

Postcomm's proposals for the future management of the PAF

A consultation document

February 2006

Executive summary

- S.1 The Postcode Address File ("PAF") is essential to the UK postal industry and important to the wider economy; PAF is owned and managed by Royal Mail. Its importance is growing with liberalisation of the postal market leading to an increasing number of users, and rapidly increasing reliance by government, commercial and not-for-profit sectors resulting from the growing number of PAF uses. Postcomm's review seeks to establish whether the existing management arrangements for PAF present a barrier to competition in postal services and meet the needs of an increasingly diverse and important market for PAF beyond the postal industry.
- S.2 In pursuit of its light touch regulation philosophy, Postcomm prefers to pursue a cooperative approach with Royal Mail in seeking to address concerns with current PAF management arrangements. Postcomm believes this approach is in the best interest of Royal Mail, postal operators and other PAF users, and that Royal Mail shares this belief. However, should this approach not prove successful, Postcomm will consult on alternative options including, if appropriate, enforcing compliance, reassessing the regulatory framework and options for greater separation.

Proposals

- S.3 Postcomm's proposals represent the second stage in a three stage process that commenced with a public consultation in 2004. The review was paused during the period from December 2004 until autumn 2005. Stage three of the process will take the form of a decision or final report on the review depending on responses to this consultation – in particular Royal Mail's response.
- S.4 Reflecting feedback from an extensive consultation, Postcomm's desired outcome is an efficiently administered, well maintained, up-to-date PAF which reflects industry needs, is available on reasonable terms that encourage accurate addressing and is managed on a fair and non-discriminatory basis. This review highlights a number of areas where Postcomm believes change is required to achieve these outcomes; Postcomm's proposals encourage Royal Mail to make these changes. The proposals are made against a backdrop of a rapidly evolving postal market, changing demands for, and of, PAF and increasing commercial pressures on Royal Mail. They are informed by

stakeholder views, together with Postcomm's research and benchmarking, and ongoing developments within Royal Mail.

S.5 Postcomm's proposals are designed to further the interests of postal users, to promote competition and to enable Royal Mail better to meet its obligations.

Specifically Postcomm proposes that:

- There is no change in Royal Mail's overall ownership of PAF but Royal Mail should create a separate, clearly ringfenced business unit exclusively responsible for managing the maintenance, development and distribution of PAF.
- Royal Mail should introduce objective and fair contractual arrangements with suppliers of address change data to PAF to secure key information sources.
- Royal Mail should ensure equal access for PAF use and resale and Royal Mail should pay directly for its PAF usage on identical terms and conditions to like users.
- Royal Mail create an Advisory Board to 'inject' market requirements into Royal Mail through direct access to the Royal Mail business unit decision maker and also to Postcomm.
- Royal Mail needs to design a flexible and responsive licensing framework that promotes use of PAF and encourages good addressing.
- Greater regulatory controls ought to be introduced with revenues based on a reasonable allocation of costs.
- Tighter regulatory and public reporting including the publication of costs, revenues and performance levels should be introduced.

S.6 Each of these proposals should be executed without delay, with all significant initiatives in place by early 2007 at the latest. In the absence of tangible progress on all fronts by mid 2006, Postcomm will consider alternative courses of action including enforcing compliance and greater regulation.

Royal Mail's performance

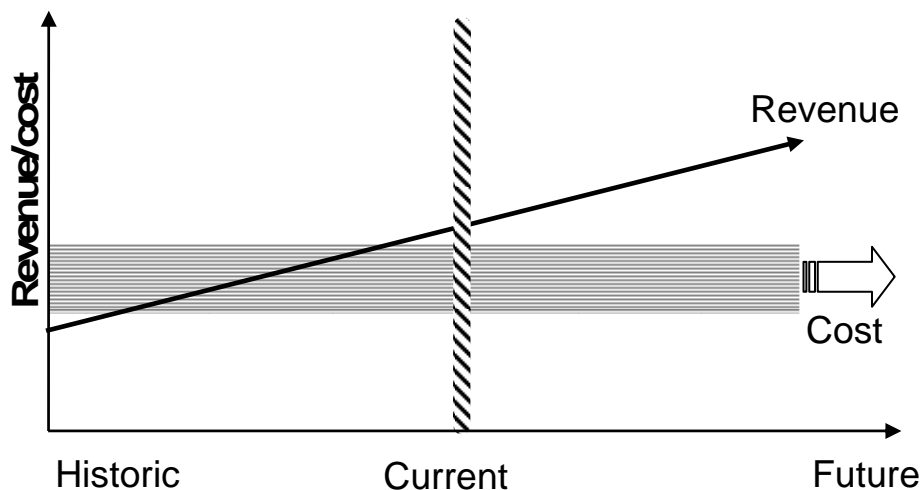
S.7 In developing the postcode system and promoting postcode use amongst mailers, stakeholders felt Royal Mail had done well to date and ought to be congratulated. Further, most stakeholders felt PAF generally represented good value for money. There were, however, concerns from some quarters about the management of PAF with increasing uncertainty about Royal Mail's

objectives and motives. In particular there was concern that Royal Mail is seeking, or might seek, to exploit PAF unfairly, that the maintenance of PAF is below par, and that some parties receive unduly preferential or discriminatory terms. Also that Royal Mail, or other parties, might derive an unfair commercial advantage in accessing PAF. These issues are explored in Chapters 5 to 9.

Context for the review

S.8 The review takes place within a legal framework that requires Royal Mail to maintain PAF, make it available on reasonable terms and to abide by some general competition conditions. The business environment is one in which Royal Mail is being exposed to increased competition in its core mail business and is generally subjected to greater commercial pressures. Rapid growth in demand has led to a situation where PAF revenues may already, but will certainly soon, outstrip the costs of running PAF – this is demonstrated in Figure 1.

Figure 1: PAF cost – revenue relationship



S.9 As well as the risk that Royal Mail might derive excessive revenues from PAF sales there is a risk that it might also derive an unfair advantage through the provision of PAF, or be unduly preferential or discriminatory. For example, Royal Mail might provide access to PAF on preferential terms to its own internal users or resellers of PAF or discriminate against its competitors.

Process

S.10 Postcomm hopes that Royal Mail will undertake to implement these proposals, where it has not already done so, to address the key issues identified by the review and to take all reasonable steps to ensure their success. Should Royal Mail not adopt this approach, Postcomm will consult on alternative options including enforcing compliance, reassessing the regulatory framework and options for greater separation. Chapter 3 explores this eventuality further.

S.11 Postcomm welcomes respondents' views on the proposals set out in this consultation document. Further background, instructions to respondents and contact details are set out in Chapter 1.

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1. Introduction

What is Postcomm?

- 1.1 The Postal Services Act 2000 (“PSA 2000”) established the Postal Services Commission (“Postcomm”) as the regulatory body for the postal industry in the UK. Postcomm’s business plan, which can be found on the website www.psc.gov.uk, gives details of its duties, functions, objectives and work programme.
- 1.2 Postcomm’s universal service duty is to act in a manner which it considers is best calculated to ensure the provision of a “*universal postal service*”. The universal postal service consists of the delivery and collection of mail (not exceeding 20 kilograms in weight) at least once every working day 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 also charged with furthering the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators. In doing so, Postcomm must have regard to the interests of those who are disabled or chronically sick, are of pensionable age, are on low incomes or who 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 functions, Postcomm must have regard to the need to ensure that licensees are able to finance the activities authorised or required by their licences.
- 1.6 Postcomm believes that its proposals for the management of PAF are consistent with its statutory duties and necessary for the fulfilment of those duties.

Postcomm’s duties and interest in PAF

- 1.7 Section 116 of the PSA 2000 is the legislation specific to the maintenance and supply of PAF. Under Section 116 Royal Mail must maintain PAF, make it

available to any person who wishes to use it, and on “*such terms as are reasonable*”.

- 1.8 Section 116 of the PSA 2000 is replicated in Condition 20 of Royal Mail’s licence. Under this condition, provision exists for Royal Mail to recover a reasonable charge from the supply of PAF. However it must not impose any term or condition other than reasonable restrictions to safeguard its intellectual property rights (IPR), and to ensure that PAF and its updates are used appropriately to encourage good addressing.
- 1.9 In addition to Condition 20, Conditions 10, 11 (relating to the promotion of effective competition) and 14 (relating to accounting separation and ringfencing) of the licence are applicable to PAF. These conditions provide a further level of detail below the general obligations of Condition 20, in relation to the terms on which access to PAF is provided.

Approach

- 1.10 Postcomm commenced the review not as a compliance audit, but as an open minded assessment of how well Royal Mail has performed historically and, to establish whether competition risks exist in the market already and the risk of them developing. Postcomm has sought a cooperative and constructive dialogue with Royal Mail and is pleased that, overall, Royal Mail has reciprocated. Postcomm believes that a number of steps could be taken to resolve existing concerns and ‘future-proof’ against potential issues.
- 1.11 Postcomm’s findings and proposals are set out in this document; Postcomm welcomes Royal Mail’s commitment to address the issues raised and hopes that action is forthcoming. In the event that Royal Mail does not wish to take, or is unable to take, sufficient steps to resolve the issues identified by the review, Postcomm will consider an investigation of whether Royal Mail is compliant with its licence obligations.

The review process

- 1.12 The review commenced with a three month public consultation in June 2004. In November and December 2004 three industry workshops were held to discuss further some of the issues raised by the consultation.

- 1.13 In December that year the review was paused until autumn 2005 while attention was focused on projects relating to liberalisation of the postal market. During this period, Postcomm continued dialogue with Royal Mail and other interested stakeholders. Around this time changes within Royal Mail brought a new approach to PAF management and a recognition that greater transparency, controls and revisions to PAF licensing arrangements were required. In January 2005 research was also commissioned into the technical constitution and costs (and benefits) associated with PAF.
- 1.14 Postcomm's review recommenced in the autumn of 2005 and in November two focus groups were held to 'refresh' Postcomm's research and to test the draft proposals. In addition, Postcomm spoke with licensed postal operators and the Mail Competition Forum.
- 1.15 Postcomm received 38 formal responses to its June 2004 consultation, including five confidential responses. See Annex E for a full list of non-confidential responses. Responses can be categorised as follows:
- 7 representative bodies
 - 7 VARs (value added resellers)
 - 3 postal operators
 - 4 end users
 - 10 local and central government agencies
 - 7 other
- 1.16 Discussions were also held with the Department of Trade and Industry (DTI), Postwatch, licensed postal operators, BT and Ofcom. Postcomm is also in dialogue with the OFT (the Office of Fair Trading) on its review of Public Sector Information.¹
- 1.17 Benchmarking has been conducted against the management of postcode address files in selected overseas postal markets, including Australia, USA, Canada, Germany, Sweden and the Netherlands. The telecommunications sector has also been used as a benchmark.

¹ See www.offt.gov.uk

Purpose of this work

1.18 The review seeks to identify and address concerns and risks raised by PAF stakeholders. To the extent that it is possible, the review seeks to ‘future-proof’ PAF against these concerns and risks. These are assessed against the background of a liberalised postal market and developing communications and data markets.

1.19 Postcomm’s approach reflects the changing circumstances since the review commenced in June 2004. While the objectives and desired outcomes remain unchanged, changes in market dynamics are driving a higher compliance threshold². There are clear steps that Royal Mail could take to ensure it is meeting this threshold.

1.20 The objectives of the review are to:

- Assess Royal Mail’s performance against Condition 20 of its licence (and statutory obligations in Section 116 of the PSA 2000).
- Ensure that the management of PAF does not present a barrier to the development of effective competition in the postal market.
- Ensure that the management of PAF is structured in the best way to further the interests of postal users.

Purpose of this document

1.21 This document sets out responses to Postcomm’s earlier consultation including Royal Mail’s performance and any existing or future issues together with views on how these might be mitigated. It then sets out Postcomm’s assessment of the issues and, where appropriate, its proposals for dealing with them.

Structure of this document

1.22 This document is structured as follows:

- Chapters 1, 2 and 3 provide background on the review, define PAF, outline key issues, and present the legal framework.
- Chapter 4 provides Postcomm’s observations on Royal Mail’s performance and highlights key issues for consideration.

² Changing market dynamics flow principally from the opening of the postal market to full competition from 1 January 2006 and the growing reliance on PAF from users.

- Chapters 5 to 9 assess responses on key issues and set out Postcomm's policy proposals.
- Chapter 10 covers the ownership of PAF.

1.23 There are 5 annexes providing relevant supporting information.

Next steps and implementation

1.24 This document has a three month consultation period. At the end of this consultation, Postcomm will consider responses it receives and publish its decision, or final report on the review.

1.25 Postcomm hopes and expects to see Royal Mail taking active steps to mitigate the risks identified. In particular, Postcomm sees no reason why accounting separation should not be introduced for the start of the 2006/07 financial year³. Postcomm also sees no reason why the steps proposed cannot be fully implemented during the 2006/07 financial year and will be discussing a timetable with Royal Mail during the consultation period.

1.26 During the consultation period Postcomm expects to continue dialogue with Royal Mail, and other PAF stakeholders as necessary.

How to respond

1.27 Responses to this consultation should reach Postcomm by 12 May 2006. They can be sent by email, post or by fax. Contact details are as follows:

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Market Infrastructure Directorate
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6 Hercules Road
London
SE1 7DB
Fax: 020 7593 2142
E-mail: Belinda.Thomas@psc.gov.uk

1.28 If you would like to discuss any points raised by this consultation document please contact Annette Win (020 7593 2106) by telephone or email Annette.Win@psc.gov.uk or Jeremy Cain (020 7593 2159) by telephone or e-mail Jeremy.Cain@psc.gov.uk.

³ Royal Mail estimates ringfencing arrangements will be complete by 1 April 2006.

Confidentiality of responses

- 1.29 Postcomm wishes to make public the responses received to this consultation. 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 clearly indicates which parts are confidential. If you are happy for the substance of your contribution to be made public but do not want the name of the individual who signed it or organisation that submitted it to be revealed, please indicate this by adding *“name of organisation/sender not to be published”*.

2. The importance of PAF

Introduction

- 2.1 This chapter considers the role PAF plays for an increasingly diverse stakeholder base, how that role has developed, and how it is likely to develop. The June 2004 consultation noted that PAF is both a vital resource for postal operators and has developed over time into an important resource for a wide variety of other commercial and non-commercial organisations. Postcomm asked respondents to comment on how important PAF is to Royal Mail, postal competitors and other stakeholders (including small businesses and consumers). Postcomm also sought comment on the role of PAF in the development of postal competition.

Importance to stakeholders

- 2.2 Looking forward, respondents were asked to consider the extent to which PAF would increase in importance, the impact of introducing different addressing systems, and what the implications would be for them if PAF were no longer available.

Respondents' views

- 2.3 Respondents, including Royal Mail, saw PAF as integral to Royal Mail's sorting and distribution systems, highlighting its reliance on PAF for the efficiency and effectiveness of these systems, and its ability to deliver its universal service obligation (USO). Royal Mail has invested significantly in automatic sorting equipment that is reliant on PAF for efficient processing of mail, *"Royal Mail's automated processes ... relies on Postcode data for the efficient machinable processing [sic] of mail items."* The Direct Marketing Association (the DMA) commented that, *"The PAF is fundamental to Royal Mail for operational, developmental, strategic and competitive reasons."*
- 2.4 Respondents agreed that PAF is vital for Royal Mail's postal competitors. The DMA stated that it has a *"... pivotal role in the development of competition ... adherence is an inevitable part of business"*. Some postal operators had structured their operational systems around PAF, making it essential for sorting mail, planning delivery routes, and distributing mail. Its status amongst the UK

public as 'the addressing standard' means postal competitors are reliant on PAF. UK Mail commented, *"Without use of postcodes it is unlikely that UK Mail or Business Post could provide customers with the services we offer them."*

This view was reflected by most other operators Postcomm spoke with. It was noted that PAF is required by downstream access (DSA) operators who rely on it to meet the requirements of their DSA agreements with Royal Mail.

- 2.5 A number of respondents commented on the significant amount of business and government activity supported by PAF. The Association for Geographic Information (the AGI) said *"PAF ... is a major information asset, underpinning £billions of business and government activity..."*. Government reliance on PAF extends to a number of activities including service delivery to citizens and geographical referencing (for example, in planning data collection arrangements for census activity). The address management industry is reliant on the accuracy of address information held on PAF.
- 2.6 Comments on the importance of PAF to small businesses and consumers focussed most on the terms of supply and are dealt with in Chapter 8. However the Mail Users' Association (the MUA) commented that the *"needs and wants of small businesses and consumers towards PAF are to a great extent unrecognised at this point in time."*
- 2.7 Looking to the future there was unanimity, barring poor decision making, that PAF will grow in importance, especially its non-postal use. Ordnance Survey (OS) cited *"location based services, e-government and sharing of information in government, joined up geography through databases, insurance and risk prediction, the use by ONS for the populations census, and the introduction of a national identity register and identity cards"* as areas where PAF's importance will only increase. Even within postal services, the MUA saw scope for PAF as *"an innovative marketing tool capable of making a considerable contribution to the future growth of mail volumes."*

Assessment

- 2.8 Understanding the importance of PAF to different stakeholder groups is fundamental to identifying and addressing the key issues confronting PAF and PAF stakeholders.

- 2.9 Postcomm's view is that PAF is critically important to the postal industry (both Royal Mail and postal competitors) but also of strategic importance to other users, and that use by government, commerce and industry will continue to increase. DSA, which has evolved as the main form of competition, is reliant on PAF. Although end-to-end competition is in its infancy this also, in particular business-to-consumer operators, relies on PAF. This view is consistent with that put forward by Royal Mail, *"PAF not only supports Royal Mail's core operation but has also developed into an integral part of 'UK plc' and it is difficult to envisage a situation where PAF data was no longer being used or maintained."*
- 2.10 In addition to the public consultation, discussions took place with licensed postal operators to understand further the importance of PAF to their businesses and the postal industry generally (see Annex C). The overall view was that regardless of whether an end-to-end or DSA business model was adopted, PAF would be fundamental to all levels of their business (sortation, delivery, and for administrative functions).

Non-availability or alternatives to PAF

- 2.11 Postcomm asked what impact non-availability of PAF would have on stakeholders, and the impact of multiple, duplicate addressing systems.

Respondents' views

- 2.12 Withdrawal, or a substantial lessening of availability of PAF, would have adverse impacts on users and result in reduced efficiency. Royal Mail noted, *"Put simply, if PAF did not exist something else would be needed to replace it."* It also noted the absence of PAF *"could seriously impact how Royal Mail sorts and routes mail"* thereby impairing its quality of service. BT said it would require a *"major change to business processes and systems, resulting in very significant expenditure (estimated as £50m plus) ... with increased operating costs."* OS said it would *"lose the ability to provide postal elements in our address products."* Allies Computing suggested that those *"who use the PAF for correct completion of addresses would find themselves set back fifteen or twenty years as regards address quality."*

2.13 In relation to the introduction of multiple addressing systems respondents felt the impacts would hit businesses but would have knock on effects to customers, with confusion about which address to use, requiring re-education and probably resulting in a decline in overall addressing accuracy. A confidential respondent suggested the introduction of alternative postal addressing systems could have an adverse effect on address quality. In addition, most postal operators shared this view and expressed a preference for using PAF over developing parallel address coding systems. TPG Post (TNT) noted *“The creation of an alternative system would be confusing, costly and would act as a barrier to mail users transferring from Royal Mail to other postal service providers.”* Royal Mail stated that it would have *“a negative impact on Royal Mail’s quality of service.”*

Assessment

- 2.14 Consistent with respondents’ views, Postcomm believes withdrawal - or a substantial negative change to the availability - of PAF would have negative consequences for PAF users and Royal Mail, with significant investment, time and efficiency implications. Address quality, overall postal efficiency and quality of service could be expected to decline.
- 2.15 In relation to the introduction of alternative addressing systems Postcomm considers it inefficient to *require* competitors to Royal Mail to develop alternative systems. Requiring operators to develop their own addressing systems, explicitly or through failing to ensure reliable access to PAF, would be inefficient and impose additional costs on customers, in particular if switching to competing postal providers. In addition, it is likely that multiple systems would lead to greater confusion and a decline in addressing quality. However there could be value in an operator developing a bespoke addressing system to improve efficiency as has been seen with the private box network operated by DX Network Services.
- 2.16 Separately, to understand the value of PAF to Royal Mail, research was conducted on behalf of Postcomm by Postal and Logistics Consulting Worldwide (PLCWW) looking at the value Royal Mail derives from PAF. This concluded that PAF enabled, but was not the sole determinant of, significant efficiencies in mail processing and delivery. Although it is difficult to place a

value on PAF, it is true to say Royal Mail derives immense value from PAF. Further consideration is given to this matter in Chapter 5.

- 2.17 In developing its proposals Postcomm has sought to ensure that due emphasis is given to the further development of PAF to ensure that it remains a relevant resource for stakeholders.

Conclusion

- 2.18 Postcomm concludes that PAF plays a vital role in Royal Mail's postal operation which relies on accurate postcode information. In addition, it is fundamental to the activities of Royal Mail's competitors and business users; PAF is part of the "*postal infrastructure*" – a term increasingly used to describe postal facilities which are essential to the development of competition and which it is not economic or practical to replicate.
- 2.19 In addition to being part of the postal infrastructure, PAF is also vital to a wide range of UK businesses, government and other organisations, as Royal Mail stated, "*[PAF is] an integral part of 'UK plc'.*" Royal Mail is the sole supplier of postcode data and has conflicting interests and incentives in both the data supply / value added market and the postal service market. These issues are explored in detail in Chapter 6.
- 2.20 In managing PAF, Postcomm expects Royal Mail to recognise the wide use to which PAF is put by its stakeholders (both postal and non-postal) and the increasing reliance on PAF for new applications.

3. The legal framework

Introduction

3.1 This chapter introduces the legal framework within which the review is being conducted. It sets out Postcomm's duties under the PSA 2000, both general and specific to PAF, then introduces and considers the parts of Royal Mail's licence relevant to PAF and links with other relevant legislation. After introducing the licence and relevant legislation it considers the effect of the current legal framework on Postcomm's policy objectives.

Background

3.2 Postcomm is responsible, under Section 2 of the PSA 2000, for implementing and enforcing the requirements of that Act. Postcomm has the power, pursuant to Section 12, to grant licences to postal operators including the universal service provider, Royal Mail. Postcomm may enforce a postal operator's licence by order.

3.3 The PSA 2000, via Section 116, deals specifically with PAF⁴ and requires Royal Mail as the owner of PAF⁵ to maintain and make PAF available on reasonable terms. Section 116 is broadly replicated in Condition 20⁶ of Royal Mail's licence. Postcomm can therefore enforce Royal Mail's obligations through civil injunction⁷ or through its licence.

3.4 In addition to PAF-specific provisions in Royal Mail's licence there are some general conditions which also apply to PAF. These are explored below but include:

- Condition 10: Prohibition of obtaining an unfair commercial advantage
- Condition 11: Promotion of effective competition
- Condition 14: Accounting separation and ringfencing

⁴ See Annex A for relevant sections of the PSA 2000.

⁵ Under Section 116 of the PSA 2000, Royal Mail is the "owner for the time being of the Postcode Address File". See Annex A.

⁶ See Annex B for relevant Royal Mail licence conditions.

⁷ Section 116 may be enforced by injunction.

- 3.5 Separate, although related to Condition 10 and 11, are Royal Mail's obligations under the Competition Act 1998 and certain remedies that might be pursued under the Enterprise Act 2002. Condition 11 broadly reflects Chapter 2 of the Competition Act which prohibits the abuse of a dominant position. The Enterprise Act allows for a 'Market Investigation Reference' to be made to the Competition Commission where a feature of a market prevents, restricts or distorts competition.
- 3.6 Postcomm has some powers to promote competition and to prevent certain abuses, for example, Condition 10 and Condition 11, but it does not have powers to enforce either the Competition or Enterprise Acts itself. Postcomm has a Memorandum of Understanding (MoU) with the OFT, the statutory body with primary responsibility for enforcing both Acts, that sets out the working relationship in relation to regulating and enforcing competition issues.

The legal framework

- 3.7 Pursuant to Section 3 of the PSA 2000, Postcomm is required to ensure the continued provision of the universal postal service. Subject to this, Postcomm must exercise its functions in the way best calculated to further the interest of postal users, wherever appropriate through the promotion of effective and efficient competition between postal operators. Postcomm has sought to execute these duties through the licensing regime and in particular Royal Mail's licence, where there are specific competition-related conditions reflecting Royal Mail's market power.

Condition 20: Access to the Postcode Address File

- 3.8 This condition relates specifically to PAF and requires Royal Mail to:
- i. Maintain PAF (in an electronic form); and,
 - ii. Make it, and any updates to it, available (to any person who requests it) on payment of a reasonable charge; and,
- impose no terms or conditions other than reasonable restrictions to ensure:
- i. Intellectual property rights are protected; and
 - ii. PAF is utilised in such a way as to encourage good addressing; and
 - iii. That the reasonable charges are paid.

3.9 Royal Mail is entitled to charge for providing PAF to third parties but it may only apply a reasonable charge. In addition it may not impose any term or condition other than a reasonable one to protect its IPR, promote good addressing and ensure reasonable charges are paid. These obligations and Postcomm's interpretation of what is required for Royal Mail to comply with them are considered further in Chapters 5, 6, 7, 8 and 9.

Condition 10: Prohibition of obtaining unfair commercial advantage

3.10 This condition applies where Royal Mail is required to provide access to its postal facilities to other persons. Paragraph 2 requires Royal Mail to conduct its business in the way best calculated to ensure that neither it, nor any other person, receives any unfair commercial advantage in relation to the provision of access. Paragraph 3 restricts the use of information gained through the provision of access to third parties.

3.11 Paragraph 5 of Condition 10 requires that the terms on which Royal Mail, and any related person, may access the licensee's postal facilities may be no less and no more favourable than the terms on which access is provided to a third party. This provision is important as it requires Royal Mail to make PAF available to third parties on the same terms as to itself. These provisions, together with Postcomm's assessment of their application to PAF, are considered in Chapters 5, 6, 7 and 8.

Condition 11: Promotion of effective competition

3.12 Paragraph 1 of this Condition sets out the circumstances in which the condition may be applied; effectively where Postcomm otherwise regulates the price of the service, competition does not exist and the terms are not required for Royal Mail to satisfy its universal service. Condition 11 applies to PAF.

3.13 Paragraph 2, which describes the prohibitions and is set out below, should be read in conjunction with Paragraphs 1, 3 and 4 of the Condition and Paragraph 18 of the Competition Act 1998⁸.

⁸ See <http://www.opsi.gov.uk/acts/acts1998/80041--c.htm>

“Subject to Paragraphs 1, 3 and 4 to its obligations under Condition 2 (Universal Service) of this Licence, the Licensee –

- (a) in the terms on which it supplies or offers to supply postal services to customers-*
 - i. shall not show undue preference to any person or class of person, and*
 - ii. shall not exercise any undue discrimination against or seek to impose any undue restriction on any person or class of persons, and*

- (b) shall not set terms or prices for the supply of postal services*
 - i. which are excessive, or*
 - ii. which are predatory”*

3.14 This condition is important because it prohibits Royal Mail from giving unduly preferential or imposing unduly discriminatory terms in the supply of PAF. It also prohibits Royal Mail from either charging excessively or on a predatory basis. These prohibitions together with Postcomm’s assessment of their application to PAF are considered in Chapters 5, 6 and 8.

Condition 14: Accounting separation and ringfencing

3.15 Condition 14 relates to accounting separation and ringfencing. Different categories of service are defined in Condition 14, each with different accounting and reporting requirements.

3.16 Those services which are licensed or part of the universal service must be separately accounted for; non-licensed postal services must be accounted for in an aggregated form and non-postal services must be accounted for separately in an aggregated form.

3.17 The purpose of the condition is to introduce greater transparency in a business wide in scope, to prevent cross-subsidy from non-competitive or monopoly activities to competitive activities. Transparency and accountability issues are considered further in Chapters 6 and 7.

Relevant legal precedent and experience

3.18 Postcomm has sought to reflect relevant economic and legal precedent in reaching its proposals. Reference is given throughout the document to either specific UK or EU case law or regulatory precedent with postcodes or comparable resources.

Summary of the legal framework

3.19 Condition 20 is explicit recognition of the importance of the postcode (and PAF) as part of the 'postal infrastructure' and more broadly as an important part of the economic, industrial and social fabric of the UK. Though implicit in the general obligations of Condition 20 for PAF to be provided on reasonable terms, Condition 11 explicitly prohibits anti-competitive, discriminatory or exploitative behaviour. Condition 10 explicitly prohibits Royal Mail gaining unfair commercial advantage in providing access to its facilities. Condition 14 provides for clarity in financial reporting to allow identification of cross-subsidy.

3.20 In aggregate, the provisions of Royal Mail's licence provide access to PAF to any person on reasonable terms, which are not unduly discriminatory and no more or less favourable than those that Royal Mail has in its access to PAF. In addition they provide sufficient scope to encourage Royal Mail to innovate and develop PAF to support a variety of changing postal and other business applications for PAF data.

3.21 It is within this framework that Postcomm seeks to satisfy the review's objectives (see Chapter 1). If this framework does not enable achievement of the review's objectives, Postcomm will consider modifying the licence. It is against this framework and these obligations that Postcomm makes its observations on Royal Mail's performance and considers whether further steps are needed.

Assessment

- 3.22 In making this assessment Postcomm has considered points raised by stakeholders and experience from other sectors and countries with similar objectives and challenges. The first question Postcomm considered was whether the scope of the existing licence facilitated achievement of the review's objectives. This question led to greater consideration of the role and applicability of the general competition and reporting provisions of the licence – in particular how they complement or enhance Condition 20.
- 3.23 Postcomm is satisfied that the provisions of the licence, when taken in conjunction with the additional options provided by the Competition Act and the Enterprise Act, are sufficient to allow achievement of the review's objectives.
- 3.24 One question is whether applying four licence conditions to PAF might be unwieldy and whether there is a simpler, more explicit way of regulating PAF. For example, a single licence condition relating to PAF that provides, in one condition, the specificity that Conditions 10, 11 and 14 provide separately. This brings together all Royal Mail's obligations in relation to PAF and possibly reduces ambiguity. It would, however, involve replicating the provisions of Conditions 10, 11 and 14 in Royal Mail's licence. This raises the risk of the PAF licence condition falling out of step with the general pro-competition and transparency conditions. These conditions reflect broader regulatory experience and legislation; repeating them throughout the licence would not enhance their effectiveness.
- 3.25 Postcomm does not have the power to enforce separation of ownership from Royal Mail. This might be perceived as a weakness and has been highlighted by Royal Mail. However Postcomm, for the reasons described in this document, does not seek this power. It is appropriate to note, however, that although no explicit power to change ownership exists, or is contemplated in Section 116 of the PSA 2000, if Postcomm considered it appropriate and the relevant criteria were established, alternative remedies which might include greater separation could be explored under the Enterprise Act 2002⁹.

⁹ See www.ofst.gov.uk for information on the Enterprise Act 2002.

3.26 Postcomm does not consider separation of ownership to be necessary or beneficial in the short term or proportionate to the degree of concern within the market.

Conclusion

3.27 Postcomm concludes the existing provisions of the licence are sufficient to deliver the objectives and 'desired outcomes' of the review and, at this stage, does not propose any changes to the existing legal framework.

3.28 Postcomm proposes to investigate Royal Mail's compliance, with any or all of the relevant conditions, if inadequate action is taken by Royal Mail following conclusion of the review, or if a valid complaint is received.

4. Observations on Royal Mail's performance

Introduction

- 4.1 This chapter sets out stakeholder views on Royal Mail's performance, gives Postcomm's observations and highlights particular concerns or issues. It provides a lead in to the remainder of the document which considers, in more detail, the issues raised and options for addressing these. The first section considers Royal Mail's performance. Developments within Royal Mail since the consultation began, which impact on the review, are then looked at. Finally, Postcomm overviews the issues identified from the review and provides an update on developments within Royal Mail since the review commenced.
- 4.2 A key aim of the review is to identify areas where Postcomm believes change is needed to address legitimate issues raised by respondents and to make proposals for change. It is important to note that this review is not intended as an investigation into Royal Mail's compliance, rather, to assess the way Royal Mail has performed its duties, based on respondents' concerns, and to identify any existing or potential compliance risks. Opportunities for Royal Mail to 'future-proof' against these risks are identified in Postcomm's assessment and proposals, presented in Chapters 5 to 9.

Royal Mail's performance

Background

- 4.3 The review commenced in June 2004 specifically in relation to Condition 20 but with Postcomm's broader duties in mind: ensuring the provision of a universal postal service, and promoting effective competition. At this time Royal Mail's management of PAF was a matter of growing concern to stakeholders and Postcomm. Its actions implied an internal mandate to maximise the revenues derived from PAF. In addition, Royal Mail had spent several years seeking to introduce a complex and onerous licence and had lost a major IPR court case relating to PAF usage.

Observations

- 4.4 PAF is a valuable resource and Postcomm attributes this to Royal Mail's past success in its development, promoting its use and creating a 'virtuous circle' of increasing postcode awareness.
- 4.5 Respondents' views suggest Royal Mail, generally speaking, has performed adequately in making PAF available on reasonable terms, although a number of reservations have been expressed over Royal Mail's maintenance of PAF to an acceptable standard. This is consistent with the absence of formal complaints in the five years since Royal Mail's licence was issued¹⁰. Furthermore, Royal Mail has acknowledged further changes are necessary given the way the market for PAF is evolving and has already taken steps in the right direction to address some of the concerns raised by the review.
- 4.6 Respondents' interests and concerns varied. However there was general consensus in relation to a few fundamental issues and the steps needed to meet the objectives of the review. For simplicity the issues are presented under Royal Mail's broad obligations in Condition 20, to maintain PAF and make it available on reasonable terms.

Maintenance

- 4.7 Under Condition 20 of its licence Royal Mail is required to maintain PAF; implicit in that requirement is a requirement that such maintenance should be to an acceptable standard. While acknowledging the good work done by Royal Mail in originally developing PAF and the challenges of keeping it updated, respondents' views indicate a number of issues and concerns with PAF quality. These relate to maintenance failings, system inadequacy, generally poor performance with regard to its maintenance, and lack of adequate commercial arrangements with information providers. All of this raises serious concerns about Royal Mail's performance.
- 4.8 Postcomm's view is that there are clearly opportunities to improve the maintenance of PAF and a number of relatively straightforward steps could address many of the concerns raised by respondents. Royal Mail is aware of the issues and concerns raised by the review and, Postcomm understands, has

¹⁰ One formal complaint was made to the OFT but not investigated.

taken steps to address some of these. Chapter 9 considers maintenance and quality (and development) issues in more detail and presents Postcomm's proposals in this area.

Supply of PAF on reasonable terms

- 4.9 Under Condition 20 of its licence Royal Mail is required to make PAF available to any person on reasonable terms (both price and non-price terms). While no formal complaints have been made to Postcomm about access to PAF¹¹ or the reasonableness of terms, respondents raised a number of concerns with the terms on which PAF is made available. Concerns relate to a lack of financial, operational and strategic transparency and accountability to stakeholders, as well as a greater need to ensure a fair and non-discriminatory PAF licensing structure.
- 4.10 Postcomm's view is that in addressing these issues, Royal Mail will need to do more than simply adapt the current licence terms. To its credit, Royal Mail recognises the current licence structure is not "*fit for purpose*" and must be improved. Chapters 5 to 8 consider issues associated with the supply of PAF on reasonable terms in more detail and present Postcomm's proposals.

Issues identified by the review

- 4.11 In answering the questions set out in the consultation, Postcomm finds that respondents' overall view is that Royal Mail has performed reasonably well given the size and complexity of PAF and the rapidly evolving marketplace. However clear areas of concern were raised and opportunities for improvement identified when considering the future management of PAF. This section groups respondents' concerns into a number of key issues, introduced below, and discussed in detail in Chapters 5 to 9.
- **Ownership:** not a question directly posed by the consultation, but widely commented on. Key issues include Royal Mail's potential to exploit the resource, the setting of preferential terms for itself, blocking and inhibiting innovation and improvements, and a lack of accountability to stakeholders.

¹¹ See Chapter 5.

- Financing: specifically, who should pay for PAF and how much. Key issues include uncertainty about what constitutes a ‘reasonable charge’ for PAF¹² and the fact that Royal Mail does not pay directly for its PAF usage.
- Competition issues: both in supply of PAF and in the development of postal competition. Key issues include that Royal Mail could derive undue commercial advantage through the information it gains in supplying PAF, and that postal operators could be treated differently to internal Royal Mail users of PAF, particularly in a fully competitive postal market.
- Licensing: relating to the reasonableness of licence terms and Royal Mail’s objectives for PAF. Key issues include the restrictiveness of licensing terms, the price of PAF for certain market segments, the removal of the corporate licence, and the administrative process for licensing PAF to end users.
- Transparency and accountability: key issues include the need for Royal Mail to be more open in regulatory and public reporting of PAF financial information, and when undertaking PAF decisions that significantly impact on PAF users.
- Maintenance, quality and development: key issues include the need for a proper quality measurement system, and resolution of equity issues inherent in the update process.

Recent developments

Organisational developments

4.12 Since Postcomm’s consultation began, a series of changes have been made within Royal Mail. These include an organisational change moving the Address Management Centre (AMC), which is the part of its business responsible for managing PAF, from Royal Mail’s marketing function into its sales and customer services function. Internal changes were also made within the AMC including establishing a new management team. These changes followed Royal Mail’s recognition that efficiency of its PAF operation could be improved, and that greater transparency and controls in its management of PAF (in addition to revisions to licensing arrangements) were required.

4.13 Royal Mail has initiated steps to ringfence its PAF operation as a stand alone

¹² Under Condition 20 of its licence, Royal Mail is entitled to make a “reasonable charge” for use of PAF.

function with separate accounts; it has also renamed the AMC the 'Address Management *Unit*' (AMU). Royal Mail's focus so far has been on cost identification and developing a draft Profit and Loss statement that relates specifically to the AMU's PAF related activities. It has indicated that it will shortly focus attention on the establishment of intra-business unit charging, establishing formal 'ground rules' for dealings between the AMU and other Royal Mail businesses. Royal Mail is also giving consideration to the introduction of a payment to suppliers for information received and used in the maintenance and update of PAF, subject to normal commercial considerations.

Licensing developments

- 4.14 The approach to licensing and consultation on changes has been revised; the objective is a fee structure more conducive to growing PAF use. Postcomm has observed this consultation process but has not played a direct role. Postcomm understands, from Royal Mail and those stakeholders it has spoken with, that Royal Mail's approach and the proposed licence changes are more acceptable than previous proposals. Postcomm is advised by Royal Mail that the proposed licensing regime will be 'revenue neutral'. Issues relating to PAF finances are discussed in Chapter 5.
- 4.15 Royal Mail, specifically the AMU, has adjusted its consultation process over the past 12 to 18 months. While Postcomm has not been directly involved in this process, Postcomm understands that the licensing consultation has been 'opened up' to involve a wide range of PAF users including end users, Bureaux, direct customers and VARs.

Maintenance developments

- 4.16 Postcomm understands Royal Mail has taken, and is taking, steps to improve PAF quality and plans to implement a new system based on confidence levels that will allow every address on PAF to be validated and the amendments shown as a date stamp on PAF. This is intended to address a limitation of the current system which biannually measures a random sample of postcodes for accuracy, providing limited value to stakeholders. Issues relating to PAF maintenance are discussed in Chapter 9.

5. Financing

Introduction

5.1 This chapter introduces issues associated with the financing of PAF. This is followed by Postcomm's assessment of the issues and its proposals for addressing them.

Background

5.2 This section focuses on the financing of PAF at an aggregate level. It considers issues such as who should pay for PAF, whether Royal Mail should pay directly for its use of PAF, what level of revenue should Royal Mail be able to earn from PAF, and Postcomm's role in PAF financing going forward. These issues were raised by stakeholders in relation to a number of questions in the consultation and in discussions following the consultation period. Issues associated with the structure of PAF licence fees are considered separately in Chapter 8.

5.3 In developing proposals for the financing of PAF, Postcomm has considered Royal Mail's requirement under Condition 20 of its licence to make PAF available to any person who requests it upon payment of a reasonable charge. Postcomm also draws on other relevant conditions of Royal Mail's licence (see Chapter 6 for further detail)¹³.

Finance issues identified by the review

5.4 Several responses questioned the appropriateness of Royal Mail charging for PAF. They highlighted a concern that Royal Mail does not pay directly for its PAF usage and that the efficiencies Royal Mail enjoys from widespread use of PAF are not taken into account in defining PAF costs or setting prices. UK Mail

¹³ Postcomm's proposals do not relate to the revenue Royal Mail can earn from PAF value added activities. The definition of value added activities is explored in Chapter 9.

felt there needed to be a structure where *“Royal Mail are treated equally to all other users of PAF (including the need to purchase access to PAF data in the same way as all other users ...”*. Some respondents felt it would be fair and in the best interest of both PAF users and Royal Mail for Royal Mail to make PAF more cheaply or freely available. The MUA said that *“... as a national asset it should be the fundamental right of every UK citizen to access postcode information free of charge.”* The Demographics User Group (the DUG) thought this would benefit Royal Mail operations, commenting that *“PAF should be available free at the point of use ... We believe that increased use would reduce Royal Mail’s own costs of incorrectly addressed mail.”*

- 5.5 Other respondents felt that giving PAF away would impact on users’ ability to influence PAF quality. OS recognised that *“... Royal Mail needs to receive a revenue stream to maintain the quality at a satisfactory level.”* All felt that Royal Mail should make at least some contributions to the cost of PAF.
- 5.6 The absence of publicly available PAF financial information provided limited scope for stakeholders to respond in an informed manner on the reasonableness of PAF costs, revenues and charges. Capscan commented, *“It is impossible to comment on the reasonableness ... of the current licence fees unless there is a clear rationale for them ... Royal Mail does not disclose the revenues from PAF, nor the costs of maintaining PAF.”*

Assessment

Who should pay for PAF?

- 5.7 There is some merit to the suggestion of a few respondents to make PAF freely available or available at a nominal cost. Royal Mail derives considerable benefit from growing PAF usage, as the cost of delivering a mail item with an incorrect or missing postcode exceeds that of a correctly postcoded item. This provides Royal Mail with a financial incentive to increase postcode compliance and information provided by Royal Mail suggests it has made some improvements in this area in recent times¹⁴.

¹⁴ Source: postcode usage information provided by Royal Mail for 2001-02, 2002-03 and 2003-04 (April to September only).

5.8 Postcomm has undertaken analysis to estimate the size of the benefits Royal Mail derives from improved postcode compliance. Information provided by Royal Mail shows that Stamp and Meter mail have the lowest levels of postcode compliance at 85.5% and 89.5%, respectively (see Table 1). Interestingly, respondents that use Stamp and Meter mail had greatest concern with current PAF prices¹⁵. Postcomm's analysis, based on estimated costing information derived by PLCWW¹⁶, indicates that if Royal Mail could increase postcode compliance for Stamp and Meter mail to 90%, (assuming no improvements in postcode compliance from other payment methods) it would save at least £7.5m per annum in costs (almost half Royal Mail's estimate of the total cost of PAF). One option to achieve this could be lowering the cost of PAF or otherwise promoting postcode use to these market segments¹⁷.

Table 1: Postcode usage by payment method, April to September 2003

	Postcode compliance	Incorrect postcode	Missing postcode
Stamp	85.5%	7.3%	7.1%
Meter	89.5%	6.7%	3.9%
PPI	94.2%	4.3%	1.5%
Bulk	97.7%	2.2%	0.1%
Total	93.1%	4.8%	2.1%

Source: Royal Mail

5.9 Postcomm would welcome Royal Mail endeavours to improve postcode use by increasing the use of PAF (potentially through lower prices), but recognises Royal Mail is only required to make PAF available at a "reasonable charge" under Condition 20 of its licence. Postcomm also recognises that many other users obtain substantial benefit from PAF (for example, mailers, insurance companies, banks etc) and that making PAF freely available may dilute their say in PAF matters.

¹⁵ PAF licensing is considered further in Chapter 8.

¹⁶ PLCWW undertook research to estimate the cost to Royal Mail of delivering mail items that are correctly postcoded, incorrectly postcoded and missing postcodes, June 2005.

¹⁷ Postcomm has not undertaken formal analysis of the nature of the relationship between the price of PAF and postcode compliance.

5.10 Postcomm's view is that all users of PAF obtain benefit from PAF and should make some contribution to its continued provision, by way of a 'reasonable charge' levied by Royal Mail. That said, Postcomm does not want to foreclose Royal Mail's option of promoting incremental improvements in addressing standards¹⁸ by adopting more favourable PAF prices.

Should Royal Mail pay directly for its PAF use?

5.11 A number of responses expressed doubt that Royal Mail pays directly for its use of PAF. Historically, Royal Mail appears to have made an indirect contribution to the cost of PAF by subsidising the gap between total PAF revenues and costs, rather than paying directly for its use of PAF on the same basis as similar third parties. The benefit accruing to Royal Mail through increasing postcode use (as outlined above) has made this worthwhile.

5.12 Financial information provided by Royal Mail suggests PAF licensing revenue has grown to such an extent that Royal Mail is now no longer required to make a contribution to the cost of running PAF. Further, growth in the number of users and uses of PAF suggests licence revenue is likely to increase under current licensing arrangements.

5.13 Postcomm's view is that Royal Mail should pay directly for its PAF usage on equivalent terms and conditions to like third parties. Similar arrangements have been introduced in a number of industries characterised by essential infrastructure¹⁹ as well as DSA in postal services. To not do so would create competition concerns as all other PAF users would, in effect, be cross-subsidising Royal Mail's PAF usage and is also likely to be inconsistent with Condition 10 of Royal Mail's licence.

PAF revenues and costs

5.14 There has been significant growth in PAF usage over the last decade. Initially it was used primarily within the postal sector, but as technology evolved, so has a wide range of commercial applications. Information provided by Royal Mail suggests it received revenues from licensing PAF of less than £1m in the early

¹⁸ As anticipated in Condition 20.

¹⁹ For example, the OSIS database and BT's downstream network (following Ofcom's strategic review).

1990s; by 2000-01 this had increased approximately 9 fold, and 17 fold by 2004-05.

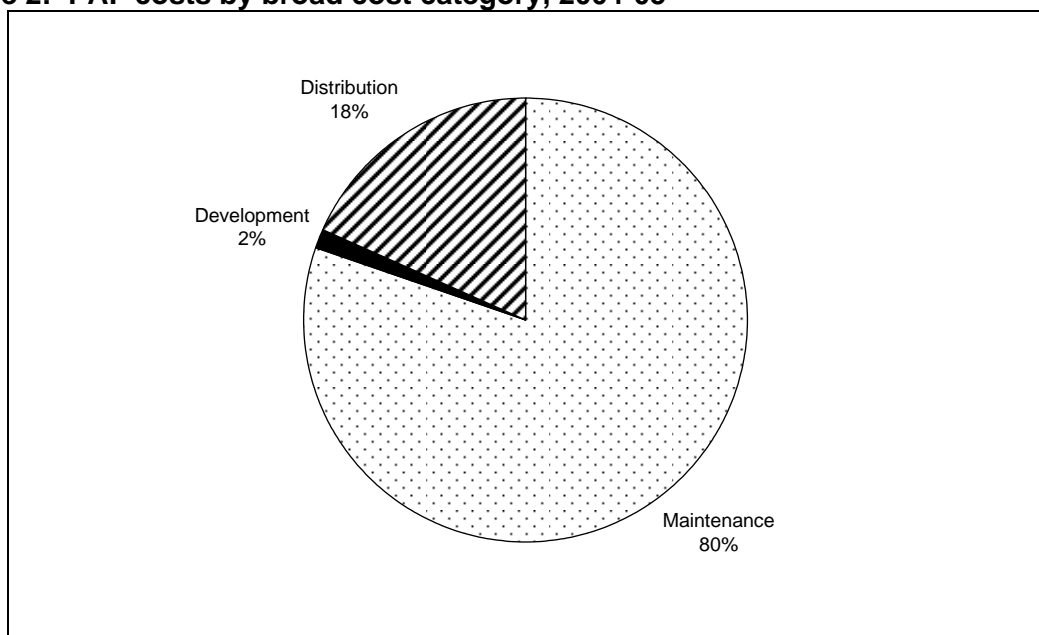
What revenue should Royal Mail be able earn?

- 5.15 Under Condition 20 of its licence, Royal Mail is entitled to make a 'reasonable charge' for use of PAF, reflecting an allowance in the PSA 2000 for it to charge a fee for licensing PAF. It is evident to Postcomm that the value of PAF to VARs and other end users is considerably greater than its cost; and, if allowed, Royal Mail could choose to price PAF at the level that the 'market could bear'. Postcomm's view is that such an approach would be inconsistent with a 'reasonable charge'. In defining a 'reasonable charge' regulatory precedent²⁰ points toward a charge that is reflective of efficient costs incurred. It is also pertinent to reflect on Postcomm's approach to setting prices for access to Royal Mail's other postal facilities²¹. Postcomm's view is that a reasonable charge should be reflective of the efficient costs incurred plus a reasonable profit allowance.
- 5.16 To establish whether current charging arrangements are cost reflective, Postcomm needs to be assured that an appropriate level of costs is allocated to the AMU and that the nature and level of intra-business costs are justifiable.
- 5.17 PAF costs can be broadly allocated into three categories: maintenance, development and distribution. Maintenance costs account for the majority of PAF costs (around 80%). Key maintenance costs include PAF validation activities undertaken by delivery staff, AMU staff costs and overhead costs. Distribution costs are a significant PAF cost, about 18%, and include staff costs and enquiry line and online support costs. Development costs account for about 2% of PAF's costs (see Figure 2).

²⁰ For example, access to the OSIS database and DSA.

²¹ In particular DSA, common operational procedures and Royal Mail's price control.

Figure 2: PAF costs by broad cost category, 2004-05



Source: Postcomm estimates based on Royal Mail cost estimates

- 5.18 In establishing the PAF cost base Postcomm wants to ensure the nature and level of intra-business costs are justifiable and to eliminate any double recovery of PAF costs, for example, costs recovered through both PAF licence fees and Royal Mail's price controlled activities.
- 5.19 Postcomm has concerns about the nature, level and potential double recovery of certain PAF costs presented in the draft 2004/05 PAF Profit and Loss statement. One example is the internal cost allocation for PAF validation activities undertaken by delivery staff. Postcomm is, therefore, currently in discussions with Royal Mail to define the PAF cost base.
- 5.20 Postcomm appreciates it could be argued that a cost base should reflect the investment Royal Mail has made in developing PAF and promoting its use over the past 40 years. Equally, it could be argued that in setting a 'reasonable charge', account should be taken of the significant value Royal Mail has derived from postcode use over this period. Postcomm's view is that historic costs and benefits should not impact on establishing a 'reasonable charge' for PAF going forward. Past PAF investments are likely to have been fairly accounted for in Royal Mail's price control and, if not, the vast majority of PAF investments took place many years ago and as such these costs could now be considered to be fully recovered.

- 5.21 Once the efficient PAF cost base is established it is necessary to consider the level of profit allowance Royal Mail can earn from PAF. Postcomm's view is that in setting PAF prices Royal Mail should be able to recover efficient and reasonable costs associated with the maintenance, development and distribution of PAF plus a reasonable profit allowance. Reasonable costs will be determined based on Postcomm's well established approach to cost attribution and include intra-business unit charges, for example, human resources or finance costs.
- 5.22 Consistent with the approach taken in other areas (most notably Royal Mail's price control), Postcomm believes the size of any profit allowance should reflect the level of risk faced by Royal Mail in providing PAF products and be sufficient to ensure that it has the means to attract and retain efficient investment. Postcomm is in the process of benchmarking PAF against similar essential infrastructure in other industries and relevant Royal Mail comparators.

Postcomm's role going forward

- 5.23 Postcomm is required to ensure Royal Mail provides access to PAF, to anyone who wishes to use it, on reasonable terms. This can be achieved by either monitoring Royal Mail's PAF financial data on a regular basis²², by monitoring Royal Mail's licensing approach, and reacting to complaints; or by taking a more proactive and interventionist approach, for example, taking an active role in the setting of PAF prices. Postcomm's preference is to adopt the first option as it believes this is proportionate, more consistent with Condition 20, and reflects the absence of formal complaints by postal operators or other end users of PAF. There is also a real risk of developing an overly complex regime that imposes unnecessary compliance and administrative costs.
- 5.24 One area where Postcomm envisages a greater role may be required for Postcomm is in approving the mechanism Royal Mail introduces for dealing with any over or under recovery of PAF revenues. Postcomm also believes consideration should be given to introducing an independent body to review any major PAF development or investment expenditure proposals.

²² Postcomm's proposed approach to monitoring PAF finances is outlined in further detail in Chapter 7.

- 5.25 Postcomm is keen to ensure Royal Mail recovers efficient and reasonable costs associated with the maintenance, development and distribution of PAF plus a reasonable profit allowance. However, Postcomm recognises that introducing a licensing regime that achieves this requirement is non-trivial, especially given the nature of the PAF product (i.e. high fixed costs and very low distribution costs).
- 5.26 In developing its licensing regime Royal Mail will need to forecast PAF user numbers for each category of user. Any error in PAF user volumes will lead to under or over recovery of PAF revenues. Given Royal Mail's licence requirement to provide PAF on reasonable terms, Postcomm is willing to accept some variation in year-on-year PAF returns. Postcomm acknowledges that Royal Mail (and PAF users) require certainty around PAF prices. However they would expect Royal Mail to revise PAF prices on a regular basis, for example every year (consistent with its licence requirement to provide PAF on 'reasonable terms') and for revisions to reflect under or over recovery in previous years. Royal Mail should notify Postcomm of any changes to the terms and conditions on which PAF is supplied.
- 5.27 Postcomm and PAF stakeholders support Royal Mail undertaking efficient development and investment in PAF, for example, to improve the quality and usefulness of the database. However, Postcomm wants to minimise the likelihood of Royal Mail undertaking inefficient PAF investment or investment with benefits accruing disproportionately to itself because all PAF users via PAF licence fees would pay for these investments. One option to mitigate the risk of this occurring is to require all PAF development proposals be sent to an Advisory Board (see Chapter 7 for further detail).

Proposals

- 5.28 Postcomm proposes that Royal Mail, to the extent not already in place, puts in place a range of agreements that allow Royal Mail (the AMU) to:
- Recover the efficient and reasonable costs of updating, maintaining and distributing PAF (including some allowance for investment and development of PAF) plus a reasonable profit allowance.
 - Pay directly for its use of PAF on equivalent terms and conditions to like users.

5.29 Postcomm welcomes views on its proposals.

6. Competition issues

Introduction

6.1 This chapter introduces and considers the existing, and potential, competition issues associated with Royal Mail's management of PAF. It considers competition issues relating to the markets for postal services, data supply and value added services in the context of the legal framework for the review set out in Chapter 3. The issues and concerns highlighted by the review are linked to individual 'competition issues' followed by Postcomm's assessment of these issues and its proposals for dealing with competition issues.

Background

6.2 The June consultation asked the extent to which the status quo presents a barrier to the development of effective competition for postal services. It did not specifically address competition issues in data supply and value added services, although questions did touch on issues and potential competition issues in these areas. The principles of competition law are transferable and Postcomm does not distinguish between the data supply, value added services and postal markets other than in addressing specific concerns raised by stakeholders focussed in particular markets. The issues discussed in this chapter are closely related to, and should be read in conjunction with, those in Chapters 5, 7, 8 and 9.

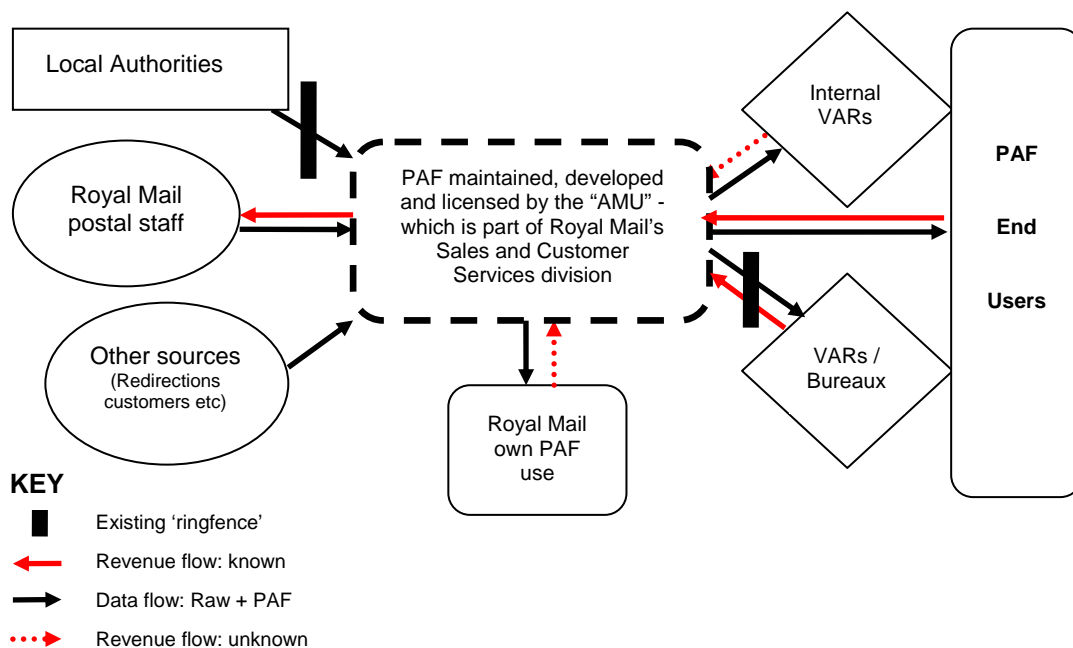
6.3 In managing PAF, Royal Mail is required to comply with overlapping legislation designed to protect customers and prevent anti-competitive behaviour. This legislation includes the PSA 2000, as well as the Competition Act 1998 and the Enterprise Act 2002 and the provisions of Royal Mail's licence granted under the PSA 2000. Although Postcomm will always seek to use its statutory powers when investigating complaints of anti-competitive behaviour, where these powers are insufficient, or Postcomm is not the best placed statutory authority, it will consider seeking other alternatives, for example by referring an issue, or combination of issues, to the OFT²³, according to the MoU between the two bodies.

²³ The MoU can be found on Postcomm's website: www.psc.gov.uk

Competition issues identified by the review

6.4 It is helpful to consider the current and legacy management arrangements for PAF and the location of PAF within Royal Mail's organisation. In 2004 Royal Mail moved the management of PAF from its marketing division to its customer services and sales division; Postcomm understands this was to address the risk of conflicts of interest. Figure 3 illustrates the structural arrangements for PAF, it also provides some guide to where competition issues might arise.

Figure 3: Current / legacy PAF management arrangements (illustrative)



6.5 This diagram highlights a number of risk areas. Postcomm believes that further steps are necessary in order to remove potential conflicts which might result in licence breach. It is imperative that Royal Mail make an open, objective and comprehensive assessment of the risks, which are detailed later in the chapter, and considers any others it may additionally identify when deciding on lines of accountability and appropriate management structure. Specific issues identified by the review are considered below. These issues arise as a result of Royal Mail's status as a vertically integrated monopoly supplier of PAF - those who wish to use PAF have no choice but to buy it from Royal Mail. This issue is compounded by Royal Mail's market power in the postal market.

Use of information

- 6.6 Some respondents, in particular VARs, expressed concern that information required by the AMU for PAF licensing purposes was unnecessarily specific and might be used by Royal Mail to secure an unfair commercial advantage. For example, customer information supplied by VARs might be used by the AMU or other parts of Royal Mail's business to target customers with Royal Mail services. There is concern that there are inadequate *"Chinese walls"* between Royal Mail's PAF and retail activities – creating a genuine risk of unfair commercial advantage. Capscan, a VAR, noted *"... there is insufficient separation of the Address Management Centre from their own PAF products retailing operation."*
- 6.7 Royal Mail commented that VAR customer information *"... is treated 'In Commercial Confidence' and is kept secure within the AMC ... it is not shared with third parties and is not available to any other individuals within RM."*
- 6.8 The concern that the AMU might intentionally or inadvertently use or disclose information provided as a requirement of using PAF is exacerbated by the dual role Royal Mail plays as both the supplier of data and a competitor in the value added market. Allies Computing, a VAR, stated that *"... Royal Mail should not sell software which adds value [to] the PAF and which competes directly with VARs products."* Royal Mail's view was that VARs were *"confident in sharing a commercial relationship with a data owner"* and that *"Overall the Licensed Resellers view the relationship as transparent ... that the Address Management Centre is not trying to compete for customers ..."*. Competition issues in the postal market further complicate matters, TPG Post noted (there needed to be) *"Safeguards ... to avoid Royal Mail using licensing procedures to obtain information about customers' dealings with private operators."*

Inequality of access to PAF and postcode allocation

- 6.9 Most responses queried the terms on which Royal Mail's own internal users access PAF and question whether or not revenues are collected by the AMU. In addition to concerns of direct financial advantage there is concern that certain information is withheld from the publicly available version of PAF – PAF®. For example, AFD Software, a VAR, pointed out that important address information is not included within PAF® including *"Freepost"* and *"PO Box"*

addresses. In addition to general problems this might cause PAF users, there are implications for postal competitors. This was highlighted by UK Mail who said, *“Any variation between content, accuracy and timeliness between the address coding used by Royal Mail ... and that used by other operators will artificially and unfairly weaken the ability of other operators to provide comparable choice and compete effectively.”*

- 6.10 There was also concern that new addresses, updates to PAF and other changes to PAF might be made available sooner or on preferential terms to Royal Mail’s internal users. Also, that in updating, maintaining and developing PAF other operators may be excluded by Royal Mail to their detriment, and potentially to the detriment of the overall quality and value of PAF. BT highlighted a concern relating to the allocation of Postcodes, noting that Royal Mail’s role in allocating postcodes, as well as controlling access to PAF, placed it in a unique and powerful position.

Undue preference or discrimination

- 6.11 Several responses implied that the AMU might provide internal VARs, for example, Royal Mail’s marketing division (and the AMU’s own value added products), preferential terms, for example, by not charging PAF revenues on sales. Royal Mail’s desire to establish a greater presence in the VAR market has contributed to the unease amongst VARs that Royal Mail controls the PAF data supply market and also actively competes in the value added market. This concern is exacerbated by a perceived lack of transparency, a lack of *“Chinese walls”* and opaque accounting between Royal Mail business units.
- 6.12 There was also concern that Royal Mail might show undue preference to some VARs or end users, for example, large VARs or those who express support to Royal Mail, over others. No evidence of specific examples was supplied but it was implied that Royal Mail might favour or discriminate against some VARs over others in relation to reporting requirements and consulting on changes to PAF.

Reasonableness of charges

- 6.13 There was much discussion about the level and nature of charges for access to PAF. These are considered in greater detail in Chapters 5 and 8 where the ‘reasonableness’ of prices is considered.

6.14 Most of those who commented felt that PAF represented “*good value for money*” and that the benefits of using PAF outweighed its cost. Responses speculated that in allocating costs to PAF, Royal Mail might not be reflecting the benefit it derives from PAF, also that it might already have recovered the allocated costs through postage prices (which are regulated to allow Royal Mail to recover its costs). Secondly that Royal Mail was potentially over-estimating its costs for maintaining and supplying PAF, therefore over-recovering its costs.

Assessment

General

6.15 Postcomm urges Royal Mail to listen to these concerns and to heed the lessons of other comparable companies (for example, BT in its management of OSIS²⁴ and its downstream network) as well as its experiences in other parts of its business. In particular, transparency and effective ringfencing are important.

Use of information

6.16 In licensing access to PAF the AMU comes into possession of important and highly sensitive VAR customer information. Royal Mail is required to conduct its business in the manner “*best calculated*” to secure that neither it nor any other party derives unfair commercial advantage through providing access to its postal facilities. Any ‘leakage’ of information from the AMU’s PAF licensing activities to other value added or postal activities within Royal Mail is likely to constitute a breach of Royal Mail’s licence. The absence of adequate separation between activities may also constitute or lead to a licence breach.

6.17 Royal Mail, in its response and subsequent discussions, recognised the risk and proposed, in addition to changing reporting lines for the AMU, creating a separate business unit to mitigate the risk of conflict and to create greater transparency. Structural change, such as Royal Mail’s proposed ‘ringfencing’, helps mitigate competition risks. Experience from other industries shows that ringfencing can be effective if applied in a structured and disciplined way. However, if applied only partially or without full commitment, ringfencing will be ineffective (as per early experience in telecoms with the OSIS database).

²⁴ Operator Services Information System.

Inequality of access to PAF and postcode allocation

- 6.18 The importance of postcode and postal address information to other operators is clear²⁵. Whether for pre-sorting DSA mail or sorting and delivering mail through competing delivery networks, postal operators are heavily reliant on PAF. PAF is an important element of the postal infrastructure. Postcode and address information gathered and managed by the AMU and previously considered to be of postal value only, and therefore not supplied as part of PAF®, is important for other postal operators. Without access to this information these operators are at a disadvantage compared to Royal Mail.
- 6.19 Any preference toward Royal Mail's internal users, for example, early access to postcode changes or new postcodes, is likely to disadvantage competitors and may constitute an unfair commercial advantage. For postal operators this disadvantage may be compounded by higher costs for DSA mail (if it resulted in a greater number of mis-sorts or residues), and higher delivery costs for end-to-end operators if forced to pay Royal Mail for delivery to certain addresses.
- 6.20 In relation to the allocation of new postcodes Postcomm believes it is worth considering and pre-emptively addressing this potentially important competition issue. In particular Postcomm is concerned that Royal Mail might refuse, or not act quickly enough, to allocate postcodes to new delivery points, or otherwise discriminate against its competitors. Although not specifically addressed in responses, Postcomm has looked at experience from the UK telecoms industry with regard to phone number allocation and the Swedish postal industry with regard to postcode allocation and PAF management.
- 6.21 The management of UK telephone numbers was initially undertaken by BT. However, the introduction of competition in the UK telecoms market in 1994 saw the transfer of telephone numbering to Oftel (now Ofcom) to alleviate competition concerns about undue preference in the allocation of telephone numbers. In the Swedish postal industry, where the regulator has specifically considered postcode allocation as a competition issue, greater PAF regulation has been introduced (but Sweden Post retains ownership). Specifically, Sweden Post's competitors also have the right to equal access and to input into

²⁵ See Chapter 2.

PAF (if they identify errors or omissions), and in relation to private boxes Sweden Post is required to allocate new postcodes to competitors.

6.22 Postcode allocation is not fraught with the same strategic conflicts that existed in telephone number allocation²⁶ - postcodes do not signify customer ownership for a particular operator. The approach taken by Sweden Post and PTS, the Swedish regulator, was to require postcodes to be allocated on a non-discriminatory basis to private box addresses on request; this has been effective and satisfactory for Sweden Post and its competitors. Another feature of the Swedish example is giving equal attention to change requests from other postal operators; for example, where a postman notices an error in the postcode file (such as a new delivery point or demolition). Postcomm understands that this arrangement has contributed to an overall increase in the accuracy of the postcode file in Sweden. Matters of substance in relation to changes or developments with the Swedish postcode file are considered by a 'Council' of stakeholders and by the regulator. These points are considered in more detail in Chapter 9.

Undue preference or discrimination

6.23 Undue preference or discrimination is prohibited because it creates distortions in the market making some equivalent users either more or less competitive than others. Due preference or discrimination can have positive effects if it is warranted and objectively justifiable, for example, between different categories or segments of users where cost or policy rationale justify the difference.

6.24 It is important to healthy competition that Royal Mail does not show undue preference or discrimination toward PAF resellers or end users. No tangible evidence has been submitted or investigation conducted²⁷ leading to a suggestion that Royal Mail has shown preference to or discriminated against any reseller or end user of PAF. As alluded to earlier in this chapter, perception is very important and the widespread scepticism about the effectiveness of Royal Mail's internal charging arrangements raises concerns. Royal Mail's recognition that greater business unit separation and transparency

²⁶ Telephone number portability has mitigated many of these issues in telecoms.

²⁷ Several informal complaints have been made to Postcomm, one formal complaint has been made to the OFT; none have been investigated.

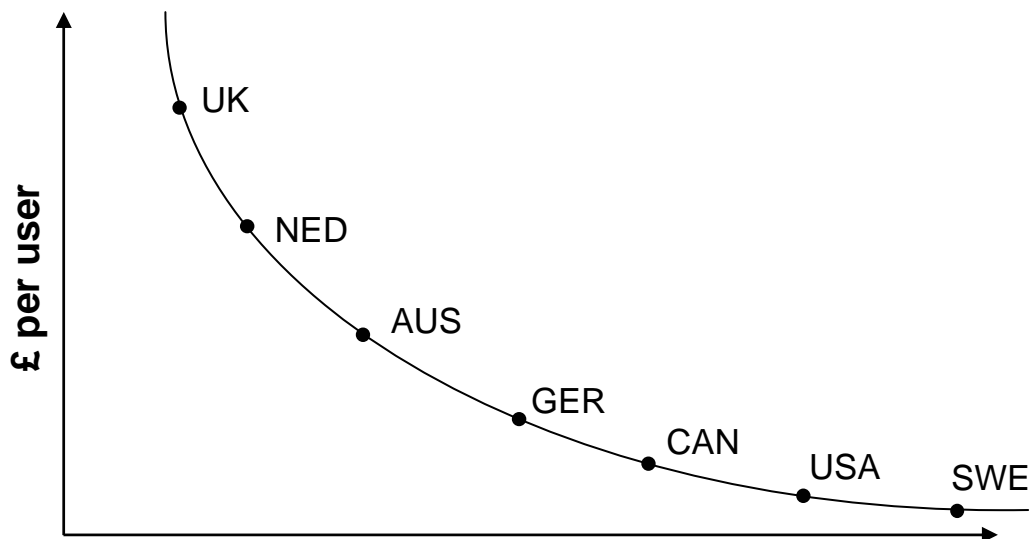
is required reinforces these concerns and points to the necessity of the proposed steps.

6.25 Royal Mail is prohibited from discriminatory behaviour that gives undue preference to anyone through its licence and general competition law. If Postcomm has sufficient reason to suspect that Royal Mail is unduly discriminating it will consider initiating investigation, using its published procedures, and if necessary, refer the matter to the OFT.

Excessive pricing

6.26 Postcomm wishes to avoid a situation where either the overall tariff revenues received, or individual tariffs charged, by Royal Mail are unreasonable or excessive. Figure 4 illustrates the relative price for PAF data in the UK and other comparable countries: it should be noted that variations in pricing structures make direct comparisons difficult so the figure is illustrative only. It shows that PAF is priced considerably higher in the UK, suggesting Royal Mail adopts a less 'user friendly' pricing approach than other countries. The reasonableness of PAF pricing is explored in detail in Chapters 5 and 8 both in relation to the total revenue recovered and the setting of individual tariffs.

Figure 4: Indicative PAF prices in the UK and other countries, 2005-06



Source: Postcomm research

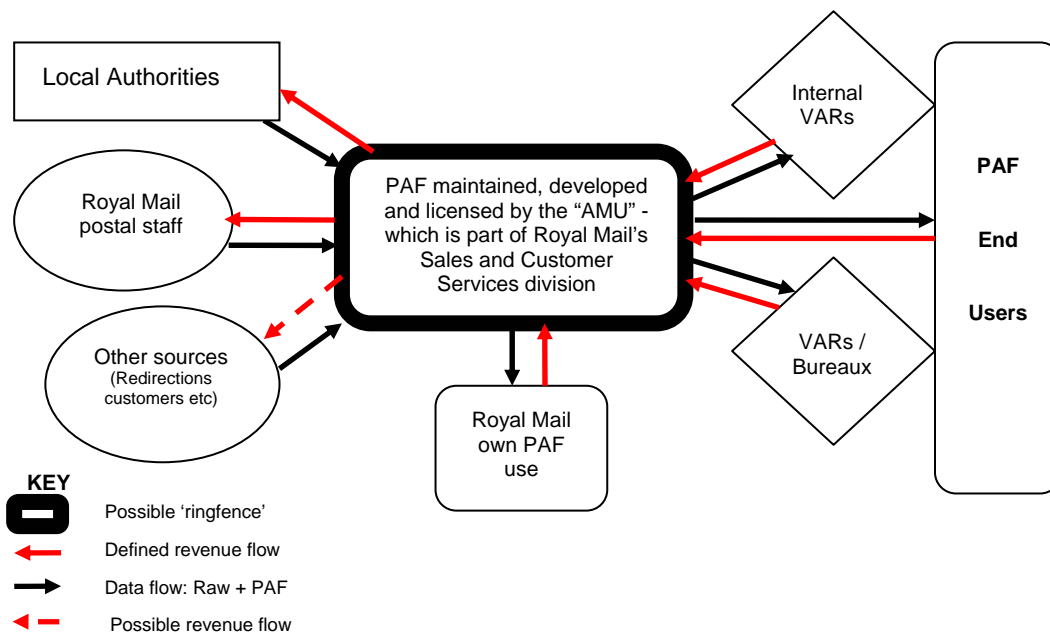
6.27 The value of PAF to VARs and end users is considerably greater than its cost and it is evident to Postcomm that Royal Mail could recover considerably more

money in licence fees than the costs it incurs in maintaining and distributing PAF. When considering the ‘reasonableness’ of prices Postcomm reflected on its approach in setting prices for access to Royal Mail’s other postal facilities²⁸ where its approach has been to allow Royal Mail to recover its reasonable costs, including an allowance for investment in improvements to PAF, plus a reasonable profit margin.

Ringfencing

6.28 The competition issues discussed in this chapter are directly linked to the degree of separation between Royal Mail’s AMU, marketing (internal VAR) and operational activities. Furthermore, the degree of separation and transparency between these functions will directly influence, in stakeholders view, the probability of Royal Mail abusing its control of PAF. Earlier in the chapter an illustration was used to highlight potential competition issues; another diagram is employed to demonstrate how Royal Mail might address some of these issues.

Figure 5: PAF management - legacy arrangements (illustrative)



6.29 Postcomm does not propose to ‘spell out’ in detail the necessary ringfencing arrangements Royal Mail needs to put in place to address competition issues. Rather we encourage Royal Mail to adopt “best practice” ringfencing

²⁸ In particular DSA, common operational procedures and Royal Mail's price control.

arrangements. We will maintain a high degree of vigilance on developments and Royal Mail's performance in this respect.

6.30 Postcomm has been in discussions with BT in relation to its experience in ringfencing its "Directory Solutions" business. Six years ago, after an Oftel led review of the directory enquiries (DQ) data market, BT moved its already partially ringfenced "Directory Solutions" business unit from its retail business into its Wholesale division – that was created to address concerns about undue preference / discrimination or unfair commercial advantage through provision of access. The new arrangement led to a complete ringfencing of the business with all identified resource being brought within the business unit and all costs associated with those resources specially coded to ensure absolute clarity of costs. Where other parts of BT Wholesale provide services to Directory Solution, for example, HR and finance, a cost allocation is made.

6.31 Given the close parallels between OSIS and PAF, Postcomm believes Royal Mail can learn from BT's experience in developing its ringfencing arrangements. Key lessons that can be applied to PAF include:

- Ringfencing must be crystal clear and totally unambiguous – the AMU should be treated as a totally separate business otherwise the competition issues that ringfencing seeks to address will resurface.
- Royal Mail must make it very clear that it is paying a fair contribution to the cost of PAF.
- Royal Mail must not only be impartial and fair but be seen to be so: perception is very important.
- Spending the time and effort to get ringfencing arrangements right from day one is worthwhile and pays dividends in the longer term.
- Ringfencing arrangements will come under the microscope so any weaknesses in the model should be pinned down and resolved, for example, reporting lines.

6.32 In relation to the last point, the issue of where within Royal Mail's business PAF is located has only been touched on briefly (PAF is currently within the Sales and Customer Services²⁹ division). Royal Mail has recognised²⁹ that the risk of conflict, and potential compliance failure, is reduced if the AMU's line of

²⁹ In its move of the AMU from its Marketing to Sales and Customer Services division.

reporting is kept separate from those areas that have an interest in influencing its decisions. Postcomm has not ascertained the extent to which Royal Mail's move mitigates this risk but notes discussions with BT emphasised that to deliver effective ringfencing, lines of accountability must be carefully considered. BT noted, in relation to OSIS, that initial ringfencing within its 'retail' business had not alleviated stakeholder concerns to the extent that it relocated the ringfenced business into its 'wholesale' business.

Proposals

6.33 Resolving, or preventing potential competition issues, is a key outcome of the review. Postcomm proposes that:

- Royal Mail create a separate, clearly ringfenced, business unit exclusively responsible for managing the maintenance, development and distribution of PAF and ensure appropriate controls are employed to prevent unfair advantage occurring to Royal Mail or any third party.
- Any postcode or postal address information made available to internal users or resellers is made also available to external users.
- Provision is made for new postcodes to be allocated to other postal operators for private box addresses.
- Updates and additions to PAF are made available to all resellers and users on the same timetable and terms as to Royal Mail's internal PAF users of resellers.
- Royal Mail should introduce clear, objective and non-discriminatory contracts for inter-business unit transactions and external supply arrangements.
- Royal Mail should adopt explicit operational measures with 'Chinese walls' to restrict information flows and avoid the possibility of Royal Mail driving an unfair commercial advantage. Royal Mail should consciously assess the risk of undue preference or discrimination when designing terms and conditions for access to PAF.

6.34 Postcomm welcomes views on its proposals.

7. Transparency and accountability

Introduction

7.1 This chapter considers the issues relating to transparency and accountability for PAF that were identified by the review. It deals with transparency and accountability first in relation to finances and secondly in relation to decision making. It outlines respondents' views, Postcomm's assessment and proposals for each issue.

Background

7.2 The consultation posed general questions on the sustainability of the PAF management structure in the future, and what steps would be the best way forward for PAF; drawing out comment on a wide range of issues and possible solutions. In particular, respondents commented on the need for greater levels of transparency and accountability in PAF financial information and many suggested "*ringfencing*" as a solution. Recent Royal Mail developments suggest that it recognises the need for greater openness and accountability and is in the process of developing proposals for ringfencing its PAF operations.

7.3 In developing its proposals for improving the transparency and accountability of PAF financial information, Postcomm has considered options that are available under Condition 14 of Royal Mail's licence. Functional, or 'operational', aspects of ringfencing are discussed separately in Chapter 6. This condition does not address public disclosure of information although this is considered later in the chapter.

Transparency and accountability in finances

Respondents' views

7.4 Although most respondents felt licence fees were reasonable or 'about right', there was widespread concern about the lack of transparency and accountability in the costs and revenues associated with PAF. Capscan noted that "*Royal Mail have tended to be rather coy of late in publishing the PAF licence revenues ...*".

- 7.5 A number of respondents suggested ringfencing as a possible solution. BT commented that *“... PAF should be managed in a transparently non-discriminatory manner. BT believes PAF management should be undertaken within a separate, ringfenced business unit within RM...”*. i-CD (on behalf of several directory enquiry providers) agreed, commenting that *“... the division within Royal Mail responsible for management of PAF should be ringfenced from the rest of the organisation in order to ... ensure a fair and reasonable license regime with transparency on costs and revenues ...”*.
- 7.6 The objective of ringfencing was discussed in more detail at the PAF workshop on management and governance, particularly in relation to BT’s ringfencing of its OSIS operation. BT commented that ringfencing and clear recording of revenue flows had allowed them to be able to show how the prices of OSIS licences were drawn up; demonstrating how they were related to costs. Royal Mail recognised that transparency around PAF activities was *“... essential to stakeholders ...”* and commented that it was its intention *“... to create a separate unit for Address Management which will create a transparent commercial and operational offering.”*
- 7.7 Many respondents had concerns that Royal Mail’s motivations and ultimate objective may not be to promote PAF and good addressing, but instead to maximise PAF revenues and that decisions were made with scant regard to stakeholders’ views. Capscan suggested that Royal Mail’s real objective lay in making *“... as much as possible from the sale of the PAF data to third parties and end users.”* Satori Software drew on experience from other countries, stating that *“... keeping the barrier of PAF usage low increases Address Quality throughout the economy. This is how other countries approach their PAF asset.”*
- 7.8 It was obvious from responses, however, that the lack of transparency makes it very difficult for stakeholders to determine whether Royal Mail is charging a reasonable price for PAF. Capscan commented *“It is impossible to comment on the reasonableness ... of the current licence fees unless there is a clear rationale for them ... Royal Mail does not disclose the revenues from PAF, nor the costs of maintaining PAF.”*

Assessment

- 7.9 Postcomm has a statutory duty to ensure access to PAF is provided on reasonable terms. Historically, Royal Mail has provided PAF financial information to Postcomm in an aggregated form, reflecting its view that PAF is not a 'licensed service' under Condition 14 of Royal Mail's licence.
- 7.10 More recently Royal Mail has provided Postcomm with more detailed information on PAF finances including unaudited draft Profit and Loss statements for the AMU³⁰. Postcomm welcomes these developments, but is of the view that a more formalised procedure encompassing the provision of audited PAF financial information, at a disaggregated level with explanatory notes, at regular time intervals is necessary for Postcomm to assess whether Royal Mail is meeting its licence obligations.
- 7.11 Postcomm has considered the best way to meet its objectives for greater transparency while minimising the administrative burden on Royal Mail. Postcomm's view is that the provision of Condition 14 (which relates to financial separation and ringfencing) if applied to PAF would be adequate. Within Condition 14 there are varying degrees of separation. Currently PAF is not separately reported; Postcomm proposes applying the higher degree of separation provided by the Condition. This would result in Royal Mail providing PAF financial information to Postcomm in the same way it currently provides information for other licensed services under Condition 14.
- 7.12 Applying Condition 14 is an attractive approach because it is designed specifically to prevent unfair cross-subsidisation and to provide greater transparency in relation to the costs of regulated activities. These arrangements are familiar to Royal Mail and there seems little sense in requiring Royal Mail to provide information for PAF on a different basis to other licensed services falling under Condition 14. This condition sets out cost allocation and auditing requirements along with reporting requirements.
- 7.13 Turning to the public reporting of financial information, Royal Mail does not provide any publicly available information on PAF costs and revenues. Even the best informed industry players can only speculate how much PAF costs or

³⁰ Royal Mail has provided Postcomm with draft PAF Profit and Loss statements for 2003-04 and 2004-05.

how much Royal Mail receives in licence revenues. Stakeholder concerns relate not only to financial transparency and accountability but also to quality of the PAF product they are purchasing³¹.

- 7.14 Postcomm's view is that some degree of public reporting of PAF financial information is required, but not to the same extent as the regulatory reporting requirements proposed above. Postcomm's view is that Royal Mail should publish, at a minimum, financial statistics; including total costs and revenues, PAF investments, and PAF usage (by segment and licence type); on an annual basis. Postcomm is encouraged by informal recognition from Royal Mail of the need for, and benefits of, greater clarity in PAF finances.

Transparency and accountability in decision making

Background

- 7.15 The consultation did not pose any direct question on the transparency of Royal Mail's PAF decision making processes, although it did recognise a prior concern of some VARs that the PAF User Group had little influence over Royal Mail beyond exerting 'gentle pressure'. Many respondents chose to comment on a perceived lack of transparency in Royal Mail's PAF decision making processes, specifically in relation to meaningful consultation, the wider implications of its actions and a belief that the ultimate decision makers with Royal Mail were unaware of PAF user concerns. These issues were subsequently discussed at the PAF workshop on management and governance³².
- 7.16 There is no clear provision in Royal Mail's licence requiring Royal Mail to be transparent in its decision making or to consult effectively with stakeholders. In this section, options are developed for improving transparency in decision making, based on consultation responses and subsequent discussions with Royal Mail and PAF users. Postcomm welcomes recent developments by the AMU (Royal Mail) to widen its consultation process on licensing changes and its intention to develop and publish consultation procedures. Discussions with

³¹ Proposals to improve transparency in PAF maintenance, quality and development are discussed in Chapter 9.

³² Held in November 2004.

Royal Mail also suggests it is open to the idea of developing a PAF Advisory Board.

Respondents' views

- 7.17 Respondents perceived a lack of transparency in Royal Mail's PAF decision making, highlighting a number of specific concerns. There was a perceived failure on the part of Royal Mail to consult 'meaningfully' in relation to PAF; this was expressed particularly in relation to Royal Mail's consultation on licensing terms of supply. For example, a confidential respondent felt Royal Mail was possibly consulting better with some larger VARs than with smaller stakeholders, and a second confidential respondent felt that end users were not being consulted with directly. Royal Mail maintained that it "...consults widely..." and "... recognises the benefit and need for consultative debate."
- 7.18 There was a widely held view amongst respondents that Royal Mail did not adequately consider the implications of PAF related decision making on external users of PAF. This concern was raised quite clearly in relation to the removal of the corporate licence. UK Mail felt this had reduced the range of options for PAF users, while Postwatch commented that it had caused confusion. Allies Computing, while supporting the decision, felt that "... some very large companies would have been badly affected by the removal of the corporate license ...".
- 7.19 The issue of decision making was discussed at the PAF workshop on management and governance. Many participants highlighted a belief that the ultimate decision makers in Royal Mail are unaware of PAF user concerns and the impact of PAF decisions on them. Options were considered on how stakeholder views could be better represented. Postwatch supported the idea of an Advisory Board. Whilst some participants felt that the PAF User Group Executive fulfilled this role, there was concern that it had limited ability to influence Royal Mail. In its consultation, Royal Mail disagreed that the PAF User Group Executive had little influence, stating that it "... has an important role to play in representing the views of customers and as a Committee Royal Mail values its views."

Assessment

- 7.20 Royal Mail appears to conduct comprehensive (and lengthy) consultations over most substantial PAF decisions; it also has a code of practice in place for modifications to actual postcode data³³. Royal Mail has been consulting on a proposed new PAF licensing framework since some time in 2001; the main reason for the extended timeframe is believed to be that Royal Mail's proposals had not addressed concerns raised by VARs³⁴ and other users who, consequently, refused each proposal. Postcomm acknowledges Royal Mail has, in the past 12 to 18 months, introduced a new management team that has commenced a consultation on new licensing proposals which appear to be more acceptable to stakeholders.
- 7.21 Postcomm welcomes this recent development and is looking to Royal Mail to consolidate the improvement and consult more meaningfully going forward. Postcomm believes it would be beneficial for both Royal Mail and the industry if Royal Mail formalised its PAF consultation procedures. Postcomm's view is that Royal Mail should, as a minimum, define and publish its consultation procedures applicable to PAF related changes and adhere to these procedures. Postcomm welcomes the opportunity to comment on these procedures prior to publication. Further, Postcomm's view is that these procedures should require Royal Mail to publish explanatory notes in relation to decisions likely to impact PAF users. Such decisions are likely to include licensing, PAF development and quality levels/measures.
- 7.22 Postcomm is also keen to address concerns about a lack of direct access by PAF users to decision makers within Royal Mail. Postcomm would like key concerns of stakeholders to be considered by decision makers within Royal Mail. A way to achieve this would be to develop an Advisory Board, possibly an extension of the existing 'PAF Executive'. The Advisory Board would be consulted by Royal Mail on relevant PAF decisions and have direct access to decision makers within Royal Mail. Postcomm appreciates that Royal Mail must retain the ability to make decisions. However it believes that the formation of an Advisory Board would allow for greater transparency on the part

³³ Agreed with Postcomm.

³⁴ Postcomm wrote to Royal Mail highlighting concerns over proposed changes in 2004.

of PAF users resulting in speedier decision making and less risk of complaint to Postcomm.

7.23 Postcomm does not wish to prescribe the structure and function of an Advisory Board as it believes this is best addressed by discussion between Royal Mail and PAF stakeholders. However discussions with PAF stakeholders in late 2005 indicated it would be useful for Postcomm to outline at a 'high level' how an Advisory Board might operate. Postcomm's view is that the Advisory Board would consist of industry experts and be reflective of key user groups. The Board would be consulted by Royal Mail and would have direct access to the decision maker within Royal Mail. Further detail of how an Advisory Board might operate is presented in Annex D.

Proposals

7.24 Improving financial and decision making transparency, and accountability, are key desired outcomes of the review. Postcomm proposes that:

- The disaggregated auditing reporting and accounting separation provisions of "*licensed services*" in Condition 14 be applied to PAF.
- Royal Mail should introduce clear, objective and non-discriminatory contracts for inter-business unit transactions and external supply arrangements.
- Royal Mail ought to develop and publish consultation standards and guidelines setting out the process that it will follow for relevant decisions³⁵, in addition to those already provided for in the PAF Code of Practice.
- Royal Mail should publish explanatory notes in relation to each relevant decision.
- Royal Mail should introduce, after consulting with stakeholders and Postcomm, a PAF Advisory Board consisting of industry experts and reflective of key user groups. The Advisory Board would be consulted by Royal Mail and have direct access to the decision maker within Royal Mail and also to Postcomm.

³⁵ 'Relevant decisions' to be confirmed may include, for example, decisions relating to licensing, PAF development and quality measures.

- Royal Mail should publish specific PAF related statistics, in particular information about total costs and revenues, PAF investments, and PAF usage (by segment and licence type); on an annual basis.

7.25 Postcomm welcomes views on its proposals. Postcomm also welcomes views on what decisions should be deemed 'relevant decisions' and therefore be consulted on by Royal Mail.

8. Licensing

Introduction

- 8.1 This chapter considers issues associated with the licensing of PAF by Royal Mail. It considers user concerns in relation to two broad categories: 'price' and 'non-price' terms. This is followed by Postcomm's assessment of the key concerns together with any broader issues identified and its proposals for addressing these.
- 8.2 The terms under which Royal Mail provides access to PAF is one of the most important issues for PAF stakeholders. Depending on how licensing terms are constructed, PAF licence terms may stimulate use of PAF and encourage the VAR market to grow or they may inhibit postcode use and erode the value of PAF. Issues associated with the overall financing of PAF are considered separately in Chapter 5.

Background

- 8.3 Prior to the consultation, stakeholders had raised a number of concerns; specifically Royal Mail's proposed changes to the terms of the PAF licence, the removal of the corporate licence, and the administrative process for licensing PAF to end users (regarded as inefficient and outdated). The consultation asked respondents to consider the validity of these specific concerns and to give broader consideration to the reasonableness of the terms of supply for PAF. With an eye on the future, stakeholders were asked for their views on possible licensing and pricing structures for PAF and their rationale for why these might be preferable to the current structure.
- 8.4 Concerns at over-extension of IPR were raised at the time of Royal Mail's unsuccessful court case against i-CD, a directory publishing company, over data validation against PAF. This was followed by an attempt to introduce new terms that would require an increasing number of businesses to have a PAF licence and greater *restrictions* on how PAF 'validated' addresses were used.
- 8.5 In assessing the reasonableness of non-price terms Postcomm considers Royal Mail's requirement under Condition 20 to impose only reasonable

restrictions to protect IPR in PAF, to encourage good addressing, and to ensure reasonable charges are paid.

Price terms

8.6 Price terms are those that directly affect the amount paid to Royal Mail for accessing PAF. PAF is licensed for conventional applications through either single user licences priced at £150 per user or banded licences which start at £3000 for a single server up to £9000 for multiple servers. For internet applications a per-click option is available where each reference to PAF is charged at 0.5 pence with a maximum charge of £3000³⁶. The use of technology as a differentiator has caused problems for some users. Royal Mail is currently consulting on a variety of different licensing models. The biggest change appears to be moving from the server, or 'technology based' model, to a use based model. This would see customers paying for PAF based on the number of individual applications that used PAF; there would be a tiered pricing structure discounting prices for high volume users.

Respondents' views

- 8.7 As outlined in Chapter 5, several responses questioned the appropriateness of Royal Mail charging for PAF. Despite these concerns, many respondents felt that PAF prices were reasonable and that PAF represented good value for money. AGI regarded “... *current pricing levels for PAF to be reasonable ...*” while OS referred to fees as “*acceptable*”.
- 8.8 For certain market segments however, PAF was not considered to be good value for money. Some respondents felt that small business and consumer needs for PAF were not being met. The DMA commented that “*PAF is important to small companies but the cost of licences is acting as a barrier to use ...*”. A number of respondents felt that the licensing structure did not support the needs of local government as it targeted commercial use of PAF. DNA-Scotland commented that where local government use PAF as a searching tool, paying a per click fee, the number of government bodies meant “... *this would generate an additional £1.5M for Royal Mail ...*”. Royal Mail's

³⁶ 12 free PAF checks may be conducted per day through Royal Mail's website, rising to 24 during Christmas.

view was that *“The pricing arrangements for PAF are freely available and are applied consistently to all users.”*

- 8.9 The response from i-CD (on behalf of several directory enquiry providers) highlighted a variety of concerns with the fairness of existing licensing arrangements and proposed a solution that reflected the net value received by / provided by each user. It concluded that there are *“net beneficiaries”* and *“net benefactors”* and this, combined with usage, should drive licence fees for using PAF.
- 8.10 Several respondents were concerned at the removal of the corporate licence in 2003 as it resulted in the increase in the price of PAF for a small number of the largest PAF users. While many noted that the pricing structure was iniquitous, with small users overpaying and large users (potentially) underpaying, it was widely felt that this could be addressed quite easily. Royal Mail conceded that the removal of the corporate licence *“... has not proved as easy to introduce and maintain as Royal Mail had envisaged ...”*.
- 8.11 In considering future licensing structures, respondents proposed a variety of structures that reflected the diversity of the PAF stakeholder base as well as reiterating the level of uncertainty about what constitutes a reasonable charge for PAF. Options for licensing included:
- Differential fees for different user ‘segments’ – variations on this theme including ‘beneficiary / benefactor’, usage level / type of use and value derived from use.
 - A use-based fee structure based on postal versus non-postal use of PAF.
 - Separate licensing arrangements for public sector use.
 - Tiered discounts based on volume usage.
 - Access to PAF available without charge.
 - Extract value to Royal Mail from better addressing by aggressively promoting PAF use and compliance – including a PAF accreditation scheme for mailers.

Non-price terms

- 8.12 Non-price terms relate to the protection of IPR and any term designed to encourage good addressing.

Respondents' views

- 8.13 Respondents indicated real frustration at what they perceived to be attempts by Royal Mail to overstep legitimate IPR in its proposed licensing terms. In particular, there was a risk that IPR would be asserted over existing customer data cleansed against PAF. Capscan commented *"This assumption/presumption of rights ... goes beyond any intentions on the part of the list owner when they submitted the file for cleansing in the first place."* It was felt that such terms would see an increasing number of businesses require a PAF licence and greater restrictions on how PAF *"validated"* addresses were used.
- 8.14 Whether Royal Mail's non-price terms for PAF encourage good addressing was not a question directly posed by the consultation but it was commented on by a number of respondents. The generally held view was that Royal Mail's real motive lay in profit maximisation from restricting the use of PAF and from not encouraging good addressing. Capscan suggested that Royal Mail's real objective lay in making *"... as much as possible from the sale of the PAF data to third parties and end users."* The protracted consultation on licensing changes from 2001 to 2004 and the removal of the corporate licence in 2003 - which apart from financial implications, signalled a degree of volatility in the terms of supply for PAF - were factors that influenced this view.
- 8.15 The current licensing proposals were also of concern, particularly the separate charge for Bureaux, seen to conflict with Royal Mail's requirement to promote good addressing. The MUA expressed particular concern saying (for certain market segments) Royal Mail's licensing structure *"... serves to disincentivise customers from using postcodes ..."*.
- 8.16 The administrative process was also seen to place a significant burden on licensees, through onerous paper forms and reporting requirements, inhibiting widespread PAF usage and therefore address quality. One respondent suggested the implementation of a PAF certification programme would assist address quality.

Assessment

Price terms

- 8.17 Postcomm is acutely aware of the concerns many respondents have with the removal of the Corporate licence and the PAF pricing structure more broadly. In setting price terms, Royal Mail is accountable to the users of PAF and is required under Condition 20 to make PAF available at a reasonable charge and to encourage good addressing. Respondents' concerns suggest Royal Mail may not have been focussed adequately on these requirements in the past. Postcomm's view is that the preferred solution to address respondents' concerns does not involve Postcomm taking a more active role in PAF licensing at this stage³⁷. The preference would be for Royal Mail to respond to user concerns by developing an evidence-based PAF pricing structure consistent with its requirements under Condition 20. Recent pricing proposals developed by Royal Mail appear to signal a movement in the right direction but further work is clearly needed.
- 8.18 Postcomm is concerned that the price of PAF is acting as a barrier to use for certain market segments. Postcomm's view is that Royal Mail should provide PAF at a reasonable charge and on a non-discriminatory basis, consistent with Conditions 20 and 11 of its licence, unless there is an objective justification for any exception. An example of an objective justification may be licensing based on 'bands' of users or discounting for large PAF users. Postcomm encourages flexible and innovative licensing of PAF that is designed to help Royal Mail achieve its licence obligations. An example of this could be where charging different prices for PAF "*encourages correct addressing*" - an objective of Condition 20.
- 8.19 Information provided by Royal Mail shows that retail customers and small-medium enterprises (SMEs) have the lowest levels of postcode compliance at 85.5%, respectively (see Table 2). Interestingly, respondents felt PAF prices were least attractive to these market segments. Postcomm's view is that promoting better addressing in market segments characterised by poor addressing would be consistent with better achieving Royal Mail's licence

³⁷ Postcomm would take a more active role in PAF pricing in response to an investigation, or complaint, for example.

obligations. Further, Postcomm's analysis in Chapter 5 indicates Royal Mail could achieve operational efficiency improvements of over £7m from relatively small improvements in postcode compliance in these segments – potentially much greater efficiencies are available to Royal Mail.

Table 2: Postcode usage by broad market segment, April to September 2003, in per cent

Market segment	Postcode compliance	Incorrect postcode	No postcode	Estimated volume of mail
Consumer	85.5%	7.3%	7.1%	8.6%
SME	85.5%	7.3%	7.1%	10.5%
Med-Large Business	89.5%	6.7%	3.9%	16.0%
Large Business	96.9%	2.7%	4.0%	64.9%
Average	93.6%	4.2%	4.6%	100.0

Source: Postcomm estimates based on Royal Mail data.

8.20 Table 2 demonstrates the opportunity that exists for Royal Mail, via a coherent strategy, to increase postcode 'compliance' and realise significant additional operational efficiencies. Postcomm recognises Royal Mail's right to make a reasonable charge for PAF but it is unclear why Royal Mail does not make greater efforts to promote postcode use.

Non-price terms

8.21 The effect of Royal Mail over-extending IPR is an undue burden on resellers and end users of PAF. It reduces the ability and incentive for innovation and growth in value added products and acts as a disincentive for postcode usage. Inevitably, this will lead to a reduced level of usage, higher average PAF prices and, most importantly, reduced efficiency in the UK postal market.

8.22 Royal Mail is required under Condition 20 to impose only reasonable restrictions to protect its IPR in PAF. Postcomm benchmarked the intellectual property (IP) restrictions imposed in several different countries and established that the UK and Royal Mail are unique in the degree to which postcodes are protected and exploited.

8.23 Postcomm recognises that IP law, and in particular database IPR, is complex and for this reason the review does not go into detail on what is 'reasonable'. If

the need arises Postcomm will make a judgement on what an unreasonable restriction might be in response to a specific complaint.

8.24 In setting its new licence terms, Postcomm would expect Royal Mail to draw precedent from relevant European and UK legislation, case law and regulatory precedent.

Summary

8.25 Respondents highlighted a range of concerns with PAF price and non-price terms. Postcomm does not propose to take an active role in setting PAF terms, as it considers this an unnecessary level of regulatory intervention. Postcomm notes, however, that improvements are required to PAF licensing arrangements and strongly encourages Royal Mail to finalise its current consultation and introduce terms consistent with its licence obligations and objectives. If this cannot be achieved promptly, Postcomm will need to reconsider its involvement in PAF licensing.

Proposals

8.26 Licensing arrangements for PAF are important to stakeholders and directly influence the availability of PAF. Postcomm proposes that:

- The licensing regime should be non-discriminatory but recognise that in certain circumstances, and where objectively justifiable, it may be appropriate to distinguish between PAF users.
- The terms employed to protect the IPR vested in PAF should be consistent with, and no more onerous than, the prevailing precedent established by European and UK case law.
- The terms of the licence should be designed to maximise PAF usage and to encourage good addressing.
- Postcomm does not propose to take an active role in setting PAF prices or licence terms unless Royal Mail holds back on implementing these changes on a voluntary basis.

8.27 Postcomm welcomes views on its proposals.

9. Maintenance, quality and development

Introduction

9.1 This chapter discusses the ongoing maintenance and product development necessary to ensure PAF retains its currency and value. It relates to a licence requirement for Royal Mail to maintain PAF and an objective, implicit in Condition 20, for PAF to be an accurate address database capable of being used to encourage good addressing. It sets out issues identified by the review, and provides Postcomm's assessment and proposals.

Background

9.2 Royal Mail is responsible for the maintenance of PAF, as well as updates to it. It is one of the main contributors to PAF in terms of address change information, along with customers and local authorities. Prior to the consultation, some stakeholders had criticised Royal Mail for the time taken to update PAF to reflect address changes. Postcomm asked respondents to consider this issue and the broader question of how well Royal Mail had performed with regard to the maintenance of PAF and its overall quality as an address database. Views were sought on what opportunities for innovation and development exist with PAF, with or without a change to the current management structure.

PAF maintenance and quality

Respondents' views

9.3 Responses indicate the quality of PAF is generally acceptable, but that there are a number of problems and some clear opportunities to improve the maintenance and, therefore, accuracy of PAF. Also a more robust quality measurement system is needed. Problems identified included address inaccuracies and inadequacies³⁸, the process for updating, decision making criteria, and the AMU interface with key contributors.

9.4 These points were raised again at the PAF workshops held at the close of the consultation. Participants felt that problems could be due to an unclear process

³⁸ Such as the exclusion of multi-occupancy, PO Box and freepost addresses.

for database maintenance. Royal Mail responded that it did have a clear maintenance process but that it needed to do a better job of communicating this to the market.

PAF accuracy

- 9.5 PAF is maintained at an estimated 96% address accuracy³⁹. Royal Mail stated that it was “... *very conscious of the need to maintain PAF accuracy ...*”. However, for some respondents, an error rate of around 4% was unacceptable and they felt that there should be progressively increasing targets for accuracy. There was a feeling that quality aims had reduced and that local knowledge of postal delivery staff could limit PAF accuracy by offsetting errors in PAF addresses. The General Register Office for Scotland (GROS) commented that problems such as discrepancies on PAF could be “... *solved if ... clear performance targets [were] set, and if performance information was made publicly available.*”
- 9.6 A number of respondents commented on the currency of business addresses on PAF; finding them considerably less complete and accurate than residential addresses. Respondents recognised that the frequency of business address changes presented challenges for Royal Mail in keeping PAF current. Postwatch cited the discrepancy between the number of business addresses on PAF versus the Dun and Bradstreet database⁴⁰, as an indicator of the currency of PAF business addresses. UK Mail felt that out-of-date business addresses could result from “... *the strong reliance of Royal Mail on delivery people to notice a new Business has opened or changed hands. Or because Royal Mail does not release PAF updates frequently enough ...*”.
- 9.7 Multi-residency addresses and premises where community services are required (such as bedsits and shelters) were also cited as ‘gaps’ in PAF. The lack of a reliable indicator for recording how many private residences existed at an address had particular problems for the census of population. The Office of National Statistics (ONS) stated that the census “... *aims to include all citizens in the Population Register and it sees the accurate recording of households within multi-occupied premises as being important in ensuring this can be achieved.*” Royal Mail commented at the PAF workshop in December 2004

³⁹ Source: Royal Mail.

⁴⁰ 1.7m v 2.7m respectively. Source: Postwatch.

that some restrictions exist where certain addresses cannot be included on PAF, for example, women's hostels.

PAF updates

- 9.8 Some respondents criticised the time taken to get an update into PAF and to the market. Respondents generally felt that Royal Mail had the resources and ability to provide more timely updates and should do better. The implications of delays were commented on by the MUA who, reflecting on a delay of two to three months from address change to entry on PAF, said "... *the list they are using in the last month of any quarter could potentially have 200k – 300k inaccuracies in it.*"
- 9.9 It was recognised that whilst Royal Mail is responsible for updating PAF, many of the perceived problems with out-of-date address data stem not from PAF being out-of-date but from businesses failing to update their records in line with the latest PAF – something Royal Mail has no control over. Christopher Roper commented that "... *very few government agencies update postcodes on addresses they already hold as they are changed in PAF. For example the NHS code service was ... distributing addresses for all doctors in the country, at least 10% of which did not hold a currently valid postcode.*"
- 9.10 Royal Mail explained the process for updating PAF further at the PAF workshop in December 2004, commenting that delays are sometimes necessary for verification purposes (for example, to ensure mail is not delivered to a property that has not been built) but accepted improvements were possible. It also said that it has no control over how quickly businesses update their own systems.

Decision making criteria

- 9.11 Responses expressed concern about unclear and variable criteria for decisions made that related to PAF format and content. There were also suspicions that the AMU made unnecessary changes to postcodes to suit Royal Mail's operational needs. The MUA suggested inaccuracies on PAF could be reduced by introducing a "*policy of stability*" for the types of changes that could be made – thus eliminating all but absolutely essential changes.

Interface with key contributors

- 9.12 There was concern that the interface between the AMU and key parties contributing to the update of PAF was poor and dysfunctional. Some respondents were concerned about the dis-inclination of Royal Mail delivery staff to report changes, the incentives (and disincentives) for them to do so, and the amount of time they invested in this activity. Some respondents questioned whether delivery staff are even aware of the requirement to provide address change information. For information provided by customers, one respondent felt the AMU did not always act on information provided and that closer cooperation with key contributors was needed.
- 9.13 This issue was felt to be most significant for the AMU's relationship with local authorities. No contractual arrangements, or even standardised procedures for information supply, exist for what is perhaps the most important supplier of address change information for PAF outside of Royal Mail.
- 9.14 Linked to this issue was a perceived lack of equity in the local authority relationship with the AMU; whereby Royal Mail compensates itself for its contribution through rebates in the charging for PAF, but local authorities receive no such compensation. Local authorities were concerned that they receive an unfair deal, receiving no recognition for the important role they play in up keeping the database but being required to pay high revenues to Royal Mail to use PAF. While not the biggest contributor of address change information, Leeds City Council commented that the local authority contribution *"... is of greater importance than implied by the figures because it relates largely to the creation of new addresses, a more important event than the modification of address labels for property records already existing."*⁴¹

Assessment

- 9.15 To some extent Postcomm's proposals are guided by the initiatives the AMU is making in this area and it is useful to consider these here.
- 9.16 Postcomm's view is that without secured address change information and regular updates the value of PAF is of a lower standard than it should be and

⁴¹ Postcomm's consultation incorrectly cited the contribution from local authorities to PAF as relating to 4% of changes. This is believed to be closer to 20% of changes.

will erode over time. This will reverse the 'virtuous circle' of value growth witnessed over the last decade. Condition 20 of Royal Mail's licence reflects this obligation; requiring Royal Mail to maintain PAF such that PAF is capable of being used to encourage good addressing. A primary objective of the AMU should be ensuring PAF accuracy.

- 9.17 In relation to PAF accuracy and quality, Royal Mail is aware of the scope for improving accuracy and is introducing a new quality management system. This may help address weaknesses in the current system which is sample-based and infrequently conducted.
- 9.18 A number of respondents argue PAF accuracy should be a higher priority and could be achieved through better / more efficient systems between Royal Mail and local authorities. Most recognise that there is a point at which incremental improvements will require additional cost and there is a balance between cost and accuracy, which is yet to be defined. Postcomm considers that Royal Mail and the market are best placed to decide whether increases in costs are warranted to achieve incremental improvements in PAF accuracy.
- 9.19 Postcomm recognises that Royal Mail is taking steps to produce a listing of multi-residency addresses; however it is not yet clear whether these will be included within 'core' PAF or sold as a supplementary dataset. Gaps in PAF such as multi-residency addresses will become more important in a competitive postal market, particularly where operators begin delivering business-to-consumer mail. It is Postcomm's view that any dataset that fills a 'gap' in PAF and is not easily replicated or created by the market should be regarded as core PAF and not sold as a value added product.
- 9.20 Postcomm is alert to respondents' concerns that Royal Mail makes decisions about changes to postcodes to suit its own operational needs. In practice, changes to postcodes are governed by the PAF Code of Practice which sets out the process individuals and organisations must go through in order to institute a change to a postcode. While the process for changes to individual postcodes is not the focus of this review, this issue is a good example of where a clearly defined process exists but stakeholder perception is poor because the change process is not widely communicated.

- 9.21 In relation to the interface with contributors, PAF updates and changes come from three main sources; local authorities, postal delivery staff, and customers⁴². While many updates come from postal delivery staff, the importance of the local authority contribution cannot be overstated. Local authorities are the statutory street naming and numbering authority for the UK and are, therefore, an irreplaceable source of timely and accurate new address data for PAF. Despite this the interface between Royal Mail and local authorities is not good, with no standardised procedures for exchanging information and largely manual data transfer processes. The absence of an effective interface reduces the timeliness, efficiency and accuracy of updates to PAF.
- 9.22 It is Postcomm's view, and that of a number of respondents, that the lack of formal arrangements represents a quality and continuity risk to PAF that is unacceptable. If local authorities ceased to supply PAF data, which has been hinted at, the quality of PAF would quickly erode. Importantly this erosion in quality would affect predominantly new properties causing problems with utilities, removing a vital marketing opportunity for many firms and affecting mail delivery.
- 9.23 In future, new address or address change information could come from other sources, for example, other postal operators. This issue was discussed at the PAF workshop in November 2004. BT saw a parallel between OSIS, where other telecoms providers contribute to the updating of OSIS, and PAF.
- 9.24 Like PAF, OSIS has to source new data in order to comply with an obligation to maintain the database. BT seeks to encourage providers to supply data by meeting or contributing to their costs. Different charges apply for different sources, but are based on objectively justifiable criteria. This appears to be a sensible and sustainable approach to ensuring continuity of supply of data needs for maintaining and updating PAF. Postcomm understands that Royal Mail is currently designing such an arrangement for PAF data suppliers.

⁴² For example, notification of new addresses through mail redirections.

PAF development

Respondents' views

9.25 Respondents saw a number of opportunities for improvement and innovation in PAF. Specific points were that PAF could be a core component of any broader national address database developed, and that Royal Mail should be aware of the opportunities presented to them by other addressing initiatives. Reference was made to previous initiatives such as Acacia, and it was recognised that the primary obstacle was individual agencies defending their IPR. Respondents felt that any future initiative would be constrained by IPR issues and the self-interest of data owners. The DUG saw PAF as a “... *fundamental component ... of the national data infrastructure. This should be driven by the needs of end users rather than suppliers ...*”. Royal Mail commented on its “... *ongoing dialogue with stakeholders on development opportunities ...*” and said it “... *is not complacent and has been proactive in seeking ongoing improvements to the file ...*”.

9.26 Ideas for developing PAF included:

- Develop an online enquiries facility for large users of PAF, subscription based (similar principle to the existing low user service).
- Research efficient methods for PAF updates to get to market more quickly (web etc).
- Maintain changes in the delivery point suffix (DPS).
- PAF to be linked to other national databases such as “*Standard Industry Classification (SIC) codes*” and local authority unique property reference numbers (UPRN).
- Non-geographic addresses (for example, PO Box postcodes) to become part of PAF and extending PAF to cover multi-occupancy addresses.
- Stop reallocating terminated postcodes.
- Develop a system to flag “*gone-aways*” within PAF.
- New postcodes to sit within existing sectors, and old postcodes available as a history file.
- Development of a mobile ‘personal’ postcode to enable people to be addresses regardless of where they are physically located.
- Introduce a PAF certification programme for bulk mailers and Bureaux.

Assessment

- 9.27 It appears to Postcomm that the variety of development suggestions indicates the variety of uses to which PAF is put and the future potential for PAF. It also signals a wide range of different applications and requirements that must be reconciled and balanced against relevant criteria, for example, cost.
- 9.28 Historically Royal Mail has been strongly of the view that PAF is a postal database first and foremost and a commercial application second. While PAF will always be a postal database, the contribution made by users to financing PAF makes them important stakeholders. It is Postcomm's view that both end users and VARs can make a valid contribution when it comes to decisions about innovation and development of PAF and that their views should be taken into account. Postcomm wishes to encourage the PAF development initiatives that are currently under way. It also encourages Royal Mail to welcome a greater degree of influence from external users. This is considered in Chapter 7 where an Advisory Board is proposed.
- 9.29 In relation to addressing initiatives, Postcomm encourages Royal Mail to cooperate with stakeholders and seek to find ways in which to promulgate PAF rather than restrict its use. An Advisory Board with the appropriate level of influence to drive change should help ensure that such decisions are at least informed by a wider interest than just Royal Mail's.

Proposals

- 9.30 Royal Mail is obliged to maintain PAF; the quality of PAF is of paramount importance to users. Postcomm proposes that:
- Royal Mail should secure key sources of information necessary to keep PAF current by formalising supply conditions and introducing contractual arrangements with suppliers that include performance measures and incentives / penalties for performance.
 - Royal Mail should continue, with greater reference to external users (including an Advisory Board), to invest in and develop PAF.
 - Royal Mail develop, in consultation with stakeholders, and publish on its website, quality measures and targets for PAF.

- Performance against these targets should be measured, with annual performance against targets published. This should include analysis of any exceptions or where it has failed to meet targets and the steps taken to ensure those targets are met.

9.31 Postcomm welcomes views on its proposals.

10. Ownership

Introduction

10.1 This chapter introduces the issue of PAF ownership and considers the extent to which a change in ownership might address the concerns raised by the review. Respondents' views are set out followed by Postcomm's assessment, which includes some benchmarking against relevant industries and countries, and Postcomm's conclusions are presented in relation to the question of ownership.

Background

10.2 Ownership was not a question directly posed by Postcomm's consultation but was widely commented on. Comment related in particular to the scope of the review and consideration of the question about the best way forward for PAF. Postcomm's consultation sought to focus on the issues and the appropriate solutions rather than the ownership of PAF *per se*. However Postcomm recognises that some stakeholders see many of the issues associated with the current management of PAF as directly relating to ownership. Examples of these issues include Royal Mail's desire to exploit the resource, the setting of preferential terms for itself, deliberate or unintended stifling of innovation and improvements and a lack of accountability to stakeholders.

10.3 Royal Mail is recognised under the PSA 2000 as the "*owner for the time being of the Postcode Address File*". Postcomm is not currently empowered to enforce ownership separation; this would require a change to the PSA 2000⁴³. Postcomm will seek, in the first instance, to address the issues raised using its statutory powers, but will consider the merits of ownership separation as part of its assessment.

Respondents' views

10.4 Some respondents felt that a change in ownership was the most effective way to address issues associated with the current management of PAF. But most felt a change in ownership was not the best solution. The MUA felt change was

⁴³ Although ownership might be considered as part of a Market Investigation Reference – see Chapter 3.

necessary to “... divorce ... Royal Mail’s fundamental right (as owner) to manipulate PAF to suit its own operational needs ... other PAF users have had to swallow the fact that ‘the owner’ can simply change, add or withdraw postcodes to suit their own routing requirements ...”. AFD Software commented that “... the ownership of PAF should be in the public interest ... Royal Mail could be licensed to operate PAF ... but should have to competitively tender for this licence ...”. UK Mail stated that “... the PAF should be owned, maintained, managed and licensed independently of Royal Mail under the remit of a public body or a publicly accountable provider”, but noted this would be “... the model to adopt if starting from scratch.”

10.5 Most respondents felt the problems identified by the review were best addressed through greater regulatory oversight, which would also be less disruptive to the market. Christopher Roper commented “*Provided Royal Mail is prevented from exploiting PAF ... we see no reason to separate PAF from Royal Mail. However, the safeguards need to be strengthened.*” If, however, it proved impossible to resolve these issues through behavioural remedies then some respondents believed ownership change should be reconsidered, highlighting the incentive and risk this provided to Royal Mail. Postwatch stated it was inappropriate “... *at this time to dramatically change the ownership of PAF, although ... this may certainly be a viable option in the future when sufficient competition has developed.*”

10.6 Royal Mail stated that it believes the ownership and management of PAF is outside Postcomm’s remit. However it recognises Postcomm’s wide ranging interest in furthering the interests of users of postal services and felt that the review provides a useful vehicle for this.

Assessment

10.7 Postcomm believes ownership separation provides scope for resolving some of the tricky issues identified by the review, in particular for addressing the competition issues presented in Chapter 6. For example, if PAF were owned independently of Royal Mail the incentive for the owner to show preference toward Royal Mail or to discriminate against Royal Mail’s competitors would be removed. Separating ownership also introduces a level of transparency that is difficult to achieve with internal ringfencing and serves to alleviate stakeholder concerns about undue preference of cross-subsidy.

10.8 Postcomm's view, consistent with the views of the majority of respondents, is that many of the issues highlighted by the review cannot be addressed by ownership separation alone. For example, independent of the owner an incentive remains to maximise profits with the risk of unreasonable or excessive prices or terms; in addition, the owner may show undue preference or discrimination toward users. Further, ownership separation is likely to have several undesired consequences including:

- A potential impact on Royal Mail's ability to meet its Universal Service Obligation.⁴⁴
- Limitations of Postcomm's powers over any new owner (especially in relation to achieving competition outcomes under Condition 10 and 11).
- A continuity risk arising from changeover and the need to source the address and postcode information to update and maintain PAF.

10.9 To inform further its thinking Postcomm considered how similar issues have been dealt with internationally and in comparable UK assets; this benchmarking is introduced below.

Benchmarking

10.10 To further inform its thinking Postcomm benchmarked PAF against two broadly comparable UK assets – OSIS (directory enquiry data "DQ") that continues to be owned and managed by BT, and UK phone number allocation that Ofcom manages on behalf of the telecommunications industry.

10.11 OSIS shares a number of characteristics with PAF and the DQ industry arrangements were designed to address many of the same concerns that have been raised about PAF. For example, like Royal Mail, BT is a vertically integrated firm with substantial market power in the supply of DQ data and a presence in the retailing of value added solutions. BT is required under Condition 7 of its Universal Service Regulations to:

- Maintain and update a directory information database on a regular basis.
- Make directory information available to any communications provider or person.

⁴⁴ Royal Mail requires PAF, or an alternative coding system, to meet its Universal Service Obligation (*Source: Royal Mail*)

- Make directory information available on terms which are fair, objective, cost oriented and not unduly discriminatory, and in a format which is agreed between BT and the person.

10.12 The solution employed to address competition and dominance issues in the supply of DQ data appear to have worked adequately and been proportionate to the problems they sought to address. It is also important to recognise the important role that BT plays in ensuring the base data is up to date; the risk of eroding continuity and quality would need to be managed if OSIS were to be separated from BT.

10.13 The management of UK telephone numbers was initially undertaken by the government owned telecoms provider (BT). However, the introduction of full competition in the UK telecoms market in 1994 saw the transfer of telephone numbering to Oftel (now Ofcom) to alleviate competition concerns about undue preference in the allocation of telephone numbers. The solution employed to address competition and dominance issues in the allocation of telephone numbers appears to have worked adequately and been proportionate to the problems they sought to address. It reflects the value attached to individual telephone numbers and the widely held view that telephone numbers are a UK national resource – not an asset of BT.

10.14 Postcomm also benchmarked PAF against arrangements for managing postcode files in Sweden, the Netherlands, Germany, Canada, the USA and Australia. Sweden, where the regulator has dealt with this issue specifically in relation to competition issues, has introduced greater regulation (but allowed Sweden Post to retain ownership) and equality of access to all operators. In Germany and the Netherlands the postcode file is managed and controlled by the national postal operator but ownership is vested in the community (so no royalties are payable for core data) - TPG (the Dutch Post Office) and Deutsche Post both compete in the market for value added services. In Canada, the US and Australia the postcode file is owned by the national postal operator; Canada operates a similar system of licensing postcode data usage to the UK (Australia and the US also license postcode data but do so for only a nominal fee)⁴⁵.

⁴⁵ International benchmarking and analysis provided by Arthur D Little and PLCWW, April 2004.

Conclusion

10.15 Postcomm concludes from its assessment that while separating ownership of PAF from Royal Mail may address many of the competition concerns presented in Chapter 6, it is unlikely to provide a material change in the need for regulatory oversight, i.e. independent of the owner there will still be an incentive to exploit the PAF resource. Further, removing PAF from Royal Mail would create a range of new issues and involve costs.

10.16 Postcomm's view is that it is possible to put in place arrangements to mitigate the risk of undue discrimination or preference and the other competition risks that exist⁴⁶. This is consistent with the majority of respondents' views and Postcomm's benchmarking of how similar issues have been dealt with in comparable resources. Postcomm also believes this approach is proportionate to the degree of concern within the market.

10.17 Postcomm believes that there may be an issue in relation to the allocation of postcodes, for example, to 'nests' of private boxes controlled by rival operators, but believe this can be addressed relatively easily⁴⁷ – as has been achieved in Sweden. In addition, the dynamics of the market make the risk of the incumbent controlling postcodes lower than with telephone number allocations – customers do not change their address when they switch operators (unlike switching phone providers where often a new number is required)⁴⁸.

10.18 Postcomm proposes no change to the ownership of PAF but that the measures described in Chapters 5, 6, 7, 8 and 9 are taken to address the issues highlighted by the review. This does not rule out a future change in ownership, and if the lighter touch approach proves unsuccessful, the situation should be reassessed.

⁴⁶ See Chapter 6.

⁴⁷ See Chapter 6.

⁴⁸ Telephone number portability has mitigated many of these issues in telecoms.

Annex A: Section 116 of the Postal Services Act 2000

*The Postcode Address File.*⁴⁹

116. - (1) The owner for the time being of the Postcode Address File shall-

- (a) maintain the File, and
- (b) make the File available to any person who wishes to use it on such terms as are reasonable.

(2) Compliance with subsection (1) shall be enforceable by civil proceedings brought by the Commission for an injunction or for interdict or for any other appropriate relief or remedy.

(3) In this section-

“the Postcode Address File” means-

- (a) the collection of relevant information which, immediately before the coming into force of this section, was owned by the Post Office, or
- (b) that collection as it is from time to time revised, and

“relevant information” means postcodes in the United Kingdom which may be used to facilitate the identification of delivery points for the purpose of providing postal services.

(4) The terms which may be imposed under subsection (1)(b) include terms as to the payment of such fee (if any) as the owner considers appropriate.

⁴⁹ D Section 116 requires the owner (currently the Post Office) of the database of United Kingdom postcodes (known as the Postcode Address File) to make it available to those who wish to use it, on reasonable terms and on possible payment of a charge. It also requires the owner to maintain it.
In force on 26 March 2001 – No.1 Commencement Order, Article 2(3) and Schedule 3.

Annex B: Royal Mail Licence Condition 20

Condition 20: Access to the Postcode Address File

1. For as long as the Licensee is the owner of or has control over the Postcode Address File (in this condition referred to as “the File”), the Licensee shall –
 - (a) maintain the File in an electronic format that can be read by computer software packages that are commonly available, and
 - (b) furnish a copy of the File to any person who may request it upon payment of a reasonable charge.
2. The Licensee may not impose as a term or condition (however expressed) of furnishing a copy of the File (or of any revision or update to it) any term or condition other than reasonable restrictions to ensure –
 - (a) that such intellectual property rights in the File as are vested in the Licensee are protected,
 - (b) that the File and any updates to it are utilised in an appropriate manner to encourage correct addressing, and
 - (c) that such reasonable charges referred to in paragraph 1 are paid.
3. Before the expiry of six months from the commencement of this Licence the Licensee shall –
 - (a) discuss and endeavour to agree with the Council, and
 - (b) establish and submit to Postcomm in writing,
a code of practice for modifying and updating the File, to be known as the PAF Code of Practice.
4. The PAF Code of Practice shall –
 - (a) set out procedures for ensuring that any persons or classes of persons named in the File that are likely to be affected by proposals to change the File (other than to make routine additions and deletions to it) are given –
 - (i) reasonable advance notice of such proposals, and
 - (ii) an opportunity to make representations and objections in respect of such proposals,
 - (b) set out procedures for ensuring that persons likely to be affected by changes in the File (other than routine additions and deletions to it) are given adequate notice of those changes,
 - (c) set out procedures through which the Licensee may be made aware of and reasonably respond to the needs and views of users of the File in relation to it, and
 - (d) shall be in such terms as may be agreed between the Licensee and the Council, provided that if –
 - (i) there has been no such agreement between the Licensee and the Council within the period of six months from the commencement of this Licence, and

(ii) Postcomm has given the Licensee not less than 28 days' notice in writing that it proposes to make a determination as to the terms of the PAF Code of Practice, and

(iii) Postcomm has given to the Licensee the opportunity in that period of not less than 28 days to make representations to it in relation to its proposal to make such a determination, then

the PAF Code of Practice shall be in such terms as may be determined in writing by Postcomm.

5. The Licensee shall –

(a) publish the PAF Code of Practice in such manner as to ensure reasonable publicity for it,

(b) at all times observe the provisions of the PAF Code of Practice, and

(c) not alter the PAF Code of Practice other than with the approval in writing of Postcomm.

Annex C: PAF and postal competition

Background

C.1 When Postcomm's initial consultation process concluded at the end of 2004 relatively little competition had developed in postal services. In the intervening period there has been rapid change in particular with DSA where exponential growth has occurred but also with the wider market. Reflecting this, Postcomm sought to validate its early assessment of the role of PAF in postal competition by speaking with a number of postal operators in late 2005. The discussions further informed the review and are reflected in Postcomm's proposals, the main points arising included:

Uses for PAF

C.2 DSA operators and E2E operators have different uses for PAF. DSA operators use PAF to pre-sort mailings, match the 'national posting profile'⁵⁰ and to segregate unsorted mail into the correct DSA codes. End-to-end operators use PAF to design their delivery networks (often postcode based) and individual delivery routes, to presort mailings and segregate unsorted mail to delivery route and to assist in defining delivery point lists and maps for delivery workers. In addition to these operational applications, PAF is used by both DSA and end-to-end operations for other applications such as billing, customer services and profiling. A number of operators also highlighted the importance of PAF to the parcels and express industry where often entire routing and delivery (and the supporting IT) systems are derived from PAF.

Importance of PAF

C.3 PAF is critical to both DSA and end-to-end business models. Without PAF it would be difficult if not impossible to use DSA. Equally, not having access to PAF would require the development and implementation of an alternative postal coding system for end-to-end operators. While theoretically this is possible, it would be extremely expensive and time consuming and ultimately would take many years to be as complete and effective as existing postcodes. Not all operators rely on access to PAF, for example networks of private boxes

⁵⁰ A postcode driven requirement of most DSA agreements.

(such as DX's long established network) has its own coding system. In addition some end-to-end operators with more manually based systems do not explicitly use PAF – though most use postcodes as the primary sorting instruction.

Views on PAF

- C.4 Postal operators recognise the important role that Royal Mail plays in managing PAF and consider it best placed to continue in this role. They highlight the need for equal access to PAF noting any preference to Royal Mail or discrimination against other operators (in terms of access or generally) could have disproportionate outcomes on the postal business. This view, combined with general concerns about overcharging, includes support for clear ringfencing of PAF activities – separate from Royal Mail's value added activities and postal operations. Operators were more explicit than VARs in drawing out the risk of conflict of interest if PAF is retained within Royal Mail's 'retail' business – where the incentive to secure an unfair advantage over competitors is greater. They also highlighted the need for tight controls over the use of information provided to Royal Mail when licensing PAF.
- C.5 Overall, operators felt that PAF was of a good standard and was an important part of the infrastructure of the postal market; they did however highlight some scope for improvement for example in relation to the efficiency of licensing arrangements and limiting the number of changes to existing postcodes. In addition there were concerns that some postcode or postal addressing information might not be included with PAF – for example multi-occupancy addresses, disadvantaging other postal operators.

Conclusions

- C.6 Royal Mail is best placed to continue its role as owner and manage PAF. Greater regulation of PAF is required to ensure it does not overcharge PAF users, discriminate or favour any party or derive unfair commercial advantage. It is also needed to ensure PAF is maintained to an acceptable standard and not starved of investment. PAF is a valuable part of the postal infrastructure and relied on by all postal operators, and most express and parcel operators to some extent with larger operators particularly reliant. Alternative routing codes are possible (the DX private box network uses separate coding) but no operator proposes creating a rival postcode and those who expressed a view felt this

would be inefficient and confusing, and unnecessary, provided PAF was readily available on reasonable terms.

Annex D: PAF Advisory Board

Overview

- D.1 This Annex presents an example of the possible structure and function of a PAF Advisory Board. It is provided as a point of reference or starting point for discussions between stakeholders, not necessarily as the optimal approach. Postcomm does not wish to prescribe the features of an Advisory Board as it believes this is best achieved by Royal Mail and PAF stakeholders; it does, however, expect to be involved in its development.
- D.2 Advisory Boards are used in a variety of contexts and across a wide range of regulated industries. Advisory Boards that function well produce considerable value for all participants. The company benefits from expert advice and industry experience; particularly in rapidly evolving markets or in situations where the incumbent's role is expanding. It provides stakeholders with the opportunity for strategic input into important decisions. An Advisory Board is also a demonstration of commitment to open consultation.
- D.3 Postcomm's view is that the Advisory Board should be established with a clear charter to grow the use, quality and subsequently the value of PAF. It would consist of industry experts and be reflective of key user groups. The Board would be consulted by Royal Mail on all relevant PAF related decisions and would have direct access to the Royal Mail decision maker.

Advisory Board

Clear Charter or Constitution

- D.4 To grow the use and value of PAF through encouraging sensible licensing, maintenance and quality policies and through advising on sound PAF investment / development decisions. In particular the Board will:
- Promote data hygiene and good addressing to the benefit of the postal industry.
 - Promote growth through anticipating and responding to new technologies and applications for PAF.

- Advise at a strategic and commercial level, not a technical or operational level, although separate working groups may consider technical issues.
- Promote innovation in PAF through consideration of development opportunities.

Membership

- The Board will consist of industry experts from relevant sectors – government, industry (end users), VARs, postal operators – plus a dedicated secretary.
- Members elected, based on a selection process that allows the right type and level of expertise to be included (Royal Mail would need to develop a person specification to ensure appropriate levels of expertise).

Administrative matters

- Memorandum of Understanding between the Board and Royal Mail establishing terms of reference and relationship.
 - Clear process for advising AMU and Royal Mail decision makers (on Royal Mail proposals and proactive advice).
 - Obligation on Royal Mail to provide information reasonably requested.
- Relevant information published including: charter, terms of reference, minutes and advice (etc).
- Terms of reference to capture role, objectives, membership, reporting.

Other matters

- Options for funding: Advisory Board to be resourced from PAF revenues (although other options may be considered).
- Meeting frequency, location, organisation (etc) as required to achieve objectives.
- Royal Mail would establish the Board with Postcomm approving the Constitution, terms of reference, and membership.

Annex E: Responses to the June 2004 consultation

E.1 Non-confidential responses to Postcomm's consultation "*Royal Mail's management of the PAF*" were received from:

- AFD Software
- Association for Geographic Information (AGI)
- Allies Computing
- Barrow-in-Furness Borough Council
- British Telecom (BT)
- Capscan
- Christopher Roper
- Communication Workers Union
- Demographics User Group (DUG)
- Digital Content Forum (DCF)
- Direct Marketing Association (DMA)
- Directory Enquiries industry combined (Absolute Data, BT Directories, i-CD Publishing, The Number UK)
- DNA-Scotland Programme
- Dr Robert Barr
- General Register Office for Scotland
- Hawliaith Mudiad Hawliau Ieithyddol
- Landmark Information Group
- Leeds City Council
- Lighthorne Parish Council
- Mail Users' Association (MUA)
- Office for National Statistics (ONS)
- Ordnance Survey (OS)
- Periodical Publishers Association (PPA)
- Perth & Kinross Council
- Postwatch
- Royal Mail
- Satori Software
- Scottish Executive

- South Gloucestershire Council
- Thomson Directories
- TPG Group
- UK Mail
- Welsh Language Board
- 5 confidential responses

E.2 Any confidential elements within public responses have been excised as requested by the respondent.