

## **ERGP consultation – Access to the postal network and elements of postal infrastructure**

The Communication Workers Union (CWU), the largest trade union for communications in the UK, represents over 200,000 members employed in the postal, telecommunications and financial services industries.

### **CWU issues and comments**

The CWU welcomes the opportunity to comment on the ERGP report on access competition in the postal market. The report presents the findings of ERGP's 2011 survey of European regulators, and contains a number of case studies, including from the UK.

Access competition as it has been introduced has had a profound impact on the UK postal market and the finances of Royal Mail. Consequently, access competition has for a number of years been an area of great concern to the CWU, and we have a number of comments on the presentation of this issue by the ERGP, which we hope will contribute to improving the work of that group. Our comments are restricted to the UK dimension in this debate.

### **Access competition and the universal service**

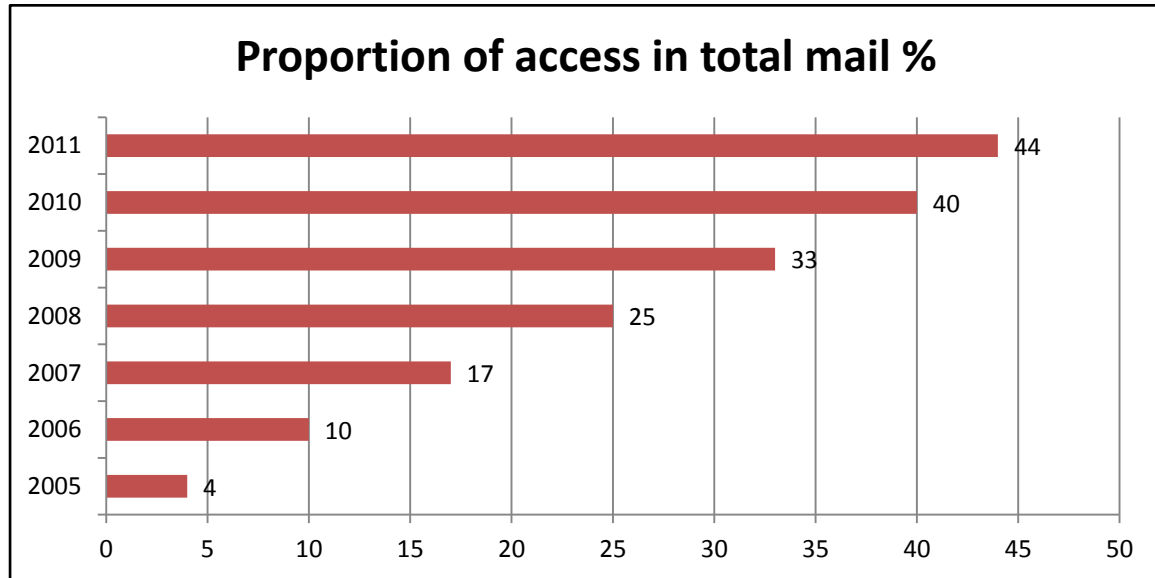
It is striking that in their extensive treatment of access competition, ERGP do not once consider the impact this has on universal service provision. The reality is that Royal Mail's financial position has, since the introduction of liberalisation, become so precarious as to raise serious concerns about their ability to provide the universal service. Of all the elements of the liberalisation process, access competition has had the most significant impact on the shape of the market and Royal Mail's finances. Poor decisions by the regulator on how access should be introduced have significantly contributed to the current situation.

The CWU has long argued these points, but in more recent times our views have come to form the consensus among stakeholders, notably the UK Government and Royal Mail management. It is therefore of serious concern that regulators continue to consider access in isolation of the broader issue of universal service delivery. This paper summarises the impact of access competition in the UK, highlights mistakes in the regulatory framework which introduced it, and provides evidence that criticisms of the regulatory framework are not limited to the CWU.

### **The impact of access competition in the UK**

To date, the vast majority of competition in the UK has been in the form of downstream access. Between 2005 and 2011 the proportion of all UK mail delivered under access arrangements grew from 4% to 44%, while other forms of competition in letter post remain at an embryonic stage. With the overwhelming majority of final delivery in the UK still carried out by Royal Mail, these figures suggest that almost one in two letters delivered today by a CWU member will have been collected by an access operator. It is unlikely Royal Mail will be in a position to recapture any significant market share, not least because declining upstream volumes combined with fixed costs of delivering the universal service have served to increase Royal Mail's unit costs. This is a fundamental shift in the composition of the UK postal market, which is not recognised by the ERGP report.

## Proportion of access in total mail 2005 – 2011



Source: Ofcom Communication Market Report 2012

### The regulatory framework

The Postal Services Act 2000 permitted the introduction of competition with Royal Mail in the postal market, but left the detail of how to implement competition in the hands of the regulator, at that time Postcomm.

Downstream access was mandated by the regulator at the outset of liberalisation, rejecting arguments for a gradual introduction or mechanisms to assess the impact of proposals on universal service provision. It may have been of interest for the ERGP report to consider whether early mandatory access was successful in delivering efficiency improvements.

The regulator took an interventionist approach to the setting of access prices in the first major negotiation, between Royal Mail and competitor UK Mail. As ERGP report, the regulator published a notice of intention to direct the terms of the access contract, including specific prices, following lengthy negotiations between the two companies<sup>1</sup>. The threat of direction effectively undermined Royal Mail's negotiating position, so that they were forced to reach an agreement at lower prices.

The regulator at the time claimed the specified prices would allow a return of 6% on cost, rejecting arguments by Royal Mail that the cost analysis had failed to consider certain network costs. It is now accepted that the regulator's assessment was incorrect, leading to prices set below marginal cost. The ERGP report paints an incomplete picture of this process, failing to identify this crucial error.

In addition to involvement in setting the price, Postcomm introduced ex-ante price controls known as the access headroom regime. Under this control, the minimum price Royal Mail could charge for high volume bulk mail products was regulated at a fixed level above the

<sup>1</sup> Postcomm, Notice of a proposed direction to royal Mail on downstream access by UK Mail to Royal Mail's posting facilities, 2003

price charged for access to the downstream network. As this 'headroom' remained fixed, Royal Mail could not reduce its end-to-end bulk mail prices without also reducing the already below cost price it was required to charge for downstream access. These regulations effectively prevented Royal Mail from competing for bulk mail contracts.

The regulator also rejected arguments for a universal service support fund to contribute towards the costs incurred by Royal Mail in providing the universal service.

### **The impact of access competition on Royal Mail**

The collective impact of regulatory decisions on access competition was to create a regulatory environment which very quickly had severe consequences for Royal Mail.

Mandatory downstream access under the terms imposed by Postcomm rapidly resulted in vast loss of business for Royal Mail. In itself this contributed to major losses for the company, but the pricing and headroom regime compounded the impact. Royal Mail effectively subsidised competitors activities by being forced to provide final mile delivery at a loss, while unable to set competitive prices to retain bulk mail contracts, encouraging inefficient cream-skimming entry.

The commercial data detailing the impact of access is not available to the CWU. However Royal Mail have stated that 50% of bulk mail contracts were lost over the liberalisation period; claim that access pricing led to them subsidising competitors by as much as 2.5 pence per item; and estimate the losses directly attributable to unfair access competition at £150m a year.

Royal Mail's overall financial position has become so precarious that in 2011 the company was subject to monthly going concern evaluations, and would without intervention have been unable to meet its costs by 2012.

As a result the UK government intervened with substantial financial support for Royal Mail, following state aid approval from the European Commission<sup>2</sup>. The state aid package included:

- Government to take on approximately £9bn of unfunded pension liabilities;
- £1.7bn of debt write-off;
- £200m credit facility.

### **Criticisms of the access regime**

There is now a broad consensus that mistakes were made in the way access competition was introduced in the UK.

#### The UK Government

The UK sought to justify the provision of state funding to support Royal Mail in its application for state aid approval from the European Commission. The public version of the application states that:

"The UK claims that the disproportionate size of the pension deficit is at the heart of the

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<sup>2</sup> State aid No SA.31479 (2011/C - ex 2011/N) – United Kingdom state aid measures to Royal Mail

current financial problems of RMG. According to the UK, other factors contributing to RMG's financial difficulties include:

...

- Negative impact of the pro-competitive regulatory regime

According to the UK, the allegedly too low access prices that competitors have had to pay for the use of RMG's network have led to a substantial decrease of RMG's market share in the upstream services market."<sup>3</sup>

### Ofcom

Whilst generally diplomatic in avoiding overt criticism of their predecessor organisation, Ofcom made significant changes to the treatment of access since taking responsibility for postal regulation.

These changes include abolishing the access headroom regime, and leaving Royal Mail the commercial freedom to set access prices through negotiations.

In relation to the access headroom regime, Ofcom consider arguments by Royal Mail that its rigid nature impeded efficiency improvements. In a tacit admission that this was the case, Ofcom state that their revised framework for regulating margin squeeze would eliminate these impediments.<sup>4</sup>

Ofcom also abandoned Postcomm's interventionist approach to access price setting. Although not as explicit as the Government on the issue of below-cost pricing, Ofcom clearly imply that under Postcomm access prices forced Royal Mail to operate at a loss, and undermined the universal service:

*"In terms of setting prices for access, however, it is clearly necessary that these allow Royal Mail to cover the costs of the network adequately. If they do not, then the universal service will be further undermined."<sup>5</sup>*

### Academic experts

A number of commentators have raised questions about the suitability of access competition as it has been introduced in the UK.

John Panzar analysed the impact of mandatory unbundled access in postal markets where a universal service obligation and uniform tariffs apply. Panzar concludes that the potential benefits of mandatory downstream access needed to be weighed against the costs. He also examined the question of pricing such access through a system of work sharing discounts, with the objective of avoiding undesirable cream-skimming entry, and demonstrated the need to apply average incremental cost price floors in the presence of averaged uniform tariffs. Panzar questioned the overall welfare benefits of mandating downstream access in postal markets, compared with other infrastructure industries such as telecoms, because of

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<sup>3</sup> *Ibid* s. (30)

<sup>4</sup> Ofcom. 2011. Securing the Universal Postal Service: Proposals for the Future Framework for Economic Regulation, ss. 2.39 – 2.40

<sup>5</sup> Ofcom. 2011. Securing the Universal Postal Service: Proposals for the Future Framework for Economic Regulation, s. 1.58

the absence of high sunk costs. The same paper also predicted that such an access regime would naturally lead to attacks on the crucial 'one price goes anywhere' tariff.<sup>6</sup>

Similarly, when Crew & Kleindorfer proposed increasing competition by allowing downstream access with regulated tariffs, combined with negotiated upstream access, they were clear there was "...no guarantee that our proposals will safeguard the USO". Noting that Postcomm were the only body at the time considering such radical competitive structures, they urged a "gradual and conservative introduction of change"<sup>7</sup>.

The CWU's position on the impact of regulation in the UK are set out in more detail in [our submission to the 2012 Conference on Postal and Delivery economics](#).

## **Conclusions**

The CWU believes there is potential value in the work of ERGP, in particular in establishing best practice and pan-European norms for regulatory processes within the common market.

In order for this potential to be fulfilled, it is crucial that ERGP present an accurate and balanced picture of the role of regulation in the competitive postal market. We are concerned that, at least in the case of the UK representative, this does not appear to be the case. ERGP is of questionable value, and indeed has the potential to contribute to the dissemination of damaging regulatory practices, if it is allowed to operate for the benefit of its members, rather than users of the postal service.

We note that under the ERGP's mandate they are instructed to consult "...extensively and at an early stage of its expert work with market participants, consumers and end-users in an open and transparent manner."<sup>8</sup> We hope the ERGP's reporting on access arrangements will properly reflect the experience of stakeholders, in the spirit of this direction, and in order to ensure their work is of genuine value.

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<sup>6</sup> Panzar John. 2002. Reconciling Competition, Downstream Access, and Universal Service in Postal Markets

<sup>7</sup> Crew, Michael & Kleindorfer, Paul. 2002. Balancing Access and the Universal Service Obligation s.3 para 3

<sup>8</sup> Commission decision (2010/c 217/07), Art. 2(d).