

COMPETITION IN UK POSTAL SERVICES

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1. In recent years, this conference has discussed leading research in postal markets, their evolution and regulation. Much of the research has focussed on the vexed issue of competition and its:

- Merits;
 - interplay with the universal service; and
 - how the incumbent can respond to competition.
2. I believe that this debate will be enriched by actual experience of competition. At the moment, there is relatively little experience to evaluate, except for the “famous four” of Sweden, Finland, Argentina and New Zealand.
 3. In this regard, there was an important reform development in the UK only 7 days ago. The announcement was Postcomm’s final decisions on the Framework for Competition within the UK, which set out how we aim to join the exclusive club of countries that have fully opened their markets.
 4. I know from talking to many of you this week that you are aware something has happened in the UK, but not sure what it is - as there has not been much press coverage. The reason you may have missed it is that despite the hype surrounding our proposals in January, when it came to our final decisions, there was very little press comment and negative public reaction from key stakeholders. I could take this as a sign of stunning success in that everyone accepts and believes we have adopted the right approach!
 5. However, the truth as to why we received little attention may relate more to the fact that at the time we published our decisions, two events occurred that held a greater grip on the heartstrings of the Great British public and press, namely:
 - our Queen’s Jubilee celebrations; and
 - the England football team’s preparation for the World Cup.

No matter how much we in this room believe post is exciting – in the UK, we cannot compete with the Monarch and football, at least not at the same time!

Slide 1

Outline



Background

1. What is Postcomm?

Key Elements of the Competition Framework

2. Full market opening
3. Orderly transition process
4. Safeguards for the universal service
5. Measures to promote effective competition

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6. Given the recent nature of these developments in the UK, I wanted to use this opportunity to outline what the main changes will be and some of the factors that influenced our thinking. In doing so, I also want to touch upon some of the themes that are emerging from this conference in the last couple of days.

Slide 2

1. What is Postcomm?



- **Independent sector regulator for Postal Services in the UK (established 2000)**

- **Duties include:**
 - Primary duty to ensure continued provision of a universal service at an affordable and geographically uniform tariff.
 - Furthering the interests of postal users, wherever appropriate by promoting effective competition.
 - Promoting efficiency and economy.

- **Power to issue/set terms of operators' licences**

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7. So who are we? Postcomm for those of you that do not know is the independent sector regulator for Postal Services in the UK. Although the UK has a long history of regulation of utilities such as telecommunications, energy, water, airports and railways, Postcomm was only established two years ago with the passing into law of the Postal Services Act 2000 and is therefore very much the new kid on the regulatory block.

8. Our status is quite important. Under the Postal Services Act, Postcomm is independent from Government and the incumbent postal operator, Consignia.

9. So what are we paid for – what is our remit? Under the Act, Postcomm has a number of duties. Our primary duty is that we must act in a manner best calculated to ensure a universal service at an affordable and geographically uniform tariff. Subject to this, Postcomm has a duty to

further the interests of postal users, wherever appropriate by promoting effective competition. It also has a duty to promote efficiency and economy.

10. Everything we do must be in accordance with these duties. As a creature of statute, if stakeholders believe that we are clearly acting outside our duties, they can ultimately seek to review our decisions in the courts.
11. I am often asked why what we are doing in the UK is different to what is happening in other countries. The answer often lies not in a difference of view about economic principles or application but with different institutional starting points relating to the role of the regulator, its duties and powers. My point here is that sector reform depends as much on the basic institutional framework as the decisions that are subsequently taken.
12. What powers do we have? Like most UK sector regulators, Postcomm's principal powers are the ability to issue and set terms for licences that are granted to operators. For some operators, we expect the licences to be little more than a licence to compete for specified segments of the market with very few other restrictions, save for some basic integrity conditions along the lines of those we have heard about today in operation in New Zealand. However, for Consignia, additional licence terms were inserted into its licence recognising the fact that it is the established universal service provider and in a dominant market position.
13. The session earlier touched upon what are the most important features of regulatory licences. Whenever I am asked this question, people often seem disappointed when I pass over the exciting issues such as third-party access and anti-competitive behaviour and tell them that, for me, the two most important provisions are:

- Modification provisions. Can licence terms be changed by the regulator after the licence is issued? What is the process and what are the appeals mechanisms? Is this an objective and independent process? In the UK Postcomm can set the initial terms of licences. Once a licence is issued, Postcomm, if it wants to make a change, can either do so by mutual agreement with the licence holder or if consent is not given, refer the matter to the Competition Commission for investigation and appeal.

 - Information provisions. This will doubtless strike a chord with my regulatory colleagues here today. We all, I think, accept that good information is the oxygen of good regulation. Important questions are therefore: how much power has the regulator got to seek information? and what are the penalties for non-compliance by operators? In the UK, Postcomm's power to request information is enshrined in the Act and backed up with a licence obligation on Consignia. Personally, I do not believe incentive regulation is possible without the back-up of powers like these.
14. The \$64,000 question of course, is how should Postcomm use its powers in a way that is best calculated to further its duties? This is the "policy problem" that we have been set up to solve. Clearly, we were not so naive as to expect that in our deliberations on competition all stakeholders would be satisfied with the outcome. Finding an answer inevitably means trade-offs and balancing conflicting demands of stakeholders.
15. To help address the issue of balancing stakeholders' interests, Postcomm undertook a period of public consultation lasting almost two years, involving four consultation documents, consultants' reports, public workshops, regional visits, etc. All material relating to our consultation

process, including responses by stakeholders, are available from our website. I am pleased to say that this process itself spurred effective competition – to the extent that Consignia’s responses were often longer than our documents!

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1. What is Postcomm? (cont)



➤ **Guiding regulatory principles.**

- **Proportionality.** Any restrictions on competition or other forms of regulatory “compensation” should be no more than the minimum necessary to ensure the universal service.
- **Incentive Based.** Establishing an incentive framework that encourages efficiency improvements and innovation.

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16. The session yesterday touched upon the appropriate principles that regulation should adopt. In terms of our work, we kept in mind a number of guiding regulatory principles to help rank options for strategies for competition. There is not anything novel with these principles and they will have resonance in other regulatory regimes. To help understand our Competition Framework, I want to say a brief word about two.

- **Proportionality.** The grant of a monopoly – which essentially denies customers their usual right to shop around for a better deal- is an enormous commercial and management privilege. It is not a company’s “right” to possess a monopoly for the sake of it. The benefit from this privilege should be set so as to offset the

disadvantages caused by undertaking to supply the non-commercial operations of the universal service.

Otherwise, if the benefit from the monopoly outweighs the costs of the universal service, then all the regulator has done is grant excessive benefits to the monopoly to the disadvantage of other stakeholders such as customers and other operators. This applies to other forms of compensation that can be given to the universal service provider, such as pricing flexibility or external funding.

- **Incentive based.** Don't believe the hype - regulators cannot and should not run businesses. Their job is to establish the rules of the game in a way that achieves their clearly specified objectives and let management do what it is paid for and manage the business. If we believe the economic theory that businesses respond to incentives, then the role of the regulator is to set a framework that aligns its objectives with the incentives of the company.

To make incentive regulation work, then risk must be appropriately allocated between the various stakeholders. Put another way, the company must face the consequences of its own action. For instance, if it can be manifestly inefficient, then passing these excess costs on to customers in the form of higher prices is unlikely to encourage more efficient behaviour.

Incentive regulation, such as the RPI-X framework that is often used in price controls, is usually designed to encourage efficiency by ensuring that forward looking efficiency targets are built into prices. Failure to meet these targets means loss to the shareholder, who in turn can be relied upon to put pressure on management to perform. Conversely, efficient performance better than the target level generates higher returns, boosting profits. In the context of competition, this means

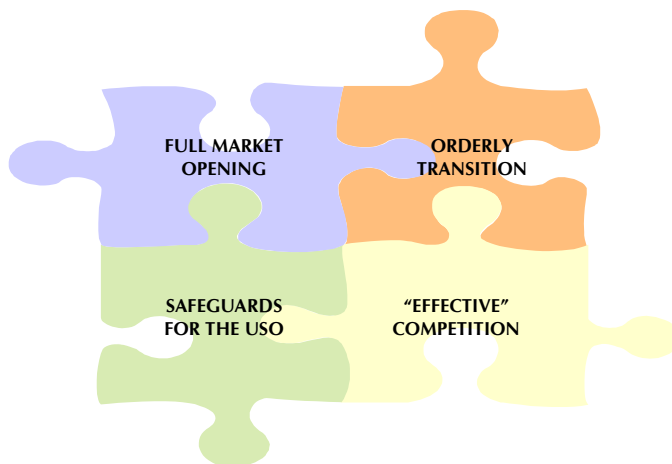
that regulatory compensation, such as restrictions on competition or price rises, should be used to finance the disadvantages of the non-commercial constraints such as parts of the universal service, but not blatant inefficiency. All this does is to ensure regulation mimics as far as possible the effects of a competitive market.

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Competition Framework



➤ **Key commitments established in four main areas**



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17. So what have we done with this remit? Our Competition Framework is best summed up by four key commitments we laid down in our decision last week. These are:

- a commitment to full market opening;
- a commitment to an orderly transition towards full market opening;
- a commitment to safeguards for the universal service; and

- a commitment to promote effective competition as distinct from merely allowing the possibility of new entry.

18 I will now explain what these mean in practice and some of the factors that influenced our decisions in these areas.

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2. Full Market Opening



- **Competition can bring benefits to customers**
 - Present monopoly not working effectively.
- **Cost of the use?**
 - Not significant in present market environment
 - Could change with liberalisation/keep under review
- **Cost of liberalisation?**
 - Consignia more sensitive to cost control and efficiency than market share loss under competition.
 - Question arises: what is the best framework to encourage efficiency? ⇒ Competition.

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19. Postcomm's first commitment is to full market opening. A number of factors influenced this.

Competition will bring benefits to customers

- i) Aside from the textbook benefits from competition, one of the key results for customers is innovation. 86% of letters are paid for and posted by businesses. Many who responded to Postcomm's consultation said that they would give more volumes to Consignia if it was more flexible to new ideas and product innovation. Indeed, some went as far as to say that without innovation on the

part of Consignia they would be pushed –not pulled- into seeking alternative media for their products.

The present monopoly is not working

- ii) The monopoly is failing customers in that service standards continue to be below target and innovation to evolving customer demands is not as it should be.
- iii) The monopoly is also failing Consignia in that the last regulatory accounts show that the competitive use part of the business is profitable and offsets losses in the monopoly area. This is counter to what we might expect in that the monopoly is granted to support losses generated from the use business operating in the competitive market.

Cost of the USO?

- iv) What a question! Answering this seems to be like answering the meaning of life. A worthy pursuit, but ultimately a fruitless one! We wanted to know which services Consignia was compelled to provide at a loss and hence might not be provided by an operator free from the use restriction. We undertook a standard Net Avoided Cost type analysis and found that the sum of loss-making routes was £81m – about 1.5% of mails revenue. We consider this an outside limit for the net cost because:
 - a. it looked at all inland letter products (even some that Consignia did not class as universal service);

- b. it excluded any benefits from being a universal service provider – something our speaker later from London Economics will no doubt criticise me for!;
- c. it was based on actual costs not an estimate for efficient costs; and
- d. it used highly disaggregated data of some 30,000 delivery “routes”.

Overall, we could not conclude that the universal service represented a significant burden in the current market environment. This analysis concurred with the results of a previous study undertaken for the European Commission in 1997.

- v) This conference has helped me put these results in context. Yesterday, we heard that the German Regulatory Authority had reached the same conclusion as far DPWW’s universal service obligation is concerned – i.e. it is an integral part of their business model, not something which is a burden. In terms of quantification, I am also heartened that my Norwegian colleague, using the same methodology, finds that the net avoided cost of the universal service in Norway is just 2% of the incumbent’s mail revenues.
- vi) I stress that our analysis was based on data that was cast in the present market environment, one characterised by a monopoly. Therefore, its relevance for decisions on competition is limited because the question we really want an answer to is the cost of the use under competitive conditions. This is something we have no way of knowing in advance of competition. Also, there is unlikely to be just one answer. Competition by its nature is a dynamic

process. We have therefore committed to reviewing this analysis periodically to see whether the passage of time, refined data and analysis and the effects of market changes brought on by competition change the results.

Cost of liberalisation

- vii) Under competition, it is not sufficient for Consignia to recover only the sum of the loss-making universal services. It must also recover what is called its “fixed” costs, which it estimates amounts to about 40% of its total costs.
- viii) Putting to one side my scepticism about whether these costs are as “fixed” as Consignia suggests, the key question of course is whether competitive entry makes the recovery of these fixed costs impossible. Much depends on assumptions made about the nature of entry as well as assumptions about the nature of costs.
- ix) To help pick through these issues, Postcomm, with consultants Andersen, developed a detailed financial model of Consignia to help measure the sensitivity of various assumptions.
- x) We mentioned earlier the faults in such exercises. From my perspective, experience from liberalisation models in other sectors has taught me to be fairly cautious about such modelling when it is used as a reason for not introducing competition. This is because:
 - a. The benefits of competition such as innovation and changes to business models cannot be foreseen in advance but are the principal motivations for encouraging entry in the first place;

- b. Incumbents find ingenious ways to respond to competition to hold on to their markets. The experience we have learnt today from our New Zealand and Swedish friends is a case in point. The point is that incumbents are not helpless souls – no matter how scary impending competition may look to some of them!
- c. The ease of entry is often oversimplified and overstated. All the entry pricing models assume entrants do not have fixed costs and can compete on the basis of the incumbent's marginal costs. Really? Entrants have fixed costs and are also at a competitive disadvantage in terms of economies of scale. We also know that brand loyalty matters following the presentation this morning. In the UK, the Post Office is the second most widely known brand after Coca Cola. And just think about how much of a fraction of Coca Cola's marketing spend is necessary to achieve this coveted silver medal.
- d. Issues such as cost of the universal service and other social obligations get obscured with the cost of entry resulting from inefficiency and lack of innovation on the part of the incumbent.

I am not saying that this work should not be undertaken or has less value. However, I would contend that given that in any reform process, the burden of proof is always on those wanting change, not those resisting it, these drawbacks of predictive models of liberalisation suggest that any quantified „cost-benefit“ analyses will tend to be biased in favour of the status quo.

- xi) Nevertheless, one fundamental conclusion emerged from our detailed analysis, which was robust against this and other

sensitivities. Namely, that Consignia's financial position was more sensitive to it making efficiency and cost savings than to estimates for volume loss under competition. Provided Consignia could make reasonable efficiency savings (in line with its public commitment to cut costs by £1.4bn or 15% of total mails costs), then Postcomm believed Consignia could withstand full market opening.

- xii) The policy question for Postcomm was therefore: what is the best regulatory incentive framework to encourage efficiency improvements? You will not be surprised to hear me say that we believed competition was the best such framework. Why?
 - a. This firmly puts the onus on management (and by extension the shareholder) to become efficient. The company rather than customers faces bears the risk if it does not. This is a change in risk allocation from the situation of a monopoly, where save for regulatory controls, inefficiency can be passed on to customers in the form of higher prices.
 - b. Customers and other operators should not be expected to lose out in the form of continued restrictions on competition as a result of inefficiency. This is the main departure with the entry pricing type analyses – who pays for the cost of liberalisation? Where this is related to inefficiency, it must be for the company to deal with, not the captive customer in terms of higher prices or other operators in terms of continued restrictions on competition.
 - c. Regulation is a poor substitute for the rigours of competition. Competition tends to encourage operators to beat each other.

Regulation tends to encourage operators to innovate to beat the regulator!

Slide 6

2. Full Market Opening (cont)

POSTCOMM 

- **Operators, Consignia and customers need certainty over long-term expectations for the market.**
- **Degree of competition not proportional to degree of market opening.**
- **Other safeguards exist**

End-date set as 31 March 2007. From then:

- All restrictions on market entry removed
- Postcomm will licence with a „light touch“ and deregulate wherever possible.

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19. There were a number of other factors behind our decision to set a firm “end-date”.
- market players need certainty about the long-term rules of the game as far as market entry is concerned. Uncertainty about the end point will give rise to barriers to investment and entry. It will also frustrate change on the part of Consignia.
 - Competition is not linear with respect to the degree of market opening. Opening 10% of the market does not necessarily mean that 10% of the market is effectively contestable. Economies of scale and

scope mean that the degree of contestability is likely to increase as the size of the market opening is increased.

- Other safeguards exist for the universal service, which are preferable to restrictions on competition in the form of a reserved area. These include greater pricing flexibility. I want to come on to these later.

20. So what was Postcomm's decision? In the end we decided to set an end-date of 31 March 2007 for restrictions on competition. From this date, we have committed to light touch regulation and deregulation wherever possible.

21. I wish I had a Euro for every regulator that said that his or her intention was to regulate themselves out of a job – I would be a rich man. Performance in this regard in UK utility regulation has been patchy. Empires and power once acquired are difficult to forego. Also, as the need for economic regulation to establish the competition framework wanes, regulators have tended to find themselves busy with distributional and social concerns. Despite this patchy performance elsewhere, I believe that the prospects for deregulation in post are fairly good. I expect it to take two principal forms.

- Deregulation in terms of the need for licensing to enter the market and the degree of regulatory oversight that Postcomm will require.
- Deregulation in terms of the restrictions that are placed on Consignia being the dominant player. The more competition takes hold and the more Consignia embrace this change, the more I would expect to rely on the general operation of competition law rather than specific sector regulation.

Slide 7

3. Orderly Transition process



- **Duration.**
 - “Big-Bang” not desirable.
 - Balance providing too little time with too much time.

- **Market Opening.**
 - No just rely on EU Directive steps.
 - No unique strategy (weight/price thresholds, type of mail, etc)

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22. As the success of new regime critically depends on Consignia’s adjustment, judgement was required in choosing the right transition duration and market opening strategy during the transitional period.
- **Duration.** A balance had to be struck between allowing Consignia a period of rationalisation to prepare to competition whilst not giving it too much time to discourage its efforts or potential entrants. April 2007 gives Consignia the best part of five years to adjust – and eight years since the publication of the Government’s White Paper, which underlined its desire and intention to bring greater competition to the market.

 - **Market opening strategy.** Postcomm believes it is inappropriate to rely solely on the reduction in the weight/price thresholds resulting from the amended European Directive. Most post is concentrated on lower weight thresholds making predictable and distinctive product lines difficult for higher weight items. In addition, customers and operators face mail segregation costs. We believed that more was

needed to encourage sufficient contestability in the UK to deliver benefits to customers and encourage Consignia to reform.

There is however no unique strategy. Competition works because of differences in business models and therefore there is no “off the shelf” licence category that will suit all players. Predicting nature of entry is very difficult and it will change with evolving technologies and customer demands. A pragmatic solution is required. We have opted for a menu of options for licences in the transition period, that are both attractive to potential entrants and ensure that Postcomm meets its aim of providing Consignia with an orderly transition.

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3. Orderly Transition process (cont)



Phase I: 1 January 2003 – 31 March 2005

- Large „bulk“ mailings (30% of mkt)
- Consolidation
- „Defined Activity“ licences

Phase II: 1 April 2005 – 31 March 2007

- Large „bulk“ mailings (60% of mkt)

Phase III: 1 April 2007

- End-date and full market opening (100% of mkt)

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23. The transition path comprises 3 distinct Phases. In addition to the market opening resulting from the amended EU Directive, Phases I and II present opportunities in terms of Bulk Mail, consolidation and what we call defined activities.

Bulk Mail

24. Bulk Mail in Phase I is any mailing collected from the same site in the same format with a minimum of 4000 items. This will expose some 30% of present market revenues to competition (mainly the Workshare products). This threshold and/or definition will be altered for Phase II with the aim of expanding the competitive market to 60% of market revenues.

Consolidation

25. Consolidation licences enable operators to aggregate mail flows from several customers. Consolidators will have a restriction preventing them from injecting mail into non-Consignia networks. Under Consignia's licence, it must negotiate in good faith with a view to setting non-discriminatory terms for third-party access. Postcomm can make a determination if the parties fail to reach agreement.

Defined activities

26. Defined activities reserve a discretion to Postcomm to open up further small scale and specialised segments of the market following an application from an operator.

4. Safeguards for the use

> Incentive framework

- Encourage efficiency and innovation
- Transition process to enable Consignia to adapt

> Pricing flexibility

- Upwards – subject to „affordability“ constraint?
- Downwards – subject to competition conditions

> Scope of the universal service

- Products classed as universal narrowed?

> External funding

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27. I said before we that must ensure we have adequate safeguards for the universal service. I have already discussed the first two – encouraging Consignia to become more efficient and providing it with a transition process to enable to to adjust in an orderly way.
28. Pricing is an important safeguard. This can work in both ways – in terms of granting Consignia greater freedom to price competitively to new entry and greater freedom to raise prices if this is necessary to meet our objectives. The work we undertook with Andersens suggested that even if certain “downside” sensitivities, such as low growth or “cream-skimming” come about, then pricing would act as a sufficient safeguard.
29. Scope of use. You may be surprised to see that a safeguard for the use is something that reviews what it is actually is. In the UK it is not clear and Postcomm has said that it will consult on the appropriate definition that satisfies the requirements of the Act. One issue is whether every letter

service should be classed as universal and whether we should only consider single piece items.

30. Another possible safeguard we have touched upon today is external funding through a compensation fund. This is allowed under the Directive. We have said that we do not believe one is currently necessary and at this stage have no plans for recommending its introduction.

31. Postcomm also has a backstop measure or a “nuclear” option. This is that we could seek a licence modification to put back the end-date. We would need to exhaust all other safeguards first – and agree with operators that this should be done. Operators receive protection against this discretion because if they do not like our proposed modification they can refer the matter to our Competition Commission for appeal. The cumbersome nature of this safeguard is actually its virtue!

5. “Effective” competition

- **Introducing possibility of competition may not be the same as effective competition**

➤ **Work to be carried forward in number of areas:**

- Implementation issues consultation (June 2002)
- Access arrangements and pricing
 - Access price determinations (Autumn 2002)
 - Developing an Access Code (2003)
- Price control review (Autumn 2002)
- Anti-competitive behaviour
- Special Privileges

- **All must complement the competition framework and philosophy of deregulation where possible**

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32. Finally, just a quick word about measures to promote effective competition and our next steps. Just allowing the possibility of competition is not the same as effective competition – just think whether in Europe, anyone seriously posts a 400g letter with an alternative operator?
33. We will be carrying work forward in a number of areas as you can see from this slide. I think the most important part of this work programme is that the third-party access arrangements work. With such strong economies of scale with the incumbent, we cannot expect competition to become effective without it. However, this does not mean entry will occur at the expense of Consignia. We are very keen to see it develop a profitable, vibrant and innovative downstream business model.

34. I shall leave it there. I hope to have the opportunity again to come back here and let you know how the UK's new arrangements are working out in practice.

End