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**Regulatory Risk and Uncertainty in British Postal Regulation - A Governance Perspective**

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*Abstract*

In this paper we focus on risk and uncertainty caused by the (1) discretionary behavior of regulatory bodies and (2) the instruments and mechanisms implemented to regulate public services in general and the postal sector in particular. In previous articles we developed an analytical framework for the assessment of direct and indirect regulatory governance costs in regulated industries. In the present paper we aim to further develop the construct of indirect costs of regulatory governance with respect to regulatory risks and uncertainty. The topic gains increasing importance in the debate on current regulatory reforms. Regulatory risks may occur on different levels of regulatory activities. To analyze where possible indirect costs of risk and uncertainty could occur we investigate a case study in the UK postal market. In postal markets these types of costs occur mainly with regard to universal service obligations, licensing regimes, access regulation, price control, structural market entry barriers and adaptations of regulatory regimes.

*Keywords*

regulation, regulatory risk, uncertainty, governance costs, postal sector

## 1. Introduction

Several definitions of regulatory risk and uncertainty are described in the literature. The topic gains increasing importance in the debate on current regulatory reforms. In this paper we focus on risk and uncertainty caused by the (1) discretionary behavior of regulatory bodies and (2) the instruments and mechanisms implemented to regulate public services in general and the postal sector in particular. In previous articles (e.g. Maegli/Jaag, 2009) we developed an analytical framework for the assessment of regulatory governance costs in regulated industries. In this framework we distinguish between direct and indirect costs of regulation: Direct costs occur in relation with the institutional design of the regulatory framework and the behavior of actors. Indirect costs arise because of distorted incentives in the regulated market which result in an inefficient supply of goods and services. In this article we further develop the construct of indirect costs of regulatory governance with respect to regulatory risks and uncertainty.

Regulatory risks may occur on different levels of regulatory activities. Knieps and Weiss (2008) for example state that as long as the competency to specify the areas and the instruments of sector specific regulation is delegated to regulators, a clear and economically founded regulatory basis will not be implemented due to conflicting interests of the regulator himself. Another aspect of regulatory risk and uncertainty is that today's regulatory institutions always affect future regulation. By the time the characteristics of the monopolistic bottlenecks and network-specific market powers disappear within parts (or the in whole) network (e.g. due to technological advances), the regulatory intervention becomes obsolete. The "phasing out" of sector-specific regulation may be delayed by regulator's self-interested behavior and his interest in continuance. The uncertainty associated with the evolution of the regulatory framework affects the market participants' decisions and hence the development of the market itself.

The two main questions we would like to answer in the present article to further develop the framework of regulatory governance costs<sup>1</sup> are:

- (1) Where do regulatory risks and uncertainties in postal regulation occur?
- (2) What are possible impacts on the development of the market?

The paper will be structured as follows: After this short introduction we give a brief overview about regulatory risks in public services in general. In order to address the two questions we will outline the British postal regulatory regime before we apply the idea of regulatory risk and uncertainty in the postal sector and explore some practical examples in section three. In section four we draw some conclusions.

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<sup>1</sup> The costs will not be quantified in the present article.

## 2. Overview: Regulatory Governance Costs

In this rather theoretical section we briefly line out our framework of regulatory governance costs and its background. The focus is set on indirect regulatory governance costs with respect to regulatory risk and uncertainty.

### 2.1 Regulatory failure and its effects on an economy

The original model of perfect competition leads to many desirable results: only the most efficient suppliers survive and produce at the lowest possible prices, prices are optimal, consumer welfare is at its maximum and consumers can't get better off without making any other worse off. The original rationale for government intervention and the introduction of regulation in network industries was the correction of market failures linked to persistent monopolistic bottlenecks. The result of regulatory intervention (such as network access or price regulation) is ideally positive, thus an existing market failure is corrected. But if economic regulation is more costly than beneficial, it results in an overall welfare loss. Indirect costs of regulation do rarely arise because of the institutional design of the regulatory system, they are rather a consequence of the mode of regulation and the instruments implemented to achieve the regulatory objectives. The economic assumption was that without regulatory intervention, prices will be too high, restricting demand and creating excess profits; all these inefficiencies lead to high social costs and a loss of welfare. But it may come about that policy makers and/or regulators use wrong or imperfect models to guide their decisions, with a major impact on the investment incentives of firms, a misallocation of resources and a lowering of social welfare. The indirect negative effects of regulatory governance may result from a distorted static and dynamic allocation through improper pricing, technology choice and innovation incentives. The characteristics of these issues are often a result of regulatory governance respectively regulatory decisions.

The overall assumption of regulatory failure is that while the objective of regulatory intervention is to improve market functioning, actions of regulators can have unintended negative outcomes as well. These outcomes may have effects on the nature of the market and the availability of products provided in the market, consumer choice, the level of innovation or even discourages firms from entering into markets. The impacts of the costs are observable in form of suboptimal choice of technology, a biased behavior in the market or a biased investment and innovation in the regulated market.

In sum regulatory failure might occur because some regulatory mechanisms work adequately in a particular sector or country, but do not consequently result in the same outcome in another sector. Regulatory mechanisms do not work adequately in other markets or industries without any adjustment. Therefore the choice of adequate or optimal regulatory tools and mechanisms is often related to specific characteristics and the market structure in a particular industry or geographical market.

### **Market and prices**

Crew and Kleindorfer (2006) argue that price regulation does not necessarily result in economically optimal prices in monopolies. The optimal (Ramsey) access price, for example, considers not only the marginal costs but also the price elasticity of demand and the substitutability between the full service and partially access to sub-processes. The determination

of Ramsey charges in practice often fails by reason of its sophisticated econometric calculation and the analysis of costs.<sup>2</sup> Whenever regulators try to determine the efficient Ramsey price, they face considerable information asymmetries because they have to know price elasticities as well as the marginal costs of the operators. This information may be inaccurate or simply not available. Crew and Kleindorfer (2006, p.74) conclude that due to the predominant information asymmetries expectations from Ramsey price regulation as well as the incentive regulation intended to motivate operators toward more efficient pricing and production is limited. These instruments are not likely to result in efficient pricing. According to Knieps (2005) regulators should not oblige operators to rigid pricing structures since this constrains the entrepreneurial initiative for innovative pricing. Furthermore it is possible that more favorable pricing rules and tariff systems are found in the future. The development of innovative pricing schemes should be open to all competitors (incumbents and new entrants) and not be hindered by inadequate authorization procedures of regulatory authorities. If some pricing systems can be offered exclusively by entrants, this will constitute a structural handicap for competition and discrimination for other operators. Moreover, the pricing structure of a functioning market is an important signaling function for new competitors: If prices are cut too deep through price regulation it may prevent potential competitors from market entrance.

Other factors associated with the development of a market are structural or institutional entry restrictions. A general attribute of network industries is that governments (or regulators) grant licenses and concessions. The aim of the licensing system is (1) to oblige the operators to render a certain level of public services or (2) conversely to limit the scope of the provided service. But who defines due to which information what the optimal and efficient number of operators in the market is? Depending on the criteria applied, there are different effects on competition.<sup>3</sup>

Another restriction with effects on the market may be the setting of minimum wages. The setting of minimum wages in the German postal sector shows that potential competitors have not entered the German market.<sup>4</sup> This measure and the exemption of Deutsche Post DHL from VAT are criticized by many competitors (especially TNT) as being market access barriers: Noting that market deregulation in Germany is incomplete the Dutch government has therefore already postponed complete liberalization twice. The example of Germany shows that not only no new competitors entered the market, but also the opening of a foreign postal market has been delayed.

Other negative consequences of regulatory intervention may occur by weighting market power and distortion of competition against efficiencies in the market. Thus potentially anti-competitive mergers, agreements or business practices could also have positive effects on the market. While a merger leads to a higher concentration of firms in a market, it also lowers costs through economies of scale. Exclusive supply or purchase contracts may result in more efficient sales and improved information exchange, but also protect operators from (desired) competition.<sup>5</sup> This

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<sup>2</sup> See Elsenbast (1999: 59).

<sup>3</sup> For example, in 2000, the Swiss government tendered four UMTS licenses in the telecom market. Even if rational considerations led to the perception that the number of licenses is four, this does not necessarily imply that four players are the optimal number of competitors. See Vantomme/ Fratini (2008) to learn more about licensing systems in the postal sector.

<sup>4</sup> See Ecorys (2008).

<sup>5</sup> See Oxera (2004, p.15).

does not imply that competition regulation in general, and merger control in particular has just negative effects on markets. However, the principals should take in consideration that potentially positive market developments may be prevented by this type of regulation.

### **Investments and technology**

An excessive regulation with rigid social, regional or even environmental objectives might prevent the regulated operators from aligning their supply with the effective demand and the consumer needs. This may adversely affect investment activities: regulation should provide innovation and investment incentives in a manner that allows the companies to exploit their investments. As long as the incentives and protective measures are sub-optimal and don't protect investments, there is less innovation and no investment in new technologies in the sector. In turn the market may not develop to the desired extent.

An illustrative example for this kind of phenomenon is access regulation to monopolistic bottlenecks. Access regulation leads to a situation where access prices are under constant pressure by the customer. Thus access customers are interested in low prices to cut their costs and to offer their services below the incumbent's price level. However, the owner of the monopolistic bottleneck is traditionally motivated to negotiate access prices as high as possible. The incentives for innovation are therefore negatively influenced by the fact that on the one hand the facilities' owner is not interested in developing its facilities and pass its efficiency gains to rivals at a low price. At the same time, other operators or new entrants have little incentives to invest in their own infrastructure and potential substitutes. The problem gets even worse if regulators set access prices ex ante and on a low level. Depending on the characteristics of the industry it might happen that the more efficient market situation rather results from no regulation than from too rigid regulatory rules.

Knieps (2005) as well as Sidak and Spulber (1998) argue that potential new competitors have no incentive to enter a market with a new technology, if they can buy the necessary capacity at the same (or even better) conditions from the incumbent and fulfill parts of the services by means of the existing infrastructure. This is increasingly the case, if entrants have reasons to fear that the new technology is substituted by more efficient solutions and therefore devaluated in a short time period. Furthermore the incumbent operators lack incentives to invest in the network infrastructure because they can hardly expect to recover their capital expenditures.

## 2.2 A framework: Categories of regulatory governance costs<sup>6</sup>

In our previous articles we developed a framework of regulatory governance costs. In the following part we give a brief overview about the definition and the categories of the different costs before we further develop the idea of indirect costs of regulatory governance.

The original rationale for state intervention in markets (respectively in network industries) was the correction of market failure, i.e. (1) to stimulate competition where it is inexistent or poor, (2) to guarantee a minimum level of public service and (3) to assure the efficient use of the network infrastructure. Regulation should therefore have a positive effect on the economic and social

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<sup>6</sup> Section 2.2 and 2.3 rely on Maegli/ Jaag (2009).

welfare.<sup>7</sup> However, governmental regulatory intervention also causes costs. In determining the optimal regulatory intervention it is therefore necessary – as for other projects - to analyze the costs as well as the benefits of regulation. Ideally the net costs of the regulatory intervention are negative (a surplus), otherwise an intervention shouldn't be implemented.

According to new institutional economics, these costs will depend upon the formal and informal rules among the involved actors, upon the allocation of property rights among these actors, as well as upon the various principal-agent or more generally contractual relationships among these actors. At the most general level new institutional economics reaches the conclusion that regulation has a cost, which can be of course optimized, but which nevertheless will be unevenly distributed among the actors of the broader institutional framework.<sup>8</sup> We assume that these costs are inherently present in any institutional arrangements and as such are determined by

- (1) the institutional design and the alignment of competences (rules and actors),
- (2) the behavior of the actors,
- (3) as well as by the choice of regulatory instruments,

within an institutional framework. These costs are related to tasks and transactions in regulatory regimes concerning bargaining and decision-making processes in policy making as well as policy enforcement, the control of institutional actors and the industry and the search and supply of information. We define regulatory governance costs as the *costs of establishing<sup>9</sup>, maintaining and coordinating, evaluating and adjusting a regulatory arrangement.*

In line with Bauer (2005) and his definition of administrative burdens we describe governance costs in a regulatory context as the costs related to tasks performed to sustain competitive but fair markets, set incentives for involved actors to provide a certain level of public service, and to coordinate public authorities involved in regulation.

In the following we distinguish between direct and indirect costs of regulation. Direct costs occur in relation with the institutional design of the regulatory framework and the behavior of actors. Whereas the indirect costs arise because of false incentives as well as regulatory risk and uncertainty. They finally turn out in an inefficient supply of goods and services. The amount of direct cost may in some cases be quantified (e.g. the annual budget of regulators or administration costs). In contrast to direct costs the indirect costs and their negative impacts are often hardly quantifiable and may have to be analyzed on a qualitative basis.<sup>10</sup>

### 2.3 Direct Costs of Regulation

As mentioned above, regulatory interventions in markets are not costless. On the one hand the institutional regime has to be defined. On the other hand the relevant authorities have to be set up and furthermore get granted with the resources which enables them to monitor markets as well as

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<sup>7</sup> See Stigler (1971) and Peltzman (1976) on the theory of economic regulation.

<sup>8</sup> Similar work on costs and benefits of government regulation is done by den Butter et al (2009).

<sup>9</sup> We will not go into the details about the costs of establishing or building up a regulatory regime in our explanations.

<sup>10</sup> See Oxera (2004, p.15).

the involved actors and consequently to implement the regulatory guidelines. This includes the creation of independent bodies which control the activities of regulatory authorities and coordinate different authorities involved in regulation (e.g. competition regulators vs. sector-specific regulator) and compliance requirements. In short we distinguish three different types of *direct* regulatory governance costs<sup>11</sup>:

- *Monitoring costs* arise because of informational asymmetries in their relationships of principals with their agents.
- *Compliance costs* are the costs the industry face in order to comply with regulatory requirements.
- *Coordination costs* result from multiple institutional actors involved in regulated industries, and that the different actors have to be coordinated.

#### 2.4 Focus: Indirect Costs of regulatory risk and uncertainty

The important questions regarding indirect costs of regulation are whether adequate regulatory models and methods are implemented and if the chosen means are capable to correct a market failure rather than result in regulatory failure. We would like to introduce the term of regulatory risk and uncertainty to integrate a more dynamic perspective in the framework of regulatory governance costs. A crucial question related to (long-term) investments is: Who bears the risks? Is it the incumbent operator, the new entrants, the government or the customers?

#### **Regulatory uncertainty**

The outcomes from future regulatory decisions and its impact on the developing of markets can't be predicted with certainty. This leads to regulatory uncertainty, which is a direct consequence not only of regulatory discretion by regulators but also of government legislation and the interaction of different regulatory bodies. Today's regulatory institutions always affect future regulation. By the time the characteristics of the monopolistic bottlenecks and network-specific market powers disappear within parts (or the in whole) network (e.g. due to technological advances), regulatory intervention may be obsolete.<sup>12</sup> Armstrong and Sappington (2006: 360) state in this context: "Consequently, although liberalization should ultimately lead to reduced regulatory oversight and control, more pronounced regulatory and antitrust oversight may be required on an interim basis to ensure that regulatory policy is tailored appropriately to the evolving level of competition and that competition is protected".

The process of so-called "phasing out"<sup>13</sup> of sector-specific regulation may be delayed by regulator's self-interested behavior and its interest in on-going regulation.<sup>14</sup> It is fairly obvious that regulators are rarely interested in reducing their influence and cutting their own competences. Regulators have some bureaucratic self-interest and tend to act in their own

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<sup>11</sup> Direct regulatory governance costs are nor subject of the short case study in section 3 They are mentioned for the sake of completeness. See Maegli/ Jaag (2009) for a detailed discussion of regulatory governance costs and examples in the area of postal regulation.

<sup>12</sup> See Knieps (2007, p.191).

<sup>13</sup> "Phasing Out": The period of time when the rationale for regulatory intervention is no longer tenable and the sector-specific regulation is likely to be abolished.

<sup>14</sup> See Knieps (1997).

interests and contrary to the intentions with which they were originally established.<sup>15</sup> Bonardi et al. (2006) argue that agency decisions can have important consequences for stakeholders (especially firms)<sup>16</sup> and that agencies behave differently from elected political institutions. Regulators are generally appointed rather than elected. Therefore they do not face the election constraints that typically motivate elected politicians' behavior. Mueller (2003) and Wheaterby (1971) highlight that that regulatory agencies' objective functions are multidimensional: regulators tend to maximize their budgets, enlarge the number of employees or enhance career prospects and political reputations. Wilks and Bartle (2002: 148) argue that the agencies were not expected to be extremely active in developing and implementing policies. However, the regulatory agencies have become more active than expected and have contributed to policies.

### **Regulatory risk**

There are not only technological and systemic risks<sup>17</sup>, but also risks and uncertainties in relation to regulation and the socio-political goals of universal service. Oxera (2004) defines regulatory risk as "the risk that arises when the interaction of uncertainty and regulation changes the cost of financing the operations of the firm" (p. 16). Investment activities and thus the development of an efficient market are seriously constrained if these risks are unilaterally borne by some operators or even solely by the incumbent operators.

The extend of regulatory risk is highly related to the modality regulators apply to the operators: Inconsistent decisions, new control mechanisms and the application of new regulations may result or lead to an increase in regulatory risk. Previous work on the issue with regard to the UK highlights that inconsistencies in the actions of regulators at price reviews may result in an increase of cost of capital.<sup>18</sup> Furthermore, regulatory risks may occur on different levels of regulatory activities. Knieps and Weiss (2008) for example state that as long as the competency to specify the areas and the instruments of sector specific regulation is delegated to regulators a clear and economically founded regulatory basis will not be applied. Following their example the market power regulation might be either oversized or undersized or even leave areas of network specific market unregulated. Another example they examine is that the application of price-cap

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<sup>15</sup> Actors react differently to external threats, constraints and opportunities because they differ in their intrinsic perceptions and preferences but also because these are shaped by the specific institutional setting within which they interact (Scharpf 1997: 37). Crozier (1964) interprets such a behavior as "the active tendency of human agent to take advantage, in any circumstances, of all available means to further his own privileges" (p.194).

<sup>16</sup> With regard to the liberalization of former regulated industries Larson and Bunn (1999) state: "Moving from an technical/political orientation towards a much more commercial way of thinking and acting is a difficult process, involving a major re-organization towards a customer and competitor focus. This is especially true in the cases where full retail competition is being encouraged. Therefore, to sum up the changes that take place at the company level in connection with industry restructuring, we can observe that in a regulated monopolistic market, regulators can aim at a social optimum, as approved costs associated with this can be passed on to the final users, whereas in a deregulated industry, a company cannot be certain to get costs associated with 'social' initiatives covered in the price that the final users pay. This is a major shift in how a number of external issues, such as Conservation, Demand Side Management, and the Environment can be incentivised. Nevertheless, politicians seek to achieve various goals in these areas, and in doing so induce another area of regulatory risk, for example, the 'temporary' moratorium by the UK government in 1998 on all investment in gas-fired generation to help the coal industry."

<sup>17</sup> Systemic risk refers to the risks imposed by interdependencies in a system or market, where the failure of a single unit or network of entities can cause a cascading failure.

<sup>18</sup> See Oxera (2004) and Bishop et al (1995).

regulation in a competitive section of markets may reduce economic risks but should be rejected because functioning market signals get disturbed.

Knieps (2005) argues that many monopolistic bottleneck areas in dynamic sectors gradually disappear by reason of rapid technological progress. Due to the emergence of intermodal competition it is actually possible that the original need for regulatory intervention disappears. The regulatory interventions (especially its necessity) are to be reviewed regularly. In this context two categories of possible regulatory failures exist: First, a "false positive" occurs when regulators intervene in the market while competition is functioning and there is no need for intervention. Second, a "false negative" occurs when regulatory authorities do not intervene, whereas the need for regulatory intervention exists from a competition-policy point of view. Other potential negative impacts of regulation arise because of a lack of regulatory dynamics.<sup>19</sup> If regulated operators link the design of their business model too closely to regulatory rules, prices may be deadlocked in the long-run. Furthermore, the elimination of regulation endangers the companies' means of existence.

The extent of regulatory risk and uncertainty is highly related to the way regulators apply regulation to companies. In summary the type of regulatory regimes and the way these regimes are implemented are likely to influence the extent of the scope to which regulated companies are exposed to market uncertainties and risk.<sup>20</sup>

### **3. Indirect regulatory governance costs in the British postal market**

In the following we give an overview about some elementary characteristics of postal markets to make the reader familiar with the sector before we describe the history and the regulatory regime of the UK. Finally we give examples and analyze where potential costs of regulatory uncertainty occur in the British regulatory regime.

#### **3.1 General characteristics of postal markets and regulatory risk**

In this section we briefly introduce some characteristics of the postal sector and the challenges in its regulation.

##### **Characteristics and economics of postal markets**

Postal markets (respectively postal operators) were historically isolated from anti-trust laws and regulatory intervention. They were not only state-owned but also integrated in ministries and therefore flush with regulatory bodies. This has changed radically with the corporate share of postal operators. They are nowadays subject to sector-specific as well as competition regulation. This occurs on the one hand because of ongoing liberalization and on the other hand because of the privatization of the operators in some countries. Ecorys (2008) notices that "both the regulatory frameworks and the mandate and resources of the regulatory authorities differ considerably from country to country, making it difficult to identify best practices....The developments in the regulatory (legal) framework have not always been driven by the regulatory authority in isolation, and may involve legal changes instigated by the state, and competition

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<sup>19</sup> See Knieps (2007).

<sup>20</sup> See Oxera (2004).

authorities (p.87).” Therefore, there are considerable difficulties to identify best practices for postal regulation.

Nowadays postal regulatory bodies are principally concerned with tasks related to the supervision of the *universal service*, the extent of *monopoly and reserved services*, the *quality and the accessibility of services*, issuing *licenses and concessions*, *access* to the established postal infrastructure and finally *price regulation*.<sup>21</sup>

A rather controversial issue concerning monopolistic bottlenecks is whether this type of facility exists in postal markets or not. From an economic perspective only the existence of bottleneck facilities would legitimate government intervention in form of access regulation for some elements of the existing postal infrastructure. Government regulation of access is not justified in the other parts of the network and regulation would constrain efficient negotiations of the involved parties.<sup>22</sup> It becomes evident that there are different opinions and interests – particularly in connection with access regulation regarding the economic nature of postal markets. The possibility to have access to the established postal network facilitates market entrance for potential new competitors. From an incumbent’s perspective negotiated access could bring advantages as well as drawbacks: individual parts of the infrastructure or processes could be better charged but this results in the (new) opportunity of a selective market entrance with the corresponding risk of cherry picking by competitors.<sup>23</sup> Knieps (2002) argues that there are no monopolistic bottleneck facilities in the primary processes (clearing, sorting and delivering mail items).<sup>24</sup> The European jurisdiction supports this proposition with its court ruling:<sup>25</sup> The European commission finally came to the same conclusion since there is no mandatory access regulation in the postal directive 2008/06/EC.

Even though, there are no bottleneck facilities the daily delivery of mail items constitutes a natural monopoly. However, the necessary resources are not related to significant sunk (respectively fixed) costs; but they are rather scalable variable costs (such as labor costs) or disposable assets (e.g. vehicles or immovables).<sup>26</sup> The very labor intensive sub-process of delivery represents approximately 55 % of the costs of mail conveyance.<sup>27</sup> Thus the postal monopoly is a contestable monopoly and was successfully attacked in (partly) liberalized postal markets notably Sweden, Finland, Germany or the UK. As mentioned above, physical postal products are furthermore subject to potential substitutions through electronic communication and media (intermodal competition). In spite of the absence of monopolistic bottlenecks and the

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<sup>21</sup> See section 3.3 for examples in British postal regulation.

<sup>22</sup> See Knieps (2002).

<sup>23</sup> Cherry picking concerns the conveyance of cost-efficient mail items of business customers/ bulk mail in urban and dense regions.

<sup>24</sup> This view is also supported by several European studies, e.g. Ecorys (2005).

<sup>25</sup> The existence of monopolistic bottleneck facilities in the early-morning newspaper delivery is negated in 1998 in the so called “Bronner”-case. Cf. Plaut Economics (2007) and Knieps (2007 p.166).

<sup>26</sup> See Knieps (2007 p. 116).

<sup>27</sup> See Nera (2004).

contestability of the monopoly the ex-post and ex-ante access regulation is constantly discussed and claimed by the different actors and stakeholders in postal markets.<sup>28</sup>

### **Regulatory Risk concerning the provision of services in postal Regulation**

Universal service obligations usually require firms to provide certain services that they otherwise would not supply. In general the universal service is defined from an individual consumer's perspective: It is a service or product to which a consumer is entitled no matter where he lives, i.e., in terms of access to the service, quality and affordability. The traditional definition of the universal service in the postal sector implies ubiquitous delivery at a uniform price at least for letter mail but in many cases also parcels. Because of the characteristics of their networks, providers of postal universal services can even be obliged to provide services that go beyond postal services. These can include public missions like the nation-wide delivery of daily newspapers before a specific hour or to provide financial services. Especially customers in non-densely populated areas are less attractive from a supplier's point of view, and less likely to receive attractive competing offers. Second, they are also the most vulnerable to price increases. Therefore the provision of universal services and its financing in the future, risks in the postal sector concerning public interests are related to two important issues:

- The provision of postal services to all customers / citizens
- To provide the universal services at affordable prices

The universal service was usually funded by the reserved area but markets are expected to be more and more liberalized and to avoid monopolistic market structures. Under a reserved area the rural (high cost) area are cross subsidized by urban (low cost) areas and as mentioned above, the receivers do not pay for the services they consume. Mail to rural areas is not only subsidized by urban areas, but also by large business customers with high volumes. As a result prices of postal items do not necessarily depict the actual price of delivery. PriceWaterhouseCoopers (2006) state that this fact is the source of "obligation" in the discussion about universal service obligation, and leads to a number of problems. In liberalized markets the cross-subsidization as a general way of funding universal services is no longer feasible. Because there is no reserved area and bulk-mail is excluded from universal services. The customers who have large volumes of mail sent to low-cost areas will be most attractive to entrants. New competitors that are not expected to provide full universal services would penetrate on the more profitable segments in which incumbents still offer higher prices to cross-subsidize the non-profitable segments which they are obliged to serve. At the worst, the funding of universal services is no longer guaranteed. Therefore the operator(s) that fulfill the obligation must at least be compensated for the cost of the universal service instead to install higher uniform tariffs to compensate market share losses in rural areas. Hence the regulation of postal universal services is installed to ensure the provision to all customers to affordable prices no matter which financing mechanism is chosen.<sup>29</sup>

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<sup>28</sup> See de Bijl et al. (2006) for a discussion on access regulation in the postal sector. They conclude: "Our finding that there are no monopolistic bottlenecks in the delivery chain implies that the essential facility doctrine cannot be used to impose downstream access obligations upon the dominant postal operator."

<sup>29</sup> See Oxera (2006) for a more detailed overview on funding mechanisms for the universal service.

## 3.2 The British Mail Market: Structure and Postal Services Regulation

### History

Despite its role in the reform of other public utilities, the UK acted rather as a follower than a leader in the European postal liberalization debate and seemed to be less optimistic regarding the liberalization of postal services than in other areas of liberalization.<sup>30</sup>

Historically the UK was the founder of the traditional post office model and the role of the state in the provision of postal services goes back to many centuries.<sup>31</sup> The development of Roland Hill's Penny Post in 1840 has been widely recognized as dominant principles of postal service administration and the provision of services. Organizationally the British Post Office was operated as a civil service department until 1969 and then got transformed in a public corporation.

In the 1970s the overall British discussion on postal office reform emphasized rather on organizational matters – like the separation of telecommunications - than on questions regarding the development of competition and ownership. In the late 1970s the Post Office<sup>32</sup> went from a loss making to a profitable enterprise. As part of the improvement in 1985 the Post Office restructured its operation by splitting in our businesses: Letters, parcels, counter services and banking.<sup>33</sup> The initial debate on postal reform begun in the late 1980s and the first substantial proposals were presented in 1991 in the wake of the “Citizens Charter” a government initiative on public sector reform.<sup>34</sup> The initiative proposed the possibility of a further reduction of the postal monopoly and the implementation of independent regulation in the UK. Therefore, the government announced plans for the reduction of the monopoly and for privatization. Competition was expected to increase under the control of a postal regulatory agency while meeting the universal service obligations. While several proposals were provided<sup>35</sup>, they failed upon a combination of differences in the government (e.g. doubts on the possible financial losses of the treasury and the popularity of such a policy) as well as the governing party (which was worried about the reduction of universal services in rural areas and the closure of post offices). Moreover, trade unions waged a campaign against privatization which was backed by many other groups. The campaign challenged the effects of privatization and liberalization on quality of services and social cohesion. During this time, the Post Office management which was strongly in favor of privatization not only failed to ensure privatization but also missed to obtain greater autonomy in the public sector. In this rather uncertain situation concerning the development of British postal market, the government supported the European Commission's proposals for the liberalization of the postal sector. In the negotiations they positioned themselves between the enthusiastic liberalizers and the opponents of change: The UK adhered

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<sup>30</sup> See McGowan (2002).

<sup>31</sup> See Coase (1939) und Daunton (1985).

<sup>32</sup> The British “Post Office” was renamed in 2000 as “Consignia”. This change was in both the public as well as the staff very unpopular. The organization's name then changed again in 2002 to “Royal Mail Group plc” operational with three units: Royal Mail (delivering letters), Parcelforce (delivering parcels) and Post Office Limited, managing the nationwide network of post offices).

<sup>33</sup> The banking unit was sold off in 1989. See McGowan (2002).

<sup>34</sup> See Government of the UK (1991).

<sup>35</sup> Notably the green paper on postal reform in 1994. See department of Trade and Industry (1994).

to the primacy of universal services and uniform tariffs, supported only gradual liberalization and made reservations concerning the commission's intentions for the implementations of competition policy in the postal sector. The post office itself had been highly skeptical regarding the initial proposal of the Directive as it was seen as a potential threat to the postal system in the UK.

In 2001 The British government created a regulatory body for the postal affairs called Postcomm. In the same year, the Consumer Council for Postal Service - better known as Postwatch - was founded. It should ensure that customers can express their problems with the post services.

In late 2001 the British Council of Ministers reached an agreement on further liberalization of postal services and Postcomm published a report and recommended a phased opening of the market with full competition implemented in 2006.<sup>36</sup> Finally the mail market has been fully liberalized since January 2006 with respect to the postal services act 2000 which regulates the provision of postal services. The act has been revised in the end of 2003 after several consultations undertaken by the British regulatory authority Postcomm.<sup>37</sup> These include the definition of an industry code of practice for common operational procedures and protecting the integrity of mail.<sup>38</sup>

### 3.3 Central regulatory obligations in British postal services regulation

The Postal Services Commission (Postcomm) is an independent regulator established by the Postal Services Act 2000. The agency is answerable to Parliament for ensuring the provision of a universal postal service throughout the UK. In the original Postal Services Act there was a reserved area up to 100g for incoming cross-border single items. Direct mail was liberalized above 100g for mailings over 4000 items. The primary goal of the of the regulatory agency under the Postal Service act 2000 is to assure the provision of universal services. The Service has to be provided at affordable and uniform prices nationwide in the UK. An additional objective of the regulator is the promotion of competition between postal operators. Nevertheless the promotion of effective competition is lower-ranking than the protection of postal service user's interests.<sup>39</sup>

In sum Postcomm is in charge and active in the following areas<sup>40</sup>:

- Protecting the universal service
- Licensing postal operators
- Introducing competition in the mail market
- Regulating Royal Mail
- Advising Government in questions concerning the post office network
- Complaints and redress procedures<sup>41</sup>

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<sup>36</sup> See Postcomm (2002) .

<sup>37</sup> Discussions with a variety of stakeholders around the UK, including Royal Mail, Postwatch, postal operators, mail customers and postal sector trade unions.

<sup>38</sup> See Ecorys (2008).

<sup>39</sup> See Eccles (2009).

<sup>40</sup> See Ecorys (2008) and [www.postcomm.gov.uk](http://www.postcomm.gov.uk)

Even though this is not part of postal law, the Consumers Estate Agents and Redress Act 2007 sets up the merger of the postal consumer body Postwatch with other consumer protection bodies in “Consumer Focus” resulting in a formal abolition of the sector specific watchdog.

In the following we give a short overview on the most important regulatory issues in the British postal regulatory regime.

### **The Universal Service Obligation<sup>42,43</sup>**

The regulator is responsible for the definition of the universal postal service. In June 2004, following a year-long review, Postcomm listed areas of postal services offered that the incumbent operator Royal Mail is required to provide as universal postal services at an affordable flat rate.

- priority and non-priority mail services up to 2 kilos
- a non-priority service for parcels weighing up to 20 kilos
- a registered and insured service a range of support services to ensure the security and integrity of the mail<sup>44</sup>
- international outbound service<sup>45</sup>

Furthermore, it was decided that Royal Mail’s universal service obligation should also include its Recorded (signed for) product and at least one bulk mail product. Stakeholders were consulted on which bulk product or products should be included in the universal service, and in June 2005, Postcomm announced that it had decided to include “Mailsort 1400” (first and second class) and “Cleanmail” (first and second class).<sup>46</sup>

There are special provisions that include free services which cover free postal services for items specifically produced or customized for blind as well as partially sighted people.

Moreover, collection and delivery of items should be provided at six days per week (without public holidays). This includes that at least one delivery of postal items must be provided at

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<sup>41</sup> Postcomm is not in charge for individual complaints. On an individual level the former consumer body Postwatch and today’s cross-sectoral consumer watchdog “Consumer Focus” helps with individual complaints about postal services.

<sup>42</sup> [www.postcomm.gov.uk](http://www.postcomm.gov.uk)

<sup>43</sup> The provision of postal universal services has played a key role for the definition of all the European directives which aims simultaneously (1) to safeguard postal services as a universal service in the long run and (2) to increase competition. Concerning this universal service, the European directive 2008/6/EC provides that “member states shall ensure that users enjoy the right to a universal service involving the permanent provision of postal service of specified quality at all points in their territory affordable prices for all users.” Furthermore the directive describes the minimum requirements of the Universal Services which includes clearance and delivery (minimum 5 days per week), the scope of products in the universal service (clearing, sorting, transport and distribution of postal items/parcels up to 2/10 kilograms).

<sup>44</sup> Royal Mail’s re-direction (up to 12 months), Keepsafe, Poste Restante, certificate of posting and business collections.

<sup>45</sup> Royal Mail's international public tariff and international signed-for products. The UK is also subject to the Universal Postal Union’s requirement to deliver mail coming from abroad.

<sup>46</sup> Mailsort 1400 covers mail of all formats up to 2kg in weight and pre-sorted according to the location of the 1,400 delivery offices, and Cleanmail does not require users to have sorting machines and is the "entry level" bulk mail product most often used by smaller businesses.

every working day to the home of every individual in the UK as well as at least one collection of postal items per working day must be done from each access point.<sup>47</sup>

### **Licensing system**

The standard license granted by Postcomm to the operators is effective for ten years. The license framework sets out the standards and requirements for the licensees with the goal to “strike a balance between protecting customers and encouraging new postal operators to come into the market.”<sup>48</sup> An individual license does enable but not require the provision of postal services. The framework applies to all operators and came into force on 1 January 2006 and was amended on 16 January 2008. The license area covers the most types of mail items (unaddressed direct mail is not included) costing less than £1 or up to 350 grams.

The mentioned standard license

- is issued for a rolling ten years period.<sup>49</sup>
- requires each licensee to provide information about its own performance.
- requires license holders to set up systems to handle customer complaints
- introduces two codes of practice, to make sure that all operators meet common standards when handling mail.<sup>50</sup>
- requires some licensees to pay an annual fee. Only those licensees with a licensed area turnover in excess of £10 million per annum have to pay an annual license fee, which is based on market share.

There are additional requirements that apply to Royal Mail. As the dominant company, Royal Mail is subject to rigid price and service quality requirements. The incumbent Royal Mail was granted its current 15 year license on 23 March 2001. The special license sets out in detail Royal Mail's obligation to provide a universal postal service across the United Kingdom, as well as the service standards it is expected to meet. Royal mails license contains the following obligations related to competition:<sup>51</sup>

- Negotiate access to royal mails network without illegitimate discriminating between users (condition 9 part 1) or on the basis of an access code to be agreed with postcomm (condition 9 part 2).
- Avoidance of any unfair commercial advantage in favor of Royal Mail's business or any other contracting party involved with the grant of network access (condition 10-2).
- Not to disclose any information gained through the provision of access to the facilities to any other business of the Royal mail group (condition 10-2).

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<sup>47</sup> See Eccles (2009). Access points: post boxes and other facilities provided by by Royal Mail for the collection of postal items into its network.

<sup>48</sup> <http://www.psc.gov.uk/postal-licences-and-operators/the-multi-operator-market/licensing-framework.html>. There are 30 licensed operators (including Royal Mail) in the UK.

<sup>49</sup> Notice of ten years cannot be given until 25 March 2016, which brings other licences into line with that of Royal Mail. Postcomm believes this will provide operators with enough certainty to invest in the newly-opened market.

<sup>50</sup> (1) a mail integrity code, requiring licensees to ensure the safety and security of the mail they handle, and (2) a common operational procedures code, is designed to manage inter-operator issues and dealing with operational issues, including handling wrongly addressed and misdelivered mail.

<sup>51</sup> See Eccles (2009).

- To grant no more favorable terms of access to Royal Mail's business than those on which access is made available for other persons (condition 10-5).
- Avoidance of undue discrimination and or undue preference between persons and classes of persons (condition 11-2a)
- Avoidance of excessive or predatory pricing (condition 11-2b)
- Transparency of pricing of postal services by means of the submission to Postcomm and the consumer council of detailed tariffs (condition 7)
- To provide Postcomm with copies of merger control notifications and informal submissions to made to the European Commission or the Office of fair Trading (condition 12).
- Employment of a competition compliance officer to facilitate compliance with the regulatory obligations under the licence (condition 13).
- Accounting separation as regards individual types of licensed services, other universal postal services and individual types of postal services outside the scope of universal service, and non postal services, respectively not to reduce the scope of its regulated services or to offer less favorable terms to users without Postcomm's approval (conditions 15 and 21).

Furthermore Royal Mails services are subject to quality and performance obligations grounded on its license. These obligations are backed up by a compensation system for business customers.<sup>52</sup> Moreover Postcomm is allowed to impose a monetary fine if it considers that Royal Mail has not done all reasonable efforts to achieve the service targets.

Concerning the financing of the USO Postcomm made an assessment of whether and by how much providing the universal service imposes a cost or a benefit on Royal Mail in 2001. The incumbent operator Royal Mail is currently the only provider of the universal service in the UK and is required to provide the service under the terms of the license granted by Postcomm. At this time Postcomm came to the conclusion that Royal Mail's capability to deliver to every address in the UK is a commercial advantage rather than a burden. Postcomm estimated that the cost<sup>53</sup> of Royal Mail's universal service provision was about £81 million, representing about 1.7% of its revenues from its mails business. This excluded any quantification of the benefits of being the universal service provider and was based on actual rather than efficiency costs.<sup>54</sup> Postcomm finally concluded that the universal service did not represent a significant burden in the market at that time.

### **Access regime**

Due to its license Royal Mail is required by to provide access to its facilities since 2001. Therefore Royal Mail provides downstream access to services concerning the mail conveyance and delivery facilities of its network. Condition 9 of Royal Mail's license sets down the access

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<sup>52</sup> The compensation scheme involves a one percent reduction in postal charges for each percent that Royal mails fails below the national delivery time target and a retail compensation system to compensate customers for domestic first class mail failed to deliver within three working days.

<sup>53</sup> The cost of the USO in the UK is measured as the total potential cost of "loss-making elements" across all of Royal Mail's mail products - net avoidable costs.

<sup>54</sup> [www.postcomm.gov.uk](http://www.postcomm.gov.uk).

rules for the incumbent.<sup>55</sup> Access is open for mail consolidators, competing operators as well as some bulk-mail customers. The access point is usually at the delivery or sorting office for downstream conveyance and delivery by Royal Mail (see figure 1 below).

Access prices are not strictly regulated and to negotiate between the involved parties. Access terms must be on prices which are based on reasonable allocations of costs and must not unduly discriminate between parties having access to Royal Mails Network. According to Postcomm prices should be based on costs of the downstream delivery. In the event negotiations fail, the parties can appeal Postcomm to determine the conditions in form of a direction to Royal Mail concerning the terms of access.<sup>56</sup>

The postal act does not regulate the cost-price relation for access pricing. The price control is also settled in the license in condition 21 which says that access prices should be set by reference to a margin between the corresponding retail and access services (the so called head room margin).<sup>57</sup>

A first access agreement was implemented in 2004 between Royal mail and its competitor UK Mail after a two years negotiations period and only after a preparatory intervention of Postcomm. The regulator regulated the minimum headroom as a minimum percentage price difference ex-post. Today Royal Mail offers a “National Condition 9 Access Agreement” that sets out detailed standard terms and conditions on which access customers can feed in mail into Royal Mail’s network. The mail entered by the access customer must comply with the national geographic posting profile requirements.<sup>58</sup> The National Condition 9 Access Agreement is based on the access agreement with UK Mail. The consequence of such an agreement seems to be that access customers which would like to hand over items only for expensive to deliver rural areas they have to pay more than the basic access price per item specified in the Condition 9 agreement.

During 2004 another pricing access agreement was negotiated which is based on average zonal tariffs.

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<sup>55</sup> Condition 9 was adapted in May 2006.

<sup>56</sup> Eccles (2009).

<sup>57</sup> We do not discuss the definition of the head room margin in detail here. Please find further details in the appendix.

<sup>58</sup> Each posting handed over by the customer must contain items to for delivery for 31 postcode areas defined as mandatory and must also hand over postal items for delivery to a minimum of 60 postcode areas. Based on this profile the prices charged are geographically uniform.

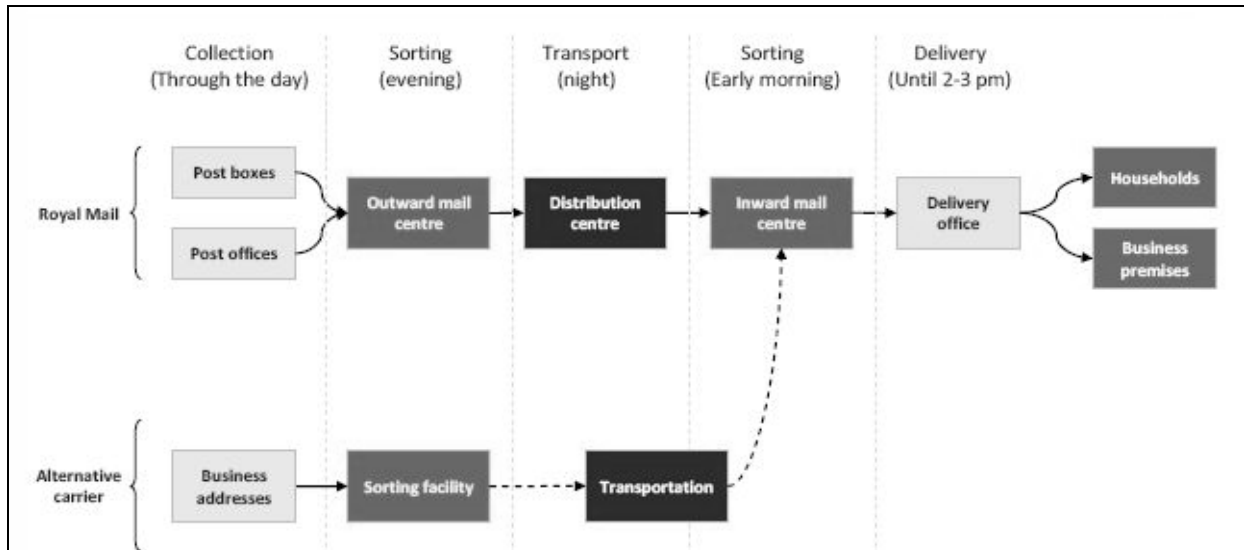


Figure 1: Access Arrangements in the UK<sup>59</sup>

### Price controls

Condition 21 of Royal Mail's license defines the pricing framework within which Royal mail is required to operate. The current price controls apply during 2006-2010 and recently Postcomm decided not to change the system after 2010. The price control provision in condition 21 includes a complex formula for royal mails retail prices. The price control is in the form of an RPI-X, across two different baskets.<sup>60</sup> Eccles (2009) lines out that it is "important to note that the pricing provisions contain no reference to the price being geared or oriented to costs as required by the relevant provision of the EU Postal Services Directive 97/67 and the further amending Directive 2008/6/EC (p. 347)". Based on the license Royal mail is obliged to apply affordable prices and a uniform tariff for services within the universal service. The price control applies not only to products within the universal service but also to all regulated services. E.g. the price control mechanisms are also applied to bulk-mail services outside the USO. Due to condition 7 Royal Mail is obliged to take steps to ensure transparency of its prices and not to offer discounts without submitting Postcomm and the consumer council details of the tariffs.

All license holders in the UK are required to conduct accounts which separate revenue and costs in relation with postal services within the licensed area from other operations and to provide the information on annually basis to Postcomm.

### 3.4 Indirect Regulatory Governance Costs in the UK

In the following we give some examples in the regulatory area which raise regulatory risk and uncertainty in the British postal market. In general it occurs in combination with unclear regulatory ruling ending in juridical proceedings, too rigid regulatory regimes that hinder the development of markets or unforeseen consequences of regulation.

<sup>59</sup> Source Hooper Report (2008, p.28).

<sup>60</sup> See Royal Mail's licence for further details.

## **Universal Service Obligation**

After the full market opening in the UK the universal service essentially remained as it was before and the regulatory body PostComm was assigned new, extensive competencies. The definition of the USO in the UK is more extensive than required in the directive. Royal mail therefore claims that the definition of the USO should be narrowed. Furthermore Royal Mail states that stamp prices should cover economic costs of providing the service. TNT argues that the number of days for deliveries and collection could be reduced to five days but that the decision should be left to Royal Mail. The other major competitor UK Mail is also in favor of a reduction of the delivery days and mentions that there is a potential opportunity to reduce the costs of the USO.<sup>61</sup>

The British postal market is thus now the most strictly regulated in Europe and its universal service provider the Royal Mail is the postal service with the biggest financial difficulties. The network of postal outlets was outsourced to Post Office Ltd. many years before. It is operated by franchisees and currently runs a deficit despite the fact that it receives state subsidies and offers no payment services.

The definition of the USO and its financing is under discussion because Royal Mails 2007/2008 report shows an estimated loss of £100 million for the universal service<sup>62</sup> and because Royal Mail is exempted from VAT for its universal services. Therefore the competitor TNT filed a court complaint to dispute the validity of the VAT exemption from services provided by Royal Mail, saying it provided comparable services but was subject to VAT. The European Court of Justice took the view that the services provided by the two companies were not comparable and that Royal Mail supplies postal services under a legal regime which is substantially different from that of an operator such as TNT. Royal Mail was designated in 2001 as the only universal postal service provider in the United Kingdom. The UK postal market was later fully liberalized in 2006, without affecting the status and obligations of Royal Mail, the court said.<sup>63</sup> The VAT distortion in the British mail Market almost does not apply in the access case but nevertheless it constitutes a key barrier which hinders end-to-end competition.<sup>64</sup>

### **Access:**

The British regulator Postcomm enforced a de facto regulation of access to Royal Mail's network. In Britain competition is less intensive than in other liberalized postal markets - there are so far hardly any new competitors across all stages of the postal value chain. Instead, the trend in consolidation (collection and sorting) is growing faster than in other European markets. Mail items are handed over to Royal Mail's network for delivery at low prices. This kind of access regulation not only strengthens the delivery organization but also weakens the position of Royal Mail in the upstream market. This example shows that the original interventions may cause a follow-up regulatory intervention. These follow-ups which are implemented to correct

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<sup>61</sup> See Ecorys (2008, p.960ff) for detailed statements of the operators concerning the definition of the USO in the UK..

<sup>62</sup> See Ecorys (2008).

<sup>63</sup> See Decision: Judgment of the Court of Justice in Case C-357/07.

<http://europa.eu/rapid/pressReleasesAction.do?reference=CJE/09/32&format=HTML&aged=0&language=EN&guiLanguage=de>

<sup>64</sup> See the Hooper Report (2008).

the failure of a previous regulatory action can even be stronger than the original intervention. The combination of mandatory access and headroom regulation was originally intended to accelerate the evolution of competition. Postcomm estimated that new entrants would be likely to use the opportunity of access to royal mail's facilities to realize economies of scales which in turn facilitates the development of their own end-to-end networks. The Hooper Report (2008) states that the British access regime finally prevented other operators from building their own networks because the headroom margin approach lead to the rather low access prices. TNT stopped its own end-to-end delivery and concentrates in the UK on the consolidation Business again. Even if the overall mail volumes in Britain are declining the other operators succeeded to increase their volumes in the upstream markets.<sup>65</sup> Approximately every third letter in the UK is collected by competitors of Royal Mail but finally handed over to Royal Mail for the delivery. Royal Mails access volumes increased in 2008 about percent. Due to the headroom margin system Royal Mail loses money on these items. Therefore, they call for an adequate regulation which takes the changed situation in the sector in consideration.

To resolve risks concerning claims about unfair commercial advantages and as a reaction on a number of complaints regarding discriminatory behavior (as regards negotiations as well as Condition 10 of Royal Mail's license), royal mail established its separated wholesale unit in early 2006. The unit was formerly based within the regulatory affairs department of Royal Mail and Postcomm claimed the lack of physical separation of Royal Mail's wholesale unit and retail teams or of no separation of data systems, accounts, and security systems.<sup>66</sup>

Another issues concerning access agreement is the length of negotiations of the parties. TNT for example states that one of the most important reasons to opt for the standard national access agreement instead of negotiating its own condition with Royal Mail was that with a potential long period of negotiations could be avoided. In turn this is a compromise where TNT chose to reduce the time to market instead of optimizing its access conditions.

Concerning the development of end-to-end competition the Hooper Report (2008) concludes that there is uncertainty about the future development of the market which makes it difficult for operators to assess the likely return on the investment. The consequences of falling volumes, developments in new technologies and regulation at the end of current price control are difficult to predict. Furthermore, some operators claim that any investment in an end-to-end delivery network would be threatened by the ability of Royal Mail to hamper competition in the future.<sup>67</sup>

### **Price Control**

The Ecorys Study (2008) includes a survey which asked the three biggest competitors (among other things) about their opinion concerning the UK price control. The statements are fundamentally different. Whilst royal Mail states that it is prevented from competing with the other operators from the pricing perspective. UK mail and TNT claim that Royal Mail's pricing policies are irrational and aimed to squeezing opportunities for competitors rather than

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<sup>65</sup> The overall reduction of the letter volume was 3.2 (5,5) percent in 2007 (2008) and Royal Mail expects a further decrease up to 10 percent in 2010.

<sup>66</sup> See Eccles (2009). Royal mail was in contravention of condition 10-2 of its license which says not to disclose any information gained through the provision of access to the facilities to any other business of Royal Mail.

<sup>67</sup> See Hooper Report (2008, p. 155).

recognizing needs of customers. Therefore TNT filed a complaint with Postcomm concerning the pricing policies of Royal Mail. In their conclusion on pricing Ecorys (2008) then states that the main battle field in the next few years will be the pricing policies of Royal Mail and how Postcomm deals with the issue.

### **Other sources of risk and uncertainty**

In order to analyze the situation of the universal service an independent Review with the title “Modernise or decline- Policies to maintain universal services in the United Kingdom” was conducted. The so called Hooper Report (2008) shed light on diverse risks and uncertainties concerning the future of UK’s postal services. With respect to the shape of the sector-specific Regulator Postcomm and the regulatory regime the report proposes: “Effective competition can help realize a positive future. A new regulatory regime is needed to place postal regulation within the broader context of the communications market. (p.15)” Therefore the report recommends not only to transform the self-contained Postcomm to Ofcom<sup>68</sup> but also to conduct a comprehensive analysis about the postal markets and to analyze the extent to which Royal Mail has market power in the different segments. Following the report, the moving to a new system of regulation would first require a greater clarity of royal mails costs. However, even though the report lines out a couple of other suggestion to improve the situation in the British mail market and of Royal Mail itself in order to reduce risks concerning the USO it also rises uncertainty because it proposes radical changes in the regulatory regime which affect the operator’s businesses and therefore their return on investment in the long-run.

## **4. Conclusions**

In the theoretical chapter we outline the framework of regulatory governance costs with focus on the indirect cost of regulatory risk and uncertainty. These costs occur mainly in combination with unclear regulatory ruling ending in juridical proceedings, too rigid regulatory regimes that hinder the development of markets or unforeseen consequences of regulation.

In postal markets these types of costs occur mainly with regard to universal service obligations, licensing regimes, access regulation, price control, structural market entry barriers and adaptations of regulation.

- Concerning the universal service obligation: The risk and uncertainty are related to the scope and the definition of the universal service and the adequate financing mechanisms in the long term. Another question is whether the Universal service does rather constitute a burden or a competitive advantage for the one how is designated to provide it.
- Licensing Regimes are subject to risk and uncertainties in case they bear incisive license requirements (e.g. far-reaching delivery requirements).<sup>69</sup>The question to ask is whether the licensing regime is fair for all operators or if some operators are worse off than others due to asymmetric regulations.
- Access: In the access-regime the risk and uncertainty occurs concerning the type of access regulation and the tariff principals. It is to analyze whether the chosen regime promotes the original goal of the regulatory intervention (e.g. end-to-end competition)

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<sup>68</sup> Ofcom is the independent regulator and competition authority for the communications industries in the UK.

<sup>69</sup> Predominantly for new entrants but also incumbent operators.

and how different business models of operators are affected by the particular regime. An important question is whether the chosen regime puts the financing the universal service at risk (e.g. cherry picking).

- Price Control: It is to analyze whether the tariff system is non discriminatory for all operators as well as the end customers. Or does the Tariff system hinder or promote certain business models which in turn affect the financial situation of the operators?
- Structural market entry barriers: These risk and uncertainties mainly concern new entrants. They occur e.g. in case of discriminatory VAT-regimes,
- Adaption of regulation affects the cost of capital of the operators because of the uncertainty on how the regulators behave as well as on how regulatory framework evolves and what the effects on their business are.

Following the statements above we come to the conclusion that there exist regulatory risks and uncertainties not only concerning the maintenance of public interests but also for the postal operators (for new entrants as well as for incumbents).

A particular weakness of our study is that we so far just rely on secondary data and the analysis and interpretation of the British mail market is grounded on desktop research. After this preliminary study we therefore plan to conduct empirical qualitative research to learn more about regulatory governance costs and to improve our framework. Moreover we would like to investigate on how these different costs (including direct as well as indirect costs of regulatory governance) are perceived in practice by the different actors involved with postal regulation. The insights about the costs and its impact on market evolution will be useful to analyze regulatory policies in postal markets as well as in other network industries (certainly with respect to the characteristics of the different industries).

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## Appendix: Access Headroom Regulation in the UK

### Box 17: Access headroom regulation

In postal services, there are two main prices:

- ▶ the retail price: the price of carrying an item of mail end to end; and
- ▶ the wholesale access price: essentially the price paid for delivery. This price excludes the cost of 'upstream' collection, sorting and transportation.

Margin squeeze occurs when a vertically integrated business, supplying wholesale services to its competitors and competing in the same retail markets as those competitors, reduces its retail prices while holding or increasing its access price to the point where its competitors' margins become too low to make their business viable.

Under the current price control, margin squeeze is restricted through the use of an access headroom control. This control maintains a fixed margin, or "headroom", between a set of access prices and their Royal Mail "reference" retail prices. Consequently, if Royal Mail increases a relevant access price or lowers a relevant retail price, it must reflect that change in the corresponding access or retail price to maintain the headroom.