

POSTCOMM



The evolving regulatory function A UK perspective

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Chief Executive

The UK postal market

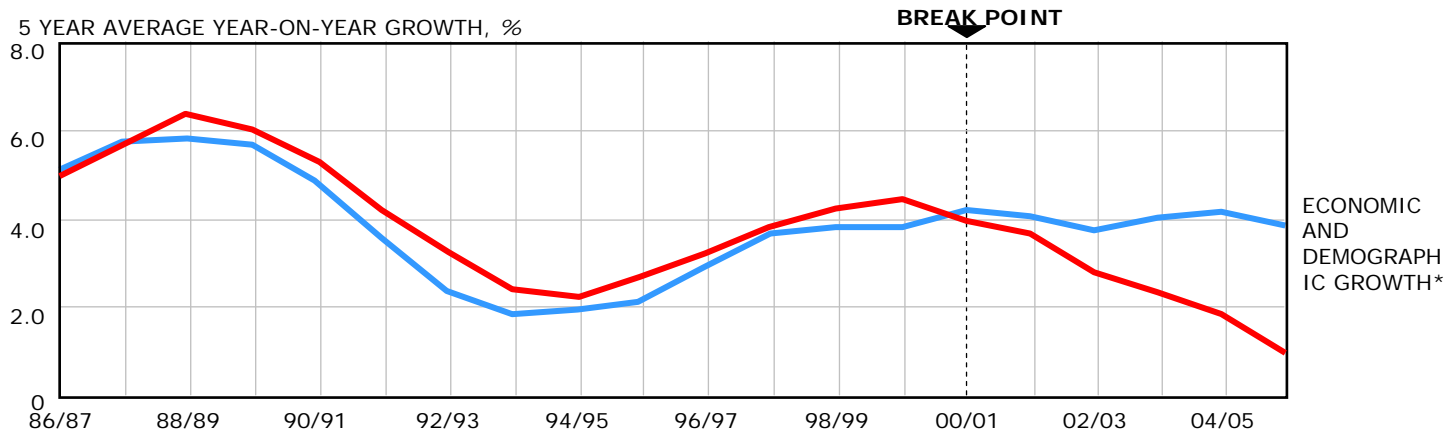
- **UK Addressed Mail market was worth £6.6bn in 2006/07**
 - 21.9 billion items
 - 2% down on 2005/06
- **Full market opening in 2006, now 18 licensed operators**
- **Competitors carry upstream mail through access agreements with Royal Mail:**
 - Access was 11.8% of Royal Mail volumes in 2006/07, now over 20%
- **Alternative operators' end-to-end volumes decreased from 39m to 35m items in 2006/07**
- **Royal Mail still dominates the final mile delivering over 99% of regulated letters - but delivery networks do operate in the unregulated parts of the market**



Postal market trends

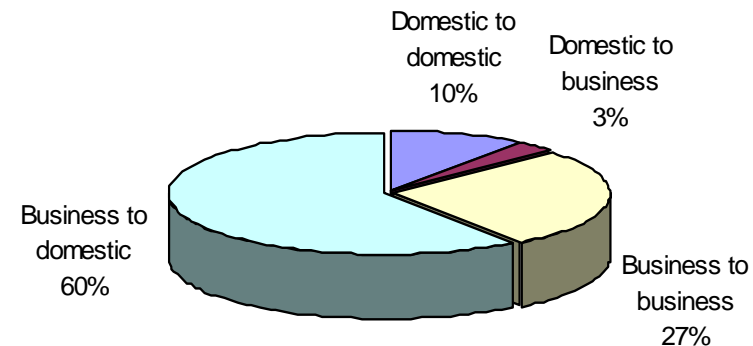
- After years of modest growth in line with GDP, volumes have declined around 1.5% year-on-year over the last three years.

Inland letter traffic compared with economic and demographic growth



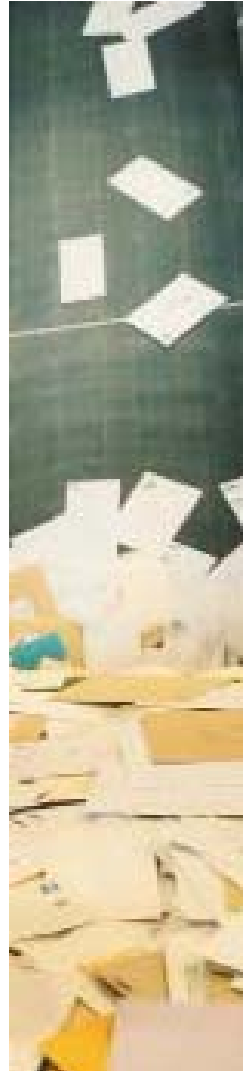
* Economic growth is weighted by letter demand; demographic growth is measured by growth in number of households

- Continued decline in traditional mail (DM, transaction and social), but significant growth in goods fulfilment.
- 90% of all volume is business related,
- 87% business generated

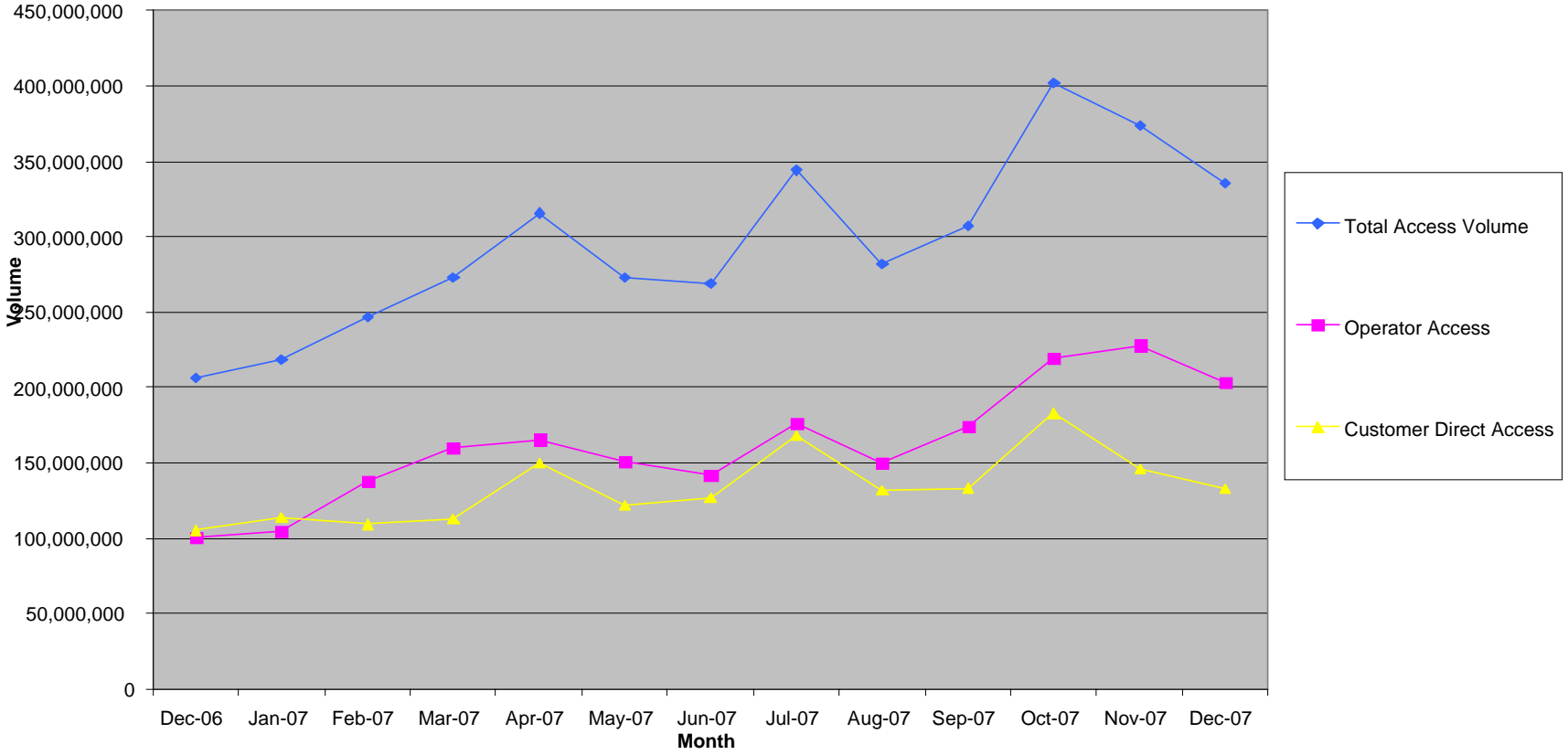


The market is evolving...

- **Competition and regulation have benefited customers and the mail market through:**
 - Improved quality of service
 - Some product innovation
 - Bulk mail prices reduced by competition; stamp prices kept down by regulation
 - Cross subsidies reduced by cumulative effect of price controls
- **New business models emerging**
 - Hybrid mail (distributed print)
 - Mailing houses
- **Media substitution v. convergence**
- **Environmental issues of increasing importance, operators are responding**
- **End-to-end competition in niche markets but potential to grow**
- **Access competition growing**



Access competition



▪ Access volumes are expected to plateau at about 35% of total volume in the next few years

Key issues...

For the market...

- How does the industry respond to structural changes in the market? Is mail dying?
- Are the returns in the UK market sufficient for investment, innovation and competition?
- Can the current position in the UK sustain a universal service?

For Postcomm...

- How can we help mail to adapt to the changing market and exploit potential of e-fulfilment?
- Royal Mail will be an integral part of this market so how can it be incentivised to be more efficient, innovative and customer responsive?
- Competition in the UK is not fully developed so how can this be encouraged and sustained along the pipeline?
- What are the future requirements of a universal service?

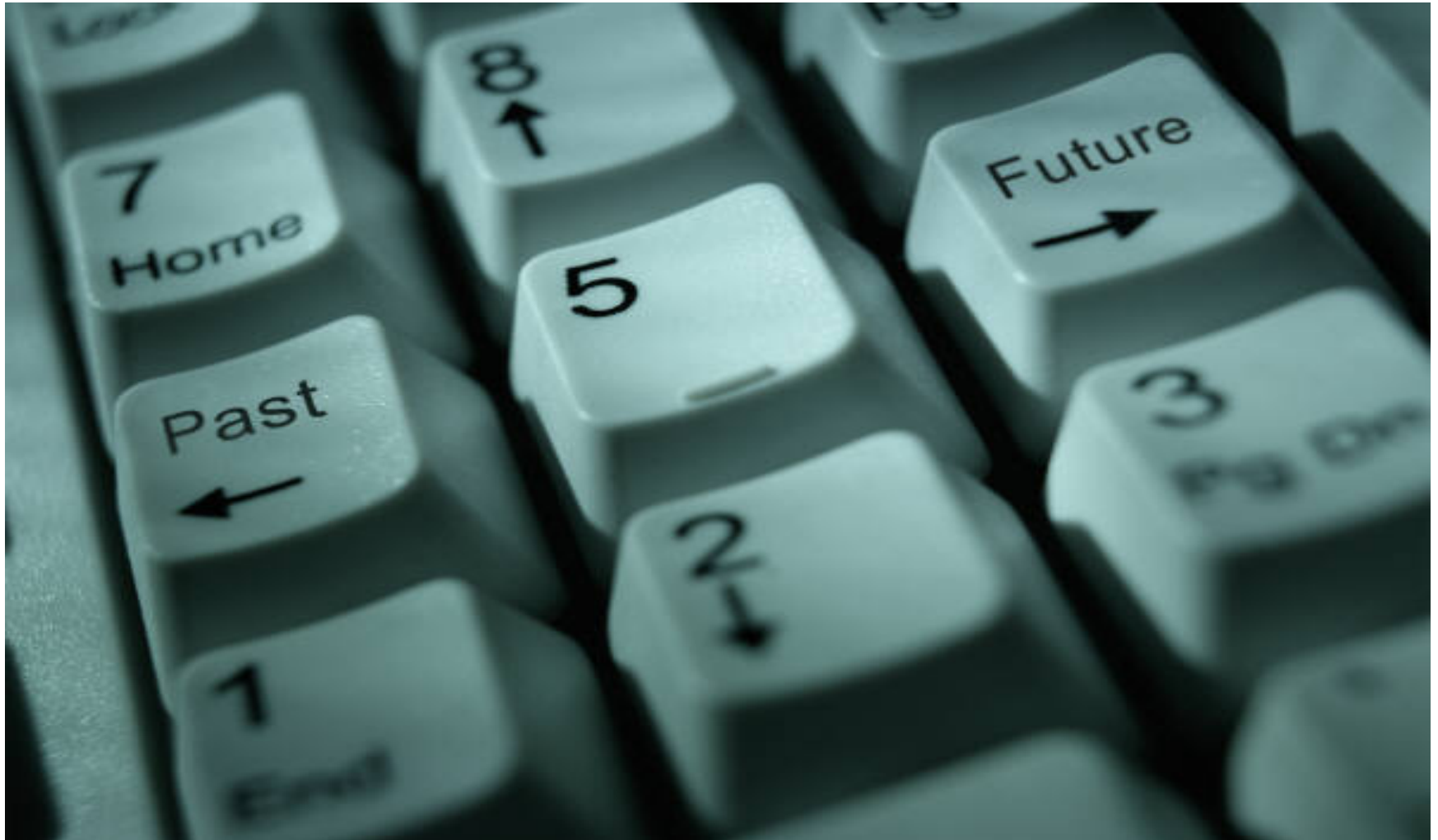


Key issues for Royal Mail...

- Its competitors are now its biggest customers. How does it manage this conflicting relationship?
- Investment and efficiency lags significantly behind international comparators. How does it not only catch up but become a leading benchmark?
- How does it exploit the growth in fulfilment given that in the last year it has lost market share?
- How can it turn the universal service from an obligation into an opportunity?
- How does it fund its pension deficit?



Options for the future Regulatory Framework...



Scenario 1: Status Quo minus...

- No significant progress on cost transparency, wholesale equivalence or structural separation
- Retain broad set of price controls, removing just those bulk mail products where competition is already established or in prospect

Advantages

- Maintains existing degree of protection for customers and operators
 - Explicit headroom regulation for access competitors



Disadvantages

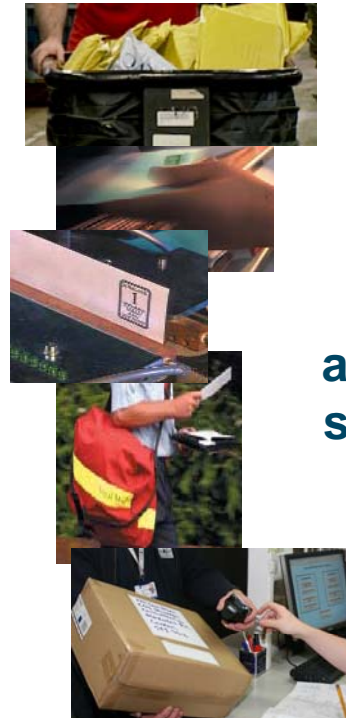
- Cumbersome way to control price of access products
- Broad scope of price regulation discourages flexibility and innovation
- Could discourage end-to-end competition

Scenario 2: Setting Benchmarks...

- Barriers to entry (eg. uneven VAT regime) reduced
- A single stamped mail service price controlled
- Downstream access price controlled directly by Postcomm taking a judgement on Royal Mail's costs
- Pre-sorted bulk mail and metered/PPI not price controlled

Advantages

- Focuses only on current products where Royal Mail has enduring market power
- Benchmarks influence pricing behaviour elsewhere
- Reduces scope of regulation
- Protects residential customers
- Access price regulation could be scaled back



Disadvantages

- Would require high level of confidence (for example, through cost transparency) in ability to prevent access margin squeeze (i.e. to ensure no cross subsidy from delivery to upstream activities)

Scenario 3/4: Wholesale equivalence

...with or without price caps...

- Barriers to entry (eg. uneven VAT regime) reduced
- A stamped mail service price controlled (first or second class standard tariff)
- Wholesale equivalence in delivery (with or without price control)



Advantages

- Protects residential customers
 - Could help avoid margin squeeze
- Does not distort end-to-end competition

Disadvantages

- Risk is rising access prices and therefore bulk mail prices, relying on competition developing in delivery in the medium term

Scenario 5: Stamp price regulation

- Barriers to entry (eg. uneven VAT regime) reduced
- A stamped mail service price controlled
- Ex-post control of other products, including access price

Advantages

- Protects residential customers as senders
- Allows Royal Mail considerable pricing flexibility

Disadvantages

- Requires quick and effective investigation of anti-competitive complaints by Postcomm
- Little protection for access competition or for non-residential customers



Looking ahead...

- **The market in the UK is in a period of transition**
- **There is possibility of a win-win (for customers and for mail operators including Royal Mail)**



- **But this cannot be achieved without a radical approach to regulation**
- **The risk of not changing is potentially very serious:**
 - Accelerating decline in volumes;
 - Higher cost; and
 - Threat to quality of service and the USO.

POSTCOMM

