



POSTCOMM'S COMPETITIVE MARKET REVIEW PROPOSALS:

ROYAL MAIL'S RESPONSE

December 2004

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EXECUTIVE SUMMARY

Introduction

1. Postcomm's consultation document *Competitive Market Review: Proposals for Consultation* (September 2004) has no specific questions for respondents to consider. Its purpose is to provide background and supporting information on the development of the UK postal market in support of its market opening proposals and other policies and we welcome the opportunity to comment on the consultation paper.

Recent Market Developments

2. Postcomm outlines the development of the licensed area of the postal market (0-350g; <£1) up to the first half of 2004. Since then the downstream access market has developed rapidly, bringing new services to customers. Although there has been limited entry to date into the former monopoly area, we believe this could change dramatically in the coming months. Some competitors also remain interested in providing end to end services.
3. We welcome the market survey by Postcomm's consultant, Roland Berger Associates, and its early publication on Postcomm's website. Although that report suggests that customer awareness and the potential for switching is low, our interpretation of this published information (reinforced by some additional work by Roland Berger using its conjoint model) is that customer awareness and the potential for switching is high so that there is a significant market potential for services offered by new postal operators.
4. Roland Berger presents a number of recommendations "...aimed at promoting effective competition whilst ensuring the continued provision of a universal service" (para 2.22). The most important one is "to fully open the market in "Phase II" of market opening". However, the consultant's work is based on a customer survey and does not model the extent of entry, financial impacts on Royal Mail or the regulatory framework (for example, structure of price controls). **No substantive evidence has been provided that any of its recommendations ensure the continued provision of a universal service.**

Barriers to Entry

5. Postcomm reviews a number of barriers to entry including economies of scale, Royal Mail's VAT exemption, potential anti-competitive behaviour and customer inertia.
6. We believe that economies of scale, which are significant in delivery and collection, are a benefit to consumers by helping to lower prices and, where necessary, can be overcome by entrants through downstream access. This is developing rapidly such that Postcomm's vision of Royal Mail sharing downstream economies of scale with other operators, thereby encouraging, efficient competition and innovation in other network activities, is already happening.
7. Downstream access has been achieved through commercial, freely negotiated contracts, with minimal regulatory involvement. The success of these contracts supports our view that Postcomm's proposals for a greater degree of accounting

separation for the Access operation and controlling Access prices are unnecessary and likely to be counter-productive.

8. We agree with much of Postcomm's analysis of the impact of VAT in the Review's annex, but continue to oppose the removal of VAT exemption, as it would lead to a 15% price rise for the majority of customers (17.5% standard rate of VAT lowered by our ability to recover input tax). Postcomm's analysis concentrates on large customers, where entry is most likely, and shows that for these the impact on price competitiveness is quite small (about 2% on average) because the majority can reclaim input tax.
9. We are puzzled and disappointed by Postcomm's expectation of anti-competitive behaviour by Royal Mail. We have consistently supported the liberalisation of postal services in the UK, and demonstrated our determination to avoid predatory or discriminatory behaviour with a comprehensive compliance programme designed to ensure adherence to competition law. We reject the view that we will adopt anti-competitive behaviour. Postcomm's proposed investigative teams and procedures need only be implemented when and if firm evidence of anti-competitive behaviour emerges.
10. On the basis of the evidence available, particularly from the Roland Berger study, we believe that Postcomm has over-stated the extent of customer inertia in the postal services market. We have no objection to Postcomm's proposed market awareness programme but we are not convinced it is necessary.

Prospects for Entry

11. As a whole, Postcomm's *Competitive Market Review* document is an informative and useful statement of the licensed area of the UK postal market (addressed inland letters below 350g) in the first half of 2004. In addition, the market research undertaken by Roland Berger is a step forward in seeking to understand customer preferences.
12. However, our assessment of the material Postcomm presents is that the prospects for entry are significantly greater than it believes and that the barriers to entry are less. An example of entry is the development of the access market. We welcome, therefore, Postcomm's intent to monitor the development of the market carefully and to undertake regular Competitive Market Reviews. Alongside this we believe it is essential that Postcomm has proactive policies to manage possible long term risks to universal service as discussed in our responses on Postcomm's two consultation papers on *Revised Market Opening Timetable* and *2006 Royal Mail Price and Service Quality Review*.

COMPETITIVE MARKET REVIEW: MAIN RESPONSE

1. INTRODUCTION

- 1.1 This document sets out Royal Mail's response to Postcomm's *Competitive Market Review: Proposals for Consultation*, published in September 2004. On the same day Postcomm published two other papers: *Revised Market Opening Timetable* and *2006 2006 Royal Mail Price and Service Quality Review*. Royal Mail is responding separately to each paper although it believes all three are interrelated.
- 1.2 The purpose of Postcomm's *Competitive Market Review* consultation paper is to provide background and supporting information on the UK postal market in support of its market opening proposals. Postcomm has posed no specific questions for respondents to consider. However, the consultation paper presents recommendations as well as analysis from its consultant on market developments, Roland Berger Associates, regarding the promotion of effective competition whilst ensuring the continued provision of a universal postal service. Material is also presented on other areas such as VAT and barriers to entry from which Postcomm seeks to draw evidence to support its policies in these areas. Accordingly, Royal Mail welcomes this opportunity to respond to Postcomm's consultation paper allowing it to state where Royal Mail supports Postcomm's analysis and to explain the basis of differences where Royal Mail takes an alternative position.
- 1.3 The chapter numbers, letters and paragraph numbers used throughout Royal Mail's response reference the appropriate section of Postcomm's *Competitive Market Review* consultation paper. There are summaries at the beginning of the two longer chapters in this response: Chapter 2 on Recent Market Developments and Chapter 4 on Barriers to Entry (including Annexes on Economies of Scale and VAT). For its response, Royal Mail commissioned, through Postcomm, additional analysis on customer switching from Roland Berger Associates.

CHAPTER 2: RECENT MARKET DEVELOPMENTS

Summary

- 2.1 Royal Mail welcomes the process followed by Postcomm in developing its competitive market review and, in particular, the customer survey and conjoint analysis work undertaken for it by Roland Berger Associates.
- 2.2 Postcomm focuses its attention on the licensed area which equates only with addressed inland letter products (0-350g; <£1) and does not cover other parts of the wider postal market which includes other segments such as unaddressed mail, express services and delivery of newspapers and magazines.
- 2.3 Roland Berger and Postcomm interpret the results of Roland Berger's customer survey to indicate that "*customers had a low appetite for switching to other operators*" (para 2.21). Royal Mail's interpretation of the results is quite different. In Roland Berger's report, 30% of companies could envisage using entrants' in the near future and 30% were undecided while additional analysis by Roland Berger using its conjoint model showed that over 20% of volume could switch to an entrant offering an equivalent service specification at a price difference of 10%.
- 2.4 Postcomm states "*Roland Berger made a number of recommendations to Postcomm aimed at promoting effective competition whilst ensuring the continued provision of a universal service*" (para 2.22). The first and most significant was "*to fully open the market in "Phase II" of market opening*". However, Roland Berger's recommendations were based on a customer survey. It did not consider the continued financial viability of Royal Mail in a liberalised market, nor did it model entry. Royal Mail concludes, therefore, that while the Roland Berger study provides valuable information on one aspect of the continued provision of universal service (the extent of customer switching), the study provides no substantive evidence to support Roland Berger's assertion about the sustainability of universal service in a fully liberalised market.

Overall Comment on Postcomm's Chapter

- 2.5 Royal Mail broadly agrees with Postcomm's view of the development of the postal market to 2003/04, including the number of competitors, their range of products and the continuing growth of the overall market. However, there are some aspects of Postcomm's analysis that Royal Mail believes are misleading or misinterpreted. These are covered in the appropriate sections below.

Measures of Competition (2.2 - 2.4)

- 2.6 The five measures of competition identified in the paper are all valid with the exception of the test relating to Royal Mail's performance and behaviour; but it is essential to define the markets to which they are applied. Postcomm concentrates on the segment of the market where, until 2001, Royal Mail had a statutory monopoly. This may be valid when analysing the direct effects of Postcomm's liberalisation programme, but it is definitely not appropriate for assessing the competitive pressures on Royal Mail. Royal Mail faces serious competitive threats from the wider communications market: advertisers, for example, can easily switch from direct mail to media advertising or telephone selling.

- 2.7 It is also important to understand the key sub-sectors within each market. For example, the Special Delivery market has two distinct sub-sectors: a business sector which is highly competitive and an over-the-counter sector with limited competition. Applying the standard measures of competition to the Special Delivery market as a whole can produce misleading results, and lead to decisions for the whole market that may not be appropriate for either sub-sector in isolation.

Scale and nature of competition

(a) Market Entry to Date (2.5 - 2.9)

- 2.8 Postcomm focuses its attention on the licensed area which equates only with addressed inland letter products (0-350g; < £1). Until the issue to Royal Mail of its first licence in March 2001, this was a reserved area by law where Royal Mail's share, except for infringements of the monopoly, was 100%. From June 2001 Postcomm issued interim licences to a small number of licensees. In January 2003, the EU reduced the reserved area to 100g and Postcomm began to issue long-term licences to operators for mailings above 4,000. Other components of the wider market such as unaddressed mail, express services and newspapers and magazines are not considered. These are highly competitive sectors and while Postcomm is interested specifically in the important segment of the market which was until very recently a monopoly service its use of the terms "the letters market" or "the postal market" appears to be a catch-all for this segment alone.

Market Volumes and Market Shares

a) End to End Volumes (2.10 - 2.13)

- 2.9 Royal Mail generally agrees with Postcomm's summary, but would put the growth in volumes for the licensed area during 2003/04 at 1.6%, rather than Postcomm's rounded 2%. Royal Mail volumes were higher than forecast primarily because of the delayed impact of liberalisation, particularly from downstream access

b) Access Volumes (2.14 - 2.15)

- 2.10 In table 3, Postcomm reports forecasts for 2004/05 from the three consolidator services which have so far signed access agreements with Royal Mail. Additionally, it is very important to note that, under the EU Directive, downstream access must also be offered directly to customers that can meet the requirements for such use of the network. This is the case for customers that post large numbers of items and these, too, can be expected to start to make use of downstream access before the end of 2004/05. Consequently the total number of access items may exceed the figures in Q4 reported by Postcomm.
- 2.11 A combination of consolidator services and customer direct access is expected by Royal Mail to lead to a very significant increase in downstream access through 2005. The evidence to date indicates that downstream access volumes appear mostly to be displacing items that were previously carried by Royal Mail from collection through to final delivery (end to end) or as bulk mail through the RDC network.
- 2.12 In measuring volumes for the purpose of calculating market shares, Postcomm adopts a convention of counting an access item as a half of an end-to-end item. Royal Mail believes that a more useful method is to distinguish between delivered volumes, which consist of the total number of items delivered by Royal Mail and

includes access as a full item, and Royal Mail end-to-end items, which excludes access items. Access leads to different amounts of volume flowing through different stages of Royal Mail's network. Treating access as half an item obscures this and either over or understates the shares of entrant and customer direct access in the market.

c) Market Revenues (2.16 - 2.17)

2.13 Given its definition of the letters market as equal to the monopoly area prior to 2001 and, apart from some short term licences, effectively up to January 2003, it is unsurprising that Royal Mail's market share of revenues was close to 100% in 2002/03. The reasons for this share having changed little during 2003/04 either by revenue or end-to-end volume are well rehearsed and summarised by Postcomm in its document.

Customer Awareness and Behaviour

(a) Roland Berger's Customer Survey (2.18 - 2.20)

2.14 Royal Mail welcomes Postcomm's commissioning of its customer survey which was undertaken for it by Roland Berger Associates, a market research company, 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, should be undertaken on a regular basis.

(b) Key Results of the Survey (2.21)

2.15 Royal Mail's interpretation of the extensive results published by Postcomm differ somewhat in a number of important respects to Postcomm's summary. In particular:

- a) Roland Berger and Postcomm interpret the results of the customer survey to indicate that "*customers had a low appetite for switching to other operators*" (para 2.21). Royal Mail's analysis of Roland Berger's data reached a quite different conclusion. In Roland Berger's report, 30% of companies could envisage using entrants in the near future and 30% were undecided while additional analysis by Roland Berger at the request of Royal Mail showed that over 20% of volume could switch to an entrant for an equivalent service specification at a price difference of 10%.
- b) Roland Berger and Postcomm also state that "*customers were generally not well informed about potential new operators or the market liberalisation process.*" Again, Royal Mail's analysis of the same data reaches a different conclusion; namely that customers were well informed about new operators and the liberalisation process. Indeed, other survey results identified in paragraph 2.21 of the consultation paper support this view: customers must be well-informed to be aware of entrants' added value, risks and costs, and of the alternative services on offer.
- c) Roland Berger and Postcomm state that "*some 41% of customers interviewed had not been contacted by an alternative provider*" (para 2.21). The corollary of this is that the majority of customers, 59%, had been contacted.

- 2.16 Royal Mail's conclusions are based on an analysis of the full results of the survey, including further information requested from Roland Berger. This included the output from a number of additional simulations Royal Mail asked the consultancy to undertake using the conjoint model it produced for Postcomm.
- 2.17 The results indicate that customers stated a high willingness to switch from Royal Mail products where entrants are able to offer lower prices with an equivalent service specification. For example, from Roland Berger's model at an equal price/quality offering, Royal Mail would retain 55% of customers' preference in a market with alternative suppliers. If, however, an alternative supplier were to offer a service using downstream access at a price 10% lower than Royal Mail's, the Roland Berger model indicates that the entrant would take 40% of customer preference while Royal Mail's share would drop to 40% as well. Far from suggesting that "*customers had a low appetite for switching to other operators*", these results suggest that for an equivalent service specification customers are very price sensitive with over 20% of volume switching to an entrant for a price difference of 10%. Indeed Royal Mail's conclusion is consistent with Postcomm's own assumption of a multiple of 2 in its analysis of VAT in Chapter 4 of its consultation document. There, Postcomm shows that a uniform VAT regime would improve the price competitiveness of entrants by about 2% and it then assumes that this will be associated in a 4% improvement in the share of volumes being captured by entrants.
- 2.18 Royal Mail notes that in its *Revised Market Opening Timetable*, Postcomm includes at Annex 1 an "Impact Analysis" in which it seeks to re-assess the impact of competition on Royal Mail's volumes and revenues. In its annex it reports various results from its analysis of these issues. A selection of results are reported which imply some customer switching to access or entrant end-to-end volumes. Royal Mail seeks clarification from Postcomm on the use it has made of Roland Berger's detailed work on customer switching in setting its assumptions on this in its assessment of the impact of competition.

(c) Roland Berger's Recommendations to Postcomm (2.22)

- 2.19 As Postcomm states "Roland Berger made a number of recommendations to *Postcomm aimed at promoting effective competition whilst ensuring the continued provision of a universal service*" (para. 2.22, Royal Mail's emphasis). However, Roland Berger's analysis is of customer preferences alone. The continued provision of a universal service, currently through Royal Mail, requires either the continued financial viability of Royal Mail following entry by other suppliers or some alternative means of provision. The latter is not considered in the report by Roland Berger and it presents no model of entry and no estimates of the expected level of entry. Consequently, it is not in a position to say whether the level of entry following liberalisation will be high or low. Roland Berger's recommendations therefore need to be seen from the perspective that it is not able to estimate the impact of any of its recommendations with regard to whether the continued provision of universal service is possible or not.
- 2.20 In particular, its first and principal recommendation is "to fully open the market in 'Phase II' of market opening". It is a truism that fully opening the market will maximise the extent of competition in that market. However, the impact of such a development over the long term on "*the continued provision of a universal service*" is not assessed in Roland Berger's work because it has no model of competitive entry to the letters market and the impact of this on Royal Mail. Nor does it explain the regulatory framework (for example, structure of price controls) that would exist in a

fully opened market which would be highly material to the sustainability of universal service. **Accordingly, Royal Mail wishes to make clear, and for the avoidance of doubt, its assessment that the Roland Berger study provides no substantive evidence to support Roland Berger's statement that fully opening the postal market is compatible with ensuring the continued provision of universal service.**

2.21 Two of Roland Berger's other recommendations concern the promotion of Access business. The development of Access business has, as the paper acknowledges, progressed considerably since the survey. As a result of Royal Mail's recent Access agreements with other operators, and the ensuing publicity, there is no longer a need to "*increase market confidence that access was a reliable alternative*" (para 2.22). This view is supported by the number of Access enquiries Royal Mail is receiving. Furthermore, in view of these enquiries, and also the number of Access agreements freely negotiated with Royal Mail, the need for Postcomm to "*take the lead in implementing a clear and quick negotiation process (i.e. access code)*" is unclear. In similar vein, Royal Mail is not sure how Postcomm can "*raise market awareness of the liberalisation process with operators and customers*" more effectively than the operators themselves. Indeed, there is a danger that untimely promotion of liberalisation could generate a level of interest in the entrants that they are not ready to fulfil, thereby leading to a loss of credibility in the liberalisation process.

2.22 Royal Mail agrees with Roland Berger's recommendation that "*a level playing field needs to be established for all operators.*" Royal Mail expects Postcomm to adopt this principle when specifying licensees' obligations for mails integrity, quality of service (measurement methodologies and reporting requirements), compensation, complaints' reporting and accounting separation. This issue, together with Roland Berger's recommendation for early market opening, are considered more fully in Royal Mail's response to Postcomm's *Revised Market Opening Timetable* consultation paper.

(d) Postscript (2.23 - 2.24)

2.23 Royal Mail supports Postcomm's comments in its postscript regarding the Roland Berger work and welcomes Postcomm's intent to update its market research on customer preference in the future. Roland Berger's survey and conjoint analysis provides extremely useful information as a starting point although it is only one component of a number necessary to assess the impact of competition on the market and on the continued provision of universal service.

Royal Mail's performance and behaviour

a) Overall financial performance (2.25 – 2.26)

2.24 Royal Mail agrees that it "*has seen a sharp improvement in its financial performance over the last year*" (para 2.25) and that further improvement can be expected as the Renewal Plan is completed. However, the improvement was on a disappointingly low base and does not mean that Royal Mail's profitability is now at a satisfactory level, nor at a level that guarantees the ongoing viability of universal service provision.

b) Segmental financial analysis (2.28)

2.25 Paragraph 2.28 states that “*Postcomm has not endorsed Royal Mail’s approach for the allocation of costs*”. Whilst this may be strictly true, the allocation of costs is on the same basis as that used in Royal Mail’s regulatory statements. This methodology was developed following consultation with Postcomm, and the regulatory statements prepared on the basis of the methodology are audited by Ernst & Young.

c) Royal Mail’s quality of service performance (2.33 - 2.43)

2.26 Royal Mail believes there is a data error in paragraph 2.37 where the 55.9% figure for 2003/04 is not consistent with the figures for 2001/02 and 2002/03. This is because the minimum floor target rose to 90.5% in 2003/04; in the two previous years it was 90.0%. The comparable figure for 2003/04, using the same 90.0% target, would have been 62.7%.

2.27 More generally, Royal Mail is disappointed that the consultation paper refers repeatedly to the “*deterioration*” in Royal Mail’s quality of service. Royal Mail accepts that its quality of service was below targeted levels in 2003/04, and is making every effort to ensure significant improvements and achievement of targets in 2004/05. However, as the paper notes in paragraph 4.76 “*when compared to its main European counterparts, Royal Mail’s prices are very competitive and its service quality targets (if not current performance) are high.*” In fact, even current performance is high when compared with that achieved both in other European countries and, historically, in the UK.

CHAPTER 3 : STAKEHOLDER VIEWS

What regulatory measures can Postcomm take to improve the prospects for effective competition benefiting postal users and leading to innovation?

- 3.1 Although competitive entry (including losses due to customer direct access) has been slow to develop, a critical issue remains how entry will increase over the medium and longer term and the extent to which such competition impacts upon the ability of Royal Mail to provide universal service while remaining financially viable. It is essential that Postcomm takes seriously the possibility that, over the longer term, entry could reach a level which undermines the funding of universal service (the so-called “graveyard spiral”)¹ and that it has in place clear and explicit mechanisms to manage this risk to prevent its occurrence. The financial framework for Royal Mail is the price control and it is through both that element of the regulatory framework that this fundamental risk should be managed as well as through its approach to market opening and licensing of entrants.
- 3.2 These risks are considered further in Royal Mail’s responses to Postcomm’s *Revised Market Opening Timetable* and *2006 Royal Mail Price and Service Quality Review* consultation papers.
- 3.3 Royal Mail considers it perverse that its prices might need to be raised so that entrants would have sufficient “headroom” to enter the market (para 3.33). Where entry occurs, prices generally should be lower for customers rather than higher.

¹ Crew, Michael A. and Paul R. Kleindorfer. 2005. “Competition, Universal Service and the Graveyard Spiral”. In *Regulatory and Economic Changes in the Postal and Delivery Sector*, edited by M.A. Crew and P.R. Kleindorfer. Boston, MA: Kluwer Academic Publishers; Hill, Roger, Richard Robinson and Frank Rodriguez. 2005. “The Financial Equilibrium of Universal Service Providers in a Liberalized Postal Market”. In *Regulatory and Economic Changes in the Postal and Delivery Sector*, edited by M.A. Crew and P.R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

CHAPTER 4 : BARRIERS TO ENTRY

Summary

- 4.1 Royal Mail agrees with many of Postcomm's conclusions regarding economies of scale in Royal Mail's network. These are greatest in collection and delivery but also exist in trunking and distribution. These economies of scale are linked to Royal Mail's position as provider of universal service and as such are a benefit to postal users.
- 4.2 In line with its response to Postcomm's consultation response on special privileges, Royal Mail does not support Postcomm's proposal for VAT on postal services. Because a VAT rate of other than 17.5% would require unanimity among all EU states, realistically the introduction of VAT will lead to a 15% price rise for the majority of Royal Mail's customers (17.5% standard rate of VAT lowered by Royal Mail's ability to recover input tax).
- 4.3 However, Royal Mail agrees with much of Postcomm's analysis of the effect of the removal of Royal Mail's VAT exemption which concentrates on the effect of this on the largest mailers. This concludes that because the majority of Royal Mail's top 100 customers are rated for VAT purposes (and so can reclaim input tax) removal of the exemption would lead on average to a 2% improvement in entrant competitiveness, overall, not 17.5% as sometimes claimed. In turn, Postcomm applies a multiple of 2 and then asserts that a 2% improvement in price competitiveness will lead to a 4% gain in market share by entrants.
- 4.4 This is quite a significant switching impact in line with the results from Roland Berger's additional analysis for Royal Mail. Elsewhere, however, Postcomm quote ADL and Roland Berger's statements that switching will be low. Royal Mail seeks clarification from Postcomm on its position regarding expected switching by customers.
- 4.5 Royal Mail is puzzled by Postcomm's apparent expectation of anti-competitive behaviour by Royal Mail and rejects the view that Royal Mail will use anti-competitive behaviour as a barrier to entry. Royal Mail fully supports Postcomm continuing to monitor compliance within existing legislation and licence conditions and investigations of genuine complaints regarding Royal Mail's behaviour.
- 4.6 Royal Mail believes that the consultation paper has overestimated the extent of customer inertia in the postal services market. Royal Mail has no objection to Postcomm's proposed market awareness programme but is not convinced that it is necessary.

Royal Mail's Economies of Scale (4.2 – 4.25 and Annex 1)

- 4.7 In table 4.1 Postcomm shows its consultant's estimates of Royal Mail's economies of scale for different "service offerings" and network segments. Royal Mail generally agrees with the sense of Postcomm's conclusions drawn from this table. However, the table does not demonstrate a fully accurate understanding of the dynamics of the operation of Royal Mail's network and an alternative table shown below is proposed:

Service Offering	Collection	Consolidation	Outward Sortation	Trunking	Inward Sortation	Local Distribution	Walk Sequencing	Final Delivery
B2B	M/H	L	L	M	L	M	L	M
B2C	M/H	L	L	M	L	M	L	H
C2B,C2C	H	M	L	M	L	M	L	H

- 4.8 The shaded cells in the table represent changes to Postcomm's table. In general the changes reflect a number of points. First, activities that require the individual handling of each item of mail separately (i.e. sorting) demonstrate few economies of scale (and conversely). Secondly, there are greater economies of scale in the collection segment of the network because of the need to provide universal service i.e. collection every day from a prescribed density of collection points, regardless of the volume of mail to be collected. Thirdly, there are greater economies of scale in the trunking segment of the network because of the need to provide a link, within a limited time window, to all inward mail centres and delivery offices every day as part of the provision of universal service.
- 4.9 Royal Mail agrees with the conclusions Postcomm draws from its table 4.1 that economies of scale would make it difficult, first, for entrants to offer service to individual customers and households (C2B, C2C segments) and, secondly, for entrants to put in place a complete end-to-end delivery network to provide universal service. Households send about 15% of mail and, on Postcomm's analysis, they will not see entrants offering services to them. Similarly, Postcomm's analysis reinforces the importance of Royal Mail continuing to be in a position to fund its collection and delivery network in order to be able to provide universal service for it is very unlikely, as Postcomm's analysis shows, that any entrant would seek to replicate it.
- 4.10 However, for business customers (which collectively post about 85% of mail), particularly bulk mailers requiring delivery less than every day, economies of scale are much more modest. This is especially so because entrants can use Royal Mail for final delivery through downstream access which has been achieved through commercial, freely negotiated contracts with minimal regulatory involvement. Postcomm does not state in its competitive market review document how much entry it expects under given scenarios nor does it provide quantitative estimates of the responsiveness of costs to volumes. Royal Mail's assessment is that significant entry is possible for certain types of product and downstream access is developing rapidly such that Postcomm's vision of Royal Mail sharing its downstream economies of scale with other operators, thereby encouraging efficient competition and innovation in other network activities, is already happening.
- 4.11 Furthermore, it should also be recognised that operating and maintaining the national delivery network, and the associated obligation to provide a universal service at a uniform, affordable tariff has some disadvantages. In particular, there are high fixed costs, which could not be reduced quickly if volumes fall significantly, perhaps as a result of losses to competitors or e-substitution.

Royal Mail's VAT Exemption (4.26 - 4.54)

- 4.12 Royal Mail's position regarding the removal of its VAT exemption remains as stated in its response to Postcomm's January 2004 consultation document, *A Review of Royal Mail's Special Privileges*. Royal Mail does not support Postcomm's proposal for VAT to be levied on postal services. VAT at the standard rate would lead to a 15% price rise for the vast majority of our customers, including the general public, the fundraising activities of charities, and small businesses. (17.5% standard rate of VAT lowered by Royal Mail's ability to recover input tax).
- 4.13 Clearly, any changes in this area are not for Postcomm to implement but for the UK government. However, there is no realistic prospect of EU law permitting a VAT rate other than the standard rate of 17.5%, at least in the short to medium term. Postcomm notes that the European Commission put forward a proposal on 5 May 2003 which, if it became law, would enable a lower rate of VAT to apply. However, as Postcomm notes at para 4.30, this proposal will only become law if it is unanimously agreed by all member states. Member states have very divergent views on this issue and it is unlikely that an early agreement will be reached. In view of this any proposal to change the VAT status of postal services in the UK must assume the VAT rate is 17.5% for the foreseeable future.
- 4.14 Postcomm put forward its proposal on VAT in January 2004 in its consultation document on Special Privileges. Postcomm's current paper sets out the responses it received to its January 2004 proposal. Royal Mail notes that, unsurprisingly, Postcomm received no support from customers for a VAT change that led to a price increase.

Postcomm's further VAT analysis (4.44 – 4.50 and Annex 2)

- 4.15 Postcomm has undertaken an analysis of the impact of VAT which is summarised in Annex 2 of its consultation paper. Royal Mail agrees with much of that analysis. In particular, it is important to draw the distinction between the effects on customers that are rated for VAT purposes (and so can recover input tax) and those that are not rated for VAT purposes (VAT exempt and so cannot recover input tax). This point is not brought out in the main document where reference is made only to the position of VAT exempt customers. Instead, Annex 2 draws this out very clearly and shows that while a uniform rate of VAT across all customers would improve the competitiveness of entrants by about 13% for customers that are VAT exempt it would actually worsen competitiveness of entrants by about 3% for those customers that can recover VAT. Postcomm notes further that of Royal Mail's top 100 customers 31 were VAT exempt so that entrants would be disadvantaged by the VAT regime currently in place in offering services to such customers. These include some of the largest customers such as banks. However, 69 were rated for VAT purposes. Here the lack of VAT on postal services gives entrants who wish to offer postal service a small price advantage of about 3% to over two thirds of top 100 customers. From the comments made by some, this point is generally not well understood and it is helpful that Postcomm has brought it out so clearly in its Annex 2.
- 4.16 More tentatively, Postcomm then calculates a weighted average indicating that a uniform VAT rate would improve the competitiveness of competitors by about 2% overall, taking account of those that gain (31% x 13%) less those that lose (69% x

3%)². This is far removed from some comments which quite incorrectly, as Postcomm shows, claim that Royal Mail has a 17.5% price advantage from not being required to levy VAT on letter services at the current standard rate of VAT in the UK. Postcomm states in para 4.48, without referring to supporting evidence, that a 2% improvement in entrant competitiveness would allow them to gain 4% of Royal Mail's volume and comments that the impact might even be larger than this. However, this multiple of 2 is broadly consistent with Royal Mail's interpretation of the market research information from Roland Berger but this is not referred to by Postcomm to support its assertion that a 2% improvement in entrant competitiveness will lead to a gain of 4% of Royal Mail's volumes. Instead, in para 4.46, Postcomm refers to ADL's belief that for competitors to win share from Royal Mail they would need to offer average discounts of around 20% to persuade customers to switch.

- 4.17 The multiple of 2 noted in para 4.48 suggests that Postcomm agrees with Royal Mail that customers are very price sensitive and that significant volumes will switch to entrants at relatively small price differentials. Royal Mail seeks clarification of Postcomm's position in this respect particularly as it refers to ADL's belief which appears to be contrary. In its analysis of VAT Postcomm concludes that large amounts of volume would switch to entrants at relatively small differences in prices. Elsewhere in this and other consultation documents it seems to take the position that switching will be very modest and provides no threat to the continued provision of universal service.

Potential anti-competitive behaviour by Royal Mail (4.55 - 4.75)

- 4.18 Royal Mail recognises entrants' vulnerability to unfair competition during the early stages of liberalisation, and accepts Postcomm needs to consider how to deal with complaints about anti-competitive behaviour from end-users or other postal operators. However, Royal Mail is puzzled by Postcomm's apparent expectation of anti-competitive behaviour by Royal Mail. This expectation is strong enough for Postcomm to rate it one of the top four barriers to entry, to actively plan for a team of staff to deal with the expected level of complaints and to "*consider 'own initiative investigations' where it suspects that competition is not developing to further the interests of postal users*" (para 4.60).
- 4.19 Royal Mail has consistently supported the liberalisation of postal services, even though it has not always agreed with Postcomm's approach, and has genuine concerns about the potential risk to the universal service. Royal Mail has demonstrated its determination to avoid predatory or discriminatory behaviour with a comprehensive compliance programme designed to ensure awareness of and adherence to competition law. Indeed, its voluntary negotiation of Access agreements, ahead of Postcomm's timescale for a determination, has accelerated the availability of a product Postcomm considers essential for the development of effective competition.
- 4.20 As Postcomm rightly points out, there are already several legal constraints on anti-competitive behaviour, both under EU and UK competition law and, more specifically, in Conditions 9 to 13 of Royal Mail's Licence. Postcomm seems to be suggesting that it is expecting Royal Mail to flout these laws as a matter of policy.

² Royal Mail considers that "netting off" the winners and losers in this way is not always appropriate as the relationship between a customer's propensity to switch suppliers is not a linear function of the price differential between the suppliers. This has been shown in the Roland Berger survey. Conclusions reached using the simpler approach employed by Postcomm must therefore be treated with a degree of caution.

- 4.21 Postcomm should be able to distinguish between anti-competitive behaviour and a valid response to the competitive market. Royal Mail's strategies to become more customer focussed, and to move to more cost-reflective tariffs, are designed primarily to prevent the loss of business to competitors, but they are also intended to be fully compliant with both competition law obligations and Licence Conditions. It is unreasonable and inconsistent for Postcomm to criticise Royal Mail's lack of innovation and customer focus and then, when these issues are being addressed, accuse them of being anti-competitive.
- 4.22 Royal Mail rejects the view that it will use anti-competitive behaviour as a barrier to entry in the liberalised postal services market. No action is necessary other than:
- (a) continuing to monitor Royal Mail's compliance with existing legislation and licence conditions;
 - (b) investigating genuine complaints, backed by supporting evidence, about Royal Mail's behaviour. Malicious or frivolous complaints, based on anecdotal evidence or hearsay, should not be investigated.

Customer Inertia (4.76 – 4.77)

- 4.23 Royal Mail accepts that customer inertia influences the pace of market entry, but believes the consultation paper has overestimated the strength of inertia in the postal services market, and misrepresented the views and intentions of customers in the business sector. The main body of this response shows how Postcomm's findings that customers are unaware of liberalisation, and unwilling to switch suppliers, is a misinterpretation of Roland Berger's research.
- 4.24 Royal Mail has no objection to Postcomm's proposed market awareness programme, but is not convinced it is necessary, given that the need for it is based on the fallacies that customers are unaware of postal liberalisation and are reluctant to switch to other operators. Furthermore, Royal Mail believes that such a programme may over stimulate demand to an extent that competitors may not be able to meet it.

CHAPTER 5 : PROSPECTS FOR ENTRY

- 5.1 Postcomm outlines a number of ways in which entrants can enter the UK letters market defined as addressed inland letters (0 to 350g; <£1). To these should be added the significant impact on Royal Mail's end-to-end volumes of customer direct access. Most of these, to a greater or lesser extent, include segmentation and cream skimming. It is clear from its discussion that the overall impact on Royal Mail's volume and hence financial viability could be significant. As Postcomm notes, entrants have entered the market extensively in countries where liberalisation has occurred such as Sweden, New Zealand and Germany. However, one of the main reasons that the sustained loss of market share has not been greater in these countries has been the very active response by the incumbent either through the steep level of price discounts or via legal challenges. It is not clear what the level of entry would have been without these types of responses and, indeed, what it might be in the future if incumbent behaviour were to be much more constrained.
- 5.2 Postcomm proposes in its *Revised Market Opening Timetable* to licence operators for all types of mail from January 2006. This fundamental issue is addressed in Royal Mail's separate response to that consultation paper. However, from the material Postcomm has presented in its competitive market review, Royal Mail makes the following points regarding the prospects for entry:
- a) the limited extent of entry to date either by access, where the situation is changing rapidly, or bypass provides no guide to how much entry will occur over the longer term.
 - b) similarly, the experience of countries such as Sweden, New Zealand and Germany, which Postcomm cites, has been affected significantly by the response of the incumbent. Postcomm has made clear in the competitive market review document and elsewhere that it would act to restrain such behaviour by Royal Mail were Royal Mail to contemplate such actions.
 - c) Postcomm estimates that a uniform rate of VAT would improve entrants' competitiveness by about 2% on average (rather than the UK standard rate of VAT of 17.5% as is sometimes claimed by some). It also believes that a 2% improvement in entrants' competitiveness would produce a 4% loss in Royal Mail's market share.
 - d) a loss of this magnitude (a multiple of 2) appears to be consistent with the analysis undertaken for Postcomm by Roland Berger Associates which used conjoint analysis. Although Postcomm's summary suggests that this work shows that "*customers had a low appetite for switching to other operators*", results from Roland Berger's model suggest otherwise and that customers are very price sensitive, a view that Postcomm appears to share in its analysis of VAT.
 - e) Postcomm identifies a large number of ways in which entrants can enter the postal market profitably, in all cases by segmenting the market and cream skimming without needing to offer universal service. The availability of downstream access helps reduce the one significant bottleneck in the postal network, namely, final delivery.
 - f) Nevertheless, as Postcomm notes, individual as opposed to business customers are unlikely to see new services offered by entrants and because of the high fixed cost of having a nationwide network of delivery offices to provide

universal service, no other postal operator is likely to wish to offer universal service except through use of Royal Mail's delivery network.

- 5.3 Royal Mail notes the numerous possible entry strategies identified by Postcomm, as well as the additional opportunities associated with downstream access, and the significant opportunities to benefit from new technology and innovation identified by the ADL survey. Royal Mail further notes that some operators are already exploiting these competition and innovation opportunities.
- 5.4 These developments suggest the barriers to entry identified by the Competitive Market Review are not prohibitive. If, as Royal Mail expects, the growth of new entrants' business continues to accelerate, the barriers to entry are not effective, and corrective action is unnecessary.