



The Real Network

SUSTAINING A VIABLE UNIVERSAL POSTAL SERVICE

ROYAL MAIL'S RESPONSE TO POSTCOMM'S
CONSULTATION DOCUMENT "THE UNIVERSAL POSTAL
SERVICE IN THE UK: WHAT SERVICES SHOULD BE
PROVIDED?"

SUSTAINING A VIABLE UNIVERSAL SERVICE

SUMMARY

Royal Mail is committed to its role as the universal service provider and welcomes the opportunity to comment on Postcomm's consultation paper. Royal Mail endorses Postcomm's proposed framework for the universal service although important changes are required – in particular, greater flexibility to price postpaid products on a geographic basis– in order to guarantee the long term sustainability of the universal service.

(1) Royal Mail is the universal service provider, and guarantees a minimum standard of postal service for social groups who might otherwise not receive it.

(1.1) The EU Postal Services Directive (PSD), Postal Services Act 2000 (PSA) and Royal Mail's Licence establish a framework for the universal service whose purpose is to ensure provision of a postal service in the national economic interest that would not be provided on a commercial basis. It also provides a social safety net for vulnerable groups – the disabled, pensioners, people on low incomes, those living in rural areas – and must be provided at affordable prices.

(1.2) Crucially, the framework also specifies a nationally uniform price for universal services which has been traditionally interpreted to mean a price that is uniform irrespective of where it is posted to or from.

(2) While Royal Mail welcomes competition, the viability of the universal service will come under threat from the requirement to deliver six days a week to all destinations at a uniform price.

(2.1) Since the framework for the universal service was established, Postcomm has embarked on a process of market liberalisation allowing entry by both end to end players and consolidators accessing Royal Mail's delivery network. Since Royal Mail's delivery costs vary substantially by density, the need to sustain a geographically uniform tariff results in a large cross-subsidy from urban to rural areas.

(2.2) This cross-subsidy creates opportunities for cream skimming. For example, competitors can undercut the national uniform tariff by delivering only urban mail, which is substantially less expensive to deliver than rural mail, either not taking, or re-posting, the remaining mail. Furthermore, if they also have access to Royal Mail's delivery capability at a national uniform price, then this provides a lower cost route to dispose of costly-to-deliver mail, further subsidising cream skimming entry.

(2.3) Moreover, the fact that competitors will not under Postcomm's liberalisation programme bear any USO requirements allows competitors to deliver second and third class mail only once or twice per week on a given walk, potentially reducing their costs substantially below those of Royal Mail.

(2.4) Over the longer term, this combination of cream skimming opportunities could render the universal service unviable at a geographically uniform price. If so, new methods of funding the universal service – such as through surcharges for mailings with skewed fall-to-earth profiles, or competitor contributions to a universal service fund – may have to be considered. However, a more market-driven approach would be to re-interpret national uniform pricing to allow geographically cost-reflective pricing of universal services.

(3) While Royal Mail finds Postcomm's framework useful, Royal Mail recommends modifying the current interpretation of the uniform tariff to allow tariffs to be differentiated by destination.

(3.1) Royal Mail endorses most elements of Postcomm's proposed framework for the universal service, including “everyone”, “everywhere”, “everyday” and “everything”, which together guarantee the fundamental provisions of the universal service to all users.

(3.2) However, the current interpretation of a “uniform tariff” is detrimental to the viability of the universal service and should be modified. The PSA requires that universal service products are provided at a tariff that is “uniform throughout the United Kingdom”, and views expressed in Hansard and the 1999 White Paper interpret this as ruling out tariffs that vary by destination. An alternative interpretation – preferred by Royal Mail – would allow tariffs to vary by destination cost-reflectively while the tariff for any given destination would remain uniform for all senders throughout the country. For example, a “rural Mailsort” product could be priced above an “urban Mailsort” product, but the price of each product would be the same for all customers. This alternative interpretation would allow Royal Mail to price cost-reflectively on a geographic basis, so discouraging inefficient urban entry but allowing efficient rural and urban entry and supporting the long term viability of the USO. Under this approach, prepaid mail – namely stamped and meter mail – would for practical reasons remain priced on a geographically uniform basis, although Royal Mail would have the flexibility to vary the prices of all postpaid (account) mail on a geographic basis.

(3.3) Furthermore, this modified interpretation is consistent with the PSD, which recommends that *‘to avoid distortions of competition ... the tariffs applied to the universal service should be objective, transparent, non-discriminatory and geared to costs’* [Recital 26]. Geographic pricing would be geared to costs and would therefore avoid distorting competition as it would not provide incentives for inefficient entry.

(3.4) Finally, section 4.2b of the PSA states that “the conclusion with customers of individual agreements as to prices, shall not be taken to preclude the provision of a universal postal service”, clearly allowing Royal Mail to vary the prices of its contract mail products on a geographic basis even if these products lie within the USO. Since Royal Mail's Mailsort product is provided to

customers through individual contracts, Royal Mail should be permitted to propose cost-reflective geographic price differences to customers even if Mailsort remains within the USO.

(4) An alternative approach to allowing Royal Mail to price geographically on a cost-reflective basis would be to adopt a definition of the universal service comprising prepaid mail, Standard Parcels and a generic, easy access bulk mail product only, with all other major products excluded from the universal service itself although remaining within the scope of the USO in order to allow Postcomm to continue to manage the liberalisation process through licensing.

(4.1) It could be argued that coverage of the universal service should be limited to first class prepaid mail only. This is because 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. However, both the public and business also expect a non-priority, less expensive prepaid service, and Royal Mail would expect to continue to provide a prepaid second class product within the USO. Since for practical reasons prepaid products cannot be easily priced geographically, both first and second class stamped and metered mail would remain uniformly priced within the USO.

(4.2) Removing products from the USO would not allow Royal Mail to withdraw these products from service, nor would it give Royal Mail any greater freedom to increase product prices than it already has under the price control, since Condition 19(1) of Royal Mail's licence prevents Royal Mail from withdrawing or changing the specification of any product that Royal Mail currently provides to one that is less beneficial to users without Postcomm's agreement, and products with significant revenue which might be removed from the USO fall under the price control. The only concern raised by removing products from the USO would be if, by doing so, Postcomm no longer had licensing authority for those products, reducing its powers to manage the introduction of competition.

(4.3) The Postal Services Regulations of December 2002 – which were enacted to implement the amended European Postal Directive – introduce the distinction between the USO and the *scope of the USO*, with a product being within the scope of the USO either if it is within the USO or if it is sufficiently similar to a USO product. Any product within the scope of the USO requires a licence, so allowing Postcomm to manage the liberalisation process for products that lie outside the USO itself but still within the scope of the USO.

(4.4) To allow for there to be a bulk postpaid product within the USO, Royal Mail would propose to include a generic, easy access bulk mail product (i.e. Cleanmail) in the USO. Royal Mail would also continue to provide a standard parcels USO service, and a registered product through the registered and insurance components of Special Delivery.

(4.5) All other products would be outside the universal service but within the scope of the USO as they are products derived from universal services – e.g., Mailsort 2 is a second class service workshare discount product. Royal Mail recognises that it is arguable whether Mailsort 3 should lie within the scope of the USO given that were it removed from the USO there would be no economy

USO product. In practice, Royal Mail believes that Mailsort 3 is currently treated in a sufficiently similar operational manner to second class mail that it should continue to lie within the scope of the USO.

(4.6) In summary, this alternative approach would in practice guarantee a geographically uniform tariff for prepaid mail and Cleanmail, while allowing Royal Mail to price geographically on a cost-reflective and commercial basis on postpaid products, so fostering efficient competition and helping to support the long term viability of the universal service within the limits of the price control.

(5) A range of Royal Mail products do not conform to Postcomm’s proposed definition of the USO and should be removed from the universal service itself while remaining within the scope of the USO.

(5.1) Postcomm proposes that USO products should be available to everyone, capable of handling all items, delivered everywhere, provided every day, and priced on a geographically uniform basis. Many of Royal Mail’s current products do not meet these criteria.

(5.2) Most importantly, presorted bulk mail products are not available to everyone as they have stringent volume and operational requirements. Postcomm itself recognises that Mailsort 3 is restricted to large mailers, but of course this is also true of Mailsort 1 and 2. These bulk mail products should be removed from the USO, as they have been already in the Netherlands and Sweden.

(5.3) Similarly, Mailmedia is only available to the direct mail industry and so is not for everyone. Presstream products are available only to certain types of user (publishers) and are zonally priced, so they do not meet either Postcomm’s “everyone” or “uniform” criteria. The express components of Special Delivery (next day service, track and trace, consequential loss, confirmation of delivery) are more akin to express parcel product features than core mail market products, so the express components of Special Delivery should fall outside the USO.

(5.4) Again, all of these products, to the extent that they lie within the price and weight limits, while outside the universal service, would remain within the scope of the USO and therefore within the licensing remit of Postcomm.

(6) Beyond facilitating cream skimming by competitors, the universal service imposes additional operational burdens on Royal Mail which it would not incur voluntarily even if it provided a next day service to everyone, everywhere, and Postcomm should consider recommending the relaxation of these operational restrictions to reduce the burden of the universal service as competition develops.

(6.1) The requirement to deliver not just five days a week (the minimum established in the PSD) but six days a week for letters significantly increases delivery costs, as does the requirement to deliver not to domestic post boxes at the roadside (as in the United States) but to letter boxes in doors at each address. Similarly, the requirement for a high density of pillar-boxes significantly increases the cost of collection.

(6.2) All of these costs could be reduced within the context of still providing an every working day collection and delivery service to all parts of the country, and Postcomm should consider ways to lessen this burden by moving to a system of requirements in line with those expected of universal service providers in other jurisdictions.

(7) Royal Mail's proposed definition of the universal service will benefit customers, competitors and government.

(7.1) Royal Mail's proposal will ensure the provision of the core elements of the universal service of daily delivery and collection to all users everywhere, and geographically uniform pricing to all destinations for prepaid mail and Cleanmail, but will provide Royal Mail with the flexibility to price geographically on a cost-reflective basis for postpaid mail.

(7.2) This proposal will be good for customers. First, customers who send mail to urban and semi-urban areas will benefit from lower prices. Customers – especially large direct mailers – may face price increases on their rural mailings, but these are cost-reflective and will be offset by reductions in urban prices. Customers will also benefit from more competition for expensive-to-deliver mail. Most importantly, Royal Mail's proposals would discourage excessive entry in urban areas and encourage more entry outside urban areas helping to drive down industry unit costs and, over time, prices. Finally, no products will be dropped, and prices will not rise by any more than is already planned under the price control despite most products being outside the coverage of the universal service obligation.

(7.3) Royal Mail's competitors will also benefit if they are efficient. Competitors who wish to set up delivery networks outside low-cost zones will not face artificially low Royal Mail prices. Efficient competitors will still find entry in urban areas attractive, but the cross-subsidy that provides artificially strong incentives to enter will be removed.

(7.4) Government and the regulatory authorities will also benefit since the long term financial viability of Royal Mail, and therefore of the universal service, will be improved while efficient competition will be encouraged. Cream skimming entry that simply duplicates industry costs will be discouraged, and industry unit costs – and therefore prices – will fall over time as a result of efficient postal operators competing on a more level playing field.

Introduction

This document forms Royal Mail's response to Postcomm's consultation on the universal postal service. The response is structured into the following sections:

1. The context for the Universal Service Obligation
2. The threat to the viability of the universal service
3. Postcomm's proposed framework for the USO
4. An alternative approach to cost-reflective geographic pricing
5. Product coverage under Postcomm's framework
6. Operational burdens imposed by the USO
7. Implications for stakeholders

In addition, there are two annexes:

Annex A: Universal Service Provision in Several Countries

Annex B: Royal Mail's Response to Postcomm's Sixteen Issues in the Consultation on the Universal Service

1. The context for the Universal Service Obligation

The purpose of the Universal Service Obligation (USO) is to guarantee a service in the national economic interest that would not be provided on a commercial basis. The 1999 White Paper set out these benefits in terms of the postal service being a vital part of the national infrastructure by helping to generate wealth and increase social cohesion through good communications and swift flows of information and knowledge.¹ In addition, the USO provides a social safety net for vulnerable groups: the disabled, pensioners, people on low incomes, and those living in rural areas.

The legal framework for the universal postal service is laid down in the EU Directive² and has been transposed into UK legislation by the Postal Services Act 2000 (the PSA). This framework does not specify that any particular postal service or product should be provided. Instead it lays down minimum infrastructure requirements to ensure widespread access to postal services. This is the approach taken in all countries for which we have information. Annex A gives an overview of the way in which universal services are defined in a selection of countries across the world.

The universal service is defined in Article 3 of the Directive in the following way:

1. Member States shall ensure that users enjoy the right to a universal service involving the permanent provision of a postal service of specified quality at all points in their territory at affordable prices for all users.

2. To this end, Member States shall take steps to ensure that the density of the points of contact and of the access points takes account of the needs of users.

¹ "Post Office Reform: A World Class Service for the 21st Century" (1999, Cm 4340)

² Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service as amended by Directive 02/39/EC of the European Parliament and of the Council of 10 June 2002 with regard to the further opening to competition of Community postal services

3. They shall take steps to ensure that the universal service provider(s) guarantee(s) every working day and not less than five days a week, save in circumstances or geographical conditions deemed exceptional by the national regulatory authorities, as a minimum:

– one clearance,

– one delivery to the home or premises of every natural or legal person or, by way of derogation, under conditions at the discretion of the national regulatory authority, one delivery to appropriate installations.

Any exception or derogation granted by a national regulatory authority in accordance with this paragraph must be communicated to the Commission and to all national regulatory authorities.

4. Each Member State shall adopt the measures necessary to ensure that the universal service includes the following minimum facilities:

– the clearance, sorting, transport and distribution of postal items up to 2 kg,

– the clearance, sorting, transport and distribution of postal packages up to 10 kg,

– services for registered items and insured items.

5. The national regulatory authorities may increase the weight limit of universal service coverage for postal packages to any weight not exceeding 20 kg and may lay down special arrangements for the door-to-door delivery of such packages.

Notwithstanding the weight limit of universal service coverage for postal packages established by a given Member State, Member States shall ensure that postal packages received from other Member States and weighing up to 20 kg are delivered within their territories.

6. The minimum and maximum dimensions for the postal items in question shall be those laid down in the Convention and the Agreement concerning Postal Parcels adopted by the Universal Postal Union.

7. The universal service as defined in this Article shall cover both national and cross -border services.

Moreover, the Directive states explicitly in Recital (26) that:

...in order to ensure sound management of the universal service and to avoid distortions of competition, the tariffs applied to the universal service should be objective, transparent, non-discriminatory and geared to costs

The Directive, therefore, sets out a minimum standard of what the universal service should be and expects Member States to define their universal service requirements. The PSA does this in Section 4(1):

For the purposes of this Act, . . . , a universal service is provided if-

(a) except in such geographical conditions or other circumstances as the Commission considers to be exceptional-

(i) at least one delivery of relevant postal packets is made every working day to the home or premises of every individual or other person in the United Kingdom or to such identifiable points for the relevant postal packets as the Commission may approve, and

(ii) at least one collection of relevant postal packets is made every working day from each access point,

(b) a service of conveying relevant postal packets from one place to another by post and the incidental services of receiving, collecting, sorting and delivering such packets are provided at affordable prices determined in accordance with a public tariff which is uniform throughout the United Kingdom, and

(c) a registered post service is provided at such prices.

The PSA is therefore different from the Directive. The Section 4(1) describes the circumstances under which a universal postal service is deemed to be provided in the United Kingdom. A universal postal service is provided if the circumstances of Section 4(1) obtain. In other words the Directive sets a minimum standard, whereas the PSA actually defines what is necessary for there to be a universal postal service. Consequently, provided the requirements of Section 4(1) PSA are being fulfilled by Royal Mail a universal postal service is indeed being provided.

The term *uniform tariff* is not defined in the Act, but the current interpretation is taken from Hansard and the White Paper as a price “of sending a letter within the UK [that] is the same irrespective of where it is posted to and from”.³

The Postal Services Regulations of December 2002 – which were enacted to implement the amended European Postal Directive – introduce the distinction between the *USO* and the *scope of the USO*. A product is within the scope of the USO either if it is within the USO or if it sufficiently similar to a USO product. The nature of sufficient similarity is not precisely defined, but Section 4(3) of the Regulations⁴

³ Quotation taken from page 36 of the 1999 White Paper “Post Office Reform: A World Class Service for the 21st Century” (Cm 4340). See also Hansard col 664, 1 April 1993.

⁴ The following is an extract from the Postal Services Regulations:

"7A Scope of the universal postal service: meaning

(1) For the purposes of section 7(1A), a postal service is outside the scope of the universal postal service in the United Kingdom if it is not, or is not substantially similar to, a postal service within subsection (2).

(2) A postal service is within this subsection if it is a postal service—

(a) which a postal operator is required to provide in the discharge of any duty to provide a universal postal service, or part of such a service,—

make it clear that just because a product might not be available to everyone does not imply that the product would fall outside the scope of the USO. Consequently, for example, given that Royal Mail's 1st and 2nd class services are USO services, the workshare products with the same standards of service (Mailsort 1 and Mailsort 2) would, on the basis of the Postal Service Regulations, be sufficiently similar to these services to be within the "scope of the USO" and therefore licensable, even if they were not classified as USO products.

Any product which is within the scope of the USO requires a licence, thereby allowing Postcomm to manage the liberalisation process for products that lie outside the USO itself but still within the scope of the USO.

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- (i) imposed under section 3(2) as a condition of the operator's licence under Part 2, or
 - (ii) included in his licence as a condition by virtue of section 13(1), or
- (b) which a postal operator is required to provide in the discharge of any duty to provide a postal service imposed on him by an order under section 102(2).
- (3) For the purposes of subsection (1), a postal service is not to be regarded as being not substantially similar to a postal service within subsection (2) merely because—
- (a) the service in question does not comply with section 4(1),
 - (b) where the person providing the service provides it only to persons within a class specified by him for the purposes of its provision, it is not available to all persons within that class, or
 - (c) where the service has the characteristic of three day delivery, it also has one or more of the characteristics mentioned in subsection (4).
- (4) Those characteristics are that—
- (a) the service provides for the collection of a postal packet at a place specified by the sender of the packet,
 - (b) the service provides for the delivery of a postal packet at or by a time specified by the sender of the packet,
 - (c) the service provides for the delivery of a postal packet to be recorded, and
 - (d) the service provides for postage to be chargeable in a form or manner, or to be paid at a time or in a manner, different from that provided for by a postal service within subsection (2).
- (5) For the purposes of subsection (3)(c), a postal service has the characteristic of three day delivery if, in all or the majority of cases in which a postal packet is sent by it, it seeks to deliver the packet before the end of the period of three working days beginning with the day after the day on which it is received or collected."

2. The threat to the viability of the universal service

Since the framework for the universal service was established in the Directive and the PSA, Postcomm has embarked on an aggressive liberalisation programme which allows competitors to set up rival networks with their own delivery capability as well as requiring Royal Mail to provide access to its delivery network to customers and operators.

In particular, Postcomm's liberalisation programme opens the UK postal market to competitors wishing to set up networks with their own delivery capability, through:

- The provision of bulk mailer licences that allow a competitor to set up an end-to-end service that bypasses Royal Mail entirely – including collection, sortation, trunking and delivery – with the thresholds that define bulk mailings being reduced from 4,000 items of the same size and weight in 2003/04 (including items under 100g) to zero at full liberalisation which Postcomm indicates is likely to take place in 2007
- Immediate unrestricted delivery of items weighing more than 100g (compared to 350g previously) whether they are bulk mail or not, with this threshold being reduced to 50g in 2006 and then zero in 2007

Postcomm's programme also allows operators (through consolidation licences) and customers (through Condition 9 of Royal Mail's licence) to collect, sort and trunk mail which must then be handed on to Royal Mail for delivery – known as downstream access – although after 2007 Postcomm may allow consolidated mail to be handed to any operator for delivery including competitors who have set up their own delivery networks for bulk mail.

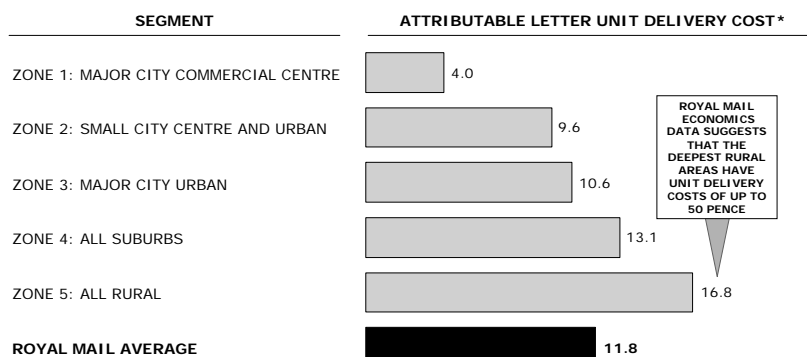
As a consequence of this liberalisation programme, all of Royal Mail's volumes of over 20 billion items a year are available to operators and customers seeking to access Royal Mail's delivery network, and over 60% of these volumes are also open to operators providing their own end-to-end service.

Royal Mail welcomes competition, which will increase customer choice and encourage innovation. However, as the universal service obligation creates distorted incentives for competition, it needs to be carefully defined so as to avert rendering unviable the requirement to deliver six days a week to all destinations at a geographically uniform price.

First of all, Royal Mail's delivery costs vary substantially by geographic density. In urban and semiurban areas the high density of address points means that the fixed costs of delivery operations – principally the postman's walk but also delivery office space – are spread over a large number of items. By contrast in rural areas these fixed costs are apportioned over a far smaller number of items, and also the variable costs per item are likely to be higher than in dense areas since an additional item of mail is likely to require a greater extra distance to travel for delivery than in urban areas. As a result, Royal Mail's delivery costs vary from about 4 pence an item in cities to about 17 pence an item in rural areas, and about 50 pence an item in deep rural areas (Exhibit 1).

EXHIBIT 1: ROYAL MAIL'S DELIVERY COSTS VARY SUBSTANTIALLY BY DENSITY EVEN THOUGH PRICES ARE GEOGRAPHICALLY UNIFORM

Pence per item, FY 2003/04



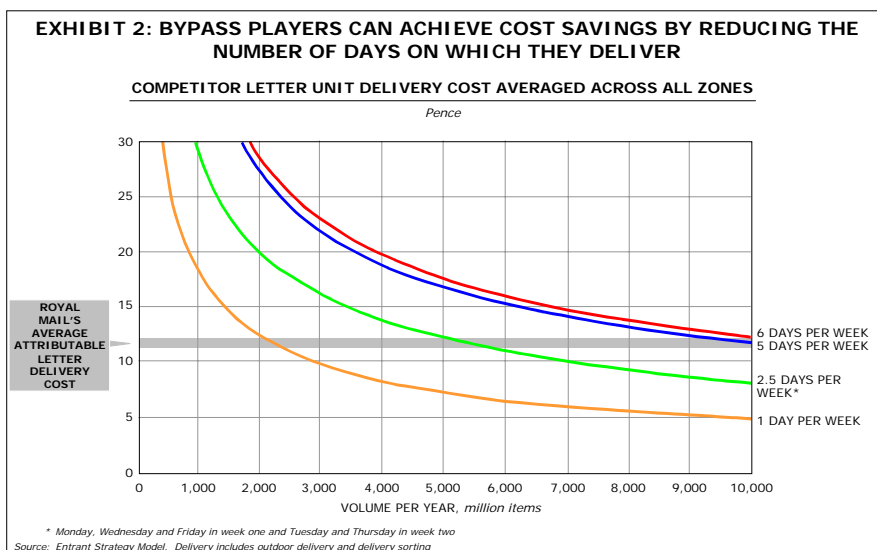
* For average of first and second class account mail. Includes outdoor delivery, delivery sorting and delivery related non pipeline costs as per Postcomm's analysis
Source: Royal Mail Economics; Postcomm's Notice of a Proposed Direction on Downstream Access by UK Mail, May 2003; Entrant Strategy Model

The combination of very different delivery costs across densities and the uniform tariff creates a large cross subsidy from urban to rural areas that creates opportunities for cream skimming. For example, competitors can undercut the national uniform tariff by delivering only urban mail and either not accepting rural mail or handing these items back to Royal Mail for delivery. Moreover, if third parties have access to Royal Mail's delivery capability at a national uniform price then this provides competitors with an artificially low cost route to dispose of costly-to-deliver mail, further subsidising cream skimming and leaving Royal Mail with a high-cost profile of mail to deliver.

The uniform tariff also discourages efficient entry outside dense areas since competitors may have lower costs than Royal Mail in rural areas but nevertheless find it uneconomic to enter because Royal Mail is forced to price at an artificially low level.⁵

Secondly, the fact that competitors will not, under Postcomm's liberalisation programme, bear any USO requirements allows competitors to deliver second and third class mail only once or twice per week on a given walk, potentially reducing their costs substantially below those of Royal Mail (Exhibit 2).

⁵ See for example Mark Armstrong, "The theory of access pricing and interconnection" in *Handbook of Telecommunications Economics* edited by M Cave et al (North-Holland, 2003). Armstrong states in Section 2.1.1 of his article that "whenever the incumbent's prices are required to depart from its costs of serving subscribers, there is a danger of undesirable entry into profitable markets and of too little entry into loss-making markets".



The combination of being able to deliver only in dense areas and only once or twice per week could result in competitors having delivery costs below 5 pence an item in cities, which will create excess entry and duplication of fixed delivery costs as well as unravelling the cross subsidy that underpins the uniform tariff. Indeed, Royal Mail's financial modelling estimates that cream skimming competition could have a negative contribution impact on Royal Mail of over £800 million by 2009 – two years after full liberalisation – if Royal Mail is forced to maintain a geographically uniform price.

The combination of the uniform tariff and unbridled competition from both access operators and delivery operators is therefore unsustainable in the longer term. One solution to this would be for the regulator to introduce safeguards on Royal Mail's delivery business, such as:

- Extending beyond 2007 the 50g threshold and the requirement on consolidators to hand their mail to Royal Mail for delivery – this would be similar to, but more limited than, the framework in the United States where access to the United States Post Office's delivery network is fully liberalised, but the USPS retains a monopoly over letter delivery
- Introducing a licence fee for delivery competitors who do not provide a USO service, for example because they deliver only in certain areas and/or fewer than 6 days a week – this would be similar to Finland, where private operators have to pay up to 20% of turnover to the regulator in compensation for the Finnish post's universal service obligation

Royal Mail believes that delivery safeguards are a desirable solution for the industry, but also that more market-driven solutions are appropriate, in particular geographically cost-reflective pricing of universal services. The need to reduce the burden of the universal service by restricting its coverage is greater if less pricing flexibility is permitted for the universal service provider.

3. Postcomm’s proposed framework for the USO

Postcomm in their consultation document have proposed – from the legal framework and from international comparisons – a set of essential elements of a universal postal service (paras 2.26 and 2.27):

- Available to **everyone** at an affordable tariff
- Handling **everything** (i.e., all postal items, within established limits such as maximum weight)
- Delivers **everywhere** in the UK as well as to outbound international addresses
- Delivers **every working day**
- Priced on a **geographically uniform** basis.

Royal Mail endorses this framework as providing a useful guideline to which services should be provided as part of the USO, with two exceptions.

First, the definition of universal postal services should be explicitly restricted to *postal* services. Add-on features to a postal service which are not in themselves postal (i.e. do not consist of the collection, processing, transporting and delivery of postal items) should not, therefore, be classified as an element of a universal postal service.

Second, for the reasons set out in Section 2 above, the current interpretation of a “uniform tariff” is detrimental to the viability of the universal service and should be modified. As noted in Section 1, the PSA does not define the term “uniform tariff”, but the current interpretation rules out tariffs that vary by destination.

An alternative interpretation – preferred by Royal Mail – would allow tariffs to vary by destination while the tariff for any given destination would remain uniform for all senders throughout the country – for example there could be a “rural Mailsort” product priced above an “urban Mailsort” product, but the prices of these two products would be uniform across all users.

This alternative interpretation would allow Royal Mail to price cost-reflectively on a geographic basis, so discouraging inefficient urban entry but allowing efficient rural entry and supporting the long term viability of the universal service.

Under this approach prepaid mail – namely stamp and meter – would for practical reasons remain priced on a geographically uniform basis, although Royal Mail would have the flexibility to vary the prices of postpaid business mail on a geographic basis.

It is worth noting that this approach supports the requirement stated in the PSD, that *‘in order to ensure sound management of the universal service and to avoid distortions of competition, the tariffs applied to the universal service should be objective, transparent, non-discriminatory and geared to costs’* [Recital 26]. Pricing on a geographic basis gears tariffs directly to costs, and would help provide for sound financial management of the universal service as well as removing the cream skimming incentives for inefficient entry that would otherwise distort competition.

Regardless of the interpretation of the uniform tariff, however, section 4.2b of the PSA states that “the conclusion with customers of individual agreements as to prices,

shall not be taken to preclude the provision of a universal postal service”, clearly allowing Royal Mail to vary the prices of its contract mail products on a geographic basis even if these products lie within the USO. Since Royal Mail’s Mailsort product is provided to customers through individual contracts, Royal Mail should be permitted to conclude individual agreements on Mailsort prices with customers that include geographic price differences even if Mailsort remains within the USO.

This section has proposed greater commercial flexibility for Royal Mail to price its services – in practice, its business account mail products – geographically on a cost-reflective basis. It is worth noting that this approach is in the spirit of the 1999 White Paper, which argued that given the intensifying competition both within the postal sector and from alternative technologies (e.g., e-mail):

“it is vitally important for the Post Office to be able to price commercially to keep and increase business customers, particularly in those areas where it is most susceptible to competition. Maintenance of the systems used to deliver social mail is dependent on the volume of mail generated by business. Without business mail (including business to individuals and vice versa) the universal service and uniform tariff would be unsustainable without direct subsidy. Royal Mail customers may currently qualify for discounts for pre-sorted work (based on avoided average costs). Further price flexibility is a logical extension of these current arrangements...subject to [normal competition rules] the Post Office will be free to negotiate prices with individual customers taking into account volume and other specific characteristics of any contract (eg timing of delivery).” (pp. 36-37)

4. An alternative approach to cost-reflective geographic pricing

An alternative approach to allowing Royal Mail the ability to price geographically on a cost-reflective basis would be to adopt a definition of universal service comprising prepaid mail, Standard Parcels and Cleanmail only, with all other major products excluded from the universal service itself although remaining within the scope of the USO in order to allow Postcomm to continue to manage the liberalisation process through licensing.

Arguably, coverage of the universal service should be limited to first class prepaid mail only. This is because first class prepaid mail, available to everyone, drives the costs of the USO by requiring an extensive upstream network and an every door, every day delivery capability. However, the British public also expects a non-priority, less expensive prepaid service, and Royal Mail would expect to continue to provide a prepaid second class product within the USO. Since for practical reasons prepaid products cannot be easily priced geographically, both first and second class stamped and metered mail would remain uniformly priced within the USO.

Removing products from the USO would not allow Royal Mail to withdraw these products from service, nor would it give Royal Mail any greater freedom to increase product prices than it already has under the price control:

- Condition 19(1) of Royal Mail's licence prevents Royal Mail from withdrawing or changing the specification of *any* product that Royal Mail currently provides to one that is less beneficial to postal users without Postcomm's agreement
- All products with significant revenue which might be removed from the USO fall under the price control, which provides tight limits on individual product prices regardless of a product's USO status

The only concern raised by removing products from the USO would be if, by doing so, Postcomm no longer had licensing authority for those products, reducing its powers to manage the introduction of competition. However, the Postal Services Regulations of December 2002 – outlined in Section 1 above – introduce the distinction between the USO and the *scope of the USO*, with a product being within the scope of the USO either if it is within the USO or if it is sufficiently similar to a USO product. Any product within the scope of the USO requires a licence, so allowing Postcomm to manage the liberalisation process for products that lie outside the USO itself but still within the scope of the USO.

To allow bulk postpaid products to remain within the scope of the USO, Royal Mail would propose to include Cleanmail in the USO as an operationally easy-to-use bulk mail universal service, available at a low volume entry level (e.g., 1000 items per mailing). Royal Mail would also continue to provide a Standard Parcels USO service, and a registered product through the registered and insurance components of Special Delivery.

All other products would be outside the universal service but within the scope of the USO as they are products derived from universal services – e.g., Mailsort 2 is a second class service workshare discount product. Royal Mail recognises that it is arguable whether Mailsort 3 should lie within the scope of the USO given that were it

removed from the USO there would be no economy USO product. In practice, Royal Mail believes that Mailsort 3 is currently treated in a sufficiently similar operational manner to second class mail that it should continue to lie within the scope of the USO.

In summary, this alternative approach would in practice guarantee a geographically uniform tariff for prepaid mail, Standard Parcels and Cleanmail, while allowing Royal Mail to price geographically on a cost-reflective and commercial basis on postpaid products, so fostering efficient competition and supporting the long term viability of the universal service.

5. Product coverage under Postcomm's framework

Under Postcomm's definition of a universal service, a range of products do not conform to the USO and should therefore be removed from the universal service itself while remaining within the scope of the USO. We examine each of Royal Mail's current "universal services" as classified in the Regulatory Accounts against the criteria listed.

A service which does not have all of the features defined would not be classified as a universal postal service although it may operate within the scope of the universal service. So, for example, a service which has a seven day delivery span and which therefore does not require an infrastructure for delivering every working day would not be a universal service. A service that is only available for direct mail advertisers, on a contractual arrangement, is not available to everybody and therefore cannot be classed as a universal service. Similarly, a service which does not offer a geographically uniform tariff (for example the Presstream service), or a tariff which is not determined in accordance with a public tariff or which is not an "affordable" tariff could not be classified as a universal service (although affordability is not easy to quantify). Services for "closed user groups" – for example a pouch service, an internal mail service for large companies over several geographically diverse sites, or a Document Exchange Service, would not be a universal service since they are not available everywhere.

Postcomm points out that postal services fall into three speed ranges: priority, non-priority and economy, and that each of these could be offered as a secure service. Postcomm suggests that potentially any combination of these speed and security features could be offered, although Postcomm does not have the power to direct Royal Mail to introduce a new service. Consequently, it would be surprising if Postcomm were to determine that a service that is not currently offered by Royal Mail should be a universal service as that would immediately place Postcomm in breach of its duty under S. 3(1) of the Postal Services Act 2000. The speeds of service that are currently provided by Royal Mail for public use are 1st class, targeted for next day delivery, and 2nd class, targeted for delivery within three working days. The only slower service that Royal Mail offers is Mailsort 3 (within 7 working days, excluding Saturday) and in contrast to 1st and 2nd class services this service is only available to bulk, contract mailers.

Two services within the definition of Controlled Services in Condition 19, namely Presstream and Mailmedia, are not currently classified as universal services:

Presstream. Presstream is only available to periodical and magazine publishers and is, therefore, not available to everyone. It is a product only for magazines and periodicals, and does not therefore carry everything. It does not have a geographically uniform tariff. This product fails at least three of the tests specified by Postcomm.

Mailmedia. Mailmedia is a recently introduced product limited to direct mail. So it does not carry everything, is only available to the direct mail industry and so is not for everyone. Mailmedia does not satisfy the criteria for a universal service.

In the view of Royal Mail, the universal postal service that Royal Mail should be obliged to provide should be restricted to single piece items of mail at the first and second class service standards and Standard Parcels up to the 20 Kg weight limit specified in the PSA. This should apply to both domestic and international mail. Included within the universal service obligation should also be the associated services which provide for the forwarding, redirection and retention of mail items. A registered and insurance service (limited in the way defined below) should also be a universal service. Bulk contract mail and parcel services from individual customers should not form part of Royal Mail's universal service obligation.

The Royal Mail Services, which are currently listed as Universal Services in the Royal Mail Regulatory Accounts but which, according to Postcomm's (amended) criteria, do not qualify as universal services are listed in Table 1 below together with a brief reference to the criteria which they fail to meet.

Table 1. Services currently classified as Universal Services in Royal Mail Regulatory Accounts which should not be universal according to Postcomm's amended criteria.

Service Which Should Be Excluded From The USO	Justification based on amended Postcomm criteria
Mailsort 1 and 2	Not for everyone
Mailsort 3 services	Not every working day
Mailsort Light	A Mailsort 3 service
Bespoke Packetsort , 1 st and 2 nd class	Not for every one.
Mailsort RSVP	This service was withdrawn at the beginning of 2001.
Safebox	Not for everyone
Closed User Group	Not for everyone, not everywhere.
Freepost Name	Not for everyone
Large User Response Barcode	Not for everyone
Response Services Barcode	Not for everyone
Electronic Services Postage	Not for everyone.
Prepaid Stationery	Not a postal service.
Business collections	Not for everyone.
Collection from Locked Private Posting Box	Not for every one.
Collection from Locked Private Posting Box Weekends	Not for everyone.
Floor Fees	Not postal
Bespokes	Not for everyone.
Franking Machine Resetting	Not postal service.
Ministerial Pouch Services	Not for everyone.
Railway Letter Service	Not for everyone, not everywhere.
Selectapost	Not for everyone.
Timed Delivery	Not for everyone

Royal Household Mail	Not for everyone.
RLB Postings (Belfast)	Not for everyone
Special Appeals/Charities	Not for everyone
Unofficial Redirections	Official redirection service provides the universal service.
Aerogrammes (prepaid)	Pre-payment is not a postal service
Airmail Printed Papers	Not for everything.
Surface Printed Papers	Not for everything
International Signed for	Not everywhere
Perishable Biological Substances	Not everything
Post Office Group Official Mail	Not for everyone

The more significant of these are discussed in more detail below:

Mailsort 3. Mailsort 3 is a bulk mail service with a 7-day delivery span. For this service there is no contractual requirement to deliver on Saturdays. Only business customers or other organisations that mail a minimum of c.1000 or more items at a time (depending on the precise service offering) can make use of bulk mail services. Royal Mail estimates it has approximately 11,000 Mailsort customers out of a customer base of over 25 million.

Postcomm recognises in Paragraph 5.20 that “it is difficult to argue that [Mailsort 3] is available to everyone because of the numbers and type of items needed to meet individual mailing/preparation requirements which effectively restricts it to large mailers”.

Furthermore, in Annex B of the consultation paper Postcomm suggests that Mailsort 3 should satisfy its requirement for an “Economy post” – a slower service than a standard service. Since Mailsort 3 is not available to everyone and does not require a delivery every working day it would appear to fail Postcomm’s test for a universal service. There is, therefore, no existing postal service that can satisfy Postcomm’s criteria for an “Economy post” universal service at a price and standard of service below that of second class.

Mailsort 1 and 2. Mailsort 1 and 2 are also bulk mail products, and so by Postcomm’s argument for Mailsort 3 should also lie outside the USO.

Printed Postage Impressions (PPI). PPI is a preprinted alternative to stamps or franking for large mailings. Royal Mail handles approximately 3.3 billion items of PPI per annum, of which approximately 2.9 billion items are in postings of more than 1000. PPI is, like Mailsort, not available to everyone and so should also be removed from the USO.

Ancillary Services. The Railway Letter Service is listed as an Ancillary Service and in Annex B is classified as a universal service. Two ancillary services are defined in the Schedule to the Licence: Retention of Mail and the Railway Letter Service. Of these, the Railway Letter Service is a specialised service available only to heritage railway companies and so does not satisfy the criterion of being available to all.

Services with add-on features which are not postal, where there is an alternative service that provides all the postal elements of the service, should not be part of the universal service. In particular:

1st and 2nd class prepaid stationery. The provision of stationery is a non-postal service and therefore cannot be part of the universal postal service.

Airpacks (Business & Consumer), Air Letters, and Aircard differ only from the Airmail public tariff services by virtue of the fact that they offer prepaid, prepackaging services and, as these are non-postal services, they should not form part of the universal service obligation.

Special Delivery (registration and insurance). Special Delivery currently satisfies the universal service requirements for a registered and insured service. However, the current Special Delivery product operates in the courier and express market and provides more than just registration and insurance i.e. it is an express service as well. Therefore only the registered and insurance components of the Special Delivery product should form the universal service obligation.

The registration and insurance element of the universal service should be defined as:

- Registration into the system through certificate of posting / receipt / label slip
- Compensation (for loss and damage)

But not:

- Next day guaranteed delivery (i.e. speed is not a requirement)
- Full tracking of service
- Consequential loss (other than what is defined in the compensation scheme)
- Confirmation of delivery (physical and telephone)

Access. Through Condition 9 of its Licence, Royal Mail is required to negotiate in good faith, with third party operators and customers, access to its postal facilities. The Licence also provides for an Access Code that can be used to form the basis of access to Royal Mail's postal facilities. Postcomm asks for views as to whether or not "downstream access" of this kind should form part of the universal service obligation. Postcomm is currently consulting on the access prices that will be provided to UK Mail, and Royal Mail does not consider it appropriate to comment on the USO status of access until the outcome of the consultation is known.

6. Operational burdens imposed by the USO

Beyond facilitating cream skimming by competitors, the universal service imposes additional operational burdens on Royal Mail which it would not incur voluntarily even if it provided a next day service to everyone everywhere, and Postcomm should consider recommending the relaxation of these restrictions to reduce the burden of the USO as competition develops.

Operational burdens imposed by the current definition of the USO in the UK include the following:

- The requirement to deliver not just five days a week (the minimum established in the Directive) but six days a week for letters significantly increases delivery costs
- The requirement for a high density of pillar boxes significantly increases the cost of collection
- The requirement to deliver not to domestic post boxes at the roadside (as in the US) but to letter boxes in doors at each address increases delivery costs

All of these costs could be reduced within the context of still providing an every working day collection and delivery service to all parts of the country, and Postcomm should consider ways to lessen this burden on Royal Mail by moving to a system of requirements in line with those expected of universal service providers in other jurisdictions.

7. Implications for stakeholders

Royal Mail's proposal as described in this response will ensure the provision of the core elements of the universal service of daily delivery and collection to all users everywhere, and geographically uniform pricing to all destinations for prepaid mail and Cleanmail, but will provide Royal Mail with the flexibility to price geographically on a cost-reflective basis for postpaid mail.

This proposal will benefit customers, competitors and government.

The proposals will be good for **customers** for the following reasons:

- Customers who send mail to urban and semiurban areas will benefit from lower prices
- Customers – especially large direct mailers – may face small price increases on their rural mailings, but these are cost-reflective and will be offset by reductions in urban prices
- Customers will also benefit from more competition for expensive-to-deliver mail
- Most importantly, Royal Mail's proposals would discourage excessive entry in urban areas and encourage more entry outside urban areas helping to drive down unit costs and, through time, prices
- Finally, no products will be dropped, and prices will not rise by any more than is already planned under the price control even for those products outside the coverage of the universal service obligation

Competitors will benefit if they are efficient:

- Competitors who wish to set up delivery networks outside low-cost zones will not face artificially low Royal Mail prices as presently
- Efficient competitors will still find entry in urban areas attractive, but the cross-subsidy that provides artificially strong incentives to enter will be removed

Government and the **regulatory authorities** will benefit:

- The long term financial viability of the universal service provider Royal Mail will be improved
- Efficient competition will be encouraged, but cream skimming entry that simply duplicates industry costs will be discouraged
- Industry unit costs – and therefore prices – will fall through time as competitive entry becomes more efficient

In summary, Royal Mail's proposals for the USO provide a way forward that will benefit industry stakeholders as well as supporting the long term viability of the universal service itself, and therefore should be supported by customers, competitors and government.