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Modernise or decline

Policies to maintain the universal postal service in the United Kingdom.

16 December 2008

An independent review of the UK postal services sector

Richard Hooper CBE | Dame Deirdre Hutton | Ian R Smith

Cm 7529 £26.60

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Headlines

1. This review was established to maintain the universal postal service. The size and scope of the Post Office network – the country's largest retail and financial chain – are largely outside its scope.

2. The universal postal service is important. The ability to deliver items to all 28 million business and residential addresses in the UK is part of our economic and social glue.

3. But the universal service is under threat. The explosion of digital media – internet, email, mobile text and broadcasting – has prompted an unprecedented decline in the letters market.

4. There is a positive future for the postal service, provided that postal companies are able to respond quickly to the changing needs of customers and embrace the opportunities which new technology brings.

5. The only company currently capable of providing the universal service in the UK is Royal Mail. But it is much less efficient than many of its European peers and faces severe difficulties.

6. There is a general consensus that the status quo is untenable. The universal service cannot be sustained under present policies.

7. A radical reform of Royal Mail's network is inevitable. The company has a plan to achieve this. But the pace of change needs to accelerate significantly.

8. Unless Royal Mail can modernise faster, a forced restructuring under European rules is highly likely. That would be a costly and poor outcome for the taxpayer, for consumers, for Royal Mail and its employees.

9. Now is not the time to reduce the universal service. Reducing the number of deliveries each week from six to five would be in no-one's best interests.

10. Sustaining the universal service depends fundamentally on modernising Royal Mail.

11. The company urgently needs commercial confidence, capital and corporate experience to modernise quickly and effectively.

12. Modernisation will not happen through conflict or attrition. The CWU and Royal Mail must develop a more constructive working relationship in which both are engaged in the long-term strategic future of the company.

13. We recommend a strategic partnership between Royal Mail and one or more private sector companies with demonstrable experience of transforming a major business, ideally a major network business.

14. Given the wider social role of the Post Office network, Post Office Ltd should remain wholly within public sector ownership.

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15. We also propose that the Government should tackle the historic pension deficit, to enable the company to reap the benefits of modernisation.

16. Effective competition can help realise a positive future. A new regulatory regime is needed to place postal regulation within the broader context of the communications market.

17. Parliamentary accountability for providing the universal service should be strengthened.

18. Our recommendations are a package. Each element of the package is needed if the universal service is to be sustained: modernisation achieved through partnership, tackling the pension deficit, and changing the regulatory regime.

19. Our recommendations require substantial change. But we believe that they are proportionate to challenges faced by the postal sector and can be implemented successfully.

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Executive summary

The facts

The universal postal service is important. The ability to deliver items to all 28 million business and residential addresses in the UK is part of our economic and social glue.

- The review was established to maintain the universal postal service: the collection, sorting, transportation and delivery of letters. Our recommendations are designed to do exactly that.

- The universal service has a strong social and economic rationale. Customers place a high value on the affordability of the service, on a uniform tariff, and deliveries on six days per week. Many depend on it for their communication and business needs: attracting customers, invoicing, supplying goods and receiving income. Without it, consumers in different parts of the country would face different levels of service and different prices.

- We are clear that post offices provide a vital point of access to the universal service for residential consumers and small businesses. But the Post Office provides a much wider range of services. Indeed, it is the country's largest retail and financial chain. For that reason, the size and shape of the Post Office network lies well beyond the scope of this report.

The issues

But the universal service is under threat. The explosion of digital media – internet, email, mobile text and broadcasting – has prompted an unprecedented decline in the letters market.

- For the first time on record, the volume of letters sent in the United Kingdom is falling each year as consumers make greater use of electronic media. Until now, this structural decline has been moderated by economic growth. As the economy slows, however, volumes could fall by as much as 5-7% per year.

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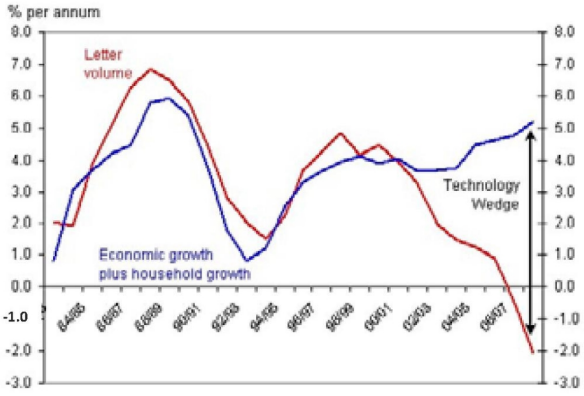
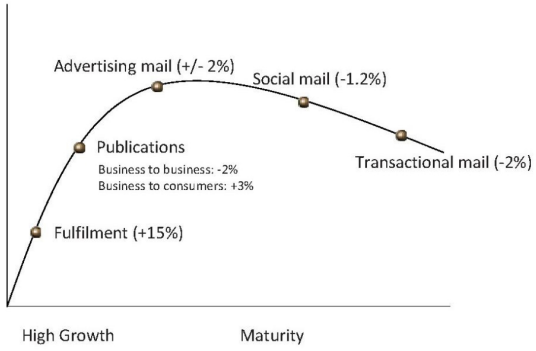
Growth in letters, compared with economic growth, 1984-2007



- The digital age brings both challenges and opportunities for the postal service. Transactional mail (such as bank statements) and social mail are in decline. They account for over a quarter of the UK postal market's value. Meanwhile, goods ordered on-line (fulfilment mail) are growing and delivered at a higher value than letters. And new technology heralds new services in which post complements other media. Publishing and advertising mail could well benefit.

Indicative stages of the life cycle for different mail applications



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There is a positive future for the postal service, provided that postal companies are able to respond quickly to the changing needs of customers and embrace the opportunities which new technology brings.

- Mail has unique properties. It is more personal, compared to other media. And many items currently sent by post are difficult or impossible to transmit in digital form. These attributes can provide the foundation for a successful future if, but only if, the postal service is dedicated to meeting the needs of all consumers. Mail must be a delivery service of choice, not merely a safety net or a service of last resort.

- A thriving postal market must appeal to a wide range of customers. Postal companies must be obsessive about meeting the needs of senders and recipients alike. They must provide reliable and convenient services at competitive prices. These services must be sustainable, with a low environmental impact, and without the need for subsidy by taxpayers. And postal companies must be innovative, seizing new opportunities in the communications and logistics markets to offer new and better services.

The only company currently capable of providing the universal service in the UK is Royal Mail. But it is much less efficient than many of its European peers and faces severe difficulties.

- Royal Mail delivers 99% of all items posted in the UK. No other company is likely to have an equivalent national network in the foreseeable future. Its financial viability is, therefore, vital to the future of the universal service.

- Royal Mail needs to respond urgently to the structural decline in the UK letters market. It will need to drive down costs and diversify as traditional revenues decline. But it faces many constraints in doing so.

- First and foremost, Royal Mail is much less efficient than many of its European peers. While Royal Mail has already removed around £500 million in costs from its operations (including over 40,000 jobs), the management recognises that it is only part way through the transformation necessary to regain its status as best in class. Last year, Royal Mail's letters business was the least profitable postal company amongst its Western European peers, and the only one to make an operating loss.

- Since the 1990s, Royal Mail's national distribution network is virtually unchanged, whereas modern European companies have reduced the number of mail centres by around 50% to optimise their operations. At Royal Mail, postal workers sequence all their letters by hand before setting off on their delivery rounds. By comparison, European operators sequence 85% of their letters by machine. A number of restrictive practices inhibit Royal Mail's efficiency, while the company pays its workforce above current average market rates.

- Royal Mail faces other constraints, too. Its pension deficit is higher than any of the FTSE 100 companies and is highly volatile. As customers have access to a wider range of communications media, increasing postal prices is no longer guaranteed to generate sufficient revenue to offset falling volumes. The company suffers from poor labour relations. In 2007, the postal sector accounted for 60% of the days lost to industrial action across the whole economy. The relationship between the company and its regulator is similarly difficult.

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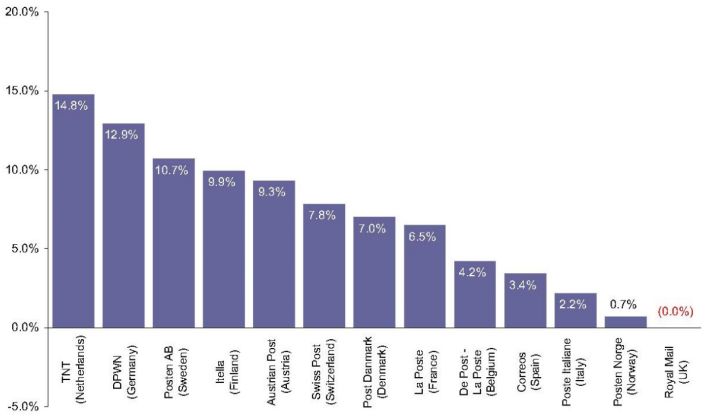
There is a general consensus that the status quo is untenable. The universal service cannot be sustained under present policies.

- Companies such as Deutsche Post (Germany) and TNT (Netherlands) achieved profit margins of between 13% and 15% from their mail operations, even though they faced greater end-to-end competition than Royal Mail does in the UK. By contrast, Royal Mail's financial position is precarious. It made an operating loss last year.

Operating profit margins of Western European postal companies, 2007 (%)



- The introduction of postal competition has had only a limited impact on its profitability. Royal Mail's relative inefficiency is far more significant.

- And there remain major challenges ahead. Royal Mail lost around £500 million in operating profit to other forms of communication in 2007-8, five times the operating profit lost to postal competition. Against the backdrop of an unprecedented, structural decline in the letters market, the company's financial position will deteriorate unless there is significant change. The universal service is under threat and the status quo untenable.

The choice

A radical reform of Royal Mail's network is inevitable. The company has a plan to achieve this. But the pace of change needs to accelerate significantly.

- Without policy changes, it is likely that Royal Mail will need to approach Government for emergency financial support, and that transformation would have to be carried out under European rules on restructuring aid.

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Unless Royal Mail can modernise faster, a forced restructuring under European rules is highly likely. That would be a costly and poor outcome for the taxpayer, for consumers, for Royal Mail and its employees.

- It could force Royal Mail to withdraw from parts of the market. It could weaken the company's ability to develop, expand and diversify its business in the future. And it would mean accelerated job losses. That would make it difficult to manage the transition through redeployment and voluntary redundancy. Doing nothing, therefore, is not a credible option.

Now is not the time to reduce the universal service. Reducing the number of deliveries each week from six to five would be in no-one's best interests.

- Some have suggested that the demands of the universal service may need to be reduced, either by withdrawing the uniform tariff or by reducing the number of deliveries from six per week, to five. Some have proposed that other postal companies should compensate Royal Mail for having the obligation to provide the universal service. Both are permitted under European law. But neither is appropriate, necessary or effective. These options would not address the fundamental issues undermining the financial health of Royal Mail.

- We recommend that degrading the universal service and a compensation fund should be rejected as policy measures in current circumstances. They would penalise consumers, postal companies or the taxpayer while Royal Mail's costs are substantially higher than necessary. They represent a poor deal for the consumer and the taxpayer. And they would weaken the incentives for Royal Mail to respond to structural change in the postal market.

The solution

Sustaining the universal service depends fundamentally on modernising Royal Mail.

- To sustain the universal service, Royal Mail must be able to respond, and respond quickly, to the structural decline in the letters market. That means tackling its inefficiency, the pension deficit, and the difficult relationships between the company, unions and regulator. All constrain Royal Mail's ability to change. It must be able to modernise more quickly and go further than current plans.

- The process of modernisation has two distinct phases. Royal Mail's first priority must be transformation. There is too much resistance to change at a time when the company must focus relentlessly on meeting the needs of customers. Royal Mail must change the culture of the organisation, improve efficiency and reduce costs. Secondly, that will enable the company to diversify, finding new sources of revenue either by providing related products or expanding to cover a wider geographical area.

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- In practice, modernisation involves a radical change to Royal Mail's national network. It must be for management to decide on the infrastructure which best meets the requirements of the universal service and the changing needs of its customers. Experience from other countries suggests that the company could provide the universal service with around half its current mail centres.

- Transformation is no ordinary proposition. It is expensive, complex and must be completed while meeting some of the highest quality of service standards in Europe. It will be challenging for the existing workforce. There will be a significant reduction of jobs over time, as investment in new capital replaces labour. But if well-planned and implemented effectively, modernisation will secure the future of the postal service in the UK, bringing stability to Royal Mail.

The company urgently needs commercial confidence, capital and corporate experience to modernise quickly and effectively.

- Commercial confidence. Royal Mail must have greater clarity about its objectives over the short and long term. That will require removing the spectre of political intervention, enabling management to make decisions about modernisation entirely on a commercial basis, in order to safeguard the universal service. Political separation must be matched by effective engagement between management and the unions about the long-term strategic direction of the business.

- We believe strongly that modernisation of the business will only be achieved if industrial relations are modernised. That requires change at the Communication Workers Union – the main postal union – as well as Royal Mail. The CWU must accept the scale of transformation required and show that it can tackle the behaviour and internal processes which at present result in confrontation and obstruction. Management, in turn, must be prepared to play its role in improving relationships at a national and local level by setting out its vision for the company in a transparent way, the implications of transformation, risks of failure, and the opportunities for diversification.

- Access to capital. With a pension revaluation due next year, significant market uncertainty, letter volumes declining even more quickly than anticipated and the beginning of an economic downturn, what was a tight but manageable financing position now has substantially more risk attached. As a matter of prudence, the company must be in a position where it can quickly and easily raise more capital if that becomes necessary in the near future.

- Government funding comes with constraints. There are many other calls on public finances. And any investment by Government must meet strict rules set out by the European Commission. This takes time. By contrast, private capital is generally more flexible and more tolerant of necessary risk. It can be raised more easily, faster and for a wider range of purposes and does not come at the cost of competing public priorities.

- Access to corporate experience. The scale of change required at Royal Mail is huge, and the impact of failure very high. Royal Mail needs access to the corporate experience of one or more private-sector companies which have successfully managed complex change on a similar scale and under equally challenging circumstances, ideally in a network business. The capacity to draw deeply on a wide range of experience at junior, middle and senior

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management levels, as and when challenges arise, would add much greater value than hiring a limited number of people, however well-qualified.

- Addressing just one or two of these three requirements will not be sufficient. All three are vital to Royal Mail's successful modernisation and, therefore, sustaining the universal service. Based on experience to date, it is our strong view that the existing policy framework is not capable of meeting these needs.

We recommend a strategic partnership between Royal Mail and one or more private sector companies with demonstrable experience of transforming a major business, ideally a major network business.

- To provide commercial confidence, capital and corporate experience, we recommend that there should be a strategic partnership between Royal Mail and one or more private sector partners with demonstrable experience in transforming a major business, ideally a network business, in circumstances comparable to those now faced by Royal Mail. The precise nature of such a partnership, and its detailed terms, should be a matter for the Government to negotiate. At its core, however, will be Royal Mail's obligations under the universal service, as required under EU and UK law.

Post Office Ltd should remain wholly within public sector ownership.

- Given the social obligations of the Post Office, there is little prospect that the network will be sustained on a fully commercial basis. We recommend, therefore, that it should remain wholly within public ownership. To ensure that post offices continue to provide a point of access to the universal service, we recommend that there should be a long-term agreement between Royal Mail and Post Office Ltd. We also believe that the post office could enhance the service available to recipients by providing a collection point for parcels and packages.

We also propose that the Government should tackle the historic pension deficit, to enable the company to reap the benefits of modernisation.

- The size and volatility of the pension deficit would be extremely difficult to manage for any business. But it has severe implications for Royal Mail and, therefore, the universal service. The deficit is a very significant long-term drain on the company's cash. Royal Mail is already balance sheet insolvent. The deficit makes it difficult for the company to compete effectively, even allowing for an improvement in efficiency. It is a barrier to external investment by a strategic partner and inflates prices.

- Following liberalisation, Royal Mail must respond to competitive pressures while also meeting its obligation to provide the universal service in a declining market. Tackling the pension deficit, on its own, will not be sufficient to achieve modernisation. But a new approach is needed if the benefits of liberalisation are to be realised.

- In our view, the best long-term solution is that the risk associated with the historic pension liabilities should be transferred to Government.

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- We recommend that the Government should take responsibility for the historic pension liabilities in a way which is linked to the achievement of modernisation. It could, for example take a staged approach in which the scheme's assets and liabilities related to pensioners and members with deferred benefits were transferred to separate, Government-backed arrangements.

Effective competition can help realise a positive future. A new regulatory regime is needed to place postal regulation within the broader context of the communications market.

- Regulation is needed to ensure that the universal service is met. Regulation also protects consumers from excessive prices and can play a role in the modernisation of Royal Mail by creating incentives for it to become more efficient.

- We recommend that the responsibility for regulating the postal sector should be transferred from Postcomm to Ofcom. This move will reflect the fact that postal services are increasingly part of the wider communications sector, in competition with broadcasters, internet providers and telephone companies. Ofcom has a deep understanding of these media. It also has the experience of regulating markets undergoing rapid technological change and, in particular, creating a regulatory framework for a large company (BT) facing the challenge of modernisation and liberalisation.

- We recommend that, as postal regulator, Ofcom should have a primary duty to maintain the universal service. In carrying out its duty, Ofcom will need to recognise that competition brings benefits for consumers but that, in particular circumstances in future, competition may also pose a threat for the universal service. We recommend that Ofcom should continue to promote competition in relation to the postal sector "where appropriate".

- We recommend that Ofcom conducts a thorough and comprehensive analysis of the markets which make up the postal services sector, and the extent to which Royal Mail has market power in each segment. The exercise should take into account the increasing links between postal services and the wider communications sector. This exercise may enable deregulation of the sector in future.

- We also recommend that Ofcom should have competition powers in relation to postal services, as it does for its existing portfolio. This would enable Ofcom to investigate anti-competitive conduct in any aspect of the postal market, whether or not connected with Royal Mail's licence. It would also enable deregulation in future.

- Effective regulation depends partly on improving information about Royal Mail's costs. We recommend that Ofcom should address cost transparency as a priority and build its own model of costs in consultation with Royal Mail. We do not recommend the formal separation of Royal Mail into differently owned business units.

- We are clear that the decision to grant alternative carriers "access" to Royal Mail's delivery network has had benefits for customers. We recommend that the regime should be continued, but that Ofcom should review the way in which access is currently regulated. Moving to an alternative system of regulation would first require greater clarity about Royal Mail's costs.

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Parliamentary accountability for providing the universal service should be strengthened.

- We recommend that the regulator should report on an annual basis to Parliament specifically on its responsibilities in ensuring the provision of the universal service, with a hearing before the BERR Select Committee. In turn, the regulator should ensure that, when monitoring Royal Mail's obligations, there is a clear and specific focus on sustaining the universal service.

Our recommendations are a package. Each element of the package is needed if the universal service is to be sustained: modernisation achieved through partnership, tackling the pension deficit, and changing the regulatory regime.

- None of these changes will be sufficient to resolve the issues which we have identified, if implemented on its own. If implemented together, on the other hand, we believe that our recommendations are capable of bringing about the structural changes necessary to achieve a positive future for the postal service.

Our recommendations require substantial change. But we believe that they are proportionate to challenges faced by the postal sector and can be implemented successfully.

- The Government should move urgently to provide the whole market with the certainty it needs to invest. Ideally, the new regulatory regime, to be designed by Ofcom, should be in place for the start of the next price control in 2010. This will require legislation in the current session of Parliament.

- We recommend that the process of searching for strategic partners should begin in parallel. Likely consolidation in the European postal market in the future means that opportunities may not recur. Clarity about the future of the pension deficit will be an important part of the negotiation, vital in enabling Royal Mail to reap the benefits of modernisation and in providing certainty for scheme members.

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Introduction

1. We have entitled our report "Modernise or Decline" to reflect the stark choice which many other European countries have tackled already, and which we now face in the UK. The world of communications, and the needs of consumers, are changing fast. So too must postal services, else face inexorable decline. The choice applies not only to postal companies but those with a direct interest in the future of the postal services: unions, regulators and Government.

2. The economic outlook has changed significantly since May, when we published our interim report. A significant economic downturn increases the urgency of challenges we outlined just a few months ago. At a time when the Government has acted to secure stability in the financial system, there is also a need to take decisive action to secure the future of the universal postal service. And as in other sectors, the Government takes on financial risks historically carried in the private sector, there is an opportunity to find a better balance of risk and reward for the postal sector. This is particularly true in relation to Royal Mail – where we judge the current risk to taxpayers is significant and, without action, will continue to increase.

The postal service is no stranger to change. It has had to adapt to many new circumstances since its foundation in 1635.

3. Our national postal service is no stranger to change. Founded in 1635 by Charles I, it has constantly adapted to new circumstances.

   - Rowland Hill's introduction of the "penny post" was simultaneously the beginning of the modern universal service, and the business model which survives today: "one price goes anywhere" and "the sender pays". Consumers were given more choice by 1968 – with the introduction of second class mail, using the same principles. The market is now fully open to competition, offering a wider range of products aimed at different customers.

   - The way in which letters are delivered has systematically evolved with the development of transport. The last 180 years have seen the rise and fall of the mail train for example. While some rail services are still used for slower mail, air transport is now used to ensure that Royal Mail can deliver first class mail overnight from one end of the country to the other. Each innovation in transport has required a fresh look at resources and organisation.

4. Changes in technology over the last century have been accompanied by changes to the Royal Mail's legal status, organisation and governance.

   - The idea of converting the Post Office[1] into a nationalised industry was raised as early as 1932. Proposals from the Bridgeman Committee in that year were, however, rejected and the Post Office remained a department of central government, with the Postmaster General sitting in Cabinet as a Secretary of State.

[1] For much of this period the business that is now known as Royal Mail Group was called the Post Office (or the General Post Office). This included both post offices, and the letters business.

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- A series of studies and reports in the 1960s led to the Post Office Act 1969 which established the Post Office as a statutory public corporation with two divisions: Post and Telecommunications. In 1981, the telecommunications operation was transferred to a new public corporation, British Telecommunications. BT was privatised in 1984.

- In 2001, the postal business became a public limited company under the Companies Act, with Government holding all of the shares. Its name was changed from Consignia to Royal Mail Group in 2002.

The postal service must be ready to adapt again, as circumstances change rapidly.

5. There will be many more changes in future. And change brings uncertainty. We cannot predict how quickly consumers will move from mail to electronic media, any more than we can foresee the next step forward in digital technology. That said, it seems clear to us that the arrival of new technologies will bring new business opportunities, as well as risk. Moreover, we have no doubt that the rationale for the postal service – the exchange of information and goods – remains relevant and important in today's society. Post can and should continue to play an important role as part of a dynamic and growing communications sector.

6. This is, then, no post mortem. Our findings have been informed by history. But we look mainly to the future - at managing risks and realising opportunities.

7. We focus first and foremost on customers. Our recommendations seek to ensure that they benefit from a universal postal service which responds to their needs, is efficient and, therefore, can be sustained at reasonable cost.

8. We have considered taxpayers. They have lent Royal Mail £1.2 billion in the last two years to modernise its operations: the equivalent of around £40 each. Without substantial change, this investment may be at risk. If, on the other hand, Royal Mail is able to find new sources of revenue, and reduce costs, the taxpayer will share in the company's success.

9. We have been mindful of the sector's significance not only to the economy but to the lives of pensioners, former and current employees of Royal Mail and other postal companies, and their families: around a million people in all. The wider public, also, has great affinity with the postal service. Many have told us of their affection for, and trust in, their local postmen and women. For both reasons, we have devoted as much of our time as possible since January to meeting people at all levels who know about postal services and have a direct interest in their future.

Establishing the right framework to maintain the universal service is a shared responsibility.

10. In presenting our recommendations to Government, we hope that this engagement amongst all stakeholders in the success of the postal sector will continue and develop. More than at any other time, the future of the market depends on effective working relationships between consumer organisations, management, unions, regulators and Government, a willingness to explore issues together, and the capacity to find common solutions. Establishing the right framework must be a shared responsibility. Royal Mail should then be accountable for providing the universal service, and should have the freedom to get on with the job. The regulatory framework should ensure that Royal Mail's commercial objectives are compatible with its public service obligation.

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11. We have written this report with a general audience in mind. Post may be a simple concept. But the business of transferring items from any one of 28 million homes and companies to any other is complex. We have included a glossary (Annex B) and a brief guide to the postal market at the beginning of this report for those coming new to the subject. It includes some of the facts which we found most interesting in beginning our task in January 2008. From facts, we move to analysis: a diagnosis of the problem. And then judgement: the solution which we believe will secure the universal service.

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Part 1.

Some basic facts

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A brief guide to the postal service

This first part provides some basic facts about the mail market, its customers, the mail process and its regulation.

Summary

- *It is important to distinguish between the postal service and post offices.*
- *This report is about the postal service: the business of collecting, sorting, transporting and delivering mail. It does not comment on the much wider retail and financial business of Post Office Ltd.*
- *Mail is big business. In all, 86% of letters are sent by companies.*
- *Residential consumers are important, since they receive 70% of items posted in the UK.*
- *The UK has led the way in Europe by opening up the postal market fully to competition.*

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Not the Post Office

Our review is about the postal service. We have not been asked to make recommendations about the much wider retail business of the Post Office.

12. The postal service and the Post Office tend to be used interchangeably by most people. In the postal business, however, and in our report, there is a marked distinction between the two.

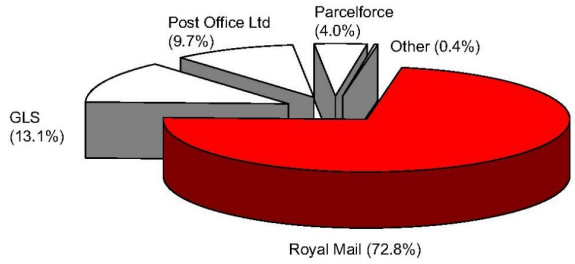
- The postal service is the main subject of our study. It covers the collection, sorting, transportation and delivery of mail: letters, packages and parcels. The largest postal company in the UK is Royal Mail. There are 21 other companies with a licence to provide postal services.

- Post Office Ltd has a network of 12,000[2] outlets across the country. These "post offices" are a vital point of access to the universal postal service for residential consumers and small businesses: they provide advice about postal services, sell stamps and act as a collection point for letters and parcels. But they offer a much wider array of products and services. Post Office Ltd is the largest[3] retail and financial services chain in the country. It is largely outside the scope of this report. We have not been asked by Government to consider the scope or size of the Post Office network.

13. Confusion sometimes arises because *The Post Office* was the name of the public corporation which ran both the postal service and post office network before 2001. Post Office Ltd is now a subsidiary company of *Royal Mail Group Ltd.* This review is concerned with the 73% of Royal Mail Group's revenue generated by what is often called the "letters business". We refer to this throughout the report simply as "Royal Mail".

Figure 1

External revenues of Royal Mail Group, 2007-8
By division



Who uses postal services?

Residential consumers receive 70% of the mail posted in the UK.

14. Only 11% of all letters are sent between households, the majority of which are sent over the Christmas period. Including letters sent to

[2] This will be the number of post offices nationwide (including the mobile "outreach" services) after the completion of the network change programme.
[3] Measured by the number of outlets.

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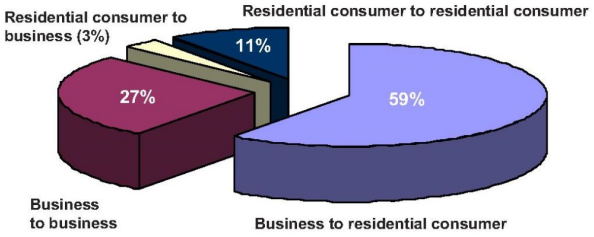
businesses, the average household spends 50p per week on mail[4]. As recipients, however, residential consumers are particularly important. They receive 70% of the mail posted in the UK. Figure 2 provides a full breakdown of the letters market by sender and recipient.

Figure 2

Segmentation of the letters market (volume)
by sender and recipient



Mail is big business. The vast majority of post is sent by companies.

15. By far the largest proportion of mail is generated by businesses and received by residential consumers. The 50 companies which make the most extensive use of the postal service account for 40% of mail volumes[5]. They comprise financial service companies, utilities and major retailers. But smaller enterprises are also regular users, and are often dependent on the postal service in carrying out their business. A survey by the Federation of Small Businesses[6] found that:

- 88% of small businesses send post every day, 59% delivering goods and services and 69% sending invoices;
- 41% use the postal system to order goods which enable them to carry out their business.

Definition of the postal market

16. The postal market comprises:

- **addressed** letters, large letters and packets which are small enough to be posted through letterboxes. This is the main focus of our report.

[4] *Family Spending 2007*, Office of National Statistics
[5] Table 1, Postcomm's first submission to the review panel
[6] *Small Businesses and the UK Postal Market postal survey: First Past the Post*, Federation of Small Businesses, January 2007. The survey had responses from 3,356 small businesses.

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- **unaddressed** items[7] which can be posted through letterboxes but do not contain an address, such as leaflets, catalogues and brochures.
- **express** and courier items[7] which are guaranteed to arrive on a particular day or time, and / or which require a signature on delivery or "track and trace" facility.
- **standard parcels**. These items are not guaranteed to be delivered by a specific time and cannot be posted through letter boxes.

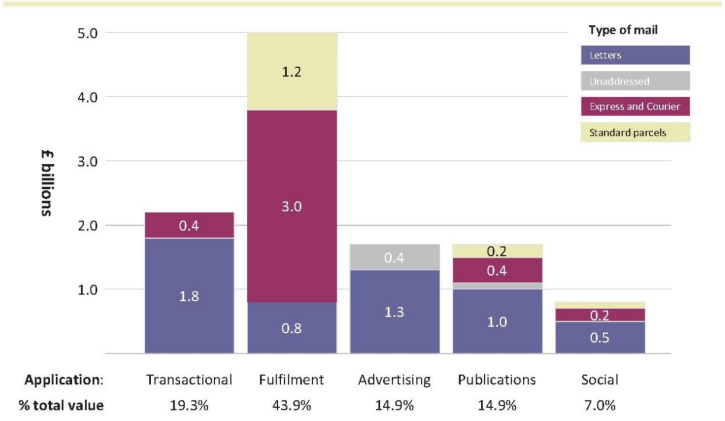
17. Mail can also be classified **by application**:

- **transactional** mail: generated by businesses used in a financial transaction, such as bank statements and credit card bills.
- **fulfilment**: goods ordered by mail, internet or telephone which need to be delivered to residential consumers and businesses.
- **advertising** mail: mail advertising products or services, sent to a named member of a business or household.
- **publications**: periodicals and magazines delivered to the consumer.
- **social mail**: mail sent between residential consumers, such as birthday cards.

Figure 3

Value of the UK postal market, 2006-7 (£11.4 billion)

by postal type and application



[7] Express, courier and unaddressed mail are not regulated. Companies undertaking these activities do not require to be licensed by the regulator, Postcomm

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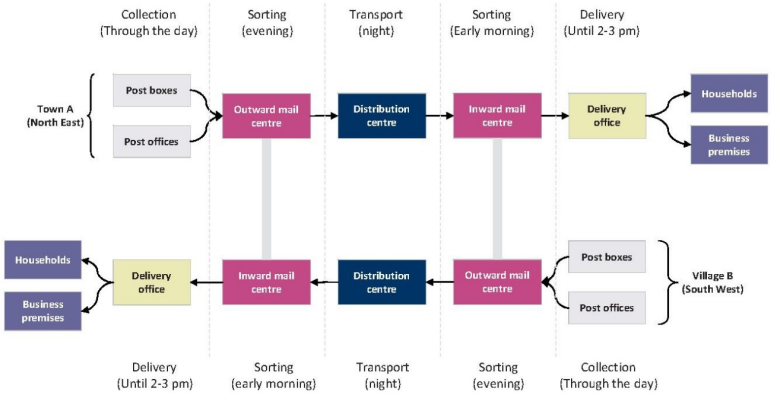
The letters process

18. The postal process for letters typically has five stages: collection, sorting by region, transportation, sorting into "walks", and delivery. Figure 4 provides a basic guide to Royal Mail's operation.

19. Collection takes place from one of the UK's 115,000 post boxes, 12,000 post office outlets and around 87,000 business addresses. After initial sorting during the evening at one of 69 mail centres, letters pass through one of nine distribution centres on their way to a second mail centre. Each of the mail centres receives mail from different parts of the country, sorts letters at local level, and transfers them to one of 2,249 delivery offices[8]. There, they are put into the right sequence and delivered to the door.

Figure 4

The 24-hour letters process



Each of the 69 mail centres has an inward and an outward function at different times of the day. Bulk mail handled by Royal Mail which has been pre-sorted is taken directly to one of the nine distribution centres.

20. Companies are permitted to carry out collection, sorting, transportation, and delivery services for addressed letters under a licence issued by the regulator, Postcomm. A number of postal companies take advantage of downstream access arrangements. They collect mail in bulk from businesses, sort and transport it, before handing it over to Royal Mail at one of the inward mail centres for delivery over the final mile of the journey (Figure 5). Businesses which frequently mail in bulk also have direct access to Royal Mail's network.

[8] This includes 884 Scale Payment Delivery Offices (at September 2008). These are post offices, predominantly located in rural areas, which provide premises, facilities and supervision for Royal Mail delivery staff.

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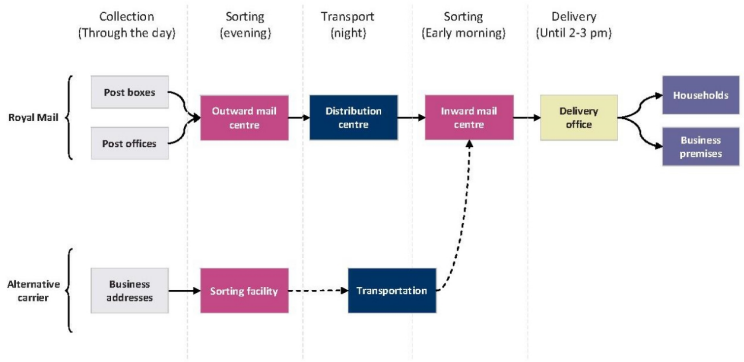
Figure 5

Access arrangements



The introduction of competition

UK has led the way in Europe by opening the postal market to competition.

21. The UK has been amongst the first countries in Europe[9] to open the postal sector to competition. The Postal Services Act 2000 gave Postcomm a primary duty to ensure the provision of a universal service at an affordable uniform tariff, and to promote effective competition where appropriate. Since 2001, the regulator has introduced competition into the UK market in a number of stages: through niche licences; by staged opening of the bulk mail market; and then by full liberalisation on 1 January 2006. In all, 21 companies are now licensed to provide postal services in the UK in addition to Royal Mail.

22. Almost all competition in the letters market is focused in the 'upstream' area. New entrants collect, sort and transport 39%[10] of the bulk mail sent by business to other companies and residential consumers. Overall, they have acquired 20% of Royal Mail's upstream activities. This equates to a 2% reduction of Royal Mail's revenues from letters because the company still charges access competitors for delivery over the final mile.

[9] Sweden and Finland liberalised their postal markets in 1993 and 1991 respectively.
[10] Source: Royal Mail, 2007-8

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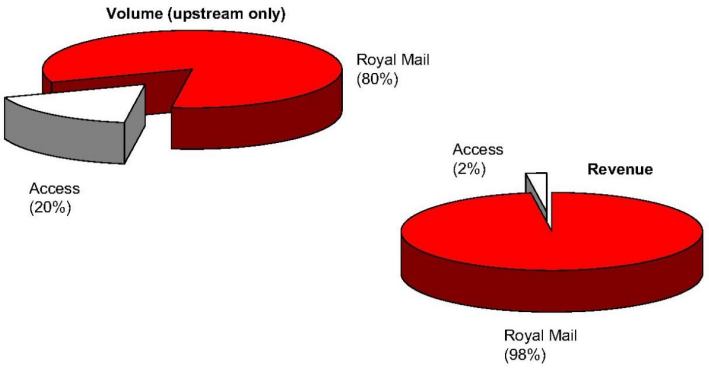
Figure 6

Impact of access competition on Royal Mail, 2007-8

By volume (upstream), and by revenue



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Part 2.

The issues

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Post matters

This section describes the relevance of the universal postal service in the 21st century and the views of customers about the service which they currently receive.

Summary

- *The universal service has a strong social and economic rationale.*
- *It involves the collection and delivery of letters to any of the UK's 28 million business and residential addresses on six days per week.*
- *Without the universal service, consumers in different parts of the country would have a different level of service and different prices.*
- *Residential consumers place a high value on the uniform tariff and a six-day collection and delivery service.*
- *The pattern of our lives and work has been changing. As recipients, consumers want more flexible services which deliver at their convenience.*
- *Although some customers are using the service less, others remain dependent on it for their communication and business needs.*
- *Most small businesses are dependent on Royal Mail's services. We would expect them to share in the benefits of competition over time.*
- *Large businesses have seen prices fall since 2005, as their choice of postal service providers has increased.*
- *Competition has brought clear benefits and is encouraging Royal Mail to provide a more efficient service that consumers want.*

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What is the universal service?

23. Consumers value mail – as they do energy or water – not only when using the service, but also because the service is available to use at any time, as and when needed. The universal postal service provides customers with that guarantee. Box 1 gives a detailed description. There are two essential features.

- The price of the service must be affordable. In the UK, the price of sending a letter must be the same between any two points in the country, regardless of the distance covered.
- The universal service ensures communications across all 28 million business and household addresses in the UK[11], regardless of their location, on six days a week. That requires a national network of collection points, mail centres, distribution centres and delivery offices.

What difference does it make?

The universal service continues to have a strong economic and social rationale.

24. A national network and uniform tariff are beneficial for the economy and society in a number of ways.

- The national network strengthens social cohesion by ensuring that everyone, whether in urban, rural or remote areas, has an accessible, reliable means of communication and the capacity to send and receive physical goods. It also enables access to other services, such as internet shopping.
- The universal service is important to the UK economy for precisely the same reason: it enables trade. Companies of all sizes rely on the postal service to build their business, supply goods and receive payment.
- A uniform tariff protects those who use the postal service rarely or who live in areas of low population density. They might otherwise face a connection charge, higher prices or less convenient services.
- An affordable service protects the ability of vulnerable consumers and those with lower incomes to send and receive goods, without the need for means testing.

Public opinion

25. The public values the social and economic glue which the universal service provides. Although only 13% of residential consumers are familiar with the concept of the universal service, they place a high value on:

[11] There are currently an estimated 2,812 delivery addresses which are exceptions to this universal availability on grounds of health and safety or accessibility. For example, there are some remote islands where a ferry visits from the mainland only three times a week. These exceptions account for roughly 0.01% of all addresses.

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Box 1: the Universal Service.

The universal service is a set of requirements set out in the European Postal Services Directive, transposed in UK law by the Postal Services Act 2000. Some aspects of the universal service are unique to the UK.

The universal service obligation applies to letters, packets and parcels up to 20 kg in weight. There are seven types of requirement:

- **Collection**. One clearance from each of the nation's 115,000 post boxes and 12,000 post offices per day on six days per week for letters, and five for parcels. (The timing of collections is not regulated).
- **Delivery**. One delivery per day on six days a week for letters, and five for parcels. (The timing of deliveries is not regulated).
- **Point of delivery**. Letters and packets must be delivered to the letterbox, unless health and safety issues or access restrictions make it impossible.
- **Reliability**. The regulator sets 12 standards for quality of service in Royal Mail's licence.
- **Accessibility**. The number and density of access points – post boxes and post offices - in the network.
- **An affordable price**. In the UK, prices for products contained within the universal service are controlled by the regulator.
- **A uniform tariff**. The price of a stamp is the same for any letter of a given weight and size, regardless of how far it will travel within the UK.

The regulator, Postcomm, is responsible for deciding which of Royal Mail's products should form part of the universal service. Under current regulations, they include first and second class stamps, standard parcels (up to 20kg), special and recorded delivery, redirections, poste restante, first and second class metered mail, bulk mail products (first and second class Mailsort 1400 and Cleanmail) and international delivery (both airmail and surface mail).

Consumers strongly support the uniform tariff and a next day delivery.

- the uniform tariff and its affordability. In research commissioned by Postcomm[12], 90% of respondents believed that a uniform tariff was very important or fairly important: the highest rating in the survey. A separate report by Postwatch[13] reports a strong opposition to any move away from uniform pricing.
- a next-day delivery service on six days per week. In the same survey, 82% of residential consumers, and 73% of businesses said that a six-day service is either important, or fairly important. Similarly, 82% of residential consumers also wanted a guaranteed next-day service to be provided.

[12] *The Needs of Users of the Postal Service: Customer Service Report*, Postcomm 2007
[13] *Postal Universal Service Obligation: Value to the Citizen,* Prepared for Postwatch by Accent, 2008

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26. These results are supported by evidence submitted directly to the panel. While there was debate about the mix of products which should be covered by the universal service, most agreed that all other elements (see Box 1) were still relevant. In particular, there was overwhelming support across all interest groups for deliveries on six days per week. Organisations warned that reducing the number of deliveries would send a damaging signal that mail is less relevant than other forms of communication and undermine the business, rather than enhance it. Moreover, those who send advertising mail – and so help to fund the universal service – had a preference for retaining deliveries on Saturday when people were more likely to be at home.

Figure 7: Recent survey evidence of the most valued aspects of the postal service

Year of survey	2008[14]	2007[15]	2006[16]
Residential consumers	Mail gets to its destination on time Delivery directly to the door Universal price Six-day collection Six-day delivery	Affordable prices for everyone Same stamp price irrespective of where sent in the UK. Collections Monday to Saturday. Deliveries Monday-Saturday.	Collection every working day. Delivery every working day. Affordability Universal price.
Business customers	Mail gets to its destination on time Guaranteed next day delivery Parcels get to destination on time Universal price Choice of 1st and 2nd class	Affordable prices for everyone Same stamp price irrespective of where mail is sent in the UK. Collections Monday to Saturday Deliveries Monday to Saturday	Collection every working day. Delivery every working day. Affordability Universal price.

[14] Accent 2008, op. cit.
[15] *The Needs of Users of the Postal Service - Customer Survey 2007*, Postcomm
[16] *The Needs of Postal Users - Customer Survey 2006,* Roland Berger for Postcomm, Postwatch and Royal Mail

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Residential consumers

27. At first sight, the views of residential consumers about the postal service seem contradictory. When asked about Royal Mail's services, the majority are positive. Yet there remains a fundamental concern that quality is falling. A clearer view emerges by differentiating between the two roles of the residential consumer: as sender (14%) and recipient (70%) of mail.

28. As senders, residential consumers are positive about Royal Mail's service. Taking into account that first and second class stamp prices have increased by 7% and 14% respectively in real terms since 2005:

- 86%[17] (and 90% of those who live in rural areas) believe that Royal Mail's first class service provides good value for money.
- 84%[18] believe that second class mail offers good value for money.

Measured according to standards set by the regulator, Royal Mail's performance is at its highest on record. The company met eleven of its twelve quality of service targets in 2006-7[19] (allowing for variations in quality, mainly in London and some other major cities).

29. The introduction of a new cost-reflective pricing structure for letters, based on weight and dimension ("Pricing in Proportion") means that consumers are more likely to need advice about sending their letters. These changes have greatest impact on those who work and live in more rural areas, as well as consumers unable to travel to the nearest post office, including the elderly and those with disabilities.

Fewer and less predictable deliveries are perceived as a reduction in the quality of service.

30. As recipients, residential consumers have been affected directly by a series of changes over recent years. Royal Mail reduced the number of daily deliveries from two to one in 2003-4. In 2003, Royal Mail aimed to complete the first delivery by 9.30 am. The company now aims to deliver mail to 2.00 pm for most consumers, and 3.00 pm in outlying areas of the country.

31. As the volume of packets increases, customers are least satisfied with the arrangements for collecting those which arrive when no-one is at home[20]. Lifestyles have been changing over recent years, as more households have two adults in employment. Working hours have been increasing, as have daily commuting times. As people spend fewer hours in the home, it becomes more likely that they will miss deliveries of large packets, parcels or items which need a signature.

32. Changes in the pattern of deliveries are perceived by recipients of mail to be a reduction in service. Similarly, the twelve quality of service targets which Royal Mail must meet under its licence conditions are configured to meet the needs of paying customers, rather than recipients.

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[17] *The Needs of Users of the Postal Service - Customer Survey 2007*, Postcomm
[18] *The Needs of Users of the Postal Service - Customer Survey 2007*, Postcomm
[19] Royal Mail's performance in 2007-8 was affected significantly by industrial action.
[20] Accent 2008, op. cit.

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Small and medium-sized enterprises

33. Small and medium-sized businesses make a major contribution to the UK economy. They account for 59.2% of the UK's private-sector employment and 51.5%[21] of private-sector revenues.

34. In spite of advances in technology and on-line banking, many small businesses are dependent on the postal network to organise financial transactions. Over 50% of companies surveyed by the Federation of Small Businesses[22] send over three quarters of their bills and invoices through the post. When profit margins are tight, the ability to receive payment and avoid penalties for the late settlement of bills is vital. With that in mind, small companies want later collections and earlier, predictable delivery times. The length of time between the delivery and last collection is particularly important for sole traders so that they can exploit the working day to maximum effect and, in particular, bank cheques promptly.

35. Surveys show high levels of satisfaction for the quality of service offered at today's prices. Some 83% of small businesses believe that first class mail offers good value for money. The response is higher still for medium-sized enterprises: 92%.[23] But they do not believe that the service fully meets their particular needs. Like residential consumers, smaller businesses place most value on regular, consistent collections and deliveries[24]. And in some cases, recent changes in collection and delivery have made it more difficult to carry out their business.

36. Recent research[25] shows that small businesses are least content with the timing of deliveries. Half of small and medium-sized enterprises whose delivery times varied experienced a difference of over three hours between the earliest and latest time their post arrived. Concerns about the variable nature of delivery times outweigh those about the time of the delivery. There is contradictory evidence, though, as to whether small businesses would be willing to pay more to secure earlier and more reliable deliveries.

Most small businesses are dependent on Royal Mail's services.

37. As senders, many small businesses use Royal Mail meters. In doing so, they qualify for a discount of 2p for each first class letter under 100 grams handled by Royal Mail (and 3p for every second class letter). There are similar discounts of up to 15% for packets. This is a significant improvement on the experience of small businesses immediately before liberalisation of the postal market.

38. Relatively few small businesses have a choice of provider, yet. Meters are configured only for Royal Mail products. And research by Postwatch[26] suggests that only 3% post more than 250 items per week: the current threshold for an alternative carrier to take the business. As a result, the vast majority of smaller businesses still rely on stamps and use post offices as the main access point for postal services.

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[21] Small and Medium Sized Enterprises Statistics for the UK 2007, BERR Statistical Release, July 2008.
[22] Federation of Small Businesses, op. cit.
[23] Source: Postcomm 2007 FDS, op. cit.
[24] *Small and Medium-Sized Enterprises' Current and Future Postal Needs*, prepared for Postwatch by RS Consulting, May 2008.
[25] Postwatch 2008, op. cit.
[26] Ibid. Statistics for small businesses relate to companies with between two and 250 employees. They exclude sole traders. Postcomm's Business Customer Survey suggests that the number is substantially higher, but by defining small businesses according to their expenditure on post, rather than by the number of employees.

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39. This is, however, early days for the postal market after liberalisation. We would expect small businesses to see greater benefits from postal competition over time. The threshold for contracts with alternative carriers has already reduced significantly from 4000 items per week in 2003, to 250 now. And as many as 36% of small businesses have mailings of over 250 items, on average 28 times per year.[27] Alternative carriers are already offering to collect any amount of unsorted mail with pre-sorted letters or parcels. It seems likely that more small businesses will take advantage of the choice in services in future.

40. If a wider range of small businesses is to benefit from competition, there will need to be more intermediate companies to collect and consolidate mail on their behalf before feeding it into the Royal Mail network. The growth of consolidators would give small businesses a better opportunity to say what they need from the postal service, based on their location and the volume of their mail. Royal Mail should consider how it might encourage this practice of consolidation which is common in many other European countries.

Box 2: Extending the benefits of competition to small businesses

Physical consolidation

First Post builds on the document service for solicitors in Scotland. Some 60% of solicitors' mail is destined for recipients outside the profession. First Post consolidates these letters from its 240 exchanges before handing the mail to TNT for sorting and, ultimately, delivery through Royal Mail. The service regularly handles over 15,000 items per day. The company has plans to offer its services more widely to small and medium-sized businesses in future.

Enabling greater access

One Post has designed a service which extends the benefits of competition to smaller customers. It uses software to compare the cost of using different postal companies, then manages the contract on its client's behalf. One Post is able to use the combined buying power of its customers to achieve better discounts than would be available if customers were acting individually.

Electronic consolidation

A number of companies offer 'hybrid' solutions" (*TNT-it; iMail* and *Viapost*) which are accessible to smaller businesses regardless of the number of items sent. Customers send their letters to the service provider electronically. The provider checks the postal address is valid and sends it to the printing company closest to the recipient. The price of the service covers the cost of paper, envelopes, printing and postage.

Large businesses

Large companies benefit from lower postal prices than 2005, and more choice of providers.

41. Since the 50 companies which make the most regular and extensive use of the postal service account for 40% of mail volumes, their business is the subject of keen competition. Since liberalisation, they have a choice of services, greater flexibility in negotiating contracts and greater assurance about the quality of services. Those which use alternative carriers are able to track their mail at all stages from collection until it is transferred to Royal Mail.

[27] Source: Postwatch 2008, Needs of SMES research.

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42. Large businesses have also benefited from liberalisation through lower prices. On average, Royal Mail's prices for second and third class bulk mail products have fallen by 1% and 3% respectively since 2005[28]. Across the market as a whole, it is estimated[29] that prices are 5% lower than might otherwise have been expected without competition.

43. The fact that large businesses have been the first to benefit from liberalisation reflects experience in other markets which have been opened to competition.

- Large companies help sustain the universal service by sending the majority of mail in the UK.
- Discounts for large businesses help them keep down the price of their products and services to residential consumers.

44. Some large companies which continue to use Royal Mail have told the panel that the company is still not customer-oriented, in spite of competition. They want to negotiate contracts which suit the particular requirements and constraints of their business, but have found this difficult to achieve. They are confused about the flexibility which Royal Mail has under the regulatory regime, after talking to both the regulator and the company.

45. While large companies acknowledge the benefits of downstream access, some believe that the system has done all it can for them. Having taken advantage of discounted upstream prices, they are looking for new ways to reduce the costs of their business. They believe that there are opportunities to do so in the delivery of mail. Yet, having exercised their choice in selecting a different upstream provider, these companies no longer have any direct leverage over the cost of Royal Mail's delivery operations.

The impact of liberalisation

46. After the publication of our interim report, some headlines reported that there had been no real benefits from liberalisation. That is not our view. The competitive postal market is still in the early stages of development. Benefits are already visible for the largest customers. Over time, we would expect both smaller businesses and residential consumers to benefit from choice, a more efficient service and new products.

47. Others have suggested that liberalisation has threatened the universal service. Again, we do not believe that this is the case. On the contrary, competition has brought clear benefits and is encouraging Royal Mail to offer a more efficient service which consumers want. It is conceivable that competition could present risks for the universal service in future. But as of today, it is not competition within the postal sector, but competition much more broadly across the communications sector, which poses the greatest threat to the universal service.

[28] Royal Mail's first submission to the panel.
[29] *The Benefits of Competition in the UK Mail Market*, Europe Economics, March 2008.

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The market has changed

This section considers the major development facing the postal sector – the digital revolution – and its implications for the future.

Summary

- *For the first time on record, the volume of letters sent in the United Kingdom is declining each year as consumers make greater use of electronic media.*
- *Until now, the impact of this structural decline has been moderated by economic growth. As the economy slows, volumes could fall by as much as 5-7% per year.*
- *The digital age also brings opportunities for the postal service. Goods ordered on-line are delivered at a higher value than letters. And new technology heralds new services.*
- *Like all universal service providers, Royal Mail will need to become more efficient and diversify, as traditional revenues decline and substitutes constrain their ability to raise prices.*
- *There is a positive future for the postal service, provided that companies are able to respond quickly to the changing needs of consumers and embrace the opportunities which new technology brings.*

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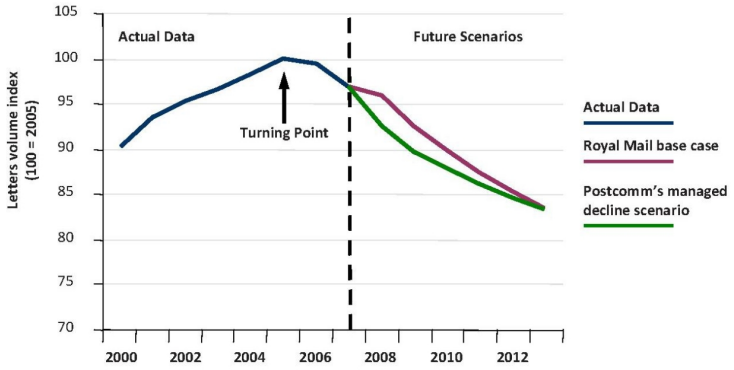
The digital revolution

The letters market is facing an unprecedented decline.

48. The UK letters market is now in structural decline[30]. Evidence suggests that letter volumes reached their highest point around 2005, and have been falling since then. In each of the three years from 2005-6, fewer letters were handled by the postal service.

Figure 8

UK letters market, 2000 to 2012



49. This continuous decline is unprecedented[31] and represents a fundamental change in the letters market. Our experience in the UK is consistent with trends in mature mail markets right across the world.

Figure 9: Reduction in addressed letter volumes[32]

Country	Growth in 2006-07
UK	-3.2%
France	-1.0%
Germany	-1.4%
Netherlands	-4.4%
Italy	-4.4%
United States	-1.8%

[30] UK addressed letter volumes declined by 3.2% over the year to March 2008. Early indications suggest that volume decline could be greater still in 2008-9. Royal Mail's results for the first half of 2008-9 highlighted a decline of 4%.

[31] Data available to the review panel begins in 1970.

[32] Company data of national operators, based on the 2007 financial year. Royal Mail figures are based on the 2007-8 accounts.

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Cyclical change

50. Letter volumes are partly a function of economic performance. Until recently, there has been a straightforward correlation between economic growth and the growth in letter volumes. People send more mail in response to increased economic activity. Conversely, as the economy slows down, businesses look for ways to reduce costs and letter volumes grow more slowly. Analysis suggests that a 1% change in GDP leads to around a 1% change in mail growth, other things being equal[33].

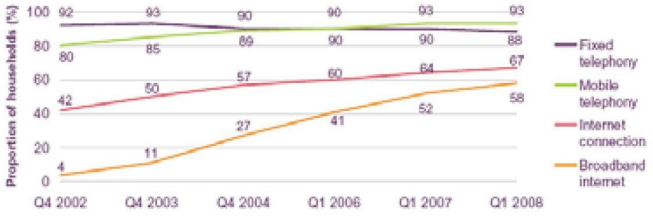
Structural change

51. In the last few years, however, a new phenomenon has complicated this simple trend. Broadband internet, email, mobile telephony, text messaging and digital broadcasting offer alternative ways for people to keep in touch, carry out business transactions and advertise. Compared with mail, they are immediate, flexible and have a low, often zero, marginal cost.

The explosion in digital media is the main factor behind the recent fall in the volume of letters.

Figure 10

Household penetration of key telecoms technologies, 2002-8



52. As Figure 10 shows, access to alternative media has increased significantly over the last six years. So has the extent to which alternative media are used. Amongst adult internet users, 69% go on-line every day, or almost every day. Some 59.1 billion text messages were sent in the UK in 2007, a growth of 36% over 2006[34].

53. The rate of substitution has become the most significant factor behind market decline, driving a "wedge" between economic growth and letter volumes. This is the sign of structural change affecting the postal market (Figure 11).

[33] Royal Mail's first submission to the panel. Analysis is based on regression techniques.
[34] *The Communications Market,* Ofcom, 2008

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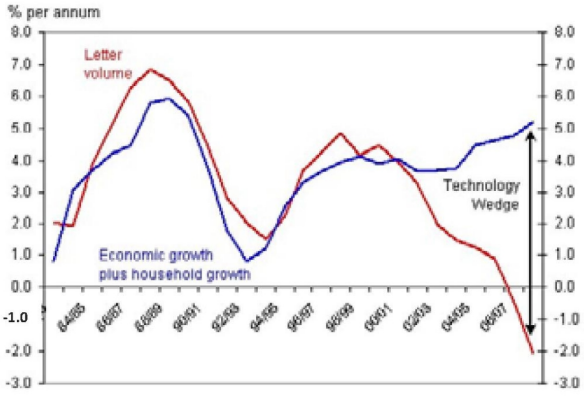
Figure 11

Growth in letters, compared with economic growth, 1984-2007



Challenges and opportunities

54. There are many factors which are likely to affect demand for postal services. They include the speed of the digital revolution and the rate at which new services become available; perceptions about the security of email transactions, particularly in relation to financial, legal or official matters; our understanding of climate change, and the carbon emissions from IT and postal services; the development of computer hardware; and the extent to which different age and demographic groups will prefer to use particular forms of communication. These are difficult to predict with any accuracy.

55. With more difficult economic times ahead, however, we can expect that e-substitution and slower economic growth will both exert downward pressure on mail volumes. This decline will have profound implications for all postal operators, and particularly Royal Mail.

56. The digital revolution brings a number of challenges.

- **Transactional mail**. Large companies, such as utilities, are offering their customers financial incentives to receive statements and pay bills on-line, or by direct debit, as part of their campaign to reduce costs. Large companies are likely to use bulk mail products for a number of years yet, while they remain committed to offering customers a choice between email and paper statements. But in the long-term, transactional mail seems very likely to be in decline.

- **Social mail**. Mobile telephones are now widely used as a means of sending short, immediate messages to family and friends at a low marginal cost. On average, 67 text messages were sent from each UK mobile connection every month. This compares with 29 text messages per connection in France and 20 in Germany[35]. Some 80% of adult broadband users also make use of email. That said, greetings

[35] *The Communications Market,* Ofcom, 2008

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cards account for a large proportion of social mail. And most consumers continue to attach value to giving and receiving greetings cards in paper rather than electronic form.

New forms of communication bring opportunities for the postal service, as well as challenges.

57. But there are opportunities, too.

- **Fulfilment**. UK consumers spent £42 billion on-line in 2007: 10% of all retail sales in the UK[36]. This generated 860 million parcels. With on-line spending expected to double to 20% of retail sales (around £78 billion) by 2010, the growth in packets handled by the postal service seems secure. Packets have relatively high margins, compared to letters.

- **Publications**. Some 700 million copies of magazines are circulated through the postal service each year. The demand for magazines, like newspapers, is falling, owing to the availability of information on the internet. That said, sales by subscription are increasing, relative to copies sold by newsagents. And because journals are more easily read in physical form, and can be passed to others, publishing companies believe that the scope for e-substitution is limited. Customers often use printed catalogues to make decisions about what to buy, before ordering on line.

- **Advertising mail.** Companies using large mailshots to generate new customers have seen the return on their investment fall in recent years. Advertising companies suggest that websites have become more attractive as a modern and less expensive means of advertising. But falling volumes need not imply reduced revenue for postal companies. The combination of digital print and sophisticated data handling offers the potential to personalise mail to an unprecedented degree. Carefully targeted advertising campaigns have strong potential and reduce waste. Moreover, mail has a strong role to play when businesses want to communicate with their existing customers. Although one-page leaflets can easily be transferred to the internet, longer publications with colour images, such as catalogues, tend to be more successful in print. Mail also offers a guarantee that companies' messages will be received, at a time when filters are becoming increasingly successful in blocking unsolicited email.

[36] Interactive Media in Retail Group (IMRG), April 2007

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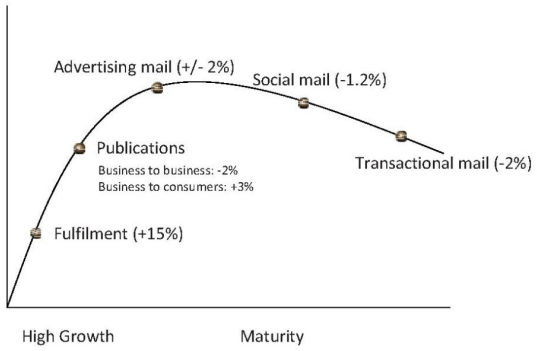
The value of the market could increase, if postal companies can capitalise on new opportunities.

Figure 12

Indicative stages of the life cycle for different mail applications



58. Overall, evidence seems to suggest that new volumes created by e-commerce are unlikely to match the reduction in volumes of transactional, advertising and social mail. But, because unit prices for fulfilment are higher than for traditional mail, carriers which are able to capitalise on the opportunities that e-fulfilment presents are more likely to prosper.

A positive future

59. Since change brings opportunities, as well as challenges, we believe that there is a positive future for postal services.

60. Mail has unique properties. Many regard post as a more personal medium than its electronic alternatives, and more likely to be opened by the recipient. Many items currently sent by post are difficult or impossible to transmit in digital form. There will always be a need for a physical delivery service accessible to consumers in all parts of the UK. And an efficient national delivery network is a crucially important asset, particularly in a world which is just beginning to come to terms with the implications of climate change.

Mail must be a service of choice, not a service of last resort.

61. These attributes can provide the foundation for a successful future if, and only if, the postal service is dedicated to meeting the needs of its customers. Mail must be a delivery service of choice, not merely a safety net or a service of last resort. A thriving postal market must appeal to a wide range of consumers. It will:

- be obsessive about customers, recognising that the needs of the recipient are as important as the those of the sender.
- be reliable and convenient, supported by an efficient national network which draws fully on the skills and local knowledge of delivery staff.

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- offer competitive prices. Services must be affordable and represent good value for money.
- be sustainable, with a low environmental impact, and without the need for continued subsidy by taxpayers.
- be innovative, seizing new opportunities in the communications and logistics markets to offer new and better services.

62. With this in mind, a successful postal service of the future will be very different from today's. It will be more capital intensive, less labour intensive, and will embrace new technology. Services will be delivered by companies which operate across historic market boundaries and which collaborate with others to compete more effectively, enhancing choice and reliability. There will be a much stronger focus on efficiency to reduce costs and increase value for consumers. There will be greater flexibility to innovate and to respond more quickly to opportunities in the market to meet customer needs.

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Box 3: Opportunities for innovation in the postal sector

The digital revolution brings the prospect of greater innovation in a sector where competition is currently focused predominantly on price. New ideas may emerge by using new technology in at least four ways:

- **Complementary services**. Mail is often considered to be in competition with other media. Yet internet advertising can create new volumes such as the despatch of catalogues, which in turn lead to e-commerce and the need for fulfilment. Shoppers often rely on a combination of printed brochures (delivered by post) and on-line information when making their choices. There may be opportunities for postal companies to work in partnership with internet companies, broadcasters and others in planning major advertising campaigns.

- **Hybrid solutions**. Some mail companies are looking to exploit the advantages of the internet to reduce the costs of transporting information in physical form. Senders can email letters so that they are printed as close as possible to the recipient before being transferred to Royal Mail's network for delivery.

- **Green solutions**. As awareness of climate change grows, customers are looking for ways to reduce the impact which their activities have on the environment. TNT Post has developed the first carbon neutral initiative for addressed mail in conjunction with The CarbonNeutral Company. The service is made up of four elements: carbon evaluation, carbon reduction, offset and the use of a *CarbonNeutral* logo which signifies a mailing is carbon-neutral.

- **Increasing the quality of service for recipients of mail**. Currently, choice lies mainly with the sender of mail who pays for the service. Mobile telecommunications, and the use of encrypted data on letters, provide new opportunities to offer the recipient greater flexibility about the timing and location of delivery. More flexible solutions may enable the postal company to increase the rate at which it is able to deliver packages at the first attempt, reducing costs.

  For example, *Packstation* is a service in Germany to solve the problem of parcels being delivered when their recipients are not at home. Customers can opt to have any parcel delivered to a local *Packstation* instead of their home address. As soon as their parcel arrives, they are notified by text message or email. The service never closes. So customers can call in at any time to suit their needs. On entering the customer code, the compartment containing their parcel will open automatically. Customers have nine days to make the collection, and are automatically sent regular reminders.

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Royal Mail faces severe difficulties

Royal Mail is the only company with the national delivery network necessary to provide the universal service. This section considers the company's ability to respond to the growth in digital media and the implications for the universal service.

Summary

- *Royal Mail delivers 99% of all items posted in the UK. No other company is likely to have an equivalent national network in the foreseeable future.*
- *Royal Mail's financial viability is vital to the future of the universal service.*
- *Royal Mail needs to respond urgently to the structural decline in the UK letters market caused by the growth of digital media.*
- *Royal Mail's ability to respond is constrained by five factors:*
  - ***Inefficiency.*** *Royal Mail is much less efficient and less profitable than its main European peers.*
  - ***Pension deficit****. Royal Mail's historic pension deficit is one of the largest in the UK, and is highly volatile.*
  - ***Pricing.*** *Increasing postal prices is no longer guaranteed to generate sufficient revenues to offset falling volumes.*
  - ***Labour relations.*** *The relationship between management and the Communications Workers Union is extremely difficult.*
  - ***Relationship with the regulator.*** *So too is the relationship between the company and its regulator, Postcomm.*
- *The combination of these factors led to an operating loss at Royal Mail in 2007-8. The universal service was loss-making for the first time.*
- *Royal Mail's financial position is precarious, the universal service is under threat and the status quo is untenable.*

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The significance of Royal Mail

Royal Mail is likely to be the only company with full coverage across the UK for the foreseeable future.

63. Royal Mail is the only company which operates a network capable of delivering letters and packages to any of the 28 million business and household addresses nationwide. Royal Mail's financial health and ability to respond to its customers are critically important to the universal service and, therefore, the future of the sector as a whole.

64. Competition has developed in the collection, sorting and transportation of mail, more quickly than anyone predicted[37]. There is, however, virtually no competition in providing a full "end to end" service for *addressed mail* in the UK. Almost all letters processed by alternative carriers are injected into Royal Mail's network at one of its 69 mail centres. As a result, around 99%[38] of letters sent to addresses in the UK are delivered through letterboxes by postal workers employed by Royal Mail.

65. In our view, end-to-end competition (collecting and delivering letters) may emerge in future, particularly if there are changes to the VAT regime[39]. But it is likely to be limited to the most profitable routes. Even the most optimistic forecasts would leave Royal Mail with a substantial share of the market.

The challenge posed by structural decline

The effect of competition from digital media on Royal Mail is much more significant than the impact of postal competition.

66. After a long period of growth, the volume of letters in the UK mail market has been declining since 2005. In 2007-8, Royal Mail handled three million fewer letters a day than it did in the previous year: a decline of 3.2%. As a result, Royal Mail's revenues have fallen over the last two years. This is the result of three trends[40]:

- Royal Mail is facing competition from digital media. The company estimates that the substitution from postal services to alternative digital media reduced its operating profit by £500 million in 2007-8.
- After liberalisation, alternative carriers are collecting, sorting and transporting 20% of mail, before handing it to Royal Mail for delivery. The introduction of postal competition is estimated to have reduced Royal Mail's operating profit by £100 million in 2007-8.
- Customers are moving to cheaper products: from first class to second class mail, for example. This is estimated to have reduced Royal Mail's operating profit by £160 million last year.

In addition, the impact of structural change is now being accompanied by volume decline as a result of the cyclical downturn in the economy.

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[37] In 2005, Postcomm's projected that access competition would have reached 2.6 billion items by 2007-8. The actual figure was 4.1 billion items.

[38] Estimates vary. This figure is quoted from Postcomm's *Strategy Review: Emerging Views*. Royal Mail calculates its share of the end-to-end market to be 98%.

[39] See Annex D and the discussion of VAT in Part 4 of this report.

[40] Calculations are based on modelling by Royal Mail. Numbers are first-order effects and do not include any changes to pricing plans, regulation or transformation plans which might result if e-substitution and postal competition did not exist. The £500 million digital media substitution and £100 million postal competition effects relate to switching estimated to have occurred since 2005-6. The numbers do not include the positive impact that e-fulfilment revenues generate.

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67. Liberalisation has had a relatively limited impact on Royal Mail's financial position because the company continues to deliver, and charge for, almost all items over the final mile. The effect of competition between post and other communications media has been much more significant.

In a declining market, Royal Mail will have to "run to stand still".

68. In a declining market, Royal Mail will need to reduce costs in order to become efficient, profitable and remain a viable business: "running to stand still".

Box 4: Running to stand still - the imperative for efficiency

When people send fewer letters, Royal Mail's fixed costs are distributed across a smaller volume of mail, and so the cost of delivering each letter increases. Unless Royal Mail can increase its prices by a similar amount, falling volumes of mail can rapidly lead to a situation in which each letter – and the company – is making a loss.

To avoid this outcome and maintain a viable financial position, Royal Mail must reduce its costs wherever possible. It must also ensure that more of its essential costs are variable in line with changes in demand for postal services.

Reducing costs in a declining market is particularly challenging because the benefits of a reduction in costs are continually eroded by falling volumes. If Royal Mail is to achieve a more secure financial position, it will have to cut costs not only in line with the falling market, but more quickly than the rate at which volume is declining.

Royal Mail's ability to respond to market decline

69. Royal Mail is unable to respond sufficiently quickly to the declining market. It suffers from five main constraints: inefficiency, a large and volatile pension deficit, pricing, poor labour relations, and its difficult relationship with the regulator.

Inefficiency

To make its letters business profitable, Royal Mail has no option but to reduce costs.

70. Between 2002 and 2005, Royal Mail removed between £460 million and £600 million in costs[41] from its business. The Group's workforce was reduced by over 40,000 employees[42], the majority from Royal Mail. Over the next seven years, the company aims to reduce costs by a further £1.2 billion. This represents around a fifth of Royal Mail's total current costs.

71. In its accounts for 2006-07, Royal Mail estimated that it was 40% less efficient than its competitors. There are five reasons:

[41] Estimates vary. Postcomm estimates that the (annual) savings were £460 million. Royal Mail's estimate is £600 million.

[42] Royal Mail Group embarked on its Renewal Plan between 2002 and 2005. During that period, the company's workforce was reduced by approximately 25,000 employees. There have since been further reductions of 16,000. Both these figures exclude outsourced workers.

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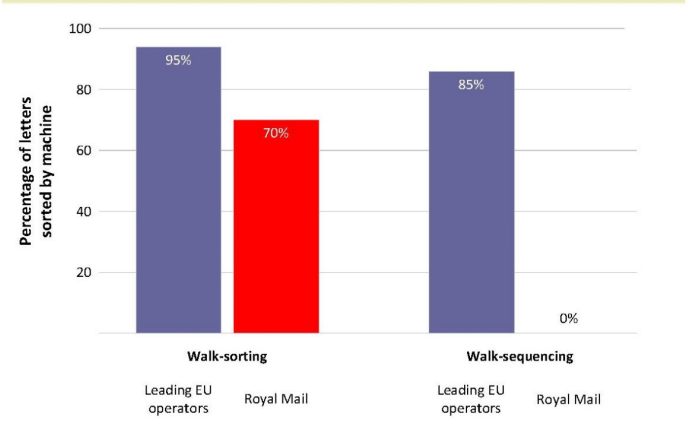
- **The network of mail centres and delivery offices**. European companies such as TNT and Deutsche Post began a radical restructuring of their networks in the early 1990s. In marked contrast, Royal Mail's distribution network is largely unchanged. Since the commencement of the Renewal Plan in 2002, the number of mail centres has reduced from 71 to 69, and the number of main delivery offices from 1,377 to 1,365[43].

- **Automation**. Letters are prepared for delivery in two, separate procedures: walk-sorting, and walk-sequencing. In the first, Royal Mail uses machines in its mail centres to sort 70% of letters into groups which correspond with the addresses covered by each postal worker's 'walk'. This is a substantial improvement from 50% just two years ago, but is still markedly lower than the 95% managed by leading European operators. In the second procedure, walk-sequencing, letters are placed in the correct sequence for delivery. At Royal Mail, this is carried out entirely by hand. It takes each postal worker between 2-3 hours each morning before starting his or her delivery round. The leading European companies use walk-sequencing machines to perform the same job automatically for around 85%[44] of their mail. As a result, their costs are significantly lower. Royal Mail is in the process of buying and installing walk-sequencing machines across its network, and aims to sequence 75% of letters automatically by 2012-13.

Figure 13

Royal Mail's automation in context



[43] Source: Royal Mail. These are net movements and exclude reference to the Scale Payment Delivery Offices. The figures for mail centres reflect the closure of Paddington, London North and Slough. In relation to delivery offices, offices have opened as well as closed.
[44] Source: Royal Mail.

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- **Working practices**. Over time, the accumulated effect of local agreements has resulted in various working practices which restrict Royal Mail's efficiency.

    - Early finishes. It has been common practice that postal workers go home when they have finished their round. In the summer or on certain days of the week when volumes are low, this can be up to three hours before their paid hours have ended. If, however, additional time is needed to complete a round, overtime can be claimed or the round not completed.

    - Covering for absence. Employees will on occasion not carry out a colleague's deliveries without being paid overtime to do so, even when their own workloads are relatively light. So a postal worker who is paid until 2.00 pm and finishes his or her own route at 11.00 am may still claim overtime to cover a colleague's deliveries, even though they could be completed within paid hours.

    - Equipment. In some locations, the CWU has instructed its members not to use new technology (such as machines for sorting larger letters and hand-held devices to track mail) until there is both a national and local agreement about their use.

    - Demarcation. Employees in some mail centres have been known to refuse to work in the delivery office, for example, even though both are on the same site.

  The Pay and Modernisation agreement accepted by the CWU membership in November 2007 (following industrial action earlier in the year) was intended to address these practices and to pave the way for the modernisation of Royal Mail. Some progress has been made. But changes in some mail centres and delivery offices continue to be resisted by local CWU representatives and some of the workforce in spite of the national agreement.

- **Pay**. Research conducted for the current price control found "substantial evidence to suggest that, on average across the country, Royal Mail currently pays above market average rates". This study found that base pay for operational grades is between 6% and 25% above median base pay in comparable roles across all sectors, and above the top quartile base pay in some sectors[45]. The most recent economic data continues to support this view. Full-time pay is 20% higher for Royal Mail employees than other postal workers[46]. Figure

[45] *Future Efficient Costs Of Royal Mail's Regulated Mail Activities*, LECG, August 2005.
[46] Source: *Annual Survey Of Hours And Earnings,* Office for National Statistics, 2007. Analysis based on a comparison of the gross earnings (including overtime) of male full-time workers in national postal companies, versus male full-time workers involved in the collection, transport and delivery of letters and mail-type parcels and packages by firms other than national postal companies.

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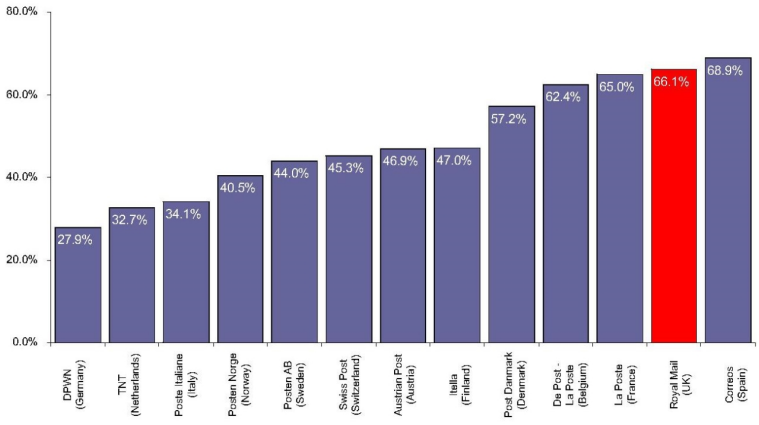
14 shows that labour costs at Royal Mail Group were among the highest of European postal companies[47].

Figure 14

Labour costs as a percentage of revenues in 2007
Postal companies across Western Europe



- **Ongoing pension contributions**. Royal Mail is the sponsoring employer for one of the UK's largest funded defined benefit pension schemes: the Royal Mail Pension Plan. The scheme has 452,000 members of whom 161,000 are current employees. At 20% of pensionable pay, the cost of current service contributions[48] is significantly higher than the average for defined benefit schemes of 16.1% and around three times more expensive than schemes based on defined contributions[49]. To ensure that pension arrangements are sustainable, the company consulted and decided to close the scheme to new members with effect from 1 April 2008. Existing members are able to continue to accrue new benefits, but with an increase in the pensionable age from 60 to 65, and the calculation of benefits on the basis of a career average salary. New employees will be eligible to join a new defined contribution scheme. Over the next few years, these changes are expected to reduce Royal Mail's costs associated with current service to levels that are broadly consistent with industry averages.

72. All of these factors contributed to Royal Mail's operating loss of £3 million in 2007-8. The company was the least profitable postal company[50] amongst its Western European peers, and the only one to make an operating loss.

[47] Source: Deutsche Bank, based on company data at a group level for the 2007 financial year. Royal Mail Group figures are based on the 2007-8 accounts.
[48] This is the expected cost of new benefits accrued by employees within the current year.
[49] Source: *Occupational Pension Schemes Survey,* Office for National Statistics, *2007*. Average private sector employer contribution rates: defined benefit schemes (closed to new members), 16.1%; defined contribution schemes (open to new members), 6.4%
[50] Source: Deutsche Bank, based on company data at the mail business unit level for the 2007 financial year. Royal Mail figures are based on the 2007-8 accounts. Figures for Correos, Post Danmark and De Post-La Poste relate to the group level.

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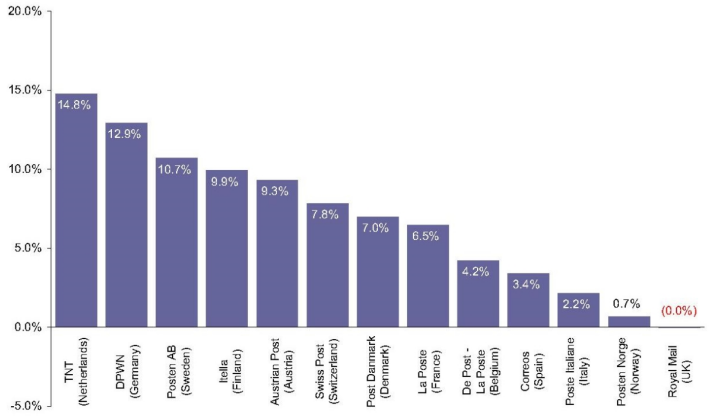
Figure 15

Operating profit margins of Western European postal companies, 2007 (%)



The company's handling of letters and packages is much less efficient than its European peers. That is reflected in poor operating profit.

Royal Mail's inefficiency has a much bigger impact on profitability than postal competition.

73. Figure 16 assesses how a lack of efficiency, pension payments and competition each contribute to the gap between Royal Mail's performance today, and that of a modernised Royal Mail achieving an operating profit margin of 13.5%[51]. Market decline is not featured within the diagram, because it is a common challenge facing all European operators.

- While access competition has added to Royal Mail's pressures, Figure 16 shows that its impact has been limited. Without competition in the postal market, Royal Mail might have made a 1.4% operating profit margin.

- The company's operating profit margin would have been significantly higher – 4.3% – were it not for pension costs having been set at levels well above industry standards. This has clearly been a significant constraint on the business and has been addressed by recent amendments to the pension scheme.

- It is the other sources of Royal Mail's inefficiency, compared with leading European counterparts, which have the most significant impact on the company's operating profitability and long-term financial health. The comparison suggests that Royal Mail could have achieved a 7.8% operating profit margin if it had reduced costs and generated new sources of revenue to the same extent as modernised companies in The Netherlands and Germany, for example.

[51] This percentage has been used for indicative purposes, as a rounded average of the margins achieved in 2007 by TNT and Deutsche Post, widely considered to be "best in class" among European postal services having modernised their operations over the last 15 years.

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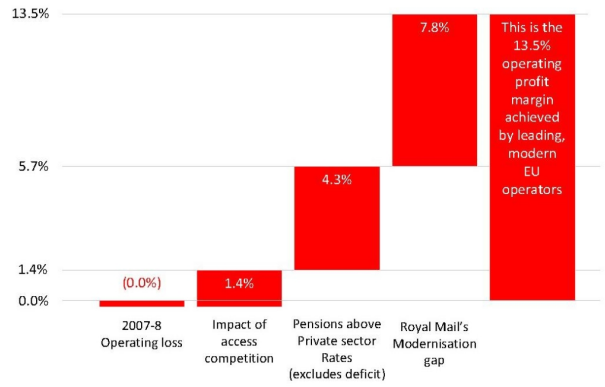
Figure 16

Factors affecting Royal Mail's operating profit margin in 2007-8 and their relative significance



Pension deficit

The company is bearing a much higher level of risk associated with the pension deficit than many larger, financially stronger companies.

74. Royal Mail has taken action to reduce the cost of future pensions provision. But it must also make contributions to address the deficit: the gap between the assets of the pension plan and the forecast liabilities. At the time of the last triennial valuation, the deficit was calculated at £3.4 billion[52]. In 2007-8, Royal Mail's cash deficit payment was £284 million, with payments expected to continue for the next 15 years. In spite of this, the deficit has increased by £2.5 billion (some 75%) since 2006, with the most recent estimate putting it at £5.9 billion[53]. Even before this recent increase, the deficit was among the largest of any reported by a UK company, as is illustrated in Figure 17[54].

75. Although consumers bear part of the cost through higher prices, the burden of the deficit payments contributes significantly to the current financial pressures on Royal Mail, and makes it more difficult for the company to compete in a liberalised market. The recent growth in the size of the deficit means that the size of its contributions may have to be increased (or the repayment period extended) following the next triennial valuation due in 2009.

76. The volatility of the deficit is also highly significant for a business of Royal Mail's size. The company is bearing a much higher level of risk associated with the pension deficit than many much larger and financially stronger companies. On an accounting basis, its pension deficit is over six times larger than the cash generated by its business operations (before

[52] Deficit calculated on an actuarial basis as at 31 March 2006.

[53] *Royal Mail Pension Plan Annual Report and Accounts, 2007-8.* The deficit is calculated on an actuarial basis as at 31 March 2008. Most of the deterioration is the result of a fall in index-linked bond yields, leading to a higher assessment of the value of the Plan's liabilities.

[54] *Accounting for Pensions 2008,* Lane, Clark and Peacock. The comparison is based on published accounting deficits. Few schemes or companies publish their actuarial deficits, meaning that comparisons are only possible on the basis of accounting deficits calculated on standard methodology (FRS17/IAS19)

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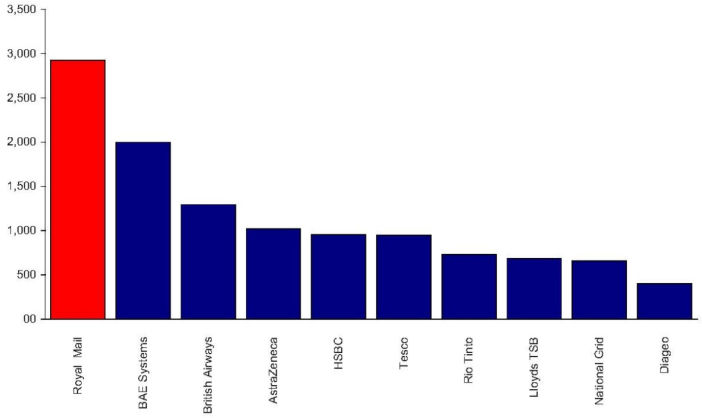
financing and investing activities)[55]. Both the size of the deficit and its volatility adversely affect the company's ability to finance and invest in its core business. Because of the size of the deficit, this is likely to remain a problem for the foreseeable future.

Figure 17

Royal Mail's pension deficit in context

Largest accounting deficits among FTSE 100 companies (£million)



Pricing

A strategy based on raising prices carries risk.

77. Price rises are becoming less effective at generating additional revenue for Royal Mail. When Royal Mail increased the price of its products in 2007-8 by a weighted average of 5%, for example, revenues fell slightly[56]. This effect can be explained by a combination of factors. As prices rise:

- some customers will decide to use electronic media or give their business to one of Royal Mail's postal competitors[57].
- others will opt for less expensive postal products, such as second class mail.

An aggressive rise in prices could precipitate further decline.

78. To generate additional revenue, price rises must be sufficient to offset the revenue lost as the number of letters falls. The fact that prices in the UK are low relative to many other European countries suggests that there is scope for an increase (see Figure 18). Yet any aggressive increase in prices could prompt a faster movement away from mail to electronic media, compounding the problem of declining volumes and revenues rather than solving it[58]. This places even more emphasis on the need to reduce costs.

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[55] *Royal Mail Annual Report and Accounts, 2007-8.* Net cash inflow from operating activities: £450 million. IAS19 deficit: £2.9 billion.

[56] *Royal Mail Annual Report and Accounts, 2007-8,* page 5

[57] Business customers are more likely to substitute away from mail than social customers as they have a greater choice of alternatives. (Access competitors do not currently serve social users, for example). Consequently, the elasticity of demand for business products like Mailsort tends to be higher than for 'captive' social products like stamps.

[58] There is uncertainty about the stability of price elasticities associated with large changes in price. While Royal Mail can perhaps be confident that small changes in price of say 1%, will generate

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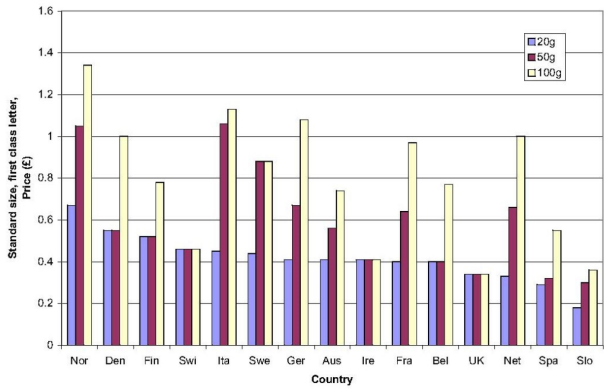
Figure 18

EU first class stamp prices, by weight



Labour relations

Labour relations are extremely difficult

79. Any business facing such significant changes as Royal Mail needs effective engagement with the unions. In its submission to the panel, the Communications Workers Union recognised the need for Royal Mail to modernise its operations by investing "to increase levels of automation and efficiency". It also acknowledged that the necessary changes would entail a significant reduction in jobs, while making the case for maintaining employees' terms and conditions of service.

80. Poor industrial relations at Royal Mail have been well documented, most notably by the review led by Lord Sawyer in 2001[59]. They remain extremely difficult. Over the past decade, disputes between Royal Mail's management and the Communication Workers Union have had a major impact on the company's ability to implement change and make progress in transforming the business. In 2007, over 627,000 employee days were lost as a result of industrial action, the highest total since 1996. This represented 60% of days lost to strikes across the whole of the UK economy in 2007[60].

additional revenues (because demand is 'inelastic'), price changes of say 20% may cause revenue to fall (because demand might be elastic for large price rises).

[59] *Independent Review of Industrial Relations between Royal Mail and the Communications Workers Union*, Lord Sawyer, 2001

[60] Source: *Labour Disputes in 2007,* Office for National Statistics.

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Box 5: Unions

Employees in Royal Mail have the choice of being represented by one of two unions.

Communications workers union.	The largest union for communications workers in the UK with 250,000 members. Of these, 160,000 are employed in the postal sector, working for Royal Mail and the Post Office. The Union's National Executive Council is responsible for policy decisions and is elected each year by a postal ballot of all members. The Council comprises two industrial executives to decide on occupational policy: one for postal matters, the other for telecommunications. The CWU sponsors or supports eleven members of the House of Commons.
UNITE – the union.	Unite is the UK's largest trade union with 2 million members across the private and public sectors. The union's members work in a range of industries including manufacturing, financial services, print, media, construction, transport, local government, education, the health service and not for profit sectors. The Communication Managers Association (CMA) Sector of Unite represents some 11,000 communications professionals of whom the majority are managers in the Royal Mail Group, Post Office Ltd, Parcelforce, Guernsey Post Limited, Jersey Post and Isle of Man Post Office. It is the only union recognised for managers in Royal Mail and represents all grades. A large percentage of its members work in joint ventures with Royal Mail or outsourced companies such as Romec, Quadrant, Capita, Atos Origin, CSC, Xansa. The CMA also has members in other postal operators such as Deutsche Post.

Industrial action can accelerate structural decline, endangering the universal service.

81. Industrial action in recent years has promoted discussion about the reliability and cost of postal services to boardroom level in major companies. There is evidence to suggest that some companies using the postal service for transactions and advertising decided to use other media on a permanent basis after strikes in 2007, accelerating a decline in the postal market[61]. In a survey of Direct Marketing Association

[61] *Impact of Strike Action at Royal Mail in 2007,* submission to the panel from the Mail Users Association.

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members, 41% said that their companies had suffered long-term adverse effects as a result of industrial action and that further disputes would exacerbate the situation. Because the universal service relies on economies of scale, any action which reduces the volume of mail endangers the universal service.

82. These difficulties are exacerbated by a lack of understanding about the Government's role as Royal Mail's sole shareholder. However strongly the Government emphasises that Royal Mail must follow commercial objectives, the union perceives that it is in the interests of its members to encourage Ministers to intervene in the management of the company. This would be the case irrespective of which political party forms the Government.

Relationship with the regulator

There is strong tension, too, between Royal Mail's management and the regulator.

83. Tensions can be expected in any regulatory relationship, particularly in the early stages of market liberalisation. There are comparisons with the early relationship between BT and Oftel in the telecommunications market. We have, however, been struck by the depth and range of disagreements between Royal Mail and Postcomm. Even the most basic facts are disputed. The definition of the postal market, the company's performance against efficiency targets, and the size and distribution of Royal Mail's costs, are notable examples. The systems and necessary data needed to build a constructive and professional regulatory relationship are not yet in place.

84. The tension reflects Royal Mail's belief that Postcomm is too focused on the introduction of competition, at the expense of the regulator's primary duty to protect the universal service, and Postcomm's frustration at the slow pace of change in Royal Mail. There is a lack of trust on both sides. The situation is exacerbated by the fact that Royal Mail is the only postal company whose prices are directly controlled by the regulator. These tensions act as a constraint on Royal Mail by diverting management attention from the main task at hand.

Royal Mail's financial position

Royal Mail made an operating loss in 2007-8.

85. Royal Mail's profitability is low compared to the leading European operators such as TNT and Deutsche Post. Last year, TNT and Deutsche Post achieved operating margins of 13-15% from their mail operations, yielding an operating profit of £500 million and £1.6 billion respectively.

86. As Royal Mail's revenues have fallen over the last two years, its operating costs have continued to rise, and now stand at over £6.9 billion. As a result Royal Mail made its first operating loss (of £3 million) in 2007-8[62] since the company's reorganisation in 2001-02.

87. The company and regulator agree that the number of letters handled by Royal Mail over the next ten years could fall by around a third. This reflects declining volumes in the market as a whole, as customers

[62] At the mid-year point in 2008-9, Royal Mail made a small profit of £46 million against revenues of £3.3 billion, in spite of falling volumes. Even so, the company's profit margin is still amongst the very lowest of its West European peers at 1.4%.

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continue to move to electronic communications, and the possible impact of some end-to-end competition.

88. In its submission to the panel, Royal Mail indicated that its "overall financial situation is becoming increasingly difficult" and that the "forecast headroom against the company's financing facilities allows little margin for error". With a pension revaluation due in 2009, significant market uncertainty and letter volumes declining more quickly than predicted, even before the current economic downturn, what was a tight but manageable financing position now has substantially more risk attached.

89. Postcomm, too, believes that "without extensive change, the Royal Mail's business model will become unsustainable". Under a "managed decline scenario" which assumes no transformational changes, Royal Mail's profitability could fall further (Figure 19) and it could have a negative cash flow in the region of £400 million each year by 2009-10 (Figure 20).

Figure 19

Royal Mail projected profit, 2008-13
(EBITDA in £ millions, based on a managed decline scenario)

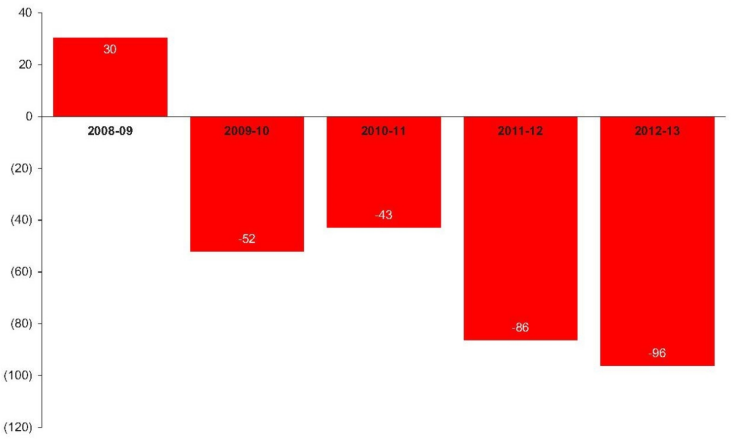

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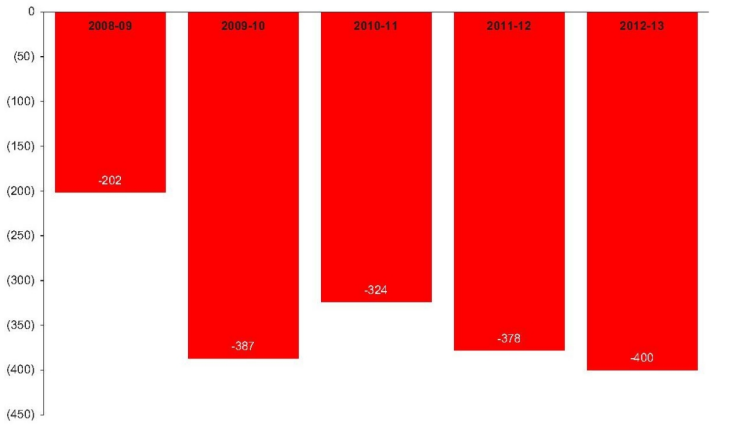
Figure 20

Royal Mail projected cash flow, 2008-13
(£ millions, based on a managed decline scenario)



The universal service is under threat

90. Royal Mail is the only company currently capable of providing the universal service. That is likely to remain the case for the foreseeable future. Consequently, Royal Mail's financial viability, its ability to invest to develop the business, and its response to the changing demands of its customers (including other postal companies) is vitally important to the universal service and to the sector as a whole.

91. In the year ending March 2008, Royal Mail reported that the universal service had made an operating loss, for the first time, of around £100 million. Royal Mail was also unprofitable, making an operating loss of £3 million.

92. Royal Mail's financial position is already precarious. And there remain major challenges ahead. Without significant change, the company's financial position will deteriorate against the backdrop of an unprecedented, structural decline in the letters market. The universal service is under threat and the status quo untenable.

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Part 3.

The choice

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Modernise or decline?

This part explains why the universal service cannot be sustained under the present framework and examines the options available to Government. It sets out the implications if there were no change in policy. It concludes that short-term cost-saving and compensatory measures are not appropriate solutions under current circumstances. Modernisation is the key to a positive and profitable future for the postal service.

Summary

- *The universal service cannot be sustained under present policies.*
- *Sustaining the universal service means removing the constraints which currently impede Royal Mail's ability to respond to a structural decline in the letters market.*
- *We do not recommend degrading the universal service or opening a fund to compensate Royal Mail for the obligation to operate the national network.*
- *These options are not appropriate in current circumstances. They would penalise consumers, competitors or the taxpayer while Royal Mail is inefficient and its costs are too high.*
- *Nor are they desirable. They would not address the fundamental problems undermining Royal Mail's financial health and could well hasten decline.*
- *The only effective method of sustaining the universal service is to modernise Royal Mail.*
- *A restructuring at Royal Mail is inevitable.*
- *Unless measures are taken to accelerate the process of modernisation, it is likely that the company will need to approach Government for emergency financial support.*
- *Emergency financial support would lead to forced and rapid restructuring carried out under European rules on restructuring aid. That would be costly and a poor outcome for the taxpayer, for Royal Mail, and for its employees.*
- *The measures which we set out in Part 4 are necessary to ensure that Royal Mail can modernise effectively. This is critically important if the postal service is to have a positive future.*

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The status quo is untenable

93. In Part 2, we set out a positive future for the postal service: a future which exploits the unique properties of mail, in which postal companies are obsessive in meeting the needs of their customers, services are reliable and convenient, priced competitively, sustainable and innovative. Achieving that future will be demanding under current circumstances. The digital revolution has prompted an unprecedented decline in letters. And Royal Mail – which operates the national network – was not profitable at the end of the last financial year. There is a broad consensus among postal companies, business users, consumer organisations and the regulator that the status quo is not tenable.

Box 6: Views of some key stakeholders

Postwatch: "We are acutely aware that declining mail volumes and the recent announcement by the Royal Mail that the universal postal service has become loss making give customers real cause for concern about the future of the service they value."

Communications Workers Union: "Currently, the policy and funding of Royal Mail makes its future untenable and damages the service to customers, the terms and conditions of workers in the industry and the future of the universal service."

Postcomm: "The future health of Royal Mail, the universal service, and the addressed letters market are inextricably linked. Decisions about fundamental reform must be taken swiftly if Royal Mail is to lead a healthier mail market and provide a strong universal service."

Royal Mail: "It is equally untenable to wait for the next price control in 2010 to address the urgent funding gap and the challenges facing the industry and Royal Mail. Action is needed in the short-term … to address these issues and the increasing risks to the universal service."

Without policy changes, Royal Mail is likely to need emergency financial support.

94. Without policy changes, financial pressures on Royal Mail will mean that emergency financial support is likely to be needed. Because no other company is currently able to provide the universal service, there would be strong policy reasons for the Government to meet such a request. Funding would, however, need to be compatible with European state aid guidelines on rescue and restructuring.

Box 7: Restructuring Aid.

The purpose of restructuring aid is to restore the long-term commercial viability of a business in financial difficulty without further need of state support. All restructuring aid requires approval from the European Commission, following a full investigation.

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95. The implications of restructuring aid for Royal Mail would depend upon the circumstances in which aid was given and approved by the European Commission. Based on the Commission's guidelines and decisions made in other cases, its conditions could well include:

- an accelerated rationalisation programme involving extensive closures across Royal Mail's network of mail centres and delivery offices.
- the forced introduction of other measures to reduce Royal Mail's costs, such as closure of the final salary pension scheme to existing members and contracting out parts of the delivery chain.
- the sale of subsidiaries such as GLS and Parcelforce.
- compensatory measures to benefit competitors. Examples include a withdrawal from upstream bulk mail activities in favour of direct access operators, the closure of new commercial activities such as logistics and document management, and restrictions on future investment outside its core mail business.

Box 8: Restructuring Aid – Case Study.

The European Commission approved the UK Government's restructuring aid for British Energy in 2004. Although the aid related to the future decommissioning of nuclear power plants, as part of the approval process a series of conditions was imposed to limit the adverse impact on British Energy's competitors. These conditions were far reaching and will remain in force even after the recently announced ownership change. They included :-

- a requirement that British Energy introduce accounting separation, ring-fencing its main business units
- a cap on the company's energy production capacity (from all sources) until 2010
- a prohibition on the company extending its fossil-fuel based generation activities outside of the UK
- a prohibition on the company acquiring large hydro-electricity plants within the UK
- restrictions on its ability to compete when selling power to large business users until 2009

Restructuring aid would weaken Royal Mail's ability to develop its business.

96. Stringent conditions, backed by a monitoring process, would force Royal Mail to cut costs. But this default option of modernisation through restructuring aid has significant disadvantages.

- The forced divestment of some of Royal Mail's activities and restrictions on those that remained would weaken Royal Mail's ability to develop, expand and diversify its business in the future.

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- Accelerated job losses would make it difficult to manage the transition by using existing processes of redeployment and voluntary redundancy.

- Royal Mail's fragile condition as an employer could cause the pension trustee to revisit the assumptions used to calculate the deficit, increasing it significantly.

97. Doing nothing, therefore, is not a credible response to the challenges which we have set out in this report. The alternative options available to Government are to allow Royal Mail to adopt a series of measures which will ease the situation in the very short term, to compensate Royal Mail for the obligation to provide the universal service, to reduce the specification of the universal service, or to put in place policies which will encourage and support the modernisation of Royal Mail for the long term. We look at the implications of each in turn.

Short-term measures

Short term measures would accelerate the cycle of decline.

98. Royal Mail could respond to current financial pressures with short-term cash saving measures. This could include halting or slowing down the modernisation programme, selling part of the business or implementing a pay freeze. It could also seek approval for emergency cost-cutting measures, such as lowering service standards.

99. These options would offer limited short term relief. But none would be sufficient to resolve Royal Mail's financial difficulties. They would accelerate, not halt, the cycle of decline.

A compensation fund

100. Some stakeholders have proposed that the burden of providing the universal service should fall on the market as a whole, rather than just one company. It would be technically possible, for example, to establish a fund with the intention of compensating Royal Mail for any losses it incurs by providing the universal service. Alternative carriers could be asked to contribute to the fund on an equal basis, or according to their market share. Alternatively, Royal Mail could be compensated directly through a subsidy by taxpayers.

101. The amounts which can be recovered in this way are tightly prescribed under European law. They would be limited to the net cost of the services which Royal Mail would not provide, were it not under an obligation to do so. As a result, a compensation fund would have only a limited effect on the company's financial position, particularly in the short term.

102. More importantly, we believe that compensation, from any source, would be counter-productive in the present situation. It would considerably weaken the incentive for Royal Mail to adapt to changes in the market. It would not address the fundamental issues undermining the financial health of Royal Mail.

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Alternative carriers should not be penalised for Royal Mail's lack of efficiency.

103. We also believe that, while Royal Mail's competitors should be required to pay a fair price for the use of its delivery network, they should not be penalised for the company's inefficiency. We therefore recommend that an industry-based compensation fund should be rejected in current circumstances.

Degrading the universal service

104. Others have suggested that the demands imposed on Royal Mail by the universal service should be reduced. This is feasible only to the extent that standards set in the UK are higher than those required by the relevant European directives. The number of deliveries each week could be reduced legally from six to five, for example. And the uniform tariff could be abolished altogether, provided that prices were deemed "affordable" under European law.

105. Analysis suggests that £271 million would be saved annually if the company were required only to deliver on five days per week, rather than six[63]. This is comparable with a 1% improvement in efficiency per year, over the four year period of a price control.

106. Reducing the basic requirements of the universal service, making it less flexible and therefore less responsive to consumer needs, carries a high risk of accelerating the decline in the mail market. A faster decline would have a negative impact on Royal Mail's opportunities for new business, leading to a vicious circle.

Reducing standards would simply penalise consumers.

107. In short, we do not believe that the universal service will be sustained by degrading it. Reducing standards would simply penalise consumers to support a business whose costs are substantially higher than necessary.

108. We recommend that a reduction in the universal service should be rejected in current circumstances. It would not address the fundamental issues undermining the financial health of Royal Mail. It would be a poor deal for the consumer. And it would not provide security for the company's employees.

Modernisation – in principle

Modernisation of Royal Mail is the only credible option to safeguard the universal service.

109. To sustain the universal service, Royal Mail must be able to respond, and respond quickly, to the structural decline in the letters market which is now under way. That means tackling the constraints which we identified in Part 2: inefficiency, the pension deficit and poor relationships with unions and the regulator. In our view, modernisation of Royal Mail is the only credible policy option.

110. In the next part of this report, we explain the implications of modernisation for Royal Mail, and make recommendations for the policy changes required to bring it about.

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[63] *The Costs and Benefits of Modifying the Scope of the Universal Service*, prepared for Postcomm by Frontier Economics, May 2008.

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Box 9: Modernisation.

In a declining market, modernisation can be defined in very simple terms: the need to change culture in order to focus on customers, reduce costs and increase revenues.

Based on experience in other countries, the process of modernising a national postal operator such as Royal Mail can be divided into two distinct phases. Both are important.

- **Transformation**. The company's first priority must be to improve efficiency and reduce costs. Typically, this involves restructuring the company's national network of mail centres, distribution centres and delivery offices to ensure that it is configured to meet current and future demands in the most efficient way. This process will require investment in automation and a more flexible approach to working patterns, embraced by both management and unions.

- **Diversification and expansion.** With the letters market in structural decline, finding new sources of revenue is essential. This may be achieved by extending the range of its postal services (taking advantage of the growth in e-fulfilment for example), by providing related products, or by expanding to cover a wider geographical area.

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Part 4.

The solution

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Modernising Royal Mail

This first section sets out our recommendations for modernising Royal Mail to ensure that the universal service can be sustained in future.

Summary

- *We believe that for the universal service to be sustainable, Royal Mail must modernise more quickly. That means removing the constraints which the company currently faces.*
- *To modernise, Royal Mail needs **commercial confidence**. That will not happen unless there is political separation, better engagement between the management and workforce, and a joint commitment to modernise the service in the best interests of the taxpayer, consumer and employees.*
- *It will also require **access to capital** more quickly, without the constraints attached to funding by Government.*
- *And the company must be able to draw on **corporate experience** of managing change in difficult circumstances.*
- *The current governance and funding structures are not capable of addressing these needs.*
- *It is essential that a new approach is adopted which works for the circumstances we now face in the UK.*
- *We recommend a strategic partnership between Royal Mail and one or more private-sector companies with demonstrable experience of transforming a major business, ideally a network business, in circumstances comparable to those now faced by Royal Mail.*
- *Post Office Ltd, which provides an important social service, should remain wholly within public ownership.*
- *We recommend that Government should tackle Royal Mail's historic pension deficit, to enable the company to reap the benefits of modernisation.*

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Modernisation in practice

A positive future for Royal Mail requires fundamental change.

111. There is no doubt that Royal Mail is less efficient than its counterparts. Its modernisation began after many other postal companies and is taking place more slowly, against a background of declining volumes of business.

112. The company recognises that it is only part way through its transformation and has some way to go to be best in class. In its second submission to the panel, Royal Mail said that it "fully recognises that the pace and extent of change in business performance and culture needs to accelerate." Others agree. When we asked a wide range of organisations to give their impressions of the modernisation process, the consensus was that Royal Mail had achieved between 25% and 40% of the necessary changes.

113. The immediate focus of modernisation should be to transform the national network. It is for the company's management, rather than the Panel, to decide on the precise shape of the company's infrastructure. In doing so, management will need to take into account the population distribution, geography and demand for postal services in the UK, and requirements of the universal service. But the experience of other European operators offers some indication as to the scale of change likely to be needed and what can be achieved with the determination of management and unions. Figure 21 offers a basic comparison.

Figure 21: Changes to national networks across Europe

	Time (years)	Mail centres		Delivery offices	
		Before	After	Before	After
Germany - Deutsche Post	10	328	83	11,000	3,700
France - La Poste	10	100	45	7,000	4,000
Holland -TNT	8	12	6	700	550
Switzerland - Swiss Post[64]	3	18	9	1,735	1,185

114. We believe it likely that the UK postal service could operate efficiently with around half the current number of mail centres. This has been the experience in all countries where postal services have been modernised. The scale of reduction in delivery offices depends on the business model adopted by each country. But in each case, the reduction in numbers is significant: between a fifth and two-thirds for this sample.

115. The modernisation of Royal Mail is no ordinary undertaking.

- Restructuring of its network is an expensive proposition. Royal Mail is already expecting to invest at least £1.5 billion in new machinery and new and improved facilities over the next five years. The final cost could significantly exceed this figure[65].

[64] Reorganisation to be completed by March 2009

[65] For example, around £3 billion (at current exchange rates) was invested by Deutsche Post in the 10 years from 1990 to 2000. The value of this investment would be significantly higher if adjusted for current prices.

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- It presents a management challenge on the scale of modernising the telecommunications trunk network by BT in the 1980s. Consultation with staff, planning for the transition to a new network structure, and the adaptation of working patterns demand a major investment of time and expertise at all levels of the organisation.

- The process will need to be completed swiftly and cost-effectively while maintaining some of the highest service standards in Europe, without disruption to businesses or residential consumers.

116. Modernisation on this scale will clearly be challenging for Royal Mail's existing workforce. Transformation will bring a significant reduction in jobs over time. But changes to policy will also bring rewards, secure the remaining jobs and help manage risks.

- If planned and implemented effectively, modernisation will secure the future of the postal service, bringing stability for the company and establishing a sound basis for future growth.

- The alternative – to be avoided – is decline: a downward spiral of insecurity, lower standards, and instability. Continuing with present policies will not remove the need for restructuring, but in due course is likely to lead to rapid and enforced changes in the business, with accelerated job losses. Delay, therefore, is not in the interests of consumers, the taxpayer, or Royal Mail's workforce.

117. The second phase of modernisation – diversification and expansion – will similarly involve major capital expenditure, and may involve the acquisition of other companies over time. Over the last five years Royal Mail has made only limited moves to adapt its business, either through moving into other parts of the value chain or through geographic expansion. This is in marked contrast to European leading operators, TNT and Deutsche Post (Figure 22).

What does Royal Mail need to modernise?

118. If the universal service is to be sustained, we believe that the process of modernisation must happen more quickly and go further than Royal Mail's current plans.

119. Modernisation will be a significant challenge for all concerned. There is an urgent need for all stakeholders to work together, and to do so quickly. Since all stakeholders have agreed that the status quo is not tenable, they must also accept that their long-term interests and the universal service cannot be secured through opposition to change.

120. To modernise quickly and effectively, Royal Mail needs:

- **commercial confidence** and greater clarity in its objectives over the short and long term. That will require removing the spectre of political intervention, enabling management to make decisions

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about modernisation on a commercial basis (to safeguard the universal service).

- **access to capital** free of the constraints (such as state aid approval) which are attached to government finance, so that modernisation and the development of new commercial activities can be funded.

- **access to the corporate experience** of a company or companies which have managed change in difficult circumstances.

Commercial confidence

Clearer political separation is necessary to accelerate modernisation.

121. In order to modernise, Royal Mail must be able to plan and deliver necessary business changes at least as fast as its competitors. It needs to consult with its workforce and unions, and be held accountable by its shareholder. But it also needs confidence that its plans can be carried out free from outside intervention, particularly when conflicting agendas and competing relationships threaten to interfere with the process.

122. Since the Government owns Royal Mail, it is required to approve all significant financial decisions. This is normal practice for any shareholder. But in the case of Royal Mail, it brings Ministers into the strategic governance of the company. Because of the connection which the postal service has with the public and their MPs, Ministers often face political pressure to intervene in the operational management of the company. It is the perception that Ministerial intervention may be possible, now or in the future, which presents difficulties for the company. Handling these risks takes time and makes the task of running the business much more complex.

123. During our discussions, postal operators in Europe and the United States have repeatedly highlighted the need for political separation as a necessary condition for successful modernisation. We believe clearer political separation is necessary in the UK to enable the Royal Mail's management to accelerate the modernisation process.

BOX 10: Commercial focus and political separation

The Belgian Government announced in October 2004 that it was seeking an industrial partner for its postal business, De Post – La Poste, to help accelerate modernisation and, through a capital increase, provide the funds to do so before European postal markets were fully open to competition.

In October 2005, an agreement was announced in which Post Danmark and CVC agreed to purchase a minority stake in the business (50% less one share). The new partners have four out of nine seats on the board. The Belgian Government is unable to make any major changes unilaterally.

As part of the agreement, Post Danmark seconded a number of postal experts to De Post – La Poste to improve efficiency and levels of customer service. At the time of the announcement, CEO, Johnny Thijs, said: "You can only have a social postal service if it is an efficient one". A clear vision and commitment from senior management has been a vital element in driving through the modernisation process.

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124. The current structure also affects the relationship between the company's management and:

- the regulator. In a framework without a strong drive for shareholder value, some perceive that the regulator has been drawn into the detail of management decisions. This has led to claims that the regulator, frustrated by the slow pace of change, has attempted to "micro-manage" the company, or even to pre-empt decisions by management.
- its employees and unions. The fact that the Government has a direct involvement with the company encourages unions to take up issues directly with Ministers and MPs, rather than resolving them directly with management (as would be the case in most businesses). This impedes the development of effective relations between the company and its workforce.

125. We are particularly concerned about the impact of poor industrial relations. The relationship between the Communication Workers Union and management remains extremely difficult. There is a lack of trust in the relationship at many levels. Both sides feel the need to defend past decisions and reactions. Both have been accused of taking a tactical and piecemeal approach to change, rather than a focus on long-term strategy. Although management and unions recognise that their relationship is a problem, neither side has found a way to resolve it.

126. Speaking to the House of Lords in 2006, Lord Sawyer commented that:

> *"In the past few months, the national officers of the CWU and senior members of the Royal Mail's management team have jointly reviewed the strategic plans that the business feels it must address with the arrival of the competition … There would be obvious and great public benefit if these discussions bore real fruit and changed the culture of industrial relations at the Royal Mail.*
>
> *"But there are many difficult operational and employment changes to be contemplated and implemented on which it will be difficult enough to come to a common conclusion. In particular, the major union, the CWU, will need to adapt to change and refocus what its role should be so that it can effectively influence—and not just challenge—the Royal Mail's thinking on these sorts of issues."*

127. We share Lord Sawyer's view that engagement would beneficial, and that all stakeholders need to adapt to change. We also note that the attempt to which he referred in 2006 – like others in the past – ended in failure.

128. We do not believe that these difficulties are insoluble. The postal sector is now facing a fundamental decline in the letters market. The scale and urgency of the challenges facing Royal Mail and its workforce mean that the incentives on all stakeholders to find a new way forward are stronger than before. The price of failure is much higher.

129. We believe strongly that modernisation of the business will only be achieved if industrial relations are modernised. That has been the experience in other countries. This is not within the remit of

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Effective labour relations will require a change in approach on both sides.

Government but squarely the responsibility of the management and unions. Political separation can help achieve this goal, by clarifying responsibilities and reducing concerns about intervention in the management of Royal Mail. But it will also require a change in approach on both sides.

- For the CWU to be a credible partner in the process of modernisation which we believe vital and urgent for the future of Royal Mail and the universal service, it must accept the scale of the transformation required, and show that it can tackle the behaviour and internal processes which at present result in confrontation and obstruction.

- Management, in turn, must be prepared to play its role in improving relationships at a national and local level, by setting out its vision for the company in a transparent way, the implications of transformation, the risks of failure, and the opportunities in diversification.

130. This engagement needs to be based on a realistic assessment of the precarious position in which Royal Mail now finds itself, and the urgency with which changes must be made if the spiral of decline is to be ended. Further delay will accelerate decline with the result that all stakeholders will lose out.

Box 11 : Transformation and Engagement at Deutsche Post[66]

When Deutsche Post began its modernisation process in 1990, it faced many of the same challenges as Royal Mail, including a public sector heritage, and the need to work with a strong union representing over 80% of the workforce.

Four factors were critical in achieving a transformation that all partners regarded as socially compatible:

- a constructive and trusting climate between the trades unions and management, including the active engagement of all parties in communicating the need for radical change;

- a combination of cost reduction and quality enhancement;

- a collective agreement on dealing with staff interests in a fair manner, including agreements on no compulsory redundancies, improvement in working conditions, part time working and early retirement, and virtually no outsourcing in core operations; and

- the absence of political opposition to management's plans.

[66] Sources: Panel member's visit to Deutsche Post, 12th August 2008; and *Transformation at Deutsche Post World Net using the example of Socially Compatible Workforce Adjustment,* Maschke W. (2002) in M.A. Crew and P.R. Kleindorfer (eds); *Postal and Delivery Services: Delivering on Competition*, pages 303-319.

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Access to capital

Royal Mail must be able to raise more capital quickly and easily.

131. In its submission to the panel, Royal Mail said that "the company's financing facilities allow little margin for error". We agree. With a pension revaluation due in 2009, significant market uncertainty, letter volumes declining even more quickly than anticipated, and the beginning of an economic downturn, what was a tight but manageable financing position now has substantially more risk attached. The cash headroom is unacceptably small for a business of this size, given the scale of investment that will be required. Our view is that, as a matter of prudence, the company must be in a position where it can quickly and easily raise more capital if that becomes necessary in the near future.

132. Access to finance is particularly important for the modernisation of a company in a rapidly changing market. Wholly under public ownership, Royal Mail has only one source of capital: Government. While Government's investment in Royal Mail is made on commercial terms, it is less flexible than other forms of finance for two reasons:

- With so many demands on public finances, funding for Government investment in Royal Mail has to compete with other projects of economic and social importance.
- It is likely that any significant Government investment, even on a commercial basis, will be subject to scrutiny by the European Commission under the rules on state aid. This process takes time, and creates uncertainty for the company, and the market as a whole. The current £1.2 billion financing package is still the subject of a continuing investigation by the European Commission, some 18 months after the Government's support was finalised.

133. These will be significant constraints for Royal Mail when further investment is urgently needed to support the company's development, its expansion, or diversification into other areas of business comparable with the joint ventures, alliances and acquisitions made by some of its competitors (see Figure 22). By contrast, private capital is in general more flexible and tolerant of commercial risk than the taxpayer. It can be raised more easily, faster and for a wider range of purposes, and does not come at the cost of other competing public priorities.

Access to corporate experience

134. There are many risks associated with modernisation. The scale of transformation required is huge. There are numerous pressures on management. And the impact of failure is very high, as we set out in Part 3. For these reasons, we believe that Royal Mail needs access to the corporate experience of one or more private-sector companies which have successfully managed complex change on a similar scale and under equally challenging circumstances, ideally in a network business.

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Figure 22

Joint ventures, strategic alliances and acquisitions in mail

TNT and Deutsche Post, 2003-7

	2003	2004	2005	2006	2007
TNT 	• Acquired majority ownership of Prime Vision (Netherlands, electronic recognition software/product developer) • Strategic co-operation with Korea Post (South Korea, mail and express) • Acquired Full Service (Italy, print and mail) • Acquired DocVision (Netherlands, document management) • Strategic partnership with China Post (China, mail, express and logistics) • Acquired blitzpunkt (Germany, unaddressed mail)	• Joint venture with Essent (Netherlands, electronic communication and service channels)	• Strategic co-operation with Japan Post (Japan, express and logistics) • Acquired Euro Mail (Netherlands, print and mailing house)		• Acquired stake in Nordwest-Mail (Germany, publishing house) • Strategic alliance with Süddeutscher Verlag and Ippen (Germany, mail and publishing house)
Deutsche Post 		• Acquired stake in Unipost (Spain, mail) • Acquired SmartMail (USA, mail)	• Acquired Koba (France, direct marketing and mail) • Acquired Mail Merge (Netherlands, mail)	• Joint venture with Yamato Holdings (Japan, mail) • Acquired Williams Lea (UK, document management and mail)	• Acquired The Stationery Office (UK, information management and publishing)

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Access to corporate experience of managing change will enhance the prospects for Royal Mail's successful modernisation.

135. Access to corporate experience is, in our view, substantially different from appointing new members of the senior team, or involving consultants. Forging a relationship with another company would enable Royal Mail to establish joint teams with specific expertise and skills to tackle particular objectives of the modernisation process at the right time, building on best practice. It would also provide a constructive support to junior, middle or senior management. In either case, drawing deeply on such a wide range of expertise would add much greater value than hiring a limited number of people – however well qualified – into specific roles.

136. Access to corporate experience will enhance the prospects for successful modernisation. It will also reduce the risks for all stakeholders, including the taxpayer. It may be that relevant experience of managing change is available in some UK network companies. Since Royal Mail dominates the postal sector, however, the closest parallel is likely to be found amongst mail companies in Europe.

Meeting these requirements together

All three requirements need to be met.

137. All three of these requirements – commercial confidence, access to capital, access to corporate experience – are fundamental to Royal Mail's modernisation and, therefore, sustaining the universal service. Addressing just one or two of these requirements will not be sufficient. For example:

- commercial confidence and access to capital on their own will leave the transformation facing very significant risks, given the massive scale of the undertaking;
- access to capital and corporate experience on their own will mean that modernisation is slower than required and will not provide the conditions in which there can be constructive engagement between management and unions; and
- commercial confidence and corporate experience on their own will leave the company struggling to finance the investment required for both transformation and diversification.

138. In the next paragraphs, we set out our recommended approach for meeting these requirements: partnership. By securing modernisation, partnership will help ensure Royal Mail's commercial success. And by ensuring Royal Mail's commercial success, it will safeguard the universal service.

Partnership

The future of Royal Mail and the universal service depends on forging a strategic partnership

139. If the universal service is to be maintained, a new approach is required. To achieve the modernisation of Royal Mail and secure the future of the universal service, we recommend that there should be a strategic partnership between Royal Mail and one or more private sector companies with demonstrable experience in transforming a major

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business, ideally a network business, in circumstances comparable to those now faced by Royal Mail.

140. Based on experience to date, it is our strong view that the existing policy framework is not capable of supplying the commercial confidence, capital and corporate experience which we believe is necessary to accelerate modernisation. Change is required if the universal service is to be maintained.

141. The current policy framework set out in the 1999 White Paper on postal reform[67], and implemented in 2001, made a number of significant reforms. It established Royal Mail Group[68] as a public limited company operating under a new financial regime, and recognised the need for greater commercial freedom based on a new "arms length" relationship between the Government as shareholder and the Board.

142. This was an important step forward. But greater commercial freedom has proved to be difficult to realise in practice. Royal Mail continues to operate in a highly political environment. It has been unable either to finance the modernisation programme from retained earnings, or to obtain new government investment through the 'fast track' process envisaged in the White Paper.

143. Secondly, and more significantly, the market and industry context have moved on since 1999. Royal Mail's principal European competitors have moved ahead in terms of performance and modernisation, and a number have gained further advantages through cross-border alliances and consolidation. Market liberalisation has provided increased choice for business customers. And – most importantly – substitution arising from the growth in electronic communications anticipated in 1999 has resulted in declining mail volumes.

144. The precise nature of a strategic partnership, and its detailed terms, should be a matter for Government to negotiate. At its core, however, will be Royal Mail's obligations under the universal service as required under European and UK law. We believe that partnership is the right approach now because:

- it will provide the management with greater commercial confidence in delivering modernisation, with reduced risk of external intervention, and establish an environment in which there can be effective engagement with the workforce and unions.
- it will, through a significant equity investment, bring access to the capital required to finance both transformation and diversification.
- it will bring practical corporate experience and expertise in the transformation of a network, reducing the risks to the modernisation process.

[67] *Post Office Reform: A World Class Service for the 21st Century*, CM 4340
[68] What is now Royal Mail Group was then known as the Post Office.

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The UK needs a pragmatic solution, not an approach based on ideology.

145. Although some other countries have modernised postal services wholly within public ownership, the circumstances have been very different. In many cases, modernisation was carried out in a growing market and with limited competition. There is an increasing trend towards private-sector investment as a catalyst for modernisation (see Figure 23).

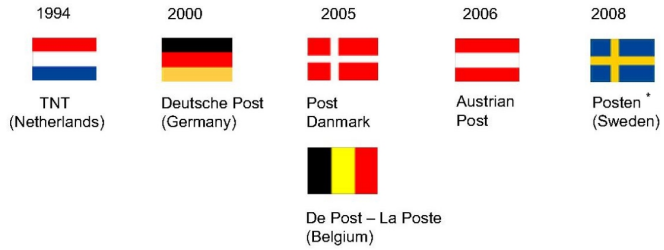
Box 12: Modernisation in the United States

In 1970, a decision was taken that the Postmaster General would no longer be appointed directly by the President. Just as important, there was an agreement that the company would finance all future investment from its retained earnings.

Parallels between the United States and Europe are, however, limited. USPS retains a monopoly in the delivery of letters, while European directives require that all European postal markets must be fully open to competition by 2012. Moreover, industrial action is prohibited by law. There is no precedent for this in the UK, even in sectors which are important for national security.

Figure 23

EU postal operators which have introduced private capital
1994-2008



* Merger with Post Danmark announced on 1 April 2008

146. There are very significant limitations attached to other structural reforms.

- Public listing. While we would not dismiss the possibility of listing the company on the public markets as an option for the future, it would not deliver the access to corporate experience which we believe Royal Mail requires. Moreover, the company's poor financial performance and the market uncertainty driven by e-substitution and liberalisation would make it difficult to raise the required capital, if the company were to be listed now. This option would only be appropriate and feasible if modernisation had been completed. Royal Mail's pension deficit would need to be more manageable, the

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business would need to have restructured, the company would have plans to expand in the mail market and be capable of paying a dividend.

- Not-for-profit and not-for-dividend models, such as Glas Cymru or Network Rail, are not appropriate or workable in current circumstances. Water and rail networks are natural monopolies, operating in stable markets with low levels of risk, with long-term investment needs funded by significant debt positions. Since Royal Mail is facing much higher risks to its business driven by structural market change and increasing competition, the level of debt funding it could bear is unlikely to be sufficient to meet its capital requirements. Access to risk-seeking equity capital is much more relevant to its current needs.

147. In short, we believe that partnership is the only approach which can deliver Royal Mail's modernisation and, therefore, secure the future of the universal service.

Post Office Ltd

The Post Office should remain wholly within public sector ownership.

148. Given the wider social role of the post office network, we recommend that Post Office Ltd should remain entirely in public ownership.

149. Like Royal Mail, Post Office Ltd is a commercial business with a social obligation. But the nature of its social obligations – ensuring access to government services and sustaining rural communities for example – means that there is little prospect that Post Office Ltd will be sustained on a fully commercial basis. Around three quarters of its 12,000 outlets do not make a profit and can only be sustained by a direct subsidy of £150 million from Government each year.

150. We have not been invited to conduct an analysis of the Post Office network, or consider the wide range of services which it provides. We are, however, clear that post offices are essential for the future of the universal service. They are an important access point for many customers, particularly since the introduction of cost-reflective pricing for letters and packages.

151. The Post Office network could be used more extensively in future. Recipients might, for example, be given greater choice to collect packets or parcels which are too big for letterboxes from their local outlet. This would reduce the number of deliveries which fail at the first attempt and remove the need for longer journeys to delivery offices or regional depots. This option is already available for items handled by Parcel Force. Otherwise, recipients have little control over deliveries.

152. To ensure that the Post Office network can continue to act as an access point for the universal service, there should be a transparent, long-term business agreement between Royal Mail and Post Office Ltd.

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Pensions

153. We believe that the changes already made to reduce the cost of future pension provision are essential. They have been carried out after consultation. We do not believe that it would be in the interests of the business or its employees for these new arrangements to be the subject of industrial action. A strike would do nothing to establish a sustainable future for the company. It would very likely damage the universal service, by encouraging more customers to explore alternatives to mail.

The historic pension deficit is large and volatile.

154. The costs and risks associated with the pension deficit, however, are more significant. They pose a constraint on Royal Mail's business and, therefore, represent a threat to the universal service. The size of the scheme means that the deficit, already very large, will remain extremely volatile. Moreover, Royal Mail is only able to pay off the deficit over a much longer timescale than would be the case for a stronger employer. The problems are structural and so can be expected to persist.

155. For any business, this position would be extremely difficult. In Royal Mail's case, it has wider implications for the future of the universal service and, therefore, for the postal services market in the UK.

- **Cashflow**. Royal Mail's obligations in relation to the deficit represent a very significant drain on its cash resources during a period when it will need to fund a significant modernisation programme against a challenging market background. Even as the company's financial position improves through increased efficiency, new investment (including the funding of diversification and innovation necessary for longer term business growth) will continue to be constrained because of the expectation that any improvement in financial performance should be reflected in increased cash contributions to the pension scheme.

The deficit acts as a major constraint on Royal Mail's business.

- **Balance sheet constraint**. Because the pension deficit is so high relative to Royal Mail's business and assets, the company is balance sheet insolvent. Although this does not affect the company's ability to trade, it does mean that the company's directors are under particular legal constraints which force them to consider decisions (including investment) on the basis of their short term cash effects at the expense of longer-term factors such as the improvement in service quality.

- **Costs**. The historic pension deficit is unique to Royal Mail, within the postal sector, as a former monopoly. The costs associated with the deficit cannot be avoided by Royal Mail. It is much harder for the company to compete in a liberalised market because its cost base is higher than its competitors' who do not have similar pension obligations. Few other European incumbent operators have an equivalent issue, owing to the nature of arrangements made at the time of liberalisation of their markets[69].

- **External investment.** As well as being a barrier to investment by Royal Mail, the pension deficit is such a significant financial risk for the business that it effectively excludes the possibility of any future

[69] *Main Developments in the Postal Sector 2004-2006*, Wik Consulting, in a report for the European Commission.

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external investment in Royal Mail, or its participation in joint venture arrangements, even where that investment is necessary or beneficial as part of the modernisation of the company, or in ensuring a strong position for Royal Mail in any future consolidation of the postal sector across Europe.

Customers are paying higher prices because of the pension deficit.

- **Prices**. Under the current price control set by Postcomm, all consumers (including business customers) are effectively paying prices that are some 5% higher than would be the case if there were no pension deficit[70]. This is equivalent to an additional 2p on the price of a first class stamp. Any future increase in the deficit is likely to require further price rises for consumers. These may cause customers to use substitutes, or simply not to send mail, accelerating market decline.

156. The constraints which the pension deficit imposes on Royal Mail, particularly in terms of investment, will make it harder to achieve the necessary efficiency improvements across the business and build an innovative, responsive service for consumers with the universal service at its core.

A new approach

157. Although Royal Mail is not the only business or public sector body with a significant pensions deficit, its circumstances are unique. Following the decision by Government to liberalise the market, Royal Mail is having to respond to new competitive pressures whilst also meeting its obligations to provide the universal service. And it is now having to do so against a background of falling volumes and revenues brought about by the digital revolution. A new approach is needed to tackling Royal Mail's pension deficit if the benefits of liberalisation are to be realised.

158. In other sectors previously dominated by a state-owned monopoly, Government has taken action to address historic liabilities in order to facilitate beneficial change in the industry. Changes to the rail industry in 1993, and the coal industry in 1994 are examples where action on pension liabilities was fundamental to enabling necessary restructuring of the industry – including in the case of coal against the background of a contracting market.

159. In the case of Royal Mail, the cost of the deficit is currently shared between consumers, Royal Mail and the taxpayer as shareholder. We doubt whether this is appropriate or effective as a long-term solution, particularly given the prospect of a significant increase in the size of the pension deficit.

- The increasing resistance of customers to paying higher prices for postal products, and falling letter volumes, mean that further price rises to meet the increasing cost of the deficit are unlikely to be effective. Instead, they are more likely to accelerate market decline driven by e-substitution.

[70] Source: Postcomm

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- Although Royal Mail does have scope for significant efficiency savings, the benefits of these savings will be fully absorbed in placing the company on a sustainable financial basis going forward. There is very little margin, particularly in the short term, to fund increased deficit contributions, and doing so could in fact endanger the universal service.

160. Other, short-term measures are possible. But, on their own, they would not address the underlying causes of the deficit, nor would they alleviate the adverse impact of the deficit on Royal Mail and the wider postal services market.

- the sale of GLS would be one option to reduce the pensions deficit. But since GLS generates cash, it may also weaken the ability of the company to fund the significant ongoing deficit payments that would still be required.

- a one-off injection of taxpayer funding into the scheme by Government would require clearance under state aid rules, and could well make it more difficult to obtain subsequent approval for longer-term measures to address the underlying cause.

Responsibility for the historic pension liabilities should be transferred to Government, in parallel with our recommendations for the modernisation of Royal Mail.

161. A long-term solution is therefore essential. And it is our view that that the best long-term solution must be for the risk around the historic liabilities to be managed by the body – central Government – that has the size and financial resources best suited to perform that role in a way which does not threaten the universal service.

162. Provided that the constraints on Royal Mail's ability to modernise have been removed, we recommend that:

- the responsibility for the historic liabilities should be transferred from Royal Mail to the Government. This would leave Royal Mail with a much smaller scheme and liabilities that would no longer be of a size that called into question the financial viability of the business. It would relieve the cash and balance sheet constraint on new investment and increase Royal Mail's competitiveness. It would also benefit consumers by reducing the pressures on stamp prices.

- the Government should take responsibility for the historic liabilities in a way which provides an incentive on all stakeholders, including the unions, to modernise Royal Mail. It could, for example, take a staged approach in which the scheme's assets and liabilities related to pensioners and members with deferred benefits were transferred to separate, Government-backed arrangements. As active members left the company as a result of the modernisation process, their liabilities and assets could be also be transferred.

163. These recommendations are not a complete solution for the problems currently faced by Royal Mail. On their own, they will not bring about the company's modernisation. They are, however, a significant part of the solution if implemented with our other recommendations, especially partnership.

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164. Detailed practical arrangements for transferring the risk associated with the pension liabilities should be a matter for Government. Options might include, for example, legislation to take over relevant assets and liabilities of the scheme and pay benefits from general taxation; the purchase of annuities; or the operation of a separate, managed fund. As part of this process, Government would need to obtain state aid approval from the European Commission.

165. We recognise that the long term impact on public finances arising from risks such as longevity could be significant. Nevertheless, we believe that the recommendation is consistent with our objective to reduce the risk to public finances and, therefore, to the taxpayer. It does not require the Government to fund the full deficit immediately. And by removing a very significant financial risk and business constraint, the transfer of historic pension liabilities from Royal Mail would result in a compensating uplift in the value of Government's equity stake in the business.

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Changes to the regulatory regime

This section describes the reasons why changes to the regulatory regime are now necessary and outlines the panel's recommendations for Government. It also considers more detailed issues which will fall to the regulator.

Summary:

- *Ofcom should be appointed to regulate the postal sector, reflecting its connections with the broader communications sector.*
- *While regulation and competition can encourage Royal Mail to become more efficient, changes to the regulatory regime alone will not be sufficient to ensure modernisation.*
- *The regulator needs a new set of tools to regulate the sector: wider reaching regulatory powers, formal market analysis, and a significantly improved understanding of the costs of Royal Mail's business.*
- *The regulator should take an approach which balances the benefits of competition with the risks to the universal service. Preserving the universal service should remain the regulator's primary duty.*
- *The access regime has brought benefits and should be continued, but the system of 'access headroom' should be reviewed. Moving to an alternative system would first require progress on achieving cost transparency.*
- *There should be clearer accountability to Parliament and to the public for the provision of the universal service.*

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A new regulator for a changing market

Ofcom should be appointed the new regulator for the postal sector, to reflect growing links with the broader communications sector.

166. Part 2 described how the explosion in digital media has changed the demand profile for postal services, and has prompted an overall decline in the volume of letters. Post is increasingly part of a much wider communications sector, in competition with broadcasters, internet providers, and telephone companies. Indeed, e-substitution had a much greater impact on Royal Mail's performance in 2007-8 (reducing operating profit by £500 million) compared with postal competition (a reduction of £100 million). Despite increasing competition from digital media, it is highly likely that Royal Mail retains market power in the provision of some postal products. Focusing regulation on the areas where Royal Mail's market power lies will require a regulator which can set post within this broader communications context.

167. We therefore recommend that responsibility for regulating the postal sector should be transferred from Postcomm to Ofcom. This reflects the practice in other European countries such as Netherlands, Sweden and Germany where the regulation of post and telecoms is integrated. Box 13 describes the duties and organisation of the two organisations. We believe appointing Ofcom is appropriate because:

- it has a deep understanding of the communications media which are increasingly interacting with the postal sector: broadcasting, instant messaging, telephony, email and the internet.
- it has experience of regulating markets undergoing rapid technological change, including the switch from analogue to digital television, the convergence of digital media (television, broadband, internet) and the growth of mobile broadband.
- it has specific experience of creating a regulatory framework for a large company – BT – facing the challenge of modernisation and liberalisation.

168. There are a number of other practical considerations which support the transfer of regulatory responsibilities.

- As a larger organisation of some 850 staff, compared to around 70 at Postcomm, Ofcom benefits from economies of scale. It is able to offer a broader range of opportunities for its staff. It can also attract and develop deeper expertise on particular aspects of regulation.
- A regulator with a range of range of responsibilities can be more efficient in allocating resources to meet the most difficult and time-consuming stages of price control negotiations.
- Ofcom has experience of formal market analysis, the exercise of competition law powers and achieving cost transparency. We believe that these will be an essential part of the regulator's toolkit.
- Appointing Ofcom would move away from the current system in which Postcomm's regulations are focused exclusively on one company: Royal Mail. This structure is one cause of the difficult relationship between the company and Royal Mail. Ofcom already

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regulates a number of companies of a size comparable with Royal Mail, including BT, British Sky Broadcasting and Vodafone. The transition would also present an opportunity for a fresh start.

169. There are two risks associated with this recommendation: that new responsibilities could impede Ofcom's work on other priorities, and that the attention needed by the postal sector (particularly during the preparation of the next price control) could be diluted as it is subsumed into a wider policy agenda. The new regulator will need to ensure that both these concerns are addressed in planning the transition and managing resources in the longer term.

Box 13: Who are Postcomm and Ofcom ?

	POSTCOMM The Postal Services Commission, independent regulator for postal services	Ofcom OFFICE OF COMMUNICATIONS
Primary Duties:	Postcomm shall exercise its functions in a manner which it considers is best calculated to: (a) to ensure the provision of the universal service; and subject to (a), (b) to further the interests of users of postal services, wherever, appropriate by promoting effective competition between postal operators.	It shall be the principal duty of Ofcom, in carrying out their functions to: (a) further the interests of citizens in relation to communications matters; and (b) to further the interests of consumers in relevant markets, where appropriate by promoting competition
Regulates:	Postal Services Market (universal services and items weighing less than 350 grams or costing less than £1).	Communications industries, including television, radio, telecommunications and radio spectrum allocation.
Staff:	70	850
Annual Budget:	£10m	£130m
Competition law powers:	No	Yes
Legal status:	Non-Ministerial Government Department	Statutory corporation without shareholders
Established by:	Postal Services Regulations 1999 and empowered by Postal Services Act 2000	Office of Communications Act 2002 empowered by Communications Act 2003

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The role of regulation

Regulation has three main roles in the postal sector.

170. Regulation has three main roles in the postal sector.

- Regulation is needed to ensure that the universal service is provided to the specification set out in the Postal Services Act[71]. Because the universal service has features which are not profitable (such as the delivery of letters to some high cost areas or certain service quality standards), it is unlikely that the universal service would be provided in its current form in the absence of regulation.

- Regulation is required to protect consumers. Because competition in some parts of the postal sector is limited, regulation is needed to prevent Royal Mail from charging excessive prices[72].

- Regulation can play a role in the modernisation of Royal Mail, by creating incentives to improve the efficiency of its operations. This will not, however, be sufficient on its own to achieve the necessary transformation of the business.

171. Regulation can deliver these objectives using two main instruments:

- Direct ex ante[73] controls on prices and service standards. The regulator can, for example, constrain the ability of Royal Mail to raise prices for bulk mail by imposing price caps which prevent excessive pricing. Or the regulator can specify the minimum percentage of first class mail which should be delivered the next day.

- By facilitating competition within the postal sector. Postcomm has required Royal Mail to give other postal companies access to its delivery infrastructure, for example. This has enabled the development of competition for bulk mail products which, in turn, curbs Royal Mail's ability to charge excessive prices or lower the quality of its service in this part of the market[74].

Limitations on the role of regulation

Changes to regulation alone will not be sufficient to bring about the modernisation of Royal Mail.

172. It is equally important to understand the limitations of regulation and competition, and why changes to the regulatory regime alone will not be sufficient to bring about the modernisation of Royal Mail.

- Direct, ex ante regulation can create pressure on a company to become more efficient. But, in order to reduce costs, the company must also have strong incentives to create value for its shareholders.

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[71] More detail is given in Box 1 of this report.
[72] Excessive pricing is normally defined as allowing a business to sustain profits higher than it could expect to earn in a competitive market (also described as 'supernormal profits'). Despite the growth of digital competition and liberalisation of the postal market, Royal Mail is likely to retain the ability to charge excessive prices in some parts of the market, particularly for residential consumers.
[73] *Ex ante* means 'before the event'. See Box 14 for further discussion.
[74] When competition is sufficiently developed to protect consumers, the regulator can remove *ex ante* regulation and move to *ex post* regulation. See Box 14.

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- Well designed regulation will minimise the constraints on a company's ability to innovate. But regulation is not a mechanism which directly encourages companies to develop new products and streams of revenue.

- The introduction of postal competition will strengthen Royal Mail's incentives to modernise, but the introduction of competition on its own will not be enough to ensure modernisation. Royal Mail needs the commercial confidence, access to capital and access to corporate experience to modernise and respond to the challenges of competition.

The regulator's duties

Ofcom's duties should reflect that maintaining the universal service is of primary importance.

173. We have argued from the beginning of this report that the universal service has an important social and economic function, and that it should be maintained. We recommend that, as postal regulator, Ofcom's primary duty should be to maintain the universal service. Ofcom should promote competition where appropriate.

174. This recommendation is consistent with Ofcom's existing statutory framework. Under this framework, the regulator has separate and specific primary duties in relation to broadcasting, spectrum and telecommunications. Each of these must be secured in accordance with its principal duty to pursue the interests of citizens in communications matters and the interests of consumers in relevant markets. Ofcom should, therefore, be required to secure the provision of the universal service as its primary duty in relation to post, to fulfil its overriding duty to citizens and consumers in postal matters.

175. Because the development of the mail market is inherently uncertain, we recommend that Ofcom should adopt a risk based approach to the protection of the universal service. This involves planning a regulatory response to a broad range of scenarios, from the rapid development of end-to-end competition, to a more limited increase in the number of companies providing upstream services. The regulator also needs to plan for the market to decline at various rates, now that the combination of cyclical and structural change is making mail volumes more difficult to predict.

Regulatory tools

176. Ofcom will need to be granted new powers, and develop a new set of analytical tools to fulfil its duties in relation to the postal sector.

Formal market analysis

Ofcom will need a new set of tools to regulate the postal sector.

177. There has not yet been a formal analysis of the markets within the postal sector. We recommend that Ofcom conducts a thorough and comprehensive analysis of the postal services which are in competition, and the extent to which Royal Mail has market power in each segment.

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Crucially, the exercise should take into account the emerging links between postal services and the wider communications sector.

178. We believe that this is the essential foundation for designing a regulatory regime which focuses ex ante regulation on those areas where Royal Mail exhibits dominance. It will create a stronger, more objective evidence base, increase certainty for all those involved, and set clearer criteria for regulation. A similar methodology has been adopted in other sectors, such as telecoms, energy and airports, particularly at the point where deregulation is under consideration. Ofcom has extensive experience of conducting market analysis exercises of this kind.

Regulatory powers

Ofcom will need to be granted wider powers to regulate the postal sector.

179. Unlike other UK sectoral regulators[75], Postcomm does not have concurrent competition law powers. (These are also known as ex post powers. See Box 14). Granting the postal regulator competition law powers would bring benefits for the market as a whole:

- For competitors and consumers, the regulator would have a more powerful set of tools at its discretion to investigate anti-competitive behaviour. The regulator's powers of investigation would no longer be restricted by Royal Mail's licence. Ofcom would, therefore, be able to investigate conduct in any aspect of the postal services market.

- For Royal Mail, competition law powers would remove a barrier to future deregulation. The regulator is better equipped to remove products and services from the ex ante price control if it has the assurance that it can take suitable action in the case of a dominant company abusing its market power.

Box 14: Ex ante and ex post regulation

Ex ante regulation aims to stop something that is undesirable from happening *before* it causes damage. Examples of ex ante regulation include price controls under the RPI-X model which aim to prevent excessive pricing, and access headroom control which aims to prevent anti-competitive pricing behaviour.

Ex post economic regulation relies on the application of competition legislation *after* anti-competitive behaviour has taken place. It can result in significant penalties, including criminal sanctions, if allegations are proven correct. These penalties provide companies with incentives not to engage in anti-competitive conduct.

There is trade-off in the use of ex ante and ex post regulation. In general, ex ante regulation sets more constraints for Royal Mail, but provides competitors and customers with more certainty and protection against anti-competitive behaviour. Ex post regulation would be more flexible for Royal Mail, but offers competitors and customers less certainty, particularly because remedies can take a long time to apply. It is possible that an ex post remedy could take too long for some competitors to survive in business in the face of anti-competitive behaviour.

[75] Other sectoral regulators have concurrent powers to apply the Competition Act 1998 or to apply Part 4 of the Enterprise Act 2002. This enables them to make market references to the Competition Commission and accept undertakings in lieu of making references.

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180. We recommend that, in transferring the duty of regulating the postal sector, the Government legislates to grant Ofcom concurrent, competition law powers for the postal sector. Ofcom already has experience of exercising competition law powers for its existing portfolio.

Cost transparency

Rapid progress is needed to agree Royal Mail's costs.

181. There has been persistent disagreement between the regulator and Royal Mail about the allocation of the company's costs. This lack of transparency is evidenced by the disagreements about the appropriate level of access headroom, and whether downstream access services are provided at a loss or profit. Although achieving cost transparency is a challenge shared by postal regulators across Europe[76], we have been struck by the lack of agreement between Royal Mail and Postcomm about even the most basic statistics. A shared understanding of costs would bring benefits for all concerned.

- It would improve the quality of information available to Royal Mail to manage its business operations.
- It would enable the regulator to monitor whether the universal service remains sustainable, and to assess the scope for efficiency savings within Royal Mail when setting price controls.
- Cost transparency would reassure alternative carriers that the regulator could respond effectively to any complaints about anti-competitive behaviour by Royal Mail.
- It would also answer the complaint often voiced that Royal Mail subsidises its competitors in relation to the access regime.

182. A further delay in reaching a suitable level of agreement about costs with the regulator would be unacceptable. We believe it should be possible to reach a substantial agreement about Royal Mail's costs within the next 12 months. In our view, improved cost transparency must be achieved before the regulator can consider alternatives to the current 'headroom' system of regulating downstream access.

183. We recommend that Ofcom should:

- regard cost transparency as a major priority.
- build its own detailed model of costs, in consultation with Royal Mail.[77] This has been the practice in other sectors, such as telecommunications.
- consider how developing a system of separate accounts for different parts of Royal Mail's network could improve cost transparency.

[76] *Main developments in the postal sector (2006-2008),* ECORYS report for the European Commission, page 74.
[77] The model should include the ability to measure the long-run incremental costs of products (LRIC).

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Box 15: Why is achieving cost transparency so difficult?

- In network industries, it can be difficult to identify the cost of particular products (first class mail, for example) because many products use the same systems. Nearly all postal products, for example, use Royal Mail's nationwide delivery network (which represents around 44% of Royal Mail's costs).
- Because the cost of measuring the volume of letters is high compared to the revenue generated by those letters, it can be difficult to justify significant costs per item to measure the volume and mix of products in an accurate way.
- In a sector dominated by one company, the regulator is dependent on Royal Mail to provide detailed information about its business. There are no comparable firms which the regulator can use to act as a benchmark for Royal Mail's performance.
- Before liberalisation of the postal market, Royal Mail did not need to collect data in a form suitable for an economic regulator to examine. Meeting the regulator's requirements involves building new systems to compile cost information.

RPI-X and promoting efficiency

RPI-X has been less effective in promoting efficiency in the public sector than the private sector.

184. Royal Mail's prices are controlled by the RPI-X regime. This is a form of direct price control which was designed for use in the privatised utilities. By constraining the price which Royal Mail can charge for postal products, it creates incentives for management to make the company more efficient[78]. Shareholders will only achieve an adequate return if the company meets efficiency targets set by the regulator. In the private sector, shareholders and city analysts exert strong pressure on management to do so, signalled through a company's share price, and with the threat of takeover if the company fails to achieve the performance that the market believes is possible.

185. Royal Mail has no shares quoted on an exchange. Having the Government as sole shareholder removes the possibility of trading shares and the threat of takeover. Moreover, Government has multiple and conflicting economic, employment and political objectives. Our recommendations about partnership will make the RPI-X system more effective by giving Royal Mail stronger incentives to maximise efficiency.

[78] A second objective of the RPI-X mechanism is to prevent excessive pricing. The system works well in achieving this objective.

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A risk-based approach to regulation

Benefits of competition for the universal service

Competition can support the universal service ...

186. Competition from other postal operators, or more widely across the communications sector, can support the universal service[79] by:

- encouraging Royal Mail to reduce its costs and, therefore, to become more efficient.
- encouraging product innovation. Innovation creates new streams of revenue which support the universal service.

Impact of competition on Royal Mail's revenues

... but may bring risks in certain circumstances.

187. Competition may also bring risks in certain circumstances. Because Royal Mail is currently the only company with the infrastructure required to deliver a universal service, its financial health is critically important to sustaining the universal service. Yet the introduction of postal competition reduces Royal Mail's revenue. Whether the introduction of competition will threaten the universal service is an empirical question which depends on:

- the extent of market share which postal competitors achieve;
- the rate of market decline driven by e-substitution; and
- the potential for Royal Mail to deliver efficiency savings and innovate in response to competition.

188. The company has said that it can reduce its cost base by £1.2 billion: 20% of its current total costs. We believe that there is more than enough potential in cost savings at Royal Mail to make up for the impact of postal competition and market decline in most scenarios. In its submission to the Review, Royal Mail welcomed competition. It argued that – by accelerating modernisation – the company could finance the universal service from profits in spite of liberalisation and structural decline in the volume of letters.

Competition and the universal service constraint

189. The universal service places a constraint on Royal Mail which changes the economics of the postal market. Competition in the postal sector is asymmetric. While the obligation to provide a universal service rests with one company, Royal Mail, alternative carriers have no restrictions on their business models. As a result, some forms of competition can be inefficient and undesirable.

[79] For a review of the empirical evidence which suggests that competition drives efficiency gains and innovation, see for example *'The impact of liberalisation on efficiency: a survey'* 2002. Frontier Economics.

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190. "Cherry picking" has been used to describe a situation in which competitors take advantage of Royal Mail's universal service constraint to compete in a way to which Royal Mail is unable to respond. Box 16 shows how the requirement to charge a uniform price across the country could, in theory, lead to "cherry picking" and a spiral of events in which unit costs rise and the universal service becomes unsustainable.

191. A system of cost-reflective pricing for access products has been introduced by Royal Mail to protect against cherry picking based on the uniform tariff. In our view, this system represents a reasonable response to the risk.

Box 16: The theory of an unsustainable spiral.

A spiral could occur, in theory, because of a misalignment of costs and prices caused by a uniform pricing constraint, making it attractive for competitors to enter where this misalignment is most pronounced. The risk of this spiral occurring in practice depends on:

- the extent to which costs vary according to routes within the network;
- the ease by which entrants can gain market share;
- the extent to which this fuels an increase in Royal Mail's unit costs; and
- whether an increase in price leads to further losses in volume.

Ofcom should take a risk-based approach to promoting competition within the postal sector.

192. Competition is asymmetric in other ways. While Royal Mail is obliged, as the universal service provider, to carry out one delivery on six days of the week, other postal companies may in the future opt to provide a service which delivers on just two or three. Potentially, this would offer Royal Mail's competitors a cost advantage. On the other hand, Royal Mail derives benefits from the universal service: a strong brand, large economies of scale and scope, and an exemption from VAT, all of which are unavailable to competitors. Whether Royal Mail benefits from the obligation to carry out the universal service, or is disadvantaged, depends on the weight given to these factors. The regulator will need to take a balanced view of these issues to ensure fair competition.

193. In conclusion, we believe that competition brings benefits for consumers in the postal market, as it has in the wider communications sector. By creating pressure on companies to be more efficient and create new streams of revenue, it will support the universal service. But there are some risks too. Competition reduces Royal Mail's revenue available to support the universal service. And some forms of competition may be inefficient if they simply exploit the constraint placed on Royal Mail to provide the universal service.

194. We believe these risks can be managed in the foreseeable future if the regulator takes a proportionate approach to competition and if Royal Mail is given the appropriate incentives and freedom to modernise its business quickly and effectively. Our recommendations on partnership, therefore, are essential if the process of liberalisation is to be consistent over the longer term with sustaining the universal service.

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195. If it becomes clear that the potential for efficiency gains is slowing in the longer term, and the tensions between competition and the universal service become more pronounced, it may be that the Government will need to consider introducing a new funding methodology, such as a compensation fund or direct government subsidy, in order to maintain the current specification of the universal service. But that is neither necessary nor desirable now, while there is significant scope to reduce the costs of the national network.

The regulatory framework

The downstream access regime

The downstream access regime has brought benefits, and should be continued.

196. Competition in the collection, sorting and transportation of letters is made possible by the system of downstream access – where competitors use the Royal Mail's national network to deliver letters over the final mile. To assess the benefits of this access regime, it is important to compare the situation now with the position which would have been reached if Royal Mail had retained its monopoly. We are clear that the access regime has brought benefits. Large businesses have greater choice, lower prices and better assurance about the quality of service. We believe that, over time, these benefits will be extended to smaller businesses.

197. Whilst access competition has so far been predominantly based on price, and there has been less innovation than might have been hoped, the situation is still fundamentally better than one of a monopoly. We recommend, therefore, that downstream access should be continued.

198. The UK access regime differs from the approach used by other countries in two ways:

- Royal Mail is required to allow other postal companies access to its national network on a non-discriminatory basis. Very few other countries operate a mandatory regime in this way.
- the price which Royal Mail charges other postal companies to deliver their mail over the final mile is regulated through a system of access headroom (see Box 17). We are aware of no other country which has a comparable system.

Ofcom should review the current "headroom" system of regulating access.

199. The combination of mandatory access and headroom regulation were designed to kick-start competition in the postal sector. Postcomm hoped that other postal companies would use the downstream access arrangements to generate the economies of scale which they needed to build their own delivery networks. In reality, however, end-to-end competition has declined since the 2006-7 financial year[80]. Some have argued that the access regime (along with other factors such as VAT) may have dissuaded alternative carriers from developing their own end-to-end networks because the regime results in an access price which is too low[81].

[80] Source: Postcomm.

[81] The access price affects competitors 'make or buy' decisions with respect to delivery services. If the access price is *low* then, other things equal, a competitor would rather use Royal Mail's delivery network than set up its own alternative delivery network. Conversely, a higher access might encourage competitors to set up their own delivery networks.

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200. We recommend that the regulator should review three aspects of the access regime:

- The access headroom margin is not directly related to Royal Mail's upstream costs. As Royal Mail's costs change over time, the level of headroom does not. As a result, the margin available for competitors to enter the upstream market could be too large for some products (encouraging inefficient entry) and too small for other products (discouraging efficient entry).

- Headroom may dilute some of Royal Mail's incentives to become more efficient. Royal Mail cannot pass upstream cost savings through to lower retail prices without also having to cut its access price. If Royal Mail does not wish to cut its access price, it has less incentive to reduce retail prices and upstream costs[82].

- There is uncertainty whether access services are currently being provided by Royal Mail at a loss or a profit[83]. Some stakeholders have claimed that Royal Mail is effectively subsidising competitors in being required to provide access services at a loss. Royal Mail's activity-based costing system suggests that access services made an operating loss of £48m in 2006-7[84]. In its second submission to the panel, Postcomm reported preliminary results from a service-based costing methodology which suggested that access products made a small profit for 2006-7. This uncertainty demonstrates the need for improved cost transparency. It is, however, clear that the scale of potential loss from access services is small compared with the cost savings which Royal Mail has identified as necessary.

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.

[82] This point should not be overstated. Cutting costs in the upstream can still be beneficial, even if these cost savings cannot be passed through into lower prices.
[83] Postcomm's second submission to the panel, table 6, page 63,.
[84] Source: Royal Mail regulatory financial statements 2007-8. The 2006-7 accounts were restated to align the treatment of property now held by Royal Mail Estates.

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201. It will be for Ofcom to assess the benefits of access regulation and consider viable alternatives. This is a technical matter which requires significant detailed analysis of which Ofcom has strong experience in relation to telecommunications. We do not propose to constrain Ofcom's ability to make a judgement. But it may be helpful to offer some contributions to the debate.

- We believe that significant progress on cost transparency, and a formal market analysis are prerequisites for any alternative to access headroom.

- An alternative to headroom must provide adequate protection against margin squeeze. This could be facilitated through the use of separate accounts for different parts of Royal Mail's network, in particular the upstream and downstream elements.

- Our view is that, in future, a regulatory regime should not seek to favour any particular type of competition, but should be neutral towards the form of entry in the postal market, in particular between access-based competition and end-to-end competition. The current regime may provide more incentive for access-based competition over end-to-end competition. One option for achieving a neutral approach would be to introduce a system of cost-based access prices.

- Under the current framework, access prices are set by a process of negotiation between Royal Mail and the access seeker[85]. The regulator should consider the case for directly setting the price for access to Royal Mail's network. This approach would enable the regulator to set a price which is reflective of downstream costs and would be more transparent. The access price could also include an efficiency target, to encourage downstream cost reduction over time.

- While competition has developed very quickly in the upstream bulk mail market, Royal Mail is likely to retain significant market power for the foreseeable future in the delivery of letters and, therefore, the provision of access services. Our view is that, in these circumstances, relying on ex post competition law to regulate downstream access is unlikely to be suitable.

- As a way to ensure non-discriminatory access to Royal Mail's network, we have considered the case for separating Royal Mail's delivery network (effectively a monopoly) from the upstream function, in a model similar to that of BT Openreach. In current circumstances, we do not believe that this option is a proportionate way of ensuring non-discriminatory access to Royal Mail's network. Separation in the telecommunications sector followed consistent problems of non-price discrimination. We have not uncovered evidence to suggest that this problem exists in the postal sector to

[85] The regulator has the power to determine the access price in the event of disagreement between the access seeker and Royal Mail. Royal Mail's expectations about what price the regulator is likely to determine in the event of disagreement will therefore have an influence on the access price Royal Mail negotiates. The outcome of the negotiation is also likely to reflect the relative bargaining strength of the parties and will not necessarily produce a cost based access price.

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any comparable degree. Moreover, the growth of upstream competition has exceeded the regulator's predictions, suggesting that the need to implement a radical solution to protect the development of postal competition is not currently necessary.

- Any changes will need to be clearly signalled and phased to allow competitors time to adjust their business models.

The potential for deregulation

There is scope to reduce regulation on Royal Mail

202. Royal Mail is the subject of three types of ex ante regulation:

- the requirement to offer a product as part of the universal service. These are products which, in Postcomm's view, may not be provided by the market unless regulated and should be protected for consumers. Designating a product as part of the universal service ensures that it is provided across the UK and at a uniform price.
- a control on the prices charged for particular products. This mechanism protects the consumer from excessive prices in areas of the market where competition has yet to develop.
- requirements to meet particular standards may be imposed by the regulator on any product contained in Royal Mail's licence.

203. Evidence suggests that there is potential to reduce the ex ante controls on Royal Mail over time, allowing the company more flexibility to introduce new products and services more quickly. Alternative carriers have quickly acquired 40% of the upstream bulk mail business market and large companies are making much greater use of customer direct access arrangements than expected. Lower prices and innovation are evidence that the bulk mail market is becoming increasingly competitive.

204. We believe that there is a strong case for Ofcom to consider whether competition is sufficiently well-developed to remove bulk mail products, *Mailsort 1400* and *Cleanmail*[86], from the universal service specification. This would focus the universal service on social products and the remaining business products (such as metered mail) for which there is so far little competition. Decisions about whether these and other products should continue to be price controlled will depend on the formal analysis of the market recommended earlier, and progress in achieving cost transparency.

Value added tax

205. VAT is a matter for Government, within the framework of the EU VAT directive[87]. It is clearly outside the regulator's control. That said, the VAT status of postal companies has important implications for the development of competition and therefore the regulation of the sector.

[86] Both *Mailsort 1400* and *Cleanmail* both have first and second class options. All four products are designated as universal service products under the existing regime.
[87] The Sixth VAT Directive (77/388/EEC)

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206. Royal Mail is currently exempt from VAT. This status derives from European legislation which exempts supplies made by "public postal services" and the sale of stamps from VAT. As the legislation has been applied in the UK, all postal services supplied by Royal Mail Group are exempt from VAT. This means that, unlike its competitors, Royal Mail does not charge VAT to its customers. But it also means that Royal Mail is unable to recover a significant portion of the VAT it has to pay when purchasing goods and services such as fuel for its vehicles, or sorting machinery. This adds to Royal Mail's costs and restricts flexibility in its business. For example, the VAT exemption constrains the company's ability to contract out parts of its business and operations.

207. Royal Mail's unique VAT status has only a limited impact for customers who themselves supply goods and services liable for VAT. This is because these customers – roughly half the market – can reclaim any VAT charged to them by one of Royal Mail's competitors. For the remainder of the market – principally financial services charities and businesses who are unable to reclaim VAT – Royal Mail's VAT exemption does provide the company with an advantage over its competitors, particularly competitors considering setting up their own delivery networks.

208. Various proposals have been made in the past, by the regulator and others, concerning how this position should be addressed going forward. Consumers who are currently VAT exempt, including charities, have expressed concerns regarding the increase in their postal costs that would result from the removal of Royal Mail's exemption. There are also broader concerns that price rises could accelerate the decline in overall market volumes. All these concerns have some degree of validity: while there are some clear losers under the current position, there are others who would be adversely affected by any change.

209. The inconsistency in how the exemption in the VAT Directive has been implemented across Europe has also been identified as a wider issue for competition in the European postal market. Following legal action concerning Royal Mail's exemption, the European Court of Justice is expected to rule in 2009 on the correct application of the exemption. The Court's ruling will be binding on all member states, including the UK. It is possible that the Court could rule that the scope of the exemption should be restricted – for example to exclude services such as bulk mail. Or it could rule in favour of the UK's current interpretation of the exemption as applying to all of Royal Mail's services.

The European Court is expected to rule on Royal Mail's VAT exemption in the next few months

210. There is a significant degree of uncertainty for all stakeholders – Royal Mail, its competitors, and consumers – about the future of the exemption. There are, however, strong arguments that the Government should wait for the Court's ruling in the next few months, rather than considering any changes now. When the Court does make its decision, the Government and the regulator will need to consider the implications carefully. Although any change may reduce one factor which distorts competition, there may also be other implications in terms of the effect on Royal Mail's finances[88]. It is important that any adverse effects on the universal service can be mitigated.

[88] Royal Mail's own modelling suggests removing or restricting its current VAT exemption would have an adverse impact on EBIT of between £10M and £250M per annum by 2013/14, depending on the nature of the change to the VAT exemption and its effect on competition.

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211. We are not in a position to take a view on the matters of law being addressed by the Court. But in terms of policy for the postal sector, it does appear to us that the balance of the arguments is against the indefinite continuation of the exemption in its current form, and therefore in favour of change. In particular, if the justification for the exemption is to offset the additional burdens that Royal Mail bears as the universal service provider, then as a policy measure it is poorly targeted and has wider adverse consequences for the sector as a whole. In the longer term, therefore, if the Court's ruling does not change the current position in the UK, we believe that there is a strong case for revisiting the exemption as it currently stands so that it applies only to products associated with the universal service.

Shared responsibility but clear accountability

212. The universal service is the primary public service obligation placed on Royal Mail. Royal Mail is responsible for organising its activities so that it can deliver its obligations alongside its other commercial activities. But it does so in a framework that is set by Parliament, and by the regulator.

- Parliament has the responsibility for setting, through primary legislation, the high level requirements for the universal service in the UK, reflecting also the requirements in European law[89].

- The regulator has the responsibility for securing the provision of the universal service. The future of the universal service is central to many of the regulator's decisions, for example on market liberalisation and regulatory price controls. And it also decides, after consultation, which of Royal Mail's different products and services should fall within the scope of the universal service, and which should be provided on a purely commercial basis.

213. There is, therefore, a shared responsibility for the provision of the universal service. This is for good reasons. Parliament should set the broad public service requirements for the service; but it is not in a position to make more detailed regulatory decisions regarding how that is best secured, or how the Royal Mail should organise its activities to deliver the required service.

214. With a sharing of responsibility goes the need for clear accountability. We believe that as part of safeguarding the future of the universal service, there is a need to strengthen current mechanisms for accountability. And because the universal service is a public service, that primary responsibility should be to Parliament and to the public more widely.

215. Despite the central importance of the universal service, we have been struck by the lack of clear and specific mechanisms which provide effective public accountability for its delivery. For example although there is reference to the universal service in the regulator's annual report to Ministers (which is published and laid before Parliament), this is in the context of a range of other matters covering the full range of its

[89] The 1997 Postal Services Directive, 97/67EC.

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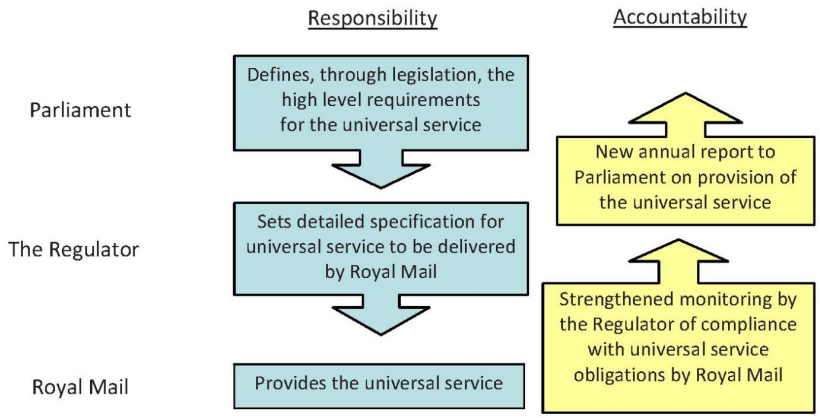
functions. We doubt whether the current mechanisms are sufficient or appropriate going forward given the central importance of the universal service at the core of Royal Mail's public service obligations, and at the core of the regulator's duties.

Box 18: Responsibility and accountability within the postal sector



There should be clearer accountability to Parliament and to the public for the provision of the universal service.

216 We recommend that the Government should strengthen public and Parliamentary accountability for the provision of the universal service. The regulator should provide Parliament with an annual report on its responsibilities in ensuring the provision of the universal service, with a hearing before the BERR Select Committee. In turn, the regulator should ensure that, when monitoring Royal Mail's obligations, there is a clear and specific focus the universal service.

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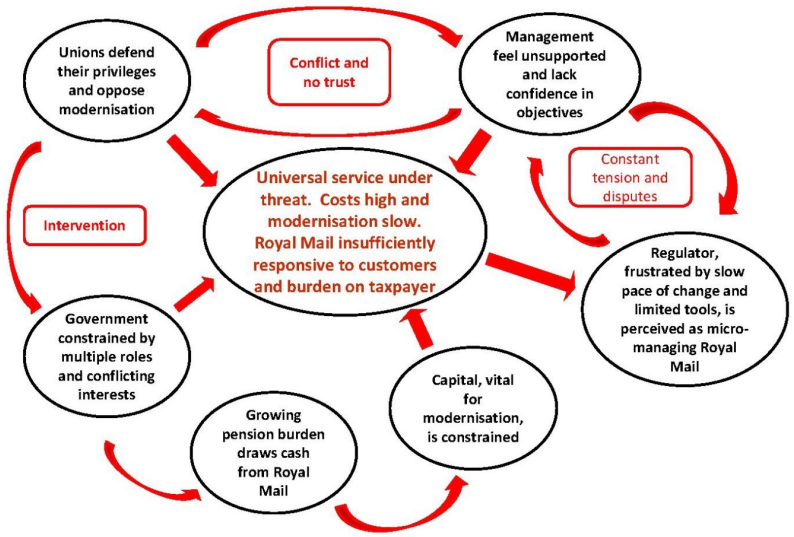
From policy to practice

Sustaining the universal service

217. In carrying out this review, we have explored a number of objectives: how to develop a vibrant postal market which can respond quickly to the changing needs of consumers; how to reduce the risks currently facing the taxpayer and, most important, how to maintain the universal service. The status quo will meet none of them. That is why we describe the current position as untenable. It is a view widely shared by consumer organisations, postal companies, unions and the regulator. It makes a compelling case for change.

218. Many of the problems we have described in the postal sector are the result of complex and inter-related factors. At present, many of these are both negative and mutually reinforcing, resulting in 'vicious circles': unacceptable and unsustainable outcomes.

Figure 24: Unacceptable and unsustainable outcomes under the status quo



219. Our recommendations form a coherent package. A strategic partnership for Royal Mail, action to address the historic pension deficit, and a new regulatory regime are all required to secure a sustainable future for the universal service. None will be sufficient on its own. But, if implemented together, we believe that they are capable of bringing about the structural changes that are necessary to achieve a positive system of mutually reinforcing factors: a virtuous circle.

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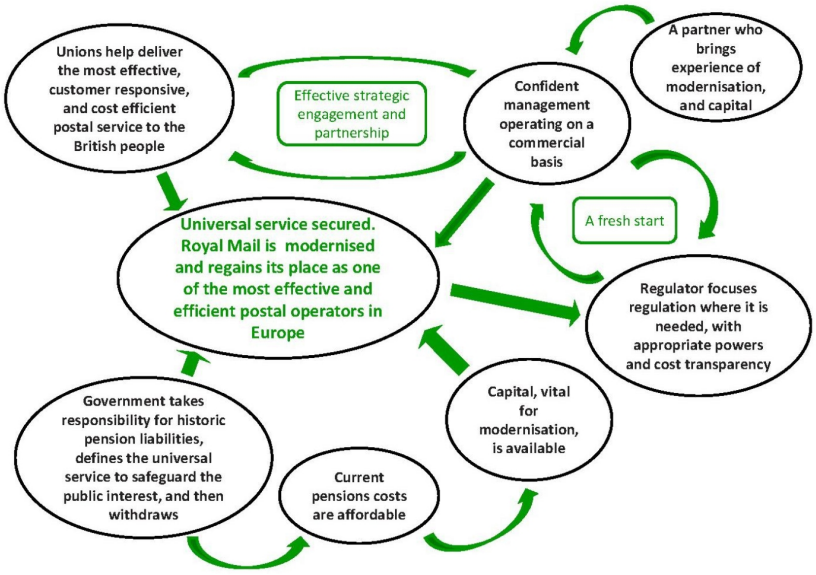
Figure 25: Sustainable outcomes as a result of implementing our recommendations



220. We are, however, clear that the modernisation of Royal Mail is most critical to the future of the sector. With that in mind:

- The Government should move urgently to provide the whole market with the certainty it needs to invest. The transfer of Postcomm's powers to Ofcom should be undertaken as swiftly as possible so that the new regulatory regime is in place for the start of the next price control in April 2010. This will require legislation in the current session of Parliament.

- The process of searching for a strategic partner for Royal Mail should begin in parallel. Likely consolidation in the European postal market in the future means that opportunities may not recur.

- Clarity about the future of the pension deficit will be an important part of the negotiation with a strategic partner, vital in enabling Royal Mail to reap the benefits of modernisation and providing certainty for scheme members.

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Part 5.

Annexes

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Annex B:
Glossary of technical terms

Access	The arrangement by which mail users and licensed postal operators can use Royal Mail's facilities to carry their post for part of its journey. For example, a company might collect bulk mail directly from a utility, sort and transport it to one of Royal Mail's mail centres, and then contract with Royal Mail to deliver these items over the *final mile*. See *downstream access*
Access headroom	Under regulation, the margin which Royal Mail must maintain between a *wholesale access price* and the relevant *retail price*.
Access point	The point at which mail is fed into the Royal Mail network. This can be pillar boxes, post offices, collection from a sender's premises, for example.
Access price	The price which Royal Mail charges other companies for *downstream access*. Also known as the "wholesale" price.
Accounting deficit	The difference between the total value of the pension scheme's assets and its liabilities, where both are calculated according to current accounting standards (currently known as FRS17 or IAS19). For example, those standards require the calculation of the present value of future liabilities by discounting at the rate of interest payable on corporate bonds.
Actuarial deficit	The difference between the total present value of the pension scheme's assets and its liabilities, where the liabilities are calculated according to assumptions set by the scheme Trustees (on the advice of the actuary) at the time of each Triennial valuation. These assumptions will cover key parameters such as longevity and investment returns on different asset classes that are set on a scheme-specific basis rather than according to a standard approach applicable to all schemes. It is the actuarial deficit that is used as the basis for calculating the employer's obligation to make payments to make good any deficit.
Advertising mail	Mail for marketing and advertising purposes, sent by businesses to consumers. Sometimes called *direct mail*.
Addressed mail	Mail with a named recipient.
Alternative carriers	Postal companies other than Royal Mail.

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Application	The mail market can be broken down by application into five categories: transactional mail, advertising mail, publications, social mail and fulfilment.
Bulk mail	A large number of mail items of the same format, posted by a single user, from a single site.
Bypass	The collection, sorting, transportation and delivery of mail using a network other than Royal Mail's.
Cleanmail	A service provided by Royal Mail which offers customers a discount if they prepare their mail in such a way that machines can automatically read the addresses and sort the mail.
Communications market	This includes post, email, internet, broadcasting and telecommunications.
Consumers	Large businesses, SMEs and residential consumers, both those who send mail and those who receive it.
Cost-reflective pricing	The practice of calculating the price of a service according to the cost of the operations needed to provide that service.
Cost transparency	A shared understanding between Royal Mail and the regulator about the detailed cost of the company's postal services.
Delivery office	A Royal Mail facility at which mail is sorted into the right sequence for delivering to addresses.
Direct mail	Mail for marketing and advertising purposes, sent by businesses to consumers. This paper uses the term *advertising mail*.
Dominance	A position of economic strength enabling a business to behave independently of competitors and consumers.
Door to door mail	Mail posted in bulk with no named recipients. This is also called *unaddressed mail*.
Downstream	The delivery of mail to addresses.
Downstream access	The arrangement by which *alternative carriers* have access to Royal Mail's distribution systems at an inward mail centre.
DPWN	Deutsche Post World Net
EBIT	Earnings before interest and taxation. This is generally known as operating profit.
EBITDA	Earnings before interest and taxation, depreciation and amortisation.

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E-commerce	Trading by the use of electronic media, particularly the internet.
E-fulfilment	The delivery of mail containing goods ordered via the internet.
Economies of scale	A company has an economy of scale if its unit costs fall as output rises.
Economies of scope	A company has an economy of scope if it can produce a specified output at a lower cost than two or more companies.
Elasticity	Price elasticities describe the relationship between changes in price for a product and changes in demand for that product. High price elasticities (other things being equal) mean that increasing the price for a product can reduce total revenues because the higher price leads to an offsetting fall in the product's sales.
End-to-end	A service which comprises all parts of the postal service chain: collection, sorting, transportation upstream and delivery of mail to its final destination.
Equivalence	A system which ensures that mail is treated in the same way during the process of delivery for the same price, whether or not it was collected and sorted by Royal Mail.
E-substitution	The effect of a decision by consumers to use electronic alternatives to the postal service.
Ex ante regulation	Requirements designed to prevent anti-competitive behaviour before it arises.
Ex post regulation	Regulation designed to resolve cases of anti-competitive behaviour in the course of events.
Final mile	The process of delivering mail from one of Royal Mail's delivery offices to one of the 28 million addresses in the UK.
First mile	The process of collecting mail from one of Royal Mail's pillar boxes or post offices.
Fulfilment	The delivery of mail containing goods ordered by mail order, telephone or the internet.
GLS	General Logistics Systems: a subsidiary of Royal Mail Group.
Letters market	Items which can fit through letterboxes, including packets, delivered by any carrier. It excludes unaddressed mail, international mail, standard parcels, express and courier services.

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Liberalisation	The process of creating a market in which companies can compete to offer postal services. In the UK, liberalisation has been achieved under the regulatory framework set by the Postal Services Act 2000, and rules laid down by Postcomm.
Licensed area	The area of postal activity for which postal operators must have a licence: letters weighing less than 350g and costing less than £1 to post.
Mailsort	A service provided by Royal Mail aimed at customers who send large volumes of mail in the UK which cannot be sorted by machine.
Mail centre	Royal Mail facility at which mail is sorted and sent to a delivery office.
Margin squeeze	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.
Outreach services	A service providing access to postal services in communities where there is no permanent Post Office. Some are mobile.
Packet	An addressed item of mail enclosing large documents, normally sent in padded or sturdy envelopes.
Pension deficit	The difference between the total present value of the pension scheme's accrued liabilities, and the value of its assets, where the former is greater than the latter.
Postcomm	The regulator of the postal sector.
Postwatch	The national organisation which represents those who use the postal service. On 1 October 2008, the responsibilities of Postwatch transferred to a new organisation, *Consumer Focus*.
Poste restante	A service provided by Royal Mail which allows people travelling in the UK to pick up their mail from a nearby post office. UK citizens travelling internationally can arrange to pick up their mail in larger towns abroad.
Price cap regulation	Regulator places a ceiling on the prices that Royal Mail is allowed to charge
Price elasticity	Price elasticity describes the relationship between changes in price for a product and changes in demand for that product. High price elasticities (other things being equal) mean that increasing the price for a

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	product can reduce total revenues because the higher price leads to a fall in the product's sales
Residential consumers	Those who send mail for reasons other than their business. This includes letters, cards and packages to family and friends.
Retail price	The price which a company charges its customers for the collection, sorting, transportation and delivery of mail.
Royal Mail	We use this throughout the report to refer to Royal Mail's letters business.
Royal Mail Group	Royal Mail Group incorporates Royal Mail, Post Office Ltd, Parcelforce WorldWide, and GLS.
Scale Payment Delivery Office	Post offices, predominantly located in rural areas, which provide premises, facilities and supervision for Royal Mail delivery staff.
SME	Small and medium-sized enterprises with fewer than 250 employees.
Social mail	Mail sent between residential consumers.
State aids	An advantage conferred by a public authority on a selective basis to a company with the effect of distorting competition and trade between members of the European Union.
Structural developments	Changes outside the postal market which have an impact on mail volumes. These include the increased use of alternative forms of communication.
Letters market	The market which excludes parcels and courier services.
Transactional mail	Mail generated by business which is conducting a financial transaction with consumers (such as credit card bills or bank statements).
Unaddressed mail	Mail without a named recipient, such as a leaflet or flyer.
Uniform tariff	A single price for the delivery of mail to any address in the UK.
Universal (postal) service	Postal products and associated minimum service standards that must be made available to all 28 million addresses in the UK.
Upstream	The collection, sorting and transportation of mail to one of Royal Mail's mail centres.

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Vertical integration	Where one business controls or owns all stages of the production and distribution of goods or services.
Walk sorting	A process in which letters are sorted into groups which correspond with the addresses covered by each postal worker's 'walk'.
Walk sequencing	The final stage of sorting mail before its delivery. Having been *walk-sorted*, letters are placed in the correct sequence for delivery.
Zonal pricing	A system of pricing which takes account of the different costs of sending letters or parcels to different parts of the country.

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Annex C:
Summary of written submissions

1. In total, 43 organisations gave evidence on the 60 questions in the panel's Approach Paper. Submissions were received from Royal Mail and alternative carriers in the UK, Postcomm, Postwatch, unions representing postal workers (CWU, Unite), the National Federation of SubPostmasters, major users of the postal service and their representatives (including the Federation of Small Businesses and Institute of Directors), political parties and politicians. We also received shorter submissions, often on particular points, from individuals and constituency MPs.

2. This summary provides an overview of these formal submissions. It has been written to protect information which is commercially sensitive and has been submitted on a confidential basis. It does, however, refer to the views of individual organisations where their submissions have been made public.

Questions about overall objectives

Question 1: What do you consider to be the essential aims of, and vision for, a postal service in the 21st century?

3. Responses to this question were consistent. All respondents wished to see a vibrant, competitive postal market providing high quality, innovative services which met the needs of all customers, both business and social.

4. Some respondents specifically referred to the need to maintain and protect the universal service. Royal Mail said that it "absolutely" wanted to continue to provide the universal service because of the "essential" role it played in social cohesion across the UK. No-one said that the universal postal service should be discontinued.

5. Many of the responses, including those from alternative carriers, indicated that the postal services market depended on having a healthy Royal Mail at its centre for the foreseeable future. It was also thought that postal markets needed to evolve and be flexible enough to adapt to meet the needs of consumers in an era where new communications media would emerge.

6. Postal companies and others were keen that competition in the postal services market should take place on a "level playing field". Royal Mail wanted to see changes to the margin for direct access products. Alternative carriers emphasised the need to amend the tax regime so that all postal companies paid VAT.

7. Customers and their representatives emphasised the importance of affordable prices. They believed that higher prices would lead to a

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further decline in the market. Some customers wished to see greater certainty about pricing, as they prepared their own business plans.

8. All respondents recognised that mail was competing with new forms of communication and expected that this competition would intensify over time.

Questions about liberalisation

Question 2: What has been the impact of liberalisation so far on:

- *Social customers sending and receiving mail*
- *SMEs sending and receiving mail*
- *Large companies sending and receiving mail*

in terms of the price of services, the choice of services to suit particular needs, and the quality of service.

Social consumers sending and receiving mail

9. Evidence was mixed on this question. Some submissions pointed to the improved quality of performance by Royal Mail as a benefit to social users, the increased certainty about the delivery date of mail brought about through access products and that prices remained low compared to the rest of Europe. Others, however, believed that the service had declined, owing to changes in Royal Mail's operations. Changes comprised the end of the second delivery, later delivery times, earlier collections and withdrawal of all collections on Sunday. Some felt that post office closures had been detrimental to the service. Others believed that there had been little discernible change. Responses did not differentiate between sending and receiving mail.

SMEs sending and receiving mail

10. The general view was that small and medium-sized enterprises had not yet benefited significantly from market liberalisation. New carriers had focused on winning the major bulk mail contracts. While some of these involved medium-sized businesses (21% according to surveys carried out by the Federation of Small Businesses), there was little evidence to show that the wider range of small companies were using alternative carriers or that alternative carriers had focused on the needs of this sector. SMEs in remote areas such as the Highland and Islands of Scotland were unable to get as good a deal as those in other parts of the country. That said, TNT and UK Mail did offer collection services for customers with low volumes (200-250 items).

11. The level of satisfaction with Royal Mail varied.

- Overall, small companies were said to be broadly satisfied with Royal Mail's services and prices. Changes to the delivery times, however, were a concern. Many wished to receive post earlier in the day.

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- Medium-sized companies were less likely to be satisfied with Royal Mail's customer care and prices as competition had been introduced. Magazine publishers strongly considered that liberalisation has been detrimental to their interests and that they had not seen any benefits, as prices had increased well above inflation and above those for other Royal Mail services. Publishers also considered that liberalisation and regulation had created more uncertainty about postal rates.

Large companies sending and receiving mail

12. The majority of respondents agreed that large companies were the main beneficiary of market liberalisation. Switching to alternative carriers had brought real price reductions. Large companies had seen an increase in customer care both from alternative carriers, with some innovations (such as the ability to track and trace mail). They also had more choice of service delivery standards (such as the day of delivery, or the number of days taken to deliver).

13. Some customers and alternative carriers did consider that, even for bulk users, the choice of products available was limited and that two carriers dominated this area of the market. One bulk user thought that the division between Royal Mail Retail and Royal Mail Wholesale had an adverse impact because the customer was forced to manage two relationships. Others said that with various carriers offering postal services, management and reconciliation of their postal requirements had become more complex.

14. Opinion about Royal Mail's response to competition was divided. Some acknowledged that the company had improved its quality of service, while others saw little change and believed that the company had failed to adopt a dynamic approach. Some made the point that Royal Mail continued to focus on competitors rather than the needs of its customers.

Question 3: What has been the impact of liberalisation so far on:

- *people in rural areas;*
- *people with disabilities;*
- *senior citizens;*
- *people in areas which receive relatively little mail.*

15. The consensus was that services to vulnerable groups had not been affected by liberalisation. Like other social users, they had adapted to changes in Royal Mail's collection and delivery schedule, and had benefited from better performance against the company's quality of service targets. Royal Mail's free service for blind people, and those sending post to blind people, remained unchanged. Several respondents made the point that Royal Mail's proposals on zonal pricing – had they been accepted by Postcomm – would have been detrimental to those living in rural areas.

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Question 4: What has been the impact of liberalisation on Royal Mail?

16. Most submissions recognised that Royal Mail had lost a share of the bulk mail market, with a negative impact on the company's financial health.

17. Several respondents noted that alternative carriers had targeted the most profitable contracts for bulk mail. They pointed out that this had an impact on the internal cross subsidies which supported the universal service, particularly in rural and remote areas of the country.

18. At the same time, almost all respondents recognised that Royal Mail still had a dominant position in the market. Competition had mainly taken the form of "direct access" products. End-to-end services had declined slightly after liberalisation.

19. There were many references to the positive impact of competition on Royal Mail, including greater efficiency and the company's record performance in meeting quality of service targets. Some believed that Royal Mail had become more commercial. Others considered that the company had reacted mainly defensively to competitive threat, in particular with regard to its pricing policies, rather than providing new services to meet the needs of consumers and introducing new products.

Question 5: What has been the impact of liberalisation on alternative carriers?

20. All respondents recognised that liberalisation had presented an opportunity for alternative carriers, with strong growth in the use of access products (zero to 4 billion items in four years). Alternative carriers said that margins were low because of pressure from Royal Mail on pricing and pressure from other carriers seeking to gain market share. The volume of letters which were collected, sorted and delivered by an alternative carrier (providing an end-to-end service) had fallen since liberalisation. Several respondents noted that two new entrants (one using downstream access, the other operating an end-to-end network) had withdrawn from the market. It was also suggested that other companies, while continuing to provide services, had withdrawn from certain product areas because of margin squeeze.

Question 6: To what extent has competition emerged since postal services were liberalised, and what kind of competition has developed? Please consider:

- *The collection and delivery of letters, packets and parcels*
- *Transactional mail, direct mail, social mail and publications*
- *Services for large businesses, SMEs and social consumers.*

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The collection and delivery of letters, packets and parcels

21. Submissions confirmed that the parcels market had been unaffected by liberalisation. Having been opened to competition in 1981, there were already many companies carrying parcels and packets.

22. Since 2000, new competition had been focused in the upstream collection and transportation of bulk mail. There had been little development in downstream competition. Royal Mail continued to handle the delivery of almost all letters in the UK.

Transactional mail, direct mail, social mail and publications

23. Respondents were clear that business for transactional mail sent on a regular basis (such as bank and credit card statements) and advertising had moved from Royal Mail towards alternative carriers. Customers in this area had a choice of carrier (although Royal Mail still made the final delivery). Competition had brought lower prices.

24. There was no competition in providing services to social customers. Submissions also suggested that there was little competition in the distribution of publications. The publishing industry was dependent on Royal Mail and pointed to price increases well above inflation in recent years. It also believed that further increases could damage the market by making the delivery of the publications too expensive.

Services for large businesses, SMEs and social users

25. Respondents agreed that there had been a significant increase in competition for the provision of services to large businesses; some competition for services to medium-sized businesses; little competition for services to small businesses; and none for social users. Some considered that downstream access arrangements did not provide "real" competition to Royal Mail. Postwatch considered that the arrangements were like "work-sharing". Several respondents said that the alternative carriers providing services through downstream access had simply mirrored Royal Mail products.

Question 7: Has liberalisation made an impact on any other groups?

26. The Communication Workers Union, Royal Mail and Postcomm all referred to the pressure which liberalisation had applied to the number of people employed by Royal Mail. Some respondents commented that liberalisation had failed to improve positive and productive relations between Royal Mail management and the CWU.

27. UK Mail argued that liberalisation had not succeeded in enabling post offices to provide services for alternative carriers. The National Federation of SubPostmasters pointed out that such a move could lead to a complex and unmanageable system for sub-postmasters.

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28. Postwatch claimed that charities and financial institutions had not experienced the same choice as others. As customers who were exempt from VAT, it was financially more attractive for them to do business with Royal Mail.

29. One respondent commented that costs for mailing houses who prepare mail for third parties had increased due to the greater complexity in mail presentation requirements. Another thought that liberalisation offered an opportunity to mailing houses as well as software and print management companies.

Question 8: Have Royal Mail and new entrants been able to compete effectively and fairly?

30. Submissions were divided about the competitive advantages enjoyed by Royal Mail and alternative carriers.

- Postcomm and the alternative carriers considered that the current VAT regime (in which Royal Mail services are exempt) created an unfair playing field for the new entrants and a barrier to entry. Some respondents, notably the CWU, were concerned that removing Royal Mail's VAT exemption would have an adverse impact for social customers and VAT exempt organisations (such as financial organisations and charities).

- TNT also referred to the National Geographic Posting Profile as a barrier to the introduction of end to end competition. One respondent considered that more of Royal Mail's delivery network (such as post boxes) should be opened to access.

- Royal Mail did not believe that it could compete effectively on price with the alternative carriers because of the "access margin". Royal Mail also argued that downstream access arrangements stifle innovation, since any benefits from new products have to be passed to alternative carriers.

- On the basis of market share, respondents agreed that alternative carriers have been able to enter the market and to take a significant share of the upstream market. Postcomm did, however, consider that Royal Mail had the potential to abuse its dominant position by raising barriers to entry or offering less favourable terms to other operators in accessing Royal Mail's delivery network. Some entrants believed that Royal Mail had used its dominant position, particularly on pricing, and that prices in the UK were too low to offer a reasonable commercial return on sales or investment in the long term. Submissions did not include evidence to prove these claims, and there has been no action by the regulator to date to address any anti-competitive behaviour.

- Several respondents referred to the absence of any change in the transparency in Royal Mail's pricing since liberalisation.

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Question 9: What can we learn about liberalisation from international experience?

31. Submissions suggested that because of different economic circumstances, demographics and geography across Europe, there were no straightforward comparisons to be made, particularly when countries were at different stages of market development. The UK had liberalised more rapidly, and uniquely through downstream access, than other Member States. Several respondents referred to the access arrangements in the United States as a positive approach to market liberalisation which would benefit the direct mail industry. There was a general view that liberalisation of postal markets should lead, and has led, to the incumbent postal service provider becoming more efficient.

Questions about structural changes

Question 10: Which changes in the communications market do you consider have had an impact on postal services: (a) internet; (b) email; (c) text messaging on mobile phones; (d) others?

Internet

32. All respondents recognised that the increased use of the internet had made an impact on postal services, particularly in relation to advertising and transactional mail. Evidence showed that internet penetration is increasing throughout the UK. The internet brought opportunities for the mail market in the form of e-fulfilment, as well as the risk of e-substitution. One respondent provided evidence that the industrial action that took place in Royal Mail in 2007 has encouraged customers to look to other means of communication to meet their needs and that the continued use of mail had been significantly damaged. Many respondents referred to the initiatives by some High Street banks and utilities to incentivise their customers to receive statements, invoices etc through electronic communication rather than post.

Email

33. All respondents considered that use of email communications (including e-cards) was increasing, and that the trend would impact on the volume of social mail in future. Young people, in particular, were likely to use email instead of physical mail. Respondents also said that advertisers and on-line retailers were using email to reach potential customers.

Text messaging on mobile telephones

34. Respondents believed that the use of text messaging was particularly high among younger generations and would impact on the use of social mail. Some respondents did point out, however, that text messages had different attributes to social mail, and that short, instantaneous

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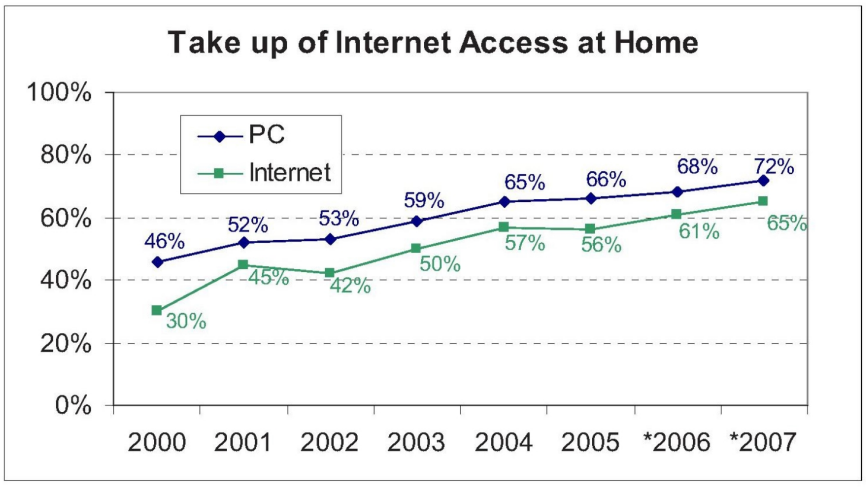
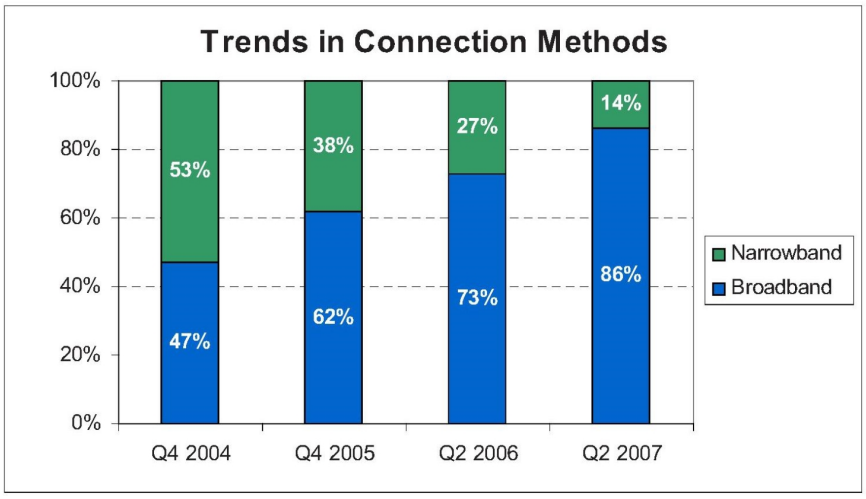
messaging would not replace more traditional correspondence. There was some evidence of small but increasing use of text messaging by advertisers and for transactional communications. Royal Mail thought that this practice had the potential to replace physical correspondence in the future.

Question 11: Can you quantify these changes?

35. Several respondents referred to the internet penetration statistics published by Ofcom. Two tables have been reproduced below from Ofcom's "The Consumer Experience" Research Report of November 2007 showing the increasing take up of the internet at home and the rise in broadband as the method of connection.





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36. There were also references by respondents to the following:

- Internet based sales grew by 3,533% between April 2000 and December 2006;
- British consumers spent £42bn on-line in 2007 and this was expected to increase to £78bn by 2010;
- 57 billion text messages were sent in 2007, with 6bn sent in December 2007 – almost 5,000 per second;
- Average response rates in the UK for text campaigns approaches 11%;
- Holiday postcards have declined by 75% in the last ten years

Question 12: What is the relationship between e-fulfilment and e-substitution in terms of their impact on the volume and value of postal business?

37. Royal Mail suggested that letter volumes were declining by 2-3% per year. Its analysis showed that volume lost through e-substitution was not replaced by e-fulfilment. The majority of respondents agreed that this was the likely future scenario. However, because unit prices for fulfilment (e.g. packets, parcels) are higher than for letters, the revenue impact of e-fulfilment and e-substitution combined was expected to be positive for the postal services market. Royal Mail estimated this to be £0.7bn by 2014-15 at constant 2006-7 prices.

38. Most respondents agreed that the higher value items prompted by e-fulfilment would only partly compensate for e-substitution. Postcomm thought that the compensation would be significant and might, in due course, exceed the value lost through e-substitution. Royal Mail argued that, because of the highly competitive nature of the parcels business, carriers which were losing business in letters were projected to gain less than £0.1bn of the total growth of £1.6 billion projected in parcels and packets. Royal Mail suggested that the winners would be the networks which already provide express and courier services.

Question 13: What has been the impact of e-fulfilment and e-substitution for:

- *Social consumers sending and receiving mail;*
- *SMEs sending and receiving mail;*
- *large companies sending and receiving mail;*
- *Royal Mail;*
- *alternative carriers?*

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Social consumers sending and receiving mail

39. Respondents recognised that social mail was in decline. UK Mail said that e-substitution had now all but replaced social mail, especially among the younger age groups. The general view was that bills, complaints and enquiries tended to be made by email, rather than mail or telephone. The use of internet auction sites had increased the number of packets and parcels sent and received by social consumers, normally via Royal Mail. Although the use of e-cards was growing, greeting cards represented a high proportion of social mail. Some respondent indicated that, while publishers were offering their products on line, there remained strong demand for paper copies of magazines and journals.

SMEs sending and receiving mail

40. Most respondents said that SMEs were increasingly turning to the internet for billing and invoicing. Their incoming transactional mail had also declined. Small businesses were most likely to use Royal Mail when meeting orders for goods. Some medium-sized companies used alternative carriers.

Large companies sending and receiving mail

41. Evidence suggested that e-substitution was driving the reduction in transactional mail sent and received by large businesses. Royal Mail pointed out that large companies were now offering customers financial incentives not to receive statements by post. Large companies (such as retailers) offering on-line services would be sending more packets/parcels.

Royal Mail

42. While Royal Mail expected e-fulfilment to grow, the company did not expect to recover revenues lost by e-substitution, because of the competitive nature of the market for delivering parcels.

Alternative carriers

43. Evidence suggested that, so far, the impact of e-substitution and e-fulfilment on the new entrants had been minimal. Alternative carriers had been taking market share from Royal Mail, but were likely to be competing in a declining market as e-substitution continued. Carriers competing for delivery of parcels and packets had benefited from an increase in volumes.

Questions about future scenarios

Question 14: What does international experience tell us about the challenges and opportunities facing the UK market?

44. Respondents agreed that postal markets throughout the world were facing similar challenges, particularly in providing a universal service while facing competition from other communications media and volumes were falling.

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Question 15: What factors might encourage – and discourage – the use of electronic services as an alternative to the postal service for:

- *Transactional mail;*
- *Direct mail;*
- *Social mail;*
- *publications;*
- *other purposes?*

45. Responses are summarised in the table below. Security of communications and the environment were the main concerns.

Mail type	Encourage	Discourage
Transactional mail	• Financial incentives • Growth in internet usage • Cheaper for sender • Convenience • Environmentally friendly • Complexity of multi-supplier market place for bulk mailers	• Company or consumer concerns about internet safety • Signature needed. • Not all households have access to a PC
Direct mail	• Environmentally friendly • Cheaper for sender • Higher response rates • Fully trackable	• More targeted • Product samples • Email treated as spam and deleted unread or seen • Opt in/opt out rules
Social mail	• Convenience • Cost • Time (instant)	• Need to send physical item • Physical product more personal
Publications	• Cost (no printing or postage) • Environmentally friendly	• Physical product important to consumers. • Cannot use inserts e.g. samples

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Question 16: In particular:

(a) what advantages might consumers ascribe to paper mail, as the volume of electronic mail increases?

(b) how far is environmental policy and regulation likely to affect the market, in either a positive or negative way?

(c) to what extent can the postal sector successfully provide complementary services to other media channels, including broadcasters and companies advertising on the internet?

(d) what innovations are likely, or possible, in the development of IT hardware and software, with implications for the postal sector?

Advantages of paper mail

46. Longer communications and publications were more easily read in paper form, than on screen. Social users placed importance on sending and receiving greeting cards and thank-you letters in physical form.

Environmental policy and regulation

47. Respondents believed that environmental issues were rising in profile for the industry, both in terms of the use and recycling of paper, and carbon emissions, particularly those generated by road transport. There was a need for the postal industry and marketers to show that they take this seriously and that post can be "environmentally friendly". Initiatives already existed to reduce waste e.g. cleansing of databases, greater use of recycled and recyclable papers and inks. Royal Mail considered that the impact of customers switching to other means of communication from post because of their concerns about the environment could amount a loss in revenue of around £350 million per year.

Complementary services

48. Respondents pointed to existing examples of co-ordination between mail, internet and broadcasting, and generally considered that there were opportunities to exploit wider links.

Innovations

49. Some respondents drew attention to new market offerings which printed mail close to the point of delivery. Royal Mail highlighted the developments in scanning equipment which would enable greater amounts of information to be stored on mail; improved mechanisation; and handheld technology to increase information gathering right up to delivery. The introduction of these would enable the more efficient handling of mail (enhanced track and trace) and produce cost savings for

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postal carriers. TNT referred to development of electronic and reporting systems by Itella in Finland and its own TNT-it service.

Question 17: Is it possible to provide evidence for these factors, as a basis for preparing projections for the future of the mail market?

50. The main responses to this question were provided by Royal Mail and Postcomm. The full detail is set out in their responses which are on their respective websites (and the review pages on the BERR website) but below we have picked out some highlights.

51. Royal Mail referred to the following

- the link between GDP growth and mail volumes had broken down but it will still be a driver in the sector;
- consumer subscription to the Mail Preference Service had risen from 2m in 2004 to 3.7m today;
- sending one item by post generated an average of 26g of CO2;
- powering a computer for 1 minute resulted in 1.8g of CO2; and
- direct mail accounted for only 2% of landfill waste compared to 9% for newspapers.

52. Postcomm provided examples of international postal operators' product innovation to complement digital communication. These examples were from the USA, Germany and France and included:

- USPS' "Carrier Pickup" provided on-line notification of collections;
- the Mailing Factory in Germany, a web based system for sending out advertisements through various media including by post, email and SMS/MMS; and
- La Poste had an on-line shop which also offered a paid service for customising and sending greeting cards.

53. The results of a survey of its members submitted by the Institute of Directors indicated that 51% of respondents expected to decrease their use of Royal Mail services by 2010 and would during the same period increase their use of the internet and email by 83%.

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Question 18: What factors may limit the ability of companies to enter the market, or their market share:

- in providing upstream services?
- in providing a downstream service?
- other services?

Upstream services

54. Respondents pointed to a range of deterrents, including the absence of a "level playing field" for competitors e.g. VAT treatment, decreasing volumes of mail, regulation and low margins. There was also a view that regulation stifled competition and held back developments in the sector. Some alternative carriers and bulk mail customers were critical of Royal Mail's requirements for downstream access, e.g. forecasting, surcharge for non-compliance, which they considered were operational restrictions.

Downstream service

55. There was broad agreement amongst those who provided evidence that the costs of building a national delivery network prohibited competition to Royal Mail. It was also considered that if delivery prices were not set at the correct cost covering level to make Royal Mail a commercial profit, then it would not be feasible for others to enter the market. The National Geographic Posting Profile was considered by TNT to be the greatest barrier to end to end competition as it contained a de facto exclusivity clause. UK Mail suggested that downstream services could be contracted out on a local basis.

Question 19. Are there three broad scenarios which you believe would provide a useful framework to test policy options? (Scenarios should focus on economic, environmental, social and technological changes outside the mail market, assuming that current policy is maintained in relation to the postal sector). Please give your own projections for the volume and cost of mail under each.

56. A number of respondents did not suggest any scenarios. There were, however, substantial contributions from Postcomm and Royal Mail.

57. Postcomm set out 3 possible medium term outcomes based on its Strategic Review exercise. These all related to the future of Royal Mail and were:

- Managed decline of the business;
- Royal Mail going into administration; and
- Transformation of Royal Mail.

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58. Postcomm believed that transformation of Royal Mail would have a major impact on the size of the mail market five years from now along with the development of digital services.

59. Royal Mail suggested 3 market scenarios. These were:

- a central case with growth in communications markets but flat or declining growth in mails, including end to end competition;
- a downside case with a steeper decline in volumes due to competition from alternative technologies; and
- an upside case where external developments lead to higher growth for the mail market e.g. slowing down of e-substitution due to security concerns and disenchantment with spam emails.

60. More detail on these scenarios is set out in Postcomm and Royal Mail's submissions.

61. The other suggested scenarios submitted were:

- innovation in technology provides secure email capability, proven over a period of time and trusted by consumers, resulting in a dramatic decrease in postal volumes and thereby requiring significant price increases in postage prices.
- environmental concerns generate a reluctance amongst consumers to use paper communications requiring physical transport, as both have an adverse impact of the environment. This results in little or no consumer to consumer mail, with the exception of seasonal post.
- there should be a regulatory regime that embraces the benefits of service provider competition. It was suggested that this is a model that had been proven in other network industries and ensured that all service providers had access to key bottleneck facilities on equivalent terms. Some respondents were of the view that this would open the door to service innovation and economic benefits throughout the industry.

Questions about consumer needs

Question 20: Is a delivery on each working day important to consumers, either for social or business reasons?

62. The overwhelming response to this question from all interested groups, especially users and their representatives, was that the current requirement for the delivery of mail from Monday to Saturday should remain unchanged. This was supported by research carried out for both Postcomm and Postwatch which indicated that 82% of social consumers and 73% of business customers rate deliveries on 6 days per week as either fairly important, important, or very important. Large mailers still considered Saturday deliveries to be important. Only 36% of social

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consumers believed that deliveries on Monday to Friday would be sufficient.

63. Several reasons for not making a change to the existing six day delivery were given by respondents. These included:

- Reduced delivery frequency would signal a declining relevance of mail and hasten migration of advertising and transactional mail to alternative media.
- Because many businesses operated on a Saturday, it should also be considered a working day.
- The importance to of daily deliveries in supporting priority (next day) products.
- The potential impact on quality of service targets.
- The dependency of a significant proportion of population on mail as their primary communications channel.
- The increasing demand for weekend delivery, especially for signed services.

64. It was noted that the reduction of the number of days mail is delivered was an emotive subject and that the first reaction is to safeguard what is on offer now. A small number of respondents believed that the number of deliveries should be reduced to five (and in one case, even lower than this over time).

Question 21: Is the time at which mail arrives important to consumers, either for social or business reasons?

65. Respondents, particularly businesses, were strongly of the view that the time of delivery was important. Business customers – large and small - wanted deliveries as early as possible so that they could process mail received on a same day basis and to allow for workflow planning. Some customer service departments opened up as early as 6am.

66. For social consumers, views differed but it was still considered that delivery times were important. Those sending packets for fulfilment considered that social consumers wanted items delivered when they were most likely to be at home i.e. early morning or in the evening. For most deliveries a target of 12 noon was thought to broadly meet the needs of all users, provided that there was a window to process the mail so that there was a suitable collection later in the day. One respondent considered that for the universal service to social users a window between 8am-6pm should be adequate and this would help reduce costs.

67. Postcomm research suggested that residents and businesses were generally satisfied with delivery times.

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Question 22 : Do business or social consumers have sufficient choice of services when sending mail for different purposes?

68. Overall, respondents considered that large businesses had the greatest choice of services and that while those for SMEs and social consumers were less, in terms that they did not have access to the service provided by new entrants to the market, there was still a range of services to meet their current needs. All users of Royal Mail services had benefited from improved quality of service.

69. For large businesses, the fact that Royal Mail had lost 40% of upstream volumes to competitors was thought to be a clear indicator that there was a choice of supplier to meet their needs. SMEs sending more than 250 items a day also had a choice of supplier but those below this level and social consumers had no choice of supplier. However, the overall view expressed was that, while these groups did not have the use of alternative supplier (except for express/parcels), there was still a good range of services available to meet their needs. That said, the current range of services needed to be better advertised and had to be reliable and convenient.

70. Some respondents felt that there was still opportunity to provide a wider choice of services even for larger customers. These included more tailored and bespoke services to meet businesses needs. More opportunity for evening deliveries was also mentioned and also the use of alternative points to post and collect mail such as supermarkets and petrol stations. "Greener" offerings would be welcome.

71. The view was also expressed that the reduction in the number of post offices had reduced choice by making access to postal services more difficult, and that pricing in proportion had also made it more difficult to send items by post.

72. It was considered that greater innovation and the provision of services that met business needs were necessary to maintain volumes of services and to prevent faster migration to other communications media.

Question 23 : Do consumers have sufficient choice as a recipient about where and when mail is delivered?

73. The responses to this question were more mixed. It was generally agreed that there was some choice but more was needed to keep pace with the changing needs of the consumer and working patterns, especially with regard to fulfilment and having packets and parcels delivered when somebody is at home.

74. Business had a choice of timed delivery but this came at a cost. It was considered that deliveries by Royal Mail were centred on its operational efficiency not on the needs of customers. In this regard, Royal Mail was thought to be introspective and not understanding of the problems that changes to deliveries had on its customers, especially businesses.

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75. Consumers broadly continued to want delivery to the door rather than the boundary of their property because of security concerns, but there also appeared to be a demand by social consumers for alternative places to collect their deliveries at alternative sites (e.g. closer to where they work or close to home). This would help to reduce the number of undelivered items, the associated costs of handling them and the inconvenience to the recipient. Senders of fulfilment items wished to see more evening and weekend deliveries. There was a clear message that more innovation was needed here to meet consumers changing needs.

Question 24 : Would consumers accept that greater choice in services may mean a variable (but specified) delivery time?

76. There was a no clear consensus on this even among the various groups of interested parties. For example, the responses from customers and business recipients were split down the middle. There did not seem to be any evidence that consumers wanted this particular trade off.

77. Business customers reiterated that they wanted to have their deliveries as early in the day as possible and that variable delivery times would be difficult to accommodate. What was important was for postal carriers to find out what their customers wanted and to provide that service for them. The service should be about what is good for the customer not what is beneficial to the postal operator.

78. Other views expressed were that social consumers were more interested in ensuring that their mail arrived at its destination on a specific day regardless of the time and that while social users might accept a later delivery time, this did not meet the needs of those working from home.

Question 25 : Would consumers be willing to pay more for a wider range of services, whether as a sender or recipient of mail?

79. The overall view was that consumers considered that prices for existing services were affordable, but they would be willing to pay more for enhanced services (i.e. not just a wider range of similar services). The view was expressed that this was already the situation especially with regard to guaranteed delivery services. Royal Mail's experience when launching new value added products suggested this was the case.

80. Caution was expressed about price elasticity (which was limited) and because prices for post in the UK are low. Increases would have to be justified and have clear benefits.

81. With regard to fulfilment, on-line ordering meant that receiver pays for delivery and has a choice of options. Prices might be high for certain options but customers could decide delivery times and convenience. The notion of the "Receiver pays" could be developed but only if balanced by enhanced service options.

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82. It was thought that SMEs were not looking for broader range of services and would not want price increases unless there were tangible benefits.

Question 26 : What services should be offered as a minimum for senders and recipients of mail?

83. There were variations on responses to this question but the overall view was that current universal service requirement as set out in the Postal Services Act (six day collection and delivery, registered post and international services) was the minimum, with variations on what should overlay this e.g. 1st class post, bulk mail, traceability of products, high reliability, consistent time of delivery.

84. The majority of respondents considered that there should be no change to the six day delivery although one respondent considered that this should be kept under review as the needs of consumers may change in future years. It was considered that degrading current services at this time would accelerate market decline. It was thought that the minimum service should include special services for vulnerable and under-served groups.

85. On the timing of deliveries, there was a preference by consumers that all post should be delivered before midday.

86. Few respondents referred specifically to the uniform tariff. Those who did either supported it because it was important to have pricing certainty for their business cases, or queried whether it was necessary (while recognising that administratively it was probably the most practical charging method).

87. It was also suggested that the key issue was to determine what service was really needed by business and social consumers in both sending and receiving capacities.

Question 27 : Which of these services do you believe would not be delivered by the market, on the basis that they are not economically viable?

88. There was a consensus that only Royal Mail could meet the minimum requirements in the Postal Services Act. It was considered economically feasible, however, for alternative carriers to replicate services on a regional basis.

89. It was also agreed that the market would be more likely to provide services in high density areas and less inclined to do so in rural areas, or to provide services at no charge to special groups such as the blind and partially sighted.

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Questions about universal service

Question 28 : The universal service was originally established to ensure that all UK citizens have access to postal services at a uniform tariff. Do you consider that the universal service as currently defined fully meets that aim?

90. The majority of respondents agreed that the universal service, as currently defined, continued to meet this aim. One respondent thought, however, that the universal service was not introduced to give access to uniformly priced services. This was simply the most administratively practical method of charging.

91. Concern was expressed that zonal pricing and cherry-picking were threats to the universal services.

Question 29 : Do you believe that the universal service has other objectives, not covered in the Postal Act?

92. There was broad agreement that the universal service was important for social cohesion and the economic well being of the UK, and that it played an important role in the provision of services to vulnerable citizens and communities.

93. The role of Royal Mail's postmen and women as trusted members of the community was also seen as a benefit from the provision of the universal service and it was suggested that there was untapped value in their relationship with the community.

94. It was also considered that the universal service had the effect of sustaining the competitiveness of mail as a medium, and of supporting the wider industry via wholesale access to Royal Mail's economies of scale and delivery network.

Question 30 : Are there elements of the universal service as currently defined which are no longer relevant to consumers?

95. There was general agreement that all elements of the universal service remained relevant. The key issue of whether the current universal service was over specified was raised by several respondents. For example, it was debatable whether bulk mail services should be included in the universal service. The view was also expressed that 1st class mail need not be included in the universal service on the basis that it should seen as a premium product not a basic service. Many business customers had switched to 2nd class already to meet their needs.

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Question 31 : Do you believe that bulk mail services for business (either directed at other businesses or consumers) should be part of a universal service, and why?

96. The majority of respondents considered that bulk mail (Mailsort 1400 and Cleanmail) should be removed from the universal service.

97. For those respondents who opposed any change, the main reason given was the potential impact on the small and medium-sized businesses who use these services. Others thought that the market for these products was still immature and that until a fully competitive market existed and these services were available to all users it was important to keep them in the universal service. A number of business users or their representatives thought that bulk mail should stay in the universal service until end to end competition had developed. If taken out, one respondent said that there was still a case for the services to be covered by price control. Concern was also expressed that removal would have an adverse impact on businesses in rural areas as the uniform tariff would be lost for these services. Another respondent thought that Royal Mail's push for zonal pricing was a clear indication that Royal Mail was showing monopolistic behaviour.

98. The general view expressed, however, was that only stamped (and metered) mail should be part of the universal service. It was considered that business users had access to competitive services for bulk mail services from other postal operators and from other media.

Question 32 : What is the (variable, fixed or sunk) cost to Royal Mail of the Universal Service Obligation, as it is currently defined?

99. Most respondents did not have access to detailed information about Royal Mail's costs to enable them to properly respond to this question. Royal Mail indicated that cost of providing the universal service was £3.4bn in 2007-8, with approx 44% of this total relating to fixed costs.

100. Other comments that were made included:

- the key question for panel was the need for full cost transparency to ensure that the universal service was correctly financed and that market development was not hindered.
- while labour costs were normally variable, the universal service obligation meant that they were fixed for delivery and collections.
- Royal Mail reported that the universal service was loss-making. Much depended, however, on the way in which the universal service was defined.
- An "everywhere, everyday" service was a commercial asset and should be able to generate positive financial contribution
- In a network business, it was difficult to unpack costs.

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Question 33 : What are the externalities (for example, environmental and social) associated with postal services?

101. Concern about the environmental impact of postal services (both the generation of emissions and recycling of materials sent by post) was the main externality identified by all respondents. Environmental issues had an increasingly high profile and could impact on the future use of postal services and the development of the market as consumers sought to reduce their personal or businesses' carbon footprints.

102. Statistics provided in submissions included:

- sending one item of mail generated on average 26g of CO_2 whereas powering a PC for one hour generated 108g of CO_2 .
- Direct mail accounted for 2% of landfill compared to 9% for newspapers.

103. As most trunking and local delivery took place overnight or early morning road congestion was limited.

104. One respondent suggested that if there was a "free for all" in setting up delivery services, this would lead to duplication of effort and increase in carbon emissions.

105. The social role of mail service, e.g. to the vulnerable, was also identified as an externality that could impact on the postal service.

106. The "credit crunch" and general economic conditions could have an impact as businesses reduce their advertising budgets.

Question 34 : What are the public goods associated with the provision of postal services?

107. There was agreement amongst respondents that postal services contributed to the smooth running of the UK economy and social cohesion by allowing individuals, including the vulnerable, to communicate. It was considered that this was mainly due to the provision of the universal service. The view was expressed that universal service "cements the nation together".

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Question 35 : What other options are available for meeting consumer needs; and what would be their cost?

108. The majority of respondents referred to digital communications, in particular the internet and email. It was not thought that this would be able to replace all mail, as physical goods had to be delivered to the recipient. One respondent calculated that approximately £1bn of mail might be replaced by digital communications. Compared to digital communications the average monthly spend on post (£2.20) was dwarfed by that on telecoms/internet services (£64.70).

109. Some respondents felt that digital communications did not have the same social cohesion aspects as post and were less ubiquitous.

Questions about providing universal services

Question 36 : Considering both the current and any proposed new definitions of the universal service, do you consider that the obligation to provide the universal service is a commercial benefit or disadvantage for Royal Mail? Why?

110. A significant majority of respondents said that the universal service was a commercial advantage to Royal Mail. It was considered to be a "significant benefit", "unique selling opportunity", "an advantage if exploited" and a "tremendous asset". One respondent said that all items carried by network should be regarded as contributing a full and fair share to the universal service network. Another said that the status of the incumbent universal service provider gave them an air of dependability and security others did not have.

111. All of the alternative carriers saw the universal service as an advantage. Royal Mail themselves considered it to be a valued asset, although it was also costly to deliver.

112. Those who thought it was a disadvantage believed so because of the costs associated with providing the service. If not regulated effectively it was a liability. It was thought that if the service needed subsidy from Government then it would be a disadvantage.

113. Some respondents said that the universal service was neither an advantage nor disadvantage. It was described as a "curate's egg" by one.

Questions 37 : Could the obligation be shared among Royal Mail and alternative carriers?

114. The majority view was that the universal service could, at least in theory, be shared among Royal Mail and alternative carriers. All of the alternative carriers who responded agree with this. However, some did

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consider that this would be sub-optimal due to duplication and potential consumer confusion, TUPE and VAT arrangements.

115. The general view was that the way to achieve this would be through contracting out/outsourcing. For this to be successful, there would need to be a change to the VAT regime to make it economically viable. Another way of sharing the obligation would be through franchising. With any sharing of the obligation, consumers considered that the system would need to be properly enforced and that commercially unattractive areas should be protected.

116. Those who were opposed to the sharing of the universal service thought that the break-up of an integrated service would complicate the efficient operation of the business and that a high quality of service would be difficult to achieve. They also considered that the cost of additional complexity would offset any savings from the sharing process. One respondent also thought that the sharing of the universal service would lead to greater impact on the environment.

Question 38 : What should be Royal Mail's role in providing the Universal Service?

117. There were a number of different responses to this question but the underlying theme was that Royal Mail's role was to provide an end to end service (collection and delivery) throughout the whole of the UK.

118. Several respondents said that Royal Mail was the only postal operator capable of providing such a service and that it needed to be financially robust. One alternative supplier considered that Royal Mail should have a broader role as supply chain manager, advisor, centre of excellence, training and development resource, compliance officer and provider of an information network. It was also commented that Royal Mail needed access to adequate capital for investment in operational improvement and products and service innovation.

Question 39 : Can the universal service continue to be financed internally (without a subsidy)?

119. The majority of respondents considered that Royal Mail could continue to finance the universal service without an external subsidy. However, there were strongly held views that to do so Royal Mail had to improve its efficiency and to provide services that met customer needs. One respondent said that improving efficiency was the biggest single lever available to Royal Mail, and had additional benefits in terms of funding the pension deficit and providing profits for the shareholder. Another said that lighter regulation was needed for Royal Mail to be able to fund the universal service without external subsidy.

120. It was noted that the universal service was provided in other markets, such as Sweden, the Netherlands and New Zealand, without external financing.

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121. Some customers commented on cross subsidies within Royal Mail's business. It was considered that cost reflective pricing would be ideal and that subsidies for social consumers from business mail should be phased out over time. But others considered that the access regime meant that social consumers were subsidising alternative postal operators who should help pay for the upkeep of Royal Mail's network.

122. One customer said every other "natural monopoly" had struggled with the cross subsidy question and had never managed to remove it entirely. Another thought that it was acceptable for Royal Mail to cross subsidise between universal and non-universal products.

123. One respondent considered that Royal Mail needed to take more radical action to address its inefficiencies, and that there was a serious strategic gap between now and 2012 that needed to be closed to avoid the accelerating trend of declining profitability.

Question 40 : If not, how should the universal service be financed?

124. The main funding mechanisms that were identified were direct subsidy from Government, and a compensation fund that would mean that alternative carriers would support the universal service by paying directly into the fund.

125. There was little support for a compensation fund. One respondent said that a compensation fund would further distort the market and it was better to fund the network by ensuring that access charges were set at the right level to ensure that the alternative carriers contributed fully to the maintenance of the network. It was also considered that "taxing" competitors would reduce margins even further and discourage development of competition.

126. One respondent said that the universal service could be supported by the effective commercial development of Royal Mail. The idea of increasing licence fees for non-universal service providers was also mentioned.

127. Some respondents suggested that as Government had previously taken dividends from Royal Mail, if external funding was needed this should come from Government.

Question 41 : Does Royal Mail have the capacity to provide the universal service in an effective way?

128. The overall response from respondents to this question was positive. However it was also thought that Royal Mail had to be more efficient and to implement its transformation plan quickly.

129. There was criticism from consumers about Royal Mail's performance. One business consumer was not convinced that the management could take this forward. There had been some progress but this had been frustratingly slow. There needed to be a real commercial attitude and approach to meeting customers' needs. Another said that Royal Mail

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needed changes to working practices as well as automation in order to provide the universal service in effective way. The weak industrial relations in the company and last year's strike were also mentioned. It was considered that these had only resulted in business focusing on alternatives to Royal Mail and post altogether.

130. Some respondents considered that Royal Mail needed access to additional funding to invest its infrastructure. Others thought that contracting out/market testing would ensure that Royal Mail was as efficient as possible.

Question 42 : If not, what are the changes necessary, in terms of the company's mission, management, investment plans, structure or working practices?

131. There were a number of different responses to this question. The majority of respondents again mentioned the need for Royal Mail to implement its transformation plan.

132. Others argued:

- the need for Royal Mail to put customers at the centre of its strategy. The management culture was currently inward looking and should be more focused on customers.
- that Royal Mail should make more rapid use of the investment funding provided by Government;
- that Royal Mail and the CWU needed to adopt a flexible and efficient approach that was responsive to consumers work patterns. The current protectionist attitude did not generate good working partnerships with business customers.
- that a split along lines of commercial equivalence was inevitable if Royal Mail continued to behave as a stereotypical monopoly.
- that incentive schemes should be changed to focus on delivering customer satisfaction.

Question 43 : Can these changes be delivered within public ownership?

133. There were mixed views about whether the changes could be delivered in public ownership. Even amongst who considered that this was possible there were concerns about the speed of change and the need for it to be accelerated. It was also thought that a change in ownership could result in more uncertainty and upheaval.

134. Those respondents who thought that an change in ownership was needed also doubted whether the necessary changes, particularly a change in Royal Mail's culture, could be achieved in public ownership. Others said that ownership should change to enable Royal Mail to gain access to equity capital. One thought that it might be difficult to find a purchaser unless Government could give some assurances about

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industrial relations. It was thought that Royal Mail would benefit from the introduction of commercial disciplines that would support changes in management and employees' behaviours needed to revitalise Royal Mail, removing the existing "safety net".

135. Another respondent said that, as long as Royal Mail was state owned, there would be political pressure on the sole shareholder to provide increased funding and reduced pressure on Royal Mail to improve efficiency. A commercial shareholder would be more demanding to ensure management maximises productivity and profitability and ensured return on capital invested.

136. One respondent proposed a public/private partnership using a "Limited Liability Partnership (LLP)" framework.

Question 44 : If not, why?

137. In addition to those given in response to the previous question, a number of points were made by respondents, including:

- future funding and business responsiveness could be more effective in private sector.
- there was a possible perception of conflict in the private sector delivering such a traditional service.
- change in ownership would result in a sustained period of disruption that would irreversibly damage market which has not recovered from last year's strikes.
- a period of stability was needed to rebuild the market to ameliorate effect of e-substitution and to restore consumer confidence.

Question 45(a): What further measures would be necessary to enable the changes listed in your response to Q42? In particular, should Royal Mail and Post Office Ltd continue to form part of the same group?

138. There was a small majority amongst respondents in favour of Royal Mail and Post Office Ltd remaining part of the same group.

139. Those who favoured no change considered that there was no compelling reason to separate them. The points made to support this position included:

- The view that Post Office Ltd was the retail arm of Royal Mail;
- The view that Post Office Ltd was part of an integrated business model;
- The view that Post Office Ltd would be financially weakened by a break up and endanger provision of the universal service, because

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the mail contract between the two is approximately a third of Post Office revenue);

- The view that there were synergies between the businesses;
- Good quality management was needed rather than ownership change;
- There is no known international precedent where such a split has happened.

140. Those who favoured a split considered that:

- A demerged Post Office could seek to find other services of social value to boost its revenues;
- Post Office and Royal Mail were different business and separation would help efficiency and transparency of costs.
- It would enable each business to focus on its divergent problems;
- The need for public subsidy would mean that Post Office was an uneasy fit with a commercial approach.

141. In either case, a number of respondents considered that alternative postal carriers should have access to the network of post offices as this would be beneficial to customers and act as an additional revenue stream for POL.

142. It was also considered that the contract between the two companies was important to ensure that there was continued access to postal services through post offices. For example Post Office could be under direct HMG control with arm's length commercial contracts with Royal Mail.

Question 45(b) : Do you support the idea of wholesale equivalence (separating Royal Mail's upstream and downstream operations), and why?

143. A small majority of respondents favoured wholesale equivalence. This was mainly on the grounds that genuine competition would be driven by a properly separated access regime as it would help establish a "level playing field" with Royal Mail just being another customer. Another proposed that Postcomm needed to systematically identify bottlenecks and barriers to market entry, and providers wishing to access these bottlenecks and others should be able to do so on terms of full equivalence of price and conditions.

144. Those who were opposed considered that cost transparency was the best way of ensuring fair competition as it would allow the regulator to test whether Royal Mail's prices were fair and non-discriminatory. It was also thought that the cost of implementation would be high and that it would lead to potential internal conflicts in Royal Mail with the danger of dysfunctional practices impacting on consumer. Other respondents

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suggested that wholesale equivalence was impractical and would increase rather than reduce costs, raise barriers to efficiency and not provide an adequate catalyst for change. One respondent considered that any move to equivalence should focus first on services where there was no upstream competition. Existing services needed to be protected against margin squeeze along current lines until the system is shown to be robust.

Question 45 (c) : Do you support the idea of commercial equivalence (separating Royal Mail's sales and marketing function from the management of the collection, sorting, transportation and delivery network) and why?

145. The clear majority of respondents did not favour commercial equivalence. The main reasons given were that this would not address the key issues facing Royal Mail and the sector and there was no compelling reason to make such a change. It was thought that it would be costly, damaging and time consuming and add complexity, reduce efficiency and increase prices. One respondent said that if the absence of separation was creating genuine barrier to competition then it may be useful, but it should not be considered if it was merely "economist dogma".

146. It was suggested that commercial equivalence made no sense while Royal Mail retained the universal service obligation. Adopting a model that mirrored the one in gas, electricity and telecoms was not sensible because Royal Mail's business was different. Another respondent's view was that if there was commercial separation Royal Mail was more likely to invest more in the downstream and therefore there would be no reason for end to end competition to develop. It would set the infrastructure in stone and prevent the market developing to meet emerging requirements.

147. Those who favoured the change thought that it avoided the pitfalls of wholesale equivalence as entire network would be under single control. It would give Royal Mail the opportunity to outsource, and develop a retail business with the capability to operate with true commercial customer focussed attitude. Some who supported the move recognised that it was not perfect but believed that it would be beneficial for the market.

Question 46 : What is the impact of Royal Mail's pension liability and deficit on the company's ability to trade; and what are the implications for management?

148. It was recognised that Royal Mail's pension deficit was one of the largest of any UK Company and that it had a significant impact on Royal Mail's financial position. It was generally agreed that the deficit had implications for management as time had to be devoted to ensuring that there was sufficient cash to meet the necessary contributions to the fund and to ensure that future liabilities were reduced. The deficit was volatile and subject significant fluctuation making it difficult for Royal Mail to finance its business operations.

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149. A number of respondents considered that Royal Mail could not operate on a level playing field and compete while it had to fund this overhead. They also felt that the deficit distorted Royal Mail's financial position. Under the present price control, there was also a burden on customers to fund the pension deficit through increased prices.

150. One respondent thought that the pension deficit only amounted to 3% of Royal Mail's costs and that the greater concern was the size of deficit by comparison of assets and liabilities which made Royal Mail balance sheet insolvent.

151. Respondents raised several implications for management, including:

- the need to take account of liability to trustees when embarking on investment strategies;
- increased difficulties in considering a reduction in size of core business due to need for cash to service the pension deficit;
- pressure from the Plan trustees to de-risk Royal Mail's business;
- uncertainty about future cash flows, coupled with balance sheet insolvency, restricts management's ability to take a long term view

152. A number of respondents suggested ways in which the deficit should be tackled. These included:

- consideration should be given to moving pension fund to separate control and management (private, commercial) and allow business to be self-funding afterwards;
- increasing revenue from services (prices) and decreasing costs;
- shareholder funding on commercial terms but taking account of the 13 year pension holiday;
- pension reform to minimise the deficit;
- using assets/real estate (£2bn) to reduce deficit as M&S has done on sale and lease back;
- move the scheme's investments away from stock market investments to decrease fluctuations;
- direct Government intervention to ensure the scheme is properly funded.

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Questions about the regulatory framework

Question 47 : Is the "final mile" (the ability to deliver to all 28 million addresses in the UK) a natural monopoly?

153. The majority of respondents considered the final mile to be a "natural monopoly" especially to rural and remote areas. The main reason for this was the huge investment that would be needed to replicate Royal Mail's national network. A number of respondents believed that it would not make sense to have two or more postmen or women delivering to your door, in particular from an environmental perspective.

154. It was thought that it would be feasible to develop alternative delivery networks in high density areas, on a regional basis or through a network that only delivered 2 days per week. One respondent considered that when looked at from first principles, it was not a natural monopoly but accepted that Royal Mail's legacy infrastructure is an "historic, de facto natural monopoly".

155. Another respondent pointed out that there was competition in delivery in other markets including the Netherlands, Sweden, Germany, Italy and Spain, and some alternative carriers had plans to provide end to end services in the UK. The conditions had to be right to do this. For example there needed to be equal VAT treatment. It was considered that simplicity of using universal service at uniform tariff, the widespread infrastructure (post boxes, delivery houses, POL) and the obligation to deliver six days a week meant Royal Mail had a monopoly in this area.

Question 48 : Is the "first mile" (the ability to collect from all postboxes and post offices in the UK) a natural monopoly?

156. The generally held view was that the collection from the nationwide network of post boxes was a natural monopoly but other networks could be developed more easily than that for delivery. For example, collections were already being made from business consumers by alternative carriers, and there was the possibility of collecting from petrol stations or supermarkets. It was thought that multi-operator collection may serve the market more efficiently than a single operator.

157. It was pointed out that the mail conveyed through the network of post boxes only accounted for around 13% of mail posted in the UK.

158. One respondent pointed out that in Germany, PIN had launched its own stamps and a network of green post boxes in competition with Deutsche Post. In was also pointed out that an alternative collection network such as this had failed in New Zealand. Another respondent thought that alternative carriers should have access to the post office network and that mentioned that Royal Mail had exclusive rights to erect post boxes.

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Question 49 : To what extent has the access regime enhanced the possibility of competition in the final mile, or reduced it?

159. The majority of responses suggested that the access regime had enhanced the possibility of future competition in the final mile. The main reason for this was that the access regime had enabled the alternative carriers to build up volumes and form direct relationships with customers, laying the foundation for alternative delivery networks. It was suggested that access had allowed customers to experience choice, new services, excellent customer service, greater accountability and price competition, enabled operators to establish direct customer relationships collection networks, sales forces, and to invest in premises, vehicles, sorting machinery and IT infrastructure.

160. It was thought that it was questionable whether end to end services would exist in the absence of access, and certainly not on a national scale.

161. It was suggested that some aspects of the current regime could act as a barrier to an end to end service. For example, margins were so small that there was little incentive to compete, and crucially the National Geographic Posting Profile in Royal Mail access agreements meant that alternative carriers could not chose to deliver in high density areas whilst using the access arrangements for other deliveries without being surcharged.

162. Some respondents said that it was very important for Postcomm to understand the segments in the postal market so that it could better understand where Royal Mail could use market power to anti-competitive effect. It was also considered that the level of price flexibility (3-8.5%) in the price control was a barrier to entry. Others said that it had made no difference, and that access had reduced competition in delivery.

163. It was thought that the VAT regime was a significant barrier to the introduction of end to end services.

Question 50 : Do you believe that the regulator should set limits on prices for social mail, or other forms of mail, and why?

164. The overwhelming majority of respondents agreed with this suggestion. The main reasons were that social consumers continued to need protection, and to ensure that the universal service remains affordable. It was pointed out that the European Directive set requirements for tariffs for universal services, so as long as there were universal services there was likely to be a need for price control.

165. For business customers, it was considered that franked mail should continue to be price controlled as it was difficult for alternative carriers to get into this market. It was thought that price control maintained the pressure on Royal Mail to become more efficient in all services.

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166. It was considered that price control was needed in a mail market still in its infancy with a dominant incumbent.

167. Respondents from the magazine industry continued to support price control because they considered that there is no choice for them in the market, and that Royal Mail's strategy of continually higher prices threatened the industry and would reduce volumes, leading to a spiral of decline. The magazine industry wanted a period of stable prices to enable business planning.

168. It was considered important that the regulator tested price elasticities in the market so that it had a clear understanding of what the market could bear. One respondent said that the universal should remain affordable but the overall aim should be to remove cross subsidies. It was also thought that the current RPI-X price control was failing because Royal Mail was not improving its efficiency. One respondent warned that if zonal pricing was allowed for business services it would only be a matter of time before it is applied to social mail.

169. Among those who believed that price control was not necessary, it was suggested that provided that social mail was priced affordably and covered fully allocated costs, there should be no need to regulate social mail prices. This then would set the ceiling for the whole market and market forces will set lower caps. To ensure financial health of Royal Mail and to promote effective and efficient competition, all services should be subject of a price floor which was no less than the fully allocated costs for the service plus a reasonable margin. It was also considered that price control was not necessary for business mail as it was already a competitive market.

Question 51 : Which is the more appropriate system of regulation under the current market conditions: ex ante or ex post regulation, or a combination of both? Please explain.

170. The majority of respondents thought that a combination of both ex ante and ex post regulation was needed.

171. Ex ante regulation would be required for the universal service to protect social consumers as this was the area of the market where there was little competition. Other advantages of ex ante were that it provided stability for the market, enabling alternative carriers to enter, and that it enabled the regulator to address economic bottlenecks in the Royal Mail network, to allow reasonable access to them, thereby enabling reduction in regulation elsewhere. One respondent believed that ex ante benefited the dominant supplier by setting clear parameters for its behaviour and reducing regulatory uncertainty.

172. With regard to arrangements for the parts of the market where competition was better developed, it was suggested that this could move to ex post regulation as competition developed. For example it was suggested that the introduction of wholesale or commercial equivalence would give the opportunity for a lighter touch regime based on ex post.

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173. It was noted that to move to ex post it would be necessary for the regulator to have concurrent competition powers (which Postcomm did not have at present), and that a disadvantage of ex post was that it was applied after potential damage had been done to the market. Other respondents suggested that provided that the regulator was quick, decisive, consistent, efficient and robust in tackling anti-competitive behaviour then it did not matter whether ex post or ante.

174. One respondent considered that the UK postal market was a series of separate or markets that should be defined properly. The regulator should then establish where Royal Mail has significant market power and establish which aspects of Royal Mail's infrastructure represents genuine bottlenecks to competition and whether there are enduring. Bottlenecks should be regarded as national assets to be utilised in the wider public interest. The regulator should insist on fullest and most comprehensive transparency of costs, and understand inter-relation between costs, shared costs and allocation of overheads. The Regulator should ensure that national assets/bottlenecks were not monopolised by Royal Mail.

175. It was also noted that the UK was the only market in the world that had introduced an access headroom regime.

Question 52: What criteria should be used to determine when regulation can be withdrawn, as competition develops?

176. There were a number of responses to this question. There was agreement that regulation should only be withdrawn when there was a genuine competitive market that would maintain the affordability of the universal service and protect the interests of consumers. Other suggestions as to when regulation could be withdrawn included:

- to protect the public interest;
- when link between price and cost was clearly identified;
- when effective market mechanisms were evident and regarded as sustainable;
- on the basis of clear criteria such as patterns of entry, barriers to entry, achievement of scale, ability of consumers to switch between providers, extent to which price leadership was with one supplier;
- that regulation could be removed for urban areas where there was end to end competition, but not rural areas;
- to decide whether to withdraw regulation, Postcomm needed to have a clear understanding of the market with a detailed analysis so that it could understand where Royal Mail had dominant power and where competition was sufficiently developed;
- Postcomm should invest in scenario planning to have a better understanding of the outcomes in the postal market.

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177. One respondent said that they did not see competition developing in a number of areas (e.g. the final mile for deliveries), which would therefore need some degree of regulation for the foreseeable future. Another said that there was a conflict of interest in Government between its shareholder role (maximise revenues and minimise cost) and as guardian of public service/legislator, and that the Government should publish its vision for the sector.

Question 53 : Should the price of different postal services reflect their costs? Or are cross-subsidies a natural and inevitable part of running a network business?

178. The majority view amongst respondents was that the price for postal services should be cost reflective. Although it was thought that it was difficult to establish exact costs for postal services, the aim should be to have cost transparency and cost reflective pricing. The cost information should be subject to annual audit. Royal Mail should be able to recover its costs and to make a reasonable profit.

179. A number of respondents made the point that cost reflective pricing should not mean that social consumers were disadvantaged though excessive price increases. Any future changes should have consumers at the forefront. Business consumers needed predictability and stability of price changes for business planning. It was also thought that Royal Mail should have the flexibility to strike long term deals with business customers.

180. On cross-subsidies, there was a general view that this was inevitable in a network business, in particular to meet social obligations. For example, the same equipment was used for social and business mail, and delivery was handled by the same postman or woman. One respondent considered that cross subsidies had been built into prices since Royal Mail's inception, and removal needed to be managed to ensure unfair advantage was not gained because of speed of removal.

181. The view was expressed that cost reflective pricing would create a decline in mail to remote areas as cross-subsidies support the uniform tariff concept. Business mail which benefited financially from communicating with these customers should pay true cost of delivering to remote locations. It was also felt that the current regime had led to SMEs and social consumers subsidising large companies.

182. One respondent believed that liberalisation undermined the system of cross subsidisation which supported the universal service. There had to be an agreed method of measuring costs. The options included Entry Pricing or Net Avoided costs.

183. It was pointed out that the European Directive required prices for the universal service to be geared to costs. Member States were required to monitor cross-subsidies and maintain the obligation on universal service providers to keep separate and transparent accounts.

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Question 54 : In current market conditions, what sort of regulatory framework would be most effective in stimulating innovation in the postal services sector to meet consumer needs?

184. There were very mixed responses to this question with no set of conditions gaining a significant consensus or agreement amongst respondents.

185. A number of suggestions were made, including :

- lighter touch ex post regulation in market conditions of falling volumes and customer down trading, thereby promoting efficient competition to stimulate innovation and meet customer needs.
- that because competition did not inevitably lead to innovation, incentives must be set in regulatory framework with innovation as a policy goal.
- current access regime was not the best launch pad as there was little scope for innovation.
- key barriers should be addressed, such as VAT.
- regulation needed to be proportional to Royal Mail's dominance.
- the regulatory framework needed to set controls to monitor the link between cost and pricing.
- there should be a regulatory framework that allowed innovation to be rewarded, allowing rewards to be kept by the innovator over regulatory review cycles in whole or at least part. Failure to do so would mean innovation was constrained.
- the regulatory regime should allow the opportunity for both Royal Mail and its competitors to make sufficient margin to encourage them to invest in new equipment and processes and – more importantly – to experiment and take risks.
- a stable regulatory environment was required so that everybody could make sound business decisions.
- that current conditions were adequate. Royal Mail's ability to innovate was only constrained by needing to publish 3 months before launch. Provided this was done nothing prevented them from innovating.

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Question 55 : To what extent is an efficient Royal Mail important for the development of the postal sector more generally?

186. There was overwhelming agreement amongst respondents that an efficient Royal Mail was essential to the development of the postal market in the UK. It was thought to be key to ensuring that mail competes effectively with other media. Other views were that it was "absolutely critical", "fundamental", "crucial" and "the market can only thrive with a vibrant and efficient Royal Mail at its heart".

187. The point was strongly made that as the dominant player for the foreseeable future, Royal Mail should be leading the market on efficiency, innovation and customer service. A decline in Royal Mail would have an impact on not only the universal service but the market as a whole.

188. One respondent noted that without Royal Mail's network, there would be no competition at all.

Question 56 : Is it feasible that the postal sector should continue to be regulated separately from the wider communications market?

189. The general view expressed by most respondents was that postal services should continue to be subject to sector specific regulation in the short term. This was mainly due to the view that the market was still in its infancy and competition was not fully developed. But there was recognition that, in time, regulation in the wider market was sensible and feasible.

190. On the other hand, those who supported integration of regulation of the wider market suggested that the postal sector was an integral part of communications sector and fulfilment market, and its separate regulation was no longer appropriate as customers increasingly explored and demanded multimedia services. Isolated regulation of one medium such as postal services therefore ran a real danger that regulation would not reflect the full nature of competition and relevant market factors. It was also considered that Postcomm lacked a number of fundamental tools needed for the regulation of the sector, such as a complete understanding of the markets.

191. Other respondents recognised Postcomm's record as on balance being positive for the postal sector. However, it was thought that it might not be optimum, and OFCOM might offer a better regime given dynamics of wider market but Postcomm's knowledge should not be lost.

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Question 57 : What sort of regulatory framework would be the most effective in stimulating innovation in the postal services sector, under current market conditions?

192. Most respondents referred back to their response to question 54. Other points raised here were that there was considerable scope for simplifying the current regulatory framework and to make it more effective. It was also thought you could not regulate to encourage entrepreneurial development.

Question 58 : Does the current VAT regime create distortions in the postal market? What are they?

193. Almost all respondents considered that the VAT regime distorted the market and should be changed. Many considered that the regime seriously hindered the development of end to end competition. It prevented alternative carriers providing services to approx 40-50% of the market who were VAT exempt (for example financial services and insurance) and who therefore used Royal Mail. It was also thought that consistency of application caused confusion in the market.

194. Some respondents suggested that there should be a low common VAT of around 5%. It was thought that the VAT exemption for Parcelforce could not be justified as it was active in a fully competitive market.

195. Those who opposed change said that the VAT exemption compensated to some extent for the fact that universal service provider carried a burden which competitors do not. The impact of removal of VAT would depend on how much would be passed on to end customer in form of higher prices. Apart from financial services companies, customers most likely to lose out from the imposition of VAT would be those who cannot claim it back i.e. social consumers, charities and non-vat registered small businesses. It was also thought that VAT on Royal Mail services would accelerate the drop in Royal Mail volumes (and overall volumes) and profits and endanger the universal service.

196. One respondent proposed that the VAT exemption should remain for the universal postal service only.

Other issues

Question 59 : In what order should any policy changes you believe necessary be implemented?

197. There were a number of responses to this question with no real agreement. The suggestions were as follows:

- rapid change was needed but it should be systematic and ordered.

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- cost transparency would lay foundation for ex post regulation.
- changes then to the Postal Services Act would allow access to equity capital and update regulatory framework.
- no particular order but consumers must be protected in the interim.
- delivery performance, pricing, service enhancement.
- regulation should be reduced after the introduction of wholesale equivalence and changes to the VAT regime.
- immediate – stability, change VAT, separate POL; short term – remove 1st class from the universal service, change frequency of the universal service to five days (and in the medium term, three days offering the provision of universal service to regional franchises.
- Postcomm should make a determination on urban access pricing to enable would be competitors to assess the viability of entry into the end to end market (2008-9); establish a robust cost allocation system so that costs for each service can be established (2009-10) enabling removal of many existing price caps; ECJ VAT ruling (2009); stabilise fluctuations in pension fund ands plan to fund deficit and utilise assets to reduce the deficit as far as possible (2008-9); consider private shareholding in Royal Mai- 2009-10; ensure that there is a flight path to more efficiency and modernisation (agreed with Royal Mail, shareholder and unions) 2008-9.
- priority should be given to areas that help stabilise the universal service to at least break-even position.
- first step should be to safeguard the universal service and return it to profit is to review Royal Mail price-controlled products in universal service basket.

Question 60 : Are there any other issues which you believe should be considered by this review which are not covered by the questions set out above?

198. Only a small number of respondents answered this question directly.

199. One business consumer pointed out that changes to Royal Mail's operational specifications and behaviours have had a detrimental impact on large organisations and smaller ones. For example, changes of Cleanmail specifications resulted in stock write offs; IT changes on major users – need notice period, use of trays instead of bags – caused huge operational issues for users. Royal Mail should be more aware of the impact on its customers.

200. Another said that Royal Mail needed a change in culture and to be genuinely customer focussed. The industry could not afford any more strikes; these had an adverse impact on business and postal volumes, and more strikes would have worse cumulative effect.

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201. It was also considered that fines for poor Royal Mail performance should not go back to Government but be earmarked for improvements to quality of service.

202. An alternative carrier thought that it was difficult to see how Royal Mail could confidently say that it is 40% less efficient than competitors and pay 25% more.

203. Another carrier was strongly opposed to a minimum wage in the postal sector and said that the emphasis should be on making Royal Mail more competitive. Any changes to the universal service should not have adverse effect on express sector which is already highly competitive, and should remain outside the licensing regime.

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Annex D:
End-to-end competition

1. It would have been surprising to have seen the rapid expansion of "end-to-end" competition so soon after the market's full liberalisation. Whether end-to-end competition will emerge in future, and the speed at which it emerges, is the subject of considerable debate. Written submissions to the panel provided mixed views.

2. Some argue that a 20% share of the upstream market ought to give alternative carriers sufficient volume to generate the economies of scale needed to make delivery services profitable. Companies developing new delivery services would most likely begin in urban areas with a high population density and relatively large number of mail items for each address, perhaps on the basis of two or three deliveries per week.

   - TNT Post is conducting a limited end-to-end trial in Liverpool.
   - Royal Mail forecasts that, in 2009-10, there will be 446 million items of mail handled end-to-end by alternative carriers (2% of the market), rising to 4.4 billion items (21%) by 2016-17.
   - Postcomm's estimate is more modest: 200 million items by 2009-10, compared with 35 million in 2006-7[90].

3. Those who remain sceptical about the prospect of end-to-end competition point to various barriers which prevent companies from entering the market.

   - The cost of establishing a national delivery network is high. The "final mile" is a labour intensive business and represents 44% of Royal Mail's costs[91].
   - Royal Mail's economies of scale and scope give the company a significant advantage over competitors for delivery, where high costs are spread over a large volume (around 80 million items per day).
   - European VAT legislation provides a mandatory exemption for public postal services (including Royal Mail) and for stamps. This is a distortion in the market. Alternative carriers are certainly at a disadvantage in securing business with that part of the postal market which is unable to reclaim all of the VAT charged to it. This includes financial institutions and charities: some of the most extensive users of the postal service.
   - There is uncertainty about the future of the market, making it difficult for companies to assess the likely return on their investment. Falling volumes, developments in new technology and regulation of

[90] Page 74 of Postcomm's submission to the panel, 2007 forecast
[91] Source: Royal Mail. This figure includes the costs of sorting the mail into its final order, delivery, and relevant pensions costs. It excludes overheads and inter-business costs.

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the postal sector at the end of the current price control, including zonal pricing, are all difficult to predict.

- Some carriers believe that any investment in a delivery network would be threatened by Royal Mail's ability to impede competition in the future.

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Annex E:
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Published submissions to the review panel

Written submissions from the following organisations have been published with the authors' permission at

www.berr.gov.uk/whatwedo/sectors/postalservices/Review/ Responses/.

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Federation of Small Businesses
IMRG
Institute of Directors
Mail Competition Forum
Mail Order Traders' Association
Mail Users' Association
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Annex F:
Terms of reference

The Secretary of State for Business, Enterprise and Regulatory Reform, John Hutton, announced this review of the postal services sector on 19 December 2007 with the following terms of reference:

- To assess the impacts to date of liberalisation of the UK postal services market, including on the Royal Mail, alternative carriers and consumers.
- To explore trends in future market development and the likely impact of these on Royal Mail, alternative carriers and consumers.
- To consider how to maintain the Universal Service Obligation in the light of trends and market developments identified.

The review is independent of Government.

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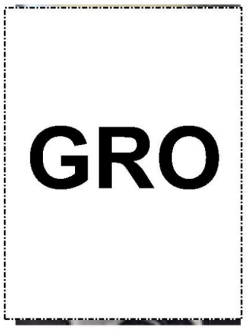
Annex G:
Members of the panel

Richard Hooper CBE (Chair)



Richard Hooper is currently Chairman of VocaLink Holdings Ltd, and a non-executive Director at YELL Group plc. He stood down as Chairman of Informa plc in May 2007. He was Deputy Chairman of Ofcom between 2002 and 2005 and Chairman of the Radio Authority for three years until 2003. He is a lead mentor for Bird & Co Boardroom and Executive Mentoring.

Previous directorships include MAI plc, United News & Media, Superscape plc and IMS Group plc. He was also Director, Prestel, at Post Office Telecommunications (1980-81) and Chief Executive Value Added Systems and Services, BT (1982-86).

Dame Deirdre Hutton



Dame Deirdre Hutton was appointed Chair of the Food Standards Agency in 2005 and is a non-executive director on the Board of HM Treasury. She has served on a number of public bodies and has considerable experience of corporate governance, risk-based regulation and consumer policy. She was a Board member, including Deputy Chair, of the Financial Services Authority between 1997 and 2007. For five years, she was Chair of the National Consumer Council, having formerly chaired the Scottish Consumer Council. Prior to her appointment at the Food Standards Agency, she had been a member of the Better Regulation Task Force since 1999.

Ian R Smith



Ian Smith has recently been appointed as CEO, Reed-Elsevier. Previously he was Chief Executive of Taylor Woodrow prior to its merger with George Wimpey. He was appointed Chief Executive Officer of the General Healthcare Group in September 2004, was previously CEO, Europe for Excel, Group Commercial Director of Ocean Group and prior to that, Managing Director of Monitor Company Europe, a strategy consulting firm. Ian began his business career with ten years at Royal Dutch Shell Group, working mainly in the Middle East. He has undertaken ad hoc advisory work for Government on industrial policy. He is a non-executive Director of Galiform.

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The review team

The review team was led by Jon Booth. Its members were Sue Bide, Stephanie Dales, Rob Faull, Martin Hall, Alistair Rawson, Michael Ridley and Duncan Tessier. The team was drawn from different Departments in the civil service and private sector. To ensure the independence of the review, none of those appointed had been employed previously in the postal sector.

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