

# **USO Exceptions**

## **A submission from an excepted address**

8/11/2006

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# 1 Summary

- 1.1 Mailers in general seem unaware that the daily delivery is non-universal, and that the only service universal throughout the UK is weekly. This has an impact on any mailer using time sensitive processes standardised for customers throughout the UK (such as most banks and utilities), or using the mail in synchronism with other timed or day sensitive initiatives (such as mailings announcing commercial promotions). Whilst, obviously, any USO frequency and associated cost has to be affordable (ie, Royal Mail has to be fully funded for it from the tariff), the Price Control illustrates that more than sufficient revenues are available for a delivery frequency that actually meets the needs of banks and utilities - such as a minimum three deliveries weekly. And access prices are agreed at a sufficient level to profitably reward Royal Mail for its delivery network. It is unclear, then, why Postcomm permits Royal Mail to charge its customers for this more frequent delivery, but then to unnecessarily reduce the delivery frequency to a little as once weekly, causing process and compliance costs for both mailers and for recipients.
- 1.2 In the consultation Postcomm has published, for the first time, the costs of reaching these last 5 addresses in the USO. The figures show that the USO isn't a burden, and never has been because revenues have always much more than covered costs - and no service is a burden if the service tariff covers its costs and appropriate profits. (In fact the Obligation is there only to prevent Royal Mail making supplementary extra monopoly profits by choosing not to serve even where it has received sufficient revenue to do so and has accepted timed mail for delivery.) Postcomm says that each address costs on average £4,000 per year - this sounds a lot of money, but in fact senders have already paid for this (and paid at least £9m more than this, it turns out). The uniform tariff is not set to underfund RM - on the contrary, it is set to cover delivery on all routes, from the cheapest to the most expensive; senders willingly pay their 32p even though it is much more than needed to reach city and suburban addresses, so that they can also reach all other addresses at the same uniform tariff. The principle of averaging the tariff is uncontroversial, and widely supported - it is much simpler than having to pay separate tariffs for every place or distance any mail item has to travel. The uniform averaging of the tariff does not result in senders paying less than needed to reach every address - the tariff gives Royal Mail £344m profit - and Postcomm even fined Royal Mail £9.6m this year for quality problems - illustrating that senders have, obviously, paid more than enough to reach every address promptly.
- 1.3 And just to keep things in perspective - Royal Mail spends more on throwing away rubber bands than it saves by refusing to deliver promptly to the last few addresses in the USO.
- 1.4 The minimum delivery frequency mandated in the 2003 Direction has never been shown to be a *necessary* restriction of the USO. Alternative frequencies of 3 deliveries weekly, say, more or less meet society's needs, are already paid for, and would avoid all the current problems.
- 1.5 The 2003 decision did not discuss the necessity for restriction, nor the reasons why other delivery frequencies were inappropriate. As a result of the inappropriate minimum frequency decision, and Royal Mail's intention not to

budge from it irrespective of the harm caused, those affected have incurred substantial losses. Addressees have had to procure the more frequent deliveries that senders' time critical mail required, while Royal Mail has been able to charge users enough to deliver their mail promptly and instead pocketed the receipts for its own purposes.

- 1.6 This effect, of denying mailers their right under Article 3 to reach addresses, while charging them to do so, was not the intention of either the legally mandated USO, or its provisions for exceptions. Allowing this to happen results in extra costs of late delivery. Sometimes these costs were borne by the sender, sometimes by the recipient, sometimes extra deliveries are procured at significant cost to avoid late delivery. These extra costs, coming on top of the costs already paid by users, result in users not only paying the full price for delivery they are denied, but also paying the costs arising of late delivery. Users are paying 'twice'. The provision for exceptions was definitely not intended to raise the costs to users in this manner.
- 1.7 The provision for exceptions was intended to provide a mechanism for Postcomm to ensure that the cost of delivery everywhere, the USO, would not exceed the revenues from an affordable tariff. EC guidance, and the regulatory literature, makes frequent reference to the possibility of reducing service level to reduce the cost of the USO to users. But over-excessive reduction actually raises costs - as soon as the service becomes sub-optimal, as soon as extra deliveries have to be procured or money is spent solving problems caused by time-expired mail, consequential costs begin to bite. Analysis of the costs of delivering to the last 5 addresses in the UK (just 5 - goodness me, what has regulation come to?), the only ones Royal Mail has chosen to serve so poorly, show that the tariff already covers the cost of delivering to them. Given that funding is available, common sense suggests that there is no need to restrict so extremely, since senders of mail do need to reach every address promptly.
- 1.8 It is not clear from the consultation why Postcomm has not published this analysis itself, nor placed it before consultees, nor explained whether the decision to allow service to be so restricted was necessary, let alone desirable, nor checked what the effects of its decision are. None of these aspects are covered in this consultation. Instead, consultees are asked only to comment on whether anything has changed - implying that the 2003 decision is desirable. Postcomm seems not to consider the possibility that the 2003 decision was sub-optimal and has led to difficulty - this despite these issues having come up in an appeal.
- 1.9 Intervening to set a minimum delivery frequency of one delivery weekly unnecessarily, with serious consequences for users, appears to be inconsistent with the legislation, jurisprudence, and principles of Better Regulation. Postcomm has never stated what its intention is in restricting deliveries to one weekly - a clear objective is a requirement of Better Regulation. Without an objective (preferably on which it has consulted and shown to be desirable), it is difficult to comment on whether the decision to reduce the USO to one delivery weekly at some addresses is proportionate.
- 1.10 In this submission I show that there is no necessity for such an extreme restriction of the USO, and that a higher delivery minimum delivery frequency

will achieve Postcomm's (probable) objective of ensuring the USO remains affordable.

### **2003 Decision is sub-optimal**

- 1.11 Postcomm's 2003 decision insofar as it relates to those island and mainland addresses not served by road or ferry and only accessible by boat is flawed:
- in not meeting the needs of senders it breaches Articles 3 and 5 of the Directive
  - it ignored requirements of EC legislation and guidance
  - the cost of the necessary deliveries to those few addresses are not, under Postcomm's proposals, fully funded from USO revenues
  - it failed to assess the affordability of more frequent delivery at these addresses
    - and it ignored evidence that more frequent deliveries are easily affordable
  - it took no account of necessity and proportionality
    - the need for such an extreme exception has not been assessed or shown
    - the consequential costs of the exception unnecessarily and disproportionately borne by users have not been assessed
    - the private benefit to the service provider has not been justified
  - it showed scant regard for sparsely populated areas of fragile local economy
    - and ignored the effects on small businesses in such areas
  - it is based on a fictional presentation of alternative means of communication
    - and on criteria that did not form part of the 2003 consultation.
  - its implication that administrators should not expect that all citizens be able to participate in normal societal processes (in effect, that administrators forego their right to use the postal service for time sensitive mail) drew on powers the regulator does not have.
- 1.12 It was drawn from a consultation that:
- was incomplete
  - did not present all the relevant factors affecting an exception decision
    - employing an incomplete representation of the issues, and
    - exposing only those factors consistent with the regulator's temporary determination that some addresses should be served only once weekly irrespective of the needs of senders to those addresses, and reckless of the consequences for senders and recipients
  - did not place the principles of the EU Directive or guidance before consultees

- omitting reference to EU guidance that service provider profitability is determined by the regulator setting tariffs
- omitting discussion of whether the service provider required relief from an (unstated yet in practice trivial) amount of cost of the USO, and if so, in providing that relief
  - whether public or private benefits arose,
  - whether the exclusion arising was proportionate to the relief sought, and
  - which of several options for providing that relief might be preferable.

### **The 2006 consultation**

1.13 The present consultation fails to address most of these points, either, only mentioning the possibility of problems for businesses and acknowledging that telecommunications might not be the substitute Postcomm first thought, but not addressing the remainder. It is disappointing that consultees are denied the opportunity to see those aspects and principles, all of which might be expected to have been of some interest and applicability in the case. The need to consider consequential costs, for example, is even a UK procedural requirement - mandated in the Treasury Green Book, itself a requirement of Better Regulation - though not apparently employed in either 2003 or this consultation.

## 2 Public Law, the Directive & EC guidance

### European Directive (ref 1)

#### *Article 22*

2.1 Article 22 requires that Postcomm enforce the Directive. The duty is especially relevant for those parts of the Directive overlooked in the domestic legislation:

- The grant of a right to reach, in Article 3
- The absence of discrimination, the prohibition on dissimilar service levels, and the meeting of senders' needs, in Article 5
- The need for regulatory decisions to be made independently of the service provider

#### *Operational independence*

2.2 Postcomm's stated obligation to consult with the service provider in determining exceptions has no explicit basis in law, and is only to be found in Royal Mail's licence. Article 22 requires that Postcomm be legally separate from and operationally independent of the service provider.

2.3 In law, Postcomm is separate, but it is independent only if it makes decisions without simply adopting the suggestions of the provider at the expense of the public interest, that of senders of mail. Yet Postcomm appears to have sanctioned the undertaking given by Consignia at the time of the 2003 consultation of 1 delivery weekly, without any objective rationale. Article 22 requires exception decisions to be made independently of the service provider - ie the regulator must independently determine what the exceptions should be, using his own, independently derived, objective assessments including review of the affordability of alternatives. Reading of the 2003 decision document does not suggest that Postcomm has done so. Postcomm has always sought a consensual way forward but this should not be at the cost of pursuing a thorough analysis or correct assessment of the frequency needed by senders.

2.4 Royal Mail is well placed to inform Postcomm about aspects and facts of the postal industry - for example, Royal Mail can very usefully inform debate about quantitative aspects of the USO. But service provider attempts to limit service instead of becoming efficient are exactly the abuses that the Treaty provisions and the Directive seek to avoid - and regulators are independent precisely so that provider assertions will be probed and tested.

#### *Article 3*

2.5 Article 3 grants 'users' a 'right' to a Universal Service, an element of the Directive not transposed into PSA 2000. The Act described the USO as a delivery service at all points, shifting the emphasis away from users, resulting in more emphasis on serving recipients and allowing questions to be raised of whether recipients should be served rather than whether senders should be able to reach them. The central principle is that delivery from sender to recipient is paid for by senders through the overall revenues from the affordable tariff. In practice, because of the absence of concern for the needs of senders, the

regulator in 2003 presented the USO as a service to recipients, rather than a vital service for senders to reach. Senders' need to do so is important, often statutorily based, even if the recipients are in remote areas.

- 2.6 Postcomm's duty under Article 3 is to ensure the user's right to reach at an affordable tariff. A delivery frequency of one delivery weekly is consistent only with mail of less than 9 days sensitivity to delay. Article 3 expressly confers the right to deliveries at 'all points in the territory', and does not suggest that some points should only be reachable by non-urgent mail. Postcomm has not reconciled this requirement with its proposal for one delivery weekly.
- 2.7 Postcomm has not presented to consultees the implications of Article 3 for senders of administrative mail (from whose processes not even remote residents are exempted) - that Postcomm must provide senders with a postal service that enables administration to proceed normally. Neither did Postcomm advise consultees that its powers have been granted so that island and mountain areas can be served adequately - such an important objective that market sectors could be reserved or prices arbitrarily set to ensure SP profitability and sufficient funding for the USO.

#### ***Article 5***

- 2.8 Article 5 of the Directive, which does not appear in PSA 2000, places important extra requirements on the USO. Consultees are left unaware that Postcomm's discretion to determine the USO is constrained by Article 5, which states:
- 2.9 Each Member State shall take steps to ensure that universal service provision meets the following requirements:
- (i) it shall offer a service guaranteeing compliance with the essential requirements,
  - (ii) it shall offer an identical service to users under comparable conditions,
  - (iii) it shall be made available without any form of discrimination whatsoever, especially without discrimination arising from political, religious or ideological considerations,
  - (iv) it shall not be interrupted or stopped except in cases of force majeure,
  - (v) it shall evolve in response to the technical, economic and social environment and to the needs of users.
- 2.10 Article 5 has 'direct effect'. This means that even though not transposed into domestic law, its provisions can be enforced in court, or relied upon.

#### ***EC guidance***

- 2.11 The EC guidance on application of the Treaty's competition provisions to the postal sector permit "competition rules of the treaty not to apply to postal services, to the extent necessary to ensure the provision of a universal postal service"
- 2.12 Postal services can only be excluded from the Treaty's competition rules to the extent necessary to ensure the USO. The European Commission published guidance notes on the application of Community Law to the Postal Services which usefully point out some of the abuses it seeks to avoid. Taking account of them helps avoid institutionalising as an exception what might previously

have been a market abuse by a dominant provider. In practice, the Directive's requirement for independent regulation is intended to limit the possibility of these abuses. But none of this was placed before consultees in 2003, or in this consultation; rather, Postcomm cites only the provisions giving it power to determine exceptions but does not help consultees understand why independent regulation was considered essential. Neither did Postcomm explain to consultees the types of abuses that the European Commission sought to avoid, even though exactly those abuses were occurring at the time of the 2003 consultation. Royal Mail refused to deliver to some addresses, delivered only infrequently to others, and provided a better service at a few more - the service was inconsistent and breached the non-discrimination requirements in EC law. The service provided did not meet senders' needs and particularly affected addresses in remote areas.

2.13 Postcomm did not reveal these aspects to consultees. By not doing so, Postcomm prevented consultees unfamiliar with the EC's guidance from commenting in an informed manner. Since Postcomm drew on consultees' responses as endorsing a minimum frequency of one delivery, it is important to note that consultees may not have been given the full picture before being asked to comment - consultees' endorsement of the 2003 proposals is unreliable.

2.14 The references below refer to the sections of the Commission's guidance (ref<sup>2</sup>).

## *2. Market Definition and Position*

### *(b) Dominant position, para 2.7, p14*

“Another type of possible abuse involves providing a seriously inefficient service [... ..] The examples given illustrate the possibility that where they are granted special or exclusive rights, postal operators may let the quality of service decline and omit to take necessary steps to improve service quality.”

The Commission goes on to observe, *para 2.8 p13*

“Unjustified refusal to supply is also an abuse prohibited by Article 86 [now renumbered 82] of the Treaty. Such behaviour would lead to a limitation of services within the meaning of Article 86 [now 82], second paragraph, (b) and, if applied only to some users, result in discrimination contrary to Article 86 [now 82], second paragraph, (c), which requires that no dissimilar conditions be applied to equivalent transactions.”

### *6. Measures adopted by Member States*

The Commission explains in para 6.4, p18, that Member States should employ an independent supervisory authority to monitor potential abuses.

## *8. Service of General Economic Interest*

### *(a) Basic Principles*

The Commission describes the service of general economic interest as consisting “primarily in the provision and maintenance of a universal public postal service guaranteeing at affordable [...] tariffs [...] the timely delivery of such items to the address indicated. [...] The universal service is to evolve in response to the social, economical and technical environment and to the demands of users.”

### *(b) (ii) Conditions for the application of Article 90 (2) [now 86 (2)]*

The Commission gives as an example of an element of the universal service “the possibility of every citizen in the Member State concerned, and in particular those living in remote areas, to have access to newspapers, magazines, and books”. The Commission notes that “the Member State must take action” to implement a delivery service [referring, in footnote 31 to its competition guidance ref 2, “according to Article 3 of the Postal Directive, Member States are to ensure that users enjoy the right to a universal service”].

***Public law principles***

- 2.15 PSA 2000 makes it clear that Postcomm’s secondary duties to service providers are without prejudice to its first duty. Postcomm must determine a USO without letting secondary considerations guide it to unnecessary limitations of the USO.
- 2.16 A legal discretion is never unfettered. Public Law principles (the Wednesbury principle, Denning in *Breen v AEU*, Reid in *Padfield v MAFF*) require that Postcomm direct itself in accordance with the statutes. Those principles require that discretion only be applied to further the objectives of the legislation.
- 2.17 Postcomm would have no legal basis for seeking to achieve an objective of limiting the cross-subsidy or the cost of any route. Neither is limiting the aggregate cost of the USO a reasonable objective despite its link with the affordability of the tariff - limiting the overall cost of the USO is only permitted if otherwise the USO tariff would be unaffordable. Any other objective in limiting the cost of the USO is not consistent with the legislative requirement that other considerations are without prejudice to the USO. If while fully funded, limiting any route cross-subsidy were to limit the USO such that users’ needs were not met, or different service levels were provided in comparable circumstances, contrary to Article 5, then the approach would contravene both the specific Domestic and European legislation, and established principles of Public Law. The exceptions have to meet users’ needs, be consistent, and only be proposed if essential to ensure that the tariff remains affordable and uniform.
- 2.18 If the costs of a USO are fully funded from USO receipts, then a USO is not a burden in any sense at all. While fully funded, Postcomm should not have proposed, in the 2003 consultation, exercising its discretion with the intention of limiting an imagined burden on Royal Mail, leaving users to incur extra costs to ensure timely delivery to coastal addresses, for three reasons.
- Firstly, limiting the burden on Royal Mail is not an aim or objective of the legislation. The legislation asks Postcomm to encourage economy, which is different. Economy is to do with the internal efficiency of the provider in meeting the defined USO, not with the scope of the USO which is separately defined in statute and is specifically protected in PSA 2000 from this subsidiary duty. Economy might demand that a route be served by vehicle (be it postvan or boat) rather than a helicopter. Economy on the part of the service provider cannot demand that a route simply not be served adequately.
  - Secondly, the USO has to meet senders’ needs. Hence Postcomm must exercise its discretion in a manner that furthers the aim, instead of undermining it.
  - Thirdly, consultees should have been advised of the limits to the discretion.

- 2.19 Similarly, Postcomm could not exercise its discretion by mandating a service level to remote addresses rendering them, in effect, unreachable within time, with the intent to limit the cross-subsidy. Again, the same two principles apply: the intent has to be lawful, and the discretion must not frustrate the aim of the legislation. Capping the cross-subsidy for individual routes is not an objective of the legislation. And, the USO has to meet senders' needs and Postcomm must further that aim.
- 2.20 Both these examples of questionable discretion were proposed by Postcomm in the 2003 Consultation document, paragraphs 3.1, 3.34, 4.3 refer, and presumably still play a part in Postcomm's stance. Conspicuously absent, then and now, was any evidence of the balance - between the private benefit to the service provider, and frustration of the public rights granted by the Directive for all users to reach all points in accordance with their needs.
- 2.21 Exceptions which merely enable the service provider to avoid cost and thus avoid having to grapple with more fundamental inefficiencies to meet the affordability objectives, or to fend off competition, merely institutionalise a private benefit. Exceptions were not intended to create private rights for the service provider, while passing extra costs to users.

### 3 Better regulation

3.1 Postcomm cites the Better Regulation principles in the consultation. The Better Regulation handbook explains what these mean, and it is clear that these principles are central to any regulatory decision Postcomm made or may make to restrict the USO:

#### 3.2 Proportionate

- Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.
- Policy solutions must be proportionate to the perceived problem or risk and justify the compliance costs imposed – don't use a sledgehammer to crack a nut.

3.2.a These two requirements mean that before intervening, that is, before restricting the USO, Postcomm has to have decided that an intervention to restrict USO frequency is necessary. Postcomm has never shown any necessity for intervening to restrict the USO frequency, nor has it published any data or research that suggest any frequency restriction is necessary. However, it is possible that the costs of maintaining 6 deliveries weekly everywhere in the UK, including all the offshore islands presently not served by a daily ferry, and the 135 other coastal addresses might, just might, not be covered by the existing tariff. This might be true because the costs of procuring ferries on days when there are none might be sufficiently expensive to be unaffordable with the existing tariff. Hence an objective might be: reduce the USO costs so that they are covered by the tariff.

3.2.b The second requirement would then come into play, if the Better Regulation guidelines were being followed. The policy solution must be proportionate; don't use a sledgehammer to crack a nut - ie, not excessive. Of course limiting delivery frequency to once weekly would solve the problem, but so might limiting frequency to three weekly. Restricting delivery from 6 to 3 weekly is less excessive than restricting delivery from 6 to 1 weekly. To determine which frequency restriction is appropriate, Postcomm has to consider frequencies of 5, 4, 3, 2 and 1, and has to select the least restricting frequency that is consistent with the objective of bring the USO costs under the tariff. That should be a candidate for minimum delivery frequency. But there are further tests as well, see below in this section.

#### 3.3 Accountable

- Regulators must be able to justify decisions, and be subject to public scrutiny.
- Proposals should be published and all those affected consulted before decisions are taken.
- Regulators should clearly explain how and why final decisions have been reached.

3.3.a The accountability requirements do not affect the reaching of the minimum delivery frequency

**3.4 Consistent**

- Government rules and standards must be joined up and implemented fairly.
- Regulators should be consistent with each other, and work together in a joined-up way.
- New regulations should take account of other existing or proposed regulations, whether of domestic, EU or international origin.

3.4.a Consistency between regulators, with Government, and with forthcoming regulations are all recommended. The guidelines do not say something which presumably the drafters of the guidelines thought should be obvious - that Postcomm's decisions should themselves be consistent - consistent with other related decisions (such as the Price Control), consistent with the research data used to guide related decisions (such as surveys of customer needs, and findings in the USO scope decision). Unfortunately, the 2003 decision, which is the basis of the one weekly delivery,

- Did not utilise the data available in the Price Control which was going on at the same time,
- did not draw on customer survey data already gathered by Postcomm,
- Suggested that the Directive was out of date and would not require a USO today despite having assisted the Minister to give effect to the revised Directive, which not only re-iterated the need for a USO but also re-inforced the need to serve mountain and island areas such as those it wanted to serve badly

3.4.b The 2003 decision is not consistent with other Postcomm decisions at the time, and the inconsistencies help to lead to its flawed decision. If Postcomm had drawn on the material available in the other work it was undertaking, it would have:

- Had a robust profitability model into which it could test whether 3, 2, or 1 delivery weekly was affordable
- Understood what senders' needs were
- Been less likely to conclude that the Directive's mandate of a Postal USO was old-fashioned and out of place today

**3.5 Transparent**

- Regulators should be open, and keep regulations simple and user-friendly.
- Policy objectives, including the need for regulation, should be clearly defined and effectively communicated to all interested parties.
- Effective consultation must take place before proposals are developed, to ensure that stakeholders' views and expertise are taken into account.
- Stakeholders should be given at least 12 weeks, and sufficient information, to respond to consultation documents

3.5.a The policy objective giving rise to the need to reduce deliveries to once weekly still has never been defined.

3.5.b Consultation in 2003 on the minimum delivery frequency was ineffective because consultees were not given sufficient (or any) information about necessity for the restriction, the alternative frequencies that could have been considered, the legal constraints on Postcomm's discretion, the guidance in European Law, the principles of necessity and proportionality, any analysis of mail roles, current uses, and typical senders - unsurprisingly, many consultees responded without taking account of any of these factors. The few representations that did draw Postcomm's attention to those other aspects, and supported them with evidence were ignored. The findings in the 2003 decision do not therefore accord with the better regulation principles of transparency, and as such its conclusions may not be reliable or dependable.

### 3.6 **Targeted**

- Regulation should be focused on the problem, and minimise side effects.
- Regulations should be systematically reviewed to test whether they are still necessary and effective. If not, they should be modified or eliminated.

3.6.a Without the statement of the 'problem', as recommended elsewhere in the guidelines, it is difficult for Postcomm to focus its regulation of a minimum frequency. Costs can easily be kept within the affordable tariff even if these last 5 addresses were served three times weekly.

3.6.b Three deliveries weekly would avoid all the (presumably unintended) side-effects of compliance failure, consequential cost, loss of trade, etc that arise from the unnecessarily extreme restriction of one delivery weekly.

3.6.c So if USO cost is the problem, focused regulation could lead to a minimum of three deliveries, and avoid the side effects.

### 3.7 **Better Regulation**

3.8 As well as citing the better regulation principles, we strongly urge Postcomm to follow them in this consultation. We urge postcomm to:

3.9 Define the objective in intervening on delivery frequency

3.10 If the objective is at all controversial - for example, if it appears to prejudge a solution, or an extreme condition - consult on whether the objective is supported, and whether a different less prescriptive objective would achieve the same result. For example, users might prefer that Royal Mail becomes more efficient, to keep its costs below the tariff, rather than be allowed to cut services excessively. Or if the objective is merely to relieve Royal Mail of around £20,000 of efficient USO cost - users might prefer that the USO is not compromised just to create a private benefit for Royal Mail.

3.11 Identify the different interventions that might be adopted, and analyse the costs and benefits accruing to each - including the consequential costs in accordance with Green Book principles. Identify the least extreme intervention.

3.12 Consult on the deployment of the preferred option, with full information about the other options and how the preference was derived.

## 4 Necessity and Proportionality

- 4.1 Necessity and proportionality are important concepts in regulation. The Better Regulation principles encapsulate them and so do very many UK and European legal judgements. In essence, Postcomm can only restrict the rights to daily delivery if it is necessary to do so, and it can only do so to the extent necessary to solve whatever problem has been identified. The jurisprudence goes one step further - the objective of the regulatory decision itself has to be lawful and cannot be some whim of an official or Royal Mail.

### No necessity shown

- 4.2 In making exceptions, Postcomm has to consider their necessity, and whether the effect of the exception is proportionate to the aim. The 'necessity and proportionality test' fails if Postcomm mandates delivery frequencies that did not meet the needs of senders, because senders may have to procure deliveries at the full economic cost, or may expect recipients to subsidise them. Neither of these is consistent with the principle of the affordable tariff covering the cost of delivery (nor is it equitable). Senders require uniformity of delivery times so they do not have to operate different, special, procedures to cater for delays to some addresses. Those with time-critical requirements would have to keep records of those addresses for which they must employ non-standard procedures and non-standard mailing systems - such systems and procedures are costly, and costs would be incurred by virtually all administrations and companies.
- 4.3 Postcomm has not undertaken any cost/benefit analysis in respect of the USO - we had expected it to do so before deciding any exceptions. Even the appeals process only offers to consider route costs, and does not offer to consider the costs of the lost benefits foregone by senders and society, or the consequential costs arising. Yet the Treasury Green Book recommends all these costs be quantified.
- 4.4 It is hard to see any public benefit arising from extreme frequency exceptions and Postcomm has cited none, but a private benefit to the service provider certainly accrues, albeit tiny. The cost savings will typically be £4,000 a year for each of the 5 addresses affected out of the UK's total of 27,000,000. Postcomm has not said what the costs to the rest of the UK might be.
- 4.5 In Annex 1 we show that the public will never see these savings. They will simply be absorbed into profits by the service provider, effectively providing a private benefit, a double private benefit for the provider since limiting the USO saves the service provider making other efficiency savings.
- 4.6 Full arguments were offered in the 2003 consultation but at that time Postcomm appeared neither to take them into account, nor to explain why they should not be engaged. The arguments remain valid, and are repeated:
- 4.7 In respect of Exceptions, Postcomm should not:
- i cause correspondence of senders of mail, or correspondence intended for any addressee to be impeded unnecessarily,
  - ii cause an addressee to suffer loss, or

- iii show overt, intrinsic, or implied predisposition, unless there is
  - iv an overriding societal advantage at stake (as opposed to a private benefit to the service provider),
  - v no other way in which society could achieve its needs, such as the service provider becoming more efficient,
  - vi provision in law to cause that damage,
- and
- vii the degree of damage is proportionate, ie the damage is the minimum necessary to achieve that objective,
  - viii the exception service level still meets needs of senders especially for time-critical mail, and
  - ix the exception service level is comparable to others in similar conditions

- 4.8 In essence, these are the public policy necessity and proportionality principles. These are also the Better Regulation principles of objectivity, necessity, proportionality, and transparency.
- 4.9 Exceptions must also have been determined in a manner that is wholly independent of the service provider, ie draws from the needs of society and the nature of the geography rather than being constrained by service provider attitudes, inefficiencies, historic or current practices, the provider's present cost estimates and network routing designs, its convenience, offers, or preferences
- 4.10 The 2003 decision appeared not to explain the minimum frequency relating to coastal addresses in terms of geographical difficulty or distance of address, but instead in terms of demographic sparseness at addresses easily reached by a sub-contractor. Yet the sender's need to reach is not diminished just because there is no other nearby address. Indeed, the Inland Revenue, say, is statutorily barred from treating sparsely located taxpayers any differently from taxpayers on denser postal routes. Hence the Inland Revenue expect taxpayers on all postal routes to respond to 7-day notices.
- 4.11 We suggest that Postcomm should not have limited the USO through capping the cross-subsidy in order to limit the service provider's expenditure - doing so effectively safeguards the service provider's existing inefficiencies, and lets the service provider avoid serving.
- 4.12 These are the exact inversions of Postcomm's statutory duties to ensure a USO and promote economy. Parliament required Postcomm to encourage the provider to seek more efficient ways of serving the address, rather than rewarding its inefficiency and denying senders the opportunity to send mail timely to the address.
- 4.13 The test for an exception should be simply - is it otherwise unaffordable (ie, does it raise the tariff by some observable and unacceptable amount), and is it necessary and unavoidable?
- 4.14 In conclusion, Postcomm has never objectively justified a minimum frequency in terms related to the affordability of the USO as a whole, but in terms of cost of an individual route. The need and right of senders to send mail to an address

is not diminished because one route is more costly than another - different routes will always incur different costs.

### **Unsound basis for 2003 decision**

4.15 The reasons Postcomm cited in 2003 for restricting the service to coastal addresses include:

- a fictional view of alternatives available to rural communities
- a vague prediction about processes senders of mail may use in the future
- speculation about demographic change,

none of which was consulted upon, or supported by any evidence, and none stands up to examination. The reasons are covered in detail in a later section, below.

### **Exception unnecessarily extreme**

4.16 Postcomm has shown no necessity for such an extreme exception.

4.17 In the Introduction, Section 1, of the 2003 Decision document ref 4, Postcomm suggests that

4.18 Exceptions “affect only a very small proportion of the UK population” (1.11), [some 20,000 senders of mail are affected, including the most important government departments and half the FTSE 100 companies.] Postcomm’s use of the word ‘only’ implies that such a small minority is somehow unimportant.

4.19 ‘*Exceptions affect only a small number...*’ We have estimated that some 600 individuals and organisations write to us. The severe restriction of the USO therefore affects not only residents of the coastal addresses, but the thousands of other mail users, including many FTSE 100 companies (from financial institutions to utilities), and nearly all government departments, who wish to write to them. Effectively, first class post is delayed up to a week - longer (if the mail just misses one week’s delivery and has to wait seven days for the next), so no sender of urgent mail can be sure of reaching the recipient in time for it to be dealt with. As an example, we were unable to meet the requirements of Swinton Insurance (part of Royal & Sun Alliance plc) for return of a new motor insurance proposal within 7 days - with one delivery weekly, we cannot be sure to receive the form within that period let alone deal with it and return it. We have never received a DVLA reminder in sufficient time to complete the form, post it back with enclosures to DVLA and receive back the tax disc.

4.20 Article 3 of the 1997 European Directive indeed allows for exceptions to the daily delivery, as Postcomm mentions (2.7 ref 4), but in “circumstances or geographical conditions deemed exceptional”. Not *different* but *exceptional*. Dr Begg, Chairman of Postwatch Scotland, suggested (press release May 2002) that: Exceptions ... should only be permitted under truly exceptional circumstances.

### **Disproportionately extreme**

4.21 Postcomm comments on the number of exceptions, but doesn’t report on or evaluate equally serious effects - those of scale of exception. Reaching an

address three times weekly instead of six would have little perceptible effect on sender or recipient, but reaching a community only once weekly places businesses and residents beyond the reach of society's norms - with significant effects of cost and exclusion. There seems not to be any duty on Postcomm to minimise the absolute number of exceptions, but there is a clear duty under 'proportionality' to minimise the effects of exceptions.

- 4.22 Public authorities can impede access to correspondence only where necessary and to an extent reasonable. To impede it to the extent that the deliveries society needs are no longer funded by the USO revenues, but by recipients or directly by senders, represents an unreasonable impediment to communication. And to do so where there is no difficulty, but simply because access is by sea, amounts to unreasonable discrimination.
- 4.23 For Postcomm staff, whom senders can reach daily, and who benefit from a high level of telecommunications services, it is no doubt difficult to envisage the effects of systematically impeded mail.
- 4.24 Postcomm's duty under accepted Public administration standards, and Better Regulation, is for it to have revealed a necessity for restriction of communications, and shown that the extent proposed is the most reasonable choice in the circumstances.

#### ***Impact on provider***

- 4.25 Annex 1 reveals the impact of USO limitation on the provider. Reduction in scope of USO enables the provider to re-allocate the savings it makes to redeem its other inefficient costs, or cross-subsidise non-USO businesses, or achieve fewer economies in its renewal plans, or just add to profits - while the economic funding of that saving - the resources needed to perform the deliveries, are provided by the disadvantaged users either directly by procuring extra deliveries, or indirectly by absorbing the consequential costs of failed processes, or loss of trade, or, ultimately, specific exclusion from social or political processes or initiatives.
- 4.26 This is contrary to
- requirements of the Directive for delivery at the affordable tariff (because users face extra costs),
  - requirements of the EU treaty to limit competition only for services of general economic interest - cross-subsidy of non-USO activities falls outside that requirement
  - the rules on State aids intended to prevent the involuntary subsidy by users of windfall benefits to the state-owned Royal Mail for services it does not provide
  - intention of the Directive to encourage social cohesion in island and mountain areas

## 5 Affordability

### EC provisions for funding the necessary USO

- 5.1 Powers for ensuring funding are provided in the Directive, referred to in EC guidance (ref 2) and explanations, and repeated in the EC's consultant's report (ref 3).
- 5.2 Postcomm has restricted the USO to coastal addresses citing concerns in 2003 about Royal Mail's profitability despite the price control proposals suggesting profitability in the mails businesses. But the European Commission points out that USP profitability is, in practice, determined by the National Regulatory Authority adjusting postal tariffs, and that NRAs have several 'tools' at their disposal to safeguard the Universal Service. They may:
- reserve an area (to enable prices to be set by the provider above those that might be set under competition, to enable cross subsidy of less profitable routes)
  - regulate prices in the reserved area (ensuring sufficient funding for the USO)
  - license providers, requiring them to provide a universal service (even if they could make more profit by not doing so)
  - establish a compensation fund (to ensure that USPs have extra revenue for the unprofitable USO activities)
- 5.3 These powers are reiterated in the report by the EC's consultants, Omega Partners (ref<sup>3</sup>). And their report (ref 3, 4.1) shows that the UK is one of only five of the fifteen member countries of the EU in 2001 to have defined its USO to mandate deliveries on six days a week. (In the other ten countries, there are deliveries on only five days a week). Thus delivery frequency in the UK exceeds the legal requirement, without apparently creating any financial difficulty for Royal Mail.
- 5.4 Nowhere does the European Commission suggest that the USO should
- not meet the needs of senders of time-sensitive mail, or
  - be restricted to benefit the USP at the expense of users of mail.
- 5.5 In its exception decision, Postcomm ignored its tariff setting powers. This was unreasonable, since it exercised those very powers around the same time, not to ensure the USO, but to enable the service provider to recover pension contributions it had previously spent elsewhere - despite those being non-USO costs. [An efficient new USO entrant with new staff and new equipment would not have to allocate extra cash to make good a historic avoidance of pension contribution - hence these are not part of the 'efficient costs' of the USO.] This would appear to be contravening its duty to promote economy. That the decision was reached on financial grounds while ignoring the data available in the concurrent price control suggest that the 2003 decision may be more extreme than Postcomm's estimates of Royal Mail's funding needs suggested - and hence it may be inappropriate to continue to rely on it.

- 5.6 Royal Mail has now become profitable, though industry comment suggests that it remains inefficient - its profitability owing much to a generous tariff decision. Since a higher delivery frequency has always been affordable, and since there is now no evidence of profitability problems at Royal Mail, Postcomm can no longer use concern for viability as a justification for restricting the USO. Since this reason is explicitly cited in the 2003 decision as the reason why a minimum frequency of 2 or 3 deliveries could not then be mandated, Postcomm can now follow the 2003 decision and mandate 2 or 3 deliveries as the minimum frequency. In doing so, it would solve all the other problems as well.

***Cross subsidy***

- 5.7 The principle of the legislation is that deliveries are procured from the sum of the revenues available to the USO provider (or from a USO fund if one is implemented). There is no legislation suggesting that recipients of mail should fund delivery, and especially not when the senders have already provided sufficient funds.
- 5.8 The principle that deliveries on more expensive routes are subsidised by revenues from less expensive routes is uncontroversial and widely accepted. All administrative mail, whether commercial or governmental, is sent on that assumption. For example, mailing systems are not separately programmed to deal with the procurement of delivery to a remote address at its unsubsidised full economic cost.
- 5.9 If senders need mail to be delivered to every address, which they clearly do, the deliveries have to be funded out of the USO revenues, because (a) legislation requires it, (b) senders to remote addresses do not want to pay the full economic cost, and (c) there is no provision in the legislation for recipients to fund it.
- 5.10 We stated in our 2003 response that senders require to reach addressees irrespective of whether the address is situated in a sparsely populated area. But when the principle of full cross-subsidy is denied, the sender can no longer rely on delivery as a result of paying 32p; instead he has to rely also on the addressee having sufficient resources to commit to transport the mail and being fit, willing, permitted by his employer, and able to do so. If the addressee cannot afford to transport it, is not given time off work to do so, is unable to because he is ill, or his equipment breaks down, then the sender is potentially damaged because its mail does not get through. (So may the recipient be, if the undelivered mail contained, say, a demand for payment or a statutory notice, etc.) All mail sent is in the senders' interest - some is also in the wider interest of Society, for example, most mailings from Government administrative processes.
- 5.11 It is the intention of the legislation that everywhere be reachable solely on the basis of payment of the affordable tariff. All the background material of UK white papers, and EC guidance and interpretation, underline the importance of post in social cohesion and inclusion, including the delivery of, say, a postal ballot paper to a resident on the coast. Using a discretion, unnecessarily, to avoid cost (or inconvenience) to the service provider is not consistent with legislation.
- 5.12 Focus on costs of a specific route will intrinsically discriminate against sparse communities, where by their nature, total costs of a route could be 'allocated' to

very few delivery points. Sparse communities are only found in rural areas, and legislation provides for the needs of rural areas to be taken into account. It is likely that this guidance is provided because of the possibility of rural addresses appearing to be attractive targets for a cost-cutting service provider unwilling to grapple with more entrenched inefficiencies. It is not necessary to limit service because of sparsity - in Norway sparsity is specifically excluded from being a reason to limit service - the number of delivery points is not an issue.

- 5.13 The cross-subsidy is always available to Royal Mail for its deliveries; Royal Mail is (and has always been) sufficiently funded to perform the necessary deliveries. Royal Mail does not justify its announced job losses to underpin the provision of the USO - it justifies them so to be able to ward off competition. In doing so, Royal Mail reveals that although it has sufficient revenues to fund the USO, it has an uncompetitive cost base that prevents it making competitive offers to bulk customers.
- 5.14 Hence the need for independent regulation to ensure service requirements are not obstructed by the service provider choosing an easy way to cut costs for its own purposes.
- 5.15 In our response to the consultation, we offered a test that could be applied in determining exceptions:  
“Is the timely transport of mail to the recipient fully funded from the USO revenues?”
- 5.16 Reading the decision, since the timely delivery of mail here requires allocation of the addressee’s resources that are not funded from the USO revenues, it would appear that Postcomm had not applied this test. The test is the essence of the right granted in Article 3 – since the test fails the UK is in breach of Article 3.

#### ***Power to ensure funding not taken into account***

- 5.17 Neither in the Exceptions Consultation, nor in the Decision document, did Postcomm mention its powers to ensure the provider had sufficient funds.

#### **Numbers of exceptions not analysed**

- 5.18 Postcomm made no attempt to analyse the likely number of exceptions, and the probable costs of serving them, elements of information required before Postcomm can estimate whether a tariff covering these costs becomes unaffordable.
- 5.19 Postcomm suggested that increased deliveries would increase the overall cost per letter - but that is expected, applies everywhere, and is not a reason to delay a sender’s communication. The test is, simply, whether the tariffs cover the overall USO cost.

#### **Range of frequency options**

- 5.20 Postcomm neither analysed the interaction between delivery frequency and the postal tariff, nor did it explore its options for tariff setting. But affordability of the needed delivery frequencies can only be assessed by doing so. Postcomm has published estimates of delivery cost for these last 5 addresses, and these can be plugged into Postcomm’s Price Control. The results show that deliveries

three times weekly have no impact on Postcomm's profitability analysis and require no alteration to the tariffs or its price control regime - the deliveries are affordable, in fact already covered by existing USO receipts (the senders have already paid for these deliveries) and hence a restriction to once weekly is unnecessary.

- 5.21 Table 1 reproduces Table 9.10 in Postcomm's 2005 Price Control. The table shows that revenues exceed costs, ie Royal Mail is profitable. It should be noted that these tables draw from the December 2005 proposals. Postcomm revised its calculations in February 2006. Its final figures may differ very slightly.

**Table 1 2005 Price Control**

from Table 9.10	£m	05/06	06/07	07/08	08/09	09/10	Total	% of Revenue
<i>03/04 prices</i>								
<b>Revenue</b>		5,858	5,860	5,755	5,473	5,226	28,172	
<b>Opex</b>		5,314	5,071	5,003	4,785	4,506	24,679	88%
<b>Capex</b>		260	227	308	273	240	1,308	5%
<b>Pension deficit</b>		109	274	274	273	273	1,203	4%
		5,683	5,572	5,585	5,331	5,019	27,190	97%
<b>Volumes (m items)</b>		20,565	20,199	20,801	20,768	20,805	103,138	

Sources: *Postcomm: Final\_Proposals\_061205.pdf*; *finiteSTATE: Total & proportion*

- 5.22 Postcomm state that there are 8 addresses on 5 routes that are served by charter boat. Of these, some already receive more than one delivery weekly. Table 2 shows the effect on Opex of providing 3 deliveries weekly to the remaining 8 addresses served by charter boat. Postcomm had estimated £100,000 pa total, but had overlooked the discount that accrues if more than one delivery weekly is provided. (Not all marine costs vary with volume - twice the deliveries, for example, does not cause twice the number of annual MCA inspections, or renewal of the twice the number of liferafts. Such marine costs are fixed. As a result, more deliveries can be added at a discount. Evidence has been obtained, and provided to Postcomm, that 15% is realistic for 3 deliveries weekly.) The difference between £85,000 and the £34,000 that has already been included in the opex figures is, therefore, £51,000 for 3 deliveries weekly.
- 5.23 This quick estimate does not take account of some addresses already being served more than once weekly - so the real costs would be lower than shown.
- 5.24 We estimate, though do not show in the table, that the extra costs for 2 deliveries weekly would be £20,000 (because some of the addresses already receive more than one delivery).

Table 2 Effect on Opex of 3 deliveries weekly

Effects of three deliveries weekly	£m	05/06	06/07	07/08	08/09	09/10	% of	
							Total	Revenue
Marine delivery <sup>1,2</sup>		0	0	0	0	0	0	0.0009%
Revised opex		5,314	5,071	5,003	4,785	4,506	24,679	88%

<sup>1</sup> Royal Mail declare £m 0.034 per daily delivery; contractors offer 15% discount for 3, assume 2 more req'd

<sup>2</sup> £m 0.051; rounded as Postcomm, who treats amounts < £1m as insignificant in Price Control / Affordability ie, Opex unchanged, and cost is approx 1/20th of minimum amount considered relevant in affordability assessment

Sources: **Postcomm**: *Final\_Proposals\_061205.pdf*, *Exceptions consultation*;  
**finite STATE**: *Contractor discounts*

- 5.25 The results show that to the nearest million pounds (the level of precision used by Postcomm), these 5 addresses make no difference to the Opex figures - either on a yearly basis, or in aggregate over the price control period. Put another way, the cost of serving these last addresses thrice-weekly, even daily, is negligible - smaller even than the rounding error intrinsic in Postcomm's calculations, let alone any errors of range or estimation, inherent in Postcomm's analysis.
- 5.26 The cost of serving these 5 addresses has no effect on profit estimates. The approximations and inexactitudes in Postcomm's own calculations are orders of magnitude greater than these avoided costs. It is wrong to limit the USO believing that to ensure its profitability Royal Mail requires to avoid the £20,000 of efficient USO cost because of its financial state.
- 5.27 Para above shows that these last addresses do not put at risk the USO. In 2003 Royal Mail's well-publicised difficulties were mostly in its other non-regulated businesses, which are nothing to do with its USO. Limiting the USO so that Royal Mail can avoid the delivery costs and use the savings to subsidise its non-USO loss-making businesses represents a subsidy by mails customers of its non-mails business. Not only is this unreasonable (as Postcomm itself stated in response to Consignia's letter to Members of Parliament in autumn 2002), it may render the reserved area open to legal challenge. The non-mails businesses such as Parcelforce, and Citymail in Sweden, are not services "of general economic interest" as covered by article 86(2) of the EU treaty. Hence the reservation of the mails market would become challengeable under competition law if Postcomm were to create the conditions for its proceeds to subsidise other businesses not "of general economic interest".
- 5.28 In its price control proposals (4.2, ref 5) Postcomm suggested PSA 2000 requires it to take a judgement of the affordability of the USO. But PSA 2000 requires Postcomm *only* to ensure that the overall USO is provided at an affordable *tariff* - i.e. to assess whether 27p, 32p, 35p, etc is an affordable price to pay to send a letter. Postcomm has no duty to examine the affordability to Royal Mail of any of Royal Mail's individual *constituent* costs (of the urban USO, the rural USO, the island and coastal USO, provisions for capital replacement, pension provisions, profits, or any disbursements) - these are all supply-side issues which, provided that the *overall* USO is funded by an affordable tariff, are not a statutory concern of the regulator. Indeed, the

*affordability* of any *constituent* cost could only be determined by making an arbitrary *allocation* of part of the revenues available - Postcomm clearly has no power to allocate the provider's revenues specifically to any of its costs.

- 5.29 The affordability of the USO should be considered on aggregate, not on a route by route basis. No individual route will render the USO unaffordable - it would depend on which route was to be considered the 'critical' route, and there is no objective basis for that - the USO can only sensibly be considered as a whole.

### Re-assessing the case for restriction

- 5.30 Postcomm has not offered any evidence that the present USO tariff is unaffordable - indeed we are unaware of any complaint that it is unaffordable today, or would be unaffordable with 3 deliveries a week to the 5 remote addresses that Royal Mail decided should receive only one. Postcomm's own process for determining the USO tariff (and thus any potential unaffordability) recognises that users should not pay increased postal charges if the service provider remains inefficient, implying that price increases should not be endorsed by Postcomm unless it is satisfied that no more efficiency savings can be achieved to ensure the necessary profitability. (Limiting service to avoid cost while preserving the same tariffs also creates a windfall benefit for the service provider and is equivalent to not limiting service but raising tariffs by the same amount. Only if Postcomm were satisfied that no more efficiency savings can be made to ensure the necessary profitability would it be expected to limit service to avoid cost if it. However, Postcomm's decision limits service to users irrespective of whether there are further efficiency savings to be made by the service provider.
- 5.31 The negligible cost of deliveries to coastal areas, and the absence of measurable impact on profitability, reveals that Postcomm's concerns were ill-founded, and arose because it had not performed the necessary analysis.
- 5.32 Postcomm based its exception decision partly on these economic grounds:
- the deliveries were "particularly difficult or expensive to provide"
  - exceptions are a "recognition [some deliveries are] too much of a burden for the rest of the community to bear", and
  - potential impact of competition
- [2.35 ref<sup>1</sup>] "particularly difficult or expensive to provide"*
- 5.33 These coastal addresses are not difficult to serve - they are served the same way that Royal Mail has served other coastal addresses for over a hundred years. Neither are these addresses, in aggregate, more of a burden than the unprofitable urban routes. Expensive is not synonymous with unaffordable - shown by our calculation not to be, either for the service provider or the price of postage.
- 5.34 Postcomm has a secondary duty to promote (not to ensure) economy on the part of service providers. It should therefore satisfy itself that Royal Mail is discharging its obligations efficiently (which does not mean, and is separate from, limiting its Universal Service obligations at the expense of senders and recipients). Postcomm has not published in its decision or in the price control document any assessment of affordability of the tariff, and nowhere has it

published any data to suggest that the additional deliveries to meet the necessary minimum delivery frequency to these last addresses gives rise to an unaffordable tariff. Our figures in Tables 2 (above) indicate that it will have no effect whatsoever on the tariff.

*“recognition [...] too much of a burden for the rest of the community to bear”*

- 5.35 Article 3 does not imply that for any particular country, the full USO will inevitably reach the point where the USO tariff becomes unaffordable. It does not follow therefore that some exceptions, of arbitrary effect, must be made irrespective of need. Instead, the geographical exception is recognition that if the tariff necessary to fund the USO were to become unaffordable, then a mechanism is available to reduce the scope of the USO to alleviate the problem. A need for an exception should first be adduced.
- 5.36 This sentence implies Postcomm recognises that if the cost of the USO became too much for the rest of the community to bear, for example by necessitating a 3p rise in postal charges, then it might be necessary to restrict the USO. (But it does not immediately lead to any need to over-restrict the USO on any particular route or type of route, especially not on ideological grounds.) Conversely, if there is no measurable burden when compared, say, to the burden of service provider inefficiency, there is no reason to limit the USO. Limitation has to be preceded by necessity, otherwise it is simply an ideological restriction, and barred by the Directive’s Article 5.
- 5.37 Even without seeing the price control policy, it was clear that there would be very few addresses where cost is material, hence any ‘burden’ is imagined not real. (In any event, customers will not see the benefit of cost avoidance - savings are simply absorbed into the service provider’s funds, helping the provider avoid grappling with internal inefficiencies. This point is explained in detail in Annex 1).
- 5.38 And despite the Price Control decision revealing that Royal Mail will have more than sufficient funds in to meet a USO that would adequately serve these last addresses, Postcomm has chosen, seemingly without analysis or calculation, to suggest that more than one delivery per week to these addresses may not be affordable.
- 5.39 The USO is not a burden compared to the burden imposed by Royal Mail’s inefficiency. As stated, the UK is only one of five EU countries to provide a sixth weekly delivery - the Directive calls only for five. Yet Postcomm is not proposing to remove the 6th delivery, despite the relief it would provide for Royal Mail, nor, seemingly, is it requiring that Royal Mail address its inefficiencies. Instead, Postcomm has determined that that Royal Mail must, irrespective of societal effects, be relieved of £20k of cost, a cost which society is happy to meet. NERA’s study for Postwatch revealed that senders’ greatest need was for timely delivery - not on a specific day, but by a specific date - senders wanted to depend on mail being received in time - whether it be a marketing campaign, return of a contractual document, or some other action within a stated time limit.
- 5.40 Royal Mail has always described some (but, interestingly, not all) coastal addresses as a burden - despite then being hugely profitable and fully funded to deliver to them, and perfectly capable of procuring deliveries to them as it

willingly did elsewhere. Since deliveries were neither impractical nor unaffordable, the description seems unrealistic, and may be a proxy for disinclination, for its own reasons, to serve them - probably because historically it has served them badly. It is unclear why Postcomm also should now attempt to assert, without evidence, that they are a burden - especially since it intends to place them beyond the reach of timely delivery of time sensitive mail - an unjustified reaction to a non-existent problem. Postcomm has powers to ensure that Royal Mail can always be funded to serve them; most especially under competition the costs of serving them can be added to access charges because the charges are required by Article 12 to be geared to costs - the more the USO costs, the higher the access charge Royal Mail will receive.

*Impact of competition*

- 5.41 In 2.36, Postcomm states that competition will be the “main guarantee of affordability”, but expresses concern about the “extent to which revenues from one element of the universal service will be available to support other elements ... might well diminish.” But Postcomm’s own figures for Royal Mail’s future profits (£339m in 2005/06) reveal that the cost of deliveries to the last addresses is so small as to be “below the radar” in any assessment of mail delivery costs as a whole. Postcomm has published no evidence that these deliveries cannot be afforded, while our figures show that their cost would not impact on the postal tariffs. (It is the Postal Tariffs that Postcomm is required, under PSA 2000, to ensure remain affordable.) Postcomm’s assessment of the likely evolution of the competitive market is that Royal Mail would retain very significant volumes despite the competition, citing examples showing this to be the experience in other countries (Table 7.3 Price Controls document ref [x](#)). Postcomm is so concerned about Royal Mail’s likely continuing dominance that it believes price control will continue to be necessary despite competition. In addition, Postcomm can ensure through tariffs that Royal Mail retains sufficient funds for the ‘drop in the ocean’ that the cost of these last deliveries represents.
- 5.42 Postcomm concluded in the Price Control decision (4.19, ref <sup>5</sup>) that regulation will continue to be necessary to protect users from price increases. In other words, the data available to Postcomm strongly suggests that Royal Mail will not have difficulty in a competitive market, will continue to be dominant, and would be capable of setting arbitrarily high prices. Thus even with competition there is no need to restrict the USO to these last addresses simply to ensure that Royal Mail can meet the cost.
- 5.43 As stated, Article 3 requires the USO to be affordable; and Article 5 requires it to meet needs and provide consistent service in comparable circumstances. These two requirements mean that Postcomm must determine consistent and non-discriminatory service levels which meet users’ needs (provided that the USO remains affordable). If some service levels (rather than lack of ‘economy and efficiency’, pace PSA 2000 s5, on the part of the service provider) would require the USO to become unaffordable, then Article 3 allows Postcomm to reduce service levels consistently until the USO becomes affordable.

## **6 Other comments on Consultation**

### **Appeal process**

- 6.1 The appeal process appears not to consider, at any stage, whether the actions of Royal Mail are consistent with the Directive - yet Postcomm has a duty under Article 22 to enforce the provisions of the Directive. If Royal Mail's actions are inconsistent with the Directive, Article 22 requires Postcomm to act to restore compliance with the Directive - even if Royal Mail's actions were permitted in its Licence - and even if Royal Mail's actions were consistent with the 2003 Exceptions Decision.

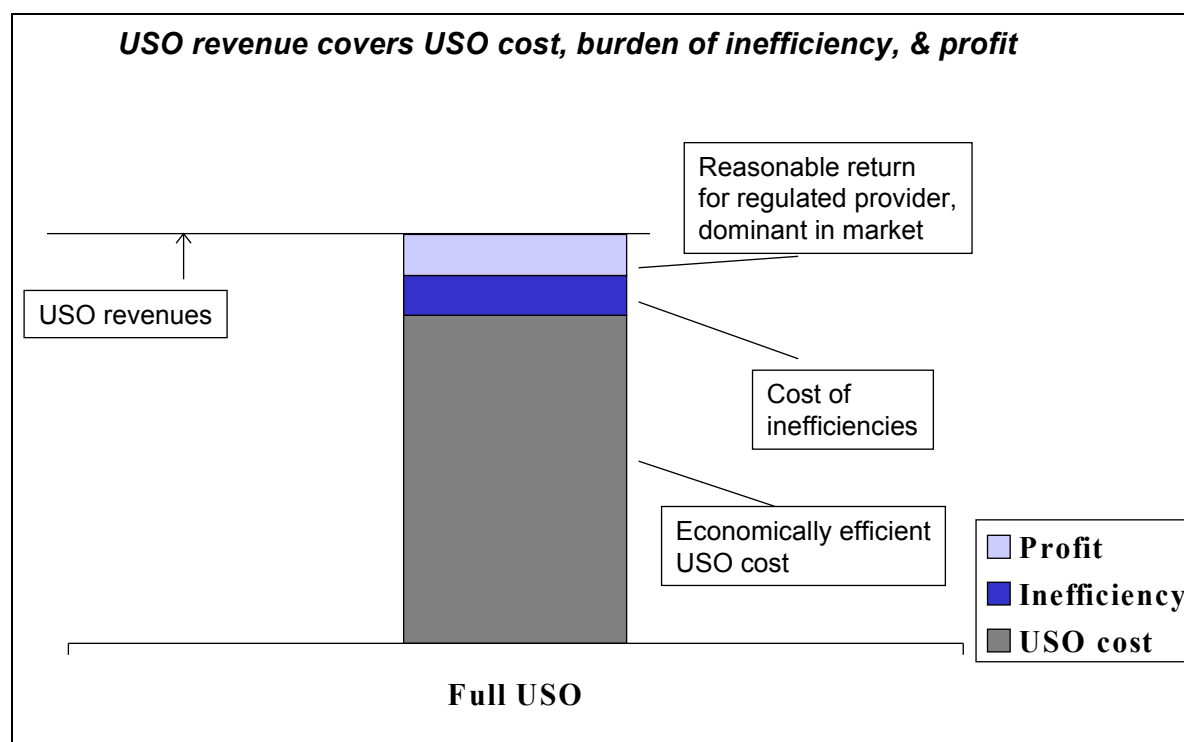
### **Scope of 2003 Decision**

- 6.2 The 2003 decision did not deal with all the relevant issues. Many points were made, particularly in terms of regulatory principles that Postcomm did not respond to, and ignored. Some of those points are mirrored in the Better regulation principles, so the points were certainly not without merit.

## Annex 1

The profitability of a Universal Service Provider (USP) is governed by three factors - its Universal Service revenues, the costs of an (optimally efficiently) provided Universal Service, and the extra cost burden of inefficiency or waste in the service provider. Established principles of cost-based regulation in Europe draw a distinction between a monopoly provider's actual costs (which are likely to contain avoidable inefficiencies) and the costs incurred for provision of the service by an economically efficient provider. The best known example is the principle in telecommunications access pricing of estimating a Long-Run Incremental Cost (LRIC) for network service, which is used as the basis of access pricing for other operators. Regulators take that approach because it avoids the service provider being rewarded for its inefficiency, something that a provider would not be able to do in a competitive market where it was not dominant. (In competitive markets, providers can only receive the market price for services, they cannot set their own prices, and the market prices may well be below the prices that would allow recovery of cost that are either historically high, or otherwise economically inefficient.) The costs of providing a universal postal service that would be borne by an optimally efficient provider are referred to as the 'economically efficient USO cost'.

The separate cost elements for a universal service provider are illustrated in Figure 1.



*Figure 1 Cost elements in Universal Service Provision*

The full economic costs of the USO that would be incurred by a perfectly efficient operator are represented in dark grey at the base of the column. The extra inefficiency costs incurred by an inefficient provider (such as overmanning, unnecessary buildings, inappropriate equipment, misguided marketing expenditure, etc) are represented in dark blue in the middle of the column. At the top of the column is an area of light blue representing a reasonable return or profit for a dominant provider in a regulated market. The USO

revenues are shown by the horizontal line, and can be set by a regulator so as to provide compensation for all those items. The European Commission expects national regulatory authorities such as Postcomm to do exactly that.

The picture also helps illustrate Postcomm's statutory duties in respect of *profitability*, *affordability* and *economy*. Postcomm has firstly to ensure that service providers have sufficient *funding* for their activities. Postcomm must ensure that the USO revenues cover reasonable profits, the cost of the USO, and whatever level of inefficient cost burden it believes reasonable for society to bear. Postcomm can ensure sufficient funding by setting the USO revenues at a level where the provider is adequately re-imbursed - as shown in Figure 1.

Postcomm has to satisfy itself that the postal tariff giving rise to those revenues is *affordable* - figures in the range 28p to 35p or so for the bottom weight step are not thought to give rise to any problems in that respect.

Postcomm also has to 'promote economy', illustrated in Figure 2.

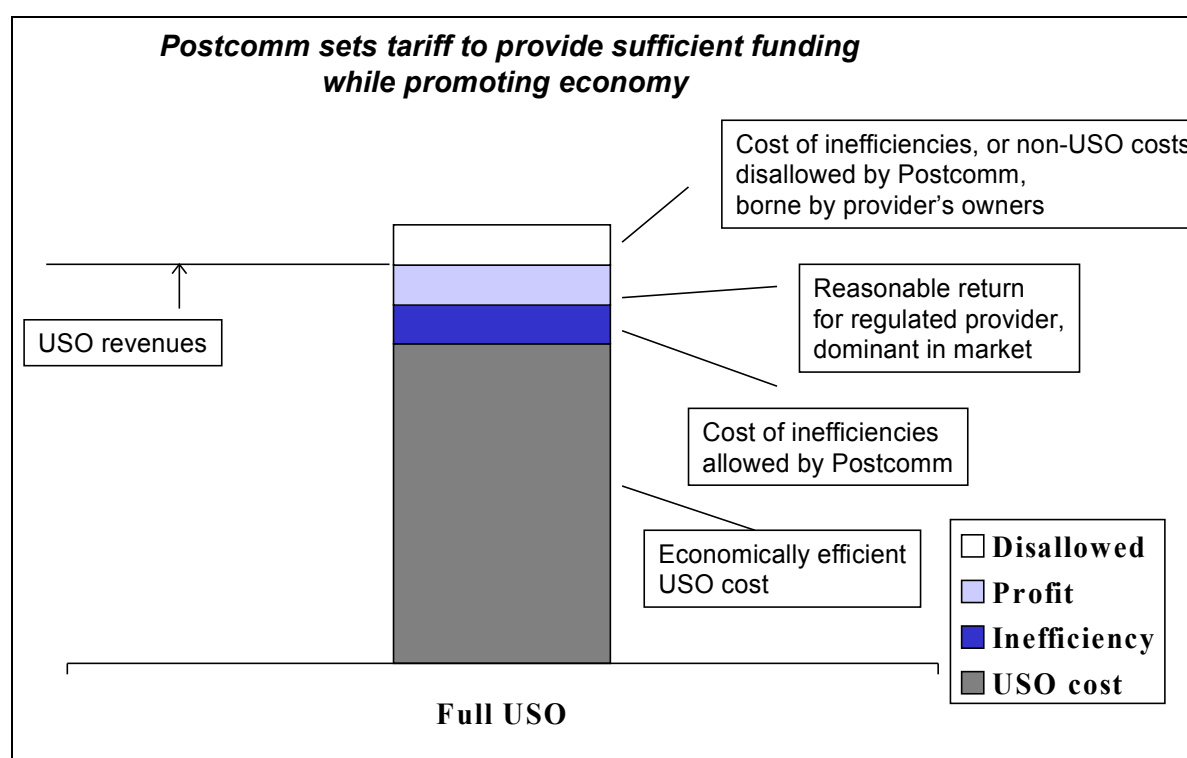


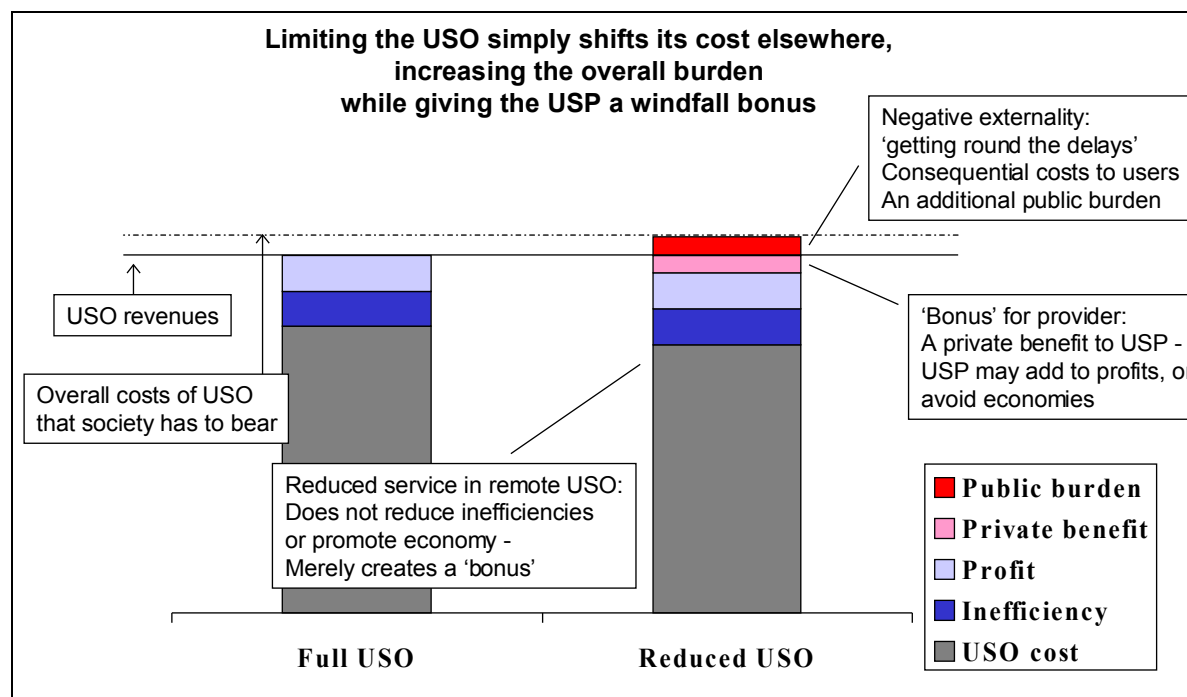
Figure 2 Promote economy

In its duty to promote economy, Postcomm is of course expected to target the inefficiencies the provider exhibits - by setting the postal tariff at a level where the provider cannot recover inefficiencies Postcomm believes should not be re-imbursed (represented by a white area above the line of the USO tariff). Postcomm may also, over time, seek to reduce the amount of inefficient cost recovered by the provider in future years, by capping the USO revenues using techniques such as RPI-x for USO tariff increments - encouraging the provider to safeguard its profit by reducing the inefficient costs represented by the blue area.

Reducing the scope of the USO, the dark grey area, does nothing to reduce the dark blue area - the provider's inefficiency costs. Nevertheless, it is to be expected that a service provider might lobby for reductions in the obligations inherent in the grey area so as to use

the money saved to recover some of the inefficient costs in the white area whose recovery Postcomm had disallowed. Postcomm's duty to encourage economy requires it to be alert to the possibility, and act to prevent it.

Postcomm has chosen to limit the USO at addresses reached only by sea. The effect of limiting the USO to reduce its cost is shown in Figure 3.



*Figure 3 Effect of limiting the USO*

The grey area representing the efficient cost of the USO has been reduced by a small amount (a noticeable amount has been drawn in the picture, to illustrate the principle. The actual reduction Postcomm seeks to achieve is less than three hundredthousandths of the grey area – less, incidentally, than the margin of error in its profitability calculations for Royal Mail, illustrating that its stated concern for profitability is spurious). The service provider's inefficiencies of overmanning etc do not reduce as a result of limiting the USO, so the dark blue area remains the same. The service provider's reasonable profits can be assumed to be the same and continue to be shown in light blue. Postcomm is not proposing to reduce the postal charges to users as a result of limiting the USO, so USO revenues remain the same, shown by the horizontal line.

As a result, the service provider receives a windfall 'bonus' of the difference between the USO revenues and its (now reduced) overall cost base. Postcomm has no power to force the service provider to do anything specific with that extra revenue, so the provider may just add it to profits, or absorb it perhaps through letting its inefficient costs not be held down so firmly, or even recovering some of its previously disallowed costs such as losses in overseas businesses.

Meanwhile, users of first class post have to deal with the consequences of an inadequate service not meeting their needs - sometimes extra deliveries are paid for by the recipient, or companies sending time sensitive mail incur the extra administration of manually restarting stalled or failed processes. In some instances the problems cannot be overcome - delayed service giving rise to lost opportunities to trade is reflected in lower UK growth and tax revenue, and increased unemployment and public debt. These consequential costs are what

economists call a ‘negative externality’, and in this case provide the economic funding of the provider’s bonus.

Society pays not just the full USO charge, but the extra costs caused by the impediment to first class mail. The Passport Agency implied these when they advised Postcomm that other arrangements were made if the delivery service did not meet needs. *Limiting* the USO *increases* the burden on society by triggering extra costs for users that would be avoided with an adequate USO.

Postcomm’s decision to limit the USO yields a ‘bonus’ to the USP, which it can use in a variety of ways, as shown in Figure 4

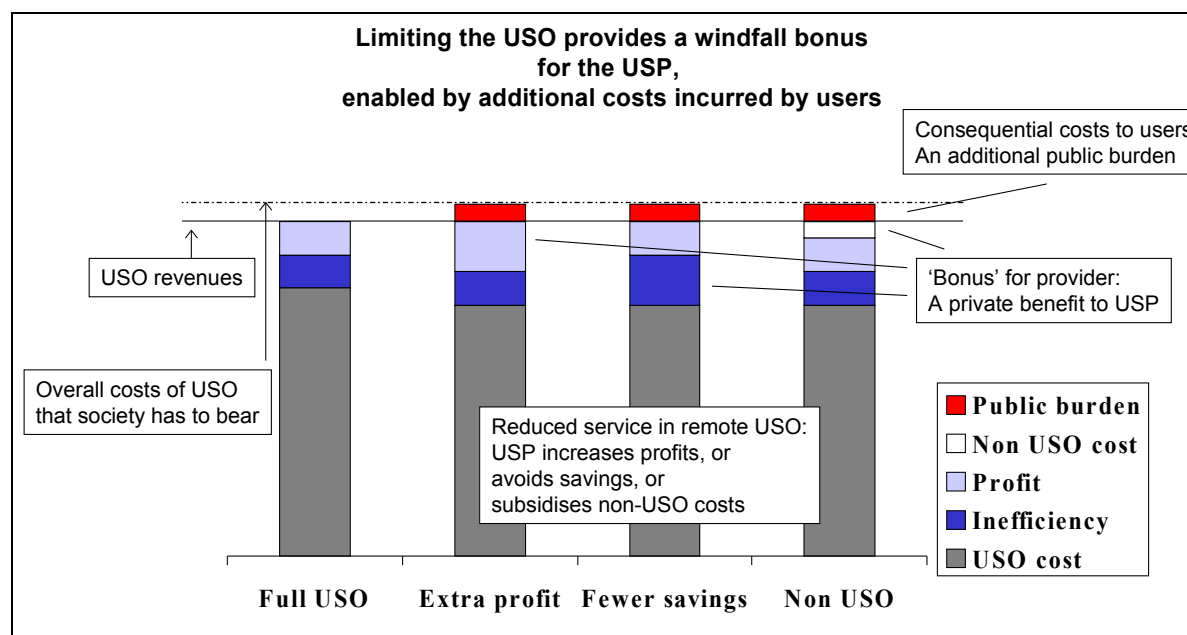


Figure 4 The windfall bonus

The service provider can use the USO limiting windfall in any manner it wishes - Postcomm has no powers to influence the use of the windfall. The service provider might use it to make extra profits if it manages to hold down its inefficiencies, or to fund inefficiencies it had not managed to control, or even to cross-subsidise some of its other non-USO businesses.

There is no explicit provision in the Directive, the EC’s guidance, or the UK government’s guidance, for limiting the USO to the extent it no longer meets users’ needs, incurring extra expense for users while the service provider enjoys that private benefit. The EC guidance specifically mentions meeting senders’ needs, and Article 5 of the Directive requires that a USO that has not meet users’ needs since it took effect in 1999 should have evolved to do so.

Postcomm’s decision to limit the USO enabling windfall bonuses for the USP at the expense of users while delaying time sensitive mail would appear to be an exercise of its discretion beyond the intentions of the legislation and guidance, and beyond the generally accepted principles of the universal service funding.

The exception decision takes Postcomm into controversial territory as far as Postcomm has not taken account of these costs in its decision.

The implication of Postcomm's stated policy in 2003 'not to increase Royal Mail's costs', (despite those costs being at that time unreasonably reduced because senders required that more deliveries were provided) is that Royal Mail should be able to use the windfall either make more profit, or to pay for avoiding meeting its planned efficiency targets, or to cross-subsidise its non-USO businesses. The savings from avoided delivery will be added by Royal Mail to its reserves, while the costs will be borne by senders and recipients of delayed time-sensitive mail, an effect referred to by economists as 'a negative externality'. It is a cost Postcomm has ignored in its USO and price control determinations, contrary to best practice in Cost/Benefit analyses.

Reduction in scope of USO enables provider to re-allocate the savings it makes to redeem its other inefficient costs, or cross-subsidise non-USO businesses, or achieve fewer economies in its renewal plans, or just add to profits - while the economic funding of that saving - the resources needed to perform the deliveries, are provided by the disadvantaged users either directly by procuring extra deliveries, or indirectly by absorbing the consequential costs of failed processes, or loss of trade, or, ultimately, specific exclusion from social or political processes or initiatives.

This is contrary to the

- requirements of the Directive for delivery at the affordable tariff (because users face extra costs),
- requirements of the EU treaty to limit competition only for services of general economic interest - cross-subsidy of non-USO activities falls outside that requirement
- the rules on State aids intended to prevent the involuntary subsidy by users of windfall benefits to the state-owned Royal Mail for services it does not provide
- intention of the Directive to encourage social cohesion in island and mountain areas

## **References**

- 1 Directive 97/67/EC, 15 December 1997 (European Commission)
- 2 Notice from the Commission on the application of the competition rules to the postal sector and on the assessment of certain state measures relating to postal services (98/C39/02)
- 3 Study on the Impact of Certain Aspects of the Application of the Directive 97/67/EC on the Postal Sector, Omega Partners, August 2001 (EC, and Omega Partners)
- 4 Royal Mail Licence Condition 1 - Exceptions to the Universal Service Obligation, A Decision Document and Direction, January 2003 (Postcomm)
- 5 Review of Royal Mail Group plc's Price and Service Quality Regulation, February 2003, Second Price Control, Quality Service Targets and Compensation - Final Proposals Document (Postcomm)