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Dear James,

POSTCOMM'S STRATEGY REVIEW – THE POSTAL MARKET 2010 AND BEYOND

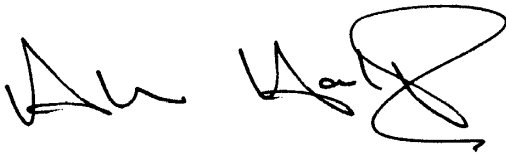
1. MUA thanks the Regulator for assisting in its work schedule by providing an extension to respond to Postcomm's Strategy Review. As with the Regulator's previous consultation on the same subject, MUA members are keen to provide feedback on emerging themes and opinion on where the UK postal industry may be going in the future, given that a reliable and cost effective postal service is integral to the success of their own businesses.
2. MUA members would begin by stating they believe the vast majority of the comments originally submitted in the association's response to Postcomm's first consultation, remain as pertinent now as they did at time of writing, and MUA has therefore attached a summary of these points. In addition to this, members would also wish to make a number of key observations they believe are relevant to the debate:
 - a) What ever proposed strategies Postcomm may eventually come up with to stimulate further competition in the market, MUA would stress business mailers require stability in order to run and develop their own business activities, and would urge Postcomm to bear this in mind when considering future regulation. MUA also believes that the lack of stability in the postal market is a major barrier to new entrants.
 - b) Another significant obstruction to the development of end-to-end delivery competition is the existing VAT regime, and in some way overcoming (or at the very least marginalising) the inequalities within the present arrangements must represent a key priority for the Regulator. MUA recognises this is not directly a matter for Postcomm, members would nevertheless urge the Regulator to champion resolution of this matter.
 - c) The UK postal market needs full and fair competition in place, because with it will come innovation. Without equitable competition in place, the need to regulate the market will carry on *ad infinitum*, and whilst MUA supported Postcomm's approach to market development 18 months ago, members remain disappointed that Postcomm's policies to

date have not driven forward the development of end-to-end competition. It is therefore important that Postcomm fully investigates why its policies to date have been ineffective, and re-considers the speed at which it moves from ex ante to ex post regulation.

- d) MUA considers Postcomm's attainment of a full and comprehensive understanding of Royal Mail's cost base remains a challenge. The Regulator needs to be extremely cautious about developing market opening strategies on the back of existing figures, in order to guard against creating market distortions. In short, members believe any decisions need to be based on figures that reflect full cost transparency, encapsulating every aspect of Royal Mail's operations.
- e) In many ways, Postcomm's championing of downstream access could be argued to have held back the development of full market opening, and is essentially viewed by many in the industry as being but one further stage of work share, rather than true competition *per se*.
- f) At present it is extremely difficult for a new market entrant to make a case for a viable end-to-end delivery network, not least of all because present access prices offer no scope for profit in final mile delivery. The failure of new market start ups such as Speedmail, Challenger and Express Dairies are representative examples of this.

3. I trust that the above comments and the attached documentation will be of use to you. Should you have any questions do not hesitate to contact me.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Alan MJ Halfacre', with a large, stylized flourish at the end.

Alan MJ Halfacre
Chairman
Mail Users' Association

POSTCOMM'S STRATEGY REVIEW – EMERGING THEMES

1. The Future of the Universal Service

- 1.1** MUA members believe postal users' needs from the universal service will change considerably over the next decade or so. What remains a given, however, is that in the next 10 years and well beyond, there will continue to be the need for provision of a universal service. Maintenance of a universal service in some form or fashion is not only in the interests of maintaining the social fabric of the UK, but also recognises that a large percentage of businesses will wish to continue to communicate with their customers through this medium, in some if not all eventualities.
- 1.2** Quite who delivers and collects universal service mail, at what regularity it is collected and delivered, and the cost customers will be expected to pay for it, are all debatable issues. MUA would start from the premise that the delivery of single item mail to every address in the country, and a collection service from all existing designated access points is a necessity – i.e. a single price for national delivery.
- 1.3** The ramifications of a universal service provider supplying a less comprehensive service either in terms of a significant reduction in collection points, or a marginalisation of the delivery addresses visited would only serve to arrest potential mail growth, and further encourage electronic substitution.
- 1.4** Differentiation between the needs and wants of users from the universal service is important. Although business mailers ultimately want to get their messages, magazines, transactional mail etc. to the final customer, even now they do not necessarily need them to be delivered to every household, everyday. Predictability and day-specific fall to ground assurances are increasingly becoming far more important criteria for business mailers, and MUA considers many businesses may well be prepared to pay a lower price for a more defined, but less frequent service.
- 1.5** MUA also considers that in the way the marketplace appears to be evolving (i.e. primarily through direct access agreements and downstream access), and in light of its previous statement concerning the importance it attributes to a fully maintained collection and delivery network, members consider the retention of bulk mail services within the universal service will become less and less relevant as competition enters the market.
- 1.6** This assumption is based on the fact that the real profit in mail distribution is, and will remain, in final delivery operations. It is, therefore, extremely unlikely that a dominant player (and/or universal service provider(s)) will withdraw products directed at the bulk mail distribution market, given that it is these mailstreams which provide economies of scale to sustain any final delivery network, and it is for this reason that the majority of new entrants have targeted the high volume bulk mailers.

- 1.7** Turning to the needs and wants of social mailers, an inherent problem the industry faces today, is that in many ways the future of postal services in the UK remains a politically emotive subject. Given the historical context in which Royal Mail has evolved in the lives of the voting public, more often than not it is the wants of social mailers that drive the political agenda and not necessarily their needs. Put another way, the average member of the general public wants to retain most, if not all, of the attributes of Royal Mail's universal service because it represents bedrock in their life.
- 1.8** Were the mindset of a generation of social customers to be in some way altered to the point where there was an acceptance that unless they want to pay a premium for a more comprehensive service, mail would subsequently only be delivered on a Monday, Wednesday and Friday, or that in future the cost of delivering the mail before 9.00am is more expensive, then those same customers might be more predisposed to recognise that their needs from a Universal Service (as opposed to their wants) are actually quite different. In those circumstances, it may be that social mailers would be prepared to accept a trade-off between the provisions of a less regular delivery service, for a cheaper more predictable one.
- 1.9** Other speculative thoughts concerning how the universal service might evolve include:
- Geographical pricing that offers price reductions for social mailers, such as discounts for the delivery of unsorted 'In County' mail;
 - better track and trace facilities for standard mail items, for instance the availability of over the counter 'pay for a premium' Radio Frequency Identification Systems (RFID transponder technology), that can be affixed to an envelope, allowing it to be tracked through the mail system from home, office or remote locations;
 - a re-direction service that will allow social mailers to segregate different types of mail for delivery to different addresses, for instance bill and bank statements to an office location, and magazines and direct mail to a home location.
 - Social mailers may also value predictable, designated-day deliveries for particular types of mailstreams. For instance utility bills and bank statements delivered on a Monday, enabling them to deal with them during the working week,
- 1.10** Returning to bulk mailers, MUA envisages business customers will be actively looking to alternative providers in a bid to trade off reduced daily delivery specifications, for lower prices. This again brings into question the feasibility of the universal service provider sustaining an 'every working day' delivery structure, given that a USP's economies of scale rest with bulk mailstreams.
- 1.11** MUA also envisages both business and the general public's use of alternative forms of communication will continue to exert downward pressure on mail volumes as uptake in existing and new technologies increase. This factor coupled with the afore-mentioned upstream competitive pressures and the potential for emerging downstream final delivery competition in the next 5-10 years, will continue to put downward pressure on the universal service provider's ability to sustain its obligation.

1.12 This having been said, MUA has always advocated the fact that the universal service need not necessarily be carried out by Royal Mail alone. Indeed there is a strong argument to say that in circumstances where Royal Mail is for some reason unable to finance the universal service due to its relatively high fixed costs, providing Postcomm is in possession of a fully quantifiable financial breakdown of the costs of the USO, it would be feasible to geographically break down the USO and/or offer it out for tender to incoming and existing postal operators under licence.

2. Promoting Effective Competition

- 2.1** Postcomm's policy toward downstream access has so far only facilitated the entry of competition that could viably have been expected to develop under the present market conditions. To date, Postcomm's downstream access policy has not facilitated the development of end-to-end competition, but has instead provided time for the incumbent postal operator to get its house in order, and make the transition from a monopoly supplier to a dominant player within a competitive environment. However it is acknowledged the level of the access price can change market dynamics between end-to-end and downstream access operators.
- 2.2** What members believe Postcomm's downstream access policy has done however, is enable a number of new market entrants to develop customer relationships, gain much needed knowledge of the market, and build some economies of scale and finances on which to form a platform for growth. These circumstances are no more or less than Industry predicted long before Postcomm's policy was put in place.
- 2.3** Against a back drop of a vastly dominant player with market strength, economies of scale, and in the presence of a VAT inequality which disadvantages incoming competition, members are not surprised end-to-end competition has so far failed to materialise. Members recognise the setting of VAT thresholds is outside Postcomm's direct control, but remain of the opinion that in order to ensure the emergence of end-to-end competition that is able to deliver solutions which continue to offer value to the customer, the VAT distortion needs to be addressed in some way, and members strongly believe Postcomm has a duty to continue to champion this cause.
- 2.4** Indeed, in discussions with alternative carriers it is clear until such time as the market is able to circumvent the VAT problem, it is inevitable any emerging end-to-end competition likely to develop will either be through the 'cherry picking' of lucrative urban conurbations, or through the provision of less regular delivery infrastructures to all but the least accessible addresses in the country. Once these and other barriers to entry are removed large international postal operators with equivalent market strength will begin to consider their options in the end-to-end delivery market.

- 2.5** In the meantime, however, as would be the case for any organisation in the same position, Royal Mail can be expected to aggressively protect its own interests. Even with Postcomm's policies on downstream access in place, upstream suppliers are raising questions about the inadequacies/inequalities of existing access arrangements, which in hindsight appear to have been the price for downstream access to occur in the UK. Whilst some may say this is only to be expected in the infancy of a competitive market, it is questionable whether Postcomm's light touch approach to regulation has been pervasive enough at this important juncture.
- 2.6** Whilst, MUA broadly agrees with Postcomm's belief that regulation should be targeted at those parts of the market where competition can be least expected, it would note that even in areas where competition is established, effective regulatory policing mechanisms need to be fit-for-purpose, to ensure no commercial advantage is gained by a dominant player.
- 2.7** MUA recognises regulating this transition will continue to be a challenge given the intrinsic problems faced by the incumbent postal operator (for instance its pension deficit), and the fact that the unique nature of the UK postal market as a heavily labour intensive operation does not necessarily lend itself well to comparisons with other industries and/or regulatory models. Nevertheless, members recognise Postcomm considers it is approaching completion of phase one of market liberalisation, and whilst it is entirely appropriate full and open dialogue begins on developing the market further, existing downstream access arrangements need to be made bullet proof first.
- 2.8** MUA is also of the view that it is not until Postcomm has enacted to remove the key barriers to the development of effective competition, and Royal Mail's improved efficiency programme has run its course, that customers will see the full potential of Royal Mail as a market innovator, rather than an organisation simply reacting to new found competitive pressures. In the main, therefore, Members consider the final delivery business strategies likely to be adopted by new market entrants over a 10 year period will most probably develop through geographical expansion of city centre delivery networks, brought about by the preparedness of large volume mailers to trial new postcode areas based on the success of existing business. These networks will either be serviced by their own upstream collection, sortation and trunking operations, or by alternative upstream providers other than Royal Mail.
- 2.9** Otherwise, MUA envisages the main competitor growth at least in the next five years, will continue to develop through downstream access. Existing and new market entrants will be looking to develop strategies to rapidly expand upstream activities, and in response Royal Mail will be likely to increasingly focus its energies on honing and developing its upstream activities in order to compete, probably via partnerships with some of the largest mail intermediaries. New entrants choosing the downstream access option, however, are also encumbered by the requirement to meet fall to earth conditions (i.e. the National Geographical Posting Profile) which in all but zonally priced access agreements, will to some extent limit their ability to develop final delivery networks alongside those operations.
- 2.10** Royal Mail's reluctance to date to make good on its commitment to develop a generic downstream access code is also not lost on customers seeking direct access agreements, and alternative providers looking for downstream access opportunities. Potential operational

barriers, 'such as more stringent mail specifications leading to greater rejection of mail, difficulties in meeting Royal Mail's need for volume forecasting requirements, not being able to use Royal Mail equipment, and Royal Mail's access window only allowing one delivery to go into a mail centre at a time', are all operational barriers which serve to complicate competitors' operations, in ways which do not affect Royal Mail.

- 2.11** Indeed, MUA remains concerned about the potential Royal Mail presently has to discriminate in favour of its own upstream operations and potentially restrict competition. As Postcomm has rightly pointed out vertical integration is not a problem *per se* when both stages (of a vertical supply chain) are part of the competitive market. However when a vertically integrated company has a dominant position in one market and also competes in a prospectively competitive market, it has the incentive, and the ability through its market power, to use its control over access facilities to restrict competition in other parts of the supply chain.
- 2.12** MUA therefore believes the development of sustainable end-to-end competition will be greatly enhanced by ensuring Royal Mail has no incentives to treat acceptance of mail from its upstream business more favourably than mail from rival upstream operators. Members would also concur with Postcomm that the elimination or mitigation of such circumstances may allow light touch regulation or even deregulation of some parts of the market, allowing Postcomm to focus its energies on the more non-competitive parts of the market, whilst offering Royal Mail greater freedom to take advantage of more sophisticated access pricing schemes.
- 2.13** Finally, in light of MUA's expectations regarding the future development of the UK postal market, members would not discount the possibility that over the next 10 years, the separation of various facets of Royal Mail's operations into independently managed and run businesses may be required, with perhaps Royal Mail's collection and final delivery network being separated from its upstream and marketing functions (the operational demarcation point in the infrastructure suggested as being the inward/outward mail centres).
- 2.14** Indeed, whilst MUA is united on the importance of implementing accounting/financial separation, once this has bedded in members would generally agree the need for further separation to provide increased transparency will have to be assessed by Postcomm, and will be dependent on how the market environment changes in response to other incentives put in place to stimulate end-to-end competition in the short term.
- 2.15** At present, it has to be said there is no consensual view amongst MUA members as to how far any separation needs to extend. There is a camp of members who believe providing there is genuine accounting/financial ring-fencing there is no need to move to a physical separation model. However, there are also members who believe the policing of virtual separation is fraught with problems, and a planned separation programme starting from accountancy ring-fencing and/or financial separation, but then leading on to management separation with the establishment of different corporate identities and cultures, and ultimately leading to operational separation in the future, may be in the best interests of the industry.

2.16 However, were Postcomm to decide to move in this direction, MUA members would state they believe the Regulator would need to develop a set timetable for 'stepped separation'. This would allow the Regulator to manage change in a financially viable way for Royal Mail, enable it to carefully control and monitor transition phases, and provide customers and stakeholders with stability in the market through a clear timetable for change.