

Postcomm's Strategy Review

The postal market - 2010 and beyond:

Key questions for stakeholders

August 2006

Foreword

This consultation document seeks feedback from all our stakeholders about how Postcomm should develop its regulatory strategy so that it remains appropriate for the future needs of postal users.

Ensuring the continued provision of an affordable universal service and furthering the interests of postal users in the UK, where possible by promoting competition, are the two key statutory duties that Parliament assigned to the Postal Services Commission (Postcomm) in the Postal Services Act 2000.

During the first three and a half years of Postcomm's existence, the seven Commissioners – under the chairmanship of Graham Corbett – put in place a policy framework which they felt was most likely to secure these front ranking statutory duties. The programme of liberalising the mail market began in January 2003 when a third of the market, covering large bulk mailers, was opened to competition. It was completed on 1 January 2006 when Royal Mail's monopoly over the remainder of the market was removed.

I was appointed Chairman of Postcomm in January 2004 and since then have been working with fellow Commissioners in guiding the development of a mail market which provides the universal service and allows users to benefit from better service, more choice and greater innovation, all provided through the impetus of competition. A framework for the next stage of market development has recently been established by the new Royal Mail price and service quality control which came into effect from 3 April 2006 for a period of four years.

Postcomm has always sought to be open and transparent in its decision making and so all our policy initiatives have been informed by an extensive process of consultation. The policies we have adopted were informed by regulatory best practice in other markets. However, the mail market has some very different characteristics to other UK industries that have been opened to competition. In addition, the UK has taken a leading role in implementing the liberalisation agenda set out by the EC Postal Services Directive¹.

To date, our consultation with stakeholders has focussed on specific issues. Two recent examples are the scope of the Royal Mail price and service quality control – on which we

¹ The European Postal Services Directive 97/67/EC as amended by Directive 39/2002/EC.

had three separate consultations – and the nature of the obligations that need to be imposed on licence holders to assure consumer confidence in a competitive market. We believe it is now timely to seek the views of stakeholders about our policy framework or regulatory strategy ‘in the round’.

Royal Mail has had to contend with limited competition for over three years but only during the past 12 months has the momentum started to build. Thus far Postcomm's policies appear to have achieved their intended effects, although it is too early to make a fully informed judgement. Royal Mail is bringing costs under control and has raised its reported service levels in response to competition. We have sought a significant amount of feedback from key mail users and this has confirmed that competition is providing many of them with more product innovation, lower mail costs and greater responsiveness to their specific mail needs. The public have also benefited from Royal Mail's quality of service improvements.

At this early stage, we at Postcomm are particularly interested to see how the competitive market is developing. End-to-end competition is very limited, with most of the current new operator business models relying on access to Royal Mail's ‘last mile’ delivery network. Entry barriers remain high particularly because of Royal Mail's unique VAT advantage. Royal Mail also has the advantage of considerable economies of scale. As a consequence new entrants are finding it more difficult than expected to establish viable business models. Although Royal Mail appears to be doing many of the right things to ensure that it will succeed in a competitive market, it still has to tackle successfully the legacies of an under-invested network, poor industrial relations and a very large pension fund deficit.

Furthermore, the needs and expectations of mail users are changing significantly. As with telephony, technology is a major driver of change, particularly now that broadband is becoming so widely available. E-mail, text messaging, internet advertising and web shopping are all important developments which are impacting upon the usage of traditional mail products. This means that some of the things we take for granted could change as a result. Against this background, it is vital we ask some fundamental questions about what users need from postal services to ensure we maintain both a valued universal service and a vibrant competitive industry.

All this demonstrates why Postcomm needs actively and critically to assess the impact of its regulatory policies. We are following market developments very closely and are

seeking to collect all the information that we can to assess the effectiveness of our policies. In doing this we pay particularly close regard to the principles of better regulation which help guide us in the way we work.

These are the reasons why we are now asking stakeholders for their views on how the mail market is likely to develop in the years ahead and for their assessment of what regulatory strategy by Postcomm would be most appropriate for the medium to long term.

This consultation document – on which we are seeking responses by Thursday 9 November – sets out our current approach for each major subject area of our work, lists some key issues relating to those policies and poses some important questions where, in particular, we are seeking the views of all stakeholders.

Responses to this consultation – together with targeted research that we are conducting on some specific topics – will form the basis for a careful review by Postcomm of our current regulatory strategy. Our plan is to provide feedback to this consultation as early as possible in 2007, and, depending on the significance of the issues raised, to develop specific proposals as soon as possible thereafter. The review is unlikely to prompt any immediate or significant changes to key aspects of the approach Postcomm is currently taking in introducing competition into the UK mail market. Our expectation is that the review will help inform the development of our strategies over the medium to long term.

The value to be derived from this Strategy Review depends, to a significant extent, on the quality of the dialogue we have during the process with all stakeholders. As far as possible we will be meeting with key stakeholders for one-to-one discussions about these issues. We will also be holding an industry workshop to debate the most important of the issues on 10 October 2006 in central London. Lord O'Neill who was until last year the Chairman of the Trade and Industry Committee of the House of Commons, has kindly agreed to chair this workshop.

My fellow Commissioners and I hope you will give us your feedback and considered thoughts on all the key topics covered by this consultation. By doing so you can help ensure that Postcomm's vision of a range of reliable, efficient and innovative postal services, including a universal service, valued by customers and delivered through a competitive postal market, remains valid and that we take all the steps we possibly can to realise that vision.

Nigel Stapleton
Chairman

Summary

Purpose of this document

- S.1 Postcomm wishes to consult all stakeholders on the best long term regulatory strategy for achieving its vision for the market. Postcomm's vision is:
- 'a range of reliable, innovative and efficient postal services, including the universal service, valued by customers, and delivered through a competitive market'.*
- S.2 Postcomm often consults on individual policy initiatives, but the aim of this process is for it to take stock in a more holistic way and to assess whether our regulatory strategy is currently best aligned to achieving our vision in the medium to long term. The relevant horizon for the review is 5 to 10 years from today.
- S.3 The UK postal services market, worth over £6bn per year, is a vital means of communication and distribution for people, businesses and government. It can reach every door every working day and is held in special regard by the public. Postcomm would like as many stakeholders as possible to contribute to this process to ensure their views can be taken into account.
- S.4 This first consultation opens the debate by asking some key questions. These are necessarily high level at this stage. Postcomm will carefully consider all responses. The strategy that results from this process will be developed according to the principles of better regulation. It will help guide decision making on individual policy areas in the future.

Postcomm's current regulatory strategy

- S.5 Since it was established in 2000, Postcomm has sought to achieve its vision by adopting a regulatory strategy based around three core objectives. Underlying each of these strategic objectives is Postcomm's view that to achieve its vision for the market, there need to be successful, innovative and customer focussed mail operators.

- S.6 **Securing an affordable universal service.** This is consistent with Postcomm's statutory duties and the views of many postal users who want to ensure the preservation of a service that they value. Postcomm has pursued this objective by defining the scope and nature of the universal service with reference to Royal Mail's many products and services. The coverage was redefined by Postcomm in 2005 to ensure that it is a vibrant service that reflects changing customer needs. Postcomm ensures that Royal Mail has sufficient money to finance these services when it periodically reviews the control over many of its prices (the price control). Postcomm sets quality parameters for Royal Mail's services, and it then closely monitors its compliance with these quality standards. It also takes action where Royal Mail's performance falls short of these targets. Within the context of ensuring affordability of the universal service, Postcomm has also reviewed several initiatives by Royal Mail to bring its prices closer into line with its costs, for example, through its Pricing in Proportion application. Finally, Postcomm reviews those few individual premises where Royal Mail does not provide a daily universal service. Postcomm considers carefully the impact on the universal service of every major decision that it takes.
- S.7 **Furthering the interests of postal users, wherever appropriate, by promoting effective competition.** In a market that seeks innovation, flexibility and high levels of customer service, and that needs to respond actively to the threats and opportunities posed by new communications media, Postcomm believes that this strategic objective is best achieved through competition and not by the retention of monopoly privileges. Postcomm has, therefore, removed Royal Mail's statutory monopoly: for bulk mail in 2003 and for all mail in 2006.
- S.8 Postcomm recognises that merely opening the market does not in itself lead to effective competition and innovation if there are barriers to entry or other significant and sustained conditions that give Royal Mail an advantage over entrants. Postcomm's work has identified two such issues for special attention. First, Royal Mail's VAT exempt status provides it with a distinct pricing advantage compared to new entrants who have to charge their customers the full rate of VAT of 17.5%. Postcomm recognises that VAT policy is a matter for the Government, but has undertaken comprehensive analysis on its distortion to competition. Postcomm has consistently recommended to Government that a solution to the VAT issue should be found that levels the playing field but does not lead to a significant increase in prices. Secondly, Royal Mail's economies of scale from its national daily network carrying over 80 million items per day. Everybody benefits

from these economies as they give Royal Mail low unit costs and allow it to offer a relatively affordable price. However, it means that entrants find it difficult to compete even if they are efficient and even if Royal Mail is not as efficient as it could be. Postcomm has sought to address this barrier through the development of downstream access, which effectively enables operators to share Royal Mail's scale benefits by paying it for the 'last mile' final delivery.

- S.9 **Where appropriate protecting postal users by regulating Royal Mail's behaviour.** Postcomm undertakes three principal forms of regulation. First, it acts 'ex ante' to control the prices and service quality offered by the dominant player, Royal Mail. This helps drive efficiency improvements through incentives on Royal Mail to meet and beat price caps, whilst setting minimum standards on certain quality specifications valued by customers, thereby protecting postal users where they do not have an effective choice of operator. Second, it acts 'ex post' by investigating complaints and if necessary taking action to ensure that Royal Mail, in responding to competition, does not abuse its market power by acting in an anti-competitive way, for example by discriminating unduly between different types of customers or between operators that use access arrangements. Third, Postcomm imposes certain conditions on all licensed operators where minimum levels of customer protection are warranted, for example by including obligations within all operators' licences to ensure they handle the mail in a safe, reliable and trustworthy manner.
- S.10 Where appropriate, Postcomm has sought to reduce the extent of 'ex ante' regulation. For example, Postcomm has recently removed Special Delivery for large business users from the price control, has excluded genuinely new products from Royal Mail's price control, and has streamlined Royal Mail's quality of service targets. Postcomm has made it clear that it wishes to continue to reduce the scope of regulation and to promote the development of effective competition.
- S.11 These core strategic objectives are relatively uncontroversial as they are based on Postcomm's statutory duties and regulatory best practice. However, how these strategic objectives are achieved is the subject of much debate among stakeholders. There are also potential tensions and trade-offs between these objectives that must be identified and reconciled.

Rationale for reviewing Postcomm's regulatory strategy

- S.12 Postcomm's strategy for achieving its vision recognises that regulation will need to evolve over time. Postcomm believes that there are several reasons why it is now timely to review its regulatory strategy for the longer term.
- S.13 **Emerging competition is changing behaviour within the market.** The UK mail market is now fully open to competition. Postcomm has so far issued licences to 18 operators (including Royal Mail). The new entrants have a wide range of business models. Although, ultimately, some wish to develop end-to-end networks, most mail currently conveyed by competitors is given to Royal Mail for final delivery through access arrangements. Other entrants have identified value added niches to serve customers. The main benefit of competition is that new entrants have sought sustainable profit opportunities through innovation, for example by identifying new services and new ways of doing business in the postal industry. Some customers are benefiting from these new services and many of the largest mailers are using their new found bargaining power to get better value for money by shopping around.
- S.14 Competition is also starting to change behaviours within Royal Mail as it strives to ensure that it can meet the challenges of a competitive market. Since the market was opened to competition it has raised its game: both quality of service and profitability have increased significantly, making for a better customer experience and a stronger Royal Mail. With profits and quality of service both at or near record levels, the universal service is more secure than it has been since Postcomm was established in 2000. Although the deficit in Royal Mail's pension fund continues to weaken its financial position, the company has been put on a more sound long term footing with the combination of its 2006-2010 price control settlement and the recent financing package announced (provisionally) by the Government in its role as shareholder. Royal Mail is now about to embark on an ambitious modernisation programme and wishes to engage better with its workforce to ensure all its staff 'pull' in the same direction.

- S.15 Whilst the early signs from the fully liberalised market are encouraging, there is scope for competition to develop further. Royal Mail still retains almost 97% (by volume) of the licensed market. All but 0.2% (by volume) of the market share it has lost has been through downstream access, with Royal Mail retaining the majority of the revenue associated with access items. Some barriers to entry remain. Royal Mail has a statutory advantage from its unique VAT status, and it has the advantage of considerable economies of scale. New entrants are responding to increasing preference for greater choice but are taking longer to develop alternative delivery networks than some had previously anticipated.
- S.16 Postcomm is concerned to ensure that where customers do not have choice, Royal Mail does not simply seek profit opportunities by devaluing the service that it provides. Efficiency should be driven by genuine productivity improvements and innovation, not simply by cutting services or changing service specifications. A balance does, however, need to be struck between the value placed on the service by postal users and the costs to Royal Mail of its provision. It is therefore important for Postcomm, Royal Mail and users continually to reappraise the nature of the products and services Royal Mail is required to offer as part of the universal service. This is particularly relevant now that internet based products such as e-mail, web advertising and internet shopping are impacting upon the demand for traditional mail products and beginning to redefine what customers need from a universal service.
- S.17 **The market itself is evolving with changing customer demands and technologies.** The market has experienced modest mail volume growth of about 1-2% per year since 2000. Forecasts from Royal Mail and Postcomm (as part of the analysis for the recently finalised price control) suggest that this should continue over the next few years. However, Royal Mail's 2005/06 Regulatory Accounts show that overall, Royal Mail's total mail volumes² (from its regulated and non-regulated letters business) increased by only around 0.2% between 2004/05 and 2005/06. This may reflect changing customer demands. While Royal Mail's first class and second class volumes have fallen, it has experienced volume growth in Special Delivery (up 7.4% in 2005/06) in response to increasing customer demand for time certainty and security.

² Total Mails is the aggregation of total 'Price Control' products (excluding Door to Door), 'Other letter' products, 'USO Non Price Control' products and 'Downstream Access'.

- S.18 The evolving market may pose challenges to postal services from electronic substitutes for some mail volume such as social correspondence, bank statements, and bills. Some European countries have already experienced a decline in total mail volumes. There are, however, significant opportunities from the rapid growth of fulfilment of online transactions (e.g. 'eBay' type purchases) and from continued growth in advertising mail (direct mail). These dynamics could lead to a fundamental change in the mix of mail volume over time. For mail to stay competitive as a medium of communication and for mail to prosper, the operators must be cost effective, innovative and continually aligning and re-aligning their services to customers' needs. It is also important for Postcomm to consider how the universal service should evolve against the background of longer term trends in technology, availability of alternatives, customer preferences, costs of provision and so on.
- S.19 **Regulatory policy objectives are becoming increasingly inter-related.** Postcomm has always had to consider potential tensions between the universal service and competition. However, with the changing nature of the market the inter-relationships between policy objectives are becoming more complex. For example, the framing of the universal service obligation affects the degree of geographic pricing flexibility available to Royal Mail. This in turn influences the degree to which it can respond to localised market entry.
- S.20 Furthermore there are different views on the long term role of access, which is the Royal Mail service that gives other operators and major mail users the opportunity to utilise Royal Mail's facilities for 'final mile' delivery. Postcomm believes these views should be explored in more depth. It may be argued that greater regulatory ring-fencing and business separation are required to ensure greater cost transparency and to provide competitors with confidence in Royal Mail's operation of the access regime, given that its economies of scale may provide only limited opportunities for end-to-end business models. It could also be argued that access is an enabler of end-to-end competition by allowing operators to build customer relationships and scale. Alternatively, it could be argued that access may hinder end-to-end competition if a low price for delivery is set therefore making it difficult for other end-to-end operators to compete in delivery.

- S.21 **Postcomm is keen to ensure that it is applying an appropriate long term regulatory model.** With full market opening from 1 January 2006 and a four year price control settlement for Royal Mail now agreed, Postcomm has concluded that consistent with the principles of better regulation it should consider the appropriate long term regulatory framework. Postcomm believes that, in general, competition and choice further customers' interests better than detailed regulation. Therefore, it wants to consider more carefully the potential scope for deregulation and what needs to happen in order to achieve this objective. Postcomm wants to understand whether there are ways of regulating less but in more effective ways. This includes gaining a deeper understanding on whether all or some parts of the market are potentially contestable in order to consider the balance between 'ex ante' regulation (such as price caps) and 'ex post' regulation (such as responding to complaints about anti-competitive behaviour). This will inform Postcomm's decisions up to and including the next price control.
- S.22 In considering its appropriate long term strategy Postcomm must also take into account the discussions that are occurring at a European level and the introduction of a new Postal Services Directive in 2009. This could impact various parts of the regulatory framework and in particular the future definition of the universal service.
- S.23 In addition, changes to the Directive could require changes to the UK Postal Services Act ('the Act') or at least provide an opportunity for the Government to consider whether any changes should be made to the Act. Therefore, throughout this Strategy Review Postcomm will consult on its own regulatory strategy as well as consulting on whether the Act, as it is currently written, is appropriate for the postal market in the medium to long term.

The scope of this review

- S.24 Postcomm believes that its regulatory strategy has, in the main, been successful in its first five years. Postcomm has made progress towards its vision, especially in establishing the main building blocks, such as full market opening, access and a balanced quality of service and price control policy. Moreover, customers have benefited from competition, either directly through having a choice to shop around or indirectly through Royal Mail raising its game on quality of service. Postcomm now wishes to build on this progress to ensure it has a relevant vision and a strategy that is fully aligned to achieving it.

S.25 In addition to considering how the regulatory model ought to evolve to meet longer term challenges, a strategic context is required for some major decisions which Postcomm will need to make over the next few years. For example:

- Postcomm has said that it will keep under review the scope of the universal service and ensure that it continues to meet the needs of users as they evolve;
- Postcomm is likely to need to consider further applications from Royal Mail to change the structure of its prices. For example, Royal Mail recently announced that it wants to introduce zonal pricing for some of its retail tariffs (not covering its universal service products);
- Postcomm has frozen Royal Mail's access zonal pricing structure (under which instead of one price for national delivery there are five different prices for delivery depending on the geographic location of the recipient) for two years from April 2006, along with the margins available to operators (i.e. the difference between the access price and Royal Mail's end-to-end price for the equivalent product). It is intended that Postcomm will review these arrangements when further information is available from Royal Mail and other operators;
- Postcomm has committed to reviewing the appropriate ring-fencing and separation arrangements for Royal Mail;
- Postcomm needs to prepare for Royal Mail's 2010 price control review and wants to ensure that the detailed work is undertaken within the context of the most appropriate regulatory strategy; and
- Postcomm appreciates that the structure of the Post Office network will be important to postal users in the future. However, Postcomm understands that the Government may consult on the future of the social (rural and urban deprived Post Offices) network in the Autumn³ and does not therefore seek comment on the matter in response to this Strategy Review.

³ Jim Fitzpatrick MP, Minister in the Department for Trade and Industry, at the Trade and Industry Committee on 18 July 2006.

Key issues for this consultation

- S.26 Postcomm recognises that regulatory stability is a valuable facet of any regulatory regime, particularly when investments need to be made with long pay-back periods. However, Postcomm is also conscious that the mail market is evolving and will continue to evolve, and the regulator needs to adjust its strategy in the light of experience and new opportunities. Postcomm, therefore, is seeking a regulatory strategy that is effective in addressing longer term trends and challenges; hence the time horizon of this consultation is the next 5 to 10 years.
- S.27 Given its statutory duties and vision for the market, Postcomm believes that in order to review its regulatory strategy, it must seek to answer three fundamental questions:
- A. How might the postal market develop over the next 5 to 10 years?
 - B. What will postal users need from the universal service, given its cost, and how will it best be provided?
 - C. What is the best long term framework for promoting effective competition and deregulation?
- S.28 These questions are interrelated and lead to many further detailed questions. This consultation is designed to raise these questions and seeks stakeholders' feedback on how they ought to be addressed. Some of the key detailed questions raised in this consultation are set out below. We would like as many stakeholders as possible to consider all the questions in full. However we would also greatly value the detailed knowledge that specific stakeholders have of specific issues. For example, large direct mailers should feel free to comment about the factors influencing the future of direct mail and should not necessarily seek to forecast trends for the total mail market.
- S.29 This consultation document poses a large number of questions: some will be relevant and others will be less relevant for individual stakeholders. Postcomm therefore asks respondents to answer only those questions which are relevant to their particular perspective. Postcomm also appreciates that respondents may prefer not to address the specific questions but to use the questions as a basis for developing a critique of Postcomm's strategy from their perspective.

'Top 10' questions for stakeholders

Fundamental issue	Key issues for consultation
<p>A. How might the postal market develop over the next 5 to 10 years?</p>	1. The volume of which types of mail are likely to grow, decline or remain stable over the next 5 to 10 years?
	2. How are customers' needs likely to develop in the next 5 to 10 years in the various segments (e.g. business-to-consumer, business-to-business).
	3. How are operators' business strategies (both Royal Mail's and new operators') likely to change in the next 5 to 10 years?
<p>B. What will postal users need from the universal service, given its cost, and how will it best be provided?</p>	4. How will customers' needs from the universal service change over the next 5 to 10 years in response to developments in the postal market and other communication markets?
	5. How will the provision of a universal service be affected by the changing postal market and various trends such as competition, the cost of its provision, and people's increasing use of alternative forms of communication?
	6. How should the regulatory requirements of a universal service respond to the changes in the market?
	7. How should Postcomm allow Royal Mail greater pricing flexibility to remove cross-subsidies and what could be the impact on the affordability of universal service products?
<p>C. What is the best long term framework for promoting effective competition and deregulation?</p>	8. Does Postcomm's policy towards downstream access facilitate or inhibit the development of end-to-end competition?
	9. Assuming a secure universal service, should Postcomm consider a greater degree of ring-fencing or separation of Royal Mail's postal activities in order to promote competition and transparency?
	10. What more can Postcomm do to enhance customer benefits from competition and innovation, whilst providing the best prospects for deregulation?

Process and timetable

- S.30 As stakeholders will appreciate, the questions above are fundamental to how postal services' regulation may be shaped over the next few years. Postcomm therefore hopes that all stakeholders contribute to this debate.
- S.31 This document is subject to a three month consultation period. Postcomm therefore requests responses by no later than 9 November 2006. Postcomm encourages stakeholders to seek meetings with the team during this period so we can get a better understanding of how their business or postal needs are affected by regulation and any changes we might make. Our contact details are below.
- S.32 Postcomm will hold a stakeholder workshop to discuss this document and related issues in London on 10 October 2006. This will be chaired by Lord O'Neil, former chair of the Trade and Industry Committee of the House of Commons (TIC), which is responsible, among other things, for holding independent regulators such as Postcomm to Parliamentary account. Please contact Ruth Elliot (ruth.elliott@psc.gov.uk, 020 7593 2151) if you would like to attend this event.
- S.33 Postcomm will carefully consider all the input it receives to this consultation.
- S.34 Postcomm would, however, like to remind stakeholders that it is carrying out a separate review of Royal Mail's zonal access pricing and its intention to introduce zonal pricing for some of its retail bulk mail tariffs. Interested stakeholders should respond to both documents.

Contact details

- S.35 Anyone with views on the issues raised in this document should send their responses by 9 November 2006 to:
- Sophie Yorke
Postcomm
Hercules House
6 Hercules Road
London
SE1 7DB
- S.36 If you would like to meet Postcomm to discuss this review or have any questions please contact Sophie Yorke (sophie.yorke@psc.gov.uk, 020 7593 2129) or James Francey (james.francey@psc.gov.uk, 020 7593 2155).
- S.37 Stakeholders may make their response **confidential** if they do not want anyone outside Postcomm accessing it. All other responses will be published on Postcomm's website.