

## **GUIDANCE FROM THE POSTAL SERVICES COMMISSION ON ROYAL MAIL'S LICENCE AND COMPETITIVE TENDERS**

1. This guidance is for all participants in the UK postal services market – customers, suppliers of postal services and intermediaries such as mailing houses or agents acting on behalf of customers or suppliers. However, it is particularly relevant to customers who are considering issuing an invitation to tender, for the provision of mail services.
2. This guidance is not a substitute for the Postal Services Act 2000 or Royal Mail's licence. It should be read in conjunction with these legal instruments and other relevant EC and UK law. Any company in doubt about how it may be affected should seek independent legal advice.

### **Purpose of this Guidance:**

3. The Postal Services Commission (Postcomm) believes that the UK postal services market benefits from postal operators competing with each other on a fair basis and that as a result, amongst other things, customers benefit from innovative new mail services. Therefore, Postcomm wishes to encourage the introduction of new services tailored to customer demands while at the same time maintaining the level playing field necessary for competition to thrive.
4. Royal Mail is currently the main supplier of postal services in the UK. It can introduce new services for its business retail customers in two ways. First, it can add new services to its standard portfolio of services (and this might include new services added as a result of "bespoke" agreements with customers). Secondly, it can supply new services to individual customers under contracts won through a competitive tender. This guidance has been prepared by Postcomm for all business users of mail services in the UK to explain how the obligations in Royal Mail's licence are applied in relation to new services won through a competitive tender, which are referred to as "individual contracts". Individual contracts include contract terms - including prices, terms and conditions, and bundling of services – that are not ordinarily available to all business users. This guidance does not add anything more to the obligations in Royal Mail's licence, but seeks to reflect how those obligations will be applied to individual contracts.

5. Postcomm recognises that large business customers often have needs for postal services that are very specific to their business, e.g. linking collection times to internal business processes. Therefore, business customers' needs may often be best met by products and services tailored to their specific requests, even if the core product or service is a standard service offered by Royal Mail or another operator.
6. Postcomm does not want to restrict customers and operators, including Royal Mail, from agreeing arrangements like these that better meet customers' needs. However, Postcomm has to be mindful that Royal Mail's dominant position<sup>1</sup> in the regulated addressed letters market could allow it to apply different conditions and prices to equivalent transactions with customers. If this were to happen it could have a detrimental effect on the postal services market, by preventing the development of competition, thereby restricting customer choice in the long term. Therefore, Postcomm is concerned to ensure that any individual contracts agreed by Royal Mail are not anti-competitive and do not stop the future development of competition.
7. This guidance will be reviewed by Postcomm in light of market developments. Postcomm would expect that, in general terms, as competition develops, Royal Mail will be subject to fewer regulatory controls.

**Context:**

8. Postcomm has the statutory duty to exercise its functions in the manner which it considers best calculated to ensure the provision of a universal postal service. Postcomm also has a statutory duty to exercise its functions in the manner which it considers best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators. In addition, Postcomm has a statutory duty to carry out its duties in the manner best calculated to promote efficiency and economy on the part of postal operators. As part of its work, Postcomm may from time to time prepare and publish general advice and information to postal operators and users of postal services.
9. Royal Mail is the holder of a licence ("the licence") granted by Postcomm under section 11 of the Postal Services Act 2000 ("the Act") on 23 March 2001<sup>2</sup>. The licence places obligations on Royal Mail to provide the universal postal service within the UK<sup>3</sup> and to desist from any actions that could frustrate the promotion of effective competition between postal operators.

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<sup>1</sup> In its Competitive Market Review, published in October 2006, Postcomm calculated that Royal Mail retained a 97% share of the regulated addressed letters market (letters weighing between 0 and 350g and cost less than £1 to deliver).

<sup>2</sup> The Licence was amended on 1 April 2003, 2 November 2005 and 25 May 2006.

<sup>3</sup> Licence Condition 2.

10. Royal Mail is not precluded by its universal service obligation from entering into an individual agreement as to prices<sup>4</sup> with a customer. Therefore, in principle, Royal Mail may conclude individual contracts with its customers, which may include responses to invitations to tender, issued by customers for the supply of mail services. However, as the dominant operator in the UK regulated addressed letters market, Royal Mail has obligations under its licence and under UK and European competition law, which govern how it may offer such services.
11. The relevant obligations in Royal Mail's licence concern the provision of information and the price and non-price terms of Royal Mail's contracts with its customers and other postal operators. They are discussed in more detail below and are meant to ensure that Royal Mail's charges are transparent and non-discriminatory<sup>5</sup>.

### **Enforcement Powers**

12. Postcomm has the power to make an enforcement order ("final order") where it is satisfied that Royal Mail is contravening any condition of its licence, or is likely to contravene any such condition<sup>6</sup>. A final order is an order making such provision as is needed for the purpose of securing compliance with the condition in question. A final order may include a requirement that Royal Mail terminate the contract.
13. Postcomm also has the power to make a provisional order<sup>7</sup> where it appears that Royal Mail is contravening, or is likely to contravene, any condition of its licence. In deciding whether to make a provisional order, Postcomm will have regard, in particular, to the extent to which any person is likely to sustain loss or damage as a result of anything likely to be done or omitted to be done in contravention of the licence condition before a final order may be made. Postcomm may issue a provisional order at any stage and will not necessarily complete a full investigation before issuing a provisional order. A provisional order may require Royal Mail to terminate any contract agreed with a customer.
14. Additionally Postcomm has the power to impose on Royal Mail a financial penalty of such amount as is reasonable<sup>8</sup>, where Postcomm is satisfied that it has contravened any condition of its licence or is contravening any such condition.

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<sup>4</sup> This is permitted by Article 12 of the Postal Services Directive 97/67/EC (as amended by Directive 2002/39 EC) and section 4 of the Act.

<sup>5</sup> Postal Services Directive (see note 5).

<sup>6</sup> section 22 and section 25 of the Postal Services Act 2000.

<sup>7</sup> Section 23 and 25 of the Postal Services Act 2000.

<sup>8</sup> Section 30 of the Postal Services Act 2000.

15. Postcomm will consider each case on its merits and may apply these powers cumulatively. However, it is important to note that, generally, these powers will be enforced where Postcomm is satisfied that any term of an individual contract entered into by Royal Mail is contravening or is likely to contravene any condition of Royal Mail's licence.

### **Condition 7: Provision of Information**

16. Condition 7 of the licence applies to information relating to Royal Mail's prices and terms. Condition 7 requires Royal Mail to publish and to notify Postcomm and Postwatch of any changes to tariffs (including discounts and credit facilities), standards of service and compensation arrangements on licensed and non-licensed services not less than 3 months before they come into effect. The requirement to notify prices and terms allows Postcomm and Postwatch to keep up to date with Royal Mail's prices.
17. However, under Condition 7(5) individual contracts entered into by Royal Mail following a tendering exercise do not have to be published and notified 3 months before they come into effect. This is because Postcomm recognises that such an obligation might make it impracticable for Royal Mail to respond to competitive tenders. This only applies to competitive tenders which are open to other postal operators and to which such operators can reasonably be expected to be capable of responding.
18. Postcomm recognises that competitive tenders are unlikely to be straightforward and may not necessarily follow the same pattern. Therefore, Postcomm believes that competitive tenders should be defined as broadly as possible and would consider a competitive tender process to include all of the following characteristics:
  - It must be customer initiated and not initiated as a result of Royal Mail making an approach to the customer;
  - The customer will issue a written invitation to take part in the tender process to a minimum of two potential suppliers capable of providing the services required;
  - Suppliers are required to submit written responses to the invitation within a set timeframe;
  - Clarification meetings and negotiations on price may be held with all short-listed suppliers;
  - Any retrospective amendments to the competitive tender are discussed with and/or offered to all short listed suppliers;

- The customer holds detailed negotiations with the successful supplier;
  - There are no significant changes to the contract (services or prices) awarded to the successful supplier on which the shortlisted suppliers were competing (otherwise Postcomm would not consider the contract to have been awarded via competitive tender for the purposes of Royal Mail's licence).
19. Within seven days of entering into any such contract that it has been awarded following a tendering exercise, Royal Mail must provide a copy of it to Postcomm. If a written contract has not been concluded at that time a summary of its main terms and the name of the customer must be provided within that period. A copy of the written contract must then be supplied when it is concluded.
20. In enforcing this condition, Postcomm will regard a contract as having been entered into following a competitive tendering process at the earlier of a legally enforceable obligation to convey letters arising (including a future obligation) or of letters being conveyed and one or more of the terms of conveyance being attributable to the tendering process.
21. In addition, for each of these contracts, within 14 days after the end of each month, Royal Mail must give Postcomm and Postwatch details of the main terms of the contract including:
- Duration of the contract;
  - Prices charged (and the way the price was determined);
  - Weight and format of the items that will be conveyed;
  - Volumes anticipated by the contract;
  - Sortation requirements;
  - Points at which mail may be injected into Royal Mail's postal facilities;
  - Times at which mail may be injected into Royal Mail's postal facilities;
  - Target delivery times for delivery by Royal Mail and the percentage of letters to be delivered within such targets; and
  - The distribution of volumes of letters between postcode districts envisaged in the contract.

22. Royal Mail must also publicise these statements in such a manner as will ensure reasonable publicity (this includes on their website and publications such as sales brochures etc) within 7 days of providing them to Postcomm and Postwatch.
23. When notifying details of individual contracts that it has entered into under Condition 7(5), Royal Mail must provide a statement of the differences from its standard terms for the most closely comparable price controlled service. Postcomm may require Royal Mail to explain any differences from prices of standard products, differences in non-price terms and conditions from standard products and to substantiate how any price differences compared to standard products are justified by differences in product specifications. Postcomm would expect that any discounts offered by Royal Mail to its customers will be justified on the basis of cost savings made by Royal Mail and in line with the requirements of Conditions 11 and 21 of the licence (see below).
24. The notification process under Condition 7(5) does not represent an approval process. Postcomm may decide to review contracts, either on its own initiative or in response to complaints, at any time after they have been notified. Where Postcomm does review contracts, it will do so on a case-by-case basis. Postcomm reserves the right to review the operation of the Condition 7(5) provision at any time during the next price control if it believes its operation is counter to Postcomm's objectives.

### **Condition 11: Price and Non-Price Terms**

25. Condition 11 of the licence contains restrictions on Royal Mail with respect to behaviour which is damaging or likely to damage competition in the market. An explanation of the restricted behaviour relevant to individual contracts is set out below.

#### *Undue Discrimination and Undue Preference*

26. Undue discrimination and undue preference involve applying different conditions (price and/or non-price terms) to equivalent transactions or similar conditions to different transactions.
27. In practice, this means that if Royal Mail makes an offer to one customer, it must also make that offer available to all customers who can meet the terms of the offer. In addition, the terms of the offer must be fair and objectively justified; for example, Royal Mail cannot make an offer exclusively to one customer purely because that customer might otherwise take its business elsewhere.

28. Postcomm will take enforcement action where it is satisfied that Royal Mail has shown undue discrimination or undue preference towards a customer. This may include a provisional order requiring Royal Mail to terminate the contract with that customer and the imposition of financial penalties.

#### *Undue Restriction*

29. Undue restriction may arise where Royal Mail restricts its customers' ability to move to other operators in order to obtain a better offer.
30. Although Royal Mail may conclude individual contracts, it cannot tie a customer into that agreement if that customer finds a better offer elsewhere during the course of the agreement. Customers must be free to move to take advantage of better offers without incurring any charge other than that which is objectively justified (e.g., based on clearly identifiable costs). For example, Royal Mail may not include punitive clauses in its individual contracts that could prevent a customer moving to another mail operator.
31. In addition, Royal Mail cannot offer "exclusive contracts", whereby a customer receives a discount in return for buying all – or most – of its mail services exclusively from Royal Mail. While it may be reasonable to link discounts to volumes, it is important that such discounts are not granted in return for a customer's loyalty or fidelity to Royal Mail. Postcomm, as part of any analysis it undertakes, will consider whether these discounts are fixed objectively and applied without discrimination by Royal Mail. In addition, Postcomm will consider whether the discounts are objectively justifiable and the likelihood of identifiable cost savings. Similarly, Royal Mail must also be prepared to offer any part of an individual contract on an unbundled basis. In other words, if two or more discounted services are available in a contract, the same discounted services must also be available to other customers on an individual basis.
32. As with undue discrimination, Postcomm will take enforcement action against Royal Mail, where it is satisfied that Royal Mail has shown undue restriction towards a customer. This may include a provisional order requiring Royal Mail to terminate the contract with that customer and the imposition of financial penalties.

#### *Predation*

33. Predatory behaviour would involve Royal Mail deliberately incurring short term losses in order to eliminate competitors, or, in the case of individual contracts, discourage competitors from participating in tendering exercises.
34. Predatory behaviour is judged by the relationship between price and cost. The economic test used to assess whether a price is predatory or not states

that where a price is below average variable costs then predation can be assumed; where a price is above average variable costs but below average total costs, then predation can be assumed, if accompanied with evidence of intent to eliminate a competitor. However, different methodologies can apply to network industries such as the mail industry, where average variable costs can be very low. Furthermore, any assessment of predatory behaviour might also be influenced by the degree of market power exhibited by the dominant firm. Because of these factors, Postcomm would look to test for predatory behaviour on a case by case basis, examining whether or not the prices set can be justified on normal commercial criteria and whether there is a risk that competitors will be eliminated.

35. Postcomm will take enforcement action against Royal Mail, where it is satisfied that Royal Mail has engaged in predatory behaviour. This may include a provisional order requiring Royal Mail to terminate the contract with that customer and the imposition of financial penalties.

### **Condition 21: Price Controls**

36. Royal Mail's price control – contained in Condition 21 of its licence (“prices for postal services”) – prohibits Royal Mail from adopting new structures to pricing products which are price controlled without first obtaining approval from Postcomm (as they were required to do with their Pricing in Proportion proposals<sup>9</sup>). Postcomm's prior approval will be required in situations where Royal Mail intends to introduce geographically de-averaged prices for non-universal service bulk mail products which are price controlled. For price controlled products, Postcomm's prior approval will also be required for any changes Royal Mail makes to the structure of prices or where Royal Mail introduces discounts for innovative concepts such as predictability, capacity or volume.
37. The price control also regulates the relationship between Royal Mail's retail prices and their equivalent downstream access prices (for those access services offered as at 1 April 2006). If Royal Mail changes these retail prices, it must maintain the same price difference – or “headroom” – with the downstream access price<sup>10</sup>. This means that Royal Mail cannot lower retail prices without ensuring that the downstream access price is first lowered to maintain the minimum headroom. The regulation of headroom prevents competitors' margins being cut by lower retail prices.

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<sup>9</sup> “Royal Mail's Proposals for Pricing in Proportion”, Postcomm Decision Document, August 2005

<sup>10</sup> Postcomm will review the level of headroom between the retail and downstream access prices by April 2008

## **UK and European Competition Law**

38. In addition to its obligations under the licence, Royal Mail is also subject to potentially applicable UK and EC competition law. This is not qualified in any way by the conditions in Royal Mail's licence and includes:
- The Chapter I and II prohibitions within the Competition Act 1998;
  - Articles 81 and 82 of the EU Treaty; and
  - Market investigations under the Enterprise Act 2002.
39. The Office of Fair Trading (OFT) has the power to apply and enforce the Chapter I and II prohibitions and Articles 81 and 82 (further details can be found in the Competition Act Guidelines on the OFT's website<sup>11</sup>). However, there is potential overlap between the roles of Postcomm and the OFT in this area. Thus, there is a Memorandum of Understanding<sup>12</sup>, which aims to promote co-operation and co-ordination between Postcomm and the OFT when dealing with cases of anti-competitive behaviour for which they have overlapping powers.
40. The European Commission also has the power to apply and enforce Articles 81 and 82<sup>13</sup>. The OFT has also been empowered under Part 4 of the Enterprise Act 2002 to make market references to the Competition Commission for the investigation of particular markets.
41. This guidance should not be interpreted as Postcomm's view on any existing contracts with, or contract negotiations by, Royal Mail.

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<sup>11</sup> [www.offt.gov.uk](http://www.offt.gov.uk)

<sup>12</sup> <http://www.postcomm.gov.uk/competition/anti-competitive-behaviour.html>

<sup>13</sup> [http://ec.europa.eu/comm/competition/index\\_en.html](http://ec.europa.eu/comm/competition/index_en.html)