

COMPETITIVE MARKET REVIEW

PROPOSALS FOR CONSULTATION

September 2004

KEY PROPOSALS

This review has identified four principal barriers to entry that are hindering the development of competition:

- *Royal Mail's downstream economies of scale.* Postcomm proposes to continue to promote and monitor Royal Mail's access arrangements. To ensure transparent costing and pricing, Postcomm proposes a greater degree of separation by pipeline activity in Royal Mail's regulatory accounts. Postcomm is also considering whether to include access products within the price control from April 2006.
- *Royal Mail's VAT exemption.* Postcomm's advice to government, which is responsible for VAT policy, is that Royal Mail's VAT exemption is not required for the universal service and distorts a large part of the letters market. In terms of furthering its duties, Postcomm wants a solution that levels the playing field, but does not lead to a significant increase in prices. A reduced rate applied to postal services might be one way to achieve this. Postcomm will continue to provide advice and analysis to Government to ensure the effects of this barrier on the postal market are fully understood and, if feasible, addressed as soon as possible.
- *Potential anti-competitive behaviour.* The impact of anti-competitive behaviour by Royal Mail could be disproportionately high at the current early stage in the development of competition. Postcomm is planning to increase its resources devoted to this issue in order to take a more proactive approach to ensuring anti-competitive behaviour does not occur (or is dealt with quickly). Postcomm will also take steps to raise awareness within the industry of its processes for addressing complaints.
- *Customer inertia.* Postcomm's market research suggests that customers are not generally well informed about the liberalisation of the market and alternative choices. This may reflect the current early stage of the liberalisation process and a strong brand loyalty to Royal Mail. Postcomm intends to undertake a

programme of visits and events aimed at raising customers' awareness of the market opening timetable and competition.

Postcomm would like to hear stakeholder views on these key proposals by Monday 20 December 2004. Postcomm's conclusions will be included in its decision document for its review of the market opening timetable in early 2005. This consultation and a consideration of the responses to it will also help Postcomm formulate its Forward Work Plan for 2005/06.

Summary

Postcomm's vision for the letters market

- S.1 Postcomm, working in the interests of postal users, is committed to establishing a regulatory framework that facilitates a competitive and innovative postal market. This is central to Postcomm achieving its vision for the market of:

“a range of reliable, efficient and innovative postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market”.

- S.2 Postcomm believes that a successful Royal Mail, the UK's only universal service provider, is central to the delivery of this vision.
- S.3 To inform its decisions on regulatory actions to achieve its vision, Postcomm believes it is important that it, and all industry stakeholders, have a thorough understanding of the market and how it might develop. This document, following consultation with the industry, contains Postcomm's review of the mails market. Postcomm hopes that this document will act as a catalyst to raise stakeholders' awareness of market developments and the opportunities for new entrants, and (perhaps more importantly) encourage stakeholders' feedback on how they see the development of the market.
- S.4 Postcomm believes that customers' interests will be best served in a market where effective competition offers customers choice and encourages vigorous rivalry, efficiency and innovation on the part of postal operators.
- S.5 The arguments put forward in this document demonstrate that Postcomm is yet to achieve its vision; and more needs to be done. Although the breadth of entry so far is encouraging in terms of innovation, competition is still only in its formative phase and some key barriers to entry have been identified that prevent it from becoming effective. Also, Royal Mail's quality of service performance has affected postal users' perceptions of the reliability of postal services.

Indicators of competition

S.6 Postcomm, in common with regulatory best practice, believes that there is no unique indicator of competition, such as market share. Postcomm's view is that it should try to use as much evidence and opinion as possible and take a view about the development of competition in the round. Important evidence that will be considered includes entry and innovation to date, market shares and volumes, Royal Mail's performance and behaviour, customer awareness and barriers to entry. Postcomm consulted on these indicators in November 2003 and now reaffirms this position.

Developments so far

S.7 The postal market is in the process of being opened to competition. Operators can currently provide services in all parts of the market except delivery of non-bulk items weighing less than 100g (to be reduced to 50g on 1 January 2006 by the European Postal Services Directive).

S.8 Postcomm's review of its market opening timetable, published alongside this document, proposes that the remaining areas of Royal Mail's monopoly should be completely removed from 1 January 2006.

(i) Entry and innovation to date

S.9 Since March 2001, Postcomm has issued seven long term licences to new operators. The range of operators is diverse. It includes:

- o Royal Mail as the universal service provider;
- o other national postal operators with activities in the UK, such as TNT Post Group (TPG) and Deutsche Post Worldwide (DPWW);
- o several operators with existing mail, parcel and express businesses outside the regulatory area, including UK Mail (a subsidiary of Business Post plc), Speedmail and DX Services; and

- o some licence holders looking to add post to an existing delivery network, for example, Express Dairies (Arla plc).

S.10 These operators are licensed to provide a wide range of services. Royal Mail, as the established operator with its universal network, offers a full range of services that will deliver mail to every address in the country. Its economies of scale generally give it a significant unit cost advantage for basic letter products.

S.11 However, new entrants have adopted a range of innovative strategies to differentiate their products from Royal Mail's products. UK Mail is primarily offering a two day business class service utilising its pioneering agreement with Royal Mail for third party access to its delivery network. DX Network Services offers an enhanced document exchange system for business-to-business mail flows among closed user groups. Express Dairies, in partnership with TPG, utilises its network of milkmen to deliver mail to people's doors.

(ii) Market volumes and shares

S.12 Recent growth of mail volume has been healthy. Although some countries in Europe have experienced flat or mildly declining mail volumes, the regulated market in the UK has continued to grow robustly over recent years at about 2% per year. Most of this growth has been in pre-sorted second and third class items used by direct mailers and advertising mailers in the business to consumer (B2C) segment of the market.

S.13 The postal market continues to be dominated by businesses posting to household consumers. Businesses pay for and send around 86% of all mail items: about 58% is delivered to household consumers throughout the UK (B2C); and about 28% is delivered to businesses (B2B). Household consumers post around 14% of mail items: about 9% to other households (C2C) and about 5% to businesses (C2B).

S.14 It is very difficult to assess whether the rise in electronic communication will have a negative effect on mail volumes. Although there is some evidence to suggest that some customers are seeking alternative media (e.g. utilities offering their customers a discount to receive bills online), this has been outweighed by mail growth in other sectors. Doubtless the rise of electronic media poses some risks to certain mail volumes.

Postcomm believes it is vital that Royal Mail responds with a positive mindset to prevent customers being driven to use alternative media.

- S.15 Postcomm also believes that the rise in electronic communication offers opportunities. For example, for most items purchased online (a growth industry with online shopping and auctions), an operator will need to fulfil this transaction and deliver the item to the customer. Some of these items are time sensitive, heavy or bulky and therefore of higher value than basic mail products.
- S.16 The postal value chain is also evolving with opportunities available for backward integration into customer databases and other media management systems. Operators are increasingly becoming more involved in related markets such as database management, information processing and logistics. Many now offer “track and trace” services and are incorporating more technology and value added features into their basic product.
- S.17 Although entry by competitors to Royal Mail has been broad in scope, it has not been particularly “deep” in terms of the volumes handled. Competitors combined handled a volume equivalent to about 0.3% of the regulated market in 2003/04 by revenue.

(iii) Royal Mail’s performance and behaviour

- S.18 Postcomm recognises that, given Royal Mail’s market size, its actions will be an important determinant of whether postal users benefit from the new commercial and regulatory regime.
- S.19 Royal Mail’s financial performance has improved considerably over the past couple of years. In 2003/04, it made a profit from operations of £348m (before pension deficit payments and exceptional costs) on price controlled products (6% on turnover). This has been largely driven by stronger than anticipated volume growth and the price rises afforded to Royal Mail under the current price control. Royal Mail will also complete its Renewal Plan within the next six months, aimed at improving its efficiency and cost effectiveness.

- S.20 Regrettably, customers have been disadvantaged by the fact that the turnaround in Royal Mail's financial performance has taken place against the background of a deterioration in Royal Mail's quality of service performance against its regulatory targets. In 2003/04, Royal Mail failed all 15 of the quality of service targets in its licence¹.
- S.21 Postcomm is disappointed and concerned by the deterioration in Royal Mail's quality of service performance. Postcomm has launched an investigation into why standards deteriorated so sharply in the second half of 2003/04, and whether Royal Mail complied with its licence requirement to use all reasonable endeavours during 2003/04 to achieve those targets. This will also include an assessment of the robustness of Royal Mail's action plans for achieving its 2004/05 targets. Postcomm will decide, in consultation with Postwatch, whether to impose a financial penalty on Royal Mail, and whether any enforcement action should be taken to accelerate improvements for 2004/05. Postcomm aims to publish the conclusions of this investigation this Autumn.
- (iv) Customer awareness and inertia
- S.22 Customer perceptions about competition are critical to its success. Postcomm has undertaken some detailed market research of non-residential customers with the consultant Roland Berger. This concluded that customer awareness of competition and the programme for market opening was generally low. Although this was common among all types of customers, awareness was particularly low for smaller businesses.
- S.23 Customer inertia was found to be fairly high. Business customers value Royal Mail's brand and ubiquity. Customers' appetite for switching is currently not high, and price discounts are needed to persuade them to move operators. Some 28% of customers say they would start to negotiate with a new entrant if offered a discount of 10%, whilst 13% said they would begin negotiations if offered a discount of 5%.

¹ When determining the appropriate level of compensation for customers, Postcomm accepted Royal Mail's argument that the fire at the Northampton mail centre should be considered a force majeure event. Taking this into account meant that Royal Mail met one of the targets (Mailsort 3) for the purposes of determining the appropriate level of compensation.

S.24 These discounts are significant because they would be in addition to operators having to overcome other barriers to entry.

Key barriers to entry and Postcomm's response

S.25 Postcomm believes that barriers to entry in the regulated market are more significant than appeared to be the case when it put in place its original market opening timetable in 2002. These barriers prevent operators from gaining a strong foothold in the UK letters market and tend to reinforce Royal Mail's market strength.

(i) Economies of scale

S.26 Royal Mail handles over 80m items every day through a network that reaches 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. Economies of scale mean that it is possible for Royal Mail to be inefficient but at the same time overwhelmingly cost competitive compared to any operator wishing to establish a rival daily nationwide delivery network without Royal Mail's scale. Royal Mail's scale means that it can offer customers much lower prices than would otherwise be the case. Postcomm notes the view expressed by some stakeholders that Royal Mail's prices are among some of the lowest in Europe.

S.27 Postcomm's analysis suggests that economies of scale barriers effectively rule out, in the short-to-medium term, a rival nationwide daily delivery network. 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 within restricted geographical areas (such as financial districts). However, Postcomm would expect entrants to 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.

S.28 To address this barrier Postcomm has recognised the benefits of Royal Mail's economies of scale to postal users, in terms of keeping unit costs (and hence prices) lower than would otherwise be the case. Postcomm has accordingly pursued downstream access to Royal Mail's network for other operators. This approach enables competition

upstream, whilst recognising and sharing Royal Mail's advantage downstream. Operators can access Royal Mail's delivery network at a price where both parties should be able to make a profit.

- S.29 It took a considerable time for the initial access agreement to be concluded between Royal Mail and UK Mail (the first access seeker). This led to considerable uncertainty that was, in itself, a major barrier to entry. However, since the UK Mail agreement in February 2004, two other operators (TPG and DPWW) have agreed to similar terms.
- S.30 Postcomm would like to see these bilateral arrangements formalised into an access code. Royal Mail has told Postcomm that it expects to propose such a code towards the end of 2004, which represents a delay when compared with the previous expectations of a proposal being made in the Summer. Postcomm is currently considering bringing access products within the next price control (from March 2006).
- S.31 Third party access raises the issue of "ring fencing" and transparency of Royal Mail's cost allocation between various activities in the supply chain. Upstream operators may be concerned that Royal Mail does not discriminate against them, as this could result in a margin squeeze. Postcomm proposes that Royal Mail should, as part of its regulatory accounts, include costs, broken down by supply chain activity, such as delivery, sorting, collection, etc. This is a common approach adopted for other regulated utilities, such as British Telecom. Postcomm will consider including a high-level summary of pipeline costs by activity in the published part of Royal Mail's regulatory accounts.
- S.32 Postcomm will monitor closely the access regime for any evidence of anti-competitive behaviour, either by object or effect, and act quickly if necessary. Should Postcomm believe that after the other options have been implemented and evaluated, Royal Mail still cannot be entrusted with operating the access regime in a fair way that furthers the interests of postal users and promotes effective competition, then Postcomm may consider further alternatives, such as more direct regulatory control of access arrangements or a greater degree of business unit ring-fencing.

(ii) Royal Mail's VAT exemption

- S.33 The Government's 1999 White Paper on postal services 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 advantage over its rivals that are required to charge VAT at the full rate. Although Royal Mail cannot claim back most of its input VAT, the exemption means that other things being equal, its prices are cheaper than its rivals' prices for customers that are themselves VAT exempt. This advantage is not required to support the universal service.
- S.34 VAT exempt customers include some of the largest and most attractive mailers, such as financial institutions, charities and some government departments. Postcomm's analysis suggests that the VAT exempt market segment could comprise up to half the total letters market by value.
- S.35 VAT policy is a matter for the Government, not Postcomm. Following its consultation on Royal Mail's special privileges in January 2004, Postcomm confirms that its recommendation to the Government is 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. This would be in the interests of achieving fair and open markets and also contributing to the UK economy's productivity, given the important social and economic dimensions of postal services. Postcomm's revised analysis suggests that a lower rate of VAT (around 5%) applied to all postal services would achieve this. Royal Mail would be able to reclaim VAT on its inputs and, if passed back to customers, this would avoid the need for significant price rises.
- S.36 Postcomm sees no justification for Parcelforce's VAT exemption or its other special privileges, given that it no longer provides any universal services. Parcelforce's universal service activities were transferred to Royal Mail in 2003.

(iii) Potential anti-competitive behaviour

- S.37 While competition is at its current early stage, new entrants' strategies can be very vulnerable to an aggressive response by Royal Mail. Some of Royal Mail's responses will be within the general "cut and thrust" of business and commercial activity. However, Postcomm is keen to ensure that Royal Mail does not abuse its market power, either through object or effect. Postcomm will take any complaint very seriously and will work closely with industry representatives (for example through its Operators Advisory Group) to understand their concerns in relation to Royal Mail's activities.
- S.38 Postcomm will also work closely with the Office of Fair Trading. There is a Memorandum of Understanding between the two organisations on working practices and processes.
- S.39 Postcomm will not just respond to complaints but seek positive action that will improve the prospects for effective competition and innovation. For example, next year, Postcomm will consider reviewing the "reciprocal exclusivity" agreement between Royal Mail's letters business and Post Office Ltd.
- S.40 Postcomm is also undertaking a detailed review of Royal Mail's cost reflectivity. This work will underpin its work for Size Based Pricing and the price control review. It will also be useful for indicating whether Royal Mail's price structure is anti-competitive in terms of how its prices are set relative to costs.
- S.41 Postcomm intends to raise the level of awareness within the industry about its regulatory processes and principles in dealing with anti-competitive complaints. It will do this through industry workshops with the aim of ensuring industry players can more effectively evaluate Royal Mail's behaviour.

Conclusions

- S.42 Competition has started and should develop further with the establishment of bilaterally negotiated third-party access arrangements and Postcomm's proposal to bring forward full market opening to 1 January 2006.

- S.43 Given its present cost advantages from its economies of scale, Royal Mail retains, and can be expected to retain for some time, a commanding share of the letters market. Opportunities do exist, however, for new entrants to differentiate their products based on service, innovation and value added features compared to Royal Mail and this is starting to happen. Opportunities also exist from expanding the scope of the market. For example, e-opportunities and the potential for postal operators to integrate through an extended value chain (e.g. customer database management) should also benefit new operators as well as Royal Mail.
- S.44 Postcomm's analysis, however, suggests that market opening on its own is unlikely, in the short-term, to lead to effective competition due to the presence of some significant barriers to entry. These include Royal Mail's economies of scale, VAT exemption, potential for anti-competitive behaviour and customer inertia.
- S.45 Postcomm is proposing to take steps to address these barriers. It would like to understand from stakeholders whether its limited resources are being focussed on the key barriers. It will monitor the market carefully and evaluate the impact of these proposals and assess whether any further action is required to promote effective competition that furthers the interests of postal users. Postcomm will review the market and expects to publish its findings annually.

Postcomm's consultation and next steps

- S.46 Postcomm would like to take this opportunity to thank all those stakeholders who have so far contributed towards this review. Postcomm now invites views from stakeholders on the policy proposals contained in this document. Responses can be sent by post, e-mail or fax and should reach Postcomm by no later than Monday 20 December 2004. Postcomm will be pleased to meet with stakeholders to discuss their views in advance of this deadline for formal representations. Full contact details can be found in Chapter 1.

S.47 Postcomm will publish its decisions in relation to the specific proposals in this document as part of its decision document on market opening in early 2005. This consultation and a consideration of the responses to it will also help Postcomm formulate its Forward Work Plan for 2005/06.

Risk Assessment

Introduction

- S.48 Postcomm believes that in making any major regulatory decision, it should assess the risks inherent in its actions, including the risk of not taking any action. This is consistent with its approach to market opening in 2002 and regulatory best practice.
- S.49 Some risks have been identified and discussed in the market opening document, published alongside this document. These include risks relating to:
- too much competition undermining Royal Mail's ability to provide a universal service;
 - too little competition to change Royal Mail's behaviour;
 - Royal Mail foreclosing the market through anti-competitive behaviour;
 - pending effective competition, Royal Mail's efficiency may not improve significantly; and
 - Royal Mail fails to improve its service standards.
- S.50 This section does not repeat discussion of these risks but identifies additional risks.

Risk of delay and anti-competitive practice by Royal Mail in developing access arrangements?

- S.51 Postcomm recognises that considerable time was taken establishing the initial access agreements. Postcomm is keen to ensure that Royal Mail and the industry now consolidate this progress to establish a vibrant and innovative upstream industry.
- S.52 Postcomm expects Royal Mail to propose an access code to formalise its access arrangements by end 2004 (Royal Mail previously committed to a date of Summer 2004). Postcomm would expect to consult the industry extensively before approving such a code. Should progress on developing an acceptable code (with appropriate

regulatory controls) take too long, Postcomm will consider whether it is necessary to bring access products within the scope of the next price control from April 2006.

- S.53 Postcomm also believes that Royal Mail should have a greater degree of transparency and separation in its regulatory accounts, and therefore Postcomm will seek to ensure that Royal Mail's future regulatory accounts include a breakdown of costs by product by supply chain activity. This should make responding to determinations for access and complaints about Royal Mail's pricing behaviour more efficient and less time-consuming than would otherwise be the case.
- S.54 Should Postcomm believe that, after the other options have been implemented and evaluated, Royal Mail still cannot be entrusted with operating the access regime in a fair way that furthers the interests of postal users and promotes effective competition, then Postcomm would consider alternative options, such as more direct regulatory control of access prices or a greater degree of business unit ring-fencing.

Risk that Royal Mail's prices are too low to encourage competition?

- S.55 Postcomm notes this concern of potential entrants. Postcomm would be very concerned if it believed that Royal Mail was pricing in a way that was anti-competitive and therefore a breach of either its licence conditions, general competition law or both. For many key services, Postcomm has powers under Royal Mail's licence to ensure it does not, in the absence of competition and an overriding universal service need, price those services in a way that is predatory, unduly discriminatory or unduly preferential.
- S.56 Postcomm, however, does not believe it is in postal users' interests simply to raise Royal Mail's prices to enable operators to take the business away. This is not in customers' interests, whose needs are ultimately what Postcomm is charged with serving.
- S.57 That said, in making decisions on the price control about setting prices at a level that reflects forward looking efficient costs, Postcomm will take into account the potential impact on competition (see Postcomm's consultation document on Royal Mail's price control review, published alongside this document).

Risk that the VAT position is not resolved?

- S.58 VAT policy is not under Postcomm's control. Postcomm can only provide advice to the Government on how the VAT regime affects its ability to discharge its duties under the Postal Services Act 2000.
- S.59 Postcomm confirms its view, following extensive analysis and industry consultation, that Royal Mail's VAT exemption is a significant barrier to entry. To mitigate the risk of Royal Mail's VAT exemption, Postcomm has undertaken extensive analysis and industry consultation on its effect. Postcomm will also take measures to address other barriers to entry, such as removing the remaining elements of Royal Mail's monopoly and tackling other barriers such as economies of scale, potential anti-competitive behaviour and customer inertia.
- S.60 Postcomm will continue to provide advice and analysis to Government to ensure the effects of this barrier on the postal market are fully understood and, if feasible, addressed as soon as possible.

Risk of "inefficient entry" based on Royal Mail's tariffs being out of line with its costs?

- S.61 Postcomm recognises that some operators may seek to enter the market by taking advantage of opportunities to arbitrage against Royal Mail's tariffs that are most out of line (i.e. in excess) of its costs. Postcomm does not believe that all entry will happen in this way, as demonstrated by experience to date where operators have tried to distinguish their services from Royal Mail on service quality, innovation and other value added features.
- S.62 Postcomm recognises, however, that Royal Mail will want to align some of its prices with its costs. Postcomm, in general, supports the principle of more cost reflective pricing. It should enable Royal Mail to compete more effectively and efficiently. However, Postcomm believes that certain safeguards must be in place to prevent Royal Mail from abusing this flexibility or from making changes that have a detrimental effect on customers or other operators and therefore on Postcomm's ability to discharge its statutory duties.

- S.63 Postcomm's review of its market opening timetable, published alongside this document, sets out how Postcomm is responding to particular issues that have been proposed by Royal Mail.
- S.64 Where operators do enter the market as a result of arbitrage opportunities, they should take into account whether their business model would be sustainable should Royal Mail, subject to regulatory constraints, seek to make its prices more reflective of the underlying costs.

Risk that action to address barriers to entry proves insufficient to encourage competition and more "pro-active" measures are necessary?

- S.65 Postcomm notes that to encourage competition, some regulators have deliberately gone beyond ensuring a "level" playing field and have "tilted" it in favour of new entrants. This recognises the difficulty of encouraging entry into a market that has a strong single incumbent with high customer inertia.
- S.66 This review has focussed on identifying barriers to entry and setting out steps aimed at addressing them. It does not discuss more assertive measures aimed at encouraging entry. Some measures that have been mentioned by stakeholders include adjustments to access prices and tightly restricting how Royal Mail can respond in terms of its pricing. Competition is still in its infancy and Postcomm would like to see how it develops further before considering more assertive action. However, Postcomm will undertake periodic competitive market reviews in order to assess the market, the effectiveness of its policies to promote competition and whether more assertive action is required.

Contents

Summary	i
Risk Assessment	xii
1. Introduction	1
Postcomm's statutory duties	1
Postcomm's vision and regulatory strategy	2
Purpose and structure of this document	2
Process so far	3
How to respond	5
Confidentiality of responses	5
2. Recent Market Developments	6
Introduction	6
Measures of competition	6
Scale and nature of competition	7
Market volumes and market shares	9
Customer awareness and behaviour	12
Royal Mail's performance and behaviour	16
Summary	22
3. Stakeholder Views	24
Introduction	24
Stakeholder views	25
Summary	32
4. Barriers to Entry	33
Introduction	33
Royal Mail's economies of scale	33
Royal Mail's VAT exemption	39
Potential anti-competitive behaviour by Royal Mail	46
Customer inertia	50
5. Prospects for entry	53
Introduction	53
Prospects for competition	53
Potential for innovation	55
International experience	57

Courier, parcels and express market	59
Summary	61
Annex 1 - Economies of Scale Analysis	62
Annex 2 - VAT Analysis	66

1. Introduction

Postcomm's statutory duties

- 1.1 Before the Postal Services Act 2000 was enacted, Royal Mail Group plc, formerly The Post Office, had the exclusive privilege of a monopoly in the provision of postal services within the UK for items weighing less than 350g and costing less than £1 to convey. The changes introduced by the Postal Services Act 2000 (the "Act"), established Royal Mail as the successor to the Post Office and Postcomm as the sector regulator with duties in relation to the universal service, consumers and competition. Postcomm's main power is the issuing of licences to operators within the former monopoly area.
- 1.2 Postcomm's universal service duty is to exercise its functions in the manner it considers best calculated to ensure the provision of a universal postal service. This consists of the delivery and collection at least once every working day of mail (not exceeding 20Kg in weight) and the provision of a registered postal service, all at affordable prices that are geographically uniform throughout the UK.
- 1.3 Subject to this, Postcomm is 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.
- 1.4 Subject to both the duties above, 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.
- 1.5 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.

Postcomm's vision and regulatory strategy

1.6 Postcomm's vision for the postal services market, in the discharge of its duties is:

"A range of reliable, efficient and innovative postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market."

1.7 Postcomm's strategy for achieving this vision recognises that regulation will need to evolve over time. Postcomm believes that its duties will be best discharged by encouraging a dynamic and competitive market that stimulates innovation and customer focus on the part of postal operators. In the short-term, when competition is not sufficiently developed to protect postal users' interests and provision of the universal service, Postcomm recognises that it will need to regulate the activities of Royal Mail.

1.8 Postcomm's review of market opening², published alongside this document, highlights in its introduction the main initiatives (with their relevant documents) that Postcomm has put in place to implement this strategy.

1.9 Postcomm's current Forward Work Plan, which can be found on its website www.psc.gov.uk, gives details of its duties, functions, objectives and work plan. This will be updated early in 2005 to reflect initiatives proposed in this and other consultation papers.

Purpose and structure of this document

1.10 The Competitive Market Review (CMR) that Postcomm has conducted, and on which it is now consulting, aims to give Postcomm and stakeholders a more thorough understanding of the UK letters market, including how competition has developed to date and how it might develop in the future. The review assesses the prospects for future competition and how Postcomm should regulate to help ensure

² "A Revised Market Opening Timetable", Postcomm, September 2004.

that the development of effective competition furthers its statutory duties. Postcomm is keen to understand stakeholders views on the current state of the market and how stakeholders think the market will evolve over time.

1.11 The Competitive Market Review considers a number of factors, including:

- o where competition has developed;
- o Royal Mail's response to competition and the regulatory regime;
- o how competition is likely to develop bearing in mind any barriers to entry and innovation and what are the likely benefits for postal users; and
- o what regulatory measures Postcomm can take to improve the prospects for effective competition, benefiting postal users and encouraging innovation, while continuing to safeguard the universal service.

1.12 Chapter 2 examines recent market developments, including the development of competition and the performance of Royal Mail. Chapter 3 sets out stakeholders' views on how competition might develop. Chapter 4 considers the prospects for competition and the key barriers to entry that may hinder the success of new operators.

Process so far

1.13 Postcomm has based its proposals in this document on a wide number of inputs. These include:

- o in November 2003, Postcomm issued its consultation on the criteria it should use to assess competition³;
- o in January 2004, Postcomm issued its consultation on Royal Mail's special privileges⁴;

³ "Assessing competitiveness in Postal Services: Postcomm's Proposed Criteria", Postcomm, November 2003.

- in January 2004, Postcomm issued its 'Market Report' setting out how the market was developing and explaining current trends⁵. This document consulted on the main barriers to entry that may be impeding competition and innovation;
- on 5 May 2004, Postcomm issued a consultation letter to stakeholders⁶. Among the main issues raised were potential options for further market opening. Postcomm complemented this consultation by meeting with many interested stakeholders (including Royal Mail, Postwatch, operators, customers and the unions) to listen to their views;
- an extensive market research survey (conducted with the consultant Roland Berger) of business customers to listen to their views on competition and how it should be progressed⁷;
- on 9 June 2004, Postcomm presented its views on competition to stakeholders at its London Forum event. Postcomm also continues to undertake a series of regional "roadshows" and since January 2004 has been to Belfast, Edinburgh, and Builth Wells; and
- on 1 July 2004, Postcomm discussed how operators view the prospects for competition and innovation in the market and what barriers they have to overcome with the Operators Advisory Group (OAG).

⁴ "A Review of Royal Mail's Special Privileges", Postcomm, January 2004.

⁵ "The UK letters market 2000-2003", Postcomm, January 2004.

⁶ A copy of this letter is available on Postcomm's website www.psc.gov.uk.

⁷ A copy of the survey results can be found on Postcomm's website www.psc.gov.uk.

How to respond

1.14 Postcomm invites stakeholder views on the policy proposals contained in this document. Responses can be sent by post, e-mail or fax and should reach Postcomm no later than Monday 20 December 2004. Responses should be sent to:

Matthew Ward
Postcomm
Hercules House
6 Hercules Road
London
SE1 7DB

Telephone: 020 7593 2117

Fax: 020 7593 2142

E-mail: matthew.ward@psc.gov.uk

1.15 If you would like clarification of any points raised in this document please contact Matthew Ward, or Pav Dhesi (on 020 7593 2120 or at pav.dhesi@psc.gov.uk).

1.16 Postcomm is always happy to meet with stakeholders to discuss its policies and listen to stakeholders' views.

1.17 Following consideration of responses to this document, Postcomm expects to set out its conclusions in its decision document on market opening, expected in early 2005.

Confidentiality of responses

1.18 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 that your response is clearly indicated as confidential.

2. Recent Market Developments

Introduction

2.1 This chapter reviews recent developments in the letters market since the introduction of competition, and provides an update to the market report published in January 2004⁸.

Measures of competition

2.2 Postcomm's focus is on the licensed area. This consists of items weighing below 350g and costing less than £1. These were the dimensions of the reserved area when Postcomm assumed its powers under the Act. Postcomm notes, however, that the wider mail market extends beyond these parameters.

2.3 Postcomm, in common with regulatory best practice, believes that there is no unique indicator of competition. Postcomm's view is that it should try to assess as much evidence and opinion as possible and take a view on the development of competition in the round. Important evidence that it will consider includes:

- scale and nature of competition;
- market volumes and market shares;
- customer awareness and behaviour;
- Royal Mail's performance and behaviour; and
- barriers to entry.

2.4 All these factors are discussed below, except for barriers to entry which is the subject of Chapter 4.

⁸ "The UK Letter Market 2000-2003", Postcomm, January 2004.

Scale and nature of competition

(a) Market entry to date

- 2.5 In March 2001, Postcomm granted Royal Mail a long term licence valid for 15 years. In addition, Postcomm has issued long term licences to seven new operators.
- 2.6 Since the introduction of competition, new operators have targeted niche and value added services for business customers. Table 2.1 summarises the services operators are currently offering (as at the final quarter of 2003/04) in the licensed area (though all operators covered in the table offer numerous services outside the licensed area). The number of circles gives an indication of the volumes handled by each operator (O – over 1,000 items, OO – over 100,000 items, and OOO – over 1m items).
- 2.7 Mailroom services continue to be supplied by TNT, Securicor and Speedmail. Express and Datarun continue to provide a collection and delivery service in particular cities. Speedmail has expanded from mailroom services and publication sector letter distribution to providing consolidation services, and tracked business-to-business services.
- 2.8 DX Network Services introduced new services under its long term licence. The “DX” service is an enhanced document exchange service, and the “Assure DX” service is a tracked mail service. These services now account for the majority of its licensed revenues.

Table 2.1: Services currently provided by new operators (final quarter of 2003/04) in the licensed area

	Mail Room Services	Bulk Mail End-to-End	Consolidation	Enhanced document exchange	Tracked B2B	Other licensed mail
Datarun		OO				
Deutsche Post						
Express		OO				
DX Network Services		OOO		OO	OOO	
Securicor ²	O					
Speedmail	O	OO	OO		O	OO
TNT (LTSB & RBS)	OOO					
TPG						
UK Mail			OOO ¹			

Notes:

¹ Estimate for 2004/04Q1.

² Securicor (now operating as DHL) and Speedmail are wholly-owned subsidiaries of Deutsche Post.

³ TNT is a wholly-owned subsidiary of TPG.

Source: Postcomm

2.9 With respect to consolidation services, UK Mail, TPG and Deutsche Post have thus far signed access arrangements with Royal Mail. UK Mail began offering these services in April 2004. TPG has also just begun operating. Deutsche Post expects to offer consolidation services shortly. Speedmail is also offering consolidation services (but does not have a specific access agreement).

Market volumes and market shares

(a) End-to-end volumes

2.10 The volumes of the postal market continue to be dominated by businesses posting to consumers. Businesses pay for and send around 86% of all mail items: about 58% is delivered to household consumers throughout the UK (B2C); and about 28% is delivered to businesses (B2B). Household consumers post around 14% of mail items: about 9% to other households (C2C) and about 5% to businesses (C2B).

2.11 The total letters market (for the licensed area) has continued to grow, accounting for 19.3bn items in 2003/04, which is principally driven by the 2% rise in Royal Mail's volumes from 2002/03. Royal Mail's volumes were higher than forecast by both Postcomm and Royal Mail at the time the current price control was set.

2.12 Total mail volume (for the price controlled area) has grown from 20.4bn to over 20.9bn items. This is driven primarily by a 4% increase in the volume of second and third class Mailsort products. Royal Mail's Presstream and Cleanmail services also experienced volume increases.

2.13 Table 2.2 below shows end-to-end (E2E) volumes by operator. New operators carried 57m items in 2003/04. Overall, Royal Mail continues to dominate postal services, accounting for over 99% market share by volume in 2003/04. In terms of forecasts for end-to-end volumes in 2004/05, if non-Royal Mail operators' own estimates are realised, their end-to-end volumes will account for 76m items in 2004/05. This would represent a 33% rise compared to 2003/04.

Table 2.2: End-to-end letter operator volumes (licensed area) 2002/03 to 2004/05

Operator	End-to-end letter volumes (m items) ¹		
	2002/03	2003/04	2004/05 ²
Royal Mail ³	18,865	19,216	19,600
Non Royal Mail operator E2E volumes	51	57	76
Total E2E market	18,916	19,273	19,676
Growth	-	1.9%	2.1%
Royal Mail market share	99.73%	99.70%	99.62%
Non-Royal Mail operators market share	0.27%	0.30%	0.38%

Notes:

¹ Excludes access volumes.

² Based on Postcomm's forecast for the remainder of the financial year.

³ These volume figures are calculated from revenue derived data received monthly from Royal Mail covering "UK Mails". Royal Mail defines "UK Mails" as including all letter products, Special Delivery and parcel services that Royal Mail defines as being provided under the USO and mail order returns (it excludes international USO traffic). Volumes authorised or required by Royal Mail's licence accounted for approximately 96.5% of "UK Mails". The figures are adjusted to reflect this.

Source: Postcomm

(b) Access and consolidation volumes

2.14 Table 2.3 shows operators' own forecasts for consolidation services in 2004/05. This shows that operators forecast a total consolidation volume of 111m items in 2004/05 (compared to 76m end-to-end items).

Table 2.3: Access volumes forecasts 2004/05 (by non Royal Mail operators)

Access volumes	Full year 2004/05
Total (m items)	111

Source: Licensed operators

2.15 If the assumption is accepted that access volumes count for 50% of one whole postal item (reflecting the broad split of upstream and downstream activities), then access volumes and end-to-end volumes combined conveyed by operators other than Royal Mail will amount to about 132m items. This is equivalent to 0.66% of the total regulated market (end-to-end and access combined).

(c) Market revenues

2.16 Table 2.4 shows Royal Mail's revenue growth (from the licensed area) over the last year. Overall, its revenue grew by 5.4% last year. This was driven in large part by a rise in average unit prices.

2.17 New operators experienced a 12% increase in mail revenues in 2003/04, reflecting the growth in their volumes, given that their average unit revenue decreased compared to the previous year. New operators' revenues accounted for £14m (0.3% of the total market) in 2003/04. Although caution must be exercised in making comparisons, on the face of it, there is a very small difference between the average revenue per unit earned by Royal Mail (24.2p in 2003/04) and new operators (24.1p), which indicates that entry has not been of a "cream skimming" nature.

Table 2.4: Letters Market (licensed area) by revenue (£m)

	2002/03	2003/04
Royal Mail ⁹	4,417	4,655
Change	-	5.4%
Total non-Royal Mail operators	12	14
Change	-	11.5%
Total market	4,430	4,669
Change	-	5.4%
Royal Mail's market share	99.72%	99.71%
Total non-Royal Mail market share	0.28%	0.29%

Source: Postcomm

Customer awareness and behaviour

(a) Roland Berger's customer survey

2.18 Postcomm commissioned Roland Berger to conduct a detailed survey of non-residential customers, to identify their needs, experiences and likely future switching behaviour in a competitive market. Postcomm asked Roland Berger to focus on non-residential customers as they represent 86% of the market.

⁹ These revenue figures are approximate figures and are derived from data received from Royal Mail covering "UK Mails". Royal Mail define "UK Mails" as including all letter products, Special Delivery and parcel services that Royal Mail define as being provided under the USO and Mail Order Returns (it excludes international USO traffic). Licensed volumes account for approximately 79.4% of "UK Mails". The figures are adjusted to reflect this.

2.19 Roland Berger was also asked to use this market research to draw recommendations for Postcomm in relation to its forthcoming regulatory decisions. A sample of 549 customers was interviewed as shown in the Table 2.5.

Table 2.5: Customers interviewed

Segment	Definition (by mail expenditure p.a.)	Number of Interviews ¹	Volume of total mail (%)
Top 500	Greater than £500k	56	76.57%
Large	£200k to £500k	253	20.93%
Medium	£30k to £200k	94	1.94%
Small	£10k to £30k	146	0.56%
Total	-	549	100%

Notes:

¹ A disproportionate sample was interviewed. This was done in order to obtain enough interviews in the “Top 500” segment, which has a low incidence in the population of all companies.

Source: Roland Berger

2.20 This survey was conducted between January and March 2004, and the full results published in June 2004.¹⁰

¹⁰ Available from Postcomm’s website: www.psc.gov.uk.

(b) Key results of the survey

2.21 The customer survey identified five principal areas that may impede competition.

- Customers were generally not well informed about potential new operators or the market liberalisation process. Some 41% of customers interviewed had not been contacted by an alternative provider.
- Customers had a low appetite for switching to other operators. Customers currently perceived little added value from new entrants, but some risks and costs. Indeed, around a third of customers interviewed perceived cost implications when switching mail to alternative providers.
- Of the customers that did use alternative operators, lower prices, higher reliability and better customer service were the main reasons why they switched. Some 33% of the “Top 500” customers that were currently using new entrants (either for regulated or unregulated services, e.g. courier and express services) believed they were providing a better quality of service than Royal Mail, 42% say it was the same. However, more than 50% of those who use new entrants did not plan to switch more postal business to them.
- Customers strongly preferred entrants who collected and delivered the mail (end-to-end). They were generally not keen on access as an option (citing interconnection problems). Some 42% of customers interviewed preferred an operator who offered an end-to-end service. While, only 7% indicated a preference for access, 32% indicated no preference. It should be noted however, that the survey had begun before the recent announcements of the access deals for UK Mail, TPG and DPWW.

- Customers were generally satisfied with Royal Mail's service. Although customers liked the fact that Royal Mail had a Key Accounts Management service, customers felt this could be improved and be more responsive to their needs. Some 55% of the "Top 500" customers interviewed said that Account Management was extremely important to them. However, 52% of these customers indicated disappointment with Royal Mail's Account Management.

(c) Roland Berger recommendations to Postcomm

2.22 Roland Berger made a number of recommendations to Postcomm aimed at promoting effective competition whilst ensuring the continued provision of a universal service. These recommended that Postcomm ought to:

- fully open the market in "Phase II" of market opening. Failing that, it should open the business-to-business segment;
- increase market confidence that access was a reliable alternative to full national end-to-end service provision;
- raise market awareness of the liberalisation process with operators and customers. This could include the communication of "success stories" of new entrants, to improve customer confidence;
- take the lead in implementing a clear and quick access negotiation process (i.e. access code). It was imperative that Postcomm enforced clear and fair access rules and terms aimed at promoting competition; and
- lobby for uniform conditions for all entrants. For competition to develop, a level playing field needs to be established for all operators. This is currently not the case for mailings from VAT exempt customers.

(d) Postscript

2.23 Roland Berger's results need to be viewed in the context of how early the market is in its liberalisation process. Indeed, similar views emerged at similar stages of liberalisation of other regulated utilities (e.g. gas and electricity). As mentioned above it should also be noted that the survey had begun before the recent announcements of the access deals for UK Mail, TPG and DPWW.

2.24 Postcomm intends to keep the situation under review and will carry out further market research to inform its reviews of the competitive market in the future.

Royal Mail's performance and behaviour

(a) Overall financial performance

2.25 The division of Royal Mail that provides the universal service has seen a sharp improvement in its financial performance over the last year, mainly driven by the price increases from the first year of the present price control, together with approximately 2% mail volume growth. Last year (2003/04) the universal service products made a profit from operations¹¹ before pension deficits and exceptional costs, of £322m (compared with £78m in 2002/03). This is a margin of about 6% of turnover.

2.26 There are other changes that are strengthening Royal Mail's business. Its 'Renewal Plan' is scheduled to be completed in the next six months. It should improve its financial strength by making efficiencies following three major initiatives: Single Daily Delivery¹², Transport Review and the Mail Centre Review. It should also help make the business more flexible and better able to deal with shocks (such as a fall in

¹¹ Royal Mail's preferred measure of underlying profit.

¹² According to a Royal Mail press release (8 October 2000), a number of the initiatives that are part of Royal Mail's Renewal Plan, including Mail Centre Review, Single Daily Delivery and the Transport Review, are expected to reduce operating costs, once implemented. These reductions should lead to lower operating costs in future years. For example, Royal Mail claimed that the second delivery accounted for 4% of volumes but 20% of costs. Part of the Renewal Plan savings have been used to raise the basic postal workers weekly wage from around £270 to £300.

volumes) than was the case in the past, when adverse events that increased costs were usually cushioned with price rises for captive customers.

2.27 Overall, the 2003/04 accounts show that Royal Mail is in an improved financial position. Indeed, the financial prospects for Royal Mail seem positive. Currently Royal Mail is benefiting from mail volume growth and limited competition, and should soon see the benefits of its Renewal Plan improving its operational efficiency.

(b) Segmental financial analysis

2.28 It should be noted that the following figures are based upon Royal Mail's cost allocation. Different approaches for the allocation of costs could affect the results, and Postcomm has not endorsed Royal Mail's approach. Postcomm's review of its market opening timetable, published alongside this document sets out the steps Postcomm is taking to assess Royal Mail's approach to costing, to help inform its decisions on some of Royal Mail's pricing initiatives.

2.29 As reported by Royal Mail, the overall £322m of profit from operations from the universal service, masked differences when the result is examined by weight-step. This is shown in Table 2.6. Royal Mail estimates that it makes a loss in the part of the market that is still subject to partial monopoly restrictions, whilst it makes relatively healthy profits in the part of the market that is open to competition. Postcomm notes Royal Mail's analysis suggests that it makes a return on turnover of almost 30% on items weighing more than 350g, which has been liberalised for over twenty years.

Table 2.6: USO profit from operations by weight step

£m	0-100g	101-350g	+ 350g	Total USO
Revenue	3,687	812	1,303	5,802
Operating costs	3,845	717	918	5,480
Profit from operations	(158)	95	385	322

Source: Royal Mail

- 2.30 Royal Mail is currently attempting to address the apparent misalignment of prices and costs by weight through its Size Based Pricing proposals¹³.
- 2.31 According to Royal Mail's regulatory accounts, profits on products aimed at bulk mail users accounted for £124m, with non-bulk mail accounting for £198m of profit in 2003/04.
- 2.32 In terms of profit by class, first class was much more profitable than second class, showing £163m profit, compared a loss of £148m for second class. The remainder is made up of other products (e.g. Mailsort 3).

(c) Royal Mail's quality of service performance

- 2.33 Royal Mail's quality of service deteriorated significantly in the final half of 2003/04, which resulted in Royal Mail announcing in May 2004 (and again in August 2004, with respect to the first quarter of 2004/05) that it had failed to meet all 15 of its quality of service targets for the year. Royal Mail's quality of service performance is shown in Table 2.7.

¹³ For a discussion of this proposal please see "Royal Mail's Sized Based Pricing Proposal", Postcomm, March 2004.

Table 2.7: Royal Mail Quality of Service performance (2001 to 2004)

	2001/02		2002/03		2003/04		
	Target March 02	Apr 01-March 02 (cum)	Target March 03	Apr 02-March 03 (cum)	Target March 04	Apr 03-March 04 (cum)	% diff. against target
1c Stamp & Meter All	92.1	89.9	92.5	91.8	92.5	90.1	-2.4
2c Stamp & Meter All	98.5	98.3	98.5	98.6	98.5	97.8	-0.7
1c PPI	90.0	81.4	92.5	83.9	90.6	83.5	-7.1
2c PPI	97.0	94.4	98.5	96.9	97.4	94.6	-2.8
1c Response Services	90.5	78.1	92.5	80.3	90.3	81.7	-8.6
2c Response Services	97.0	93.7	98.5	93.7	97.5	92.2	-5.3
Special Delivery	99.0	98.5	99.0	98.6	99.0	97.9	-1.1
Mailsort 1	92.1	90.0	93.0	90.8	91.0	89.2	-1.8
Mailsort 2	97.6	95.5	98.5	96.5	97.5	95.7	-1.8
Mailsort 3	98.5	97.9	98.5	98.0	97.5	97.4	-0.1
Presstream 1	91.0	89.2	92.5	90.8	90.5	88.1	-2.4
Presstream 2	97.6	96.2	98.5	96.8	97.5	95.1	-2.4
Standard Parcel	88.0	81.0	90.0	88.5	90.0	88.9	-1.1

Source: Postcomm and Royal Mail

(i) Royal Mail first class performance

2.34 As shown in Table 2.7 the cumulative total of 1st class stamped and metered products delivered the next day was 89.9% in 2001/02, this increased to 91.8% in 2002/03 but fell to 90.1% in 2003/04 against a target of 92.5%. A similar pattern of performance can be seen for Mailsort 1 and Presstream 1. Although the cumulative performance of the 1st class Postage Paid Impression (PPI) and Response Services products has shown an increase between 2001 and 2003, they continue to fall significantly below their targets, with performances of 83.5% and 81.7% respectively against targets of 90.6% and 90.3% for 2003/04.

(ii) Royal Mail second class performance

2.35 The cumulative total of stamped and metered products delivered 2nd class was 98.3% in 2001/02, this increased to 98.6% in 2002/03, but fell to 97.8% in 2003/04 against a target of 98.5%. Both 2nd class PPI and Response Services also failed to achieve their 2003/04 licence targets, with performances of 94.6% and 92.2% respectively, against targets of 97.4% and 97.5% for 2003/04.

(iii) Royal Mail Special Delivery, Standard Parcel and Mailsort 3 service performance

2.36 The cumulative total of Special Delivery items delivered next day was 98.5% in 2001/02, this increased to 98.6% in 2002/03 but fell to 97.9% against a target for 2003/04 of 99%. A similar performance can be seen for Mailsort 3, whose performance fell to 97.4% against a target of 97.5% in 2003/04. Standard Parcels saw a slight improvement in its performance in 2003/04 with 88.9%, against 88.5% in 2002/03, however this was still below the 90% target for 2003/04.

(iv) Postcode performance

2.37 The percentage of postcode areas which achieved 90% or greater for delivery targets for 1st class stamped and metered was just 60.2% in 2001/02 (against a target of 83%), this increased significantly to 91.5% in 2002/03 (against a target of 100%). For 2003/04 however this fell to just 55.9% (against a target of 100%).

(v) Assessment of Royal Mail's quality of service performance

2.38 Royal Mail has attributed the deterioration of its quality of service to a number of reasons, including a fire at the Northampton mail centre¹⁴, industrial action in the third quarter of 2003/04, and three major change programmes initiated under their renewal plan, which adversely impacted performance in the final quarter of 2003/04 (particularly its Transport Review).

2.39 Postcomm is disappointed in the deterioration in Royal Mail's quality of service performance. Postcomm launched an investigation into why it deteriorated so sharply in the final half of 2003/04 and whether Royal Mail complied with its licence requirement to use all reasonable endeavours during 2003/04 to achieve those targets. Postcomm is also undertaking an assessment of the robustness of Royal Mail's action plans for achieving its 2004/05 targets.

2.40 In October 2003, for the first time, a "bulk" compensation scheme for larger mailers was introduced by Postcomm. As part of the scheme business users can expect a 1% reduction in their postal bills for each 1% Royal Mail falls below the national target. The scheme operates between the ranges of 1% and 5% and is backdated to April 2003. In August 2004, Royal Mail announced that it had begun to pay customers compensation that was due for the underperformance in 2003/04.

¹⁴ When determining the appropriate level of compensation for customers, Postcomm accepted Royal Mail's argument that the fire at Northampton should be considered a force majeure event. Taking this into account, meant that Royal Mail was considered to have met its Mailsort 3 target for the purposes of determining the appropriate level of compensation.

- 2.41 A “retail” compensation scheme was introduced in January 2004 for domestic mail. Compensation can be claimed in the event of a delay. For example, Royal Mail is required to compensate customers if it does not deliver first class post within three working days.
- 2.42 Postcomm can also impose a financial penalty on Royal Mail if it considers the company has not used all reasonable endeavours to achieve the service targets in its licence. Before reaching a decision Postcomm needs to take account of all evidence provided by Royal Mail, and representations made by Postwatch, the consumer body.
- 2.43 Postcomm’s current investigation into the underperformance in 2003/04 will result in a decision, taken in consultation with Postwatch, over whether to impose a financial penalty on Royal Mail, and whether any enforcement action should be taken to accelerate improvements for 2004/05. Postcomm will publish the conclusions of this investigation in October 2004.

Summary

- 2.44 The latest market data confirms that competitive entry has been broad in scope but not deep in terms of the volumes attained by new entrants. However, it is gaining momentum and will be helped by the development of access arrangements. This trend is consistent with international experience, where incumbents have continued to dominate their respective markets. Customer awareness is also generally low and inertia is high.
- 2.45 Royal Mail’s financial performance has improved. This has been largely driven by stronger than anticipated volume growth and the price rises afforded to Royal Mail under its current price control. Costs have been brought further under control and Royal Mail will complete its Renewal Plan next year, further enhancing its strength.

2.46 Regrettably, customers have been disadvantaged by the fact that the improvement in Royal Mail's financial performance has taken place against the background of a deterioration in Royal Mail's quality of service performance against its regulatory targets.

3. Stakeholder Views

Introduction

- 3.1 Postcomm has consulted extensively with stakeholders from a broad range of interest groups. It wishes to understand their views on how the postal market is developing and what Postcomm might do to further the interest of postal users through promoting effective competition, while ensuring customers continue to benefit from a universal service.
- 3.2 Over the past year, Postcomm has issued three consultation documents. These consultations include:
- a consultation document on Postcomm's proposed competition criteria for assessing the degree of competition in postal services, published in November 2003;
 - a consultation document on Royal Mail's special privileges, published in January 2004; and
 - a consultation document on barriers to entry as part of the UK Letters Market 2000-2003 Market Report published in January 2004.
- 3.3 Since May 2004, Postcomm has also conducted twenty interviews with key stakeholders, and received eleven substantive written replies from stakeholders in response to a published Competitive Market Review consultation letter.¹⁵
- 3.4 This chapter summarises stakeholders' views on the competitive market review, and also considers, where relevant, responses to the consultations mentioned above. This section excludes questions specifically relating to Postcomm's market opening proposals, which are summarised in Postcomm's proposals document on the market opening timetable, which is published alongside this document. It also excludes a

¹⁵ A copy of this letter is available on Postcomm's website at www.psc.gov.uk.

discussion of stakeholders' views on the criteria for assessing competition, which is set out in Postcomm's latest consultation document for Royal Mail's price control, which is also published alongside this document.

Stakeholder views

How do you think competition has developed to date?

- 3.5 Royal Mail believed the main reason for limited competition to date was due to uncertainty. Much of this is a direct result of the time required for key regulatory decisions, such as moving from an interim to long term licensing regime. Some of this was unavoidable. However, the process, especially the final decision, was often subject to delays. Furthermore Royal Mail believed that the downward regulatory pressure on its prices was restricting the development of competition, with UK prices amongst the lowest in Europe.
- 3.6 Other operators gave three principal reasons to explain limited market entry. First, Royal Mail's prices were too low, which meant the margins to be made were unattractive. They believed that Royal Mail's retail prices set the benchmark for other products and they should be increased. A number of operators argued that Mailsort 2 and 3 prices in particular were too low. Some believed this would make downstream access unattractive because the "headroom" between access prices and retail prices was not sufficient.
- 3.7 The second significant issue was Royal Mail's VAT exemption, which operators argued effectively closes half the market.
- 3.8 Third, a number of operators believed that Royal Mail had used delaying tactics to deter market entry, citing the delay in agreeing the UK Mail access agreement as a prime example. The uncertainty created by the delay in setting this agreement was considered a significant reason for the slow pace of market entry.

- 3.9 Postwatch believed competition was slow to develop due to Royal Mail's reluctance to sign access agreements. This compounded several key barriers to entry that operators faced, including overcoming Royal Mail's economies of scale, VAT advantage and customer inertia.
- 3.10 Customers generally thought little had changed. They did not believe there was an alternative to Royal Mail. Many of the larger customers (particularly customers who could not reclaim VAT) argued that Royal Mail's VAT exemption was a major reason why other operators could not offer them competitive prices.
- 3.11 Some customers said that confidence in rival operators, lack of experience and mail integrity concerns were also reasons why companies were reluctant to switch. However, some customers believed that there had been some benefits from competition, in particular Royal Mail's response in terms of increased use of Tailor Made Incentives, together with opportunities for access.
- 3.12 The Communications Workers Union (CWU) and Amicus believed that while little competition had developed to date, current developments in relation to access meant that the picture is likely to be unclear for some time. They argued small scale entry in part reflects the fact that Royal Mail's services are better and cheaper due to its economies of scale.
- 3.13 Suppliers to the industry believed there was little competition because only the business-to-consumer (B2C) segment had been opened to competition and that economies of scale prevented end-to-end entry because that segment requires extensive delivery networks.

How do you think Royal Mail is adapting to competition and the regulatory regime?

- 3.14 A number of operators argued Royal Mail was using pre-emptive tactics to delay competition. In addition to the delay in establishing downstream access, they argued that Size Based Pricing and de-averaged geographic prices were also attempts to discourage entry.
- 3.15 Some customers agreed that Royal Mail had appeared to be deliberately slowing down competition. Some of the larger customers said that Royal Mail's attitude at senior management level had changed, but this had still to filter down to account management and sales staff. Though the majority of customers indicated Royal Mail's customer care was satisfactory, they believed it could be much better, particularly key account management.
- 3.16 Many customers voiced dissatisfaction with Royal Mail's quality of service, saying that it had got worse. They argued this was unacceptable against the background of higher prices and Royal Mail's increased profits. Of particular concern to smaller users were late and inconsistent delivery times.
- 3.17 Customers were also concerned that Royal Mail was poor at consulting about changes to services and prices. These views were supported by Postwatch.
- 3.18 The CWU and Amicus believed that Royal Mail's Renewal Plan had been accelerated due to liberalisation. They believed Single Delivery was a direct response to competition. They said changes had been introduced too quickly and that profits had been achieved at the expense of quality of service. They also believed Size Based Pricing was also a response to competition, with one trade union indicating that it retained concerns in relation to Size Based Pricing believing the price rises for some customers could be excessive.

3.19 One supplier to the industry believed Royal Mail had built better relationships with large customers and was offering improved discounts for high quality bulk mail. Another supplier believed Royal Mail was not a customer orientated and competitively focused organisation.

How do you think competition is likely to develop in the medium-term?

3.20 Royal Mail said it expected to see a steady growth in competition, initially with relatively limited volumes, but a rapid expansion once there was reduced regulatory uncertainty over its price control, market opening, access and its pricing flexibility. This activity was likely to be focused on specific market areas, such as city centres and access.

3.21 Most operators agreed that access would help to develop competition, though none saw extensive end-to-end competition developing.

3.22 Customers believed that we were likely to see access creating competition upstream, but that this would do nothing to create end-to-end competition. Much would depend on whether barriers to entry such as Royal Mail's VAT exemption could be tackled.

3.23 Trade unions believed it was difficult to judge how the market would develop. Amicus argued that since letters are a point-to-point and discreet service, the service could never be completely automated and therefore competition in delivery is unlikely to transpire.

3.24 One supplier agreed that there was likely to be a combination of access and end-to-end delivery. This would take time to develop, but that the steady state would comprise probably one or two large players with a number of niche operators.

What regulatory measures can Postcomm take to improve the prospects for effective competition benefiting postal users and leading to innovation?

- 3.25 Royal Mail believed the price control should be restricted to services which may not be offered without a licence. Royal Mail believed it was important to establish criteria for a "Competition Test" and if these criteria were met, products should be removed from the price control, reducing the degree of regulation.
- 3.26 Royal Mail also believed that Postcomm should consider the possibility that competition could accelerate rapidly and therefore establish safeguards that would guarantee funding for the universal service.
- 3.27 Operators recommended a number of solutions:
- o the development of clear access arrangements, to ensure other operators would benefit from Royal Mail's scale advantage, including an access code that facilitated greater competition and was less open to discretion and delay from Royal Mail;
 - o Postcomm's price control review should increase Royal Mail's prices which would enable greater 'headroom' within which operators could compete. The price control should only apply to universal services;
 - o Postcomm should lobby HM Treasury to remove Royal Mail's VAT exemption;
 - o clear ring-fencing was needed to prevent cross subsidies and ensure transparency in Royal Mail's pricing, particularly between the upstream and downstream functions;
 - o Postcomm should tackle any anti-competitive behaviour by Royal Mail; and
 - o operators should be given access to post offices, as this would give them access to mail from small and medium sized businesses and increase the revenue to post offices.

- 3.28 Customers recommended a number of measures to encourage competition: the most common being that Postcomm should mandate an access code. One large customer believed this should include prices for third class pre-sorted letters to compete with Mailsort 3.
- 3.29 Most customers stressed the importance of Postcomm's work on market infrastructure, such as access, interoperability and the Postcode Address File as this would raise customers' confidence in a multi-operator environment.
- 3.30 A number of customers said that Postcomm should do more to make customers aware of new entrants and the services they offer.
- 3.31 Postwatch believed that Postcomm must develop its own access code to provide fair, transparent and non-discriminatory terms and conditions. It also argued that Postcomm should consider the future direction of European standardisation (as the cost of applying these standards can be high). Furthermore, Royal Mail's VAT exemption should be tackled, and given the Government's apparent reluctance to remove this privilege, Postcomm should reconsider its market opening timetable. Postwatch believed with Royal Mail back in profit at the expense of higher prices for customers, the next price control should tip the balance back in favour of customers.
- 3.32 The CWU believed it was too early to assess the impact of access upon Royal Mail. It said that Postcomm should concentrate on supporting the universal service, protecting consumers and concentrate on improving Royal Mail's quality of service. This should be done by ensuring increased investment in Royal Mail's business.
- 3.33 One supplier said Postcomm should also look at the margins available to entrants. This should include a "headroom" analysis and that action should be taken to ensure sufficient margins were available to new entrants.
- 3.34 Another supplier believed that the price control should be removed as competition is fierce enough with other non-postal sectors (such as electronic media).

Do you think Postcomm should consider more radical measures, for example the ring-fencing of different parts of Royal Mail's business, for example between the wholesale and retail arms of the business, or upstream or downstream?

- 3.35 Royal Mail said the European Postal Services Directive¹⁶ already required separate accounting for the non-reserved services for universal service and non-universal service. Royal Mail's Licence required separate accounts for regulated services and prevented Royal Mail from obtaining any unfair commercial advantage from its provision of access services. Royal Mail could not see how further separation would aid competition or benefit customers.
- 3.36 Operators supported clear ring accounting fencing to ensure that there were no cross-subsidies between profitable and less profitable parts of the business, and that there was transparency in Royal Mail's pricing.
- 3.37 While some operators saw merit in structural separation, a number of others argued that delivery would remain a monopoly and therefore believed separation would not be beneficial. This view was supported by the equipment suppliers.
- 3.38 Postwatch supported structural separation, proposing vertically separating Royal Mail. Postwatch believed this would require Royal Mail to compete on the same basis as its competitors for access to its pipeline. It would also help reveal the true costs of the network and transfer pricing.
- 3.39 A number of customers indicated their support for clear ring-fencing to ensure transparency in Royal Mail's pricing. One large customer supported the idea that Royal Mail should split itself into two business units: wholesale (i.e. delivery) and sortation (i.e. upstream activities).
- 3.40 The CWU supported the retention of an integrated Royal Mail because of the saved coordination costs, arguing that structural separation would be detrimental to the provision of the universal service.

¹⁶ European Postal Services Directive (97/67/EC) as amended by Directive (2002/39/EC).

Summary

- 3.41 Stakeholders generally agreed that competition had been slow to develop. Some core reasons were cited by stakeholders such as Royal Mail's economies of scale (and hence low prices), its VAT advantage, customer inertia, and the delay in agreeing terms for third party access to Royal Mail's network.
- 3.42 In terms of improving the prospects for competition, although some stakeholders felt Postcomm should "wait and see", most believed that more effort was needed to tackle some of the barriers to entry and innovation in the market. Among the suggestions were development of an access code, removal of Royal Mail's VAT exemption, increasing Royal Mail's prices and greater ring-fencing and separation between Royal Mail's business units.
- 3.43 Chapter 4 discusses Postcomm's assessment of the main barriers to entry and sets out Postcomm's proposed response to addressing them.

4. Barriers to Entry

Introduction

- 4.1 Barriers to entry that grant Royal Mail ongoing monopoly power provide a rationale for economic regulatory intervention in the postal market. Barriers to entry might not be a problem in themselves if they are expected to be transitory and eroded by the pace of competition over a reasonable time period. This chapter assesses the main barriers to entry and outlines Postcomm's proposals for minimising their impact on the development of competition.

Postcomm welcomes views from stakeholders on its analysis and proposals in this chapter in relation to Royal Mail's scale, its VAT exemption, potential anti-competitive behaviour and customer inertia.

Royal Mail's economies of scale

(a) Analysis

- 4.2 Economies of scale occur where average costs fall as volumes increase. Economies of scale can act as a significant barrier to entry if the average cost falls continuously over such a large volume range that a new entrant would require a significant share of the market before realistically being able to compete with Royal Mail.
- 4.3 Postcomm, assisted by the consultancy Indepen, considered which of Royal Mail's pipeline activities exhibited significant economies of scale.
- 4.4 Eight individual pipeline activities were considered: collection, consolidation, outward sortation, trunking, inward sortation, local distribution, walk sequencing and final delivery. These fit with Royal Mail's own activity definitions. Postcomm has subsequently grouped each of Royal Mail's services into four broad categories: business-to-business (B2B), business-to-consumer (B2C), consumer-to-business (C2B) and consumer-to-consumer (C2C).

- 4.5 Table 4.1 summarises Postcomm’s and Indepen’s findings. An entry of ‘high’ in a cell indicates that Indepen considered that a particular service offering passing through a particular part of Royal Mail’s pipeline had a high degree of scale economies. For example, a predominantly B2C service (such as many of Royal Mail’s bulk mail products) benefits to a ‘high’ degree from the economies of scale in final delivery.
- 4.6 The main conclusion from this analysis is that Royal Mail should be well placed to compete with new entrants where it has a service offering passing through a pipeline component that has a high or medium advantage from its scale (e.g. all of Royal Mail’s products from outward sortation through to final delivery).

Table 4.1: Degree of economies of scale in Royal Mail’s pipeline

Service Offering	Collection	Consolidation	Outward Sortation	Trunking	Inward Sortation	Local Distribution	Walk Sequencing	Final Delivery
B2B	L	L	L	L	M	M	M	M
B2C	L	L	L	L	M	M	M	H
C2B, C2C	M	L	M	L	M	M	M	H

Source: Postcomm and Indepen

- 4.7 This suggests that Royal Mail’s nationwide daily universal service delivery network will be an important strategic asset in a fully open market. This supports one of the findings of Postcomm’s market research (see Chapter 3), which suggested that customers favour operators that can offer ubiquity of service.

4.8 More detailed analysis is set out in Annex 1. This shows that operators may try to overcome the barrier of scale economies by either reducing the frequency of delivery, say to once a week, or else only concentrating on a restricted geographic areas where volumes are high and unit costs might be low, such as in financial districts. Evidence from international experience, however, suggests that this is unlikely to lead to significant loss of volume from the incumbent.

(b) Downstream access

4.9 Scale is a significant benefit to Royal Mail and acts as a barrier to entry in final delivery in the UK. To enable operators to share in the benefits of scale that Royal Mail enjoys, Postcomm has been keen to encourage downstream access arrangements with Royal Mail. Downstream access allows an operator to inject mail into Royal Mail's delivery network, taking advantage of Royal Mail's low unit costs of delivery, and to compete with the activities in the pipeline that are not characterised by a high degree of economies of scale. This is an approach adopted by regulators of many other utilities in the UK.

4.10 Condition 9 of Royal Mail's licence allows for access seekers, in the absence of an access code, to negotiate the terms of access with Royal Mail. If agreement cannot be reached, then either party can come to Postcomm for a determination. Royal Mail has so far agreed three downstream access arrangements for mail injected into Royal Mail's inward mail centres (IMCs).

4.11 Many stakeholders view the success of access as crucial to the success of competition in postal services. Indeed, for consolidators, competing with Royal Mail's upstream activities, their success will be highly dependent on their mail receiving similar treatment to that of Royal Mail's own mail. If a consolidator's mail were to receive unfavourable treatment (e.g. delay) it would jeopardise that operator's prospects.

4.12 Alternatively, some operators have expressed concern that Royal Mail might in the future reduce the margin between access prices and its bulk mail prices (such as Mailsort). This could lead to a “margin squeeze” on consolidators as this margin needs to be sufficient to cover the consolidator’s upstream costs, a potential discount for customers and a profit margin for the operator. The potential impact of this could be to force the consolidator out of the market. Currently, access prices are subject to an RPI-1% cap in the bilaterally negotiated contracts. This is consistent with the terms of Royal Mail's price control.

(c) Ring-fencing

4.13 One approach to any ring-fencing is to require Royal Mail to introduce greater separation into its regulatory accounts. In 2003/04, Royal Mail has included basic financial data by pipeline activity to Postcomm (in a confidential annex to the regulatory accounts). This is a useful indicator of the relative costs of the different pipeline activities and therefore gives a good indication as to Royal Mail’s view of the appropriate difference between retail prices and access prices.

4.14 Another solution put forward by Postwatch and other stakeholders to the problem of inferior access terms (i.e. higher prices or poorer quality of service) being offered to a rival is vertical separation of Royal Mail. This would involve the separation of Royal Mail’s upstream and downstream activities into two businesses. This is an approach that has been adopted for other utilities in the UK, such as gas and electricity.

4.15 Such a step would help to reduce the incentives on the downstream business offering more favourable terms to mail being received from ‘Royal Mail upstream’. Regarding price, the downstream business would simply be interested in making a profit (irrespective of where the mail came from). It is likely to need to be price controlled, but supporters of this form of separation argue that Royal Mail would have little incentive to offer anything other than the same price to any operator depositing mail with it. Equally, it would have little incentive to offer a different quality of service to different operators.

- 4.16 Over time, structural separation could also help reduce regulation over the postal industry. While the economies of scale in downstream operations make competitive entry more difficult in delivery, competition upstream is probably more likely. This could reduce (in the longer term) the need for regulation of Royal Mail's upstream activities if new entrants successfully win market share from Royal Mail, reducing Royal Mail's dominance upstream. This means that regulation could perhaps be narrowed over time to just local delivery.
- 4.17 Structural separation has potential disadvantages. An integrated Royal Mail has obvious incentives to coordinate investment in and improve its delivery activities, in order to improve the product it can offer to its own customers. A downstream business (in a monopoly situation) could have less of an incentive to invest, other than those incentives provided by the regulator.
- 4.18 There are also questions as to the appropriate point in the value chain where Royal Mail could be split. If the company were split between the mail centres and delivery offices, there may be a requirement for investment at delivery offices for sorting mail. In addition, inward mail centres are usually the same as outward mail centres (depending on the time of day).
- 4.19 To the extent that various parts of the value chain share common and joint costs, separation may lead to an increase in total costs due to the duplication of overheads, for example.
- 4.20 Finally, the costs of implementing structural separation may not be trivial, especially if they require ongoing monitoring and compliance costs.

Postcomm's response

- 4.21 Postcomm recognises the advantages Royal Mail's scale gives it in certain pipeline activities. Downstream economies of scale are an advantage enjoyed by Royal Mail which pose a major barrier to downstream entry. Postcomm has pursued downstream access in an attempt to allow other operators to share this advantage, in order to enable competition and innovation in other pipeline activities.

- 4.22 Royal Mail took a long time to develop access and agree terms with other operators. However, Royal Mail has now agreed access arrangements with three operators, and is likely to reach further agreements with other operators and customers in coming months. Postcomm now proposes to monitor the development of access and hopes that it will lead to the development of a vibrant and innovative upstream market.
- 4.23 Postcomm believes there is merit in these bilateral agreements being formalised into an access code. Royal Mail expects to propose such a code to Postcomm towards the end of 2004, a delay from the previous expectations of a proposal being made in the Summer. Postcomm is currently considering bringing access products within the next price control (from March 2006).
- 4.24 Third party access raises the issue of ring fencing and transparency of Royal Mail's cost allocation between various activities in the pipeline. Upstream operators may be concerned that Royal Mail may discriminate against them, resulting in a margin squeeze. Postcomm proposes that Royal Mail should continue, as part of its regulatory accounts, to include costs, broken down by pipeline activity, such as delivery, sorting, collection. This is a common approach adopted for other regulated utilities, such as British Telecom. Postcomm will consider including a high-level summary of pipeline costs by activity in the published part of Royal Mail's regulatory accounts.
- 4.25 Royal Mail's scale advantage is significant and, as a result, Postcomm will monitor closely the access regime for any evidence of anti-competitive behaviour, either by object or effect, and act quickly if necessary. Should Postcomm believe that after the other options have been implemented and evaluated, Royal Mail still cannot be entrusted with operating the access regime in a fair way that furthers the interests of postal users through promoting competition, then Postcomm would consider alternative options, such as more direct regulatory control of access prices or a greater degree of business unit ring-fencing.

Royal Mail's VAT exemption

(a) Background

- 4.26 Royal Mail is currently exempt from charging VAT on services it supplies to customers. In contrast, other postal operators, including those licensed to provide competing postal services, are required to charge their customers VAT at the full rate of 17.5%.
- 4.27 Royal Mail also has a number of other special privileges. Postcomm's remit from the Government's White Paper "Post Office Reform: A World Class Service for the 21st Century", is to review all Royal Mail's special privileges including its VAT exemption and make recommendations to the relevant government departments responsible for making a decision to maintain, amend or abolish these privileges.
- 4.28 This document sets out Postcomm's recommendation to Government in relation to Royal Mail's special privilege of it being exempt from VAT¹⁷.

(b) European developments

- 4.29 The UK Government must operate within the constraints of the common VAT regime of the European Union. This provides a mandatory exemption for certain supplies made by "public postal services". In this context, Postcomm notes that on 5 May 2003 the European Commission published a proposal about the application of VAT to postal services. In publishing its proposal, the European Commission asserted that the current VAT regime distorts competition in the supply of postal services. The overall aim of the proposal is to remove what Postcomm perceives as the distorting effects in respect of competition, due to the differences created between end-user prices. The main element of the proposal is to remove the current VAT exemption and to extend VAT to all postal services. The proposal also makes

¹⁷ Postcomm will take forward its advice on Royal Mail's other special privileges in due course. In its recent consultation on special privileges, VAT was identified as the most significant issue.

provision for member states to opt for a reduced VAT rate in respect of certain kinds of postal services.

- 4.30 The proposal is being discussed by member states, and would have to be unanimously agreed by all member states before it could become law.
- 4.31 The treatment of VAT for competing postal operators in a number of selected countries is set out in Postcomm's review of Royal Mail's special privileges¹⁸. Some countries, in particular where competition has been introduced, already have a level playing field for the treatment of VAT for competing postal operators.

(c) Postcomm's consultation on VAT and Royal Mail's special privileges

- 4.32 Postcomm conducted analysis and published a consultation document on Royal Mail's special privileges in January 2004. In this document, Postcomm stated its initial view that Royal Mail's VAT exemption was not necessary for the provision of a universal postal service and that the current exemption distorted competition in a significant part of the UK postal services market. Postcomm's initial recommendation was that the Government should review the VAT arrangements with the aim of finding a solution that created a level playing field without leading to significant price rises for customers.

(d) Responses to Postcomm's consultation on VAT

- 4.33 This section outlines respondents' specific comments on VAT from the CMR consultation and the consultations on Royal Mail's special privileges, and barriers to entry (as part of the Market Report), both published in January 2004.
- 4.34 A large number of customers, users groups, operators, and Postwatch agreed that Royal Mail's VAT exemption distorted competition and was not necessary for the provision of a universal service. Royal Mail's advantage over other operators should therefore be removed, so as to create a level playing field.

¹⁸ "A review of Royal Mail's Special Privileges", January 2004.

- 4.35 A major user group said that some of its members would like to see VAT at 0% applied to all core products and services. This would allow Royal Mail to reclaim its input VAT, relieving pressure on future price rises (assuming Royal Mail passed on the benefit of its recovered input VAT to customers through lower prices). This would also protect overall mail volumes. Other members of this user group were content with a reduced rate, providing assurances could be given that this would have little impact on Royal Mail's prices.
- 4.36 One operator argued that Royal Mail's VAT exemption created a distortion in the market and was contrary to European law. While it argued that a reduced rate of VAT would be desirable, this operator argued that the key objective should be a level playing field. It pointed out that a reduced VAT rate would require a new Directive to be approved unanimously among all member states. If this were not successful, this operator supported applying the full rate of VAT on all postal services.
- 4.37 A major user group believed Royal Mail's VAT exemption was one of the most significant barriers to entry and that it was not necessary for the provision of a universal service, as Royal Mail's price control ensured prices reflect cost. It believed, however, that removing this exemption would lead to price increases for some customers. Therefore, this user group called for the application of a reduced VAT rate of around 5%, believing this would ensure no price rises and a level playing field. There would also need to be special provision on reimbursing financial service providers, charities etc, for the fact that they would experience price rises due to their inability to recover the VAT charged to them. Without these provisions, or something similar, this user group would not support removing the VAT exemption.
- 4.38 Another major user group said the overwhelming majority of its members were VAT recovering, and so would not be disadvantaged if Royal Mail charged VAT. Given that there would be considerable extra cost to residential and non-VAT recovering customers, it believed it would be desirable if VAT were levied at a lower rate. This user group supported removing the exemption provided it took account of the cash

flow impact of delays in VAT recovery, and there was no significant extra cost for residential and non-VAT recovering customers.

- 4.39 Postwatch argued that a level playing field was needed and supported a reduced VAT rate. It argued that any solution must take into account the impact on organisations such as charities that cannot re-claim VAT. Postwatch suggested creating a system where these organisations can re-claim VAT or have a reduced VAT rate applied to them. Postwatch suggested that should resolution not be forthcoming on this issue, Postcomm should consider opening up a greater part of the market in 2005, perhaps 100%.
- 4.40 Royal Mail did not support the removal of its VAT exemption. It said imposing VAT at the standard rate would lead to a 15% price rise, while a reduced VAT rate of 5% would mean a 2.5% price rise. It argued this would impact those least able to afford the increase, the elderly, charities and small businesses. Royal Mail said a 2.5% rate of VAT would make it possible to protect its customers from a price rise, however a 2.5% rate of VAT was not permitted under EC law.
- 4.41 While it agreed that creating a level playing field was reasonable, Royal Mail argued this would contradict Postcomm's obligation to protect customers. Royal Mail also questioned whether VAT would be a significant factor in opening up the market. It argued VAT appeared to have had minimal significance in the development of competition in the parcels market. If Royal Mail was to absorb the imposition of VAT and not pass on the cost to its customers, at the standard rate of 17.5% it would cost it £500m per year, or £150m at a VAT rate of 5%. Royal Mail believed that the social purpose of the universal service should continue to be recognised and supported by the current exemption.
- 4.42 The CWU and Amicus supported Royal Mail in opposing the removal of Royal Mail's VAT exemption. The CWU and Amicus argued that even a lower level of VAT would have a serious impact on Royal Mail's social customers. If VAT were applied at its current standard rate and Royal Mail passed on the savings from reclaiming VAT, this would mean a price rise of 15%, equivalent to an 8p rise in postage costs per household per week (assuming they spend 56p a week). Small

businesses that were not VAT registered would also suffer from postage price rises. Charities, educational establishments and financial institutions would also be worse off as they would not be able to recover the VAT charged to them.

4.43 Responses were also received from a number of charities arguing against removing the VAT exemption. One (non-postal) trade union said they would only be able to claim back a small proportion of any VAT charged to it. If Royal Mail's exemption were ended the union would (as a not for profit organisation) expect to be reimbursed for any additional costs. A number of charities argued that post was a significant proportion of their overheads, and that removing the VAT exemption would impact small, medium and large charities. One charity believed if the proposal went ahead it could lead to charities switching away from post and towards other media. This charity also said that if the proposal went ahead the Government should ensure the price of stamps in the UK did not increase. If Royal Mail did lose its exempt status, then charities should be compensated for their financial loss.

(e) Postcomm's further analysis

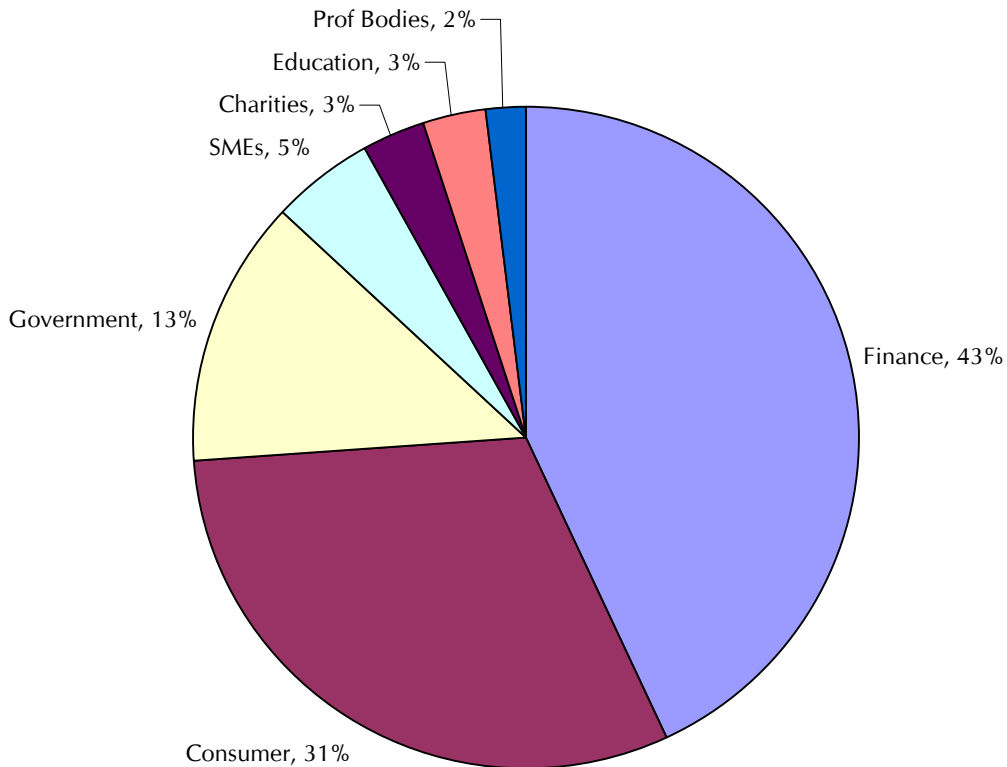
4.44 Research by Postcomm assisted by consultants Arthur D. Little (ADL), confirmed Postcomm's previous analysis that around 50% of customers by value cannot reclaim all the VAT charged to them.

4.45 Chart 4.1 below shows the type of customer unable to fully recover VAT. Some of the largest bulk mail customers are VAT exempt, including banks and financial institutions, charities, and some government departments.

4.46 ADL believed that for competitors to win market share from Royal Mail, they would need to offer average discounts of around 20% to persuade customers to switch. Given operators need to overcome an approximate 13% price disadvantage against Royal Mail for customers that are not VAT recovering before offering a discount, this implies Royal Mail's VAT exemption is a significant barrier to entry.

4.47 The reason the difference is 13% and not 17.5% is because Royal Mail's prices implicitly include its input VAT, which it cannot itself reclaim. If Royal Mail services become subject to VAT then it would be able to reclaim all its input VAT.

Chart 4.1: Total UK letters market for VAT non-recovering customers (£2,502m)



Source: Royal Mail (2002 data)

4.48 Postcomm has undertaken further analysis of the potential impact of this barrier on new entrants. This is summarised in Annex 2 and suggests that VAT could prevent an extra 4% of total market volumes being captured by new entrants (or 1bn items per year by 2010/11). Given the present scale of entry is less than 1% of the market, this represents a significant lost opportunity for new entrants. The effect is likely to be understated because VAT exempt volumes from customers such as banks and financial institutions are very advantageous to building critical mass and scale to compared to other market segments, such as single piece items.

4.49 Postcomm notes that VAT is less of an issue in the parcels market because only a small amount of Parcelforce's business is with VAT exempt customers (around 20%, by revenue, according to Royal Mail). In addition, financial services, charities and government are relatively small users of parcel services (in comparison to the

letters). Many of these customers do not purchase parcel/express services centrally (i.e. they are purchased more on an ad hoc basis).

4.50 Furthermore, interviews with parcel operators have indicated the costs associated with operating a parcel network and margins available may allow sufficient discounting to overcome the VAT barrier, due to the high value per item for each parcel (as compared with relatively cheaper letters).

Postcomm's response

4.51 The Government's 1999 White Paper on postal services¹⁹ asked Postcomm to advise on the continuation of Royal Mail's special privileges, including VAT. Postcomm's analysis, following detailed industry consultation, continues to show that Royal Mail's exemption from VAT gives it an advantage for a large part of the market over its rivals that are required to charge VAT at the full rate. Although Royal Mail cannot claim back some input VAT, this means that, other things being equal, its prices are cheaper than its rivals for customers that are themselves VAT exempt. This advantage is not required for the universal service.

4.52 Policy on VAT is a matter for the government, not Postcomm. Following its consultation on Royal Mail's special privileges in January 2004, Postcomm confirms 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. This would be in the interests of achieving fair and open markets and also contributing to the UK economy's productivity, given the important social and economic dimensions of postal services.

4.53 Postcomm's revised analysis confirms that a lower rate of VAT (around 5%) applied to all postal services could achieve this, even if requiring European legislation before being implemented. Royal Mail would be able to reclaim VAT on its inputs and, if passed back to customers, this would avoid the need for significant price rises across

¹⁹ "Post Office Reform: A World Class Service for the 21st Century", DTI, 1999.

the board. Postcomm would also welcome other solutions that met its overall objectives of a level playing field with no significant increases in prices.

4.54 Postcomm sees no justification for Parcelforce's VAT exemption, or its other special privileges. It no longer provides any universal services in relation to the collection and delivery of parcels. These activities were transferred to Royal Mail in 2003.

Potential anti-competitive behaviour by Royal Mail

(a) Concern

4.55 New entrants are concerned that Royal Mail may seek to unfairly undermine their chances to establish and grow their business. While competition is at such an early stage, new entrants' strategies can be very vulnerable to any response from Royal Mail.

4.56 Its position of strength in the supply of many different services and the current absence of effective competition in postal services, gives Royal Mail scope to abuse its position and actively (or passively) prevent the development of competition.

4.57 There is significant evidence from other countries (most notably Sweden) that anti-competitive behaviour has arisen in the early stages of postal competition.

(b) Postcomm's response

4.58 Conditions 9 to 13 of Royal Mail's licence set out the terms for the promotion of effective competition between postal operators. In particular, Condition 11 sets out Royal Mail's obligations in respect of the promotion of effective competition, and the behaviour that is prohibited. Condition 11 of Royal Mail's licence prohibits, in specified circumstances, the following behaviour:

- o predation;
- o excessive terms or charges;
- o undue discrimination or preference; and

- o undue restriction.

4.59 Postcomm would be concerned if Royal Mail engaged in any such behaviour, and encourages complaints should this be the case, both from operators and/or customers. Complainants should note, however, that Postcomm would normally require some evidence to be provided at the outset to support allegations. This will enable Postcomm to identify those complaints that raise real concerns about anti-competitive behaviour and, therefore, to target resources on the most important issues.

4.60 Postcomm will also consider “own initiative investigations” under Condition 11 in areas where it suspects that competition is not developing to further the interests of postal users.

4.61 Most anti-competitive complaints that Postcomm receives are typically subject to a two-stage process.

- (i) Stage one: preliminary assessment

4.62 The aims of the preliminary assessment are to establish:

- o whether there is a potential case to investigate;
- o whether there is sufficient reason to conduct a full investigation; and
- o whether, given the nature of any evidence supporting the complaint, a Provisional Order should be made.

4.63 During the preliminary assessment stage, Postcomm would normally seek Royal Mail’s response to the allegations made and would respect complainant confidentiality wherever possible.

4.64 Postcomm is also aware that it is not always possible for complainants to provide conclusive substantive evidence in support of their complaints. Therefore, where Postcomm thinks it necessary, it may also seek further information from interested

parties (e.g. customers, operators and consumer groups) again respecting complainant confidentiality wherever possible.

4.65 Upon completion of the preliminary assessment, Postcomm may decide that:

- o the complaint appears unfounded;
- o the allegations and the information supporting them do not merit a full investigation or do not merit a full investigation at the time in question;
- o there is a potential case to investigate and sufficient reason to conduct a full investigation;
- o there is a potential case to investigate and sufficient reason to conduct a full investigation and a Provisional Order should be made; or
- o the matter is best handled by referring it to the Office of Fair Trading (OFT) under the terms of the Memorandum of Understanding (MoU) between the two organisations²⁰.

4.66 Under Section 23 of the Act, Postcomm must²¹ make a Provisional Order against Royal Mail if it appears that Royal Mail is contravening a licence condition and that a Provisional Order is needed.

4.67 In deciding whether a Provisional Order is needed Postcomm shall have regard, in particular, to the extent to which any person is likely to sustain loss or damage as a result of anything likely to be done or omitted in contravention of the licence condition before a Final Order may be made.

²⁰ The OFT has various responsibilities in relation to competition policy in the UK. In particular, it has power to apply the Competition Act 1998 and Articles 81 and 82 of the EC Treaty. To avoid any potential overlap between the roles of Postcomm and the OFT, the two organisations agreed a Memorandum of Understanding. A decision document on the MoU was published by Postcomm in June 2003.

²¹ Subject to Section 25 of the PSA2000.

4.68 A Provisional Order has effect for three months, after which it may either lapse or be confirmed as a Final Order. A Provisional Order may also be made, if justified, at any subsequent stage in this process.

(ii) Stage two: full investigation (under Condition 11)

4.69 A full investigation involves the collection of information and an assessment of whether Condition 11 has been breached. Postcomm will collect evidence from all the main parties to the complaint. Postcomm may also seek further evidence from other parties, including customers of either the complainant, or Royal Mail. In most instances, Postcomm will use its formal powers under Section 47 of the PSA 2000, or Condition 16 of Royal Mail's licence, to collect evidence.

4.70 Once Postcomm has collected all the evidence required, it will assess whether there has been a breach of Condition 11.

4.71 If Postcomm considers that Royal Mail has engaged in behaviour prohibited by Condition 11, it may take the following action against Royal Mail:

- o a Final Order under Section 22 of the PSA 2000;
- o a Provisional Order under Section 23 of the PSA 2000; and
- o impose a financial penalty under Section 30 of the PSA 2000.

4.72 In some instances, where appropriate, the matter may be settled through Royal Mail providing Postcomm with suitable assurances (i.e. through signing of undertakings).

4.73 Whether Postcomm takes action or not, or judges that Royal Mail has not engaged in behaviour prohibited by Condition 11, it will publish its findings or otherwise explain its decision.

4.74 Postcomm intends to raise the level of awareness within the industry about its regulatory processes and principles in dealing with anti-competitive complaints. It will do this through industry workshops with the aim of ensuring industry players can more effectively evaluate Royal Mail's behaviour.

4.75 Postcomm has received some concerns about the current arrangement of reciprocal exclusivity, under which post offices do not sell the service of competing postal operators, and Royal Mail services are not (with limited exceptions) delivered through other outlets. Postcomm, over the course of next year, will consider whether to investigate these arrangements.

Customer inertia

(a) Issue

4.76 Apart from the economic and legal barriers to entry identified above, Postcomm recognises that other factors influence whether an operator enters the market and how it can successfully expand. Royal Mail enjoys a number of benefits from being the incumbent universal service provider with national coverage. This gives it a considerable advantage over competitors. For example:

- *Royal Mail's brand value.* This is significant across a wide range of customers and postal users. This has been borne out by Postcomm's market research. Royal Mail's brand benefits from having a universal coverage. A further brand benefit might be derived from Royal Mail's universal network of pillar boxes and post offices, which might contribute to promoting Royal Mail and its products. Oftel found that public telephone boxes offered a similar benefit to British Telecom;
- *Royal Mail's prices and service quality.* Postcomm notes that when compared to its main European counterparts, Royal Mail's prices are very competitive and its service quality targets (if not current performance) are high;
- *Ubiquity.* Postcomm's market research indicates the provision of a universal service might provide beneficial effects based on customer awareness. Even when a customer moves to a new address, Royal Mail will supply a service. At the new location the customer may not know of potential competitors. As a result of this lack of knowledge, a proportion of customers will choose Royal Mail over alternative suppliers where they are available. Another benefit arising from ubiquity derives from the likelihood that customers will choose to

use Royal Mail when sending mail to wide ranging or new addresses given that, by virtue of the universal service obligation, they can be sure that Royal Mail will deliver to all addresses. In this sense, ubiquity may also serve to reduce customer switching; and

- o *Confidence in rival operators.* Postcomm notes that in the formative stages of competition, customers will have a reluctance to switch to rival operators. This may be reinforced by the incentives on those individuals responsible for making purchasing decisions. The risk to these individuals of mail integrity problems is very significant and may outweigh the potential benefits from lower prices and better quality of service.

(b) Postcomm's response

4.77 Postcomm believes it has a role in improving the confidence of customers in terms of the liberalised environment. It will therefore undertake, in conjunction with Postwatch, a detailed market awareness programme of visits, events and publications. This will particularly focus on the lead up to full market opening on 1 January 2006.

Summary

4.78 Postcomm has identified some significant barriers that may risk it not being able to quickly achieve its vision for the market. Postcomm is putting in place a number of measures to address these barriers.

- o *Royal Mail's downstream economies of scale.* Postcomm proposes to continue to promote and monitor Royal Mail's access arrangements. To ensure transparent costing and pricing, Postcomm also proposes a greater degree of separation by pipeline activity in Royal Mail's regulatory accounts. Postcomm will also consider whether to include access products within the price control from April 2006.
- o *Royal Mail's VAT exemption.* Postcomm's advice to Government, which is responsible for VAT policy, is that Royal Mail's VAT exemption is not required

for the universal service and acts as a significant barrier to entry for a large part of the market. In terms of furthering its duties, Postcomm wants a solution that levels the playing field, but does not lead to a significant increase in prices. A reduced rate applied to postal services might be one way to achieve this.

Postcomm will continue to provide advice and analysis to the Government to ensure the effects of this barrier on the postal market are fully understood and if feasible, addressed as soon as possible.

- o *Potential anti-competitive behaviour.* The impact of anti-competitive behaviour by Royal Mail could be disproportionately high at such an early stage in the development of competition. Postcomm is planning to increase its focus on this issue in order to take a more proactive approach in ensuring anti-competitive behaviour does not occur. Postcomm will also take steps to raise awareness within the industry of its processes for addressing complaints.
- o *Customer inertia.* Postcomm's market research suggests that customers are not generally well informed about the liberalisation process and alternative operators. This may reflect the early stage of the liberalisation process and a strong brand loyalty to Royal Mail. Postcomm intends to undertake a programme of events and visits aimed at raising customers' awareness of the market opening timetable and competition.

5. Prospects for entry

Introduction

5.1 This chapter briefly examines some of the potential ways in which operators might seek to enter the market. It then discusses how innovation might affect the postal value chain. It also sets out how competition has developed in international markets that have fully or partially liberalised their postal markets. It then assesses how competition has developed in the courier and express market.

Prospects for competition

5.2 The current distinction between the areas of the market open to competition and those areas reserved to Royal Mail is complex:

- the European liberalisation programme will, irrespective of Postcomm's proposal on market opening, reduce the 'reserved area' from 0-100g (or three times the price of a first class stamp) to 0-50g (or 2½ times the price of a first class stamp) from 1 January 2006;
- Postcomm's licensing regime for consolidation licences has already 100% opened this market (via downstream access); and
- Postcomm's licensing regime for bulk licences has opened the market for bulk mail (mailings of 4,000 similar items and above). In effect, this means that most workshare services are open; and
- In addition, operators can apply for defined activity licences.

5.3 The principal area of the market that is not open to competition is for delivery of non-bulk letters weighing less than 50g (or 2½ times the price of a first class stamp). Postcomm's revisions to the market opening timetable, published alongside this document, propose a new date for market opening of 1 January 2006.

- 5.4 As part of the Competitive Market Review, Postcomm has analysed potential market entrants' strategies that are likely to be employed in competing with Royal Mail.
- 5.5 In spite of the advantages enjoyed by Royal Mail over market entrants, and the costs and risks associated with launching competing services, the value of the market being opened to competition is relatively large, and growing. Within this market there will be opportunities for innovative, efficient businesses to compete successfully with Royal Mail.
- 5.6 There appear to be a number of possible market entry strategies, as summarised below. Royal Mail currently has a commanding advantage with its low unit costs through economies of scale and a price advantage due to its VAT exemption. The generic strategies of entrants in the short-term are therefore likely to concentrate on differentiating their products in terms of innovation and service specification from Royal Mail's basic letter services. New entrants may also seek to focus on particular market niches.
- o *Upstream competition only.* This may involve permanent use of Royal Mail's access product (e.g. UK Mail). International experience has shown competition already emerging in collection and transportation, with specialised mailing houses collecting and consolidating mail from business users. With the development of hybrid mail, physical collection (before the sorting stage) could be eliminated completely and arguably make it easier to offer this service.
 - o *Speed to market.* Use of access could facilitate a faster way to enter the market and build awareness, know-how and market share.
 - o *Marginal business model.* This model could be exploited by those leveraging existing businesses and competing by covering the marginal costs of the new operation.

- *Reduced delivery frequency.* Some operators may choose to provide a once-a-week mail service, allowing them to reduce their cost per mail item.
- *Local competition.* For example, this might happen if operators provide limited geographic provision of a delivery service e.g. to high density delivery areas (e.g. Citipost). A number of localised delivery services might develop, as in Sweden and New Zealand.
- *Niche/value added products.* For example, use of tracking technology for time-certain, and high value products (e.g. SMS competing with Special Delivery). Time-certain services attack a gap in Royal Mail's offering because its network is designed for speed and security and not time-certainty. This can be combined with a reduced delivery frequency service, in order to make unit costs competitive. This may also include certain services that seek to extend the value chain back into the customers' operations, such as database management and information processing.
- *Market segmentation.* Operators may try and segment the market, e.g. senders of computer generated and addressed mail or non-VAT exempt volumes.

5.7 It is, of course, possible that new entrants will combine a number of these approaches, for instance offering a reduced geographic and delivery frequency just to mailers that are able to recover VAT. New technology will also permit new business models not yet thought of.

Potential for innovation

5.8 Postcomm has been assisted by consultant Arthur D. Little (ADL) to briefly survey opportunities for innovation in postal services in the short and medium term. Postcomm concluded that there were significant opportunities for both Royal Mail and new entrants to benefit from new developments in technology and innovation in postal services.

- 5.9 For Royal Mail, the main benefits might be improvements in sorting technology and walk sequencing with the potential for cost savings throughout the pipeline. With more sortation to delivery route, the required number of sorting offices could be reduced. For example, Post Denmark sorts to delivery route and expects to reduce its number of mail centres from eight to four, by 2005. The technology is based on optical character recognition (“OCR”) which reads the address, allowing for further mechanised sortation of mail (down to individual walks). Improvements in OCR mean that hand sorted mail could be machine sorted. The cost savings could benefit the whole industry (if introduced by new entrants, or translated into access prices).
- 5.10 There may also be scope to introduce improved add-on services such as barcoding, which businesses would use on envelopes, to track quality of service on mass mailings. The United States Postal Service (USPS) already uses such a barcoding system, called POSTNET (Postal Numeric Encoding Technique) for mail auditing purposes.
- 5.11 Another opportunity for Royal Mail (and other operators) is hybrid mail. Hybrid mail combines digital and paper media, where the mail piece is sent electronically to inward sorting offices, or delivery offices, for printing and final delivery. Belgium Post already offers a hybrid electronic telegram service, and electronic transfer of invoices and secure email services are offered by TPG and Norway Post in their respective countries.
- 5.12 For new entrants, innovation is most likely to take the form of creative segmentation and service development. Rather than invest in technology, new entrants might target customers who already pre-sort their own mail and then sub-contract transport to efficient specialist companies. In this way, new entrants can develop their own networks without unnecessary capital investment, creating “virtual” pipelines, provided by sub-contractors.
- 5.13 Information technology is likely to be important, particularly in targeting customers whose delivery profile will match an entrant’s network, and in managing the elements of the delivery chain, many of which may be outside the entrant’s own

direct control. This means that entrants are likely to try to integrate themselves with customers' and suppliers' IT systems to enable seamless service.

- 5.14 Other than technology, new entrants may be able to innovate by offering different service specifications. For instance, they could dramatically reduce costs by offering fewer deliveries per week in urban areas only. They could set up mail collection boxes at appropriate pick-up points (e.g. supermarkets or petrol stations). Such a system is used in the USA, where US firm American Locker Systems provides Cluster Box Units for delivery collection with additional compartments for outgoing mail.
- 5.15 New entrants could also employ lower cost and more flexible labour on a part time or piecemeal basis. This approach has been used elsewhere in Europe, notably by Sandd, a new operator in The Netherlands, where its workforce is paid depending on how much mail they deliver.

International experience

- 5.16 International experience has brought about a variety of developments in postal services. Based on simple market share statistics, the results have been mixed. This may be due to a number of factors, including the overall size of the market, the advantages of scale and the established reputation and customer relationship enjoyed by the national postal operator. However, despite limited change in market share, international experience has shown that competition has benefitted users through innovation, improved standards of service, falling real prices for most customers, and greater efficiency.

(a) Greater choice of products

- 5.17 In Sweden and New Zealand competing operators have developed different price and service quality offerings, particularly for local collection and delivery. Sweden has seen numerous market entrants, the majority of them involved in local delivery.

5.18 In the Netherlands, competing operators have tailored direct mail services to suit individual customers' needs, such as ensuring that the delivery time coincides with the timing of other media.

5.19 In Germany there has been a growth in "higher quality services" which include collection of items from customers at fixed times or locations; delivery of letters on the same day; collection after 5 p.m. for delivery by 12 noon the next day and contractually agreed non-payment of fees in the event of late delivery.

(b) Improved standards of service and emphasis on customer satisfaction

5.20 In Sweden, the number of households not receiving a five-day postal service due to their geographic location has fallen by 25%. The development of a customer satisfaction index, based on issues such as reliability and range of services, has contributed to better informed target setting that has delivered steady improvements.

(c) Falling real prices

5.21 In the Netherlands, the price of a standard letter has risen at below the rate of inflation with only one tariff increase in over ten years. In Germany, which is generally viewed as being at the higher end of the postal rates scale, prices were reduced in January 2003 for the first time since 1948. In several countries, large volume customers have benefited from increased discounts. For example, in Sweden the prices of bulk mailings have been cut by a third since liberalisation, although retail prices have risen. In New Zealand, discounts are offered on the standard letter tariff and for bigger customers, it is possible to negotiate individual contracts with additional discounts.

(d) Greater efficiency

5.22 In the Netherlands, investment in automation has delivered higher levels of productivity as measured by the number of addressed letters per employee. Sweden, New Zealand and Germany have also improved efficiency since liberalisation (and in anticipation of it). Another benefit is the behavioural change competition has encouraged with respect to cost control. These benefits might have come about in the absence of liberalisation, however, their scale and diversity suggest that increased competition was in part a driving force.

5.23 Effective competition requires that at least some entrants sustain their position in order to generate a stream of profit necessary to justify the risk of entry and the sustainability of ongoing operations. International experience of entrants sustaining their operations has been mixed. In Sweden, New Zealand, and Germany there have been insolvencies and market exit. This has included both local delivery operations where barriers to entry and exit are relatively low and larger types of entrants that have sunk significant costs into their business - for example, New Zealand's National Mail in December 2000. These business failures appear to have been due to responses by the incumbent, for example in reducing prices which have led to a failure to capture sufficient volume needed to build critical mass and benefit from economies of scale. Many would-be entrants to the German postal market, especially smaller businesses, have been deterred by the costs and delays of fighting legal challenges with Deutsche Post (DP). In 2000, DP disputed 500 licences granted by the regulator, while pressing in the civil courts for injunctions to prevent the licensees from operating services. The regulator has granted licences for letter deliveries to around 1,500 companies. Of these, a maximum of 900 were active in the market in 2003. Almost 500 have exited the market already and around 100 are not yet operating.

Courier, parcels and express market

5.24 Liberalisation of the parcels/express market is an example of the benefits of competition. The Association of Independent Courier and Express Operators (AICES) and other commentators have argued that the reduction of the price limit to

£1 facilitated the rapid growth of courier and express letter services, which provided new services to the benefit of postal users. Postcomm understands that there are over 4,000 operators active in this market. The freedom to enter and compete for these services has encouraged operators to exploit the potential offered by new technology and the greater availability of air transport to meet the increasing customer demand for time critical and guaranteed delivery.

- 5.25 This innovation has led to greater customer choice. Use new technology has also created the possibility of new types of postal services, for example integrated solutions linking postal services to logistics operations and electronic commerce. This may have helped UK businesses more generally, for example by reducing inventory costs.
- 5.26 This innovation and new product development has led to markets with high growth rates in terms of volume, value and employment. Competition in these areas appears to have brought about growth in the postal market as a whole rather than just cannibalisation of existing volumes.
- 5.27 The high levels of competition have made companies innovate by looking to add further service offerings in order to offer additional benefits to customers. An example of this is 'track and trace', which is now common among the majority of express delivery companies. Companies offer customers the opportunity to track their parcel throughout its transport and delivery. Some companies also offer proof of delivery through electronic signatures from the recipient, which are relayed to the sender by e-mail or can be accessed through the internet. "Same day" services are being offered by companies whose networks are built around speed.

Summary

- 5.28 This chapter has discussed some possible ways in which new entrants might seek to enter the market and provide valuable rival services to postal users, despite the barriers to entry identified in Chapter 4. It has also suggested that competition and innovation opportunities exist in the postal value chain and are beginning to be exploited by some operators.
- 5.29 International experience of liberalisation of postal markets suggests that it leads to a number of benefits for postal users such as better quality of service, more choice and more efficiency on the part of the incumbent operator. Experience from the liberalised courier and express market in the UK suggests a similar result with emphasis on the development of innovative products more tailored to customer requirements.

Annex 1 - Economies of Scale Analysis

Economies of scale in delivery

- A1.1 Analysis of the postal pipeline would suggest that some of the activities could be undertaken profitably by other businesses (e.g. transportation). This may not, however, be the case for local delivery, particularly to residential and small business customers. Clearly, average costs will decline as volumes increase, up to the point when volumes reach a level that requires an additional postman or alternative delivery arrangements (e.g. an interim point on a route, where additional mail is stored²²).
- A1.2 An operator that has low delivery volumes may incur a much higher marginal cost for every letter than an operator that is the size of Royal Mail.
- A1.3 Postcomm has adapted a model developed by Royal Mail that looks at delivery costs in the UK by dividing the UK into five geographical zones based on delivery characteristics – mainly the density of delivery points. The model calculates the unit cost that a new entrant would have with different market shares (indexed to 100, with 100 representing Royal Mail's cost, in Chart A1.1 and A1.2). The model also allows the frequency of delivery by the new entrant to be anything between one and six days a week, with six days a week being equivalent to the universal service obligation in the UK that Royal Mail currently provides for letters.

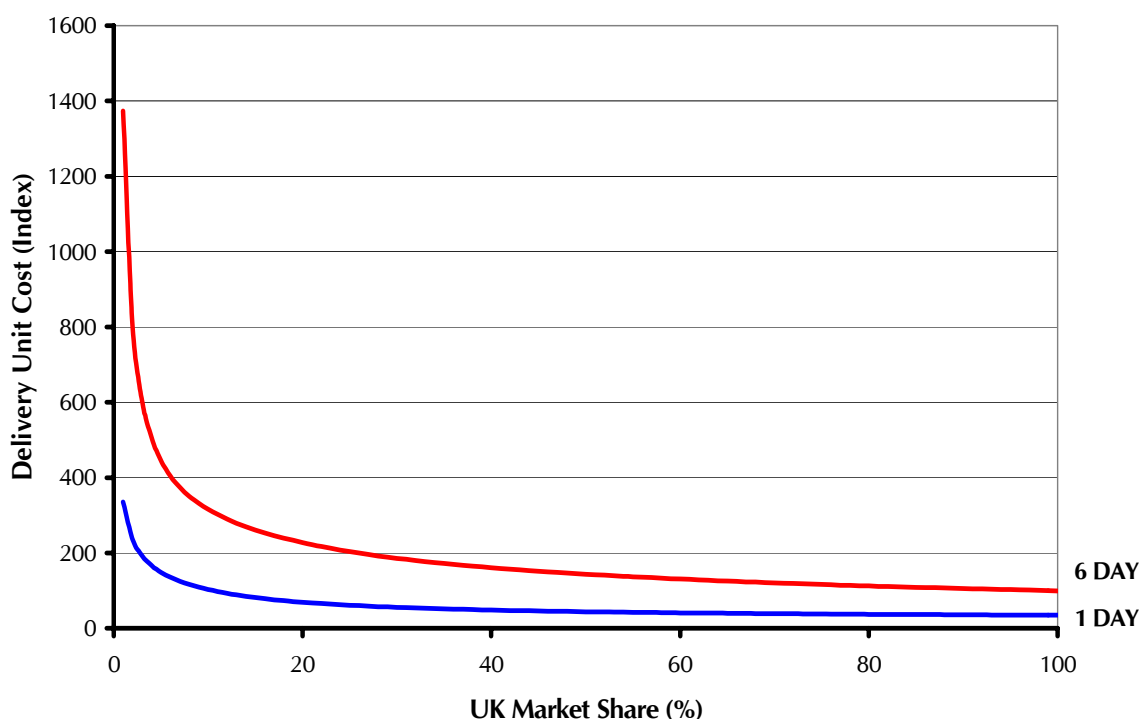
Reduced delivery frequency

- A1.4 Chart A1.1 sets out the results from running the model for delivery on a nationwide basis, either for one or six days a week. It shows that for delivery for both one and six days a week there are significant economies of scale, with average costs declining dramatically as volume increases. The chart also shows that for both one

²² This analysis is premised on the basis that delivery costs are driven by four main elements – the volume of mail items to be delivered, the average number of drops per delivery point, the distance between delivery points and labour/vehicle costs depending on the delivery method.

or six day per week delivery, a new entrant would need to acquire a significant market share before becoming competitive with Royal Mail. For example, to match Royal Mail's present unit costs for delivery six days per week, and depending on the assumptions about new entrants' costs compared to Royal Mail, a new entrant might need to capture around 50% market share.²³ This clearly limits the number of operators that could realistically compete with Royal Mail for a daily delivery service across the country.

Chart A1.1: The costs for postal delivery in the UK based on delivering one and six days per week



Source: Postcomm analysis using Royal Mail data

A1.5 New entrants might not seek to compete against Royal Mail for nationwide delivery six days per week. By reducing the frequency of delivery to one day per week,

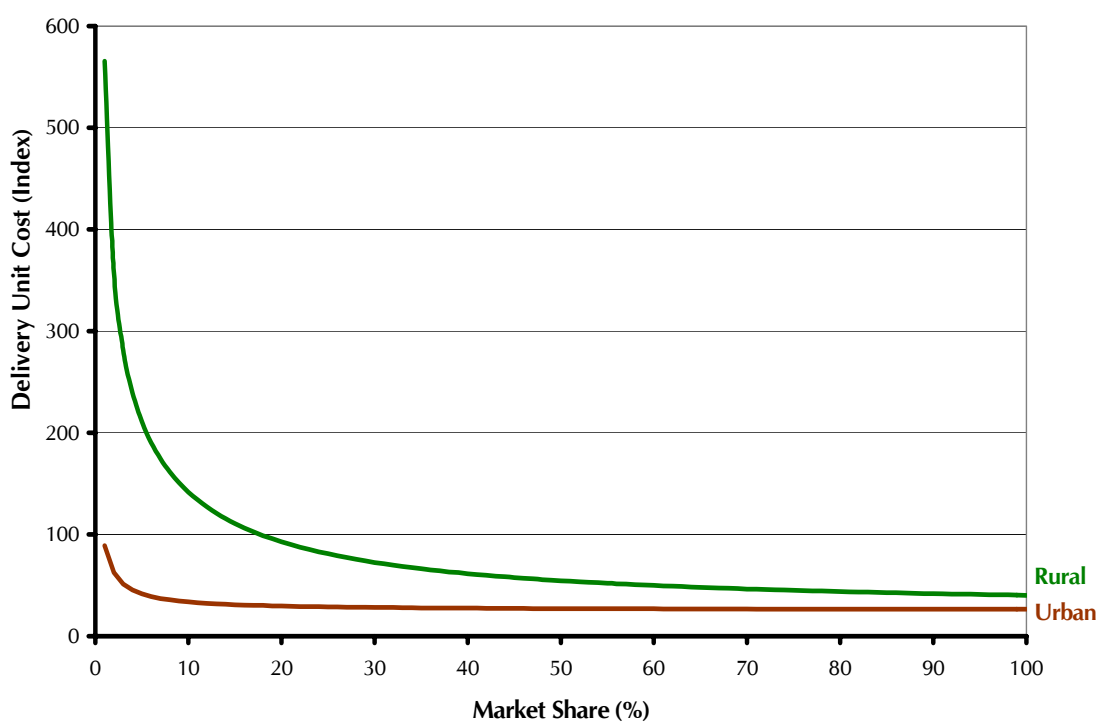
²³ In reality, it is likely to be less because if new entrants take volume away from Royal Mail, its unit costs could rise as it starts to lose some of the advantages of economies of scale. However, the static representation in Chart A1.1 makes the point that significant volume is required to compete profitably head-to-head with Royal Mail.

competing with a Royal Mail service such as Mailsort 3, new entrants would probably need a lower market share (depending on the assumptions about new entrants' costs compared to Royal Mail) to match Royal Mail's average unit costs of delivery (in fact less than 20% market share).

Geographic cost variation

A1.6 Chart A1.2 compares the costs of delivery one day per week in 'rural' and 'urban' areas.²⁴

Chart A1.2: The costs for postal delivery in the UK based on delivering one day per week



Source: Postcomm analysis using Royal Mail data

²⁴ Rural areas are defined as areas of the UK with a delivery density of up to 23 delivery points per square kilometre, while urban areas are defined as areas of the UK with a delivery density of over 1,715 delivery points per square kilometre.

A1.7 Chart A1.2 shows that delivery in both rural and urban areas is characterised by economies of scale, but that the average cost curve for urban areas is significantly flatter and lower than the average cost curve for rural areas.²⁵ This is principally because of the lower volume per delivery point and the distance between delivery points in rural areas. The implication is that less market share is required in urban than rural areas to be cost competitive with Royal Mail.

A1.8 To summarise, the only way for a new entrant to profitably compete against Royal Mail may be to reduce the frequency of delivery to say one day per week and also concentrate on higher volume drop areas such as financial or business districts, until it has won substantial volumes.

A1.9 This analysis suggests that even after full market opening, Royal Mail's economies of scale in delivery, particularly to residential areas and for small business customers, are likely to constitute a significant barrier to entry to delivery. The prospects for entry in delivery in less densely populated areas appear weak. When combined with business customers' desire for competitors to have universal coverage, it suggests downstream access will be necessary for competition on a national basis.

²⁵ Postcomm had previously used information from Royal Mail to estimate the costs and benefits to it of providing the universal postal service ("An assessment of the costs and benefits of Consignia's current Universal Service Provision, A Discussion Document," Postcomm, June 2001"). This approach to assessing the costs and benefits of providing the universal service was based on an 'avoidable cost' approach rather than calculating overall unit costs.

Annex 2 - VAT Analysis

Further analysis

A2.1 Postcomm has undertaken some further research since its consultation document on Royal Mail's special privileges was published in January 2004. Postcomm has assessed the effect of Royal Mail's current VAT exemption on competitors to Royal Mail.

A2.2 Postcomm will continue its analysis to inform the debate on VAT on postal services in the UK.

Scenarios

A2.3 Postcomm has considered three different VAT scenarios:

- "Now": Royal Mail retains its VAT exemption, and competitors charge full rate of VAT;
- "5%": Royal Mail and competitors both charge VAT at a reduced rate (5% is modelled). In this scenario Royal Mail's VAT exempt prices are cut by 2.6% across the board to reflect the fact that Royal Mail would be able to recover its input VAT (approximately £150m per annum) if it lost its VAT exemption; and
- "17.5%": Royal Mail and competitors both charge VAT at standard rate (17.5%). In this scenario Royal Mail's VAT exclusive prices are cut by 2.6% across the board to reflect the fact that Royal Mail would be able to recover its input VAT (approximately £150m per annum) if it lost its VAT exemption²⁶.

²⁶ Extending Royal Mail's VAT exemption to all postal operators within the licensed area was not modelled by Postcomm. While extending the VAT exemption is likely to have the desired effect of levelling the playing field, under the 6th VAT directive the exemption extends to the "the supply by the public postal services of services other than passenger transport and telecommunication services, and the supply of goods incidental thereto." Postcomm's understanding is that previous attempts to argue that "the public postal services" is a broad concept and could include private entities performing services in the public interest has not been accepted by the European Court (Commission v Germany, ECR2655). It was held that "the public

Understanding the impact on various market segments

A2.4 Royal Mail's VAT exemption creates a distortion as competitors' offerings to non-VAT recovering customers are at a competitive disadvantage to Royal Mail. In addition, Royal Mail is unable to recover around £150m of (input) VAT that it is itself charged by suppliers. Both factors result in Royal Mail and new entrants operating under different trading conditions.

A2.5 A predictive quantitative assessment of the impact of Royal Mail's VAT exemption is very difficult. This is because of the uncertainties in predicting the scale of competition in a market that has until recently been subject to monopoly. It is also difficult because different customer segments are affected in different ways by Royal Mail's VAT exemption. This is largely due to the fact that while the current VAT distortion disadvantages Royal Mail's competitors when targeting VAT exempt customers, it provides Royal Mail's competitors with a slight advantage when targeting VAT recovering customers. The removal of the distortion could, all other things being equal, therefore be expected to increase competitive entry in one segment of the market but reduce it in another segment of the market.

A2.6 To illustrate this point, if it is assumed that Royal Mail and its competitors are equal in every respect other than VAT, both will have the same level of underlying costs (including any allowance for profit). If this level of costs is indexed at 100 units, then Royal Mail will need to charge 102.6 units (to recoup the irrecoverable VAT it incurs), and its competitors will need to charge 117.5 units (including VAT).

A2.7 For VAT exempt customers, these are the effective prices that they will see under the current VAT regime, and a move to a uniform regime either at 5% or 17.5% will result in higher Royal Mail prices but a levelling of the playing field, as summarised in Table A2.1

postal services" refers to the entity and not the services. The entity referred to is the traditional (state owned) monopoly provider. On this understanding, Postcomm did not consider this option further.

Table A2.1: Impact of VAT on rival operators' competitiveness from a VAT exempt customers' point of view

Effective Costs	VAT Regime		
	Now	5% uniform	17.5% uniform
Royal Mail	102.6	105	117.5
Competitor	117.5	105	117.5
Change in price competitiveness of competitor		12.7%	12.7%

Source: Postcomm

A2.8 VAT recovering customers, on the other hand, currently see a competitor price of 100, which gives competitors a price advantage in this segment of the market. A uniform VAT regime will result in a slight reduction in the price competitiveness of competitors, as summarised in Table A2.2.

Table A2.2: Impact of VAT on rival operators' competitiveness from a VAT recovering customer's point of view

Effective Costs	VAT Regime		
	Now	5% uniform	17.5% uniform
Royal Mail	102.6	100	100
Competitor	100	100	100
Change in price competitiveness of competitor		-2.6%	-2.6%

Source: Postcomm

A2.9 Whereas it is clear that a uniform VAT regime will deliver a level playing field, it is less clear what the net effect is from increased price competitiveness in the VAT exempt segment of the market and decreased price competitiveness in the VAT recovering segment of the market for Royal Mail's competitors.

A2.10 Some indication of the net effect can be gained from examining the relative sizes of these two market segments. Postcomm examined Royal Mail's top 100 customers, which account for around 40% of all of its business by value and around 50% by volume (and are the most likely target market for competitors by virtue of their size and propensity to switch provider). The analysis reveals that 31 are VAT exempt and 69 are VAT recovering. Assuming an equal average revenue for each customer group suggests that on a weighted average basis the net impact of a uniform VAT regime would be to improve the price competitiveness of competitors by around 2% (31% x 12.7% less 69% x 3%).

A2.11 The impact of improved cost competitiveness on new market entry is hard to quantify. It might be expected that for every 1% of improved cost competitiveness, market entry would increase.

A2.12 It is probably also the case that mail volumes that are currently sent by VAT exempt organisations could be critical to rival operators building scale in the market. Postcomm is currently doing more analysis to quantify the increase in competitive entry that could be expected from a new entrant being more cost competitive than Royal Mail as a result of a VAT "level playing field".