

postwatch

**Postcomm's Strategy Review
'Emerging Themes':
The Postwatch Response**

14 December 2007

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Executive Summary

There have been significant developments in the market since the first stage of this review in August 2006. These include:

- debate on a new Postal Services Directive and over an agreed date for European liberalisation of the postal market;
- developments outlined in the Competitive Market Review (CMR) & Business Customer Survey (BCS);
- a period of industrial unrest followed by strikes from June to October 2007, damaging Royal Mail's quality of service and user confidence; and
- the Government's announcement of its policy towards the post office network, and commencement of Royal Mail's post office closure programme.

Nevertheless, we believe our vision as set out in our first response is still broadly valid.

Postwatch appreciates that Royal Mail's current situation, including volume downturn and loss of revenue, has been due largely to factors beyond its control. But clearly it is for the Universal Service Provider to respond to such challenges in an effective, efficient and innovative manner – including timely and well-planned investment. Equally, it is for the regulator to target its interventions carefully and proportionately.

There are several areas on which Royal Mail must focus if it is to maximise its opportunities in the competitive marketplace and deliver value for customers. It must:

- stimulate market **growth** where possible and minimise decline where not;
- **transform** in order to **compete** in the marketplace;
- drive **innovation** and **efficiency**;
- use **intelligent technology** to the best effect;
- exploit and adapt the **existing network** to customers' advantage; and
- add new **value** to mail as a communications medium.

Postwatch believes that through innovation, customer focus, increased efficiency and exploitation of new mail streams Royal Mail's letters business can generate significant profit. This will protect and sustain the universal service, which is crucial to meeting the needs of consumers and to the success of the competitive postal market. At the same time Royal Mail must focus on offering real value. Indeed, as well as stimulating the market in terms of volume Royal Mail must grow it in terms of value, taking account of recent and rapid trends in electronic communication and activities such as e-fulfilment.

This paints a picture of a Royal Mail more flexible, entrepreneurial and creative than we have generally seen. The settling of the strike and the funding package which Royal Mail has received from the Government provide an unrepeatable opportunity to make a reality of this vision.

We look forward to Royal Mail's publishing its plans for investing the £4bn Government funding package and for introducing new and imaginative ways of meeting its customers' needs and wants.

Postwatch's view on the USO is still evolving as we await the results of our USO research. With Postcomm's agreement we will re-visit the USO after we have reviewed all the available evidence early in 2008. Any decision by Postcomm on the future scope and funding of the USO must balance risks to consumers against the pressures of the changing market. The key issues include:

- **Declining mail volumes**

Here, the price control must allow for corrective mechanisms if mail volumes fall significantly below anticipated levels. But as we argued in our response to Postcomm's Interim Review, it is crucial that this does not allow price increases to customers where falling volumes and reduced revenues are within Royal Mail control: Royal Mail must not be protected from the consequences of management failings. Equally, regulation must incentivise Royal Mail to develop new and effective responses to changes in mail volumes and/or product downtrading.

Steering the right course clearly poses great challenges for the regulator as well as for Royal Mail.

- **Price increases applying to captive social users**

Customers may have to bear price increases where prices are adjusted to reflect the true cost of providing a service. But **Postcomm must ensure that any such price increases are transparent, necessary and genuinely and demonstrably more cost-reflective.** Royal Mail must not be permitted to recover revenues by way of price increases to captive customers simply because they are the easiest to target.

- **Changing the scope of the USO**

Royal Mail now faces a fully open market with competitive pressures. It makes at best only a small profit on its USO activity. Postwatch accepts that the scope of the USO must be kept under constant review and may need to be modified if and to the extent that this is necessary to ensure a strong, sustainable universal service in the long term. The alternative is to provide clear and separate funding of the Universal Service - either by cross-subsidy from Royal Mail's other operations, or from Government.

This response sets out the views of Postwatch on the specific issues in the second stage of the regulator's Strategy Review. Postwatch (and we hope its successor body) looks forward to playing an active part in the more detailed debate, in the context of proposals for the next price control (and associated licence modifications), which will take place over the next two years.

1. Introduction

- 1.1 Postwatch welcomes the opportunity to respond to Postcomm's Strategy Review 'Emerging Themes' document. This response is structured in two parts: the emerging themes, and individual responses to the questions in the consultation document.
- 1.2 The importance of the postal industry in the European and worldwide context should not be underestimated. It is thought that national postal operators worldwide¹ account for over \$250 billion in revenue and employ five million people. A recent study² commissioned by the European Commission reveals that postal services in the EU earned about €90 billion in 2004 or 0.9 percent of the gross domestic product (GDP). The postal sector makes a significant direct contribution to both domestic and EU economies. But mail is one of several communications options and customers will increasingly focus on the channels best suited to their specific needs.
- 1.3 Moreover, Royal Mail is entering a period of real change, during which it will need to refocus and diversify while continuing to address the nation's mailing needs by providing an affordable and reliable universal service. The company now faces the challenge of reassessing its priorities and focusing on those areas where it can add value and make profit by satisfying customer needs and meeting changing demands. But we note with disappointment that in the recently published Royal Mail statement³ on modernisation there was little reference to customers. By putting customers first and detailing a strategy that has the customer as a focal point, Royal Mail will undoubtedly strengthen its position.
- 1.4 Further, as the world becomes more concerned about carbon emissions, global warming and sustainability of the planet, the environmental positioning of the postal industry will become a bigger issue. Postcomm, Royal Mail, and the wider market should be mindful of 'greener' options and the move, both domestically and in international postal markets, to more environmentally friendly business methods.
- 1.5 The following points summarise Postwatch's original submission to the Strategy Review on the universal service obligation:
 - Social consumers, especially vulnerable consumers, need the universal service obligation to be protected. This does not mean that its scope and funding cannot be reviewed in the light of changing circumstances over the next decade, but it does mean that the USO must reflect properly-determined consumer needs and be adequately funded.
 - Royal Mail has responded to the new competitive environment by commencing a programme to rebalance tariffs in order to achieve more cost-reflectivity. We understand the logic of aligning prices more closely to costs. But we believe that this has to be done in a phased manner in order that services remain affordable to all consumers.
 - Competition has already started to reduce Royal Mail's market share, at a

¹ How to Regulate the Postal Industry – International Post Corporation, August 2007

² WIK, 2006

³ Royal Mail Embarks on Modernisation - 31 October, 2007

time when overall mail volumes have ceased to rise and are experiencing a gradual but maybe sustained decline. While we certainly favour a level playing field, reduced barriers to entry and greater competition, such changes must be introduced gradually, with proper regard to their impact on social customers and the implications for the funding of the USO. They also need to take place in a manner which ensures that competitors are not undermined before they have become properly established.

- Although the consultation document does not mention the post office network, we see this network as an integral part of the delivery of postal services and therefore an essential part of the Strategy Review. Since our original submission, the Government has made clear its plans for the network, and we are working with Post Office Ltd on the implementation of these plans.
- ‘Separation’ is a term often used very loosely. The idea is sometimes seen as the easy or obvious route to a more competitive framework. But it is essential to define precisely the problem one is seeking to address before considering whether any of the many possible forms of separation might be of net benefit to the market in general and to consumers in particular. Moreover, the postal services network, not being a ‘pipes and wires’ network, is different from other regulated utilities in the UK and may require special consideration and/or different approaches.
- Given that competition is so new and fragile and that the postal market has so many differences from other regulated markets, we see a continued need for a sector-specific regulator and indeed sector-specific expertise in consumer representation (wherever that might be located organisationally). The regulator needs to make timely and transparent decisions, based on evidence, and to work closely with all stakeholders including the statutory representative of postal consumers.

1.6 After this consultation has concluded and Postcomm has considered the responses, there must be a clear direction and work programme for Postcomm for 2008 and beyond. Additionally, there should be scope for engagement with the new NCC on future customer issues: the customer perspective is essential in key areas such as the continuing USO debate and future discussions over price control and product definition and scope.

2. Postwatch views on emerging themes

2.1 Universal Service Obligation (USO)

2.1.1 Postwatch strongly believes that it is important to have a well defined and adequately funded universal service accessible to everyone everywhere in the UK both now and for the foreseeable future. Postwatch firmly believes that the USO needs to be protected in terms of collections and deliveries, access to the postal network, an affordable social product and certain value added products. But clearly market conditions have changed significantly in recent years. The scope and financing of the USO needs to be reviewed periodically to identify potential threats to its continuing economic viability and to take account of changes in consumer attitudes and behaviour.

Understanding the relevance of the USO

2.1.2 Since Postwatch's last submission (January 2007), there have been new developments which support our original arguments on the USO.

Roland Berger research – Collections and Deliveries

2.1.3 Postwatch, Postcomm and Royal Mail commissioned Roland Berger Associates to undertake a national survey on the needs of postal users⁴. The results have enabled Postwatch to represent postal customers with greater confidence and a deeper understanding of customers' needs.

2.1.4 The research revealed a widespread view that all features of the universal service were important, including deliveries and collections at least every working day, affordable prices for all, and geographical uniformity of stamp prices.

2.1.5 Early delivery times and late collection times were seen as being very important, with most respondents reporting that it was important to them that deliveries were made as early as possible, and last collections made as late as possible.

USO research

2.1.6 Postwatch has commissioned a major piece of research on the future of the USO from Accent supported by Rand Europe and the Centre for Economics and Business Research. In progressing this research project, we have worked closely with both Postcomm and Royal Mail. The primary objective of the research is to assess whether the current USO is fulfilling the needs of citizens ('citizens' being all postal users and potential users – both senders and receivers).

Key objectives are therefore:

- to assess citizens' needs from a USO;
- to assess the effects on the existing USO of present and future competition;
- to assess alternative models of USO provision; and

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http://www.postwatch.co.uk/images/stories/pdfs/Research/2007/1.6.07Summary_note_Roland_Berger.pdf

- to undertake a valuation of the USO from the perspective of citizens.

The research findings are due to be published in January 2008. These will allow us to make further input to Postcomm's future strategy decisions.

Changes to the USO

- 2.1.7 Much of the current debate centres on two questions. First, what products should be included in the USO? And second, what services should be required of Royal Mail as Universal Service Provider (USP)? These are inextricably linked with many other issues, including Royal Mail's financial position, what customers (both senders and receivers) require from a modern day postal service, and what are the risks to customers in reducing the USO. Indeed the debate may be taken even further by viewing the postal USO in the context of a wider communications USO.
- 2.1.8 It is fair to say that the long-term objective shared by Postcomm and by Royal Mail is to reduce the scope of the USO, as Royal Mail now faces a fully open market with competitive pressures and makes only a small profit on its USO activity. Postwatch accepts this principle but only to the extent that any narrowing in its scope is absolutely necessary in order to ensure a strong, sustainable USO in the long-term. But Postwatch also believes that:
- Royal Mail's non-USO activities must not undermine it;
 - competition (and competition law controls) in the wider mail market must be sufficient to provide the necessary spurs to efficiency, innovation and price and quality; and
 - any proposed change must be controlled and carefully phased.
- 2.1.9 With changes such as the loss of Sunday collections (albeit outside the USO), collections taking place earlier in the day, deliveries later in the day and increased prices for social users, it is easy to understand why customers might conclude that the universal service is already being eroded.
- 2.1.10 A reduced USO may be acceptable to customers in the long term (so long as social users are not disadvantaged) so – subject to the findings of our research – it may be that bulk mail, franked mail and PPI could potentially be withdrawn in a phased manner. But there are three caveats to make to even this cautious statement. First, changes adversely affecting social users would not be acceptable to consumers. Second, the remaining USO must be adequately and securely funded, preferably by the existing mechanism. Third, such a reduction in the scope of the USO can work only if competition is sufficiently developed properly to take the place of regulation. In this context it is particularly important that customers are able to access the service with geographically uniform pricing.
- 2.1.11 We believe that the 'political construct' of the USO in European and UK legislation is a good one – it provides an outline definition but is wide enough to allow different product offerings between member States, and allows enough flexibility for USO providers to change their product offerings as markets evolve. We do not argue for a change in the legislative situation with respect to products; but a legally defined framework for services (eg number of days per week for collection and delivery) will still be required.

2.1.12 Fundamentally, the USO provider should be under a statutory duty or licence obligation to provide a service available to all whereby an item can be posted with the assurance that it will be delivered to the correct address in a timely manner and without loss, damage or interference.

2.1.13 In order to progress this debate, there must be clarity on the definition of the current USO, distinguishing between services and products and between what is required by the Directive and the Act and what is required by Royal Mail's licence. Such a suggested schematic is attached at Appendix A.

International comparisons

2.1.14 We note Postcomm's international comparisons of the USO and Royal Mail's comparisons with other EU countries on price. We raise a note of caution with this approach. It is almost always possible to cite an international example to support one's case, whether on services delivered or on price. But we must be aware of the geographical, political and competitive context of each country – which means it is difficult to make any valid comparisons at all. Moreover, different EU countries set different criteria for mail categories in terms of weight, size and product definition. So certainly we should learn lessons from overseas, but we should be cautious about direct comparisons.

Summary

2.1.15 We cannot predict the future. But we can seek to identify and minimise the risks to consumers of the changing market, and address what is and is not acceptable in terms of short-term pain versus long-term gain. The health of the USO and mail volumes are inextricably linked. Postcomm must monitor them closely and identify trigger points to indicate when the USO may be under threat. A series of contingencies must be drawn up in case this situation does arise.

2.1.16 Furthermore, a process has to be put in place to enable the universal service to be reviewed so it can evolve and remain relevant to consumers without recourse to primary legislation. Within any future review process there should be a clear role for the new NCC as the voice of vulnerable users of the service. This role should not be so much to suggest changes to the USO as to evaluate proposed changes to see if they are in keeping with social, technological and economic factors and if they fit comfortably within the wider communications market.

2.2 Promoting effective competition

2.2.1 VAT remains a key barrier to the promotion of effective competition and, although there have been recent endeavours through access to bypass the VAT requirements, we would urge Postcomm to engage openly with the industry on this issue in order to arrive at a well evidenced and realistic policy position to influence the debate at Governmental level prior to any decision being taken at an EU level.

2.2.2 Postwatch remains convinced that customers' needs are best served by a healthy universal service provider operating in a competitive market in which barriers to

entry are minimised. The regulator plays a crucial role in securing this desirable state of affairs. First, there needs to be a clear regulatory framework. Second, Postcomm needs to develop a process for addressing any remaining regulatory privileges enjoyed by Royal Mail that may distort the market and make it difficult for other operators to enter. Third, Postcomm must develop a detailed understanding of Royal Mail's operations, to deter anti-competitive behaviour.

2.2.3 Postcomm's Business Customer Survey and Competitive Market Review⁵ both clearly show that competition is active both between Royal Mail and competitors and also among competitors themselves. However, a difficulty arises when assessing whether competition is effective and sustainable – what indicators to use, how to identify problems and how to promote it in the future. It is evident that large mailers are benefiting from competition. But social users are not in general better off (apart from quality of service improvements, which might be argued to be down to the growth of competition), and while SMEs are experiencing some benefits from competition they do not tend to have sufficient volumes to influence the market.

2.2.4 Postcomm's recent Business Customer Survey⁶ reports mixed views on competition, with 54% agreeing that it has improved choice, 39% saying it improved quality of service but only 15% believing that it has resulted in significantly lower prices. Overall there appears to be support for the market opening up to competition, with 70% of respondents agreeing. But it does not appear to those asked that the market has reached its full potential – which suggests that Royal Mail needs to react faster and be more co-operative while paying greater attention to customers and their various needs. History shows that initiatives around achieving cost reflectivity, including controversial ones such as Zonal Pricing, can be introduced successfully by including the customer in preliminary discussions and addressing concerns appropriately.

Separation

2.2.5 Royal Mail must be transparent about its costs. To achieve this, ring-fencing certain of its operations may need to be considered. This should not be interpreted as a call for a greater quantity of data, but rather as a plea for higher quality – specifically in terms of the full, transparent and accurate allocation of overheads and shared costs

2.2.6 Postwatch continues to believe that ring fencing and separation are issues for the regulator. But as we have said before, whatever structure Postcomm decides, it must guarantee the following:

- price transparency;
- cost reflective pricing (with transparent cross-subsidies if necessary to maintain USO price at an affordable level); and
- sufficient and effective controls over anti-competitive behaviour and abuses of market power.

⁵ http://www.psc.gov.uk/postcomm/live/policy-and-consultations/documents-by-date/2007/2007_10_30_Postcomm_CMV.pdf

⁶ http://www.psc.gov.uk/postcomm/live/policy-and-consultations/documents-by-date/2007/2007_10_30_Postcomm_BCS.pdf - pg16

2.3 An efficient and innovative Royal Mail

- 2.3.1 The postal industry is competing with several other industries: the transport business, media distribution systems, and e-commerce. Most importantly, new online services by banks, energy providers, other utilities, or e-business platforms have created new options for consumers to send 'mail' across the internet. It has become increasingly difficult for those operating within the traditional postal market to compete with what are perceived as more efficient and cost-effective methods of communicating, and with this lack of growth there has been little appetite to innovate.
- 2.3.2 An efficient Royal Mail is essential to support the development of the mail market. Competition, we believe, will maintain the pressure on Royal Mail to deliver a high quality of service to customers, and drive innovation. It may be that customers are not clear about what they want from the market as competition is still relatively immature and has been introduced relatively quickly. It is to all intents and purposes a market in transition.
- 2.3.3 The demands of customers and the market have evolved considerably over recent years: as the recent mail flow figures⁷ would suggest, the postal industry appears to be moving away from a two-way communications market to a more distribution-type market. Currently, businesses send 87% of all mail with 60% going from business to domestic customers.

Royal Mail and other licensed operators

- 2.3.4 The lack of radical innovation on the part of Royal Mail and new operators since the market opened fully in 2006 is largely due to declining mail volumes, strained industrial relations and a market within which opportunities may be scarce and difficult to exploit. The incentive to innovate is therefore not strong and competitors within the market who use access tend to provide almost identical products to those of Royal Mail. However, innovation has taken place, with some end to end operators looking at new ways to protect mail and to offer track and trace facilities to provide customers with comfort and confidence in the service. Royal Mail seek to lead the market in identifying new trends, exploring new opportunities, and exploiting the unique selling point of its end to end network.
- 2.3.5 The most obvious area for development is e-fulfilment. The Internet provides new ways for postal companies and retailers to work together. In a report published in the Financial Times⁸, it was revealed that 80% of internet shoppers first look and then choose their purchase from a catalogue they received in the mail. They then go on-line to order their purchase and finally the shipment arrives via the post. This is a growing market and a great opportunity for innovative market entrants. Royal Mail must be at the forefront of this.
- 2.3.6 Understanding the barriers is a precondition for overcoming them. One barrier may be regulation. Postwatch worked with Postcomm and Royal Mail to assist genuinely innovative products through the regulatory approval process and supported the relaxation of Trials requirements and the exclusion of some

⁷ Competitive Market Review 2007 Mail flows, domestic v business

⁸ 'Flick to click' shoppers turn new page, Financial Times - Aug 09, 2007

products from Condition 7⁹. We believe the process of getting products to the market is now more efficient as a result, both for Royal Mail and for customers.

Market activity

- 2.3.7 Royal Mail must now seek to grow the market where that is possible, and to minimise decline where it is not. Now that the recent industrial action is over, and the Government funding package secured, Royal Mail must embark quickly on its modernisation programme, investing in efficient technology and using it well. It must introduce innovations for customers which make mail an attractive medium to use. Not just innovation but personalisation drives interest in mail, increases its use and refreshes it as a communication channel.
- 2.3.8 One example of growing the market, exploiting growth areas and ultimately increasing volumes is Australia¹⁰. It appears to have contradicted the existing trend of many mail markets in decline. Domestic letter volumes grew by 1.9 per cent (or 93.1 million items), and domestic parcel volumes increased by 3.7 per cent. Royal Mail – and Postcomm – need to consider whether Australia has really bucked the trend in this respect, and if so, how this was managed and what lessons there are to learn.
- 2.3.9 Finally, in some situations innovation may be driven by the needs of the recipient rather than the sender. For example, there may be developments to be explored in delivery flexibility, when and where items are delivered. Access to items through enhanced collection options could also be an area for innovation. The industry (both Royal Mail and its competitors) must investigate these options and whether customers want or need them – and are prepared to pay for them.

2.4 The future of sector specific regulation

- 2.4.1 The role of postal market regulation is twofold: to create a framework that facilitates effective competition, and to protect consumers by acting as a substitute for competition where it is non-existent, limited or ineffective. In the latter role, it must prevent the incumbent from allowing commercial interests to damage those of customers. The introduction of PiP, the pursuance of Zonal Pricing, single daily delivery and the withdrawal of Sunday collections are all issues which have required to regulator to make difficult judgements in a complex and fast moving environment.
- 2.4.2 We understand that Postcomm has long committed to ‘light-touch’ regulation, removing its burden when sustainable competition emerges; but how the regulator assesses whether a truly competitive market exists is key to deregulation. In any case, there is, and for the foreseeable future will continue to be, a need for regulation to protect the universal service and to take account of Royal Mail’s market power.
- 2.4.3 Postcomm may wish to consider whether downstream access is the best way to achieve real competition for social users. Access regulation offers new entrants the possibility to enter downstream markets without investing in their own

⁹ Provision of information to users of postal services

¹⁰ http://www.ipc.be/index.php?option=com_news&task=view&id=330&Itemid=510

(upstream) infrastructure. While this can be seen as fostering market entry and hence competition, this may not increase overall efficiency.

- 2.4.4 Over the next five to ten years Postcomm must decide on the direction it wants to see the market take. Trying to create competition quickly and by using access may not have been the optimal route. A decision must be taken whether to promote end-to-end competition actively.

3. Postcomm Strategy Review Questions: The Postwatch Response

3.1 Universal service

A. *In what ways, if any, do you believe that the universal service should evolve to meet changing social, technological and economic factors and over what time period?*

The USO is both a social and a political construct. It is essential to retain a universal service which provides a level of postal service which meets the needs of all customers, and specifically vulnerable users.

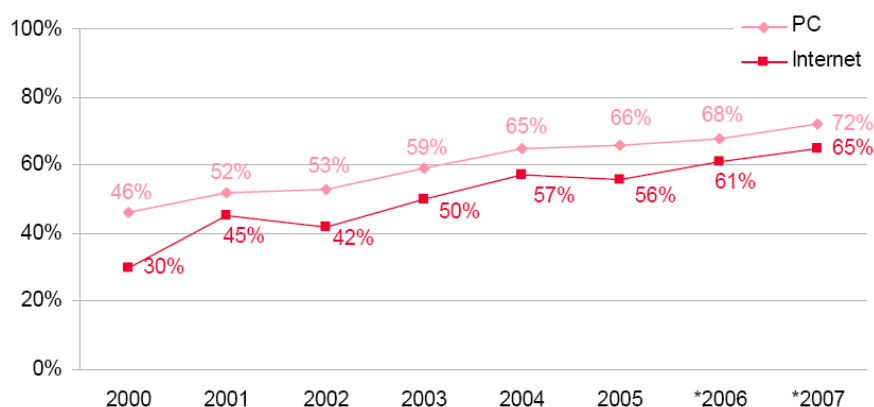
Nonetheless, there continues to be significant changes affecting the universal service. The central one is falling volumes, mainly due to e-substitution and competition.

There is also an increasing focus on sustainability, which may accelerate migration to other media (e-substitution). We have already seen significant change in the way transactional mail is being replaced by on-line bill payment and 'green' factors will increasingly be a consideration when companies offer online transaction services.

Similarly, technological changes in terms of e-communication (email, SMS messaging) will continue to affect physical mail volumes.

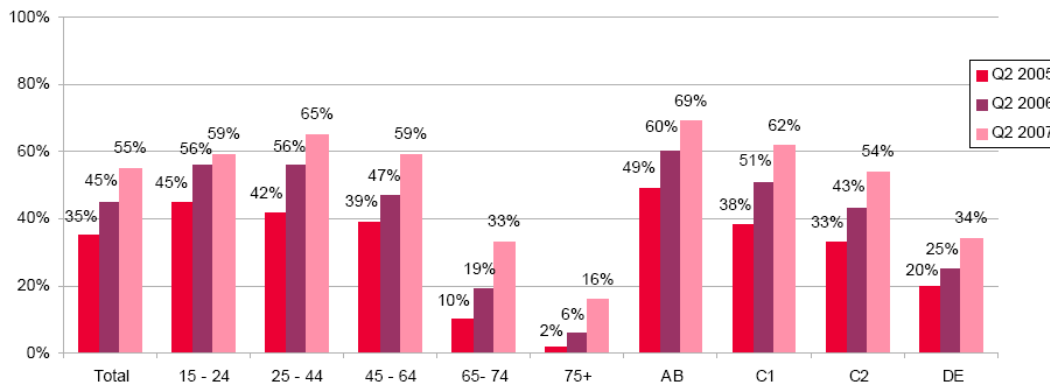
It may be that the increase in internet penetration is slowing down. Whether or not this is so (and the evidence is mixed), the households without internet access are generally those of poorer families, older people and people with disabilities. For many such customers electronic communication and transactions are unlikely to replace physical mail in the short term (see figures 1 & 2). Additionally, concern over on-line security and data may lead to some slowdown in e-substitution in this area.

Figure 1: Take-up of the Internet at home



Base: All adults 15+¹⁰. *Q4 data for 2001 to 2005, Q2 data for 2006.
Source: Ofcom communications tracking survey

Figure 2: Age and Socio-economic profile of those who have broadband access at home



Base: All adults (Q2 2005, 2206) (Q2 2006, 2439) (Q2 2007, 2265)
 Source: Ofcom communications tracking survey

In order to ensure those customers on low income are able to access postal services, there should for the foreseeable future be a backstop of an affordable service at a uniform tariff to every address in the UK. In terms of the how this is funded, there are a number of options. It is preferable that the USO is wholly funded by the provider, but if this is not the case then a range of funding mechanisms (including a reduced USO scope) will need to be considered. The European Commission has stated that the future funding mechanisms are for individual member States to determine.

Notwithstanding these issues, Postwatch considers that the key purpose of the USO is to provide a safety net of products and service. The scope of this service needs to meet customer basic needs to ensure accessibility for all users. This may be the current (or close to the current) level of products and services. The scope should, however, continue to be reviewed and a set of trigger points using assessments of the market and customer needs could be defined to ensure a USO that meets ongoing and future needs. The changes we would be prepared to contemplate in the short term are dealt with in our answer to question B.

B. What do you believe are the advantages or disadvantages of removing the requirement to provide existing universal bulk mail services at geographically uniform tariffs while maintaining the requirement to provide them on a universal basis?

It has been put to us that Mailsort 1400 is the only non-machineable bulk mail product and that protection for bulk mailers using this product would be afforded by maintaining its status within the USO. Postwatch believes that additional research and market analysis are necessary to determine what if any customer detriment there would be in taking Mailsort 1400 out of the USO, and we are certainly not persuaded that it should be taken out of price control. We consider that Cleanmail, as the lowest point of entry for bulk mail products, should remain within the USO. We have yet to see any real competition to this product.

We believe any move to a zonal structure could have a potentially negative impact on the USO particularly for people living in rural areas, due to the potential loss of volume of

mailing to such areas. However, one advantage may be that, if zonal pricing were to be introduced in a phased and acceptable manner to customers, then it could have benefits for Royal Mail through cost reflective pricing and achieving efficiencies.

C. What risks or benefits can you see to adopting a two stage approach to taking bulk services out of the universal service?

We consider there is advantage in a two stage approach to taking bulk services outside of the USO. If appropriate, products could be taken out of the universal service relatively soon but retained in the price control. The price control introduced in 2010 should contain a provision to review the scope of price controlled products within the period of the control. This would allow for the market for these services to develop further and for Postcomm to assess whether there would be any customer detriment to taking them outside the USO.

The benefits of a phased two stage approach outweigh any risks. There is no immediate need to withdraw these products and speed is not a key factor in this. Any well timed and well defined approach that involves the market in the consultative process would be of considerable benefit, by allowing the market time to prepare for change. However, this two stage process is not very clear. Any process must be well set out, clearly timetabled, effectively communicated and with well defined criteria and purpose.

3.2 Promoting effective competition

D. What do you think is holding back greater innovation in the UK mail market?

Royal Mail is investing in technology and introducing new pricing structures (e.g. PiP). But now that the damaging period of industrial action is over and that Royal Mail has been given a funding package by the Government for modernisation, needs to invest quickly, intelligently and imaginatively: it is unlikely to have such an opportunity again.

But the need to innovate is not for Royal Mail alone in lacking an innovative drive. The mail industry as a whole has not showed the entrepreneurial, customer focused and adventurous approach which was hoped for with the introduction of competition. The shrinkage of volumes overall is no doubt a factor in this; but it is not beneficial simply to have operators competing over a diminishing customer base. Postcomm may wish to consider putting incentives in place to entice niche operators to offer services, particularly in the yet to be exploited upstream area.

E. By what route, if any, should there be more transparency of Royal Mail's costs and ring-fencing of its activities (e.g. requiring Royal Mail to prepare separate accounts on a pre-defined basis for competitive and non-competitive parts of its business)?

The benefits of accounting separation would relate to allocating costs more accurately and making the regulator's job easier in assessing pricing applications. This should result in the industry's having more confidence in Postcomm's decisions.

We continue to believe that any decision around separation of physical assets is a

decision for the regulator. However, as stated in our response to the first stage of this review, whatever structure or framework Postcomm decides on, it must guarantee the following:

- price transparency;
- cost reflective pricing (with transparent cross-subsidies if necessary to maintain USO prices at an affordable level); and
- sufficient controls over anti-competitive behaviour and abuses of market power .

F. What do you believe are the potential benefits or problems arising from imposing greater cost transparency on Royal Mail (i.e. requiring Royal Mail to prepare separate accounts on a pre-defined basis for competitive and non-competitive parts of its business)?

There would be benefits for **Postcomm** in being able to assess readily the financial health of Royal Mail, enabling it to take an informed view whether the USO is under threat. It should also result in **Royal Mail's** being able to submit realistic and clearly defensible pricing structure proposals for consideration by Postcomm. And it would give **the industry** more confidence that applications are based on sound data and that any resultant change to the pricing structure is, in fact, cost reflective.

One disadvantage is that to implement processes and procedures to deliver such an output could be costly at first.

G. What do you believe are the advantages or disadvantages of Postcomm moving from ex ante to ex post measures for tackling anti-competitive behaviour?

So long as the regulator is quick, decisive, consistent, efficient and robust in tackling any anti-competitive behaviour it may not matter whether it employs an ex ante or ex post regime. However, in practice, no regulator can ensure that anti-competitive practices will not occur. In a newly-deregulated market, ex ante regulation is essential. A strong and efficient regulator should lead to the view that respect for the regulatory regime will deter companies from breaking the rules.

Given the market power Royal Mail enjoys, ex ante particularly important. In practice, a company with the market share of Royal Mail is always in a position to exploit its power to the detriment of customers and of the market. The need for it should decline as the competitive market matures and Royal Mail's market power lessens. The disadvantage of ex ante regulation is greater uncertainty in forecasting where potential market failures or anti-competitive issues lie than in dealing with matters ex post, where something has actually happened, and accurate lessons can be learned and controls applied to subsequent activities.

Disadvantages surrounding ex post measures are that they apply 'after the damage has been done'. They can also be costly and time-consuming, involving lengthy legal battles which may result in an unsuitable outcome for the postal market as a whole. Such an approach also requires a willing and able regulator to take on difficult cases and bring offenders to book.

H. Where in the longer term are customers likely to remain captive to Royal Mail such that continued price regulation is required?

Ultimately social users, where competition is unlikely to develop, will require price protection - though customers protected by the price control have already had to suffer above inflation price increases for the last few years. Should these products be removed from the price control or the pricing regulations relaxed, then Royal Mail would be certain to raise the prices for 'captive' products significantly, since few alternatives exist. This approach may also extend to franked mail as this is a difficult area for other competitors to enter unless they have access to franking machines on the same basis as Royal Mail. This is unlikely and these customers should be protected by regulation until alternatives exist.

It may be appropriate for Postcomm to review exclusivity arrangements that Royal Mail has with franking machines and it may look to introduce some form of regulation in this area so as to foster competition for those franking machine users who do not have a competitive alternative.

3.3 Price control and regulation

I. What, if any, further pre-conditions (beyond cost transparency, strong ex post controls on anti-competitive behaviour and equalisation of VAT treatment) do you think are required to justify a reduction in the scope of the post 2010 price control?

Postwatch believes that Postcomm should reduce the scope of the price control only when it is sure that effective competition in the postal market has been established and is judged to be sustainable. There is a serious risk of halting emerging competition in the market should the scope of the price control be reduced. In addition, it is not realistic to assume that VAT, cost transparency measures and ex post controls will be in place by the time the next control is introduced.

J. If Royal Mail implements better cost transparency, which commands the confidence of the industry, between now and 2010, what would be the benefits or risks of a proposal to reduce considerably the scope of price and service quality controls on Royal Mail?

The time between now and the lead up to 2010 is short. Accordingly, we do not believe that this is a realistic question or that the goal, or what is being suggested to be implemented in the context of cost transparency, is achievable within this timeframe.

K. What would be the impact (positive and negative) of restricting the next price control on Royal Mail (due to come into force from April 2010) to benchmark services (such as stamped single piece items and access services), rather than covering a wide range of similar services?

We believe that to restrict the price control to stamped items and access only would be extremely risky and would leave many customers exposed, primarily small and medium businesses which use franking machines as their mail channel. Additionally, there may be a risk of stifling competition in the areas where it is beginning to become established.

L. What alternatives are there to the current approach of regulating minimum headroom for access products?

We refer Postcomm to our response¹¹ to the Interim Review. We believe that the minimum headroom should not need to be revisited until a case has been made by Royal Mail to do so or until there is sufficient pressure on Royal Mail's finances to justify such issues being addressed. Every proposed price adjustment should then be subject to wide consultation and should be considered on its merits and on its possible impact on headroom and in the wider industry.

¹¹ [http://www.psc.gov.uk/postcomm/live/policy-and-consultations/documents-by-date/2007/Postwatch_Response\[1\].pdf](http://www.psc.gov.uk/postcomm/live/policy-and-consultations/documents-by-date/2007/Postwatch_Response[1].pdf)

Appendix A

Universal Service table

Postal Services Directive	Postal Services Act 2000	Royal Mail Licence
<p>A postal service of specified quality at all points in the territory at affordable prices for all users</p>	<p>A service provided at affordable prices in accordance with a public tariff which is uniform throughout the UK</p>	<p>Condition 4 specifies detailed quality of service targets for USO <i>and other price-controlled</i> products</p> <p>Condition 2 lists [18] specific products to be provided at a uniform tariff that is uniform throughout the UK.</p> <p>Condition 21 (the price control) is used by the regulator to ensure that prices of these products are affordable</p>
<p>Save in exceptional circumstances, the universal service must include as a minimum</p> <ul style="list-style-type: none"> - one clearance - one delivery to home, premises or appropriate installations <p>every working day and not less than 5 days/week</p>	<p>Except in exceptional circumstances, the universal service must include</p> <ul style="list-style-type: none"> - at least one collection from each access point - at least one delivery to home, premises or identifiable point approved by the Regulator <p>every working day: letters: collection & delivery 6 days/week postal packets: collection & delivery 5 days/week</p>	<p><i>As in the Postal Services Act</i></p>
<p>Minimum USO facilities:</p> <ul style="list-style-type: none"> – Clearance, sorting, transport and distribution of: <ul style="list-style-type: none"> - Postal items up to 2 kg - Packages up to 10 kg – Services for registered items and insured items <p>(weight limit for packages can be up to 20 kg, but must be 20 kg for incoming international packages)</p> <p>Minimum and maximum package dimensions defined by Universal Postal Union rules</p>	<p>Postal packets' weight does not exceed 20 kg</p> <p>A registered post service is provided (at a uniform affordable price)</p> <p>Dimensions fall within permitted [UPU-defined] limits</p>	<p>The universal service ... shall include a registered and an insured service and incoming and outgoing services for letters posted from and to addresses outside the UK</p> <p><i>Specific products satisfying these criteria are included in the list in Condition 2.</i></p>
		<p>Condition 3 sets out detailed requirements for the density of letter boxes and access points</p>