



Richard Hooper CBE
Chair
Independent Review of the
Postal Services Sector
Department for Business
Enterprise and Regulatory
Reform
1 Victoria Street
London, SW1H 0ET

Date:- 15th May 2008.
Direct Line:- 020 7593 2102
Email:- nigel.stapleton@psc.gov.uk
My ref:-
Your ref:-

Dear Richard,

Second Submission to the Review Panel by the Independent Regulator:

I am enclosing our second set of evidence which Postcomm would like to have considered by your Independent Review Panel. Given the requirement for transparency in all that we do, we are placing the submission and this covering letter into the public domain.

Postcomm's first statutory duty is to ensure the provision of a universal service and the submission focuses on how we think this can best be achieved.

The Panel's Interim Report which was published last week concluded that the postal services market in the UK is at a critical juncture because technology is changing how people communicate and mail is losing share to other media. As demonstrated by Royal Mail's 07/08 Preliminary Results which were also published last week, this is putting their finances under significant pressure which, in turn, could jeopardise the ability to provide the universal service at the level of price and specification to which mail users have become accustomed.

Postcomm's focus has always been on furthering the needs of postal users and we have never seen competition to be an end in itself. But we do believe that there is compelling evidence that competition in the UK postal market will continue to promote innovation, investment and customer focus. This in turn, we believe, will help ensure the continued provision of a valued universal service. Every long established monopoly has found it difficult in the early years of liberalisation to come to terms with the challenges of competition. For Royal Mail these challenges are, as we explain in this set of evidence, particularly demanding because of the governance structure and political constraints under which it is operating.

Postcomm has concluded in its first submission to the Panel that Royal Mail's current business model is likely to be unsustainable. Unless some bold actions are taken very quickly, its letters business can be expected to move to a position of managed - but accelerating - decline. We now put forward to the Panel our recommendations on how to address this untenable situation and instead to secure a vibrant and competitive mails market, centred on a successful Royal Mail, in which a universal service that is valued by customers can be internally financed.

1. What customers need from the Universal service?

The European Directive anticipates that the Universal service should evolve to reflect changing social and technological conditions. However, little or no customer research has been conducted by Royal Mail in recent years to identify the changing Universal service needs of its customers. In addition their

costing systems cannot readily identify how providing particular features of the Universal service impacts on the overall cost base.

Because of these limitations, both Postwatch and Postcomm have recently conducted consumer research about what customers – both as senders and recipients – most value from the Universal service. The key findings of our research are being published in parallel with this Panel submission, together with the results of a Postcomm project which has sought to identify more clearly the cost of providing particular features of the current Universal service specification.

What is abundantly clear from the research is the degree to which customers value the universal service. Its importance as a socially cohesive public service is underlined by the research results. It is worth noting that findings show that those who send large volumes of mail are becoming increasingly sensitive to the comparison between the costs of mail and alternative media. This factor, rather than the Universal service specification, will be a major determinant of whether they continue to use mail. Since these large mailers generate more than 70% of addressed letter volumes, thereby providing the economies of scale and scope that keep down the cost of providing the Universal service, this is an issue that cannot be ignored.

Postcomm intends to consult later this year about removing both Bulk and metered mail from the Universal service from April 2010 whilst maintaining some measure of price control on metered mail. Our evidence also sets out the principles that we believe should be applied to determine the USO's coverage of the universal service going forwards. The customer must come first and any changes must serve the best interests of customers. However, how best to reconcile the changing needs of both those that pay for the Universal service and those who receive it is a very real dilemma. This has to be addressed in close consultation with all users and after careful consideration of all the research data.

3. How to secure a sustainable, valued universal service.

Postcomm considers that there are two key policy measures to secure a sustainable universal service that is valued by mail users. The first is to continue to promote liberalisation of the mails market. Competition is delivering better customer focus and incentives for all mail operators to innovate and to become more efficient. The second is a set of policy initiatives designed to secure a radical transformation of the Royal Mail business which surpasses significantly the achievements of the management team over the last four years. It is unreasonable to expect that the universal service can be internally financed by Royal Mail if it remains so much less efficient than the “best in class” operator that it aspires to become and for as long as it is saddled with having to recover from customers the costs of funding an enormous, and highly volatile, pensions deficit.

The Panel's Interim Report concludes that only large customers have thus far benefitted from liberalisation. It is undoubtedly true that the main benefits of choice and lower prices have accrued to large customers. But small businesses and residential customers have also shared in the benefits of increased reliability in service, which has been caused in part by the threat of competition, in part by regulation. The fact that the most direct initial benefits have gone mainly to large customers is no different from the experience of other markets; in the early stages of liberalisation new operators have always started by targeting the bigger customer. But in post, these larger customers provide the volumes which keeps down the cost of mail for all users. They are also using mail to a greater extent than they otherwise would because it is estimated that for them liberalisation has reduced prices by 5%.

To secure further liberalisation of the mails market, Postcomm wants equality of treatment on VAT so there can be fair competition across the mail pipeline, including delivery. Also it is in the interests of both Royal Mail and other operators that there be much improved cost transparency so that everyone can be assured that a fair price is being paid by those operators with access to part of the Royal Mail

network. To reduce regulation post 2010, in line with the fast changing competitive scene, we are also recommending arrangements which will assure equivalence (of both price and non price terms) between third parties and Royal Mail's retail business for access to any relevant part of Royal Mail's network. Provided all these changes are made, we are optimistic that some measure of competition will develop across the whole mail pipeline, as it has begun to do in other European countries.

Two further options for maintaining the universal service are either a very sizeable Government subsidy – which already exists to provide the public with access to postal services through the Post Office Network - or a substantial degradation of the specification of the Universal service. We believe that neither of the latter two options would be palatable from a public policy perspective, so we focus most of our evidence on the measures needed to secure the radical transformation of Royal Mail.

If this does not happen very soon, then the prospects for the addressed letters market overall are seriously diminished. A universal service compensation fund does not offer a solution because for any significant sums of money to be raised there needs to be a vibrant mails market with quite extensive end to end competition. Neither of these conditions will be fulfilled without an innovative and significantly reshaped Royal Mail.

KPMG have produced a report for Royal Mail which suggests that over the four years of Postcomm's current price control - through to April 2010- the Company expect to generate £2.5billion less cash than was foreseen when the current price control was agreed. In part this is because mail volumes are tracking below the expectations of Royal Mail, and taken into account by Postcomm, when the control was finalised in late 2005. However over half of the difference is because Royal Mail is now expecting to achieve efficiency improvements significantly below the 3% per annum assumed in the price control and despite this the Company will be paying far higher performance related bonuses than provided for in the control. This provides a vivid demonstration of how much cash can be generated to fund internally the universal service if Royal Mail is able to transform its business radically, as other former State owned monopolies have done after their markets were liberalised.

We acknowledge that it is more difficult to achieve a significant efficiency improvement when the mail market is contracting, rather than growing. However the need to do so is still more urgent, given that customers are increasingly resistant to paying higher prices. This is why we see it as crucially important that the focus be on all possible measures to secure a radical transformation of Royal Mail.

3. Pre-conditions for securing a radical transformation of Royal Mail.

The Review Panel's initial findings, which were published a week ago, highlight the major challenges that Royal Mail has to confront. Royal Mail's first submission has also identified the extent to which funding constraints have prevented it from taking the initiatives required to address such challenges. They also say that they would be very open to opportunities to collaborate with other companies to accelerate their own transformation. The mail industry in Europe is being reshaped, most recently reflected in the proposed merger between the national operators in Denmark and Sweden, and the most successful operators in the next decade are likely to be those with operations that extend across national boundaries.

All this serves to reinforce the many points in Postcomm's second submission to the Review Panel which demonstrate why we believe that it is much less likely that Royal Mail will confront successfully all these challenges if it remains fully in public ownership.

Although the rewards from successful transformation are substantial the risks to the downside are significant. If mail volumes decline further a more extensive restructuring of the network will be necessary, for which more funding would be required than is available under Royal Mail's existing Shareholder credit lines. The business risks are compounded by the significant difficulties of working within the current corporate governance structure. We believe strongly, therefore, that introducing

better access for Royal Mail to funding, together with the incentives and disciplines that come with private capital, can make a very big difference in raising the probability of achieving a successful transformation.

No new equity investor can be expected to assume a share of Royal Mail's significant pensions deficit or to help fund the Post Office network, which unlike the addressed letters business cannot be operated as a wholly commercial business. A solution would have to be found, - if feasible by Government assuming the historic pension liabilities and providing for Post Office Limited to be demerged before any private capital is introduced. These initiatives would strengthen significantly the covenant available to pensioners. There would also be a step reduction in Royal Mail's costs and an increase in its competitiveness, if it no longer had to provide for funding the historic pension fund deficit.

4. A "contingency Plan" to secure the Universal service.

We acknowledge that introducing private capital may not be an easy decision for Government and will, in any event, take some time to put into effect. Our evidence includes a scenario analysis that considers how harmful is the financial effect of either delaying the implementation of a more radical transformation or else achieving a less dramatic turnaround in financial performance.

The provision of a Universal service that fully satisfies the needs of postal users is, in our view, too important for it to be entirely dependent either on a successful radical transformation of Royal Mail or on the willingness of Government to provide substantial public funding. Therefore, Postcomm will be working hard to make sure that a robust and effective "fall-back" position - based on tendering by other operators – is put in place. This concept has worked well in Germany (for retail and small business collections) and in Australia, New Zealand and the USA (for rural deliveries) although it does require careful coordination and close supervision either from the National operator or the Regulator. If this "fall back" position cannot deliver the desired result, the likelihood of needing Taxpayer support or a degradation of specification of the service is substantially increased.

My fellow Commissioners and I look forward to the opportunity of discussing our views with Panel members. We ask that the Secretariat should contact us if there is further information that we can usefully provide to the Panel.

We await your Report with keen interest because the recommendations you make will be critical to securing a successful industry which provides a universal service and other postal services that are valued by customers as well as a profitable future for postal operators, including Royal Mail.

Yours sincerely,

NIGEL STAPLETON

Chairman.