



Business models for a dynamic and successful postal market

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5 February 2008



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EXECUTIVE SUMMARY

The UK postal market is at a crossroads in its development, with policy makers and regulators now discussing best approaches for moving the sector forwards.

In this paper, which is intended to be a contribution to these discussions, we review the implications of different business models for Royal Mail. In particular we consider the impact that different options for Royal Mail may have on the promotion of commercial and customer focus in the sector.

Towards this objective we put forward a business model of 'Commercial Equivalence' for Royal Mail.

'Commercial Equivalence' would involve creation of a new business unit, "Royal Mail Sales" to develop and sell new postal products, providing greater incentives for product innovation and customer responsiveness. "Royal Mail Network" would continue to sell services to access customers, downstream access providers and to "Royal Mail Sales".

Under this model, "Royal Mail Sales" would be a distinct business unit within the Royal Mail group that interfaces with customers, defining products. It would contain all existing retail sales, marketing and product development aspects of Royal Mail.

Royal Mail would also have a "Network" unit which provided the operational delivery of postal services and included all the operational infrastructure, resource and capability. "Royal Mail Network" would have a market facing remit which offered services across the value chain, to access customers, downstream access providers and "Royal Mail Sales".

This model would include a new corporate structure with "Royal Mail Sales" and Royal Mail Network each having its own Executive but each with a seat on the Royal Mail Group Board.

Both "Royal Mail Network" and "Royal Mail Sales" would have specific and independent profit and loss accounts and targets as part of their commercial disciplines and incentives as business units.

The other objectives, targets and incentivisation of Royal Mail Network and Royal Mail Sales would be distinct and independent.

Further, it would include new arrangements whereby competing operators were able to gain access by arrangements with Post Office Ltd to Royal Mail's network of post offices in offering mail and parcel services to posting and receiving customers.

Such a model would have a number of key advantages compared to other options which have been proposed:

- It would provide new incentives for Royal Mail staff to develop and promote new postal products from both "Royal Mail Sales" and "Royal Mail Network", providing a much need spur to innovation;

- It would include clear commercial drivers for Royal Mail Sales and Royal Mail Network, acting to improve efficiency and service to customers;
- It could stimulate a step change improvement in the customer interface for leading mailers providing them with more reason to use mail services;
- The new separation between the sales and network functions would allow for genuine non-discriminatory access for downstream access providers, providing them with greater options for serving their customers and innovating in upstream services;
- Such a model would not impose on the market the potentially significant and damaging costs of a full-scale separation of Royal Mail's businesses;
- Such a model would avoid other potential costs of separation such as loss of accountability and practical difficulties, for example in relation to the allocation of costs of services or confusion in the customer interface;
- Such a model would be consistent with the shape and development of the postal market and would not involve substantial new structural costs or significant delays.

We believe that such a model would give Royal Mail staff much stronger incentives to maximise the value of its universal service infrastructure as a commercial asset- providing postal services to a wide range of customers, including mail users and other service providers, and would ensure all customers- access customers, downstream access providers and end-to-end customers being treated in the same way.

This could increase the benefits that the UK is deriving from this infrastructure and assist the safeguarding of universal service provision for the future.

It would enable Royal Mail to realise a viable, market-leading and commercially driven future that saw Royal Mail at the heart of a vibrant postal market in the UK.

1 INTRODUCTION AND BACKGROUND

- 1.1 In this section we set out the purpose of this study, the background to it and the structure of the report.

The purpose of this study

- 1.2 This study has been commissioned by UK Mail, a leading provider of downstream access services in the UK. The purpose of the study is to provide a qualitative consideration of possible business models for Royal Mail to improve innovation and promote non-discriminatory access in light of the need to safeguard the universal postal service and proportionate regulation. This study is to inform the discussions currently being held about the future of the UK postal market and possible models for the structure of Royal Mail.

About Europe Economics

- 1.3 Europe Economics is an independent economics consultancy with an extensive track record in providing advice for UK and European regulators and European Community institutions. The postal team at Europe Economics is led by David Stubbs who is a recognised expert and media commentator on the postal sector.

Our general approach

- 1.4 It is generally accepted in economic regulatory theory that the promotion of competition in markets (or the removal of barriers to competition) creates benefits for users and operators. We consider that greater competition is essential to foster the innovation and dynamism in the supply of postal services which is most likely to safeguard universal service provision and sustain a healthy mail market.

The structure of this report

- 1.5 This report includes the following sections:

Introduction and background: This section sets out the purpose, structure and background to the report and our general approach.

The need for a rejuvenation of the mail market: In this section we outline why there is a need for a new type of business model for Royal Mail.

Options for change in the structure of Royal Mail: In this section we set out the options for changing Royal Mail.

A review of the options: In this section we consider the costs and benefits of these options.

Conclusions and recommendations: In this section we conclude the report.

2 THE NEED FOR A REJUVENATION OF THE MAIL MARKET

Introduction

2.1 In this section, we set out why Royal Mail's business model is in need of change.

Postal market development

2.2 The mail market is changing in line with the evolution of customer requirements. Recent analysis undertaken by Postcomm has shown that the demand for postal services is moving away from traditional transactional mail products and towards more tailored direct mail solutions and fulfilment mail.¹

2.3 Whilst this development offers significant opportunities for postal operators (particularly when considered alongside the broadly positive developments in the express and logistics services) it also offers short term threats, particularly for Royal Mail in sustaining revenues during its adaptation to the changing market.

2.4 To take advantage of these potential opportunities for growing revenue streams operators need to take a dynamic and innovative approach.

The problems at Royal Mail

2.5 It can be argued that dynamism and innovation have not been words associated with Royal Mail over the last six months, as media reports have ranged over the damaging strike and other issues such as the pension deficit. It can be argued that over time lack of innovation, both in terms of taking most benefit from the use of new technology and adapting the customer interface and sales function has prevented Royal Mail from fully growing postal volumes.²

2.6 These problems for Royal Mail contrast with the situation in some other EU Member States where postal operators have been encouraged to reform within the context of a market gradually becoming more competitive and a social consensus about handling the industrial relations issues.³ Further other operators appear to have been given greater commercial freedom to take benefit from potential synergies in ancillary services.

¹ 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.

² It can be argued that this is due in part to regulatory uncertainty and lack of investment in the sector.

³ Clear examples here would include DHL and TNT.

- 2.7 Royal Mail has also shown a mixed record in achieving continuing efficiency improvements in all areas and downstream costs in particular seem to have shown little or no efficiency gain so far (indeed, the introduction of the single delivery resulted in increased rather than reduced downstream costs).

The development of competition

- 2.8 The development of competition in the market has acted to promote innovation in the sector with entrants providing new services for customers.
- 2.9 Mail market opening has been achieved. However, whilst around twenty percent of mail is collected by downstream access providers there are principally only two such providers and less than 1 percent of mail is delivered by competitors to Royal Mail - so market entry, particularly in delivery has been limited. UK Mail and other downstream access operators have been able to capture a growing slice of the market.
- 2.10 The remaining VAT exemption available for Royal Mail has prevented the development of significant competition for end-to-end services compared to some other EU Member States.⁴
- 2.11 Nevertheless, the rate of switching to downstream access providers suggests that customers have seen benefits in the new services and it may also be the case that Royal Mail's customers also have benefited, as Royal Mail has responded to competition.

The potential effects of access on innovation and volumes

- 2.12 International experience suggests that the development of access services can lead to a significant expansion of postal volumes as competitors offer new more tailored products and potential customers take benefit from lower prices or higher quality services. For example, it has been argued by the US postal regulator that the introduction of work sharing significantly increased volumes, with these more than doubling in scale from 1970 to 2004 after the introduction of work sharing.
- 2.13 It could be argued that in the UK downstream access providers are creating new demand for postal services or are helping to sustain existing demand.

Current problems for competing postal operators

- 2.14 Current arrangements for access are set out in Annex 1. These arrangements are typical of those which have been initially put in place by regulators aiming to promote non discriminatory access, and, it can be argued, have run into comparable problems to

⁴ For example greater competition has developed in the Netherlands.

'Chinese walls' set up elsewhere.⁵ For example, there appear to remain difficulties for operators providing downstream access services.

2.15 These relate, in part, to a culture lag of resistance to competition or new models of postal provision amongst Royal Mail staff.

2.16 Remaining problems encountered by access providers include:

- Cultural lags for Royal Mail staff. Indications that some Royal Mail staff continue to regard access providers as a threat rather than as customers;
- Conflicting organisational incentives. Whilst staff at Royal Mail Wholesale are required not to discriminate against access providers, it could be argued that wider corporate objectives (for example taking into account perceived costs of the loss of upstream business for Royal Mail Group) may also have an impact.
- Royal Mail's inefficiency and unimproved quality of service. Delivery service failures by Royal Mail affect customers who have used access services;
- Operational requirements imposed by Royal Mail are currently a barrier to or drag on the development of competition, stifling the development of new services;
- A lack of proactive innovation in offering access services.

The effects of these problems

2.17 These problems appear to be similar in type to those which have emerged in the development of access competition in other sectors. In Annex 2 of this document we provide a quick review of the experience of access regulation in comparable sectors. We note that the effect of problems of access may be to delay the pace of competitive entry and the development of access services.

2.18 Further, over time, it could be argued that these may prevent downstream access providers from innovating in their service provision for customers and, therefore dampen any potential increase in volumes generated by downstream access.

Safeguarding the universal service in a dynamic market environment

2.19 It can be argued that in weakening possible opportunities for growth of volumes and for operators to innovate in the provision of services, the current conditions are damaging the financial base of universal service provision and the essential underpinning of it by rooting the service in the needs of customers.

⁵ See Annex 2 on the regulation of access in other network industries

- 2.20 The economics of the universal service suggest that (unless it is to rely on large public subsidy) the financing of universal postal service provision depends upon sustaining the volumes of mail travelling across its delivery infrastructure.
- 2.21 In this respect, 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. Conditions which promote innovation and increased customer responsiveness by postal providers are most likely to safeguard the volumes needed to fund universal service provision.
- 2.22 Further, weakening of innovation in the postal sector may act to dislocate the sector from its customers and over time may threaten the long term relevance of the services and ultimately the current pattern of universal service provision.

3 OPTIONS FOR CHANGE IN THE STRUCTURE OF ROYAL MAIL

Introduction

- 3.1 We have seen in the previous section that promotion of downstream access competition could assist in ensuring the future financial sustainability of Royal Mail and universal service provision. We have also detailed current arrangements.
- 3.2 In this section, we review the experience of access in other sectors and the different options which have been proposed for changing the structure and organisation of Royal Mail.

Postcomm's scenarios for future regulation

- 3.3 In its recent consultation Postcomm proposed a number of scenarios for how it should regulate the postal market when the current price control is due to be replaced from 2010 onwards.⁶
- 3.4 These scenarios include changes in the current scope of price controls based around a scenario of no separation and scenarios based on a move towards Wholesale Equivalence.⁷

Wholesale Equivalence and separation of Royal Mail's businesses

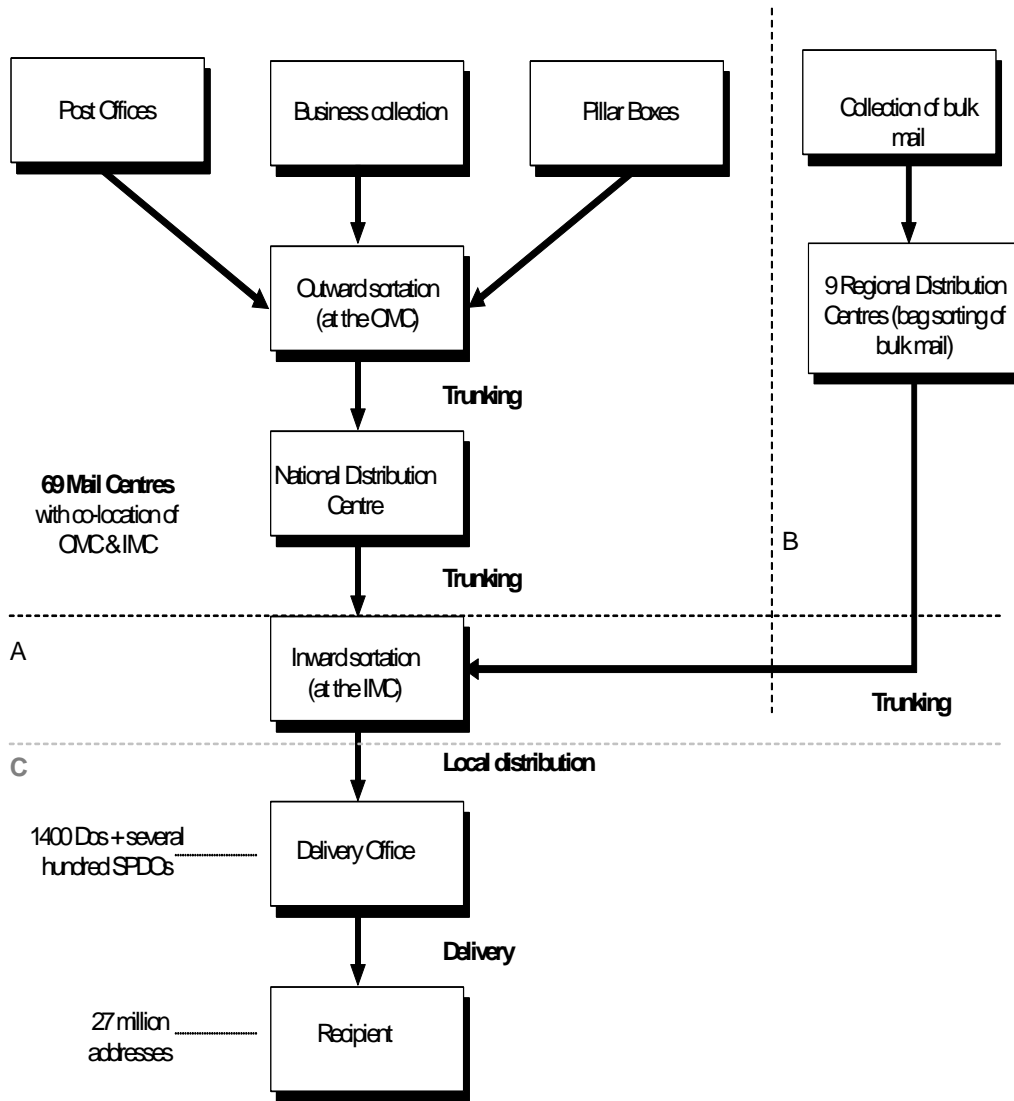
- 3.5 Postcomm has suggested that Wholesale Equivalence would probably be accompanied by separation of Royal Mail's businesses into "two or more business units" and that this split might occur at the level of the inward mail centre.
- 3.6 Further it would be accompanied by a licence obligation on Royal Mail to provide equivalence of wholesale service offering to its separate divisions and to third parties.

⁶ Postcomm: "Regulatory Framework for Postal services from 2010". Issued on 15th January 2008.

⁷ This would mean that different divisions of Royal Mail are offered the same set of products, receive the same terms and conditions, use the same set of systems and process to request new access products, have the same level of access to information on products and services and systems relating to the delivery network.

- 3.7 The separation of businesses would probably include:
- A downstream or operations business clearly separate from Royal Mail's other business units with separate staff, management and remuneration activities
 - Specific obligations with respect to commercial and customer confidentiality;
 - Clear financial transparency.
- 3.8 Postcomm has raised the issue of where the point of separation should be and has suggested three options:
- Separation at the inward mail centre;
 - Separation between the network of regional distribution centres and the mail centre network;
 - Separation between the inward mail centres and delivery offices.
- 3.9 This is shown in Figure 3.1 overleaf.

Figure 3-1: Postcomm's Proposals



3.10 Postcomm has proposed that in considering any of the above approaches operational issues are also important; for example, the ability to ensure that universal service mail has access to slots at the mail centre, the potential requirement to revenue protect universal service mail upstream and downstream and the limited use of delivery offices for collection.

3.11 In addition to this consultation Postcomm has also launched consultation on future access.⁸ This has asked for views in relation to the workings of current access arrangements and how they may be improved.

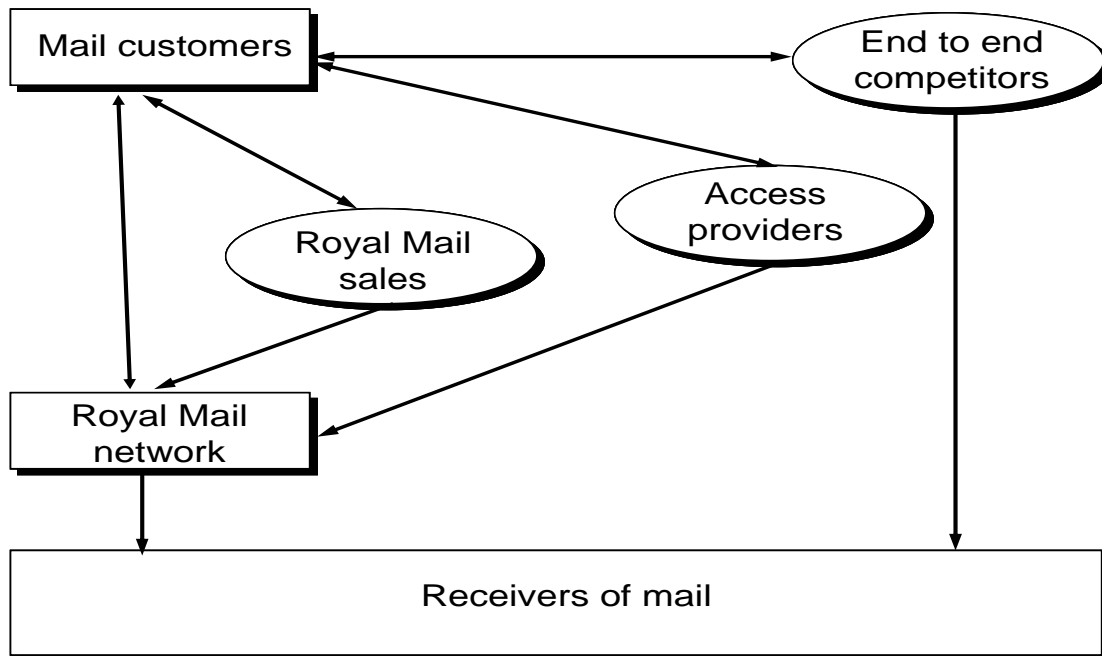
Other options for improving access

3.12 UK Mail has asked us to consider another option for making the mail market work better for all postal customers.

Commercial Equivalence

3.13 This option involves dividing retail sales activities at Royal Mail from the rest of its provision of postal services. This is shown in Figure 3.2 below.

Figure 3-2: Commercial Equivalence



3.14 Under this model:

- Royal Mail would have a “Network” Unit to provide the operational delivery of postal services and include all the operational infrastructure, resource and

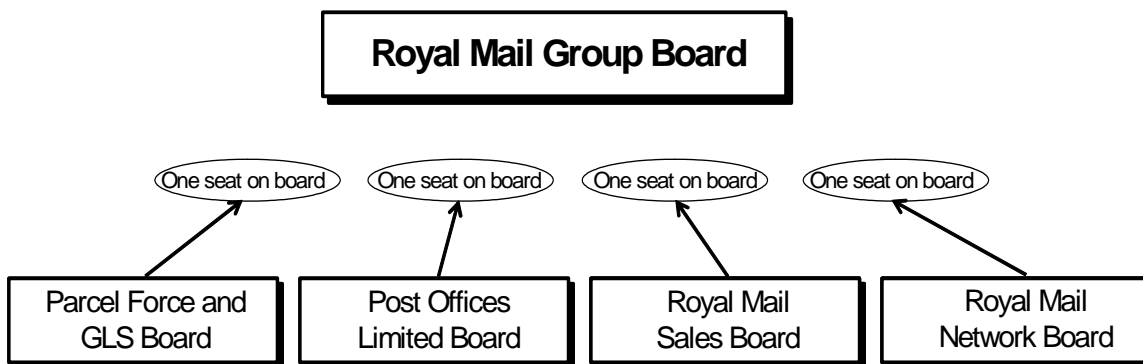
⁸ Postcomm: “Access Review: A consultation document.” January 2008.

capability. “Royal Mail Network” would also have a vital market and customer facing role that would interface with “Royal Mail Sales” for end-to-end services as well as with access customers and down stream access providers such as UK Mail - taking forward the existing Royal Mail Wholesale unit. . It would have commercial incentives to sell services across the value chain including its upstream collection and distribution capability and to strive for increased efficiency in service provision.

- “Royal Mail Network” would include the current customer services area of Royal Mail. Further it would open up non discriminatory access to Post Offices Ltd to make the post office network available to other operators.
- “Royal Mail Sales” would be a distinct selling business unit selling end-to-end postal services to mailing customers. It would contain all existing retail sales, marketing and product development aspects of Royal Mail;
- Very importantly, both “Royal Mail Network” and “Royal mail Sales” would have distinct and independent objectives, targetry and incentivisation that would drive and reward their own commercial performance rather than merely being accountable towards Royal Mail Group objectives;
- Both “Royal Mail Network” and “Royal Mail Sales” would have specific and independent profit and loss accounts and targets as part of their commercial disciplines and incentives as business units.

3.15 This model would also imply a different corporate structure for Royal Mail.

Figure 3-3: Corporate structure for Royal Mail



- 3.16 Under this model “Royal Mail Sales” and “Royal Mail Network” would have a separate “boards”, coming together through membership of the Royal Mail Group.

Universal service provision under this model

- 3.17 As we have seen in section 2 of this report, the promotion of innovation and volume growth may well be essential for the maintenance of the universal service in the longer term.
- 3.18 In practical terms, under this option Royal Mail would be obliged to provide the universal service under its licence and would be required to ensure universal service products were offered by Royal Mail Sales.

4 A REVIEW OF OPTIONS

Introduction

- 4.1 In this section we review the costs and benefits of different options. We consider three options:
- The counterfactual option- no change on existing arrangements;
 - The Wholesale Equivalence option- with separation at the level of the Inward Mail Centre;
 - Commercial- Equivalence- with the creation of a new business unit within Royal Mail- “Royal Mail Sales” handling product innovation and the provision of services by Royal Mail Network.

Our general approach to the review

The experience of other network industry regulation

- 4.2 We set out in Annex 2 a summary of access regulation in the telecoms and energy sectors in the UK. From this we can derive clear examples of the need to strengthen arrangements which may have been based on “Chinese Walls”.

The uniqueness of postal regulation

- 4.3 Although we have set out this experience from other sectors, we believe that the postal sector is different in some important respects from both energy and telecoms, not least in that to some extent the shape of the postal infrastructure (of universal service infrastructure) is imposed by regulatory obligations rather than natural market features.
- 4.4 In post, regulators can make significant changes to the economics of the sector for example by changing the shape of the universal service obligation or quality of service requirements. Given this it can be argued that Postcomm has a wider menu of available choices to achieve its aims than other regulators perhaps allowing for less emphasis on structural solutions as opposed to other regulatory actions.

The need for measured change

- 4.5 Royal Mail is currently faced by a significant set of problems, such as the pension deficit and industrial relations problems. At this delicate stage in the transformation of the sector any changes which may impose significant costs and dislocation to Royal Mail should be considered within the context of the challenges it currently faces.

Our criteria for reviewing options

- 4.6 In reviewing the options described in paragraph 5.1 we have considered the following issues:

Customer needs

- 4.7 We have aimed to assess which of the options is most likely to best serve postal users. In doing so we have aimed to assess solutions in part as to how they work with the grain of how the postal market functions from a business perspective. Further, as postal demand is fairly concentrated and the quality of the customer interface is important to the generation of demand, any arrangements which may cause confusion or deterioration in this interface will damage the market.

Effects on access competition

- 4.8 Clearly, a central point of the options is to improve the conditions of access and this is an important criteria.

Effects on innovation

- 4.9 Postcomm has noted in its Strategy Review, that it has been disappointed by the pace of innovation in process and the impact of any arrangements on innovation should also be considered.

Effects on Universal Service

- 4.10 The effects of any arrangements on the development of competition and the universal service should be considered.

Administrative and practical costs

- 4.11 In this respect we consider the likely administrative and practical costs of any solutions.

Regulatory uncertainty

- 4.12 Where possible solutions may create uncertainties, for example in relation to cost allocations for products or services offered by different parts of the same unit we would regard this as a cost of the arrangements.

Unintended consequences

- 4.13 Finally, we also need to consider the potential for unintended consequences to arise from the reorganisation, for example any confusion or perverse incentives this may create, and also other issues such as loss of accountability.⁹

A review of the options

- 4.14 We set out overleaf a qualitative review of the costs and benefits of different options.

⁹ These issues have of course been felt most strongly in the rail sector.

The counter factual: Royal Mail Wholesale

Costs

4.15 We have seen in the previous section that current arrangements appear to have significant failings in relation to the promotion of access competition and innovation in the market. In particular the current Chinese Walls arrangement does not appear to be working effectively in relation to guaranteeing a dynamic interface with access providers.

4.16 Current problems include:

- Perverse incentives. Whilst downstream access providers are competing with Royal Mail businesses for upstream business there are perverse incentives for Royal Mail staff in dealing with downstream access providers, in particular where it is felt that wider corporate objectives may conflict with the promotion of access.
- Cultural lags. There is a remaining culture at Royal Mail which views downstream access as a threat and aims to thwart access providers;
- Cost allocation and accounting issues. A lack of clear business delineation creates some ambiguity (and perverse incentives) in the separation of costs for products across Royal Mail's value chain. Given the estimation and sampling involved in activity based costing and the significance of even slight variations in the level of access prices, this creates some level of regulatory uncertainty and dilutes incentives for cost efficiency;
- Regulatory burden. This point relates to the need for Postcomm to monitor access prices and accounting techniques, a requirement which could impose a significant regulatory burden.

Benefits

4.17 The benefits of continuing with current arrangements include:

- No transformation costs. Staying with current arrangements will not impose costs of implementing new arrangements;
- Regulatory certainty. It could be argued that stakeholders know what the current arrangements are and this contributes to regulatory certainty;
- The promotion of downstream access. Current arrangements have not prevented a significant rise in access volumes.

Wholesale equivalence

4.18 In considering the costs of Wholesale Equivalence we have assumed that this would involve structural separation of Royal Mail, for example at the level of the Inward Mail Centre. This would involve the following costs:

- Costs of reorganisation. It can be argued that separation would involve significant costs of reorganisation of the business;
- Ongoing practical costs. Separation within a business unit or a sorting office may impose significant practical difficulties in relation to the daily operation of the postal service;
- Regulatory uncertainty. Such a separation would be controversial and may involve significant political debate and delay provoking regulatory uncertainty;
- Lack of positive incentives. It is not clear how a move towards Wholesale Equivalence would generate positive incentives for Royal Mail to innovate, for example.

Benefits

4.19 Wholesale Equivalence would however generate some benefits.

- Separation should remove perverse incentives for Royal Mail staff between business units and improve the points of access for downstream access providers;
- Separation should remove some ongoing difficulties of cost allocation.

Commercial Equivalence

Costs

4.20 Commercial Equivalence, focusing on the provision of mail services across the value chain to different customers, and utilising some of the Openreach style arrangements, would have the following costs

- Reorganisation costs. Setting up the new business unit would create some costs.
- Initial change costs at Royal Mail. There would be some internal costs to Royal Mail in implementing the cultural and leadership changes involved in establishing a commercially driven “Royal Mail Network” and in making “Royal Mail Sales” a successful, now distinct, venture.

Benefits

4.21 Benefits may include:

- Generation of positive incentives for Royal Mail staff to treat access providers and other customers in a non discriminatory way;
- Greater incentives for Royal Mail to innovate in product development;
- An improved interface for downstream access providers;
- An improved process of competition;
- Generation of greater volumes of mail and retention of existing competitive mail products.

A comparison of options

4.22 We compare the costs and benefits of these options below in Table 4.1 overleaf:

Table 4.1: A comparison of options

Option	Benefits for customers	Effects on access competition	Effects on innovation	Effects on universal service	Compliance costs	Regulatory uncertainty and unintended consequences
No change counterfactual	This has not prevented access competition developing but has not provided full clear incentives for Royal Mail staff to welcome access volumes and facilitate access access proactively.	Competition has developed so far but some ongoing problems for example in relation to the effectiveness of Chinese Walls.	Has created some innovation and investments by access providers but not yet Royal Mail. Not clear how far this would continue	Universal service has been maintained. Volumes decline appears to be main emerging threat.	Accounting and negotiation, additional admin costs of running RM Wholesale.	Current situation- should not generate additional uncertainty but may be suppressing possible increase in postal volumes and access competition
Wholesale Equivalence	Could produce cheaper access services if implemented positively but may create confusion and delays during implementation and accountability issues	Yes- but the initial delay due to reorganisation may cause some disruption to the development of access services	Not clear why this would be increased- separation may dilute incentives to sell upstream services	Dislocation and re-organisation costs may impose a significant burden on Royal Mail.	Could be significant depending on location and nature of separation- for example there could be problems of accountability.	Could generate considerable uncertainty about future models of separation with unintended consequences including disruption to access and perverse incentives for Royal Mail staff.
Commercial Equivalence	Should create a more dynamic and non-discriminatory customer interface-	Yes	Should create more product innovation and allow Access Providers and RM Sales to compete in developing upstream products	Commercial Equivalence may stimulate increased revenues and volumes for Royal Mail. This should not involve excessive disruption costs.	Not likely to be significant should be more than offset by additional revenues generated by product innovation and more access competition.	Some initial uncertainty but a shorter implementation schedule compared to Wholesale Equivalence and clearer structures and positive incentives for operators.

5 CONCLUSIONS AND RECOMMENDATIONS

Introduction

5.1 In this section we provide conclusions and recommendations based on our analysis.

Our findings

5.2 Our qualitative review compared different business options in relation to how far they are likely to promote positive incentives, promote competition, serve customers and be workable.

5.3 From this review we have found that overall a Commercial Equivalence of Royal Mail to create a new business unit, Royal Mail Sales is the option which best meets this criteria.

Why Commercial Equivalence is the best option

5.4 We believe that Commercial Equivalence is the option which is most likely to promote a healthy mail market and safeguard universal service provision. It will provide a direct stimulus to innovation and customer responsiveness at Royal Mail and allow downstream access providers to better meet customer needs. By doing both these things it should allow for the development of greater mail volumes without imposing the substantial structural reorganisation costs and regulatory uncertainty of Wholesale Equivalence.

5.5 The case for further improvement to the conditions for access to Royal Mail's businesses is a compelling one. There have been substantial complaints by downstream access providers that the conditions of access remain suboptimal and there remain perverse incentives for Royal Mail staff in treating access providers.

5.6 In light of this, and the urgent need to promote upstream competition to increase postal volumes, we regard the status quo counterfactual as unlikely to best meet future customers' requirements.

5.7 This leaves the options of Wholesale Equivalence and that of Commercial Equivalence.

5.8 We regard the models of separation proposed for Wholesale Equivalence as likely to produce serious ongoing problems of a practical nature. For example splitting the business within a business unit such as an Inward Mail Centre could create confusion and duplication and loss of accountability.

5.9 Further the set up costs of this type of separation may be considerable and unless current perverse incentives are addressed the effect on the morale of Royal Mail staff may be negative.

- 5.10 Compared to these scenarios that of Commercial Equivalence appears much more likely to produce the types of positive incentives and stimulation of volumes which are much needed.
- 5.11 The creation of a new business unit, a new volumes generation and value maximisation focus could rejuvenate Royal Mail's business and provide customers and access providers with a much more customer focused partner.
- 5.12 Clearly there are some initial costs associated with any organisational change which may be imposed on Royal Mail and we recognise that the creation of "Royal Mail Sales", building upon the interface arrangements already set up in "Royal Mail Wholesale" will involve some initial burdens on Royal Mail.
- 5.13 We do not propose here an exact organisational model but would suggest that the reorganisation needs to include:
- Creation of "RM Sales" and "Royal Mail Network " as distinct business units
 - Internal incentive structures at both "Royal Mail Sales" and "Royal Mail Network" to encourage new business and promote product innovation in the sale of new services;
 - Training and cultural adaptation for Royal Mail's staff to change the culture to welcome access providers in the same way as other customers;
 - Training and cultural adaptation for "Royal Mail Network" to encourage staff to seek to offer new services for the network.
- 5.14 However, we consider that most of these costs are for activities, such as cultural changes, which would be worthwhile, whatever new business solution was eventually adopted.

Recommendations

- 5.15 Our analysis suggests that Commercial Equivalence of Royal Mail's businesses would confer most benefits for postal customers and we recommend that policy makers consider this approach in their deliberations over the future of the sector.

ANNEX 1: CURRENT ARRANGEMENTS FOR DOWNSTREAM ACCESS

Current Access arrangements

- 5.16 The current arrangements are that downstream access providers liaise with Royal Mail Wholesale.

Royal Mail Wholesale

- 5.17 Royal Mail Wholesale officially came into being as a separate business unit of Royal Mail Group on **1st April 2006**; it manages all aspects of Royal Mail's interface and commercial arrangements with customers wanting to make use of Royal Mail's postal facilities under **Condition 9 of Royal Mail's Licence**.
- 5.18 Royal Mail Wholesale is managed by the Royal Mail Wholesale Executive which includes the directors of the unit together with the Royal Mail Group Finance Director, Royal Mail Group Strategy Director and a representative from Royal Mail Operations.
- 5.19 The current role of Royal Mail Wholesale includes:
- (a) Management of Condition 9 Access contracts
 - (b) Development of new Condition 9 Access service variants
 - (c) Implementation and management of operational interface issues with competitors (e.g. Code of Practice issues, redirections etc.)
 - (d) Interface with associations of other postal operators (e.g. Mail Competitors Forum)

Relevant licence conditions

Condition 9

- 5.20 This is the principal Condition that applies to the Royal Mail Wholesale unit. It **specifies the basis on which Royal Mail is required to approach "access to its postal facilities"**. These include:
- (a) Negotiating in good faith with a view to agreeing terms;
 - (b) At prices based on a reasonable allocation of costs;
 - (c) Such that Royal Mail does not unduly discriminate or show undue preference.
- 5.21 To date, access requests have **exclusively taken the form of operators and customers seeking access to Inward Mail Centres** for downstream access mail to receive final sortation and delivery.

Condition 10

5.22 This requires Royal Mail Wholesale to maintain '**Chinese walls**' between itself and the **commercial departments of its retail business** (particularly marketing and sales). It requires Royal Mail to

- (a) "Conduct its business as a postal operator in the manner best calculated to secure that [it does not] obtain any unfair commercial advantage in connection with the provision by the Licensee of access to its postal facilities."
- (b) "Use all reasonable endeavours to secure that no information in the possession of the Licensee as a result of giving access to its postal facilities to other persons is disclosed for the benefit of or used for the purpose of any trading business conducted by the Licensee."

Condition 11

5.23 This requires that

- (a) "the terms on which it [Royal Mail] supplies or offers to supply postal services to customers
 - o shall not show undue preference to any person or class of persons, and
 - o shall not exercise any undue discrimination against or seek to impose any undue restriction on any person or class of persons, and
- (b) shall not set terms or charges for the supply of postal services
 - o which are excessive, or
 - o which are predatory."

Compliance

5.24 Royal Mail Wholesale is committed to adhering to the letter and spirit of its compliance obligations. It is the responsibility of each employee to comply with Royal Mail's licence requirements. In order to ensure that Wholesale adheres to its own licence obligations in all respects, a Head of Compliance has recently been appointed, who reports to the Wholesale Managing Director. Also, as required by Condition 13 of its Licence, Royal Mail has a Compliance Officer who reports to the Royal Mail Group board

ANNEX 2: REGULATION OF DOWNSTREAM ACCESS IN OTHER NETWORK INDUSTRIES

The experience of other network industries

- 5.25 In general structural separation has occurred when regulators felt that there were economic bottlenecks to competition such as natural monopoly features and competitors needed access to the incumbent supplier's infrastructure (or pipeline) in order to be able to compete.

Telecoms

- 5.26 In September 2005, Ofcom carried a major strategic review of the industry telecommunication in which decided that BT's position as wholesale and retail operator could act against the interest of fair competition in the UK.
- 5.27 Following this review, BT signed a legally binding series of obligations, the "Undertakings", with Ofcom to help create a better regulatory framework for BT and the telecoms industry. These obligations are in addition to extensive regulation imposed by Ofcom under Communication Act 2003.
- 5.28 To meet the "undertakings" BT created a new line of business to manage **the access and the backhaul network** together with the associated products portfolio: Openreach which is part of the BT group, but legally separated from BT Company.
- 5.29 Openreach was established on 22 January 2006, its management of products and services include:
- (a) Wholesale Line Rental, analogue and digital products (WLR);
 - (b) Unbundled Local Loop (ULL);
 - (c) Private circuits access and backhaul components;
 - (d) Wholesale Extension Services (WES); and
 - (e) Backhaul Extension Services (BES).
- 5.30 Together with Openreach, the undertakings include also the separation of BT Wholesale Division (BTW) in three different units, whose role is the product management, product development, product specification and product related procurement processes of different groups of products.
- 5.31 The units and the relative products are:

- BT Wholesale Core Network (CN) Services, for the main BT Wholesale SMP products, as: DataStream, Carrier Pre-selection, Partial Private Circuits and network charge control services);
- BTW Value-added Network Service, for products considered by Ofcom to be “significant to other Communications Providers, as Wholesale Calls, IPStream; Leased Lines for Communication Providers;
- BTW Unregulated & New Services, for the main unregulated products, as New products based around 21CN capabilities.

BT codes of practice

- 5.32 The Code of Practice will ensure that people working for BT adhere to the behaviours and support the spirit of the legally-binding undertakings given to Ofcom by the BT Group.
- 5.33 There are three different but similar version of practice codes which refer to BT people dealing respectively with BTW, Openreach, and Northern Ireland. Each of them include three different areas of work to ensure that Communications Providers are able to compete fairly and on equal terms:
- (a) BT organisation;
 - (b) Sharing commercial information and customer confidential information; and
 - (c) Influencing commercial policy.
- 5.34 Ofcom can take legal proceedings and disciplinary actions to enforce the Undertakings and also refer BT to the Competition Commission under the Enterprise Act.

Electricity & Gas¹⁰

- 5.35 Before 1986 British Gas operated as the publicly owned, vertically integrated transporter and supplier of natural gas in the United Kingdom. In 1986 the government privatized British Gas, choosing to leave it a single, vertically integrated company in order to speed the transaction and maximise the sale proceeds. At the same time it separated the gas market into three major segments:
- (a) The wholesale market
 - (b) The contract market, where gas is supplied to large consumers

¹⁰ Natural Gas Markets in the U.K (1998), World Bank publications.

(c) The tariff market, where gas is supplied to small consumers

- 5.36 Seven years later, following a report by the Monopolies and Mergers Commission, the company was re-structured into five business divisions when British Gas decided to comply with regulatory requirements.
- 5.37 Ofgas asked British Gas to release more natural gas to independent suppliers and to build “Chinese walls” separating its gas supply and pipeline transportation businesses. The intention was to increase independent suppliers’ access to natural gas from producers and to level the playing field for suppliers contracting for pipeline transportation.
- 5.38 In 1997, the company was split into two separate companies BG plc and Centrica. Transco became part of BG plc and in December 1999 Transco became a plc - BG Transco plc.
- 5.39 In October 2000 a de-merger from BG plc resulted in Transco becoming a part of the Lattice Group plc. Two years on, Lattice Group plc merged with National Grid to form National Grid Transco plc, the UK’s largest utility.
- 5.40 On 27th July 2005 National Grid Transco plc changed its name to National Grid plc. On 10th October 2005, Transco plc changed its name to National Grid Gas plc.