

Agenda

Advancing economics in business

Enhancing delivery: the peculiarities of postal regulation

What's so peculiar about postal regulation? After all, it is in theory based on the same model as that used for the regulation of the monopoly elements of the energy, rail, telecoms and water sectors. Sarah Chambers, Chief Executive of Postcomm, explains why the postal service can be regarded as a special case, and how the regulator is responding to this

On the surface, postal regulation does appear to be quite similar to that of other industry sectors, yet the context is profoundly different. In other industries, the development of regulation followed a particular pattern:

- fatten up the nationalised industry to make it fit for privatisation at a healthy price;
- privatise it, introducing a regulatory framework at the same time, and perhaps gently start to promote a little competition;
- then actually promote competition, perhaps at the same time promoting similar frameworks around the European Community.

In the postal market, the process has happened the other way round:

- Europe came first with the 1997 Postal Services Directive. This set out rules for a universal postal service and the setting-up of independent regulatory authorities in Member States;
- the government then introduced legislation and created a regulator to regulate postal services and promote competition;
- share ownership remained with the government.

The government has stated that it wishes to act like a commercial shareholder, and that Royal Mail should be treated as a commercial company. This is what is needed, but a company owned entirely by the government inevitably leaves the regulator without some of the useful indicators that apply in a fully commercial market. For example:

- lack of competition in the capital market means that key signals, such as share price and credit rating, are absent;

- there is no market threat of a takeover if management underperforms, and Royal Mail is spared the attentions of investment analysts;
- to cap it all, the Department of Trade and Industry Shareholder Executive, Royal Mail's only shareholder, is also in charge of the regulatory regime, and appoints Postcomm Commissioners—one of whose duties is to promote competition to Royal Mail!

With less access to information and benchmarks, the postal regulator is regularly subjected to trial by media, Parliament and government.

Other peculiarities relating to the regulation of postal services include the following.

- *The universal service*—other utilities have the equivalent to our universal service, but not quite like this one, which is enshrined in Directives and an Act stating that the universal service must be delivered at the same tariff throughout the country, even if the costs of supply are very different.
- *A public service but a commercial imperative*—people, and politicians, really do think that there is something special about post and that it is more of a public than a commercial service. This is related more to its place in our culture as a vital means of communication for households, businesses and government. When people think of post, they often think of popping a letter into a post box or mail landing on their doormat. However, although these activities are important, they give a misleading impression of the economics of the business.

In terms of who pays for mail and who sends it, the mail market is dominated by large businesses and

This article is based on 'Overview of Full Market Opening and the Postcomm Review', a presentation by Sarah Chambers at the Oxera conference, 'The Future of Infrastructure Regulation', London, May 15th 2006.

government. Domestic mail makes up less than 10% of the market. In addition, there is a high degree of customer concentration: the top 500 customers account for half of all volume. Post is also subject to competition from other media, such as email. So there is an element of contestability which is absent from markets such as water.

- *Entry barriers*—Royal Mail is a large super-dominant player, with more than 95% of the market. It is vertically integrated, owned by the government, and has government-imposed advantages over its competitors. The advantages include a unique VAT exemption, not available to competitors, which acts as a significant barrier to entry—even though this is a market where the government has stated that it is seeking to promote effective competition.
- *Infrastructure*—this is a networked industry, with a large established infrastructure; however, unlike the water, energy and telecoms sectors, this infrastructure is not sunk as cables and pipes under the ground. In the postal sector the infrastructure goes home at night. It is also heavily unionised with a history of delicate industrial relations.

It is true to say that the postal market will see more change during 2006 than it has over the past 350 years. The three key events this year are:

- January 1st: full market opening;
- April 3rd: Royal Mail's new price control took effect;
- August 21st: introduction of pricing in proportion (PiP).

Each of these events is discussed in turn below.

Full market opening

Postcomm opened up the bulk mail market to partial competition in 2003. The threshold was a minimum of 4,000 items of mail at a time, and it interested major mailers such as banks, insurance companies, building societies and direct mail houses.

With full market opening, and no threshold, the switch from a single-operator to a multi-operator mail market called for some different rules. Postcomm developed a new licensing framework—a single standard licence for all new entrants that contained codes on mail integrity and common operating procedures, but with no restrictions on the scale or scope of their operations. By January 1st 2006, 14 companies were licensed to compete with Royal Mail, and the number is still rising (although new licensees have picked up only a very small proportion of the market to date).

So far, full market opening has brought some new products and services, including a two-day service, mail

tracking, secure services, guaranteed delivery dates and later collection times.

Royal Mail's response has been positive. Its quality of service is at a record high (eg, 94% of first-class mail is delivered the next day, compared with a target of 93%), profits are up, and it is introducing new products. However, it still has work to do on improving efficiency, cost variability and delivering a better customer service.

We never expected that fully opening the mail market would generate a 'big bang' in terms of bringing effective competition overnight or delivering revolutionary changes to the customer experience. However, it has been managed in a way that poses no threat to the universal service. There have already been direct benefits to business customers who are now being offered lower prices and a greater range of services from new operators. Furthermore, a spin-off is that all customers are now receiving an improved quality of service from Royal Mail.

There has been a marked change in attitudes to market opening over the past five years. In 2001, Royal Mail described it as 'death by a thousand cuts'.¹ One year later, a report from the National Audit Office (NAO) stated that:

The introduction of competition could result in a breakdown in the delivery of a universal service at a reasonable uniform price.²

In the same report, the NAO also pointed to the opposite risk that too little competition would fail to spur the sort of change within Royal Mail that could lead to better customer service.

These rather pessimistic predictions can be compared with what was being said in 2005:

The market has opened up ... and has been very successful both for the end customer, competitors entering and, indeed, the Royal Mail.³

The evidence that liberalisation delivers an improved service for customers is compelling.⁴

The price control

The previous price control was for three years (2003–06) and was set at a time when Royal Mail was losing £1m per day.

The current control (2006–10) had to be developed in a wholly different context. Instead of a business on the verge of collapse, losing money on operations and with industrial relations problems, we now have a reasonably successful, profitable business, capable of making some

changes in its operations to render itself technically more efficient.

But we have a new problem in the shape of an enormous pension deficit. Royal Mail is now no longer simply a mail business. It is now a massive pension fund with a relatively small mail business attached. The mail business may be doing quite well, but this is not particularly helpful when the pension fund is ten times the size of Royal Mail's regulated business assets, and the deficit alone is twice as big.

This was the slightly unusual context in which Postcomm had to set Royal Mail's price control for the next four years. The key elements of the settlement were:

- an allowance of £320m per year to help reduce the pension deficit;
- a pension pass-through mechanism to allow increased contributions if the deficit rises to more than £5.9 billion;
- a requirement for efficiency improvements of 3% per year;
- an allowance of £1.2 billion for investment over the four-year period;
- the price of a first-class stamp could rise to a maximum of 37p by 2010.

Pricing in proportion

The next major change will be in August, when Royal Mail will begin pricing its products by size as well as weight.

Since the days when mail was carried on horseback, postage has been levied according to the weight of the item, but nowadays this bears little relationship to Royal Mail's cost structure. It has been losing money on large lightweight items, such as letters in A4 envelopes and oversized greetings cards, and making considerable profits on small heavier items such as books and catalogues. Thus, customers posting small heavy items were heavily cross-subsidising those posting large light ones.

This will be corrected through a new system in which both size and weight will determine the price. Although 70% of prices will remain the same, this will still be a complicated change which many may find unwelcome. It is important that Royal Mail gets its communications right so that customers are aware of the changes.

The future: what form will competition take?

The partial market opening that began in 2003, and full market opening this year, have brought about a limited amount of competition. Yet, as discussed above, Royal

Mail still has more than 95% of the market, and almost all of the competition in bulk mail uses access arrangements to Royal Mail's network, where competitors collect mail and deliver it to mail centres, at which point it is passed to Royal Mail's postmen and women to deliver the final mile. Royal Mail makes a profit from access and still delivers virtually all the mail in the UK.

To date, few operators have offered end-to-end (E2E) services. Will these develop in the next few years in any volume? Will access prove to be the launch pad for new entrants who will move to E2E as some of their business plans suggest, or will access continue to be by far the largest element of competition, as proved to be the case in telecoms?

If access competition is the only area of effective choice, will this generate all the benefits to customers that we expect from a fully competitive market, or will some customers still lose out?

Alternatively, will E2E start to take off, perhaps not everywhere, but in cities and other urban centres, taking substantial volumes away from Royal Mail?

There are reasons to doubt the size and speed of E2E competition. Some of these are discussed below, along with an explanation of how Postcomm is addressing them.

- *The VAT barrier*—Postcomm is influencing the debate with the European Commission and HM Treasury in an effort to secure a more even-handed VAT regime on postal services that would create a more level playing field. However, this is likely to take some time to change.
- *Customer inertia*—we are helping to spread the message about the benefits of testing the market, although this is mainly a task for operators.
- *Network economies of scale*—this is a significant benefit which Royal Mail enjoys, but since it acts to the clear advantage of customers, there may be nothing that Postcomm can or should do to address this.
- *Anti-competitive practices*—when Royal Mail seeks to abuse its dominant position through anti-competitive behaviour, we take decisive action to stop this.⁵

Unanswered questions: Postcomm's strategic review

There is still a great deal about the postal market that we do not know, along with considerable speculation. We

will therefore shortly be launching a long-term strategic review, modelling different scenarios about the future, and asking questions of operators and mail users about what they think will really happen. For example, are we doing enough to protect the universal service, promote customer interests, and generate effective sustainable competition? Will current policies enable us to achieve our vision of a successful competitive market delivering a universal service and protecting vulnerable customers? If not, what changes in regulatory policy do we need?

After gathering feedback on these issues from stakeholders, Postcomm will be proposing regulatory policies for the future. The review will be conducted in the context of our statutory duties—particularly the preservation of the universal service.

Competition is still very new and fragile, and has taken only a tiny share of the market. During the review, we will be learning lessons from other industries, including the very difficult question of whether to respond to market developments, force the pace, or leave it well alone.

We will also be looking for opportunities to withdraw from regulation, on the grounds that markets are almost always better for customers than regulation, provided that they work freely and competitively.

Ultimately, we hope to be able to identify much more specifically the means to achieve our vision of a postal market with a range of competitive services, including a successful Royal Mail, delivering the universal service and serving all types of customer to a higher standard.

Sarah Chambers

¹ Allan Leighton, Chairman of Royal Mail, commenting on Postcomm's proposals to open up 30% of the postal market to competition in 2003. *Guardian*, March 6th 2002.

² NAO (2002), 'Opening the Post: Postcomm and Postal Services—The Risks and Opportunities', January.

³ Quote by Adam Crozier, Chief Executive of Royal Mail, House of Commons Trade and Industry Committee (2005), 'Royal Mail after Liberalisation', December.

⁴ House of Commons Trade and Industry Committee (2005), *op. cit.*

⁵ For example, on February 17th 2006, Postcomm issued an enforcement order and proposed a penalty of £2.16m on Royal Mail for securing unfair commercial advantage over new operators. See <http://www.psc.gov.uk/competition/anti-competitive-behaviour.html>.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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