efficiency on delivery over the final mile appears lower than in many other European countries may be because of these differences in the universal service specification. Royal Mail’s costs also may be higher because its six days per week delivery specification is misaligned with its five day working week, which it introduced in 2004.

Before proposing any changes to the universal service specification we would need to understand more clearly the cost savings to Royal Mail and the

disbenefits which would be incurred by other stakeholders. In particular we would want to establish the extent to which lower delivery costs could be reflected in mail prices and, therefore, the improved sustainability which might be associated with a different service specification.

We could then consider whether these factors are outweighed either by the detriment to some users (particularly the vulnerable) or by such a large reduction in the value experienced by mail users that any cost savings are more than countered by a lower usage of mail. Finally, we would need to examine carefully the extent to which any detriment to vulnerable groups could be mitigated. The interests of recipients as well as senders of mail must be fully considered in this analysis.

These are complex questions to which Postcomm does not yet have answers and where we do not have the necessary cost information that would help us assess the significance of changes to the service specification. We will be asking stakeholders, in particular Royal Mail, to help us identify the costs and to contribute to an evaluation of the benefits and disbenefits of any change to the universal service specification.

We are seeking to encourage a thorough debate about what should be the future scope and nature of the universal service. Should the evidence suggest that bold changes to the scope of the universal service are justified, even to the extent of reducing its scope over the longer term to the minimum required by the Directive, we will need to consider the best way and timetable to introduce the changes.

Financing the universal service

In terms of financing the universal service, our preferred outcome is that provision of an evolving universal service should be ensured by it continuing to be internally financed, through prices that cover economic costs. Furthermore, upward price pressure should be mitigated by continuous improvements in efficiency to reduce costs and ensure that the service is not over-specified.

The self-financing path that has been successfully followed in Sweden, Germany and the Netherlands where the national operators have been able to maintain a high quality universal service (albeit more restricted in scope than in the UK) despite having lost volumes to end-to-end competitors. In Germany and the Netherlands 10% and 14% respectively of end-to-end volumes have been lost by the national operator, compared to less than 1% in the UK. In Sweden, which has had a fully liberalised mail market since 1994, the national operator has been significantly challenged by an end-to-end operator – CityMail – who now serves over 40% of delivery points nationally and plans to increase coverage to 65%. However, because significant cost reductions have been made every year since Swedish Post was exposed to competition, the universal service remains of a high quality and is self financed. In all three instances the national operators regard their universal

service obligation (USO) not as an obligation but as a unique selling oppportunity when marketing their products in competition with other operators.

We consider that Royal Mail should also be able to deliver sufficient enduring cost savings to enable it to achieve a sustainable, self-financed universal service in the UK. This, coupled with postal users paying a fair price to cover the economic costs of provision (subject to requirements of affordability and geographic uniformity on some services), should enable Royal Mail and/or other operators to sustain a healthy universal service.

However, it is a source of concern that when Royal Mail has only lost less than 1% of its mail volumes to end-to-end competition, it already claims that its ability to finance the universal service is under threat. Given the high priority that we attach to achieving a healthy universal service and the doubts that Royal Mail has about its ability to achieve this outcome, we intend to explore the merits of alternative long term models for providing it.

The draft revised Directive envisages the possibility of several different financing measures for the universal service. During the Strategy Review we considered these options which include external financing mechanisms (such as subsidies and industry compensation funds) in the context of the UK market. We conclude that not only are such measures unnecessary at present, but that they could also lead to significant distortions to competition and Royal Mail's behaviour. This could restrict investment and innovation at exactly the time when more of both are required to ensure mail remains a competitive medium in the broader communications and distribution markets. This would, we believe, not be in the long term interests of mail users.

Therefore, any alternative long term safeguard must limit distortions and maximise efficiency. Options that might be considered include requiring Royal Mail to contract out, or franchise, parts of the service through a process of competitive tendering. Although Postcomm has no direct powers to implement such an arrangement, we wish to establish whether such an approach could help to ensure that the long term provision of the universal service can be provided in the most cost effective way with minimal need (or preferably no need) for subsidies. We will be examining, in relation to the tendering option, whether there could be difficulties relating to Royal Mail's inability to recover its input VAT, and issues relating to employment law, particularly if there is any transfer of staff or assets.

There are many examples internationally of how the contracting out or tendering approach has been applied successfully. In Australia and New Zealand, for example, the majority of rural collections and deliveries are contracted out to third parties. In Germany that part of the universal service relating to rural collections and most of the upstream trunking is contracted out by the national operator to third parties. Despite Royal Mail's increasing concerns about the financing of the universal service in a competitive market it has not come forward with any such suggestions.

2. Our policies for promoting effective competition

A commitment to promoting competition through a “level playing field”

We are committed to promoting effective competition in the UK market. This is part of one of our statutory duties and evidence increasingly supports our contention that competition is critical to stimulating innovation and better service quality, which are two of the key determinants of the health of the market in the longer term. This, in turn, will help underpin the universal service.

We are seeking to establish a regulatory framework that will encourage market entry, growth and innovation. However, we have to ensure that the framework acts to remove barriers and distortions in the market instead of ‘tilting the playing field’ in favour either of the incumbent or new entrants or particular business models (i.e. end-to-end versus access). In applying this regulatory framework so far we are accused by Royal Mail of over regulation and by the new operators of not giving them sufficient help to compete against what they consider to be a super dominant Royal Mail which enjoys many special privileges including VAT exemption.

Experience from other sectors suggests strongly that competition in mail will only be sustainable in the long term if it is based on genuine efficiency, innovation and customer service, rather than on favouring any particular business model at the expense of others. Any attempt to “pick winners” would allow inefficient historic practices to continue, or otherwise would lead to distortions that encourage inefficient entry in the market that is not based on value for money and innovation.

Ring-fencing and separation

In the first consultation document of the Strategy Review we sought the views of stakeholders on the possibility of further ring-fencing and separation to the organisational structure of Royal Mail. This would be a means of restricting Royal Mail’s incentive and ability to discriminate between its own upstream business and business from a rival upstream operator. It would also provide additional cost transparency and reduce the need for detailed regulation of Royal Mail’s business. The lesson from other industries is that it also provides a spur to management focus on core competencies leading to greater efficiencies.

Royal Mail’s strongly held view is that structural separation at this stage would create confusion, introduce costly and complex interfaces and jeopardise its modernisation programme. Few other respondents to our consultation were in favour of this option.

It could be argued that the “final mile” represents a natural monopoly for Royal Mail. There could, if this were the case, be a more rapid path to more effective competition and deregulation by implementing some form of separation, either between the network infrastructure and customer facing

sales and marketing functions or between the upstream and downstream activities. Evidence from structural separation in other industries has been very positive, although this may not be directly transferable into the mail industry and needs to be considered carefully.

Since ownership separation is a matter for the Government, we have decided not to pursue it as part of this Strategy Review and instead to focus on other priorities that are within our direct remit. However, we would expect these issues to be considered seriously by Royal Mail and the Government if there are discussions about the most appropriate long term business model for the company and its shareholder in the future.

Putting aside the issue of ownership separation, we believe that there could be circumstances where greater separation of Royal Mail's present activities by ring-fencing, and in accounting transparency, and possible associated changes to incentive structures, could provide significant benefits to the competitive market and to mail customers as well as to Royal Mail. It could also facilitate our ability to address Royal Mail's desire for an easing of regulation. Such changes might be facilitated by realigning incentive structures.

Ring-fencing will provide other operators with greater confidence that the terms of access to the final mile are fair in comparison with those offered to Royal Mail's own operations. In addition, we believe this would offer benefits to Royal Mail as well as to other operators. It should also help Royal Mail in responding to the fast changing market and would support its initiatives to achieve greater efficiencies.

In the coming months we will, therefore, be undertaking further work on this subject. We believe that greater ring-fencing and cost transparency of Royal Mail's activities is also required to identify better the costs of providing universal and other services, like access.

We would welcome stakeholders' views on the appropriate scope of the separate ring-fenced parts of Royal Mail and where the boundary lines should be drawn. For example, we would like views as to whether the best approach is to split out the marketing and sales functions from the infrastructure functions and/or to split out the upstream and downstream activities. If the latter, which parts of the network represent upstream activities and which parts downstream?

Access Review and Access Code

Ring-fencing, and the greater cost transparency associated with it, should reduce the scope for price discrimination against access operators. This is a key reason why we are keen to make progress in this area.

We also plan to undertake a wider review to determine how well access has operated to date and to consider whether the introduction of an Access Code could be an efficient way to address potential concerns regarding non-price

forms of discrimination for access users. An Access Code could combine the price and non-price terms and conditions for access to Royal Mail's network that are currently provided in access contracts and the Access User Guide.

Depending on the outcome of our review of access and the discussions we hope to have with Royal Mail and other stakeholders regarding the introduction of an Access Code, we may need to consider introducing a licence obligation to require Royal Mail to introduce an Access Code.

Wholesale equivalence

Some have argued that we should go further and pursue a form of 'wholesale equivalence' through licence conditions and undertakings, akin to the arrangements Ofcom agreed with BT for its Openreach unit.

We see some merit in this concept, but before we seek to apply it to mail, we want to allow time to judge the degree of Royal Mail's cooperation in establishing the ring-fencing and transparency measures described above. We will, therefore, be initiating discussions immediately with both Royal Mail and other operators to make sure that we can make as much progress as possible on these issues in advance of the start of the next Royal Mail price control in April 2010

Other initiatives to promote competition

In addition to these measures we believe that there are further steps that could be taken to promote competition, both for access and end-to-end operators. In this respect our emerging view is that our future strategy for promoting effective competition ought to include the following initiatives:

Licensing Framework

We are seeking a licensing framework for new entrants which is relevant to today's and tomorrow's postal market, imposing only justified regulatory constraints and presenting no significant barriers to entrepreneurial activity and innovation. When the market was fully opened to competition we chose to adopt a licensing regime that would minimise the risk of confidence in the mail market being damaged by the activities of new market entrants. This aim has been achieved but some of the associated licensing conditions now appear to be too restrictive.

The licensing review published on 18 May 2007 began a two stage process to progress to a more liberal regime. The first stage seeks to amend the current licensing framework. The second stage, due to begin early in 2008, will consider more fundamental changes.

Removing barriers to entry

We reaffirm our determination to remove or reduce barriers to entry. A major concern to new entrants has long been the unequal application of the VAT regime. We have recommended to Government that it should tackle this issue as a matter of urgency. We have suggested, for example, that if a uniform rate of 5% could be applied to all mail operators there would be no significant impact on mail prices whilst creating a level playing field.

We plan to continue to work with Government and the industry, to find a satisfactory resolution to this issue. We also welcome the steps already taken by some mail operators, and Royal Mail's wholesale business, to reduce the impact of the unequal VAT rate for access users. However, these initiatives are no substitute for a removal of this significant barrier to entry.

Greater reliance on ex post regulation

We are proposing a carefully phased transition from *ex ante* regulation (e.g. price and service quality controls) to *ex post* measures (e.g. rules against undue discrimination etc. in Conditions 10 and 11 of Royal Mail's licence) for dealing with any anti-competitive behaviour.

We recognise that, whilst it has the advantage of certainty and immediacy, *ex ante* regulation can be a blunt instrument as a means to protect other operators. In some circumstances, instead of promoting effective competition, *ex ante* regulation can cause distortions that may inhibit the development of effective competition and thereby frustrate the benefits to customers that derive from this.

Such concerns are particularly pertinent to markets that are potentially highly dynamic or are undergoing fundamental changes. Addressing this important issue will require a renewed focus on making our processes for dealing with allegations of anti-competitive behaviour as effective as possible. It also raises the issue of whether Postcomm should be put on the same footing as other economic regulators and granted concurrent powers (with the Office of Fair Trading) under the Competition Act 1998 in relation to the postal market. We believe this proposal has merit but it is a matter for Government.

3. Reducing the scope of Royal Mail's price and service quality controls

In the early phase of market liberalisation it was necessary for us to control Royal Mail prices and service quality across a wide spectrum of products to ensure the protection of customers, because there was little competition. However, this situation is starting to change.

Scope of price control

Responses to our initial consultation have demonstrated that much has changed over the past three years. It is becoming clear that some customers believe that competition and innovation are now more effective tools than regulation for securing a healthy future for the mail market and protecting customer interests in the long term. We believe that this can best be achieved by reducing the scope of regulatory controls in a carefully phased way. This applies particularly to the scope of Royal Mail's price control.

Therefore, as part of the next price control – due to start in April 2010 – we intend to explore an approach that offers simplification and is more targeted than the current control. This could include directly controlling the prices of fewer products and focusing price regulation primarily on a small number of benchmark products, such as access and the first or second class standard tariff stamp services. Regulation would be focused on the economic 'bottlenecks' and regulated universal service products where users' interests require continued protection. We would, in so doing, acknowledge that controls on a smaller number of products can indirectly continue to influence a larger number of other products' prices because the price controlled products are, to a considerable extent, substitutes for other products.

We believe that if this sort of approach can be adopted, it would give Royal Mail more commercial freedom in setting and rebalancing its prices than we have allowed it to date. However, it would still provide essential protection for customers.

Scope of service quality control

In addition to controlling the price of fewer products in the next price control, we would also look to reduce the number of quality of service targets, particularly those that relate to bulk mail. Royal Mail is now consistently reaching high quality of service targets. We see evidence that this is a commitment that is now becoming embedded in the company's culture. Competitors have suggested that the regulatory protection of quality of service targets, and the compensation schemes that are linked to them, can create a barrier to customer switching.

Removing mandatory quality of service targets for non-universal service products would allow users and Royal Mail more commercial freedom. It could then agree lower quality of service targets in return for a lower price or, alternatively, higher targets that require a price premium, according to users' specific business needs. However we need to acknowledge that for users of standard tariff stamped, franked and PPI mail these considerations do not apply in the short to medium term and it will be necessary to continue to offer them regulatory protection in the foreseeable future.

Regulation of access

We believe that even with a simplified price control, continued regulation is likely still to be required after 2010 for third-party access terms unless Royal Mail and its shareholder decide to separate the upstream and downstream business into two distinctly owned businesses.

We say this because it seems unlikely that by 2010 significant competition will have developed in the provision of the “final mile”. However, during our consultations about the shape of the post 2010 price and service quality control – which will commence in early 2008 – we will explore carefully whether there is a more effective regulatory approach to ensuring the sustainability of upstream competition than placing a control on the minimum margin between access products and their comparable retail products.

Our options for introducing a less demanding form of control will be enhanced, if by that time, Royal Mail has introduced greater cost transparency and more effective ring-fencing. If the market and Postcomm can be assured of the effectiveness of such measures, it could open the way for a more rapid move to deregulation.

Pre-requisites for further deregulation

In deciding on the degree to which the scope of Royal Mail’s pricing and service quality controls post 2010 can be reduced, we will have regard to a number of factors including:

1. The continuing development of competition, giving increasing and genuine choice for customers.
2. Royal Mail taking reasonable steps to implement our other proposed measures to promote effective competition – such as greater ring-fencing and cost transparency – and the extent to which these measures command the industry’s confidence.
3. Progress being made towards replacing Royal Mail’s VAT privilege by a more even-handed regime or some clarity about its replacement.
4. The possibility that continued price and service controls in some market segments could act to distort competition and Royal Mail’s behaviour, with the potential costs of intervention, could in time outweigh the potential benefits.

G. Responses to our Emerging Themes

We would like to hear views from stakeholders before we develop specific proposals on implementing the emerging themes from our Strategy Review.

We believe that we have considered fully the shorter term issues in other streams of our work, such as our review of access headroom and Royal Mail's price rebalancing request and our consultation on their retail zonal pricing application. The purpose of this document is, therefore, to consider longer term market evolution and we urge respondents to focus on the longer term and how the mail market is likely to develop after 2010.

In particular we would like to understand stakeholders' responses and reactions to the following specific questions:

Universal service

- In what ways, if any, do you believe that the universal service should evolve to meet changing social, technological and economic factors and over what time period?
- What do you believe are the advantages or disadvantages of removing the requirement to provide existing universal bulk mail services at geographically uniform tariffs while maintaining the requirement to provide them on a universal basis?
- What risks or benefits can you see to adopting a two stage approach (outlined earlier) to taking bulk services out of the universal service?

Promoting effective competition

- What do you think is holding back greater innovation in the UK mail market?
- By what route, if any, should there be more transparency of Royal Mail's costs and ring-fencing of its activities (e.g. requiring Royal Mail to prepare separate accounts on a pre-defined basis for competitive and non-competitive parts of its business)?
- What do you believe are the potential benefits or problems arising from imposing greater cost transparency on Royal Mail (i.e. requiring Royal Mail to prepare separate accounts on a pre-defined basis for competitive and non-competitive parts of its business)?
- What do you believe are the advantages or disadvantages of Postcomm moving from *ex ante* to *ex post* measures for tackling anti-competitive behaviour?

- Where in the longer term are customers likely to remain captive to Royal Mail such that continued price regulation is required?

Price control and regulation

- What, if any, further pre-conditions (beyond cost transparency, strong *ex post* controls on anti-competitive behaviour and equalisation of VAT treatment) do you think are required to justify a reduction in the scope of the post 2010 price control?
- If Royal Mail implements better cost transparency, which commands the confidence of the industry, between now and 2010, what would be the benefits or risks of a proposal to reduce considerably the scope of price and service quality controls on Royal Mail?
- What would be the impact (positive and negative) of restricting the next price control on Royal Mail (due to come into force from April 2010) to benchmark services (such as stamped single piece items and access services), rather than covering a wide range of similar services?
- What alternatives are there to the current approach of regulating minimum headroom for access products?

We look forward to hearing your views. The questions we have raised should not be regarded as restrictive. If you think that we have overlooked issues that you think are important please give us your views.

We would like to thank again all those that have contributed so far to our Strategy Review. We can assure you all responses have been carefully considered. We are grateful for the opportunity to take these issues forward with your input.

The Postal Services Commission
6 Hercules Road
London SE1 7DB

23 August 2007

NOTE:

Anyone with comments on these emerging themes should send their responses by 26 November 2007 to:

James Francey
Postcomm
Hercules House
6 Hercules Road
London
SE1 7DB

If you would like to discuss these emerging themes or have any questions please contact James Francey (james.francey@psc.gov.uk, 020 7593 2155).

Stakeholders may make their response **confidential** if they do not want anyone outside Postcomm to have access to it. All other responses will be published on Postcomm's website.

Annex 1 – The UK Mail Market

Part I - Evolution of the UK mail market to date

A1.1 In reviewing Postcomm's strategy it is important to understand how it has developed over the past few years, especially the statutory and market context within which Postcomm works.

a) *Statutory and market context for Postcomm's Strategy Review*

A1.2 Postcomm was established by the Postal Services Act 2000 (the "Act") along broadly similar lines to the other economic regulators for sectors such as telecommunications, energy, water and rail. It was given a number of clear duties by Parliament including those of ensuring an affordable universal service, furthering the interests of postal users through promoting effective competition where appropriate, and having regard to the needs of certain vulnerable groups of customers.

A1.3 There are, however, some characteristics of the postal industry that differentiate it from the other regulated industries; these characteristics have influenced the development of Postcomm's strategy since 2000:

- the universal service duty reflects Parliament's historic view that an affordable basic postal service of good quality, available at a uniform geographic price, contributes to social and economic cohesion;
- there is a high concentration of mail volume sent by large customers compared with other industries where the largest customers account for a much smaller proportion of total sales;
- the industry is labour (as opposed to capital) intensive compared to other utility industries which require significant long term capital investments in pipes, wires and rails; and
- the vertically integrated incumbent, Royal Mail, is 100% owned by the Government, and is required to undergo a significant process of turnaround and transformation in order profitably to provide the services that its customers expect.

A1.4 The main way in which Postcomm regulates is through setting and modifying the terms of operators' licences. As with the other economic regulators, this power is constrained. Should an operator not agree to a modification to its licence, Postcomm may refer the matter to the Competition Commission for investigation of whether the proposed change is in the public interest. Another check on Postcomm's exercise of its powers is through judicial review if a stakeholder

believes Postcomm has acted irrationally, outside its powers, or without procedural fairness. Postcomm is accountable to Parliament and has on various occasions defended its policies before Parliamentary Committees.

b) *Regulatory Strategy 2000-2007*

- A1.5 Postcomm's vision for the market in the discharge of its duties is a "range of reliable, innovative and efficient postal services, including a universal postal service, valued by customers and delivered through a competitive market".
- A1.6 To achieve this vision, Postcomm has always believed that competition rather than regulation is the best way to safeguard the universal service and to protect customers' interests. Regulation should only be applied where necessary for these purposes and should be targeted at those parts of the market where competition can least be expected to protect and benefit customers. Regulation is unlikely to provide the full benefits of a competitive market in terms of efficiency, innovation and the range of services offered to customers.
- A1.7 Postcomm recognises that not all customers will benefit to the same degree, and at the same time, from the emergence of competition. Large mailing customers including banks, other financial institutions, utilities and government departments have been the first to benefit from choice in the market and were amongst the first to take up competitive offerings as a way of lowering costs, and/or improving flexibility. However, as in other markets, new entrants are gradually expanding their focus to smaller customers such as medium sized enterprises with these users increasingly likely to benefit directly from competition. Although social customers (as senders of mail) may be unlikely to be targeted by new operators for some time, competition for mail sent by large mailers and other business customers should provide indirect benefits to all customers in terms of improvements in quality of service and efficiency that result from using Royal Mail infrastructure and processes.
- A1.8 Postcomm has found that there is not an inevitable conflict between its duties in relation to securing a universal service and promoting effective competition and having regard to the need of licence holders to be able to finance their activities. Postcomm concluded in 2002 that more effective competition would contribute to ensuring the provision of the universal service, since it provides incentives for Royal Mail to raise efficiency and become more responsive to customers' needs. This conclusion has been borne out by the fact that Royal Mail has continued to provide the USO profitably¹¹. However, that improvement in financial performance is unlikely to be sustained without further

¹¹ Regulatory Financial Statements 2006/07.

efficient investment and changes to processes and products by Royal Mail.

A1.9 Postcomm's strategy has therefore been based on promoting effective competition where this is feasible and developing appropriate regulation to safeguard customers' interests where it is not yet established.

i) *Promoting customer choice*

A1.10 Postcomm's approach to achieving greater choice for customers and to ensuring an affordable universal service has included tackling barriers that prevent operators from entering the market and innovating to give customers better value:

- *Royal Mail's statutory monopoly.* Postcomm removed Royal Mail's letters monopoly progressively over time with the first major phase in 2003 for bulk mail and certain niche services and then the remainder of mail from 1 January 2006. Any operator can now enter the market and deliver whatever postal services it wishes, subject only to obtaining first a licence from Postcomm where necessary.
- *Royal Mail's economies of scale.* Handling over 80 million items every working day gives Royal Mail some significant unit cost advantages over rivals, despite the remaining inefficiencies in its operations and the costs of its pension deficit. Customers benefit from these scale economies through lower prices than would otherwise be the case. Postcomm's approach has been to facilitate an access regime that enables other operators to share the benefit of these economies of scale by, in effect, sub-contracting the 'final mile' delivery to Royal Mail. Postcomm's underlying policy for the development of access competition has been for Royal Mail and other operators to settle terms through commercial negotiations, against the background of a power by Postcomm to direct terms in the absence of agreement. In addition, Postcomm introduced additional protection in the 2006 price control to prevent Royal Mail from "squeezing" the margin between access and retail prices.
- *Royal Mail's special privileges, such as its VAT exemption and parking rights.* Postcomm has no powers in relation to these historically derived privileges, but it has consistently advised the relevant government departments that they are no longer appropriate in their present form and that there ought to be a level playing field for all postal operators. In the case of the unequal application of VAT, Postcomm has provided analysis to the Government to suggest that a reduced rate of 5%, applied consistently to all mail operators, could meet the twin objectives of levelling the playing field and not causing any significant price increase for customers (Royal Mail would then be able to reclaim

most of its input VAT) which would help offset the need for it to fully pass on the 5% VAT to its customers.

- *Customer Awareness.* Whilst large business customers appear relatively well informed about competition in the liberalised postal market, awareness among medium-sized and smaller business mailers is limited, according to Postcomm's 2006 Business Customer Survey. Postcomm is keen for all the market to benefit from competition and it strives to tackle barriers that prevent customers from exercising choice. To this end, Postcomm meets regularly with a large number of representative trade associations and individual customers to discuss the evolving market and issues that might be relevant to their postal supplier choice.

ii) *Safeguarding customers' interests in the absence of choice*

A1.11 Postcomm adopted a cautious approach in developing Royal Mail's initial licence. This was because there was uncertainty over what licence conditions would be necessary to ensure that Postcomm could adequately meet its statutory duties in a changing market. It also reflected a degree of anxiety on the part of customers and the public about the changes that might occur and the need to have control mechanisms in place to safeguard their interests. Hence the scope of the initial licence was fairly broad in terms of its price control coverage of Royal Mail's letters business, covering around 90% of the business's revenue. Further, the universal service product range was defined by Postcomm as including virtually all the products and services provided under the Royal Mail brand at that time.

A1.12 Since then Postcomm has considered, through various reviews, the case for relaxation of controls both in terms of price and service quality, and the issues of the scope and specification of the universal service. Some products have been removed from the price control (e.g. contract Special Delivery) and some products have been removed from the universal service (e.g. most bulk mail products). The price controlled products in 2006/07 accounted for about 85% of Royal Mail's letter revenues. They are controlled by an "RPI-X" type mechanism that aims to incentivise greater efficiency on the part of Royal Mail. Those products that are currently defined as universal service products comprised about 56% of Royal Mail's 2006/07 regulated revenues¹².

¹² Regulated revenues are total of price control product revenues and USO non-price control product revenues.

c) Achievements of Postcomm's current strategy

i) The universal service is more secure

A1.13 Royal Mail has returned to profitability from a position of making very substantial losses in 2002/03. We believe that this achievement has been assisted by the disciplines of regulation and competition.

ii) Large mailers are increasingly experiencing the direct benefits of competition

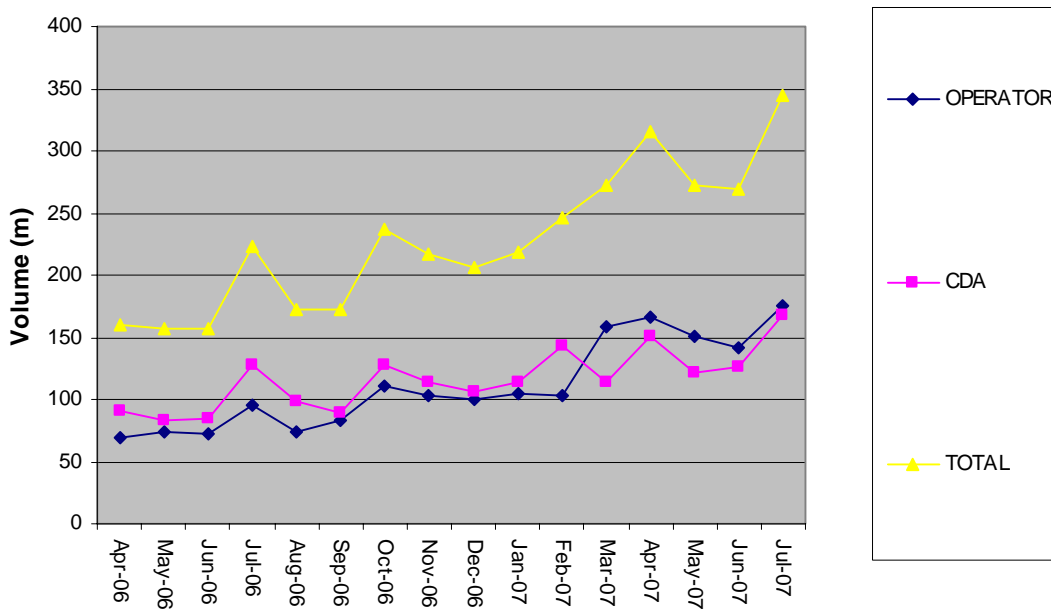
A1.14 The introduction of competition in postal services has allowed new competitors to enter the market offering a variety of new services and keener prices. This has been particularly beneficial to large business users, many of which are household names such as BT and British Gas.

A1.15 According to Postcomm's 2006 Business Customer Survey, business customers are enjoying a high level of quality of service from all the main postal operators. The benefits of using alternative operators include new products such as day specific delivery and add-on services such as track and trace facilities that help to improve management and reliability.

A1.16 Many of the large bulk mailers have benefitted from lower prices offered by alternative operators, particularly mailers in the financial services, utilities and retail sectors. Several of these large mailers initially moved part of their mail to alternative operators and, having realised cost savings with good quality of service, are now looking to move the remainder of their mail. Competition is also beginning to benefit smaller business and local authorities. Some operators are starting to invest in sortation equipment and are targeting smaller mailers who send as few as 250 items per day.

A1.17 Access volumes for both customer direct access and operator access have grown steadily since market opening, as shown in the chart below. In 2006/07 total access volumes handled by alternative operators were 2.4 billion items, around 12 per cent of Royal Mail's total mail volume.

Figure A1.1: Monthly access volumes (April 2006-July 2007)



A1.18 However, the pace of growth of operators offering end-to-end services has not so far been great, with several operators scaling back their ambitions for delivery networks for various reasons. In addition, the number and range of entrants has been disappointing with very limited numbers of local or regional players entering the market to offer letter delivery services.

A1.19 A significant barrier to entry remains in the form of the unequal VAT regime.

iii) All postal users have benefitted indirectly from competition

A1.20 All postal customers including business, government, not for profit organisations and social users have benefitted from Royal Mail raising its quality of service performance in response to the pressure of competition. Quality of service has steadily improved for many products, with first class performance improving from 90.1% in 2003 to 94.0% in 2006/07. In 2003/04 Royal Mail failed all its quality targets but as a result of the improvements it achieved all but one of its 12 targets in 2006/07 (and the 12th was missed only by a small margin). However, some aspects of change to the service have been seen as deteriorations, such as the move from two deliveries a day to one, and earlier collection in some rural areas.

A1.21 Although there have been modest rises in stamp prices in real terms over the period, postage appears to remain affordable to all citizens and accounts for a very low share of households' disposable income

(about 50p per week on average). Stamp prices still remain relatively inexpensive by Western European standards.

A1.22 Social users have benefitted from regulation in other ways. These include:

- Fewer exceptions from the 'go anywhere' universal service. Before the introduction of Postcomm's delivery exceptions policy on 1 April 2003, there were 4,323 excepted addresses out of a total of approximately 27 million addresses in the UK. The number of exceptions fell to 2,761 by 2006.
- Greater focus from Royal Mail on its procedures to prevent items being lost or damaged. Postcomm introduced a Code of Practice for 'Protecting the Integrity of Mail' in January 2006. The Code sets out minimum standards for protecting customers' mail whilst it is in operators' networks, which all licensed operators including Royal Mail are expected to meet. Since its introduction Royal Mail has realigned its own mail integrity policies and procedures to better meet the objectives of the Code. Total loss of mail figures¹³ for 2005/06 when compared with 2004/05 show a reduction of lost mail of 1.2m (from 15.3m to 14.1m items).
- Fewer customer complaints received by Postwatch, reducing from around 33,000 in 2005/06 to around 22,500 in 2006/07.

A1.23 Our research suggests that users are generally satisfied with their postal service. Postcomm recognises, however, that over the past seven years while changes to the postal system have been accepted, not all developments have been welcomed by all social users. This includes measures undertaken by Royal Mail, ostensibly to improve its efficiency, such as moving to one delivery per day in 2003 (which, as a result of other changes introduced at the time, actually resulted in higher costs to Royal Mail) and measures to improve the cost reflectivity of its pricing such as Pricing in Proportion, which was introduced in August 2006.

¹³ Mail loss figures are estimates.

Part II - Future challenges and opportunities facing the mail industry

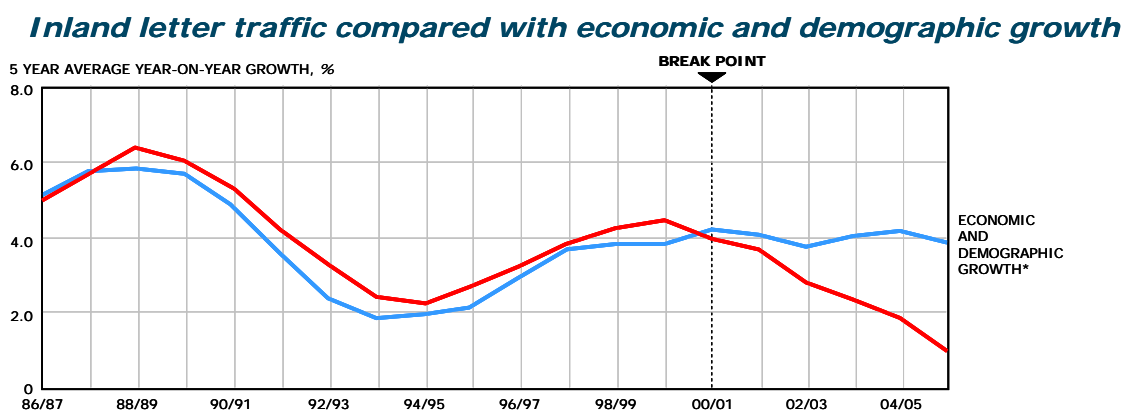
A1.24 Postcomm's aim in this Strategy Review is to gain an understanding of industry dynamics and likely future trends and then to decide whether it needs to adapt its strategy. This part of this Annex sets out the key issues that Postcomm has identified following feedback from stakeholders and Postcomm's assessment of the implications of those issues for future mail demand, universal service provision, competition, Royal Mail and its shareholder and Postcomm's regulatory strategy.

a) *The structure of mail demand is changing*

A1.25 The total UK addressed mail market is about 22 billion items per year, equivalent to about 365 items per capita. The market is worth about £7 billion annually.

A1.26 Following many years of continuous growth, mainly driven from business-to-consumer (b2c) mail, addressed mail volumes have experienced a modest decline over the past couple of years. Royal Mail's total mail volume fell in 2005/06 by 1.1 per cent on the previous year, and fell a further 2.3 per cent in 2006/07¹⁴. Direct mail, transactional mail and social mail all appear to be in slight decline.

Figure A1.2



* Economic growth is weighted by letter demand; demographic growth is measured by growth in number of households
 Source: Royal Mail

A1.27 Economic activity and new household growth are no longer the reliable determinants of mail volume growth they once were, suggesting that there has been a 'structural' change in customer demand.

¹⁴ Based on Royal Mail Letters total (excluding Door to Door) as published in Royal Mail Group Ltd's Regulatory Financial Statements 2006/07.

A1.28 Direct mailers, who account for about 23% of mail, have led the way in influencing the changing demand patterns. As printing and production costs have decreased, postage now accounts for around 40-60% of the total cost of a mailing. A change in postage prices can have an impact on the viability of a mailing campaign and incentivise those advertisers using direct mail to try other communication media to reach their target customers. Although many businesses adopt a 'multi-channel' strategy, evidence suggests that, increasingly, direct mailers are able to use substitute (or complementary) channels for mail, such as email, the internet and television advertising.

A1.29 Most industry players believe that direct mail volumes fell in 2006/07 compared with the previous year. However, combining Royal Mail's retail bulk mail volumes with access volumes gives an increase of 5.1% compared to 2005/06¹⁵. This 5.1% growth figure could be driven by either direct mail or fulfilment mail. Postcomm believes that there may still be opportunities for direct mail volume growth in the future. However, there is concern that the combination of more effective alternative media and a public reaction to the environmental consequences of physical mail could cause overall volumes of addressed direct mail in the UK to decline, with adverse consequences for the whole mail industry.

A1.30 However, Postcomm believes that going forward there are opportunities for operators who can 'add more value' per item for direct mailers. There is already evidence in the USA, for example, that direct mail is a valuable tool for advertisers in driving people to company websites. Companies send interactive DVDs through the post to a highly targeted audience, or give consumers the ability to create their own customised brochure from their website and have it fulfilled by post. Audi recently trialled a CD-Rom campaign offered by Royal Mail and found it received a response rate of over 10%.¹⁶ This demonstrates an increase in the value and relevance of advertising mail with a reduction in wasted mail. According to the US Direct Marketing Association, direct mail has been growing in the USA, although overall mail volumes are in decline. Indeed, direct marketing spend is set to overtake broadcast media in the USA for the first time this year.

A1.31 Transactional mailers, such as businesses sending utility bills and financial statements, which make up nearly 30% of the market, have also adopted multi-channel strategies for reaching their customers. Many now offer discounts for foregoing paper statements, though most still offer their customers a choice of communication channels. Customers have migrated to alternative channels gradually rather than in dramatic numbers, a trend that most transactional mailers expect to

¹⁵ The 5.1% figure is derived by adding the 2006/07 Mailsort and access volumes and comparing the total to that of 2005/06.

¹⁶ "Sony seals partnership with Royal Mail", Precision Marketing, 1 May 2007.

continue with most banks and utilities expecting to retain around 90% of their physical transactional mail in the medium term. There is speculation that the gradual trend away from physical statements could accelerate at some point during the next few years, especially if mailers begin charging people to receive physical statements, potentially leading to a steep decline in mail volumes. On the other hand, many transactional mailers are beginning to enhance the value of their bills and statements by using advertising inserts or extra white space on bills and statements to cross-sell to existing customers, blending transactional mail with advertising media. In other words, most mailers currently are opting to offer customers a choice of communications media which continues to include physical mail.

A1.32 Central and local government is another large mailing segment accounting for about 10% of mail items. These users are generally under pressure to find more cost effective ways of communicating with citizens and businesses. For example, many government departments and local authorities now offer online facilities for services such as renewing tax discs, filing tax returns and paying fines. Substitution away from mail is somewhat limited in the government sector because government remains obliged to reach every household. In addition, according to Royal Mail, government is one sector where direct mail use is growing, as the key departments increasingly seek to engage effectively with citizens. Royal Mail figures show that government organisations sent a total 17.47 million mail items in the last quarter of 2006, up from 16.48 million in the same period in 2005.

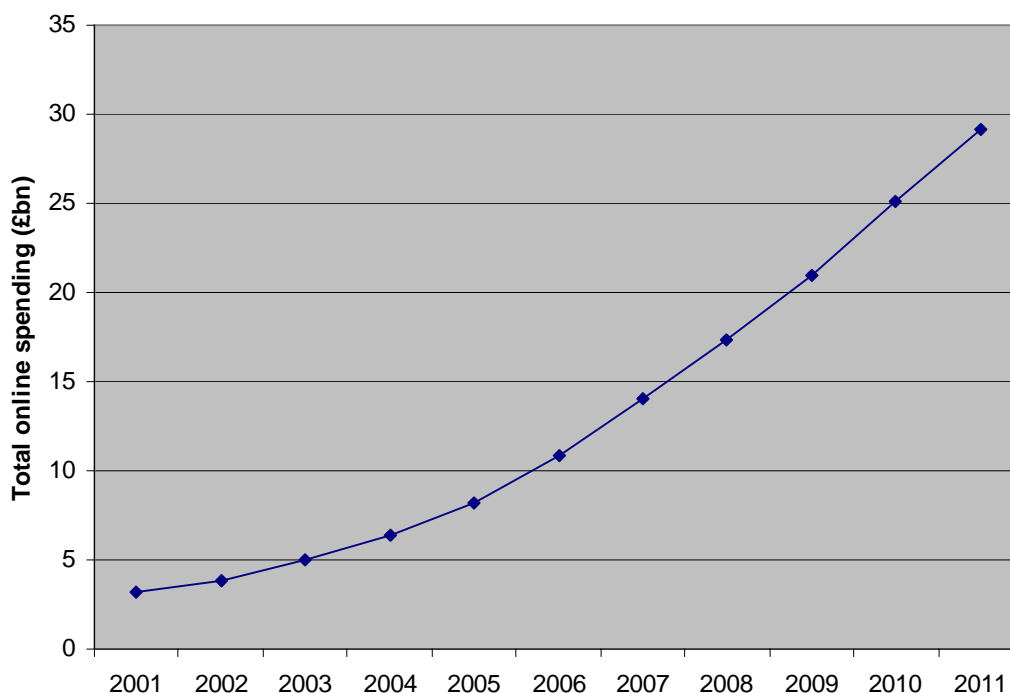
A1.33 Publishing represents a potential growth area as more magazines are purchased by subscriptions. However, this is a highly price sensitive sector, particularly business-to-business magazines which are showing declines as more content goes online. For 2006/07, Royal Mail's Presstream product, which is commonly used for the delivery of publications such as magazines, showed a decline in volumes of 13%. This is significant since a decline in magazine distribution could also trigger a decline in related direct mail. The publishing sector currently generates around 300 million items of direct mail per year.

A1.34 Business-to-business mail and social mail, representing 27% and 10% respectively of Royal Mail's total volumes, are showing signs of modest decline as people increasingly turn to email for communication. However the postal system is increasingly used for distributing "objects", which may include physical items as well as communications that are not optimally delivered through other channels, such as certain high impact marketing material.

A1.35 Although alternative communication channels pose challenges to some traditional uses of mail, they also offer potential opportunities for mail operators to exploit. The internet has driven the rapid growth in 'fulfilment' mail. This growth is consumer driven and complements the growth in online shopping (all online orders need a delivery channel).

Verdict Research¹⁷ estimated that in 2006 consumers shopping online increased their spend by 33.4% to £10.9bn from the previous year and is predicting online sales of around £29bn in 2011. This rapid actual and projected growth path is shown in the graph below.

Figure A1.3: e-Retail market size 2001-2011



Source: Verdict Research¹⁸

A1.36 This growth also poses opportunities for innovation in terms of new supply chain solutions for operators (such as ‘backward integration’ with database management). The growth in this sector is causing a blurring between the traditional addressed letter market and the courier and express industry. For example according to Pitney Bowes, internet users in the UK receive 67% more mail than non-internet users.

A1.37 In addition to the fact that mail choices are increasingly being made in the context of a wider communications market, users are becoming ‘smarter’ in their use of addressed mail. Many users have reviewed whether it is more cost effective for their businesses to change the class of mail they send and/or the format of mail items, and whether alternative suppliers can offer better value for money. Customer awareness of the potential to use mail more effectively has been raised by liberalisation, word-of-mouth and changes introduced by Royal Mail such as Pricing in Proportion. A frequent comment from large mailers is that decisions about the postage budget are increasingly moving ‘out of the mailroom and into the boardroom’.

¹⁷ Verdict Research, UK e-Retail 2007, May 2007.

¹⁸ These figures do not include online spending on flights, tickets and insurance.

b) Implications for future mail demand

A1.38 The implications of these trends for mail operators, including Royal Mail, are that large customers who account for over 50% of mail volume are:

- a. increasingly seeing mail as an 'optional' communication medium. In some cases mail has to prove its worth with other media such as email, though it can also complement other types of media;
- b. becoming more 'intelligent purchasers' of mail, switching between operators, classes of mail, formats of mail and presentation types, in order to make more cost effective use of mail. Where postal operators cannot offer the customer a unique value proposition, 'commoditisation' could result for some mail streams. To avoid this, operators will need to pursue strategies to innovate and provide customers with 'more value per mail item';
- c. increasingly responsive to price changes from Royal Mail. Royal Mail's average price rise was about 4% in 2006/7 but the associated revenue yield was only about 1%, suggesting that customers are less prepared to bear price increases for standard mail items without associated value added features; and
- d. increasingly sensitive to Royal Mail's behaviour. Many customers have told Postcomm that the manner in which changes such as Pricing in Proportion and further proposals such as Zonal Pricing have been handled has caused some of them to consider their choices more urgently than might otherwise have been the case.

A1.39 Having carefully evaluated feedback to its August 2006 Strategy Review consultation document, Postcomm has updated its view on the prospects for addressed mail volume growth over the next few years.

A1.40 Postcomm expects the trends identified above to continue to affect customer behaviour. Through our engagement with stakeholders, and monitoring of mail volume data we anticipate that there is a potential volume growth or decline range in the UK mail market of +1% to -3% over the next few years. Predicting mail volumes accurately at this time is more challenging than in the past, when mail volume growth mirrored economic growth. A significant factor influencing the UK mail market will be Royal Mail's behaviour in encouraging customers to use physical mail, and in being very proactive in the emerging growth areas, for instance relating to the internet, home shopping and fulfilment. Promoting mail as a valuable means of reaching customers

and the unique value of physical mail compared to alternative media will be essential.

A1.41 Clearly there are upside and downside risks associated with these projections but international experience suggests that recent volume changes in mature mail markets range from about +1% to -1% per year. Volume changes tend to be gradual rather than dramatic.

c) *Implications for mail operators*

A1.42 Given the pattern of competition seen to date, the feedback received from operators and customers and the expected future market dynamics described above, Postcomm has also updated its forecasts for the nature of competitive activity over the next few years. In summary, assuming no change in strategy and policies, it is now expecting more volume handled through access and less end-to-end volume over the medium term compared with the forecasts that Postcomm made in 2005.

A1.43 By the end of 2009/10, Postcomm is now expecting nearly 6 billion items, or nearly 30% of total market volume, to be handled through access arrangements as alternative operators continue to broaden their target customer base with unsorted offerings and new services.

A1.44 By the end of 2009/10 it is now estimated that end-to-end competition will account for less than 1% of all regulated mail volume. End-to-end competition has been slow to develop outside niche areas such as delivering high value items or business-to-business intra-city mail. A few operators have begun setting up new local networks in city centres, but achieving enough volume in high density areas to establish a nationwide network seems likely to take many years to achieve.

A1.45 The table below provides details of the mail companies that are currently licensed, and the focus of their businesses.

Table A1.1: Business focus of licensees

Licensee	End-to-end (items costing less than £1 or weighing under 350g)	Access (delivered under C9 or Customer Direct Access Agreement)	Focus/business model
ANC			Pouch services. Not currently operating in the licensed area.
Citipost AMP	+++		Niche B2B markets. Also offer DSA services (consolidated, zonal and national).
Challenger Security Services (Admin)			Disguised mail delivered by Royal Mail/couriers.
CMS	++		B2B (mostly London).
DHL Global Mail (UK)	+++	+++++	Mainly B2B. UK wide collection, delivery to defined postcodes in some cities. B2C through DSA.
DX Network Services	+++++		National next day B2B through own delivery network (document exchange, business mail and parcels).
Intercity Communications	+		B2B niche markets, own delivery in London; international courier services.
Racer Consultancy Management Services			UK and international mail and courier services; B2B and B2C mainly through Royal Mail (not Access). Some B2B (not in licensed area) through own network.
Red Star Parcels (trading as Lynx Mail)		++++	National DSA, bulk pre-sorted mail, B2C and B2B.
Secured Mail Limited		+++	National consolidated and bulk mail through DSA.
Secure Mail Services			National B2C and B2B through own secure delivery network (valuable items such as bank cards, passports, event tickets) - not in the licensed area - and through Royal Mail (not Access).
Securicor Omega Express			Acquired by DHL Express. Interim licence to convey mail between HSBC and the Royal Bank of Scotland. Pouch services.

Target Express Parcels (now trading as City Link Post)		+++	Express, parcels; B2C through DSA.
The Mailing House Group			Bulk mail through DSA.
TNT Post UK		+++++	Pre-sorted and unsorted B2C and B2B letter mail with delivery through DSA. Parcel and packet delivery through own network and DSA.
UK Mail		+++++	Pre-sorted (bulk mail), unsorted and international B2C and B2B mail through DSA.
Zip Mail	+	+	Fully franchised business in the London/M25 area.

Note: The volumes are as reported by Licensees for the Financial Year 2006-07. The Mailing House Group only received its licence on 11/4/07.

- + is under 100,000 mail items
- ++ is between 100,000 and 1 million mail items
- +++ is between 1million and 10 million mail items
- ++++ is between 10 million and 100 million mail items
- +++++ is over 100 million mail items conveyed.

A1.46 Innovation in postal services has so far been mainly limited to product and service modification, such as day specific delivery or improved management reporting. Two growth areas in the mail market, fulfilment and publishing, seem most likely to drive innovation as customers demand more flexible and cost effective delivery options.

d) *Implications for Royal Mail and its shareholder*

A1.47 Postcomm's discussions with industry stakeholders have revealed a consensus on the need for Royal Mail, as the dominant incumbent, to transform its business. A vibrant Royal Mail is seen as essential to the future of mail as an effective communications medium, and not simply because competitors at present rely on Royal Mail to deliver their letters through its universal service network.

A1.48 A significant achievement of the industry (and particularly Royal Mail), as discussed earlier, has been the improvement in quality of service, reaching levels that many people expected a few years ago could not be achieved, and with relatively little capital investment.

A1.49 Looking to the future, Postcomm is pleased that Royal Mail has agreed at a crucial time a financing package with its shareholder after a prolonged period of uncertainty. This should herald a major programme of automation and drive for efficiency, bringing Royal Mail closer into line with some of its European peers¹⁹.

¹⁹ Royal Mail will of course need to manage carefully any associated industrial relations issues.

- A1.50 Large customers have told Postcomm that Royal Mail is more 'commercial' than it has been in the past. However, it has not overhauled its business product portfolio as quickly as it initially indicated and many customers have told Postcomm that Royal Mail 'blames regulation' for why it cannot be more flexible²⁰. A move from a 'production-led' product portfolio to one that is 'customer-led' would appear necessary given the changing structure of mail demand described earlier.
- A1.51 There is also concern within the industry that some of Royal Mail's changes aimed at improving its cost efficiency (such as the move from two to a single delivery per day) were more than offset by increases in labour costs. Royal Mail has been successful at reducing gross hours, but most of these cost savings seem to have been absorbed through pay rises and the "Share in Success" bonus scheme. Rising costs are also due to the significant pension scheme obligation, which in 2006/07 accounted for about 10% of Royal Mail's total costs²¹. With business customers increasingly unwilling to accept price increases, Royal Mail will need to contain such costs if it is to sustain a strong position for mail as electronic communications develop further. Simply resorting to raising prices may no longer be an option for increasing revenue in some parts of the market, because higher prices now tend to lead to lower volumes. In addition, Royal Mail's costs must become more variable and less fixed if declining volumes are not simply to reduce profitability in the future.
- A1.52 Royal Mail has made a start, but the recent Interim Results for 2006/07 demonstrate that it still has a long way to go if it is to face the challenges of new market realities. Declining market volume and intelligent purchasing by customers are two of the factors that reduced profitability from £159m in the first 6 months of 2005/06 to £22m in the first 6 months of 2006/07. Whilst Royal Mail has yet to publish its full year Statutory Accounts, its Regulatory Accounts (2006/07) give an operating profit of £41m for Royal Mail Letters (compared to £192m for 2005/06).
- A1.53 It is important that the Government exercises fully and effectively the duties and responsibilities of a shareholder. It is Postcomm's role to establish an appropriate regulatory framework but it is Royal Mail's responsibility to respond. Only effective shareholder pressure, unencumbered by non-commercial considerations that may have influenced decisions in the past, will make that happen.

²⁰ Royal Mail initially had planned to restructure its Mailsort portfolio of products and introduce new packet services.

²¹ In addition, Royal Mail is also required to make payments to its pension deficit.

A1.54 Like any shareholder, the Government needs to ensure:

- the continuous pursuit of a challenging approach to cost reduction. For example, Postcomm notes that some incumbent postal operators in other countries and many logistics, courier and express operators have contracted out various activities as a way of increasing efficiency and flexibility to a far greater extent than Royal Mail and with positive results; and
- that the creation of long term shareholder value and facing up to the challenge of a changing market is not sacrificed by excessive focus on short term tactical measures aimed at trying to undermine mail competitors or maintaining volumes in the short term.

Annex 2 – Selected International Comparisons

A2.1 Postcomm monitors and learns from the experience of other postal markets in Europe and the rest of the world. It draws on evidence in reports for the European Commission, the Universal Postal Union and others. It also gathers intelligence from conferences and meetings with postal regulators, ministries, operators and their customers. It uses this information to inform the development of its policies on the universal postal service and on how best to develop competition in the interests of postal users.

Competition

Netherlands

A2.2 The postal market in the Netherlands currently has a reserved area for letters weighing less than 50g and priced at less than three times the public single item letter tariff (excluding printed mail matter).

A2.3 The liberalisation of the delivery of addressed printed matter (broadly corresponding to addressed direct mail) in 2000 has given rise to a variety of new entrants. To date, two competitors, Sandd and Selekt Mail (51% owned by Deutsche Post) have focused on the business-to-consumer (B2C) segment and have developed end-to-end networks with 100% national coverage. Sandd and Selekt Mail operate low cost end-to-end models focusing on pre-sorted bulk mail with two deliveries per week achieved partly with a flexible work force²². Between them the two competitors employ almost 20,000 staff²³.

A2.4 On 4 June 2007 the Dutch Parliament passed a law for the full liberalisation of the postal market from 1 January 2008. This is, however, dependent on full liberalisation in Germany by the same date. Both Sandd and Selekt Mail intend to deliver low weight transactional mail (<50g) when the market is fully liberalised.

A2.5 In 2006, the market share of the incumbent operator (TNT) was approximately 88% of the addressed mail market. The two largest competitors to TNT, Sandd and Selekt Mail, had market shares of about 6% and 5% respectively, with both expected to rise in the future. There were approximately 5.5 billion items of addressed mail in 2005 and 2006. The regulator, OPTA estimates that this number will decline slightly due to electronic messaging and other forms of substitution. Last year 92% of the addressed mail market was for business mail

²² Analysis by Ecorys.

²³ OPTA: Annual Report and market monitor 2006.

(business-to-consumer and business-to-business), the remainder consumer-to-consumer and consumer-to-business.²⁴

- A2.6 The incumbent operator in the Netherlands, TNT, is confronted with declining mail volumes because of the impact of competition and substitution from mail to other media. However, despite this, TNT argues that mail activities have provided it with a stable source of revenue and income. In addition, TNT believes that due to the efficiency of its operations and customer orientation it will retain its leadership position in the home market but recognises that adjusting to reduced mail volumes will require an increased effort to realise cost flexibility. As part of this, TNT announced in April 2007 that it would be making cost savings by cutting between 6,500 and 7,000 jobs.
- A2.7 Netwerk VSP, a subsidiary of TNT, has also been established. Netwerk VSP is the market leader in unaddressed mail delivery in the Netherlands, delivering approximately 5 billion pieces a year. Netwerk VSP also now delivers addressed mail in the Netherlands, offering an economic 'next week delivery' service to business mailers. This new subsidiary is now providing a significant challenge to Sandd and Selekt Mail.

Sweden

- A2.8 The postal market in Sweden was fully liberalised on 1 January 1993. The largest competitor to the incumbent operator (Posten) is CityMail, although there are 31²⁵ other smaller local postal operators.
- A2.9 The total number of addressed postal items distributed nationally was steady between 1993 and 2000. There was a gradual decline in addressed mail volumes from approximately 3.4bn items in 2000 to 3.2bn items in 2006²⁶.
- A2.10 CityMail (owned by Norwegian Post) does not have national coverage. It is established in four regions: Stockholm, Gothenburg, Malmo and the island of Gotland. CityMail's business strategy is to distribute large volumes of pre-sorted mail at low cost. The business model is based on offering tailor made solutions to customers without having a fixed infrastructure. CityMail outsources parts of its activities to sub-contractors while maintaining an overview of the supply chain²⁷. CityMail covers more than 40% of the total number of households and companies in Sweden and plans to increase its coverage to 65%. Its volumes of nationally distributed addressed postal items increased from 149 million addressed items in 2000 to 275 million addressed items in 2006 and it has a market share of approximately 13% of the

²⁴ OPTA Annual Report and market monitor 2006.

²⁵ National Post & Telecom Agency (PTS).

²⁶ PTS.

²⁷ Ecorys: Development of competition in the European postal sector country information sheets 2005.

bulk mail and 8.6% of the total letter volume. During the last few years CityMail has been profitable.

A2.11 The vast majority of the other operators are small companies that only provide local collection and distribution of mail. In most cases, they use their own stamps and letter boxes and each operator handles volumes of between 150-2,500 letters a day. Some of the operators are direct mail companies or newspaper delivery companies also distributing addressed postal items. All those small companies together distributed 11 million postal items in 2006 (only four of them carried more than one million items each).²⁸

A2.12 The incumbent operator (Posten) stated in its 2005 Annual Report that it recognised the challenge from the increasing level of substitution of conventional mail by electronic mail. In 2006, after 14 years of a liberalised postal market, Posten had an approximate market share of 91%²⁹, broadly the same as in the previous two years.

Germany

A2.13 The German postal market currently has a reserved area consisting of the conveyance of domestic mail items weighing less than 50g (and with a price of less than two and a half times the stamp price).

A2.14 There are approximately 750 active licensed operators in the market, which appears to be going through a consolidation phase with takeovers, mergers and exits. There are 336 operators with turnover in excess of €100k in the market. The operators are mostly localised distribution companies (with backgrounds in delivering newspapers regionally or couriers). There are now 1.6bn items handled by competitors, which represents approximately 9% of the overall licensed market.³⁰

A2.15 Deutsche Post AG, the incumbent operator, is sub-contracting work and reducing staff numbers. For example, rural mail collection and trunking is now, to a large extent, sub-contracted.

A2.16 Deutsche Post is providing innovative solutions to customers. These include direct marketing monitoring and consulting services that provide advice to customers to improve mailing strategies. Deutsche Post has also developed websites and databanks for companies planning to target specific international markets that provide mailing lists. In addition, it has established the Siegfried Vögele Institute that provides research and training to the direct marketing industry on how to improve its success and achieve best practice.

²⁸ PTS: The Liberalised Swedish Postal Market (March 2007).

²⁹ PTS.

³⁰ The Federal Network Agency for Electricity, Gas, Telecommunications, Post and Railway (BNetzA) - 10th Market Study in the Field of Licensed Postal Items.

A2.17 According to Ecorys (July 2005)³¹, the entry strategies of competitors in the German mail market can be classified into the following categories:

- Local entrants that are active in express and courier services and are expanding into mail services;
- Local delivery organisations of unaddressed mail that are moving into the addressed market;
- Regional press distributors that are expanding into mail services;
- Internal post operations of companies being outsourced; and
- Interconnecting local postal operators.

A2.18 TNT, one of the larger competitors to the incumbent operator (Deutsche Post), is following the last of these approaches and is aiming to build up its own delivery network by using a network of independent postal service providers through partnership agreements. It provides sorting and transportation services with collection and delivery services mainly undertaken by 150 local operators through partnership agreements.

A2.19 TNT is targeting national mail volumes in the business-to-consumer market segment with value-added services for transactional mail and addressed direct mail. TNT has doubled its volume in the last five years³² (although not all of the mail is won by TNT directly since some is won by its partner organisations at a local level).

A2.20 The geographical coverage of the delivery network is over 90% and TNT is planning to reach 100% coverage during 2007³³.

A2.21 PIN Group AG was established in 1999 and was developed through using the existing German newspaper door-to-door delivery service to deliver postal items. By 2007, only approximately 20%³⁴ of postal items delivered by PIN are expected to be handled by newspaper delivery staff with the majority being handled by specific postal delivery staff.

A2.22 Where PIN is unable to deliver it will use non-PIN staff to deliver (such as Deutsche Post) but it expects to deliver all of its own mail by the end of 2007. PIN also has aspirations to develop a Europe wide network.

Spain

A2.23 The regulatory framework in Spain diverges in some respects from the regulatory framework in the rest of the European Union. The delivery of items of correspondence with a weight of less than 50g and less than two and a half times the basic tariff is reserved for intercity mail

³¹ Ecorys: Development of competition in the European postal sector country information sheets 2005.

³² TNT Germany.

³³ Analysis by Ecorys.

³⁴ PIN Group AG.

and international mail and included in the universal service. However, domestic intra-city postal items and international mail up to 2kg and parcels up to 10kg are not part of the reserved area but are part of the universal service. The delivery of direct mail has always been open to competition.

A2.24 La Sociedad Estatal Correos y Telégrafos (Correos) is the national postal operator and universal service provider in Spain. It is owned 100% by the State. In 2005 the company saw a decline in mail volume for the first time from 5,400m items (2004) to 5,371m items, due to electronic substitution and competitor activity. Correos expected a further decline in volumes of 0.5% in 2006 rising to an annual decline of 1.9% in 2009³⁵.

A2.25 Competitors are especially active in urban areas and focus on local mail (which is not part of the reserved area) with approximately 150 local/regional competitors. The main competitor is Unipost which comprises a network of the twelve main private postal operators in Spain that integrate and collaborate with other local and regional postal operators to form one national network. Some postal operators have merged into Unipost, other operators work under their own name but are part of the Unipost network and others act as franchisees.

A2.26 Unipost covers about 70% of the Spanish population daily and expects to increase coverage to 100% by 2009.

A2.27 It is estimated that the market shares in 2006 were: Correos 92-93%, Unipost 7-8% and the remainder of competitors less than 1%.

New Zealand

A2.28 The New Zealand postal market was fully liberalised in 1998. Competition is limited and since 1998, small competitors generally provide services in smaller towns (up to 40,000 people) delivering crosstown mail. There were 27 active postal operators in December 2006. Any mail that cannot be delivered is sent by competitors via New Zealand Post (the incumbent) by putting its stamps on the mail.

A2.29 The main competitor is Pete's Post that initially provided cross-city mail delivery in New Plymouth and conveyed any other mail by giving it to New Zealand Post to deliver in areas that it did not cover.

A2.30 By 2002 other competitors were active in the market and Pete's Post had expanded to thirteen franchise networks. New Zealand Post now offers a new prepaid access arrangement for Pete's Post whereby Pete's Post provides an envelope that can be posted in any New Zealand Post mailbox. Under this agreement Pete's Post gets a 17% discount from New Zealand Post.

³⁵ Analysis by Ecorys.

- A2.31 The Prepaid Access arrangement was trialled in Auckland for six months and following the success of this, Pete's Post decided to change more of its network to the prepaid access model.
- A2.32 In December 2006, Pete's Post sold its remaining delivery networks to DX Mail. At this point Pete's Post was handling approximately 13 million mail items per year, of which about 6 million were delivered via New Zealand Post and 7 million via Pete Post's own network. This has led to Pete's Post concentrating on marketing, with New Zealand Post concentrating on delivery.
- A2.33 DX Mail is building up an end-to-end service, using its base in document exchange and courier services, and focusing on full price mail. The company is seeing an increase in mail volumes.
- A2.34 New Zealand Post has an estimated market share of over 95%. Mail volumes in New Zealand are estimated to be declining by approximately 3% per annum³⁶, with the decline starting around 2003. However within this trend there is a mix of increasing and declining volumes. There is a greater decline for stamped mail, bulk mail is growing slightly, there are fewer bank statements (all the banks are encouraging use of email), direct mail has seen an increase and a significant increase has occurred in packets and parcels due to internet fulfilment.³⁷
- A2.35 New Zealand Post has contracted out parts of its service. For example, all rural delivery is contracted out to around 500 owner-drivers. The owner-drivers provide their own vans that are branded as New Zealand Post, and are able to deliver other items such as other couriered mail, milk and newspapers. Deliveries in metro/urban areas are carried out by New Zealand Post's own employees.

Australia

- A2.36 Australia Post is a Government Business Enterprise owned by the Federal Government which is required to act in a commercial manner. Australia Post enjoys an exclusive privilege over the letters market for items of 250g and less, or less than four times the standard letter rate. The parcels market is fully liberalised.
- A2.37 Australia Post provides a range of services that can help a company access names, contact details and potentially identify customers who could be most profitable. For example, Australia Post offers access to a database of over two million Australians who have responded to the comprehensive Australian Lifestyle Survey. The survey asks over 200 questions about lifestyle, demographics and purchasing intentions,

³⁶ Ministry of Economic Development.

³⁷ New Zealand Post.

enabling a client company to build a list of prospects who match their direct marketing offer.

- A2.38 Mail volumes have increased modestly over recent years with all growth coming from direct mail.
- A2.39 Australia Post has also been proactive in adapting its product range to recognise the increasing use of electronic mail. For example, Australia Post can provide warehousing, inventory management, packing and dispatch right through to delivery.
- A2.40 "Post eDeliver" is a technical platform that facilitates a seamless flow of data between the client's website and Australia Post's back-end systems, eliminating the need for data entry and providing the ability to track the progress of orders. As soon as a customer's order details are accepted, data flows continually through to Australia Post's warehouse management and delivery systems. This enables Australia Post to respond immediately to orders and allows enquiries on the status of orders and parcels in its warehouses and delivery network to be made at any time.
- A2.41 Australia Post uses third parties for the delivery of parcels to most parts of Australia and for the delivery of letters to a significant number of deep rural and urban/rural fringe areas. Since 80% of Australia's population live in urban areas, the contracting out covers less than 20% of total letters but it extends over a land area comprising over 90% of the country.
- A2.42 Third party contractors delivering letters for Australia Post usually offer a five day per week service although in very deep rural areas delivery can drop to twice a week.
- A2.43 The parcels delivery is contracted out to a large number of parties, most of whom only offer coverage within a very restricted geographical area.

USA

- A2.44 United States Postal Services (USPS) maintains a monopoly over the delivery of mail. Mailboxes in the US are owned by USPS and only items delivered by them can make use of the mailbox.
- A2.45 Competition in the US market is characterised by worksharing arrangements with the United States Postal Service (USPS) and a number of mailing houses of which PSI (owned by Pitney Bowes) is the largest. This is similar to access arrangements in the UK. Approximately 80% of all mail delivered by USPS has been handled by a third party at some point in the network.

A2.46 USPS works closely with workshare operators and mail preparation companies and considers these companies as partners in the process with the aim to get the mail to the customer at the lowest cost so that the market remains buoyant. By following a strategy of encouraging workshare arrangements and promoting mail with other media types, direct mail volumes increased by around 5-6% last year.

A2.47 Overall mail volumes increased by 2.3% in the US market last year (2006/07). USPS is the largest mail operator in the world and claims to account for 46% of world mail volumes. In 2005 households received an average of approximately 1,800 items of addressed mail per year compared to only 850 in the UK³⁸.

A2.48 Intelligent Mail™ has recently been introduced by USPS. These are products and services that use machine readable codes to uniquely identify mail, enabling large mailers to follow the progress of their mail through the pipeline to delivery. It is believed that this can help businesses better manage their resources, be more responsive to customers and by adding value to the mail help secure the future of mail usage³⁹.

A2.49 The regulatory regime has changed with the introduction of a new postal law which came into effect in December 2006. This provides the regulator, the renamed Postal Regulatory Commission, with significant new powers and also allows for a simplified rate change process.

Canada

A2.50 The incumbent operator, Canada Post, enjoys an exclusive privilege over the collection, processing and delivery of addressed letters under 500g. The exclusive privilege does not apply to addressed magazines, newspapers, catalogues, and other printed matter or to letters of an urgent nature that are transmitted by a messenger for a fee at least equal to three times the 50g domestic letter rate.

A2.51 A key strategy for Canada Post in delivering value to customers has been to reorganise itself internally around its three main lines of business. These are transactional mail, parcels and direct marketing. It is claimed that this has led to a clearer focus on “what matters for customers” and to strong accountability for results.

A2.52 Mail volumes have grown for Canada Post, with an increase from 9.8 billion items in 2002 to over 11 billion by the end of 2005. Canada Post has been developing strategies to grow its Direct Marketing and parcel business and energetically supports the continued growth of its electronic services.

³⁸ Pitney Bowes Mail Database 2006.

³⁹ USPS website.

A2.53 Canada Post laid the groundwork almost a decade ago for operating in a multi-channel world by developing its epost electronic service that delivers mail to a secure electronic mailbox. By building an electronic infrastructure Canada Post has been able to offer a new portfolio of 'Multi Channel Mail Presentment Solutions' designed to manage a customer's entire communications processes. This allows it to create, deliver and manage the customer's mail in both physical and electronic form.

A2.54 Canada Post offers customised and fully integrated solutions for web-based retailers, providing a range of value-added services beyond delivery including risk management, order processing, fulfilment, inventory management and processing of returns.

Europe: Universal Service

A2.55 The universal postal service in every country in Europe reflects the historical development of postal services and what people in each country have come to expect. The European Postal Services Directive⁴⁰ (the Directive) sets certain minimum requirements for the universal service but leaves the detailed definition of the universal service in the hands of Member States.

A2.56 The minimum requirement for the universal service provided by the Directive is that (subject to certain exceptions) Member States must ensure the provision at an affordable price of at least:

- One collection from appropriate access points;
- One delivery to all addresses;
- Every working day (in many countries this is taken to be five days per week but in the UK the universal service requires a six day delivery for letters);
- In respect of postal items up to 2 kilograms and domestic packages up to 10 kilograms (which may be extended to 20 kilograms), up to 20 kilograms from other Member States; and
- A service for registered and insured items.

A2.57 The Directive refers to a universal service of a 'specified quality at all points in the territory' and also provides that 'Member States shall ensure that quality of service standards are set and published in relation to the universal service in order to guarantee a postal service of good quality'.

A2.58 The Directive does not specify what specific services should be included in the universal service. The historic differences between Member States mean that in some the universal service includes services such as the delivery of newspapers and periodicals, financial services and the provision of post offices, but in others it does not. The

⁴⁰ Directive 97/67/EC as amended by Directive 2002/39/EC.

number of days that post is delivered and delivery times vary as well. There is a similar range of experience and historical precedent in respect of whether post is delivered to the door, to post boxes in an apartment building, or to the apartment building superintendent. In some Member States, the postman has to use a key to open the mailbox of each household – only the postman and the householder have a key to open the mailbox.

A2.59 Different Member States have adopted different definitions of the universal service, some of which are narrower in definition than in the UK and some of which are wider. Table A2.1 provides a summary of these differences.

Table A2.1: European Comparisons

Country	Scope of Universal Service	Deliveries per week	Other
Austria	Postal items < 2kg Parcels <20kg Registered & insured items	5	Opening hours of the Post Offices > 20 hours per week
Belgium	Postal items < 2kg Parcels < 10kg Incoming int. parcels < 20kg Registered & insured items Newspapers, magazines	5	Average waiting time in Post Offices < 4 minutes
Czech Republic	Letters < 2kg Parcels < 15kg Registered & insured items < 2kg Money orders	6	Residential district > 10,000 inhabitants clearance of certain letter boxes on Saturdays. Residential district > 100,000 inhabitants clearance of certain letter boxes on Sundays. Residential district > 250,000 inhabitants clearance of certain letter boxes every day up to midnight
Denmark	Addressed mail, catalogues, brochures, newspapers & periodicals < 2kg Parcels < 20kg Literature for the blind < 7kg Registered & insured items	6 (letters) 5 (parcels)	
Finland	Items of correspondence < 2kg Parcels < 10kg Ingoing int. parcels < 30kg Registered & insured items	5	
France	Letter mail < 2kg Parcels < 20kg Addressed catalogues & magazines	6	

Germany	Letter items < 2kg Parcels < 20kg Newspapers & magazines Registered & insured items Cash-on-delivery items	6	Post Offices are opened throughout the entire year (self-commitment)
Greece	Postal items < 2kg Postal packages < 20kg Registered & insured items Newspapers & magazines	5	
Hungary	Items of correspondence < 2kg Postal packages < 20kg Registered & insured items	5	Maximum queuing time in Post Offices: 15 minutes Post Offices have to be open a minimum of 2 hours a day. In cities with more than 15,000 inhabitants they have to be open on workdays a minimum of 6 hours per day, with one opening hour either before 8am or after 5pm
Ireland	Postal items < 2kg Packages < 20kg Registered & insured items	5	
Italy	Mail items < 2kg Parcels < 20kg Registered & insured items	5	
Luxembourg	Postal < 2kg Parcels < 10kg Registered & insured items	5	
Netherlands	Items of correspondence < 2kg Domestic parcels < 10kg International parcels < 20kg Registered & insured items P.O. Box rental Bulk mail letters < 50g (Unaddressed mail and addressed bulk mail above 50g excluded)	6	Exclusive right to place public post boxes and print stamps with the monarch's likeness and/or 'Nederland'.
Poland	Letter mail < 2kg Parcels < 10kg Insured parcels < 10kg Ingoing int'l items < 20kg Registered & insured letters < 2kg Money orders	5	
Portugal	Correspondence, books, catalogues, newspapers < 2kg Postal packages < 20kg Registered & insured items	5	Maximum waiting time in Post Offices under 10 minutes > 70% of occasions

Slovakia	Postal items < 2kg Parcels < 15kg Incoming int'l parcels < 20kg Registered & insured items	5	Average queuing time in Post Offices during peak hours < 12 minutes. Detailed requirements for Post Office opening hours
Slovenia	Postal items < 2kg Parcels < 20kg Registered & insured items Delivery of postal items for the blind and visually impaired.	5	
Spain	Domestic and international postal items < 2kg Parcels < 10kg Newspapers, magazines, books Registered & insured items Money Orders	5	
Sweden	Addressed items < 20kg Registered & insured items	5	Act requiring provision of a nationwide basic counter service
UK	1st, 2nd class, bulk mail, registered and insured <2kg, parcels <20kg, Special Delivery and International outbound, Mailsort and Cleanmail (plus some minor services)	6	

Source: European Commission studies on universal service in member states by Wik-Consult (2006) and ECORYS (2004) and postal operators' annual reports for updates.

Annex 3 – Postcomm’s Process

A3.1 This annex briefly outlines the process that Postcomm has followed during this Strategy Review to understand how stakeholders believe the mail market is likely to evolve in the future and how Postcomm should adapt its regulatory framework to ensure that it achieves its vision for the market.

Timetable

A3.2 Postcomm started its Strategy Review in May 2006 and the table below summarises the key milestones in the consultation process.

Table A3.1: Summary of key milestones

Date	Milestone
May 2006	Postcomm started its Strategy Review
August 2006	Postcomm published initial consultation document “Key questions for Stakeholders” Postcomm published “Forward thinking” leaflet
October 2006	Strategy Review Industry Workshop
November 2006	Consultation period ended
March 2007	Commission meeting dedicated to Strategy Review issues
June 2007	Postcomm Forum – The postal market for the future
August 2007	Postcomm published “Emerging Views”

Stakeholder views

A3.3 In addition to these milestones, Postcomm has worked with stakeholders and postal experts to ensure that it has a good understanding of the postal market and how it is developing.

- **Stakeholder responses** – Postcomm has received views from a number of interested parties in response to its “Key questions for stakeholders” document. These responses have been summarised later in this Annex and full copies of all the non-confidential responses are available on Postcomm’s website – www.postcomm.gov.uk. In addition to the August 2006 consultation document, Postcomm also issued a leaflet entitled “Forward thinking”, to which it received nine responses.
- **Visits** – Postcomm has conducted about fifty visits to stakeholders in the mail industry, including users (businesses, charities and government departments) as well as operators, to get a better understanding of the developments in the mail market. In addition to visits in the UK, Postcomm has also visited a number of mail

regulators, and operators, in other countries to understand mail trends and the development of regulatory frameworks elsewhere.

- **Roadshows** – Postcomm has discussed its Strategy Review at a number of its regional roadshows. In addition to the roadshows Postcomm also organised a number of regional think tank gatherings to discuss the Strategy Review with local experts.
- **Analysis and research** – Postcomm has made use of a number of economic and financial consultants to help inform its emerging views, including LECG, Frontier Economics and Brockley Consulting.
- **Independent experts** – Postcomm has benefitted from advice from members of a group of independent experts. This group included Adam Mantzos (Brockley Consulting), Chris Osbourne (LECG), Phil Burns (Frontier), Martin Cave (Warwick Business School) and Martin Smith (Simmons & Simmons).

Responses

A3.4 Postcomm received 23 non-confidential responses to its “Key questions for stakeholders” document from the following stakeholders:

Crown Lodge Management Co Ltd
Communications Workers Union
Direct Marketing Association
DX Network Services Ltd & Secure Mail Services Ltd
eyemagnify Ltd
Jim Fitzpatrick MP
Greater Manchester Chamber of Commerce
The Highland Council
Mail Competition Forum
Mail Users Association
Model Stop
National Federation of Subpostmasters
Postal Choices Ltd t/a ONEPOST
Postwatch
Periodical Publishers Association
Regional Mail Services & Postalnet
Royal Mail
South Ribble Borough Council
TNT Post UK Ltd
UK Mail
Mr Rufus Waddington
Wandsworth Borough Council
Welsh Language Board

A3.5 In addition to publishing the full responses on our website, we have summarised below the responses to the ‘Top 10 questions for

stakeholders' that were posed in Postcomm's document published in August 2006.

A. How might the postal market develop over the next 5 to 10 years?

1. The volumes of which types of mail are likely to grow, decline or remain stable over the next 5 to 10 years?

Mail volumes in the UK have been in slight net decline for the past two years. There was much debate amongst stakeholders as to the extent to which this is an endemic decline due to electronic substitution or whether electronic media is complementary to physical mail and may actually generate future mail growth.

Direct mail has experienced a decline in mail volume over the last three years and industry speculation varies considerably as to likely future volume trends. Some respondents predicted growth in certain segments, while others predict long-term gradual decline. There seemed to be widespread acknowledgment, however, that the pattern of direct mail use has been changing. The DMA points out, for example, that customers are tending to use direct mail less for acquisition and more for retention and brand building activity, so while more businesses may be using direct mail, volumes will remain static because individual mailers are using smaller more targeted campaigns. Some respondents believe there is a cultural shift occurring in communications, with people becoming increasingly selective about what they receive, as evidenced by spam filters, the Mail Preference Service etc. These respondents predicted that direct mail volumes will grow because it remains the medium that can be best targeted.

Most respondents predicted a gradual steady decline in transactional mail volumes, in line with the observed trend toward online banking. A few respondents, including UK Mail, believe physical mail will remain an important medium for the financial services sector, and that any further decline will be limited.

Fulfilment and home shopping delivery was considered to be a growth area by several respondents, driven by online sales. RMS & PostalNet observed that the physical catalogue as a shopping mechanism is complementary to the growth in internet shopping, therefore they predict that catalogues will continue to be used to drive online sales.

According to most respondents, publishing was considered to be a potential growth area. OnePost explained that printing and digital technology have increased the proliferation of specialist magazines, and noted that business-to-consumer magazine subscriptions are growing.

2. How are customers' needs likely to develop in the next 5 to 10 years in the various segments (e.g. business-to-consumer, business-to-business)?

Several respondents observed that large businesses are looking for fast, safe and reliable electronic media with which to carry out business activity, causing business-to-business mail to decline. In addition, as customers get used to using online financial services, banks will increasingly encourage them to go online to cut costs, decreasing customer-to-business mail.

Stakeholders pointed out that the public is increasingly concerned about environmental issues and data protection issues, and that as a result of the "junk mail" campaigns in the press, there may be an emerging aversion to direct mail that could damage the market. They believed the direct mail industry as a whole should work to overcome these negative perceptions.

Concerning direct mail use, the DMA predicted there will be increasing emphasis on reliability rather than speed, a demand for day-specific delivery, the need for evening and weekend delivery, "green" services, and increased track-and-trace facilities so that the customer knows when the recipient will be getting the mail.

Most respondents considered electronic media to be the biggest threat to the use of mail as it offers speed, low cost, and confirmation of receipt. They pointed out that at present, paper-based media offer advantages in terms of portability and ease of use, but developments with mobile devices are eroding this distinction.

The MUA predicted a decline in consumer generated mail, as individuals continue to prefer to communicate with one another electronically (as opposed to letters and cards), and will increasingly transact with businesses online as they get used to ordering and paying bills on the internet.

On the other hand, several respondents believed that consumers will be the ones to drive innovation in the postal industry as they increasingly demand solutions for home-delivery such as out-of-hours delivery and enhanced security.

The MUA predicted that small and medium sized businesses may drive the mail market, to the extent that direct marketing in this segment is still underdeveloped. SMEs will be looking to benefit from mail consolidation, new products and pricing to meet their needs, and possibly outsourcing all or part of their mailing operation, creating upstream opportunities.

3. How are operators' business strategies (both Royal Mail's and new operators') likely to change in the next 5 to 10 years?

Many respondents believed that over the next five years, the main competitive development will continue to be through downstream access. Downstream access will be pursued as a business model in its own right, and will also be used to establish critical mass in terms of volume and drop density to lead to the development of end-to-end provision.

OnePost pointed out that the access market is becoming increasingly commoditised and access operators' strategies need to focus on their size, efficiency and price. Where new entrants can break out of the commoditised market is by offering end-to-end delivery, and OnePost believed this will develop with a combination of operators working through a "lead" company.

The MUA believed that competitors will also be looking to maximise on the underdeveloped SME market where profit margins are higher, linking sortation, consolidation and in-house mailing services. OnePost suggested this would continue to be a growth area, and may expand into consumer-to-business mail, with collection points at alternative locations such as supermarkets.

Most respondents believed the establishment of a national end-to-end network to compete with Royal Mail is unlikely in the next 5-10 years.

There were some suggestions that final delivery business strategies might develop through the geographic expansion of city centre networks brought about by large volume mailers being prepared to undertake trials in specific postcode areas based on the success of existing services.

Royal Mail believed end-to-end competition is unsustainable because it increases industry costs by duplicating delivery networks, threatens the provision of the universal service, and has potentially damaging environmental implications.

The MUA believed new market entrants will also seek niche opportunities in areas such as home shopping and fulfilment by developing strategies to overcome customer access problems such as delivery "out of hours" via alternative locations or customer drop-boxes, flexible delivery times and other non-standard delivery features.

B. What will postal users need from the universal service, given its cost, and how will it best be provided?

4. How will customers' needs from the universal service change over the next 5 to 10 years in response to developments in the postal market and other communications markets?

It was generally accepted that customer requirements and behaviours are changing and being influenced by changes in technology and alternative communication media. Most stakeholders believed that electronic communication would play a more dominant role in communications over the next five to ten years, with an increasing number of people using e-communication to replace at least part of their postal communication.

Whilst stakeholders believed it was necessary for the universal service to continue to provide a reliable postal service which can be reasonably accessed and which is offered at affordable prices, the changes in the market were expected to impact on customers' needs from the universal service in a variety of ways. For example, as more people purchase goods online the delivery service for parcels will become more important. The MUA believed that increased security requirements for parcel carriage and delivery, and more convenient arrangements for the collection of undelivered parcels, might become necessary.

The DMA highlighted the growing public concern regarding environmental issues which could impact on customers' needs in the form of demanding 'green services'. Other stakeholders believed that competition in the market would determine how customers' needs might change. For example, DX Network Services/Secure Mail Services believed that end-to-end competition will bring real innovation to customers that will fulfil needs that have not yet been identified.

5. How will the provision of a universal service be affected by the changing postal market and various trends such as competition, the cost of its provision, and people's increasing use of alternative forms of communication?

The majority of stakeholders recognised that a decline in the market would affect the provision of the universal service and believed that the universal service should be reviewed on a regular basis to take account of this.

The NFSP, among others, believed that the provision of an affordable universal service in the future could be jeopardised as a result of competition if it reduced Royal Mail's economies of scale. If increasing competition results in falls in Royal Mail's level of activity, Royal Mail's unit costs would increase which would result in increased prices to customers and a possible reduction in quality of service.

It was generally accepted that increasing use of alternative forms of communication would exert downward pressure on mail volumes, which in turn would exert pressure on the universal service provider's ability to sustain

the universal service. Competitors to Royal Mail were concerned that the universal service should not become a cost to the industry as a whole.

A number of stakeholders suggested ways in which the universal service could be adapted to ensure its future sustainability, for example, UK Mail argued that the obligation to deliver to every door could be challenged. The MUA argued that Postcomm may ultimately need to consider zonal pricing on all universal service products including stamps.

6. How should the regulatory requirements of a universal service respond to the changes in the market?

The majority of stakeholders recognised that the scope of the universal service would need to change in light of developments in the postal and non-postal market, most notably that bulk mail products could be removed from its scope.

Royal Mail argued that its business customers do not need the protection of the universal service and the scope should ultimately be reduced to a narrower range of products which focus on the essential needs of social customers, which it believed could be fulfilled through stamps, airmail and a registered and insured product. This, it believed, would better protect the viability of the universal service and minimise the extent of cross-subsidy required.

Whilst Postwatch believed that there would not be a major change in the needs of customers in 5-10 years time, it believed that if the market develops more express communication (either developed through competition or as a response to e-commerce), then social customers may only require one standard product, for example a two day service rather than 1st and 2nd class. However, this product would need to meet customer requirements and be affordable in order for it not to disenfranchise vulnerable customers.

A number of stakeholders believed that Royal Mail must work at decreasing its fixed and variable costs, but be allowed to become more innovative and flexible to meet customers' needs in order to ensure the provision of the universal service; they also thought that Postcomm's regulatory requirements should encourage this.

7. How should Postcomm allow Royal Mail greater pricing flexibility to remove cross-subsidies and what could be the impact on the affordability of universal service products?

The majority of stakeholders accept that Royal Mail should be allowed to price in a cost reflective manner and that the removal of cross-subsidisation over the longer term is desirable. However there is a recognition that the removal of cross-subsidies might result in higher prices for domestic and social users of mail. For this reason stakeholders representing customer groups, such as Postwatch, DMA and MUA argued that the removal of cross-subsidies should be done in a controlled manner so as not to result in dramatically increased

prices for any group of customers. Postwatch argued that cross-subsidies should continue for universal service products to ensure the uniform price for vulnerable customers.

There were also a number of stakeholders, including Postwatch and some operators, who argued that Postcomm should be careful about how the introduction of cost-reflective pricing could impact competition. There was some concern that the timing and manner of introduction of cost-reflective pricing which was being proposed by Royal Mail was intended to remove competition rather than to remove cross-subsidisation. To avoid this, stakeholders urged Postcomm to be transparent in its approach to deciding on cost reflectivity.

However, Royal Mail and the CWU argue that it is necessary for Postcomm to allow Royal Mail to remove cross-subsidies through greater price re-balancing, to ensure it can remain competitive and continue to provide the universal service.

C. What is the best long term framework for promoting effective competition and deregulation?

8. Does Postcomm's policy towards downstream access facilitate or inhibit the development of end-to-end competition?

The majority of stakeholders believed that access was not an inhibitor of end-to-end competition and that access had allowed competitors to build volumes, customer relationships and market knowledge that could facilitate end-to-end competition in the long-term.

Royal Mail supported this view and argued that the fixed cost nature of the delivery operation meant that even limited end-to-end competition would have a significant impact on prices and Royal Mail's efficiency. It argued that the duplication of costs arising from widespread delivery competition could significantly raise industry costs in outdoor delivery. It believed that access competition would preserve the economies of scale that maintain low unit costs for the good of the universal service and economic welfare.

However, not all stakeholders subscribed to this view.

DX Network Services/Secure Mail Services believed that the access model has had a negative effect on the development of end-to-end competition. It argued that access was not, by itself, a fully effective form of competition in the mail market, provided only limited added value beyond lower prices for large mailers and had been used by Royal Mail as a means of protecting its delivery network from end-to-end competition.

The CWU argued that the experience of liberalisation to date had reinforced its view that real competition in postal services was a myth since no other postal operator is in a position to genuinely replicate and compete with Royal Mail's national delivery, sortation and distribution network. It argued that

Postcomm's approach had sought to create an artificial form of competition in bulk mail services via downstream access arrangements.

9. Assuming a secure universal service, should Postcomm consider a greater degree of ring-fencing or separation of Royal Mail's postal activities in order to promote competition and transparency?

Royal Mail argued against a greater degree of ring-fencing or separation being introduced to its activities and believed that the introduction of Royal Mail Wholesale was sufficient to restrict the incentive and ability for Royal Mail to discriminate against third parties. It recognised that separation had taken place in other industries within the UK, but believed that postal operations did not share the same characteristics as gas or electricity infrastructures. It argued that Royal Mail's operations are complex and interdependent with assets and people shared across different parts of its business. It believed separating Royal Mail would introduce complexities and costs that could endanger end-to-end quality, and potentially threaten Royal Mail's transformation plan.

Although other stakeholders could see the merit in introducing further ring-fencing or separation to Royal Mail's activities, there was not widespread support at the present time for radical forms of separation such as further physical separation between parts of Royal Mail. This stance tended to be on the basis of either a lack of evidence to support such forms of ring-fencing or separation, uncertainty around the specific point of separation and the impact this might have on the market, or practical concerns around the ability to introduce physical separation.

However, many stakeholders were supportive of introducing less radical measures such as further accounting separation.

The MUA believed that accounting and financial separation was fundamentally important and should be carried out quickly whilst the MCF argued for greater cost transparency and for the incentive structures of those who work in Royal Mail Wholesale to be based on the success of Royal Mail Wholesale rather than Royal Mail as a whole.

Although agnostic about separation as a point of principle, Postwatch believed that there were barriers to competition around access terms (not only pricing) whereby entrants could be required to comply with more onerous requirements than Royal Mail's retail customers and therefore supported the regulation of access prices and associated non-price terms.

10. What more can Postcomm do to enhance customer benefits from competition and innovation, whilst providing the best prospects for deregulation?

Royal Mail argued that the current regulation it faces was stifling its ability to innovate and meet customer needs. In particular it highlighted the large range of services that Postcomm continues to regulate under the price control; the time required to remove products from the price control being too lengthy in a fast changing market; Royal Mail's notification requirements under Condition 7 delaying the launch of new and innovative services; and quality of service standards under Condition 4 being too onerous.

Royal Mail argued that the upstream market in many business markets – most notably bulk presorted – is competitive and that Royal Mail's prices were already constrained by competition and the ceiling set by stamp prices and other retail products. It believed that deregulating the retail business market would allow Royal Mail to respond more quickly to customer needs.

In contrast to Royal Mail, other stakeholders and in particular other operators believed that it was too early for Postcomm to consider deregulation and that Postcomm should focus on making the current regulatory regime more robust to protect emerging competition. However, there was a general response from operators that Postcomm should consider methods other than RPI-X for Royal Mail's price control and that the next price control should focus on reducing Royal Mail's costs rather than restricting its prices.

The MUA believed that before deregulating, Postcomm needed to ensure a stable regulatory environment in which existing postal operators, new market entrants and the customers they serve can make sound business decisions.

Postwatch believed that Postcomm could look at the level of information it provides customers and the overall role it plays in 'directing' customers to alternative providers, making them aware of competition and setting the foundations for potential deregulation should competition develop.