Collections series 7

CRI

CENTRE FOR THE STUDY OF REGULATED INDUSTRIES

THE DEVELOPMENT OF POSTAL REGULATION
– A COLLECTION OF REVIEWS

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THE DEVELOPMENT OF POSTAL REGULATION
~ A COLLECTION OF REVIEWS ~

COLLECTIONS SERIES 7

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The CRI is a research centre of the University of Bath School of Management. The CRI was founded in 1991 as part of the Chartered Institute of Public Finance and Accountancy (CIPFA). It transferred to the University of Bath School of Management in 1998. It is situated on the 8th floor of Wessex House (North), adjacent to West car park.

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PREFACE

The CRI is pleased to publish ***The Development of Postal Regulation - A Collection of Reviews***, its seventh 'collection' of reviews drawn from the Regulatory Review and other CRI series. The previous collections have covered the development of energy, rail, airports and water regulation and, more generally, regulatory practice and design. The idea for the collections arose, in part, because bringing together contributions from successive Regulatory Reviews provided insights, for example, into the development of regulation, but also because we often have requests from readers to the effect that it would be useful if we could bring together the material on, for example, energy.

We have continued that philosophy with our seventh collection, and have continued with a sectoral theme. It is divided into two parts, postal regulation and its development as reflected in successive CRI regulatory reviews, and five sectoral themes concerned with third party access to the incumbent's network to facilitate competition in other parts of the supply chain, the conflicts between promoting competition and maintaining universal service, and the degree to which consumers' interests are put first. We hope that the juxtaposition of regulatory development and specific themes will provide a broader, but integrating view, of postal regulation and policy.

The contributions are reproduced as they were published, except for some presentational changes to achieve a common format. Revisions would have defeated the purpose of the 'historical' perspective. Readers should be aware, of course, that institutional changes in particular have taken place, for example, Offer and Ofgas became Ofgem, in rail Opraf was taken over by the SRA, and Energywatch has replaced the Gas Consumers Council and the Electricity Consumer Committees.

The CRI publishes a wide range of occasional and technical papers, research reports and regulatory briefs, and encourages those working in the field – whether as academics or in other types of organisation – to submit suitable material for consideration for publication. Enquiries and manuscripts should be addressed to: CRI, School of Management, University of Bath, Bath BA2 7AY.

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Director, CRI
May 2004

Publication acknowledgement

The CRI was founded by the Chartered Institute of Public Finance and Accountancy (CIPFA), but it transferred to the University of Bath on the 15 October 1998, and is a research centre of the School of Management. CRI publications before that date were therefore published by CIPFA. For consistency, where reviews in this collection, or CRI publications cited in those reviews, were published before 15 October 1998 they refer to the University of Bath as the publisher. This is to recognise the fact that the University of Bath now holds the copyrights, and also to avoid the possibility of enquiries being made to CIPFA about publications now held at the University of Bath. This note is to formally acknowledge, however, that CIPFA was the original publisher of CRI publications prior to the 15 October 1998.

Peter Vass
Director
CRI

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John Blakemore & Frank Rodriguez

Introduction

The system for regulating the postal sector in the UK is based on a combination of national competition law and the government's control framework for the Post Office which is a public corporation. Developments in 1995 were prefaced by the government's decision on privatisation announced at the end of 1994 and the paper begins a regulatory review of 1995-96 by recapping on this background. An earlier paper in the CRI's Regulatory Review series provides further context on the UK system.[1] However, the drive towards a single market in Europe will have very important implications for posts in the UK. 1995 saw the publication of a draft directive on common rules for the development of Community postal services and the improvement of quality of service by the European Commission and, perhaps as important, a draft Notice by DG IV (Competition Directorate) on the application of competition rules for the postal sector. When the Directive on Posts is adopted by the Council of Ministers, it will need to be acted upon by the UK government.

This paper covers regulatory developments from both the UK and also Europe up to March 1996, although there is some

[1] Boon R and Golay J (1994), Post: Developments and Trends, CRI Regulatory Review 1994, chapter 7, pp117-134, June, University of Bath.

Acknowledgement
This chapter was first published as Regulatory Developments and the UK Postal Sector 1995/96, CRI Regulatory Review 1996, chapter 4, pp55-71, October 1996, University of Bath.

John Blakemore at the time was an Economist and Frank Rodriguez the Head of the Economics Group, Royal Mail.

limited reference to events after this date. In many ways, the developments emanating from Brussels are likely to be the more significant of the two in terms of their longer-term impact on the structure of the postal industry and, hence, on its likely workings and performance. The process of developing the European regulatory framework has been protracted and its end date is uncertain but this makes the process no less important. In the UK, given the decision on privatisation, developments have been restricted mainly to amendments to, and a rolling forward of, the traditional framework for controlling public corporations, with some changes being made to this during 1995.

The market and commercial environment upon which the regulatory regime impacts has been one of rapid change in 1995/96. Each of the main businesses of the Post Office (Royal Mail, Parcelforce, and Post Office Counters Ltd (POCL)) had a successful year. There has been a significant growth in communication by fax and e-mail, with the use of the internet rising dramatically, but inland letter volumes rose by a little under 4% in 1995-96, close to the growth rate in the preceding year.

Although part of this was due to direct mail (defined here to mean unrequested advertising mail) most of it was due to other categories of mail. Overseas mail volumes grew more rapidly than inland. In the fiercely competitive parcels market, Parcelforce made a small profit before exceptional items, while POCL benefited from extended powers, as outlined below, to offer a wider range of products. Key indicators from the 1995-96 Annual Report and Accounts are reported in **Table 1**.

Outcome of the Post Office review

In July 1992, the government announced a review of the structure and organisation of the Post Office which had been preceded immediately before by a statement of intent to privatise

Parcelforce.[2] The Review had still not been completed by spring 1994 and the House of Common Trade and Industry Committee, in its report on the 'Future of the Post Office' in March, urged the President of the Board of Trade to report the government's conclusions without delay.[3]

Table 1: Post Office Group
Indicators of financial performance (£m)

	1994-95	1995-96
Turnover	5,878	6,210
Profit before taxation	472	422
of which Royal Mail	449	411
Parcelforce	(11)	1
Post Office Counters	30	35

Source: Post Office, Annual Report and Accounts, 1994-95 and 1995-96

The government published a Green Paper on the 'Future of Postal Services' in June 1994 setting out a range of options for the structure and organisation of the Post Office.[4] Its preference, and provisional conclusion, was that Royal Mail and Parcelforce should be privatised with the government retaining a 49% equity stake. The Green Paper noted that greater commercial freedom within the public sector would fall short of the 'commercial needs of Royal Mail' with a clear risk that this option would 'condemn the business to slow decline'. Post Office Counters should remain in the public sector with its existing structure but also with greater freedom to provide a wider range of services. The Green Paper also proposed greater competition in postal services although it accepted the need to retain 'a degree of monopoly…to support the maintenance of the universal service and uniform tariff structure'.

[2] Statement by the President of the Board of Trade to the House of Commons, 15 July 1992
[3] House of Commons Trade and Industry Committee: The Future of the Post Office, March 1994
[4] The Future of Postal Services: A Consultative Document, June 1994.

It became clear during the consultation period that it would not prove politically feasible for the government to secure its preferred option of privatisation. On 3 November 1994, following a Cabinet discussion, the Department of Trade and Industry confirmed that privatisation of Royal Mail and Parcelforce would not be part of the government's legislative programme for the forthcoming Parliamentary session. However, the DTI did announce that Post Office Counters would be allowed to transact a wider range of business as outlined in the Green Paper.

Since then, the Counters Business has extended the range of activities that it offers through its 20,000 outlets, most notably bureaux de change, travel insurance, the National Lottery, and payment of gas bills. This relaxation was welcomed both by the Post Office and the National Federation of Sub-Postmasters, whose members operate 19,000 of the Counters' outlets. Nevertheless, this was a relatively modest outcome to a major review that had been commenced two and a half years earlier. The ownership, control and operating framework of Royal Mail and Parcelforce remained essentially unchanged from that at the time the Review was initiated, despite accelerating change in the market place, both domestic and international, and in electronic means of communication. Developments of the regulatory framework in 1995 need to be seen in the light of these contrasting positions.

1995-96 targets and the Trade and Industry Select Report

In early 1995, the Post Office was coming to the end of a three year target period which had started in April 1992. The targets covered profit, measured by return on capital employed (ROCE), and cost reduction, measured by real unit cost reductions (RUC). On 31 March 1995, the Industry and Energy Minister, Tim

Eggar, announced that the three year targets would be extended for a further year.[5] The targets for 1995-96 were set as follows[6]:

- return on capital employed: Royal Mail 18.0% (1994-95 target, 14.5%), Post Office Counters 9.5% (unchanged from 1994-95 target) and Parcelforce required to break even before exceptional items;
- real unit cost reductions cumulative from 1992-93 to 1995-96: Royal Mail 5.5% (cumulative to 1994-95, 4.0%), and Post Office Counters 6.5% (cumulative to 1994-95, 3.0%). No RUC target applies to Parcelforce.

  A third financial control, the external financing limit (EFL) which counts as part of the public sector borrowing requirement, is set annually in the government's unified budget in November.

Table 2 reports achievement against targets in 1995-96, all of which were met. Together with Table 1, it demonstrates the strong performance of the Post Office Group and its three main businesses during the year. Royal Mail and POCL both exceeded their targets for return on capital employed with pre-tax profits of £411m and £35m respectively, while Parcelforce posted a profit of £1m before exceptional items, marking a return to trading profitability. Royal Mail and POCL also exceeded their targets for real unit cost reduction, underlining the continued improvement in efficiency. These improvements, when

[5] DTI Press Notice (1995), Written answer to Parliamentary Question by Industry and Energy Minister, (P/95/239), 31 March.

[6] These targets are adjusted to allow for significant movements in interest rates after the targets are set. This affected the ROCE for Royal Mail and both of POCL's targets. Table 2 reports that targets as amended to allow for movements in interest rates and compares them with the outturns for 1995-96. The rates of return of the Businesses are calculated from accounts prepared under 'the alternative accounting rules as set out in the Companies Act 1985 and reflect the effect of changing prices where material and appropriate' (Post Office Annual Report and Accounts, 1995-96, p33).

combined with growth in volumes, have supported a rising trend in overall profitability in recent years.

Table 2: Post Office Group
Financial targets 1995-96

	Target[7]	Achievement
Return on capital employed		
Royal Mail	16.8	23.4
Parcel Force	0.0	0.3
Post Office Counters	5.2	13.1
Real unit cost reduction (against 1991-92 base)		
Royal Mail	5.5	6.0
Post Office Counters	5.6	7.0
External Financing limit (Outturn cash surplus) £m	213	215

Source: Post Office, Annual Report and Accounts, 1995-96

The 31 March statement also announced that a performance review would be conducted before setting the next three year targets to apply from April 1996 and that discussions would continue on possible changes to the control framework to apply from that time. The purpose of the review was to examine the operational efficiency of the Post Office. It was conducted by the management consultants KPMG during the Summer of 1995. However, given the failure of privatisation to go forward, the government appeared reluctant to envisage other than marginal changes to the regulatory regime for the Post Office.

[7] These targets are adjusted to allow for significant movements in interest rates after the targets are set. This affected the ROCE for Royal Mail and both of POCL's targets. Table 2 reports the targets as amended to allow for movements in interest rates and compares them with the outturns for 1995-96. The rates of return of the businesses are calculated from accounts prepared under the '*alternative accounting rules as set out in the Companies Act 1985 and reflect the effect of changing prices where material and appropriate*' (Post Office Annual Report and Accounts, 1995-96, p33).

Just prior to the government's announcement on Post Office targets the Trade and Industry Select Committee had published a report on the future of the Post Office in the wake of the privatisation decision.[8] The Committee interviewed the President of the Board of Trade in January. He again emphasised his view that privatisation was the right option for the Post Office and questioned whether it is possible to have commercial freedom in the public sector. He identified the Private Finance Initiative as a means by which the Post Office could expand its operations in partnership with the private sector and also reaffirmed the government's commitment to maintaining a universal service with a uniform tariff supported by a monopoly.

The Committee published its report in March having taken evidence from a wide range of interested parties, from users and unions to competitors. Its recommendations included the following:

- the Post Office should be converted into a 100% government owned plc and given greater commercial freedom;
- future legislation should define the Post Office's social obligations and standards of service;
- the government should define a nationwide network of post offices and express this in terms of the minimum acceptable number of offices.

Perhaps the most significant of these recommendations related to an increase in commercial freedom. The Post Office had proposed a commercially based ROCE, an EFL set by reference to an agreed percentage of planned profits, and an RPI related price formula instead of the RUC cost reduction target. The Committee fully endorsed these proposals for changing the regulatory regime but felt that they were 'insufficient as more than a temporary measure' and that, instead, it was vital that the Post Office be given greater commercial freedom.

[8] House of Commons Trade and Industry Committee: The Post Office, March 1995

Changes to the regulatory framework

Some six months after the decision not to proceed on privatisation and nearly three years after the original announcement of the Post Office Review, the government came forward with proposals to change the regulatory regime in a statement to the House of Commons by the President of the Board of Trade in May 1995. This acknowledged the influence of the Select Committee in promoting progress in this area.[9] The statement confirmed the greater freedom given to Counters to provide a wider range of services. The President also announced a number of changes to the Post Office's operating environment, notably:

- in future the government 'shall aim to set' the 'negative' EFL at 'about half of the Post Office's forecast post-tax profit' and hoped 'to make progress in that direction this autumn';
- 'to remove the formal limit on the Post Office's capital expenditure, together with the associated detailed scrutiny of investment projects in its core business'. The Post Office and DTI will, in future, engage in a more strategic corporate plan process that will focus on the key strategic issues facing the businesses;
- 'convert the main operating units of the Post Office into Companies Act companies';
- the President would consider requests by the Post Office to extend into 'adjacent markets' subject to greater use of the private finance initiative.

As a package, these measures have the potential to modernise some aspects of the control framework within which the Post Office operates but much rests with the discretion of ministers and their officials. Progress has been mixed during 1995 and the first part of 1996. In some areas there have been significant steps forward but elsewhere this has not occurred and, indeed, the

[9] Statement by the President of the Board of Trade to the House of Commons, 11 May 1995.

direction of change had been the opposite to that proposed in the Statement.

The two proposals from above which have been implemented are the removal of the formal limit on capital expenditure and the introduction from 1995 of a more strategic corporate plan process. Additionally, in May 1996, POCL announced a joint programme with the Benefits Agency to automate the payment of benefits at its outlets in partnership with the private sector under the private finance initiative.

Progress has been disappointing and in the improvement of the system of short-term financial controls embodied in the EFLs although there is now a limited carry forward provision. This allows an over-achievement of up to £30m in a single year to be rolled forward and be counted against the EFL for the subsequent financial year. Nevertheless, with after tax profit in 1995-96 at £270m, a figure set at 50% of this would have implied an EFL of about -£135m in 1996-97. In the event, the chancellor sharply raised the absolute size of the EFL previously announced in the 1994 autumn budget from -£180m to -£300m in the November 1995 budget although the roll over provision has been used to offset this by £30m.[10] EFLs for 1997-98 and 1998-99 were set provisionally at £320m (an extra £120m) and -£310m. These amounts flow directly into reducing public borrowing or allowing taxes to be lower and/or public expenditure higher than otherwise.

One consequence of the tightening of the Post Office's EFL was the need to raise letter prices (from July 1996 by 1p on both first and second class letters). The previous increase had been in November 1993, the longest period of letter price stability since the early 1960s. The EFL announcement also highlighted the long-standing conflict inherent in the current regulatory system, against which the President of the Board of Trade's May

[10] Financial Statement and the Budget Report, 1996-97. The figures quoted are from the Red Book itself which, for plan years, are published rounded to the nearest £10m.

statement offered some prospect of progress between the government's short-term need to raise revenue and the Post Office's ability to plan over the medium-term, not least in pricing its products to meet growing competitive pressures in the market place.

Developments from Europe

The move towards the single market in Europe will add to, and in some ways supersede, the regulatory framework for the postal sector set by the UK government. The European dimension is becoming increasingly important. While changes to the framework in the UK were relatively modest during the period covered in this paper, there were significant developments on the European front. At the same time, competitive pressures in the international sector have been growing with some postal administrations, notably the Dutch PTT and Sweden Post, becoming more active, as have private operators.

The move towards a European-wide regulatory framework stems from the development of a single market in the EU. The European Commission first turned its attention to the postal sector in earnest with the publication in June 1992 of the Green paper on The Development of the Single Market for Postal Services. The paper proposed a 'reserved area' (monopoly area) to support the universal service and uniform pricing. It also proposed a narrow definition of what mail items and processing activities should be included in the monopoly, in effect leading to a substantial liberalisation of the European postal sector (Boon and Golay, 1994).

In December 1995, following consultation, Directorate General XIII of the European Commission, the directorate responsible for post and telecommunications, published a draft directive on …Common Rules for the Development of Community Postal

Services and the Improvement of Quality of Service.[11] At the same time, the Competition Directorate, Directorate General IV, published a draft Notice on …the Application of the Competition Rules to the Postal Sector.[12] In its final form, the directive will introduce new law and must be adopted in each country's domestic legislation. The Notice will be the Commission's interpretation of existing law as it applies to the postal sector and compliance with it will be required to meet competition rules.

Draft EU Directive and Notice on Postal Services

The draft directive addresses the differences in quality of service, universal service and monopoly areas in member states which the Commission believes are detrimental to cross-border trade. The main proposals are summarised in **Table 3**. These will have a major impact on the working of postal markets throughout the EU if adopted in their current form.

Some of the proposals already apply in the UK or will be little different to the current situation. These include the definition of the letter monopoly (which in the UK currently applies to letters under £1), regulation independent of the postal operator (in the UK, the Department of Trade and Industry) and minimum quality of service standards (where, at 92% in 1995-96, the UK is far above the proposed level of 80% for next day delivery for first class mail).

[11] Official Journal of the European Communities, 2 December 1995, No 95/C 322/22.
[12] Official Journal of the European Communities, 2 December 1995, No 95/C 322/03.

Table 3: Main proposals in EU Draft Directive

- the 'reserved area' (or monopoly) to be five times the basic tariff for national items of mail only, provided the items do not exceed 350 grammes;
- incoming cross-border mail and direct mail (all advertising mail) may (if justifiable) be reserved until 31 December 2000, after which in principle they will be open to competition. The Commission will review this by June 1998 at the latest;
- prices for services in the universal service will be cost-based and member states can determine that they must be uniform (ie, the same, regardless of origin or destination, as in the UK) but it is unclear whether this applies to cross border universal services;
- 'terminal dues' (payments made between postal administrations for cross border mail) should be cost-based and it is reasonable to proxy these by national tariff. They may be modified to allow for quality of service differences;
- member states may require competitors to be licensed (authorised) and contribute to a universal service fund as an alternative to exclusive rights;
- separate accounting for reserved and non-reserved services and for each of the reserved services, distinguishing between the separate stages of processing (collection, transport, sorting and delivery). Separate accounts to include an annual balance sheet and profit and loss account;
- the Commission will review the whole scope of the reserved area in 2000 at the latest;
- minimum quality standards to apply to domestic an intra-Community services, defined in terms of the percentage to be delivered within a specified number of days. For example, at least 80% of first class equivalent mail should be delivered by the next working day. At least 90% of cross-border mail should be delivered within three working days following the day of posting and 99% within five working days;
- each member state to appoint a regulator independent of the postal operators.

There are important differences, too. In particular, the directive's definition of universal service does not require a uniform price, contrary to practice in almost all countries in the EU and elsewhere, and the move towards a cost-based method of payment for cross border mail is a significant change from the current system which is largely based on the number of items posted between countries. Separate accounts for reserved and non-reserved areas, which share the use of the postal network, also raises both conceptual and practical issues in its implementation. The treatment of common and joint costs across the network is an obvious example of the difficulties which will need to be addressed.

Perhaps the most contentious of the proposals in the draft directive relates to the possible liberalisation of incoming cross-border mail and direct mail. If this were to occur, it would risk undermining mail volumes in the reserved area which could leak into either of these categories, weakening the economies of scale and scope that exist within postal networks. Opportunities would be created for domestic mail to become cross border and so avoid the monopoly. For example, messages generated in one country could be sent abroad electronically for printing there as letters and then mailed back to the original country for delivery, with the result that such mail would no longer be technically within the monopoly. At the same time, it would prove extremely difficult to police mail by its content as would be required if direct mail were liberalised. Additionally, research both by the Commission and by others indicates that, while direct mail users might gain from lower prices, this could be at the cost of other postal users.[13]

Unlike the directive, which will create new law, the Notice purports to set out the Commission's interpretation of existing legislation and, in particular, on how competition legislation

[13] European Commission Directorate General XIII: Assessment of the Impact of the Liberalisation of Direct Mail in the Community, 25 April 1995; and Pieper F and Stumpf U (1993), Liberalisation of Addressed Mail and Universal Service.

applies to the postal sector. Its main provisions are set out in **Table 4**.

Table 4: Main provisions in EU Draft Notice

- the reserved area should be defined so as to provide adequate resources to finance an affordable universal service. This should be achieved through the 'general letter service' of items weighing less than 350 grammes and costing less than five times the basic tariff;
- postal activity can be separated into four 'markets' (collection, sorting, transport, delivery(distribution), with, in principle, only the last being reservable;
- postal operators may be obliged to allow 'downstream access' (the inputting of mail into the postal network downstream from collection) to competitors on non-discriminatory terms;
- direct mail forms a separate market and should, in principle, be exposed to competition. However, this sector is developing at a different pace in member states so that the Commission will review this on a case by case basis;
- the delivery of inward cross-border mail should be open to competition when terminal dues are reformed;
- prices of competitive services should not be cross-subsidised. Price above average incremental cost will meet this requirement. Postal operators should maintain separate accounts for reserved and competitive areas and show the (downstream) access conditions and prices applied.

The draft Notice points out that member states are allowed to maintain a monopoly in postal services to the extent that it is in the 'general economic interest' to do so. It then describes which areas member states may restrict to a monopoly and which areas should be open to competition to comply with EU Articles.

Some of the proposals for liberalising the postal sector are similar to those contained in the draft directive, for example, inward cross-border and direct mail. Both documents also give the same weight and price definitions for the reserved area. The draft notice, however, is more restrictive in its definition of the reserved area because it would allow ‘downstream access’ for all mail items. In effect, the reserved area would be the delivery of items weighing less than 350 grammes and less than five times the basic tariff. This would undermine the uniform tariff by, in effect, requiring postal administrations to offer a local tariff for delivery at well below the current national tariff to large posters.

The draft Notice, which interprets current law, goes further in its arguments for liberalising the postal sector than the draft directive, which defines new law, and is not fully consistent with it. It also goes further than current European Court case laws would suggest is permissible.[14] Although it is not binding, the Notice could influence a court in reaching a judgement as persuasive evidence. Part of the significance of the distinction between the two draft documents is that each is operating on a different timescale. The directive is being taken forward under the co-decision process of article 100A. This means the European Parliament and the Council of Ministers must agree on the proposals before the directive can be adopted. The Notice is under article 90 which, inter alia, defines how competition rules should apply to public monopolies. The Notice will indicate how the Commission interprets this article and does not require approval by the European Parliament or Council of Ministers. As a result, the Notice may come into effect more quickly than the directive.

Conclusion

There is rapid change in the communication market as the possibilities from electronic means such as faxes and email grow and multiply. Competitive pressures within the postal sector

[14] The European Court of Justice has widened the derogations to Article 59 to permit limitations on the freedom to provide services where the ‘general good’ justifies this (van Binsbergen Case [1974] ECR 1299, 1309).

itself are increasing, not least at the international level, from other national postal administrations. At the same time, there is general support throughout the country for the UK government's 'non-negotiable' requirement for mail of a universal service at a uniform affordable set of prices. There is a similar commitment to a nationwide network of post offices.

The key issue, from a regulatory perspective is to set a framework which will enable the achievement of these aims in the best possible way. These aims are shared in Europe. The EU directive on postal services, when it is enacted in its final form in the UK, will largely set this framework and, as outlined above, this may include some important changes compared with the current environment. The EU Notice on postal services may also have a very significant impact, certainly over the longer term. A further stage in this process was completed in the early summer of 1996 with a response to the drafts from the European Parliament although when the Council of Ministers met in June 1996 to discuss the draft directive and Parliament's response, they failed to reach agreement. As a consequence, the draft has been put back on the agenda for a future meeting of the Council of Ministers. The House of Lords Select Committee report on European communities also reviewed the proposals contained in the draft directive and Notice and was broadly supportive of the Post Office's stance.[15] The challenge for the UK government, in this changing environment, is to secure a framework within which a successful UK postal service can continue to deliver the widely shared aims of universal service and also be able to innovate and compete on equal terms internationally.

[15] House of Lords Select Committee on the European Communities: Community Postal Services, May 1996.

2 POSTAL REGULATION 1997/1998

Andrew Forbes and Frank Rodriguez[*]

Introduction and background

As has been the case for several years, 1997/98 was another year of review and uncertainty about the longer term regulatory framework for the postal sector in the UK. The year brought with it the prospect of major change to the regulatory environment rather than change itself. In the UK, shortly after being elected in May 1997, the new Labour government announced a review of the Post Office.[1] In April 1998, some modest changes were announced but the principal outcome was the announcement and setting out of the terms of reference for a further stage of review through the summer and autumn.[2] In Europe, the long awaited Postal Directive was adopted in

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[*] Note: This paper has benefited from comments by colleagues within the Post Office. The views expressed within it are those of the authors and not necessarily held by the Post Office as a whole.

[1] Department of Trade and Industry, Ian McCartney announces immediate and comprehensive review of options for the Post Office, Press Release P/97/332 16 May 1997.

[2] The Trade and Industry Committee, Fifth Special Report: Government observations on the third report from the Committee (session 1997-98) on The Post Office, (HC684) 8 April 1998.

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Andrew Forbes at the time was Competition Policy Analyst, Royal Mail and Frank Rodriguez, Chief Economist, The Post Office

December 1997 but was almost immediately superceded.[3] This was by issuing of a Notice from the Competition Directorate of the European Commission (DGIV).[4] Again, although from the perspective of the UK some relatively minor changes were contained in the directive, one of the main elements was the setting up of a series of studies which will be used by the Commission to bring forward proposals for further liberalisation of European postal markets. On the current timetable, these proposals are due before the end of 1998.

While these events have been unfolding and some limited change has occurred, the Post Office continues to operate as a nationalised industry of which it is the largest remaining. It is made up of a number of businesses - the principal ones are Royal Mail, Parcelforce Worldwide and Post Office Counters Limited (POCL). As a public corporation, it is regulated through a long-standing system of financial targets which are agreed with its sponsor ministry, the Department of Trade and Industry (DTI). The consumer interest is represented by the Post Office Users National Council (POUNC).

However, market developments have moved on apace making this regulatory framework increasingly inappropriate. Although the monopoly on letters will remain, albeit with a small reduction in scope after implementation of the Postal Directive which is due by February 1999, competition is developing in various areas. Neither Parcelforce Worldwide nor POCL have monopolies and both are subject to widespread and growing competition in their markets. Royal Mail's inland letter traffic grew by 5% in 1997/98, the best outturn since the late 1980s, but

[3] Directive 97/67/EC of the European Parliament and 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 of European Communities, L15/14 1.1.1998.

[4] The European Commission, Notice from the Commission on the Application of the Competition Rules to the Postal Sector and on the Assessment of Certain State Measures Relating to Postal Service, Official Journal of European Communities, C39 6.1.98.

there are infringements of the monopoly by prospective entrants to the letters market, and the substitution of mail by electronic means has been given a further boost by the rapid expansion of e-mail and internet services.[5] The outward cross-border market has become *de facto* liberalised, leading to a number of foreign postal administrations setting up offices in the UK. In turn, some of these have made major acquisitions or have become involved in joint ventures such as the Dutch PTT with TNT to form the new TNT Post Group (TPG) and Deutsche Post AG (the German Post Office) with DHL.

This short review focuses on regulatory developments in the UK postal sector during 1997/98 against the background of these changes in the market. It covers the following main areas:

- the performance of the Post Office against the current system of targets;

- developments towards a new regulatory framework in the UK;

- the European Postal Directive and Notice and work set in train by the European Commission to underpin further liberalisation of European postal markets

- concluding comments and issues for 1998/99.

1997/98 targets and performance

The current target round is overseen by the DTI and covers the three year period 1996/97 to 1998/99. The principal businesses are targeted in different ways to reflect their contrasting market circumstances:

- each has a target on pre-tax profits. In the case of Royal Mail and Parcelforce Worldwide, this is expressed as a return on

[5] The Post Office, Annual Report and Accounts, 1997-98.

capital employed but the new target round introduced a return on turnover for the Counters business. POCL has the largest number of retail outlets of any business in the UK and return on turnover is the standard measure for the reporting of profitability by large retailers in the private sector.

- in addition, Royal Mail has an efficiency target as an extra discipline on the business arising from its letter monopoly. The efficiency target is in the form of a requirement to reduce annually the real unit costs of its operations. Neither Parcelforce Worldwide nor POCL now have such a control given the degree of direct competition in their markets.

- collectively, the Post Office also faces a cash limit in the form of a (negative) external financing limit (EFL) which implies that effectively it is a net lender to HM Treasury each year. This acts as a surrogate dividend policy and is the Post Office's contribution to the public sector borrowing requirement.

Overall turnover in the Post Office in 1997/98 was £6.8bn of which Royal Mail's contribution was £5.4bn while profits outturned at £651m, up 13% on 1996/97 (**Table 1**). Performance against each of the targets in 1997/98 is summarised in **Table 2** and the record for 1996/97 is shown also in (square) brackets. All of the targets set for 1997/98 were achieved with the exception of Parcelforce Worldwide's profit target. The EFL outturn at £338m meant that the cash surplus generated by the Post Office was, in effect, transferred to the Treasury making a total of over £1bn in the last four years. The current target regime allows a roll forward of up to £30m of any over-achievement to the following year so that the EFL for 1998/99 has been reduced by £25m, the extent to which the target was over-achieved in 1997/98.

Over the years, the precise form and coverage of the regulatory control framework for the Post Office has varied a little from target round to target round. The current round, for example, introduced the return on turnover for POCL and the £30m roll forward provision for EFLs.

Table 1: Post Office Group
Indicators of Financial Performance (£m)

		1996-97	1997-98
Turnover		**6,370**	**6,759**
Profit before taxation		**577**	**651**
of which	**Royal Mail**	**518**	**547**
	Parcelforce Worldwide	**(21)**	**(14)**
	Post Office Counters	**34**	**33**

Source: Post Office, Annual Report and Accounts, 1997-98

Table 2: Post Office Group
Financial Targets 1997-98*

	Target %	Achievement %
Return on Capital Employed		
Royal Mail	**20.0 [20.0]**	**26.5 [28.2]**
Parcelforce Worldwide	**3.5 [1.5]**	**6.3 [(9.9)]**
Return on Turnover		
Post Office Counters	**2.5 [2.5]**	**2.9 [2.9]**
Real Unit Cost Reduction**		
Royal Mail	**3.5 [1.0]**	**4.1 [2.0]**
External Financing Limit***		
Outturn Cash Surplus, £m	**313 [268]**	**338 [268]**

*** Figures in square brackets are 1996-7 target and performance**
**** On 1995-96 base**
***** 1997-98 target includes £17m roll forward from 1996-97, with performance for 1996-97 expressed after roll-over. £25m roll-over will reduce 1998-99 EFL from £335m to £310m**

Source: Post Office, Annual Report and Accounts, 1996-7, 1997-98

In essence, however, the structure of the system remains unchanged from that introduced two decades ago following the 1978 White Paper.[6] Since then, markets, customer expectations, technology, regulatory thinking and practice and the competitive environment generally have all moved on dramatically. As a result, the Post Office's regulatory framework has come to be seen as increasingly anachronistic. In particular, the importance of commercial freedom for the Post Office has become widely accepted but devising a regulatory framework which will facilitate this has proved to be a challenging and as yet uncompleted task for government.[7]

The Conservative government undertook a major review of the Post Office which recommended the privatisation of Royal Mail and Parcelforce but failed to implement that set of proposals.[8] Although it continued to believe that privatisation remained the best way forward, it had no means of delivering this given the small size of its parliamentary majority. The development of a new framework therefore needed to wait until after the general election of May 1997 and the change of government at that time led to the start of a further attempt to address the situation.

Developments in the UK towards a new regulatory framework

Labour's election manifesto contained the following commitment:

[6] The Nationalised Industries, Cmnd 7131, 1978.
[7] The House of Commons Trade and Industry Committee noted: "*It has long been accepted as a maxim that the status quo is not an option for the Post Office*", Third Report, The Post Office, HC380 14 January 1998, pviii.
[8] Blakemore J and Rodriguez F (1996), Regulatory Developments and the UK Postal Sector 1995/96, CRI Regulatory Review 1996, chapter 5, pp55-71, University of Bath.

> "We will ensure that self- financing commercial organisations within the public sector - the Post Office is a prime example - are given greater commercial freedom to make the most of new opportunities".[9]

To that effect, Ian McCartney, the newly appointed DTI Minister with responsibility for the Post Office, announced on 16 May a review to establish ways in which to achieve this. He also suspended at the same time the Post Office Counters franchising programme then underway until the completion of the review. It is worth recalling that the main areas in which the Post Office has been seeking commercial freedom are the following:[10]

- participation in strategic joint ventures and investment in companies in the UK and abroad;
- raising external finance;
- introduction of a predictable commercial dividend policy;
- freedom to price in competitive areas, with a price cap on monopoly areas;
- freedom to develop rewards and incentives for employees.

Some limited progress had been made prior to 1997/98, for example, through the £30m roll forward provision on the EFL and investment in companies overseas, such as Royal Mail US Inc.

The government embarked on an extensive consultation exercise which was completed in November. By January, when the Trade and Industry Select Committee published its report on the Post

[9] The Labour Party (1997), The Labour Party Manifesto, New Labour: Because Britain Deserves Better.
[10] Trade and Industry Committee Third Report, The Post Office, HC380 14 January 1998, px.

Office, no announcements had been made to Parliament. As the Trade and Industry Select Committee noted, with some frustration:

> "It has been a slow process so far..........We are surprised that it should have taken the DTI so long to conduct yet another consultation exercise, following that conducted between 1992 and 1994 by the previous government".[11]

Finally, in April, through its 'observations' on the Select Committee's report, the government set out the issues that had arisen during the consultation process and its proposed way forward.[12] It also responded to the Select Committee's recommendations. The 'observations' covered two key areas - the announcement of a further review to consider the Post Office's 'future organisation, structure and financing' and an extension to domestic markets of the current limited freedoms to undertake joint ventures internationally.

As this phase of the review may prove decisive, the full terms of reference for it are reported in **Table 3**. The context and the parameters within which it will undertake its task are set out clearly in the preamble. The Post Office will remain in the public sector although the options being reviewed include a minority share sale along with a modestly amended status quo, a public trust and an independent publicly-owned company (IPOC). At the same time, there is a very clear and explicit reaffirmation of the new government's commitment to the 'non-negotiables' of a universal postal service at a uniform price and a nationwide network of post offices. There appears to be greater urgency about this phase of the review and a new review team was set up involving outside consultants. This reported its findings privately

[11] Trade and Industry Committee Third Report, The Post Office, HC380 14 January 1998, pviii.
[12] The Trade and Industry Committee, Fifth Special Report: Government Observations on the Third Report from the Committee (session 1997-98) on The Post Office. (HC684) 8 April 1998.

to government during the summer which is now deliberating and hopes to announce its proposals this autumn.

Table 3: Terms of reference for next phase of Post Office Review - summer/autumn 1998

> "The government are committed to The Post Office remaining in the public sector and continuing to provide a universal postal service at a uniform tariff and a nationwide network of post offices. Against that background, the review will make recommendations on the Post Office's future organisation, structure and financing that will best deliver:
>
> - greater commercial freedom to enable it to compete effectively in the UK and overseas and;
> - improved efficiency, effectiveness and service standards.
>
> The review is to take account of the ways in which overseas competitors and analogous organisations are facing, or being set up to face, the challenges of the changing market, and to consider in particular:
>
> - a range of options for partnership with the private sector (such as joint ventures) and for the involvement of employees and customers;
> - how best to ensure fair competition in postal services;
> - the role of Post Office Counters in the delivery of government services, and;
> - the Crown Office conversion programme.
>
> The government hopes to announce its proposals in the autumn."

Source: The Trade and Industry Committee, Fifth Special Report: Government Observations on the Third Report from the Committee (session 1997-98) on The Post Office. (HC684) 8 April 1998

Many of the key areas that the review will attempt to cover were addressed by the Trade and Industry Select Committee in their hearings and most of their recommendations will be examined. These provide a useful check list of the main issues associated with the development of the new regulatory environment in the UK. The principal recommendations from the Select Committee's report include the following:

- the Select Committee highlights the need for "*radical structural reform*" and favours the conversion of the Post Office into an IPOC. This would pay a commercial dividend to the Treasury (40% of profit is suggested and would replace the current EFL mechanism) with Articles of Association and an independent regulator;

- there should be a detailed scheme for regulation to replace the existing system involving the DTI, possibly along the lines of that in place for the privatised utilities. This is seen as the *quid pro quo* for greater commercial freedom and should tackle issues of competition in the postal sector;

- the Committee favours no change to the coverage of monopoly other than the marginal amendment necessary to accommodate the EU Directive. Mirroring developments from the European Postal Directive, there should be greater transparency in financial reporting and an "*ever more rigorous distinction*" between the reserved (monopoly) area and non-reserved area;

- the critical role of the pace of change in postal markets, growing competition and prospects for liberalisation and the need to create conditions where the Post Office can compete in the global market for postal services;

- the importance of maintaining a nationwide network of post offices as well as explicitly addressing the future status of Parcelforce Worldwide;

- the importance of improving industrial relations if the benefits of increased commercial freedom are to be secured.

At the time of announcing the terms of reference for the next phase of the review, the government also stated that some leeway would be permitted on joint ventures, alliances and partnerships (collectively referred to as partnerships) in domestic markets. The guidelines for these require that developments should be in markets related to the core business of the Post Office and be financially viable in their own right. While they need to be funded from internally generated funds, this must not be at the expense of improvements to the core business.

The European Postal Directive and Notice[13]

While domestic reform of the UK's postal markets has been subject to government review, the European Commission's programme for reform of European postal markets completed its initial phase with the publication by early 1998 of a directive and Notice on European postal markets. Member states have one year from the date of publication to implement European directives into domestic legislation. It is expected that the directive will be implemented into UK law by February 1999, probably by means of a statutory instrument rather than primary legislation.

The Directive on Common Rules for the Development of the Internal Market of Community Postal Services and the Improvement of Quality of Service (to give it its full title) was adopted on 15 December 1997. [14] It came at the end of a long period of consultation, preparation, discussion and compromise dating back to the late 1980s and included in its development the publication of the Green Paper on postal services in 1992. Given its importance as a landmark in the development of the regulatory framework for postal services, not only in the UK, but also the

[13] For a summary overview of the European reform and relevant case law see Blum F and Logue A (1998), Competition and Exclusive Rights in the Postal Sector, in State Monopolies under EC Law, Willey, 1998.
[14] Directive 97/67/EC of the European Parliament and 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 of European Communities, L15/14 1.1.1998.

European Union as a whole, a listing of the chapters and main provisions of the directive is set out in **Table 4**.

The direct implications of the directive are relatively modest as most of its requirements are already fully met by the UK. The benchmark level of universal service set out in chapter 2 of the directive is below that in operation today in the UK although it is more explicitly set out than in current legislation. The £1 letter monopoly will need to be amended slightly because, although this is below five times the basic weight step of the fastest category of public tariff mail, it is a little above the present 350gm price (see summary of Chapter 3 in Table 4). The principles on tariffs are met by the UK as are the requirements on quality of services.

Table 4: Main Provisions of the EU Postal Directive, December 1997

Chapter 1: Objective and Scope

Chapter 2: Universal Service

- Definition of universal service includes a collection and delivery every working day to every "natural or legal" person covering postal items up to 2kgs, postal packages up to 20kgs and registered/insured items

Chapter 3: Harmonisation of the Services which may be Reserved

- A reserved area (monopoly) allowed "to the extent necessary to ensure the maintenance of universal service"

- This reserved area to cover "the clearance, sorting, transport and delivery of items of domestic correspondence...... the price of which is less than five times the public tariff for an item of correspondence in the first weight step of the fastest category.... provided they weigh less than 350gms". Cross-border and direct mail can be included in the reserved area by Member States.

- European Parliament and the Council to decide not later than 1 January 2000 on "further gradual and controlled liberalisation of the postal market from 1 January 2003" - in particular, around cross-border and direct mail and lowering of price and weight limits. These decisions to be based on proposals from the Commission before the end of 1998 based on a review of the sector.

Chapter 4: Conditions Governing the Provision of Non-reserved Services and Access to the Network

- Member States may if they wish subject postal operators operating outside the reserved area to a system of authorisation before they start providing services

- Permitted postal operators will have to meet 'essential requirements' defined in the directive (such as observance of confidentiality of correspondence, maintenance of secure network free from dangerous goods) and contribute, in appropriate cases, to the provision of the universal service

- Member States may also ask all postal operators in the universal sector to contribute to a compensation fund which would help ensure the provision of a universal service

Chapter 5: Tariff Principles and Transparency of Accounts

- Prices must be affordable, geared to cost, transparent and non-discriminatory

- Member States may require a uniform tariff but this is not compulsory

- Tariffs (terminal dues) for intra-Community cross-border mail to be cost based and related to quality of service achieved

- Internal accounting systems to capture separate accounts for each of the services in the reserved area and separately non-reserved services as a group. The directive's favoured procedure for allocation of common costs amounts to use of fully distributed cost algorithm but the national regulatory authority may approve an alternative

- These accounting procedures to come into effect within two years of the directive coming into force and are subject to independent verification

- On request, accounting information from these systems shall be made available, in confidence, to the national regulatory authority and Commission. Published accounts should be in line with general legislation for commercial undertakings

Chapter 6: Quality of Services

- Member States to set and publish quality of service standards of good quality with independent monitoring at least once a year

- Standards for intra-Community cross-border mail shall be set by European Parliament and Council and detail is set out in the directive

Chapter 7: Harmonisation of Technical Standards

- The directive provides for the harmonisation of technical standards in accordance with the interests of users with the European Committee on Standardisation (CEN) mandated to establish technical standards for the postal sector.

Chapter 8: The Committee

- The directive provides for an advisory committee comprising of representatives from Member States under the chairmanship of the Commission to deliver an opinion on proposals from the Commission

Chapter 9: National Regulatory Authority

- Each Member State to have one (or more) national regulatory authority separated from universal service provider to ensure compliance with the directive and possibly, more widely, competition rules in the postal sector

Chapter 10: Final Provisions

Source: Directive 97/67/EC of the European Parliament and the Council of 15 December 1997 on the common rules for the development of the internal market of community postal services and improvement of quality of service, Official Journal of European Communities, L15/14 1.1.1998.

The directive sets out in some detail requirements on the transparency of accounts, although much of this focuses on internal accounting systems rather than those that are to be published or information to be made generally available. The Commission and the national regulatory authority, which must (as is already the case in the UK through the DTI) be separate from the universal service provider, can have access on a confidential basis to detailed cost information on reserved or monopoly services. The directive requires full allocation of common costs across services for these internal accounting procedures, although it is generally understood that such rules are arbitrary and the interpretation of calculations produced in this way subject to considerable debate.

In some ways, the most significant part of the directive is Chapter 3 on reserved services. This recognises the principle that the monopoly exists to fund the universal service and defines the area in terms of price subject to a weight constraint. The definition of the monopoly is cast widely and Member States may, if they wish, include both cross-border and direct mail within the reserved area. The coverage of the monopoly or the necessary extent of the reserved area to meet requirements of the universal service has been a highly contentious issue. It has proved difficult to gain agreement between regulators, postal administrations, private operators and consumers on how to strike the appropriate balance between the meeting of social obligations by postal administrations and gaining the benefits of greater competition. The directive effectively side-steps the issue by setting in place a process for further review of the whole question.

The first stage of this got under way before the directive was adopted. Chapter 3 states that the Commission is required to bring forward proposals for the liberalisation of postal markets by the end of 1998. This will allow the European Parliament and Council to decide not later than 1 January 2000 on "*further gradual and controlled liberalisation of the postal market from 1 January 2003*". The Commission, therefore, prepared the ground for this during 1997 by commissioning a number of studies to be undertaken by consultants this year.[15]

The first of these is attempting to estimate the cost of the universal service obligation in each member state as well as reviewing alternative ways of financing it. This is being followed by five other studies which seek to identify and quantify the impacts of the liberalisation scenarios being examined by the Commission. They will cover the liberalisation of direct mail and of cross-border mail, reduction of weight and price limits for the reserved area and liberalisation of clearance, sorting and transport or effectively a monopoly over delivery only. The fifth study will attempt to draw together these strands through modelling and quantification of the impact of these possible liberalisations.

The Commission intends that together these studies will provide the basis for evaluations of the financial viability of universal service provision under any liberalisation scenario. This lies at the heart of the question of the extent to which postal liberalisation should take place, for the Commission's proposals

[15] The European Commission, Open Call for Tenders for a set of studies on the impact of liberalisation in the postal sector. Official Journal of the European Communities Supplement 13 September 1997, 97/S178-113516.

need to allow for a reserved area "*to the extent necessary to ensure the maintenance of universal service*" or identify an alternative method of financing. The cost of providing universal service clearly could be met by differentiating prices and offering this to senders for certain types of mail and destinations only at very high tariffs. However, nearly all countries in the EU currently hold that there should be universal postal service at a uniform price - not least the UK which recently, as noted above, has reaffirmed this position quite unambiguously. The central issue, therefore, is much more about the cost of meeting the universal service **obligation** under various possible forms of liberalisation where the obligation in posts is widely held to embody the uniform price constraint in addition to the level of service itself.[16]

In addition to the directive the Commission also published at the beginning of 1998 a Notice on the Application of the Competition Rules to the Postal Sector and on the Assessment of Certain State Measures Relating to Postal Service.[17] The Notice was intended to be complementary to the directive and set out how the Commission would apply competition rules in the Treaty of Rome, in particular Article 85, Article 86 and Article 90, to the postal sector. The Notice is not legally binding but is influential as it is the Commission's opinion as to how the rules will be applied.

The Notice indicates when state measures or the actions of postal administrations might infringe the competition rules. The Notice, the main points of which are summarised very briefly in **Table 5**, sets out:

[16] Rodriguez F, Smith S and Storer D (1998), Estimating the Cost of the Universal Service Obligation in Posts. Paper presented to Sixth Conference on Postal and Delivery Economics: Emerging Competition in the Postal and Delivery Sectors, Montreux, Switzerland.
[17] The European Commission, Notice from the Commission on the Application of the Competition Rules to the Postal Sector and on the Assessment of Certain State Measures Relating to Postal Service, Official Journal of European Communities, C39 6.1.98.

- the way the Commission will approach the issue of market definition (a crucial exercise in competition law cases) in the postal sector;
- what may constitute abuse of a dominant position;
- the extent to which the Article 90(2) exemption from the application of Treaty rules for services of general economic interest may be applied to the postal sector.

The Notice makes it clear that, whether acting on its own initiative or upon complaint, the Commission will consider the application of competition rules on a case by case basis and that the extent of any monopoly protection is conditional on the extent to which it is necessary in order to support the universal service obligation. Although such a case by case approach has some merits, it is not clear that this type of approach will meet one of the Notice's objectives of bringing clarity and legal certainty to the application of the competition rules to the postal sector. The differing market conditions and service obligations in each member state mean principles of precedent may not be successfully applied from one case to another.

Further potential for uncertainty arises from inconsistencies between the Notice and directive. These are less marked in the final published versions than in earlier drafts but the issue of the uniform tariff again comes to the fore. While the directive states that member states may require a uniform price, the Notice's approach to access pricing may be inconsistent with this. As noted above, the uniform tariff is a 'non negotiable' UK government service commitment and common practice across European postal administrations. However, the statement in the Notice that third parties can choose from available access points to the public postal network "*at price conditions based on costs, that take into account the actual services required*" may infer geographic pricing. The sustainability of the uniform price depends critically upon the overall approach to access pricing followed by the regulatory authority and whether this is along the lines of a price at a discount from the public tariff or a charge reflecting only the costs of a particular component of the service such as delivery.

While work sharing discounts, which are already offered widely by Royal Mail, would be consistent with maintenance of the uniform tariff, 'bottom-up' pricing would not and instead would tend to encourage locally differentiated pricing. [18]

[18] Agay S and Reay I (1999), Postal Pipeline Liberalisation: The Beginning of the End for the Uniform tariff?, in Emerging Competition in Postal and Delivery Services, edited by Crew M A and Kleindorfer P R, Boston, Kluwer (forthcoming).

Table 5: The main points of the European Commission Notice on the Postal Sector, January 1998

Preface

- Definition of terms

Market Definition

- The Commission considers Member States form separate geographical markets with regard to the delivery of domestic mail and the domestic delivery of inward international mail
- The Commission identifies a number of separate product markets including the general letter service, direct mail, the express mail market, document exchange market and the market for new services
- The Commission also considers the general letter service consists of activities which may constitute separate markets, i.e. collection, sorting, transport and delivery

Abuses of a Dominant Position

- The Commission highlights behaviour which it believes may constitute abuse of a dominant position. This includes provision of an inefficient service and failing to take advantage of technical developments, unfair cross subsidy from the reserved to non reserved sector, predatory pricing, refusal or discriminatory granting of network access and illegal state aids.

Services of General Economic Interest

- The Commission recognises that Art 90(2) of the Treaty of Rome allows an exception from the Treaty rules where their application obstructs in law or in fact, the performance of the particular task assigned to the operator for the provision of a service of a general economic interest (in this case the universal service obligation). The Notice states that the Commission will consider whether the postal monopoly falls within this exemption on a case by case basis. The level of reservation set by the directive is conditional to the extent that it is necessary to support the universal service obligation.

Source: Notice from the Commission on the application of the competition rules to the postal sector and on the assessment of certain state measures relating to postal service. Official Journal of European Communities, C39 6.1.98.

Concluding comments and issues for 1998/99

While 1996/97 saw relatively few developments in terms of the regulatory framework for posts and 1997/98 has been largely a year of review, the position at the end of the year saw a number of important developments in train. The next stage of the Post Office Review appears to have more urgency about it and although the government only "*hopes to announce its proposals in the Autumn*", after years of drift and uncertainty, it will be under pressure to deliver more than the *status quo* or the promise of a further review in 1999. As the Trade and Industry Select Committee pointed out, the form and structure of the regulatory arrangements will be a central issue that will need to be tackled decisively. In Europe, the Postal Directive requires the Commission to bring forward proposals for further liberalisation of postal markets in the light of the analysis provided by its studies and review of the postal sector. It states that this will be followed by action by the European Parliament and Council within a further year.

The rapid pace of change in the communication and distribution markets, both nationally and globally, the ease of entry into postal markets and the government's commitment to increased commercial freedom for the Post Office, make the design of a new regulatory regime suitable for the millennium challenging. The benefits of liberalisation through the prospect of lower prices and extended choice for some customers need to be weighed against the requirements of universal service at a uniform price (the universal service obligation) and the maintenance of a nationwide network of post offices. The government's task is to build that framework and the prospects of the outlines of this appearing during 1998/99 are higher than for many years.

3 POSTAL REGULATION 1999/2000

Ian Reay

Introduction

This millennium year is a suitable moment to reflect on the fact that the Post Office has a history of continuous existence dating back to its establishment in 1635.[1] In 1657 the state postal monopoly was affirmed by an Act of Parliament, although a statutory privilege on the delivery of letters had been asserted in 1591 by a royal proclamation for foreign mail and by a further proclamation, in 1609, for inland mail. Although the original justification for the statutory privilege, the suppressing of treason and sedition, seems archaic now, the letter monopoly has been reaffirmed in all subsequent legislation relating to the powers of the Post Office. In recent decades, however, the need for this monopoly has been increasingly questioned and its scope has been, and is continuing to be, reduced but, at the end of the 20th century, the Post Office remains the only major United Kingdom business still in public ownership.

During the 19th century the Post Office underwent significant change, beginning with the publication of Post Office Reform by Sir Rowland Hill in 1837. In this pamphlet Rowland Hill proposed a uniform price for postage between post towns throughout the United Kingdom. He also proposed that post

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[1] Daunton M J (1985), Royal Mail: The Post Office since 1840, Athlone Press, London.

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should be pre-paid and not, as was previously possible, paid for by the recipient. At the time of this pamphlet the Post Office was in serious need of reform and over the ensuing decades much change occurred, including, for example, the placing of pillar boxes in streets - an invention of Anthony Trollope who is more famous for his novels than his postal career. In 1840 the Penny Post was introduced. As well as being a geographically uniform price, as proposed by Rowland Hill, this was a substantial price cut and led rapidly to a significant increase in the number of letters carried by the Post Office. During the year 1839, 75.9 million letters were posted, whereas in 1840 this had risen to 168.8 million. In the subsequent years of the 19th century the Post Office was involved in the debate about the management of the emerging public utilities and gained control of telegraphs and telephones.

In the 20th century, postal reform returned with the 1969 Post Office Act which established the Post Office as a publicly owned statutory corporation. Since the election of the Conservative administration in 1979 there has been an almost continuous process of evaluation of the postal service. The first reform was the splitting of the Post Office into separate telecommunications and postal businesses in the 1981 British Telecommunications Act. In that year also the letter monopoly was limited to the delivery of letters at a price below £1. The letter post operations were reviewed in both 1979 and 1984 by the Monopolies and Mergers Commission, and on both occasions the principle of the letter monopoly was supported, justified by the requirement on the Post Office to provide a universal service at a uniform and affordable tariff.

In 1986 the Post Office was reorganised into five businesses: Royal Mail, Parcelforce, Post Office Counters, Girobank (the Post Office's banking operation) and Subscription Services (TV Licensing). The Girobank was sold in 1989. In 1992 a review of the postal service was announced, with the ultimate objective of privatisation, but this came to nothing after it became clear that the Secretary of State, Michael Heseltine, would be unable to obtain enough support from Conservative backbenchers. Soon after the General Election in 1997 the incoming Labour government announced another review of the postal sector and the outcome of that exercise is the main subject of this chapter.

Although in 1969, when the Post Office was formed into a public corporation, the United Kingdom was leading the world in postal reform, the subsequent pace of change has been slow and this has led to the situation in which reform has now progressed much farther in other parts of the world than it has in the UK. Consequently, pressure for change is now being exerted on the government by the European Union. The progress of the development of postal policy by the EU is another important theme to be discussed in this chapter.

The key problem which has to be solved by current moves towards postal reform, both in the United Kingdom and overseas, is how to balance the need to allow greater competition in the postal sector, which is being brought about by the relentless development of technology and process of globalisation, with the government's social requirement for the provision of a nation-wide universal service at a geographically uniform and affordable price.

The White Paper

The formal review process instigated by the new government in 1997 ended with a statement in Parliament in December 1998 which presented an outline package of reforms designed to respond to the increasingly competitive situation in which the Post Office was now operating, and to allow the Post Office greater commercial freedom. This was heralded as 'the most radical set of reforms since the modern Post Office was created in 1969'. The details of the proposals did not appear until July 1999 when the government White Paper was published.[2]

The White Paper listed the following five objectives for the reform of postal services:

- to improve postal services for business and domestic customers through greater choice, better quality and falling real prices;
- to maintain a universal service of postal delivery throughout the UK, and a uniform tariff;
- to establish clear and accountable relationships between the government, the Post Office, the Regulator and POUNC (The Post Office Users' National Council);
- to equip the Post Office to meet the challenges of the changing postal market both domestically and internationally;
- to support a viable network of post offices so as to ensure nation-wide access to a range of public and private sector services.

Among the main elements of the government's proposals as set out in the White Paper were, first, that the Post Office would be formed as an independent, publicly owned corporation under the Companies Act, with the government as sole shareholder. Any sale of shares in the Post Office would require new legislation, except in the case of a share swap or sale that was part of a commercial venture or partnership approved by Parliament. The involvement of the government would be restricted to the strategic level and to setting social and environmental objectives. Each year the Post Office would agree its five year rolling strategic plan with the government.

[2] Post Office Reform: A World Class Service for the 21st Century, July 1999, Cm 4340.

Second, an independent postal regulator was to be established. The primary duties of the regulator would be to promote competition, set quality of service standards, regulate prices and ensure that the Post Office is able to provide the universal service at a uniform tariff. In consultation with POUNC, the regulator would also monitor the Post Office's performance against the established service standards and performance targets and impose penalties for failure to meet them. The White Paper also addressed the growing concern about the viability of rural post offices in the light of an accelerating programme of closures, and the regulator was to be given the task, in consultation with POUNC, of monitoring the network of offices within criteria provided by the government.

Third, competition was to be extended by liberalising the postal market. In fact, the White Paper proposed an immediate reduction of the price threshold of the letter monopoly to 50 pence (down from the £1 limit in force since 1981). The government was dissuaded from taking this course after pressure from the postal workers' Trade Union at the Labour Party conference later in the year, and in response to a report from the Trade and Industry Select Committee recommending that the new regulator be asked to look at this issue. As a result the regulator was given the task of advising the government on the scope of the letter monopoly as an initial task.

Finally, The Post Office was to have greater freedom to operate commercially in its markets. The financial demands of the government will be limited to receiving a commercial dividend payment - 50% of post tax profits in 1999/2000 and 40% of such profits thereafter - subject to a cash floor. The Post Office will be allowed to borrow to make investments and for acquisitions, joint ventures, alliances and partnerships up to a limit of £75 million each year. For investments beyond this limit, approval of ministers will be required.

A new Postal Services Bill was given its first reading in Parliament in January 2000 and received Royal Assent in July.[3] This enacted the proposals set out in the White Paper and defined
the regulatory regime, and the financial framework within which the Post Office would operate. The Postal Services Commission was created which would have the power to issue licences in the regulated area (the monopoly), including that for the Post Office itself. POUNC is strengthened and renamed as the Consumer Council for Postal Services (CCPS) with a special focus on consumer protection.

The Postal Services Commission

The Post Services Commission (PostComm) does not follow the previous model of regulation of privatised public utilities in the United Kingdom and has a structure which would have been unique in the UK in that it does not have a single, responsible individual with wide powers to regulate the industry but, instead, relies on a commission of seven people: five part-time Commissioners, a part-time chairman and the chief executive (the Utilities Act 2000 introduced the Gas and Electricity Markets Authority to replace the Director Generals for Electricity and Gas Supply). This more closely resembles the regulatory structure that is often to be found in the regulation of public utilities in the USA. Formally, PostComm (as it is now known) came into existence in April 2000 but the chairman and commissioners were not all appointed until July. The new chairman is Graham Corbett, previously deputy chairman of the Competition Commission, and the new chief executive is Martin Stanley, a career civil servant. It was originally conceived that PostComm would have a staff of about 50 people, although it will take some time for the staffing level to build up to this complement.

[3] Postal Services Act 2000, The Stationery Office.

Among the first tasks of the new postal regulator will be to:

- agree a licence within the terms of which Post Office plc will continue to operate after April 2001;

- advise the government on the scope of the letter monopoly;

- put in place a price control regime, which will almost certainly be based on a version of the familiar RPI-X formula used by other sector regulators.

The Post Office licence is expected to contain, amongst other things, conditions on standards of performance, compensation arrangements, complaint handling, price control, regulatory accounting practices, access to postal facilities by users and third parties and prevention of monopoly abuse.

This is the first time in this country that an independent regulator has been instituted to regulate a wholly publicly owned company. Many new issues concerning the relationship between the independent regulator and the government as a shareholder, when the government is also responsible for setting the social and environmental framework, will be certain to arise. Also, the enhanced role and powers of the consumer body, the CCPS, implies that early work by PostComm involves arriving at an agreement on the method of working between PostComm and CCPS, to be expressed through a memorandum of understanding.

A draft of this memorandum, agreed between PostComm and CCPS, was published for consultation in early November. It suggests that CCPS would propose service quality targets and complaint handling standards to PostComm. It should also propose systems for monitoring performance against these targets and standards, and for reporting on performance against them to PostComm. PostComm will have the role of deciding on the targets, standards and monitoring systems. CCPS also has the role of monitoring and advising on the size and make up of the

Post Office counters network, with the power to make recommendations on the provision in rural areas.

In October 2000, PostComm published two consultation documents. One of these was on the licensing regime for postal services. The second was on the subject of promoting effective competition between postal operators. Although PostComm has made some public statements which may be interpreted as questioning the need for a monopoly in letter delivery, it is not expected that firm recommendations on liberalisation will be made before July 2001.

Liberalisation of the postal market

Throughout 1998 and 1999 there was a vigorous debate at the European level on the scope of postal monopolies across the European Union. This debate was triggered by the requirements set out in the 1997 directive on postal services (97/67/CE) which required the Commission to bring forward proposals by the end of 1998 on further gradual and controlled liberalisation of the postal market from January 2003.[4] The studies that the European Commission put in train to study different liberalisation options were not all completed and placed in the public domain until March 1999.[5] During that same month the entire College of Commissioners resigned amid allegations of corruption and mismanagement, and no new legislative proposals could emerge

[4] Official Journal of the European Communities, 21/01/98, No L15/14, Directive No 97/67/EC of the European Parliament and of the Council on common rules for the development of the internal market of Community postal services and the improvement of quality of service.

[5] Arthur Andersen (1998), Study on the Impact of Liberalisation in the Postal Sector, Lot 1: Direct Mail, November; CTcon (1998a), On the Liberalisation of Clearance, Sorting and Transport, December; CTcon (1998b), Study on the Weight and Price Limits of the Reserved Area in the Postal Sector, November; NERA (1998), Costing and Financing of Universal Services in the Postal Sector in the European Union, November; PriceWaterhouseCoopers (1998), The Impact of Liberalisation on Cross-Border Mail, December.

until the new Commission had been approved by the European Parliament and put in place. As a result the Commission did not agree proposals for a new postal services directive until May 2000. These proposals were put in the public domain in June although formal publication occurred some months later.

The Commission proposed that the scope of letter monopolies should be reduced by lowering the weight threshold to 50 grams (from the 350 grams limit specified in the 1997 Directive) and the price threshold to two and one half times the basic letter price (previously set at five times). The letter monopoly to be defined in this way is referred to as ‘the reserved area’. It also proposed that outgoing cross-border mail should be fully liberalised but that incoming cross-border mail, within the weight and price limits, should be left within the reserved area. No firm date for full liberalisation was quoted but the next phase of liberalisation is scheduled to take place on 1 Jan 2007 following a further review of the sector. The explanatory memorandum accompanying the proposals contained an estimate that 16% of the postal market would become subject to competition in 2003 as a result of these measures.

The Commission proposals introduce a new category of ‘special services’, including express services, which would be outside the reserved area, regardless of their weight and price. However, with the wording contained in the Commission’s initial draft, this would, in practice, make it impossible in any dispute to provide legal certainty as to the boundaries of the reserved area.

These proposals will now have to be agreed by the European Parliament and the Council of Ministers through a co-decision procedure. It is expected that this process will result in some modifications of the proposals before agreement is reached. The Commission’s draft proposals are more radical than the original extent of liberalisation suggested by the UK government in the 1999 White Paper, from which they later withdrew. The government will take into account advice from PostComm in taking a position on the new postal services directive at the

Council of Ministers, although the pace of development in Brussels may mean that PostComm's advice, if it comes as late as July 2001, may be too late to influence the European wide decision.

Access to the postal pipeline is an issue which has been widely discussed at the Community level but without any Community wide policy on access being agreed. No statements on access were included in the 1997 postal Directive, but the European Commission did publish a Notice, early in 1998, which, amongst other things, laid down the Commission's view on non-discriminatory access to the postal network and the regulatory safeguards required to ensure fair competition in the sector.[6] The Notice requires that intermediaries, including operators from other member states, should be able to choose from amongst available access points and obtain access at prices "*based on costs*". In the preparation for the current draft amending the 1997 Directive, the Commission reviewed the possibility of liberalising upstream activities in the postal pipeline but, in the end, did not make any provisions. The draft text does, however, clarify the statement on access pricing in the Notice to the extent that it states that the tariffs for access to the postal pipeline should take account of the "*avoided costs compared to the standard service covering the complete range of features*".

The financial regime

The system of financial control which has been the method by which the government has controlled the Post Office in the past has been through setting, on a three year rolling basis, the allowed return of capital employed (ROCE), a real unit costs

[6] Notice from the Commission on the application of the competition rules to the postal sector and on the assessment of certain State measures relating to postal services. (98/C39/02). See Chapter 4 of the CRI Regulatory Review 1998-99, The Postal Sector 1997-98, by Andrew Forbes and Frank Rodriguez, for a brief description of the Notice and the difference in status between a Notice and a Directive.

(RUC) target and an external finance limit (EFL). In the financial control of nationalised industries in the past the EFL limit was intended as a limit on the borrowing allowed. In the case of the Post Office, however, this has been a ‘negative’ EFL which has instead been used as a means of drawing cash from the business, and accounted for as long terms loans to the government. The replacement of this complex and often inconsistent system with a combination of a dividend payment to the government, based on a fixed proportion of post-tax profits, together with a price control regime based on RPI-X, will undoubtedly produce improvements in the strategic management of the Post Office, even though there will still be a requirement to obtain government agreement for investments above £75m a year. The provision for a dividend to the government during the year 1999-2000 is set at £151m.

During the financial year 1999-2000 the Post Office made its first full year loss for 23 years. This was due to a £571m write down of investment in the Horizon programme. This is a project to automate all post office counters throughout the country. The write down was caused by the fact that the original purpose of the investment was rendered unnecessary because of the government’s decision to make Benefits Agency payments directly into recipients’ bank accounts after 2003. The current method of paying them is through post office counters. This will reduce the revenues of the Post Office counters network by approximately 35% each year after 2003. Attempts to compensate for this loss by the forming of a ‘universal bank’ in co-operation with high street retail banks have yet to produce results. Consequently, at the present time, it appears that the continuation of the nationwide counters network at the level required to meet the government’s social objectives may only be feasible with the help of an explicit subsidy.

Future challenges for the Post Office

The major challenge faced by the Post Office at the beginning of the 21st century is to provide all customers with a universal, efficient and reliable service at a uniform and affordable price, irrespective of where they happen to live or work, whilst at the same time responding to further competition in the sector. The introduction of competition in the postal market is expected to produce benefits in efficiency, service quality and cost reduction, leading to reductions in price and increases in choice for all classes of customers. However, there is a fundamental conflict between a requirement to provide a universal service at a uniform and affordable price and the introduction of competition. This conflict needs to be addressed. The Post Office supports the view that competition can bring benefits and has long maintained a pro-liberal stance. Competition is an opportunity; it can catalyse change and increase efficiency and productivity. However, the introduction of competition should be achieved in a gradual and controlled way to ensure that the universal service is not jeopardised (see bibliography of critiques at page 52).

Liberalisation of the postal market is being proposed at the same time as the market is being transformed in an unprecedented way by technological changes that are also affecting the wider economy. Companies and institutions are under pressure to increase their use of electronic communications. E-commerce and e-billing are increasingly being used as substitutes for physical mail. A substantial proportion of households will have Internet access by 2005 (predicted to be 60% in the UK). This transformation of the marketplace will lead to organisations having to change the way they do business.

A consequence of this will be, however, that those members of the public who are unable to participate in these new developments will become increasingly excluded. A key role played by the Post Office is that it provides access to the public. The nation-wide counter network provides a unique face to face contact point for customers and plays a valuable role in the community where it offers a vital service, particularly to the less mobile. It has always been a 'gateway' to government Departments: for example, the Benefits Agency, the Passport Agency, the Driver and Vehicle Licence Agencies and National Savings. However, there is a major unresolved issue over the viability of the network in the UK with the loss of Benefits Agency business after 2003, and the Post Office will be challenged to find creative ways to sustain this network in a way that is commercially viable. This is of particular importance for rural communities, where services are degrading as a result of the decline of agriculture, and for the elderly and socially deprived who are unable to take advantage of the new electronic forms of communication.

The Post Office is reacting to the challenge of new developments in the economy by seeking new and innovative ways of meeting important obligations to provide universal service and access to all members of the community. This involves not just cutting the costs of delivery but also developing new ideas that take full advantage of the opportunities provided by the new technology. Nevertheless, the introduction of competition, whilst at the same time imposing the obligation to provide universal service at a uniform tariff, could severely damage the ability of the Post Office to make the profit level required to maintain a viable business.

It remains to be seen how the new regulatory bodies rise to this challenge. The five newly appointed Commissioners have a wide range of backgrounds, with varied business, trade union and social interests. It may be expected that they will take a broad view of their responsibilities, taking account of both the economic and social objectives of postal policy.

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4 POSTAL REGULATION 2000-2002

Roger Louth and Tasneem Azad

Introduction

In 2000 the Postal Services Act established Postcomm as an independent regulator, triggering unprecedented changes in the UK postal market.[1] This has led Postcomm to take forward a comprehensive programme of research, analysis and consultation leading to a public commitment to the full opening of the market, following over 350 years of statutory protection of Royal Mail's letter service. This chapter sets out Postcomm's rationale for this significant reform and the future regulatory challenges that Postcomm faces.

Postcomm's role and remit

The starting point is to be found in the 1997 European Postal Services Directive which took the first steps in the wider process of liberalising postal services throughout the European Union. The Postal Services Act, which implements that directive in the UK, gives Postcomm a number of powers – for example to license postal operators. Postcomm, like other UK economic regulators, is subject to a hierarchy of statutory duties which it

[1] The act also transformed the incumbent postal operator, Royal Mail, from a public corporation to a public limited company whose sole shareholder is the government.

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Roger Louth at the time was Director, Competition, and Tasneem Azad, Deputy Director, Competition, Postal Services Commission (Postcomm)

must follow in carrying out its functions. Postcomm's primary duty is to act in a manner which it considers is best calculated to ensure the provision of a universal postal service service at an affordable, geographically uniform tariff. Subject to this duty, Postcomm is charged with furthering the interests of postal users, wherever appropriate by promoting effective competition in UK postal services. Postcomm has a further duty to promote efficiency and economy on the part of postal operators and, in carrying out its functions, must have regard to the need to ensure that licence holders are able to finance their activities.

In carrying out its work, Postcomm has a vision of 'a range of reliable, innovative and efficient postal services, including a universal service, valued by customers and delivered through a competitive market'.

Inherent conflict between duties?

Conventional wisdom suggests that there is an inherent conflict between Postcomm's duties, in particular between the continued provision of a uniformally priced universal postal service and the promotion of effective competition. The traditional argument for the national operator having monopoly privileges has been that they were necessary to support the universal service. Historically, postal policy in most countries has assumed that competition would erode the profits that a universal service provider needed to support its loss-making universal services. Competition was seen as a threat to the national incumbent's business and its continued provision of a universal service.

Postcomm's initial programme of work involved a rigorous examination of this traditional justification for the maintenance of Royal Mail's monopoly in the UK, against the background of a number of important developments.

Changing postal market

The postal market has grown over time – normally at a rate higher than the general rate of economic growth – although there has been some lessening of growth rates in recent years. The market itself, however, is changing. Changing customer demands (86% of mail is now sent by businesses), growing use of alternative technologies by customers (such as email), the increased automation of the postal process, and a general move internationally towards opening up postal markets to competition, are all affecting the dynamics of traditional mail markets. Such pressures will require postal operators to be more innovative and flexible, providing customers with more choice and better value for money. Indeed, Royal Mail's current monopoly in the letters market has not been working in the best interests of postal users or Royal Mail, with Royal Mail consistently failing to meet its own delivery targets. In particular, Royal Mail has consistently failed to meet its targets for first class post and standard parcel services as shown in **Table 1**.

Table 1: Selected Consignia standards of service: percentage of 1st class and 2nd class stamped and metered mail and standard parcel delivered by target dates

	1st class mail		**2nd class mail**		**Standard parcel**	
	Target	**Result**	**Target**	**Result**	**Target**	**Result**
1996	92.5	92.3	98.5	97.9	90	83
1997	92.5	85.9	98.5	96.2	87	85
1998	92.5	91.5	98.5	98.3	87	87
1999	92.5	91.1	98.5	98.6	88	88
2000	92.5	91.0	98.5	98.8	88	84
2001	92.5	89.0	98.5	98.4	88	84
2002*	92.1	89.9	98.5	98.3	88	81

*__Note:__ The **targets** for 2002 are based on the end of year performance for the year ending March 2002. The performance quoted is for the April 2001 to March 2002 period.

Source: Consignia report and accounts.

Postcomm has in this context, issued proposals for revisions to Royal Mail's service reliability targets.[2]

The 'cost' of a universal service

The universal postal service involves the provision of a ubiquitous collection and delivery service. In the UK this is defined as a daily collection from all access points, such as pillar boxes and post offices, and daily delivery to all 27m addresses for postal items weighing up to 20kg – all at prices which are geographically uniform and affordable. In practice, any postal operator should be willing to provide a service to any part of the UK. What is less clear, however, is whether they would be prepared to do so on terms that are considered either 'affordable', or more particularly, geographically uniform.

The past arguments for monopoly protection have been on the basis that the costs of delivery differ significantly according to geography, and there has therefore been a need to ensure that profits are generated on some services to cross-subsidise losses made on other services (ie, those services where the affordable uniform tariff compels Royal Mail to price below costs). In order to quantify the scale of this issue, Postcomm undertook an analysis of the net cost of Royal Mail's universal service in June 2001 and concluded that overall the universal service was profitable and that the 'loss-making' elements were not significant (no more than of the order of £80m) in the present market environment.[3] No individual product category (eg, first

[2] Postcomm (2002), Review of Consignia plc's Price and Service Quality Regulation, October (available from www.psc.gov.uk).

[3] This was assessed by considering all the instances where the uniform tariff resulted in its pricing services below long run avoidable costs. This methodology was used by NERA and the EC in 1997 when calculating the cost of the universal service. NERA then found that the sum of losses where unit revenues did not cover long run avoidable costs amounted to £22.6m, which was equivalent to about 0.5% of Royal Mail's revenue from letter mail services in that year. The difference between this figure and the £80m is likely to largely result from the different base years and the degree of aggregation adopted in the two analyses.

class) or generic delivery density (eg, rural and urban), was found to be ‘loss-making’ in aggregate. Where losses for specific types of mail flows were identified, they were mainly related to mail that could not be machine processed and which incurred additional handling costs.

Postcomm considered that even this modest figure was an overestimate of the cost of the universal service. In particular, the assessment – which covered all Royal Mail’s services and not just its universal services – did not take into account any of the benefits that Royal Mail derives from being the UK’s sole universal service provider, both in terms of its brand loyalty (it is estimated that Royal Mail is the second best known brand in the UK) and Royal Mail’s ubiquity. In addition, no adjustments were made to take account of efficiency improvements and innovations by Royal Mail that could lower this ‘cost’ of the universal service. Finally, the figures relied on Royal Mail’s own detailed cost allocation data, and in particular its allocation of costs down to a very disaggregated set of factors (reflecting different mail characteristics such as weight, distance, format and delivery area). That level of disaggregation can lead to an overestimate of the net avoided cost of the universal service because it identifies particular mailflows that cannot commercially be separated out and avoided.

The conclusion of this work was that the provision of a universal postal service in the UK currently involves no significant ‘cost’ but does provide the universal service provider with a commercial advantage in the marketplace. All of the major mailers require a service which is capable of reaching all of their customers, wherever they live. International experience of competition in postal markets supports this analysis and conclusion. Some countries have already opened their postal markets to more competition than has been permitted in the UK. The universal service has been sustained in those countries and customers, especially the large mailers who account for the overwhelming majority of purchases of postal services, have received significant benefits from the availability of choice. A key lesson from such international experience is that an incumbent universal service provider has significant advantages over new entrants in terms of scale, brand recognition and established relationships with customers, which have thus far protected incumbent operators from loss of significant market share.

Incentives to make efficiencies

Postal services play an important role in the economy and it is therefore vital that they are provided as efficiently as possible, and that the regulatory system provides the right incentives for Royal Mail, as the UK's universal service provider and dominant operator, to maximise efficiency savings, to innovate and to be responsive to the needs of customers. Experience in other regulated utility sectors in the UK is that competition in the provision of services is the best way to provide the necessary stimulus for efficiency and innovation by giving customers choice.

In order to consider this issue further, Postcomm commissioned independent consultants to analyse the relative importance of different factors on the financial position of Royal Mail.[4] This analysis revealed that Royal Mail's financial position was more sensitive to changes in its efficiency than to any potential loss of business volume through competition. In other words, Royal Mail's financial viability, and in turn its provision of the UK's universal postal service, is at greater risk from a failure to take action to root out inefficiencies and reduce costs than from the impact of competition and the loss of business to competitors.

[4] Andersen report, Sensitivity Analysis of the Impact of Liberalisation on the Financial Performance of Consignia and its Business Segments, January 2002 (available from Postcomm's website, www.psc.gov.uk).

Sustainable competition

Postcomm's conclusions were that the universal service should be seen as a commercial advantage and not a burden, and that competition was less likely to put the universal service at risk than theory might suggest. On the contrary, Postcomm considers that competition will provide a spur that will ensure the continued provision of the universal postal service within a more vigorous postal services market which, as a whole, will be better placed to respond to the challenges of changing technologies and customer demands.

In considering how best to introduce competition, Postcomm concluded that an immediate move to full market opening risked creating market confusion and would not give Royal Mail sufficient time to adjust to the new market conditions. Postcomm, accordingly, committed to a clear timetable for an orderly transition to the introduction of full competition, thus providing Royal Mail, other operators and users with clarity and certainty, and providing potential operators with sufficiently attractive incentives to enter the market. This is more likely to create an environment where all operators are able to make investments and plan their businesses. At the end of May 2002, Postcomm published its market opening strategy, setting out a three phase plan under which Postcomm will open up to competition 30% of the inland letters market (by revenue) from 1 January 2003, a further 30% from 1 April 2005, and with all restrictions on market entry being abolished on 1 April 2007.[5]

This strategy is being implemented through the licensing of postal operators to provide 'bulk mail' and 'consolidation' services and certain other 'defined activities'. Bulk mailers will be permitted to collect, sort and deliver individual large mailings of at least 4,000 items (or an average of 4,000 items under a

[5] Postcomm decision document 'Promoting Effective Competition in UK Postal Services', May 2002 (available from Postcomm's website www.psc.gov.uk).

multiple mailing contract), provided these are in the same format, from a single user and from a single site. Consolidators will be permitted to collect mail from any number of users and feed it into Royal Mail's network for final delivery. Defined activities are likely to be relatively small-scale specialised postal services.

Postcomm's market opening strategy is also consistent with the european directive, as changes made to the directive in terms of reducing the weight and price thresholds will also be transposed into the UK regime. In developing its strategy, Postcomm had been of the view that, in the UK, solely relying on reducing the weight and price thresholds would not be the most appropriate way to introduce competition. Indeed, this is because most mail volumes are at the lower end of the spectrum and volumes at higher weight and prices are unlikely to attract significant entry, given the cost of splitting mailstream.[6]

Safeguarding the universal postal service

Postcomm sees competition as the foremost safeguard for the universal postal service. Competition will provide the stimulus to Royal Mail to become more efficient. In the light of its primary duty to ensure the continued provision of the universal postal service, however, Postcomm has considered it essential to have available additional means of safeguarding the universal service, should they prove necessary. These include the possibility of allowing Royal Mail more commercial flexibility in terms of how it provides the universal service in such areas as service specification and the overall level and structure of prices.

Another potential safeguard – but one which would be more difficult to introduce – would be some kind of external funding

[6] 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.

mechanisms, such as a universal service support fund. Postcomm is clear, however, that such a safeguard is not likely to be necessary in the early stages of the market's development – if at all. Such a safeguard would only need to be considered if alternative safeguards have been exhausted and if the practical problems of such a fund could be overcome. In any event, such a funding mechanism would need statutory backing and the Postal Services Act does not make provision for such a fund.

Completing the picture

Postcomm will actively monitor 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.

With the establishment of its market opening strategy, Postcomm has set in place the central feature of the regulatory framework. Postcomm has in this context issued its long term licensing policy, establishing the key requirements that alternative operators, in applying for bulk mail, consolidation or defined activity licences, will be subject to.[7] Postcomm is also currently consulting on three long-term licences (Hays, TNT and TPG), although a number of other licensees are currently operating within the market under Postcomm's interim licensing policy (under that policy Postcomm issued 14 short term pilot licences).

Postcomm is in addition now working on three other key areas.

The universal service

The Postal Services Act 2000 formally enshrined in UK law for the first time the concept of the universal postal service. The

[7] Licence under the Postal Services Act: Standard Conditions, November 2002 (available from Postcomm's website www.psc.gov.uk).

licence which Postcomm issued to Royal Mail in March 2001 requires Royal Mail to provide the UK's universal postal service but without specifying what that obligation amounts to in practice. It does, however, require, 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).

Royal Mail takes the view that most of its postal services are universal services but others consider that the universal service should encompass a narrower range of services. What can be said is that there is a need for a more definitive statement of what exactly constitute the services that make up the universal postal service. This review will consider the ranges of services currently provided by Consignia, and consider which of them 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.

More importantly, however, Postcomm believes 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 as being 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. Postcomm intends to address this issue in a consultation document to be issued early in 2003.

Price controls

Customers will continue to be protected against unreasonable price increases by the requirement of the Postal Service Act 2000 for the universal service to be 'affordable' and by Postcomm's controls over Royal Mail's prices imposed in its licence. The current interim price control was intended to last until April 2003. Postcomm has recently consulted on proposals for a new price control (and associated service standards) which reflects the fact that Royal Mail continues to be the dominant operator in the market and that, until competition becomes effective, customers will still need a degree of protection. These proposals included:

- a 3% increase in average prices from April this year. This would allow Consignia to increase the basic 1st and 2nd class stamp prices by 1p, and make equivalent increases in other business services;

- a limit on further revenue increases of RPI-2.5% until March 2006. Assuming forecast rates of inflation, this would effectively freeze prices at their current levels;

- a tightening of Consignia's service standards, including an increase in the target for 1st class letters delivered next day. The new standards will also remove regional disparities and create uniformity in high delivery standards;

- for the first time, enforceable schemes to compensate domestic and business users for late delivery of post;

- Postcomm considered that such a three year price control, based on a maximum allowed average price per item of mail delivered, would give Royal Mail flexibility over its pricing decisions as it moves towards a competitive market with a new commercial focus. [8]

[**Editor's note**: Following consultation, Postcomm issued final proposals on 7 February 2003 (which revised the initial proposals

[8] Postcomm Proposal document Review of Consignia plc's Price and Service Quality Regulation, October 2002 (available from Postcomm's website www.psc.gov.uk).

above and allowed more revenue). The main features of the new control as reported by Postcomm (10 February 2003) are shown in the **Appendix**].[9]

Access arrangements

Royal Mail's delivery network – providing daily deliveries to every address in the UK – provides Royal Mail with a huge commercial advantage over new entrants and a capability which competing operators will not easily be able to rival, especially in the short term. In recognising the potential importance of third-party access and consolidation for the development of the market, Postcomm included in Royal Mail's licence a condition requiring it to negotiate, in good faith, with a view to agreeing terms for access to its postal facilities by any postal operator or users. The terms for such access are to be based on a reasonable allocation of costs and cannot be unduly discriminatory in comparison to terms offered to other operators or user. One operator has reached agreement with Royal Mail over the terms of access but in another case there was no agreement and the matter has been referred to Postcomm for determination. Royal Mail's licence also makes provision for the development of an access code, and this is a matter which Postcomm intends to take forward in the coming year.

Conclusion

We are standing on the threshold of a significant development in the postal services market in the UK. A new regulatory framework has been established and the introduction of competition promises to bring about long-awaited changes through the provision of a wider range of innovative services to meet more closely the needs of customers. The introduction of

[9] Postcomm (2003), Review of Royal Mail Group plc's Price and Service Quality Regulation, Second Price Control, Quality Service Targets and Compensation, Final Proposals document, February.

competition will also provide a spur to Royal Mail to tackle the sources of inefficiency and to provide an improved, more reliable universal postal service to all its customers in the UK. Postcomm's approach to the introduction of competition was developed in the context of the UK market but there are lessons here that other countries may find relevant as they consider how best to take forward the move towards liberalised postal services.

Appendix

Review of Royal Mail Group plc's price and service quality regulation: final proposals (Source, Postcomm 10.3.2003)

Postcomm announced on Friday 7 February revised proposals for a price control that will permit Royal Mail to raise the price of 1st and 2nd class stamps by 1p from the 1 April 2003, it also gives the option to raise 2nd class stamps by a further 1p in 2004 or 2005. This control will allow Royal Mail approximately £750m extra cash over the three years. The new control which is based on the RPI (retail price index) uses the familiar RPI-X formula.

It includes:

- a 3% increase in prices from April this year;
- a further increase of RPI - 1% in years 2 and 3. Assuming RPI of 2.5%, this means prices in 2004 and 2005 can increase by 1.5% each year. Within this limit Royal Mail will be able to increase 2nd class stamp prices by 1p in 2004 or 2005, providing it balances this with price reductions elsewhere;
- the £750m is made up of about £170m in 2003/4, £250m in 2004/5 and £330m in 2005/6;
- a 'tariff basket' form of price control that will ensure that revenues move in line with costs in the event of any change in its product mix towards higher (or lower) priced products;
- a facility under which Royal Mail can raise or lower prices of individual products within the tariff basket to bring prices better into line with costs;
- provision for genuinely new products to sit outside the price control;
- a tightening of Royal Mail's service standards, including tighter targets for the delivery of 1st class letters;
- the first enforceable scheme to compensate domestic and business customers for late delivery of post.

5 ACCESSING THE POSTAL NETWORK

Ian Reay and Frank Rodriguez

Introduction

Under the Postal Services Act, 2000, the prime objective of the postal regulator, Postcomm, is to ensure the provision of a universal postal service. This is defined in the act as at least one delivery and one collection every working day of postal items at affordable prices 'determined in accordance with a public tariff which is uniform through the United Kingdom' together with services for registered post and incoming and outward international mail. The provision of universal postal service at a uniform tariff is the universal service obligation (USO) for posts and this has traditionally been funded by the existence of a reserved area, currently defined in the UK by letter mail weighing less than 350g or priced below £1. Under the act, the 'reserved area' has now become a 'licensed area'.

Subject to its primary objective to ensure the provision of universal postal service, Postcomm has a number of subsidiary objectives including the promotion of effective competition in the postal sector. The most direct way to achieve this is by reducing the scope of the reserved (licensed) area itself, either by reducing the weight and price limits, or by freeing up certain classes of mail, such as direct advertising mail or all bulk mail.

Acknowledgement
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Ian Reay at the time was in the Department of Regulation and Frank Rodriguez, Head of Economics, Consignia

The scope of this area is under review and Postcomm will be making recommendations on its reduction to the Secretary of State during the course of 2001. At the same time, the European Union is preparing a new Postal Services Directive which is expected to bring about a substantial reduction in the permitted scope of reserved areas across all member states from January 2003. Additionally, Postcomm are examining, and have included in the licence for Consignia (formerly The Post Office), proposals for the introduction of competition within the licensed area by licensing other postal operators. Following the model that has been applied in some other (privatised) utilities, Postcomm is seeking to facilitate competition in the licensed area by giving other licensed postal operators the right to access and use, for a charge, parts of Consignia's postal network. The proposals on access are set out in Condition 9 of the licence granted to Consignia.

The remaining sections of the chapter are as follows. The first sets out key economic features of the postal sector which need to be taken into account in developing an access framework. The two sections thereafter focus on the issue of access pricing in posts in the framework set out by Professor Ralph Turvey for a competing access provider, namely the efficient component pricing rule (ECPR).[1] The chapter then provides more detail on current work-sharing discounts offered by Consignia which are closely related to the access prices which would be set up under ECPR. The provisions for an access code, as set out in Postcomm's licence to Consignia, are reviewed and concluding comments are set out in a final section. It is apparent that there is still some considerable way to go before a regime is put in place which effectively meets the objectives for access contained in the licence.

[1] Turvey R (2001), Economic Principles of Access Pricing, CRI Proceedings 26, Access pricing - Comparative Experience and Current Developments, chapter 1, pp1-16, University of Bath.

Key economic features of postal sector

The mail operation is, in outline, a relatively simple process and its elements are familiar to most people. The process starts with the collection of mail and its transfer to a mail centre for outward sorting. This is followed by transportation to the inward mail centre for inward sortation and, at the final stage, there is delivery to the destination of the item. In the UK, there are about 220,000 collection points and about 26.8m addresses, and of the latter, 1.6m, or so, are business and the remainder residential. An item of mail can travel from any origin to any destination in this network. It is worth noting that in 1999/00, there were about 19bn inland letters and a little under one billion postings of international mail.[2]

Each network industry differs in its precise characteristics and the postal sector, as described above, is particularly distinct from other industries of this type. It is important to be fully cognisant of these differences in attempting to design an access policy for the industry, and not to believe that a model which has been used in another sector will necessarily carry over into posts. The first and most obvious feature is that posts is not a ‘pipes’ or ‘wires’ activity but one which is labour intensive in nature, primarily because of the product itself which travels from a unique origin to a unique destination for delivery by hand to, in nearly all cases, a specific person. There are a number of important ramifications of the industry being labour intensive and two are highlighted here. First, quality of service is very much dependent on the performance of individuals in the workforce on a day-to-day basis. Secondly, barriers to entry for some segments of traffic are very low and entry does not need to involve high up front outlays on capital equipment. One person

[2] The Post Office (2000), Annual Report and Accounts 1999-2000, The Post Office, London.

alone with minimal equipment could, in principle, be a postal operator.[3]

There is considerable evidence of significant economies of scale in collection and delivery.[4] [5] In particular, once a delivery network capable of providing universal postal service is in place, unit costs fall significantly as volumes rise. This holds *a fortiori* in collection, although this activity is much less important in the overall cost structure of posts than delivery. There are very significant components of natural monopoly, therefore, in these two processes while, by contrast, sorting and transportation have cost elasticities closer to unity. At the same time, postal networks also exhibit extensive economies of scope - for example, in possibilities for combining collection and delivery activities in rural areas or by one activity, such as delivery, simultaneously helping to produce a number of products, such as first and second class mail. However, while there are substantial economies of scale and scope in postal networks, it is also the case that, primarily due to the delivery network, the fixed cost of providing universal postal service itself is high. Indeed, these two features are linked. It is the existence of the postal network, particularly for delivery, which creates the opportunity for these scale economies.

Most countries, not least the UK, are committed to the existence of a uniform (ie, geographically averaged) public tariff. The uniform tariff acts as the price base for traffic in the bulk mail

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[3] In EU countries, where further liberalisation has occurred, many of the operators that have entered the postal sector consist of just one or two individuals (Schwarz-Schilling (2001)).

[4] Bradley M J and Colvin J (1995), An Econometric Model of Postal Delivery, in Commercialisation of Postal and Delivery Services: National and International Perspectives, edited by Crew M A and Kleindorfer P R, Boston, Kluwer.

[5] Cazals C, de Rycke M, Florens J P and Rouzaud S (1997), Scale Economies and Natural Monopoly in the Postal Delivery: Comparison between Parametric and Non-Parametric Specifications, in Managing Change in the Postal and Delivery Industries, edited by Crew M A and Kleindorfer P R, Boston, Kluwer.

sector which is price discounted. These business tariffs are non-discriminatory between customers and are also geographically averaged. Largely for social and political reasons, the importance of the uniform tariff in posts is greater than in other network industries, and the requirement is now set out formally in the Postal Services Act. The consequences of the uniform tariff are substantial for while prices are uniform, marginal costs vary by many dimensions including area (eg, urban versus rural), handling characteristics (eg, standard letter versus large flat) and customer (eg, business versus household). As a result, margins vary very markedly across all these segments or 'routes' of traffic and this variability, when combined with the ease of entry to the sector due to the low costs associated with entry, produces cream-skimming opportunities on a large scale for potential entrants. In these circumstances, while economies of scale indicate that there are strong natural monopoly components in delivery, this may be unsustainable if widespread entry were to occur, leading in turn to a reduction in the volumes of the universal service provider (USP). The consequence of such a loss of traffic would be that consumers generally would be able to reap fewer of the benefits of the lower prices created by these scale economies.

It is for a sector with these characteristics that access to the network by other operators needs to be considered, evaluated and developed. Models from sectors with high initial capital costs, rather than low barriers to entry, or where tariffs can be based directly on cost and demand characteristics, rather than overall uniformity and the need to offer universal service, or where service is provided largely through automated capital equipment, rather than individual labour, will not necessarily be appropriate ones for designing an effective access regime in posts. The most important feature of such a regime is pricing.

Access pricing in posts

Liberalisation of the postal sector in other countries, such as the Netherlands, Germany and Sweden, and as proposed by the EU, has focused primarily on reductions in the price and weight limits of the reserved area. There are no examples in the EU of other postal operators directly accessing a USP's network for the delivery of letters, although in September 2000, the German postal regulator required Deutsche Post to deliver letters weighing more than 200 grams (ie, outside the German reserved area) on behalf of competitors if the competitors transported them in groups of more than 500 to a central collection point. The situation in the United States perhaps comes closest to such access.[6] Their 'consolidators', which are private firms collecting and assembling mail from mailers, sort and transport mail as far as the inward sorting centre or 'dropship' mail for delivery to final destinations by the USPS (United States Postal Service). In return, they receive dropshipment discounts. Because the key natural monopoly activity in the network is delivery, the presumption has always been that mailers or other postal operators would wish to have access close to the point of delivery. This is often referred to as downstream access.

Although examples of downstream access in practice are very sparse, there has been analysis in the postal economics literature of the appropriate economic principles for access pricing in the sector. Significant papers in this literature include those by Cremer et al, Crew and Kleindorfer, Dobbs and Richards and Panzar. The models developed by these economists attempt explicitly to build in the specific characteristics of the postal sector, along the lines described above, in identifying an (allocatively) efficient set of access prices subject to ensuring the financial viability of universal postal service.[7] [8] [9] [10] The latter

[6] Pickett J, Treworgy D E and Conrad A W B (2000), Access Pricing in the Postal Sector: Complexities and Practicalities of the United States Experience, in Current Directions in Postal Reform, (eds) Crew M A and Kleindorfer P R, Kluwer, Boston.

[7] Cremer H, de Rycke M and Grimaud A (1995), Alternative Scenarios for the Reform of Postal Services: Optimal Pricing and Welfare, in Commercialisation of Postal and Delivery Services: National and

is achieved within their models by setting a constraint of break-even or that the revenue of the USP is sufficient to cover its costs.

There have been two general approaches in this work. The first of these is 'top down' and adopts the efficient component pricing rule (ECPR) or Baumol-Willig rule in the context of the postal sector.[11] The second general approach is 'bottom up' and derives access prices as marginal costs of the activity the entrant wishes to use plus demand-related mark-ups which raise sufficient revenue to satisfy the overall constraint for break-even. These Ramsey prices contain the standard result of mark-ups which are higher on products that are more price inelastic in demand. Note that both of these approaches produce a price set which allows the USP to break-even. Although, in principle, the Ramsey approach yields a higher level of economic welfare, it requires detailed information on own and cross-price elasticities to allow it to be applied fully and the formulae for the mark-ups themselves are highly complex. Crew and Kleindorfer note that ECPR has informational advantages and greater transparency compared with a Ramsey approach while the welfare loss in using the rule may not be large. They conclude:

International Perspectives, (eds) Crew M A and Kleindorfer P R, Kluwer, Boston.

[8] Crew M A and Kleindorfer P R (1995), Pricing in Postal Service Under Competitive Entry, in Commercialisation of Postal and Delivery Services: National and International Perspectives, (eds) Crew M A and Kleindorfer P R, Kluwer, Boston.

[9] Dobbs I and Richards P (1994), Entry and Component Pricing in Regulated Markets, in International Journal of the Economics of Business, volume 1, No 3, 1994, pp355-376.

[10] Panzar J (1993), Competition, Efficiency and the Vertical Structure of Postal Services, in Regulation and the Nature of Postal and Delivery Services, (eds) Crew M A and Kleindorfer P R, Kluwer, Boston.

[11] Willig R (1979), The Theory of Network Access Pricing, in Issues in Public Utility Regulation, (ed) Trebing H M, Michigan State University, Public Utility Papers.

> "At present, a reasonable approach would appear to be the TECP ('top down efficient component pricing') approach which motivates efficient entry, yet provides a conservative approach to cost coverage for the postal system and equal access to the local delivery network". (Crew and Kleindorfer (1995) p127)

Efficient component pricing rule

The application of ECPR in the postal sector can be illustrated using the framework set out by Ralph Turvey (Turvey, 2001). For this, assume that there are just two activities in the postal network which are defined as delivery and all other (ie, 'non-delivery') activities to include collection, sorting and transportation. Let C_X^I, C_Y^I equal respectively the incumbent's unit avoidable cost of delivery (*X*) and non-delivery (*Y*), C_Y^C equal the potential competitor or entrant's unit cost of the non-delivery activity and *P* equal the incumbent's price (public tariff). Then $\left(P - C_X^I - C_Y^I\right)$ is the contribution per item earned by the incumbent to cover the fixed costs of the postal network. The potential entrant can undertake the collection, sorting and transportation or non-delivery activity where economies of scale are more limited. However, it wishes to use the delivery network of the incumbent as an alternative to performing the activity directly itself because, although, in principle, it could undertake this task, it can gain from the lower cost of the incumbent in delivery due to the economies of scale in that activity.

Under ECPR, the price the incumbent charges a potential postal operator to use only the delivery component of its network is made up of two parts. First, there is the opportunity cost to the incumbent of making the delivery facility available to an entrant and, secondly, there is the avoidable cost to it of undertaking the delivery task. Much depends on the first part of the charge, the estimate of this opportunity cost. Consider first the case where an entrant's gain in traffic equals the incumbent's loss. Here the opportunity cost to the incumbent of making the delivery facility open to an entrant is the contribution it loses on each item over and above the sum of the avoidable costs of the two activities, that is $\left(P - C_X^I - C_Y^I\right)$. In this case, then, the price it charges for use of the delivery network is:

opportunity cost of incumbent losing business	+	avoidable cost of providing delivery
$\left(P - C_X^I - C_Y^I\right)$	+	C_X^I
$= \left(P - C_Y^I\right)$		

that is, an entrant is charged the public tariff less the incumbent's avoided cost of the non-delivery activity (Y) that the entrant performs. As the original proponents of ECPR pointed out and as outlined by Ralph Turvey, one of the desirable properties of this form of access pricing is that if a potential entrant has a lower level of cost for the activity it performs (that is, if $C_Y^C < C_Y^I$), then entry by it will be profitable and so will occur. The entrant requires fewer resources to produce the good and so entry is (allocatively) efficient. Conversely, if $C_Y^C > C_Y^I$ then entry is unprofitable and deterred, which is, again, allocatively efficient.

Say, however, that a potential entrant is charged **only** the avoidable cost of delivery rather than **both** this **and** the opportunity cost to the incumbent of its losing business. Then it is possible for inefficient entry to occur which would be a wasteful use of national resources. Entry will now be profitable for the entrant, even if it is less efficient than the incumbent in non-delivery activities, as long as the extent to which the entrant is less efficient than the incumbent, $\left(C_Y^C - C_Y^I\right)$, is less than the contribution the incumbent makes on each item, $\left(P - C_X^I - C_Y^I\right)$. This reduces simply to the condition $\left(C_X^I + C_Y^C\right) < P$. In other words, the entrant siphons off as profit the element of the incumbent's revenue required to fund the fixed (universal service) cost.

Consequently, the greater the contribution the incumbent needs to make on each item to cover its fixed costs, the greater the likelihood that inefficient entry of this type would be encouraged by charging only the avoidable cost of delivery. By including in the access price the opportunity cost to the incumbent of the loss of business, ECPR prevents this risk of inefficient entry and encourages only entry that is efficient. In posts, the level of fixed costs is high due to the requirement to provide universal service. This implies, in turn, that the contribution on many segments of traffic is relatively high and so there would be a significant risk of inefficient entry if ECPR were not in place.

The discussion above has assumed that, in calculating the opportunity cost to the incumbent of providing delivery, one item of mail delivered by an entrant postal operator displaces one item of mail previously delivered by the incumbent. Where this is not the case and the item is entirely new (perhaps because the entrant offers a differentiated service) then there is no item foregone and, hence, no loss in contribution to the incumbent. As Turvey's review explains, since the opportunity cost component of the access price is zero, in principle, the entrant should then be charged only the avoidable cost of delivery by the incumbent.

In fact, in the specific context of the postal network, there is a further, technical reason why it may be quite difficult to ascertain the opportunity cost of a competitor supplying the final product.[12] In the UK, there is a two tier postal system.

[12] Agar S and Reay I (1999), Postal Pipeline Liberalisation: the Beginning of the End for the Uniform Tariff?, in Emerging Competition in Postal and Delivery Service, (ed) Crew M A and Kleindorfer PR, Kluwer, Boston.

Differences between the avoidable costs of first and second class services, notably in sortation and transport, are all upstream of the inward mail centre. Effectively, from that point on the two types of mail are treated as one (mail for delivery) and so the marginal costs of the two services downstream from that point are also the same. What then should be the retail price against which to deduct the incumbent's avoidable cost for the non-delivery activity? This, in turn, poses the question of how the opportunity cost of the incumbent losing traffic should be calculated - is it a first class item of the incumbent that would be displaced or a second class one? Clearly, the competitor could put mail in at the point of inward processing, claim delivery for second class which would imply the second class public tariff should be applied but receive the same standard of delivery as under first class. However, there is no means of confirming, other than through this form of adverse selection by the entrant, whether a specific item displaced in fact would have been first class rather than second class.

This is a very material issue to ensuring break even on the part of the incumbent USP. In addition to its desirable characteristics in encouraging efficient entry, the second very important advantage of ECPR (and also Ramsey pricing with mark-ups) is that it provides for cost recovery and, in the context of posts, allows the USO to be funded. However, as outlined above, in practice, it is not straightforward to calculate fully, for every item, the opportunity cost to the incumbent of making the delivery facility available. It is not certain, in advance, whether an item from a competitor would displace an item of the incumbent (in which case, contribution to fixed costs from that item would need to be added to the avoidable cost of delivery) or will be entirely new (in which case, avoidable cost of delivery would suffice). Where displacement occurs, there is then the issue of determining which type of traffic was displaced - first or second class. To provide financial viability for the USP on a continuing basis, the sum raised to cover the opportunity cost of entrants using the delivery network should, in principle, equal the sum the USP would have been able to collect as contribution to fund its fixed cost from the mix of traffic (primarily first and second class products) it would have carried in the absence of entry by other operators. However, this is not a simple task and there are practical challenges that need to be resolved still to design a regime that would be able to collect from entrants in full the opportunity cost to the incumbent of entry and so to put ECPR into operation fully.

A separate issue with ECPR concerns the starting level of the public tariff or retail price, *P*. This should be set to allow the USP a normal rate of profit to enable it to meet the USO on a continuing and sustainable basis. However, the incentives in ECPR are mainly with respect to allocative rather than *x*-efficiency. The rule itself is silent on the optimality, or otherwise, of the retail price and one criticism of ECPR is that it tends to dampen the dynamic efficiency benefits of competition by providing limited incentives for the reduction of that price and the cost levels which underpin it. Nevertheless, it is possible to combine ECPR with the use of a price cap. This can be set to bear down on the overall cost level of the incumbent and so promote the goal of *x*-efficiency.[13] When combined with a price cap in this way, ECPR can be seen as an appropriate framework for access pricing to the postal network.

It is also the case that the retail price itself may change in response to entry and the extent of this will depend on a number of factors including the nature of regulatory constraints and the pattern and form of entry. Applying the ECPR rule then becomes more complex and the nature of entry also impacts on the welfare properties of different access pricing rules (Dobbs and Richards (1994).[14]
Although further detailed work would be required before it could be applied in practice, ECPR has a number of valuable and

[13] Selection of the form of price cap will have consequences for allocative efficiency as well.
[14] More generally, Dobbs and Richards (1994) develop a computable model to evaluate alternative access pricing regimes within a welfare economic framework.

positive features for access pricing in posts. It promotes efficient entry, supports the funding of the USO on a sustainable basis and is manageable in practical terms with regard to information requirements. It also enjoys the additional advantage of being non-discriminatory between different users of the postal services, not just between different business users (which is a requirement of Competition Law for a dominant operator), but also between business users and consumers. Certainly, as a starting point, as Crew and Kleindorfer and others have noted, it has much to recommend it. Indeed, using the reasoning of ECPR, the EU draft Postal Services Directive proposes that access charges for potential postal operators wishing to use the networks of USPs should be levied on this avoided cost basis.

Use of avoided cost in the UK

Avoided cost discounts have been offered and used in the UK for some years. Bulk mailers are willing to undertake tasks which reduce the costs of Consignia in processing and handling mail. The activity of 'work-sharing', as it is called, has been formalised into a menu of work-share contracts and has evolved into a family of products called Mailsort. These were first introduced in this form during the late 1980s. Customers that undertake this work receive a discount off the public tariff based on the avoided long run marginal costs for that class of mail. The logic and approach of this structure of pricing follows that of ECPR and the retail price is set using the corresponding service among the public tariff products. Mailsort 1 provides a next day (day B) service and is price discounted from the first class public tariff. Mailsort 2 is delivery for day D and corresponds to second class while Mailsort 3 offers a day H (or seven day) service which is not matched by a public tariff product but also is discounted from the second class tariff.

The work-share discounts are available for a range of depths of pre-sortation by customers from a 120-way breakdown (Mailsort 120) down to the presentation of mail which is sorted to the level of the delivery walk (known as Walksort). Clearly, the greater the degree of sortation, the greater the discount. For Mailsort 1 and 2, discounts range from 8 % to 13 % while the discounts for Mailsort 3 rise to 28% and are greater to reflect the lower standard of service of that product. At present, pre-sortation discounts are offered on mail presented at the outward mail centre.[15] The existing discount structure has been developed over a lengthy period of time and the avoided cost discounts have been calculated to a considerable degree of refinement. This information would be used as the basis for setting access prices to potential postal operators wishing to enter the postal network upstream of delivery. However, the difficulty identified in the previous section concerning the application of an ECPR type rule with a two tier service means that discounts could not be offered to compensate customers or competitors for the costs arising from accessing the postal network close to the point of delivery.

Access in Postcomm's licence to Consignia

Postcomm's draft licence to Consignia plc was published in January 2001 and agreed in its final form on 23 March. Opening access to the postal network is one of the key elements of the licence and the provisions are contained in Condition 9. This states that there are two possible approaches in facilitating access. First, Consignia should negotiate terms with third parties and charges should be 'reasonable'. However, secondly, if there is failure to agree on the terms of access, an access code will be required to be prepared which deals with both the physical and operational requirements of access and also the charges that Consignia will make for use of its network. The final decision in setting the terms in the code will be Postcomm's.

[15] In fact, upstream of inward sortation there is a separate network to handle bulk mail products.

As stated in Condition 9, the access code is there to facilitate the achievement of the 'relevant objectives'. These are set out, effectively, in three tiers. At tier 1, the objective is the provision of universal postal service at a uniform tariff or ensuring that the USO is met. Then 'subject to that', as the licence puts it, are two further objectives: securing the interests of postal users with regard to particular groups (individuals who are disabled or chronically sick, of pensionable age, with low incomes, and residing in rural areas are the groups that are mentioned specifically) and, secondly at this tier, promoting competition between postal operators. Then 'subject to the above', there is a fourth relevant objective, namely promoting the efficiency and economy of Consignia as the licenseensee and of other postal operators. It is important to note that, in the relevant objectives, the access code is there to help 'facilitate'. Primacy is clearly given to the provision of universal postal service at a uniform, affordable tariff. This is consistent with the act and the remaining objectives, including that with respect to the promotion of competition, are subject to the need to ensure the USO is met. Comments are made below on two areas with regard to the provisions in the licence on access: practical issues surrounding the introduction of upstream liberalisation/downstream access, and pricing.

Much of the discussion earlier in this chapter has focused on the question of access pricing. However, the access code needs to take full account of the practical issues in introducing this particular form of liberalisation. During its preparations for the next Postal Services Directive, the European Commission commissioned four studies which reviewed the issues involved in alternative forms of liberalisation. The studies covered the liberalisation of inward cross-border mail, direct mail, the reduction of price and weight limits and, relevant to an access code, upstream liberalisation/downstream access. This latter study was undertaken by a German consultancy, CTcon, which advised strongly against this particular form of liberalisation.[16]

[16] Ctcon, (1998), On the Liberalisation of Clearance, Sorting and Transport, pp67-68, ECSC-EC-EAEC, Brussels-Luxembourg.

Its 'final conclusion and recommendation' statement is worth reporting in full as this study represents the most complete by far to cover the practical issues of downstream access in posts:

> "Upstream liberalisation/downstream access is not attractive as a durable scenario for the European postal markets. The potential positive effects of this concept, such as:
>
> - potential to develop a (upstream) private postal industry at a very low risk for the postal system in total;
> - prepare the universal service providers for complete competition by gradually increasing their competitive exposure;
> - set an arena, where all postal products at least partially (upstream) are subject to competition;
> - are overcompensated by the expected negative aspects, that are very specific to the approach of liberalising a few stages within the postal value chain:
> - additional investment and costs for the provision of a multi-provider system;
> - low competitive impact due to lack of attractiveness to potential large competitors;
> - high complexity and costs for regulation;
> - potential unfair regulatory situation on the international scale.
>
> Conclusively, on the way towards totally liberalised postal markets, the European Commission should prefer using other concepts of liberalisation, such as liberalisation of postal products or the further reduction of price and weight limits of the reserved area".

The European Commission, which had up to that time been favourably inclined towards liberalisation of this form, accepted CTcon's assessment of the most effective way to bring competition into postal markets. From the publication of the CTcon study, liberalisation through downstream access was considered an inept way forward and no other European country has chosen to use this method. Although the draft Directive includes some provisions in this area, it has favoured reduction in price and weight limits as the most effective form of liberalisation. This is a conclusion which has been shared by all other European countries that have evaluated alternative forms of liberalisation, taking account of the specific characteristics of the postal sector, rather than importing, without much analysis or thought, models from other network industries.

To the extent that upstream liberalisation is used as part of a broader strategy for liberalisation and the significant operational and regulatory costs highlighted by CTcon are disregarded, the key issue on access remains pricing. To date, Postcomm have not yet expressed a view on the basis for setting access prices other than that they should be based on a 'reasonable' allocation of costs and be non-discriminatory. This falls some way short of a workable set of principles on access pricing but, given that inappropriate pricing rules would lead to the possibility of encouraging inefficient entry and undermining the ability to fund meeting the USO on a continuing basis, it is essential that these principles are developed and made clear prior to the licensing of other postal operators. As argued in earlier sections of the paper, on pricing there are strong arguments for ECPR to deliver the 'relevant objectives' of Condition 9. This would also have the advantage of aligning with the position in the EU draft Directive which applies the avoided cost principle and was developed in the light of its extensive review of alternative forms of liberalisation.

Concluding comments

Bulk mailers in the UK can access the postal network upstream by 'work sharing' (for example by pre-sortation of mail) for which they receive a discount on the corresponding public tariff. These work share discounts use the avoided cost principle and are an application of the efficient component pricing rule (ECPR). The most extensive study undertaken on the practical issue of extending ideas of access more widely, and its use as a way to develop competition among postal operators (that by CTcon (1998) for the European Commission), however concluded against such an extension. Operational and regulatory costs would be high with significant doubts as to whether this form of liberalisation would encourage much competition. In Europe, the way forward for postal market liberalisation is seen to be principally through the reduction of the price and weight limits of the reserved area.

Notwithstanding this evidence, the impact of Postcomm's proposals for access depends critically on the pricing regime used to determine charges for access to the postal network. This chapter has argued that ECPR provides an appropriate framework for this purpose. The approach promotes efficient entry and improved use of national resources, supports the funding of the USO on a sustainable basis and is manageable in terms of its information requirement.

6 CONSUMERS COME FIRST

Gregor McGregor

Introduction

This chapter deliberately has the title 'consumers come first' because it is all too easy to be distracted by structures, pricing and the effects of competition and monopolies, and to forget that the fundamental objective of a service provider is to satisfy the needs of its customers.

Competition vs regulated monopoly

There are two basic choices facing the postal regulator: follow the route of competition or that of a regulated monopoly. On the one hand you can have a benign monopoly which is well regulated, achieving savings through scale and scope, delivering the universal service, and which is trusted and liked by customers. This would be a win, win, win situation.

But the drawback of this model is that it is not stable. If we look at any state monopoly privatised over the last twenty years we see that management has come first, shareholders second and customers firmly in third place. Monopolies will inevitably seek to exploit their position, and the longer they maintain this position the worse the situation becomes. They deliver the wrong products, which do not meet customer needs, are over-priced and show no innovation. Monopolies will inevitably grow stronger than the regulator, who is captured so as to serve the monopoly's interests rather than customer need.

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Gregor McGregor, Chief Executive, Postwatch

It is therefore essential to have competition to prevent both the regulator and the monopoly from becoming stale. Competition equates to choice; so in order that customers' needs are met, a mechanism must exist for competitors to enter the market to offer products and services denied them by the monopoly supplier. The process of ensuring that a choice is available will therefore ensure that the customer comes first.

Universal postal service

It is remarkable that it is only where a monopoly exists that an obligation to supply is imposed. There is, for example, no requirement for bread or newspapers to be delivered to the Outer Hebrides – but they still succeed in getting there. I would therefore suggest that the obligation to supply is an invention of the monopoly supplier in order to justify preserving its monopoly.

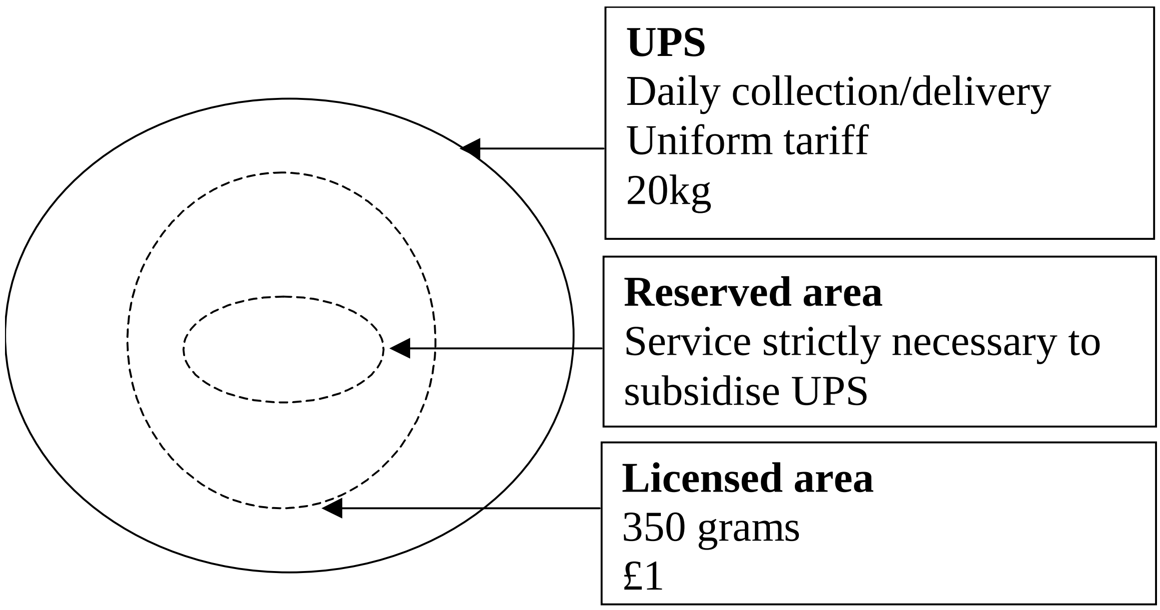
Much work has been undertaken in the telecoms sector to calculate the cost of the universal postal service (USO), and we also commend the work which Postcomm itself has undertaken in this field. However, when looked at independently there is little evidence of the USO being a cost. And even if this should prove to be the case, the cost looks remarkably small. Indeed, it is our view that there are significant commercial opportunities available to the provider of a service which reaches everywhere, every day.

Postwatch has therefore recently commissioned its own research into the opportunities available to a universal service provider with a view to demonstrating that this is in fact a net benefit rather than a burden. It is hoped that the results of this study will be available to inform Postcomm's thinking on opening the postal market to competition, but unfortunately we are encountering some difficulties owing to Consignia's reluctance to provide us with the necessary data.

Licensed and reserved areas

The approach to introducing competition is confused by the complicated legal structure surrounding provision of postal services in the UK. However, this can be modelled as shown in **Figure 1**.

Figure 1: Licensed and reserved areas



Here the outer ring represents the universal postal service (UPS), obligation of daily collection and delivery of items up to 20kg in weight at a uniform and affordable tariff.

In the UK regime we then have the ‘licensed area’, shown as a middle ring representing items weighing less than 350g and costing less than £1 to handle. These familiar limits arise from the original European Directive. Outside this area, of course, significant competition already exists in the parcels market where some 4,000 operators are already in business offering good, competitive services. And finally there is the ‘reserved area’. This is a concept embedded in the Directive and it consists of a small core of services which is strictly necessary to subsidise the UPS.

It is the existence of this reserved area which is at the heart of debate over the appropriate licensing regime. Although reducing this area would act as a strong signal to the market that would be reflected in the licensing regime, the question remains as to whether there is a need to reserve **any** services in order to maintain a cross-subsidy, if provision of the UPS is indeed fully commercial (ie, not a financial burden). Indeed, it may be argued that in such circumstances it is therefore actually unlawful to license such activities.

Opening competition

Since Postwatch does not believe that the USO is a cost – but rather a benefit – the question arises as to how the market should be opened-up to competition.

We believe that a temporary licensing regime is potentially extremely damaging because of the lack of certainty it creates and the disincentive to investment on the part of aspiring competitors. Indeed, more than that we believe that Postcomm's licensing policy is actually back-to-front in that it would be more logical for competitors to enjoy licences lasting fifteen years whilst the monopoly incumbent should be issued with a licence for a restricted period.

Postwatch would also warn against making use of a regulatory blueprint of how the market is expected to develop. It is wrong for regulators divorced from market or commercial reality to construct regulatory policies designed to deliver particular theoretical outcomes. This is because it is not only impossible, but also counter-productive, to attempt to second-guess the market. The whole point of competition is to allow customers rather than the regulator (however well intentioned) to drive the process.

There are three key strategies which can be used to open the market to competition. The first is that Postcomm should use its powers to encourage new entrants. It is simply not true that such competitors will immediately have a devastating effect on the position of the monopoly supplier. All previous experience has shown that any erosion of the incumbent's market will be slow and gradual.

The second strategy is for Postcomm to make it clear to the market that there is no restriction on the consolidation of inland mail, and that the regulator sees this activity as being positively pro-competitive. The third strategy (an extension of the second) is to ensure that any competitor may make use of the postal network on exactly the same terms as the incumbent monopoly operator (Consignia). History has shown that in other industries the creation of workable access codes to allow this to happen has taken two to three years; but this must not deter those responsible from undertaking the task – which must be regarded as a very high priority.

Where next?

So, in conclusion, Postwatch believes that Consignia is showing all the signs of a typical 350 year old monopoly – alarmed, or even frightened by, the competition, and paranoid about protecting its monopoly.

But competition should be seen as an opportunity not a threat, and we would urge Consignia's management to approach it as such. The fact is that Consignia is not performing successfully as a company: its management, industrial relations and financial management are in a mess and it needs the spur of competition to turn it around.

For the regulator's part, Postcomm cannot ride the twin horses of defending a monopoly whilst at the same time introducing effective competition. And it is clear to us that the latter course of action is the only viable solution. The market needs a clear steer from Postcomm whose licensing regime must provide certainty for investment and business growth. It also needs a big step reduction in the licensed area threshold – this important message has already been addressed in Luxembourg earlier in the week.

And, finally, a firm end date must be set for the complete liberalisation of the European postal market. Postwatch would advocate 2006, but unfortunately it appears that the powerful monopolies will succeed in stringing this out. It is regrettable that the UK government saw fit to sit on this particular fence when they had an ideal opportunity to influence the debate – otherwise we might have seen greater and more rapid progress, which would undoubtedly have been to the benefit of consumers.

7 MEETING THE UNIVERSAL SERVICE OBLIGATION IN POSTS

Ian Reay and Frank Rodriguez

Introduction

An increase in the competitive environment in postal markets is expected to produce benefits for customers by broadening choice and encouraging innovation. However, there is an inherent contradiction between full competition and maintaining the current public policy objectives of universal service and uniform tariff structures. The means of introducing competition, and the extent to which it should be permitted, are, therefore, important questions. The introduction of competition in other postal markets in Europe and elsewhere has only been possible by permitting significantly greater pricing flexibility than is compatible with the uniform tariff structure required by the Postal Services Act 2000. If, on balance, the view prevails that significant competition is required, then there will need to be a recognition that the universal service obligation and uniform tariff requirement, as currently defined, will not be sustainable financially, and that more market based pricing structures will have to be introduced. Deciding on the manner in which competition can be introduced into the postal sector cannot be done without explicitly taking into account the universal service obligation.

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Ian Reay at the time was Liberalisation and Monopoly Policy Manager and Frank Rodriguez, Head of Economics, Consignia

There are recognised benefits of competition, but entry should be introduced in a careful way, with a long-term perspective, taking into account the specific factors of the industry concerned. Barriers to entry in postal markets are very low and entry does not require high levels of up-front investment. Postal service is labour intensive and deals with a product which is conveyed from a unique origin to a unique destination for hand delivery to a specific address. Consequently, quality of service depends on the performance of individuals on a day to day basis. A regulatory structure with a short term focus, and with incentive schemes which starve the incumbent universal service provider of the funds necessary for investment in quality improvements, innovation and growth, will lead to a decline in the industry concerned. The fate of a liberalised industry which is deprived of the funds necessary for investment in medium and long term capacity is demonstrated by the experiences of the electricity sector in California, where parts of the electricity system have come close to bankruptcy.

The universal service obligation (USO)

Provision is made in European legislation which limits the application of the European Competition rules to services of general economic interest, if the provision of the relevant service would otherwise be jeopardised, and this provision is reflected in the Competition Act 1998.[1] The universal postal service is an example of such a service.

The European directive on postal services adopted in 1997 lays down minimum standards for the universal postal service.[2] This states, in Article 3, that the universal service consists of a daily

[1] Schedule 3, Paragraph 4.
[2] Directive No. 97/67/EC of the European Parliament and of the Council on common rules for the development of the internal market of Community postal services and the improvement of quality of service, Official Journal of the European Communities, 21/01/98, No. L15/14.

collection and a daily delivery to every address except at the discretion of the national regulatory authority. This applies to letters up to 2kg, packages up to 10kg (up to 20kg at the discretion of the national regulatory authority) and to registered and insured items. The European regulations, therefore, only specify an infrastructure; they do not specify any particular service (eg, first or second class) that should lie within the universal service.

The Postal Services Act 2000 carries over into United Kingdom domestic legislation the provisions in the European directive and adds the additional requirement that the services should be provided at "*affordable prices determined in accordance with a public tariff which is uniform throughout the United Kingdom*" although "*conclusions with customers of individual agreements as to prices shall not be taken to preclude the provision of a universal postal service*". [3] [4]

The 'uniform tariff' obligation in the act introduced into legislation a provision that had been a political requirement previously but which, for the first time, was now specifically incorporated into the law. It is intended to protect the rural consumer, in particular, from increases in prices which would result from a tariff re-balancing that might, for example, follow from a close alignment of service prices to costs or from a segmentation of the postal market leading to differential pricing. Both of these would be commercial responses in a competitive postal market.

The statement in the act on the possibility of individual agreements as to prices would appear to negate the previous statement in the Act on the need for a uniform tariff since if an individual agreement led to a lower price then there would be no need for customers to avail themselves of the universal postal service at the geographically uniform price. The 'uniform' price becomes in practice a 'maximum' price so that the universal service at the uniform price becomes a service of last resort used

[3] Part I, Section 4(1).
[4] Part I, Section 4(2).

only by customers who, for example by reason of location or extent of mailings, have no available alternative.

The European Commission, in the current draft of the next Postal Directive which - if agreed - will take effect from 2003, has proposed a text which would limit the application of this pricing flexibility by requiring that special tariffs should take account of the avoided costs compared to the standard service.[5]

In those utilities in which competition has already been introduced the regulator's duty to promote competition has had shared primacy with other duties, whereas in the postal sector, as laid down in the Postal Services Act 2000, Postcomm's primary duty is the provision of the universal postal service. The traditional view has been that competition is incompatible with universal service - particularly so when the provision of universal service is accompanied by a uniform tariff obligation. Hence the need for a reserved area to protect the revenues of the provider of that service. An alternative view is that the market place would of itself produce a universal service because that is what the customers of the service want. In one sense that is obviously true - if there is a need the market place will meet that need **at the market price**.

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[5] "*Whenever universal service providers apply special tariffs, for example for services for businesses, bulk mailers or consolidators of mail from different customers, they shall apply the principles of transparency and non-discrimination with regard both to the tariffs and to the associated conditions. The tariffs shall take account of the avoided costs compared to the standard service covering the complete range of features offered for the clearance, transport, sorting and delivery of individual postal items and, together with the associated conditions, shall apply equally as between third parties and the equivalent service elements of the universal service providers themselves. Any such tariffs shall also be available to residential customers who post under similar conditions*." In the Commission draft this text is in Article 9 but an amendment from the European Parliament proposes moving it to Article 12.

It is because it overrides the market price that the uniform price is such a key impediment to introducing competition. No other public utility has a uniform price obligation in the way the postal service does. Introducing competition in a manner that does not enable the long term impact on this universal service to be clearly understood, carries the risk that Postcomm may fail in its primary duty. Postcomm rightly asserts that predicting the way that the market might develop with competition is difficult. They also acknowledge that it is not possible to predict the impact on Consignia’s ability to respond to competition whilst preserving the universal service. A gradual and controlled approach is therefore needed.

Assessing the cost of universal postal service (the cost of the USO)

Decisions relating to the future state of the postal market cannot be made on the basis of the current market situation but require a forward-looking assessment. The analysis should focus on understanding the issues involved in moving from a situation of a high degree of monopoly to one of greater competition, while continuing to meet the universal service obligation of a universal postal service at a uniform, affordable tariff. In other words the question that needs to be addressed is:

- in moving from a situation in which monopoly protection is removed but in which the obligation to provide universal service remains, what is the financial cost imposed on the universal service provider (USP)? (This is known as the entry pricing calculation and is also described more fully below. Note that financial cost here refers to loss of profitability)

Unfortunately this is not the approach that Postcomm has used in undertaking their estimates of the cost of the USO. Against a background of the clear purpose of introducing effective competition, Postcomm has released, simultaneously with its consultation document on effective competition, a 'discussion document' purporting to assess, using economic analysis, the costs and benefits of Consignia's current universal service provision.[6] [7] However, in this document, the question that is tackled is:

- in the current market situation of near monopoly, what costs could Consignia save by **not** meeting the USO? (This is known as the net avoided cost calculation, which is also described more fully below and refers again to a loss of profitability).

After a long examination of this hypothetical question, the discussion document reaches the following conclusion in terms of the use of this exercise for informing Postcomm's liberalisation programme:

> "..analysis of the net cost of universal service does not answer the question of how competition might affect Consignia's commercial position and hence ability to support its operations. Therefore, a relatively low figure for the net avoided cost of the universal service, or indeed a net benefit, cannot be taken **in itself** as an indicator that full competition would not compromise the provision of the UPS. Issues relevant to considering the question of whether competition might undermine Consignia's ability to sustain its operations are discussed in Postcomm's consultation document on promoting effective competition". (p.64)

The conclusion is an acknowledgement that the exercise posed a question without relevance to the issue at hand, and that its

[6] Postcomm (2001a), Promoting Effective Competition in UK Postal Services, A Consultation Document.
[7] Postcomm (2001b), An Assessment of the Costs and Benefits of Consignia's Current Universal Service Provision, A Discussion Document.

results are of little value. However, the conclusion leaves open the impression, by use of the words, **in itself**, that a low figure from this calculation might also convey some useful information with regard to issues of the cost of continuing to meet the USO under liberalisation. In fact, that conclusion would be correct if the phrase **in itself** were replaced by **at all**, for these calculations do not tell us anything about the cost of the USO under competition.

In 1997, the European Commission set out on almost exactly the same approach as used by Postcomm. It commissioned the economic consultants National Economic Research Associates (NERA) to undertake a study on the cost and financing of the USO.[8] The EU initiative in turn encouraged and promoted a significant body of work by economists on the cost of the USO and related issues. This work was undertaken, refined and published between 1997 and 2000. NERA's approach used net avoided cost (NAC). This measures the difference in profit level of the universal service provider between the two situations: monopoly with and monopoly without the USO. It breaks the mail down into a number of different categories and calculates the difference between the revenues of the mail in each category and the avoidable costs of the mail in the category. For those categories which are loss making (ie, the revenues are less than the avoidable costs) the losses are summed to form the 'cost of the USO'. Subsequent work, however, has concluded that this calculation is not relevant to the question of liberalisation and few now argue that a NAC calculation under a situation of near monopoly provides any useful information with regard to the core issue of the cost of continuing to meet the USO in a liberalised environment with effective competition.

The key point is that a NAC calculation under near monopoly does not tell us anything about the cost of the USO under competition. The reason why this calculation is not relevant can

[8] NERA (1998), Costing and Financing of Universal Services in the Postal Sector in the European Union.

be simply made through the use of a figure based on the analysis developed in Cremer, Grimaud and Laffont (see **Table 1**).[9]

Table 1: Profitability of the Universal Service Provider

	With USO	Without USO
Under Monopoly	$Profit_1$	$Profit_2$
Under Competition	$Profit_3$	$Profit_4$

The starting position is the top left hand corner of the table. The profit level, $Profit_1$, shows the initial or 'current' position of a universal service provider (USP) meeting the USO under a monopoly. This profit level is such that the USP meets the USO and makes a 'normal' rate of profit so allowing it to meet the USO on a continuing basis.

The authorities now wish to introduce competition but ensure at the same time that the USO is met, ie, the USP is able to make a normal rate of profit **after entry** by new operators. The relevant calculation in trying to determine how far the market can be opened up while the USO is still met is the comparison between $Profit_1$ and the level of profit after entry while the USO is still met, $Profit_3$. Clearly, profits of the USP will be lower after entry and the extent of this will be greater the greater the extent of the liberalisation. To estimate $Profit_3$ it is necessary therefore to specify beforehand the liberalisation scenario to be evaluated. An assessment then needs to be made of how large a drop in profitability can be funded and by what means, weighed against the benefits of opening the market. This is the 'entry pricing'

[9] Cremer H, Grimaud A and Laffont J-J (2000), The Cost of Universal Service in the Postal Sector, in Current Directions in Postal Reform (eds) Crew M A and Kleindorfer P R, Kluwer Academic Publishers, Boston.

measure of the cost of the USO and is discussed more fully in Rodriguez and Storer.[10]

The NERA/Postcomm-Andersen comparison for the 'current' market situation with and without the USO is the NAC calculation and equals $Profit_2$ less $Profit_1$. However, whether this were to be a high or a low value, as an indicator it provides no direct information about the comparison of direct interest, namely the move to competition while the USO is still to be met. It is certainly not possible to make the inference that if the NAC calculation under near monopoly is low, it necessarily follows that this 'small cost' can easily be carried by the USP when the market is opened up to competition; that is, to try to make forward-looking decisions about liberalisation on the basis of comparison of a hypothetical alternative under monopoly.

While it adds no value under monopoly, a comparison of USP profitability with and without the USO has relevance where it is applied to the situation pertaining **after** the market has been opened to competition and a new market equilibrium secured. This is the comparison between profit levels $Profit_3$ and $Profit_4$ (Cremer, Grimaud and Laffont, 2000). Note that this measure implies, like entry pricing, that the cost of the USO is specific to the liberalisation scenario being evaluated and requires an estimate of the USP's profitability with the USO ($Profit_3$). It makes no use at all of the profit levels under monopoly which are the ones used in the NAC calculation ($Profit_1$ and $Profit_2$).

Evidence from liberalisation in other countries

Lessons can be learned from other countries that have allowed more competition into their postal markets than is currently the

[10] Rodriguez F and Storer D (2000), Alternative Approaches to Estimating the Cost of the USO in Posts, Information Economics and Policy 12, pp285-929.

case in the UK. As examples, the consultation document lists five countries, three of which (Sweden, Finland and New Zealand) are described as having full liberalisation and two (the Netherlands and Germany) are described as having partial liberalisation. All except New Zealand are in the European Union. Spain is not included, although this is a country in the European Union which has had fully liberalised local postal services since 1960, and currently has very poor quality of service (less than 70% of letter mail was delivered on target last year).

Although Finland is listed as a country that has been fully liberalised since 1994, there has not in fact been any competition in Finland since that date because of the requirement of a very high contribution to a universal service fund that is asked of entrants.

The two partially liberalised countries, Germany and Holland, both have a form of liberalisation (lower weight and price thresholds) which is the gradual and controlled approach to liberalisation preferred by the European Commission. In Germany, the threshold was reduced to its current level of 200g three years ago (this is higher than the level to which Consignia has stated that it would support seeing the threshold reduced in the United Kingdom). In Germany the decision was recently taken to postpone full liberalisation of the postal sector until, at the earliest, 2007 in order to harmonise with the rest of Europe. The threshold in the Netherlands was reduced to 100g only one year ago. It is too early to say what the long-term effect in these countries will be, but note, however, that the Dutch public tariff letter prices were increased in July 2001. The public tariff price in Holland for a letter less than 20g in weight is 0.39 euros (about 27 pence on a purchasing power parity basis), but in the range 20g-50g it is now twice this at 0.78 euros. The latter is significantly higher than the 27p price of a first class stamp for letters weighing up to 60g in the UK. The Netherlands has, of course, much less geographic diversity than the United Kingdom but, nevertheless, the Dutch Post Office has introduced separate local and national tariffs for printed paper mail, which is open to competition.

Sweden has had full liberalisation since 1993. The fact that retail prices have risen since that date in Sweden is mentioned in the consultation document, but the scale of that increase is not indicated. The public letter price has in fact risen in Sweden by 72% (60% in real terms) since 1993, whereas, in the United Kingdom, prices have fallen in real terms over the same time period. Approximately one third of the Swedish increase is due to the imposition of VAT on postal services. The consultation document does not mention the problems that would be associated with liberalising the postal market and allowing the incumbent operator to remain VAT exempt whilst continuing to require other providers of postal services to pay and charge VAT. Between 1993 and 1999 letter volumes in Sweden were static (excluding unaddressed items), while other countries, including the UK, witnessed significant growth.

In Sweden, the market share loss has been limited to approximately 5%-10%, but despite this the profitability of SwedenPost has deteriorated recently alongside significant reductions in costs. The operating profit of SwedenPost (excluding Postgirot) declined from 174m Swedish Krona in the first quarter of 2000 to an operating **loss** of 1m Swedish Krona in the first quarter of 2001.

It is stated that in the two countries that have experienced full postal liberalisation - Sweden and New Zealand - the incumbents have responded aggressively through pricing flexibility. Postcomm appear to be arguing that if Consignia applied the same pricing policy as New Zealand or Sweden then it could maintain market share and therefore protect the universal service. But would Postcomm find the pricing strategies adopted by these operators acceptable? SwedenPost has had 100 cases of illegal pricing referred to the Swedish regulator and Market Court. In Sweden, arguably, there no longer exists a geographically uniform tariff - which, in the UK, is an important public policy objective. In New Zealand there is no postal sector regulator and little or no competition law comparable to the 1998 Competition Act. The New Zealand Post Office has considerably greater freedom with which to respond to competition through pricing than would be legal in the UK. Postcomm acknowledges, in their paper, that international experience indicates that competition has in some cases undermined the provision of a universal postal service at a uniform tariff.

The lessons that can be gained from overseas experience are limited to the few countries that have liberalised to a greater extent than has so far occurred in the UK. But the evidence from those countries would seem to support the approach of a gradual reduction in the weight and price thresholds of the reserved area, as long as the pricing flexibility of the incumbent universal service provider is restricted by a uniform tariff requirement. The important consideration in assessing the viability of the universal service after the introduction of competition is the impact on the profitability of the universal service provider, given the constraints on its ability to respond to such competition. The opportunity for cherry picking competition to occur can undermine the financial viability of the incumbent, even if there is a significant increase in the public uniform tariff, and one result of an increase in competition would be an increase in tariffs to domestic and rural customers to provide benefits to large users. This pattern of impacts has been identified by recent economic analysis and is confirmed by the experience in Sweden.[11] [12]

[11] De Donder P, Cremer H, Florens J-P, Grimaud A and Rodriguez F (2001), Uniform Pricing and Postal Market Liberalisation, in Future Directions in Postal Reform (eds) Crew M A and Kleindorfer P R, Kluwer Academic Publishers, Boston.

[12] De Donder P, Cremer H and Rodriguez F (2002), Funding the Universal Service Obligation under Liberalisation: An Analysis of the Postal Market, in Postal and Delivery Services: Pricing, Productivity, Regulation and Strategy (eds) Crew M A and Kleindorfer P R, Kluwer Academic Publishers, Boston.

Postcomm present evidence to demonstrate that only a modest loss of market share has occurred in those countries in which full or partial liberalisation has taken place. The evidence that there has been limited entry in these countries is used by Postcomm to argue that the universal service would be safe after liberalisation, but elsewhere in the consultation document Postcomm argue that a form of introducing competition is required which makes a significant impact on Consignia's market share. Arguably, however, the universal service has been safeguarded in these countries **precisely because** there has been limited entry. If Postcomm wish to see significant entry and a substantial loss of volumes by Consignia it will be necessary to understand the financial viability of the postal network in such conditions. This cannot be obtained from these international comparisons since, as their tables demonstrate, no very significant loss of volumes has occurred in any of these comparator countries.

Consignia's response to entry will be constrained by two factors: the geographically uniform tariff obligation and the competition rules (the 1998 Competition Act). Postcomm suggests that Consignia has a significant degree of pricing flexibility to respond to competition. The crucial flexibility needed, however, is geographic pricing - it is this that is denied Consignia through the uniform tariff requirement, established in primary legislation. Pricing flexibility means in practice the separation of business and consumer tariffs since these constitute different markets. The result, as has been demonstrated in Sweden, is a substantial increase in the consumer tariff combined with correspondingly substantial reductions in prices to businesses, although for a large loss of traffic there is no guarantee that the ability to price flexibility in response to entry will of itself ensure the financial viability of the universal service provider.

The EU's preferred approach to liberalisation

There has been extensive debate across the European Union on the introduction of competition into the postal sector since the adoption of the European Postal Directive in 1997. This directive required the European Union to agree a further step for introducing competition into European postal markets by 1 January 2003. There is now widespread agreement, at the European level, that the best means of introducing competition into the postal sector in a gradual and controlled way, as required by the European directive, is a phased reduction in the weight and price limits of the reserved area, with the next step taking place in 2003. This approach was adopted by the European Commission in their draft directive published in May 2000, and has been endorsed by the European Parliament and most Member States. The focus of debate, which is taking place currently at the Telecommunications Council, is on the level to which the weight and price limits of the reserved area should be reduced at the next step in 2003, and the extent to which the subsequent liberalisation programme should be defined in the new directive.

At a meeting of the Transport and Telecomms Council of the European Union in Luxembourg on the 15 October, agreement was reached on a proposal for further market opening. This proposal will have to be agreed with the European Parliament. The Council proposed the reduction of the reserved area, from the 1 January 2003, to letters weighing less that 100g and priced at less than three times the basic weight step tariff. Outgoing cross border mail is also to be fully liberalised on the same date, except in those countries which judge this to be too damaging to the universal service. In 2006, there is to be a further market opening for letters weighing more than 50g and priced at two and one half times the basic tariff. The European Commission is required to prepare a report, in 2006, on a study designed to indicate what impact full liberalisation would have in all Member States. In 2007, the European Commission, together with the European Parliament and the Council will decide on a substantial further step, to take effect in 2009.

Once a reduction in the weight and price thresholds in the European directive is agreed, the result will be a loss of profit by Consignia. Introducing competition into the UK postal market using a different approach, eg, market-led licensing, introducing competition by product, customer group or market, and by third party access to the public universal postal network, risks, therefore, placing the UK out of step with the other European Member States. If the additional financial impact resulting from the new directive is not factored in to Postcomm’s thinking, the total financial impact will be larger than allowed for, with the risk that the financial equilibrium of universal service provision in the UK, which is their primary duty, will be jeopardised. It is surprising and disappointing that Postcomm has ignored this wider perspective to its task. Whatever decisions are made in Europe will bind the UK. Postcomm cannot ignore the fact that the introduction of competition will be a two-pronged approach, and that it will be essential for Postcomm to allow for the liberalisation which will originate from Europe in its own calculations and decisions.

Consignia proposed an initial reduction in the weight threshold to 150g, with a corresponding reduction in the price threshold to two and a half times the basic stamp price, in 2003. This is a level to which the weight and price limits could be reduced, which will enhance customer choice, incentivise the universal service provider to improve quality and efficiency but which will, at the same time, allow the universal service to be protected. Consignia has also proposed that there should be a substantial further step in the process of introducing competition, in 2007, subject to a review of the development of the market after the changes introduced in 2003. This approach is consistent with that applied by other sector regulators.

In their consultation document, Postcomm suggest that the approach of reducing the weight and price threshold might present Consignia with perverse incentives for efficiency and economy. But this is to undervalue the incentivising power of economic regulation and, in particular, the price cap, which could be used in combination with a reduction in the weight and price monopoly thresholds to provide incentives for a low-priced, high-quality postal service. The period between pricing reviews should be linked to the phased programme of liberalisation through weight and price step reductions.

Market-led licensing

Of the other approaches to introducing competition into posts referred to in the consultation document: competition by product, customer group or area, competition by activity within the postal value chain and third party access have been considered by the European Commission and rejected in the preparation of their current proposals. The reasons for the rejection of these proposals are clearly stated in the reports by their consultants which are in the public domain.[13]

Third party access to the public postal network is now already allowed for in the UK in that Condition 9 of Consignia's licence requires access to be provided to other operators. The pricing of such access will be determined by the principles specified in the new postal directive, that is to say, access prices should be based on the avoided cost in comparison with the standard postal service.

Postcomm propose a further alternative to bringing competition into the postal sector; that of market-led licensing within the reserved area, and has been pursuing a course of granting interim licences whilst developing its licensing policy further. Whilst Consignia accepts that licensing has a role to play in the introduction of competition, it has to be applied carefully. There

[13] Arthur Andersen (1998), Study on the Impact of Liberalisation in the Postal Sector, Lot 1: Direct Mail; CTCon (1998a), On the Liberalisation of Clearance, Sorting and Transport; CTCon (1998b), Study on the Weight and Price Limits of the Reserved Area in the Postal Sector; PricewaterhouseCoopers (1998), The Impact of Liberalisation on Cross-Border Mail.

are clear benefits in a licensing regime in that it provides a means to monitor market developments and to gain an understanding of the way in which competitors can provide alternative services. There is, however, potentially a contradiction inherent in the use of this approach that determines the limits within which it can be profitably pursued without putting in jeopardy the provision of universal service. The availability of licences is likely to attract entrants only to the profitable areas of the postal sector - thereby undermining the basis by which the universal service provider is able to balance profits and losses in order to maintain the uniform tariff structure. Also the licensing approach depends upon Postcomm acting on behalf of the market, but Postcomm says in the consultation document that regulation is second best to competition in deciding the best interests of customers. Licensing is also a much more bureaucratic approach to introducing competition, and constrains the freedom of action of potential operators.

In the consultation document it is stated that successful competitive entry will, among other things, depend on:

> "the entrant's relative position relative to the advantages possessed by Consignia, . . . the application of new technologies and innovations and the development of services that customers value".

It is suggested that competitors would develop value added or premium services not related to exploiting cost differentials. Clearly, the aim of the licensing policy should be to encourage innovative, value added alternative services.

In order that the licensed operation should be such as to ensure the protection of the universal service provision (which means ensuring that an activity is not allowed that simply exploits the uniform tariff obligation of the universal service provider by cream skimming) the licensed operation should be tightly drawn and clearly specified in the licence granted. All licence holders should have suitable consumer protection provisions in order to provide equality of consumer standards. This will inhibit the competitive activity of the new entrant who will not wish to be so closely constrained. The consequence will be, therefore, that, if applied in such a way as to effectively protect the universal service, the licensing approach will be seen, by entrants, as interventionist, indeed intrusive, hindering the development of a properly developing market. Postcomm can expect to come under pressure to broaden the scope of the licence to a degree that it becomes ineffective as a mechanism of control of the liberalisation process. Consequently, the market-led licensing approach, contrary to initial impressions, will not be able to fulfil the intention to produce a gradual and controlled liberalisation of the postal sector.

The licence applications so far submitted for consideration within the context of the interim licensing policy published by Postcomm in April 2000 have all been for services which offer an alternative to the first class service, but at a lower price in limited market niches for which delivery costs are low, eg, internal mail and pouch services and closed user group operations - in other words classic cream-skimming. These licence applications have demonstrated that in practice, competitors will not, as a rule, wish to offer substantially innovative or high quality services. They will want to offer services in niche markets where they can compete at prices below the uniform tariff and cherry pick profitable customers. To respond to this, if such interim licences are to be made long term, Consignia would need to be allowed the flexibility to respond on price.

In fact, Postcomm, in their consultation document, appear to encourage this kind of competition. It is suggested that a competitor could overcome the scale advantages that Consignia enjoys by consolidating mailings and delivering fewer days during the week. This would be a lower quality, lower price service than the standard letter service currently provided by

Consignia. This is, in fact, the main form of competition that has developed in Sweden since the liberalisation of the postal market there - the main competitor, Citymail, offers two deliveries a week to businesses at a substantially lower price than the Swedish public retail tariff. The market has separated into two sub-markets: a low cost, low quality service provided by the competitor and the incumbent service. The incumbent service, because of the reduction in volumes that are siphoned off to the low cost provider, has an increased unit cost and a higher price. Competition in Sweden has achieved an unbundling of cross-subsidies and the provision of discriminating services. The result is a higher price for the public service provided by the universal service provider and used by consumers and small businesses.

In order to be effective in protecting the universal service, a licensing policy should be used, not to license services which operate solely within the area that is reserved to provide protection for the universal service, but to 'clarify the boundaries' of that reserved area. That is to say, the licensing policy should be limited to licensing only those services that genuinely provide a high quality, alternative service. This can be judged by the price of the service offered and whether or not it provides material additional features, which dissociate it from the universal postal service. In contrast, Postcomm are in danger of developing a regime for the introduction of competition in which there are significant risks to the continued viability of the universal service and associated service standards and pricing. It is questionable whether it would be in the overall interests of customers and would be likely only to benefit large users at the expense of consumers.

Universal service and the current service provision by Royal Mail

The consultation document defines the universal service obligation in para 3.2 as the service requirement specified in the Postal Services Act, but the term is used differently at various points throughout the document. The term is sometimes used for the definition in the Act, and sometimes to the range of services and service specifications currently offered by Consignia. In paragraph 3.5 it is said that the universal service could "*evolve over time*". This presumably means the current service provision could be reduced over time to more closely match the statutory minimum requirements. This interpretation is supported by paragraph 3.6 in which it is stated that "*any restriction on competition.......may require a level of clarification on the services that satisfy the UPS obligation*", and by paragraph 5.7 in which it is stated that in the context of a dynamic market-led approach to licensing "*the scope of what needs to be protected as the universal service could change*". Postcomm concludes that this change would enable it to "*limit its interpretation of the universal service to the minimum requirements of the Act and European Directive*". The document further suggests, in para 3.44, that as a way of safeguarding universal service, Postcomm could "*modify what it might view as universal service...*". These appear to be very clear statements that if universal service forms a barrier to competition then the universal service rather than the competition will be limited.

The universal service has been a clear political commitment expressed through legislation and operates as a commercial constraint. The introduction of competition raises the possibility that customer and contractual requirements will replace universal service standards. The postal service will move away from being a part of the national infrastructure and become a service industry most of whose revenues come from a few large businesses and it is these large customers that will need to be satisfied by the postal service. To the extent that they require a universal service it can be expected to remain.

In the Netherlands the debate on the provision of universal service is further advanced than it is in the United Kingdom. It has already been suggested by a Council advising the Dutch Government that only two or three deliveries a week are needed in The Netherlands.[14] Their report argues that the universal service does not need to be obliged by legislation because the market already offers many alternatives for receiving and sending messages: e-mail, fax, telephones (including mobile phones). This reduces the importance of the postal service to consumers and society. Liberalisation will lead to price and service differentiation and therefore more choice for consumers. New market entrants will be able to take advantage of economies of scale with other delivery operations. Price reductions will occur in densely populated areas and price increases in less populated areas. Large-scale users will particularly benefit from new services and lower tariffs. Service may deteriorate for some small users and thus not everybody will experience an improvement. The Dutch Advisory Council thinks that this disadvantage is outweighed by the general advantages of liberalisation. Large mailers will want delivery to all addresses and therefore the postal operators will be required by their (large) customers to provide universal service. The Advisory Council concludes that after full liberalisation it will not be necessary to specify a universal service obligation. It is suggested that a 'safety net' set at two deliveries a week is all that is necessary.

There are a number of respects in which the service provided by Consignia exceeds the minimum universal service standards required by the Act and the directive:

- ***Delivery by 09:30***

Uniquely amongst European member states, Royal Mail aims to deliver mail by 09:30 in the morning, six days a week, to all addresses. In Germany, the deliveries are targeted to take place between 09:15 and 14:00, in Norway between 09:30 and 13:00 and in the Netherlands between 09:00 to 15:00. In Denmark,

[14] Advisory Council for Transport, Infrastructure and Water Management (April 2000), Een postmarkt zonder grenzen, The Hague.

business addresses only can receive a delivery between 08:00 and 10:00. Delaying delivery until later in the day and extending the delivery span would enable a more efficient use of labour hours and would also improve the percentage of items delivered next day - since there is more time to get the items through the network to the postman.

- ***Second deliveries in urban areas***

Approximately 85% of addresses, in urban areas receive a second delivery, five days a week. Again this service provision is unique to the United Kingdom. The main reason for this second delivery is to improve service standards by picking up and delivering mail that fail to arrive in time for the first delivery. Approximately 4% of mail is not normally available for first delivery and is necessarily taken out on the second delivery. If the first delivery were delayed with a later delivery span, this mail would now be available for the first delivery and a second delivery becomes unnecessary. With such small volumes carried on these deliveries the unit costs are very high and removing this service would enable substantial savings.

- ***Delivery to the door***

The Act does not specify that letters should be delivered to the door of each premises but "*. . to the home or premises of every individual or other person in the United Kingdom or to such identifiable points for the delivery of relevant postal packets as the Commission may approve*". In parts of the United States delivery is made to a kerb side box to facilitate deliveries. In blocks of flats and in buildings which house a number of small businesses in cities across Europe, delivery is to a bank of pigeon holes at the entrance foyer.

Universal service support funds
- a tax on entrants

The suggestion is made that Postcomm may recommend to the Secretary of State a universal service support fund. There is, however, ample evidence from countries where such funds have been attempted in the postal sector that they have not been found to be an effective means of ensuring funding for the USO. There are substantial practical difficulties. For example:

- an accurate estimate of the financial cost of the USP continuing to meet the USO under liberalisation needs to be calculated on an annual basis;

- an explicit specification of the operators required to contribute is needed;

- contributions due from any operator who withdrew from the market or went bankrupt would have to be reallocated;

- the contribution base (the set of services which are specified as the sources of revenue for the compensation fund) would need to be defined and should be set such that it has no distorting effects on the market or gives a competitive disadvantage to any contributing operator;

- a revenue based system of contribution might be regarded as preferable to traffic or profit measures. Profits present practical problems as a base for the tax because firms could artificially reallocate costs to reduce profit levels. The main problems with a traffic base are data availability and quality;

- however, a revenue base would also be problematic. Some sources of revenue ought to be excluded from the total revenue base from which contribution shares would be calculated. For example, the revenues which accrue from uneconomic areas should be excluded so that the total revenue is made of revenues from relevant, profitable services from all operators contributing to the fund;

- the provision of this information by all contributors will need to be audited and therefore operators will need accounting systems which separate the costs and revenues between their contributing and other activities;

- there will need to be an appeals mechanism for any operator to dispute payments and a penalty provision in the event of failure to pay.

Furthermore, if the financial cost to be funded is substantial, it is by no means clear that a universal service support fund on its own would be sufficient to generate enough revenue to offset the loss in profitability associated with continuing to provide universal service (DeDonder et al, 2002). Other means of funding would also be required, such as partial liberalisation so leaving in place a (reduced) reserved area. This study also demonstrated that if universal service support funds are used as a principal means to cover the losses from continuing to meet the USO, this may well require significant taxes on entrants which in turn would offset some of the gain to those consumers who would enjoy lower prices as a result of liberalisation.

Conclusions

Of overriding importance in the introduction of competition into postal services is the continuing provision of the universal service at a geographically uniform and affordable price. It has been established that there is a conflict between competition and this universal service obligation which can be minimised if competition is introduced in the right way. Consignia supports the gradual and controlled introduction of competition through reductions in the weight and price thresholds.

The European Union will in any case be proceeding with this approach irrespective of any further liberalisation that might occur in the UK, for example, through market-led licensing. Introducing competition by two different means simultaneously will have greater effect than either on their own and the threat to the financial equilibrium of the universal service provision will be greater than would have been allowed for in either of the two approaches individually. Consequently, the financial balance in the UK could be upset. To avoid an approach in the UK which may be distorted by the reductions in the scope of the licensed area brought about from the EU the only sensible way forward is, therefore, to proceed on the same basis in the UK as is being pursued at the European level and reduce the weight and price thresholds on a progressive basis.

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8 HOW FAR CAN LIBERALISATION OF POSTAL MARKETS GO?

Martin Cave

Introduction

There is fairly broad agreement that competition should be introduced into regulated industries wherever possible on the grounds that 'competition is the best regulator'. This policy has been carried forward by many of the UK regulators, particularly in the fields of telecommunications and the supply of energy. Some limited progress has even been made in the water industry. In some cases the competition has been supplied by firms offering an end-to-end service; in other cases competitors have access to the incumbent's pipes or wires.

One of the consequences of competition is to bring prices more into line with costs. This applies on both a service-by-service and a customer-by-customer basis. Thus there has been pressure to increase the line rental in fixed telecommunications services, which historically was below cost. Competition also puts pressure on the geographical averaging of the price of a service, where the cost of meeting the needs of customers differs widely. However, such re-balancing or differentiation of tariffs is often considered unacceptable on social grounds. To protect against it, regulators have intervened, often under the banner of ensuring the attainment of universal service obligations (USOs), under

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which the incumbent (normally) has an obligation to provide service even to some non-commercial or loss making customers. This objective often sits beside other objectives, such as consumer protection or the promotion of competition.

In postal services the universal service obligation has assumed an even greater significance. This is because Consignia in the UK (as elsewhere) has historically assumed an obligation to provide a universal service nation-wide at a uniform affordable price: indeed, the term ‘postalisation’ of tariffs has come to describe that policy across a range of sectors. The significance of the obligation is reflected in the fact that, under the Postal Services Act 2000, Postcomm’s primary duty is to ensure that customers continue to be able to enjoy a ‘universal postal service’. Only subject to this must Postcomm also further the interests of users of postal services by promoting effective competition between postal operators, having regard to the interests of certain specified customer groups, such as the disabled and residents in rural areas.

This hierarchy of duties imposes on Postcomm an overriding requirement to take into account the impact of licensing competitors on Consignia’s ability to discharge its universal service obligations. In other words, the USO can be treated as a constraint on the development of competition. Although there is considerable scope for debate about the precise definition of the obligation, the act makes clear that, whatever definition is chosen, Postcomm must ensure that the relevant service is provided.

Postcomm has recently addressed this issue in a consultation document.[1] The document considers ways of promoting effective competition while safeguarding the universal service, examining in some detail the options for a more competitive market. It is likely that decisions about long-term liberalisation

[1] Postcomm (2001), Promoting Effective Competition in the UK Postal Services, June.

will be taken in early 2002. Postcomm has hitherto issued only a small number of interim licences.

This chapter discusses some of the analytical problems which arise in trying to reach a regulatory decision of this order of magnitude. Although the Commission will ultimately reach a decision on the basis of judgement, it is obviously desirable that that decision is bolstered as far as possible by analysis of possible threats to the continuation of the USO. This process has been widely discussed within the industry, particularly by Consignia before and during the passage of the act, and throughout Postcomm's life. In particular, Consignia has suggested that it is appropriate to measure the 'cost of the USO' via a particular model which they have developed called the entry pricing model (EPM). This stands in contrast to an alternative methodology developed within the telecommunications industry, and also favoured by Postcomm and the European Commission, known as the net avoided cost (NAC) approach.

The distinction between these two models is discussed in detail below. Here, it is sufficient to note that the entry pricing model is designed to show the overall loss of profit experienced by Consignia if entry occurs, on the basis that, before entry, Consignia is charging a uniform tariff for its services which ensures cost recovery, and that it continues to charge that uniform tariff afterwards. The net avoided cost approach, by contrast, identifies the losses incurred on high cost routes by Consignia as a result of its obligation to supply services at a uniform price. It is clear that the two models are addressing quite different questions, both of which have a bearing on Consignia's ability to sustain its universal service obligations. The EPM raises questions about Consignia's ability to finance its functions if its pricing is constrained across the board. The NAC model focuses exclusively upon loss-making activities which Consignia has an obligation to supply.

Modelling the costs of the postal service

As is the case with many utilities, the operation of an end-to-end postal service can be decomposed into a series of discrete stages, the technology and costs of which have different characteristics. The conventional break-down for postal services is into the following activities – the numbers in brackets indicate the approximate percentage split of directly attributable costs: collection (5%); outward sorting (12%); transportation (14%); inward sorting (14%), delivery (43%); support activities (12%).[2] Each of the first five activities (omitting the heterogeneous category of support activities) will be characterised by different degrees of economies of scale. There may also be economies of scope pertaining to combinations of activities. It is the conventional wisdom that the greatest economies of scale are associated with delivery, which is also by far the most costly activity of those listed.

Forms of cost modelling

Setting on one side the estimation of econometric cost functions, which is almost invariably ruled out by lack of adequate data, regulatory cost estimation is normally done in one of two ways. In the first, the analyst investigates the incumbent's management accounting data, with a view to identifying which costs are associated with what product or service. This is usually done using techniques such as activity based costing, which focus on establishing causal relationships between costs, the activities on which they are expended and the products thereby generated. On this basis, the analyst should be able to establish the incremental cost associated with particular products or group of products, and the associated level of common and overhead costs. It is clear, however, that this analysis only permits an allocation of costs over a particular period, characterised by a particular output level. In order to deduce the underlying cost function, significant

[2] Postcomm, 2001.

further inferences have to be drawn from the cost data, or additional assumptions made.

The second, or 'engineering', method involves the construction of the model of a hypothetical enterprise capable of achieving specified levels of output of particular services. This is done through a knowledge of, for example, the sorting equipment necessary to deal with particular postal flows, or the costs associated with delivering specified volumes of material over a given geographical area.[3] Once the input required has been identified and costed, and necessary common and overhead costs have been added, a total cost can be found for the chosen set of outputs.[4] The process can be repeated for different output levels, in order to investigate the impact on total costs of changes in output. This permits the generation of marginal and average incremental cost estimates for particular services or operations.

The cost modelling underlying Consignia's EPM appears to take a third form. Operational models, representing the underlying production processes, are used to model the costs of particular activities, and it is likely that actual costs data is being used to calibrate the models. These estimates are supplemented by expert estimates.

Experience in other industries suggests that engineering cost modelling is well suited to estimating equipment costs, especially in highly capital intensive industries. It is less well suited to estimates of labour costs, where operational models may be particularly helpful, and largely ineffective in estimating common or overhead costs. Experience in the telecommunications industry also suggests that a combination of

[3] For an example of cost modelling of delivery see Roy B (1999), Technico-Economic Analysis of the Costs of Outside Work in Postal Delivery in Crew M and Kleindorfer P, (eds), Emerging Competition in Postal and Delivery Services, Kluwer.

[4] Common costs are costs which cannot be distributed among products on a causative basis. Overheads are indirect costs which cannot be so distributed, such as head office costs.

approaches is particularly fruitful in appropriate areas. This suggests that Postcomm may be able to utilise engineering cost modelling in relation to the more capital-intensive activities undertaken by Consignia, but that much cost estimation will involve operational models of labour processes.

Cost modelling in Consignia's entry pricing model

Although significant analysis has been done of the costs of postal services outside the UK, the main body of work on Consignia's costs has been done by the organisation itself, in development of its entry pricing model (EPM) noted above.[5] This model has been developed over a number of years as a means of establishing the effect on Consignia's financial returns of alternative levels of market liberalisation, on the hypothesis that Consignia is subject to universal service obligations of a particular form.

The essence of the approach is to break down the Consignia network into a set of routes, where a route is defined as the end-to-end collection and delivery of a particular product.[6] Routes differ in respect of distance (3 categories), product (x22), size (x4), type of recipient (x2), density of delivering area (x8), and weight (x11). Thus distance falls into three categories – local, neighbouring and distance. Delivery density can take five values: city centre, urban, suburban, rural and deep rural; and there are two recipients – business and residential. This creates a total of 29,040 routes.

The next step is to estimate the long-run marginal cost (LRMC) of each of the separate activities which make up each route. These are then aggregated to produce an estimate of the LRMC for each route. Activity costs are estimated using a combination

[5] The Post Office (1999), Estimates of the Costs of the Universal Service Obligation Using the Entry Pricing Approach, April.

[6] Postcomm (June 2001), An Assessment of the Costs and Benefits of Consignia's Current Universal Provision: A Discussion Document, Ch. 3 and Annex 2.

of operational models and expert judgement. Operational models cover different activities within Consignia, ranging from the very simple, such as an assumption that sorting costs are directly proportionate to sorting volumes, to more complex models of the delivery process. In some cases the operational model restricts the activity to a particular technology. To this extent, the modelling is not linked to the standard long-run time period in which all inputs are allowed to vary – for example, delivery on foot might be superseded by use of a van. In cases where particular activities are outsourced, then the actual contract costs are used to estimate the LRMC. Consignia believes that the model is capable of supplying robust estimates for changes in activity of up to 30% in either direction.

A key conclusion from the model is that LRMC accounts for 60% of total costs. In other words, the cost volume elasticity with respect to all outputs is 0.6, implying the presence of a substantial 'lump' of common and overhead costs and/or of significant economies of scale. This estimated figure has large consequences both for estimating the net avoided cost of the USO and for evaluating the likely impact of competition on Consignia. It is important for estimating the cost of the USO, because the model suggests that many costs are not avoidable if a service is withdrawn; as a result, the revenues from most services cover their net avoidable costs. On the other hand, for Consignia to have such a high proportion of fixed costs in its cost base inevitably makes it vulnerable to an increase in average costs if it loses market share to competitors.

In Consignia's view, the fixed costs are a kind of 'network cost' which it has to incur as a result of its obligation to meet its universal service obligations. In Consignia's view, this necessitates a nation-wide network of facilities which have to be provided to meet its obligations. However, this leaves open the question of how far the existing network could be re-engineered to meet lower volumes but still maintain the universal service. As Consignia's cost model imposes constraints on the re-engineering of certain processes, it may prove an unreliable guide to modelling the true long-run impact of competition on Consignia's costs.

Costing the universal service obligations

As noted above, Postcomm's primary duty is to ensure that customers continue to be able to enjoy a universal postal service. This consists of the delivery and collection at least once every working day of mail up to 20kg in weight and the provision of a registered post, all at affordable prices that are uniform throughout the UK. In fact Consignia provides a fuller service than this (6 days a week delivery, a first delivery before 9:30 am and – in many areas – a second delivery).

It has become customary to address the question of the net costs of the USO by establishing the extent to which the universal service obligation forces the universal service supplier to incur losses which it would not incur if the obligation were not present. In other words, the net avoided cost (NAC) of relaxing the universal service obligation is calculated. The maintained hypothesis is that the operator is a 'going concern', so the relevant thought experiment requires an answer to the question: what loss does the operator incur as a result of having the universal service obligation, compared with the situation in which it could withdraw from unprofitable business?

This analysis suggests that, in order to determine the burden imposed by the universal service obligation, the regulator needs to compare the revenues and long-run incremental/avoided cost of each relevant service and calculate the sum of losses on all loss-making services - those whose revenues fail to cover costs.

Evaluation of benefits

It is widely recognised that being a USO operator may confer benefits as well as impose costs. In the case of telecommunications, possible benefits are advertising, branding, and ubiquity - arising from customers' knowledge that the universal service operator necessarily provides service everywhere.

Attempts have been made by Oftel to estimate the value of USO benefits in the case of BT's telecommunications services. It is fair to say that the results are fairly speculative. Postcomm has begun to address this issue.[7] It is legitimate for a regulatory commission to incorporate a judgement of the value of the benefits in deciding whether the cost of universal service obligation materially endangers the performance of the obligation. Assuming that the benefit is zero is almost certainly wrong.

Sharing the costs of a universal service obligation

In the European Union's Directive on Interconnection and Universal Service in telecommunications, provision is made for the national regulatory agency to compute the cost of the universal service obligation, and the net avoided cost method is recommended for this purpose. The NRA may then share the cost of the universal service obligation among all operators in the market, with a *de minimis* exemption for the smallest. It is recommended that the sharing be done on the basis of revenues. It has been pointed out that, in circumstances where entrants are likely particularly to attack low cost markets, leaving high cost markets to the incumbent, there may be a theoretical case for gearing each operator's contribution to profits rather than revenues - to take account of the fact that a disproportionate share of the incumbent's sales may generate a low contribution. However, this approach has generally been rejected on the grounds that levies on profits have an adverse effect on incentives and that it is particularly difficult to generate an accurate measure of the profitability of an entrant in the start-up phase of its business.

[7] Postcomm, 2001, Chapter 8.

The establishment of a universal service fund does not lie within Postcomm's competence, but would require action by the Secretary of State. There are good arguments for Postcomm to have access to an additional policy instrument, both to provide a safety net for the universal service and to provide entrants with greater comfort in the stability of the regulatory regime relating to competition. The argument that a sharing fund provides no protection because the cost of the USO is so large is not persuasive in the face of preliminary estimates using the NAC approach, which suggests that it is quite small – of the order to 1 or 2% of revenue.

Costing the universal service obligation under competition

Although the Postcomm estimates reflect the current position, in which Consignia is free from competition over major areas in its business, the net avoided cost can be applied in a competitive environment, as is routinely done in the telecommunications sector. It has also been suggested that because entrants will focus on profitable customers, a cumulative process will be set in train in which Consignia's average costs will rise, causing the uniform tariff to rise, and exposing more of the market to competition. In the end universal service at an affordable price disappears. It is likely that, as competition develops, Postcomm will wish to revisit the question of the burden imposed by the universal service obligation. It may also be possible over time to produce more reliable estimates of the benefits of being a universal service provider. But, judging from international experience, it is not likely that Consignia's USO burden will suddenly become unmanageable.

Cost-based restrictions on Consignia's competitive responses

One of the key issues relevant to Consignia's fortunes after liberalisation is how far it can depart from the uniform tariff by offering discounts to large customers, or (less plausibly) special regional tariffs. But this discussion raises the further question: should Consignia's downward price flexibility be limited by competition law alone, or should it be subject to additional regulatory restrictions?

Competition law restrictions

Under European competition law, the price charged by a dominant firm is held to be predatory if it is satisfies the following two-pronged test:

- prices set at below average variable cost are presumed to be predatory and thus abusive; a firm charging such a price fails to recover all of its fixed costs and at least some of its variable costs. This creates a *per se* presumption of abusive behaviour;

- prices set at below average total cost, but above average variable cost, are also presumed to be predatory, but only if some evidence of intention to eliminate a weaker competitor can be demonstrated.

In the telecommunication industry, European and UK competition law has adopted an alternative test. This is because it is held that in network industries it is generally inappropriate to measure the costs of supplying of service by reference to its average variable costs. Thus the EC Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector, states that:

> "A price which equates to the variable cost of a
> service may be substantially lower than the price the

> operator needs in order to cover the cost of providing the service …… The cost considered should include the total costs which are incremental to the provision of the service ….. (Therefore,) the Commission will often need to consider the average incremental costs of providing a service, and may need to examine average incremental costs over a longer period of one year”. [8]

Oftel’s ‘Guideline on the Application of the Competition Act in the Telecommunications Sector’ accordingly notes that if a dominant undertaking is pricing below long run incremental cost, the Director General of Telecommunications will presume that it is intending to engage in predatory pricing.

Regulatory approaches

However, Postcomm is not confined to competition law remedies in setting price floors for Consignia’s competitive responses, and - in any case - it does not enjoy concurrent powers with the Office of Fair Trading under the 1998 Competition Act to enforce competition law. In discharging its regulatory responsibilities relating to undue discrimination and undue preference, there are several approaches which it could follow. One, previously adopted by the former Gas Regulator (Ofgas), is to prohibit competitive responses in markets, or market segments, where competition is not regarded as having been ‘established’. Established competition could then itself be defined by a reference to a threshold loss of market share by Consignia. Alternatively, Postcomm could follow the example of Oftel’s regulation of BT’s competitive response in the early 90s. Under this arrangement, BT was entitled to reduce its prices for individual services in progressive steps over a five year period from an initial level of fully allocated cost (including a mark-up for common and overhead costs) to an eventual floor of long run incremental costs.

[8] [1998] OJ C265/2.

A third possibility would be to link the level of the restriction to market share. For example, if Consignia's market share were 100%, it would be prohibited from deviating from the uniform tariff. If it fell to 60%, it could charge as low as long run incremental costs. For market shares between 100% and 60%, its permissible competitive response would be graduated accordingly.

I am not concerned here with evaluating these or other alternatives. However, it does seem likely that Postcomm will need the capacity to at least to estimate long run incremental costs of Consignia's services, probably broken down geographically and by product. These data requirements are closely akin to those for measuring the net avoided cost of universal service obligations.

What form should liberalisation take?

The Postcomm discussion document on competition identifies a variety of options for a more competitive market.[9] The approach used in the past has been by weight and price threshold, thereby creating a reserved area in which competition is prohibited. This approach has been used in the UK, and is the foundation of the Draft European Directive which, if enacted, will reduce the weight threshold below which competition can be prohibited to 150g in 2003 and 100g in 2006. This is the approach favoured by Consignia. Other options are to restrict competition by type and product, customer group or area.

Competition can also be achieved through mandatory access to Consignia's network. Competitors are likely to be particularly interested in access to the delivery network, which accounts for a very high proportion of costs and where economies of scale are significant. This immediately raises the related question of where access should be made available and how it should be

[9] Postcomm, 2001.

priced. On the former issue, the evidence in the telecommunications industry suggests that it is desirable that competitors should be able to choose their own access point, provided that they are willing to pay the associated costs. If this is not the case, Consignia may be able to stifle certain entry strategies by refusing to make its facilities available to accommodate them. As far as the pricing of access is concerned, then provided the problem of sharing USO costs in a competitively neutral way has been solved, prices based on long-run incremental cost with a mark-up to take account of common costs are appropriate. The alternative form of pricing, known as retail minus, under which the access provider receives the full retail tariff, minus the costs it saves as a result of services provided by its competitor, runs the risk of entrenching an inefficient retail pricing structure and severely diminishing the competitive pressures on Consignia.[10]

My own view is strongly in favour of an approach which maximises the degree of liberalisation of postal services. Halfway houses such as weight and price thresholds or restrictions on particular forms of competition place serious obstacles in the way of potential entrants. In effect, they are debarred from enjoying the economies of scale and scope available to Consignia. In the UK, it has been more normal to place a line of business restrictions on incumbents, such as BT, than on entrants. On this basis, I would regard such restrictions as being a last resort.

Nor do I think that it is likely that they will be necessary. In most industries where entry has been liberalised, the major concern has been that entrants would find it difficult to establish themselves against a former monopolist with considerable advantages. The outcome, in energy supply and telecommunications markets, where entrants have taken a

[10] For a theoretical account of one-way access pricing which supports this proposition, see Armstrong M (2002), The Theory of Access Pricing and Interconnection, in Handbook of Telecommunications Economics, Cave M et al (eds), Elsevier.

considerable amount of time to gain market-by-market shares of above 25%, has borne out these concerns. It is therefore curious and unexpected that, in the case of postal services, concern has focused on protecting the incumbent. To some extent this must be due to Consignia's inefficiency, which is acknowledged in its current plans for cost reduction, and its difficult labour relations. It would, however, be a highly unsatisfactory outcome if these factors were allowed to limit the pressures for greater efficiency which competition is likely to bring.

On this footing, my preferred outcome is for Postcomm to authorise a market-led approach to licensing, under which competitors meeting certain minimal standards are authorised to provide whatever services they want. In my judgement, the risks to the survival of the universal service can be minimised by the creation of a universal service fund and appropriate flexing by Postcomm of Consignia's ability to respond to competition.

9 THE ROLE OF COMPETITION IN THE UK POSTAL SERVICE

Saul Estrin

Introduction

The debate, and the whole issue of defining the potential role of competition in UK postal service, is a complex one. This is because the economic framework and the institutional framework are not as yet clear. These are a few general remarks to guide the discussion.

Let me start by considering the things which we know with some degree of certainty. First, I am sure we are agreed in regarding competition as a crucial mechanism for driving forward businesses and industries. There are at least three areas in which we expect competition to deliver major contributions to company performance and economic welfare:

- reducing monopoly profits and therefore prices paid to consumers;

- increasing the technical efficiency of production, and therefore cutting unit costs and prices, which also enhances welfare;

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- increasing the pace of technical change and product innovation.

There is strong empirical and international evidence to support the positive impact of liberalisation on hitherto monopolised sectors, and, more generally, the beneficial effects of competition for the bulk of sectors and activities.

However, competition is not unambiguously always a force for good. Schumpeter famously argued back in the 1920s that some degree of monopoly power was crucial to stimulate expensive research and development, and perhaps also in capital-intensive sectors. More generally, it has been accepted that in sectors with major externalities, either from their own networks or scale benefits to consumers, the beneficial impact of competition may be outweighed by the benefits of securing these externalities through some element of statutory protection of monopoly power.

Secondly, since the 1980s at least, it has been recognised in this country that statutory protection of monopoly power must be associated in some way with regulation to prevent monopolistic firms from abusing consumers, to ensure some degree of cost pressure, and to stimulate a reasonable pace of technical advance.

Postal services

The postal services sector is in the slightly anomalous position of being liberalised and regulated simultaneously – hence the tension between the need to define the scope and form of regulation on the one hand, and the area for competition to work its magic on the other. Martin Cave's survey has been a clear summary of the balance of issues.[1] The crucial question comes where the line should be drawn between total regulation of a postal monopoly, or free competition. Current ideas represent an

[1] See chapter 8.

attempt to find a compromise, which draws on the notion of a universal service obligation (USO). The conflict between the need to ensure that regulated activities generate a sufficient surplus to guarantee the USO on the one hand, and the desire to open as wide a range of products to competition as possible on the other, in order to get consumer benefits, is really what the debate is about.

In reflecting upon that choice, one must remember that the extent to which postal services are a 'natural monopoly' is not entirely clear, and, thereby, in which areas competition should be excluded on the grounds of negative externalities. There are obviously some network and scale economies in postal services, but if the collection and delivery structures are flexible, the underlying technology is probably close to constant returns. If this is correct, statutory protection is entirely concerned with protecting the USO, not with broader welfare losses from competition. This may well influence how widely the notion of the USO itself may be drawn.

I am also very concerned that Consignia, though regulated, is not a private sector company. The notion of regulation is that it substitutes for product market pressures. However, for these to impact on company performance it is normally argued that private capital market disciplines are required to enforce effective corporate governance. It is not obvious that the state as owner can effectively replicate these pressures; for example, the key discipline, that of bankruptcy, is absent with public sector ownership. There must also be uncertainty about what should be the appropriate cost of capital, or what we mean by 'viability' of state owned firms if there is no bankruptcy. Public ownership brings into question whether regulation alone can stimulate improved company performance, and highlights the critical role of competition.

All this suggests that there are a number of unresolved dilemmas when we consider regulation and effective competition in postal services. However, we should not be paralysed by this into inactivity. The postal services market has had broadly the same structure, and has offered broadly the same product, for at least 150 years. One of the key objectives of liberalisation and permitting competition is to free the market up for entry, innovation and product differentiation. As in so many other previously monopolised areas, it seems likely that the act of liberalisation will open the floodgates of dynamic product change.

In the light of this, it is not clear how much effort we should spend in determining the appropriate definition of USO, or appropriate limits to competition, at this stage. As the definition of the market, and of the product, changes it seems likely that so will the notion of universal service and of uniform price. Moreover, what seems now to be profound issues of commercial viability for Consignia in the face of competition, so that the USO can be maintained, may in fact not prove to be relevant – because the bulk of entry may in fact take the form of new or differentiated products, leaving Consignia's market largely intact. As I argued earlier, one of the key outcomes of competition, particularly in a service sector, is the generation of new products. My concern in the postal services market would be more about the advantages to incumbents of restricting entry than the damaging effects of entry.

I would also argue against attempting now to judge what the form and impact of competition will be. That is surely one thing that we have learnt from the debate about central planning – that civil servants, and even academics, cannot second-guess markets very effectively. It is not at all clear to me that entry will take the narrow 'cherry-picking' form suggested by Consignia.

So my approach to liberalisation would be this. Adopt a stance which is generous to competition, with a fairly flexible but limited notion of the USO at this stage. Liberalise the market and observe closely the impact on product innovation, market structure and Consignia’s viability. Be prepared in the light of the evidence to change everything, including the notion of the postal service itself.

We are embarking on a voyage to unknown shores, and I think the most important requirement will be flexibility and an open mind.