

23<sup>rd</sup> November 2007

James Francey  
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Dear James,

**Postcomm's Strategy Review – "Emerging Themes".**

UK Mail welcomes the opportunity to contribute its thoughts on the future development of the postal market in the UK and Postcomm's role in ensuring that market is vibrant, customer focused and efficient.

The comments included here are not confidential and may be attributed to UK Mail.

UK Mail (UKM) sees five key aspects to be addressed by Postcomm over the near and medium future (through to the end of the next Royal Mail Price Control):

- 1) A stronger commercial focus for Royal Mail (RM) with clear equality of treatment for all its customers – through a change in corporate structure
- 2) A clear price control regime that provides a fair degree of commercial certainty for the development of competition
- 3) A re-specification of the Universal Service Obligation (USO) in a way that underpins basic service to mail users while not constraining opportunities for service development by all operators
- 4) A market environment that stimulates innovation and new competition
- 5) A regulatory regime that sustains downstream access as a prime engine for competitive development

These are covered in turn below:

*1) Royal Mail restructuring*

In an environment where RM's services are VAT exempt while the services of competitors are not, RM has a massive advantage. Couple this with RM's economies of scale and opportunity to selectively alter service pricing, and the balance is insurmountably in RM's favour – to the detriment of customers and competition.

RM, if allowed to differentiate or discriminate in its sales interface between retail and access or operationally between 'internal' and 'external' customers, will be able to throttle the development of sustainable competition either through the maintenance or extension of existing barriers or through the stifling of new Access product development.

There are already examples of such differences between retail and access and use of such differentiation and discrimination will deter market entry and potentially cause current operators to exit the market.

Although RM Wholesale has been established to act as the interface with access customers, this is more a response to regulatory expectation than true evolution of a distinct, commercial market interface and RM Wholesale does not seem to have the business targets that are necessary to ensure it behaves in a pro-liberalisation manner.

UKM does not believe RM Wholesale has the necessary, specific objectives and incentives to give it a commercial focus on encouraging the development of down stream access and postal competition more widely. Nor does it have sufficient authority or power within RM to effectively champion access users as vital customers.

In UKM's view, the lack of division within RM means there is insufficient transparency to show lack of discrimination between RM serving its internal and external customers. RM is driven too much by the self interest of striving against the development of competition and internal operational objectives.

This means that competition in the postal market has not been able to develop as it should and RM itself is denied the opportunity to benefit from commercial objectives to become more pro-active, more efficient and better at delivering quality service for all its customers.

Overall, this has not served the postal market well. The opportunity for RM to be the champion of mail as a communication and marketing medium has been missed. Postcomm's strategy must encourage RM to respond to customer needs – and deter RM from merely reacting against competition.

UKM believes that RM should now evolve a new structure that will allow it to realise a rejuvenated role as the catalyst and major driver of the postal market for the 21<sup>st</sup> century.

We suggest that the existing RM be divided so that its retail sales activities (i.e. those that deal with offering and supplying RM's services to 'end user' customers) are distinct from the rest of RM. There would be a "Network" unit that provided the operational delivery of postal services and included all the operational infrastructure, resource and capability.

Both RM Retail and other mail service providers (such as UKM) would then specify and buy postal services from RM Network. RM Network would have commercial incentives to improve its efficiency, its quality of service and to respond to requirements for new service specifications. RM Retail would market and sell to mail users the services it had specified and sourced from RM Network.

This model would be consistent with the approach Postcomm are recommending to RM of seeking opportunities for outsourcing and franchising. The commercial drivers on RM Network would encourage all practical cost reduction opportunities to be pursued.

UKM intends to commission an independent industry expert to expand on this suggested restructuring and will publish his report with the aim of stimulating further debate.

## *2) Price control*

The future structure of RM and the next Price Control are interlinked as price control must provide for clear, equal and fair prices that are based on known (to Postcomm) costs which are derived from consistent accounting allocation.

Postcomm's approach and requirements for obtaining cost information from RM must be published and the cost data must be capable of analysis in a consistently robust way for a number of purposes.

It seems that too often in the past Postcomm has had to make repeated requests for more or better cost data from RM. Recently, the inability of RM to provide cost data of sufficient quality was highlighted by Postcomm in the consultation document on the Interim Review.

RM is making much of the need for it to align prices to be more cost reflective and is currently arguing for Postcomm approval for major change on that basis (zonal retail pricing).

While it may be difficult to argue with prices being cost reflective in principle, it is unlikely that RM costs are fully efficient. In such circumstances, pricing to reflect incorrect costs only embeds such costs by providing the revenue to meet them.

In its strategy for the future, Postcomm should recognise that while "better cost reflectivity" in RM pricing is clearly to be looked for in a properly effective market, two concerns need to be addressed;

- the costs of which prices are more reflective must be efficient costs, not past RM costs
- RM must move towards better cost reflectivity in a consistent way for all services, rather than what seems to have been a rather selective approach where better cost reflectivity has first been pursued in competitive, rather than captive, areas.

Postcomm must also ensure in the Price Control that margin squeeze protection is maintained or enhanced – i.e. there is no opportunity for downstream access commercial headroom to be closed by mis-matched movements in access charges compared to retail prices.

This will be especially relevant with the implementation of Walk Sequencing over the next 2 – 3 years and changes to RM Retail product specifications. Walk sequencing effects inward mail sortation and final delivery operations to a far greater extent than upstream operations, so downstream access should see the same changes as RM Retail.

## *3) The specification of the USO*

There has in the past been much conflicting opinion on whether the USO is a “blessing or a burden”. For UKM, it is clear that the ‘every where, everyday” coverage offered by RM in providing the USO is a unique commercial benefit.

For the business mailers who provide over 90% of RM’s revenues, the USO offer is a key reason for using RM and it is hence those business mailers who are effectively paying for the USO.

But that does not mean the USO has to be in the future what it has been in the past. Some of the basic features of the USO should be challenged, for example: what constitutes the delivery address – the person, the physical premises or a mutually convenient place agreed by the recipient and the USO provider?

With a majority of consumer recipients of mail having left home before their mail is delivered, many would be receptive to collecting mail from locations which they visit as part of their daily life or are more convenient for working commitments.

Similarly, collection of mail from a secure postal box away from the recipient’s actual address could suit many in areas of otherwise low delivery point density.

The changing nature of communications, the work/life pattern of recipients and the expectations of mailers and recipients are changing. Trade-offs between the maximum service provision and the optimum combination of service and price are a common feature of consumers’ decision making.

With many of the current and future concerns about the sustainability of the USO being based on the costs of the present USO definition, changing the definition is an appropriate approach to greater sustainability.

If the USO were changed, the differing costs of delivery that are at the core of the argument for zonal pricing can be re-aligned and the very real danger of zonal pricing initiating a self reinforcing threat to the USO would be removed.

And an optimal rather than maximum specification for the USO may even mean other operators would come forward to take on the USO on a regional or national basis.

Clearly, whatever is provided as the USO in the UK has to fit the EU regulatory context and requirements. But there is general agreement that the USO is currently over-provided by RM - and there is no USO provision by any operator other than RM.

Also, Postcomm has a duty to protect the interests of certain groups of customers. The impact of a change to the USO definition away from delivery to the recipient’s premises would need to be considered but could be mitigated by, for example, providing delivery to the premises free for all recipients of certain state benefits.

We seem in the UK to have a USO defined more in terms of pre-existing RM service specifications than on requirements for the features that mail users experience. Hence the debate about the USO has been more concerned with questions such as “should MS 1400 be in while MS 700 and MS 120 are not?” than with “what constitutes a daily collection and delivery service?”.

The debate needs to be on what is required to provide the USO – not on what is it that's currently being provided which should be defined as meeting the USO requirement.

The conclusion of that debate may well be that more of RM's current services are considered as non-USO, meaning less regulatory control on them. But more importantly it should bring greater focus on what choices can be offered to both senders and recipients in deciding what features they want of the mail service for which they pay. And changing the USO specification should reduce costs, securing an internally financed, profitable USO provision

#### *4) Innovation*

There has been some criticism that the development of competition in the UK mail market has not brought significant innovation.

UKM would dispute that criticism as we believe there have been several major innovations by UKM itself and by other operators, such as the product specifications enabled by downstream access and the systems and procedures that provide far greater information and detail relating to mail and its conveyance than before.

However, it would be false to expect similar levels of radical innovation in mail as in e.g. telecoms, because the physical nature of mail places some very practical provisions on what is possible.

But it is possible to encourage new thinking by reducing core requirements to emphasise added value options and by providing common access to key enablers.

In commenting above on the USO, UKM has suggested a less stringent requirement than is currently specified and (over) supplied by RM. That could offer opportunity for innovation for senders:

- When do you want your mail delivered? What day of the week? What new ways of getting your mail to your customers would be worth paying for?

and recipients:

- Where do you want your mail delivered? How could mail get to you when you are not at home? How can electronic media best be combined with physical mail? What data do you want extracted without having to process each letter?

In the future each sender and each recipient should be able to say where, when and how mail is received – paying for added value options.

Innovation must address both the competitive threat of other communication media and the environmental concerns related to mail. The introduction by UKM (and others) of services that allow mail to be sent electronically for printing local to the point of delivery is an example of innovation aimed at addressing these issues.

But service providers can only innovate in a market where there is sufficient commercial opportunity to generate the funds for commitment to investment in development and sufficient confidence in the competitive parameters to justify that investment.

Postcomm needs to provide some of that opportunity and confidence through continued regulation of RM pricing and service provision in a way that is consistent over a full Price Control period (and between Price Controls), shifting over time as RM's position and the market change but not open to disruptive step changes and revisions.

Postcomm also needs to ensure that its strategy includes provision for enablers such as postcode files, redirection instructions and other facilities to be available to all operators on equal basis. Sole or internal access to such data or facilities has the opportunity to provide RM with an unfair competitive advantage over other operators.

Customers will always seek more innovation and it is the collective responsibility of the mail industry to provide new services and new specifications – and of Postcomm to provide a supportive regulatory context.

#### *5) Down stream access regulation*

Some of the important elements of this have been covered above (e.g. under RM Restructuring and Price Control). Another key aspect is whether there should be an "Access Code"

The current RM licence provides for downstream access through negotiation (Condition 9 Part1) or through RM establishing an Access Code (Condition 9 Part 2).

It maybe fair to say that the expectations of C9/1 have been largely fulfilled as downstream access now exists for a substantial volume of items representing a significant part of the mail market and in a number of forms – most recently the 'agency access' arrangements introduced in March 2007.

As contracts and prices for all of these forms of downstream access are publicly available to any prospective accessor, many of the purposes of an access code may be said to have been met.

There are then perhaps two key factors of an access code that may be in conflict:

- a) UKM's experience is that it has in the past been able successfully to negotiate with RM in concluding several new access specifications. But as RM is effectively the only provider of final sortation and delivery available to UKM, there have increasingly been times when UKM has felt it was in a weak negotiating position and had to accept unfavourable terms (the option of determination being only of absolute 'last resort'). The presence of an Access Code regulated by Postcomm could counter this RM 'power of dominance'

But...

- b) An advantage of direct commercial negotiation with RM is retention of commercial confidentiality and 'first mover' advantage, which under a public Access Code approach may well be lost. An Access Code might then act as a brake on innovation.

The commercial incentive to encourage an operator to innovate and establish a new specification is very important here. It should not be possible for subsequent operators to use an “access code” to alter an initial, negotiated agreement (unless illegal anticompetitive impact can be shown).

What UKM believes Postcomm hence needs to develop is an approach which mitigates RM’s dominance while leaving access developments to be commercially negotiated.

This might be done by summarising the principle elements of existing access specifications into a framework document that established the remit on which further access agreements would be based (e.g. what RM could, and therefore couldn’t, require), while allowing the detail of the specification to be by commercial negotiation. Prices would also be by commercial negotiation but informed by the principles of margin protection and ‘headroom’ provisions in the Price Control. However, UKM recognises this is a fine and difficult balance.

UKM understands that Postcomm will be consulting on a number of issues related to access early in 2008 and looks forward to responding more fully at that time.

Other comments from UKM in response to points in the Postcomm Strategy Review document:

#### 6) VAT

It is well known and generally accepted that the unequal VAT treatment between RM and other operators is the single biggest barrier to the development of effective competition – and hence the development of a vibrant, innovative and efficient UK market. Addressing this barrier is recognised as a strategic priority for Postcomm, to the extent that Postcomm’s remit allows.

#### 7) Licensing Framework

Postcomm will be considering fundamental changes to the licensing regime. UKM believes that it is vital to ensure that the regime continues to require a high standard of operation and commitment from all licensees, regardless of size. It is the current prospects for commercial success that have limited the number of new entrants into the mail market – not the existing license requirements.

#### 8) Move to greater ex-post regulation

UKM believes that *ex-ante* regulation must remain an important feature of Postcomm’s regulatory approach, because competition is not yet well enough established and because Postcomm’s *ex-post* regulation in relation to anti-competitive action in the past has not been sufficiently speedy or impactful. For *ex-post* regulation to be effective it must be seen as a real deterrent, not merely a potential inconvenience or a process that can be drawn out. UKM supports the view that Postcomm should have concurrent powers with the OFT.

#### 9) Service quality control

UKM understands the reasoning behind Postcomm's ideas on reducing the scope of mandatory service quality targets and recognises the potential for greater commercial freedom. However, the current access agreements (other than for Premium Access) have service performance compensation arrangements that are linked to those in the Price Control and would have to be revised if the ability for this linkage was removed.

UK Mail looks forward to contributing to the continuing discussion on Postcomm's strategy for the coming years and to responding on specific consultations.

Regards,

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