

Assessing competitiveness in postal services:

Postcomm's proposed criteria

A Consultation Document

November 2003

Summary

The need for Competitiveness Criteria

In May 2002 Postcomm set out its market opening decision which liberalised 30% (by value) of the postal market on 1 January 2003 and commits Postcomm to opening a further 30% by 1 April 2005 and fully liberalising the market by 1 April 2007. However, Postcomm has committed to monitoring the development of competition in the market during this time to ensure that the universal service is safeguarded.

Postcomm has also put in place Royal Mail's first full price control which came into force on 1 April 2003 and lasts for three years. Embedded within this price control is the ability for Royal Mail to seek to remove certain of its services from the control to the extent that it believes competition has developed in the provision of those services. It is Postcomm's role to determine whether these changes should be permitted or not.

In addition, Postcomm will seek to ensure that any regulation of the market remains appropriate and proportionate in the light of changing market conditions. In particular, Postcomm will seek to reduce the role of regulation wherever appropriate with the intention of deregulating (unless a compelling case is made to the contrary in terms of safeguarding the universal service).

In these regards, Postcomm committed to issuing this consultation document on the criteria it intends to use in determining whether competition has developed sufficiently in the provision of services within the postal market or its various market segments in order to then seek to deregulate the provision of those.

Over time Postcomm would seek to deem particular market segments as being competitive and Royal Mail might request that its services in particular markets be removed from provisions under Conditions 11 and 19 of its licence. In such cases Postcomm, would expect to consult before concluding that particular parts of the market can be deemed competitive.

Five Criteria

The five Criteria proposed include the assessments of:

- i. Barriers to Entry,
- ii. Scale and Nature of Competition,
- iii. Behaviour of Royal Mail,
- iv. Customer Awareness and Behaviour, and
- v. Effectiveness of Competition in Postal Services.

i) Barriers to Entry

Postcomm's consideration of barriers to entry would include an assessment of:

Legal Barriers: this would include the consideration of legal constraints to entry in the market such as the extent to which competition is statutorily allowed and any other legal protection the incumbent might benefit from. Clearly if Postcomm's market opening strategy has yet to expose certain services to competitive pressures those cannot be considered to operate within a competitive market. In addition, the presence of special privileges for Royal Mail (e.g. VAT advantages) might limit the scope for competition.

Economic Barriers: economic barriers might exist in the market which limit the development of competition. These might include economies of scale and scope that make entry unattractive.

ii) Scale and Nature of Competition

Postcomm's consideration of the scale and nature of competition would include an assessment of:

Entry and exit from the market(s): entry and exit can signal that firms are free to make commercial judgements within the market. However, it may also be the case that exit indicates that firms are unable to compete effectively.

The development of market shares and sustainability of competition: both the snapshot performance of competitors within the market and the more dynamic movement of market shares would provide Postcomm with an indication of the likely effectiveness of competition. It would also be important to consider the ease of establishment and the overall size of market players.

Market growth and technological influences: Postcomm would need to consider the extent to which technology changes and market growth might impact on market shares.

iii) Behaviour of Royal Mail

Although it is not the case that Postcomm would seek to further penalise Royal Mail had it previously been found to be in breach of Condition 11 (fair competition) of its licence and/or Competition Law, Postcomm would however need to bear any such cases in mind should Royal Mail seek to argue that those market segments were competitive. Past breaches of Condition 11 or Competition Law would provide an indication that competition was not necessarily acting as an effective constraint on Royal Mail.

iv) Customer Awareness and Behaviour

Postcomm's consideration of the behaviour and awareness of customers would include an assessment of:

Customer switching behaviour: this assessment would consider the extent to which customers have changed suppliers (the costs associated with switching) and whether they have been satisfied with their alternative providers.

Customer awareness: this assessment would consider the extent to which customers are aware of alternative suppliers even if they have not sought to switch and whether they would be willing to do so should their needs fail to be met by Royal Mail.

v) Effectiveness of Competition in Postal Services

This criterion would consider whether, in the light of the assessments under the other four criteria, Postcomm considers that it can rely on competition to regulate effectively the postal services market. Postcomm would need to consider whether, in the context of the particular sector of the market, there are any special features - such as the universal service obligation - which might justify the continuation of regulatory controls.

Responding to this consultation

This consultation document proposes that there should be 5 criteria and sets out the rationale for them indicating how they would be applied. Postcomm welcomes views on any aspect of the issues covered in the document and, in particular on:

- (1) Whether the 5 proposed criteria adequately cover all the relevant factors that Postcomm will need to take into account in assessing competition?
- (2) Whether there are any comments in relation to each of the individual criterion on the factors covered and whether there additional factors that Postcomm may need to have in mind under each criterion?
- (3) Whether there are any issues of concern about how the criteria are intended to be used and Postcomm's overall approach to the assessment of competition as set out in this document?

Consultation responses are requested no later than Friday 9 January 2004.

Table of contents

1. Introduction.....	1
What is Postcomm?	1
Postcomm’s Statutory Duties	1
Background.....	2
Structure and Layout of this Document	3
2. The Need for Competitiveness Criteria	5
Chapter Outline	5
The Regulatory framework for postal services.....	5
3. Criterion 1: Barriers to Entry.....	12
Chapter Outline	12
Description of Criterion.....	12
4. Criterion 2: Scale and Nature of Competition	14
Chapter Outline	14
Description of Criterion.....	14
5. Criterion 3: Behaviour of Royal Mail	16
Chapter Outline	16
Description of Criterion.....	16
6. Criterion 4: Customer Awareness and Behaviour	17
Chapter Outline	17
Description of Criterion.....	17
7. Criterion 5: Effectiveness of Competition in Postal Services.....	19
Chapter Outline	19
Description of Criterion.....	19

1. Introduction

What is Postcomm?

1.2 Postcomm – the Postal Services Commission was established by the Postal Services Act 2000 as the independent regulatory body for the postal services industry in the United Kingdom. As part of its function, Postcomm licenses, and enforces the licence conditions of, certain postal operators. Postcomm’s Business Plan, which can be found on its website www.psc.gov.uk, gives details of its duties, functions, objectives and work programme.

Postcomm’s Statutory Duties

1.3 Postcomm's primary duty is to seek to ensure customers continue to enjoy a “universal postal service”. The universal service consists of the delivery and collection at least once every working day of postal items (not exceeding 20 kilograms in weight) and the provision of a registered postal service, all at affordable prices that are uniform throughout the UK.

1.4 Subject to this, Postcomm is also charged with furthering the interests of users of postal services wherever appropriate by promoting effective competition between postal operators. In doing so, Postcomm must have regard to the interests of those who are disabled or chronically sick, are of pensionable age, are on low incomes or reside in rural areas.

1.5 Postcomm has a further duty to exercise its functions in a manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.

1.6 Finally, in performing all its duties, Postcomm must have regard to the need to ensure that licence holders are able to finance the activities authorised or required by their licences.

Background

1.7 In May 2002 Postcomm announced its strategy for the progressive opening up of the UK postal services market leading to the removal of all restrictions to market entry by 1 April 2007. Postcomm is committed to monitoring the market both during this time and beyond it to ensure that the universal service is safeguarded and to assess the extent and impact of competition.

1.8 Alongside this, Postcomm has put in place Royal Mail's first full price control which came into force on 1 April 2003, lasts for three years, and covers those of Royal Mail's services which Postcomm considers are not yet subject to competitive pressures. Royal Mail can seek the removal of services from the price control if the competition has developed in the provision of those services. It is for Postcomm to judge whether an appropriate degree of competition has become established.

1.9 Postcomm indicated that it would consult on the criteria it proposes to use in determining whether competition has developed within the postal market and its submarkets.

Purpose of this Consultation Document

1.10 This consultation document proposes that there should be 5 criteria and sets out the rationale for them indicating how they would be applied. It seeks views on any aspect of the issues covered in the document and, in particular on:

- (1) Whether the 5 proposed criteria adequately cover all the relevant factors that Postcomm will need to take into account in assessing competition?
- (2) Whether there are any comments in relation to each of the individual criterion on the factors covered and whether there additional factors that Postcomm may need to have in mind under each criterion?
- (3) Whether there are any issues of concern about how the criteria are intended to be used and Postcomm's overall approach to the assessment of competition as set out in this document?

Structure and Layout of this Document

1.11 Chapter 2 of this document sets out the relevance of the competitiveness criteria. Chapters 3 to 7 describe each of the criteria in turn and seek views on their appropriateness.

How to respond

1.12 Consultation responses are requested by no later than Friday 9 January 2004 and should be addressed to:

Ms. Tasneem Azad
Deputy Director - Competition
Postcomm
Hercules House
6 Hercules Road
London
SE1 7DB

Tel: 020 7593 2112
Fax: 020 7593 2142
Email: tasneem.azad@psc.gov.uk

1.13 If you would like further clarification of any points raised by this document please contact Tasneem Azad on the above details or Sean Browne on 020 7593 2136 or email on sean.browne@psc.gov.uk.

Confidentiality of responses

1.14 Postcomm wishes to make public the responses it receives to this consultation document. If you do not want all or part of your response to this document to be read by anyone outside Postcomm please ensure your response clearly indicates which parts are confidential.

1.15 If you are happy with the substance of your contribution to be made public, but do not want the name of the individual who signed it or the organisation who submitted it to be revealed, please indicate this by adding "name of organisation/sender not to be published".

2. The Need for Competitiveness Criteria

Chapter Outline

2.1 This chapter sets out:

- the regulatory framework for postal services; and
- describes the circumstances in which Postcomm will need to make judgements about levels of competition and outlines the way in which the proposed criteria will be used in reaching these judgements.

The Regulatory framework for postal services

i. Postcomm Market Opening Strategy

2.2 Until March 2001 Royal Mail had a monopoly in the provision of all mail weighing less than 350g and costing less than £1. In May 2002 Postcomm announced its strategy for the removal of this monopoly through the progressive opening up of the market to competition. This was based on Postcomm's conclusion that competition in the market was the best means of safeguarding the provision of the universal service and was necessary to help create an efficient Royal Mail at the core of the postal market.

2.3 Postcomm's decision was to introduce competition in three phases:

- Phase I from 1 January 2003 to 31 March 2005, with competition in bulk mail (individual mailings above 4000 items, representing around 30% of the UK letter market by value) together with consolidation services (requiring operators to pass mail over to Royal Mail for final delivery and certain specialised business services;

- Phase II, from 1 April 2005 to 31 March 2007, when Postcomm would adjust the above restrictions to open a further 30% of the market
- Phase III, from 1 April 2007 when all restrictions on market entry will be abolished.

ii. Monitoring the market

2.4 During the transitional period, Postcomm is monitoring closely the development of the market in order to ensure that the universal service is not put at risk and to monitor the extent and impact of competition. Although in principle Postcomm's market opening strategy currently allows entry into certain parts of the UK postal market, it is not the case that competition has sufficiently developed so as to act as an effective market discipline on Royal Mail. Licences have been issued to a number of operators but Postcomm recognises that there remain a number of obstacles likely to hamper the development of competition. From next year, Postcomm proposes to carry out formal competition reviews which will report on developments in the market, assess the extent and impact of competition and draw out any implications for Postcomm's policies.

2.5 In particular, Postcomm's competition reviews will seek to assess:

The effectiveness of competition within the market (any part of it)

- what type of entry and exit is occurring?
- are new entrants able to compete effectively or are there still significant barriers to entry?
- what is the behaviour of firms within the market?

Whether competition is providing adequate choice to customers

- do competitors' services provide an adequate substitute for Royal Mail's services?
- what is the switching behaviour of customers?
- are customers fully aware of new services?

What implications Postcomm can draw from developments within the market (or any part of it)

- what regulatory steps can or should Postcomm take to ensure the effectiveness of competition?
- Is competition sufficiently developed in any part of the market to enable Postcomm to remove or relax the regulatory controls on Royal Mail (including the current price control)
- What implications, if any, are there for Royal Mail's next price control?

iii. Regulatory controls over Royal Mail

2.6 Royal Mail is subject, through the terms of its Licence, to a number of controls which reflect the fact that, in most areas of the UK letters market, Royal Mail remains the dominant operator. The Licence recognises that over time, and subject to the obligation to provide a universal service, these controls will be relaxed or removed as competition develops, especially in relation to:

- The requirement that Royal Mail must behave fairly and must not, for example, unduly discriminate in its dealings with customers (Condition 11); and
- The limits on Royal Mail's ability to change its prices (Condition 19) and the requirement for it to meet specified quality of service standards in relation to its regulated services.

2.7 Condition 19 (17) of its Licence enables Royal mail to apply to Postcomm for a direction removing services from the requirements of the price control where "competition in the provision to customers, or to classes of customers, of the service in question being sufficiently developed to protect the interests of customers". This will require Postcomm to determine whether, in fact, competition is established. If Postcomm is satisfied on that question it would issue a direction which would also have the effect of taking such services outside the scope of the "fair trading" requirement of the licence (Condition 11).

2.8 In those circumstances, the regulation of Royal Mail's competitive behaviour in the provision of those services would be subject only to the general provisions of competition law (for which the Office of Fair Trading (OFT) is responsible) and prices for those services would no longer be controlled by Postcomm.

Assessing Competitiveness

2.9 Accordingly, there are two circumstances where Postcomm will, in future be likely to be considering the state of competition in the market (or a part of it):

- As part of formal competition reviews which Postcomm will carry out as part of its monitoring of the market; and
- on a case by case basis, in response to a request from Royal Mail under condition 19 of its Licence that certain of its services should now be regarded as being provided in a competitive market. Although in the interests of clarity and certainty, Postcomm would expect to handle any such requests by Royal Mail in the context of its regular competition reviews.

2.10 In addition, Postcomm will also be taking the state of competition into account in determining the scope and nature of Royal Mail's next price control.

2.11 Postcomm therefore considers that, in advance of such events, it would be helpful to participants in the postal services market – both operators and users – to be aware of the broad criteria that Postcomm will use in assessing competition and has previously stated its intention to publish for consultation its proposed criteria.

2.12 The criteria are intended to be used in indicating broadly the kinds of factors that Postcomm would expect to be taking into account in reaching its overall view on whether competition has become established. They are not intended to be applied on a narrow, individual or sequential basis but as elements of an overall assessment. Postcomm recognises that this may require careful judgements to be made, especially in circumstances where the individual criterion do not all point towards a common conclusion.

2.13 Postcomm does not propose to stipulate in advance any specific threshold values for the criteria. At this stage, Postcomm considers that such an approach would be premature and arbitrary.

2.14 Postcomm will expect to see any request under condition 19 by Royal Mail to be supported by evidence covering each of the criterion and notes that this will require significant amounts of information to be submitted which will require critical and detailed assessment.

2.15 Postcomm's proposed criteria which are described in detail in Chapter 3 are:

- Whether there exist barriers to entry,
- The nature and scale of Competition,
- The behaviour of Royal Mail,
- Customer awareness and behaviour, and
- The effectiveness of competition in postal services.

2.16 In applying the criteria Postcomm will be mindful of the need to identify clearly the market, or the part of the market, against which to make the assessment. In advance of any assessment, Postcomm does not intend to suggest how the relevant market (or part of it) might be defined but considers that question is best addressed as part of the task of undertaking an assessment of competition whether as part of a competition review or in response to a request by Royal Mail. In the next Chapter references to "market" should be read as including relevant parts of the market.

3. Criterion 1: Barriers to Entry

Chapter Outline

3.1 This chapter sets out:

- A description of and rationale for this proposed criterion.

Description of Criterion

3.2 This criterion considers whether competition is legally permitted within the market and if so, whether competition is feasible within the market. It examines whether, practically, new entrants are able to enter the market and the extent of the difficulties they may experience in doing so.

Legal Barriers to Entry

3.3 To be considered competitive, services must in principle be open to competition. Therefore, a service must be within those parts of the market which clearly Postcomm has opened up to competition whether by licensing (or exemption). Clearly those services are not yet open to competition would not be viewed as competitive. An example would be single piece domestic mail (for final delivery), which is currently outside Postcomm's market opening strategy.

3.4 The existence of statutory advantages enjoyed by an operator could also act as a barrier to entry. In Royal Mail's case, it currently benefits from a series of 'special privileges' that many have argued act to limit the scope for competitive entry. These benefits include an exemption from VAT, special customs clearance procedures, and exemption from some parking restrictions.

3.5 Postcomm has been reviewing these privileges and expects to issue a consultation document on the subject shortly.

Economic Barriers

3.6 Entry in to the market will be affected by the extent of other barriers that may be present. Such barriers to entry could include significant economies of scale or scope.

3.7 Economies of scale occur where average costs of production fall with rising volumes, in this case the numbers of items of mail going through a mail network. Economies of scale could prevent competitors from setting up if operating at low volumes was not adequately profitable. To the extent that any part of Royal Mail's network is viewed as highly developed then competitors may be averse to replicating those aspects of it. This has proved to be the case in parts of other regulated sectors.

3.8 Economies of scope occur where average costs of production fall as the number of different products going through the system rises. In the case of post, it has been argued that significant economies of scope may be present, with Royal Mail currently providing a very wide range of services, including some directed specifically at businesses, using the same infrastructure.

4. Criterion 2: Scale and Nature of Competition

Chapter Outline

4.1 This chapter sets out:

- A description of and the rationale for this proposed criterion.

Description of Criterion

4.2 This criterion will examine whether or not entry actually occurs within the market and how competitors within the market behave and their success in establishing themselves and gaining market share.

Market Entry

4.3 Evidence of both entry and exit naturally indicates that firms are free to make commercial judgements about entry into and exit from the market for particular services but it should be noted, that although market exit may simply be evidence of the 'cut and thrust of competition' it may also be an indication of the inability of firms to compete effectively against the incumbent.

Market Shares

4.4 Both the snapshot performance of competitors within the market and the more dynamic movement of market shares will provide an indication of the likely effectiveness of and sustainability of competition.

Wider Market Impact

4.5 Market growth and technological influences may also have an impact on the prospects for competition. A declining market is likely to be less attractive to new entrants whilst one subject to significant technological change may offer potentially more rewarding opportunities for new operators.

Overall size of market players

- 4.6 It will also be important to consider the overall size of operators within the market. The entry of large firm (relative to other competitors), presence in an adjacent or wider market, may make it difficult for smaller firms to establish themselves in the market. In addition the existence of a larger number of small competitors may not be a good indicator of the existence of sustainable competition.
- 4.7 In this context, it should be noted that the global mail market has in recent years seen a significant number of cross-border acquisitions and the establishment of a presence by a few big players in the various geographic markets especially within Europe.

Ease of establishment

- 4.8 The ease with which new operators are able to develop a profitable business on a reasonable scale may be relevant. International evidence suggests that incumbent operators have been able to sustain significant market shares for an extended period before competitors have become established even in limited ways.

5. Criterion 3: Behaviour of Royal Mail

Chapter Outline

5.1 This chapter sets out:

- A description of and the rationale for this proposed criterion.

Description of Criterion

5.2 This criterion would consider whether the operation of competition is 'fair' within the market(s).

5.3 Postcomm would need to consider whether Royal Mail has abused its position in the market in a way which indicates that competition is not yet effective and which suggests that the removal of regulatory controls would not lead to a fair market.

5.4 Although it is not the case that Postcomm would seek to further penalise Royal Mail if were found to be in breach of the Fair Competition condition in its licence (and/or Competition Law), Postcomm would, however, need to bear in mind any such cases in considering whether it should withdraw its regulatory controls and rely on competition in the market to exercise the necessary discipline. In particular, Postcomm will wish to take into account Royal Mail's activities in the market and whether any of these may be directed at foreclosing the market or limiting the development of competition.

5.5 In this regard, it should be noted that Postcomm and the Office of Fair Trading (OFT) both have responsibilities in preventing abusive or anti-competitive behaviour within the postal market and have agreed a Memorandum of Understanding (MoU) which clarifies their respective roles and responsibilities.

6. Criterion 4: Customer Awareness and Behaviour

Chapter Outline

6.1 This chapter sets out:

- A description of and the rationale proposed criterion.

Description of Criterion

6.2 This criterion considers whether services available from competitors are adequate substitutes for the services provided by Royal Mail and whether customers have effective choice in the market.

Customer switching

6.3 Evidence of the substitutability of competitors' services may be provided by the actual use made by customers of these services and whether there is any trend in customer behaviour with respect to switching to or away from competing services. Customer switching behaviour (and the costs associated with switching) would indicate whether customers have effective choice in the market and, in particular, the extent to which customers have changed suppliers and whether they have been satisfied with their alternative providers.

6.4 It has been argued that customer inertia within the postal market may be high given Royal Mail's established position and the strength of its brand.

6.5 For competing services to be regarded as clear substitutes, they do not need to match the complete specification of comparable Royal Mail services but, they should do so in substantive respects both with respect to price and service quality and in terms of their availability to customers.

6.6 It should be noted, however, that the limited availability to or lack of utilisation by, a particular class of customer may not in itself be an indicator of an absence of competition but could suggest that there is no significant demand for a particular services. In this regard, Postcomm will need to consider the level of 'buyer power' (the influence of customers) within the market.

Customer awareness

6.7 Postcomm would also need to consider the extent to which customers are aware of alternative suppliers even if they have not sought to switch and whether they would be willing to do so. This would test the awareness of customers of the alternative services available, even if they do not buy them.

7. Criterion 5: Effectiveness of Competition in Postal Services

Chapter Outline

7.1 This chapter sets out:

- A description of and the rationale for this proposed criterion.

Description of Criterion

7.2 The previous four criteria consider whether overall competition is acting as a substitute for the regulation of prices and services standards within the market - i.e. the extent to which competition within the market is constraining the commercial behaviour of Royal Mail and thus effectively 'regulating' it.

7.3 This criterion would consider whether, in the light of the assessments under the other four criteria, Postcomm considers that it can rely on competition to regulate effectively the postal services market. Postcomm would in particular need to consider whether, in the context of the particular sector of the market, there are any special features - such as the universal service obligation - which might justify the continuation of regulatory controls.