

Nigel Stapleton speech to the UK Mail Show

November 1, 2005

SUPPORTING COMPETITION

Minister, Elmar, ladies and gentlemen. Before I begin, I would like to thank the organisers of the UK Mail Show for inviting me to speak today. It is a pleasure to address so many of the leading figures in the mail industry in the UK on the topic of “Supporting Competition”

We have been working hard at Postcomm over the past year to inform mail users of the opportunities for them in a competitive market. We have also put in place a licensing framework designed to secure customer confidence in the liberalised market.

Most important of all, later this month we will be publishing our final proposals on Royal Mail’s price and service quality control covering a four year period from April 2006. These are meant to create the framework for a competitive market and to protect customers for as long as Royal Mail remains a near monopoly.

These proposals will also be designed to secure Royal Mail’s successful transition from monopoly provider to the leading player in a competitive mail market.

A successful, efficient, responsive Royal Mail is a vital ingredient of our vision of a vibrant, competitive postal services market in the UK.

We are undertaking all this work at a time when there is a lot of political debate about the future of Royal Mail. Much of this relates to its future ownership structure and its pensions deficit. The first issue is definitely none of Postcomm's business, but the second one certainly is a key issue for our price control.

Although we have tried hard to keep out of this political debate, we have inevitably been drawn into it. A lot has been said during that debate that might well erode the confidence of mail customers and new market entrants at such a critical juncture in the development of the mail market.

I want to use this speech to reaffirm that we at Postcomm want no part in the ownership debate and to provide reassurance on three other key issues that have surfaced in this political debate. My focus during this address will, therefore, be on the three questions shown on this slide

SLIDE 1: The three key questions:

1. Are Postcomm moving too fast in opening the letters market fully to competition on 1st January 2006?
2. Have Postcomm “got their sums wrong” in our initial price control proposals?
3. Will it all end in disaster?

If I achieve anything today, it is to reassure you that the answer to these three questions is categorically NO.

SLIDE 2: Are we going too fast?

Postcomm was created as part of the Government’s response to a European Directive. This had the over-arching goal of developing an efficient market in postal services across Europe. Competition is the lever to drive up quality of service and hold down prices - without endangering the fundamental principle of universal service.

There is currently much discussion about why we in the UK are pushing forward market opening ahead of some (although I might add not all) of the other European countries. Listening to these arguments, I sometimes wonder if we have forgotten that Britain has led the world through market liberalisation.

After such successful outcomes from introducing competition into other network industries with universal service obligations - like telecoms and gas - why should we hold back with postal services?

At Postcomm, we believe it is right to adopt a pace-setting position – but never at the expense of Royal Mail or the universal service.

On the contrary, our view has always been that the sooner we proceed to full market opening, the easier it will be for Royal Mail to embrace fully its transition from monopolist to market leader in a competitive market.

What is curious about the “going too fast” analysis is that it assumes that full market opening on January 1 2006 represents a huge step which will endanger Royal Mail. It is nothing of the kind!

A very major step in the journey to full market opening actually took place in April 2003 when a third of the market was opened to competition. This was the moment when we opened the market for large business mailings which inevitably offer the most attractive target for new market entrants.

Since that time, we have granted 14 licences to operators wanting to compete with Royal Mail. However, nearly 30 months after the

first important step in opening the market, Royal Mail still has a hugely market dominant position in the UK.

SLIDE 3 – Market shares.

As you will see from this slide – according to the latest research we have carried out - Royal Mail still has over 97 per cent of the market.

If I say sometimes that Royal Mail behaves like a monopoly, it is because it has been in an entrenched position since time immemorial -- and making it change is a tough job.

Alan Leighton, Adam Crozier and all of their people at Royal Mail have achieved a lot already. They also acknowledge that they have a lot more to do, and none of us pretends it is easy. But monopoly behaviours only change if monopoly is challenged.

Which is why – with the full support of Royal Mail – we are moving to a fully opened market.

From January 1 2006 other operators will be able to compete with Royal Mail in the retail and small business letters market.

This will be an important step towards an efficient and innovative postal services market but let us be clear that it is of no greater significance than the first step back in April 2003.

The licensing framework for the fully competitive market has been in place since late summer but since then we have had only 3 definitive licence applications and a modest number of serious expressions of interest.

Royal Mail enjoys significant scale economies and the big advantage versus the new entrants of exemption from VAT. Neither of these major benefits are likely to erode in the foreseeable future.

It is encouraging that several new entrants are starting to create a viable business model. However, Royal Mail, at this point, faces no significant market challengers and is unlikely to do so for some time to come.

Indeed one of the new entrants, Express Dairies with its “mail with the milkman” offering, has withdrawn because it was unable to create a viable business in competition with the dominant player.

I would also contest the suggestion that Royal Mail is seriously threatened by the Dutch and German National operators who, it is claimed, are “featherbedded” in a protected home market.

Royal Mail has been competing quite competently with them for many years in the deregulated UK parcels market. It has in GLS a highly successful logistics business, which last year accounted for over 10% of its profits, competing with the Dutch and Germans on their home ground.

Furthermore, in accordance with the European directive, TPG and Deutsche Post are already facing competition in parts of their domestic letters market. In the Netherlands, for example, the entire Direct mail market is open to competition and VAT is charged on all business mail.

It is also noteworthy that more than half the market share that has been taken from Royal Mail over the last 30 months has been won either by UK plcs or by private equity backed start-ups.

Today we are publishing our 2005 Competitive Market Review which incorporates a survey we have conducted of over 1200 mail users. The executive summary of this review and our press notice announcing the key findings will be available for you at the end of this session if you would like to learn more.

Customers tell us that the threat of competition is already encouraging Royal Mail to be more responsive to their needs and to offer more choice and innovation in postal services.

But let us be honest. The development of the competitive market is at a very early stage. By its own forecasts – prepared for our price control - Royal Mail will still have nearly 90 per cent of the market in 2010.

This is a massive share of the market. Remember that some commentators are worried about Tesco's market share in major retail and c-stores – assessed by some at around 40 per cent. Compare that to Royal Mail's 97% or its forecast of almost 90% four years from now!

That is why we have to have tough regulation of Royal Mail's prices, service quality and competitive behaviour. Opening the market to competition is not enough: Royal Mail will still need to be regulated as a monopoly until the consumer has a real choice of mail provider.

SLIDE 4 - Has Postcomm got its sums wrong?

We acknowledge that the next price control, which is due to come into effect on 1st April 2006, is going to have a big impact on the degree of success with which Royal Mail makes the transition from monopolist to a competitive player.

Our focus is to strike the right balance between the interests of Royal Mail, its customers and the new entrants into the market.

That is why the initial proposals that Postcomm published in early June were so carefully constructed.

They were informed by Royal Mail's own strategic plan, the work of our executive team and the studies of several specialist consultants.

The Commission itself comprises seven members who collectively have many years of experience of the mail industry and its key customers, of regulatory economics, working with trade unions and in change management.

The allegation that "Postcomm have got their sums wrong" largely relates to how we have treated Royal Mail's need for funds to modernise the business and to pay down the pension deficit.

I would like to comment briefly on each of these issues. You will, I am sure, recognise that I can't be too specific because we are now preparing our final proposals which will be published later this month.

We are taking carefully into account the many responses we have received from Stakeholders during the consultation process. Quite a substantial amount of new information has been submitted to the Commissioners since June – including a significant rework of Royal

Mail's strategic plan – and this will be used to inform our final proposals.

However, I can tell you quite unequivocally that we have heard nothing during this consultation to support the allegation that “our sums are wrong” and that the initial proposals were, therefore, unsound. Having unpicked the rhetoric and considered all the new information we find no fatal flaws in our initial proposals.

Postcomm totally subscribes to the assessment that Royal Mail has suffered from decades of under-investment and that it won't be successful in a competitive market unless this issue is addressed quickly.

Our initial proposals allowed for £1.1billion of one-off costs including fixed asset investment over the four year period of the price control which is nearly three times the amount spent over the immediately preceding four years.

Furthermore, the price control underwrites Royal Mail's ability to recover from the customer an 8% real return of such investments. How many participants in non regulated industries are able to secure such a level of guaranteed return?

Royal Mail says we are starving it of necessary investment. This is because we have disallowed some projects. But these are projects

which, on the figures submitted in its own Strategic Plan, do not generate a positive return on the funds invested.

The Postal Services Act tells us to treat Royal Mail as a commercial company – is it therefore not reasonable to expect them to invest in projects which create, rather than destroy value? So where are our sums wrong?

SLIDE 6 – PENSIONS

This slide shows just how significant an issue is the Royal Mail pension's deficit. The company's net tangible assets are £2.2billion and yet it has over £21billion of pension liabilities covered by £17m of pension fund assets, 65% of which are invested in equities.

Postcomm's initial proposals would allow Royal Mail to recover over £250million each year from customers to help pay down this pensions deficit. We differ, however, from Royal Mail on three principal issues.

Firstly, we believe it should be recovered proportionately from all customers and not just from their captive customers. Who but a monopolist would suggest otherwise?

Secondly, there are factors such as future returns on pension fund assets and pensioner life expectancy that can cause considerable

volatility to the pension fund deficit. We differ on how this should be handled in the price control.

Thirdly – and of most significance - we believe it is an issue for the company as well as for the shareholder and the customer. Everything said thus far by Royal Mail argues that it has to be addressed either by the customer or the shareholder.

Take the example of British Airways. It too has a very large pension deficit. Because of this, the company is not paying any dividends, it is looking at ways of reducing the cost of the scheme and is working even harder to take costs out of its business. It knows that it has to do this because if it were to pass the deficit on to customers through higher prices it would lose a massive amount of business to its competitors.

On pensions, we acknowledge that our final proposals need to address further the issue of pensions volatility. We are also urging Royal Mail to look at how much it can be contributing to the solution itself through pushing still harder for efficiency gains.

SLIDE 7 – Will it all end in disaster?

This takes me to the final question of whether or not our initiatives to introduce competition into the postal market will end in disaster. I have already emphasised that we recognise fully the importance of

getting the sums right in our final proposals for Royal Mail's price control.

SLIDE 8 - Four key initiatives

There are, however, three further areas on which Postcomm is focusing, apart from the regulation of Royal Mail, to ensure that our market opening initiatives are successful.

Firstly, we have to ensure customer confidence in the market. Any major failure by a new entrant to meet customer expectations for service quality or mail integrity would represent a significant setback.

This is why we have developed a licensing regime that is meant to be "light touch" whilst at the same time requiring minimum performance standards from all market participants.

Also we have secured agreement from all the licensed operators, including Royal Mail, to a set of common operational procedures. These will ensure that services that you take for granted when using Royal Mail, such as the redirection of misaddressed mail and the repatriation of undeliverable mail, will also be offered by all the other operators.

Secondly, we are working hard to create a level playing field for new entrants. If the "green shoots" of competition that have been

identified in our competitive market review are allowed to wither and die then it is most unlikely that the improvements that customers are seeing at Royal Mail will be maintained.

Thirdly, there is an urgent need to raise customer awareness. Only 25% of the respondents to our recently completed survey could identify 1st January 2006 as the date of full market opening and fewer still had been contacted by one of the new competitors.

With the help of Postwatch we will be taking a number of initiatives to improve customer communications.

Clearly we are very keen to hear the views of all stakeholders in terms of anything we might have missed. None of the feedback received thus far would suggest that there is a disaster waiting to happen! Indeed, quite the contrary.

We are already seeing a stronger universal service by virtue of Royal Mail's recent financial performance turnaround and the improvement in its quality of service.

Postcomm wants to help Royal Mail succeed by striking the right balance with our proposals. A successful, efficient, responsive Royal Mail is a vital ingredient of our vision of a vibrant, competitive postal services market in the UK.

It will be a market in which all sides can win – Royal Mail, new operators and consumers -- all of whom (no matter where they live) will continue to enjoy an affordable and uniformly priced daily delivery.

Slide 9 - The Past 12 Months/ the Next 18.

In conclusion, I think we can justifiably claim that the past 12 months have seen important steps towards realising Postcomm's vision with:

- Royal Mail's service quality and operating profit both at an all time high
- The customer experience significantly enhanced
- Continued market growth underpinned by greater innovation

The next 18 months represent the opportunity for all parties to build on this early but tentative success. You can be assured that Postcomm will seek to deliver a regulatory package that can ensure the financability of the universal service and which is sensitive to the particular challenges that Royal Mail is facing.

Clearly it will require Royal Mail to operate as the Postal Services Act set it up to be, namely as a commercial company, and to respond to competition just as any such company would be expected to do.

Ladies and gentlemen, thank you.