



POSTCOMM'S REVISED MARKET OPENING TIMETABLE:

ROYAL MAIL'S RESPONSE

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SUMMARY

1. Overall, Royal Mail welcomes the introduction of competition. However, Postcomm and Royal Mail both need to think through the full consequences of market opening and ensure that Royal Mail has the commercial freedom to compete effectively so allowing us to provide the universal service while generating a commercial return for our shareholder. Most importantly Royal Mail must have the freedom to rebalance and restructure prices to remove historic cross-subsidies. In particular, in order for Royal Mail to compete in a liberalised market, this will require the removal of bulk mail services from the uniform tariff constraints of the universal service obligation and the introduction of size based pricing by the time of the next price control in 2006. Other aspects of Royal Mail's initial views on the principles and requirements for the next price control are set out in Royal Mail's response to the *2006 Royal Mail Price and Service Quality Review* document.
2. This summary focuses on three key areas relating to Postcomm's Market Opening document (Postcomm's "MO document"). These and other areas are covered further in the main text.

A false sense of security

3. We recognise that Royal Mail's financial position has improved in the first half of the current 3-year price control and that this provides Postcomm with some security that the provision of the universal service will not be threatened in the short-term. However, we believe that the MO document reflects a false sense of security arising from Postcomm's interpretation of the Competitive Market Review and its analysis of competition in Sweden and New Zealand, both of which omit significant information. Fundamentally, prices must be rebalanced to ensure that in a competitive market there are minimal cross-subsidies that would encourage inefficient entry and undermine the universal service.
4. In addition, we welcome Postcomm's recognition that, in the longer-term, there may also be a need for both price increases and, ultimately, a financial mechanism (e.g. Postcomm suggests a "support fund" paid for by entrants) to preserve the universal service. A significant academic literature highlights the potential problems ahead in ensuring the provision of the universal service in the longer-term. As the document correctly indicates, this should not be overlooked. This remain a fundamental issue and indeed we believe that Postcomm should set out further details of such schemes to demonstrate clearly that Postcomm has met its primary duty which is to seek to ensure the provision of a universal service.

Innovation and efficiency

5. We recognise Postcomm's emphasis on promoting competition by bringing forward the original proposals for market opening from 1 April 2007 to 1 January 2006 as a means of encouraging efficiency. However, we have

implemented significant changes to our operations and taken out cost as part of the Renewal Plan, and plan to do much more. Early introduction of market opening will neither increase nor decrease our resolve to improve efficiency, make Royal Mail a better place to work and earn a commercial return for our shareholder.

6. We welcome the MO document's emphasis on the need for innovation but believe that Postcomm's own actions have severely limited our innovation in three important respects: Firstly, while the licence made specific provision to allow us to apply to change the structure of prices, our application to change our pricing structure to introduce size based pricing has led to a 16 month process (to date) with no timetable for completion and the distinct possibility that this particular innovation will not take place within the 3-year period of the current control. Secondly, it is surely unnecessary for the licence to *require* us to provide products that are deemed to be outside of the universal service. Greater scope to change non-price terms is also needed to facilitate innovation and benefit customers overall. Thirdly, much innovation requires investment and we believe that there should be stronger incentives for investment in the price control as discussed further in Postcomm's 2006 *Royal Mail Price and Service Quality Review* document.

Bulk services are not universal services

7. While we support the proposed removal of products from the universal service obligation, we do not support the proposal to treat Mailsort 1400(1&2) as a universal service. The specific groups that need to be protected in the promotion of competition are not the senders of bulk mail items. There are only 4000 senders of bulk mail in the whole of the UK. This is not *everyone* and therefore does not meet Postcomm's own criterion of "*everyone, for everything, everywhere*". We believe that first class prepaid mail, available to everyone, drives the costs of the universal service by requiring an extensive upstream network and an every door, every day delivery capability and, consistent with this view, it could be argued that coverage of the universal service should be limited to first class prepaid mail only.
8. Furthermore, while the MO document states that smaller bulk mail customers, in particular, should enjoy the continued assurance of purchasing a bulk mail service that is a universal service, it does not explain why smaller bulk mail customers, in particular, would wish to continue with the market distortions caused by the imposition of a uniform tariff requirement on Mailsort 1400(1&2) nor explain what the benefits of retaining the uniform tariff are to smaller bulk mailers. In practice, the retention of one bulk mail service at uniform prices that are not cost reflective, while all other services are more cost reflective, may result in switching between bulk mail services to take account of arbitrage opportunities arising from the distortions of the uniform tariff. This not only increases the uncertainty of volumes and revenues for our planning and operations, but also leads to pricing to ensure a contribution neutral outcome that may not be to the benefit of our bulk mail customers because of the inherent market distortions caused by the uniform tariffs. In fact, Postcomm puts forward exactly this argument in support of a single set of access prices, rather than both uniform and zonal access prices, in the same Chapter of its MO document.

1. INTRODUCTION

- 1.1 This document sets out Royal Mail's response to Postcomm's document *Revised Market Opening Timetable* (September 2004). This is subsequently referred to in this response as "Postcomm's MO document". Postcomm's MO document refers in the Annex to an impact analysis made by one of its consultants, Frontier Economics.
- 1.2 On the same day Postcomm also published papers relating to the *2006 Royal Mail Price and Service Quality Review* (the "PSQR document") and *Competitive Market Review* (the "CMR document"), to which Royal Mail is responding separately. Royal Mail considers all of these documents to be interrelated and relevant to the price control review.
- 1.3 The issues raised in "Postcomm's MO document" to which this document responds relate directly to the proposal to advance the introduction of further market opening from 1 April 2007 to 1 January 2006 and the proposal to retain some bulk mail services under the universal service obligation.
- 1.4 For ease of reference, the subjects of the subsequent chapters of this document mirror the corresponding chapters in Postcomm's MO document (Chapters 2 to 4 and Annex) as follows:

- Chapter 2: Accelerated market opening
- Chapter 3: Licensing and other implications of full market opening
- Chapter 4: Universal service obligation and bulk mail
- Chapter 5: Impact analysis.

2. ACCELERATED MARKET OPENING

- 2.1 This Chapter is in response to Postcomm's statement: "*Postcomm welcomes views from stakeholders on its proposal to fully open the UK market to competition from 1 January 2006 (with no intermediate step between 1 April 2005 and 31 December 2005).*" (Postcomm, September 2004).

A false sense of security

- 2.2 Royal Mail recognises that its financial position has improved in the first half of the current 3-year price control and that this provides Postcomm with some security that the provision of the universal service will not be threatened in the short-term. Royal Mail notes that the materiality of the change can be factored into the development of the market for the setting of the next price control.
- 2.3 Postcomm's document on Market Opening places much emphasis on the evidence within, and supporting, its CMR document and its impact analysis. Royal Mail is concerned that Postcomm's CMR document, on which Royal Mail responds separately, has led it into a false sense of security and belief that there will be limited entry. The evidence shows that customers are sensitive to price and significant volume could switch to entrants and that the VAT status is less significant as a potential barrier to entry than was originally considered by Postcomm to be the case¹. Royal Mail has reviewed this evidence and concluded that Postcomm's CMR document is incomplete and in some critical aspects a misrepresentation of the evidence and thereby misleading. While appearing to support Postcomm's market opening proposals, the evidence within the document is to the contrary and its conclusions unsubstantiated in the critical area of whether the findings support the duty on Postcomm of ensuring the provision of the universal service in the UK (see Royal Mail's response to Postcomm's CMR document). In addition, the impact analysis in the Annex of Postcomm's MO document is incomplete and insufficient in this regard (see Chapter 5 of this response).
- 2.4 Postcomm also appears to have a false sense of security from reports of limited market entry in Sweden and New Zealand. In Sweden, the universal service provider rebalanced prices significantly to ensure that they were more cost reflective as the market opened. Even so, Citimail currently delivers about a quarter of all mail delivered in areas where it competes (essentially major cities within Sweden). In New Zealand prices were already reasonably cost reflective before liberalisation. Postcomm's MO document does not recognise this critical point and appears to support more gradual changes in prices towards greater cost reflectivity (4.45). In addition, the universal service providers in both countries have priced aggressively to try to ensure sufficient market share to sustain the financial viability of the universal service obligation. This is also not recognised in Postcomm's MO document. Royal Mail welcomes, however, the recognition that Royal Mail "*makes a loss on the part of the market that is not yet opened to end-to-end competition*" (2.55), which illustrates the fundamental and urgent need for significant price rebalancing. Fundamentally, prices must be rebalanced to ensure that in a competitive market there are minimal cross-

¹ As a corollary, Royal Mail is also concerned that Postcomm appears to see economies of scale as a barrier to entry rather than of economic benefit to the postal user.

subsidies that would encourage inefficient entry and undermine the universal service.

- 2.5 Postcomm appears to have set itself an objective “to secure a genuinely level playing field” (S.17). A genuinely level playing field is not defined by Postcomm but leaves the reader with the impression that it is one in which all competitors compete on the same basis. Yet Royal Mail is the only operator that has an obligation to provide a universal service and at tariffs that are geographically uniform. It is difficult to square this with a genuinely level playing field. The implication is that some counter balance is required to secure the provision of the universal service. This is recognised in paragraph S.37 of Postcomm’s MO document and is Postcomm’s primary duty under the Act.
- 2.6 Royal Mail welcomes the recognition within Postcomm’s MO document (in paragraphs 2.59 and 2.61 in particular) that, in the longer term, there may be a need for both price increases and ultimately a financial mechanism (e.g. Postcomm suggests a “support fund” paid for by entrants) as a means of preserving the universal service. While Postcomm’s MO document states that “no convincing case has been demonstrated to suggest that continuing monopoly privilege is required to safeguard the universal service” (2.37), a significant academic literature highlights the potential problems ahead in ensuring the provision of the universal service in the longer-term. As the document correctly indicates, this should not be overlooked. Royal Mail believes that Postcomm should set out further details of such schemes to determine clearly that Postcomm has met its primary duty, which is to seek to ensure the provision of the universal service.

Timetable, innovation and efficiency

- 2.7 Royal Mail recognises Postcomm’s emphasis on promoting competition by bringing forward the original proposals for market opening from 1 April 2007 to 1 January 2006 as a means of encouraging efficiency. Royal Mail has implemented significant changes to its operations and taken out cost as part of the Renewal Plan, and plan to do much more. Early introduction of market opening will not change its resolve to improve efficiency, make Royal Mail a better place to work and earn a commercial return for its shareholder. Whether competition has or has not manifested itself in the market to date has no bearing on this resolve. In this regard, the threat and potential consequences of entry alone provide sufficient impetus.
- 2.8 Royal Mail welcomes the MO document’s emphasis on the need for innovation. However Royal Mail must point out that words must be matched by action to facilitate innovation. Postcomm’s actions have severely limited Royal Mail’s innovation in three important respects, as follows:
- (a) while the licence made specific provision to allow Royal Mail to apply to change the structure of prices, Royal Mail’s application to introduce size based pricing has led to a 16 month process (to date) with no timetable for completion and the distinct possibility that this particular innovation will not take place within the 3-year period of the current control.
 - (b) it is surely unnecessary for the licence to *require* Royal Mail to provide products that are deemed to be outside of the universal service. Greater scope to change non-price terms is needed to facilitate innovation and

benefit customers overall. In this regard, the non-price terms are constrained to excess by the current licence (licence condition 19(1)) by focusing on the potential detriment, with no account of magnitude, to a single customer.

- (c) much innovation requires investment and there should be stronger incentives for investment in the price control. These areas are discussed further in Royal Mail's response to Postcomm's SQPCR document.

2.9 The MO document promotes the bringing forward of its 1 April 2007 proposals as a means of making the UK postal sector a leader with potential benefits for postal customers. It makes no reference to the other potential beneficiaries of other foreign postal operators and provides no hard evidence that Royal Mail will have equal access to enter their domestic markets. Royal Mail notes Postcomm's belief (or hope) that some other countries will follow its lead within a short period of time, but it is not substantiated within the document (S.29).

Other points of note

2.10 There are several more technical points within Chapter 2 of Postcomm's MO document that Royal Mail sets out below:

- (a) Royal Mail considers the references to only 0.3% of Royal Mail's market to have been lost to competitors to be misleading. This is discussed further in Royal Mail's response to Postcomm's CMR document. There is a real need to come to a single measure that is acceptable to the industry.
- (b) Royal Mail considers that the international experience is that market opening does not encourage "some" small scale niche operators, but that of many, many small operators. Royal Mail believes that the risk of these entrants destabilising the market is high (as observed in Sweden).
- (c) Royal Mail notes that UK Mail is not offering a two-day, time certain product. Access products have an approximate 95% service quality that is not time certain.

3. LICENSING AND OTHER IMPLICATIONS OF FULL MARKET OPENING

- 3.1 This Chapter is in response to Postcomm's statement: "*Postcomm welcomes views from stakeholders on its proposal for reviewing the licensing regime, raising market awareness, raising the priority of interoperability issues and the process for dealing with requests from Royal Mail to move some of its prices more closely into line with its costs.*" (Postcomm's MO document).

Licensing of other operators

- 3.2 Royal Mail supports the need for the licensing of other operators as a means of ensuring mail integrity. Royal Mail supports Postcomm's proposals for all operators being required to provide a bank, or similar, guarantee and the principle of the need for a supplier of last resort. Royal Mail notes that since the publication of Postcomm's MO document in September (2004), Postcomm has published its consultation document on its licensing policy (30 November 2004), which Royal Mail will respond to in due course (by 28 February 2005).

Market awareness

- 3.3 Royal Mail welcomes Postcomm's commissioning of its customer survey which was undertaken for it by its consultant in this area, Roland Berger Associates, and the publication of an extensive report by its consultants which it has placed on its website. Royal Mail agrees that detailed work of this type and analytical extensions, including conjoint analysis of potential switching behaviour by customers, is informative, essential to understand developments in the market and should be undertaken on a regular basis.
- 3.4 Royal Mail is surprised that Postcomm concludes that "*there is currently a low level of awareness of the market opening programme amongst the wider postal industry and its customers*"(3.18). Royal Mail does not draw the same conclusion from the report. This is discussed further in Royal Mail's response to Postcomm's CMR document.

Interoperability

- 3.5 Royal Mail notes Postcomm's proposal to consult on an industry code of practice for interoperability in Spring 2005 and welcomes this development as Royal Mail regards the issues of interoperability to be an important development of the competitive market. Royal Mail believes that it is important to maintain integrity and commercial confidence in the postal market and have in place clear and precise rules and operations for all licensees. As principles, Royal Mail should not be expected to do work for other operators at a loss and other operators should be prepared to conform to reasonable rules for use of the network used to meet the universal service obligation.
- 3.6 As a potential further development in a competitive market, interoperability should not just be limited to the use of Royal Mail's network but be extended to the use by Royal Mail of other networks. This, in turn, may need to be built into the licence of other operators.

Facilitating price restructuring

- 3.7 Royal Mail recognises that Postcomm is continuing to review Royal Mail's costing system. Royal Mail has submitted two applications (or "*rebalancing requests*") whereby price changes exceed the thresholds within the current structure. These relate to response services and size-based pricing and are discussed further in Chapter 2 of Royal Mail's response to the SQPCR document. It is necessary that the reference by Postcomm to it responding "*more quickly*" (3.32) to Royal Mail's future applications is in the context of *both* future price rebalancing and restructuring. The current review of Royal Mail's application to introduce size based pricing has taken 16 months with no timetable for completion.
- 3.8 Finally, Postcomm states that "*Once Postcomm is satisfied that the proposal is of sufficient quality, it would review the evidence submitted to it*" (3.34), but has not identified guidelines as to what constitutes "*sufficient quality*". Royal Mail believes that there is a real need for greater clarity with regard to the process and expectations. This is referred to in Royal Mail's response to Postcomm's SQPCR document for the price control review and should be taken forward as part of that review.

4. UNIVERSAL SERVICE OBLIGATION AND BULK MAIL

- 4.1 “Postcomm invites views from stakeholders on its proposals to define Mailsort 1400 (first and second class) as the generic universal service product for bulk mailers and to allow, subject to safeguards, Royal Mail some geographic pricing flexibility on other bulk mail products (including access products)” (Postcomm’s MO document).

Bulk services are not universal services.

- 4.2 Royal Mail recognises the need to define the universal service more clearly and on a rational basis. Royal Mail believes that all bulk mail services should be outside of the universal service and that the case presented by Postcomm for putting Mailsort 1400 (1&2) into the universal service does not stand up to scrutiny.
- 4.3 Postcomm’s MO document sets out the rationale for the inclusion of Mailsort 1400 (1&2) in the universal service as a “*pragmatic judgement*” (4.8) that appears to be based on a view that there is insufficient competition in Mailsort 1400 (1&2) to exclude it from the universal service and, by implication, a need to continue to distort the pricing in the bulk mail market through enforcing uniform Mailsort 1400 (1&2) tariffs. Royal Mail believes that this “*pragmatic judgement*” has no reasonable or rational grounds. Royal Mail does not support the proposal to treat Mailsort 1400 (1&2) as a universal service.

The universal service is closely related to the groups identified under the Postal Services Act (2000) that need to be protected in the promotion of competition (Part 1, Section 5(2)). These groups relate to individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low income and individuals residing in rural areas. These are not the senders of bulk mail items. There are only 4000 senders of bulk mail in the whole of the UK. This is not “*everyone*” (4.17) and therefore does not meet Postcomm’s own criterion of “*everyone, for everything, everywhere*” (4.17). Royal Mail believes that first class prepaid mail, available to everyone, drives the costs of the universal service by requiring an extensive upstream network and an every door, every day delivery capability and, consistent with this view, it could be argued that coverage of the universal service should be limited to first class prepaid mail only.

- 4.4 Furthermore, Postcomm’s MO document states that “*smaller bulk mail customers in particular should **enjoy** the continued assurance of purchasing a bulk mail service that is a universal service*” (S.35 with emphasis added). The document does not explain why “*smaller bulk mail customers in particular*” would wish to continue with the market distortions caused by the imposition of a uniform tariff requirement on Mailsort 1400(1&2). It does not explain what the benefits of retaining the uniform tariff are to smaller bulk mailers. In practice, the retention of one bulk mail service at uniform prices that are not cost reflective, while all other services are more cost reflective, may result in switching between bulk mail services to take account of arbitrage opportunities arising from the distortions of the uniform tariff. This not only increases the uncertainty of volumes and revenues for Royal Mail planning and operations, but also leads to pricing to ensure a contribution neutral outcome that may not be to the benefit of its bulk mail customers because of the inherent market distortions caused by the uniform tariffs. In fact, Postcomm puts forward exactly this argument in support of a

single set of access prices, rather than both uniform and zonal sets of access prices, in the same Chapter of its MO document.

Facilitating pricing flexibility

- 4.5 Postcomm states that the removal of services from the universal service obligation (USO) “*gives Royal Mail more pricing flexibility than was previously the case*” (S.22). This is only true if Royal Mail can proceed to introduce such pricing flexibility following the removal of the product from the USO. In practice, Royal Mail may not be able to proceed because of other restrictions within the licence (notably the restriction on the changes to non price terms in Licence Condition 19(1) and Postcomm’s process of applications for changes to pricing structures in Licence Condition 19(12)). Changes to the licence would be needed in this regard to achieve Postcomm’s objective and “*gives Royal Mail more pricing flexibility*”.
- 4.6 The European Directive sets out the universal service obligation for member states, the Postal Services Act (2000) sets out the obligation of the universal service for the UK and Royal Mail’s licence requires it to undertake the universal service. Postcomm’s document defines services that are *not* part of the universal service. Royal Mail considers that there is no requirement under the European Directive and Postal Services Act that requires Royal Mail to continue the provision of these services. Consequently, Royal Mail believes that it should not be *required* within the licence to continue to provide these services. This requirement is currently enforced only through a licence condition (Licence Condition 19(1)). This condition should be amended to remove the regulation restricting changes to the service (relating to non-price terms) and thereby facilitate the pricing flexibility envisaged by the removal of the universal service obligation from such services.

5. IMPACT ANALYSIS

- 5.1 This Chapter briefly comments on the impact analysis contained in the Annex of Postcomm's MO document.
- 5.2 Royal Mail welcomes the fact that Postcomm has asked a consultant to assess the impact of its policy change details. However, it notes that this impact assessment is only for the short-term and that the assumptions underlying the analysis are not contained within the document and have not been shared with Royal Mail to-date. Therefore it is not yet able to comment on the reasonableness of the analysis or its conclusions.
- 5.3 Royal Mail notes that the results reported are not consistent with the conclusions from Royal Mail's own models where the impact on contribution of entry is significantly more adverse than appears to be the case in the results reported in Postcomm's Annex. For the avoidance of doubt, Royal Mail does not accept, on the basis of the limited information that Postcomm has placed in the public domain from this work, that universal service can necessarily be financed in a fully liberalised market and hence that Postcomm has demonstrated that it is fulfilling its primary duty to ensure the provision of a universal postal service.
- 5.4 Royal Mail expects Postcomm and its consultants to recognise, test and show the sensitivity of its estimates of profitability to the underlying assumptions. Royal Mail believes it is potentially quite misleading to draw simple conclusion that "*It shows that Royal Mail should make a profit through the period*" (A1.31), from the points estimated in Table A1.3, without demonstrating that these results are robust with respect to the underlying assumptions.
- 5.5 Therefore Royal Mail would expect Postcomm to present information covering a range of reasonable scenarios showing evidence that it is aware of the risks it needs to manage regarding universal service in a fully liberalised market. As this is not the case. Postcomm has not been able to present mechanisms through which it can demonstrate that it is meeting its primary duty. Although Postcomm refers to work undertaken for it by Arthur Andersen in preparation for its Decision Document of May 2002, Royal Mail did not accept the conclusions of that study and set out its evidence for this as part of Postcomm's consultation at that time.
- 5.6 Royal Mail believes that greater transparency in this area is in the public interest. Postcomm has advised Royal Mail that it will be receiving some of its consultants' models a few weeks before its next consultation, scheduled in April. Royal Mail eagerly awaits receipt of these models. Since work has already been completed and referred to in Postcomm's MO document, Royal Mail believes that Postcomm should be willing to share this information now.