

# **The Benefits of Competition in the UK Mail Market**

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**12<sup>th</sup> March 2008**

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## EXECUTIVE SUMMARY

In this document we consider the benefits that the UK has derived opening the mail market to competition.

Our main finding is that the net economic benefits to the UK have already been £229 million and a net additional 3300 jobs.<sup>1</sup>

These benefits are evidenced by the considerable investments and employment created by new competing postal operators such as UK Mail, TNT and DHL Global Mail. For example, new entrants have created about 3000 jobs in areas of the UK such as Edinburgh, Runcorn, Leeds, Birmingham, Greenford, Croydon, Barking, Newcastle, Bristol and Swindon.

Already we can see that customers have been able to take advantage of greater choice in services and of new service offers from entrants to the market – in particular downstream access providers who have now been chosen by customers to provide upstream services for a fifth of total volumes. New products have also been launched on the market.

Further, we can see that the provision of the universal postal service has been safeguarded during this period and that market opening has spurred the process of sector reform vital for the continued relevance and success of mail services.

Compared to other industries which have been opened to competition these benefits remain fairly modest, reflecting the very limited development of end-to-end competition in the market and a pace of adaptation by Royal Mail that is slower than had been predicted.<sup>2</sup>

However, over the next period, as competition further develops in the market, we consider that market opening will be even more important for postal users and for the wider economy. In part this will be due to wider market trends and the possible growth in alternatives to mail distribution and also, possibly the growth of end-to-end competition.

We estimate that by 2016 – ten years after the final accomplishment of mail market opening – there will be additional benefits of between 4960 and 6600 jobs created, with an additional contribution of between £306 million to £405 million to the UK economy.

We have calculated these net benefits of competition by considering the likely impact on the wider economy of the downward pressure on prices created by mail market opening.

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<sup>1</sup> These figures include the cost reductions and changes in employment at Royal Mail and reflect the wider underlying impact of greater cost efficiency in postal provision on connected sectors such as printing and mailroom management and of cheaper postal services.

<sup>2</sup> See report by Frontier Economics: "The Impact of liberalisation on efficiency".

Downward pressure on prices can occur due to the impact of actual competitive entry in increasing the supply of mail services, or the impact of potential entry in providing greater incentives for Royal Mail to become more cost efficient and customer responsive. Before mail market opening it was estimated by consultants working for Postcomm that mail market opening would have significant impacts upon Royal Mail's cost efficiency.

In practice this has been evidenced also in analysis undertaken for Postcomm<sup>3</sup> which suggests that Royal Mail's unit costs fell by around 2 per cent per year during the period from 2000-2005<sup>4</sup>.

Using this data to put a figure on the overall downward price impact due to mail market opening we have aimed to adopt a conservative approach.

For example, although the downward impact on prices may be higher than the actual reduction in unit costs – for example if cost trends were upwards before mail market opening<sup>5</sup> - we have looked to only ascribe a part of actual cost reductions. Further, we have chosen not to assign all existing cost reductions to the effects of competitive pressure or market opening and consequently to a downward pressure on prices. During this period (2000 - 2008) price control regulation has set strict limits on Royal Mail, and mail volume increases which occurred during this period should foster a natural downward pressure on costs due to the achievement of greater economies of scale.

However, it is reasonable to assume that much of this cost saving is due to the process of market opening – not least in the interconnection of the process of reform and in the clearer incentives that competition provides for cost control and efficiency. Given this, we have chosen to adopt an assumption about a downward impact on prices of around 5% in total for the period in question.

For future effects of competition we have used two scenarios – a first scenario with a continued development of downstream access competition and a second scenario under which end-to-end competition becomes established- with stronger price effects and greater customer switching to competitors.

We used these assumptions to estimate the likely **net economic benefits** of the process of mail market opening using the most recent Office of National Statistics Input/Output tables<sup>6</sup> from 2004. The Input/output tables show the impacts of changes in the sector on the sector itself and the wider economy based on differing price reductions and price elasticity estimates.<sup>7</sup> These wider impacts are significant because mail services are a key in providing infrastructure, a vital artery for businesses, government and citizens to communicate with each other. Small and large businesses alike rely on cost efficient and reliable mail services for their daily success,

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<sup>3</sup> Analysis undertaken by LECG as part of the price control efficiency review

<sup>4</sup> Although since then costs have risen slightly due to an increase in wages.

<sup>5</sup> This was apparently the trend suggested by analysis undertaken by WS Atkins for their report on the efficiency of Consignia in 2002

<sup>6</sup> Input output tables are provided by the ONS showing the importance of changes in the performance of economic sectors to the wider economy

<sup>7</sup> For this purpose we have used Royal Mail's price elasticity estimate of -0.32.

not least in communicating with and billing their customers. Financial services, government, publishers and utilities place heavy reliance on mail services and many vulnerable customers rely on cheap and universal mail services.

In considering impacts we have compared current market conditions to what may have happened had the mail market not been opened to competition. In the years prior to the injection of competition into the market Royal Mail had undergone a period of some uncertainty, with weak incentives towards greater cost efficiency and customer responsiveness. Service provision had settled into a historic pattern based on Royal Mail's processes and the pace of innovation and reform was slow relative to that in other postal markets. Relative decline of the sector posed the possibility of a gradual obsolescence as customers found other ways to distribute and communicate with their clients or advertise their products. There were also significant risks that, over time, the universal service may simply wither on the vine without substantial state funding, as volumes declined and that when competition eventually did arrive (due to wider European de-regulation driven by the European Commission) Royal Mail may have been unable to respond to the challenge.

In this context, it can be argued that competitive pressure has been essential in beginning to prepare Royal Mail to handle the challenges of the future. We have found that there have been significant attempts during this period to change Royal Mail – ranging from the Renewal Programme to the current Transformation strategy. These have attempted to address a number of the underlying problems at Royal Mail including the lack of cost control and full pursuit of achievable efficiency gains, management failures, cultural problems and internal industrial relations difficulties. They have also promoted innovation in the sector with Royal Mail moving to rejuvenate its sorting machinery.

We can already see some of the benefits which have accrued from competitive entry in the investments made and employment created by entrants. There are now 18 licensed competitors to Royal Mail providing a range of services, from downstream access services (where they collect from customers and pass the mail for final delivery to Royal Mail) to end-to-end services. The vast majority of competing services are downstream access services, with operators injecting mail into Royal Mail's inward mail centres (sorting offices). In this upstream market segment competitors have been very successful and are expected to handle about a fifth of total volumes.

This suggests strongly that customers are finding benefits in these services – both in terms of their reliability and also in the price/service offer. End-to-end competition has been much slower to develop and reduced to a very low level (0.2 per cent of volumes) since market opening in 2003, with competitors struggling to overcome Royal Mail's inbuilt VAT exemption advantage and a number of other barriers including non-commercial pricing and exclusivity provisions in the national access agreement. We can also see benefits of greater choice in the sector with competitors providing services that include day-definite services, track-and-trace services and discounted services for both unsorted and pre-sorted mail. Innovation has been encouraged with new products such as UK Mail's forthcoming iMail products and Royal Mail's Personalised Integrated Media (PIM) Service increasing the value of the services

## 1 INTRODUCTION

- 1.1 This report was commissioned by Four Communications Limited, acting for TNT Post UK Limited for an estimation of the economic benefits of mail market opening in the UK.

### **The background to this report**

- 1.2 This report is being written at a time when policy makers at BERR and Postcomm are considering possible futures for the UK postal sector.

### **The independent review being undertaken by a panel appointed by BERR**

- 1.3 The Terms of Reference of the review launched on 17th December to be undertaken by an independent panel chaired by Richard Hooper CBE are:
- (a) To assess the impacts to date of liberalisation of the UK postal services market, including on Royal Mail, alternative carriers and consumers;
  - (b) To explore trends in future market development and the likely impact of these on Royal Mail, alternative carriers and consumers; and
  - (c) To consider how to maintain the universal service obligation in the light of trends and market developments identified.
- 1.4 Submissions to the review need to be made by 28th March for the effects of liberalisation and future trends and by the 12<sup>th</sup> of May for maintaining the universal service. The review is expected to provide its conclusions later this year.

### **Postcomm's Strategy review**

- 1.5 Postcomm launched its Strategy Review in May 2006 publishing its document on Emerging Themes in August 2007. In the document it set critical external success factors for the fulfilment of the Postcomm vision:
- (a) A healthy and innovative mail market;
  - (b) A prompt and successful transformation of the Royal Mail business; and
  - (c) A willingness on the part of mail users to accept that some changes may be required to what they have come to expect from the mail service.

### **Purposes and scope of study**

- 1.6 The main objective of this study is to review benefits that the UK economy and postal customers have derived and will derive in the future from competition, in the UK postal market. We provide here a qualitative and quantitative assessment which combines theoretical economic approaches with practical economic regulatory analysis.

## Our general approach

- 1.7 We have aimed to capture fully the benefits of the decision to open the postal market to competition. These can range from clear and direct benefits – for example in relation to investments which have been made and employment created – to more indirect, and perhaps less obvious benefits derived from expectations in the market that barriers to competition would be removed and derived from the effects of potential and actual competitive pressure on market players.

## The structure of the report

- 1.8 Following this chapter, the remaining sections of this report are organised as follows:

**Methodology:** In this section we set out our approach to estimating the benefits of competition in the postal market from a qualitative and quantitative perspective.

**The importance of mail services:** In this section we consider the economic and social importance of mail services.

**The process of mail market opening and its expected benefits:** In this section we review the development of the mail market and consider expected benefits of competition.

**The development of mail market competition:** In this section we consider qualitatively the development of competition so far.

**The net economic benefits of competition so far:** In this section we quantify the direct, linkage and induced effects of competition in the market so far.

**Market trends and the likely development of future competition:** In this section we consider likely market trends and the likely development of the market in the future.

**Quantification of the future benefits of competition:** In this section we quantify the future benefits of competition.

**Conclusions and recommendations:** In this section we consider our conclusions and recommendations.

## 2 METHODOLOGY

### Introduction

- 2.1 In this section we set out our approach to estimation of the economic benefits of competition in the mail market.

### Our general approach

- 2.2 We provide in this study both a qualitative and quantitative review of the benefits of competition to the UK mail market.
- 2.3 We begin our analysis with a consideration of the positive incentives generated by competition in postal services and a review of the expected benefits of greater competition.
- 2.4 We then quantify the benefits which appear to have accrued. To estimate these benefits we compare the outcomes of the market where the process of market opening has occurred with those of the counter-factual, which in this case would have been the continued reservation of mail services to Royal Mail and the absence of the positive incentives fostered by market opening and competitive pressure.
- 2.5 In light of the strategic importance of the postal sector to the wider economy we have used input and output tables to model the wider effects of changes in the postal sector (costs and prices). This takes into account impacts on upstream, downstream and ancillary services.

### Key issues

- 2.6 In establishing the benefits of competition in the UK postal market we consider the following key issues:
- (a) To what extent has a competitive mail market improved the quality and cost efficiency of UK postal services for consumers and customers?
  - (b) To what extent has the introduction of competition into the mail market allowed new competitors to provide innovative new services?
  - (c) What have been the additional employment, volumes and revenues generated by end-to-end and third party access competitors?
  - (d) What have been the positive effects of potential and actual competition in the market on Royal Mail?
  - (e) What have been the effects of competition on the universal postal service?

- (f) How far has the development of competition in the UK mail market lagged behind or proceeded at a faster pace than in comparable markets?
- (g) What are the likely future effects of competition in the market over the period leading up to the date ten years after full market opening?
- (h) What would be the effects if the VAT exemption for Royal Mail was removed or reduced to standard rate?

## Data Sources

- 2.7 We have used existing publicly available sources, including Postcomm studies and consultations, Royal Mail and also studies carried out by the European Commission. Further, we have discussed future trends with market experts and also with postal companies operating in the UK.

## Timing issues

- 2.8 In considering the benefits of mail market opening we have looked to capture impacts from the point where it can be assumed that the expectation of the removal of barriers to competition was beginning to influence market players.
- 2.9 In this way we can see that the process of mail market opening may be seen to have begun even at the stage of the discussions (in the European context) of the European Commission Green Paper on postal services in 1992, which posited a gradual removal of special rights (monopoly rights) in the mail market across the EU.
- 2.10 Whilst it can be argued that in many respects the UK has lagged behind other EU Member States in deregulating the postal sector, realistic market observers could have anticipated the opening of the mail market to competition by the time of the discussions over the framework Postal Directive. It may therefore be that some of the impacts could be detected as early as the mid 1990s.
- 2.11 However, to ensure a conservative estimate of the impact of competition and competitive pressure, we have considered economic impacts from 2000 – the date of the implementation of the framework Postal Directive into UK legislation, the Postal Services Act 2000 and the creation of Postcomm.

## The interaction between competition and price controls

- 2.12 In this respect it is important to note the inter-relationship between price control regulation and the impact of competition in forcing market players to be more cost efficient and innovative.
- 2.13 In theory, price controls are only used where competition is ineffective and we can see that the scope of price controls has narrowed over the last few years.

- 2.14 However, for the purposes of our analysis – where we seek to identify the effects of competitive pressure – clearly the disciplines imposed by price controls, market opening and potential and actual competition are pushing in the same direction. In this respect it is to some extent a matter of taste where the impact of the requirements of the price control ends and that of competition or potential competition begin. Further it can be argued that both elements are part of the same wider process of reform in the sector.
- 2.15 To reflect this we have made a conservative estimate of the impact of competitive pressure within the wider cost reductions achieved by Royal Mail and made our assumptions about this clear.

### **Cost reflective pricing and the development of competition**

- 2.16 It is also worth noting that a key benefit of competition over time is likely to be greater commercial focus at Royal Mail, providing stronger incentives for cost reflective prices. This should allow for a more natural market development and a more contestable market with new profitable opportunities for competitors. This should strengthen the dynamic of competition.
- 2.17 In this report we have not considered price levels for particular services, but have looked to consider the overall level of prices and the impact that competitive pressure may have on this.

### **Our qualitative review**

- 2.18 To underpin our later quantitative analysis we begin with a consideration of what we may expect to be the effects of positive incentives created by market opening and how this has worked in other sectors. This provides us with a framework for analysis which we can then use to identify where benefits from competition have occurred.

### **Our quantitative review**

- 2.19 In considering the benefits of competition we have used the following steps.

#### **Definition of the counterfactual**

- 2.20 A key element in quantifying the benefits is the definition of the counterfactual. In defining the counterfactual we have considered the prevailing trends in terms of cost efficiency and innovation when:
- (a) Maintenance of maximum special rights for Royal Mail under the Amended Postal Directive 2002/39, i.e. letter mail items 50g or below, would still be reserved to Royal Mail with the consequent implications for the ability of potential competitors to provide services above as well as below these limits;
  - (b) A regulatory regime based more on the minimum requirements set out in the Community framework, e.g. less regulatory scrutiny in areas such as the

determination of prices of Royal Mail, scrutiny of discounts and information transparency;

- (c) Third party access arrangements would not have been possible as regulation would have been too weak to protect potential entrants; and
- (d) Special privileges for Royal Mail including VAT exemption would have continued.

2.21 In identifying this counterfactual we have considered what would have happened to the postal market without the positive incentives generated by competition. This may include the following features:

- (a) There would be less incentive for Royal Mail to make efficiency improvements or quality of service innovations. Therefore some efficiency gains which have been made would not have occurred, for example the reduction of delivery rounds to one round per day. There would have been lower quality of service and additional costs resulting in higher prices would have been passed on to consumers and customers;
- (b) Royal Mail would have had less incentive to improve its industrial relations and the days lost to strikes per year would not have improved. Further, the possibility for customers to use alternative providers providing an alternative to and discipline on Royal Mail) would not have existed.
- (c) Third party access arrangements would not have been possible due to limitations to the effectiveness of access regulation and the scope of competitive services;
- (d) Competitors who have entered the UK mail market would not have been able to do so and there would be enduring legal uncertainty about the scope of reserved services for example in relation to new or special services; and
- (e) There would have been less innovation in the sector, both in terms of the application of new technology (for example to create service and efficiency improvements through more refined automation), process innovation (for example in terms of outsourcing), and product innovation (for example the provision of new services).

2.22 We provide a qualitative review of the above and estimate the benefits of competition compared to the counterfactual in terms of the proportion of the cost savings and other improvements which can be attributed to the pressures on Royal Mail due to the likelihood and reality of market opening.

2.23 Key areas that we need to define closely in the counterfactual include:

- (a) The financial and business development of Royal Mail had the process of market opening not occurred;
- (b) The development of the wider market- the development of supply and demand;

- (c) The development of the universal service, including the quality of services;
- (d) The development of employment in the sector; and
- (e) The development of technology and innovation in the sector.

### **Estimation of the effects of the process of mail market opening**

2.24 Compared to this counterfactual we estimated the benefits of market opening in relation to actual market and business developments. In doing this we have estimated the current scale and impact of competitors in the market. Further we have looked to estimate the net economic benefits of competition by considering the impact of downward price effects of the sector using input output tables.

### **Estimating the benefits of a competitive market in the future**

2.25 A key rationale for the full opening of the mail market is that many of the benefits of competition will accrue over time.

2.26 In order to capture these impacts we calculate the potential benefits of competition up to the date ten years after full market opening on 1<sup>st</sup> January 2006 (i.e. up to 2016).

2.27 This involves the following steps:

- (a) Devising scenarios about the development of competition under different market conditions; and
- (b) Drawing conclusions from our analysis of the benefits of competition in the market so far about the likely scale of benefits and forecasting the scale of these benefits using input output tables.

### **3 THE IMPORTANCE OF MAIL SERVICES TO THE ECONOMY**

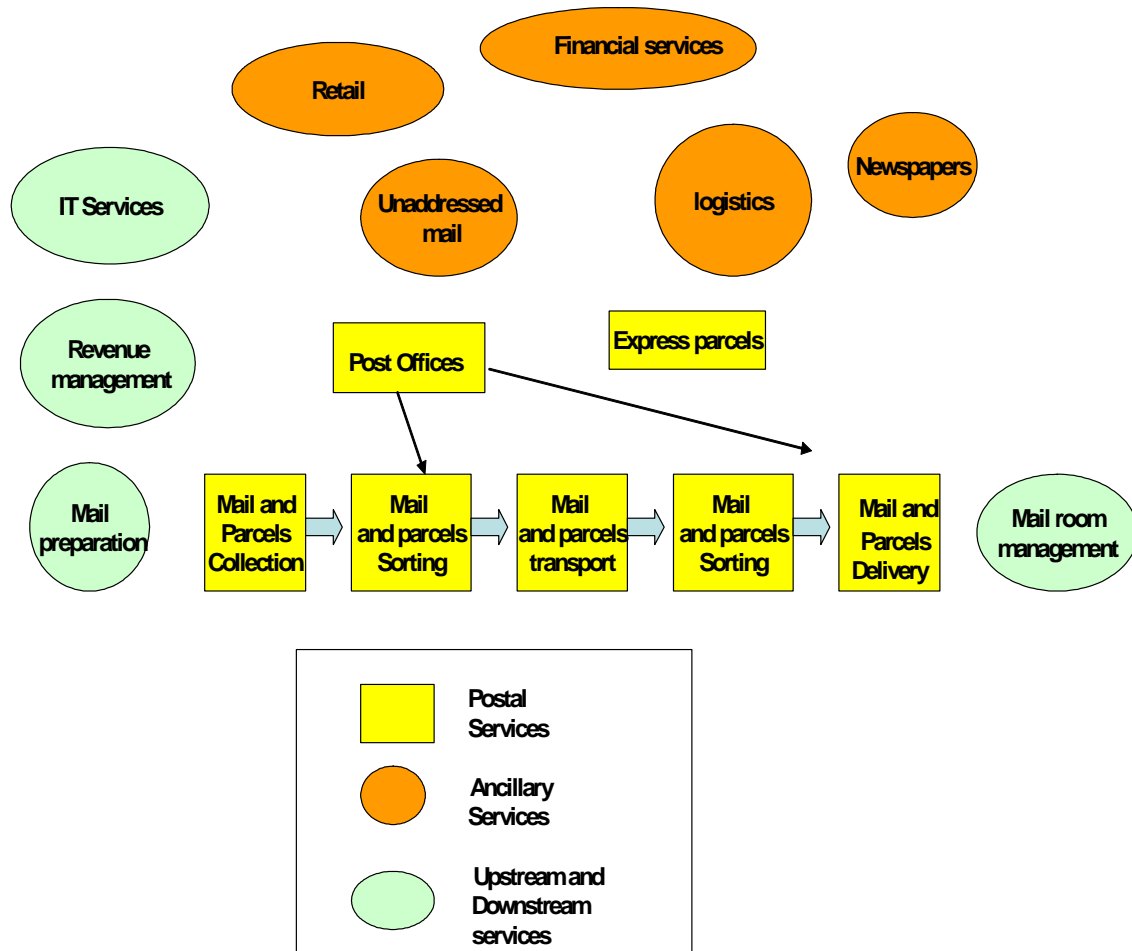
#### **Introduction**

- 3.1 In this section we consider the development of the postal market and identify relevant features in relation to our assessment of the benefits of competition in the market.

#### **The strategic location of mail**

- 3.2 Postal services are located at the strategic intersection of wider communications and distributions sectors. Post has traditionally been an important medium of communication between citizens and increasingly as a form of interaction between businesses and between businesses and their customers.
- 3.3 Over recent years growth in the postal sector has declined relative to other communications sectors. It can be argued that this is due partly to greater dynamism and technological innovation elsewhere, for example in the telecoms sectors with the development of mobile phones and increasing e-substitution possibilities.
- 3.4 However, despite this relative decline and the collapse of mail as a form of personal communication, overall mail volumes have been sustained, due a rise in the use of mail as a form of advertising and marketing, and a remaining lack of available alternatives to transactional communication.
- 3.5 Postal operators provide services which link with upstream sectors and their customers and can take benefit from opportunities to gain synergies with ancillary sectors such as express and logistics, consultancy and IT services.
- 3.6 This is shown in Figure 3.1 overleaf.

Figure 3.1: The strategic location of postal services<sup>8</sup>



3.7 Key areas of demand for mail services include transactional mail, which is related to businesses communicating with and distributing goods/bills to their customers, advertising and marketing communications, government and residual private communications.

<sup>8</sup> David Stubbs: "The Birth of the new European postal sector."

- 3.8 This is evidenced by the trend in demand for mail which shows a decline in traditional transactional mail products, where there are greater substitution alternatives, and a rise in more tailored direct mail solutions and fulfilment mail.<sup>9</sup>

### **Areas dependent on mail services**

- 3.9 From Figure 3.1 we observe that there are a wider range of services which depend to some extent on high quality, reliable and efficient postal services.

- 3.10 It can be argued that these include<sup>10</sup>:

- (a) Printers;
- (b) Envelope makers;
- (c) Direct mailers;
- (d) Mailroom managers;
- (e) E retailers;
- (f) Manufacturers of postal sorting and purchasing machines; and
- (g) Ink manufacturers.

- 3.11 The postal sector is one of the core infrastructure sectors of the economy. Improved efficiency and customer responsiveness in this sector has the potential to stimulate greater economic activity, to promote globalisation and to facilitate the rise of e-commerce.

### **Postal sector employment**

- 3.12 The postal sector is generally labour intensive<sup>11</sup> and the national posts in each of the EU Member states have traditionally been one of the major employers.

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<sup>9</sup> The Strategy Review found the following trends in the market:

- Shifting mail volumes from standard to lower priority tariffs;
- Increased volumes of fulfilment mail;
- Increased competition within the advertising market;
- A trend towards greater added value in mail products.

<sup>10</sup> See Pls Ramboll: "A study of employment trends in the EU Postal sector 1995-2000.

<sup>11</sup> This varies though with some countries national postal provision being a lot less labour intensive than others.

## **4 THE PROCESS OF MAIL MARKET OPENING AND ITS EXPECTED BENEFITS**

### **Introduction**

4.1 In this section we set out the process of market opening and the benefits that regulators and economists may have expected to be derived from it.

### **Postcomm's duties and the general rationale for market opening**

4.2 The promotion of effective competition in the postal market is one of Postcomm's statutory duties as set out in the Postal Services Act of 2000.<sup>12</sup> This statutory duty is typical of those which have been given to sector regulators- reflecting economic theory that competitive markets produce the greatest benefits for consumers and the experience of deregulation in other industries. Whilst the benefits of the introduction of competition have tended to be conflated with those of privatisation in other industries, they have been observed to be:

- (a) Lower prices;
- (b) Higher quality of service and customer responsiveness;
- (c) Greater innovation in the market; and
- (d) Greater choice for customers.

### **The rationale for market opening in the UK mail market**

4.3 Alongside this broader rationale for reform in the sector, it could be argued that the UK mail market had a number of features which could provide additional rationale for market opening.

4.4 These appear to include:

- (a) Regulatory uncertainty which had prevented players from making long term decisions about the sector and investments;
- (b) The continuing lack of commercial imperatives at Royal Mail which resulted in:
  - Lack of commercial management culture for example in relation to cost reflective pricing and cost control;

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<sup>12</sup> This duty was subsidiary to Postcomm's primary duty to safeguard the provision of the universal postal service.

- Lack of customer responsiveness and a culture of serving the customer first;
- Lack of innovation and product development;
- Lack of automation and up-to-date technology;
- Lack of wider profit seeking behaviour.
- Lack of desire to maximise shareholders' returns

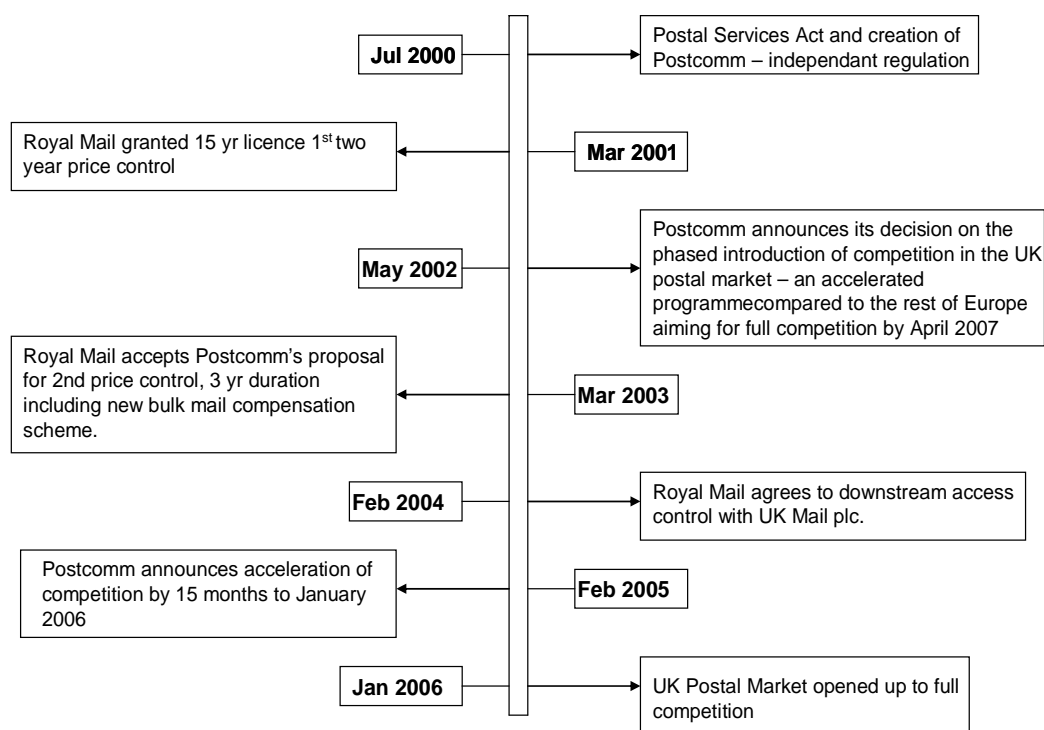
### **The universal service and the promotion of effective competition**

- 4.5 The economics of postal services suggest that (unless it is to rely on large public subsidy) the financing of universal postal service provision depends upon cost-driven pricing and optimising the efficiency of operations in line with the volumes of mail being handled.
- 4.6 In this respect, it can be argued that universal service provision is dependent on the ability of postal operators, including Royal Mail and downstream access providers, to attract customers for mail delivery services.
- 4.7 A key rationale for market opening was therefore a need to ensure the continued pressure for operational efficiency of the universal service.

### **The process of market opening**

- 4.8 In light of the above, and a series of studies and analyses Postcomm decided that removing regulatory barriers to competition was likely to foster benefits for postal users.
- 4.9 This led to the following process of mail market opening, as illustrated in Figure 4.1 overleaf.

Figure 4.1: The process of mail market opening



Source: Europe Economics from Royal Mail

4.10 As illustrated above, the reform of the UK postal market was a gradual process which was spread over 6 years.

## Expected benefits of competition in the mail market

### The experience of other postal markets

4.11 Research commissioned by Postcomm showed that in other postal markets where the mail market had been opened to competition there had been significant improvements in efficiency and reductions in the unit costs of the national post.<sup>13</sup>

4.12 This research included a forecast that a reasonable productivity profile for Royal Mail as a result of the process of market opening and wider sector reform may be as follows:

- (a) 15 per cent improvements in the first 18 months;

<sup>13</sup> See Frontier Economics: "The impact of liberalisation on efficiency: a survey." January 2002

- (b) 4 per cent per annum following this ( in line with the experience in other utility sectors);  
and
- (c) Falling to 2 per cent per annum in line with general improvements in productivity.<sup>14</sup>

### **Positive incentives**

- 4.13 In some respects the expected benefits can be inferred from the problems described. They derive in part from the positive incentives which either potential or actual competition may set market players.
- 4.14 These are summarised below:
- (a) Incentives for Royal Mail to become more efficient, innovative and customer responsive;
  - (b) Incentives for customers to begin to exercise choice and demand higher performance from suppliers and price discounts; and
  - (c) Incentives for competitors and potential competitors to invest in providing mail services.
- 4.15 These incentives may have begun to impact upon the market before the decision to open the market up for competition was finally made, as the expectations of market players concerning the likely possibility of market opening may have affected their actions. Royal Mail has stated that it expected competition to drive performance, boost innovation and increase customer focus.
- 4.16 It should also improve their performance and, overtime, prices should become more cost reflective. If Royal Mail becomes more efficient and innovative it should help it become competitive enough to safeguard the universal service. Furthermore, once a competitive market has become established, new providers of some or all universal services could emerge, especially where they are capable of providing the service more efficiently than the incumbent.

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<sup>14</sup> Ibid.

## 5 THE DEVELOPMENT OF MAIL MARKET COMPETITION

### Introduction

5.1 This chapter outlines the development of competition from the initial market opening to the present situation.

### Development of competition

5.2 There are 18 licensed mail providers including Royal Mail. These are shown in Table 5.1 below.

**Table 5.1: Licensed operators**

ANC Express	Pouch services. Not currently operating in the licensed area.
Citipost AMP	Niche B2B markets. Also offers Downstream Access (DSA) services (consolidated, zonal and national).
City Link Post	Express, parcels; B2C through DSA.
Challenger Security Services (Admin)	Disguised mail delivered by Royal Mail/couriers.
CMS	B2B (mostly London).
DHL Global Mail (UK)	DSA sorted and unsorted services provided on a national basis. Some E2E (B2B).
DX Network Services	National next day B2B through own delivery network (document exchange, business mail and parcels).
Intercity Communications	B2B niche markets, own delivery in London; international courier services.
Lynx Mail	National DSA, bulk pre-sorted mail, B2C and B2B.
Racer Consultancy Management Services	UK and international mail and courier services; B2B and B2C mainly through Royal Mail (not Access). Some B2B (not in licensed area) through own network.
Secured Mail Ltd	National consolidated and bulk mail through DSA.
Secure Mail Services (Now part of The DX Group)	National B2C and B2B through own secure delivery network (valuable items such as bank cards, passports, event tickets) – not in the licensed area – and through Royal Mail (not Access).
Securicor Omega Express	Acquired by DHL Express. Interim licence to convey mail between offices of HSBC and between the offices of Royal Bank of Scotland. Pouch services.
The Mailing House Group	Bulk mail through DSA.
TNT Post UK	Pre-sorted and unsorted B2C and B2B letter mail with delivery through DSA. First end-to-end pilot in January 2008
UK Mail	Pre-sorted (bulk mail), unsorted and international B2C and B2B mail through DSA.
Zip Mail	Fully franchised business in the London/M25 area.

Source: *Postcomm*

- 5.3 Thus far, competition has taken one main form in the UK, since the market was fully liberalised in January 2006: “access” competition.

### **Access competition**

- 5.4 Most of the competitors to Royal Mail have entered the market by using third party access to Royal Mail’s delivery network, i.e. through access competition. This is a process in which the operator collects, sorts and trunks its customers’ mail to Royal Mail’s mail centres, and Royal Mail then take responsibility for the final delivery of the items.
- 5.5 Some of Royal Mail’s large customers have “customer direct access” agreements, through which access to Royal Mail’s mail centres is arranged directly with Royal Mail, arranging upstream services themselves or through third parties. The cost to operators and access customers is approximately 13 pence per item for delivery. Access agreements may cover certain zones of the UK, or they may cover the whole of the UK. According to Royal Mail, there are 13 customers and nine operators with national access agreements, while three customers and seven operators have zonal access contracts.
- 5.6 According to Postcomm’s 2007 Competitive Market Review, in 2006/07, mail carried via access arrangements accounted for 11.8 per cent of total operational mail volumes for the year, up from 5.6 per cent in the previous year. As of August 2007, access mail accounted for 19 per cent of addressed revenue-derived letter volumes, of which just under half was carried through “customer direct access” agreements.

### **End-to-end competition**

- 5.7 End-to-end competition describes the situation in which a competitor provides the entire mailing process from collection to delivery. This type of competition is far less developed in the UK, representing just 0.2 per cent of licensed mail volumes. The few operators that do offer end-to-end services tend to offer local services or high-value services. End-to-end networks have established themselves in other European nations whose postal markets are open to competition.
- 5.8 According to Postcomm’s Competitive Market Review, in 2006/07, alternative operator end-to-end licensed area volumes declined, representing a 12 per cent fall in end-to-end items carried in the licensed area, compared to the previous year. This suggests a volumes figure of around 38-40m items per year handled by competing private end to end operators.<sup>15</sup>

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<sup>15</sup> Source Postcomm

## Entrants to the market

5.9 Table 5.2 overleaf shows the revenues and employment created by the competitors to Royal Mail.

**Table 5.2: Competing mail operators<sup>16</sup>**

	Revenue (£)	Employment
DHL Global Mail (UK) Ltd	10,760,684	301
DX Network Services Ltd	50,049,693	1400
The Mailing House Group	21,914,616	613
Secure Mail Services (DX)	3,646,478	102
TNT Post UK Ltd	11,797,428	330
UK Mail	3,968,226	111
Total	102,137,124	2,857

Source: Annual reports, industry websites and press releases

5.10 From this we can estimate that postal competitors, including downstream access operators and document exchange operators, have revenues of over £100 million and about 2850 jobs.

## Innovation in the market

5.11 A key expected benefit of market opening is that it would act to provide greater innovation in the market both by increasing competitive pressure on Royal Mail and through the new solutions and approaches taken by entrants to the market.

5.12 In practice in the postal market we can see three main types of innovation.

(a) Technology driven process innovation- for example sorting machinery and new IT systems;

(b) Product innovation- for example launch of more tailored services or new services to take benefits from upstream and downstream commercial solutions; and

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<sup>16</sup> Where direct figures were unavailable the figures have been calculated as follows: Eurostat "European Business – facts and figures, 2007 edition" lists the turnover of "post and courier" activities as €98,199 million in 2004, and the employment as 1,868,600. Based on this ratio, using the employment figures above (which remain as before), a turnover figure for each of the companies was calculated (this was then converted to sterling using a 2004 average exchange rate of £1 = €1.47).

- (c) Commercial innovation- where customers and operators have seen new commercial opportunities in a competitive market, such as intelligent purchasing and performance related remuneration.

### **Technology driven process innovation**

- 5.13 The clearest examples here are where operators may have taken benefit from new advances in sorting machinery to upgrade to more refined sorting machines- for example including delivery sequencing, and to purchase sorting machines which can handle large “flats” (A4 sized postal products).
- 5.14 Such updating is a large component of Royal Mail’s Transformation strategy.

### **Product innovation**

- 5.15 The three main competitors to Royal Mail provide products which include:
  - (a) Day definite services;
  - (b) Track and trace services; and
  - (c) Discounted services.
- 5.16 Examples of services provided by competitors include:
  - (a) Economy Sort- a product launched by TNT which competes with Mail Sort 3 traffic for bulk mailings which are not time sensitive; and
  - (b) I-Mail- a next day delivery service using remote printing which is about to be launched by UK Mail.
- 5.17 Royal Mail has also moved to innovate in a number of ways following the introduction of competition into the market. For example, recently Royal Mail has launched a new direct mail services that allows companies to send customised CDs called the Personalised Integrated Media (PIM) Service. This is a bulk mail service with a minimum quantity of 10,000 units.

### **Intelligent purchasing**

- 5.18 A key likely benefit of competition over time is the development of a more sophisticated demand for postal services. This is likely to foster a greater dynamic for modernisation and volume growth in the sector. We can already see that some businesses have seen commercial opportunities in this respect. An example appears to be Post Switch.

#### *Post Switch*

- 5.19 Post-Switch is an impartial postal broker, providing expert advice on matching direct mail to the most suitable supplier at the optimum tariff. Post-Switch already handles over one

million items of mail each month and is working with high volume mailers like Marie Curie Cancer Care and NSPCC as well as commercial operator, Network Rail. The service offered by Post-Switch delivers direct mail campaigns in 48 hours and can secure savings of up to 22.5 per cent against MailSort charges.

## **6 THE NET ECONOMIC BENEFITS OF COMPETITION SO FAR**

### **Introduction**

- 6.1 In this section we quantify the benefits which have accrued to the UK so far as a result of the decision to open the postal market to competition. In Section 5 we have seen that competitors for mail services now have revenues of around £102m and have created nearly 3000 jobs. In this Chapter we calculate the direct, linkages and induced benefits (i.e. the net economic benefits of competition in mail services) using the latest available data in Input Output tables for the UK.

### **The costs of the absence of competition**

- 6.2 In one sense the benefits of market opening can be seen by examining the costs of previous arrangements.

#### **Lack of customer focus**

- 6.3 If the market was not open to competition, Royal Mail would not have the incentive to offer customer focused service. Royal Mail would not be threatened by the prospect of customers switching to a competitor and therefore would not see the need to diversify its products or services. The lack of choice could result in un-stimulated demand and customer inertia.

#### **Lack of competitive pressure**

- 6.4 Indeed, competition naturally introduces greater pressure to actors in the market. Without such pressure, it is difficult to envisage how one service provider would be inclined to innovate, ensure customer complaints are efficiently dealt with, aim for consistently high quality of service standards and offer an array of products or services which correspond to customers needs.

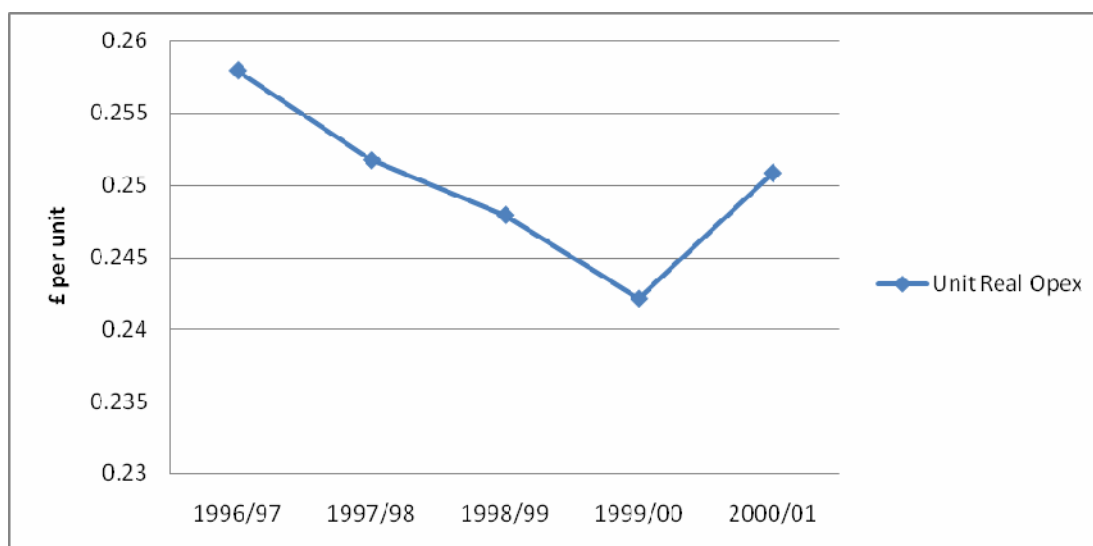
#### **Perverse incentives and lack of commercial focus**

- 6.5 Statutory monopoly could provide incentives for Royal Mail, not to control its costs, particularly where cost control would risk industrial relations conflict. In this case it may have been preferable for Royal Mail's managers to transfer additional costs onto the customer who would end up paying more for the same service or product. This suggests prevailing perverse incentives.
- 6.6 Similarly, price sensitivity would not be a priority for any incumbent since customers would have no other option but to pay for a product or service they need. In the same line of thought, aggressive sales and product development would not be a priority for an incumbent which lacks the incentive to profit maximise. Furthermore, quality management and strategy would not be as necessary as in a competitive environment in which market actors need to deploy efficient strategies and use good management skills to secure their share of the market.

## Trends prior to the mail market opening

6.7 Trends in Royal Mails operational expenditure are shown below in Figure 6.1

Figure 6.1 : Trends in Royal Mail's costs 1996-2001



Source: WS Atkins 2002.

## The effects of the process of market opening on Royal Mail

6.8 Since the beginning of the process of market opening Royal Mail has taken important steps towards increased cost efficiency and re-structuring of the organisation, in large part to prepare itself for possible market entry. These include a number of programmes of restructuring and renewal including the “Shaping for Competitive Success”, the Renewal Programme and the recent Transformation programme.

### Actual outcomes

6.9 In practice Royal Mail has achieved some cost reductions. Table 6.1 overleaf shows the development of costs between 2000 and 2005.<sup>17</sup>

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<sup>17</sup> These unit costs also include capital expenditure as well as operational expenditure and therefore are slightly higher than in figure 6-1.

**Table 6.1: Historical cost trends 2000-2005**

	2000/01	2001/02	2002/03	2003/04	2004/05	Regulated period CAGR <sup>18</sup>	Renewal period CAGR
Costs in 00/01 prices (£m)	5,184	5379	5253	5066	5016	-0.8%	-2.3%
Volumes (m)	19,233	19,887	19,648	19,923	20,143	1.2%	0.4%
Unit costs	0.27	0.27	0.267	0.254	0.249	-1.9%	-2.7%

Source: LECG: Future Efficient costs of Royal Mail's Regulated Mail Activities

6.10 Here one can observe the evolution of historical cost trends since the new regulatory framework of the postal market in 2001. The trend has been a positive one, with costs being drawn down, partly due to actual and potential competitive pressure.

6.11 Table 6.2 below shows the development of total USO costs from 2006-2007.

**Table 6.2: Royal Mail's costs and revenues from 2006- 7**

Year	USO costs	USO revenues
2005/6	3391	345
2006/7	3432 <sup>19</sup>	346

Source Royal Mail

6.12 Whilst this is not directly comparable to previous costings due to the redefinition of the USO we can again see that underlying costs of the universal services have fallen. However, the effects of the generous pay deal attached to efficiency gains appear to have resulted in some cost increases.

## The linkages and induced benefits of market opening

6.13 To calculate the direct, linkage and induced benefits of market opening we consider the price changes which have resulted from this. To do this we have used the latest available input and output tables (from 2004). These show the following possible impacts based on differing price reductions and price elasticity estimates. These are shown in Table 6.3 Overleaf.

<sup>18</sup> CAGR is cumulative annual growth rate.

<sup>19</sup> This is the newly defined USO which excludes some bulk mail products.

**Table 6.3: The range of input/output table results: direct and linkage effects**

Change in output (£m)	Change in employment (number)	Assumed price reduction	Assumed price elasticity
312	4,505	3%	0.8
520	7,509	5%	
1,561	22,527	15%	
2,081	30,035	20%	
5,203	75,089	50%	
78	1,126	3%	0.2
130	1,877	5%	
390	5,632	15%	
520	7,509	20%	
1,301	18,772	50%	
125	1,802	3%	0.32
208	3,004	5%	
624	9,011	15%	
832	12,014	20%	
2,081	30,035	50%	
234	3,379	3%	0.6
390	5,632	5%	
1,171	16,895	15%	
1,561	22,527	20%	
3,902	56,317	50%	

Source: Europe Economics calculations

6.14 It is not possible to estimate induced effects directly because of the lack of data. A standard national income multiplier of 1.1 is therefore used. The sum of direct, linkage and induced output and employment effects is reported in Table 6.4 overleaf.

Table 6.4: The range of input/output table results: direct, linkage and induced effects

Change in output (£m)	Change in employment (number)	Assumed price reduction	Assumed price elasticity
343	4,956	3%	0.8
572	8,260	5%	
1,717	24,779	15%	
2,289	33,039	20%	
5,723	82,598	50%	
86	1,239	3%	0.2
143	2,065	5%	
429	6,195	15%	
572	8,260	20%	
1,431	20,649	50%	
137	1,982	3%	0.32
229	3,304	5%	
687	9,912	15%	
916	13,216	20%	
2,289	33,039	50%	
258	3,717	3%	0.6
429	6,195	5%	
1,288	18,584	15%	
1,717	24,779	20%	
4,293	61,948	50%	

Source: Europe Economics calculations

*Our estimation of the price effects of the process of market opening*

- 6.15 In Section 6 we considered the likely scale of the cost and price effects of market opening and increased competitive pressure. We noted that the unit cost reduction for Royal Mail had been -1.9 per cent CAGR from 2000- 2005, with this unit cost reduction increasing in the Renewal period to -2.7 per cent. This suggests an overall unit cost reduction over the period around 10 per cent over this five year period.
- 6.16 To some extent of course this can be explained by increasing returns to scale as volumes have risen by 1.5-2.0 per cent per year during most of this period. Further we note that since 2005 some of the cost savings have been passed to Royal Mail staff in the form of bonus payments and increased wages.
- 6.17 However, looking at trends from years before the process of reform (as shown in the previous section) and considering in detail the actual impacts that both the expectation of

and actual market opening has had on Royal Mail we consider it is reasonable to estimate that, for 2000-2007, the process of market opening has led to an additional decrease in costs (and thereby a downward impact on prices) of about 5% compared to what may have happened without the process of market opening.

*Our estimation of price elasticity*

- 6.18 Previous research on price elasticity in the postal sector found that postal products are relatively price inelastic: less than -1, and generally ranging between -0.2 and -0.8.<sup>20</sup> However, Royal Mail's economists have estimated the price elasticity of Royal Mail's products at -0.32. We therefore use this figure as a cautious estimate.

*Our resulting estimation*

- 6.19 Given the above we estimate that the process of market opening to date has had direct and indirect benefits for the UK economy of £229 million and roughly 3300 jobs.

**Benefits of competition so far**

- 6.20 We can therefore conclude that the **net economic benefit** of competition in the UK mail market to date is £229 million and roughly 3300 jobs.

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<sup>20</sup> Alan Robinson, 2006, A Review of Price Elasticity Models for Postal Products

## **7 THE LIKELY DEVELOPMENT OF FUTURE COMPETITION AND MARKET TRENDS**

### **Introduction**

7.1 In this section we consider in qualitative terms how competition may develop in the future of the postal market in order to set the context for the quantification of future benefits of competition.

### **Drivers of change in the market**

7.2 There are a number of factors driving this change in the postal sector. These include:

- (a) **Technological advance:** This has enabled postal operators to provide new services such as hybrid mail products and track and trace products, and to benefit from new markets in the delivery of e-commerce traffic. More refined automation techniques and more sophisticated IT systems have allowed operators to achieve greater cost efficiency.
- (b) **De-regulation:** the move towards mail market opening has forced operators to look for new profitable opportunities and has generated other positive regulatory incentives, in part through the development of national regulatory bodies and their use of ex ante regulatory approaches. Prospective market opening and development of national postal regulation have influenced not only the behaviour of the national posts but also the development of national strategies towards postal operators.
- (c) **Changing customer demands:** Developments in key client sectors are changing the composition of postal demand. For example, the growth in advertising may well stimulate the development of new postal products in these markets, while the increased use of purchasing over the Internet is influencing the demand for packets and parcels delivery services more widely.

### **Current market trends**

7.3 The UK postal market has developed in a unique way due to the combination of a protracted process of market opening (compared to some EU Member States) an unfulfilled reform of Royal Mail and regulation which, it can be argued, has focused on the promotion of downstream access whilst deterring end-to-end entry through remaining VAT exemption for Royal Mail.

7.4 Postcomm has assessed the key trends in the market as follows:

- (a) Full end-to-end competition has made no noticeable impact on Royal Mail's revenues;
- (b) The loss of revenues to 'access' competition was less than a quarter of that which Royal Mail lost through volume declines and intelligent purchasing (sometimes

described as 'downtrading', eg, the use of Second Class instead of First Class services);

- (c) Royal Mail still dominates the UK postal market and its degree of dominance is greater than that of the national operators in Germany and the Netherlands;
- (d) Royal Mail still delivers more than 99% of all mail in the UK;
- (e) Competitors now handle around 20% of letters at some point during their journey, but actually deliver less than two in every thousand;
- (f) End-to-end competition is developing much more slowly than predicted by Royal Mail;
- (g) In 2006-07, Royal Mail achieved 11 out of 12 of its standards, compared to 10 out of 16 in 2005-06. For example, Royal Mail delivered 94 per cent of First Class mail the next day, against a standard of 93 per cent; and
- (h) Last year, Royal Mail delivered 99.66 per cent of items correctly, against a target of 99.51per cent.

7.5 Its assessment of the effects of these trends on Royal Mail is as follows in Table 7.1.

**Table 7.1 Key market trends**

Price Control area	Revenue (£m)	Percentage of total revenue
Total revenue - regulatory accounts 2005/06	5,987	100.0%
Increase in revenue due to: Price increases	299	5.0%
Decrease in revenue due to: Volume effects, ie, e-substitution and other demand changes	-108	-1.8%
End-to-end competition	0	0.0%
Access competition	-71	-1.2%
Intelligent purchasing	-148	-2.5%
Total revenue - regulatory accounts 2006/07	5,959	99.5%

Source: Postcomm

### Key factors influencing the development of end to end competition

7.6 There are a number of factors driving the development of competition in the market. These include:

- (a) Natural barriers to entry such as consumers demanding a full chain of postal services in postal delivery;
- (b) Legal barriers to entry;

- (c) Strategic barriers such as predatory and uncommercial pricing, vertical foreclosure and threat of use of exclusivity clauses in access agreement;
  - (d) Absence of a level playing field, such as VAT restrictions that apply to the competitors but not incumbent; and
  - (e) Dispute settlement. A lack of adequate framework might hamper the ability to deal with disputes adequately.
- 7.7 Of these, the exclusivity clauses in access agreements appear to be the key barrier which has prevented growth in end-to-end competition unlike that which has occurred wherever mail markets have been opened in other EU markets. Furthermore, unlike in The Netherlands and Sweden there is a unique VAT exemption for the incumbent.
- 7.8 Unlike access volumes, end to end volumes have not grown as much as forecast by Postcomm. End-to-end volumes for 2006/07 were only 35m compared with Postcomm's forecast at the time of setting the price control of 278m.
- 7.9 Although the volume of mail handled by competitors has grown, final delivery is undertaken by Royal Mail. A report on the development of competition in the European postal sector by DG Internal Market<sup>21</sup>, states that it appears that most competitor postal operators need 3-5 years before they start to make their first profits. However, this time period for breaking even is lower for competitors that use the existing operator for the final delivery stage as less investment is required.

### **Key factors influencing the further development of access competition**

- 7.10 Downstream access competition has been encouraged by Postcomm's regulatory intervention, in particular the use of cost-plus access price determination and the creation of Royal Mail Wholesale to provide better access conditions.
- 7.11 The key factors affecting the future development of access competition may include:
- (a) Future development in the conditions of access;
  - (b) General market development- the growth in mail revenues and volumes; and
  - (c) The development of Royal Mail; pricing and commercial response.

### **Future development of access conditions**

- 7.12 The use of access products has grown quickly in recent years and is expected to continue to grow albeit at a slower pace. There were access volumes of 2.4 billion items in

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<sup>21</sup> "Development of competition in the European postal sector", MARKT/2004/03/C, Ecorys, Rotterdam July 2005.

2006/07 compared to around 1.2 billion items in 2005/06 and 87 million items in 2004/05. This is set to grow to around 4 billion in 2007/08.<sup>22</sup>

- 7.13 In 2004 Royal Mail negotiated the first access agreement with UK Mail. Since then Royal Mail has agreed to a further five types of access agreement: National condition 9 access (for both operators and large mail users); Zonal condition 9 access (for both operators and large mail users); National condition 9 access agency (for operators only); Zonal condition 9 access agency (for operators only); Condition 9 access premium agency (for operators only).
- 7.14 The difference between Royal Mail's retail price and its respective access price for delivery is known as the "access headroom". The price control sets the levels of headroom (as a percentage) between access prices and the prices of a limited benchmark set of analogous Royal Mail retail products, which mean that Royal Mail cannot reduce headroom below a minimum set for the duration of the price control, in order to prevent "margin squeeze". This provides some certainty as to the margin for new operators and protects them ex-ante against the risk of "margin squeeze" by Royal Mail from a benchmark set of retail products, though not for other retail products.
- 7.15 The growth in access volumes since 2004/05 has been greater than forecast at the time when the price control was set. However, a large proportion of access volumes are with bulk mailers who remain Royal Mail customers, via Customer Direct Access arrangements (for 2006/07 this proportion was 50 per cent).
- 7.16 Royal Mail has claimed that the growth in access volumes demonstrates that the current headroom levels are "excessive".<sup>23</sup> Future growth in access volumes will be influenced by the level of headroom allowed in future price controls and the range of products which are included.
- 7.17 In January 2008, Postcomm rejected requests from Royal Mail, TNT Post and UK Mail to make changes to the level of access headroom as well as requests from TNT Post and UK Mail to extend the scope of headroom regulation (to more products) to be implemented from April 2008 (the Interim Review). However, changes were made in relation to rebalancing the sub-cap.
- 7.18 Currently headroom on a benchmark set of retail products is regulated ex ante, but Royal Mail has called for an ex post margin squeeze test to police any apparent anti-competitive behaviour by Royal Mail.

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<sup>22</sup> Review of Royal Mail's pricing flexibility and the level of access headroom (the "Interim Review" of the price control), A decision and direction by the Postal Services Commission, January 2008.

<sup>23</sup> Review of Royal Mail's pricing flexibility and the level of access headroom (the "Interim Review" of the price control), A decision and direction by the Postal Services Commission, January 2008.

- 7.19 At the moment Postcomm has rejected Royal Mail's call for ex post regulation, but has said that it will revisit the issue of access regulation more broadly in the context of the next price control review. However it has stated that "there is very little evidence at the moment to suggest that ex ante regulation of access can be removed at this early stage of a liberalised mail market".<sup>24</sup>
- 7.20 Other factors that affect the take up of access are: the costs and required profit margins of new entrants, customer price sensitivity, customers' brand allegiance to Royal Mail and non-price factors such as quality of service.

### **General market development**

- 7.21 The general development of volumes across the postal network will of course be of central importance in providing incentives for operators to provide downstream access services.

### **The development of Royal Mail**

- 7.22 In this respect access providers depend on a healthy and successful Royal Mail.
- 7.23 Recently, Royal Mail's total market volumes have been declining, there have been changes in volume mix and there has been an increase in access volumes.<sup>25</sup> Alongside declining volumes Royal Mail's financial position has been deteriorating. Royal Mail's operating profits (before exceptional items) for Royal Mail Letters' business fell from £344m to £294m in the year ending 25 March 2007.<sup>26</sup> Much of the decline in profitability was accounted for by higher pension costs. For the regulated areas Royal Mail had operating losses of £29m in 2006/07 compared with profits of £168 m in 2005/06.
- 7.24 However, the universal service remained profitable but to a lesser extent than in the previous year, with operating profit of £27m compared with £54 m in 2005/06.
- 7.25 Key barriers to entry appear to be:
- (a) Exclusivity clauses in downstream access agreements;
  - (b) Remaining VAT exemption for Royal Mail;
  - (c) Lack of cost reflective pricing for Royal Mail; and
  - (d) Generally low prices for contestable products.

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<sup>24</sup> Review of Royal Mail's pricing flexibility and the level of access headroom (the "Interim Review" of the price control), A decision and direction by the Postal Services Commission, January 2008, p32.

<sup>25</sup> Review of Royal Mail's pricing flexibility and the level of access headroom (the "Interim Review" of the price control), A decision and direction by the Postal Services Commission, January 2008.

<sup>26</sup> Review of Royal Mail's pricing flexibility and the level of access headroom (the "Interim Review" of the price control), A decision and direction by the Postal Services Commission, January 2008.

## **The future development of competition**

7.26 In light of the above we can see two main scenarios for the future development of competition.

- a) Counterfactual: Competition continues to develop as presently with limited end to end entry and continued development of downstream access;
- b) Greater development of competition with more extensive end-to-end entry and continued development of downstream access.

## **Key assumptions in the development of our scenarios**

7.27 We have made the following key assumptions in the development of our scenarios:

### *Volumes growth*

7.28 In looking at the impact of competition on the UK postal market we have not considered the issue of substitution or of volumes growth patterns except in reference to the likely impact of greater or lesser competition on this growth.

### *Universal service provision*

7.29 In looking at the impact of competition on employment and output we have not quantified the impact of competition on universal service provision.

### *Conditions of access*

7.30 We have assumed an improvement in the conditions of access for downstream access providers facilitating greater competition for upstream services.

### *Price elasticity*

7.31 We have assumed that price elasticity which is currently fairly low will increase in line with the development of substitutes (for example in relation to possible business to consumer substitution) and also the potential development of end-to-end competition. We have therefore assumed higher price elasticity for the future impacts- of -0.6 for scenario one and -0.8 for scenario two.

## **Scenario One: Continuation of current competitive development**

### **The continued development of downstream access**

7.32 The continued development of downstream access is common to both scenarios. So far, downstream access providers have been able to gain about a fifth of total mail volumes and we consider that this trend will continue, although there will be a competitive response from Royal Mail and the pace of switching to competitors will slow. We estimate

that up to about 40 per cent of the upstream segment will be taken by competing private operators (to Royal Mail) by 2016.

#### **Limited development of end to end entry**

7.33 In this scenario there is limited development of end to end entry this will result in Royal Mail retaining 95 per cent of the delivery market.

### **Scenario Two: Greater development of end-to-end competition**

#### **The development of new end to end entry**

7.34 In other EU postal markets we have seen greater competition for end to end services, particularly where VAT exemption for the Universal Service Provider has been removed. In other EU Member States such as The Netherlands and Germany we have seen that competitors have been able to enter the market through:

- (a) Deliveries once, twice or three times a week;
- (b) More flexible working patterns- for example part time working based on restricted shifts of 6 hours; and
- (c) More restricted delivery address lists- for example excluding delivery to areas of low population density.

7.35 We estimate that such end-to-end competitive entry in the UK could lead to entrants gaining an overall market share of around 8 per cent and creating over 20,000 part time job opportunities by 2016.

7.36 Further, we estimate that this competition may provide additional competitive pressure on Royal Mail and stimulate increased price responsiveness from customers- moving price elasticity up towards -0.8. (See earlier in this section).

## **8 QUANTIFICATION OF THE BENEFITS OF COMPETITION UP TO 2016**

### **Introduction**

- 8.1 In the previous section we considered how the postal sector has developed so far and latest market trends and we posited two scenarios of how the market may develop. In this section we provide an indicative quantification of the benefits of competition up to ten years after the full opening of the postal market to competition.
- 8.2 In this case also we have used Input Output tables and assumptions on the value of the elasticity of demand to quantify the future effects on the economy of the development of competition in the postal market.

### **Scenario One: continuation of current trends**

- 8.3 This scenario assumes continued growth of downstream access competition. This will have the following effects:
- (a) Continued employment generation by entrants (and possibly Royal Mail).;
  - (b) Continued innovation and choice for customers which will result in competitive pressure for Royal Mail;
  - (c) Higher quality of service for postal customers; and
  - (d) Pressure on postal prices.
- 8.4 Overall we estimate that this scenario will result in
- (a) A continued downward pressure on prices for Royal Mail;
  - (b) Continued positive incentives for Royal Mail to become more cost efficient and commercial in it's approach;
  - (c) Increased postal volumes;
  - (d) Greater responsiveness from customers and increased price elasticity of -0.6.; and
  - (e) Greater innovation in the market; for example more intelligent purchasing;
- 8.5 For the purposes of this study we estimate that this may result in downward pressure on prices of 5 per cent over ten years.

- 8.6 Using the input/output tables analysis, at current price elasticity (-0.6) this will result in an additional contribution of 4960 jobs and £306 million to the UK economy.<sup>27</sup>

## **Scenario Two: Greater development of end to end competition**

- 8.7 This would have the following effects:
- (a) Direct effects of entry- e.g. employment and volumes and revenues;
  - (b) Greater choice for postal customers;
  - (c) Greater innovation in the provision of new end-to-end and broader upstream and downstream services;
  - (d) Lower prices;
  - (e) Higher quality of services;
  - (f) Increased postal volumes; and
  - (g) Higher price elasticity.
- 8.8 Under this scenario we consider that the prices, volumes and employment impacts on Royal Mail will be as described in scenario one but with these additional impacts:
- (a) Increased incentives for structural reorganisation towards network re-optimisation; and
  - (b) Increased incentives for product and process innovation towards greater cost efficiency and customer responsiveness.
- 8.9 We estimate that this will result the following price and volume effects:

### *Price effects*

- 8.10 The competitive pressure will be increased due to added downstream competition leading to an overall downward pressure on prices of 5% over the ten year period. This could create the following additional economic benefits, £405 million and 6600 jobs.

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<sup>27</sup> We have assumed a reduction of 0.5 per cent per year in prices and a discount rate of 3.5 per cent as suggested by the Treasury.

## **9 CONCLUSIONS AND RECOMMENDATIONS**

### **Introduction**

- 9.1 In this section we draw conclusions about the benefits which have occurred as a result of competition.

### **The benefits of competition so far**

- 9.2 We have found that mail market opening has had significant benefits to the UK.

### **The benefits of positive incentives and greater dynamism**

- 9.3 In qualitative terms we can see that a key benefit of market opening has been the injection of positive incentives into the UK mail market to counter the inertia which had crept in after decades of statutory monopoly. A lack of competition and choice in the market threatened to create an accelerated decline for the sector relative to other communications and distributions industries.
- 9.4 In this respect we can see some positive impacts from this new situation, both in terms of its effects in galvanising Royal Mail to seek to transform itself and in terms of the new investments and innovations of the competing operators.

### **Timing issues**

- 9.5 It is however worth noting that the time frame for the working out of these incentives has been relatively short so far and that we are in the early days of the new world of competition.

### **Regulatory impacts**

- 9.6 In this respect it is also worth noting that regulatory intervention and associated access contract terms may have acted to distort the development of competition, with downstream access competition being facilitated to some extent at least whilst end-to-end competition, which has proved viable in other EU markets, being restricted by remaining VAT exemption for Royal Mail and the de facto exclusivity provisions in the national access agreement.

### **Our quantification of the benefits so far**

- 9.7 We have seen that this is reflected in the development of competition for postal services remaining largely through downstream access, with end-to-end competition actually slipping back over the last year or so.
- 9.8 However, we see that the main benefits to the wider economy have come from the changes made at Royal Mail which have been due, in part at least, to the process of market opening. Given the central importance of postal services to the wider economy, such changes have had a substantial impact over the period of the process of market

opening leading to a conservative estimate of current benefits of £229 million and roughly 3300 jobs.

### **The benefits of competition up to 2016**

- 9.9 Looking to estimate these benefits for the period up to ten years after actual mail market opening we see that there are likely to be significant benefits.
- 9.10 We estimate benefits for two scenarios- first, where current trends continue and downstream access remains of additional benefits of £306 million with a possible additional creation of up to an additional 4960 jobs and second, where end-to-end entry becomes established with additional benefits of £405 million with a possible creation of up to an additional net 6600 jobs.

### **Recommendations**

- 9.11 Given the above we see no compelling reason to reconsider the decision to open the mail market to competition, even were such a re-consideration possible (which it is not given the current proposed and largely agreed Third Postal Directive).<sup>28</sup>
- 9.12 In particular we believe that it is the injection of positive incentives which is most important at this stage in the evolution of the postal market- both to safeguard the volumes (the revenues from which fund the universal service) and to promote innovation and cost efficiency in the sector.
- 9.13 Further, given that more benefits would accrue from the greater development of end to end competition we recommend that UK policy makers and regulators take necessary actions to facilitate this development.

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<sup>28</sup> This sets the deadline for full market opening in all the EU Member States at 2010.