



Royal Mail, Licensed Postal Operators,  
Postwatch, Trade Associations and  
other interested parties

Date:– 17 April 2008  
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Dear Colleague,

## REVIEW OF COMPETITION IN DELIVERY IN THE POSTAL SECTOR

### Introduction

1. Postcomm is seeking views on potential barriers to competition in delivery in the UK postal sector, including suggestions of regulatory actions that may be taken to overcome them. As part of Postcomm's forward work plan it is assessing the potential benefits of delivery competition, particularly in ensuring a healthy universal service and supporting "a range of reliable, innovative and efficient postal services, including a universal service reflecting the needs of users, valued by customers, and delivered through a successful Royal Mail and a sustainable competitive market"<sup>1</sup>. Postcomm has already identified a number of possible barriers. Postcomm recognises that the structure of the market has changed significantly in terms of declining volumes in traditional mail, the growth in fulfilment and the growth in access competition, therefore, we are also seeking views on new and emerging issues affecting the growth of competition in delivery.
2. This letter provides a brief background to the development of competition in the UK postal market and identifies areas Postcomm recognises to be potential barriers to the development of competition in delivery. The Annex to this letter sets out these potential barriers in more detail.

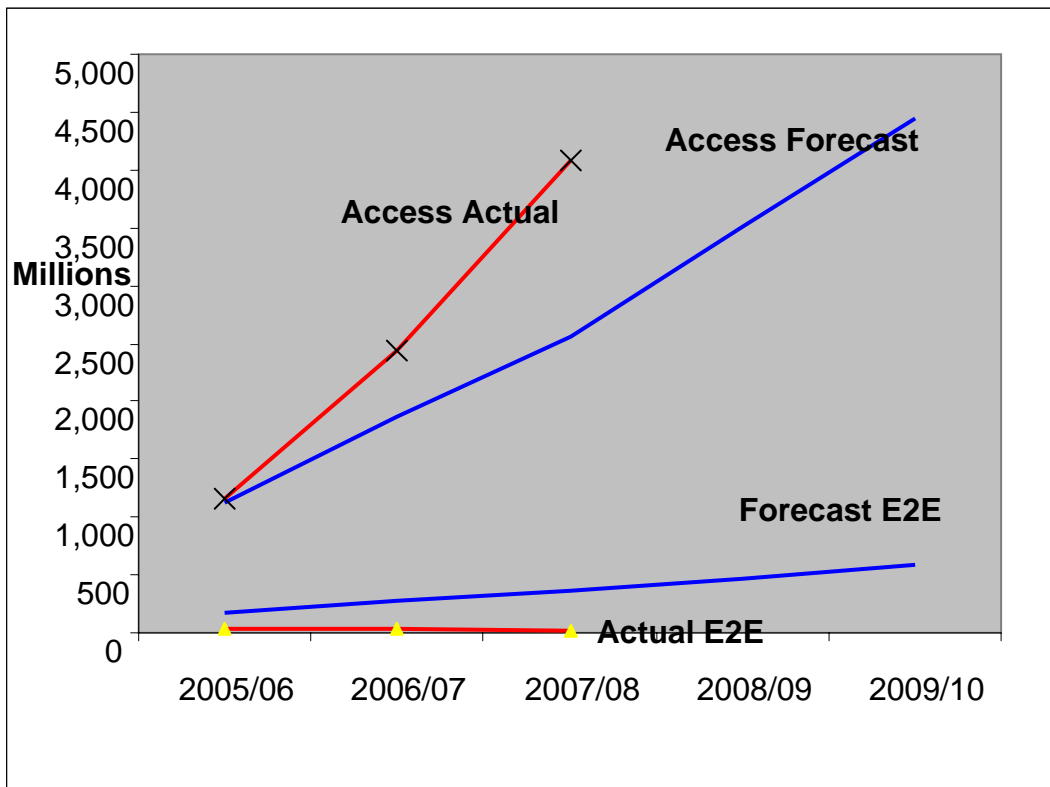
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<sup>1</sup> The independent review of the postal sector, First submission by Postcomm, the industry regulator, March 2008

## Background

3. Since full market opening in January 2006, competition has emerged in the form of downstream access, which, as at February 2008, accounted for over 20% of total upstream letter volumes. Competition in delivery, however, has actually declined for the last two years. Last year addressed mail delivered by alternative licensed operators amounted to around 35 million items, or less than 0.2% of total mail volumes, a decline of 10% on the previous year.
4. The competitive outcome to date differs substantially from the predictions made at the time Royal Mail's current price control was agreed with Royal Mail, and from the competitive experience in other liberalised markets. So far, access volumes are around 25% higher than predicted, while competitive delivery volumes are just 12% of the forecast level, as shown in the graph below.

Mail volume estimates - Postcomm forecast versus 2007/08 actual



5. Access volumes have increased more quickly than previously predicted due to, amongst other things, the development of agency VAT agreements and competitors more aggressively competing for unsorted as well as sorted services. Access volumes are limited by the size of the available market which includes primarily bulk mailers and large mail users. Currently around 50% of Access volumes are contracted directly between customers and Royal Mail (these customers often sub-contract the upstream work), the remaining 50% has gone directly to competitors.

6. Given the changing market dynamics and competitive developments over the last two years, Postcomm now needs to explore whether competition in delivery is, in fact, necessary to provide benefits to customers, and if so, seek to identify the key barriers to entry for delivery competition. The information gathered from the first stage of this consultation should enable Postcomm to identify whether and how these barriers might be relaxed, the implications for the regulatory framework after 2010, and to understand the potential implications for customers, competitors and Royal Mail.
7. Postcomm is carrying out the following pieces of work that will inform the Competition in Delivery project:
  - Access Review - Postcomm is undertaking a review to determine how well access has operated to date and to consider whether any changes are necessary to the current access framework under Condition 9<sup>2</sup> of Royal Mail's licence, to address potential concerns regarding non-price forms of discrimination for access users
  - Universal Service - Postcomm is consulting on consumers' future needs of a universal service to inform how it could evolve given changing technological, economic and social factors, and
  - Regulatory Framework from 2010 - Postcomm is consulting on the future of the regulatory regime (including price controls) from 2010, which will address whether competition is sufficiently developed across the pipeline to allow some relaxation of the regulatory regime and how to focus regulation on the areas where competition is unlikely to develop.

### **Potential barriers to competition in delivery**

8. Postcomm seeks views on potential barriers to the development of delivery competition, including:
  - Market uncertainty
  - Access headroom regulation
  - Zonal access requirements
  - Customer purchasing behaviour
  - Licensing requirements
  - Limitations of using alternative networks, and
  - Infrastructure issues
9. Prior to full market opening, Postcomm consulted on potential barriers to entry in postal services in its 2005 Competitive Market Review (CMR) proposals document, and produced a decision document in April 2006, identifying several barriers to competition (both for access and delivery competition). Postcomm believes that several significant barriers to the development of delivery competition still exist, although some of those previously identified

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<sup>2</sup> Regulates access to Royal Mail's postal facilities

have been at least partially addressed, or market dynamics have altered since they were originally identified. Postcomm seeks views on the continuing relevance or otherwise of these barriers:

- Royal Mail's economies of scale
- Royal Mail's VAT exempt status
- Royal Mail's behaviour, and
- Redirection of mail

10. Postcomm recognises that additional barriers to delivery competition may exist in addition to those identified in this consultation, and seeks views on any additional factors that may be inhibiting the development of competition in delivery. All the barriers identified above are described in more detail in Annex A.

#### Next Steps

11. Postcomm welcomes views on whether effective delivery competition is essential to realise the full benefits of competition in the postal sector.
12. Postcomm invites views on what are the key barriers to competition in delivery and what should be done to address them.
13. Responses to this consultation are invited by 13 June 2008. Postcomm will assess the responses received and is happy to discuss any issues with interested parties. It is expected that a proposals document will be issued in August 2008.
14. If you do not want all or part of your response to this consultation letter to be read by anyone outside Postcomm, please ensure your response clearly indicates which parts are confidential.
15. If you have any questions or if you would like to arrange a meeting with Postcomm to discuss any aspect of this letter, please contact Ruth Heller on 020 7593 2119 or [Ruth.Heller@psc.gov.uk](mailto:Ruth.Heller@psc.gov.uk).

Yours sincerely

Postcomm

## ANNEX A

### *Market Uncertainty*

16. Stakeholders have indicated that one of the main barriers to investment in an alternative delivery infrastructure in the UK postal market is market uncertainty. Market uncertainty may arise from uncertainty about Royal Mail's competitive response to liberalisation, uncertain market conditions or uncertainty about the future regulatory framework. The changing dynamics of the mail market, such as declining mail volumes and the changing mail mix, currently create uncertainty about market conditions that impact the market in which competitors operate. Operators, especially international operators, will favour those markets where the level of uncertainty is least and opportunity most favourable.<sup>3</sup>
17. Given that Royal Mail plays such a large part in the mail market in the UK, uncertainty about its pricing structure can give rise to uncertainty about the market. For example, Royal Mail has the flexibility to rebalance its pricing within an overall price cap, and has recently reduced prices in parts of its portfolio (e.g. heavier weight items) and increased differentials between groups of products (stamps v meters). Since the introduction of the 2006 price control Royal Mail has submitted an application to change the pricing structure of its retail bulk mail products in its zonal pricing application, and Postcomm conducted an interim review of the price control in 2007.
- **Postcomm is interested in views on whether market uncertainty has been a barrier to the development of delivery competition in the UK market.**

### *Access Headroom Regulation*

18. Postcomm is mindful that the development of access competition may pose various barriers to the development of delivery competition.
19. One factor in determining whether the access regime distorts the development of delivery competition is the relative prices of Royal Mail's retail and access prices. Currently, the price control regulates access headroom, i.e. the percentage difference between certain access prices and Royal Mail's analogous retail prices. The access headroom levels were set based on commercially negotiated prices that allowed some margin for new entrants in which to compete.
20. Operators argue that the price control is artificially depressing retail mail prices, thereby suppressing revenue and margins available to new entrants to enter the market and invest in their own delivery network. They argue that the use of access headroom controls has helped preserve opportunities for some competition to develop in the upstream market (collection and sortation) for business bulk mail.

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<sup>3</sup> The independent review of the postal services sector, "First submission by Postcomm, the industry regulator.", 2008

21. With the exception of the United States, other countries have not developed an access regime similar to that in the UK. They are either negotiated (without a minimum regulated margin) or based on “retail minus” pricing, (based on a discount on the retail price) and difficulty in reaching agreement with operators has made uptake of access in most other countries limited. Therefore, unlike in the Netherlands and Germany, for example, end-to-end operators in the UK have to compete not only with Royal Mail but also with operators using access, including zonal access (prices that are geographically differentiated), that are very competitive in high density areas.
- **Postcomm is interested in views on whether current access price regulation acts as a barrier to the development of delivery competition.**

### ***Zonal Access Requirements***

22. The national geographic posting profile requirement in Royal Mail’s national average priced access agreements requires access users’ daily postings to reflect the typical Royal Mail national geographic mix of mail items (referred to as a “fall to earth” condition). This is aimed at preventing competitors delivering only in the cheapest areas and leaving Royal Mail with the more expensive delivery areas. However, this acts as a barrier to access operators developing end-to-end delivery in high density or geographically specific areas while using their national access agreement to deliver the remainder of the mail.
23. Royal Mail also offers zonal access services in which price varies with the geographical location of the final destination of mail. Royal Mail’s zonal access agreements do not have a “fall to earth” condition, therefore competitors would theoretically be able to establish delivery in geographical areas in which they are most competitive. This should offer an alternative to the national geographic posting profile requirement and allow operators with a delivery network to use Royal Mail’s upstream access. However, several operators argue that they are unable to use zonal access agreements because of Royal Mail’s sortation requirements which add extra time (an additional day) and cost. Postcomm is currently reviewing potential non-price discrimination for zonal access users in its Access Review, as well reviewing zonal access prices following its decision on Royal Mail’s retail zonal pricing application.
- **Postcomm is interested in views on whether zonal access requirements present a barrier to delivery competition.**
24. In recent months, a number of new licence applications have been made for local delivery. In many cases these operators are targeting purely local to local traffic. However, by using Royal Mail’s upstream operation some are looking to sell a local delivery network to a national customer base, selling on additional service features such as personal delivery preferences.
- **Postcomm is interested in views on whether other forms of access could enable the development of competition in delivery.**

## ***Customer purchasing behaviour***

25. Access volumes have grown more quickly than Postcomm originally estimated prior to full liberalisation in 2006, and access competition is very price competitive. Customers have found few barriers to moving mail volumes to other operators, particularly large and medium customers, and this has led to secondary switching, or customers moving from one Royal Mail competitor to another.<sup>4</sup> As customers become more used to reviewing their mail provider, they are increasingly willing to move for small price and service differences.
- **Postcomm is interested in views as to whether mail has become commoditised to the extent that margins are inadequate to support competition in delivery.**

## ***Licensing Requirements***

26. When considering barriers to the development of delivery competition, it is worth considering those barriers that the licensing framework may present, and how these interact with provisions of the Postal Services Act 2000 and other legislation.
27. Those wishing to enter the delivery market are currently required to apply for a licence which allows Postcomm to impose controls on licensees. The licensing process itself may present a barrier at some level which dissuades entry (e.g. administrative burden). There are, however, other means by which controls on market participants could be imposed. For example, in a general authorisation regime, such as in the UK telecommunications market, there is no licence application process and those carrying on a relevant activity are automatically authorised, but have to comply with certain legislation.
28. There are currently 11 licence conditions<sup>5</sup> which can be applied to a licensed operator other than Royal Mail. Generally, these conditions were put in place to protect the interests of mail users, and were deemed necessary when Postcomm's 2006 Licensing Framework was introduced, in order to give mail users the confidence to use different operators in the newly open market. However, Postcomm recognises that these licence conditions could be considered to be restrictive from the perspective of potential operators, and may inhibit market entry. There is a risk, as a consequence, that mail users would be offered fewer competitive choices under the present licensing framework than would be the case in a less regulated market. The balance of Postcomm's concern has therefore moved from ensuring that mail users are not inhibited from using different operators, to ensuring licence conditions do not unnecessarily restrict the opportunities to do so, while making sure that protection of mail users remains appropriate.

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<sup>4</sup> 2007 Business Customer Survey, Postcomm

<sup>5</sup> Postcomm expects to introduce regulations on complaint handling to accommodate the requirements of the Consumers, Estate Agents and Redress Act 2007. For more information, see *Complaint handling standards for licensed postal operators: A consultation document*, January 2008. Postcomm

- **Postcomm is interested in views on whether stakeholders believe that the current licensing framework creates a barrier to entry for delivery competition.**

### ***Use of Alternative Networks***

29. In other European countries, the potential to leverage delivery networks in adjacent markets has been used as the basis to develop end-to-end postal networks. In the UK, this has not happened. Building an end-to-end delivery network from scratch requires high levels of start up investment at the risk of uncertain returns.

30. Networks used in other countries include:

- Parcel and courier networks
- Packets and lifestyle delivery networks
- Leaflet distribution networks, and
- Newspaper distribution networks

31. The home delivery, fulfilment and publication sectors are growth areas in the UK postal market. They consist of a combination of items that are provided within the licensed area, and parcels and express items which are unregulated. The courier, express and parcels markets are well developed and highly competitive in the UK, as is leaflet distribution, which has also been a growth area. In other countries rival operators have capitalised on newspaper and leaflet distribution networks to migrate to mail delivery with different forms and levels of competition.

32. For example, in the Netherlands, SelektMail and Sannd have emerged as competitors to TNT Post in delivery of addressed direct mail, catalogues and periodicals. They have developed alternative national delivery networks to do this with deliveries twice a week which have enabled them to grow market share substantially in their target segments. By contrast, in Germany, non-express letter competition has emerged through local unaddressed mail operators branching out into direct mail, mainly in urban areas, and regional and local operators focusing on delivering to major cities.

- **Postcomm is interested in views as to why alternative delivery networks in the UK are not being adapted to carry mail.**

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may also introduce a new licence condition covering redirections data in the near future. For more information, see *Sharing Redirections Data: Postcomm's revised proposals to facilitate a multi-operator redirections service*, October 2007.

### ***Other Infrastructure Issues***

33. Postcomm recognises that there may be additional factors inhibiting the development of delivery competition relating to the infrastructure required to set up an effective delivery network in the UK postal market that have not been discussed above. Stakeholders have noted, for example, that competitive delivery operators would currently not have access to PO Boxes, and that would inhibit their ability to provide an effective delivery service. In addition, Royal Mail has access to its network of Post Offices that give it a retail outlet with significant scale which other operators do not have.
- **Postcomm is interested in views on which, if any, infrastructure issues present a barrier to competition in delivery.**

### ***Royal Mail's Downstream Economies of Scale***

34. Royal Mail handles over 80m mail items every day through a network that serves all residential and commercial addresses in the UK. This gives it a significant unit cost advantage in certain activities such as delivery, where high fixed costs are spread over a large volume of items. These economies of scale mean that it is possible for Royal Mail to be inefficient but at the same time cost competitive compared to any operator wishing to establish a rival daily nationwide delivery network without Royal Mail's scale. Royal Mail's scale, in other words, means that it can offer customers lower prices than would otherwise be the case.
35. Operators can help to overcome this barrier if they reduce the unit cost of delivery by adopting a strategy that focuses on reduced delivery services (say once per week) or by serving restricted geographical areas (such as financial districts), or offering niche or bespoke products. However, entrants could adopt a strategy that tries to differentiate their products and services from those offered by Royal Mail both in terms of service quality and specification, and in terms of value added features, as has already been seen with access based competition.
- **Postcomm is interested on views on whether Royal Mail's economies of scale present a barrier to the development of competition in delivery.**

### ***Royal Mail's VAT Exempt Status***

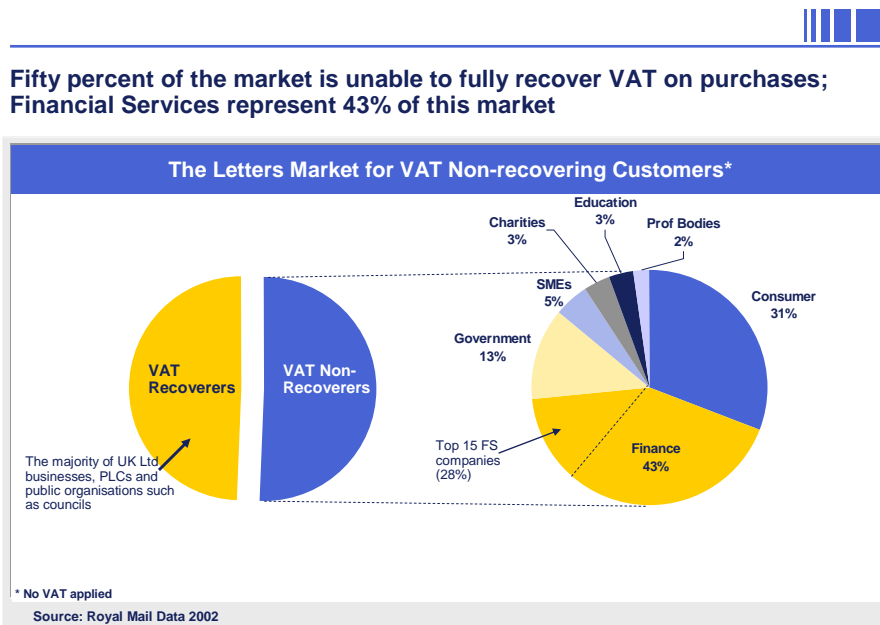
36. Royal Mail is currently exempt from charging VAT on services it supplies to customers. By contrast, alternative postal providers are required to charge their customers VAT at the full rate of 17.5%.
37. The Government's 1999 White Paper on postal services<sup>6</sup> asked Postcomm to advise on the continuation of Royal Mail's special privileges, including its exemption from VAT. Postcomm's analysis, following detailed industry consultation, continues to show that Royal Mail's exemption from VAT gives it a significant cost advantage over its rivals that are required to charge VAT at

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<sup>6</sup> "Post Office Reform – A World Class Service for the 21<sup>st</sup> Century", July 1999

the full rate. Although Royal Mail cannot claim back most of its input VAT<sup>7</sup>, (which means competitors have a slight VAT advantage with VAT paying customers) the exemption means that its prices are cheaper than its rivals' prices for customers that are themselves VAT exempt.

38. VAT exempt customers include some of the largest and most attractive mailers, such as financial institutions, charities and government departments. Postcomm's analysis suggests that the VAT exempt market segment could comprise up to half the total letters market by value.



Arthur D Little

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39. VAT policy is a matter for Treasury, not Postcomm. Following its consultation on Royal Mail's special privileges in January 2004, Postcomm confirmed that its recommendation to the Government that the VAT position on postal services should be reviewed and a solution found that achieves a "level playing field" without significantly increasing postal prices. Mail users appear to be increasingly price sensitive, therefore there is a risk that a sudden increase in prices due to Royal Mail losing its VAT exempt status could lead to a significant reduction in mail volumes.
40. A "level playing field" would be in the interests of achieving a fair and open postal market and also contributing to the UK economy's productivity, given the important social and economic importance of postal services.
41. A further factor in the VAT debate is that in July 2007, the European Commission opened second stage infringement proceedings against the United Kingdom, Germany and Sweden (under Article 226 of the EC Treaty) which are intended to ensure that the VAT exemption for postal services is applied in a way that minimises distortions of competition between former

<sup>7</sup> Input VAT is VAT that Royal Mail incurs when it buys products or services that are themselves subject to VAT, e.g. computers or sorting equipment.

monopolies and rival mail operators. A hearing is expected by mid-2008, with a ruling expected by mid-2009.

- **Postcomm is interested in views on the extent to which the current UK VAT regime is a barrier to the development of competition in delivery.**

### ***Royal Mail's behaviour***

42. While competition is at an early stage, new entrants' strategies can be highly vulnerable to responses by Royal Mail. Such responses by Royal Mail may be within the realm of legitimate business and commercial activity, however, there remains the possibility that Royal Mail might act in an anti-competitive manner, either intentionally or inadvertently, in markets where it holds market power. Postcomm is keen to ensure that it has the necessary resources and powers to protect new entrants and existing competitors, that its actions have the necessary deterrent effect to prevent Royal Mail from engaging in anti-competitive behaviour in the future, and to ensure that potential entrants are not deterred by the threat of an anti-competitive response from Royal Mail. In addition, Postcomm wants to ensure that stakeholders are informed about competition law and the obligations in Royal Mail's licence, in order that complaints are properly researched and presented and that complainants can make the distinction between commercial behaviour and anti-competitive behaviour.

43. When discussing anti-competitive behaviour, it is worth bearing in mind that, while Postcomm has investigated Royal Mail on four occasions, it has only found one licence contravention to date, and this was in relation to downstream access services. However, Postcomm is currently reviewing a number of anti-competitive complaints raised in late 2007.

- ***Postcomm is interested in views on whether potential anti-competitive behaviour from Royal Mail creates a barrier to entry to delivery competition.***

### ***Redirections***

43. When opening the market fully to competition, Postcomm acknowledged the need to develop an effective and secure industry-wide system for mail redirection when residential or business customers relocate. Postcomm is concerned that as competitors offering a delivery service enter the market, it is likely that less mail will be redirected and the value of the redirection service to the receiving customer will be reduced. In addition, Postcomm is concerned that if other licensed operators are unable to provide a redirections service this may in effect be a barrier to entry to the market due to the value sending customers place on this service.

44. Postcomm is currently developing proposals for the sharing of redirections data to facilitate a multi-operator redirection service<sup>8</sup>. These proposals were

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<sup>8</sup> Sharing redirections data – Postcomm's revised proposals to facilitate a multi-operator redirections service (October 2007)

predicated on the basis that Royal Mail would agree to a licence modification that requires it to share redirections data with other licensed operators. However, Royal Mail is now proposing to voluntarily develop a redirections data product that it intends to sell to other licensed operators on “appropriate commercial terms”.<sup>9</sup>

- ***Postcomm is interested in views on whether a redirections product could be provided without Postcomm’s intervention, and whether the lack of a redirections service would constitute a barrier to entry for delivery competition.***

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<sup>9</sup> Royal Mail’s response to Postcomm’s consultation on sharing redirections data, January 2008.