

**Promoting Effective Competition in UK
Postal Services**

A Decision Document

May 2002

Summary

About Postcomm

S.1 Postcomm is the independent regulator for postal services in the United Kingdom, established by Parliament in the Postal Services Act 2000. Its primary duty under the Act is to act in a manner best calculated to ensure that customers continue to benefit from the universal service at an affordable and geographically uniform tariff. Subject to this duty, Postcomm has a duty to further the interests of postal users, wherever appropriate by promoting effective competition. Postcomm's vision in the discharge of its duties is:

“a range of reliable, innovative and efficient postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market.”

S.2 Postcomm recognises that this market vision can only be achieved in the foreseeable future with a successful Consignia at its core. This is needed not just for the delivery of the universal service but also for the delivery of consolidation and other services which new entrants may wish to provide.

Purpose of this document

S.3 This document sets out Postcomm's policy for achieving effective competition within the postal market for items weighing less than 350g and costing less than £1. It concludes a comprehensive consultation process (commenced in September 2000) that led to Postcomm publishing detailed proposals in January 2002. In the light of the responses received to its proposals, Postcomm has made a number of adjustments and reached a final decision. The rationale for the decision and, in particular, the adjustments made to the proposals are the subject of this document.

S.4 Postcomm is satisfied that its market opening strategy, set out in this document, is fully in accordance with its statutory duties and meets the objectives set out and endorsed in response to last year's consultation. Postcomm recognises that any decision to change the regulatory regime inevitably involves some degree of risks in terms of its duties and therefore it has identified and put in place measures to mitigate and manage these risks.

Postcomm's original proposals

S.5 Following two consultation documents (September 2000 and June 2001), Postcomm's January 2002 proposals were based around four key commitments:

- Commitment to full market opening. Postcomm proposed a firm commitment to introduce full market opening by 31 March 2006 following a four-year transition. Thereafter, licences would be issued on a "light-touch" basis with Postcomm seeking to remove the need for licensing wherever possible. Postcomm also proposed that the "end-date" could be brought forward following a consultation.
- Commitment to an orderly transition towards full-market opening. Postcomm proposed that the transition period should comprise three phases. Phase I would last from April 2002 to 31 March 2004. Postcomm said it would issue licences for three market segments – large or "bulk" mailings over 4000 items (which would expose to competition 30% of inland letter revenues), consolidation and "defined activities". For Phase II, lasting from 1 April 2004 to 31 March 2006, Postcomm said it would license the same segments, but the bulk mail threshold would be reduced so as to expose to competition 60% of the inland letters market revenue to competition. A restriction was proposed for large mailing licences that would prevent licensees from accepting mail from consolidators, who would have to inject their mail into Consignia's network. This restriction was proposed for Phase I, with the intention of reviewing it and possibly removing it for Phase II. Postcomm proposed that Phase III, beginning on 1 April 2006, would see the abolition of all restrictions on market entry.
- Commitment to safeguards for the universal service. Postcomm noted that the foremost universal service safeguard was the spur to greater efficiency and innovation that competition would encourage. If it proved necessary, Postcomm had available other policy levers such as alterations to the service specification, the overall level of prices, the pricing structure or the permissible competitive response. However, Postcomm did not propose to recommend to the Secretary of State that a compensation fund should be established.
- Commitment to measures to promote effective competition. Postcomm proposed that Consignia's ability to respond to competition by adjusting prices should be restricted in the initial phases of competition to prevent the risk of market foreclosure through targeted and aggressive pricing responses.

S.6 Comments on the proposals were requested by 15 March 2002 but following receipt of requests for more time to respond to these proposals, the deadline for comment was extended to 12 April 2002. Postcomm received approximately 2,000 responses, comments and other communications from a wide range of organisations, interest groups and individuals. Postcomm is grateful to all who commented on its proposals. These comments were very helpful to Postcomm in reaching its final decision.

Postcomm's response to key representations

(a) Benefits of competition

S.7 Postwatch and many potential operators supported Postcomm's proposals. However, many of the individual comments received expressed concern about the cumulative effect of competition and other regulatory policies (such as price controls) on the continued provision of the universal postal service. Postcomm recognises these concerns but is satisfied both that its market opening policy will not undermine the universal postal service and that users will benefit from the choice and innovation that competition will stimulate over time. Moreover, the introduction of competition - by encouraging Consignia to become more efficient - will, in itself, help to safeguard the universal postal service. Postcomm also has regulatory controls to prevent adverse impacts on those customer groups identified in the Postal Services Act as meriting particular consideration (as discussed in paragraph S.19 and S.20).

(b) Timing

S.8 Consignia itself supported the introduction of competition in postal services, but along with other respondents, including the Communication Workers Union (CWU) and the Communication Managers Association (CMA), suggested that more time should be allowed. Similar concerns were expressed by some Members of Parliament and the Committee of Public Accounts. Postcomm recognises these concerns and has noted the financial problems Consignia is currently facing, Consignia's three year renewal plan to address these and the recent improvement in industrial relations. Against this background, Postcomm accepts that, in order to ensure an orderly transition, more time should be allowed for Consignia, other operators and postal users to prepare for market opening. On the other hand, Postcomm recognises that if the timetable were extended too much, the pressure on Consignia to make the changes it needs will be weak and potential entrants may lose interest in the UK market. In the light of this, Postcomm has concluded that:

- Phase I should be put back to 1 January 2003. This is the date when the changes to the weight/price threshold under the European Postal Services Directive are due to take effect, and so has the additional advantage that these regulatory changes can be introduced at the same time. Potential licensees will, however, be able to apply for licences before then, so as to be able to begin operations on 1 January 2003.
- Phase II should be deferred by one year to 1 April 2005. This in effect means that during the 3 years of Consignia's "renewal plan", which is designed to get Consignia into shape for competition, it will face only the modest competition envisaged in Phase I; and
- Phase III should be put back by one year to 1 April 2007. Postcomm has also decided to withdraw its proposal to hold open the possibility of bringing the end-date forward in response to concerns expressed by respondents that this would create uncertainty about the transition path. Postcomm's judgement is that the advantage of a clear and certain transition period with a firm "end-date" outweighs the potential benefits of an "end-date" review.

(c) Approach to market opening

S.9 There were many responses in support of Postcomm's strategy of opening up the three market segments of large ("bulk") mailings, consolidation and "defined activities". There were also criticisms of this approach and arguments were put forward that Postcomm should only introduce competition by following the approach of the European Postal Services Directive of gradually reducing the weight/price threshold. As explained in the January 2002 proposals document, Postcomm notes that reducing the weight and price threshold is the minimum that member States must achieve under the Directive. Member States are free to proceed faster and some have already done so. Moreover, relying solely on the minimum approach necessary is likely to have a limited impact in the initial stages because postal users find it difficult and costly to segregate mail on the basis of weight. Postcomm's policy, which builds on the European approach, will achieve a smoother build up to a full market opening in the UK. Postcomm has therefore decided to retain the key elements of its proposed approach to market opening entailing both more benefit to consumers and ultimately less risk to Consignia as universal service provider. The measures required under the European Directive will also be implemented in due course.

(d) Size of market opening in Phase I

S.10 Postcomm has responded to Consignia's concerns that the original definition of "large mailing" would open up a larger proportion of the market than the 30% by revenue proposed. Postcomm has decided that the definition of "large mailing" in Phase I will be restricted to mailings over 4000 items (or an average of 4000 if under a multiple mailing contract) from a single site and posted in the same format (C4, C5, etc). Consignia accepts that the single site and format restrictions limit the risk of market opening in Phase I exceeding the planned amount.

(e) Restriction on consolidation

S.11 Concerns were expressed about Postcomm's original proposal to review (at Phase II) the requirement that consolidators must hand their mail over to Consignia for final delivery, on the basis that removing this restriction could have the effect of opening up the whole of the market then and not at Phase III. Postcomm has addressed these concerns. Although it doubts that in practice this would happen, Postcomm accepts the point that it could create uncertainty and leave postal operators unclear about what the regulatory rules will be during Phase II. In the interests of providing a clear and certain transition period, Postcomm has decided not to undertake a review of the consolidator restriction in Phase II. Operators will be required to hand consolidated mail over to Consignia throughout the whole of the transition period and that restriction will now remain in force until 1 April 2007.

(f) Uncertainty about other elements of the regulatory regime

S.12 Some respondents, including Consignia, other operators and Postwatch, said that in addition to deciding its market opening strategy, Postcomm should simultaneously settle the other inter-related elements of the regulatory framework, in particular Consignia's price control regime, service standards and third-party access arrangements. Postcomm recognises that there are links between the overall competition framework for the postal services market and particular elements of Consignia's regulatory regime. However, it considers that any attempt to determine all these elements of the regulatory framework together would create significant delays and uncertainties in the market place. Postcomm has consistently made it clear that it sees it as vital that the market opening strategy (which affects all postal service operators and potential entrants) should be set in place first, as it is the core element of the regulatory framework.

- S.13 Processes are already in place to settle the longer-term framework for prices and terms for access. Consignia's licence issued in March 2001 established an interim price control which is due to be replaced by a longer-term regime on 1 April 2003 (i.e. shortly after the start of Phase I of this market opening strategy). Postcomm has work in hand to that end and will be aiming to consult on the proposed regime later this year. In this context, Consignia has expressed its desire to increase both the First and Second Class rates by 1p. Postcomm expects to receive Consignia's supporting argument and evidence for this in the course of its review.
- S.14 Consignia's licence also sets out the processes for it and operators to agree access prices and terms (or for Postcomm to determine them in the event of failure to reach agreement). Postcomm is keen to see arrangements established that create incentives for Consignia to develop a vibrant and profitable downstream business, which will be in the long-term interests of users and the market as a whole.

(g) Scope of the product range that comprises Consignia's universal service

- S.15 A number of respondents, including Postwatch, urged Postcomm to resolve, at the earliest opportunity, the question of which of Consignia's services should be regarded as being provided as part of its licence requirement to provide a universal postal service. In deciding on its market opening strategy, Postcomm has taken as the starting point Consignia's view that virtually all its inland letter services are universal services, but it recognises the importance of clarifying the position and, as indicated in its January 2002 proposals, Postcomm will be issuing a consultation document later this year. This will consider which of Consignia's many inland letter products should be regarded as universal. This consultation will not call into question the geographic coverage of services, which, subject to a power given to Postcomm to designate exceptions in certain geographical or other circumstances (on which Postcomm will issue a consultation document in June 2002), is incorporated in law.

(h) Postcomm's research and analysis

- S.16 Consignia raised a number of points on some aspects of the analysis which Postcomm had commissioned from Andersen and Frontier Economics and which supported its January 2002 proposals. As with any modelling and analytical work, there is scope for differences of view on the assumptions that form part of such work. For the reasons set out in Annex III, Postcomm considers that the issues raised by

Consignia on this work are not sufficiently significant to call into question the conclusions put forward by these reports. These are that Consignia's business and hence its ability to meet its universal service obligation is more at risk from a failure to become efficient than from a loss of volume under competition. This analysis provided helpful support to Postcomm's policy framework, but was only one of the factors that Postcomm took into account in developing its proposals and reaching its final decision.

(i) Monitoring developments in the market

S.17 Postcomm will monitor carefully the impact of its market opening strategy (and its other regulatory actions) on the postal services market to ensure that the universal postal service continues to be provided and that postal users benefit from the introduction of competition and will report the position in its annual report. If, in the light of changes in the market, a situation were to arise where Postcomm considered that there was a threat to the efficient provision of the universal postal service, Postcomm would, in pursuit of its primary duty, take whatever regulatory action was deemed necessary at that time to address the threat.

S.18 These protective mechanisms include the possibility of changing the conditions of operators' licences, including the end-date. Using the licence modification process in this way addresses the need for certainty, which is required to encourage sufficient competition, and also deals with the risk that competition may develop in such a way as to put the universal service at risk. Operators will have an appeal mechanism to the Competition Commission against changes to any licence conditions where they do not agree to the proposed change. This ensures that changing the end-date would not be a option that Postcomm could undertake lightly. Another safeguard is that at the start of Phase II, the relaxation of the bulk mail threshold and/or definition can take account of the developments in Phase I, if more of the market has been opened up than Postcomm had intended.

(j) Impact on different types of users

S.19 Many individual respondents and some organisations expressed concern about the changes that Consignia might make to its services to respond to the development of competition. Some respondents said that while some customers, particularly large mailers and those who purchased postal services under contract, would see many benefits, other users of postal services, such as recipients in rural areas or residential

customers would suffer a deteriorating service as Consignia sought to “rebalance” its services. Postcomm recognises these concerns. It expects Consignia to respond to competition by becoming more customer and commercially orientated, which will inevitably lead to some changes within its present range of services. At the same time, key aspects of Consignia’s present services are protected because they are enshrined in its licence, granted within the framework of the Act, for example a universal service of one collection and one delivery each day at an affordable geographically uniform tariff. In addition, Postcomm also regulates other aspects of Consignia’s services through its licence, such as service standard performance and pricing.

- S.20 Postcomm, with Postwatch, would expect to undertake consultations in respect of any major service change that Consignia proposes. In assessing any such changes, Postcomm will need to be satisfied that Consignia’s proposals will not affect the provision of the universal service and will further the interests of users as a whole. Postcomm will pay particular attention to its duty to have regard to the interest of vulnerable groups, such as those who are disabled or chronically sick, are of pensionable age, are on low incomes or residing in rural areas.

(k) Post office network

- S.21 Concern was expressed that Postcomm’s proposals might have a negative impact on Consignia’s network of local post offices. The future and sustainability of the post office network is the responsibility of Consignia’s Board and the Government. Postcomm’s proposals covered only the mails business. Postcomm notes that on average post offices receive only about 25% of their income from mails services and handle only a small volume of post. In addition, bulk mailings, which are liberalised during the first two phases, do not pass through local post offices. Nevertheless, Postcomm believes that market opening will encourage other postal operators to look for innovative ways of reaching target markets for residential customers. This may lead to new business opportunities, such as customer collection arrangements, and therefore could have an overall positive effect on the post office network.

Postcomm’s market opening strategy

- S.22 After reviewing responses to its proposals and making the adjustments described above, Postcomm is able to affirm the four key commitments in its market opening strategy. Postcomm considers that the adjustments made to its proposals give effect

to a coherent competition policy that addresses in a carefully thought through manner the risks involved. These adjustments address the risk of too little competition being introduced which would deprive postal users of the benefits of competition (and put at risk the universal service by not incentivising Consignia to innovate and change) and the risk of there being too much competition too soon which could put at risk the universal service by leaving Consignia insufficient time to adapt. (Chapter 7 contains Postcomm's analysis of its risk management strategy).

- S.23 The changes to the January 2002 proposals do not alter the underlying approach or the general shape of Postcomm's market opening strategy. However, the detailed adjustments that have been made add up to a material shift in favour of further safeguarding the universal service by giving Consignia more time to adapt to competition and by removing uncertainty about the transition path. Postcomm notes that the extensions to the transition timetable will mean that full competition will not now occur until eight years after the publication of the Government's 1999 White Paper, which signalled the start of the move towards a more competitive market. In developing – and deciding – its market opening strategy, Postcomm has had firmly in mind that its primary duty is to act in the manner it believes best calculated to ensure the continued provision of the universal postal service and, in consequence, that its market opening strategy and the associated commitments must be entirely consistent with that duty.

Implementation issues

- S.24 This document concludes Postcomm's work to establish a long-term strategy for market opening in compliance with its statutory duties. Postcomm will give effect to its market opening strategy mainly through the licensing of new postal operators. The market opening strategy set out in this document replaces the interim licensing policy that Postcomm has been following since April 2001. To ensure a smooth transition to the new regime, Postcomm intends to continue to accept applications for interim licences until 30 June 2002. It will consider applications for licences for those activities that are permitted under the long-term competition framework from 1 June 2002.
- S.25 Postcomm will issue a consultation document in June 2002 seeking views on the standard terms of the new licences that it will issue and on other detailed implementation issues.

Table of contents

Summary	1
1. Introduction	11
PART I: COMPETITION POLICY FRAMEWORK	18
2. Postcomm's Competition Policy	19
Part II: ASSESSMENT OF RESPONSES TO POSTCOMM'S PROPOSALS	26
3. Commitment to Full Market Opening.....	27
4. Commitment to an Orderly Transition towards Full Market Opening	40
5. Commitment to Safeguards for the Universal Service	54
6. Commitment to Measures to Promote Effective Competition	61
7. Assessment of Postcomm's Decisions	64
Annex I: Policy Statement on Licensing.....	74
Annex II: Timetable of Future Events	78
Annex III: Financial Impact on Consignia of Competition	80
Annex IV: Glossary of Terms	94

1. Introduction

What is Postcomm?

- 1.1 The Postal Services Act 2000 (the Act) established the Postal Services Commission (Postcomm) as the independent regulatory body for the postal services industry in the United Kingdom. Postcomm's Business Plan, which can be found on its website www.psc.gov.uk, gives details of its duties, functions, objectives and work plan.

Postcomm's statutory duties

- 1.2 Postcomm's primary duty is to act in a manner best calculated to ensure customers continue to enjoy a "universal postal service" (universal service or UPS). The UPS consists of the delivery and collection at least once every working day of mail (not exceeding 20 kilograms in weight) and the provision of a registered postal service, all at affordable prices that are uniform throughout the UK.
- 1.3 Subject to this, Postcomm is also charged with furthering the interests of users of postal services wherever appropriate by promoting effective competition between postal operators. In doing so, Postcomm must have regard to the interests of those who are disabled or chronically sick, are of pensionable age, are on low incomes or reside in rural areas.
- 1.4 Subject to both the duties above, Postcomm has a further duty to exercise its functions in a manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.
- 1.5 Finally, in performing all its duties, Postcomm must have regard to the need to ensure that licence holders are able to finance the activities authorised or required by their licences.

Background to competition in UK postal services

- 1.6 Before the Postal Services Act 2000 was enacted Consignia plc, formerly The Post Office, had the exclusive privilege of a monopoly in the provision of postal services

within the UK for items weighing less than 350g and costing less than £1¹. Certain services, such as document exchanges, were excluded from the monopoly. In the part of the market outside the monopoly, competition has become established, with an estimated 4,000 operators competing for business in parcels, courier and express services.

- 1.7 Among the changes introduced by the Postal Services Act 2000, Postcomm was established as the sector regulator and provided with powers to issue licences to operators within the former monopoly area and so introduce greater competition in the postal services market. The first licence Postcomm granted was to Consignia on 23 March 2001². Included within the terms of that licence were conditions relating to the continued provision of a universal service, controls on prices and performance targets for service quality. Several other conditions designed to facilitate effective competition were included, dealing for example with third-party access and avoidance of undue preference or discrimination. To date, Consignia remains the sole universal service provider in the UK.
- 1.8 On 30 April 2001, Postcomm issued a statement on its interim approach to licensing³, setting out its views on how it proposed to exercise its licensing powers pending the establishment of a longer-term policy on competition (which is the subject of this document). In accordance with its interim policy, Postcomm has granted 8 further licences to operators to provide a range of services⁴. That interim licensing policy is now superseded by the policy set out in this document.

Purpose of this document

- 1.9 This document sets out Postcomm's decision on its market opening strategy for promoting effective competition in UK postal services for items weighing less than 350g and costing less than £1. In doing so, it summarises and addresses the responses received to Postcomm's proposals for effective competition, published in January 2002, and indicates how Postcomm has taken account of those representations in modifying its original proposals. Whilst this document sets out Postcomm's decisions, it does not seek to repeat all the analysis and argument in the January 2002 document and therefore both documents should be taken together as the supporting material for Postcomm's conclusions.

¹ The Telecommunications Act 1981, section 66 and the Postal Privilege (Suspension) Order 1981.

² See Postcomm website for a copy of Consignia's licence.

- 1.10 A list of parties who will be notified of this document is on our website. The list is not meant to be exclusive. Please let Postcomm know if you think any other interested parties should be added.

Structure of this document

- 1.11 Following this introduction, this document comprises two Parts. Part I, comprising Chapter 2, summarises Postcomm's decisions on its market opening strategy. Part II comprises Chapters 3 to 7 and contains Postcomm's assessment of the responses it received to its January 2002 Proposals document. Chapter 3 assesses issues in relation to Postcomm's proposed commitment to full market opening. Chapter 4 and Chapter 5 deal with issues in relation to Postcomm's proposals regarding, respectively, an orderly transition to full market opening and safeguards for the universal service. Chapter 6 covers issues related to Postcomm's proposal to commit to measures to promote effective competition. Chapter 7 provides Postcomm's assessment of its decisions including a risk assessment and a description as to how its final decisions meet the objectives it set for itself, including its statutory duties.

Implementation issues

- 1.12 This document concludes Postcomm's work to establish a long-term strategy for market opening. Postcomm intends to discharge its duties by exercising its licensing powers in accordance with this decision. Postcomm expects to publish, in June 2002, a consultation document setting out the standard terms and conditions of licences that it expects to issue to applicants in accordance with the market opening strategy. That document will also seek views on a number of other implementation issues.
- 1.13 In addition to its work on establishing the new competition policy framework, Postcomm is also taking forward a number of aspects of the wider regulatory framework for postal services. These include reviewing the present controls in Consignia's licence on its pricing and service standards, establishing appropriate access arrangements to Consignia's network and reviewing how many of Consignia's many inland letter products should be regarded as universal services. A timetable of expected Postcomm publications on those and other issues is attached at Annex II.

³ See Postcomm website for a copy of Postcomm's interim licensing policy.

⁴ See Postcomm website for further information about these other licences.

How Postcomm has reached its decisions

1.14 The decisions set out in this document are the result of an extensive consultation process with stakeholders and interested parties in order to formulate policies that are designed to ensure fulfilment of Postcomm's statutory duties.

- Published documents. Postcomm has issued two consultation documents⁵ on promoting effective competition (in September 2000 and June 2001) and also published for comment (in January 2002) its proposals for competition which took into account the responses received to the earlier consultation documents. It has also issued an assessment of the costs and benefits of Consignia's provision of the universal service (in June 2001) and has undertaken other research and analysis which was summarised in the proposals document and is available on Postcomm's website.
- Analysis and research. In order to assess how competition might affect Consignia's business, Postcomm commissioned consultants, Andersen, to provide analysis and advice on the effect of market opening on Consignia's financial position. Postcomm also commissioned Frontier Economics to advise on the efficiency improvements that Consignia could reasonably be expected to achieve in the light of its own announcements, and the experience of other liberalised industries and postal sectors. A summary of further advice responding to comments received from the consultation process is set out in Annex III of this document. All final reports received from Postcomm's consultants are available from Postcomm's website.
- Stakeholder views. Postcomm has received extensive comments from a wide range of interested parties including Consignia, the Communications Workers Union and Communications Managers Association, Postwatch, other operators, user bodies, representative organisations, political parties, individual members of the public and postmen and postwomen. Throughout this process, Postcomm has had many discussions with stakeholders. Consignia, CWU with the CMA, and Postwatch made presentations direct to Postcomm's seven Commissioners on their views on Postcomm's January 2002 proposals.

⁵ These documents and responses to them can be obtained from Postcomm's website.

- Parliamentary hearings. Postcomm (and others) gave evidence to the Public Accounts Committee (PAC) as well as the Trade and Industry Committee (TIC). Postcomm also held meetings with some members of the Parliamentary Labour Party (PLP), the opposition parties, the Welsh Assembly and the Northern Ireland Assembly.
- Regional Visits. Postcomm undertook a series of regional visits to explain its role and, as they developed, its proposals and to promote understanding of them at a local level. It will continue to do this as it implements the new competition policy.
- Stakeholder workshop. Postcomm held a one-day workshop on 17 October 2001 in conjunction with the Centre of Regulated Industries of the University of Bath. Various stakeholders including Consignia, Postwatch, other operators and customer groups presented their views and discussed them with other stakeholders present⁶.
- Competition Working Group. Postcomm established this group of operators to advise it on market opening strategies and to supplement the on-going discussions Postcomm had with Consignia. The Working Group's report on recommendations to Postcomm is available from Postcomm's website.
- International experience. Postcomm has undertaken a number of visits to other countries to understand how they approach issues relating to competition and the universal service and their experience of liberalisation in part or all of their postal markets.
- Technical experts panel. In developing its decisions Postcomm has received advice from its panel of technical consultants, including Andersen, Frontier Economics, WS Atkins, Measurement for Management Decisions (MMD), Triangle Consulting and National Economic Research Associates (NERA). Postcomm has also benefited from advice from members of a panel of independent experts it established to consider issues relating to competition and the universal service. This panel comprised: Professor Martin Cave (Centre for Management under Regulation, Warwick University), Professor Saul Estrin (London Business School), Professor Anthony Steele (Warwick University), David Storer (independent consultant) and Nicholas Fincham (Ofgem).

⁶ Presentations made at the workshop are available from Postcomm's website.

Responses to the Proposals document

1.15 As noted in Table 1.1, Postcomm has received a large number of written communications on this matter, including:

- formal responses following the report for comment in the January 2002 proposals document,
- letters and emails commenting on Postcomm's proposals from a wide range of people and organisations including a number of Members of Parliament, and
- petitions, a number of which have been signed by groups of people but including postcards and duplicated standard letters.

Table 1.1: Responses to proposals document

Type of communication	Number
Responses	160
Letters and emails	434
Petitions	1341
Total	1935

1.16 This document highlights the main issues that were raised and provides Postcomm's response. It does not address every individual point raised by correspondents; however, all non-confidential responses can be obtained from the Postcomm website.

Contact Details

1.17 Should you wish to discuss or clarify any aspect of this document you may contact:

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1.18 In addition, you may contact either Sandy Grom (020 7593 2158, sgrom@psc.gov.uk) or Erik Maurice (020 7593 2146, emaurice@psc.gov.uk).

PART I: COMPETITION POLICY FRAMEWORK

2. Postcomm's Competition Policy

Chapter outline

- 2.1 This Chapter summarises Postcomm's decisions for ensuring compliance with its statutory duties through appropriate promotion of effective competition. The rationale for these decisions is set out in detail in Part II of this document.

Postcomm's decisions on its competition framework

- 2.2 The following is a summary of Postcomm's key decisions on its market opening strategy.

(a) Commitment to full market opening

- The UK postal market will be fully open to competition from 1 April 2007. From that date (the "end-date") all restrictions on market entry will be abolished and no area of the market will be reserved exclusively to Consignia. There will be an orderly transition path of market opening leading up to that date.
- Postcomm will achieve the opening of the market through the licensing of new operators under a "light touch" regulatory regime. Stronger regulation may be necessary for operators that are providing a universal service or in a dominant market position.
- Postcomm will seek to reduce the role of regulation wherever appropriate with the intention of deregulating unless a compelling case is made to the contrary in terms of safeguarding the universal service. (For example, Postcomm will consider exempting particular types of services from the licensing requirement and will consider removing price controls where competition can be relied upon to protect the interests of users).

(b) Commitment to an orderly transition towards full market opening

- There will be a 3 Phase transition plan leading up to full market opening on 1 April 2007.

(i) Phase I: From 1 January 2003 to 31 March 2005

Large (“Bulk”) Mailing licences

Postcomm will grant licences for operators wishing to provide large mailing (“bulk mail”) services, where a large mailing is defined as an individual mailing with at least 4,000 items in the same format (or an average mailing of 4,000 items if under a multiple mailing contract) from a single user at a single site. Postcomm’s intention is to open to competition 30% of the market by revenue.

Consolidation licences

Postcomm will grant licences for operators wishing to consolidate mail from a number of users. These licences will contain a restriction requiring all consolidated mail to be passed to Consignia for final delivery.

“Defined Activities” licences

Postcomm will consider opening up further parts of the market in respect of “defined activities”, which are likely to be relatively small scale specialised postal services. Postcomm will consider requests from operators for particular services to be classed as “defined activities” on their merits, against the facts that prevail at the time, and in the light of the expected impact on the universal service, taking into account the other aspects of Postcomm’s market opening strategy.

Terms of licences

All licences will be of indefinite duration with a notice period of 3 years, which can only be exercised after the end of the fourth year (i.e. each licence will have a minimum term of 7 years). Applicants will be able to apply for a licence covering more than one activity provided the restrictions are complied with (e.g. an operator can apply for a licence covering large mailings and consolidation but will need to keep the two streams of mail separate and will not be able to feed consolidated mail into its large mailing operations). Operators will be able to begin the process of applying for licences from 1 June 2002 although any licences granted by Postcomm in advance of Phase I will only take effect from 1 January 2003.

Transition from the interim licensing policy

As Postcomm indicated in its interim licensing statement, it will expect interim licence holders to apply in due course for licences covering one or more of the activities described above. Subject to consultation with individual licence holders about the scope of their activities, Postcomm currently expects all interim licence holders to be accommodated within the new licensing regime. Postcomm is currently considering a number of applications for interim licences and is aware that other applications are being prepared. Postcomm will consider further applications for licences under the interim licensing policy, provided the application is received by 30 June 2002. Thereafter, Postcomm will only consider applications for licences under its new policy.

(ii) Phase II: From 1 April 2005 to 31 March 2007

Large ("Bulk") Mailing licences

Postcomm will adjust the restrictions on large mailings (either in relation to the minimum number of items and/or the restrictions on the definition such as the requirement for the mailing to be posted from a single site in the same format). The intention of this adjustment will be to open to competition a cumulative total of 60% of the inland letter market by revenue.

(iii) Phase III: On 1 April 2007

The "end-date"

All restrictions on market entry will be abolished. All licences issued in Phases I and II will be framed so that the service restrictions will end on 31 March 2007.

- The reductions in the reserved services limit under the European Postal Services Directive (to 100 grams on 1 January 2003 and to 50 grams on 1 January 2006) will be incorporated into Postcomm's market opening strategy. DTI, which is responsible for implementing the Directive within the UK, is currently considering how this might be achieved and expects to consult on its proposed approach in the near future.

(c) Commitment to safeguards for the universal service

- Postcomm's primary duty is exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal service at an affordable geographically uniform price. The foremost safeguard for the universal service is the stimulus that competition will provide Consignia to become a more efficient and innovative universal service provider. Postcomm's market opening strategy has been framed to give Consignia a reasonable opportunity to adjust to the new competitive environment. As the UK's only universal service provider, and currently the only operator with a nation-wide daily collection and delivery network, Consignia will be a key player in the sector, especially during the transition to full competition, and Postcomm sees a vigorous Consignia as an essential element in a competitive and innovative UK postal services market.
- During the transition period to full market opening on 1 April 2007, Postcomm will actively monitor the market. If it is necessary to intervene to preserve the universal service, it has the mechanisms to do so. These safeguards include adjusting prices, service specifications or the terms of licences. Postcomm does not, however, intend to seek the powers necessary to establish a compensation fund at this stage.

(d) Commitment to measures to promote effective competition

- Consignia's licence already contains provisions that limit Consignia's ability to respond to competition by adjusting its prices during the initial stages of the development of competition. Postcomm will maintain that restriction, which exists to prevent the risk of market foreclosure through targeted and aggressive pricing responses, but will consider at the appropriate time whether the restriction should be removed as competition becomes established and self-sustaining.

Key changes from Postcomm's original proposals

- 2.3 Postcomm has made the following changes to the proposals it issued in January 2002.

(a) Commitment to full market opening

2.4 After carefully considering respondents' views on its proposals relating to its commitment to full market opening, Postcomm has decided the following modifications on its proposals (a full explanation is provided in Chapter 3).

- Timing. The starting date for Phase I market opening has been put back from April 2002 to January 2003. Postcomm has also decided to delay the start of Phases II and III by one year so that Phase II will now begin on 1 April 2005 and Phase III will now begin on 1 April 2007.
- End-date review. Postcomm is not proceeding with its proposal to consider bringing forward the end-date.

(b) Commitment to an orderly transition towards full market opening

2.5 After reviewing responses to its proposals relating to the orderly transition to full market opening, Postcomm has decided the following modifications to its proposals (a full explanation is provided in Chapter 4).

- Bulk Mail restrictions. Postcomm has decided to extend the restrictions on the definition of bulk mail in Phase I to restrict bulk mailings to those mailings posted by a single user from a single site and posted in the same format. The aim of these restrictions is to expose to competition 30% of the inland letters market by revenue. These restrictions will be reviewed for Phase II with the aim of exposing to competition a total of 60% of inland letter revenues.
- Restrictions on Consolidation. Postcomm has withdrawn the proposal to review for Phase II the restriction that prevents consolidators accessing non-Consignia networks.

(c) Commitment to safeguards for the universal service

2.6 After reviewing responses to its proposals relating to safeguards for the universal service, Postcomm has decided to make no changes beyond those noted elsewhere and to proceed as it proposed (see Chapter 5). Postcomm notes, however, that as envisaged in its proposals:

- Ongoing monitoring. Postcomm will monitor the market on an ongoing basis to ensure that the universal service continues to be provided and that postal users

reap the benefits from the introduction of competition and will report the position in its annual report.

(d) Commitment to measures to promote effective competition

2.7 After reviewing responses to its proposals on measures to promote effective competition, Postcomm has concluded that its proposals are appropriate and should not be altered. These include retaining the present restrictions in Consignia's licence that prevent it from pricing in a way that is unduly discriminatory, unduly preferential or predatory as described in Chapter 6.

Postcomm's decisions in the wider regulatory context

2.8 Postcomm's decisions on market opening conclude its work programme on establishing one of the major features of its wider regulatory framework, namely the powers for the introduction of competition whilst safeguarding the universal service. Postcomm intends to consult shortly on the standard terms and conditions for licences under the new regime. It also expects the licensing regime to accommodate changes brought about by the transposition of the amended European Postal Services Directive. Responsibility for transposing the Directive rests with the DTI. The DTI expects there to be a consultation later this year on the exact method to be adopted for transposition.

2.9 Postcomm recognises that other elements of the regulatory framework are very important to many stakeholders.

- Price control and standards of service. Given its dominant position, the prices and service standards offered by Consignia are regulated to provide customers with a degree of protection from monopoly behaviour in the form of excessive prices, discriminatory or predatory prices or paying for inefficiencies. In determining how to regulate prices and service standards, Postcomm will need to address these issues in the light of its universal service duty.
- Third-party access arrangements. Postcomm recognises that access arrangements will be a key factor in the success of the liberalised market. It also recognises that it is important to regulate access in a way that encourages entry and innovation and provides Consignia with an incentive to develop itself as a

profitable business. Postcomm has recently been requested by UK Mail Limited to determine its access terms.

2.10 Postcomm has work programmes under way to bring forward proposals in these areas (an indicative timetable of future consultations is attached as Annex II). In developing proposals in these areas Postcomm will need to ensure they complement the market opening strategy that has now been established whilst observing its statutory duties. In setting this wider regulatory framework, Postcomm be guided by its vision of a range of reliable, efficient and innovative services, including the universal service, valued by customers and delivered through a competitive market. Postcomm's judgement is that these proposals will lay the regulatory foundations for a strong and vibrant postal market with a strong and vibrant Consignia at its core.

Part II: ASSESSMENT OF RESPONSES TO POSTCOMM'S PROPOSALS

3. Commitment to Full Market Opening

Chapter outline

- 3.1 This chapter sets out Postcomm's original proposals for market opening and a summary of the representations it received to those proposals. This is followed by Postcomm's assessment of these representations and its conclusions.

Postcomm's original proposals

- 3.2 Postcomm's original proposals relating to its commitment to full market opening are summarised in table 3.1 below.

Table 3.1: Commitment to full market opening – Postcomm's original proposals

<i>Proposal Number</i>	<i>Original Proposal</i>
<i>Commitment to full market opening</i>	
<i>1</i>	<i>A firm commitment to a date for the full opening of the UK postal market. This date will be no later than 31 March 2006. From this date, no area of the market will be reserved exclusively to Consignia and all restrictions on market entry will be abolished. There will be an orderly transition path of market opening leading up to this date.</i>
<i>2</i>	<i>Postcomm may bring forward this date if, following consultation, it concludes that doing so would further its statutory duties.</i>
<i>3</i>	<i>Postcomm will seek to reduce the role of regulation wherever appropriate with the intention of moving to deregulation unless a compelling case is made to the contrary in terms of safeguarding the universal service. (For example, Postcomm will consider exemption from the need to license and removing sector specific regulation such as price controls where competition can be relied upon to protect customers' interests).</i>

Proposal Number	Original Proposal
Commitment to full market opening	
4	<i>From 31 March 2006, and subject to 3 above, Postcomm will continue to license operators under a "light touch" regulatory regime. Additional conditions may be necessary for operators that are either providing a universal service or in a dominant market position.</i>

Assessment of responses

3.3 The main comments received relating to Postcomm's commitment to full market opening concerned:

- suggestions that Postcomm had not given enough weight to, or recognised the primacy of, its universal service duty;
- the timing of the introduction of competition;
- the firmness of the "end-date"; and
- the effects of Postcomm's proposals on Consignia's ownership structure and its post office network business.

(a) Primacy of duties

(i) Responses

3.4 Some respondents, notably Consignia, the CWU and the CMA, suggested that Postcomm was putting its competition duty above its universal service duty.

(ii) Assessment

3.5 Given the clear hierarchy of its statutory duties, there can be no question of Postcomm putting competition or any other issue above its over-riding duty to act in a manner best calculated to ensure a universal service at an affordable geographically uniform price. It would be wrong for Postcomm to do so. In seeking to develop proposals for promoting effective competition in the letters market, Postcomm has

taken great care to act in a manner best calculated to ensure the provision of the universal service.

- 3.6 Postcomm's extensive consultation and internal review process have led it to calculate that rather than being in conflict with one another, the promotion of competition within the reserved area will, by spurring Consignia to become more efficient and innovative, contribute to ensuring the continued provision of the universal service at an affordable price in accordance with Postcomm's primary duty. Postcomm's analysis indicates that the financial position of Consignia and hence its ability to provide the universal service is more vulnerable to inefficiency and a lack of innovation than to market share loss from competition. Postcomm has no doubt that the best way to encourage Consignia to become more efficient and innovative is by introducing the rigours of competition. In this way, competition is a means to safeguarding the universal service.
- 3.7 Postcomm is reassured in this view by the fact that all the respondents who commented on the primacy of the universal service duty supported the introduction of competition, although they argued for this to be in accordance with the European Directive. The Directive sets the framework for two steps towards greater competition in 2003 and 2006 when the maximum degree to which postal services can be reserved to incumbent universal service providers is reduced from 350g to 100g and 50g respectively. The Directive goes on to call for a decisive step to be taken in 2009, following a review in 2006. This is expected to mean in due course the introduction of full competition. To support competition even at the minimum rate of introduction set by the European approach is to accept in principle and in the long-run, that competition and the universal service are compatible. Postcomm welcomes this acceptance which reflects experience from other regulated industries within the UK and from postal regimes in other countries.
- 3.8 Consignia acknowledges in its response to Postcomm's proposals that it is in a state of financial crisis and that a turnaround is imperative. This financial situation appears to be attributable substantially to a failure to control costs and to adapt the business in a timely way in response to evolving market and customer demands and the prospect of competition that has long been foreshadowed. Such a situation is less likely to recur if Consignia faces the incentive of competition in the letters market.
- 3.9 Postcomm recognises, however, that competition by its nature is unpredictable. Postcomm has therefore been keen to establish a policy framework which is

sufficiently flexible to cope with such changes. Postcomm has a range of safeguards available to it in such circumstances. (It will have, for example, opportunities to review the price control and it can propose licence modifications).

- 3.10 Postcomm will also monitor carefully the impact of its market opening policy (and its other regulatory actions) on the postal services market, to ensure that the universal postal service continues to be provided and that postal users benefit from the introduction of competition. If, in the light of changes in the market (however they may arise) a situation arose where Postcomm considers that there is a threat to the provision of the universal postal service then Postcomm would, in pursuit of its primary duty, take whatever regulatory action was deemed necessary at that time to address that threat (including, if relevant, taking steps to modify the licences issued to Consignia or other operators).
- 3.11 In granting licences Postcomm is bound to retain its discretion to set the terms of licences and make modifications to licences, where not to do so could put at risk the maintenance of an efficient universal postal service. Postcomm has available to it a range of safeguards which are described in Chapter 5 and it is not expecting to have to modify licences. However, if licence modification (e.g. amending the end-date) were to be contemplated, this would need to be discussed with individual licence holders.
- 3.12 If modifications could not be agreed with licence holders, Postcomm would have to refer the matter to the Competition Commission for investigation and decision. In order to apply this safeguard, Postcomm would need to be convinced of the need to make any changes. It would also need clear and convincing evidence, capable of meeting the public interest test which the Competition Commission would apply. This appeal mechanism is in line with the standard practice used by other sector regulators and is not a step that would be undertaken lightly. Postcomm does not plan to undertake a review at a particular date to assess whether this safeguard is necessary but will be monitoring the market on an ongoing basis and will respond to events. Postcomm will also ensure that other safeguards are exhausted before it considers such action.
- 3.13 Postcomm considers that seeking to introduce competition in postal services in a measured way will further its universal service duty and does not represent a misapplication of its statutory duties.

(b) Timing

(i) Responses

- 3.14 Many respondents (including Consignia, the CWU and Age Concern) said Postcomm's proposals should allow Consignia more time to prepare for competition and that the four-year transition period should be extended. One customer group, the Periodical Publishers Association (PPA), said that the universal must not be undermined and that liberalisation must come about in an incremental and controlled manner.
- 3.15 Many respondents also expressed concern that the UK's market would be open to competitors from other countries who would not fully open their markets until compelled to by the European Directive, a move which is not likely to take place before 2009. These respondents believed that this could place Consignia at a competitive disadvantage.

(ii) Assessment

- 3.16 Postcomm recognises that it would not be reasonable or responsible for competition to be introduced overnight into the letters market, which has been a public sector monopoly throughout its history. Postcomm recognises that Consignia, the industry and customers will need time to adjust to the new competitive environment. In addition, Consignia is in some degree of financial difficulty at the present time and if it were required to change too fast the universal service could be put at risk. Conversely, however, too little competition could have the effect of putting at risk the universal service by not encouraging Consignia to control its costs and to change in response to the evolving market. For these reasons Postcomm has decided to phase in the introduction of competition over a number of years but with a clear and certain end date.
- 3.17 The exact timing of the introduction of competition in Postcomm's proposals was based on the consideration of a number of factors. These included how quickly Consignia could adapt to competition, the need for competition as an incentive to change and how much time entrants would take to enter the market. Postcomm was mindful that if the external environment was shaped too closely by Consignia's own judgement on how it could change, this could lead to a perverse incentive to frustrate reform, which could in turn delay the introduction of organisational change and the

efficiency improvements important to secure the long-term viability of Consignia and its ability to provide the universal service.

- 3.18 Postcomm notes, however, the concern expressed by many respondents that its proposals did not strike the right balance between the relevant factors and that a longer transition was more appropriate. Postcomm also notes the point some respondents made that the credibility of the market opening by a set date was more important than the exact date.
- 3.19 In this regard, Postcomm's decision on phasing in competition needs to be seen in the context of the fact that competition has long been foreshadowed. It is three years since the Government's White Paper in 1999 and two years since the passing of the Postal Services Act 2000. Competition in post at the European level has been contemplated over a much longer period, starting with a Green Paper in 1991⁷ and with European Directives in 1997 and 2002. Consequently, Consignia has already had a good deal of notice of the moves towards a competitive market.
- 3.20 Postcomm has, however, recognised that Consignia is currently facing financial difficulties and announced in March 2003 the first steps in a 3 year plan to renew the company including its regulated mails business. The renewal plan represents a significant programme of change, but Postcomm is very reluctant to be seen to reward this management underperformance that made it necessary by putting the timetable back, but has to recognise the severity of the short-term difficulties that the business, management and employees are facing. All of them need to reform to reverse the situation and in this connection it is noted that there has been an improvement in industrial relations at Consignia in recent months. The need for an extension to the start date of the transition to competition must be balanced against the fact that Postcomm considers that competition is vital to prevent similar underperformance happening again and to encourage management and its shareholder to make changes at the time that are needed.
- 3.21 In the context of a clear commitment to full market opening by a fixed date, Postcomm has decided that it should allow more time for Consignia, operators and postal users to prepare for competition and that it would be right to delay the start of Phase I to 1 January 2003. This is also the date when the new European Directive weight threshold of 100 grams comes into effect which has the advantage that all

⁷ COM(91) 476 final.

these regulatory changes come into force at the same time. From 1 June 2002, Postcomm will accept applications for licences where the scope of activities falls into the permitted categories of activities under its market opening strategy. Any such licences granted before 1 January 2003 will not come into effect until 1 January 2003.

- 3.22 Postcomm has also decided to slightly lengthen the original transition period and in consequence put back the start dates for Phases II and III by one year. Phase II will be delayed from 1 April 2004 to 1 April 2005, and the “end-date” will be delayed from 1 April 2006 to 1 April 2007. Postcomm notes that as a result of these changes Consignia will face only the first phase of competition during the period of its 3 year renewal plan.
- 3.23 Postcomm is aware that these delays will be a disappointment to competitors wanting to come into the market and increases the risk identified in the NAO that there may not be enough competitors willing to enter the market. However, Postcomm has been impressed by the argument that firmness and certainty about the transition period and the end date are the most significant factor for businesses planning to invest in postal services and it has retained this element of its proposal.
- 3.24 Postcomm notes that some respondents wanted the UK to move in line with Europe to prevent postal regimes in other countries having unfair access to the UK market whilst UK operators are denied access to theirs. In response to this, Postcomm notes that:
- first, some European operators such as TPG and DPWW that are likely to see the UK as an attractive place to set up business have domestic markets that are exposed to more competition than in the UK at present. Consignia itself has taken advantage of this and operated directly through joint ventures in other countries, including in Sweden; there has never been absolute consistency across the European Union in the extent of postal liberalisation and it is unrealistic to expect that given the differences between member states’ postal markets;
 - second, Postcomm’s statutory duties and European law do not permit it to distinguish between operators based on their nationality. Postcomm’s duties and remit focus on benefits for UK users. Uniformity in the pace of liberalisation across the European Union is not a reason to deny UK consumers the benefits of competition;

- third, if Postcomm had evidence to suggest that an operator in the UK was unfairly cross-subsidising its activities in the UK from monopoly businesses in Europe, it has the power through its licensing functions to remedy it. Moreover, Postcomm would be only one authority looking at this issue. The European Commission and OFT have power to look into complaints about these practices; and
- fourth, although agreeing and implementing changes to the European Postal Services Directive is the responsibility of the DTI, Postcomm intends to encourage greater liberalisation of postal markets across the EU.

3.25 Overall, the transition dates to be adopted and the end dates are matters of judgment. The judgment Postcomm has reached:

- recognises the need for competition as a safeguard for an affordable universal service and for the benefits it brings customers;
- takes account of Consignia's timetable for its renewal plan; and
- is consistent with the European Directive.

(c) *Firmness of the commitment to an end-date*

(i) Responses

3.26 All those who expressed support for Postcomm's proposals, including Postwatch, strongly welcomed a firm commitment to an irrevocable "end-date", at which time restrictions on market entry will be eliminated. Most of those respondents said that the credibility of this commitment was imperative for them to have the confidence to invest and enter the market with long-term business plans. They also said that Consignia would only embrace the new regulatory regime and liberalised market once it could no longer rely on the protection of a monopoly.

3.27 Most operators said a credible end-date was the single most important factor in Postcomm's proposals. They said that the alternative, an incremental approach to competition with no firm end-date and subject to a further full-scale review would not create the right investment or employment signals. It also could be self-defeating as little entry would occur which could lead to inadequate information on which the analysis for a large scale review could be based. This could risk taking the debate no

further forward leading to delays. It could also risk a “big bang” if following a review there was a swift move to full market opening without the benefit of a more gradual build-up of competition.

- 3.28 Consignia, CWU and CMA expressed concern about the inflexibility in Postcomm’s approach to the end-date. Both said that Postcomm’s approach was less controlled than the European approach because it did not allow for a review, in which experience of competition could be fully assessed before further steps were taken. CWU said that Postcomm was taking too significant a risk without such a review.
- 3.29 Additionally, Consignia and the CWU said that Postcomm’s proposals were unbalanced because, while they contained the possibility to bring forward the end-date, they contained no provisions to delay it or make other changes to the competition framework. They argued this bias and uncertainty could undermine the planning and management of change needed to meet full competition.

(ii) Assessment

- 3.30 Postcomm’s judgement is that to encourage new entrants into the market and invest with any degree of confidence, it must provide certainty over the long-term nature of the market and in particular the date by which operators, including Consignia, customers and the wider industry, can prepare for the introduction of a fully competitive market. Postcomm accepts the consistent and strong message that has been put forward by many operators and by Postwatch on behalf of customers. Postcomm also considers that a credible end-date is vital for Consignia to encourage it to innovate and become more efficient. The more doubt there is about full market opening, the more resources Consignia is likely to direct at seeking to avoid or delay it, rather than putting in place the necessary steps to prepare for it and embrace it.
- 3.31 Postcomm accepts that ambiguity over the “end date” would be likely to limit entry and reduce the extent and effectiveness of competition before that date. Postcomm also shares the concern that ambiguity could have the undesirable consequence of introducing competition in a delayed “big-bang” way if a decision to fully open the market were then to be taken. Postcomm believes this risks undermining an orderly transition to competition which would not be in the interest of customers, operators or Consignia. Accordingly Postcomm will be inserting into all licences that it issues a provision whereby all service restrictions will lapse at the start of Phase III.

- 3.32 Postcomm will monitor carefully the impact of its market opening policy (and its other regulatory actions) on the postal services market to ensure that the universal postal service continues to be provided and that postal users reap the benefits from the introduction of competition. If, in the light of changes in the market (however they may arise) a situation arose where Postcomm considered that there was a real threat to the provision of the universal postal service Postcomm would, in pursuit of its primary duty, take whatever regulatory action was deemed at that time necessary to address the threat (including, if relevant, taking steps to modify the licences issued to Consignia or other operators).
- 3.33 Postcomm accepts the concern expressed by Consignia and CWU that its proposals to leave open the possibility of bringing forward the end-date could create uncertainty which may not be helpful in the context of planning the management of change to prepare for a more competitive market. Accordingly, Postcomm has concluded that it should remove this proposal from its competition framework.

(d) *Ownership structure*

(i) *Responses*

- 3.34 A number of respondents, including several Labour Party branches, expressed concern that Postcomm's market opening could result in the privatisation of Consignia.

(ii) *Assessment*

- 3.35 The ownership of Consignia is a matter solely for its shareholder, the Government. The Act does not require Postcomm to treat Consignia differently from other operators because of its ownership. Although Postcomm's decisions implicitly take as granted the present ownership structure, the analysis on which they are based would be no different under alternative ownership structures.

(e) *Post office network*

(i) *Responses*

- 3.36 The CWU agreed with Postcomm's assumption that market opening will have no immediate effect directly upon the rural postal network. However, it argued that competition together with Consignia's restructuring will result in further post office

closures. The National Federation of Sub-Postmasters shares with many residential respondents a concern that opening up the market would undermine the rural post office network.

(ii) Assessment

3.37 Postcomm has no direct regulatory role in relation to Post Office Ltd or the post office network beyond that part of the network that is needed to discharge Consignia's universal service obligation in relation to public collection and access points. Postcomm has an advisory role in relation to other network matters including the financing of the network, but decisions in this area are a matter for Government.

3.38 Postcomm's market opening proposals are aimed at the mails business. Postcomm recognises that the mails business of Consignia has arrangements with Post Office Ltd to ensure that its universal service obligation is satisfied in relation to access points.

3.39 Postcomm notes that on average post offices receive only approximately 25% of their income from mail services. In the context of competition and innovation in the mails market, some new entrants may wish to use this network and therefore provide it with an additional source of revenue. Indeed, some operators have suggested that they might wish to use the post office network, given that it is the largest retail network in the UK. This suggests business opportunities for the network following the introduction of competition in mails. Concern has been expressed, however, that Consignia's internal contract between the mails business and the post office network is currently too restrictive to enable the network to take advantage of such new opportunities.

(f) *Clarity and effectiveness of price control as a safeguard for the universal service*

(i) Responses

3.40 Consignia said that price control as a policy lever available to Postcomm should be linked directly with its market opening strategy. Consignia said, however, that Postcomm has not given it any indication of the likely controls that will apply to prices.

3.41 Consignia also said that full market opening meant that Postcomm would need to rely on price control as a policy lever to ensure the universal service and Consignia's

financial viability. However, this may not be an effective policy lever, because as competition is introduced, the market will begin to act as a discipline on price rises. Furthermore, any revenue gain from a price rise will need to be recovered from the narrowing set of customers who are less able to switch between operators and who therefore might see disproportionate price rises. Consignia pointed out that in Sweden where the market is fully liberalised, prices for business customers have fallen but prices for residential customers have increased. Consignia said Postcomm's proposal could result in the same occurring in the UK.

- 3.42 Consignia, in responding to Postcomm's proposals, expressed its desire to raise prices by 1p on basic First and Second Class services (with commensurate increases on higher weight items). Consignia wanted this to take effect from later this year. Consignia's proposal was supported by the CWU, who have said that they would prefer a 2p rise.

(ii) Assessment

- 3.43 Postcomm does not accept the view that more clarity is required now on the shape and level of the future price control. Postcomm's proposals are based on no change to the existing price controls in Consignia's licence. This condition restricts the majority of prices to the levels that prevailed on 1 January 2001. Some prices, mainly outside the licensed area, are permitted to rise by no more than inflation from that date. Other services that are exposed to effective competition are unrestricted.
- 3.44 Postcomm's work programme to review Consignia's price conditions is well under way and the process is very clear. In order to put a new licence condition in place for 1 April 2003, when the present condition is intended to expire, Postcomm intends to consult publicly later this year on pricing proposals. One of the key objectives for this review is to set prices in a way that ensures customer interests are safeguarded whilst Consignia can ensure it can finance its licensed activities. The review takes into account a range of factors, including the service standards, compensation and the impact of competition and Consignia's ability to finance its licensed activities. Postcomm will be subject to its overriding universal service duty. Postcomm will review Consignia's proposals for a price increase as part of this review. Postcomm therefore welcomes discussions that Consignia and Postwatch are currently having on how these various elements can be brought together in a way that can feed into Postcomm's review process.

3.45 Postcomm accepts in principle that fully effective competition could limit the effectiveness of the price control as a way of raising revenue to ensure financial stability. However, Postcomm expects that it is unlikely to happen to a significant degree before full market opening which is almost 5 years away. Given Consignia's dominance, it is unlikely to happen for some time thereafter. As discussed in the January 2002 proposals document, international experience suggests Consignia will not lose market share greater than that assumed in Postcomm's analysis. Postcomm also shares the views of many respondents who said that Consignia possessed many incumbent strengths, including brand awareness, scale economies and customer loyalty⁸. In addition, any pressure for price increases can to some extent be offset by greater innovation and efficiency, which is better encouraged in a competitive market than one characterised by a continued monopoly. In any event, to the extent that competition develops upstream of local delivery and uses access to Consignia's network, then Consignia will retain revenue through access charges.

Conclusions

3.46 After carefully considering respondents' views on its proposals relating to its commitment to full market opening, Postcomm has decided to modify its proposals in the following ways:

- Timing. Postcomm has decided to delay the introduction of Phase I to 1 January 2003. Postcomm has also decided to delay the introduction of Phases II and III by one year. Phase II will now begin on 1 April 2005 and Phase III will begin on 1 April 2007; and
- Acceleration of competition. In order to give stakeholders more certainty during the transition period, Postcomm will not review at the end of Phase I the case for bringing forward the end-date.

⁸ Many respondents, including Postwatch, said that evidence from liberalisation in other markets indicated that customer inertia in these circumstances was high.

4. Commitment to an Orderly Transition towards Full Market Opening

Chapter outline

- 4.1 This chapter sets out Postcomm’s original proposals and a summary of responses received on its commitment to an orderly transition to a full market opening. Following this, Postcomm sets out its assessment of these responses and its conclusions.

Postcomm’s original proposals

- 4.2 Postcomm’s original proposals relating to the orderly transition to full market opening are summarised in table 4.1. below.

Table 4.1: Commitment to an orderly transition to full market opening – Postcomm’s original proposals

<i>Proposal number</i>	<i>Original Proposal</i>
5	<p><i>Phase I: From April 2002 to 31 March 2004</i></p> <p>a) <u><i>Large (“Bulk”) Mailing licences</i></u></p> <p><i>Postcomm will grant licences for operators wishing to provide large mailing (bulk mail) services, where large mailing is defined as an individual mailing with a minimum of 4,000 items (or an average mailing of 4,000 items if under a multiple mailing contract). These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year). These licences will contain a restriction that prevents the acceptance of consolidated mail (see below) during the transition to full market opening (this will be reviewed for Phase II).</i></p> <p>b) <u><i>Consolidation licences</i></u></p>

Proposal number	Original Proposal
	<p><i>Postcomm will grant licences for operators wishing to provide services allowing the consolidation of mail from a number of users, which will then be passed to Consignia for delivery. These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year).</i></p> <p><i>c) <u>Defined Activity licences</u></i></p> <p><i>Postcomm intends to consider opening up further parts of the market in respect of defined activities such as local delivery services or specialised services. These licences will be indefinite in duration (with a notice period of 3 years which can only be exercised on or after the fourth year). Postcomm expects to consider the case for this further opening up on its merits, against the facts that prevail at the time and in the light of the expected impact on the universal service.</i></p> <p><i>d) <u>Licences granted under Postcomm’s interim licensing policy</u></i></p> <p><i>Postcomm has issued 6 licences under its interim licensing policy and is currently considering a number of other applications and expressions of interest. As Postcomm indicated in its interim licensing policy statement of 30 April 2001, Postcomm will expect holders of interim licences to apply for new licences once it has reached final decisions on its long-term licensing policy. Postcomm expects that some existing licence holders will apply for “Large Mailing” or “Consolidation” licences. Others may be accommodated by applying for a “Defined Activity” licence. Subject to evaluation of their effect on the provision of the universal service, it is Postcomm’s expectation that all activities licensed under the interim licensing policy will continue to be licensed under its new policy.</i></p>
6	<p>Phase II: From 1 April 2004 to 31 March 2006</p> <p><i>a) <u>Large Mailing licences</u></i></p>

Proposal number	Original Proposal
	<p><i>Postcomm will lower the Large Mailing licence threshold, with the aim of exposing a further 30% of Consignia's revenues to competition, bringing the total to 60% by revenue. Postcomm will revise the item limit for Large Mailing licences downwards (expected to be between 500 and 1,000 items of mail per mailing). Postcomm will amend Large Mailing licences issued in Phase I to reflect the revised threshold.</i></p> <p><i>b) <u>Review of restrictions on Large Mailing licences</u></i></p> <p><i>Postcomm will review the restriction in Large Mailing licences preventing holders from accepting consolidated mail.</i></p> <p><i>c) <u>"End-date"</u></i></p> <p><i>Postcomm will consider whether the end-date for full market opening should be brought forward before 31 March 2006.</i></p>
7	<p>Phase III: On or before 31 March 2006</p> <p><i>All restrictions on market entry will be abolished.</i></p>
8	<p><i>Once the amending European Directive is agreed, Postcomm will make the adjustments necessary to take account of the revised threshold limits. These propose a reduction in the reserved services limit to 100g on 1 January 2003 and to 50g on 1 January 2006.</i></p>

Assessment of responses

4.3 Postcomm received responses relating to:

- its market opening strategy of opening bulk mail, consolidation and "defined activities";
- the bulk mail threshold it should adopt;

- Consignia's immediate financial position;
- the impact of access and consolidation; and
- licensing issues related to integrity of the mail and the length of licences.

(a) Market Opening Strategy

(i) Responses

- 4.4 Consignia, CWU and CMA said that Postcomm's strategy of market opening including bulk mail, consolidation and defined activity licences was flawed on the basis it was not gradual and controlled. It was also not consistent with the market opening strategy adopted by the European Directive, which uses weight and price thresholds. Apart from these respondents, nearly all of the others, including Postwatch and many operators, who commented on this issue, confirmed Postcomm's view that a market opening strategy based on weight and price would have a limited effect in terms of introducing and promoting effective competition.
- 4.5 The CWU asserted that Postcomm's strategy of liberalising bulk mail would undermine the provision of a universal service at a uniform tariff. It argued that this will lead to private operators "cherry-picking" profitable business, thus undermining the business model that supports the operation of the postal service and enables Consignia to fund loss-making volumes.
- 4.6 Postwatch said that Postcomm's proposals sufficiently balance the aims of encouraging competition, whilst providing Consignia with an orderly and measured transition to competition. There was also a general agreement amongst operators that Postcomm's proposed method would benefit the market and postal users, and that the structured timetable would be sufficient to encourage investment in the market. Business Post and Hays DX saw the licensing of "defined activities" as the best way to encourage innovation and provide customers with more focused products. TPG suggested that liberalisation of direct mail may have been preferable to that of bulk mail. DHL commented that Consignia should be able to build on the current postal infrastructure to offer cost-effective universal deliveries and more innovative products and services. Regarding consolidation, the Direct Marketing Association (DMA) wished to see Postcomm define the term and review Consignia's current rules for consolidation.

(ii) Assessment

- 4.7 Postcomm's market opening strategy is consistent with the European Directive. Changes made to the Directive in terms of reducing the weight/price thresholds will be transposed into the UK regime. The responsibility for transposing the Directive rests with the DTI. The DTI expects there to be a consultation later this year on the exact method to be adopted for transposition.
- 4.8 It is important to note, however, that the European Directive only sets a common minimum level for the degree of liberalisation that Member States must introduce. Member States are free to go further and many already have. Apart from Sweden and Finland, which have fully liberalised, several countries have liberalised Direct Mail (e.g. Netherlands, Austria, Italy and Spain) and some have lower weight/price thresholds than the current Directive limit of 350g (e.g. Germany and Netherlands).
- 4.9 Postcomm's proposals document set out the basis for its view that, in the UK, solely relying on reducing the weight/price thresholds would not be the most appropriate way to introduce competition. This is because most mail volumes are at the lower end of the spectrum and volumes at higher weight/prices are unlikely to attract significant entry given the cost of splitting mailstream⁹. This is the case already with the 350 gram limit where there has been no significant entry in the liberalised market above 350 grams and no evidence has been provided in any of the consultation responses to refute this. Indeed, except for Consignia and the CWU, respondents to the proposals tended to confirm this view. In Postcomm's view, opening up the market simply by reducing the weight/price threshold, whilst a reasonable method for setting minimum standards, would not adequately meet the aim of an orderly transition to a competitive market. It risks being a delayed "big-bang" approach with a sudden and dramatic increase in competition occurring when the final market opening step takes place. Postcomm considers that a more measured opening of the market is necessary both to ensure the continued provision of the universal service and to protect the interests of UK users of postal services.
- 4.10 Postcomm has decided to make no changes to the general approach to its proposals for opening the market over a transition period, namely, that there will be

⁹ As noted in Postcomm's document 'Promoting Effective Competition in UK Postal Services' June 2001, volumes exposed to competition by reducing the weight threshold to 100 grams would result in a nominal 7% of Consignia's inland letter volumes (1999/2000) being exposed.

opportunities for operators offering services for bulk mail, consolidation and defined activities.

4.11 In formulating its competition policy, Postcomm has taken claims about the danger of “cream-skimming” for the universal service very seriously. Two forms of “cream-skimming” have been suggested. Firstly, operators will simply target profitable customers, particularly those where the uniform pricing requirement compels Consignia to price above costs. Secondly, operators may use the access arrangements to inject “costly” mail into Consignia, whilst retaining the low cost mail.

4.12 As a matter of commercial logic, Postcomm expects that any operator, including Consignia, will be motivated by profit. However, the question Postcomm has to assess is whether new entry into the market would be such that it would put Consignia’s business at risk, bearing in mind the obligation it has to provide the universal service. Several factors lead Postcomm to conclude that Consignia has sufficient protection against this risk. These factors include the following.

- Consignia’s dominance. Consignia’s established incumbent position in the letters market gives it opportunities for economies of scale that no competitor can reasonably expect to match for the foreseeable future. Because of this, entrants are likely to compete as much in service and value added features as price. Apart from dominance, Consignia enjoys other benefits from being the established universal service provider such as an exemption from VAT (see Chapter 6) which helps its competitive position in the bulk mail market, in particular for those customers, such as financial institutions and charities, that cannot reclaim VAT. Postcomm also notes the experience of many countries that have liberalised their postal markets further than the UK, where the incumbent has retained very high market shares, for example 95% in Sweden and New Zealand.
- “Cost” of the universal service. The universal service does not by itself compel Consignia to provide many services at a significant loss. The number of routes where Consignia is required to price at a level that does not recover long-run avoidable costs is very small. Postcomm’s assessment of the net cost of Consignia’s universal service in June 2001 (in terms of all the instances where the uniform tariff resulted in it pricing services below long-run avoidable costs) concluded that these “losses” were not significant in the present market

environment. No individual product category (e.g. First Class) or generic delivery density (e.g. rural or urban), was found to be “loss-making” in aggregate. Where losses for specific types of mail flows could be identified they were mainly related to items that could not be machine processed (and hence incurred additional handling costs). Postcomm’s conclusion reinforced a similar conclusion from consultants commissioned by the European Commission who carried out a comparable assessment across Europe. Although Postcomm will review this issue over time, it believes that Consignia’s present provision of the universal service gives it a commercial strength and Consignia has scope to turn this into a commercial opportunity. In this regard, Postcomm notes a recent study by Postwatch suggesting the universal service is a significant net benefit¹⁰.

- Likely development of access arrangements. Although the access pricing regime has not yet been established, it can be expected to act to some extent as a safeguard to prevent competitive entry from putting the universal service at risk. Postcomm accepts that consolidation, combined with the possibility for end-to-end delivery, may lead some operators to provide delivery services to those routes where it is profitable to do so but to avoid less profitable routes by injecting those volumes into Consignia’s network. Postcomm considers the risk of this destabilising the regime to be limited. Firstly, the number of routes where Consignia makes a loss (revenue minus long-run avoidable cost) is relatively low. Secondly, some operators seeking access will wish to use Consignia for routes where Consignia does make a healthy profit because it would not be viable for them to establish an alternative network prior to full market opening.
- Effects of competition. Andersen’s analysis for Postcomm concluded that the financial position of Consignia is more sensitive to changes in its efficiency than to the potential loss of business volume through competition. In other words, Consignia can do more harm to its financial viability and thus the provision of its universal service by not controlling its costs and failing to become efficient, than competition can do by taking away business. Furthermore, Postcomm believes the greatest spur to achievement of these efficiencies is through a competitive market. After considering Consignia’s criticisms of Andersen’s work (see Annex III) Postcomm is satisfied that this fundamental conclusion is unchanged.

¹⁰ This report is available from Postwatch’s website: www.postwatch.co.uk

- Benefits of competition. Postcomm is concerned that much of the discussion relating to “cream-skimming” treats competition as a zero sum game. However, competition, compared to monopoly, should lead to faster growth and innovation, making postal services more affordable and competitive with other forms of communication and distribution. The postal services market in the UK continues to grow and a competitive market is likely to provide a spur to this continued growth.

(b) Bulk mail market opening

(i) Responses

- 4.13 Consignia said that Postcomm's proposals, which were designed to open 30% of the market by revenue in Phase I, would actually open around 40% primarily because Postcomm's definition of bulk mail could apply to certain non-workshare mail streams, such as Printed Postage Impressions. Consignia suggested market opening could be even greater than this if for example customers using Metered mail aggregated their mail volumes to meet the bulk threshold.

(ii) Assessment

- 4.14 Postcomm's January 2002 assessment of a bulk mail threshold of 4000 items was based on information on Consignia's workshare products. After reviewing further information supplied by Consignia, Postcomm recognises that a bulk mailing definition based solely on a volume threshold of 4000 items (or an average of 4000 per mailing if under a multiple mailing contract) may expose more of the market to competition than Postcomm had intended. Certain of Consignia's workshare products, such as Mailsort and Walksort, have minimum mailings of 4000 items and would be exposed to competition. They account for around 30% of the market by revenue. Additionally, some services that Consignia currently provides at full tariff (e.g. PPI and metered mail) could attract volumes of over 4000 per mailing and be exposed to the contestable market, particularly if customers change their behaviour and delay mail in order to build up volume. A sufficiently reliable quantification of the risk of “leakage” of non-workshare volumes cannot be made using the limited Consignia mailing information. However, on the basis of some assumptions and a selected sampling exercise, Consignia has subsequently said that a threshold of 4000 items could open about 50% of the market by revenue to competition.

- 4.15 Postcomm has identified two ways of limiting the potential for such leakage: raising the volume threshold and restricting the bulk mail definition. Postcomm has decided against increasing the volume threshold on the basis that no robust data are available to suggest the degree of market opening for volume thresholds in excess of 4000 items per mailing. Postcomm would therefore run the risk of setting a threshold that was too low and opened too much of the market in Phase I to competition or a threshold that was too high and foreclosed the development of the competitive market. Postcomm has decided to restrict the definition of bulk mail to provide greater assurance that the Phase I market opening would be around 30% by revenue as planned. In order to do this, Postcomm has decided that bulk mailings over 4000 items (or an average of 4000 per mailing if under a multiple mailing contract) should be restricted to those from single customers from single premises and posted in the same format (e.g. in C4 envelopes).
- 4.16 At Phase II Postcomm will adjust the restrictions on large mailings (either in relation to the number of items and/or other regulatory restrictions such as the requirement for items to be of an identical format) aiming to expose to competition a cumulative total of around 60% by revenue of the inland letter market (see table 4.1). In considering the scale of such adjustments Postcomm will assess relevant information at that time. Such information may include new products and services, growth within the market and the extent and nature of competition that has developed in Phase I as well as from the European Directive weight step reduction to 100g.

Table 4.1: Bulk Mail – Intended market opening

Phases of market opening	Revenues exposed to competition as a percentage of the inland letter market
Phase I: 1 January 2003	30
Phase II: 1 April 2005	60
Phase III: 1 April 2007	100

Note 1: Inland letter market (excluding Presstream and Door-to-Door but including items above 350g). Presstream accounts for 3% of the total inland letter market by volume and 4% by revenue. Door-to-door accounts for 11% of the total inland letter market by volume and 2% by revenue.

Note 2: Revenue figures assume rolling forward of interim price control.

Note 3: Phase I figures include all volumes greater than 350g for associated bulk mail.

(c) *Consignia's financial position*

(i) Responses

- 4.17 Although Consignia welcomes competition it argues that Postcomm's proposed strategy will not allow it enough time to adapt itself, improve performance or achieve its recovery or "renewal" plan. Consignia said that Postcomm's competition decisions must be seen in the context of its present financial situation where it is losing £1.5m per day and the business is in financial crisis where a turnaround is imperative. It has said that it needs finance to pay for restructuring costs in order to enable it to compete. Consignia claims that the effect of the reduction in the weight threshold as a result of the European Directive will be a loss of annual profit after four years of about £500m and Postcomm's proposals will add a further £250m to this figure.
- 4.18 The CWU does not believe that market opening would be appropriate given the present financial difficulties Consignia is facing. Another respondent, Protecting Postal Services (PPS), expressed concern that competition combined with Consignia's present problems would see it start to limit the quality of some of its social obligations such as articles for the blind.
- 4.19 Postwatch said that on no account should competition be delayed or the proposals altered to protect Consignia's present financial position. Postwatch said that all Consignia's present problems have nothing to do with competition and are the result of Consignia's poor management and performance. Raising prices or delaying competition would result in Consignia being "let off" for inefficiency and pass the burden on to customers, whereas it should fall on Consignia's management and its shareholder. Postwatch also pointed out that many of Consignia's present problems had little to do with the regulated mails business and it would be wrong to ask mails customers, who require protection from monopoly inefficiency, to pay for losses incurred by other parts of Consignia such as Parcelforce, Post Office Ltd and the overseas ventures.
- 4.20 Several large customer associations such as the MUA and PPA said customers require protection against Consignia putting prices up. The PPA said its analysis showed in some areas, Consignia's costs are up to 30% higher than comparable costs of other regulated utilities.¹¹

¹¹ This is available from Poscomm's website.

(ii) Assessment

- 4.21 Consignia's immediate financial position has little to do with direct competition in the mails market as there is none of any significance yet. Delaying or changing the competition framework is unlikely to help because it will reduce the pressure on Consignia to address its problems. Moreover, the capacity of competitors to carry significant volumes of mail will take time to build up. The effects of competition and Consignia's ability to respond to it therefore need to be seen in a longer-term perspective over which competition can act as a spur to greater efficiency and innovation.
- 4.22 The most appropriate place for Postcomm to consider Consignia's short-term financing needs is in its ongoing work on reviewing Consignia's price control. Postcomm is in the process of developing a revised price control to come into force from 1 April 2003. Postcomm recognises that Consignia will incur transitional costs as part of its process of restructuring its mails business. Postcomm will consider whether, and if so to what extent, these costs should feature in the revenue allowances that are used to revise the levels of the tariffs.
- 4.23 Postcomm agrees with Postwatch that losses and costs associated with non-regulated businesses should not be borne by customers of the regulated business. In this context, Postcomm notes that the majority of the losses in Consignia's last financial year 2000/01 related to non-regulated business of Parcelforce, the post office network business and the overseas activities.
- 4.24 Postcomm is surprised by Consignia's assertion that the effects under the European Directive of the reduction in the weight threshold to 100 grams will result in a loss of profit of £500m while Postcomm's proposals will add a further £250m. This seems at odds with Consignia's wish for Postcomm to follow the European approach to competition in preference to Postcomm's strategy. This counter-intuitive result is caused by modelling which assumes Consignia will lose a significant share in those parts of the market that are liberalised under the European proposals. Given the higher margins earned on heavier mail, this has a disproportionate impact on the potential loss of profit under competition than where competition is across all weights of mail (including lighter weight items). Andersen can replicate a similar pattern for these results for Postcomm using the same assumptions on its model. However, Postcomm's judgement is that this profit impact from the European proposals is unlikely to materialise in practice because, as discussed above, it doubts that

competition by weight and price will lead to significant market entry. In addition, market growth, cost savings and efficiencies can offset these potential losses. Nevertheless, Postcomm's modelling (described in Annex III) is robust against a tolerance that includes the Consignia assumption for loss of profit under the European proposal.

(d) Access and consolidation

(i) Responses

4.25 Consignia, CWU and the CMA said that Postcomm's proposals to review in 2004 the restriction preventing consolidators injecting mail into non-Consignia networks meant that the market could be effectively liberalised from that date.

4.26 Many respondents, including Consignia, other operators and Postwatch urged Postcomm to set out the arrangements (including pricing) for third party access. Postwatch and some operators (including AICES) said that access would be the main vehicle for competition and therefore Postcomm's competition framework was not complete until it gave the market clarity in this area. However, one operator, TPG, said that access was not necessary for competition to be effective. It said that Postcomm should instead actively encourage the development of rival networks. TPG said that an overly aggressive access regime in terms of low prices would put Consignia at a competitive disadvantage compared with its European counterparts. Encouraging use of Consignia's services could stifle innovation, since competitors would be discouraged from setting up their own delivery networks, which would not incentivise Consignia to develop a vibrant and innovative range of competing services, to the detriment of it and the industry as a whole.

(ii) Assessment

4.27 Postcomm recognises that Consignia and the market need a period of certainty within which to plan, invest and prepare for full competition. Postcomm accepts that this task could be frustrated by uncertainty about when and how full competition will arrive. This will affect new entrants as well as Consignia. Given that the market will be fully open only two years after the proposed review, Postcomm has decided to withdraw this element of its proposals. The restriction will therefore remain until full market opening on 1 April 2007.

4.28 Postcomm appreciates that market participants would like as much certainty as possible about the access framework and how it will operate in the future. The provisions of Consignia's licence enable operators individually to negotiate access already. Only if the parties fail to agree is the matter referred to Postcomm for determination. There is also provision in Consignia's licence to move away from bilateral negotiated access and towards an Access Code, which Postcomm expects Consignia and the industry to develop in due course. However, third-party access raises some very complex and important issues about pricing and Consignia's operations and it would pose serious risks for the future competitive development of the industry if Postcomm made hasty decisions without undertaking thorough analysis and consultation. In response to Consignia's concerns about pricing, Postcomm confirms that its aim is to establish arrangements that create incentives for Consignia to develop a vibrant and profitable downstream business, which will be in the long-term interests of the market as a whole. This is in line with Postcomm's vision of achieving "a range of reliable, innovative and efficient postal services, including a universal postal service, valued by customers, and delivered through a competitive postal market."

(e) Licensing issues

(i) Responses

4.29 Although Postcomm's intention to introduce a 'light touch' regulatory regime was welcomed by operators, many still wish to see licensing continued after the end-date to ensure the integrity of the mail.

4.30 Hays DX welcomed the proposal that licences under the new regime would be for a minimum of 7 years in the first instance, with substantial notice periods thereafter, though they question the justification for the substantial differential between the proposal for 7 years for Consignia's competitors when Consignia itself has a 15 year licence.

(ii) Assessment

4.31 Postcomm accepts that there is an argument for keeping a licensing system to protect the integrity of the mail and provide a minimal level of supervision of postal operators so as to enable a compensation fund to be established if one were ever needed. However, Postcomm believes it is too early, and unnecessary, to take final decisions

on these matters at this early stage of competition. It will therefore keep this issue under review and would expect to consider nearer the time of the full opening of the market in April 2007 what licensing rules should operate thereafter.

- 4.32 Consignia was granted a longer term licence than other operators, on the grounds of its licence including the obligation for it to provide the universal service in the UK. Postcomm judges that the 7 year minimum for licences for non-universal service operators achieves a reasonable balance. Postcomm does not intend to make any changes at this point.

Conclusions

- 4.33 This chapter, after reviewing responses to Postcomm's proposals on the orderly transition to full market opening, has explained that the following modifications should be made to Postcomm's proposals (in addition to the changes to the proposal to bring forward the end-date that were dealt with in the previous chapter).
- Bulk mail threshold. Postcomm has decided to restrict the definition of bulk mail in Phase I to those mailings in excess of 4000 items (or an average of 4000 if under a multiple mailing contract) from single users of single sites and posted in the same format (C4, C5, etc).
 - Restrictions on consolidation. Postcomm withdraws the proposal to review in 2004 the restriction that prevents consolidators accessing non-Consignia networks. The restriction will therefore continue until the start of Phase III (April 2007).

5. Commitment to Safeguards for the Universal Service

Chapter outline

- 5.1 This chapter sets out Postcomm's original proposals with regard to safeguards for the USO and the responses it received. This chapter then sets out Postcomm's assessment of these responses and its conclusions.

Postcomm's original proposals

- 5.2 Postcomm's original proposals are summarised in table 5.1 below.

Table 5.1: Commitment to safeguards for the USO – Postcomm's original proposals

<i>Proposal Number</i>	<i>Original Proposal</i>
9	<i>Postcomm expects the foremost safeguard for the universal service in the short to medium term to be Consignia becoming more efficient and innovative (in the context of a phased introduction of full market opening). If it proves necessary, Postcomm believes that an appropriate additional policy safeguard would be to allow Consignia more commercial freedom in the terms on which it provides the universal service. Examples might include alterations to service specification, the overall level of prices, pricing structure or the permissible competitive pricing response.</i>
10	<i>Postcomm does not propose to recommend to the Secretary of State at this stage that Postcomm should be given powers to set up a compensation fund, but it will keep the issue under review.</i>

Assessment of Responses

- 5.3 Postcomm received no response that provided evidence to suggest that the foremost safeguard for the universal service, notably encouraging Consignia to become more efficient and innovative, was inappropriate. Many respondents raised concerns about

some of the other safeguards that Postcomm could seek to employ which have been discussed elsewhere in this document. For example, safeguards which Postcomm could use include:

- relaxing price controls. Allowing Consignia to charge more for its services can, in some circumstances, improve its financial position. A discussion of respondents' views and Postcomm's decision is set out in Chapter 3;
- licence modifications. Postcomm has the power to set terms of licences that it grants and to seek to make subsequent modifications;
- transition. Consignia's capacity to adapt successfully to a fully competitive market is enhanced if it has time to adjust for its introduction. Chapter 4 discusses how Postcomm is approaching the transition process; and
- bulk mail threshold / definition. By revising the threshold and definition for bulk mail in Phase II, Postcomm is giving itself the opportunity to take into account developments in Phase I.

5.4 This chapter considers four further issues that have been raised in the context of Postcomm's proposals for safeguards to the universal service:

- the product range that is taken to constitute Consignia's universal service;
- the possibility of the market contracting dramatically;
- the concept and practicalities of a Universal Service Support Fund; and
- the impact on different types of users.

5.5 Some respondents noted that Consignia's incumbency advantages and other benefits from universal service provision (such as VAT exemption) are significant, limiting the scope for effective competitive entry (Chapter 6 discusses these issues).

(a) *The product range that should be classed as universal services*

(i) Responses

5.6 In commenting on Postcomm's proposal to review which of Consignia's over 100 products should be viewed as part of the universal service, many respondents, including Consignia, other operators, Postwatch and customer associations said that

Postcomm should have carried out this review earlier and have decided which of the products comprise the universal service.

(ii) Assessment

- 5.7 The minimum requirement of a universal service is set out in the Act and in Consignia's licence which has been granted within the framework established by the Act. This requires, for posted items weighing up to 20kg a daily collection from all access points and daily delivery to all addresses within the UK at an affordable and geographically uniform tariff. The Act follows the requirements of the European Postal Services Directive (with an additional requirement for geographically uniform price). Postcomm's first act as a regulator was to ensure that Consignia's licence included an obligation to provide a universal service described in this way. Postcomm accepts, however, that Consignia offers a much greater number and range of products than is required to meet its universal service obligation.
- 5.8 Recognising this, Postcomm proposes to review the scope of the universal service in Summer 2002. This review will consider the ranges of products currently provided by Consignia, and consider which products should be viewed as fulfilling the universal service obligation. For instance, it is open to question whether some of the business mail products should be considered as being within the scope of the universal service. The review will not call into question the basic requirements which are established by law such as the geographical coverage of the universal service and the requirement for daily delivery and collection.
- 5.9 The fact that the market opening strategy has been decided before the precise scope of the products which make up the universal service have been settled is consistent with Postcomm's duties. Postcomm has assumed in its analysis that Consignia would continue to provide the services it currently deems to be universal, which includes virtually all its inland letters services (i.e. almost the broadest possible interpretation). The analysis also assumes that these will be priced in a geographically uniform way. Given this starting position, which encapsulates within the universal service almost all inland letter services, Postcomm considers, and has received no suggestions to the contrary, that the issue arising from the consultation is likely to be a narrowing of the range of services that are classed as universal rather than an expansion of that range. The review, therefore, is likely to lead to a reduction in the notional "cost" of providing the universal service. Given this, Postcomm sees no reason to delay its

decision on its market opening strategy pending the review of the scope of universal service products which will be published for consultation later this year.

- 5.10 Postcomm notes also that, as is recognised by the European Directive, the universal postal service should not be seen as something which is fixed for all time but is dynamic in nature. The practical interpretation of the universal service is likely to evolve over time in response to changes in the market, in technology and in customers' demands. Competition, by encouraging efficiency and innovation, is an integral part of this change process.

(b) *Potential for market collapse from declining mail volumes*

(i) Responses

- 5.11 Consignia said that Postcomm was not paying sufficient attention to the risk of falling volumes in its business. It said that it was possible, if not probable, that volumes would start to decline. The CWU also said that Postcomm had failed to appreciate the difference a declining market might have on its proposals.

(ii) Assessment

- 5.12 Postcomm does not consider that a "market collapse" in the foreseeable future is likely. Although there has been a recent decline in rates of growth, it is a fact that mail volumes have risen – and are still rising – in the UK. A 'collapse' of the market with a rapid decline in mail volumes has not been experienced in any market elsewhere in the world. On the contrary, mail volume per household is almost twice as much in the US as it is in the UK, suggesting untapped growth potential. Indeed, many large customers have told Postcomm that they would use mail more as a route to market if Consignia were more responsive to their needs.
- 5.13 Postcomm believes that competition, which spurs efficiency and innovation to enable post to compete more effectively with alternative media, is likely to be the best protection against the risk of market collapse and potentially a stimulant of market growth. Postcomm also notes that material competitive entry would in any case be unlikely in a market with significantly declining volumes. The ossification in services that the absence of competitive pressure would encourage would, on the other hand, greatly increase the risk of postal services declining as a means of communication.

5.14 In its analysis of the impact of competition on Consignia, Andersen has considered the impact of alternative market growth rates and maintains its key findings. Postcomm will monitor developments in the postal services market and will be alert to any signs of major declines in business volumes. To the extent that any such development might have an impact on the provision of the universal service, Postcomm will be ready to take appropriate action.

(c) Universal Service Support Fund

(i) Responses

5.15 Consignia and the CMA noted that in setting up a compensation fund for safeguarding the universal service, Postcomm would need to consider potential practical difficulties in allocating responsibility for contributions to it between operators.

5.16 TPG said that a compensation fund – subject to appropriate safeguards and conditions – is preferable in principle to the alternative of restricting competition. However, TPG, UPS and Hays DX pointed out that the imposition of such a fund would have a fundamental impact on the business case of any new market entrant, and if such a fund were introduced after entry had occurred, the business case on which entry was based could be undermined. For this reason, some operators said that Postcomm should commit to ruling out a compensation fund for a number of years. AICES pointed out that a compensation fund could give Consignia perverse incentives to downplay its ability to provide the universal service.

5.17 Both the DMA and the Mail Users Association (MUA) believe that any net cost/benefit of providing the universal service should be agreed before there is any debate about the need for a compensation fund.

(ii) Assessment

5.18 After considering the responses to the proposals on this issue, Postcomm does not intend to make any changes to its proposals. Whilst Postcomm cannot rule out a recommendation to the Secretary of State for Trade and Industry to establish a compensation fund, Postcomm has no plans to make one and its expectation is that a fund may be necessary is very low. Given the risk of market distortions that such support mechanisms inevitably introduce, Postcomm would wish to exhaust all other potential safeguards before considering that as a possibility. Postcomm further notes

that the Postal Services Act 2000 makes no provision for a compensation fund and legislation would be required to establish one. A decision to establish a compensation fund therefore is one that rests ultimately with Government and the Department of Trade and Industry has confirmed that, Postcomm should not assume that powers to impose a levy could be made available.

(d) Impact on different types of users

(i) Response

5.19 Many individual respondents but also some organisations expressed concern about the changes that Consignia might make to its services to respond to the development of competition. Some respondents said that while some customers, particularly large mailers and those who purchased postal services under contracts, would see many benefits, other users of postal services, such as recipients in rural areas or residential customers would suffer a deteriorating service as Consignia sought to “rebalance” its services.

(ii) Assessment

5.20 Postcomm recognises these concerns. It expects Consignia to respond to competition by becoming more customer and commercially orientated, which will inevitably lead to some changes within its present range of services. At the same time, several key aspects of Consignia’s present services are protected because they are enshrined in the Act, for example a universal service of one collection and one delivery each day at an affordable geographically uniform tariff. In addition to statutory protection through the Act, Postcomm also regulates other aspects of Consignia’s services through its licence, such as service standard performance and pricing. Postcomm, with Postwatch, would expect to undertake consultations in respect of any major service change that Consignia proposes. In assessing any such changes, Postcomm will need to be satisfied that Consignia’s proposals further the interests of users as a whole and Postcomm will pay particular attention to its duty to have regard to vulnerable groups, such as those who are disabled or chronically sick, are of pensionable age, are on low incomes or residing in rural areas.

Conclusions

5.21 Postcomm recognises that its primary statutory duty is the maintenance of the universal postal service but it does not consider that the universal service is

threatened by the introduction of competition in the phased and measured way Postcomm proposes. If at some stage in the future, for whatever reason – changes in customer demand, technology impact or other market changes – the universal service were to become under threat, Postcomm, in accordance with its statutory duties, has available a range of safeguard mechanisms.

5.22 Accordingly, after reviewing responses to its proposals on safeguards for the universal service, Postcomm has decided to make no changes and to proceed as it proposed.

6. Commitment to Measures to Promote Effective Competition

Chapter Outline

6.1 This chapter summarises Postcomm's original proposal on measures to promote effective competition and the responses received on this issue. It also sets out Postcomm's assessment of those responses and its decisions.

Postcomm's original proposals

6.2 Table 6.1 below summarises Postcomm's original proposals on measures to promote effective competition.

Table 6.1: Measures to promote effective competition: Postcomm's original proposals

<i>Proposal number</i>	<i>Original Proposal</i>
12	<i>Postcomm proposes that Consignia's ability to respond on price to competition should be restricted in the initial stages of the development of competition to prevent the risk of market foreclosure through targeted and aggressive pricing responses. The restrictions are already set out in Consignia's licence. However, there will be a transition whereby these restrictions are removed as competition becomes established and self-sustaining.</i>

Assessment of responses

6.3 Postcomm received responses relating to:

- The appropriate regulation of Consignia's pricing flexibility; and
- The implications for competition of Consignia's VAT exemption.

(a) Pricing flexibility

(i) Responses

6.4 Most respondents agreed with Postcomm's general approach towards Consignia's pricing flexibility. Consignia said restrictions on its pricing flexibility should be relaxed as market segments are opened to competition. One operator said it was sufficient to leave Consignia's pricing to be regulated by general competition legislation, in particular the Competition Act 1998.

(ii) Assessment

6.5 On the basis of responses to its proposals, Postcomm has decided to make no changes to them. As part of Postcomm's ongoing market monitoring, it will keep under review whether changes ought to be made to remove certain products from price restrictions in Consignia's licence on the basis that competition is effective. This approach is similar to that adopted by other sector regulators where the market is opened to competition.

(b) VAT

(i) Responses

6.6 Many potential market entrants including Business Post, TPG, UPS and Hays DX, as well as industry bodies such as the DMA, strongly believe that if competition is to prove effective, the advantages from special privileges currently afforded to Consignia must be removed. Some argued that either Consignia's privileges should be removed or new entrants should be granted these privileges on the same basis to create a level playing field. The key area of concern relates to Consignia's VAT-exempt status under the EU VAT Directive¹², and the nominal 17.5% advantage Consignia has in competitive bidding, especially for the business of companies and organisations in the financial and charitable sectors which are also VAT exempt. Operators firmly believe that a level playing field for VAT will be needed in order for competition to succeed.

6.7 Consignia argued against adding VAT to its USO products and services, as this would result in the price of stamps rising.

¹² Council Directive 77/388/EEC of 17 May 1977 – Article 13 as applied by the Value Added Tax Act 1996.

(ii) Assessment

- 6.8 VAT is a policy responsibility of HM Treasury. Postcomm does not have any power to change Consignia's VAT status. Nonetheless, Postcomm is currently reviewing the impact of Consignia's VAT exemption on competition and will provide advice to Government in furtherance of its statutory duties. Postcomm notes that Consignia's VAT status derives from European Directives and is likely to take a considerable time to change. However, for as long as Consignia's VAT status is unchanged it provides Consignia with a price advantage over its competitors in major sectors of the market and is thus likely to act as a safeguard to Consignia's business and a potential obstacle for competitors.

Conclusions

- 6.9 After reviewing responses on measures to promote effective competition, Postcomm has decided to make no changes to its proposals.

7. Assessment of Postcomm's Decisions

Chapter outline

7.1 This chapter provides:

- an updated assessment of the key risks surrounding Postcomm's competition decision and sets out Postcomm's risk management strategy; and
- an updated assessment of Postcomm's competition decision against the objectives originally set for its market opening strategy.

Risk management

7.2 Postcomm's January 2002 proposals included an assessment of the key risks of its proposals and its strategy for mitigating or managing those risks. Postcomm's process of seeking comments on its proposed market opening strategy was part of its approach to ensuring that it had correctly identified the key risks and that it had in place an appropriate risk management strategy.

(i) Responses and other developments

7.3 Many of the comments on Postcomm's proposals expressed concern about what were viewed as the uncertainties and potential risks of the changes that might flow from Postcomm's proposals and, in particular, the potential threat to the continued provision of the universal postal service. This debate about risks was helpfully informed by a timely report by the National Audit Office entitled "Opening the Post: Postcomm and postal services - the risks and opportunities (HC 521)". That report was not a review of Postcomm's proposals (the proposals had not been published at the time of the NAO study) but was an examination by the NAO of Postcomm's role and the issues faced by Postcomm in introducing competition in the postal services market. The NAO report also set out a general assessment of the risks faced by Postcomm in discharging its statutory duties. Postcomm had been aware of the emerging results of the NAO work and, in developing its proposals and risk assessment, had been able to take account of the NAO's work including the NAO's risk analysis.

- 7.4 Following the NAO report, the Committee of Public Accounts of the House of Commons carried out an examination of the postal services market. On 13 February 2002, Postcomm gave evidence to the Committee about Postcomm's role, its market opening proposals and the NAO report. Consignia also appeared before the Committee. On 1 May 2002, the Committee published a report of its enquiry entitled "Postcomm: Opening the Post (HC 632)" which drew attention to the need for Postcomm to be cautious about the potential consequences of competition on the universal postal service and acknowledged the complexity of the task faced by Postcomm.
- 7.5 The Trade and Industry Select Committee of the House of Commons has also been conducting an examination of postal services. On 16 April 2002 Postcomm was among a number of bodies which gave evidence to the Committee. The Committee has not yet reported on its deliberations but concerns raised during the hearings centred on the impact of competition on the provision of the universal postal service, particularly in rural areas, and the effect of opening up the UK market whilst restrictions on competition remain in most other countries within the European Union. Concerns were also expressed about the impact of competition on Consignia, especially in the light of the company's current financial difficulties.
- 7.6 Since the publication of Postcomm's proposals, Consignia has appointed a new chairman, and has revealed the extent of its current poor performance - with losses for the business as a whole running at £1.5million a day and the company failing to meet its quality of service targets. In March 2002, Consignia announced the first steps of a major 3 year renewal plan which aims to restore profitability and improve services. As part of this plan Consignia will reduce its costs by more than £1.2 billion by the end of the 3 year period and so help to secure the company and the universal postal service in the UK. (The plan for £1.2 billion cost savings had been announced originally in October 2001 at which time it was envisaged the savings would be achieved over 18 months by March 2003).

(ii) Assessment

- 7.7 Postcomm recognises that Consignia is undertaking a major programme of change involving the significant restructuring of its business and operations to strip out inefficiencies and return the company to profitability. Postcomm also notes that many of Consignia's main areas of loss-making activity are to be found in its parcels and distribution business and its network of local post offices, which are not subject to

direct regulation by Postcomm. As far as Consignia's regulated mails business is concerned, revenues and volumes have grown consistently in recent years, but profit has fallen due to costs rising at a faster rate than revenues.

7.8 As described elsewhere in this document, Postcomm has made a number of adjustments to its original market opening proposals. Overall, these have had the effect of deferring the introduction of full competition by one year but still provide an orderly transition to a fully open postal services market. Nevertheless, in the light of the concerns that there has been expressed, Postcomm has updated its risk assessment.

7.9 Postcomm considers that the seven risks identified in January 2002 (and which are very similar to those identified in the NAO's risk analysis) remain the key risks which Postcomm needs to manage or influence. Whilst much of the January 2002 assessment remains valid, the adjustments to the market opening strategy do alter the assessment in a number of areas. Rather than set out in full a detailed (and repetitive) assessment of these key risks, Postcomm has produced a shorter updated assessment of each of the key risks, identifying the impact of the changes to Postcomm's original proposals and responding to the concerns about the nature and extent of the risks associated with Postcomm's market opening strategy.

7.10 The seven risks identified in January 2002 were:

- competition develops in such a way that the universal service is threatened;
- the move to a fully competitive market happens too quickly and Consignia does not have sufficient time to adapt;
- during the transition period operators and customers are unclear about what is or is not permitted, leading to potential market and regulatory uncertainty;
- the transition plan offers insufficiently attractive market opportunities for new entrants and effective competition does not emerge;
- the market opening strategy in the first phase opens up much more of the market than Postcomm intends;
- Consignia fails to become more efficient and responsive to customer requirements; and

- in responding to competition, Consignia competes in an unfair way and thereby discourages entry in the first place or puts competitors at an unfair disadvantage.

7.11 The NAO report noted that, in developing its market opening strategy, Postcomm was faced with the challenge of finding the approach which addresses the risks of:

- on the one hand, not doing enough to stimulate competition and thus not achieving the benefits that competition can bring (including in safeguarding the universal service); and
- on the other hand, stimulating too much competition (or the wrong kind of competitive entry) so threatening the universal postal service.

7.12 Postcomm included these two risks (the first and fourth risks listed in paragraph 7.10) in its January 2002 assessment.

7.13 As explained in the January 2002 proposals document, Postcomm has given careful consideration to manage these two alternate risks. Whilst this implies a cautious approach to the introduction of competition, Postcomm does not consider this to be an argument against the introduction of any kind of competition. The European Union is committed to a policy of progressive liberalisation of postal services, a policy which the UK supports as being in the interests of users of postal services. Moreover, Consignia itself recognises the benefits that competition generates and supports the move towards a competitive market. Rather the debate has been about the nature and timing of the introduction of competition in the UK.

7.14 As explained elsewhere in this document, Postcomm considers that for the UK market, its approach of opening up discrete market segments (rather than adjusting the weight / price threshold) will be a more effective way of introducing competition in an orderly, gradual and controlled way. Postcomm's decision to defer by one year the introduction of full market opening and the other adjustments to its original proposals recognises that the new information provided by Consignia about the extent of its current difficulties and the time it would need to take the necessary remedial action implied an increase in the potential risk to the universal postal service which needed to be redressed. Postcomm considers that, with these adjustments to its original proposals, its market opening strategy adequately addressed with the two key risks referred to above. Postcomm recognises the need to ensure that changes and

developments in the market place, particularly during the transition period, do not unduly alter these two key risks.

- 7.15 To this end, Postcomm will monitor developments in the postal services market and will be ready to take whatever regulatory action may be necessary if, for any reason, Postcomm were to judge that the universal postal service was being threatened. Whilst Postcomm does not consider that such a threat is likely to arise, Postcomm recognises that this position could change over time, whether as a result of e-commerce or other technological impacts, changes in market behaviour, changes in customer needs, or through the effect of new market entry. Postcomm has a range of regulatory mechanisms, summarised in chapter 5, which it could employ if they were needed to counter any such threat to the universal service, involving adjustments to the regulatory framework in relation to prices, service specifications, the pace of market opening, or the terms for new market entry. These are in addition to the steps which Consignia, as the universal service provider, might take in terms of improving efficiency or adjusting its operations.
- 7.16 Which of these safeguard mechanisms would be appropriate to counter any potential future threat to the universal postal service would depend on the nature of the threat and the circumstances prevailing at the time. Postcomm would then decide how to deal with the threat and which of the available policy mechanisms (or any combination of them) would be most appropriately used.
- 7.17 In relation to the risk of new operators not entering the market and competition not becoming established, whilst Postcomm does not expect that to happen, it recognises that a variety of factors could lead to that undesirable outcome. Postcomm's transition plan already involves the reassessment of the bulk mailing restriction for Phase II (April 2005) and Postcomm sees that as one of the mechanisms to identify and deal with any concerns about the ability or willingness of new operators to enter the market.
- 7.18 The other key risk identified by the NAO concerned the behaviour of Consignia and is reflected in the sixth risk on Postcomm's list in paragraph 7.10. As Postcomm noted in its January 2002 assessment, this is a risk which Postcomm can influence but cannot control, since Consignia's behaviour and performance are matters that lie in the hands of Consignia's Board, its management and shareholders. The adjustments to Postcomm's market opening strategy do, however, recognise that Consignia is now reviewing its business plan.

7.19 The four other risks identified by Postcomm mainly related to the transition period. The changes to Postcomm's market opening proposals have some impact on these as follows:

- The move to a fully competitive market happens too quickly and Consignia does not have sufficient time to adjust. The deferral of the full opening-up of the market means that Consignia, other operators and users now have more time to adapt to the changes but still within the context of a clear and certain transition plan.
- During the transition period Consignia, operators and customers are unclear about what is or is not permitted, leading to potential market and regulatory uncertainty. Postcomm has now removed some elements of the transition plan (the reviews of the end date and of the restriction on consolidators) to provide greater regulatory certainty and clarity.
- The market opening strategy in the first phase opens up much more of the market than Postcomm intends. Postcomm has changed the definition of 'large mailing' to seek to ensure that in relation to bulk mail the initial market opening extends only to the existing market for 'large mailings' and to limit as far as possible leakage from other market segments. Postcomm will adjust the definition of large mailing at Phase II to keep to the original intention to open up 60% of the market (by revenues) to competition.
- In responding to competition, Consignia competes in an unfair way and thereby discourages entry in the first place or puts competitors at an unfair advantage. The changes to the original market opening strategy do not affect this risk directly.

Assessment against Objectives

7.20 In developing its proposals, Postcomm devised a set of objectives for its market opening strategy (which respondents to earlier consultations endorsed). The January 2002 document included an assessment of those proposals against the agreed objectives. The changes to the January 2002 proposals have had only a minor impact on this assessment against objectives and do not alter Postcomm's judgement that, taken as a whole, its market opening strategy fully meets the objectives originally set. The impact of the changes now being made to the January 2002 proposals and of

other comments received are summarised below in relation to each of the original objectives of:

- ensuring the provision of a universal service;
- appropriately promoting effective competition in the interests of postal users;
- encouraging efficiency and economy;
- objectivity and transparency; and
- proportionality.

a) *Ensuring the provision of a universal service*

7.21 There were three aspects to concerns expressed in relation to the maintenance of the universal postal service:

- whether the introduction of competition would put the universal postal service at risk;
- the quality of service provided by the universal postal service in a competitive environment; and
- the possible impact on rural postal deliveries and services to remote communities.

7.22 The first aspect, about risks to the universal postal service, has already been considered in detail in the risk assessment set out above and elsewhere in this document. Postcomm sees competition as a safeguard to ensuring the provision of the universal postal service and does not consider that its market opening strategy is likely to undermine provision of the universal postal service. Moreover, Postcomm has identified a range of other safeguards for the universal postal service which it could utilise if, at any stage in the future, and for any reason, the universal postal service were put at risk. Postcomm sees competition as providing the necessary stimulus for Consignia to respond to a changing market environment and to become more efficient, more innovative and more responsive to the needs of customers. Postcomm also sees competition as driving Consignia to bring about these changes in a timely way in response to market development and helping to ensure that customers receive the best possible service and an affordable service.

7.23 Accordingly, Postcomm considers that the quality of Consignia's universal service should be enhanced by the introduction of competition. The minimum quality of service standards required by Consignia are already established in Consignia's licence. Competition will encourage Consignia to improve its quality standards in order to retain business.

7.24 With regard to rural deliveries and services to remote communities, Postcomm considers that Consignia's ability to deliver to every address to be a significant commercial advantage and not a burden to be avoided. Under the terms of its licence, Consignia must continue to provide a daily delivery service to every UK address (with very minor exceptions) and Postcomm sees no reason why this should change in future. Large businesses who are responsible for the majority of the mail posted in the UK wish to communicate with their customers wherever they live and Consignia will want to continue to provide for them a nationwide postal delivery service. This is one of its key marketing strengths. To the extent that new postal operators do not provide a delivery service to rural or remote areas, the provisions in Consignia's licence enabling other postal operators to access Consignia's network, will still enable rural communities to receive post on a daily basis, irrespective of which postal operator handled it originally. Postcomm has, however, recognised customers in rural areas may require special consideration and Postcomm has proposed to Postwatch that an initiative should be taken to put in place arrangements to provide for closer liaison with representatives of rural communities on a regular basis.

b) Appropriately promoting effective competition in the interests of postal users

7.25 Whilst Postcomm's final market opening strategy involves a delay to the introduction of full competition in postal services, Postcomm considers that this delay is not so great as to reduce significantly the attractiveness for entry into the market. Postcomm considers that the maintenance of the principal strategy of opening the large mailings and consolidation segments of the market and the maintenance of a clear and certain transition period leading to full market opening allows operators the opportunity to operate in clear market segments during the transition period, with the added certainty that they will be able to expand the scope of their operations both at the start of the second phase of the transition plan (1 April 2005) and at the end-date for full market opening (1 April 2007).

c) *Encouraging efficiency and economy*

7.26 Postcomm considers that a major benefit of competition is the stimulus that it gives all operators to ensure that their services are being provided in the most efficient way and that those services meet the needs of customers. Concern was expressed at the possibility of duplicate networks emerging with multiple pillar boxes and postal workers from different operators walking the same streets. Postcomm's expectation is that the access arrangements into Consignia's network mean that duplicate networks are unlikely to emerge to any significant extent in respect of standard postal services. If, however, operators find that developing their own network is an economic way of providing their services (particularly in relation to more specialist services), Postcomm does not consider that this is something which it should seek to prevent.

d) *Objectivity and transparency*

7.27 Postcomm has placed great emphasis on ensuring that both in formulating its proposals and in finalising its decision it has acted in an open way and made sure that the reasons for changes from its January 2002 proposals are explained. Postcomm has based its decisions on an extensive programme of research, analysis and consultation.

e) *Proportionality*

7.28 Postcomm considers that the extent and nature of the restrictions on competition implicit in its market opening strategy are no more than those needed to ensure the continued provision of the universal service. This is in the context of furthering the interest of users, avoiding the risk of market disruption and providing Consignia sufficient time to adjust to a fully competitive market. As explained above, Postcomm considers such proposals to be the necessary spur to enhancement of Consignia's efficiency to the benefit of the universal service. Whilst full market opening has been deferred by one year, Postcomm considers this to be justified by the need to give Consignia more time to adapt. Full market opening will still be achieved in the UK within the expected time scale of the European Directive.

Conclusion

7.29 As set out above, Postcomm considers that its final decision on its market opening strategy appropriately addresses the potential risks and that it has in place an appropriate risk management strategy. Postcomm also considers that its final

decision fully meets the objectives originally established for this policy and takes due account of the social and environmental guidance issued by the Secretary of State for Trade and Industry in March 2001.

Annex I: Policy Statement on Licensing

Introduction

A1.1 This statement sets down the main elements of the licensing policy which Postcomm adopted in May 2002 to give effect to its market opening policy. It replaces Postcomm's interim licensing policy statement issued on 30 April 2001.¹³

A1.2 Postcomm will implement its market opening policy mainly through licensing. Licensing provides Postcomm with a significant degree of control over market opening through the ability to include conditions in licences. Licensing is also one of the available safeguards for the universal service. Postcomm, however, will keep open the possibility of recommending to the Secretary of State that particular activities should be exempted from the need for a licence, where it considers that it is appropriate to do so.

Licences

A1.3 In accordance with its policy of an orderly approach to market opening, Postcomm will grant licences for 3 types of postal business:

- large ("bulk") mailings;
- consolidation; and
- "defined activities".

A1.4 Postcomm has not become aware of any operator intending to offer an alternative universal postal service during the transition period (to 1 April 2007) and does not currently expect to receive an application for a universal postal service licence during that time. If, however, a prospective operator wished to make such an application, Postcomm, in furtherance of its statutory duties, would consider any such application on its merits.

¹³ Postcomm will issue a consultation document in June 2002 on implementation issues concerning the new licensing policy.

Large mailings

A1.5 Postcomm will grant licences for operators wishing to provide large mailing (bulk mail) services, where large mailing is defined as a mailing of a minimum of 4,000 items in the same format from a single postal user from a single site. Mail that falls into the large mail category may be delivered direct by the licence holder or passed to Consignia for final delivery. The definition of large mailing will be adjusted on 1 April 2005 so as to open up a total of 60% of the market (by revenue). This change will be achieved by modification to the licence condition for all large mailing operators.

Consolidation

A1.6 Postcomm will grant licences for operators wishing to provide mail services allowing the consolidation of mail from a number of users which must then be passed to Consignia (as the UK's sole universal service provider) for final delivery. This will allow operators to undertake upstream activities such as collection, sortation and trunking, but not final delivery. Consolidated mail may not be passed to other licensed operators for delivery.

“Defined Activities”

A1.7 Postcomm recognises that licences for large mailing and consolidation may not meet all the aspirations of potential entrants. In order to retain some flexibility to license other activities Postcomm will be prepared to consider opening up the market to other types of postal service (“defined activities”). In considering extending the market opening in this way, Postcomm will need to satisfy itself that introducing competition into the “defined activity” will not undermine the continued provision of the universal service and in this regard may look to applicants to provide supporting information where necessary. Postcomm envisages that the kinds of postal business which might become a “defined activity” will include relatively small-scale services which have features which differentiate them from standard mail services. Anyone wishing to propose a “defined activity” should contact Postcomm.

Provision of more than one service

A1.8 Operators may apply for a licence to cover one or more types of postal business (large mailing, consolidation or a defined activity). Where an operator intends to apply for a licence covering more than one type of business it will need to demonstrate how it intends to ensure that licence restrictions will be complied with

(e.g. how it will ensure that consolidated mail is kept separate from large mailings and properly handed over to Consignia). Where an existing long-term licensee wishes to apply for authorisation to provide an additional service, where granted, this will be achieved by modification to the existing licence. This will mean that each operator will have only one licence covering all its licensed postal activities. Postcomm's approach to granting the licences is that provided applicants can meet certain minimum requirements relating to integrity of mail, the propriety of applicants and business financing, and the applicant's proposed business falls within one or more of the three types of postal business, Postcomm will issue a licence.

- A1.9 Licences may not be transferred between companies. Where a new legal entity wishes to take over the operation of an existing licensee, a new licence must be applied for. It will be possible to take over a company that has a licence without making a new licence application, but the change of control would have to be notified to Postcomm.

End-date for full market opening

- A1.10 Service restrictions in all licences which have them, will be framed to lapse on 1 April 2007.

European Liberalisation

- A1.11 Under a recent amendment to the European Postal Services Directive, the maximum reserved services limit will be reduced to 100g on 1 January 2003, and 50g on 1 January 2006. DTI is currently considering how to implement this and other Directive changes. However, as most inland letters weigh under 100 grams and operators will generally want to serve that market, Postcomm considers that the majority of operators will continue to need licences to provide services in the UK letter market.

Duration of Licences

- A1.12 Postcomm will issue large mail, consolidation and defined activity licences for an indefinite period (subject to a notice period of 3 years which can only be included on or after the fourth year). This licence period is designed to provide new entrants with the certainty of an initial 7 year term and of significant certainty thereafter.

Information Requirement

A1.13 All licence holders and applicants will be required to provide certain basic information to Postcomm. At the time of applying for a licence, applicants will need to provide information to assess the application, including information about the applicant and its business plan, projected mail volumes, products and prices. In order to enable Postcomm to monitor market developments, information will be required to be provided on a regular basis such as mail volume, prices and revenue. It will be received subject to the confidentiality requirements of the Act.

Licence fees

A1.14 Each licensee will need to pay, on application, a fee of £1,000. Such fees are to be used solely to meet the cost of the regulatory regime. Where a licence holders' annual turnover in postal services exceeds a threshold of £10m, annual licence fees will be calculated by reference to their turnover in relation to other licence holders, including Consignia. Where the turnover threshold is not exceeded, a minimum annual licence fee of £1,000 will be payable.

Annex II: Timetable of Future Events

Introduction

A2.1 Postcomm's competition policy, which is concluded with the publication of this document, is one feature of a wider regulatory framework. Other major pieces of work that Postcomm are undertaking that will have an influence on the market are its review of the pricing and service standards conditions in Consignia's licence, the development of appropriate third party access arrangements and the review of the scope of products that form part of the universal postal service.

Timetable

A2.2 Against the background of the key milestones of the competition framework, Table A2.1 below details how Postcomm expects to take these work programmes forward. The timetable for these projects is indicative and may be subject to change.

Table A2.1: Timetable

Date	Event
June 2002	Publication of a consultation document on the new licences and other issues concerning the implementation of the market opening strategy.
Quarter 3, 2002	Publication of a consultation document on Postcomm's Memorandum of Understanding with the OFT regarding the processes for dealing with complaints about anti-competitive behaviour.
	Publication of a consultation document on which of Consignia's products should be classed as part of the universal postal service obligation.
	Publication of initial proposals for consultation on Consignia's new regime of prices and service standards.

Date	Event
Quarter 4, 2002	Publication of Postcomm's decisions on the new standard licence and other implementation issues.
	Publication of Postcomm's decisions on Consignia's products that form part of the universal postal service.
	Publication of Postcomm's final proposals for the review of Consignia's pricing and service standards.
Quarter 1, 2003	Phase One of the transition to full market opening begins and the weight step changes apply. (1 January 2003)
Quarter 2, 2003	New pricing and service standard licence conditions for Consignia come into effect. (1 April 2003)
Quarter 2, 2004	Expected review of the costs and benefits of the universal service.
Quarter 3, 2004	Publication of Postcomm's proposals to adjust the large mailings restrictions from 1 April 2005.
Quarter 1, 2005	Publication of Postcomm's decisions on the large mailing restrictions from 1 April 2005.
Quarter 2, 2005	Phase Two of the transition to full market opening begins. (1 April 2005)
Quarter 1, 2006	Changes to the European Directive implemented, i.e. reduction of the "reserved services" area to 50g (1 January 2006).
Quarter 2, 2007	Phase Three: Restrictions on market entry abolished. (1 April 2007)

Annex III: Financial Impact on Consignia of Competition

Introduction

A3.1 This annex considers comments received in relation to the detailed assumptions of Postcomm's technical analysis in considering the financial impact of the proposals on Consignia. This annex also sets out Postcomm's response to these comments.

A3.2 In making its market opening proposals, Postcomm commissioned consultants, Andersen, to assess the potential impact of competition on Consignia's financial position. Postcomm also commissioned advice on prospective efficiency gains by Consignia and on market demand projections from Frontier Economics¹⁴.

A3.3 Postcomm has asked Frontier Economics and Andersen to review their original analysis in the context of Consignia's response to their work or other new information which has become available since the analysis was completed. Both Andersen and Frontier Economics have concluded their key findings still hold. Their original analyses and follow-on reviews are available from Postcomm's website.

A3.4 This Appendix sets out:

- A summary of Consignia's response;
- A summary of the consultants' assessment of Consignia's response;
- Andersen's revised results; and
- The implications Postcomm draws from the revised analysis.

Summary of Consignia's response

A3.5 In preparing its response, Consignia replicated parts of Andersen's financial model, retaining a significant portion of the original data and assumptions.

A3.6 Consignia's main criticism is that within the Andersen modelling framework it is possible to adopt alternative assumptions that are equally (or in their view, more)

¹⁴ As a separate exercise, in relation to Consignia's price control, Postcomm commissioned a detailed study of Consignia's operating costs from WS Atkins. WS Atkins has not yet submitted a final report on its work. Whilst, if it were available, this final report would have been helpful for consideration, Postcomm has, as noted in this Decision document, had available to it other detailed information. Postcomm has monitored interim outputs from the WS Atkins review for any indication of information suggesting that it should not proceed with its competition proposals. No such indication has emerged.

plausible to those adopted in the initial analysis but which, when applied, yield modelling results that show that the risks to financial viability and for higher prices are larger than Postcomm claim.

A3.7 Consignia proposed two alternatives to Andersen's Base Case, Alternative Base Case 1 ('ABC 1') and Alternative Base Case 2 ('ABC 2'). With regard to volume growth, Consignia has indicated that ABC 1 is a 'central case' up to 2007, while ABC 2 is a 'downside'. However, Consignia views the assumptions in ABC 1 and ABC 2 relating to the period beyond 2007 as alternative scenarios with neither being 'central'.

A3.8 Consignia has suggested the assumptions should be revised in three key areas:

(a) Discount rate and threshold value

- *Discount rate/cost of capital.* Whereas Andersen used a discount rate of 8.7% nominal post-tax in the Base Case, Consignia argued the rate should be increased to 16% in ABC 1 and ABC 2.
- *Threshold value.* Consignia suggested that the resultant NPV should be compared to a higher 'threshold value' but did not provide a quantified alternative.

(b) Pre-liberalisation modelling

- *Market growth in inland letters.* Whereas Andersen assumed market growth of inland letters of 2.7% p.a. in the Base Case to FY10-11, Consignia proposed a profile consistent with 2% p.a. on average in the period to FY10-11 in ABC 1 and a corresponding 1.1% p.a. in ABC 2.
- *Efficiencies.* Whereas Andersen modelled one-off efficiencies in FY02-03 of 15% (before redundancy costs) followed by net annual efficiencies of 2.5% in the Base Case, Consignia suggested 10% one-off efficiencies in ABC 1 (but otherwise the same) and 5% efficiencies achieved in each of the three years from FY02-03 in ABC2 (but otherwise the same).
- *Wage inflation.* Whereas Andersen assumed wage inflation of RPI + Productivity Bonus Scheme ('PBS') (yielding 3.5% p.a. in aggregate for inland letters staff costs) in the Base Case, the effective wage inflation modelled by Consignia amounted to RPI + 1% + Productivity Bonus

Scheme ('PBS') (yielding 4.5% p.a. in aggregate for inland letters staff costs).

- *Terminal dues.* Whereas Andersen applied efficiencies to terminal dues costs, Consignia stated this was inappropriate.
- *Terminal value growth.* Whereas Andersen assumed 0% growth in free cash flows after FY10-11 in the Base Case, Consignia assumed –2% p.a. in ABC 1 and –20% in ABC 2.
- *Long-run marginal costs.* Whereas Andersen and Consignia used a long-run marginal cost ('LRMC') factor of 0.6 in the Base Case, Consignia argued that it might only be able to avoid costs at a slower rate if volumes fell in absolute terms but did not propose a quantified alternative.

(c) Liberalisation modelling and 'policy levers'

- *Bulk mail definition.* Whereas Andersen had, due to limited available data as stated in their report, limited modelling of Postcomm's proposed 4,000 bulk mail liberalisation step to workshare products subject to a 4,000 minimum purchase criterion, Consignia suggested a larger share of the market would be liberalised under this step.
- *Pattern of entry.* Whereas Andersen modelled, at Postcomm's request, 20% across-the-board market share loss in the Base Case and modelled a sensitivity derived from Consignia's Entry Pricing Model ('EPM') results, Consignia used the EPM results as the basis for ABC 1 and ABC 2.
- *Interim licences, defined activity licences and consolidation.* Whereas Consignia's and Andersen's analysis excluded the impact of these licences, Consignia argued they should be taken into account but did not propose a quantification.
- *Price elasticity of demand.* Whereas Andersen's analysis assumed a overall price elasticity of demand (PED) of –0.57, Consignia considered a range of PED from –0.2 to –1.5.

A3.9 Andersen's original analysis showed an NPV of £7.7bn under the Postcomm Proposals Scenario in the Base Case. Consignia stated that under their revised

assumptions, they obtained an NPV of -£2.5bn in ABC 1 and -£2.9bn in ABC 2. Andersen has estimated the contribution of the revised assumptions to this difference, as shown in Table A3.1 below.

Table A3.1: Impact of revised Consignia assumptions on Base Case NPV under original Postcomm Proposals Scenario: £bn

Assumptions Values in £bn	ABC 1	ABC 2
Andersen Base Case NPV	7.7	7.7
Impacts		
<i>Bulk mail definition</i>	<i>(0.1)</i>	<i>(0.1)</i>
<i>Cost of capital</i>	<i>(4.3)</i>	<i>(4.3)</i>
<i>Terminal dues</i>	<i>(0.2)</i>	<i>(0.2)</i>
<i>Demand growth</i>	<i>(1.5)</i>	<i>(2.7)</i>
<i>Terminal growth rate</i>	<i>(1.2)</i>	<i>(4.4)</i>
<i>One-off efficiencies</i>	<i>(2.1)</i>	<i>(2.3)</i>
<i>Wage inflation</i>	<i>(2.2)</i>	<i>(2.2)</i>
<i>Ongoing efficiencies</i>	<i>(1.8)</i>	<i>(1.8)</i>
<i>Competition effects</i>	<i>(3.4)</i>	<i>(3.4)</i>
Consignia 'alternative base case' NPV	(2.5) (Note 1)	(2.9) (Note 1)

Source: Andersen, Consignia

Note 1: Individual impacts do not sum to total difference between Andersen and Consignia NPV due to interaction between assumptions.

A3.10 Consignia also argued that in assessing Andersen's results, Postcomm had unduly focused on the risks surrounding efficiency, and consequently not focused sufficiently on risks from external factors such as labour market pressures and the long-term threat of declining mail volumes arising from e-substitution.

Summary of the consultants' assessment of Consignia's response¹⁵

(a) Discount rate and threshold value

(ii) Discount rate

A3.11 Consignia used analysis conducted by OXERA Consulting Ltd. ('OXERA') to suggest that a higher discount rate (based on high values of beta applied in the capital asset

¹⁵ A fuller report from Postcomm's consultants is available from Postcomm's website.

pricing model) would be appropriate. The high beta values obtained by OXERA were mainly driven by their premise that Postcomm would not adjust prices towards costs, leading to possibly large divergences between these variables over extended time frames. However, even supposing that OXERA's approach to assessing long-term risk is correct, Andersen's analysis did not share this premise. Andersen's analysis was focused on various 'downside' sensitivities and, in these sensitivities, considered the impact on Consignia's financial performance of an upwards adjustment of prices by the regulator. Andersen's approach did not consider downwards adjustment of prices since this was not relevant to 'downside' sensitivities. Consequently, as indicated by Andersen in their initial report, their approach did not constitute a valuation.

A3.12 Andersen has undertaken some further research on comparable betas which indicates that the value underlying their Base Case Weighted Average Cost of Capital (0.84) appears to be in line with similar companies in competitive postal and logistics markets. The betas obtained by OXERA (2.35 and 3.34) are implausibly high by any standard (the highest company beta in the UK is 1.87¹⁶). They generate estimated for the cost of capital that would be significantly out of line with regulatory precedents. Andersen has not considered it appropriate to adjust its assumption for the discount rate.

A3.13 In addition, Postcomm has been advised by Professor Anthony Steele of Warwick Business School that OXERA's approach to assessing long-term risk was methodologically flawed.¹⁷ For example, the methodology employed implied the risk premium grew with each year added to the forecast period, so the longer the period used for the forecast the greater the risk premium. In addition, the statistical technique used to derive the range for the risk premium has been discredited as not being a robust approach.

(ii) Threshold value

A3.14 Consignia has stated that it considers that the market value of Consignia would be significantly greater than the fixed asset value of £2.2bn, used as the 'threshold value' in Andersen's analysis, and that such a market value would provide a more appropriate benchmark. Consignia did not provide a revised estimate for the threshold value. Postcomm has not yet reached any conclusion in the context of its

¹⁶ London Business School, Risk Measurement Service, April-June 2002.

¹⁷ The OXERA paper and Professor Steele's critique is available from Postcomm's website.

work on Consignia's price control on a Regulatory Asset Value and as a result Andersen has retained this 'threshold value' as a minimum figure against which Postcomm may assess various policy options.

(b) Pre-liberalisation

(i) Market growth inland letters

A3.15 Consignia has suggested a profile consistent with 2% market growth on average in the period to FY10-11 in ABC 1 based on their latest central demand assumptions and a corresponding 1.1% in the ABC 2 'downside'. Andersen has considered it appropriate to adopt ABC 1 as the Base Case, since its original analysis was based on Consignia's then prevailing growth projections. In doing so, Andersen notes that Frontier Economics does not consider that Consignia has adequately justified the management 'overlays' (e.g. for the effect of e-substitution) which result in lower projections overall than those obtained from Consignia's econometrically estimated demand equations. Andersen has adjusted its 'Market Growth Downside' to reflect the growth assumptions of ABC 2.

(ii) Efficiencies

A3.16 Consignia has not directly challenged Andersen's original assumptions. However, Consignia has proposed two alternative efficiency profiles in ABC 1 and ABC 2 although neither of these is purported to reflect the forthcoming Strategic Plan which has not yet been finalised.

A3.17 In the context of its original analysis, Postcomm also commissioned Frontier Economics to assess the strength of links between competition and increased productivity. In its full report 'The impact of liberalisation on efficiency: a survey' Frontier Economics considered:

- the recent efficiency performance of Consignia;
- the experience of competition in the postal sector; and
- the experience of UK deregulated utility sectors.

A3.18 Consignia provided a detailed set of comments on this report, which included further information on the levels of performance Consignia could achieve. Having assessed this information, Frontier Economics believes Consignia has provided insufficient evidence to alter Frontier's view of the productivity profile Consignia may achieve. In the first instance, Consignia itself has announced a 15% cost reduction, which

Frontier has not altered. Secondly, Frontier Economics suggests a long run steady state of 2% per year, which is at the low end of other utilities' steady state performance, and is also lower than the productivity growth Consignia was able to achieve throughout the 1990s (based upon data that has been amended following comments by Consignia). Finally, the transition path adopted by Frontier Economics represents a small additional efficiency target reflecting their view that inefficiency cannot be eliminated in a single big-bang.

A3.19 Frontier Economics also notes Consignia's comments on comparisons of levels of performance (compared to changes in levels in response to policy changes such as liberalisation) attained in international postal markets. Whilst not strictly relevant to Frontier's report (which focussed on the change in performance after liberalisation), Frontier Economics notes Consignia's comparative analysis which suggests that prices (net of VAT) in Sweden are ½ pence higher than in Britain. However, if, as Consignia suggests, scale effects are significant and the current volume dealt with by Consignia is 5 times that of Sweden Post, then prices charged by Consignia ought to be substantially lower than Swedish prices. Frontier notes that no quantitative analysis was submitted that throws light on why the price differential should be so low. Finally, following consideration of comments received on the experience of liberalisation in other sectors, Frontier has not sought to alter its conclusions.

A3.20 Given Consignia's ABC 1 and ABC 2 are not purported to reflect their forthcoming Strategic Plan, Andersen has considered it appropriate to retain its original efficiency assumptions, and notes that its sensitivity range for efficiencies encompasses ABC 1 and ABC 2. However, in view of the uncertainty surrounding the timing of efficiencies, Andersen has also modelled an alternative profile for the achievement of efficiency savings yielding around the same aggregate efficiencies as in the Base Case, but with the gain spread over four years.

(iii) Wage inflation

A3.21 Consignia's response described Andersen as modelling wage inflation at RPI although significant Productivity Bonus Scheme ('PBS') costs were also included. Consignia has since confirmed that the wage inflation modelled by Andersen, after taking account of PBS, was broadly consistent with the historical rate of wage inflation and provided no basis for assuming a higher rate other than referring to prevailing low unemployment in some parts of the country. Andersen considers it appropriate to retain its original assumptions in this area.

(iv) Terminal dues

A3.22 Consignia has argued that terminal dues costs should not be subject to efficiency gains. Andersen has accepted this adjustment, but also de-linked these costs from the RPI and instead maintained them constant in nominal terms. This ensures a consistent treatment of terminal dues costs and terminal dues revenues¹⁸.

(v) Terminal value growth

A3.23 Consignia has suggested that terminal value growth should be negative (-2% p.a. in ABC 1 and -20% p.a. in ABC 2), reflecting the risk of declining volumes after 2010-11. Andersen has retained its original assumption of 0% (in the middle of Consignia's range historically used for planning purposes) with an interpretation either that the level of substitution risk was itself compatible with an assumption of constant cashflows in nominal terms or that in the event of a moderate level of e-substitution, there would be a countervailing regulatory response (e.g. through price increases or redefining the UPS). However, Andersen has adjusted the Market Growth Downside Sensitivity to reflect -2% p.a. Postcomm has asked Andersen not to model the -20% p.a. terminal value growth in ABC 2 on the grounds that it would only be consistent with a significantly different postal services sector and hence would constitute a different model for the provision of the UPS.

(vi) Long-run marginal costs

A3.24 Consignia has suggested that the long-run marginal cost ('LRMC') factor (0.6) could take longer to take effect with declining volumes, but has not proposed a revision. Andersen has not considered it appropriate to make a revision, noting that in none of their sensitivities do volumes decline by more than 30% in absolute terms (Consignia's previously stated tolerance range for the LRMC factors), and have retained their sensitivity range which goes down to 0.5.

(vii) Other changes

A3.25 Based on Andersen's review of Consignia's unaudited Period 11 accounts for FY01-02, Andersen also concluded it would be appropriate to adjust the modelled efficiencies in FY01-02 downsides as a means of obtaining a closer reconciliation between actual and modelled results for the eleven months of that year.

¹⁸ Andersen also accepted a proposed change by Consignia to apply creditor days to international outward costs.

(c) Liberalisation modelling and ‘policy levers’

(i) Bulk mail definition

A3.26 Consignia indicated that Postcomm’s 4,000 bulk mail step in its proposals would lead to a larger scale of market opening than assumed by Andersen, in particular due to Consignia’s assumption that a significant proportion of non-workshare volumes would be opened to competition. Postcomm notes that Consignia has indicated that the bulk mail definition could underestimate the degree of market opening. Postcomm has sought to address this risk by restricting the definition of bulk mail (see Chapter 4). Andersen has taken these data into account in modelling the revised Transition Path Scenario, where relevant.

(ii) Pattern of entry

A3.27 Consignia adopted its modelling of competition using the Entry Pricing Model (‘EPM’) in their replica of Andersen’s model and argued that this should form the Base Case rather than a sensitivity in Andersen’s analysis. Postcomm does not agree with Consignia’s view and has not made any changes to its analysis (Postcomm’s January 2002 document set out a number of concerns about the way Consignia has estimated the pattern of new entry, e.g. new entrants would price at a level that was equal to Consignia’s marginal costs).

(iii) Defined activity licences and Interim licences

A3.28 Although Postcomm accepts that it will in due course identify ‘defined activities’ as described in its decision, it has not yet reached decisions on any ‘defined activity’ and so the scale and nature of these have yet to be identified. In issuing defined activity licences, Postcomm will have regard to the need to ensure that they do not adversely affect the universal service. Postcomm’s expectation is that they will not give rise to large scale operators. There is therefore no need at this stage to assess the impact of defined activities on Consignia. As noted in the main body of this Decision document, Postcomm expects to consider the case for this further opening up on its merits, against the facts that prevail at the time and in the light of the expected impact on the universal service. In addition, as interim licences are by their nature small in scale and temporary, there has been no need to assess their impact on Consignia. Postcomm has, therefore, not asked Andersen to model the potential effects of these.

(iv) Price elasticity of demand

A3.29 Consignia considered that Andersen had used an overall price elasticity of demand ('PED') of -0.2 (based on Consignia's latest estimates of own- and cross-price elasticities of demand), and suggested that a range extending to -1.5 would be appropriate since they argued the PED would increase under competition. Andersen has clarified that it used a PED of -0.57, assuming that all switching between products was away from Consignia and to competitors (rather than between Consignia products). Andersen has retained -0.57 as the central assumption, but examined a range up to -1.0.

A3.30 Andersen accept that higher PEDs may be possible but that they are likely to be a function of a complex mix of factors such as market structure, prevailing price levels, relative cost structures and the product differentiation of competitors. Andersen modelled the price control 'policy lever' under assumptions of PED up to -1.0.

Revised findings of Andersen

A3.31 Postcomm has asked Andersen to model the No Liberalisation Scenario and a Revised Transition Path Scenario on the updated model as set out below. This Revised Transition Path Scenario is as follows:

- FY02-03 no opening;
- FY03-04 Postcomm's Step 1: 4,000 + items of bulk mail opening applied only to Mailsort, Walksort, and Flatsort 3 products. It also includes the European Directive effects of reducing the weight thresholds to 100g;
- FY04-05 no further opening;
- FY05-06 Postcomm Step 2 1,000 + items applied to Packetpost products and a proportion of non-workshare items as indicated by Consignia;
- FY06-07 includes the effect of reducing the weight threshold to 50g; and
- FY07-08 full liberalisation.

A3.32 As noted in the main body of this Decision document, the judgment with respect to the market opening in Phase II will be made at that time. Current data availability has allowed the modelling of the impact of liberalisation to the 1000+ items level. Andersen notes that this generates approximately 70% market opening by revenue. The modelling is, therefore, likely to encompass the financial impact of any market

opening decision of a similar nature - intended to open 60% of the market by revenue
- with the benefit of further data availability at that time.

A3.33 Table A3.2 below shows the key results for the Revised Transition Path Scenario based on the revised model (the equivalent of Table 16 of Andersen's original report, 31 January 2002). The results may be compared with a No Liberalisation Scenario Base Case NPV of £9.9bn.

Table A3.2: NPV impact as at 1 April 2002 of policy levers on Revised Transition Path Scenario: £bn

FY02-03 Threshold value= £2.1bn	Base Case NPV	Downside sensitivity NPV	Excluding overseas operations and non- postal services	Narrow UPS	Real price control at PED of -0.57	Combined effect of policy levers
Increased Competition Downside	6.4	3.8	4.8	4.9	7.8	10.3
Efficiencies Downside	6.4	(6.7)	(5.3)	n/a (no cream- skimming)	0.2	1.3
Combined Efficiencies and Parcels Downside	6.4	(6.9)	(5.5)	n/a (no cream- skimming)	0.1	1.1
Market Growth Downside	6.4	4.4	5.3	n/a (no cream- skimming)	8.0	9.0
Increased Competition Sensitivity and Market Growth Downside combined ¹⁹	6.4	2.7	3.7	3.8	6.5	8.9
Increased Competition Sensitivity and Market Growth Downside – EPM	6.4	1.9	2.9	n/a (no cream- skimming)	5.5	6.5

Source: Andersen

A3.34 These results show that Andersen's four key findings still hold on the basis of the revised assumptions:

- **Finding 1: 'The nature of competitive entry has a material effect on Base Case liberalisation results.'** The difference between the No Liberalisation Scenario and the Revised Transition Path Scenario is £3.5bn (£9.9bn versus £6.4bn). As shown in Table A3.2, increased competition could reduce the NPV by a further £2.6bn (to £3.8bn).
- **Finding 2: 'Consignia has larger problems than the prospect of liberalisation.'** Whereas the impact of liberalisation is £3.5bn in the Base Case or a further £2.6bn in the Increased Competition Scenario, the total impact of the Efficiencies Downside Sensitivity is £13.1bn (£6.4bn versus -£6.7bn).

¹⁹ Under this Scenario the terminal value growth rate is set to 0% to reflect the combined effect of competition.

- ***Finding 3: Efficiency gains and market growth are critical.*** As stated above, efficiencies are important. The efficiencies downside leads to negative NPVs. Under the Market Growth Downside, the NPV is lower by £2.0bn.
- ***Finding 4: 'Postcomm has potentially effective policy levers'.*** Postcomm is primarily concerned with its ability to exercise 'policy levers' in the context of exogenous uncertainty. Table A3.2 demonstrates that under the Increased Competition Sensitivity and Market Growth Downside Combined, the total impact of the levers is £6.2bn (raising the NPV from £2.7bn to £8.9bn), resulting in an NPV significantly above the 'threshold value'. However, Postcomm notes that under the Efficiencies Downside, the 'policy levers' only increase the NPV to around £1bn. Andersen has undertaken some further analysis to indicate that the efficacy of the price control 'policy lever' assuming a PED of -1.0 could be around two thirds of that assuming a PED of -0.57 . However, even in this case, the price control 'policy lever' would generate over £2bn in NPV terms.

A3.35 Andersen has concluded their initial key findings still hold. In addition to considering the NPV of the business, Andersen has also calculated ratios of the Entire Business over the forecast period. Under the Revised Transition Path Scenario, and under the Base Case assumptions, the Entire Business' financial performance does not deteriorate substantially in terms of its key liquidity and solvency ratios. While return on capital employed falls relative to the No Liberalisation Scenario from around 11.4-12.9% (between FY06-07 and FY10-11) to 9.1-10.1%, the current ratio falls from its FY00-01 level to 1.5 but recovers its starting level by FY05-06. Under the Revised Transition Path Scenario, without efficiency gains, however, the financial ratios deteriorate significantly compared to the Base Case and over time. Under the Revised Transition Path Scenario, Consignia has a funding requirement (before FY03-04 when the business turns cash positive) of £590m, estimated on an annualised basis²⁰.

Implications Postcomm draws from the revised analysis

A3.36 Andersen's financial analysis has shown that Consignia's prospective financial performance modelled as the Entire Business is more exposed to the risk of not achieving efficiency than to market liberalisation. Indeed, this is also shown by Consignia's analysis.

²⁰ This excludes the impact of any deterioration in POL's finances compared to the Base Year FY00-01 as detailed in Andersen's report.

A3.37 Consignia's own figures have suggested that even with no liberalisation its NPV would fall short of the 'threshold value' assuming lower rates of initial efficiency gain than in our own analysis (Consignia has estimated £1.4bn and £0.5bn in ABC 1 and ABC 2 respectively). Thus, as previously concluded by Postcomm, the risk of additional financial support being required for Consignia to support the provision of the universal service would in practice be shared between customers and Consignia's shareholder. The analysis presented by Andersen indicates that these risks will be significantly mitigated by efficiencies, which Postcomm considers will be encouraged by competition.

A3.38 Postcomm has been mindful of other risks, such as those arising from market growth or more extreme competition. In this context, Postcomm is satisfied that it has a range of policy mechanisms available to it to safeguard the universal service which provide a significant degree of assurance about the scope for protecting Consignia's financial viability, so long as it is an efficient operator.

Annex IV: Glossary of Terms

Terms used in a definition, which are themselves defined, are italicised.

Term	Definition
Access	Allowing other companies operating in the postal market to use Consignia's facilities to convey their post for part of its journey. Entry to Consignia's network could in principle be at any point in the postal activity chain (e.g. a Mail Centre or Delivery Office)
Access charge	Price paid by an operator to access Consignia's network
AICES	Association of International Courier and Express Services
Avoidable costs	The costs avoided if an undertaking ceases supplying a particular element of its business (e.g. a particular product)
Beta	A factor in calculating cost of capital that reflects how risky a company is compared to the market as a whole.
Bulk Mail (Large Mailings)	For Phase I of market opening, Bulk Mail means any individual mailing for a minimum of 4000 items (or 4000 items on average if under a multiple mailing contract) that is posted by a single user from a single site and where the mailing is in the same format
Competition Working Group	A body set up by Postcomm including key operators to provide advice on liberalisation strategies for the postal market
Consolidation licences	A licence enabling an operator to consolidate mail from a number of sources which will then be passed on to Consignia for delivery
Cream skimming	The loss due to competition by the incumbent of volumes with unit revenue above avoidable costs, in particular where the incumbent is constrained to offer a uniform tariff
Current ratio	Current assets divided by current liabilities
Defined Activity Licence	A licence issued relating to further parts of the market opened up by Postcomm in respect of defined activities (such as specialised business services) especially those that have features which differentiate them from standard mail services
Downstream / Upstream access	A general description of points of access to Consignia's distribution network; downstream access occurs at an onward mail centre or later and upstream access before that

Term	Definition
Economies of scale	Where average costs decline as output increases
End-date	1 April 2007 when restrictions in market entry will be abolished
Entry Pricing approach	The approach adopted by Consignia in assessing the impact of competition on their financial performance that calculates the lost contribution to <i>unavoidable costs</i> from a particular representation of competition
European Directive	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, Official Journal L 015, 21/01/1998 p. 0014 - 0025 which is due to be amended by a further Directive of the European Parliament and of the Council which, at the date of this decision document, has been approved by the Parliament but has not appeared in the Official Journal
Interim licensing policy	The policy followed by Postcomm for licences issued since Postcomm's licensing powers came into force on 26 March 2001. Postcomm published a formal policy statement on this policy on 30 April 2001. This policy is now replaced with the licensing policy summarised in Annex I
Interim Price Control	The price control currently embodied in Condition 19 of Consignia's Licence
Licensed area	The area of postal activity for which postal operators require a licence from Postcomm to provide postal services. This is currently the conveyance of letters weighing less than 350g or costing less than £1
Marginal costs	The cost of producing one additional unit of output
NPV	Net Present Value. A technique for converting future streams of costs and revenues into today's prices, taking account of the time value of money
Overlays	Additional factors that are applied to a model because these have been inadequately captured at earlier stages of a forecasting process
Postwatch	The Consumer Council for Postal Services established under section 2 of the Postal Services Act 2000
Productivity Bonus Scheme (PBS)	A Consignia scheme aimed at rewarding employees depending on the level of productivity and fixed targets

Term	Definition
RPI	Retail Price Index
Return on capital employed	Profit after tax divided by capital employed
Return on net assets	Profit after tax divided by net assets
Special Privileges	Privileges such as VAT exemption and freedom from traffic restrictions available only to universal service providers
Terminal Dues	Payments by a postal operator in one country to a postal operator in another for handling cross border mail
Threshold value	A valuation of the assets employed to provide postal services. The value is used as part of the calculation of an adequate return on the assets, which the regulated company is allowed to recover through regulated prices
Transitional costs	Costs associated with moving from an existing to a new structure
Unavoidable costs	The costs that cannot be avoided if an undertaking ceases supplying a particular element of its business (e.g. a particular product or route)
Universal Postal Service (UPS)	The set of postal products and associated minimum standards of service that is to be generally available to postal users irrespective of their address within the UK. More particularly described in the Directive, the Act and Consignia's licence, currently this comprises at least one collection every working day from every collection point (letter box or post office) and one delivery every working day to every house or premises in the UK for postal items weighing up to 20kg at an affordable uniform tariff, and a registered postal service
Universal service obligation (USO)	An obligation on an undertaking to provide the <i>Universal Postal Service</i>
Universal Service Compensation Fund	A fund raised within the postal sector for the purposes of funding the provision of the <i>Universal Postal Service</i>
Weighted average cost of capital	The discount rate at which Consignia's free cash-flows are discounted to produce the <i>NPV</i> for Consignia's business