Postcomm's Proposals for Promoting Effective Competition in UK Postal Services

January 2002

Summary

About Postcomm

S.1 Postcomm is the independent regulator for postal services in the United Kingdom. Its primary duty is to ensure that customers continue to benefit from the universal service at an affordable and geographically uniform tariff. Subject to this duty, Postcomm has a duty to further the interests of postal users, wherever possible by promoting effective competition.

S.2 Postcomm's vision in discharging these duties is a range of reliable, innovative and efficient postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market.

Purpose of this document

S.3 This document sets out for public consultation Postcomm's proposals for establishing a long-term framework for promoting effective competition within the postal market for items weighing less than 350g and costing less than £1. It is the result of a detailed consultation process, including two previous consultation documents on competition (September 2000 and June 2001) and an assessment of the costs and benefits of Consignia's universal service provision (June 2001). In developing these proposals, Postcomm has evaluated its proposals against its objectives and its statutory duties. It has also identified and put in place measures to either avoid or appropriately manage the main risks that may arise from its proposals.

Commitment to competition not monopoly

S.4 Postcomm believes that customers' interests will generally be best served in a competitive market that offers them choice and encourages vigorous rivalry, efficiency and innovation on the part of postal operators. Competition promises to give most customers improvements in service quality and better value for money than the maintenance of the existing de facto monopoly.

S.5 In introducing competition Postcomm must ensure that it is acting in a manner best calculated to ensure that customers continue to benefit from a universal postal service priced at a geographically uniform and affordable tariff. The traditional argument for Consignia's former exclusive monopoly privileges has been that they were necessary to support the universal service. Historically, postal policy has assumed that competition would erode the profits that Consignia needed to support any loss-making universal services. Competition has therefore been seen as a threat to Consignia's business and the universal service.

S.6 Following extensive consultation and detailed analysis, Postcomm believes that this traditional justification for the maintenance of Consignia's de facto monopoly is no longer valid for a number of important reasons.

- Competition is necessary to complement the rapidly evolving nature of the postal services market. Changing customer demands, growing use of alternative technologies by both customers and operators and a general move internationally towards opening up postal markets to competition are all changing the dynamics of traditional mail markets. Customers increasingly have access to alternatives to post. These pressures require Consignia to be innovative and flexible. Postcomm thinks that if Consignia is to thrive, it must embrace these developments and look for ways of providing customers with more choice and better value for money. Postcomm believes that a competitive postal services market is far better suited to encouraging this change in Consignia's behaviour than the maintenance of a monopoly.

- Consignia's current monopoly in the letters market is not working in the best interests of postal users or Consignia. Although Consignia continues to provide a universal service, it is not providing the variety or the quality of services that postal users now expect in a changing – but still growing – postal market. About 9 out of 10 letters are posted by businesses, who are demanding more customer responsive and innovative services and believe that this can only be facilitated by them having a choice over who provides their postal services. About 1

in 10 letters is posted by members of the public who expect a punctual and reliable service, but have suffered as Consignia has consistently failed to meet its own delivery targets. In addition, contrary to common perception, Consignia's current monopoly over letters up to 350g and £1 is not achieving its objective of supporting losses on universal services provided in the competitive market. Indeed, those universal services are profitable and help to support the monopoly, which is loss-making. Postcomm believes that a competitive market is more likely than a continued monopoly to encourage Consignia to meet evolving customer requirements in a commercial and profitable way.

- The universal service does not by itself compel Consignia to provide services at a significant loss. Postcomm's assessment of the net cost of Consignia's universal service in June 2001 (in terms of all the instances where the uniform tariff resulted in it pricing services below long-run avoidable costs) concluded that these "losses" were not significant in the present market environment. No individual product category (e.g. First Class) or generic delivery density (e.g rural and urban), was found to be "loss-making" in aggregate. Where losses for specific types of mail flows could be identified they were mainly related to items that could not be machine processed (and hence incurred additional handling costs). Postcomm's conclusion reinforced a similar conclusion from consultants commissioned by the European Commission who carried out a comparable assessment across Europe. Although Postcomm will review this issue over time, it believes that Consignia's present provision of the universal service gives it a commercial strength and Consignia has scope to turn this into a commercial opportunity.

- Independent analysis commissioned by Postcomm concludes that the financial position of Consignia is more sensitive to changes in its efficiency than to the potential loss of business volume through competition. In other words, Consignia can do more harm to its financial viability and thus the provision of its universal service by not controlling its costs and failing to become efficient than competition can do by taking away business. Postcomm notes that last year, for

the first time in Consignia's recent history, its mails business operated at an overall loss. In this period Consignia faced no competition in the monopoly area and this poor financial performance was primarily a result of Consignia allowing its costs to rise at a faster rate than its revenue growth. This all supports Postcomm's view that if competition spurs Consignia to be more efficient and innovative, then it should be able to prosper and support its business and the universal service. In this context, Postcomm notes that Consignia has publicly committed to cutting its costs by £1.2bn (15%) in gross terms over the next 18 months.

- International experience of competition in postal markets supports this analysis. Many countries have opened their postal markets to more competition than the UK. The universal service has been sustained in these countries and customers, especially large mailers that account for the overwhelming majority of purchases of postal services, have received significant benefits from the availability of choice. One lesson from international experience is that an incumbent postal provider has significant advantages over new entrants in terms of scale, brand recognition and established relationships with customers, which have thus far protected incumbent operators from loss of significant market share.

- Competition is generally better than regulatory intervention at furthering customers' interests. Whilst Postcomm, through direct regulation of Consignia's monopoly, could to some degree act as a surrogate for a lack of competitive pressure, it believes that this would generally be a poor substitute for the rigours of competition and is unlikely to provide customers with the package of price, innovation and service that suits their particular demands.

S.7 These factors highlight that there are serious risks to maintaining the status quo. A continued monopoly poses risks to Consignia's business if it prevents it from developing more innovative and responsive customer services to meet the challenge of its customers who increasingly having access to alternative forms of communication. A continued monopoly also poses risks to the

universal service to the extent that it fails to encourage Consignia to improve its efficiency, cost control and working practices. Postcomm believes that to manage these risks it must therefore establish a regulatory regime that encourages Consignia to innovate and improve efficiency. Postcomm considers that this is best achieved by exposing Consignia to competitive pressures. On this basis, competition, rather than necessarily being a threat to the universal service, will help to safeguard its continued provision whilst meeting the evolving nature of customer requirements.

Commitment to full market opening

S.8 In setting the regulatory framework, Postcomm recognises that it must set incentives for Consignia to meet the challenge of becoming more efficient and innovative in meeting the evolving requirements of its customers. Postcomm must also ensure that its policy is consistent with the need to ensure that any restrictions on competition are the minimum necessary to support the universal service.

S.9 Postcomm does not believe that incremental change will have a sufficient impact on Consignia's efficiency and innovation. Postcomm considers that Consignia will only embrace such change if it no longer has an ability to shield itself from these pressures through the preservation of a monopoly. Postcomm believes that the best environment to encourage this behaviour on the part of Consignia is the full introduction of competition over a pre-determined time frame.

S.10 Postcomm believes that a clear timetable for the full introduction of competition is also necessary to provide operators with sufficiently attractive incentives to enter the market. This provides regulatory certainty and creates an environment where operators can make investments and plan their businesses.

S.11 Postcomm, therefore, proposes to set an "end-date" for the abolition of all restrictions on entry for operators wishing to provide postal services to customers within the present licensed area.

Commitment to an orderly transition towards full market opening

S.12 Recognising that Consignia has operated as a monopoly provider of postal services in the UK throughout its long history, Postcomm believes that it would not be practicable to expect Consignia to become an efficient operator overnight and that it should be given time to adapt. It therefore proposes that there should be an orderly transition to the "end-date". Postcomm proposes that the "end-date" should be no later than 31 March 2006 and that there should be a phased opening of the market before that date.

S.13 The market opening strategy set out below balances two considerations: providing Consignia with time to adjust to competition whilst giving it an incentive to change and providing competing operators with sufficient incentives to enter the market. This transition strategy provides an additional safeguard for the universal service in the lead up to the "end-date" on 31 March 2006. This is because, there will continue to be some restrictions on market entry, albeit on a progressively decreasing scale.

Phase One: From April 2002 to 31 March 2004

a) Large Mailing licences

Postcomm will grant licences to operators wishing to provide "Large Mailing" services, where large mailing is defined as an individual mailing with a minimum of 4,000 items (or an average of 4,000 items per mailing under a multiple mailing contract). This measure is designed to expose to competition nearly 30% of Consignia's inland letters revenue, equivalent to about 40% by volume.

Large mailing licences will be issued for an indefinite period subject to a notice period of 3 years that can only be exercised on or after the fourth year (i.e a minimum licence period of 7 years). These licences will contain a restriction on accepting mail from consolidators during the transition period (to be reviewed for Phase Two). Large mailing operators will be able to negotiate terms to pass mail on to Consignia for final delivery or establish their own delivery network.

b) Consolidation licences

Postcomm will grant licences to operators for the consolidation of mail

from a number of users, which will then be passed to Consignia for delivery. This means the loss of business for Consignia will be limited to upstream activities of collection and sortation. These licences will be issued for an indefinite period (subject to a notice period of 3 years which can only be exercised on or after the fourth year). The access price and other access terms will be determined in accordance with Consignia's present licence.

c) Defined Activity licences

Postcomm will also consider opening up further discrete parts of the market in response to interest expressed by operators. This will enable Postcomm to facilitate further entry into the market in areas additional to "large mailings" and "consolidation". Postcomm's aim is to ensure that there is a minimum restriction on the development of the market commensurate with its universal service duty. The types of activity that might be covered by a Defined Activity licence are likely to be relatively small-scale and could cover services such as local delivery services or mail services for closed user groups. Postcomm has already received expressions of interest for these kinds of activities under its interim licensing policy (and some of the interim licences already issued by Postcomm cover what in future it expects to be "Defined Activities").

Postcomm will consider the case for opening up a particular "Defined Activity" in response to approaches by operators on the basis of the facts that prevail at the time (including the parts of the postal services market that Postcomm has already opened up to competition) and taking account of the need to ensure the continued provision of a universal service. Defined Activity licences will be issued for an indefinite period (subject to a notice period of 3 years which can only be exercised on or after the fourth year).

d) Licences granted under Postcomm's interim licensing policy

Postcomm has issued 6 licences under its interim licensing policy and is currently considering a number of other applications and expressions of interest. As Postcomm indicated in its interim licensing policy

statement of 30 April 2001, it will expect holders of interim licences to apply for new licences once it has reached final decisions on its long-term licensing policy. Postcomm expects that some existing licence holders will apply for "Large Mailing" or "Consolidation" licences. Others may be accommodated by applying for a "Defined Activity" licence. Subject to evaluation of their effect on the provision of the universal service, it is Postcomm's expectation that all activities currently licensed under the interim licensing policy will continue to be licensed under its new policy.

Phase Two: From 1 April 2004 to 31 March 2006

a) Large Mailing licences

Postcomm will lower the large mailings threshold, with the aim of exposing a further 30% of Consignia's revenues to competition, bringing the total to 60% (70% by volume). Postcomm will amend Large Mailing licences issued in Phase One to reflect the revised threshold.

b) Review of restrictions on Large Mailing licences

Postcomm will review the need for the restriction in Large Mailing licences preventing them from accepting consolidated mail.

c) Review of the timing for the "end-date"

Postcomm will review the end-date for full market opening and consider whether it should be brought forward from 31 March 2006 in light of developments in the market.

Phase Three: On or before 31 March 2006

a) Removal of all restrictions on market entry

Postcomm will license operators under a "light touch" regulatory regime free from restrictions on the scope and scale of the operator's activities.

b) Commitment to deregulate where possible

Postcomm proposes to deregulate wherever possible, moving towards exempting operators from the need to be licensed, unless a compelling case can be made to the contrary on universal service protection grounds. Postcomm also intends to scale back the need for sector-specific regulation (such as price controls) where competition can be relied upon to protect customers' interests.

S.14 In addition to the measures outlined above, Postcomm will also take into account the requirements of the amended European Postal Services Directive when it is finally agreed. It is presently proposed that the maximum reserved services limits will be reduced to 100g and 3 times the basic tariff on 1 January 2003 and 50g and 2½ times the basic tariff on 1 January 2006.

Commitment to additional safeguards for the universal service

S.15 Although the foremost safeguard for the universal service is encouraging Consignia to become more efficient in the context of an orderly transition to a competitive market, Postcomm believes it would be prudent to have available additional safeguards should they prove necessary. Postcomm believes that the most desirable and effective additional safeguard would be to allow Consignia more commercial flexibility in terms of how it provides the universal service. This relates to service specification and the overall level and structure of prices.

S.16 Customers will continue to be protected against unreasonable price increases by the requirement of the Postal Service Act 2000 for the universal service to be "affordable" and by Postcomm's controls over Consignia's prices imposed in its licence. Postcomm will consider pricing issues further as part of its current review of Consignia's price control and expects to come forward with initial proposals in the Summer of 2002.

S.17 In the long-run, Postcomm recognises that in certain circumstances it might be justifiable to contemplate the safeguard of external funding mechanisms, such as a universal service support fund. Postcomm believes that this safeguard will not be necessary in the early stages of the market's

development. Therefore, Postcomm does not at this stage propose to recommend to the Secretary of State that consideration be given to the legislative changes that would be needed for such a fund to be introduced. In any event, Postcomm would only wish to consider this possibility if alternative safeguards have been exhausted and provided practical ways could be found to operate such a fund without unduly distorting the market.

S.18 Postcomm recognises that there is a need to set out more clearly which of Consignia's services should be considered universal services recognising that this will change over time in the light of market developments and changes in customer requirements. The proposals in this document are consistent with Consignia's current view that nearly all its existing letter products are universal services. However, against the background of competition extending the range of choice for customers and Consignia having more flexibility to respond to these changes, Postcomm believes that it should consider whether the range of Consignia's products that are classed as universal services should be narrowed. Postcomm proposes to address this issue in a consultation document to be issued before Summer 2002.

Commitment to measures to promote effective competition

S.19 Postcomm believes that a transition towards a full market opening is a necessary but not a sufficient step to ensuring effective competition. In order to complement the benefits of full market opening, Postcomm believes that additional measures are required to ensure that competition develops in a way that will be effective and will further the interests of postal users. These include:

- a continuation of the measures, currently set out in Consignia's licence, to limit the risk of Consignia responding on price to competition in a targeted and aggressive way. Over time, as competition becomes established, Postcomm would expect to see these licence conditions relaxed (e.g. by covering a decreasing share of Consignia's business) ultimately leaving Consignia to be treated like any other operator and regulated, in this regard, by the general provisions of competition law, in particular the Competition Act 1998;

- joint publication with the Office of Fair Trading (OFT) of a Memorandum of

Understanding on the respective roles of Postcomm and OFT and the processes they will follow in dealing with complaints about anti-competitive behaviour in the UK postal market; and

- a review of Special Privileges. Postcomm proposes to review whether Special Privileges for universal service operators (including Consignia) are appropriate and proportional in the context of the universal service being provided alongside a range of other services in a competitive market.

Next steps

S.20 Following consideration of responses to this proposals document, Postcomm expects to publish, in April 2002, a document setting out its decisions on how it intends to promote effective competition in the UK postal services market. That document will explain any changes from the proposals in this document and the reasons for making such changes. Following publication of its decision document, Postcomm would expect to consider applications from operators for licences to provide postal services in accordance with its new licensing policy.

2. Summary of Postcomm's Proposals

Chapter outline

2.1 This Chapter summarises Postcomm's proposals for promoting effective competition in the UK postal services market in line with its commitment to competition not monopoly. The rationale for these proposals is set out in detail in Part II of this document.

Summary of proposals

2.2 Table 2-1 below sets out Postcomm's key proposals. The rationale for proposals 1-4 is set out in Chapter 4. The rationale for proposals 5-8 is set out in Chapter 6. The rationale for proposals 9–11 is set out in Chapter 5 and the rationale for proposal 12 is set out in Chapter 7.

Table 2-1: Postcomm's Proposals

Proposal Number	Proposal
	Commitment to full market opening
1	A firm commitment to a date for the full opening of the UK postal market. This date will be no later than 31 March 2006. From this date, no area of the market will be reserved exclusively to Consignia and all restrictions on market entry will be abolished. There will be an orderly transition path of market opening leading up to this date.
2	Postcomm may bring forward this date if, following consultation, it concludes that doing so would further its statutory duties.
3	Postcomm will seek to reduce the role of regulation wherever possible with the intention of moving to deregulation unless a compelling case is made to the contrary in terms of safeguarding the universal service. (For example, Postcomm will consider exemption from the need to licence and removing sector specific regulation such as price controls where competition can be relied upon to protect customers interests).

4	From 31 March 2006, and subject to 3 above Postcomm will continue to license operators under a "light touch" regulatory regime. Additional conditions may be necessary for operators that are either providing a universal service or in a dominant market position.
	Commitment to an orderly transition towards full market opening
5	Phase One: From April 2002 to 31 March 2004 a) Large Mailing licences Postcomm will grant licences for operators wishing to provide large mailing (bulk mail) services, where large mailing is defined as an individual mailing with a minimum of 4,000 items (or an average mailing of 4,000 items if under a multiple mailing contract). These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year). These licences will contain a restriction that prevents the acceptance of consolidated mail (see below) during the transition to full market opening (this will be reviewed for Phase Two). b) Consolidation licences Postcomm will grant licences for operators wishing to provide services allowing the consolidation of mail from a number of users which will then be passed to Consignia for delivery. These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year). c) Defined Activity licences Postcomm intends to consider opening up further parts of the market in respect of defined activities such as local delivery services or specialised services. These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year). Postcomm expects to consider the case for this further opening up on its merits, against the facts that prevail at the time and in the light of the expected impact on the universal service.

	d) Licences granted under Postcomm's interim licensing policy Postcomm has issued 6 licences under its interim licensing policy and is currently considering a number of other applications and expressions of interest. As Postcomm indicated in its interim licensing policy statement of 30 April 2001, Postcomm will expect holders of interim licences to apply for new licences once it has reached final decisions on its long-term licensing policy. Postcomm expects that some existing licence holders will apply for "Large Mailing" or "Consolidation" licences. Others may be accommodated by applying for a "Defined Activity" licence. Subject to evaluation of their effect on the provision of the universal service, it is Postcomm's expectation that all activities licensed under the interim licensing policy will continue to be licensed under its new policy.
6	Phase Two: From 1 April 2004 to 31 March 2006 a) Large Mailing licences Postcomm will lower the Large Mailing licence threshold, with the aim of exposing a further 30% of Consignia's revenues to competition, bringing the total to 60% by revenue (70% by volume). Postcomm will revise the item limit for Large Mailing licences downwards (expected to be between 500 and 1,000 items of mail per mailing). Postcomm will amend Large Mailing licences issued in Phase One to reflect the revised threshold. b) Review of restrictions on Large Mailing licences Postcomm will review the restriction in Large Mailing licences preventing holders from accepting consolidated mail. c) "End-date" review Postcomm will consider whether the end-date for full market opening

	should be brought forward before 31 March 2006.
7	Phase Three: On or before 31 March 2006 All restrictions on market entry will be abolished.
8	Once the amending European Directive is agreed, Postcomm will make the adjustments necessary to take account of the revised threshold limits. These propose a reduction in the reserved services limit to 100g on 1 January 2003 and 50g on 1 January 2006.
	Commitment to safeguards for the universal service
9	Postcomm expects the foremost safeguard for the universal service in the short to medium term to be Consignia becoming more efficient and innovative (in the context of a phased introduction of full market opening). If it proves necessary, Postcomm believes that an appropriate additional policy safeguard would be to allow Consignia more commercial freedom in the terms on which it provides the universal service. Examples might include alterations to service specification, the overall level of prices, pricing structure or the permissible competitive pricing response.
10	Postcomm does not propose to recommend to the Secretary of State at this stage that Postcomm should be given powers to set up a compensation fund, but it will keep the issue under review.
11	Postcomm proposes to consult on which of Consignia's product range should be considered to be universal services with the expectation that the range will be narrower than at present.
	Commitment to measures to promote effective competition
12	Postcomm proposes that Consignia's ability to respond on price to competition should be restricted in the initial stages of the development of competition to prevent the risk of market foreclosure through targeted and aggressive pricing responses. The restrictions are already set out in Consignia's licence. However, there will be a transition whereby these restrictions are removed as competition

	becomes established and self-sustaining.