

## The UK Postal Regulatory Regime: Success or Failure?

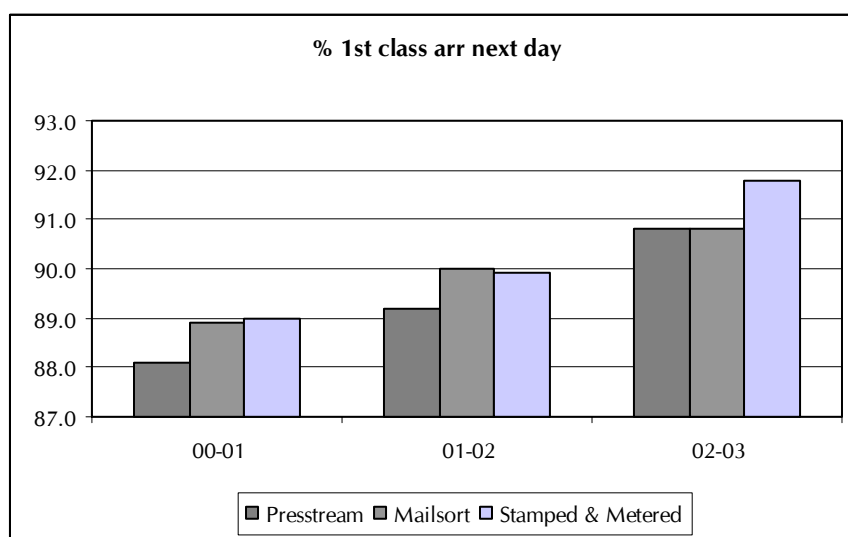
Many questioned whether the regulatory regime introduced by the Postal Services Act 2000 would be effective, especially bearing in mind the continued state ownership of Royal Mail. This paper considers the emerging evidence.

The Universal Service has been maintained.

Royal Mail is required to provide a universal postal service, at a uniform tariff, throughout the UK. There have been no serious breaches of this licence condition.

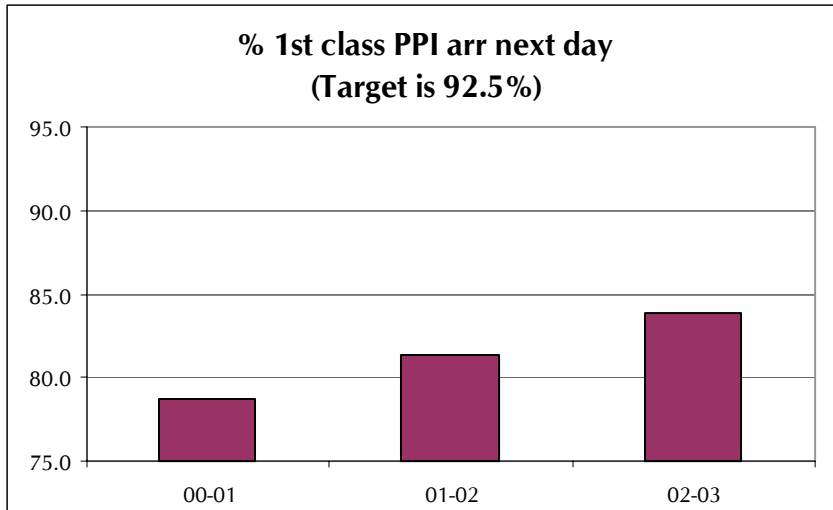
Service Quality has improved ...

Royal Mail's licence requires the company to use its best endeavours to meet certain performance targets and the company can claim credit for significant improvement to date, as is shown in the following chart. Some of this improvement is attributable to improved industrial relations.



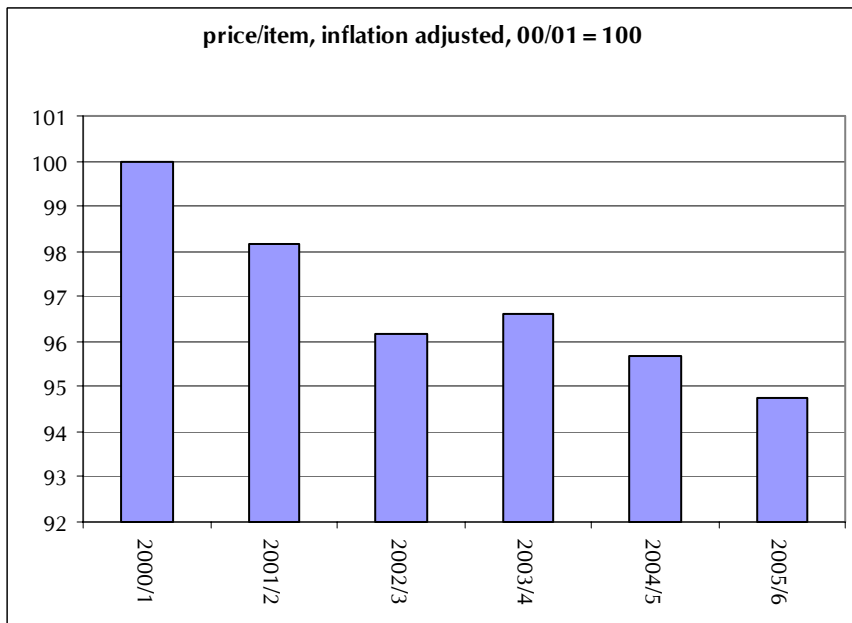
... but problems remain

The main problem area is the pre-paid service used by many businesses – see following chart. But Postcomm is taking enforcement action which should ensure sustained improvement in this area also.



Prices are coming down ...

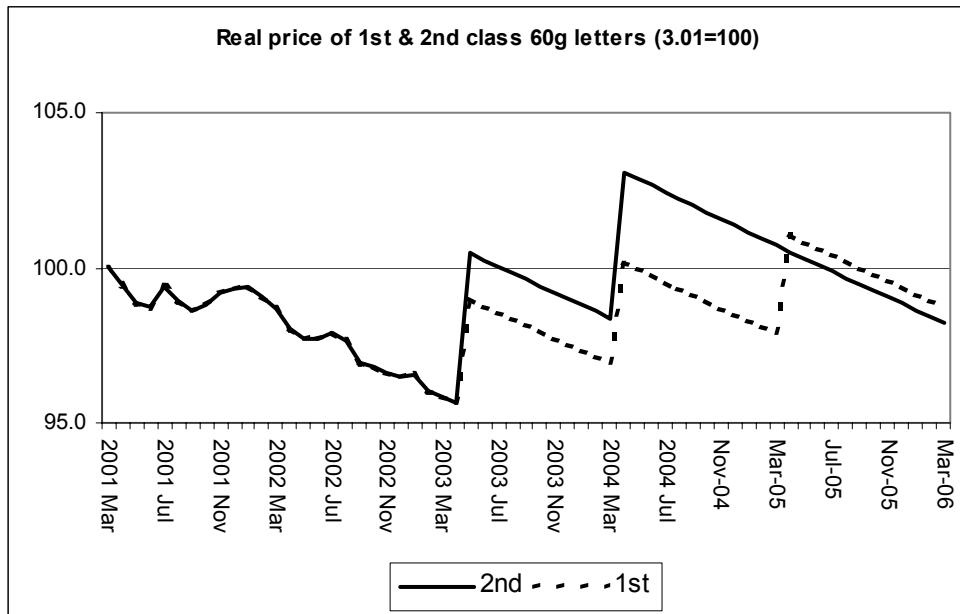
Postcomm initially imposed a price freeze on most Royal Mail products. This has now been superseded by a second price control covering the period through to March 2006. The following chart shows the effect of the two price controls, assuming no significant changes in the proportion of low and high price products. Prices will, by 2006, be over 5% lower, in real terms, than in 2001.



... and the public tariff remains affordable

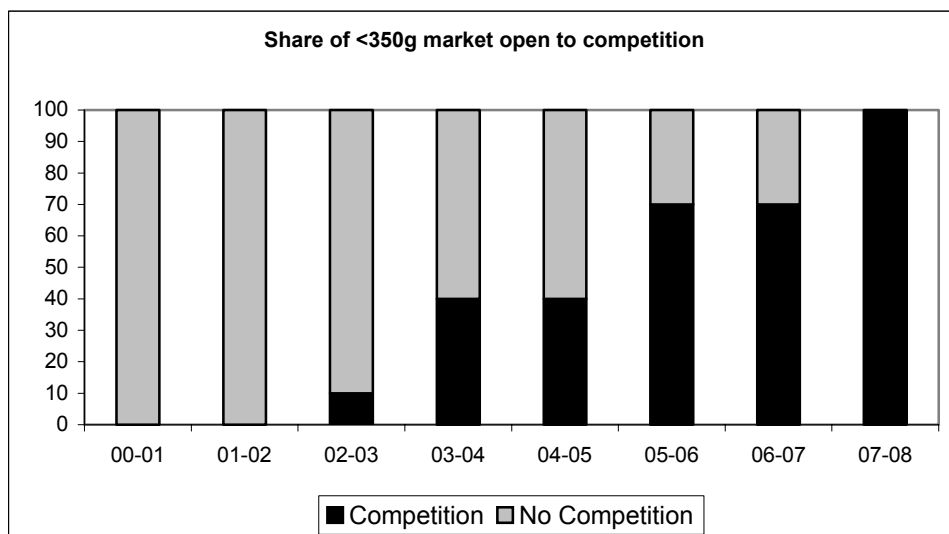
Within the overall price cap, summarised above, Royal Mail is from 2003 allowed to increase individual prices as long as it reduces other prices to compensate. It is likely that bulk mailers will be the main beneficiaries of reduced prices, but individual price caps will ensure that the public postal tariff remains affordable. The following chart shows how the real price of first and

second class post is likely to change assuming Royal Mail increases these prices to the maximum extent possible. Prices will not have risen in real terms between 2001 and 2006.



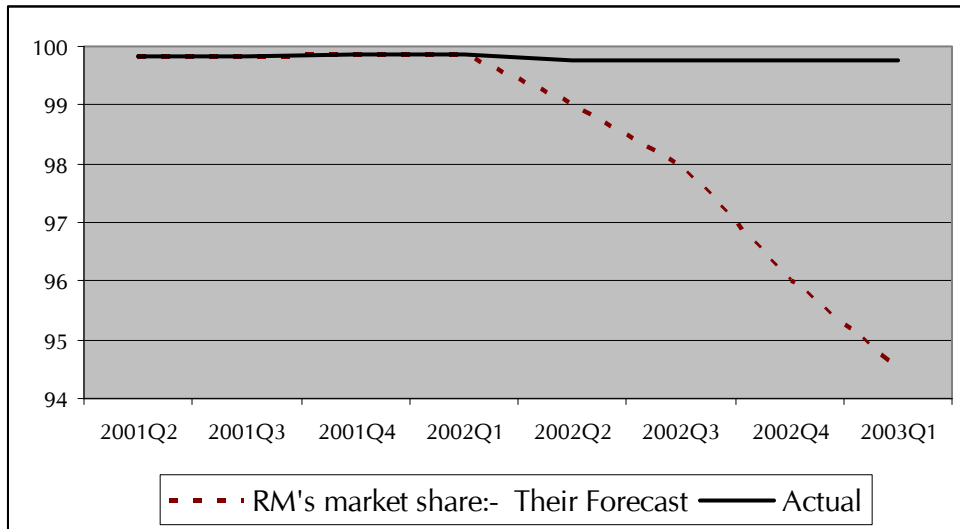
The postal market has become more competitive ...

Before 2001, no other postal operators were allowed to compete with the Royal Mail, and the company's prices and service quality were controlled by the Government. Postcomm is now, when it is safe to do so, reducing the extent of regulatory control over the industry in general, and over Royal Mail in particular. 40% of Royal Mail's market (by volume) was opened to competition in January 2003. This will be followed by a further 30% in 2005 and a final 30% in 2007. This market opening is summarised in the following chart.



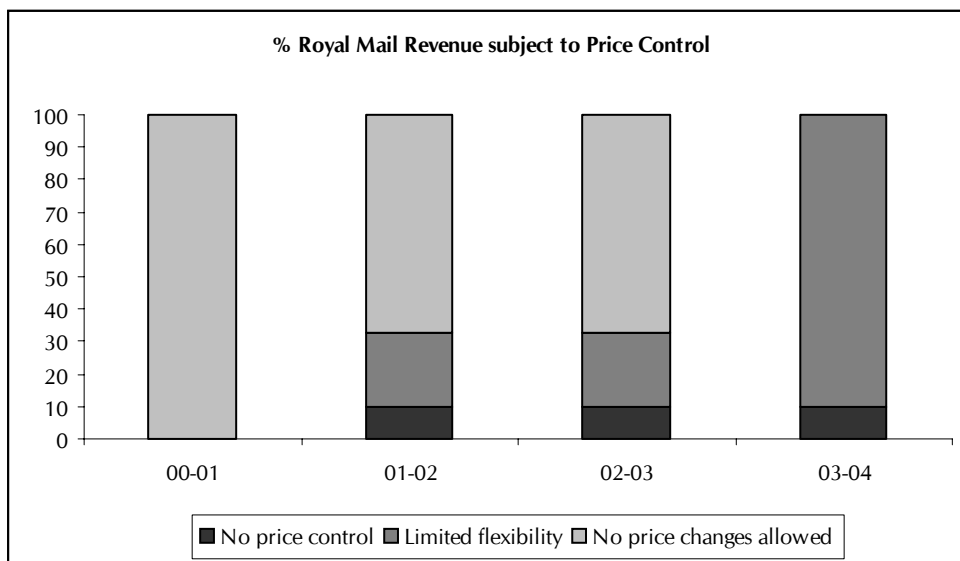
... but other operators have not yet gained significant market share

Royal Mail were initially very worried that they might lose significant market share to competitors. However, this has not yet happened. The following chart compares Royal Mail's market share with the forecast in the company's 2002 Strategic Plan. Royal Mail still has around 99.7% of the market.



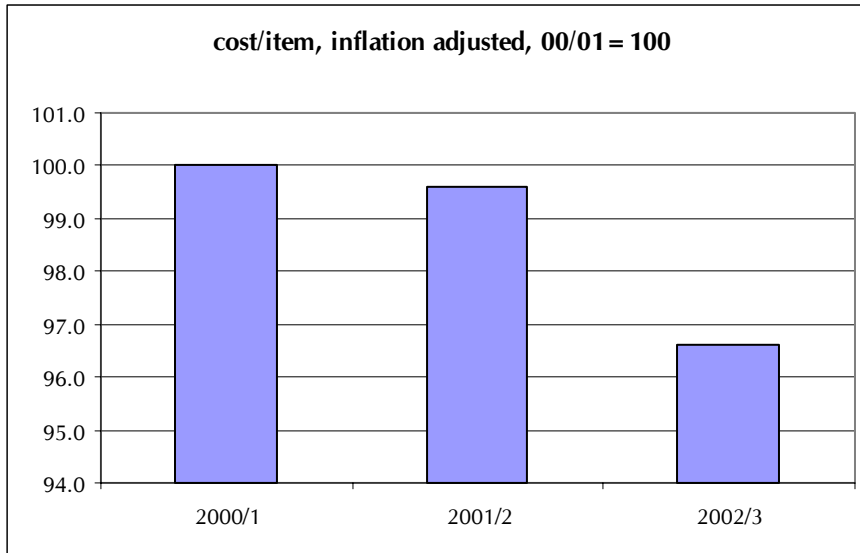
Royal Mail now has more commercial freedom, ...

The Postal Services Act 2000 gave Royal Mail considerable commercial freedom and transferred control of Royal Mail's prices to Postcomm with effect from March 2001. Postcomm has subsequently given the company significant pricing flexibility within the overall price cap summarised earlier in this note. The following chart shows how the initial price freeze (with some flexibility for certain products such as Presstream and Special Delivery) has been replaced by a tariff basket which permits significant rebalancing of prices around a weighted average.



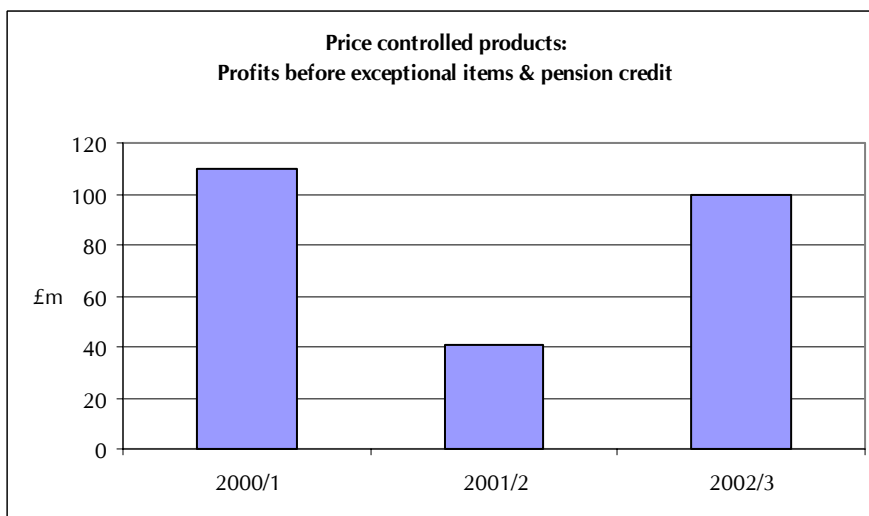
... has become more efficient, ...

The following chart summarises trends in Royal Mail's operating costs/item, after stripping out changes in pension contributions, exceptional items etc. (The 02-03 figure is a Postcomm estimate.)



... and has remained profitable

Overall, therefore, Royal Mail has come through the last two years in quite good shape, having retained market share and improved both its efficiency and its service quality. It has also remained profitable throughout the period, in contrast to the rest of the Royal Mail Group which has incurred severe losses. (The 02/03 figure in the following chart is a Postcomm estimate.)



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## ANNEX

### Explanatory Notes, Assumptions etc

**Price/item:-** 00-01 & 01-02 are from the regulatory a/cs. 02-03 is 01-02 increased by 0.4% to allow for increases in category B prices. 03-04 is 02-03 + 3%. Subsequent years are increased by 1.5%. Figures are then discounted by reference to RPI, assuming future inflation at 2.5%.

**Real prices:- 1<sup>st</sup>/2<sup>nd</sup> class first weight step:-** Assumes 19p increased to 20p in May 2003 and 21p in May 2004. Assumes 27p increased to 28p in May 2003 and to 29p and 30p in April 2004 and 2005 respectively. Figures are then discounted by reference to RPI, assuming future inflation at 2.5%.

**Share of market open to competition:-** 02-03 assumed to be 10% to reflect 40% market opening (by volume) from 1 Jan 2003.

**% Royal Mail revenue subject to price control:-** The 01-02 and 02-03 analyses reflect the initial division of Royal Mail's product range into "Category A" (no increases allowed), "Category B" (increases up to RPI allowed) and "Category C" (minor products:- no control). Category A was merged into Category B in 2003 and increases allowed up to RPI + 1 if balanced by reductions elsewhere.

**Cost/item:-** In order to aid comparability between years, costs exclude exceptionals, capital expenditure, interest, tax, pension contributions, pension credits and redundancy payments. 00-01 & 01-02 costs are from the regulatory a/cs. 02-03 is a Postcomm estimate based on provisional information from Royal Mail. Volumes are from the regulatory a/cs except for 02-03 volumes which are assumed to be slightly higher than 01-02. Figures are then discounted by reference to RPI.

**Royal Mail profits:-** These are the profits made on Royal Mail products subject to price control (including the standard parcel service) after deducting all costs except exceptionals and redundancy payments but not including the pension credit. Because of the exclusion of the pension credit, these figures are lower (to 01-02) than those published by Royal Mail.

[Note: This document is saved as "successfulregulatoryregime.pdf" in the *Accountability* subsection of Postcomm's website, and a copy is saved as "successfulregulatoryregimecopy.pdf" in the *Royal Mail's Performance* subsection of Postcomm's website.]