



## Business, Innovation and Skills Select Committee: Competition for UK postal sector and the universal service obligation

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### Consultation response from the ESRC Centre for Competition Policy

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## Consultation Response

We welcome the Select Committee's inquiry into competition and universal service in the UK postal sector. We have experience of analysing the relationship between competition and Universal Service Obligations (USOs) across different sectors, including the postal sector.<sup>1</sup>

In this response, we aim to highlight some of the key issues and attendant policy options which the Committee may want to examine. We focus on some of the inherent tensions between increasing competition, while at the same time ensuring an appropriate and sustainable level of universal service.

### *General comments on competition and USO*

Since 2006, new entrants have been able to enter the entire postal service market. No USOs have been placed on the entrants. There are strong justifications for this. Establishing a nationwide delivery network is cost-intensive, and in many areas the 'final mile' of delivery remains a natural monopoly in the technical sense. New competitors have chosen selective entry. They have been able to offer competitive prices and target the most profitable consumers, while Royal Mail as the designated universal service provider (USP) remains responsible for providing universal service at a uniform price across the whole country. The current situation creates a potential cherry-picking problem and may put Royal Mail at a competitive disadvantage, at least in the long run.

It is worth recalling the problem with introducing competition in a sector where there is a USO. The USO is needed because there are segments which would not be served without it, typically because the cost outweighs the willingness to pay for the service in those segments. By implication, a USO requires at least some cross-subsidy from one group in the economy to another. With a single state-owned or privatised but regulated supplier, dealing with a cross-subsidy does not present a problem for the viability of the firm. However, this will not normally remain the case once competition is introduced, at least in the long term.

As competitors enter the most profitable markets, it is inevitable that cross subsidies will be eroded, either by the gain of market share to those undercutting the incumbent in the high mark-up sectors, or by the incumbent's response of lowering its own price in the high mark-up sectors (and hence the subsidy available for other sectors). Where sub-groups with different levels of cross-subsidy can be identified, a firm can offer the group which is the net-subsidiser an exclusive and better deal. This group will be less costly to supply than the average and, hence, it will be possible at the same time to lower the price and increase the return to the firm. In normal circumstances, the new exclusive deal will on average remove consumers who contributed to the cross subsidy. The more firms can find ways to attract such consumers, the less attractive it will be supplying the remaining consumers, leaving them only with the service of the USP(s). Where the USO is imposed on one firm, it will be left with an adverse selection of consumers, i.e. those who it is on average more costly to supply. Such a firm would either have to raise its prices or require a direct subsidy, either from other firms or from the government.<sup>2</sup> If the response is to raise prices, more opportunities for others to introduce profitable exclusive offers are created, potentially leading to a further erosion of the customer base of the firm with the USO.

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<sup>1</sup> Antje Kreutzmann-Gallasch, Richard Cadman, Michael Harker, Catherine Waddams, 'Criteria to define essential services in telecoms services' (2013) Report for Ofcom, <<http://stakeholders.ofcom.org.uk/market-data-research/other/cross-media/affordability/>>; Michael Harker, Antje Kreutzmann, Catherine Waddams, 'Public Service Obligations and competition' (2013) Report for CERRE, Centre on Regulation in Europe, <[http://www.cerre.eu/sites/default/files/130318\\_CERRE\\_PSOCCompetition\\_Final\\_0.pdf](http://www.cerre.eu/sites/default/files/130318_CERRE_PSOCCompetition_Final_0.pdf)>.

<sup>2</sup> If markets do not work well and the USO is cheap, then it is possible that the firm with the USO can remain financially viable. However, this has implications for who is carrying most of the burden of the cross subsidy.

## *Access*

We now turn to the problem of network access. This requires that the former incumbent/USP (Royal Mail) provides entrants with access to its network. This situation allows a new service provider to choose whether it prefers to fulfil direct delivery itself or to make use of (parts of) the Royal Mail network. In urban areas the competitor may prefer direct delivery, whereas in less populated areas it will choose the second option for cost reasons.

The postal service sector is a labour intensive sector, and the costs of the ‘final mile’ of delivery account for a considerable proportion of Royal Mail’s costs. A legal requirement that every competitor has to provide direct delivery throughout the whole country would not be cost efficient. It will most likely create a significant barrier to entry, and in consequence have an adverse effect on competition.

Thus it is appropriate to allow entrants downstream access, and there need to be clear principles governing the setting of access prices. Beyond the requirements that access prices are based on transparent and non-discriminatory criteria, a number of different pricing methodologies are available. One is the Efficient Component Pricing Rule, which involves entrants paying both the marginal costs of access and a contribution to the overheads of the incumbent. In this case the access price is fixed by subtracting the non-network costs from the final (regulated) price of the incumbent, effectively reimbursing it for its foregone revenue. A company with more efficient non-network costs will be able to pass-on savings to its customers, encouraging the development of competition. However, the use of this methodology has been controversial, with it tending to be favoured by incumbents but not by entrants. Other approaches to the setting of access prices might include average incremental cost or equivalence of input as currently required by Ofcom for some telecommunication services.

## *The scope of the USO*

As mentioned above, the postal services is a market with high labour costs. The ‘final mile’ of end to end delivery is costly and in many areas is still a natural monopoly in the technical sense. Additionally, the letter market is declining as letters are increasingly substituted by e-communications. Declining demand makes it even more difficult for the universal service provider to recover its costs.

Royal Mail as designated USP is obliged to deliver mail six days a week whereas alternative service providers can choose selective entry, i.e., to whom, where and how often they deliver mail. For cost reasons, they will choose to deliver only to customers in profitable urban areas instead of offering direct delivery across the whole country. This creates a cherry-picking situation, and tends to undermine the sustainability of the USO.

Such developments could lead to an inevitable reduction in the scope of the USO. This is possible under the existing legal framework, since the UK Universal Postal Order 2012 goes beyond the requirements of the European Postal Directive which requires only a five days a week delivery/collection (Article 3(3) of Directive 2008/6/EC). Some European Member States (e.g. Sweden, Spain and Slovenia) have, in line with the European Postal Directive, only a minimum five day delivery service. In Spain the universal service provider is under certain conditions exempted from door to door delivery.<sup>3</sup>

So the question arises whether six day delivery/collection is still essential in the UK. The consumption patterns of consumers have changed. Today more and more consumers rely on other methods of

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<sup>3</sup> Alex Dieke, Petra Junk and Sonja Thiele, ‘Universal Postal Service and Competition: Experience from Europe’ (2011) Report, pp. 37, 48 <[http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/TNT\\_Post\\_Exhibit\\_1.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/responses/TNT_Post_Exhibit_1.pdf)> ; AKOS, ‘Quality of Universal Postal Service’ <<http://www.akos-rs.si/quality-of-universal-postal-service>> .

communication than letters. Other countries have already reacted to this situation and have narrowed the scope of their USO.

Following a public consultation New Zealand reduced its basic postal delivery services to three days a week for the majority of its delivery points, but continued to provide a five day delivery to rural delivery points and PO boxes and Private Bag Delivery Points (Point 4 of the DEED of Amendment and Restatement). In accordance with Article 11a of the European Directive 2008/6/EC the usage of delivery boxes especially in rural areas may be another means to reduce the ‘final mile’ costs. Further research is required in order to establish the most appropriate scope of universal service in different circumstances.<sup>4</sup>

Germany has followed a different approach. There has been no specific operator designated as universal service provider since 2007 (before then it was Deutsche Post) and the current position is that a USO will only be imposed on an undertaking if universal service is not being adequately provided. The German Postal Universal Service Ordinance requires a six day end to end delivery of letters and parcels (at least one delivery every working day).<sup>5</sup> The experience in Germany has shown that competition may not have a negative effect on the provision of a USO. The former incumbent, Deutsche Post, is no longer the designated universal service provider; in the letter market all licensed operators provide the universal service jointly.

Managing competition while maintaining the sustainability of universal service may require inevitable trade-offs. As competition increases, the scope of USO may have to be reviewed. We believe that more flexibility and a more consumer-focused approach is needed to meet the evolving nature of USO. We have analysed the evolving nature of USOs in more detail in a report for Ofcom.<sup>6</sup> Although this report focuses on universal service in telecoms, the principles can be applied to postal services. Both the telecoms sector and the postal sector have changed significantly over the last decade. In telecoms, new technologies have evolved which have challenged the traditional concept of universal service. In contrast demand in postal services has declined due to e-substitutions. However, some issues are common to both sectors – declining demand for traditional USOs, the universal service provider claims it is struggling to pay the costs of a USO, and the USOs may be leading to a distortion of competition. It is debateable whether the current concept of the USO in telecoms as well as in post still satisfies the needs of users, or does so in the most cost effective way.<sup>7</sup> However, there are certain categories of consumers (for example, the elderly, those with a disability, citizens living in rural areas and low-income consumers as well as businesses) who still rely more on postal services than other types of consumers and may therefore require a more targeted form of (regulatory) intervention to avoid social exclusion.

The Postal Services Order 2012 requires affordable prices in accordance with a uniform public tariff. Consumer welfare may be increased by replacing the uniform price constraint with a more targeted price cap aimed at securing affordability and preventing social exclusion. This is permitted under the Directive 2008/6/EC which requires affordability and guaranteed access at all geographic locations as long as prices are “cost-oriented and give incentives for an efficient universal service provision” (Article 12(2)).

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<sup>4</sup> For example, as in New Zealand, different basic services may be appropriate for different areas.

<sup>5</sup> For more detailed information on Germany, see Michael Harker, Antje Kreutzmann and Catherine Waddams, ‘Public Service Obligations and competition’ (2013) Report for CERRE, Centre on Regulation in Europe, pp. 35-38, 61.

<sup>6</sup> Antje Kreutzmann-Gallasch, Richard Cadman, Michael Harker, Catherine Waddams, ‘Criteria to define essential services in telecoms services’ (2013) Report for Ofcom, <<http://stakeholders.ofcom.org.uk/market-data-research/other/cross-media/affordability/>>.

<sup>7</sup> *ibid.*

### *Parcel delivery service*

Both the 2008 Postal Directive and the Universal Postal Service Order 2012 include the delivery and collection of packets and parcels within the scope of the USO.

Unlike letters, the size of parcel delivery market has increased as a result of the growing popularity of e-commerce. It is also more competitive than the letter market. It might therefore be possible to maintain a universal parcel delivery service without designating a particular USP. Voluntarily provision may well work in urban areas with a dense population, however, there may be rural and sparsely populated areas which remain unprofitable. Imposing a USO on new entrants to deliver parcels to rural areas might not be efficient and may raise the costs faced by consumers. The average costs of each provider would increase, and they would have to increase prices so that they could cover their costs. Additionally, increasing costs would undermine innovation and R&D.

It may be inevitable to reduce the scope of the USO and cut down the number of deliveries (for example three days a week instead of five days a week) or introduce central delivery and collection points to reduce the costs of direct parcel delivery. To lower the average costs of the USO provider by combining other services with parcel delivery services may allow economies of scope to be achieved.

### *The USO and compensation mechanisms*

In a competitive market a single USP may be unable to maintain the same level of quantity and quality of the USO without additional external funding. In the past the incumbent used cross-subsidies to finance the provision of the USO but in a fully open market the USP will have to lower its prices for profitable sub-groups in order to compete with new entrants. Consequently its margins are lower and cross-subsidisation becomes less feasible. If the USP is required to increase its (averaged) prices in order to finance the costs of the USO, the demand for its services will decrease even further, and the higher prices may result in the service becoming too expensive for disadvantaged consumers, particularly those on lower incomes. The constraints that apply to the USP do not apply to new entrants. They can choose selective entry and target only the most profitable markets. Thus, in order to maintain the USO in the postal sector the establishment of a compensation mechanism may be inevitable.

There are a number of different options, for example, a direct public subsidy, a sharing scheme, a compensation scheme based on ‘play or pay’<sup>8</sup> or franchise bidding. These mechanisms each have their own advantages and disadvantages.<sup>9</sup> Direct public subsidies are deemed to be least distortionary.<sup>10</sup> Nonetheless, a direct subsidy may hinder innovation as the universal service provider may, depending on the size of the subsidy, have no reason to invest in new technologies or make cost savings. If a sharing mechanism or universal service fund is imposed, the fund has to be proportional and be based on objective, transparent and non-discriminatory criteria to prevent the USP from exaggerating the costs of meeting the USO. Furthermore, one has to be cautious that new entry is not stifled, and it may be necessary to exempt firms who have yet to achieve a certain presence in the relevant market from contributing to the fund, so as not to create a barrier to entry.<sup>11</sup>

The play or pay mechanism can increase the costs of a new entrant. A play or pay schemes requires that each service provider operating in the market serves a particular portion of loss-making consumers or

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<sup>8</sup> This was introduced as a principle when the gas market was first opened in the UK, though not implemented.

<sup>9</sup> For an overview, see Michael Harker, Antje Kreutzmann and Catherine Waddams, ‘Public Service Obligations and competition’ (2013) Report for CERRE, Centre on Regulation in Europe, pp. 17-18.

<sup>10</sup> Commission, ‘Green paper on Services of General Economic Interest’ (COM(2003) 270 final), Annex, para 62.

<sup>11</sup> *ibid.*

pays a contribution into a central fund. If the new entrant chooses selective entry and not to provide its services to non-profitable consumers, the firm has to pay, which again may create a barrier to entry.

Entry in the postal service market might be further encouraged by introducing ‘regulated competition’. The concept of regulated competition is commonly used in the railway sector. It is based on public service contracts awarded by a competitive tendering process. The service provider would have to establish the costs of the provision of universal service in advance in order to take part in the bidding process. Franchise bidding may foster innovation, but research has also shown that franchise bidding, where after a successful bid only one operator serves in a particular market, can reduce the competitive pressure on the undertakings and may lead to higher prices. Further problems emerge if the franchise is reallocated after significant investments in assets have been made by the original franchisee.<sup>12</sup>

In calculating the appropriate level of compensation for a USP, it is important to note that offering universal service carries with it certain advantages. One intangible benefit is “the reluctance of consumers to switch away from incumbent suppliers”, the *de facto* USPs.<sup>13</sup> Other advantages of being the USP are brand enhancement, access to comprehensive customer data, and the ubiquity of a brand.

### ***Concluding remarks***

We are of the view that the Committee needs to address three key issues:

1. Since there will always be element of natural monopoly in a comprehensive postal service, there needs to be in place an access pricing scheme which strikes the right balance between encouraging new entry while at the same time maintaining the sustainability of the USO. This will involve appropriately compensating the USP.

2. Since demand in the letter market is declining, the costs of universal service, and the cross-subsidies necessary to support it, are rising. Beyond an appropriate access pricing regime, compensation mechanisms for universal service may need to be put in place. However, in order to provide incentives to keep the costs of the USO low, the Committee may want to consider the desirability of introducing an element of contestability in the provision of universal service (e.g., play or pay schemes, or franchising).

3. It may be, even within the existing legal framework, that the UK should reduce the scope of the USO currently facing the industry. This is to reflect not only the declining demand in the letters market, but also the changing consumption patterns of consumers. This could lead to a departure from uniform pricing. In doing so, however, regard should be given to the particular needs of disadvantaged consumers and the potential for social exclusion.

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<sup>12</sup> Michael Harker, Antje Kreutzmann and Catherine Waddams, ‘Public Service Obligations and competition’ (2013) Report for CERRE, Centre on Regulation in Europe, pp. 11, 17.

<sup>13</sup> *ibid* (76).