

# postwatch

## **POSTWATCH RESPONSE TO CONSULTATIONS ON: A REVISED MARKET OPENING TIMETABLE AND COMPETITIVE MARKET REVIEW**

20 December

### **1. INTRODUCTION**

- 1.1. We have chosen to combine our responses to the Revised Market Opening Timetable and Competitive Market Review (CMR) consultations, as the issues are inter-related.
- 1.2. It is clear that competition has not developed within the postal services market and is unlikely to develop significantly in the short term. Postcomm's analysis sheds more light than ever before on the reasons for this. The Roland Berger study in particular represents a significant advancement in our understanding of why competition has been slow to develop. We encourage Postcomm to repeat this study within the next year or so and we would be happy to discuss with Postcomm a joint research program on competition issues.

### **2. REVISED MARKET OPENING TIMETABLE**

- 2.1. Postwatch has consistently supported opening up the postal service market to competition. We believe this is the best way to provide customers with choice, innovation, and lower prices in the long term whether via Royal Mail or alternative operators.
- 2.2. We agree with Postcomm that the most pressing risk facing the regulatory regime is of too little competitive entry to change Royal Mail's behaviour. Royal Mail has made much progress in reviewing its business operations but is still not responsive enough to the views of its customers, even the large ones. Recent difficulties with the compensation scheme demonstrate this. Moreover bearing in mind Royal Mail's recent poor service performance we believe that competitive pressure must be maintained and strengthened as a means to force service improvement.
- 2.3. We recognise that barriers to entry are significant, the most important being Royal Mail's VAT advantage. While the VAT exemption remains in place it will (supported by other barriers such as Royal Mail's

economies of scale in delivery) prop up Royal Mail's market share as Postcomm estimates the exemption distorts pricing in up to half of the market.

- 2.4. We believe that Postcomm should use the opportunities presented by the price control review to tilt the balance in favour of new entrants. This may require more radical action than that proposed by Postcomm in the CMR because of the significance of the barriers to entry and because many of them are outside Postcomm's ability to influence directly. Postcomm must be proactive now and one way it can do this is by considering management separation of Royal Mail's pipeline in order to ensure the success of competition in the upstream part of the market. We discuss this below (4.4 – 4.8).
- 2.5. We welcome Postcomm's analysis on the likelihood of cream skimming in a fully liberalised market which exposes much of the rhetoric around this issue. It is clear that the VAT advantage coupled with Royal Mail's improved financial performance means that Royal Mail's ability to provide the universal service is unlikely to be affected by full market opening.
- 2.6. Of the dates Postcomm has considered, January 2006 appears a sensible compromise between stepping up competitive pressure while also allowing Postcomm sufficient time to consult on any modifications that may be necessary to the licensing regime. However, we note that the 1 April 2006, when the new price control is due to come into force, is also a valid date.
- 2.7. When the decision to fully open the market is taken it is important that, even in the pursuit of light touch regulation, Postcomm maintains effective oversight of operator's procedures, particularly mails integrity. We believe Postcomm should also prioritise minimising the barriers to entry and scrutinise carefully the behaviour of Royal Mail, taking action where appropriate.

### **3. BULK MAIL PROVISION WITHIN THE UNIVERSAL SERVICE**

- 3.1. Postwatch's position continues to be that there is no justification for reducing the bulk mail universal service provision. We see no reason, nor have we been offered any substantive evidence, to convince us to change our original position. We agree this area of the universal service will be the first to be exposed to competition but while competition is developing there is still a need for comprehensive provision on a universal service basis. This should change only when the market can sustain and protect businesses. Now is not the time to make a radical change to limit the bulk mail provision to one product.
- 3.2. Postwatch agrees with Postcomm that Royal Mail should be allowed some additional pricing flexibility where this is in the interests of

customers and the competitive market as a whole. However, restricting the bulk mail provision to Mailsort 1400 allows Royal Mail too large a degree of pricing flexibility in a market with limited competition and significant barriers to entry.

- 3.3. It would be more appropriate to protect the interests of postal users by monitoring the market, assessing the level of competition and reviewing the universal service when necessary rather than making major changes now. Should full market opening go ahead in January 2006 Postcomm should conduct a further review of the universal service (probably in early 2007) once the level and nature of early competitive entry becomes apparent.
- 3.4. Even if the time were right to reduce the universal service bulk mail provision we believe that this proposal is too radical. It is important to look at this matter on a customer basis to ensure that the interests of all business customers are considered. Postcomm's proposal does not take sufficient account of the needs of small and medium businesses, particularly those using the Cleanmail service, for which Royal Mail has reduced the threshold to 1,000 items to make it more relevant and attainable for small businesses. Customers using Cleanmail cannot readily switch to alternative services as many are unable to meet the thresholds for Mailsort 1400. Small business representatives represented on Postwatch's Personal & Small Business Mail Users Group were concerned that geographical pricing of Cleanmail would be detrimental, in particular for those businesses based in rural areas.
- 3.5. In addition, for large bulk mailers Mailsort 1400 is too limited to be the only bulk mail product within the universal service, even if it accounts for 50% of business mail volumes. Some Postwatch Trade Association members were of the view that Mailsort 120 and Cleanmail should also be included. Together these three products have the widest possible use across all customer segments. Concerns were also expressed about what Mailsort service specification and pricing arrangements Royal Mail would offer outside the USO.
- 3.6. Royal Mail also intends, and has been trying for some time, to get customers to move away from Mailsort 1400 and take up other bulk mail services. On the basis that this is not a secret within the industry, this policy makes nonsense of including only Mailsort 1400 as part of the universal service. Should this continue then Mailsort 1400 might not constitute a significant generic bulk mail offering, which is what Postcomm aims to achieve through this consultation.
- 3.7. It is not clear how geographical pricing affects the proposal for Size Based Pricing. Postcomm's cost allocation work is crucial here. This should be concluded before any price re-balancing - such as size based pricing - is allowed so that any decisions are taken on the basis of robust data and understanding of Royal Mail's costs.

#### 4. ACCESS AND THE UNIVERSAL SERVICE

- 4.1. There is some logic in Postcomm's view that two pricing structures for access would lead to arbitrage opportunities for customers which could potentially make access loss making. In the long run this would be to the detriment of customers because of the potential knock-on effect on Royal Mail's ability to finance the universal service.
- 4.2. However, given that Royal Mail's delivery network is likely to remain a monopoly for some considerable time; if access prices are de-averaged it is essential that this process is subject to regulatory oversight. Consequently, in the context of the current price control debate it is appropriate for access pricing to be controlled.
- 4.3. The access regime must be made to work not least because it will be some time before an alternative end-to-end competitor to Royal Mail emerges. For the reasons outlined below this may require the radical step of management separation of the pipeline.

##### *Management separation of the pipeline*

- 4.4. We believe that the market price of access for the whole industry should not depend upon the negotiated agreement between one company and Royal Mail. To achieve this the Regulator only has one real source of data – Royal Mail. The availability and accuracy of the numbers from that source has caused problems in the past. It is common knowledge that Royal Mail has been poor in recording and supplying internal data.
- 4.5. Undoubtedly Royal Mail's most valuable asset is the "pipeline" which collects – processes – and delivers mail to 26m addresses 6 days a week. Fundamental to the development of competition is access to this pipeline, particularly the last mile, and as a consequence its costs must be understood precisely.
- 4.6. This can be achieved by the internal separation of the pipeline from the remaining departments of the mail division. This does not in any way affect ownership. It is merely the creation of the pipeline as a separate profit centre within the Royal Mail Group. A further step towards achieving fair and equal access is to require the marketing arm of Royal Mail to have access to the pipeline on the same terms and conditions as its competitors.
- 4.7. The objective of the pipeline management would be to maximise the amount of mail they are delivering to boost earnings regardless of the source of mail. They will also wish to invest and modernise in order to create and maintain the most efficient pipeline in Europe if not the world. As a separate accounting entity the actual costs of the pipeline

will be visible to the regulator uncluttered by the costs of the ancillary departments of the mail division of Royal Mail.

4.8. Without the visibility of separation, there is always the suspicion that the access price contains a contribution towards the costs of the ancillary departments of Royal Mail or even unwarranted margins. Potential competitors have their own sales and marketing departments and they should only be required to pay the price for accessing those parts of the pipeline that they wish to use. They should pay for what they use and nothing else. We believe that Postcomm could require “management” separation (not ownership separation) through the licence.

## **5. LICENSING AND OTHER IMPLICATIONS OF FULL MARKET OPENING**

5.1. We intend to consider the licensing and infrastructure issues raised in Chapter 3, *Licensing and other implications of full market opening*, as part of our response to Postcomm’s recently published consultation on the licensing framework in a fully open market. Like Postcomm we believe that there should be some regulatory oversight of new entrants, particularly to ensure mail integrity. We do not believe that it is appropriate to stipulate either quality of service targets or compensation schemes for new entrants on the basis that customers should be able to choose between operators, including Royal Mail, on the basis of different price and quality levels.

5.2. We agree with Postcomm that work is required to raise levels of awareness among customers of alternative services providers by other operators and will co-operate with Postcomm in helping to raise awareness.