

# Opening the Post

## Postcomm and postal services - the risks and opportunities

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL  
HC 521 Session 2001-2002: 24 January 2002



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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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Picture courtesy of Consignia plc

# executive summary

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- 1 Postal services play a key role in modern economic and social life, providing communications between individuals, business and government. In the United Kingdom (UK), some 20 billion letters and packages are posted ever year. In recognition of the important social role of postal services, most governments seek to preserve the continued provision of **universal service** - that is, collections and deliveries to all parts of the country<sup>1</sup>. In the UK, the Government's policy is to guarantee universal service - defined as daily collections and deliveries across the country of postal packets up to 20 kilograms (44.1 pounds) - at an affordable and geographically uniform price. A uniform price<sup>2</sup> is one that does not vary with distance, so that the price of long-distance mail within the UK is the same price as local mail.
- 2 In March 2001, the Postal Services Commission (Postcomm) became responsible, under the Postal Services Act 2000 (the Act), for the independent regulation of the postal services market in the UK<sup>3</sup>. At the same time, the Post Office changed into a public limited company wholly owned by the Government, under the new name of Consignia Holdings plc (Consignia)<sup>4</sup>, but with no change to its brands such as Royal Mail. The Act also created a new consumer council for postal services (Postwatch), responsible for promoting and protecting the interests of consumers of postal services in the UK<sup>5</sup>. Taken together, these changes represent the most significant developments in the regulation of postal services for many years.
- 3 Postcomm's main statutory duties, as set out in the Act, are to:
  - exercise their functions in a manner best calculated **to ensure the provision of a universal postal service** at an affordable and geographically uniform price. This is their primary statutory duty; and
  - exercise their functions in a manner best calculated **to further the interests of postal users**, wherever appropriate **by promoting effective competition**.
- 4 Postcomm have a wide series of further duties, including advising the Secretary of State for Trade and Industry on the nation-wide network of post offices. This advisory role is distinct from Postcomm's regulation of the postal services market, and lies outside the scope of this report.
- 5 While Postcomm's statutory duties and powers resemble in many ways those placed on other industry specific economic regulators, there are a number of significant differences in the way regulation has been introduced into the postal services market:

<sup>1</sup> *The Universal Postal Union, the specialised institution of the United Nations that considers postal issues, established the provision of a universal postal service as its first objective within its mission statement.*

<sup>2</sup> *This is consistent with European legislation: Collection and delivery up to 10 kilograms is required, but a limit of up to 20 kilograms and a uniform tariff are permitted.*

<sup>3</sup> *The Postal Services Commission, appointed by the Secretary of State, comprises the Chairman, Graham Corbett CBE, the Chief Executive, Martin Stanley, and five part-time Commissioners (see Appendix 5).*

<sup>4</sup> *The Post Office will be called Consignia in this report unless we are referring specifically to the regime before the Postal Service Act 2000 came into force.*

<sup>5</sup> *Postwatch took over the duties of the Post Office Users' National Council.*

- There is an over-riding universal service duty placed on Postcomm;
  - There has been no privatisation to accompany the new regime;
  - Competition is being introduced without first introducing private sector disciplines as a result of privatisation;
  - Postcomm, rather than the Government, were charged with establishing the licensing regime; and
  - Postcomm do not have concurrent powers under the Competition Act 1998 to enforce competition law with the Director General of Fair Trading.
- 6 We therefore examined the legislative and market context in which Postcomm are operating, having regard to the current strengths and weaknesses in Consignia's performance (Part 1), and the particular risks facing Postcomm in achieving their objectives (Parts 2 and 3). In examining these matters, we obtained evidence from Postcomm, Postwatch and Consignia, carried out a public opinion survey jointly with Postcomm and Postwatch, surveyed Consignia's largest customers, and commissioned a paper on cost modelling from Professor Martin Cave of the University of Warwick.

## The legislative and market context in which Postcomm operate

The monopoly postal area has been converted to a licensed area open to competition

- 7 Until March 2001 Consignia, through its main UK postal operations, Royal Mail and Parcelforce Worldwide, had a statutory monopoly over the collection and delivery of mail weighing less than 350 grams (12.3 ounces) or costing less than £1. The Act has empowered Postcomm from March 2001 to license Consignia and other operators to carry out this function. The area of the market formerly reserved to Consignia has thereby been converted to a licensed area. Above this weight/price limit, the market has been open to competition for some years and, including courier and express services, is served by some 4000 operators. Consignia is the largest operator in this part of the market, but it faces strong competition in some segments.

There are high levels of satisfaction with the services provided by Consignia

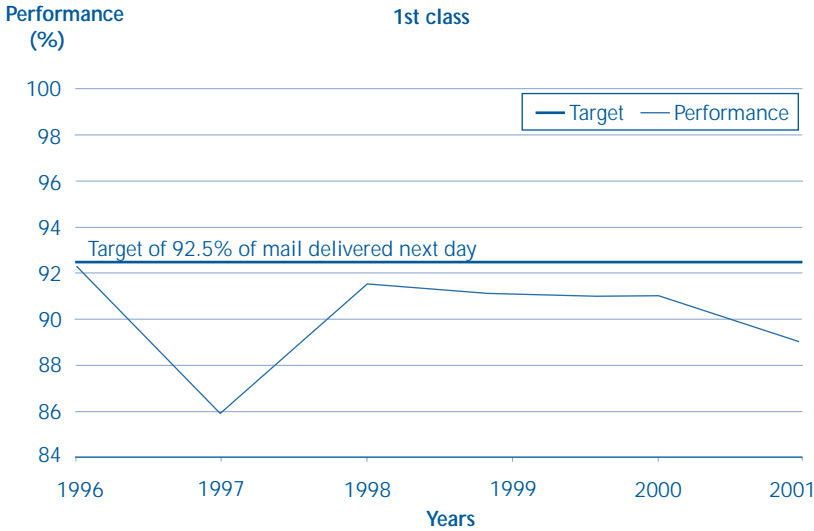
- 8 The UK benefits from Consignia's current provision of postal services in a number of ways. Consignia provides the universal service of daily collections and deliveries in almost all parts of the UK. It is committed to provide a level of service which goes beyond the minimum requirement for a daily delivery, including next-day delivery for most 1st Class mail and the delivery of most mail before 9.30 am. For basic letters, Consignia's services appear to be relatively cheap compared to postal providers elsewhere in the world. And our joint survey of domestic customers, and questionnaire to large users of postal services, show generally high levels of satisfaction with Consignia's services. Three-quarters of domestic customers replying to the survey considered that Consignia's 1st Class postal service provides good or very good value for money. Similarly, over 60 per cent of large users were either satisfied or very satisfied with Consignia's services.

Consignia is not meeting its delivery targets and many letters fail to reach addressees

- 9 But there are weaknesses in Consignia's current performance. Over the last few years, it has rarely met its own delivery targets, especially to deliver 92.5 per cent of 1st Class mail the next day (**Figure 1**). In 2000-01, it delivered 89 per cent of 1st Class mail the next day, with performance well below 80 per cent in some areas, notably in London. It estimates that around a quarter of the national shortfall was a result of disruption to the national railways. Postwatch have estimated that one million letters a week fail to reach the intended recipient, although Consignia disputes the accuracy of this calculation.

**1** Consignia's performance against its target of delivering 92.5 per cent of 1st Class mail the next day

*This figure shows that between 1998 and 2000 Consignia came close to achieving their target for delivery of 1st Class mail the next day, but that performance has since fallen back.*



Source: Postcomm

**10** Consignia is facing significant challenges to its service such as the rising use of electronic communication and greater consolidation in global postal markets. Furthermore, a recent report concluded that Consignia is facing "a very serious industrial relations problem", demonstrated by the number of days lost to strikes (60,000 in 2000-01)<sup>6</sup>. Its costs have also been rising faster than its turnover, resulting in a year-on-year decline from an operating profit from £528 million in 1998 to a loss of £3 million in 2001<sup>7</sup>. The operating loss increased to £100 million in the six months to 23 September 2001, while the post-tax loss after exceptional items was £281 million.

External and internal factors are affecting Consignia's profitability

**11** Until March 2001 the Department of Trade and Industry (the Department) were responsible for monitoring Consignia's performance and pricing. While the Department remain responsible for Consignia as the Government's shareholder, Postcomm have become responsible for protecting customer interests through the conditions in the licence they gave Consignia on 23 March 2001, the first licence issued under Act, and through issuing licences to other operators. The Department are in the unusual position of appointing the directors of Consignia and the members of the Postal Services Commission and of monitoring the performance of both.

The Department of Trade and Industry are a major participant in the new regulatory framework

<sup>6</sup> In May 2001, Consignia and the Communication Workers Union commissioned Lord Sawyer, Nicholas Underhill QC and Ian Borkett to assess the unstable industrial relations in Royal Mail and to recommend changes.

<sup>7</sup> Consignia's accounting year ends on the final Sunday in March.



Postwatch have become responsible for protecting consumer interests

12 Postwatch seek to work closely with Postcomm on setting and enforcing Consignia's standards of service. As well as campaigning on issues of concern to consumers, Postwatch help consumers that have received poor service from licensed postal operators to complain and obtain compensation. Their different responsibilities have resulted in some differences of view, for instance over the issue of Consignia's licence and access to information.

Postcomm aim to be a respected regulator

13 Postcomm have some 35 staff, supplemented by consultants undertaking specific reviews. They have sought to engage a mix of staff with experience of the postal market and regulatory policy but have found it difficult to recruit as many staff as they would have liked with such experience, especially of the postal market. In discharging their functions Postcomm subscribe to the principles of good regulation, promoted by the Better Regulation Task Force, of transparency, accountability, proportionality, consistency and targeting. Postcomm have in particular sought to demonstrate transparency in their dealings through extensive consultation on proposed licences, the introduction of competition and the cost of providing the universal service.

Improving services while maintaining a universal service has risks for Postcomm

14 Postcomm's main task, reflected in their statutory duties, is to ensure that the UK continues to benefit from universal service, while at the same time seeking improvements in the value for money of postal services through the introduction of competition and the regulation of Consignia. The challenge for Postcomm is to reverse the recent decline in the standard of postal services while maintaining the benefits provided by a universal postal service (Part 1). We have identified the following risks to meeting this challenge:

*Risks to the introduction of effective competition (Part 2)*

- there may be insufficient competition to generate an improved service to most customers; and, alternatively,
- the introduction of competition could result in a breakdown in the delivery of a universal service at a reasonable uniform price.

*Risks to the regulation of Consignia pending effective competition (Part 3)*

- pending effective competition, Consignia's efficiency may not improve significantly;
- Postcomm may fail to get Consignia to meet prescribed standards of service; and
- the Department, as the principal shareholder<sup>8</sup>, may not apply sufficient pressure on Consignia to improve its performance and respond constructively to competition.

<sup>8</sup> Consignia Holdings plc comprises 49,998 ordinary shares and 1 special rights redeemable preference share held by the Secretary of State for Trade and Industry, and 1 ordinary share held by the Treasury Solicitor (as nominee for HM Treasury).



## There are risks to the introduction of effective competition

- 15** Under the Act, Postcomm must seek to further the interests of users, wherever appropriate through the introduction of competition. The experience of other markets opened up to competition, such as telecommunications, gas and electricity, is that competition delivers greater benefits than regulation in terms of the price, quality and innovation. Postcomm's analysis of the impact of greater competition in postal markets, especially in European countries such as Sweden, the Netherlands and Germany, indicates that there are potential benefits of lower real prices, greater choice and greater quality. Postcomm see competition as a powerful means of securing better postal services, both by putting pressure on Consignia to improve its performance and by the development of new types of service.
- 16** Postcomm have taken three steps in particular towards introducing competition:
- including conditions in Consignia's licence requiring it to provide access to its postal facilities to any competitor or large user who reasonably requests it, and prohibiting anti-competitive behaviour;
  - in June 2001 issuing a consultation document on competition<sup>9</sup>; and
  - introducing an interim licensing strategy, providing for new entrants to receive licences that operate for a minimum of one year, after which Postcomm can terminate them at any time subject to three months notice, for relevant operations below £1 or 350 grams. They have subsequently issued six of these licences: to the TPG N.V. Group for three existing services, involving internal business mail; and the collection of outbound international mail; to Hays Commercial Services for a service guaranteeing delivery before 8 am; to UK Mail for a collection service for some 5,000 businesses; and to Deya for a limited business service in the event of disruption to the universal service.

Competition should deliver benefits to customers

Postcomm have made progress in introducing competition

## There is a risk that there may be insufficient competition to generate an improved service to most customers

- 17** As Postcomm place considerable emphasis on the introduction of competition as a way of leveraging improved postal services, if effective competition does not develop this could put several of their objectives at risk. This could happen for several reasons:
- licensing new entrants may not be sufficient to engender effective competition, if most customers are unwilling to change to a different supplier. Despite recent problems, our surveys show that most customers still believe they get a good service from Consignia, while the overseas experience of liberalising postal markets has been for the incumbent to retain nearly all the market;
  - Consignia may respond to competition by reducing its prices for types of service that are most attractive to new entrants or refusing new entrants access on reasonable terms to services that are difficult to duplicate, such as final delivery of mail. While the Competition Act 1998 outlaws anti-competitive practices, the tests for proving that price cutting is anti-competitive are fairly stringent, and enforcement action is the responsibility of the Office of Fair Trading. Determining whether prices are predatory or the prices which Consignia charges others for access to its network are reasonable, requires reliable information on Consignia's costs that is not yet available;

The growth of competition could be restricted by customer inertia, anti-competitive behaviour and the preferential treatment of Consignia

<sup>9</sup> This builds on an earlier consultation document issued by Postcomm in September 2000.

- Consignia's VAT exemption may give it a competitive advantage over the competition; and
- new entrants to the postal market will need to make a significant investment. Their willingness to do so may depend on their confidence in Postcomm as a credible, independent and robust regulator, able to secure a level playing field and to maintain the momentum towards competition despite threats to the universal service. In this context, Postcomm's current practice of granting new entrants licences for a guaranteed period of only 15 months (see paragraph 16) when Consignia's licence runs for 15 years, with a notice of revocation period of 10 years thereafter, may be a particular disincentive to new entrants. Not only does Consignia have a duration advantage but new entrants have the uncertainty of a short time-scale, especially as there can be no presumption that Postcomm will renew licences or that more onerous conditions will not be introduced upon renewal.

There is a risk that the introduction of competition could result in a breakdown in the delivery of the universal service at a reasonable uniform price

Competition could result in higher prices and poor service for Consignia's customers

- 18** Postcomm's primary duty to maintain a universal service at a uniform tariff could oblige them to allow Consignia to increase its prices or reduce its level of service if, as a result of competition, Consignia became unable to finance all its functions presently comprising the universal service. Competition could potentially impact on Consignia's delivery of the universal service obligation in two main ways:
- the returns on some types of postal service are lower than others: some of Consignia's services may not even cover their marginal costs, but the universal tariff requirement appears to prevent re-balancing of prices to bring the level of returns more into line. If competition is most pronounced for the most profitable services, Consignia could be left with insufficient returns to cover its overhead costs, and hence to finance remaining services without across the board price increases that might further erode its competitive position; and
  - Consignia's cost structure could have a material impact on its profitability in a competitive market. Consignia estimates that 40 per cent of its costs are fixed and that it may in the short term find it difficult to reduce costs in response to losing some of its market share to competitors. If this proves to be the case, Consignia would become loss-making and hence unable to finance its services at current prices, especially as its profits have in any case disappeared in the last couple of years.

Predicting the impact of competition on Consignia's finances is complex

19 Postcomm have undertaken modelling of the possible extent of loss-making routes and Consignia has modelled the potential impact of competition on its ability to finance its functions. The latter exercise suggests that Consignia's finances could be quite vulnerable to competition. Forecasting the impact of competition on Consignia's revenues and costs is complex. The impact in part depends on how Consignia responds to competition by reorganising its costs and products. Forecasting relies on information provided by Consignia, about which Postcomm have considerable doubts, as well as estimates of the possible actions of Consignia's potential competitors and Consignia itself. A third factor that Postcomm will therefore need to consider is that:

- Postcomm may not obtain sufficient assurance to open up the market to competition rapidly. When licensing new entrants to the market, Postcomm are statutorily obliged to have regard to the impact of competition on the universal service and Consignia is empowered to challenge new licences, ultimately in the courts. But, as Professor Cave concludes<sup>10</sup>, it is not realistic for Postcomm to determine definitively how competition will impact on the universal service solely on the basis of economic modelling techniques. Ultimately Postcomm will have to make a judgement on the basis of the best available evidence and against the possibility of a breakdown in service, increases in prices or a successful challenge in the courts.

## Postcomm's response to the risks to competition

- 20 Postcomm plan to undertake much more analysis of the various risks to the development of effective competition as well as addressing the risks to the universal service from possible competition. They aim to publish their proposals for consultation, which will demonstrably fulfil their duty to maintain universal service, early in 2002. A key element in this work is obtaining a better understanding, from a variety of perspectives, of the possible impact of competition on the universal service obligation.
- 21 Given the uncertainties about the market's development, there is likely to be no risk-free strategy for Postcomm in introducing competition. Their approach is to consider how any risk can be identified and appropriately managed to provide them with demonstrable assurance that the universal service obligation is not put in jeopardy; and then to put in place effective safeguards. Consignia itself could provide the first safeguard by responding efficiently and innovatively to competition. Postcomm have identified a number of potential measures to establish safeguards, including restricting the amount of competition permitted, redefining the universal service so that the requirements placed on Consignia are less onerous and creating a support fund, funded by a levy on all licensed postal operators, that would contribute to the costs of maintaining the universal service<sup>11</sup>.

<sup>10</sup> Appendix 6 to this report, paragraph 7.3.

<sup>11</sup> Detailed in Postcomm's June 2001 consultation document on promoting effective competition.

## There are risks to the regulation of Consignia pending effective competition

In the short-term, the main benefits to many postal users will come from Postcomm enforcing Consignia's licence

- 22 Until Postcomm can rely on competitive pressures to protect the interests of users, Postcomm's main regulatory instrument for bringing benefits to users is the licence they gave to Consignia in March 2001. Its principal conditions are:
- Consignia should provide a universal service at a uniform tariff everywhere in the UK<sup>12</sup>;
  - the prices of Consignia's principal services are subject to a price control. Until 2003, prices are frozen for services below £1 or 350 grams and may rise at no more the rate of inflation within the rest of the universal service area (up to 20 kilograms). Consignia, however, may apply for a price rise in order to maintain its ability to provide universal service. In May 2001, Consignia invoked a clause in its licence to seek a one penny increase in the price of 1st and 2nd Class postage, but subsequently suspended this application following discussions with Postcomm; and
  - Consignia must meet specified standards of service. But Consignia has not in recent years achieved its own service targets. The targets in the licence have therefore been set initially at a level lower than Consignia's own targets but then rise to reach them in 2002-03. For example, in 2000-01 Consignia delivered 89 per cent of 1st Class mail the next day. The licence sets targets for the last two months of 2001-02 and 2002-03 of 92.1 per cent and 92.5 per cent respectively, although Consignia is required to report quarterly on its performance against the targets.

## There is a risk that pending effective competition, Consignia's efficiency may not improve significantly

Improved efficiency within Consignia would benefit postal users

- 23 The extent to which all postal users benefit from falling real prices and improved quality of service depends in large part on Consignia's efficiency. The pressure of competition should give Consignia an incentive to make efficiency improvements. But in the absence of competition, Postcomm will need to address the issue directly themselves, as other economic regulators have done in the UK, primarily through the periodic review of prices. A crucial difference, however, is that there is little experience of applying this approach to a company that remains in the public sector, such as Consignia. The risks are:
- Postcomm may be unable to demonstrate the potential for cost savings, due to the limited information available on the scope for efficiencies in expenditure and insufficient experience and time available to them. In setting the price control from April 2003, Postcomm are statutorily obliged to take account of Consignia's ability to finance its functions, and hence maintain a universal service. Postcomm will need a case strong enough, should Consignia appeal against their price determination, to convince the Competition Commission that their proposals are reasonable; and
  - Postcomm's options may be limited if Consignia fails to make efficiencies, bearing in mind the need to preserve the universal service. The incentive on Consignia's management to secure efficiencies is relatively weak in the absence of pressure from private sector shareholders and the stock market, and is further weakened by the knowledge that efficiency gains would give Postcomm room to introduce more competition and to set tougher price controls. And Consignia is starting from a position where costs have been rising faster than revenues.

<sup>12</sup> There are specific exclusions from this requirement, mostly islands off the Scottish mainland.



There is a risk that Postcomm may fail to get Consignia to meet prescribed standards of service

24 For most customers of postal services the quality of the service they receive is more important than the price. For instance our survey of large users showed that two-thirds named service factors, such as consistent collection and security of mail, as their highest priority, while our survey of the public revealed that only a minority knew the prices of 1st and 2nd Class stamps. Competition should give customers a choice of service standards, but until all customers have a choice they will be reliant on regulation to secure and improve the service that Consignia provides. For Postcomm this means addressing the risks that:

Service is more important than price for most customers, but it may be difficult to ensure that Consignia's service standards are met

- Postcomm may find it difficult to take remedial action in the event that Postwatch's monitoring of Consignia's performance against the service standards specified in its licence shows that Consignia is falling short. Substantial fines would be a difficult option as, if Consignia is to continue to be able to finance the universal service, these would have to be passed on to the customer and/or the taxpayer; and
- until Postwatch and Postcomm have information on what really matters to customers there is a risk that they may not monitor Consignia's performance in a way that matches customer aspirations, and hence Postcomm may not act appropriately on customer detriment. In particular, Consignia may propose changes to the specification of the service it provides so as to cut costs, for instance by pushing back the target for delivering all mail by 9.30 am. Unless Postcomm (and Postwatch) know which aspects of service matter to customers there is a risk that they will either allow changes that cause customers concern or 'buy' a continued higher service specification for too high a price.

There is a risk that the Department of Trade and Industry, as the principal shareholder, may not apply sufficient pressure on Consignia to improve its performance and respond constructively to competition

25 The Department of Trade and Industry are seeking to behave in a similar way to private sector shareholders, by developing an effective arm's length relationship with Consignia, in which they approve the company's strategy and set financial targets, but avoid involvement in day-to-day operations. There are, however, few precedents for Postcomm to draw on in determining how the absence of financial market pressures on a regulated company affects the way they should regulate or for the nature of the relationship they should have with the Department as shareholder, so as to address the risks that:

The absence of private shareholders may limit the pressure on Consignia to improve its efficiency

- regulatory instruments, such as RPI – X price controls, may be less effective in this case. Such controls have worked in other industries because of the pressure that private sector shareholders have applied to the management of privatised companies. If the Department, acting as Consignia's principal shareholder, do not exert the commercial disciplines that the market would expect, Consignia may not respond positively to regulation and competition; and

- the Department, like any shareholder, may be concerned to protect the dividends that Consignia pay the Government, and hence seek to challenge any actions by Postcomm which put Consignia's continuing profitability at risk. As principal owner, the Department are potentially in a stronger position to do this than private shareholders whose holdings are small and diversified. To strengthen their own position, Postcomm have begun to specify the information they will need from Consignia to discharge their regulatory responsibilities effectively, but Postcomm's reliance on information from the regulatee will require Postcomm to scrutinise and verify this information carefully.

## Postcomm's response to the risks to regulation

- 26 As regards price controls, Postcomm have engaged consultants to examine the extent to which Consignia is an efficient operator. As regards service standards, Postcomm have started a process to introduce by determination<sup>13</sup> a compensation scheme for users affected by Consignia's failure to meet its service standards. Postcomm also intend, in line with good regulatory practice, to consult customers widely on their postal needs and priorities.

## Conclusions and recommendations

- 27 Postcomm's remit of promoting competition and protecting customer interests while securing the universal postal service is challenging, as the risks we have identified above demonstrate. Postcomm, aided by Postwatch, have made a good start, setting out clearly what they seek to achieve, undertaking extensive consultations and issuing six licences in what was previously a monopoly area. There are signs that Consignia is responding constructively to the challenge of competition that Postcomm have brought about, for example by announcing a programme of outsourcing to reduce costs and improve service. But opening the postal market to competition will not be easy, and it is still early days for Postcomm and other bodies, such as the Department and Postwatch, involved in the oversight of the postal market. In discharging their duties Postcomm will need to develop further their responses to the risks set out below (Figure 2).
- 28 Postcomm's success in handling each of these risks will depend on the credibility of their actions. The experience of other economic regulators shows that key factors in establishing credibility are:
- adherence to the principles of good regulation promoted by the Better Regulation Task Force, of transparency, accountability, proportionality, consistency and targeting;
  - being seen to act in an impartial and independent way, free from regulatory capture of vested interest groups;
  - employing staff with sufficient experience and expertise of the postal market and economic regulation; and
  - obtaining sufficient robust and reliable information on the costs and performance of Consignia, in a way that compensates for the inherent informational advantage that Consignia has over Postcomm.
- 29 Postcomm have been impressive in the transparency of their processes to date. The application of the other principles of good regulation will depend on the quality of their expertise and information, which Postcomm are committed to improving.

<sup>13</sup> Postwatch and Consignia were unable to agree a scheme within the six months provided for in Consignia's licence of March 2001. The licence provided for Postcomm to determine the terms of the scheme should this arise.

**2 Risks in regulating the postal services market**

| Risk area  | Main risks   | Analysis  |
|--|--|---|
| <b>Risks to the introduction of effective competition (Part 2)</b>                 | There may be insufficient competition to generate an improved service to most customers (paragraphs 2.8 - 2.20)  | <p>Customers may value the convenience and ubiquity of a universal service provider</p> <p>Consignia's response to competition may restrict entry</p> <p>Size, brand recognition and operational privileges give Consignia a competitive advantage</p> <p>Postcomm's interim licensing strategy may deter new entrants</p>  |
|  | The introduction of competition could result in a breakdown in the delivery of a universal service at a reasonable uniform price (paragraphs 2.21 - 2.39)                                  | <p>The returns on some types of postal service are lower than others</p> <p>Consignia's cost structure could have a material impact on its profitability in a competitive market</p> <p>Postcomm may not have sufficient assurance to open up the market to competition rapidly</p>   |
| <b>Risks to the regulation of Consignia pending effective competition (Part 3)</b> | Pending effective competition, Consignia's efficiency may not improve significantly (paragraphs 3.2 - 3.14)  | <p>Improving Consignia's efficiency is key to Postcomm's mission, in order to improve service standards and provide customers with better value, and ensure Consignia is better able to withstand competition</p> <p>The forthcoming price review is one of Postcomm's main tools for incentivising efficiency</p> <p>Postcomm need to form a view on the level of Consignia's efficiency</p> |
|  | Postcomm may fail to get Consignia to meet prescribed standards of service (paragraphs 3.15 - 3.26)  | <p>Postcomm need to ensure that customer needs are clearly identified</p> <p>Postcomm need to ensure that Consignia meet quality of service targets and that Postwatch have sufficient information to monitor their achievement</p>   |
|  | The Department, as the principal shareholder, may not apply sufficient pressure on Consignia to improve its performance and respond constructively to competition (paragraphs 3.27 - 3.35) | <p>The traditional RPI – X price control may not be wholly appropriate in this instance</p> <p>The relationship between the Department and Consignia may affect the company's commitment to improving efficiency</p>  |

Source: National Audit Office

# Part 1

## The legislative and market context in which Postcomm operate

1.1 Postal services in the United Kingdom play a vital role in modern economic and social life, providing communications between citizens, government and business. These services and the way they are provided are expected to change significantly as a result of the liberalisation of European postal monopolies, the growth of electronic mail and the globalisation of postal services<sup>14</sup>. In response, the Government established in 2000 the Postal Services Commission (Postcomm) to secure the continued provision of a universal service at a uniform price<sup>15</sup> and to further the interests of postal service users. To achieve these goals, Postcomm have been given the power to issue licences for the provision of postal services below £1 or 350 grams (12.3 ounces). In March 2001, Postcomm licensed Consignia<sup>16</sup>, the Government owned incumbent provider of the universal service, to provide universal postal services.

1.2 This Part of the report shows that:

- consumers enjoy a number of benefits from Consignia's delivery of postal services, but
- there are weaknesses in Consignia's current performance; and
- it is Postcomm's task to maximise consumer benefits while maintaining a universal service.

### Consumers enjoy a number of benefits from Consignia's delivery of postal services

#### Consignia offers a universal service

1.3 The universal service is defined by the Postal Services Act 2000 (the Act) as being the delivery of mail every working day to all homes and premises in the UK, and a collection every working day from each post box<sup>17</sup>. The universal service must be provided at affordable prices that are uniform throughout the UK. These arrangements apply to mail weighing less than 20 kilograms (44.1 pounds) and the physical dimensions of which fall within limits adopted by the Universal Postal Union. This definition is consistent with the definition in European Community legislation given in the Postal Services Directive<sup>18</sup>.

1.4 There are economic and social benefits to having a universal service. The Government referred to these benefits in the 1999 White Paper<sup>19</sup> on the future provision of postal services. This stated that the Post Office has been a vital part of the infrastructure of the country by helping to generate wealth and increase social cohesion through good communications and swift flows of information and knowledge.

<sup>14</sup> *Post Office Reform: A World Class Service for the 21st Century (Cm4340: July 1999).*

<sup>15</sup> *Defined as a daily collection and delivery across the United Kingdom of postal packets up to 20 kilograms.*

<sup>16</sup> *The organisation formerly known as the Post Office changed its name to Consignia Holdings plc on 26 March 2001. This Report will refer to both entities as Consignia unless referring specifically to the postal regime before the establishment of Postcomm.*

<sup>17</sup> *Postcomm may waive these requirements where they consider that geographical conditions or circumstances are exceptional. Some Scottish islands, for example, do not have a daily ferry service.*

<sup>18</sup> *Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997.*

<sup>19</sup> *Post Office Reform: A World Class Service for the 21st Century, op.cit.*



- 1.5 The universal service in the UK is provided by Consignia (Figure 3) which, until March 2001, held a statutory monopoly over the delivery and collection of mail of up to £1 or 350 grams. This weight and price limit was known as the reserved area. The Act removed the statutory monopoly and replaced it with the requirement that any postal operator wishing to provide postal services up to £1 or 350 grammes must obtain a licence from Postcomm. In this way, the Act converted the reserved area into a licensed area. Postcomm's first licence was issued to Consignia on 26 March 2001. While this licence imposed the obligation to provide universal service on the company, there is no statutory requirement for Consignia to be the universal service provider.
- 1.6 Consignia is by far the largest provider of postal services in the United Kingdom. It conveys almost all mail of up to £1 or 350 grams, and provides universal service for mail weighing up to 20 kilograms. It has no universal service obligation at and above 20 kilograms. Consignia faces competition at and above 350 grams, especially for business to business mail, and retains a significant share of this market, in which over 4,000 companies operate, notably providing courier and express services.
- 1.7 Business and domestic customers benefit from Consignia's provision of a universal service. Business customers originate 86 per cent of all mail and represent Consignia's most significant source of revenue. For instance, Consignia's top 100 customers yield almost a third of Consignia's revenue. Domestic customers are the main recipients of mail, with two-thirds of mail received by domestic customers (Figure 4).

### Consignia offers a high quality range of services

- 1.8 The Act does not specify the products and services that will comprise the universal service, nor does it set a time interval between collection and delivery, although the

European Postal Directive sets a maximum of five days. Consignia must, however, meet service standards in its licence that are more extensive and more demanding than required by the Act. Consignia's own service commitments in some cases go beyond those in the licence or the Act (Figure 5).

- 1.9 Consignia offers a wide range of services and products. Their two main services are the 1st Class and 2nd Class post, which offer delivery, in most instances, during the next and third working day respectively. For businesses that have large volumes of mail and are willing to bear the cost of pre-sorting it according to post-code, Consignia offers a discount service called Mailsort<sup>20</sup>. For businesses that require delivery on a specific day, such as the publishers of periodicals, Consignia offers its Presstream service. Other important services are Recorded Delivery and Special Delivery.
- 1.10 The National Audit Office surveyed business and domestic customers. Our questionnaire to the largest business users of mail services revealed fairly high levels of satisfaction, with over 60 per cent of large users either satisfied or very satisfied with Consignia's services. The company recognises the importance of its large customers by assigning an account manager to each one. This attention is reflected in responses to the questionnaire which show that, for more than half of respondents, Consignia has been active or very active in taking the initiative to offer bespoke solutions to business needs. The survey of domestic consumers, conducted jointly with Postcomm and Postwatch, also showed high rates of satisfaction. More than three quarters of domestic customers responding to this survey considered that first class mail offered good or very good value for money. About half of large business respondents said that Consignia's prices represent good or very good value for money, although this group of users also felt that Consignia's discounts and standard prices should be two of Postcomm's highest work priorities<sup>21</sup>.

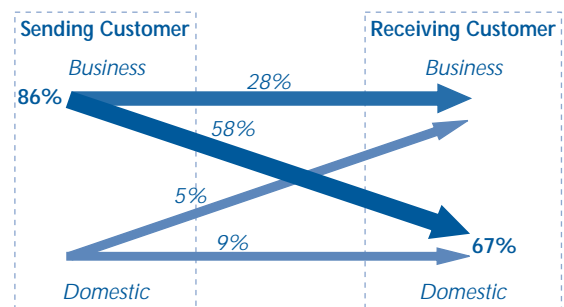
### 3 Consignia Holdings plc

- Consignia has three main operations in the UK: Royal Mail, Parcelforce Worldwide, and Post Office Counters.
- Through its Royal Mail and Parcelforce Worldwide operations, it serves 26 million addresses, handling nearly 20 billion letters and packages a year through 150,000 public collection points, mainly post boxes, and 84,000 business collections.
- It is one of the largest organisations on the UK, with nearly 200,000 employees and 35,000 vehicles. Its most recent annual accounts show UK turnover (including the counters business) of over £7 billion in 2000-01.

Source: Consignia's Annual Report and Accounts

### 4 Mail Flows between business and domestic customers

This figure shows that 86 per cent of mail is sent by business customers and 67 per cent of mail is received by domestic customers



Source: Consignia

<sup>20</sup> Businesses may select from three levels of pre-sorting. The level of discount reflects the level of pre-sorting, mail volumes and distance.

**5** **Consignia's service commitments go beyond those specified by legislation and its licence**

| Service factor                  | Requirement under the Postal Services Act 2000  | Requirement in Consignia's licence                          | Consignia's service commitments   |
|---------------------------------|---|---|---|
| Universal service               | <ul style="list-style-type: none"> <li>■ For postal packets up to 20 kilograms, collection from every posting facility and delivery to every home and premises, or such points as Postcomm may approve, in the United Kingdom</li> <li>■ A registered postal service</li> </ul> | As per Act  | As per Act  |
| Collection frequency            | At least one from each posting facility every day, excluding Sundays, Bank Holidays and, other than for letters, Saturdays.   | As per Act  | As per Act, with multi-collections from most urban posting facilities and a Sunday collection from main posting boxes in large urban areas. |
| Delivery frequency              | At least one, excluding Sundays, Bank Holidays and, other than for letters, Saturdays.  | As per Act  | As per Act, plus a second delivery to many urban addresses.   |
| Time of delivery                | Not specified   | Not specified   | Delivery to most urban addresses by 9.30 am.  |
| Time taken to deliver           | Not specified   | Annual targets set for some products and services (Note 1). | As per licence  |
| Provision of posting facilities | Not specified   | Minimum levels set (Note 2).                                | As per licence  |

**NOTES**

1. All products covered by the licence must be delivered by a specified time, either three or seven days. Supplementary targets are set for the most popular products and services, notably 1st and 2nd Class mail and Mailsort services (e.g. In the year to 31 March 2002, 92.1 per cent of 1st Class mail must be delivered the next working day).
2. A minimum level of posting facilities is set for each postcode area, based on delivery density in that area and a specified maximum distance for letter boxes and posting facilities for parcels.

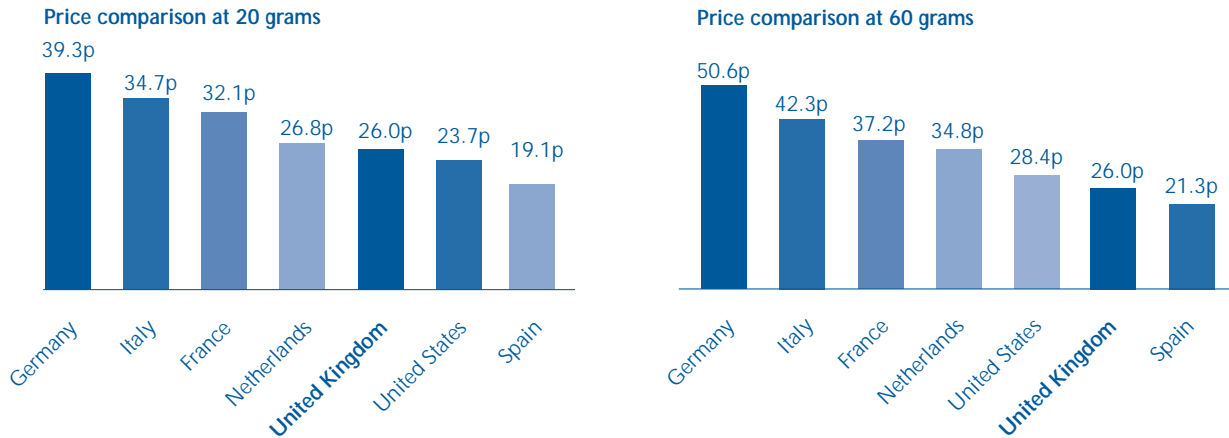
*Source: National Audit Office*

**Consignia's core services are relatively cheap for consumers**

1.11 Many of the large universal service providers in other European Union countries charge more for light letters than Consignia. Price comparisons must be treated with caution as tariff increases take place at different weights. In addition, as service levels also vary, price is not a sufficient guide to value for money. Nevertheless, price comparisons show the relative cost to low volume customers. In the United Kingdom, the cheapest 1st

Class tariff can be used for items weighing up to 60 grams, the point where international comparisons are most favourable to Consignia. At this weight, only Spain of the six most populous nations of the European Union is cheaper (**Figure 6**). This is also true at 20 grams, the weight of a small birthday card. The United States is also cheaper at this lower weight, but not at 60 grams.

**6 International comparisons show that Consignia 's prices compare well**



Source: Postcomm data for prices in 1999

**But there are weaknesses in Consignia's current performance**

Consignia's quality of service has suffered in recent years

1.12 Consignia has consistently failed to meet its own delivery targets. This especially applies to 1st Class mail where not only has Consignia failed to achieve its overall target for next day deliveries, but performance

has deteriorated in each of the three years to March 2001 (Figure 7). The fall was especially acute in the most recent period, when performance was two percentage points lower than before. Consignia attributes half of this most recent fall to internal industrial action and half to the major disruption on the railways. Performance deteriorated further between April and June 2001, with only 86.5 per cent of first class mail delivered the next day. Within this average there were eight post codes where performance was below 80 per cent, mostly in London<sup>22</sup>.

**7 Consignia has not in most years met its targets for delivering mail**

Performance achieving the target is shown in bold. This figure shows that, over the last five years, Consignia has not achieved their target for first class mail, has achieved the target for 2nd class mail in the two of the last five years, and has once achieved the target for parcels.

| Type of Service                   | Target (%)  | OUTTURN     |             |             |             |             |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
|                                   |             | 1996-97 (%) | 1997-98 (%) | 1998-99 (%) | 1999-00 (%) | 2000-01 (%) |
| First Class<br>delivered next day | <b>92.5</b> | 85.9        | 91.5        | 91.1        | 91.0        | 89.0        |
| Second Class<br>within 3 days     | <b>98.5</b> | 96.2        | 98.3        | <b>98.6</b> | <b>98.8</b> | 98.4        |
| Parcels<br>within 3 days          | <b>88</b>   | 85.0        | 87.0        | <b>88.0</b> | 84.0        | 84.0        |

Source: Postcomm

<sup>22</sup> These were East London, Enfield, South West London, Watford, Harrow, West London, North West London, and West Central (London): Press release issued by Postwatch, 31 August 2001.

- 1.13 As noted in paragraph 1.10 above, the joint survey of domestic customers shows a relatively high rate of satisfaction with the overall value for money provided by Consignia. But it did identify that one in five respondents often receive mail at home that should have been delivered to another address. It also found a strong tendency for respondents not to complain about poor service from Consignia.
- 1.14 The Post Office Users' National Council, the public body representing postal users until Postwatch replaced it, received 5,100 representations and complaints in 1998-1999 but 10,098 in 1999-2000. The main aspects of complaint concerned delivery times, delivery to the wrong address and the loss and damage to letters. A particular area of concern to the Council was lost mail and, following a survey of 15,000 test letters by the Royal Mail, the Council reported in June 2000 that up to one million letters might be going missing each week. Consignia disputes this interpretation. Instead, Consignia's Annual Report and Accounts for 2000-01 sets out the number of complaints lost letters (578,091).

There are serious challenges facing the management of Consignia

- 1.15 Postal services in the United Kingdom are being affected by a number of challenges that are likely to have a major impact on the way these services are provided in the future. Changes in the market for communications and related technological developments are likely to result in increasingly vigorous competition from alternative services. This will in turn put pressure on the company to increase efficiency and productivity to compete effectively, and to deliver services that readily adapt to changing markets (Figure 8).

**8** Main factors driving change in the postal services market

- Changing customer demands, such as businesses seeking delivery to time.
- Greater liberalisation in postal markets as a result of European legislation.
- The challenge posed by electronic communication technologies to the traditional postal market.
- Greater consolidation and globalisation.
- A decline in Consignia's performance compared to postal bodies in other countries.

Source: National Audit Office

- 1.16 Consignia is also experiencing significant problems in implementing measures aimed at improving reliability and predictability in the delivery of mail, and to raising operational efficiency. In particular, the company is introducing new working procedures in its 1,400 delivery offices and 70 mail centres. Implementation of these changes in 2000-01 was slower than planned. The changes have contributed to the loss of over 60,000 working days, mainly through unofficial industrial action. Further unofficial action in May 2001 caused major disruption to Consignia's mail operations.
- 1.17 A review commissioned by Consignia and the Communication Workers Union<sup>23</sup> reported in July 2001 that the level of industrial action was "immensely damaging and disruptive to customers, the business and its employees". It also noted that such action was "creating the perception of the Royal Mail as strike-ridden and unreliable". The report recommended an immediate end to industrial action and the introduction of partnership boards at national and local level to enable management and the main union to work together more effectively. Consignia has also suffered from high levels of absenteeism and has found it difficult to recruit and retain good quality staff in areas of low unemployment, such as south-west London.

- 1.18 Consignia's turnover has increased steadily over the last five years, reflecting amongst other things increasing use of mail for advertising. But although turnover increased, costs have also increased, and consequently, Consignia's operating profits declined during the three years to March 2001. Between 1995 and 1999, operating profits fluctuated between 6 per cent and 8 per cent of turnover (Figure 9). Operating profits fell to 5 per cent of turnover in the year to March 2000, when they totalled £381 million. In the next twelve months there was an operating loss of £3 million on a turnover that had increased by 8 per cent to £8,119 million. The operating loss increased to £100 million in the six months to September 2001. For this period the post-tax loss after exceptional items was £281 million. The main exceptional cost related to structural changes in Parcelforce Worldwide. After a decade of losses, this part of Consignia continued to be unprofitable.

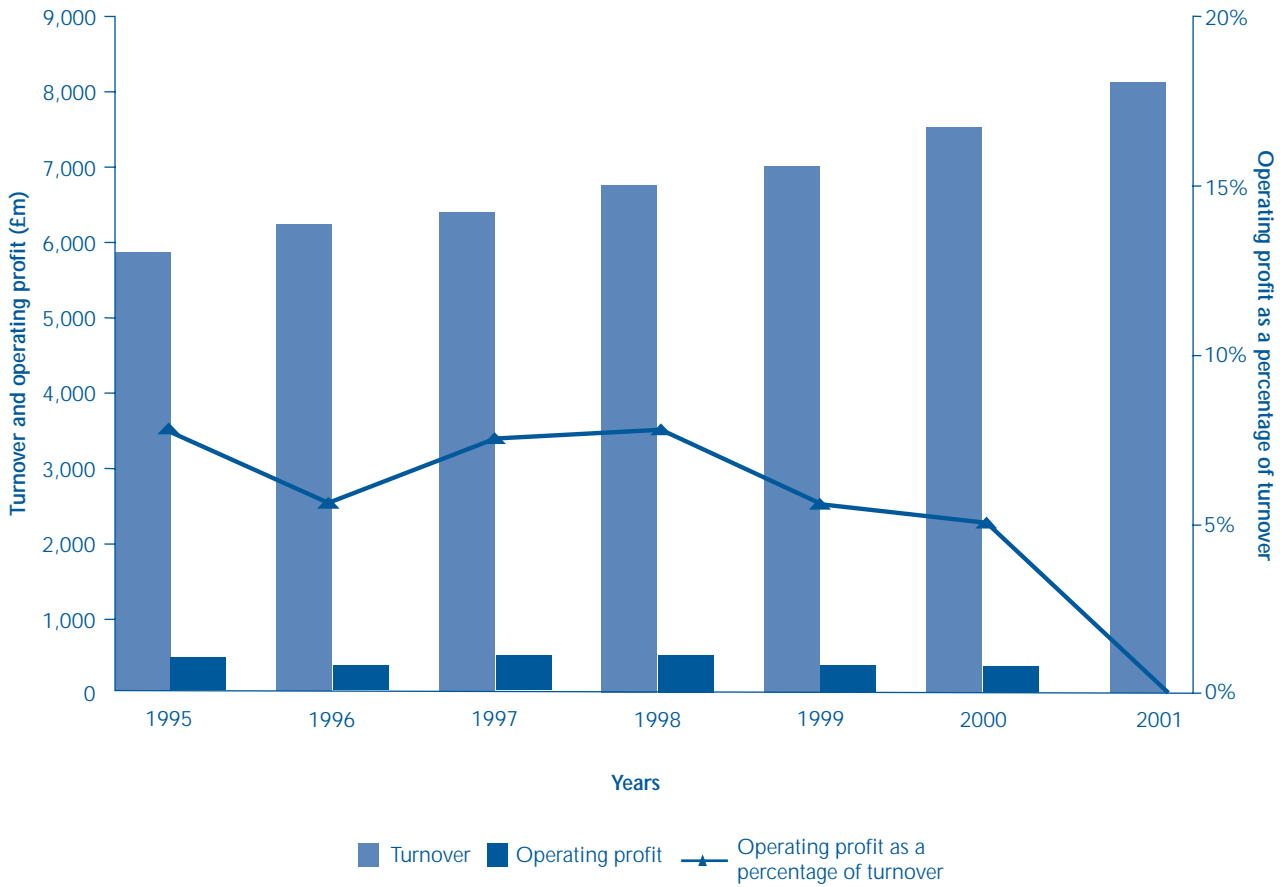
- 1.19 Some observers have attributed Consignia's fall in profits to declining efficiency, especially from 2000 when costs have escalated relative to volumes and revenues. The White Paper on Post Office reform pointed out that the Post Office had been regarded as an exemplar by other public post offices, but that its productivity had declined in the 1990s<sup>24</sup>. Other observers have suggested to us that the business is now far less efficient than it was 30 or 40 years ago. In announcing increasing losses for the six months to

23 In May 2001, Consignia and the Communication Workers Union commissioned Lord Sawyer, Nicholas Underhill QC and Ian Borkett to assess the unstable industrial relations in the Royal Mail and to recommend changes.



9 Consignia's turnover and operating profits

This figure shows that Consignia's operating profits have declined in recent years, both in absolute and percentage terms.



Source: Postcomm

September 2001 (paragraph 1.18), Consignia expressed disappointment at the modest gains in productivity in Royal Mail and the pressing need to improve productively further. It is, therefore, an important area for Postcomm to examine and Part 3 of this report sets out how they are doing so.

Postcomm's task is to maximise consumer benefits while maintaining a universal service

1.20 The Act created a new statutory structure for regulating postal services. The two main features of this regulatory regime are:

- a) Postcomm, the new regulator of the postal industry, with statutory duties that include ensuring universal service and the introduction of competition; and
- b) Postwatch, the new representative body for postal consumers.

Postcomm are the new regulator of the postal industry

1.21 In July 1999 the Government published their proposals for reforming postal services<sup>25</sup> to reflect the changes taking place in the postal service market (paragraph 1.15). At this point, the Post Office held a statutory monopoly over the collection and delivery of postal packets within the reserved area of up to £1 and 350 grams. It was not subject to the formal regulatory arrangements that are common in the privatised utility context, where independent arm's length regulators were part of the framework accompanying privatisation. Instead, its performance and pricing were subject to monitoring by the Department of Trade and Industry (the Department). Like other nationalised industries, each year it remitted part of its profits to the Government in lieu of a dividend payment to shareholders.

1.22 The Act created the Postal Services Commission, known publicly as Postcomm, as the economic regulator of the postal services market. Postcomm are responsible for

24 Post Office Reform: A World Class Service for the 21st Century (op.cit).  
 25 Post Office Reform: A World Class Service for the 21st Century (op.cit).

issuing and monitoring a licence to Consignia, and issuing licences to other postal operators wishing to provide postal services under 350 grams or £1. Postcomm is a regulatory commission with seven commissioners, including Postcomm's Chairman and their Chief Executive (Appendix 5). The Department remain responsible for the overall regulatory regime and continue to be the principal shareholder of Consignia.

## The Act also created Postwatch

1.23 The Act also created the Consumer Council for Postal Services, which has adopted the public name of Postwatch, to represent the interests of business and domestic users of postal services in the United Kingdom<sup>26</sup>. Postwatch are independent of the postal industry, the Government and Postcomm. In practice, however, Postwatch and Postcomm work closely together, not least because Postwatch are responsible for overseeing the quality of service elements of Consignia's licence. This included negotiating with Consignia the service standards in its licence. Postwatch also have an ongoing responsibility to help customers resolve complaints with Consignia, and to provide advice and information about postal services in general<sup>27</sup>.

## Postcomm's statutory duties encompass universal service and the introduction of competition

1.24 Postcomm's main duty under the Act is to work in a way that is most likely to result in the provision of a universal postal service (Figure 10). Subject to this duty, their work must further the interests of postal users, wherever appropriate by promoting effective competition between postal operators. They must have regard to certain other matters, such as specified vulnerable groups.

1.25 Postcomm interpret their principal duties as being to:

- ensure the continued provision of a universal postal service at a uniform tariff;
- promote effective competition with the Royal Mail; and
- control Royal Mail prices and service standards.

1.26 Postcomm have publicly identified a number of tensions between these statutory duties<sup>28</sup>. In particular, introducing competition could result in Consignia losing its more profitable business. If this does not have the positive effect of encouraging Consignia to be more efficient, it could necessitate a price rise or service reductions, and hence a worse deal for customers, to

enable Consignia to continue to deliver the universal service. It could also mean that any improvements in service will need to be funded from higher prices. Postcomm's statutory duties sit within a framework involving five public sector parties: the Government responsible for postal policy and Consignia's shareholder; Postcomm; Postwatch as the consumers' champion; Consignia as a wholly publicly owned company; and the Office of Fair Trading (OFT) as the general competition regulator. The framework is set out in Figure 11.

1.27 In essence, the challenge for Postcomm in balancing these tensions is to take actions that will help reverse the declining trend in the standards of postal services while not undermining the benefits that customers obtain from the service that Consignia currently provides.

## Postcomm are seeking to regulate in accordance with good practice

1.28 Since their establishment in Summer 2000, Postcomm have sought to build up expertise in economic regulation and the capacity to discharge their various duties. At the same time their philosophy is to be a 'light touch regulator' and in deciding on staff numbers to recognise that in the event of competition being successfully introduced the organisation might cease to be needed sometime in the future. By September 2001 Postcomm had some 30 staff and expenditure in 2001-02, including consultants, is expected to total £5.5 million.

### 10 Duties of Postcomm

*The duties and powers of Postcomm are formally vested in their Commission. This must consist of a chairman and no fewer than three other persons (all appointed by the Government); and a chief executive. These duties are to:*

#### Primary

- exercise their functions in a manner best calculated to ensure the provision of a universal postal service, at a geographically uniform and affordable tariff

#### Secondary

- exercise their functions in a manner best calculated to further the interests of postal users, wherever appropriate by promoting effective competition

#### Other

- have regard to individuals who are disabled, of pensionable age, on low incomes, or residing in rural areas
- exercise their functions in the manner best calculated to promote efficiency and economy on the part of postal operators
- have regard to the need to ensure that licence holders are able to finance activities authorised or required by their

*Source: Postal Services Act 2000*

<sup>26</sup> Postwatch replaced the Post Office Users' National Council (POUNC) from January 2001.

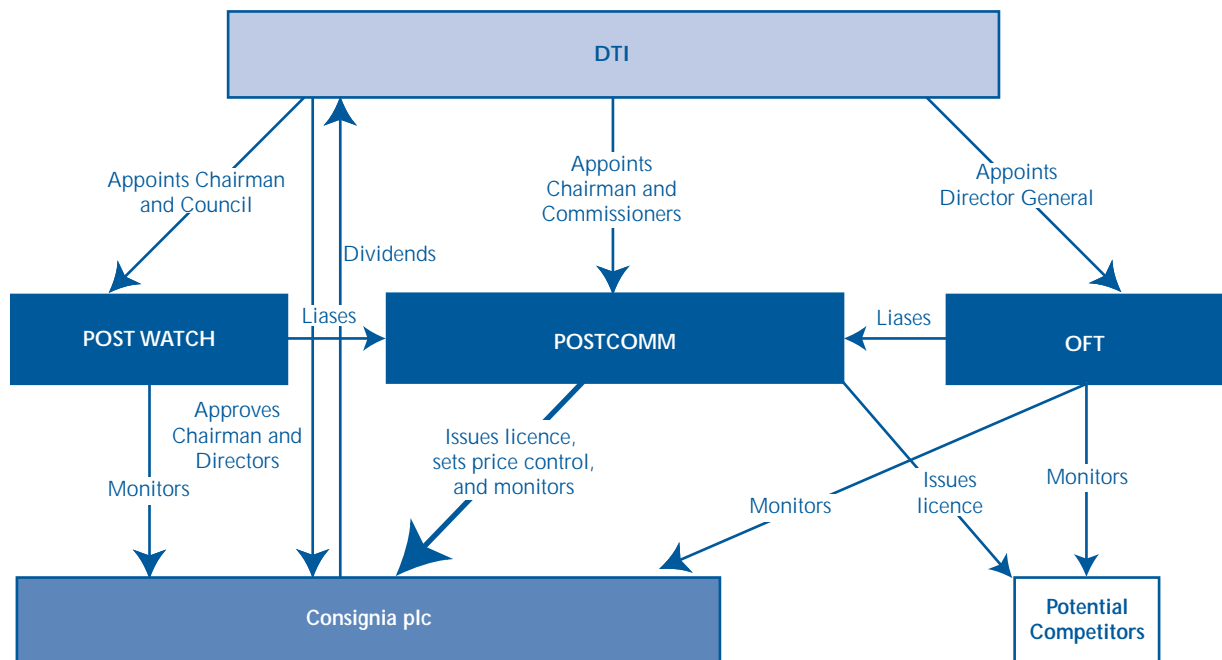
<sup>27</sup> Postwatch have a network of nine regional committees covering the UK. The Council of Postwatch comprises the national chairman, the chairman of each regional committee and four other members. The public can contact Postwatch on 08456-013265. Calls are charged at the local rate.

<sup>28</sup> Postcomm, Business Plan as at 21 November 2001, Part 4.

- 1.29 Although the independent regulation of postal services is new to the UK, there is plenty of experience of the regulation of other essential services. The Government have since the 1980s established independent economic regulators for telecommunications (OFTEL), water (OFWAT), gas and electricity (Ofgem)<sup>29</sup>, and rail (ORR). There is considerable similarity between their statutory duties and those of Postcomm. We and the Committee of Public Accounts in reporting on the other regulators have emphasised the importance of regulatory staff "understanding through practical experience the commercial pressures that businesses are under and what motivates business decisions"<sup>30</sup>. The Committee have also noted that contacts between economic regulators and their staffs can help the regulators "benefit from each others' experience and thereby improve the quality of decision making and processes followed by the regulators"<sup>31</sup>.
- 1.30 While Postcomm's staff have considerable experience of economic regulation, none have direct experience of the postal business. Postcomm have commissioned consultants WS Atkins to benchmark their costs and processes against other regulators in the UK and overseas and advise on how the organisation should develop. This review will build on an efficiency review of the other regulators that WS Atkins undertook for HM Treasury<sup>32</sup>.

- 1.31 Postcomm are also seeking to regulate in accordance with the principles of good regulation of the Better Regulation Task Force (Figure 12). In the context of economic regulation they translate into targeting action to achieve intended goals, ensuring that the extent of regulation is proportionate to those goals and acting in a consistent and predictable manner so as to reduce uncertainty among regulated companies and their investors. The transparency principle, in particular, requires that the case for regulation be clearly made, its purpose clearly communicated and that it should be informed by proper consultation. Postcomm have established a standard minimum consultation period of eight weeks, with 12 weeks for complex issues<sup>33</sup>.
- 1.32 Postcomm's preference is a light-handed approach to regulation. They wish to avoid becoming too involved in the day-to-day operations of Consignia and appearing to second guess Consignia's own management. They prefer an approach in which they can rely on competition to bring benefits to users of postal services. Where competition is underdeveloped or inadequate, Postcomm intend to create a series of incentives that will promote efficiency and economy within Consignia.

**11 The regulatory framework established by the Postal Services Act 2000**



Source: National Audit Office

29 Ofgem were formed in 1999 by the merger of the former gas and electricity regulators.  
 30 Committee of Public Accounts: Countering Anti-Competitive Behaviour in the Telecommunications Industry, (64th report of 1997-98), October 1998.  
 31 Committee of Public Accounts: The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply (16th report of 1996-97), July 1997.  
 32 W.S. Atkins Management Consultants: External Efficiency Review of Utility Regulators (February 2001).  
 33 Postcomm: Postcomm's consultation procedures, October 2000.

## 12 The Better Regulation Task Force's principles of good regulation

Transparency  
Accountability  
Proportionality  
Consistency  
Targeting

*The Government established the Better Regulation Task Force in September 1997 as an independent body that advises Government on action which improves the effectiveness of Government regulation, taking particular account of the needs of small businesses and ordinary people.*

*Source: Better Regulation Task Force, Principles of Good Regulation re-issued 2000*

### Postcomm's first major act as regulator was to grant a licence to Consignia

1.33 Postcomm's first major act was the issue of a licence to Consignia. In advance of that, from autumn 2000, Postcomm issued consultation documents setting out the form that they thought Consignia's licence could take. Consignia formally applied for a licence on 26 January 2001. The licence had to be agreed by Postcomm and Consignia before 26 March 2001 if the new licensing regime was to come into force on the date scheduled by legislation.

1.34 In preparing the licence, Postcomm sought, in order to enable them to properly discharge their statutory duties, to include mechanisms to influence the behaviour of Consignia, while not imposing licence conditions that might be considered unduly onerous, unfair, over prescriptive or contrary to best regulatory practice. During discussions before the licence was issued, Consignia was concerned that some features of the proposed licence gave Postcomm too much discretion and hence would make for unpredictable regulation. Many of the differences in view were resolved through negotiations between Postcomm and Consignia, facilitated by the Department in the last few days before the licence was due to be issued.

1.35 One of the differences resolved in those negotiations allowed Consignia to raise its prices in line with inflation on some products. These products, which provide a quarter of Consignia's revenue, are in the part of the

market that is open to competition, but where it is not yet effective to protect customers' interests. Postwatch expressed concern publicly over several aspects of the consultation and decision process, in particular that they had not been consulted by Postcomm about the change in price controls. The Act provides that Postwatch should be consulted about any future changes to a range of licence conditions, including the price control condition, and as a result of the tension which emerged between Postcomm and Postwatch over this issue, the two regulatory bodies clarified future joint working arrangements in an exchange of letters.

### Scope of our examination

1.36 Against this background, we examined what Postcomm are doing to introduce competition and other changes to the postal market while maintaining universal service, and what benefits to users Postcomm are trying to secure through the licensing of Consignia<sup>34</sup>. Our methodology is set out in Appendix 1. The main features were:

- a) we issued a questionnaire to the 110 largest users of postal services (Appendix 3). We also held discussions with the relevant trade bodies;
- b) we commissioned a joint survey with Postcomm and Postwatch of 2,000 adults to obtain their views and experiences on postal services (Appendix 4);
- c) we reviewed Postcomm's analysis of Consignia's costs and performance, and commissioned a paper from Professor Martin Cave of the University of Warwick, an expert on universal service modelling, on Postcomm's cost modelling requirements (Appendix 6);
- d) we examined international experience of introducing competition to postal services (Appendix 7) and considered the approach taken by other UK regulators to similar challenges; and
- e) we reviewed reports of the Committee of Public Accounts on economic regulation for conclusions and recommendations relevant to Postcomm.

1.37 We are grateful for the extensive help and the co-operation we received from Postcomm, Postwatch and Consignia, and for the assistance provided by the other organisations we consulted. We express our thanks to the members of our expert advisory panel for the support they gave us during this examination.

<sup>34</sup> Our examination did not address the provision of post offices, as Postcomm have no executive responsibilities in this area, only a requirement to provide advice and information to the Government.





Pictures courtesy of Hays Commercial Services, TNT UK and UK Mail



# Part 2

## There are risks to the introduction of effective competition

2.1 Postcomm have a duty under the Act to further the interests of postal users, wherever appropriate by promoting competition between postal operators. This Part considers what Postcomm have done to introduce competition to the licensed area (below £1 or 350 grams) of the postal market and the risks that Postcomm face. It sets out:

- the risk that there may be insufficient competition to generate an improved service to most customers; and
- the risk that the introduction of competition could result in a breakdown in the delivery of a universal service at a reasonable uniform price.

### Progress by Postcomm in introducing competition into the postal market

2.2 Since 26 March 2001, Postcomm have been able to introduce competition through the power to issue licences. Postcomm could licence competition in a variety of ways, for example:

- **issue licences to operators within the existing licensed area.** Postcomm could adopt a "market-led" approach, issuing licences to postal operators who request them.
- **issue licences for certain kinds of mail.** Postcomm could adopt a more targeted licensing strategy, issuing licences only for certain kinds of mail. For example, they could issue licences for competitors to convey direct mail - that is, identical mail issued to a large number of individual addresses. They could also issue licences to convey mail on behalf of only certain types of customer (eg large businesses) or only in defined geographic areas.

- **introduce competition by third-party access.**

Providing postal services involves a series of activities, including collecting mail, sorting it, transporting it and delivering it. Postcomm could introduce competition in some of these areas (for example by issuing licences allowing competitors to collect or to transport mail) while providing for competitors to gain access to Consignia's facilities for the rest of the process. The mail industry distinguishes between 'upstream access', by which competitors would collect, sort and transport mail with Consignia retaining responsibility for door-to-door delivery, and 'downstream access', in which competitors would take advantage of Consignia's sorting and transporting facilities, but deliver mail themselves<sup>35</sup>.

2.3 Postcomm could also introduce competition by recommending to the Secretary of State changes to the licensed area, for example by reducing the weight limit from 350 grams. Alternatively, Postcomm could recommend the franchising of some postal operations. In considering these issues, Postcomm need to take into account any developments in European legislation. For example, discussion is taking place in Europe on how far and how fast to reduce the maximum limits of services that may be reserved in order to maintain the universal service. The European Council and European Commission have reached a political agreement on a framework to reduce the maximum from 350 grams to 100 grams in 2003 and 50 grams in 2006, and then to do a review before deciding whether to disallow reservation of services from 2009. The European Parliament has yet to consider this framework - in its first reading of the draft legislation it argued for a more gradual reduction. This trend in greater liberalisation is taking place against the background that European legislation on competition deems monopolies to be unlawful if they are not necessary<sup>36</sup>.

<sup>35</sup> Third party access is provided for under Condition 9 of the licence issued to Consignia on 23 March 2001.

<sup>36</sup> Article 86(2) EC Treaty.

2.4 Postcomm are still consulting on their proposals strategy for competition<sup>37</sup>. They aim to publish proposals for consultation early in 2002. Since March 2001, Postcomm have already moved towards introducing greater competition by:

- including in Consignia's licence two competition-related conditions. Condition 9 requires Consignia to provide access to its postal facilities to any competitor or large user who reasonably requests it, and Condition 11 prohibits Consignia discriminating against or showing undue preference to any customer, and prohibits prices which are "excessive or predatory"; and

**13 Interim postal licences issued by Postcomm**

| Company                             | Date issued    | Scope of services  |
|-------------------------------------|----------------|--|
| TNT UK Ltd                          | June 2001      | Existing guaranteed next day delivery mail service to members of a closed user group comprising CRESTCo Ltd, a company in the financial services sector, and its customers.  |
| TNT UK Ltd                          | June 2001      | Existing internal mail services for Lloyds TSB plc, featuring guaranteed next day delivery.  |
| G3 Worldwide Mail (UK) Ltd (Note 1) | June 2001      | Existing collection service for outbound international mail.   |
| Hays Commercial Services Ltd        | September 2001 | Three niche postal services in competition to Consignia: <ul style="list-style-type: none"> <li>■ Collecting and sorting mail of customers of existing document exchange (DX) service, and moving non-DX mail in bulk for delivery by Consignia</li> <li>■ A pre-8am delivery service of letters sent by DX customers to businesses within designated postcodes in London, Edinburgh and Manchester.</li> <li>■ The delivery of items weighing less than 350 grams and costing less than £1 to named customers of Hays' Mailine service in the insurance, travel, opticians, licensed betting and retail financial services industries.</li> </ul> |
| UK Mail Ltd (Note 2)                | November 2001  | Collect mail from around 5,000 existing business customers within designated postcodes in major cities and the Thames Valley. Sort and consolidate that mail and transport it to the relevant Consignia delivery offices.  |
| Deya Ltd                            | November 2001  | A limited UK postal service for business critical post originated by local authorities and utility services (e.g. Housing benefit payments and bills for council tax) in the event of disruption to the universal service.   |

**NOTES**

1. Part of the TPG N.V. Group
2. Subsidiary of Business Post Group plc

Source: National Audit Office

<sup>37</sup> Promoting Effective Competition in UK Postal Services, Postcomm, June 2001. This builds on an earlier consultation document issued by Postcomm in September 2000.

- preparing an interim licensing strategy providing for new entrants to be given licences for one year and a rolling three month termination period thereafter, for relevant operations below £1 or 350 grams, in order not to discourage entry while they are deciding on their strategy for introducing competition more generally. As part of this strategy, Postcomm have issued six interim licences. Two are for new niche services in competition with Consignia, three are for existing services, and one is for a limited service in the event of disruption to the universal service. (Figure 13).

2.5 Postcomm see the introduction of competition as the main way of bringing benefits to users of postal services, one of their two main statutory duties. They consider that introducing competition to any market previously dominated by a monopolistic or dominant supplier is likely to bring benefits of quality, innovation and price. Giving consumers a choice of supplier creates a pressure on all suppliers - both the incumbent and new entrants - to maintain and improve quality of service to retain consumers. It also gives an incentive on each supplier to provide innovative services to differentiate itself from other suppliers. Competition can therefore lead to lower prices in two related ways:

- by revealing any parts of a market in which a former monopolist charged prices significantly in excess of costs, because entrants can undercut the incumbent. In this way, competition aligns prices with costs.
- by providing a spur to efficiency, as each supplier seeks to minimise the price it charges customers. The reduction in prices as a result of competition can be significant. The National Audit Office report on the introduction of competition to the electricity markets has shown that, on average, domestic consumers can save £30 if they switch supplier, while the National Audit Office report on competition in gas markets has shown that consumers can save £45 by switching<sup>38</sup>.

2.6 Postcomm have examined the evidence from the introduction of competition to postal services, both in the UK and overseas. In the UK, they have considered the impact of the limits placed on the Post Office's monopoly. These limits were initially applied in 1981 to items costing less than £1, and modified in 1999 in line with European legislation to items costing less than £1 or weighing less than 350 grams. Postcomm consider that this change facilitated the rapid growth in courier and express letter services, which charge more than £1 for the conveyance of a letter, and point out that this market is now served by more than 4,000 operators who offer a wide variety of services not previously provided.

2.7 Postcomm have also examined the evidence of overseas postal markets and have identified a number of benefits that have been associated with liberalisation in these markets:

- greater choice of products;
- improved standards of service and emphasis on customer satisfaction;
- falling real prices; and
- greater efficiency of postal operators.

## There may be insufficient competition to generate an improved service to most customers

2.8 Postcomm face the risk that competition will not develop sufficiently to achieve the benefits they anticipate from it. There are four particular factors which may inhibit the development of competition:

- customers may value the convenience and ubiquity of a universal service provider;
- Consignia's response to competition may restrict entry;
- size, brand recognition and operational privileges give Consignia a competitive advantage; and
- Postcomm's interim licensing strategy may deter new entrants.

## Customers may value the convenience and ubiquity of a universal service provider

2.9 Evidence from liberalised markets postal markets outside the UK shows that the original monopoly supplier tends to maintain a large share of the competitive market. Figure 14 shows the market share taken by incumbents in markets that have liberalised partially or fully.

2.10 There is no single explanation for the continued strength of the incumbent supplier in the face of competition. Possible explanations, all of which apply equally to Consignia in the UK context, include:

38 National Audit Office: Office of Gas and Electricity Markets: Giving Domestic Customers a Choice of Electricity Supplier (HC85 2000-01); and National Audit Office: Office of Gas Supply: Giving Customers a Choice - The Introduction of Competition into the Domestic Gas Market (HC403 1998-99).

**14 Market share held by incumbents in liberalised markets**

| Country     | Form of liberalisation   | Year of liberalisation | Market share held by incumbent (latest figures)                                 |
|-------------|--|------------------------|---|
| Sweden      | Full - no services reserved to universal service provider  | 1993                   | 95 per cent   |
| Finland     | Full - no services reserved to universal service provider <sup>1</sup>                           | 1994                   | 100 per cent of letter market; 90 per cent of direct mail market                |
| New Zealand | Full - no services reserved to universal service provider  | 1998                   | 98 per cent   |
| Germany     | Licensed competition above 200 grams for single letters and 50 grams for direct mail             | 1998                   | 92 per cent   |
| Netherlands | Competition above 100 grams, except for direct mail - which has always been open to competition. | 2000                   | 100 per cent of the under 100 gram market; 80-90 per cent of direct mail market |

**NOTE**

1. Finland has introduced a fee, payable by entrants, of up to 20 per cent of total turnover in postal services in some areas. This appears to have acted to deter entry.

Source: *Postcomm*

- consumers may value the convenience of a universal service provider. Continuing to use the incumbent means that consumers do not need to undertake the time-consuming and costly exercise of segregating their mail (between items going through the incumbent and items going to competing suppliers). Since for many domestic and business consumers expenditure on postal services is a very small proportion of total expenditure, the extra time spent researching the market for the best value provider, and where necessary segregating mail, may not be justified.
- the incumbent also benefits from its nationwide network, which it uses to ensure daily collections and deliveries. This network offers economies of scale that entrants may not be able to match.
- the incumbent has formidable advantages, in terms of brand awareness, as a result of its nationwide reach. In the UK, for example, the Royal Mail brand is the second most recognised after Coca-Cola<sup>39</sup>.

2.11 Evidence from other industries in the UK suggests reluctance by residential customers to switch companies for on-going services, such as banking. Our report on

the introduction of competition to the electricity market - Giving Domestic Customers a Choice of Electricity Supplier<sup>40</sup> - set out some of the factors influencing consumer switching, including where the consumer lives and the size of bills (those on lower bills are less likely to switch). The Department have also researched the decision to switch<sup>41</sup>. This shows that, in many industries, consumers are more likely to trust well-known brands over new entrants even when new entrants offer competitive deals. For postal services an important factor is the low level of expenditure, about £29 a year per household. The incentive for residential customers to switch postal operator to make savings is therefore low, suggesting that innovative services and better quality would be a bigger incentive to switch.

2.12 It is difficult to estimate, in advance of competition, the value placed by business and residential consumers on factors such as price, convenience and trust. Nevertheless, these factors can have a significant impact on how much market share competitors gain from an incumbent. Postcomm may be able to research the impact of these factors through consumer surveys and focus groups<sup>42</sup>.

<sup>39</sup> *Post Office Reform: A World Class Service for the 21st Century (op. cit).*

<sup>40</sup> *Office of Gas and Electricity Markets, Giving Domestic Customers a Choice of Electricity Supplier (HC 85 Session 2000-2001).*

<sup>41</sup> *Switching Suppliers, Consumer Affairs Report Series Executive Summary No 2.*

<sup>42</sup> *It may also be possible to amend the entry pricing model proposed by Consignia to reflect the weight placed by consumers on the "value" offered by incumbents, as against purely price.*

## Consignia's response to competition may restrict entry

2.13 Experience from other regulated industries has shown that one of the most complex tasks facing Postcomm is regulating competitive behaviour. Following our report OFTEL: Countering Anti-Competitive Behaviour in Telecommunications<sup>43</sup>, which highlighted the challenges facing regulators in this area, the Committee of Public Accounts welcomed the increased proportion of investigations initiated by OFTEL and urged them to ensure that they are not too reactive. Similarly, the Committee's report on the introduction of competition into the domestic gas market welcomed the progress made but noted that OFGEM were monitoring developments to guard against the main supplier abusing their still dominant position. Postcomm therefore need to be vigilant that, in responding to competition, Consignia does not take unfair advantage of its position by:

- **Charging unfair prices for access to Consignia's facilities.** Under the licence, Consignia is required to negotiate agreements with competitors for access to its facilities - for example, allowing access to Consignia's delivery network in remoter areas. But negotiations on access may prove difficult and protracted, in which case Postcomm would need to exercise their powers to set access terms directly themselves;
- **Cutting the prices for some products and services in a way that is characterised by competitors as predatory pricing,** and hence anti-competitive. This especially applies to the prices paid by some types of business customers (where there may be the greatest competition) for pre-sorting mail. Postcomm would then need to consider how far they would allow such amendment of tariffs within the overall obligation on Consignia to provide a geographic uniform tariff. This form of rebalancing may lead to pressure to raise prices for captive customers. Postcomm would also need to ensure that Consignia publish its tariff structure, including discounts for pre-sorting, as required by Condition 7 of Consignia's licence.

2.14 Establishing whether a company has been behaving in a predatory way is a difficult and judgmental question. It requires a detailed understanding of costs<sup>44</sup> - to establish whether a given price is below cost and hence predatory - but also an assessment of the intention lying behind that company's behaviour. As Professor Cave explains in his paper (Appendix 6, paragraph 6.1), Postcomm will need to consider whether Consignia's flexibility to reduce the prices of some products should be limited by competition law or subject to additional regulatory restrictions. In the telecommunications

industry, for instance, EC and UK regulators have developed a more stringent test than that set out in competition law. OFTEL consider that if a dominant undertaking is pricing below long run incremental cost they will assume that the undertaking is engaged in predatory pricing. Professor Cave's paper sets out various options that might be appropriate to postal services (Appendix 6, paragraphs 6.5 - 6.7).

- 2.15 Professor Cave concludes that in considering the issues arising from Consignia's response to competition, including the pricing of access to its facilities, it is likely that Postcomm will need the capacity at least to estimate the long run incremental costs of Consignia's services, probably broken down geographically and by product (Appendix 6, Paragraph 7.5).
- 2.16 Postcomm's task in dealing with anti-competitive behaviour is further complicated because, unlike other economic regulators, Postcomm do not have concurrent powers under the Competition Act 1998 to enforce competition law with the Director General of Fair Trading. Postcomm and the Office of Fair Trading are preparing a Memorandum of Understanding that will detail how cases of possible anti-competitive behaviour should be handled on a practical level. Postcomm expect to deal with such conduct before a breach of the 1998 Act has occurred, whilst the Office of Fair Trading would deal with such conduct which breaches, or is suspected of breaching, the 1998 Act.

## Size, brand recognition and operational privileges give Consignia a competitive advantage

2.17 Consignia occupies a position of considerable strength compared to any competitors who enter the market. Importantly, Consignia enjoys the benefits of brand recognition and ubiquity, and a nation-wide network capable of providing daily collections and deliveries to almost all parts of the United Kingdom. In addition, as noted in paragraph 1.18, Consignia has been able to support its loss making Parcelforce Worldwide business from profits on its other operations. It also enjoys the privilege of exemption from VAT, which is not available to competitors, although in practice competition is likely to concentrate on larger business customers who may be able to recover VAT from their customers. The advantages to Consignia from the VAT exemption are further reduced in that it may distort operational incentives. This especially applies to contracting out services, as this will attract VAT<sup>45</sup> which Consignia cannot pass on.

<sup>43</sup> National Audit Office: *The Office of Telecommunications: Countering Anti-competitive behaviour in the Telecommunications Industry (HC667 1997-98)*.

<sup>44</sup> Professor Cave's paper points out that "Under European competition law, the price charged by a dominant firm is held to be predatory if it satisfies one of two conditions: i) any prices set below average variable cost are presumed to be predatory; and ii) prices set below average total cost, but above average variable cost, are also presumed to be predatory, but only if some evidence of intention to eliminate a weaker competitor can be demonstrated."

<sup>45</sup> Applied at the standard rate of 17.5 per cent.



2.18 In principle, the cost of a public body borrowing from a commercial bank should be lower than a comparable private sector body. This is not because the business is inherently less risky, but because the Government would be expected to stand behind the public sector body and honour its commitments in the event it became insolvent. Hence the risk to a commercial bank is perceived to be lower. Consignia, however, is not at such a competitive advantage as the Government have decided that the company will borrow at a rate, from the National Loans Fund, which is broadly comparable to the rate it would charge in the market without an implicit or explicit Government guarantee. Postcomm are already considering this area as part of Consignia's next price review.

### Postcomm's interim licensing strategy may deter new entrants

2.19 While Postcomm are considering their long-term strategy of how best to introduce competition, they have introduced an interim licensing strategy. This allows new suppliers to operate in the licensed area (below £1 or 350 grams) under controlled conditions for a minimum of one year, after

which Postcomm can terminate their licences at any time subject to three months notice. They have done so in order to balance the requirement to monitor the impact of competition on universal service with their intention encourage private postal operators to enter the market.

2.20 Their interim strategy may inhibit potential competitors from entering the market. Entering a market dominated by a large company such as Consignia is inherently risky. What potential entrants need, together with existing private suppliers that are now required to operate under licence, is a degree of legal certainty over the form which competition is likely to take. Issuing licences that can be terminated, at three months notice, after one year may not provide the certainty such companies require, especially as further consultation may take place when the licences come up for renewal. The need for certainty is heightened because Consignia is able to offer any type of mail service under its 15 year licence. The nature of entry within this interim strategy may be cautious as a result, although Postcomm believe the strategy has provided much meaningful information on the impact of competition on Consignia. **Figure 15** provides a case study of the impact of legal uncertainty on one entrant to the market.

#### 15 Case Study 1 - TNT's interim licence

TNT UK Limited (TNT) is a major UK supplier of specialist postal services. It is a subsidiary of TPG N.V. Group, a worldwide postal and logistics company based in the Netherlands. TNT has since February 1999 provided express delivery services under contract to Lloyds TSB. The service involves collecting internal mail and cheques from each of the bank's branches, sorting it, and then delivering it to other branches and clearing centres within the bank's network. Delivery must happen on the next working day as part of the contractual commitment to Lloyds TSB.

TNT received legal advice that a licence was not necessary, since the EC Postal Directive (97/67/EC) permits a licensing obligation only for services that fall within the scope of universal services. However, on 15 March 2001, they received a letter from the Department of Trade and Industry alleging that the services in question breached the Post Office's exclusive privileges to convey mail (which were due to expire on 26 March 2001 under the Postal Services Act). TNT responded to this letter by re-iterating their view, and their legal advice, that the service did not infringe the Post Office's exclusive privileges because it was separate from the standard postal service.

Nevertheless, under protest and without prejudice to its rights under EC competition law, TNT decided to seek an interim licence from Postcomm because they wished to remove any doubt over the legality of these services. Postcomm duly granted an interim licence on 21 June 2001. Although TNT have obtained a degree of legal certainty through obtaining a licence, the licence has a 15 month guaranteed duration, which is shorter than the duration of the contract with Lloyds TSB bank. This has resulted in a considerable uncertainty, especially as Postcomm have stated that there can be no presumption that the licence will be renewed or that more onerous conditions will not be introduced upon renewal. The European Commission confirmed on 6 December 2001 that TNT do not require a licence to provide this service.

### The introduction of competition could result in a breakdown in the delivery of a universal service at a reasonable uniform price

2.21 The hierarchy of Postcomm's statutory duties imposes on Postcomm an overriding requirement to take into account the impact of licensing competitors on Consignia's ability to discharge its universal service obligation. In other words, the universal service obligation can be treated as a constraint on the development of competition. Although there may be some ambiguity in the precise definition of the obligation, the Act makes clear that, whatever definition is chosen, Postcomm must ensure that the relevant service is provided. Postcomm need to develop a convincing case to demonstrate that any steps they take to introduce competition will not endanger the continued delivery of universal service. We considered how they are going about this task, drawing extensively on Professor Cave's paper on Postcomm's cost modelling requirements (Appendix 6). Three main points arise:

- a) the returns on some types of postal service are lower than others;
- b) Consignia's cost structure could have a material impact on its profitability in a competitive market; and
- c) Postcomm may not have sufficient assurance to open up the market to competition rapidly.

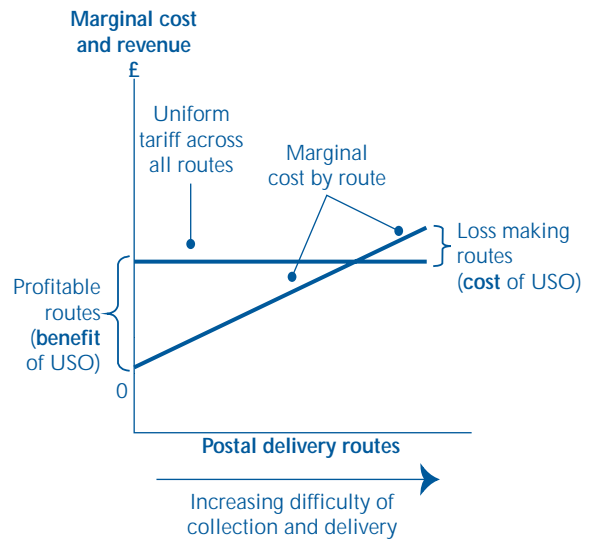
## The returns on some types of postal service are lower than others

2.22 Consignia's licence imposes the obligation to deliver universal service at a uniform tariff throughout the United Kingdom, that is the price of sending a letter of a given weight should be the same regardless of destination. But the cost of delivering different types of mail to different locations varies. For example, it costs Consignia more to deliver mail which cannot go through machines, to deliver mail in cities (because of high costs, traffic congestion and itinerant populations) and to deliver mail to remote rural locations. The unit cost of some postal routes is therefore substantially below the uniform tariff, while for others the cost is equal or greater than the tariff. In effect, the excess costs of "loss-making" routes are supported by the excess revenue earned on others. This support from low cost to high cost routes is often presented as the main reason for granting monopolies in the postal sector<sup>46</sup>. **Figure 16** illustrates the relationship of cost to uniform tariff for a hypothetical universal service provider.

2.23 To help determine the burden imposed by the universal service obligation (the first of the effects described above), Postcomm sought to compare the revenues and long run incremental/avoided cost of each relevant service and to compute the sum of all services whose revenues failed to cover their costs<sup>47</sup>. The number of loss making routes depends on how far the business is disaggregated. Postcomm chose to analyse Consignia's network across 29,040 routes. These routes do not represent geographical paths along which mail travels - for example, London to Birmingham - but rather generic categories of mail (**Figure 17**). This approach is consistent with that adopted by the European Commission in their analysis of the costs of universal service in 1998, and is similar to the approach adopted by the UK telecommunications regulator, OFTEL, to the cost of universal service<sup>48</sup>.

### 16 The relationship of cost to uniform tariff for a universal service provider

This figure illustrates the relationship between marginal cost of postal delivery routes and a uniform tariff, and how the uniform tariff can be lower than the cost for some high cost routes, for a generic universal service postal provider.



Source: National Audit Office

### 17 Categories of mail used to define postal routes

The combination of the categories mean that there are 29,040 possible postal routes.

- Types of product (there are **22** ranging from 1st Class (stamped) mail to various types of pre-sorted mail)
- Type of mail within each product (there are **four formats**: mechanised letters, manual letters, larger flat envelopes and postal packets)
- Distance from collection point to delivery address (there are **three categories** of route: local, neighbouring and distant)
- Type of recipient (there are **two categories**: business and residential)
- Density of delivery area (there are **five categories** ranging from city centre to deep rural)
- Weight (there are **11 weight bands** ranging from 1-20 grams to 350+ grams)

Source: Consignia

<sup>46</sup> For example the OECD's report *Promoting Competition in Postal Services* says: "the primary stated purpose of (postal) monopoly is to provide revenue to cross-subsidise non-commercial services, particularly the delivery of mail below cost in high-cost areas (such as rural areas)." *OECD: Promoting Competition in Postal Services (1999)*. Similarly, M.Crew and P.Kleindorfer, *Liberalization and the Universal Service Obligation in Postal Service*, states "...the Universal Service Obligation is regarded as the principal justification for the monopoly", in *Current Directions in Postal Reform* edited by M.Crew and P.Kleindorfer (2000).

<sup>47</sup> *Postcomm: An assessment of the costs and benefits of Consignia's current Universal Service Provision - A Discussion Document, June 2001.*

<sup>48</sup> *Costing and Financing of the Universal Service Obligation in the Postal Sector in the European Union, Report by NERA on behalf of the European Union (1998): Universal Telecommunications Services - Proposed arrangements for Universal Service in the UK from 1997, OFTEL (1997), chapter 6.*

2.24 On this basis, Postcomm concluded that each of the 22 products and each of the five delivery area densities covered its long-run avoidable costs. The margins, however, varied substantially, for example, the margin between revenue and avoidable cost was 32 pence per unit for Flatsort mail products, compared to 6 pence per unit for 2nd Class (stamped) mail products. At the most disaggregated level, 16 per cent of the 29,040 potential routes did not cover their long-run costs, producing an aggregate "loss" of £81 million a year, or around 1.7 per cent of Consignia's revenue for the mail products included in the analysis<sup>49</sup>.

2.25 Postcomm consider that the figures produced by this analysis should be treated with extreme caution, because:

- the estimate depends on Consignia's assumptions about the costs of their operations<sup>50</sup>. A proportion of the costs of delivering mail, however, is common to large numbers of items (for example, the cost of sorting machines) so deriving a cost per item depends on the methodology for the allocation of common costs. Furthermore, Consignia assumes that only 60 per cent of their costs vary by volume of mail. A higher figure would in turn produce a higher estimate of the costs of universal service. If all of Consignia's costs varied by volume, Postcomm estimate that the cost of universal service would be over £500 million a year;
- the estimate is based on Consignia's own figures, which Postcomm have not independently verified;
- there may well be compensating benefits to Consignia in offering a universal service, in terms of brand recognition and customer loyalty. These benefits are much harder to quantify than the cost;
- the impact of competition in part depends on how Consignia responds by reorganising its costs and products; and
- these figures are based on Consignia's current service levels, rather than on the definition of universal service provided by the Act. As noted in paragraph 1.8 above, Consignia's service levels are substantially in excess of the minimum required by the Act, and consequently Postcomm's estimate may overstate the costs of delivering the basic universal service.

2.26 Professor Cave concludes that for a variety of reasons, including the demands of setting price controls (see Part 3 below), Postcomm will need an ability to model Consignia's costs using simultaneously a product and a geographical breakdown (Appendix 6, paragraph 2.4). The estimates are likely to be of long run costs, perhaps with some allowance for a process of transition. In addition, Professor Cave has pointed out that the costs of the universal service obligation calculated in this way hinge upon the prices of the different products. If the tariffs are unbalanced so that one product is on average charged at much more below cost than another, the cost estimates of the universal service will rise (Appendix 6, paragraph 4.7). Professor Cave concludes that Postcomm need to address the structure of prices. This would appear to require Postcomm to countenance significant increases in the price of some services and reductions in others, raising questions about what is allowed within the uniform tariff and what customers would be prepared to accept.

### Consignia's cost structure could have a material impact on its profitability in a competitive market

2.27 Postcomm's estimate of the costs of universal service provides a useful insight on the current costs incurred by Consignia. But Postcomm recognise that the £81 million<sup>51</sup> a year estimate for the cost of universal service, as well as suffering from methodological limitations, does not fully take into account the potential impact of competition. They also recognise that ascertaining the level of competition that is compatible with maintaining universal service requires a different type of analysis.

2.28 Competition poses a risk to the financing of universal service at a uniform tariff. This is because such financing depends on Consignia's ability to support the costs of more expensive routes through excess revenue earned on other routes and to recover the common and overhead costs of the postal network. New entrants could target the more profitable routes, for instance mail originated by business for delivery to urban and suburban addresses, by undercutting Consignia's prices, thereby making it harder for Consignia to recover common costs. Consignia may be vulnerable to this form of competition, known as "cream skimming" or "cherry picking", because, as noted in Part 1 of this report, a significant proportion of Consignia's turnover originates from its largest customers. But, as Professor Cave observes (Appendix 6 paragraph 5.1), international experience suggests that it is not likely that Consignia's universal service burden will suddenly become unmanageable.

<sup>49</sup> Postcomm: *An assessment of the costs and benefits of Consignia's current universal service provision (June 2001)*.

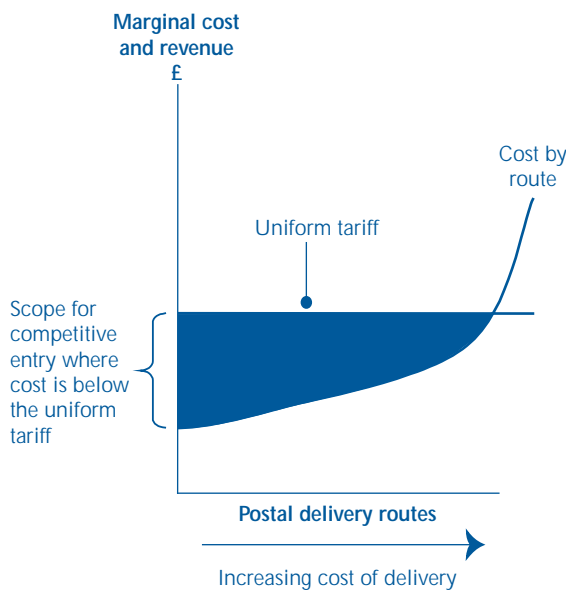
<sup>50</sup> *The conventional break-down for postal services is into the following activities: collection (5 per cent of attributable costs); outward sorting (12 per cent); transportation (14 per cent); inward sorting (14 per cent); delivery (43 per cent); and support activities (12 per cent)*. Postcomm, *Promoting Effective Competition in UK Postal Services, June 2001*, p.20.

<sup>51</sup> *This is the net cost across all of Consignia's letter products, including those outside the statutory requirements of universal service.*

2.29 By taking customers and mail away from Consignia in this way, entrants could reduce the revenue available to Consignia to support the most expensive routes. This is illustrated, for a hypothetical universal service provider, in **Figure 18**. In the worst case scenario, Consignia could be left with a rump of expensive routes whose full cost could not be covered without raising prices or reducing quality of service, or both. Consignia's response to Postcomm's consultation on competition argues that competition may lead to increases in prices for some consumers. Professor Cave concludes (Appendix 6 paragraph 5.5) that a key factor bearing upon Consignia's ability to sustain its universal service provision in a competitive market is the degree of price flexibility allowed.

**18 The potential for competitive entry with a universal service obligation at a uniform tariff**

*This figure shows that, for a hypothetical universal service provider with a universal service obligation and the constraint of a uniform tariff, there is scope for entrants to undercut the incumbent on routes where costs is far below the uniform tariff*



Source: National Audit Office

2.30 Consignia has analysed this risk, using the entry pricing model<sup>52</sup>. This model estimates the impact of competition on Consignia's financial performance by taking long run marginal costs for each route, and comparing them to revenue. It assumes that other postal suppliers face the same costs as Consignia, but do not face the same requirement to offer universal service at a uniform tariff. The model assumes that competitors would enter the market for any routes where cost is substantially below the uniform tariff, because this is where they can undercut Consignia significantly, and that some consumers would switch away from Consignia. Using this model Consignia has estimated that it could lose a substantial part of its net revenue as a result of competition (**Figure 19**).

2.31 Professor Cave concludes that the *entry price* approach adopted by Consignia appears to be capable of meeting several of the demands for cost modelling that Postcomm is likely to need. In particular, building up product costs route by route on the basis of analysing the costs of the various activities which make up those routes is a productive idea (Appendix 6, paragraph 3.6). Both Professor Cave and Postcomm consider, however, that the model is dependent on assumptions about Consignia's and entrants' costs that are difficult to test in practice. They do not think it is inevitable that, as the model assumes, entrants will have the same costs on postal routes as Consignia. On the contrary, entrants may undertake some parts of the process of delivering and collecting post in different ways to Consignia; or they may not be able to benefit from the economies of scale that Consignia can enjoy. To the extent the entrants have different costs to Consignia, the price that they are able to offer consumers will also be different.

2.32 As with Postcomm's model, the entry pricing model takes Consignia's own costs as given. But Postcomm are not convinced by all of the assumptions underpinning Consignia's own costs, for example, the assumption that 60 per cent of costs vary with volumes of mail processed. If a higher proportion of costs varies with volume, then Consignia would be able to adjust its costs more rapidly in the face of loss of mail volumes to entrants. Nor does the model capture the dynamism of market interactions, for example, any response by Consignia to the loss of business to new entrants, possibly by becoming more efficient or by changing the discount structure it offers to bulk users of mail services. As Professor Cave concludes, Postcomm will need carefully to analyse the under-pinnings of the cost model and it is likely that they will wish to develop their own model and test it using different types of data (Appendix 6, paragraph 3.6).

52 The entry pricing model is set out by F.Rodriguez, S.Smith and D.Storer: *Estimating the Cost of the Universal Service Obligation in Emerging Competition in Postal and Delivery Services* edited by M.Crew and P.Kleindorfer (1999).

**19 The extent of loss in the event of various measures to increase competition, calculated using Consignia's entry pricing model**

| Scenario for the introduction of competition   | Per cent of net revenue lost as calculated by the entry pricing model <sup>1</sup> |                  |          |
|--|--|------------------|----------|
|  | High case  | Central estimate | Low case |
| Reduction of the licensed area from 350 grams to 150 grams                             | 29   | 24               | 18       |
| Reduction of the licensed area to 100 grams  | 51   | 40               | 30       |
| Reduction of the licensed area to 50 grams   | 84   | 65               | 51       |
| Reduction of the licensed area to 50 grams, and complete liberalisation of direct mail | 100  | 90               | 72       |

**NOTE**

1. These figures are not based on actual profits. The model assumes that costs currently incurred by Consignia are inefficient, and should be adjusted downwards

*Source: Consignia: (Estimates of the Cost of the Universal Service Obligation using the Entry Pricing Approach, April 1999)*

**Postcomm may not have sufficient assurance to open up the market to competition rapidly**

2.33 When licensing new entrants to the market, Postcomm are obliged under their statutory duties to consider the impact of competition on universal service. If Postcomm cannot obtain assurance that universal service can co-exist with competition, there is a risk that they may find it difficult to justify a rapid opening of the postal market.

2.34 The relationship between competition and universal service depends on the uncertain outcome of a series of interactions between Consignia and new entrants which are difficult to model in advance. As Professor Cave's paper indicates, Postcomm will need to consider how competition will affect both the size and composition of Consignia's costs (Appendix 6, paragraph 5.7). On the positive side, competition may act as a stimulus for efficiency. But competition may also have an adverse effect on unit costs. A decline in Consignia's business overall would reduce the level of activity in functions that are common to many, notably sorting and transporting. Any across-the-board loss of business may increase the unit costs of particular routes, through loss of economies of scope.

2.35 Competition is likely also to change the composition as well as the overall size of Consignia's business. This may require a complete re-engineering of its production processes and possibly the replacement of traditional processes with new ones. Most of its limited amount of capital equipment can be used for other purposes, while buildings can be sold or leases assigned.

2.36 Professor Cave concludes that Postcomm will have considerable difficulty unpacking these effects and would probably need a series of operational models of particular processes (Appendix 6, paragraph 5.10). It would be essential to analyse the level of common and overhead costs, in order to confine this category to expenditures that genuinely do not vary with the overall scale of Consignia's activities. It would also be necessary to consider the modelling of competitive interactions within the postal market, thereby addressing the weaknesses in the *entry pricing* model - notably that the estimates produced of Consignia's loss of profitability will be, at best, an upper limit (Appendix 6, paragraphs 5.11 - 5.14, 7.4). Such consideration would require Postcomm to make a series of difficult and speculative assumptions.

2.37 As Professor Cave concludes (Appendix 6, Paragraph 7.3), it is not realistic for Postcomm to determine definitively how competition will impact on the universal service solely on the basis of economic modelling techniques. Ultimately Postcomm will have to make a judgement on the basis of the best available evidence and against the possibility of a breakdown in service, increases in prices or a successful challenge in the courts.



2.38 In response to these difficulties, Postcomm are developing an approach which does not rely exclusively on quantitative modelling work, but instead identifies several potential sources of information:

- **The structure of Consignia's costs** and the extent to which they can be adapted in the face of competition. Postcomm recognise that the work undertaken to assess the net costs of different routes, which produced the estimate of £81 million a year, provides a starting point for this analysis, but that further work is required.
- **The likely costs of competitors**, which are difficult to forecast in advance of wide-scale entry taking place. Postcomm have engaged consultants (W S Atkins and MMD, in association with Canada Post and Pannell Kerr Foster (PKF)) to consider possible cost levels of "new entrants".
- **International experience** which shows how competition can impact on real postal markets. Postcomm have already undertaken some preliminary analysis of the impact of competition on universal service in other postal markets.

2.39 Postcomm have also set out for consultation, in Promoting Effective Competition in UK Postal Services, possible further safeguards for universal service:

- **restrictions on competition:** Postcomm could restrict the amount of competition that they permit, principally through restrictive licensing (that is only licensing competitors above certain weights or only for certain types of activity or product). This would mean that Consignia would be protected from full competition.
- **altering the interpretation of the universal service.** The definition of universal service in the Postal Services Act differs from the products and services currently offered by Consignia. One option Postcomm have identified is to relax what they might view as universal service.
- **having a universal service support fund.** Under the European Postal Directive, member states of the European Union can require all postal operators to contribute to a fund to support the costs of services within the scope of the universal service borne by the incumbent<sup>53</sup>. Should Postcomm decide that such a fund is necessary, Postcomm could recommend its creation to the Secretary of State.

<sup>53</sup> Such a fund is also a reserve option in the telecommunications market in the event that the incumbents (BT and Kingston Communications) can no longer finance the universal service.

# Part 3

## There are risks to the regulation of Consignia pending effective competition

3.1 This Part of the report considers the risks facing Postcomm until effective competition for postal services develops. In the absence of a competitive market to protect the interests of postal users, Postcomm must address Consignia's efficiency, and the related issue of the prices Consignia is permitted to charge; and Consignia's standards of service. This Part sets out:

- the risk that pending effective competition, Consignia's efficiency may not improve significantly;
- the risk that Postcomm may fail to get Consignia to meet prescribed standards of service; and
- the risk that the Department, as the principal shareholder, may not apply sufficient pressure on Consignia to improve its performance and respond constructively to competition.

In addressing these risks, Postcomm will need to obtain sufficient information to undertake their regulatory tasks independently.

### Pending effective competition Consignia's efficiency may not improve significantly

3.2 Postcomm face the risk that Consignia's operational efficiency may not improve significantly while competition is still developing. There are three main features of Postcomm's approach to addressing this risk:

- improving Consignia's efficiency is key to Postcomm's mission, in order to improve service standards and provide customers with better value, and ensure Consignia is better able to withstand competition;
- the forthcoming price review is one of Postcomm's main tools for incentivising efficiency; and

- Postcomm need to form a view on the level of Consignia's efficiency.

### Improving Consignia's efficiency is key to Postcomm's mission

3.3 Postcomm have two statutory duties that are directly related to Consignia's level of efficiency. As noted in paragraph 1.24 and **Figure 10** above, the Act requires Postcomm to exercise their functions in a manner calculated to further the interests of users of postal services. It also requires Postcomm to promote efficiency and economy on the part of postal operators. Consignia's licence imposes on Postcomm the requirement to consider, in the event of Consignia applying for a price rise, whether the company is an efficient operator or is using reasonable endeavours to become an efficient operator<sup>54</sup>. And international guidelines on the best practice for the audit of economic regulation also emphasise the importance of regulators encouraging suppliers to improve their efficiency<sup>55</sup>.

3.4 Consignia's efficiency also impinges on the achievement by Postcomm of some of their other objectives. If Consignia becomes more efficient it will be able to pass on many of the benefits to consumers, either by lowering prices in real terms, or by improving quality of service, or both. And the more efficient Consignia becomes, the more confident Postcomm can be that introducing competition to the market, with all the benefits they expect as a result, will not threaten the provision of the universal service.

### The forthcoming price review is one of Postcomm's main tools for incentivising efficiency

3.5 A monopolist such as Consignia is often in the position of being able to apply across the board pricing. The normal concerns a competitive business face about how

<sup>54</sup> *Postcomm: Licence issued to Consignia, 23 March 2001, Schedule 2, Condition 19, paragraph 6 c) i). This licence condition deals with applications from Consignia for special price increases.*

<sup>55</sup> *International Organisation of Supreme Audit Institutions (INTOSAI): Working Group on the Audit of Privatisation - Guidelines on Best Practice for the Audit of Economic Regulation (October 2001), Guideline 17.*

to recover its common and overhead costs are largely absent because the monopolist can simply add an appropriate mark-up to its incremental costs. Under effective competition this opportunity is lost. The existence of competitors, however, does not automatically impose cost and financial discipline on a former monopolist. It may continue to be dominant, in the sense of being able to behave to an appreciable extent independently of its competitors and customers. The existence of such market power is reflected in the continued need to impose price controls where competition is not adequate. The experience of other regulated sectors, most notably telecommunications, suggests that the incumbent's market power, and the need for continuing price regulation, may last for a long time.

- 3.6 Price controls are required to protect users from excessive prices in those areas of the postal services market in which, at present, Consignia retains a monopoly. Under the licence issued to Consignia on 23 March 2001, prices for relevant products are subject to controls for an initial period of two years. Until March 2003, prices are frozen for services below £1 or 350 grams (the licensed area) and may rise at no more the rate of inflation within the rest of the universal service area (up to 20 kg). Consignia's licence, however, permits it to apply for a price rise in order to maintain its ability to provide universal service or to continue to be able to finance its functions. Consignia invoked this clause in April 2001 to seek a one-penny increase in the price of a 1st Class stamp and increases in prices for a range of other services, but subsequently suspended this application following discussions with Postcomm.
- 3.7 The licence provides for the control to be revised from March 2003 and gives Postcomm the opportunity to impose a multi-year price control. Postcomm see this as an opportunity to set incentives for Consignia to become more efficient. The use of price controls to incentivise efficiency is common among UK regulators. As our report *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply*<sup>56</sup> showed, all UK regulators make use of a form of price control known as RPI-X. In essence, by allowing shareholders in regulated companies to retain the benefit of any price savings for a period of time, typically five years, this form of price control provides an incentive on the regulated company to achieve efficiency savings. **Figure 20** explains the workings of RPI-X in more detail. The White Paper on Post Office reform anticipated the application of the RPI-X formula to Consignia<sup>57</sup> and Postcomm have confirmed that, at present, they expect to use it<sup>58</sup>.

- 3.8 That the RPI-X price control creates incentives to improve efficiency is illustrated by the substantial efficiency gains achieved by the privatised utilities in the United Kingdom. For instance, OFGEM have concluded that the RPI-X approach for the 1998-2000 distribution price control was justified by its achievements in reducing costs and improving quality of service: between 1994-95 and 1997-98, distribution operating costs fell by one quarter in real terms while interruptions in supply due to failures in the network fell by 10 per cent. OFGEM have also attributed the 30 per cent reduction in costs achieved by the National Grid Company between 1990 and 2000 to the incentives provided by the RPI-X price control.

## 20 How the RPI-X form of price control used by UK economic regulators works

In its most basic form, the RPI-X price control operates by restricting annual price changes for a given multi-year period, typically 4 or 5 years, to the rate of change of the retail prices index, minus a fixed factor called "X". Most often, X is set so that, over time, prices must fall in real terms.

The X is set on the regulator's assumption of efficiencies that the company should be able to achieve. The overall price control is set to allow the company a reasonable level of return should it achieve these efficiencies. If the regulator concludes that no further efficiency gains are achievable, X is set at zero. Under RPI-X, prices are controlled, rather than profits, and during the multi-year period covered by the control, it is up to the regulated company to manage its business within the price limits set by the regulator.

These factors produce incentives on efficiency in two ways. Firstly the private sector shareholders in the regulated company will only achieve a reasonable return if the company meets the regulator's assumption of efficiencies. So shareholders will pressurise management to ensure they meet these targets. Secondly, shareholders will benefit in terms of higher profits should the company exceed the regulator's efficiency assumption. So shareholders should apply further pressure on management to outperform the regulator's expectation and achieve additional efficiencies.

At the end of the price review period, the regulator passes to consumers the benefits of efficiency gains, in the form of a price cut at the start of the next price review period. In this way, the RPI-X system allocates to consumers a share of efficiency gains achieved by companies.

### NOTE

Sometimes the cost of quality improvements exceeds the achievable savings from operating more efficiently. This situation was especially prevalent in the water industry during the first half of the 1990s. In such cases, the price control formula is commonly expressed as RPI + K, where "K" is the net price increase after setting off efficiency gains against quality improvements.

*Source: National Audit Office, principally The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply (HC645 Session 1995-96)*

<sup>56</sup> *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply (HC645 Session 1995-96)*. In addition to these bodies (and OFGEM, which has taken over responsibility for regulating gas and electricity supply) other regulators making use of the RPI-X approach include the Office of the Rail Regulator and the Civil Aviation Authority.

<sup>57</sup> *Post Office Reform: A world class service for the 21st century, paragraph 21*

<sup>58</sup> For example, the *Frequently Asked Questions* section of Postcomm's website ([www.psc.gov.uk](http://www.psc.gov.uk)) signals the likelihood of an RPI-X approach to Consignia's price controls from 2003.

## Postcomm need to form a view on the level of Consignia's efficiency

3.9 A key input into the price review will be Postcomm's estimate of an efficient level of costs for Consignia, and their assessment of whether Consignia is making efforts to become an efficient operator. Although many observers have conjectured that there is considerable scope for efficiency gains in Consignia (see paragraph 1.19 above), the extent and nature of these efficiencies is uncertain. Consignia itself has announced its intention to reduce costs and improve service through a programme of outsourcing, for instance by contracting out its 40,000-strong UK vehicle fleet.

3.10 Understanding Consignia's efficiency will enable Postcomm to set sound, defensible price controls which in turn will help Postcomm protect the interests of users (until competition is sufficiently developed to allow Postcomm to rely on market pressures to do so). But this information may be needed before 2003 if questions arise about Consignia's efficiency in the context of its response to competition or the charges it should levy on other companies wishing to use its facilities. As a starting point for this work, Postcomm are seeking to understand the current costs of Consignia's operations. This should then enable them to form judgements about how these operations could become more efficient and how quickly, and to use these judgements as a basis for making projections of Consignia's future levels of cost. There are several ways to address these questions:

- making projections of the volume of mail and of the number of collection and delivery points served by Consignia in the future, and the impact of these future volumes on Consignia's costs;
- considering historical measures of Consignia's efficiency, for example the numbers of mail items handled per staff member and the relationship between mail volumes and costs;
- benchmarking Consignia's performance against that of other postal operators in other countries (this is one of the main ways of analysing consumer outcomes adopted by OFTEL, the UK's telecommunications regulator). This might in particular involve analysing the extent of contracting out undertaken by Consignia and comparing this to the levels seen in other companies of comparable size;
- benchmarking Consignia's operations internally, for example by measuring and comparing the way individual sorting offices perform the main parts of the mail sortation process. This benchmarking would be similar to the way in which OFWAT, the water regulator for England and Wales, compares the performance of the same activities by different water companies, known as yardstick competition; and

- undertaking detailed reviews of individual elements of Consignia's operations. This operational approach, often called "bottom-up" analysis, would involve an analysis of business processes within Consignia. It has been applied by OFGEM in examining the efficiency of electricity distribution companies in the UK. It requires a more in-depth understanding of the mechanics of collecting and delivering mail than many of the other, more high-level measures.

3.11 Postcomm are using all these approaches, and to help them have engaged WS Atkins and MMD, in association with Canada Post and Pannell Kerr Foster, to demonstrate and justify the degree to which Consignia is an efficient operator or moving toward becoming an efficient operator.

3.12 As experience of other economic regulators shows, Postcomm will need a considerable amount of detailed and reliable information about Consignia's costs to be able to make reasoned decisions on the scope for reducing costs. As well as considering operating expenses, which should be relatively stable or declining over time, they will also need to make decisions about how they will treat capital expenditure, which can be more volatile. This has proved a contentious area for other economic regulators who have commonly made allowance in price reviews for the costs of depreciation and of financing borrowing to meet new capital needs rather than the actual anticipated costs of investment, which has required judgements. The Committee of Public Accounts' 1996-97 examination of the regulation of telecommunications, gas and electricity supply, and water services observed that the regulators had considered the long term interests of customers of the regulated companies and the consequent ability of the companies to undertake necessary capital investment.

3.13 As Consignia is not as capital intensive a business as most other regulated companies, Postcomm may consider such complexity unnecessary. This could result in higher prices, however, in the event that Consignia, with the Department's agreement, decides that considerable further investment is needed to secure operating efficiencies and meet the challenge of competition. In this context, it is significant that Consignia gave the need for capital investment as a reason for the price rise they sought, and later withdrew, in Spring 2001. Postcomm may therefore need to make decisions on the asset value and financing costs of Consignia, which would not be easy to assess for a Government owned company.

3.14 What is clear from the experience of other regulators is that the transparency and predictability of regulation can be enhanced if the regulator is clear from the start how price reviews are to be undertaken, the precise methodology to be adopted and what information will be required. Experience also shows that many price

**21 Main priorities in sending mail for the largest users of mail services in the United Kingdom**

*This figure shows that large users of postal services have a variety of needs for their outgoing mail.*

| Factor  | Number of business users selecting the factor as highest priority |                                  |
|---|---|----------------------------------|
|   | General Post (%)  | Specialist Post (%) <sup>1</sup> |
| Minimising Expenditure  | 33  | 43                               |
| Consistent collection of outgoing mail from their business premises | 25  | 12                               |
| Knowing specific day of delivery                                    | 15  | 14                               |
| Security of mail  | 14  | 15                               |

**NOTE**

1. Specialist post is any post for which the sender makes separate arrangements: for example, the bulk mailing of shareholder communications, or direct mail advertising.

*Source: National Audit Office questionnaire to large users of postal services*

reviews can take 18 months or more to complete. With these factors in mind, Postcomm issued a consultation document in November 2001 on the high-level issues and principles that should apply in developing the controls on Consignia's prices for the period from April 2003.

its costs to reduce the net cost of the universal service obligation (paragraph 2.16 above refers).

## Postcomm may fail to get Consignia to meet prescribed standards of service

### Postcomm need to ensure that customer needs are clearly identified

3.15 The starting point for regulating the standard of any service is to establish how customers value different elements of the services provided, and their preferences between price and quality. As indicated in Part 1, especially Figure 5, the service that Consignia provide is of a higher specification than required in its licence which in turn specified more than the statutory definition of the universal service. Consignia may respond to regulatory and competitive pressures by reducing their service into line with the licence, for example by abandoning its aim of delivering to many addresses before 9.30am or providing a second delivery. An important question for Postcomm is how to react to Consignia's making such changes to service commitments.

3.16 Postcomm may also wish to consider whether other aspects of quality of service should be specified. Postwatch are responsible for representing customer interests, and it would fall to them to advise Postcomm on customer preferences. They may in particular be interested in trade-offs that different types of customer have between price and quality and the acceptability of allowing Consignia to bring its tariffs more into line with

3.17 One way of developing an understanding of customer needs and preferences is to undertake opinion surveys. To help inform this report and Postcomm's analysis of customer needs, we conducted two exercises: a questionnaire to the largest users of postal services in the UK (Appendix 3), and a joint survey, with Postcomm and Postwatch, of domestic users (Appendix 4). The former focuses on the needs of the main sending customers and the latter of receiving customers.

3.18 Responses to the large user questionnaire found that for general post the two main considerations for this group for outgoing mail are minimising expenditure and consistent collection (Figure 21). Priorities vary between users, with some primarily concerned with minimising expenditure and others valuing the quality of mail services. For special mail, such as bills and financial statements, minimising expenditure is by far the most important overall consideration. The questionnaire also found that for incoming mail, most large users need their mail to arrive by 8 am and many need it by 7 am.

3.19 Domestic customers receive 70 per cent of all mail (Figure 4). The results of the joint survey show that the cost of sending letters is not a major consideration for most of them, since they do not send significant volumes of mail. Half of respondents said they send just one item of post a week, with only a quarter sending three or more items a week. The relatively low awareness of the price of the standard 1st Class (only 44 per cent of survey respondents) and 2nd Class (only 38 per cent) stamps further indicates that cost is not a major consideration. The survey also shows that while over half of the domestic customers questioned consider that 1st Class post provides very good value for money, one in four say it is likely or very likely that they would use a faster but more expensive service than first class.



**22** The flight path: key minimum targets for standards of service in Consignia's licence

| Product type <sup>1</sup>                                       | Actual performance, year to March 2001 | Target to end of March 2002 | Target to end of March 2003 |
|---|--|-----------------------------|-----------------------------|
| 1st Class mail, percentage delivered next day                   | 89.0                                   | 92.1                        | 92.5                        |
| 2nd Class mail, percentage delivered within three days          | 98.4                                   | 98.5                        | 98.5                        |
| Mailsort <sup>12</sup> , percentage delivered next day          | 88.8                                   | 92.1                        | 93.0                        |
| Presstream <sup>13</sup> , percentage delivered next day        | 88.1                                   | 91.0                        | 92.5                        |
| Parcels (3 day standard service), percentage delivered next day | 84.0                                   | 88.0                        | 90.0                        |

**NOTES**

1. The licence includes 18 targets. Those selected represent Consignia's key product areas.
2. Mailsort is Consignia's name for services it offers to large postal users who are able to sort their mail before Consignia collect it.
3. Presstream is Consignia's name for services it offers to the press and periodicals industry.

*Source: Licence granted to Consignia Plc, 23 March 2001; Consignia's annual report and accounts*

3.20 Postcomm and Postwatch recognise that our surveys provide a useful starting point for understanding customer preferences but that more information is needed to obtain a fuller picture, including analysis of regional variations in customer priorities.

Postcomm need to ensure that Consignia meet quality of service targets and that Postwatch have sufficient information to monitor their achievement

3.21 Although Postcomm are responsible for including quality of service targets in Consignia's licence, in practice Postwatch conducted the detailed negotiations with Consignia over the service standards in the licence. The targets were negotiated against a background of Consignia's failure to meet its own targets for quality of service (paragraph 1.12 above). Postwatch concluded it would not be pragmatic to impose these targets in the first year of the licence, but instead set targets which, over two years, represent a "flight path" of improving performance, as shown in **Figure 22**. To address the risk that an adequate overall standard at the national level co-exists with pockets of poor performance in individual areas, there are also minimum standards for individual postcode districts. At the end of the two-year period, Postwatch expect to agree a new and more challenging set of standards. Respondents to the large user questionnaire considered that Consignia's service performance should be Postcomm's highest work priority.

3.22 Postwatch are also responsible for verifying Consignia's performance against these standards. To this end, Postwatch have appointed independent auditors to verify that the systems used by Consignia to monitor its postal services are robust and give accurate results. The auditors will review eight surveys performed by research companies appointed by Consignia, including a survey of 1st and 2nd metered mail that includes a range of items that more accurately reflects customer experiences<sup>59</sup>. The need to identify the impact on customers was highlighted by the Committee of Public Accounts' 1999-2000 report on how the ORR ensure that Railtrack maintain and renew the railway network. In this case the Committee expressed concern that ORR's monitoring of delays focussed on delays to trains rather than passengers, and that ORR did not therefore have a clear idea of the impact on passengers.

3.23 It has proved difficult, however, for Postwatch to obtain other performance related data from Consignia. This especially applies to the number of daily delivery rounds that have not been undertaken in the South and South West of England (**Figure 23**). In July 2001, Postwatch issued a Notice under Section 58 of the Act formally requesting such information. As Consignia did not comply, Postwatch began enforcement action on 21 September. Shortly afterwards, Consignia appealed to Postcomm that the request for information was too onerous. On 22 October, Postwatch gave the reasons why it thought it necessary to issue the Notice. On 6 December, Postcomm ruled that Consignia need not comply with the Notice as it was only reasonable to require information in respect of the four postcode areas where there was evidence of ongoing service failure, which Consignia attributed to recruitment difficulties,

<sup>59</sup> Previously only "clean mail" (Typed address with Postcode on standard size envelope with no window) was used, although this represents only 22 per cent of basic-weight 1st Class mail.

and not for all 14 areas in the South and South West. Postcomm made certain non-binding recommendations which Consignia has adopted. Consignia will supply to Postwatch information in respect of each delivery office in the four postcode areas on a weekly basis from the latter part of December. It is also providing in January 2002 historic data for the period since the end of July 2001 for each delivery office in the four postcode areas. Postwatch have powers to investigate complaints and other matters of interest to postal users. Where such investigations indicate potential breaches of Consignia's licence, Postwatch refer the matter to Postcomm. Postwatch and Postcomm will then work together to establish the extent of the problem and Postcomm will consider whether enforcement action is appropriate.

3.24 Consignia's licence requires them to establish a standards of service compensation scheme, so that users of postal services affected by failure to meet agreed quality standards are compensated<sup>60</sup>. However, Postwatch and Consignia were unable to agree a scheme within the six months provided for in Consignia's licence. Postcomm have therefore started a process to introduce a compensation scheme by determination, as intended when they drafted the licence (paragraph 1.33).

3.25 If Consignia fails to meet its national standards of service targets, Postcomm will consider what appropriate enforcement action should be taken. This may include penalties. The Act provides Postcomm with the power to impose penalties of up to 10 per cent of turnover<sup>61</sup>, but Postcomm recognise that fining Consignia may not act as a strong incentive given that any such fine would represent a transfer from one publicly-owned body to another. An alternative approach, adopted or being considered by other economic regulators, is to provide positive incentives by allowing companies to charge slightly more if they improve the service they deliver, for instance through the periodic price review process. This ought, however, to be informed by an understanding of what customers might be prepared to pay for a better service.

3.26 The Public Accounts Committee's 1997-98 report on the regulation of the quality of services to customers in the water industry stressed the importance of financial sanctions where companies fail to provide a satisfactory service. OFWAT later made proposals adopting the Committee's preference for incentives to improve service quality, accompanied by the imposition of financial penalties for poor service. The Committee revisited this matter during their 1999-2000 examination of how ORR ensure that Railtrack maintain and renew the railway network. The

Committee observed that the penalties applied by ORR were set at a national not a regional level and hence allowed serious delays to persist on individual lines. Following the Committee's recommendation that the performance incentive regime be targeted at attaining improvements in all parts of the network, ORR developed contractual incentives designed to achieve performance across the network. Similarly, the international guidelines on the audit of economic regulation have emphasised the importance to regulators of monitoring the performance of suppliers and securing improvements when suppliers' performance falls short of required standards<sup>62</sup>.

## The Department may not apply sufficient pressure on Consignia to improve its performance and respond constructively to competition

3.27 In developing a mechanism that will bring about a significant improvement in the operational performance of Consignia, Postcomm are taking into account Consignia's status as a Government owned company. There are two particular considerations:

- the traditional RPI-X price control may not be wholly appropriate in this instance; and
- the relationship between the Department and Consignia may affect the company's commitment to improving efficiency.

### 23 Information requested by Postwatch on Consignia's postal services in the South and South West of England

During 2001, Postwatch received a number of complaints about poor service in the South and South West of England. For example, some customers complained of getting no deliveries for four days. The complaints centred on four postcode areas: BA (Bath), PO (Portsmouth), RG (Reading) and SN (Swindon). However, complaints were also received from other towns in these postcode areas, including Bognor Regis, Fareham, Southsea and Wokingham.

Consignia's response to these complaints led Postwatch to believe that many of the problems might be due to recruitment difficulties, and therefore be ongoing and more widespread. From this, Postwatch identified a need for data on daily delivery failures in 14 postcode areas, covering the whole of South and South West of England. Postwatch believe that such information is necessary to establish whether a universal service is being provided.

*Source: Postwatch*

<sup>60</sup> Licence issued to Consignia, Condition 4, paragraph 10a.

<sup>61</sup> Postcomm are consulting on their policy for imposing penalties for breaches of licence conditions (Postcomm: Financial Penalties Statement of Policy. A Consultation Document. July 2001)

<sup>62</sup> INTOSAI Working Group on the Audit of Privatisation: Guidelines on Best Practice for the Audit of Regulation (October 2001) - Guideline 12.

## The traditional RPI-X price control may not be wholly appropriate in this instance

3.28 As noted in paragraph 3.7 above, UK economic regulators have made extensive use of a price control known as RPI-X. Because Consignia is wholly owned by the Government, the incentives normally provided by RPI-X may not be as strong in this instance as those applying to companies with stock market listed shares. The main reasons for this are:

- most companies subject to RPI-X regulation have shareholders who can trade their shares on a publicly quoted exchanges. This means that, in general terms, the management is subject to strong pressures on performance, including the scrutiny of a community of analysts and the constant threat that shareholders will sell their shares if unsatisfied with performance. Consignia's shares are not quoted on any exchange so the Department cannot benefit from the work of analysts and cannot sell its shares. Also, having the Government as sole shareholder removes the risk of takeover, which are strong disciplines for private sector managers;
- by contrast to a private shareholder whose holdings are small and diversified, the Department's holdings are large<sup>63</sup>, with a value in Consignia's published accounts of £4.3 billion<sup>64</sup>. This means that the Department is very exposed to any losses resulting from Consignia's poor performance;
- the Department may also differ in the multiple nature of its objectives. Private sector shareholders focus on maximising the returns from their investments. The Department, by contrast, combines the objective of earning a return with others, notably in setting strategic social objectives for postal services in the UK; and
- the Department differs from private sector shareholders through the extent of its influence over the regulated environment. The Department appoints the Postal Commissioners and issues guidance (for example on social issues) about how Postcomm should carry out their duties.

3.29 For these reasons, Postcomm are considering how best to adapt the RPI-X price control to the case of Consignia. For example, they are considering whether, in the absence of pressure from private sector shareholders on Consignia, they simulate this pressure by setting very challenging efficiency targets within the price control. Case Study 2 provides an example of how the Water Industry Commissioner for Scotland addresses the challenge of

regulating publicly owned bodies (Figure 24). They are also exploring the possibility of alternative approaches, for example closer links between service standards and prices (so that a higher standard of service would lead to a higher permitted price, and a lower standard a lower price). The Committee of Public Accounts' 1996-97 examination of the regulation of telecommunications, gas and electricity supply, and water services welcomed the action of OFWAT, taken following a reduced level of service by a water company, to make a clear link between service standards and prices.

## The relationship between the Department and Consignia may affect the company's commitment to improving efficiency

3.30 One element of the Government's postal reforms has been the development of a new relationship between Consignia and the Department of Trade and Industry. As the White Paper on Post Office reform said<sup>65</sup>:

"The Government has previously acted both as owner and regulator with no clarity as to how it balances its interests. Under the reform programme, clear boundaries and a genuine arm's length relationship will be established".

3.31 The arm's length relationship involves a clear distinction between the Government, as owner/shareholder, and Consignia, as postal operator. The Department's first report on the implementation of the postal reforms<sup>66</sup> explains that the Department as shareholder will be responsible for:

- approving Consignia's five year strategic plan;
- setting financial targets for Consignia. These include return on capital employed (currently 13 per cent), a post-tax profit target based on Consignia's strategic plan, and the proportion of post-tax profits that should be paid as dividends to Government (40 per cent of post-tax profit from 2000/01<sup>67</sup>). If profits exceed the target, then the dividend is 40 per cent of this higher figure, while if profits fall short of the target, the dividend reduces to not less than 90 per cent of the dividend that would have been paid had the target been met. It is highly unusual for a shareholder to direct a company's management to pay a guaranteed minimum dividend, in this case 36 per cent<sup>68</sup> of the post-tax profit target; and

<sup>63</sup> Unlike a shareholder in a privatised utility, whose holding is likely to be only a small portion of the total shares in issue, the Department holds all of the shares in Consignia except one (see Footnote 8).

<sup>64</sup> Consignia's published Summary Group Balance Sheet for the year ended 25 March 2001 shows group reserves of £4.3 billion, representing Consignia's assets less creditors and provisions. The Summary Group Profit and Loss Account for this period shows an operating loss of £70 million on a turnover of £8.1 billion.

<sup>65</sup> Post Office Reform: A World Class Service for the 21st Century (White Paper 1999) paragraph 19.

<sup>66</sup> Department of Trade and Industry, First Annual Report to Parliament on the progress of the reforms set out in the White Paper on Post Office Reform, December 2000.

<sup>67</sup> In 1999/2000 this dividend was set at 50 per cent of post-tax profit but the Department has lowered the target for subsequent years to 40 per cent.

<sup>68</sup> The minimum figure of 36 per cent is calculated as 90 per cent of the dividend based on the target (i.e. 90 per cent of 40 per cent).

24 Case Study 2 - the experience of the Water Industry Commissioner for Scotland

The water industry in Scotland differs from the privatised model adopted in England and Wales. The three Scottish Water Authorities remain in public ownership, and their boards are appointed by the Scottish Executive. The Water Industry Commissioner for Scotland is the economic regulator.

The Water Industry Commissioner told us that it was unrealistic to expect incentives to be as strong as the private sector: private sector boards can offer greater financial incentives to, and apply at least as powerful constraints on, their senior management in the interests of shareholders. Boards of the publicly owned Scottish water companies, by contrast, represent a wide range of interests. Much of the pressure to improve results would therefore have to come from the Scottish Executive, as owner of the water companies - hence the emphasis given by the Commissioner to having a close and effective relationship with the Scottish Executive, whilst maintaining his statutory independence. The Commissioner is also keen for the senior managers of the water companies to be incentivised through having a large part of their pay directly related to their achievement of performance targets.

The Commissioner highlighted the need for increased rigour in the governance of the Scottish water industry in his Strategic Review of the industry. The proposed Water Industry (Scotland) Bill will make provision for a strengthened corporate governance framework for Scottish Water, a new public body to be formed by the merger of the existing three authorities.

The Commissioner considers that there is little scope to provide 'carrots', in the form of incentive based regulation (there is not the same outside pressure for a publicly owned body to outperform significantly), and must perforce rely largely on 'sticks'. The Commissioner aims to obtain robust, consistently defined information on operational and capital expenditure, to compare the three authorities so that their relative level of efficiency is clear, and to oblige each to improve their efficiency accordingly. This method of regulation will not change as a result of the proposed merger.

Source: National Audit Office and the Water Industry Commissioner for Scotland

- approving borrowing in excess of £75 million a year for major commercial investments, including acquisitions<sup>69</sup>.

3.32 As explained above, many of Postcomm's statutory duties are related to a greater or lesser extent to the performance of Consignia in improving efficiency and customer service, which in turn depends in part on the effectiveness of the Department as shareholder. The Government has made a series of suggestions about how departments could become better shareholders in Public Private Partnerships: the Government's Approach, which could provide a starting point for Postcomm's consideration of shareholder issues. They include the introduction of greater shareholder expertise, perhaps by creating a shareholder panel and inviting City analysts to write and publish reports on the prospects for the business, much as they would for a listed company<sup>70</sup>.

3.33 One feature of an arm's length relationship is that the shareholder seeks to provide incentives to management to meet the shareholder's objectives. These incentives include linking remuneration to performance and providing management with a direct interest in the company's shares (for example, through share options). For many regulated industries, regulators do not take a close interest in these management incentives, because they can rely on private sector shareholders to do so. But, where regulated companies depart from a standard private shareholder model, regulators have taken a closer interest in remuneration and governance (see

**Figure 24:** Case Study on the Water Industry Commissioner for Scotland). Similarly, OFWAT's approval of the acquisition of Welsh Water by Glas Cymru, which also represented a departure from the standard equity shareholder model, was subject to meeting special conditions covering, among other things, remuneration and governance<sup>71</sup>.

3.34 In the case of Consignia, the Department has put in place incentives that link remuneration to Consignia's profits. Postcomm are also interested in remuneration, as reflected in the Act, which requires Consignia to provide details of links between management remuneration and Consignia's standards of performance.

3.35 Postcomm have an interest in Consignia's strategic plan, in as far as it indicates how the company is seeking to respond to the challenges it faces, such as investing to raise the future efficiency and performance of the business. The Department as shareholder are responsible for approving Consignia's strategic plan.

## Postcomm need to obtain sufficient information to undertake their regulatory tasks independently

3.36 All sector-specific regulators in the UK have found a need to develop quantitative cost models for the incumbent firms that they regulate. These are used for a

69 One such acquisition was the then Post Office's acquisition of German Parcel (National Audit Office report: The Acquisition of German Parcel CH858 Session 1999-00).

70 Public Private Partnerships: The Government's Approach (HMSO, 2000).

71 Glas Cymru is a not-for profit company, owned by 200 members. Its purchase of Welsh Water means that Welsh Water is no longer owned by shareholders seeking to earn profits. The potential consequences of this, and the six conditions set by OFWAT to address these consequences, are set out in OFWAT's paper The proposed acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig - A position paper by OFWAT (January 2001) and Glas Cymru's Acquisition of Dwr Cymru: OFWAT's six conditions (July 2001). OFWAT have also issued a letter to all water companies on corporate governance issues: MD121 - Board structure, the licence and relations with Ofwat.

variety of purposes, including to establish price caps, to set access prices and to evaluate whether prices for individual services or groups of services breach licence conditions or general competition law. In the case of OFTEL and the telecommunications industry, such models are also used to establish the level of costs imposed on BT and Kingston Communications by the requirement under their licences to provide a universal telecommunications service. And the international guidelines on the audit of economic regulation emphasise the need to obtain reliable information<sup>72</sup>.

- 3.37 Having robust information is central to the effective discharge by Postcomm of their statutory responsibilities, although the universal service obligation looms larger than for other regulators. The key decisions that face Postcomm, in deciding on the introduction of competition, responding to challenges to competition, controlling prices and reviewing service standards, are open to challenge by others in the postal industry if they can contend that Postcomm have failed to fulfil their statutory duties. Given the tensions between these duties (paragraph 1.26 above) Postcomm will need to be able to show how they have balanced them by demonstrating that they have taken their decisions on the basis of solid evidence. Professor Cave has set out what he considers to be Postcomm's most pressing information requirements in Figure 6.1 to Appendix 6.
- 3.38 Consignia is in a strong position relative to Postcomm, since Consignia generates most of the information, especially cost information, on which Postcomm will rely, and because Consignia has been operating postal services for many years while Postcomm are a new regulator. This means that there is a potential asymmetry of information, with Consignia holding much more information than Postcomm and in a better position to understand the information it generates. As a result of the asymmetry, there is a risk that Postcomm's reliance on information from the regulatee could prevent them from forming independent judgements. The experience of other regulators suggests that it may take time to overcome this asymmetry.
- 3.39 Evidence-based decision making is also important if Postcomm are to act in accordance with the principles of good regulation published by the Better Regulation Task Force. The experience of other economic regulators shows that obtaining the information needed to make informed decisions itself creates a regulatory burden and need to be in line with good regulation principles (paragraph 1.31 and Figure 12 above). A particular challenge faced by economic regulators is the need to obtain information in a form that is usable for assessing efficiency during periodic price reviews, and subsequent performance against the assumptions made during the review. Relevant information includes cost allocation methodologies, the mix of variable and fixed costs, and how costs change with volume.
- 3.40 The information that a regulated company such as Consignia prepares for its own management information purposes may not necessarily be in the right form for Postcomm's purposes. For instance, Postcomm may wish to assess to the efficiency of particular processes rather than the business units into which Consignia is organised, or they may wish to treat common and overhead costs differently. In Consignia's case, the business reorganisation that took place in early 2001 may make it harder to obtain consistent time series data before that date.
- 3.41 Because their requirements differ from those of regulated companies, it has been the experience of other UK regulators that they need to place heavy and costly demands on regulated companies for cost information and to expend considerable time and effort checking the information they receive. OFWAT's approach has been to reduce the requirements placed on companies during periodic price reviews by requiring annual returns which include cost and output information in a form that OFWAT can use. The Water Commissioner for Scotland has taken a step further by working with the shareholder of the water companies, the Scottish Executive, to define a common reporting format that will satisfy the needs of the Commissioner and the shareholder.
- 3.42 Postcomm have yet to specify all of the information they will need or the form in which it should be provided. In particular they have yet to finalise annual requirements for Consignia to report to Postcomm. However, they have already started working with Consignia to establish their requirements for regulatory accounts. They have also made formal information requests to Consignia and have made substantial progress in analysing information provided by Consignia. For example their work on the costs of universal service involved a close examination of cost information broken down into considerable detail by postal route. A difficulty is that in many cases the information that Postcomm request does not exist within Consignia, as its management information systems were not devised to provide regulatory information.
- 3.43 Regulators also need assurance that the information supplied by regulated companies such as Consignia is reliable. Other regulators, faced with similar informational problems, have made use of Reporters - independent experts who verify the reliability of the information provided by regulated companies<sup>73</sup>. Postcomm have still to consider how they will verify the information supplied by Consignia.

<sup>72</sup> INTOSAI Working Group on the Audit of Privatisation: Guidelines on Best Practice for the Audit of Regulation (October 2001) - Guideline 7.

<sup>73</sup> Among UK economic regulators, OFWAT have made the most extensive use of Reporters. ORR are also starting to make use of Reporters.



# Appendix 1

## Scope and methodology of the National Audit Office's examination

### Scope

Postcomm's principal statutory duties are as follows:

- exercise their functions in a manner best calculated **to ensure the provision of a universal postal service**. This is their primary statutory duty; and
- exercise their functions in a manner best calculated **to further the interests of postal users**, wherever appropriate **by promoting effective competition**;

In carrying out these statutory duties, Postcomm must choose between a range of regulatory responses and tools. They must decide the balance between fostering new entrants and protecting Consignia's ability to deliver universal service; they must choose which form of competition, if any, they intend to promote; and they must decide between a light-handed and an interventionist regulatory approach. Our examination sought to set out the challenges facing Postcomm in making these choices, and to make constructive recommendations where possible about how Postcomm should decide which regulatory approach to adopt. We started by considering the current strengths and weaknesses in Consignia's performance. Against this background, we then examined how Postcomm are opening the postal market, by analysing:

- the risks and benefits of introducing competition; and
- how Postcomm propose to bring benefits to the users of postal services before effective competition is fully developed.

We did not assess the merits of the policy decisions to set up Postcomm as an independent regulator; to give Postcomm a primary duty to maintain universal service and secondary duties including the introduction of competition; and to convert Consignia into a public limited company with 100 per cent of the shares owned by Government. We also did not examine Postcomm's separate responsibilities for providing advice to Government on the future of the network of Post Offices.

### Methodology

The key elements of our Study Methodology are set out below.

#### Analysis of consumer preferences

We conducted research into the two main users of postal services: the sending customers, through a questionnaire sent to the largest users of postal services in the country (Appendix 3), and the receiving customers, through an omnibus survey of 2000 adults (Appendix 4). The latter was carried jointly with Postcomm and Postwatch.

#### Benchmarking

We analysed how other economic regulators have addressed the challenges facing Postcomm, on the basis of our experience of these regulators and on published information (see bibliography). Regulators whose experience we examined included the Water Industry Commissioner for Scotland, OFTEL, OFWAT, OFGEM (and its predecessors) and postal regulators from other countries. We reviewed and drew on the conclusions and recommendations in the reports of the Committee of Public Accounts on economic regulation. In addition, we used the guidelines on the audit of economic regulation prepared by the International Organisation of Supreme Audit Institutions.

#### Cost modelling requirements

We commissioned Professor Martin Cave of the University of Warwick to produce a paper on the cost modelling requirements for Postcomm. The paper is included as Appendix 6. We drew on it for several parts of the report, especially the discussion of costing the universal service obligation and the impact of competition on universal service.

We also conducted our own analysis of the two main approaches to examining universal service: Postcomm's estimate of the cost of universal service and Consignia's entry pricing model. Our analysis sought to identify the main differences in approach and to ensure that we understood the main factors driving the figures produced by each approach.

## Expert Panel

We set up an Expert Panel to provide advice and guidance during the study and to test and validate the emerging findings. Membership of the panel comprised the following experts:

**Professor Rob Baldwin** - Professor of Law, London School of Economics, and author of several works on regulation, including, with Martin Cave, *Understanding Regulation* (1999).

**Dr Anthony Ballance** - Director, Regulation and Privatisation, Stone & Webster Consultants, and former chief economist of OFWAT.

**John Dodgson** - Director, National Economic Research Associates (NERA). Co-author of NERA's 1998 study on behalf of the European Commission *Costing and Financing of Universal Service Obligations in the European Union*, essential reading for those interested in the costs of universal service.

**Richard Henchley** - Law and Public Affairs Consultant, Periodical Publishers Association, the trade association for organisations who use postal services to distribute magazines and periodicals.

**Professor Tony Prosser** - John Millar Professor of Law, University of Glasgow, and author of a number of works on the accountability and regulation frameworks for publicly owned bodies, including *Nationalised Industries and Public Control* (1986).

# Appendix 2

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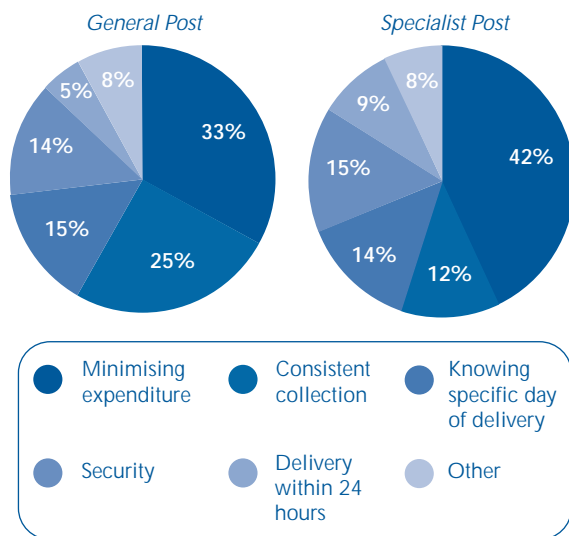
Universal Postal Union, *Beijing Postal Strategy*

# Appendix 3

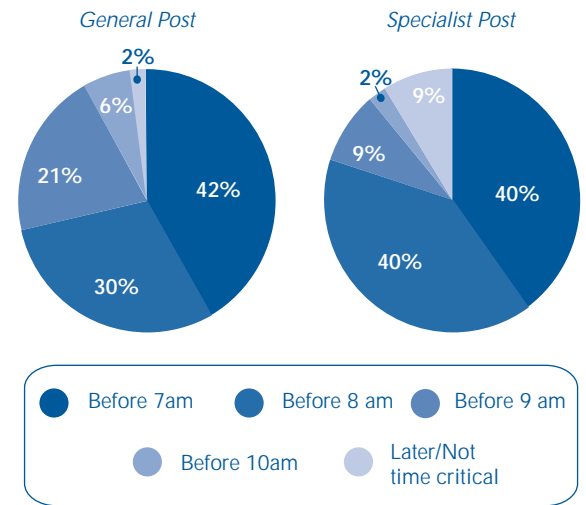
## Results of the National Audit Office questionnaire to major users of postal services

In August 2001, we sent a questionnaire to the major users of postal services in the United Kingdom. The questionnaire sought information on the needs and experiences of this group, and how these have changed over time and how these vary between Consignia and alternative service providers. One hundred and ten questionnaires were sent out and we received 59 replies, a response rate of 54 per cent. This Appendix sets out the main findings.

### 1. The main needs as sending customers are minimising expenditure, consistent collection, security and knowing the specific day of delivery



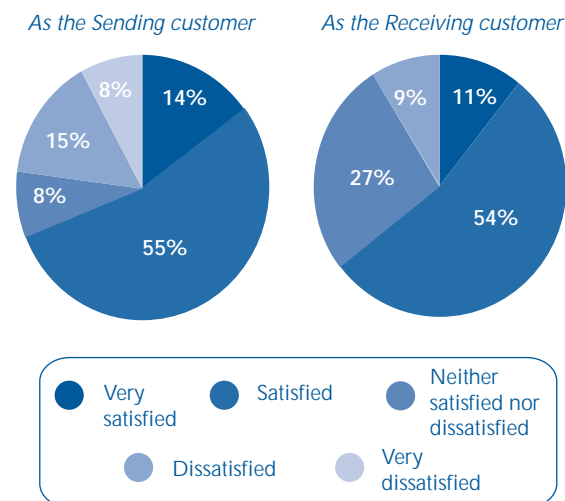
### 2. Mail is required by 8am by around three out of four large users



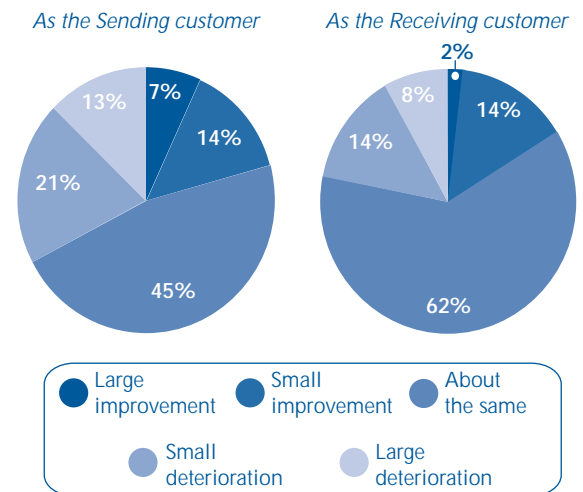
#### NOTES

- The figures represent the number of business users selecting the factor as highest priority.
- "Other" includes No damage, Knowing delivery time and Maximising weight allowances.

### 3. Nearly seven out of ten large users are satisfied with the standard of service provided by Consignia

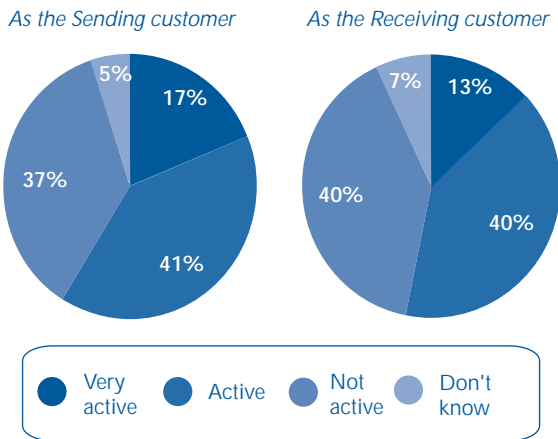


### 4. In the last two years, the level of service provided to the majority of large users by Consignia has stayed about the same. For others it has improved but for a greater number, especially when sending mail, it has deteriorated

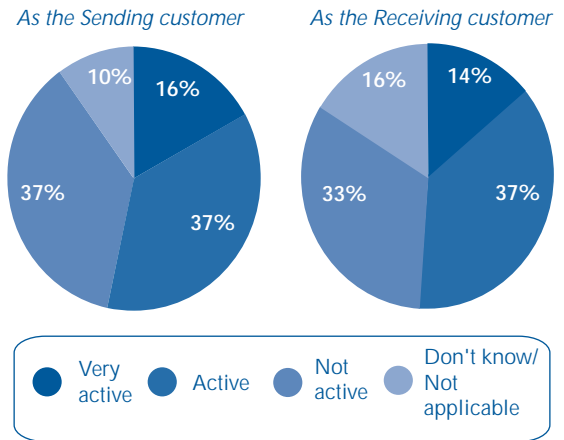




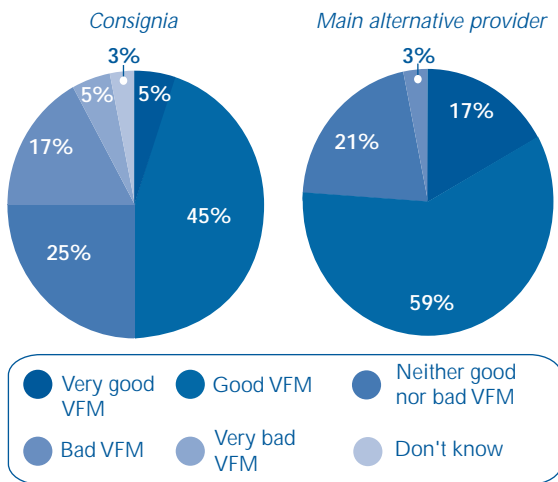
5. Six out of ten large users feel that, in the last two years, Consignia has been active or very active in taking the initiative to offer bespoke solutions to their business needs



6. The majority of large users feel that, in the last two years, Consignia has been active or very active in responding to requests from their business for changes in the service provided



7. Although half of large users feel that the prices charged by Consignia provide good or very good value for money, large users making significant use of alternative providers feel they get better value for money from these companies



NOTE

The sample sizes were 60 for Consignia and 29 for Main Alternative Provider.

8. Large users feel that the quality of Consignia's services and their prices should be the highest work priorities of Postcomm and Postwatch

|   | Postcomm % | Postwatch % |
|---|------------|-------------|
| Consignia's service performance                               | 17         | 17          |
| Consignia's discounts <sup>2</sup>                            | 15         | 13          |
| Consignia's standard prices                                   | 13         | 12          |
| Promoting effective competition                               | 13         | 12          |
| Customer relations  | 10         | 9           |
| Consignia's compensation arrangements for poor service        | 9          | 9           |
| Post that is lost, stolen items or unlawfully interfered with | 9          | 11          |
| Delivery to wrong address                                     | 7          | 8           |

NOTES

1. The figures are based on the number of occasions respondents selected the factor as high priority.
2. Comments provided by respondents indicated particular concern about the value for money of discounts and a lack of flexibility in dealing with customers' requirements.

# Appendix 4

## Results of the National Audit Office survey of domestic users of postal services

- 1 We conducted a joint survey with Postcomm and Postwatch to obtain the views and experiences of the general public on postal services in the United Kingdom. We commissioned Capibus (Ipsos-RSL Ltd) to undertake the survey using their weekly omnibus survey of Great Britain and a representative sample of citizens in Northern Ireland. The results were then merged to provide a representative sample across the UK of 2,065 adults aged 15 years and over. The survey was conducted by interview between 27 July and 2 August 2001. Because Consignia is a significant employer, we identified and then excluded those adults who had ever worked in a post office, for the Royal Mail or for Parcelforce Worldwide. This reduced the number of adults taking part in the main part of the survey to 1,931. The findings are statistically correct to +/- 1 percentage point. This Appendix sets out the main findings.

The prices of standard 1st Class and 2nd Class postage stamps are not widely known by the public - four in ten got the prices right in each case

- 2 About four out of ten respondents know the precise prices of standard 1st and 2nd Class stamps. But this increased to three out of four for 1st Class and two out of four for 2nd Class with the inclusion of those who were just one penny adrift. For this wider band, the variations are small within the sexes, the age groups and, for 1st Class only, the types of area. But there are significant variations within the social groups, with DEs least likely to know.

### What is the price of a 1st class stamp and a 2nd class stamp?

|  | All<br>1st<br>% | All<br>2nd<br>% | AB,C1,C2<br>1st<br>%<br>(Note 1) | DE<br>1st<br>% | AB,C1,C2<br>2nd<br>%<br>(Note 1) | DE<br>2nd<br>% | Urban<br>2nd<br>% | Suburban<br>2nd<br>% | Rural<br>2nd<br>% |
|--|-----------------|-----------------|----------------------------------|----------------|----------------------------------|----------------|-------------------|----------------------|-------------------|
| Correct price<br>(1st: 27p and 2nd: 19p)           | 44              | 38              | 41-48                            | 42             | 38-42                            | 35             | 39                | 39                   | 35                |
| Correct price and those<br>within 1 penny (+ or -) | 73              | 54              | 74-76                            | 68             | 55-59                            | 47             | 61                | 53                   | 48                |
| Don't know   | 12              | 24              | 7-12                             | 16             | 16-27                            | 29             | 23                | 24                   | 34                |

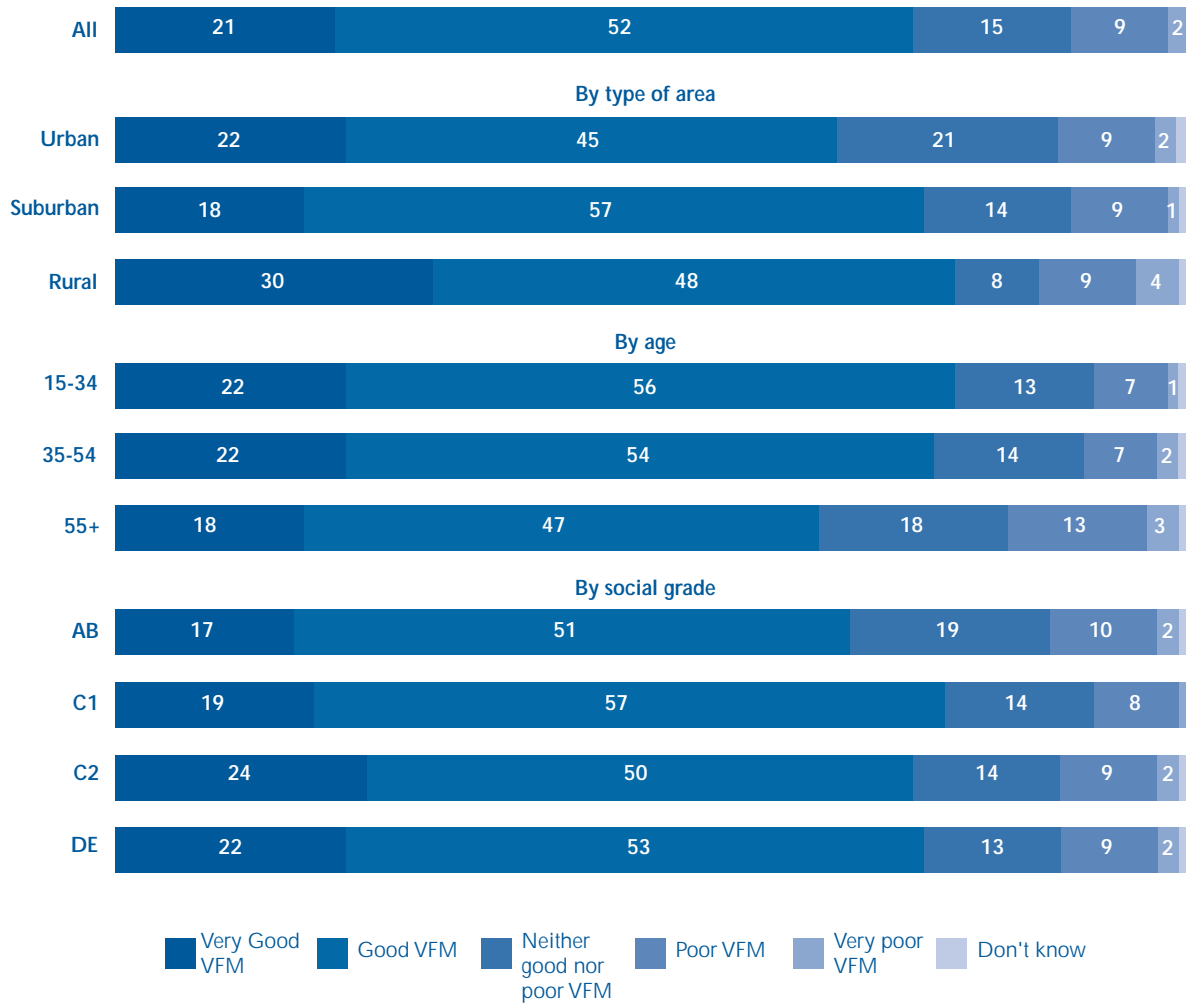
### NOTE

1. Respondents in social grades AB, C1 and C2 were separately identified. This column shows the range for these three groups.

## The public think the 1st and 2nd Class postal services provide value for money

- 3 Three out of four respondents said that the 1st and 2nd Class post provides good or very good value for money. Respondents in social grade AB are least supportive of this view, as were those living in urban areas and also those aged 55 and over. About one in ten respondents said they were dissatisfied.

A 1st Class stamp costs 27 pence and a 2nd Class stamp 19 pence. To what extent do you think each is value for money?  
The responses for 1st Class were as follows (Note 1)



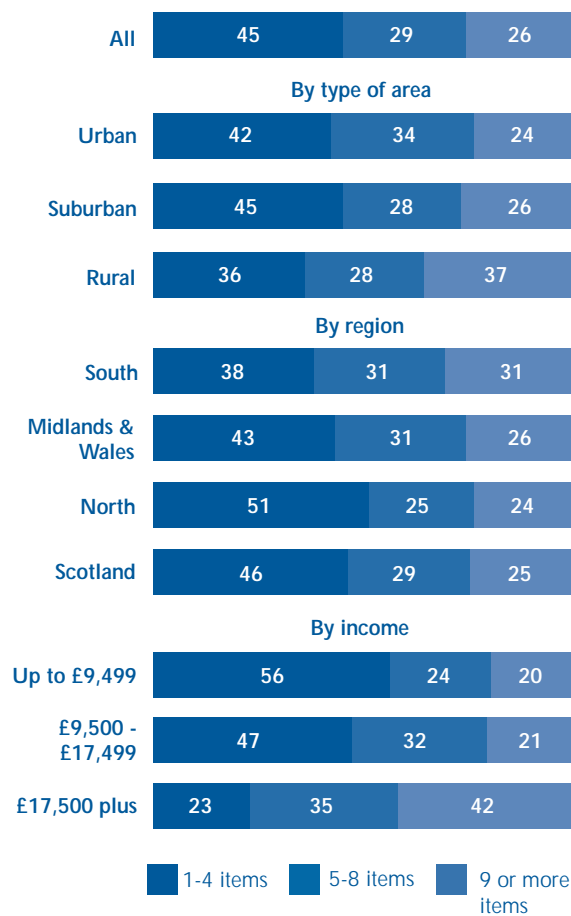
### NOTES

- The responses for 2nd Class were very similar in most cases. A notable exception is that ABs were more content and C1s less content, so that the range for Very Good + Good by social group was only 2 percentage points (73-75%) for 2nd Class compared to 8 points (68-76%) for 1st Class.
- Don't knows were 1 per cent or less.

## More items of mail are received by the public than they send - half send only one item a week, while nearly half receive up to four items

- About half of respondents said that they receive up to four items of mail each week, while a quarter receive nine or more items. More mail is received by rural than urban and suburban respondents, while those in the south of England receive more than those in the north. Those on higher incomes also receive more mail.
- Half of respondents said that they send only one item a week, while a quarter send three or more items. The pattern of usage is similar to that for receiving mail, with rural and higher income respondents and those residing in the south of England being the greatest users.

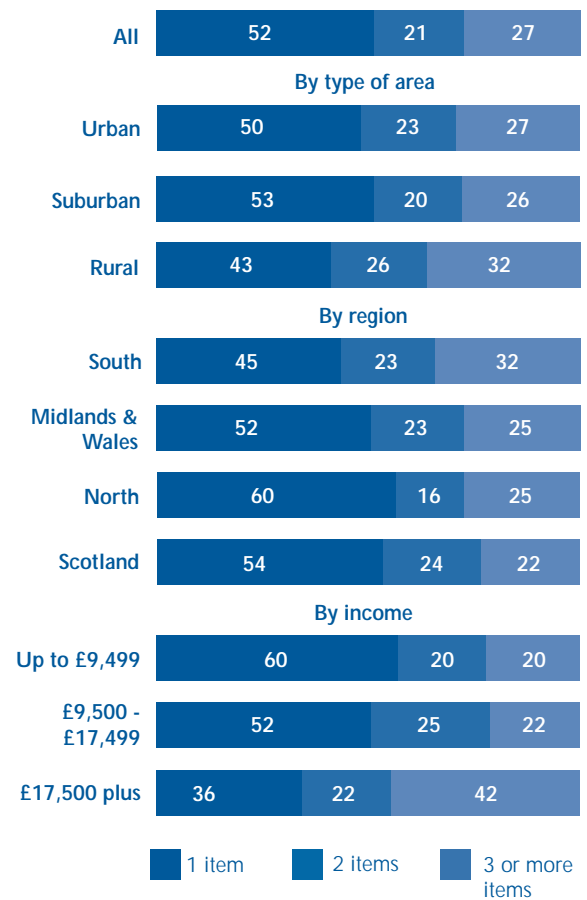
How many items of mail do you personally receive on average each week? Please exclude items of junk mail, newspapers, items of adverts hand-delivered.



**NOTE**

Norther Ireland is not shown because the sub-analysis samples were too small to be statistically accurate.

How many items of mail do you post on average each week, including any business mail if you are self-employed? This includes letters and parcels.



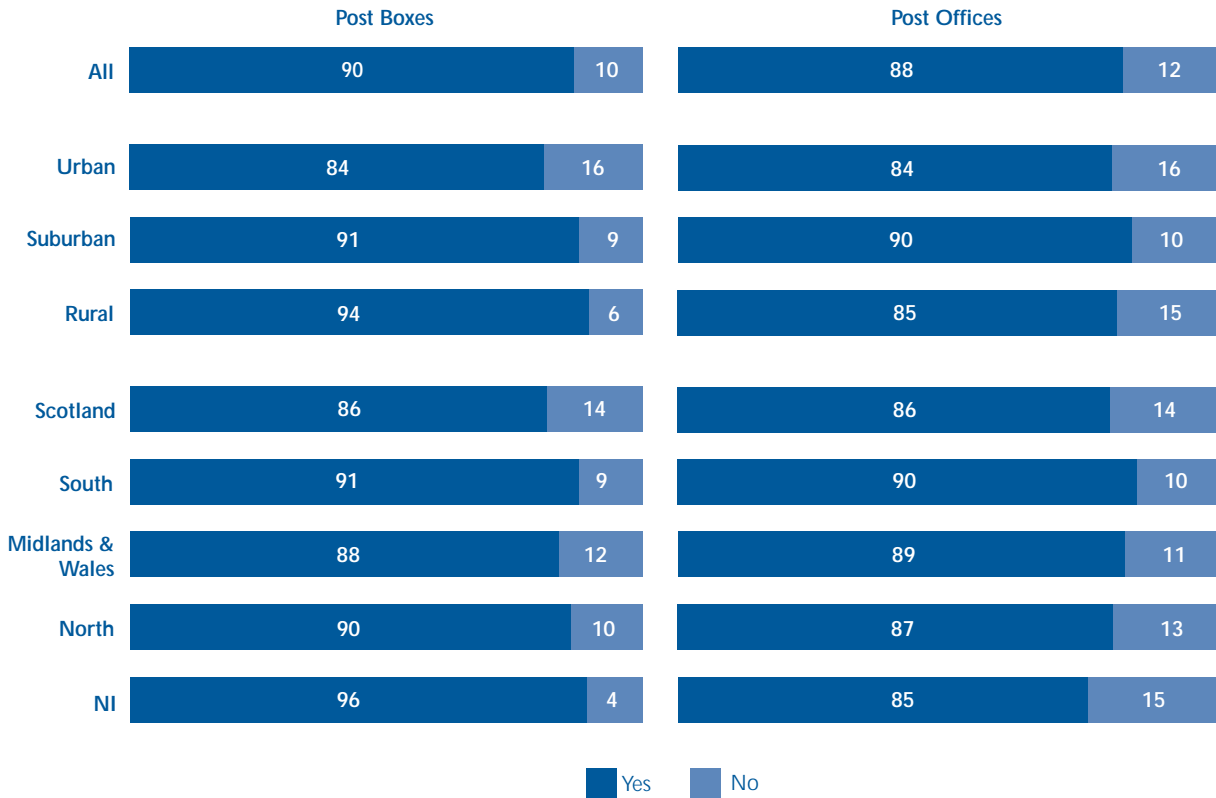
**NOTE**

Northern Ireland is not shown because the sub-analysis samples were too small to be statistically accurate. However, the responses to this question, and to No 4, indicated levels of activity below the lowest region in Great Britain.

Most members of the public are content with the provision of post boxes and post offices - nine out of ten are satisfied

6 Only one out of ten respondents did not find the provision of post boxes and post offices satisfactory. Within this overall picture of high satisfaction, urban respondents are less content with the provision of post boxes than suburban and rural respondents, while those in urban and rural areas are notably less content with the provision of post offices than suburban respondents. There are also lower levels of satisfaction in Scotland.

Is there a post box within a convenient distance from your home? Is there a post office within easy reach of your home, including those in newsagents, sweet shops etc?

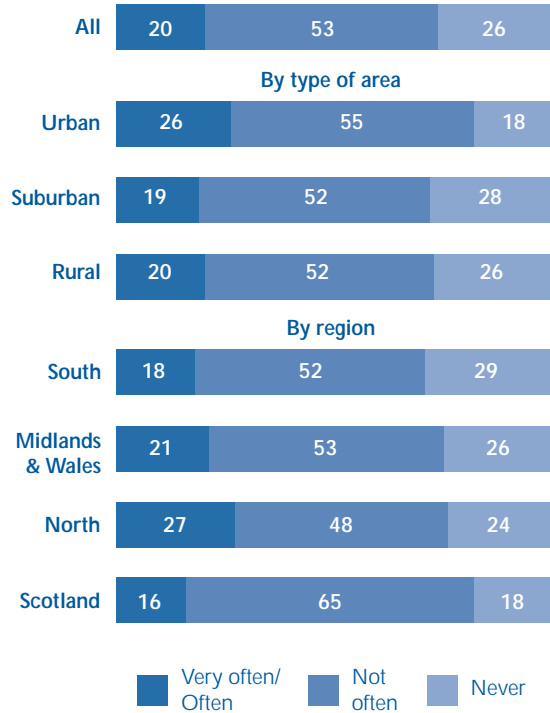




## A significant minority of the public receive mis-directed mail - about one in five say this happens often or very often

- 7 About half of respondents said that it is not often that they receive mis-directed mail, and a quarter said that this never occurs. But there are significant regional variations, with the performance in Scotland being much better than the north of England, while urban areas fare noticeably less well than suburban areas.

**How often do you receive mail at home that should have been delivered to another address?**



### NOTES

1. Northern Ireland is not shown because the sub-analysis samples were too small to be statistically accurate.
2. For "All", 7 per cent said Very Often and 13 per cent said Often. The sub-analysis samples were too small to show Very often and Often separately.
3. The sub-analysis does not total 100 per cent in all cases due to roundings and "Don't Know".

# Appendix 5

## Postcomm's Commissioners

The Postal Services Commission (Postcomm) consists of seven individuals: The Chairman, five part-time commissioners and a full time Chief Executive.

### Chairman

**Graham Corbett CBE** Appointed Chairman of the Postal Services Commission in March 2000. He was previously a Deputy Chairman of the Competition Commission and Chief Financial Officer and a main board director of Eurotunnel.

### Part-time Commissioners

**Robin Aaronson** Director of the London office of LECG Ltd, a firm of economic and business consultants. An economist by training, he was a partner at PricewaterhouseCoopers from 1989 to 1998.

**Tony Cooper** General Secretary and Chief Executive Officer of the Engineers and Managers Association and a member of the TUC General Council.

**Julia Kaufmann** Management consultant for the voluntary sector. Formerly Director of the BBC Children in Need Appeal and a Director of Gingerbread, the association for one-parent families.

**Janet Lewis-Jones** Member of the Welsh Fourth Channel Authority and British Waterways Board, and a Vice President of the British Board of Film Classification.

**Ken Olisa** Chairman and Chief Executive Officer of Interregnum plc. Board member of several information technology companies. A Governor of the Peabody Trust and Chairman of Thames Reach, a charity working to eliminate street homelessness in London.

### Chief Executive

**Martin Stanley** Appointed Chief Executive of the Postal Services Commission in 2000. Previously he was Director of the Government's Regulatory Impact Unit in the Cabinet Office.

Source: Postcomm

# Appendix 6

## Cost modelling requirements for Postcomm's regulatory purposes

Paper by Professor Martin Cave of the University of Warwick, August 2001

### 1 Introduction

- 1.1 All sector-specific regulatory agencies in the UK have found a need to develop quantitative cost models for incumbent firms, which they regulate. These are required for a variety of purposes - to establish price-caps, to set access prices, to evaluate whether prices for individual services or groups of services breach licence conditions or general competition law and, in the case of OFTEL and the telecommunications industry, to establish the level of costs imposed on BT by the requirement under its licence to provide a universal telecommunications service.
- 1.2 While costing the effects of universal service obligations (USO) has played a relatively small role in regulating energy, telecommunications and transport industries, its importance in the postal service industry is much greater. This is because Consignia in the UK and elsewhere has historically assumed an obligation to provide a universal service at a uniform affordable price: indeed the term "postalisation" of tariffs has come to describe that obligation across a range of sectors. The significance of this obligation is reflected in the fact that, under the Postal Services Act 2000, Postcomm's primary duty is to ensure that customers continue to be able to enjoy a "universal postal service". Only subject to this should Postcomm also further the interests of users of postal services by promoting effective competition between postal operators, having regard to the interests of certain specified customer groups, such as the disabled and residents in rural areas.
- 1.3 This hierarchy of duties imposes upon Postcomm an overriding requirement to take into account the impact of licensing competitors on Consignia's ability to discharge its universal service obligations. In other words, the USO can be treated as a constraint on the development of competition. Although there may be some ambiguity in the precise definition of the obligation, the Act makes clear that, whatever definition is chosen, Postcomm must ensure that the relevant service is provided.
- 1.4 This requirement makes it essential that Postcomm has available the modelling and analytical tools necessary to investigate possible threats to the continuation of the USO. Not surprisingly, this issue has been widely discussed within the industry, particularly by Consignia before and during the passage of the Act, and throughout Postcomm's life. In particular, Consignia has suggested that it is appropriate to measure the "cost of the USO" via a particular model which they have developed called the entry pricing model (EPM). This stands in contrast to an alternative methodology developed within the telecommunications industry and also favoured by Postcomm and the European Commission, known as the net avoided cost (NAC) approach.
- 1.5 The distinction between these two models is discussed in detail below. Here, it is sufficient to note that the entry pricing model is designed to show the overall loss of profit imposed on Consignia if entry occurs, on the basis that, before entry, Consignia is charging a uniform tariff for its services which ensures cost recovery, and that it continues to charge that uniform tariff afterwards. The net avoided cost approach, by contrast, identifies the losses incurred on high cost routes by Consignia as a result of its obligation to supply services at a uniform price on high cost routes. It is clear that the two models are addressing quite different questions, both of which have a bearing on Consignia's ability to sustain its universal service obligations. The EPM raises questions about Consignia's ability to finance its functions if its pricing is constrained across the board. The NAC model focuses entirely upon loss-making activities which Consignia has an obligation to supply.
- 1.6 The issue of modelling the sustainability of universal service is the primary focus of this paper. However, three further regulatory issues, the resolution of which may require cost analysis, are also relevant.

- Consignia's ability to deviate from the universal tariff. When threatened with entry, Consignia may find it advantageous to cut its formerly uniform tariff on a selective basis, in order to avoid the loss of business to competitors. This might be achieved, for example, by offering special local tariffs on low cost routes, by quantity discounts, by offering discounts associated with exclusive supply, by bundling, services, or by other means. The extent to which Consignia can do this will, of course, mitigate its vulnerability to entry. Other regulators have found it appropriate to impose restrictions on the incumbent's competitive responses, guided either by competition law or by stiffer tests during the transition to competition. This aspect is discussed below, in Section 5.
- Access Pricing. Under the terms of Consignia's licence, it is required to negotiate prices with seekers of access to its network, with Postcomm having the power to determine them should negotiations fail. As at least one operator now has a trial licence, this procedure might be triggered at any time.
- Price Control. In addition, Postcomm will have the opportunity from 2003 to impose a multi-year price control regime on Consignia. If Postcomm follows the example of other regulators, this will entail the projection of efficiently incurred costs of Consignia, conditioned on its expected output levels; Consignia will be subject to price controls which permit these costs to be recovered.

These last two purposes are not discussed at length below, but Postcomm will take them into account in determining its costing needs.

## 2 Modelling the costs of the postal service

- 2.1 As is the case with many utilities, the operation of an end-to-end postal service can be decomposed into a series of discrete stages, the technology and costs of each of which have different characteristics. The conventional break-down for postal services is into the following activities - the numbers in brackets indicate the approximate percentage split of directly attributable costs: collection (5 per cent); outward sorting (12 per cent); transportation (14 per cent); inward sorting (14 per cent); delivery (43 per cent); support activities (12 per cent)<sup>74</sup>.
- 2.2 Each of the first five activities (omitting the heterogeneous category of support activities) will be characterised by different degrees of economies of scale. There may also be economies of scope pertaining to combinations of activities. It is the conventional

wisdom that the greatest economies of scale are associated with delivery, which is also by far the most costly activity of those listed.

### What the regulator needs

- 2.3 Before addressing the cost analysis question in more detail, it is vital to be clear about the purposes for which it is intended. The first purpose identified above was that of establishing those parts of Consignia's business which it undertakes as a result of a universal service obligation and on which it is likely to incur losses. In principle, this question could be addressed at any chosen level of disaggregation, right down to the delivery of an individual letter or packet. In practice, it makes sense to address it in a more aggregated way, yet one which reflects the difference in tariffs and costs for different services, and - crucially - the difference in costs associated with different conveyance distances and delivery conditions of the letter or packet. Hence the discussion of the net costs of the USO in Section 3 below is framed in relation to different routes, where an individual route is defined in relation to the product being carried, the conveyance distance and the delivery conditions, of the letter or packet<sup>75</sup>. The regulator is likely to take the view here that, in principle, the costs should be those of an efficient operator. In other words, losses incurred as a result of inefficiency would not count as part of the USO.

- 2.4 In relation to the second issue identified above, that of investigating the sustainability of Consignia after entry has occurred, the cost modelling requirements are broader. In the first place, the regulator will require a capacity to model the costs of the incumbent when faced with different levels of loss of market share to competitors. Since the competitive threat is likely to be different in both product and geographical dimensions, information about the costs of different routes will again be important. Attention will be focused not only on the incremental/avoidable or directly attributable costs of particular routes, but also on common and overhead costs - the scale of which will influence the incumbent's level of profitability or of loss. In undertaking modelling work of this kind, the regulator will have to decide what constraints the incumbent faces in changing its costs. One aspect of this is the distinction between the short-run, when many inputs, particularly labour, are variable but others, for example capital equipment or buildings, are fixed, and the long-run in which all expenditures are variable. A related but separate question concerns the extent to which the basic network topology can be amended. In regulatory costing exercises for telecommunications, a distinction is sometimes made between an approach in which all aspects of network design are considered to be variable (known as "scorched

<sup>74</sup> Postcomm, *Promoting Effective Competition in UK Postal Services*, June 2001, p.20.

<sup>75</sup> Below, the first of these describes the 'product' dimension of the route. The second and third define its 'geographical' dimension.

earth"), and one in which only a part of the network, defined normally as a local exchange area, can be varied ("scorched node"). However, telecommunications firms are characterised by a much higher level of sunk costs than is the case with postal operators, and the arguments in favour of a long-run "scorched earth" approach are correspondingly strengthened.

- 2.5 For the purpose of estimating the extent to which Consignia is likely to lose business after entry, the regulator should also take an interest in the costs of entrants, for it is their "best offer" which will determine the limit on the incumbent's loss of market share. However, this presents exceptionally difficult challenges, especially in the pre-entry period, as the form of entry, as well as its effects, is a matter for speculation. I return to this question in Section 4 below.
- 2.6 The third issue, to which cost modelling can contribute concerns regulatory restrictions on the incumbent's competitive response to entry. More precisely, what cost test must such a response satisfy in order to be considered legitimate? Entry will have both a product and a geographical dimension, so that a model of costs which incorporates both - by costing individual routes- is likely to be helpful. In competition law, it is sometimes argued that the appropriate level of aggregation on which a dominant firm's response should be assessed is the "arena of competition", or the set of products (geographically differentiated as appropriate) on which entry is actually or potentially feasible. A regulator is not, however, bound by this approach, nor by the standard competition law cost tests.
- 2.7 The regulator's access price requirements are likely to involve an ability to model the costs of the individual's vertically separable services which access seekers may wish to buy. Depending upon the access pricing rule adopted, this may be priced on the basis either of geographically differentiated or geographically averaged costs. Finally, the regulator's price control duties are likely to be assisted by a capability to model the costs of the whole of the incumbent's regulated activity, across all routes and including an efficient level of common and overhead costs.
- 2.8 I conclude from this discussion that the regulator will need an ability to model the incumbent's costs using simultaneously a product and a geographical breakdown. The cost estimates required are likely to be long-run ones, perhaps with an allowance for a process of transition to the long run. Costs estimates for entrants are also desirable, but harder to derive on a reliable basis.

## Forms of cost modelling

- 2.9 Setting on one side the estimation of econometric cost functions, which is normally ruled out by lack of adequate data, regulatory cost estimation is normally done in one of several ways. In the first, the analyst investigates the incumbent's management accounting data, with a view to identifying which costs are associated with what product or service. This is usually done using techniques such as activity based costing, which focus on establishing causal relationships between costs, the activities on which they expended and the products thereby generated. On this basis, the analyst should be able to establish the incremental cost associated with particular products or group of products, and the associated level of common and overhead costs. It is clear, however, that this analysis only permits an allocation of costs over a particular period, characterised by a particular output level. In order to deduce the underlying cost function significant further inferences have to be drawn from the cost data, or additional assumptions made.
- 2.10 The second or 'engineering' method involves the construction of the model of a hypothetical enterprise capable of achieving specified levels of output of particular services or elements thereof. This is done through a knowledge of, for example, the sorting equipment necessary to deal with particular postal flows, or the costs associated with delivering specified volumes of material over a given geographical area<sup>76</sup>. Once the input required has been identified and costed, and necessary common and overhead costs have been added, a total cost can be found for the chosen set of outputs<sup>77</sup>. The process can be repeated for different output levels, in order to investigate the impact on total costs of changes in output. This permits the generation of marginal and average incremental cost estimates for particular services or operations.
- 2.11 The cost modelling underlying Consignia's EPM appears to take a third form. Operational models, representing the underlying production processes, are used to model the costs of particular activities. It is likely that actual costs data are used to calibrate the models. These estimates are supplemented by expert estimates.
- 2.12 Experience in other industries suggests that engineering cost modelling is well suited to estimating equipment costs, especially in highly capital intensive industries. It is less well suited to estimates of labour costs, where operational models may be particularly helpful, and largely ineffective in estimating common or overhead costs. Experience in the telecommunications industry also suggests that a combination of approaches is

<sup>76</sup> For an example of cost modelling of delivery see B. Roy, 'Technico-Economic Analysis of the Costs of Outside Work in Postal Delivery' in M. Crew and P. Kleindorfer (eds), *Emerging Competition in Postal and Delivery Services*, Kluwer, 1999.

<sup>77</sup> Common costs are costs which cannot be distributed among products on a causative basis. Overheads are indirect costs which cannot be so distributed, such as head office costs.



particularly fruitful in appropriate areas. This suggests that Postcomm may be able to utilise engineering cost modelling in relation to the relatively few more capital-intensive activities undertaken by Consignia, but that most cost estimation will involve operational models of labour processes. It is not easy to gauge from published accounts what use is made in cost modelling or Consignia's management accounting data.

### 3 Cost modelling in Consignia's entry pricing model

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

3.2 The essence of the approach is to break down Consignia network into a set of routes, where a route is defined as the end-to-end collection and delivery of a particular product<sup>78</sup>. Routes differ in respect of distance (3 categories), product (x22), size (x4), type of recipient (x2), density of delivering area (x8), and weight (x11). Thus distance falls into three categories - local, neighbouring and distance. Delivery density can take five values: city centre, urban, suburban, rural and deep rural; and there are two recipients - business and residential. This creates a total of 29,040 routes.

3.3 The next step is to estimate the long-run marginal cost (LRMC) of each of the separate activities which make up each route. These are then aggregated to produce an estimate of the LRMC for each route. The activity costs are estimated using a combination of operational models and expert judgement. Operational models cover different activities within Consignia, ranging from the very simple, such as an assumption that sorting costs are directly proportionate to sorting volumes, to more complex models of the delivery operation. In some cases the operational model restricts the activity to a particular technology. To this extent, the modelling is not linked to the standard long-run time period in which all inputs are allowed to vary - for example, delivery on foot might be superseded by use of a van. In cases where particular activities are outsourced, then the actual contract costs are used to estimate the LRMC. Consignia believes that the model is capable of supplying robust estimates for changes in activity of up to 30 per cent in either direction.

3.4 A key conclusion from the model is that LRMC account for 60 per cent of total costs. In other words, the cost volume elasticity with respect to all outputs is 0.6, implying the presence of a substantial "lump" of common and overhead costs and of significant economies of scale. This estimated figure has large consequences both for estimating the net avoided cost of the USO and for evaluating the likely impact of competition on Consignia. It requires careful analysis, both at a technical level and to form a judgement of the extent to which the current cost structure of Consignia is a product of its monopolistic status.

3.5 It is not appropriate to offer a full evaluation of the cost modelling used in the entry pricing model here, as my main objective is to identify Postcomm's cost modelling requirements rather than to evaluate a particular approach. However, the following observations are pertinent:

- The EPM relies upon a combination of operational models, which appear to be calibrated with actual data, and expert judgements. The latter are hard to evaluate.
- The constraints on the re-engineering of certain processes imply that it is not a fully "long-run" approach.
- It is not clear whether what is estimated is long-run marginal cost of particular routes (i.e. the cost of the last letter or packet delivered on that route) or long-run average incremental cost (i.e. the costs causally attributable in the long run to total output of a particular service, divided by output of that service), or some third type of cost, as a degree of cost allocation enters the process<sup>79</sup>.

3.6 To summarise, the cost modelling approach adopted in Consignia's EPM appears to be capable of meeting several of the demands for cost modelling which Postcomm is likely to need to satisfy. In particular, the notion of building up product costs route by route on the basis of analysis of the costs of the various activities which make up those routes is a productive one. It is certain, however, that Postcomm will need carefully to analyse the underpinnings of Consignia's cost model, and it is likely that Postcomm will wish to develop its own model and test it using different kinds of data - management accounting data, operational models and possibly engineering models.

<sup>78</sup> See *Postcomm, An Assessment of the Costs and Benefits of Consignia's Current Universal Provision: A Discussion Document, June 2001. Ch. 3 and Annex 2.*

<sup>79</sup> *Ibid. Para 3.15: "The operational models isolate the main elements within each activity and examine the cost drivers of these elements. The resulting marginal activity costs are then attributed to individual products. Non-directly attributable but marginal activity costs are allocated across products".*

## 4 Costing the universal service obligations

- 4.1 As noted above, Postcomm's primary duty is to ensure that customers continue to be able to enjoy a universal postal service. This consists of the delivery and collection at least once every working day of mail up to 20 kgms in weight and the provision of a registered post, all at affordable prices that are uniform throughout the UK. As in other sectors, the obligation consists of an obligation not only to supply but also to do so at uniform and affordable prices.
- 4.2 Consignia's ability to meet its obligations can be jeopardised in at least two related but distinct ways. In the first place, it might receive a uniform tariff for a service provided under its USO which was insufficient to allow it to recover its costs. This would arise if it did not make enough contribution on its low cost customers to enable it to cover the losses which it incurred on its high cost customers. In such circumstance, the appropriate remedy would be a subsidy from inside or outside the industry. This risk arises in any market structure - monopolistic or competitive - but competition may exacerbate it (see below).
- 4.3 Secondly, competitive entry (without sufficient compensating market growth) might cause Consignia's level of activity to fall and its unit costs to increase. This effect might arise in any circumstances, even in the absence of universal service obligations. It would occur, for example, if in a contestable market optimally served by a single firm, the incumbent was displaced by a more efficient entrant. This is not to deny that effects of the second kind can be exacerbated by restrictions on the incumbent's competitive response. The distinction does, however, provide an argument for treating the two effects differently, while recognising that a costly USO (in the first sense) will exacerbate Consignia's difficulties in the second sense.
- 4.4 It has become customary to address the first question, relating to the net costs of the USO, by establishing the extent to which the universal service obligation forces the universal service supplier to incur losses which it would not incur if the obligation were not present. In other words, the net avoided cost (NAC) of relaxing the universal service obligation is calculated. The maintained hypothesis is that the operator is a 'going concern', so the relevant thought experiment requires an answer to the question: what loss does the operator incur as a result of having the universal service obligation, compared with the situation in which it could withdraw from unprofitable business?
- 4.5 In deciding whether to provide an additional service, a going concern will compare the revenues associated with that service with the incremental cost of providing it. If the former exceed the latter, then the service is making a contribution. In terms of a decision whether to withdraw from provision of the service, the relevant criterion is whether the avoided cost exceeds the loss of revenue. If so, then withdrawal is profitable. In the absence of sunk costs, incremental and avoided costs are the same, so that the criteria are identical.
- 4.6 This analysis suggests that, in order to determine the burden imposed by the universal service obligation, the regulator needs to compare the revenues and long-run incremental/avoided cost of each relevant service and calculate the algebraic sum of all loss-making services - those whose revenues fail to cover costs.
- 4.7 It is apparent that the costs of the universal service obligation, measured in this way, hinge upon the level of retail prices, especially where there are several USO products. Thus if the calculation is made on a basis which is disaggregated product by product (as well as, presumably, geographically), then if tariffs are unbalanced, so that one product is on average charged at below cost and the other at above cost, the estimate of the USO costs will rise. If such a situation arose, it would normally be desirable to re-balance the tariffs on a revenue-neutral basis. Postcomm needs to be able to address this question of the structure of prices, which goes wider than the USO products alone, and, which requires demand estimates as well.

## Evaluation of benefits

- 4.8 It is widely recognised that being a USO operator may confer benefits as well as impose costs. In the case of telecommunications, possible benefits are advertising, branding, and ubiquity - arising from customers' knowledge that the universal service operator necessarily provides service everywhere.
- 4.9 Attempts have been made by OFTEL to estimate the value of USO benefits in the case of BT's telecommunications services. While the results embody a degree of judgement their work shows that these benefits can be significant, and OFTEL consider that this view is widely accepted in the telecommunications industry and at European level. Postcomm has begun to address this issue<sup>80</sup>. It is legitimate for a regulatory commission to incorporate a judgement of the value of the benefits in deciding whether the cost of universal service obligation materially endangers the performance of the obligation. Assuming that the benefit is zero is almost certainly wrong.

## Sharing the costs of a universal service obligation

- 4.10 In the European Union's Directive on Interconnection and Universal Service in telecommunications, provision is made for the national regulatory agency to compute the cost of the universal service obligation, and the net avoided cost method is recommended for this purpose. The NRA may then share the cost of the universal service obligation among all operators in the market, with a de minimis exemption for the smallest. It is recommended that the sharing be done on the basis of revenues. It has been pointed out that, in circumstances where entrants are likely particularly to attack low cost markets, leaving high cost markets to the incumbent, there may be a theoretical case for gearing each operator's contribution to profits rather than revenues - to take account of the fact that a disproportionate share of the incumbent's sales may generate a low contribution. However, this approach has generally been rejected on the grounds that levies on profits have an adverse effect on incentives and that it is particularly difficult to generate an accurate measure of the profitability of an entrant in the start-up phase of its business.
- 4.11 The establishment of universal service fund does not lie within Postcomm's competence, but would require action by the Secretary of State. There are good arguments for Postcomm to have access to an additional policy instrument, both to provide a safety net for the universal service and to provide entrants with greater comfort in the stability of the regulatory regime relating to competition.

## Estimates of the cost of Consignia's current universal service provision

- 4.12 Consignia's current target for level of service exceeds the minimum specified in European legislation. Any costing exercise has to be done on the basis of the costs of the existing service, and to the extent that service standards exceed the minimum, the cost of universal service provision will be over-estimated.
- 4.13 In order to cost the USO a key decision has to be made about the level of aggregation at which the services in question are to be treated. A high level of disaggregation increases the dispersion of costs, but reduces a component of costs which is avoidable. In telecommunications, an iterative process has been developed which involves calculations at various levels of aggregation, reflecting the fact that a telecommunications operator has the practical capacity to make highly disaggregated decisions over which customers to supply. In the case of the postal services, it seems plausible that, in practice, the relevant decision variable for the operator is a postal route - defined (as above) as the collection of a particular post product in

one area for delivery to another. On this footing, the appropriate cost data are route-by-route long run avoidable costs.

- 4.14 The previous section has discussed the degree to which the cost data underlying Consignia's EPM provide such estimates. I concluded that, in general terms, the estimates generated were akin to those required for route-by-route avoidable costs, but that there were inevitable uncertainties as to how precisely the costing procedures implemented the conceptual requirement.
- 4.15 Postcomm's discussion document utilises the EPM data to produce an estimate of the costs of universal service provisions under the current market structure. The report also contains a number of interesting sensitivities, showing particularly how variations in the relationship between long run marginal cost and total cost alter the net cost of universal service provision. It is clear that this is a vitally important element in Consignia's cost structure which requires significant further investigation.

## 5 Costing the universal service obligation under competition

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

## The sustainability of Consignia after entry

- 5.2 Quite irrespective of its obligation to provide services at a uniform tariff, Consignia's position will clearly be affected by the emergence of greater competition. Competition will impose on Consignia the same disciplines on production and pricing that most firms routinely face. The experience of other monopolies suddenly exposed to competition suggests that the company will go through an adaptation period, the length of which will depend in part upon the nature of the competitive challenge.

## The effects of competition

- 5.3 A monopolist is often in the comfortable position of being able to apply across the board cost-plus pricing. The normal concerns a business faces about how to recover its common and overhead costs are largely absent, because the monopolist can simply add an appropriate mark-up to its incremental costs. Under effective competition, this opportunity is lost.
- 5.4 However, the existence of competitors does not automatically impose cost and financial discipline on a former monopolist. It may continue to be dominant, in a sense of being able to behave to an appreciable extent independently of its competitors and customers. The existence of such market power is reflected in the continued need to impose retail price controls in areas where competition is not adequate. The experience of other regulated sectors suggests that the incumbent's market power, and the need for continuing price regulation, may last for a long time.
- 5.5 Is this situation exacerbated by the operator having a USO, apart from the obligation to provide the loss-making services noted above? A tariff ceiling may, if coupled with an obligation to supply, have the effect of requiring the incumbent to provide a loss-making service; it may also limit the incumbent's exercise of market power vis-à-vis customers in other areas. Such interventions do not, however, automatically limit the incumbent's response to competitors' prices, provided it is allowed to price below the ceiling. This points to the fact that one of the key factors bearing upon Consignia's ability to sustain its universal service provision post-entry is the degree of price flexibility to which it will be entitled.

## Sources of the competitive threat to Consignia's sustainability

- 5.6 In order to gain an understanding of the requirements to which Postcomm is subject to satisfy its overriding obligation to ensure the continuation of universal postal provision, it is useful to examine the types of impact which competition will have upon Consignia's financial viability.
- 5.7 Competition is likely to change the composition, as well as the overall size, of Consignia's business. This may require a complete re-engineering of its production processes, and possibly the replacement of traditional processes with new ones. The scale on which operations are conducted may change. Compared with most utility industries, Consignia has relatively few costs embedded or sunk in its network. Most of its limited amount of capital equipment can be used for other purposes. Its buildings can be sold or the leases assigned. Cost modelling operations undertaken by Postcomm should embody the maximum possible flexibility in re-designing processes.

- 5.8 On the cost side, competition is likely to have both positive and negative consequences for Consignia. The positive effect is the stimulus to efficiency which competition is generally regarded as exercising. As part of its work on the price control regime Postcomm intends to undertake studies of Consignia's efficiency in order to form a view about the gap between current performance and best practice. It will, consistently with the licence provisions, have to identify an appropriate transition towards best practice costs. These studies will provide part of the contextual background for evaluating Consignia's susceptibility to competition.
- 5.9 Competition may also have an adverse effect on costs. In the first place, if competition leads to a decline in Consignia's volumes (which is by no means certain, given the underlying growth in demand and the possible stimulating effect of competitive prices), then common and overhead costs will have to be recovered over a smaller volume of sales. In addition, there may be economies of scale on particular routes, arising particularly from the delivery activity. A decline in business on a single route may therefore increase unit costs. Finally, a decline in Consignia's business overall will reduce a level of activity in functions which are common to many, notably sorting and trunking. Any across-the-board loss of business may increase the unit costs of particular routes, through loss of economies of scope.
- 5.10 Postcomm will have considerable difficulties in unpacking these effects. Probably what is required is a series of operational models of particular processes, the results of which can be summarised in the form of a relatively small number of cost volume elasticities. It will also be essential to analyse the level of common and overhead costs, in order to confine this category to expenditures which are genuinely invariant with respect to the overall scale of Consignia's activities.

## Modelling competitive interactions

- 5.11 Judging the sustainability of Consignia in a competitive environment in this broader sense necessarily requires some assumptions about the behaviour of entrant and the incumbent's interaction with them. Such interactions can take many forms. Under some (probably hypothetical) cost conditions, the market may be a contestable monopoly, with the consequence that the only sustainable form of entry is one which wholly displaces the incumbent. At the opposite extreme, the entrant may act as a price follower, leading to a regime in which the incumbent cedes market share gradually to the entrant. Clearly there are a variety of intermediate stages between these two extremes; nor is it likely that Consignia's interactions with its competitors will be identical in all the markets in which entry occurs. Many commentators expect competition to be focused on certain areas, such as Mailsort and bulk customers, where the scope for discounting is greater.

5.12 In order formally to model competitive interaction it is necessary both to have a specification of the cost function of the participants and to make assumptions about the strategies which they adopt. An attempt along these lines has been made by Cremer et al<sup>81</sup>. In their model, the incumbent delivers two products, bulk and single piece mail, to all addresses, while the entrant delivers only bulk mail, to certain addresses located in low cost areas. The perceived quality of the entrant's service increases with the number of addresses served. Its desired scale of entry is thus determined by the interaction of two opposing forces: a larger scale increases average cost but makes the service more attractive. On this basis, and using a numerical simulation, the authors investigate the effects of passive (no price response) and aggressive (limit pricing) strategies practised by the incumbent and the Nash-Bertrand equilibrium. This is an interesting first attempt at modelling competitive interactions, but one where the obvious limitations make it hard to draw broader conclusions. Indeed the authors describe its contribution as being primarily methodological.

5.13 A more detailed, but more simplistic approach can be found in Consignia's entry pricing model<sup>82</sup>. It assumes that competitors set prices equal to Consignia's long run marginal costs. Where these lie below the uniform tariff (which has been adjusted to reflect urban "efficient" costs and their normal rate of return on capital), customers switch to the entrant in accordance with a pre-specified switching function, the chief parameters of which are the price difference and perceptions of quality differences. Consignia is unable to influence the price difference because its prices cannot deviate from the uniform tariff.

5.14 The contrast between these two approaches neatly illustrates the dilemmas of modelling competitive interaction. EPM solves the problem essentially by eliminating any competitive response. This naturally simplifies the arithmetic. The highly stylised Cremer approach is of limited utility at a practical level.

## A possible way forward

5.15 One way forward is to ask to what extent it is possible to 'fix up' the EPM. Its main weaknesses are the specification of the entrants' supply function and the absence of a competitive response on the part of Consignia. The latter could be relatively easily dealt with by putting some limitation on Consignia's competitive response (see the next section); it would also be possible to adopt one or more of the standard cooperative or non-cooperative solution concepts to find an

equilibrium, although regulators have great difficulty in interpreting or endorsing such formal analyses. Postcomm might then take a view on a single or cross-market basis of what outcome is likely to eventuate. However, the entrants' supply functions present a much less tractable problem. The assumption in the model that entrants are able to supply elastically at the incumbent's marginal/incremental cost is an inadequate simplification. It only seems to make sense in a context in which the entrant employs the same technology and enjoy the same economies of scale as the incumbent, yet is somehow relieved of the obligation to recover through its charges the incumbent's substantial lump of common and overhead costs. On this reasoning, it can only serve in long-run analysis as a lower bound on the entrants' supply price.

5.16 To summarise, for the purposes of judging the impact of competition on Consignia's financial viability, Postcomm's cost modelling needs to take the form of acquiring a better understanding of the scale effects associated with different activities, and of Consignia's common overhead costs. It should also begin a medium term programme of work which should enable it to better understand the costs and business plans of potential and (increasingly) actual entrants into the market.

## 6 Cost-based restrictions on Consignia's competitive responses

6.1 The previous section has emphasised the importance of whether Consignia is entitled to deviate from the uniform tariff by offering lower tariffs for particular services. As noted, in the EPM it is not entitled to do so. In the work of Cremer et al both situations are modelled; obviously the incumbent does better and the entrant worse when the former has the additional degree of pricing freedom. But this discussion raises the further question: should Consignia's downward price flexibility be limited by competition law alone, or should it be subject to additional regulatory restrictions?

### Competition law restrictions

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

81 H Cremer et al, 'Entry and Competition in the Postal Market: Foundations for the Construction of Costing Scenarios' *Journal of Regulatory Economics*, Vol. 19: 2 (2001) pp. 107-121.

82 Post Office, *Estimates of the cost of the Universal Service Obligation Using the Entry Pricing Approach*, April 1999.



- i) prices set at below average variable cost are presumed to be predatory and thus abusive; a firm charging such a price fails to recover all of its fixed costs and at least some of its variable costs. This creates a per se presumption of abusive behaviour;
- ii) prices set at below average total cost, but above average variable cost, are also presumed to be predatory, but only if some evidence of intention to eliminate a weaker competitor can be demonstrated.

6.3 In the telecommunication industry, European and UK competition law has adopted an alternative test. This is because it is held that in network industries it is generally inappropriate to measure the costs of supplying of service by reference to its average variable costs. Thus the EC *Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector*<sup>83</sup>, states that:

"A price which equates to the variable cost of a service may be substantially lower than the price the operator needs in order to cover the cost of providing the service .... The cost considered should include the total costs which are incremental to the provision of the service .... (Therefore,) the Commission will often need to consider the average incremental costs of providing a service, and may need to examine average incremental costs over a longer period of one year."

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

## Regulatory approaches

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

allocated cost (including a mark-up for common and overhead costs) to an eventual floor of long run incremental costs.

6.6 A third possibility would be to link the level of the restriction to market share. For example, if Consignia's market share were 100 per cent, it would be prohibited from deviating from the uniform tariff. If it fell to 40 per cent, it could charge as low as long run incremental costs. For market shares between 100 per cent and 60 per cent, its permissible competitive response would be graduated accordingly.

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

## 7 Conclusions

7.1 Postcomm is unique among the sector-specific regulators in the UK in that it has a primary duty to ensure the continuation of the universal postal service. Only subject to this constraint can Postcomm introduce into the market the competition which is likely significantly to benefit customers. This circumstance requires Postcomm to investigate the ways in which competition is likely to impact upon Consignia's financial viability.

7.2 One aspect of the burden of the universal service obligation, parts of which can be computed fairly accurately, is the net cost of the USO. This is defined as the sum of the losses incurred on services provided under the obligation - the loss being defined as the excess of avoidable or incremental cost over tariff revenues, minus any benefits accruing to Consignia as a result of being the universal service provider. It seems reasonable in the circumstances to adopt routes as the individual services with respect to which losses should be established. Consignia's entry pricing model provides a specification of routes and an estimate of their costs. There remain, however, questions about the degree to which Consignia's cost model adequately measures long run avoidable costs. The measurement of benefit also remains controversial.

7.3 The second and less tractable question relates to the impact which entry is likely to have on Consignia's viability. In particular, will it make it impossible for Consignia to break even? It is not realistic to expect this question to be answered definitively solely on the back of economic modelling techniques. In the end,



Postcomm will have to form a judgement based upon a variety of considerations, of which international experience (which generally suggests that incumbents maintain a high degree of dominance) is one. However, an understanding of Consignia's costs is helpful to enable Postcomm to form a view about the extent of which Consignia's costs can be contained as it loses business. If the evidence suggests the existence of substantial economies of scale, then that implies, on one hand, that loss of business will increase Consignia's average costs, but, on the other hand, that Consignia will enjoy a substantial benefit of scale compared with entrants.

7.4 I have examined attempts to go beyond the modelling of costs to analyse likely competitive interactions between Consignia and its competitors, but concluded that the results of any such analysis have to be treated with some care. In the case of Consignia's entry pricing model, some features of the analysis (notably the assumption of the entrant's supply price in the absence of any competitive response by Consignia) make it likely that the estimates produced will be, at best, an upper limit to Consignia's loss of profitability. Finally, if, as is likely, Postcomm contemplates allowing some price flexibility for Consignia, then, in order to constrain competitive responses, it may require information on the long-run incremental or average variable cost of particular routes.

7.5 **Figure 6.1** summarises these requirements, and also includes data needs for two other regulatory functions - retail and wholesale price control. I conclude from this that Postcomm's most urgent need is for a model capable of providing LRIC estimates for individual routes. At present similar estimates are provided by the cost data underlying Consignia's EPM. There are, however, question marks about the degree to which the model is designed to meet Postcomm's needs, and in any case, it is highly desirable for Postcomm to exercise more 'ownership' over its cost model than it does over the EPM. At present, Postcomm is subject to an information asymmetry which it must seek to overcome. Experience of other regulatory bodies suggests that this may take time.

7.6 The second urgent requirement relates to Postcomm's ability to project competitive interactions. On Consignia's side, the EPM can be adjusted to allow a competitive response. However, further work is required to project entrants' supply functions.

7.7 In any event, it would be a mistake to expect to rely on economic modelling to project the development of market shares. Such data can be combined with other information, particularly the result of international experience. In the end, decisions about entry must rest on judgement, guided by the array of available evidence.

**6.1 Cost modelling needs and responses**

|                                  | <b>Incumbent (I) or Entrant (E)</b> | <b>Level of Aggregation</b>                          | <b>Relevant Cost Measures</b>                       | <b>Other Issues</b>   |
|----------------------------------|-------------------------------------|--|---|---|
| Net avoided cost of USO          | I                                   | Route or lower incremental cost                      | Long run avoidable. needed                          | Benefit estimate  |
| Post-entering Sustainability     | I<br>E                              | Route or above for I; scope of entry for E           | Cost-volume elasticities; common and overhead costs | Entrants' cost estimates more problematic                     |
| Restraining competitive response | I                                   | Route variable cost                                  | LRIC or short-run determine pricing constraints     | Regulator must  |
| Price control                    | I                                   | All price controlled Services                        | Total 'efficient' cost                              | Question of controlling individual product prices also arises |
| Access pricing                   | I                                   | Unbundled activity, possible geographically arranged | LRIC plus mark-up                                   |   |

# Appendix 7

## Experience overseas

1 We completed a short review of postal liberalisation overseas, focussing on the countries with the most liberalised postal regimes (Figure 7.1). This appendix sets out our main findings. These may be summarised as follows:

- universal service is maintained under liberalised conditions;
- the incumbent retains dominance;
- there can be significant barriers to entry;
- entrants tend to be innovative and often identify niche markets;
- prices may remain unchanged for long periods, but price differentiation can result in some customers paying more and others less; and
- liberalisation tends to lead to an improvement in quality of service.

### 2 Universal service is maintained under liberalised conditions

In the countries that have introduced competition, the incumbent postal operators have maintained a universal service at uniform tariffs. Those in the European Union, such as Sweden Post AG, meet the EU's definition of universal service<sup>84</sup>. Sweden's National Post and Telecommunications Agency have reported that there is nothing in the Swedish experience that may indicate that competition in the entire postal market should be regarded as a problem. Since liberalisation, the number of undelivered letters has halved and the number of households not receiving a full five day postal service because of difficult geographic location has decreased by a quarter. There has, however, been a significant increase in prices to some customers (see paragraph 6 below).

### 3 The incumbent retains dominance

One feature of liberalised postal markets has been the continued dominance of most incumbent postal operators (Figure 7.1). In Germany, for example, the incumbent (Deutsche Post) retains 98 per cent of the letter market, in part due to its monopoly up to 200 grams. And in Finland the incumbent has remained dominant because competitors have not entered the market.

#### 7.1 The market share of incumbents in countries with the most liberalised postal regimes

| Country         | Extent of Liberalisation   | Market Share of Incumbent  |
|-----------------|--|--|
| Argentina       | Full   | 60 per cent of letter market   |
| Finland         | Full (1994): A licence is needed to deliver mail   | 100 per cent of letter market; 90 per cent of the direct mail market |
| Germany         | Partial (1998): The monopoly includes items up to 200 grams and direct mail items up to 50 grams. This monopoly is scheduled to expire in 2007. There is a menu of licences available to entrants above the monopoly area. | 98 per cent of letter market   |
| The Netherlands | Partial (2000): Reserved area up to 100 grams. This excludes direct mail, which has always been open to competition. Christmas cards are outside the reserved area.  | 90 per cent of competitive market                                    |
| New Zealand     | Full (1998)  | 98 per cent of letter market   |
| Spain           | Partial: Monopoly over all letters and postcards carried inter-city. Letters and postcards for collection and delivery in the same town are not reserved.  |  |
| Sweden          | Full (1993)  | 95 per cent of letter market; 77 per cent of the direct mail market  |

Source: National Audit Office and Postcomm

The level of dominance varies between types of mail, with a tendency for direct mail markets to be more competitive than standard letter markets. For example, Sweden Post AG has some 95 per cent of the letter market but handles only 77 per cent of direct mail. Predatory pricing practices have occurred in the German postal market, with a new entrant (UPS) successfully taking legal action against the incumbent for anti-competitive behaviour in providing access to the incumbent's facilities.

#### 4 There can be significant barriers to entry

There is a tendency for incumbents in liberalised markets to act as a barrier to entry through legal action. For example, Australia Post has challenged several firms who it feels have infringed the remaining monopoly. In Germany, legal action by the incumbent against licence holders and the postal regulator over the granting of new licences has depressed interest, with the result that business opportunities within the licensed area are not being fully exploited. In Finland, the regulator has imposed a different form of legal barrier to entry by requiring all new entrants to pay a fee to support the incumbent's universal service provision<sup>85</sup>. This fee has represented such a significant barrier that there has been hardly any successful entry in the Finnish market, despite full liberalisation.

#### 5 Entrants tend to be innovative and often identify niche markets

Where competitors have entered, they tend to operate in niche markets. In Sweden and New Zealand, for example, competing operators have developed different price and service quality offerings, particularly for local collection and delivery. In the Netherlands, competing operators have tailored direct mail services to suit individual customers' needs such as ensuring that delivery time coincides with the timing of other media. In Germany, there has been a growth in higher quality services which include collection of items from customers at fixed times. The most successful entrant in Sweden, CityMail, focuses on urban mail, principally in Stockholm, Malmo and Gothenburg, with a rolling three-day a week delivery schedule. And in New Zealand, liberalisation has resulted in stamps carrying advertising for local firms and schools.

#### 6 Prices may remain unchanged for long periods, but price differentiation can result in some customers paying more and other less

In some liberalised postal regimes, tariffs have fallen in real terms. In Argentina, for example, prices have fallen by 55 per cent since 1990, while the price of standard letters in Germany has not changed since 1997 and remained unchanged between 1992 and July 2001 in the Netherlands.

Liberalisation has also been associated with price differentiation. Notably, the Spanish national carrier, Carreras, now offers separate local tariffs for local delivery to meet urban competition. And in Sweden, where changes to the tariff structure of the universal service provider do not require prior regulatory approval (except the basic standard letter tariff), the introduction of competition has led to market-based pricing with a breakdown of the previous uniform structure and a rebalancing of prices. This has resulted in price reductions for large businesses, but for individuals and small businesses outside the principal population centres prices have increased significantly.

But there is some contrary evidence that, even in a liberalised regime, postal providers may provide uniform pricing - partly for marketing and branding reasons, and partly to reduce the costs of segregation and separate accounting for individual items. In the United States, for example, private couriers offer uniform pricing for delivery anywhere in the 48 contiguous states, although at a high price.

#### 7 Liberalisation tends to lead to an improvement in quality of service

The limited literature available suggests that competition has not led to a fall in quality of service; and if anything has stimulated an improvement. For example, there has been a 25 per cent fall in the number of households not receiving a 5-day postal service in Sweden (and Sweden post delivers 95% first class post the next day). Quality of service, however, has also improved in some non-liberalised countries in Europe, mainly due to the 1997 European Union Directive (97/67/EC of 15 December 1997) on postal services which set the minimum characteristics of the universal postal service. Italy for example, has significant increases in service quality.

<sup>85</sup> This fee is based on a maximum 20 per cent of the total value of the postal services in the area covered by the licence.

# Glossary

|                            |  |
|----------------------------|--|
| <b>Benchmarking</b>        | Determining, through comparisons with performance or good practice elsewhere, whether there are opportunities to improve efficiency and effectiveness, and to make savings.  |
| <b>Direct mail</b>         | A communication consisting solely of advertising, marketing or publicity material and comprising an identical message except for the addressee's name and address, and which is sent to a significant number of addresses.   |
| <b>Licensed area</b>       | The area within which postal operators require a licence from Postcomm to provide postal services. The current licensed area is below 350 grams or £1.   |
| <b>Long run</b>            | The period when there are no fixed costs.  |
| <b>Modelling</b>           | Analysis to establish casual and formal mathematical relationships between variables. Modelling is used to understand organisational processes, to predict results, to test the effect of a change, and to identify unusual occurrences. The basis of any model is the assumption that there is some relationship between the items being analysed.                                      |
| <b>Net avoidable costs</b> | The costs less revenues the undertaking would avoid if it were to cease to provide a particular element of its business, such as a product. The "net" refers to revenues and not any wider benefits of universal service provision.  |
| <b>Postal packet</b>       | A letter, parcel packet or other article transmissible by post.  |
| <b>Postal service</b>      | One or more of the tasks to convey postal packets from one place to another: collection, sorting, transportation and delivery.   |
| <b>Receiving customer</b>  | The addressee or, in the case of misdirected mail, the person or organisation at the address to which the item of mail has been delivered.   |
| <b>Recorded delivery</b>   | A Royal Mail service for customers wanting their items of mail to be signed for on delivery. The sender gets a receipt, which proves the item has been posted. There is no guarantee of next working day delivery. For items up to 1kilogram, the service costs 63 pence on top of the normal 1st Class or 2nd Class postage. Maximum compensation is £27, for loss or damage.           |
| <b>Sending customer</b>    | The originator of the communication.   |
| <b>Special delivery</b>    | A Royal Mail service intended for customers sending urgent and valuable items. The service guarantees next working day delivery to most destinations in the UK. A signature is obtained on delivery. Three compensation options are offered (£250, £1,000 and £2,500) against loss and damage. The minimum price is £3.60 (i.e. Items up to 100 grams for the £250 compensation option). |