Saving the Royal Mail's universal postal service in the digital age

An Update of the 2008 Independent Review of the Postal Services Sector

Richard Hooper CBE

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Personal acknowledgements

The report of the independent review of the postal services sector which I chaired, was published on 16 December 2008: Modernise or Decline: Policies to maintain the universal postal service in the UK (The Stationery Office, Cm 7529). In June 2010 the new Coalition Government asked me to update the report. I have sought the views of interested parties, and in particular, the views of those who kindly provided evidence during the original review. I am grateful for the hours and work that have been put in by so many in answering questions and explaining their respective points of view.

Thanks go to the following organisations for their written submissions to this updated review: Amazon, Association of International Courier and Express Services, Communication Workers Union, Consumer Focus, Direct Marketing Association, DX Group, Federation of Small Business, Home Delivery Network, Interactive Media in Retail Group, IPC Media, Lovefilm, Mail Competition Forum, Mail Users Association, National Federation of Sub Postmasters, Periodical Publishers Association, Postal Trade Association Forum Ltd, Postcomm, PriceWaterhouseCoopers, Royal Mail, Royal Mail Pension Plan Trustees, TNT Post UK Ltd, Unite, UK Mail. I am also grateful to those who submitted evidence in their capacity as Members of Parliament or as individuals.

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I want to thank the management, staff and union representatives at Royal Mail's Gatwick Mail Centre, Burgess Hill and Haywards Heath Delivery Offices who showed me over the World Class Mail initiative.

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Richard Hooper CBE

Executive Summary

The independent review of the postal services sector was chaired by Richard Hooper with Dame Deirdre Hutton and Ian R. Smith as panel members. The review, announced in December 2007, was asked to recommend the policies needed to maintain the universal postal service in the light of market developments and market liberalisation.

In June 2010 Richard Hooper was asked by the new Government to update the report. This update remains focussed, as was the 2008 report, on the postal service, and not the much wider retail business of Post Office Limited. It is important to distinguish between the postal service (Royal Mail) and post offices (the Post Office), as the terms are used interchangeably by most people, due to the fact that the whole business was called the Post Office prior to 2001.

We stated firmly and clearly in the independent review's report published in December 2008, that the universal postal service was under serious threat. Doing nothing was not an option. The status quo was not tenable. Royal Mail had, above all, to accelerate modernisation if the universal postal service was to be saved. This diagnosis was accepted by all stakeholders.

Today, despite continued increase in the use of electronic media to communicate, the universal postal service remains highly valued and is still considered as important today as it was in 2008. The ability to deliver letters, packets, parcels and other items to all 28 million business and residential addresses in the UK six days a week, at uniform one-price-goes-anywhere tariffs, <u>is</u> part of the country's social and economic glue.

However, twenty months after the original report, the universal postal service is still under serious threat. Most of the concerns set out in the original diagnosis have got worse in the intervening period. This worsening renders the maintenance of the universal postal service even more precarious than in the 2008 findings.

The financial health of Royal Mail, which was and is the key determinant of the sustainability of the universal postal service, has worsened for the following reasons:

- the market and Royal Mail's market share both continue to decline;
- the company has, despite good progress, still not modernised sufficiently;
- the accounting pension deficit has increased from £2.9bn in March 2008 to £8.0bn in March 2010;
- the current regulatory regime is not fit for purpose.

Today, just as twenty months ago, doing nothing is not a tenable option. Today, Royal Mail remains the only company that can provide the universal postal service. But without serious action, Royal Mail will not survive in its current form and a reduction in the scope and quality of the much loved universal postal service will become inevitable.

Worldwide, letter volumes are likely to decline between 25% and 40% over the next five years. The decline in letter volumes worldwide is predominantly structural in nature, caused by email and mobile data substitution (e-substitution). The structural decline has been exacerbated by cyclical decline caused by the recession. The hole created by falling letter revenues and profits will not, unfortunately, be filled by the welcome growth in revenues and profits from packets and parcels as a result of online shopping (e-fulfilment). This is because the packets and parcels market is smaller than the letters market and is much more competitive.

To maintain the health and future of the universal postal service, the 2008 report recommended that private sector capital was required for Royal Mail in the form of a strategic partnership with a company with corporate experience of modernisation. The specific need for corporate experience is reduced today in the light of the good progress made with modernisation at Royal Mail since 2008 and the arrival of new management.

However, private sector capital is still required for a wide range of reasons. The company is unlikely to generate sufficient cash to finance the modernisation required. Private sector capital will inject private sector disciplines into the company and will reduce the risk of political intervention in commercial decisions, thus accelerating modernisation. In addition, the state of the public finances means that Royal Mail will find it ever harder to compete for Government capital against other public spending priorities.

The introduction of private sector capital is by itself far from sufficient to secure the future of the universal postal service. Its future depends just as much on resolving the closely connected issues of the pension deficit and the need to transform postal regulation. Private sector capital will not be attracted into Royal Mail without actions on the pension deficit and the regulatory regime.

As in the 2008 report, it is recommended that the historic pension deficit of Royal Mail should be taken over by the public purse as part of the wider range of measures. This will significantly help with the future financing of the universal postal service.

Of equal importance, a new regulatory framework must be created that increases certainty for investors in the postal services sector in general and in Royal Mail in particular. Through no fault of the regulator Postcomm, the bringing into force of a new regulatory framework was put on hold whilst awaiting the results of the original independent review and then, subsequently, when the Government postponed the Postal Services Bill in July 2009 which incorporated all the review's recommendations. Since the postponement of the 2009 Bill, Postcomm has worked hard to develop a new forward work programme and has recently completed consulting on a new regulatory framework. During this time a better and more constructive relationship between Postcomm and Royal Mail has emerged – although there still remain fundamental disagreements between them about the right regulatory future.

Building on Postcomm's current work and consultation, this update sets out the high level principles that should guide future regulation. The overall burden of regulation should be reduced by:

- focussing regulation on sustaining the universal postal service;
- ensuring that inappropriate competition does not undermine the universal postal service and the ability to finance it;
- introducing a new access regime which will ensure the right balance between competition and the financial sustainability of the universal postal service; and
- focussing regulation where there is a monopoly and removing regulation much more quickly from the competitive parts of the market.

The Government should also consider whether market uncertainty would be reduced by setting an agreed date for a review of ex ante access regulation by the regulator.

The responsibility for the regulation of the postal sector should be transferred to the communications regulator, Ofcom, on a timescale that will not hold up the completion of the new regulatory framework from 2012 and thus delay the much needed regulatory certainty.

If all these policies are implemented without further delay, and Royal Mail modernises to best in class with management, workforce and unions working together, then despite the very real market difficulties the company has a healthy future. Building on its unique ability to visit 28m addresses on a daily basis, it can aspire to be the delivery company of choice for a wide range of physical mail from letters to parcels. At the same time it has the opportunity to develop new digital businesses for its huge customer base of senders and receivers in response to the erosion of the traditional letters business by the internet and mobile phones.

PART 1 : BACKGROUND AND INTRODUCTION

On 16 December 2008, the independent review of the postal services sector was published - Modernise or Decline, policies to maintain the universal postal service in the United Kingdom (The Stationery Office, Cm 7529). A summary of that report can be found at Annex A. The full report can also be found on the website of the Department for Business, Innovation and Skills (BIS) at www.bis.gov.uk/files/file49389.pdf.

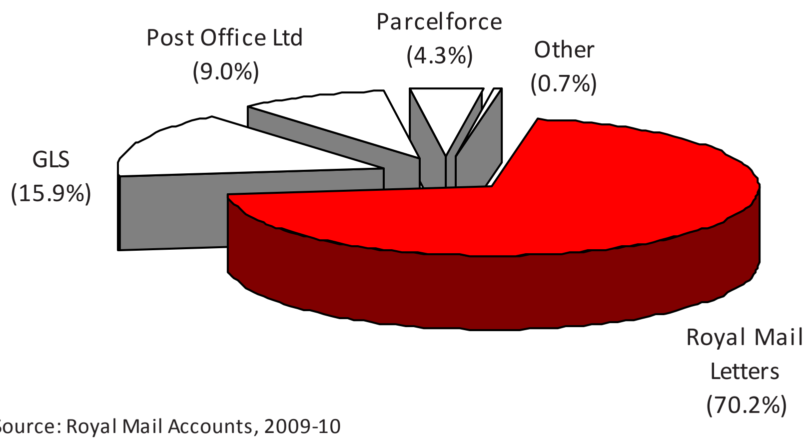
This updated report will not repeat all the details on the working of the postal market that were set out in full in the 2008 report.

The universal postal service was and is operated by Royal Mail Letters, which is the largest subsidiary of the Royal Mail Group (see Figure 1). The size and scope of the post office network (operated by Post Office Ltd), the country's largest retail and financial chain, were outside the scope of the independent review and that remains true of this updated report on that review's findings. Parcelforce and GLS are also outside the scope of this report. The term Royal Mail is used throughout this report to refer to Royal Mail Letters.

Figure 1

External revenues of Royal Mail Group 2009

By division



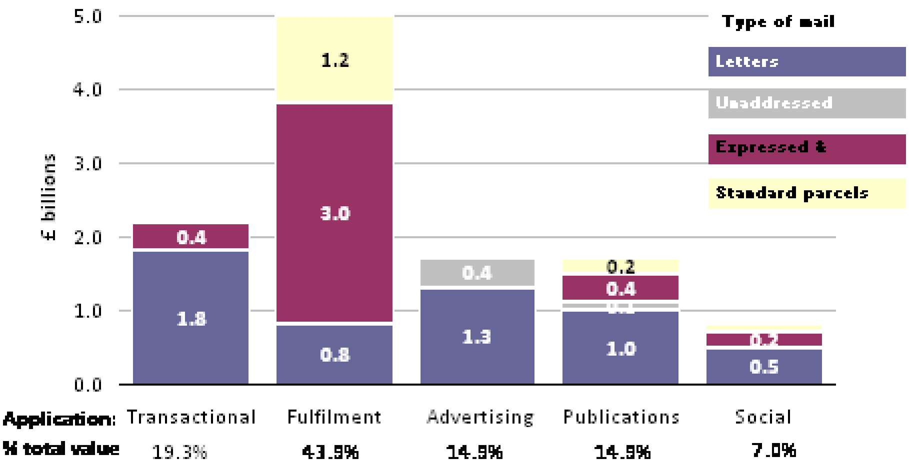
Source: Royal Mail Accounts, 2009-10

The total value of the postal market in the UK is £ 11.4bn, segmented between the various forms of mail as set out in Figure 2. When we were writing the 2008 report, we were very conscious that the issues under review were far from academic. They touched and touch the lives of well in excess of a million people in the UK (employees of Royal Mail and of competitors, pensioners, and families), not to mention the tens of millions of customers who rely on Royal Mail every day.

Figure 2

Value of the UK postal market 2007-08 (£11.4bn)

By postal type and application



Source: Competitive Market Review 2008, Postcomm

The focus of the 2008 report was on the need to maintain the universal postal service[1]. The universal postal service, run by Royal Mail, continues to collect mail six days a week from 115,000 red post-boxes and the network of post offices and delivers six days a week to 28m homes and business addresses across the UK. A crucial feature of the universal postal service obligation is that prices within the UK are independent of distance. The universal postal service is an essential part of the country's social and economic fabric. It, for example, connects those unable or unwilling to use electronic communications and is critical to connecting the rural and urban parts of the UK.

The 2008 report concluded that, in order to maintain the universal postal service in a market experiencing falling letter volumes, Royal Mail needed urgently to accelerate its modernisation, and in particular, cost reduction. Royal Mail was judged to be well below best in class. We used comparison data with Royal Mail's peer group of postal companies in other countries that almost all stakeholders accepted as fair and reasonable.

The report looked at the obstacles that were slowing up the pace of modernisation. Three closely linked courses of action to overcome those obstacles were recommended, all of which needed to be implemented together: introduction of a strategic partner who had experience of modernising a network business and who would bring capital, expertise and instil commercial confidence; removing the very large historic pension deficit from the shoulders of Royal Mail and transferring it to

[1] This report uses the term "the universal postal service". It is often also referred to as the USO, universal service obligation. USOs exist in other industries such as telecommunications.

the public purse; changing the regulatory regime in the light of market decline and growing upstream[2] competition; merging Postcomm with Ofcom. It was also recommended that, although post offices were not the focus of the work, Post Office Ltd[3] should be retained fully in public ownership. The recommendations were to be taken together as a package.

The Postal Services Bill addressing all the recommendations was taken through the House of Lords in the first half of 2009 by the then Secretary of State for Business, Lord Mandelson. Before it could enter the House of Commons in June/July of 2009, the Government decided to hold the legislation, stating that market conditions in the European postal sector had made it impossible to conclude the process to identify a partner on terms that the Government could be confident would secure value for the taxpayer.

During the summer and autumn of 2009, there was significant industrial unrest at local and then national level in Royal Mail.   The main reason for this was disagreements about the implementation of agreements on modernisation which had been reached after the national strikes in 2007. Although the short term impact of this action was not as great as the action which took place in 2007 (largely due to customers being better prepared and having contingency plans in place), the longer term impact of industrial action within two years of the previous action has still been serious. Confidence in the reliability of the postal service has been significantly shaken. A new 3-year agreement on modernisation between Royal Mail and the Communication Workers Union (CWU) was reached in March 2010.

The postal sector has been further impacted by lack of change to the regulatory regime during 2009 and 2010. The price control put in place in 2006 was rolled over in 2010 rather than a new regime being put in place as planned. However, this was through no fault of the regulator. Its work on the development of a new regulatory framework was put on hold whilst the 2008 independent review concluded and whilst the 2009 Postal Services Bill was taken through Parliament. Since the postponement of the Postal Services Bill in July 2009 (after it had cleared the House of Lords but not yet entered the House of Commons), Postcomm has worked hard to develop a new forward work programme and consulted in January of this year on a regulatory reform programme for completion by April 2012. Postcomm's consultation in May 2010 on "laying the foundations for a sustainable postal service" addresses the issues raised in the 2008 Report on cost transparency, accounting separation, reforming access headroom, deregulation and assessment of market power.

[2] Royal Mail delivers 99% of all letters downstream. Royal Mail is required by the regulator Postcomm under the terms of its licence to deliver letters for competitors who collect and sort upstream in competition with Royal Mail. This is called the access regime or downstream access regime. Competition in physical mail happens upstream whereas downstream delivery of physical mail has the characteristics of a monopoly.

[3] Post Office Ltd runs some 11,500 post offices in the UK – just over 3% of these post offices are Crown Post Offices owned by Post Office Ltd, around 97% are run by private enterprise under contract to Post Office Ltd.

Following the General Election in May 2010, the Queen's Speech stated that the Coalition Government would introduce measures that "will modernise the Royal Mail in partnership with employees and will ensure it benefits from private sector capital and disciplines".

On 22 June 2010 following the 2010 Budget, HM Revenue and Customs published the final version of its conclusions about the future application of VAT to postal services. VAT was treated at length in the 2008 report (pages 100-102). It was and is a contentious issue. Royal Mail's VAT exempt status for much of its activity is seen by competitors as giving Royal Mail unfair competitive advantage in those market sectors like financial services and charities which are also VAT exempt. Royal Mail argues that its VAT status is reasonable given its role as universal service provider. Annex C reproduces the HM Revenue & Customs notice BN41.

The new Secretary of State for Business, Vince Cable, announced on 24 June 2010 that he wanted the original 2008 report to be refreshed and updated by Richard Hooper by the beginning of September, as an independent contribution to the policy development for any forthcoming legislation.

Purpose and scope of this update

The public policy objective (and the objective of the previous report and this update of that original report) is clear: how to maintain and sustain the universal postal service as markets continue to be disrupted by digital media, especially the Internet, and create a successful future for Royal Mail that benefits the company, its employees and customers.

This update of the 2008 report has examined the developments in the postal market and Royal Mail over the past 20 months and sought the views of interested parties on two questions:

1. To what extent, from today's vantage point in the summer of 2010, does the 2008 Report's diagnosis of the problems facing the Royal Mail and the universal postal service (see pages 30-60 of that report) need updating in terms of the current state of the UK postal market and the issues being faced by Royal Mail as the universal service provider?

2. What are current views of the main recommendations set out in the 2008 report (see pages 70 to 105) to resolve the problems diagnosed:

- Royal Mail needs access to capital, greater commercial confidence and expertise through the introduction of a strategic partner or partners;

- Royal Mail's historic pension deficit needs to be taken over by the Government;

- A new regulatory regime needs to be put in place including a transfer of regulation from Postcomm to Ofcom.

This update remains focussed, as was the 2008 report, on the postal service, and not the much wider retail business of Post Office Limited. It is important to distinguish between the postal service (the Royal Mail) and post offices (the Post Office), as the terms are used interchangeably by most people, due to the fact that the whole business was called the Post Office prior to 2001.

However, it is worth noting that as customer needs continue to change, Post Office Limited still plays a vital role in providing customers with convenient access points for postal services. In particular, the use of packet and parcel services as a way of getting goods purchased over the internet or by mail or phone, from sellers to buyers (a process termed "fulfilment"), has increased. This method of shopping is likely to continue to increase steadily and, as recipients, customers want more flexible services that deliver when and where at their convenience. The post office network, in particular, has an important role to play in supporting the sending or delivery of packets and parcels.

As this update emphasises, success for Royal Mail and Post Office Limited in the growing "fulfilment" market will help compensate for the losses encountered in the declining letters market. But the fulfilment market is not big enough to make up for all the losses in the letters market.

PART 2 : DIAGNOSIS REVIEWED

The 2008 report concluded that the maintenance of the universal postal service was at risk because of the state of Royal Mail's finances. The financial health of Royal Mail was being undermined by:

- The continuing decline of the market and of Royal Mail's market share
- The failure of the company to tackle the necessary extent, and speed, of modernisation
- The unsustainability of the pension deficit
- The regulatory regime

Doing nothing was not a tenable option.

Twenty months on, that diagnosis remains largely true. The consensus around the diagnosis remains as strong amongst stakeholders today as it did in 2008. See Annex B for a summary of the views that were submitted by a range of interested parties to this update of the report.

Three positive changes of emphasis can be reported today, compared with the 2008 diagnosis:

- good progress in modernisation
- better regulatory climate
- better industrial relations

However, four interconnected concerns identified in the 2008 report have since got worse:

- decline in letter volumes
- market share losses
- the increased size of the pension deficit
- the deteriorating financial health of Royal Mail

The positive changes

Modernisation of Royal Mail has continued to make real progress over the last twenty months but the next stages are crucial to successful implementation of the agreement with the CWU.

A better and more constructive relationship between Postcomm and Royal Mail has emerged, making for a better **regulatory climate**. Postcomm has just finished consulting on the key issues outlined in the 2008 report that needed addressing –

cost transparency, accounting separation, reforming access headroom, deregulation and assessments of market power. However, there is still disagreement between Royal Mail, competitors and Postcomm on fundamentals concerning the extent and type of regulation that should replace the current regime.

Some significant improvements in **industrial relations** have occurred. The agreement on modernisation between Royal Mail and the CWU (Business Transformation 2010 and Beyond, 11 March 2010) brings out into the open for the first time the full dimensions of modernisation and how the union and management will work together to address them. There nevertheless remains a risk that the new agreement fails to be fully accepted and implemented at all levels in the CWU and in all areas. The union must continue to commit, and be perceived to commit, whole-heartedly to modernisation. The strikes in 2009 occurred despite the 2007 pay and modernisation agreement being in place. The structure of the union, as analysed in the 2008 report, allows great autonomy to local branches to disagree with, and disrupt, national agreements.

Negative trends

There are four concerns set out in the original diagnosis which have worsened in the intervening period. This worsening renders the maintenance of the universal postal service even more precarious than in the 2008 findings.

Letter volumes have continued to decline, even as the recession is beginning to lift. Postal authorities worldwide are predicting declines of between 25% and 40% in the next five years.

Royal Mail has continued to lose upstream **market share** to competitors.

The accounting pension deficit has continued to grow, nearly trebling in size over the last two years, hurting Royal Mail financially at all three points: profit and loss, the balance sheet and cash flow. Royal Mail has, however, made important changes to the pension scheme and this has materially reduced annual accrual costs.

The overall financial health of Royal Mail has deteriorated despite improvements in operating profit from a very low base.

In addition to these four concerns that were identified in the 2008 report, **the state of the public finances** in 2010 means that competition for public sector funding is even fiercer than in 2008.

Also there are many different opinions in the summer of 2010 as to the preferred solution to the regulatory concerns. What exactly should be the **optimal regulatory regime** over the next three to five years that will sustain the universal postal service, retain sensible levels of postal competition and, at the same time, allow investors to make informed decisions about providing capital to Royal Mail?

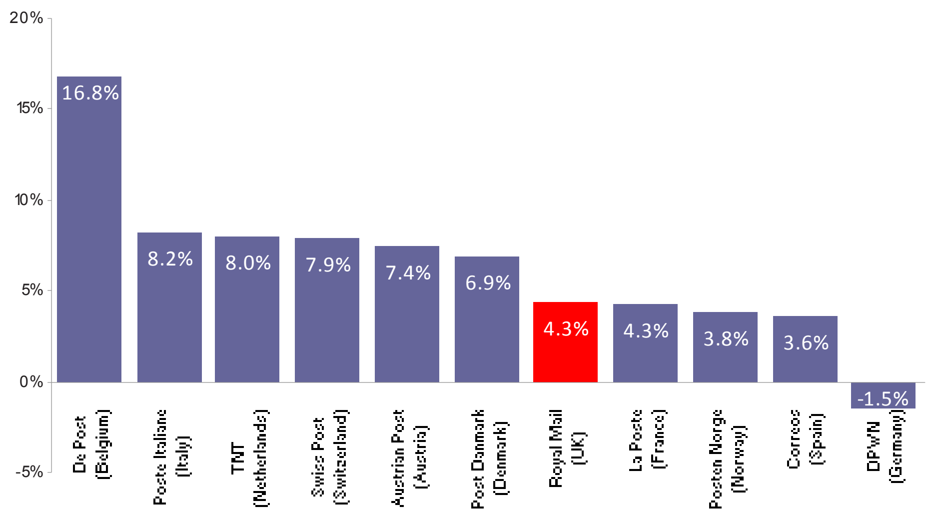
Assessing the financial health of Royal Mail today

Just as in 2008, the main obstacle to the maintenance of the universal postal service remains the poor financial health of Royal Mail. The financial health of the universal postal service and the financial health of Royal Mail are, as they always have been, intimately connected. Royal Mail's financial health has deteriorated even further since 2008.

An analysis of the most recently announced financial results (<u>Annual Report and Accounts</u> Financial Year 2009-10, Royal Mail Holdings plc) shows that there are clear risks that the company will not generate enough cash to fund the modernisation required.

Revenue growth/decline of the Royal Mail Group is not dissimilar to its peer group. Earnings before interest and tax (EBIT) compared with its peer group have improved somewhat since the 2008 report but still remain lower than most of its peer group (see Figure 3 below).

Figure 3
EBIT margins of West European postal companies, 2009 (%)



Post-tax losses for the Royal Mail Group have grown from £229m in the previous financial year to £320m in 2009-10. Pre-tax losses for Royal Mail Letters[4] have grown from £200m to £333m.

The balance sheet of the Royal Mail Group for 2009/10 shows that the accounting pension deficit at £8.0bn exceeds total assets by £2.1bn making the Group balance sheet insolvent. But if the pension deficit is considered as a financial liability i.e. a debt, then the Royal Mail Group's leverage shows that its net debt is 12.7 times greater than EBITDA (earnings before interest, tax, depreciation and amortisation), far exceeding the leverage amongst its peer group and far exceeding anything that would be remotely attractive to investors.

At the cash flow level (Royal Mail Group only), cash generation was weak. Net trading cash outflow was £517m in 2009-10. <u>The Group is therefore unlikely to be able to fund its modernisation programme from operating cash flow on any continuing sustainable basis, even given the Government's existing debt facilities of £1.2bn</u>.

With the market continuing to decline, Royal Mail has to modernise faster than was originally planned. It will need access to capital to achieve this as its financial position remains extremely tight. Yet, as already identified, capital from Government sources is and will be in scarce supply given the state of public finances and the intense competition for money from the public purse.

The issues that continue to undermine Royal Mail's financial health

The financial health of Royal Mail – which is critical to the financial health of the universal postal service - is being undermined and will continue, if nothing is done, to be undermined by four interlocking issues:

- overall market decline
- incomplete modernisation
- the pension deficit
- regulation

Each of these four issues is now analysed in turn to establish their current state in the summer of 2010. Part 3 will then recommend courses of action to resolve or at least mitigate these issues.

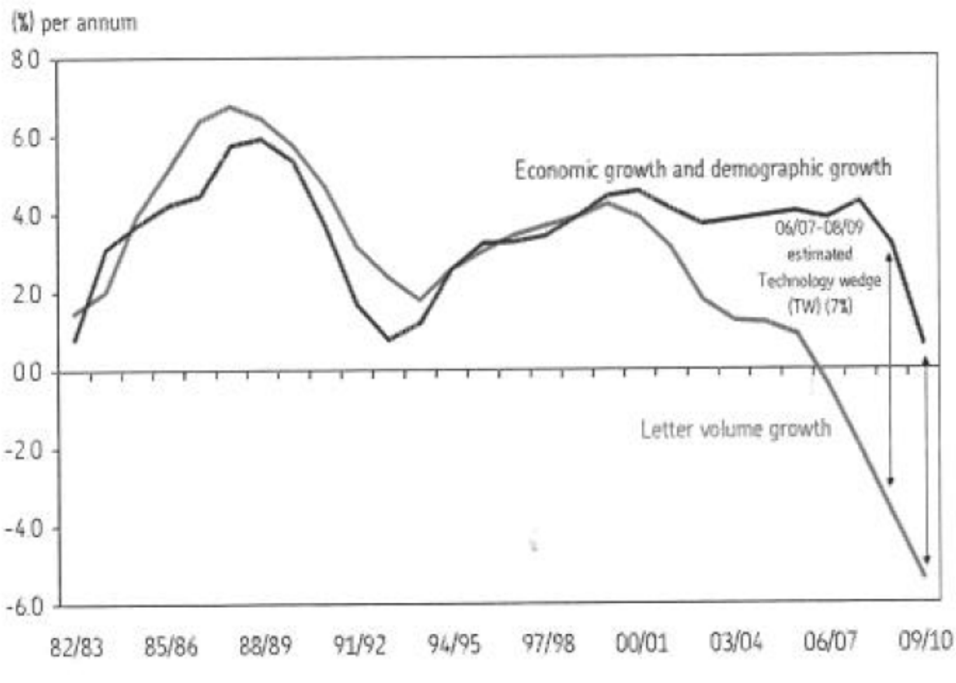
[4] Royal Mail Letters is referred to as Royal Mail elsewhere in this report, as noted earlier.

Overall market decline

The postal market continues to change rapidly, with the letters market in structural decline. Structural decline has been exacerbated by cyclical decline as a result of the worldwide credit crunch. Until 2002 there was a strong correlation between economic growth and the growth in letter volumes. Over many years the pattern had always been the same: if economic growth improved so did letter volumes, and vice versa.

But, as a result of competition from email and mobile texting, that correlation has been broken by what the 2008 report called “the technology wedge” – see the updated picture in Figure 4. In its last financial year (April 2009 to March 2010) Royal Mail reported that letter volumes declined 7% over the previous financial year. In 2005 the average daily mail bag contained 84 million letters, packets and parcels. In 2010 this is down to 71 million items.

Figure 4
Growth in letters compared with economic growth 1982 - 2010



Source: Royal Mail

The planning assumption for postal operators like Royal Mail should remain the same as twenty months ago – if something is digitisable, postal operators should act on the basis that it will sooner or later be digitised. Royal Mail, like all other traditional “analogue” businesses, should also assume that the pounds in the analogue world often convert to pennies in the digital world. Physical mail is competing with “free” digital communications. For example, letters requiring a 41p First Class stamp or a 32p Second Class stamp are competing with emails that have a marginal cost of zero pence to send.

The digitisable mail sector faces a demographic time bomb. Whilst the Royal Mail remains an icon for the older generation, it is far less used and far less cared about by the IT-literate and mobile-literate younger generation. This in itself will contribute to continued volume decline over the medium to longer term. Royal Mail predicts a further decline in Royal Mail addressed inland letter traffic volumes of over 20% between 2010/11 and 2015/16.

As if this was not enough, there is also an environmental time bomb beneath the digitisable mail sector. As one stakeholder has written: “While the postal companies are alive to sustainability questions, this topic has had a higher profile in the last 18 months and may start to impinge on demand for mail (for example large mailing organisations may find electronic substitution a useful area for carbon reduction planning)”.

The e-fulfilment market has continued to show strong growth for (non-digitisable) packets and parcels thanks to the very same technology of mobile and fixed internet that is eroding the (digitisable) letters business. However the fulfilment market is proving to be no simple panacea for Royal Mail’s woes in the letters market. The packets and parcels market, which overlaps with the express courier sector, is highly competitive, putting huge pressure on costs, prices and therefore profit margins.

The UK’s experience of letter volume decline remains consistent with trends in mature mail markets right across the world (see Figure 5). TNT reported in its latest second quarter results that addressed mail volumes declined by 8.4% over the previous year (whilst parcel volumes grew in that same period by more than 10%).

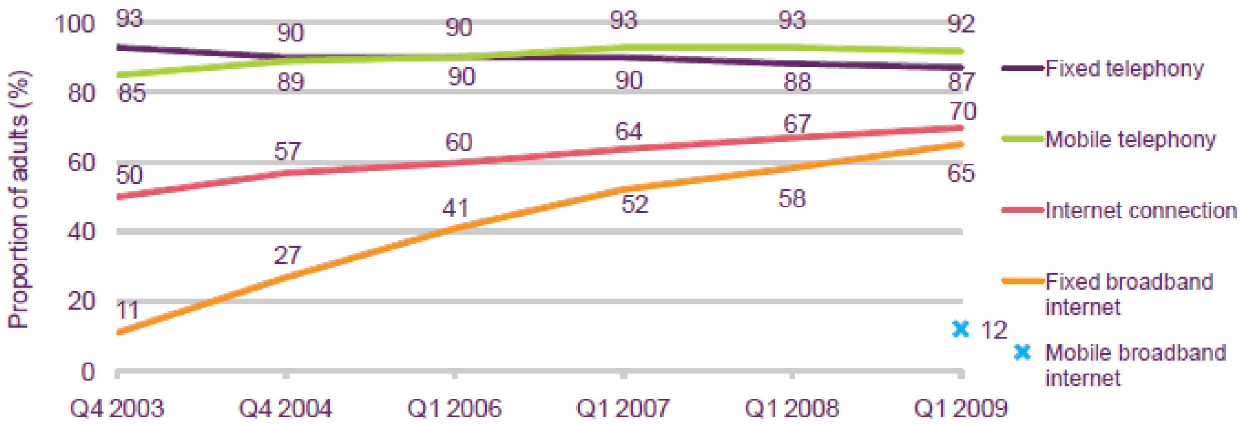
Figure 5
Reduction in addressed letter volumes 2008-09

Country	Growth in 2008-09
UK	-7.3%
France	-3.0%
Germany	-6.5%
Netherlands	-4.7%
Italy	-2.6%
Belgium	-4.0%
United States	-12.7%

Source: Company data of national operators, based on the 2009 financial year. Royal Mail figures are based on the 2009-10 accounts.

Structural decline in letters is related to continuing growth in broadband and mobile penetration, as set out in Figure 6.

Figure 6
Household penetration of key telecoms technologies



Source: Ofcom

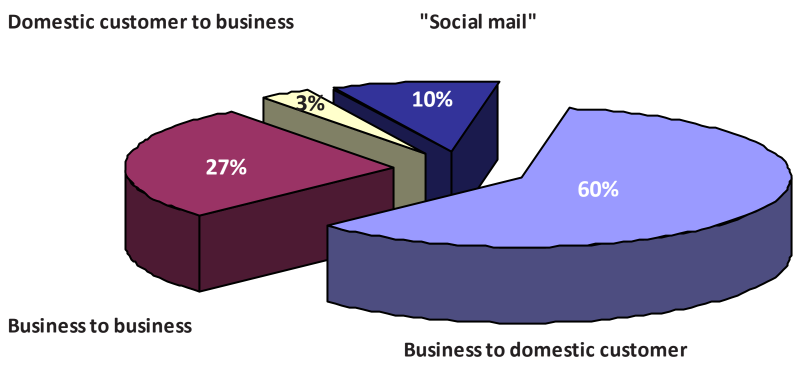
Downtrading

In addition to the structural decline in the overall market, customers in uncertain economic times, for example small businesses, find other ways to reduce costs. Senders of mail down-trade from premium to standard classes of mail, putting further pressure on Royal Mail's finances and margins.

Market share losses

But Royal Mail also continues to lose market share within the overall market that itself is declining. There has been a faster than expected growth of other operators taking business from Royal Mail upstream in collection, sorting and transport of bulk mail. 87% of all mail in the UK is sent by businesses to people at home or to other businesses (see Fig 7).

Figure 7
Segmentation of the letters market (volume) 2009
By sender and recipient



Source: Postcomm, October 2009

Liberalisation following the Postal Services Act 2000 allowed licensed competitors to collect, sort and transport mail upstream whilst enjoying mandated access to delivery downstream by Royal Mail. In Royal Mail's view, as stated to the independent review in 2008 and again to this update in 2010, a tipping point will be reached where competitors could decide to stop using Royal Mail for delivery and deliver mail themselves (so-called "end to end" or "bypass" competition). Competitors could then, if not covered by appropriate regulation, "cherry pick" or "cream skim" the universal postal service into real difficulties - Royal Mail being left to deliver to the unprofitable Orkneys six days a week, for example, with competitors delivering to profitable London on, for example, two or three days a week. Postcomm has sought to address this through their agreement with Royal Mail on a zonal access pricing structure. Competitors argue that the VAT regime (Annex C) reduces the chances of end to end competition.

Competitors have already won over 60% of the upstream pre-sorted bulk mail market, whilst Royal Mail continues to enjoy significant market share in other upstream bulk mail markets. Royal Mail continues to lose not just market share but also the all-important direct relationship with key customers is weakened. The 2008 report pointed out (page 37) that 50 companies account for 40% of mail volumes.

Incomplete modernisation

There has been good progress with modernisation at Royal Mail since 2008, as already highlighted.

But the management, workforce and unions are still a long way from achieving best in class status alongside Royal Mail's peer group of postal operators in countries such as the Netherlands, Denmark, Sweden, Belgium, Germany, New Zealand. Management claims today to be about half way there. It is important to note, however, that the changes that will have the most significant impact on its efficiency have yet to be made across the country. These are the more difficult changes to implement and are happening at a time when letter volumes continue to fall and revenues are declining rapidly. Modernisation is of course a continuous process that is never complete, as markets and customer requirements continue to change and the demand for innovation never stops.

The extent of modernisation can be measured in the following six ways. The first three are predominantly aimed at cost-reduction as mail volumes fall:

- elimination of restrictive labour practices
- levels of automation
- rationalising the mail centre network
- diversification into new revenue streams
- culture change towards customers
- culture change towards employee engagement

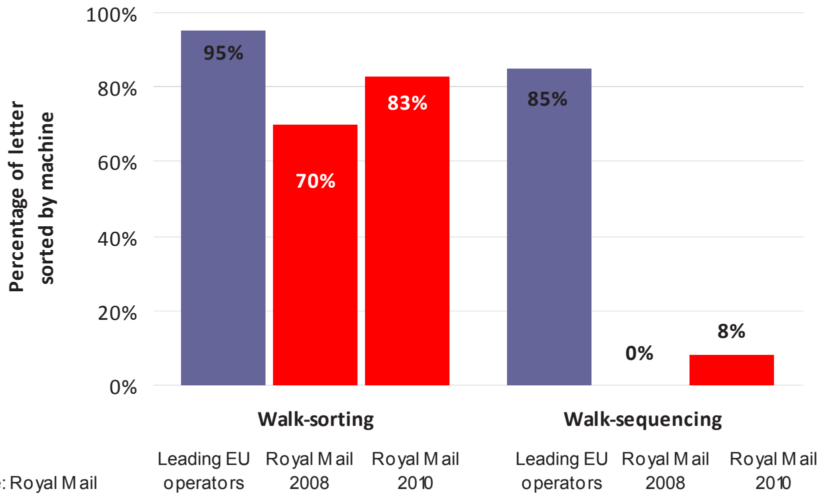
There clearly has been welcome progress in eliminating **restrictive labour practices** (see page 51 of the 2008 report) over the past two years.

Figure 8 shows the comparisons for walk sorting[5] and walk sequencing[6] **automation** between Royal Mail and its best in class peers. On walk sorting, Royal Mail is today close to best in class, a major improvement over 2008. But Royal Mail still significantly trails the peer group in walk sequencing automation. 100 walk sequencing machines are in place with 500 more to be installed in the next phase of modernisation (Annual Report and Accounts for 2009/2010 Financial Year, Royal Mail Holdings plc).

[5] Walk sorting machines sort the mail to the level of the individual postman or woman's walk, that is to say all the letters that are going to be in their mail bag on that day.

[6] Walk sequencing machines sort mail into the sequence of the postman or woman's walk on that day – 1,3,5,7 Acacia Avenue and so on. Before automation, this was done by hand by the postman or woman at around 6.00am in the delivery office.

Figure 8
Royal Mail automation in context



Source: Royal Mail

In the 2008 report, we pointed out that fully modernised postal operators tend to end up **rationalising the network of mail centres** to around half the number that they were operating prior to modernisation. Royal Mail reported in its Annual Report and Accounts for Financial Year 2009/10 that they now had 64 mail centres, five fewer than at the time of the 2008 report (69). Royal Mail is currently consulting on the future of 17 more mail centres. There is a long way to go to reach the likely target of half. Opposition to closures in the affected towns and cities cannot be ruled out. The 2008 report drew particular attention to the way that political intervention in commercial decisions could reduce Royal Mail's commercial confidence and significantly slow up, if not stop, modernisation; this intervention would be reduced with the introduction of private sector capital and disciplines.

The 2008 report concluded that little progress had occurred with **diversification** into new revenue streams at Royal Mail, for example creating new digital businesses. Since then little further progress has been made. The regulatory requirements the company has to follow before the introduction of new products are a significant factor here.

The original report was critical of Royal Mail for its lack of **culture change towards customers**. This would appear to remain a weakness in Royal Mail's progress towards full modernisation. Is there a clear commercial strategy for the booming packets and parcels market? The managing director of eBay UK writing in the Daily Telegraph (19 July 2010): "Fewer than half of the online firms that sell through our site are confident in Royal Mail's ability to meet their needs. Worryingly, a third say Royal Mail's limitations hamper their growth. For a secure future, Royal Mail must address these concerns. More flexible delivery options, greater convenience for parcel collections and improved reliability are all essential to allay current fears. Extended opening hours for delivery centres, announced this week, are a positive step."

The company has still not really developed a clear commercial strategy for this all-important growth market of packets and parcels. Royal Mail argues that they are restricted by too much regulation. They seek freedom to develop innovative products and price them competitively. For example, for products in competitive parts of the market, Royal Mail is required by the regulator to make public the proposed prices and specifications many months in advance, thus giving competitors early warning of its intentions. In Part 3 it is recommended that the regulatory regime should be such that it does not stifle Royal Mail or skew the way that Royal Mail is able to respond to customer needs, whilst at the same time promoting appropriate competition.

A final aspect of modernisation – **culture change towards employee engagement** – has begun to make good progress in a growing number of mail centres and delivery offices. This is as a result of the World Class Mail (WCM) initiative which began in Gatwick Mail Centre in late 2008. Employees are encouraged actively to make proposals about new working patterns that save money, increase efficiency and reduce accidents. As a result it has been found that costs are down, productivity is up, accidents are much reduced, employee engagement is vastly increased and management/workforce/union engagement is much better. The benefits of modernisation are clearly visible in the Royal Mail locations where the World Class Mail initiative is being rolled out. The modernisation agreement between the management and the CWU is also a huge step forward in terms of the level of trust between the two. There has been an increase in information sharing and discussion on the strategic future of the company. This should be built upon so that management and unions can implement the changes needed to ensure that Royal Mail has a sustainable future.

The Government has indicated that it is looking at opportunities for employee ownership, something which Royal Mail management keenly supports. This should strongly connect with employee engagement. It is important that any future employee ownership scheme should be taken forward with the aim of achieving the culture change that is needed within Royal Mail and should build and enhance on the initiatives that are running in the company not cut across them. If it does drive culture change, employee shares could be a powerful force in supporting the company's modernisation and future success.

THE PENSION DEFICIT

The third factor continuing to impact Royal Mail's financial health, alongside market decline and inadequate levels of modernisation, is the pension deficit. Compared with twenty months ago, the pension deficit is an even stronger risk to Royal Mail's financial health and therefore to the sustainability of the universal postal service.

The deficit continues to pose a significant constraint on Royal Mail's business, sapping cash from the company and causing Royal Mail to be balance sheet insolvent. The deficit hampers Royal Mail's ability to compete with other operators. Customers remain price sensitive; thus the market will not bear the cost of the pension through an increase in prices.

Royal Mail has made, as noted earlier, important changes to the pension scheme thus reducing annual accrual costs. The problems associated with the Royal Mail Pension Plan (RMPP) are well documented, in the 2008 report, and elsewhere.

There are two ways of valuing the pension deficit – accounting and actuarial. Both tell the same story. In March 2008 the accounting deficit was calculated as £2.9bn. Since that point the deficit has nearly trebled in size. The accounting deficit in March 2010 had risen to £8.0bn. The triennial actuarial valuation process reported the deficit to be £3.4bn in 2006. The latest triennial valuation showed a deficit of £10.3bn at 31 March 2009.

This latest triennial valuation has led to an agreement between the Pension Trustees and the company to fund and repay the deficit over 38 years, representing the shortest period of time over which Royal Mail can realistically afford to pay.

Such a long repayment period is quite unprecedented by modern standards and The Pensions Regulator (TPR) has expressed substantial concerns about this and the deficit figure. The agreement is now subject to a formal review by TPR. TPR has wide-ranging powers that could extend to imposing a new and more difficult recovery plan, with unknown consequences for the affordability of the deficit repayments.

The review by the TPR compounds the problems already associated with the pension deficit.

THE REGULATORY REGIME

The final issue impacting on the financial health of Royal Mail and thus of the universal postal service is the current regulatory framework.

Today, compared with twenty months ago, there would appear to be an even greater level of agreement amongst all stakeholders including the regulator Postcomm, that the current regulatory framework is no longer fit for purpose.

Costing the universal service

The universal postal service and its costs are central to the overall judgement about any new regulatory framework. But what are its costs?

In 2008 no clear answers were forthcoming. It is very frustrating to report that, twenty months later, this is still the case. As noted previously, this is partly due to the fact that advancing regulatory reform was put on hold during the 2008 independent review and the subsequent postponing of the 2009 Postal Services Bill. Also it is not possible to cost the universal postal service without agreement on cost transparency and Postcomm's work on cost transparency will not be completed until the end of 2010.

The lack of clear answers on the true costs of the universal postal service, externally validated and fully agreed between regulator and regulated, continues to bedevil policymaking and regulatory decision-taking.

Without being able to identify and agree costs and therefore cost allocation, it is very difficult to assess claims about the effects of regulation, negative or otherwise, on the incumbent Royal Mail or on competitors. Royal Mail has stated clearly to this update of the report in August 2010 that the universal postal service's sustainability is directly threatened by the level and type of regulation to which it is subject. The hard data and evidence to support or refute this claim do not appear to be available.

Posts not like other utilities

The delivery of the universal service in the postal sector is under much greater pressure than in other sectors which also have monopoly characteristics such as telecommunications, electricity, gas and water. This is for two reasons.

First, in contrast to these other sectors, delivery volumes, as already identified, are in sharp decline. This makes the economics of the universal postal service much more difficult.

Second, those other sectors have an invested physical infrastructure that is essential to delivery. This makes new entry much more difficult, since a new entrant must make a very large upfront investment, the fixed cost of which can be undercut by the incumbent whose capital costs have largely been written off. It is for this reason that regulation of, for example, telecommunications treats the network infrastructure of BT's final mile (or local loop) as an essential facility, with price controls and regulation of access by competitors. In physical post, the major cost in the last mile delivery network is variable, comprising feet on the ground (some 70% of Royal Mail's costs are labour).

The last mile delivery network is thus potentially contestable: a more efficient player could theoretically enter and displace the entire Royal Mail network. In reality, delivery on six days a week to 28m homes and businesses is not replicable. It appears to be a form of natural monopoly in the technical sense that two providers delivering six days a week to 28m addresses would cost in total significantly more than one provider. Postcomm is currently carrying out a series of market definition studies due for consultation in December 2010. These will establish what the markets are and where the Royal Mail has market power.

The more likely strategy for a competitor in the physical mail market is selective entry, cherry-picking the most profitable parts of the market, notably delivery in dense urban areas. If successful, this undermines the cross-subsidies which are at the heart of the universal service's viability because of the uniform single price within the UK. Cherry-picking cuts into the surplus that is available to finance universal delivery to areas where delivery costs greatly exceed the uniform price of the universal service, clearly undermining the sustainability of the universal service.

It is however interesting to report that, despite continued warnings by Royal Mail about the dangers of cherry-picking and the need for regulatory relief to mitigate those dangers, the letters volume delivered by by pass/end to end competitors has actually reduced over the past two years. As already noted, the VAT regime and the zonal access pricing structure would appear to be reducing the problem of cherry-picking.

Protecting the universal service versus promoting competition

What this suggests is that policy-makers, regulators and Government need to think carefully about the level and nature of competition that is promoted in the physical postal system. Competition within the broader communications market is assured. But the trade-off has to be considered between the degree of competition within physical post and the provision of universal service.

The overarching question on regulation today appears to be whether there is a point at which protection of the universal postal service (along with its financial sustainability) comes into direct conflict with the promotion of competition, and what is the appropriate balance between the two regulatory aims. The 2008 report stated (page 96): "Competition reduces Royal Mail's revenue available to support the universal service".

Critics of Postcomm assert that, historically, the regulator has been too encouraging of competition to the detriment of the universal postal service. It can be argued instead that, given Royal Mail's refusal to, or inability to, modernise historically, competition was needed to force the pace. It is insufficient modernisation not too much competition that really undermines the universal postal service.

The access regime

The access regime, under which competitors get mandated access to Royal Mail's delivery, has to ensure the right balance is struck between competition and the financial sustainability of the universal postal service. If the regulator allows competitors to access Royal Mail's network at many different points, including allowing competitors to extract mail, that, in Royal Mail's view, reduces their efficiency unreasonably i.e. increases their unit costs.

The prices charged to competitors for Royal Mail to deliver their letters are a crucial part of the access regime. Royal Mail states that it currently subsidises its competitors because access prices do not cover their fully allocated costs. As volumes fall so unit costs rise, and Royal Mail is left with the burden of those costs. Competitors argue that the delivery arm of Royal Mail is still not efficient to best in class so why should they and their customers subsidise Royal Mail's continuing inefficiency. Postcomm's May 2010 proposals include allowing Royal Mail to raise its prices of access to the final mile by competitors by an average of 1.1p (or just over 25%) which is a significant step in addressing Royal Mail's concerns.

There are also significant problems with the current system of access headroom[7] regulation, as the 2008 report identified and which Postcomm's consultation is also addressing: "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) or too small for other products (discouraging efficient entry). Headroom may dilute some of Royal Mail's incentives to become more efficient". (page 98)

One independent respondent to this update stated: "Regulation should be radically simplified. Ex ante regulation with ever more detailed access pricing regulation will be intrusive and probably eventually destroy the universal service." Customers and competitors of Royal Mail tend to take the opposite view.

[7] Access headroom control is used by the regulator to stop Royal Mail squeezing out competitors by the way it prices its retail products and its wholesale products. A vertically integrated business like Royal Mail which supplies wholesale services to its competitors and competes with those competitors in the same retail markets, can squeeze its competitors by reducing its retail price while holding or increasing its wholesale access price to the point where competitors' margins become too low to make their businesses viable. This is referred to as "margin squeeze".

Outside the monopoly

Outside the monopoly parts of their business, Royal Mail argues that they could improve their financial performance if the competitive parts of their business – upstream collection, transport and sorting of bulk business mail; packets and parcels – were deregulated allowing them freedom to innovate and price. Competitors argue that that could lead to unfair competition and unfair cross-subsidy from the monopoly parts of the Royal Mail business. Customers argue that Royal Mail could put up prices because of their market dominance.

Current regulatory framework not fit for purpose

Whichever arguments one finds the more persuasive, and as noted, so often the hard evidence is not always there to assess the arguments, the current regulatory framework is clearly no longer fit for purpose. A regulatory regime must be put in place that has the right regulatory tools and duties in the current market conditions. The regulator has to be able to take effective action to regulate a market which has room for competition with the benefits competition can bring, and to deregulate and take other action where appropriate to ensure that the universal service is sustainable.

PART 3 : SOLUTIONS REVIEWED

Actions are needed to resolve or at least mitigate the four issues set out in the diagnosis in Part 2: overall market decline, incomplete modernisation, the pension deficit, the regulatory regime. Solutions that help to improve the Royal Mail's financial health will in turn improve the sustainability of the universal postal service: the starting point and the end point of the 2008 report and of this update.

Market decline and modernisation - the case for private sector capital

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In order to mitigate the effects of **overall market decline,** Royal Mail needs to accelerate cost reduction in the business to improve profit margins and cash flow for future investment. Royal Mail also needs a fully worked out commercial strategy that is properly customer-focussed and encourages i) continuing innovation in the "digitisable" market to reduce the pace of decline, for example in magazine distribution and advertising mail[8]; and ii) greater success in the growing fulfilment market for "non-digitisable" packets and parcels as a result of online shopping. Both cost reduction and a properly customer-focussed commercial strategy are key elements of modernisation.

In order to accelerate modernisation, private sector capital is needed for the following reasons.

Private sector capital will:

- ensure that cash is readily available when needed to fund the accelerated modernisation programme on a commercial basis that matches, indeed tries to get ahead of, the rapid changes in the market;
- inject private sector disciplines into the business; the Queen's Speech in May 2010 talked specifically of "private sector capital and disciplines" (emphasis added);
- reduce the risk of political intervention in commercial decisions (called in the original report "the spectre of political intervention"). The mail centre closure programme, for example, is critical to achieving cost reduction targets. However it is vulnerable to political and/or union opposition.

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[8] Advertising mail, which is often referred to dismissively as "junk mail", is worth £1.7 billion a year (see Figure 2 on page 11). Advertising mail is thus a major funder of the much loved universal postal service. Properly targeted advertising mail continues to have a strong future even as the advertising pound moves ever more strongly to the internet. Consumers continue to want to read printed catalogues, for example, just as they continue to want to read printed magazines.

In addition to these reasons for private capital, there are today two new “external” factors as a result of the change of Government following the May 2010 General Election.

First, the state of the public finances means that Royal Mail will find it ever harder to compete for Government capital against other public spending priorities. Yet Royal Mail will clearly need capital to accelerate modernisation as the analysis of Royal Mail’s finances has shown.

Secondly, the Government has made employee ownership a key aspiration alongside the introduction of private capital. This could have the benefit of encouraging greater employee engagement, thus usefully reinforcing, for example, the World Class Mail initiative that is now being implemented in more mail centres and more delivery offices across the UK.

There is one other more technical reason for introducing private sector capital. It is very difficult for a regulator to drive efficiencies by means of the price control regime if the company being regulated is in the public sector. When the company is in the private sector, shareholders will demand that the efficiencies implied in the price control regime are actually achieved (or bettered) year in year out and the whole issue is far more transparent and disciplined as a result.

Less need for corporate experience

In the 2008 report, it was recommended - in order to mitigate the impact of overall market decline and in order to accelerate modernisation - that Royal Mail should seek a strategic partnership with a company or companies that had corporate experience of modernisation of a network business. Also, the strategic partner’s management should be experienced in taking workforce and unions with them on the difficult modernisation journey.

Looking at that recommendation today, there is still a strong need for the private capital and disciplines that a partner could bring. Although Royal Mail will always benefit from corporate experience, there is less immediate requirement for it than in 2008. The Royal Mail has just appointed, for example, a new CEO who has spent five years dealing with modernisation and postal unions as head of Canada Post.

The reduced need for corporate experience means that there are now greater options for introducing private sector capital and disciplines. It does not have to be a sale to a partner. The much needed equity capital could, for example, be raised by means of an IPO (Initial Public Offering), turning Royal Mail into a publicly listed company. The company’s need for cash, and the timing of that need, will influence the choice of preferred option.

<u>The introduction of private sector capital into Royal Mail is as strongly recommended today as it was two years ago</u>.

Pension deficit reform

The 2008 report recommended that the Government should relieve the Royal Mail of its pension deficit as part of a wider package of measures. Taking the historic pension deficit away hugely helps Royal Mail's ability to sustain the universal postal service. The need for that action is now greater than ever. Without such action, Royal Mail's pension deficit will continue to threaten the universal postal service and will remain a barrier to the private sector investment and discipline which it desperately needs.

However, it is still difficult to justify to taxpayers that they should take on the deficit if Royal Mail cannot deliver faster modernisation. As set out in the 2008 report, removing the deficit by itself will not solve Royal Mail's problems on a sustainable basis.

Restructuring Aid

The 2008 report stated that "doing nothing" on pensions was not a policy option. Inaction could lead to Royal Mail having to approach the Government for emergency financial support in order to continue as a going concern. Any such support, the report noted, would have to be carried out under a "forced restructuring" under EU rules to ensure that Member States do not harm competition.

Royal Mail has made progress on modernisation but the wider reforms proposed for the company in 2008 did not proceed. As a result the situation has got worse since then with faster than anticipated falls in mail volumes and substantially increased pension deficit.

Given this worsening situation, the European Commission may consider any reform of the Royal Mail pension fund under its Restructuring Aid guidelines. As stated in the previous report, the purpose of Restructuring Aid is to restore the long-term commercial viability of a business such that it no longer needs further state support. While the Restructuring Aid route has disadvantages, ultimately, a restructuring of both the pension and the business is what Royal Mail needs, and guidelines are in place at the EU level to manage such situations. Many of the measures that the Commission could ask of Royal Mail as a condition of state aid approval (such as reducing its cost base) are things that must happen and are happening anyway. The onus will be on the Government to demonstrate that its support for the pension (and any other support) does not distort competition. It is, however, important that action is taken now to address the problems to prevent it needing rescue aid in the future.

Regulatory regime change

In 2008 the report recommended the transfer of responsibility for regulation from Postcomm to Ofcom to reap the benefits of a larger regulatory authority and to hasten a significant rethinking of the regulatory regime. This recommendation was fully endorsed by all stakeholders including Postcomm itself. It required primary legislation.

With the postponement of the Postal Services Bill in July 2009, no merger could take place. Postcomm has made progress in establishing a new regulatory regime from 2011/2012 (Laying the foundations for a sustainable postal service, Postcomm, May 2010).

Defining the high level principles governing the optimal regulatory framework for the postal sector in current market conditions has been the most difficult part of this update. A transfer of responsibility for postal regulation from Postcomm to Ofcom would itself help, given Ofcom’s extensive experience of establishing regulatory frameworks in other sectors.

Royal Mail is the only company capable today of delivering the universal postal service. Because of the need to secure the health of the universal postal service, it is important that the new regulatory regime to be put in place provides sufficient clarity over how the universal postal service will be secured. This will in turn ensure that investors in Royal Mail are clear as to how regulation will affect Royal Mail and ensure that Royal Mail is an investable proposition.

Regulatory framework developments

Regulation needs to mesh with current reality. This reality is changing fast. The regulatory framework needs to set clear rules of the game for all market participants (existing and future) while being able to respond to rapid market changes. Flexibility will be key.

Postcomm has recently set out proposals for the introduction from April 2011, of the first phase of a new regulatory framework for the postal services market to replace the regime that has been in place since 2006. These proposals are a stepping stone to further deregulation in 2012.

The new regulatory framework will be founded on the principles of cost transparency and accounting separation, and aims to reflect the significant market developments in recent years. The intention of the proposals is to focus regulatory safeguards where it is necessary to help sustain the universal service, and the full package of measures is intended to give Royal Mail greater commercial freedom. However, at the same time the measures are designed to provide assurance to the market and consumers that, where Royal Mail continues to have market power, it is not able to unfairly hinder the development of competition.

The proposals include:

- changes to the system of headroom control to take effect from April 2011;

- removing price controls from all packets and parcel services weighing more than 750g, because evidence suggests that this market is increasingly competitive;

- removing retail price controls on pre-sorted bulk mail, replacing them with new regulatory safeguards on the wholesale prices Royal Mail is allowed to charge operators and other users accessing its network for 'final mile' delivery;

- giving Royal Mail greater flexibility in setting its prices for pre-sorted bulk mail and access services.

In addition, Postcomm is also consulting on cost transparency and accounting separation.

Postcomm calculates that if they were to implement all the proposals, it would allow Royal Mail to realise up to £75m of additional revenues (approximately 1% of current revenues) through price increases above retail price inflation. This equates to the revenues that would come from an average increase of 2% above inflation in the price of stamps. Such an increase in revenues would help support the universal service as Royal Mail continues to modernise and address the effects of the decline in mail volumes.

In the view of this update, these proposals by Postcomm improve the regulatory environment but could go even further given the fast changing market circumstances.

Building on Postcomm's work and proposals, there needs to be an ever tighter **focus on the monopoly** starting in 2011.

Focus on the monopoly involves the regulator defining the market as physical mail and focussing ex ante regulation[9] on the monopoly parts of Royal Mail's universal postal service i.e. the collection of letters from post-boxes and post offices ("the first mile") and the delivery of letters, packets and parcels over the "last mile".

[9] Ex ante regulation allows the regulator to protect against anti competitive behaviour before it happens. Ex post regulation deals with anti-competitive behaviour after it has alleged to have happened.

The competitive parts of Royal Mail outside the monopoly would, as a quid pro quo for tight ex ante regulation and price control of the monopoly parts, be fully deregulated and made subject to ex post competition law.

Under this option, the access regime would be substantially different from the current access regime, in relation, for example, to the number of mandated access points and the setting of access prices. Postcomm plans to consult on its access review in November 2010 which ensures that the momentum of regulatory change is sustained.

To protect against the dangers of cherry-picking, the regulator would ensure as level a playing field as possible by not allowing competitors a free run in the more lucrative areas of the market whilst Royal Mail's hands are tied by the demands of the universal postal service obligation.

The key point of this regulatory approach of focussing on the monopoly is that the regulator would start with the presumption (and duty) that the universal postal service needs protecting, that the service must be efficiently provided, and that competition should be encouraged only where it is safe to do so.

A drawback of trying to focus on the monopoly is whether it is possible to do a proper accounting separation of the collection and delivery parts of the universal postal service which effectively constitute the monopoly and separate out those parts of the Royal Mail that are properly competitive.

It could also be argued that to define the market as physical mail, whilst ignoring the impact of email, texting and the internet is plainly incongruous.

Alternative approach

There is an alternative approach which defines the market to include digital communications and **removes ex ante access regulation**. Ex ante regulation would be retained only to sustain and secure the efficient provision of the universal postal service.

Ex ante access regulation has over the last few years done a good job of introducing effective competition into the market and putting pressure on Royal Mail to change. But Royal Mail has argued to this update that ex ante access regulation is a major obstacle to sustaining the universal postal service.

The removal of ex ante access regulation would be a major rolling back of regulation. It would have the benefit of meeting the Government's desire to reduce regulatory burdens. It would bring the UK back into line with most other countries' approach to postal regulation. "The UK access regime differs from the approach used by other countries.... 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" (2008 report, page 97).

Access to delivery in most other countries is granted on commercial terms, because it suits both parties, not because it is mandated by a regulator. The need for volume is so great with an incumbent postal operator bearing high fixed costs, especially at a time of market decline, that there are clear commercial incentives to do wholesale deals with other postal companies to deliver their mail.

There are a number of problems with this radical scenario of removing all ex ante access regulation. Competitors who have entered the UK market under one set of rules would see those rules suddenly changed. Also, postal competition in the UK still remains fragile even after ten years of liberalisation. But postal competition remains important in keeping pressure on Royal Mail to improve its performance, offering choice to customers and driving innovation across the whole market.

If ex ante access regulation were removed, normal competition law would apply. This would give greater flexibility to Royal Mail. But it would give competitors and customers less certainty, particularly because remedies for any anti-competitive behaviour can take a long time to apply. It is possible that a remedy could take so long to be applied that smaller competitors in the meanwhile would go out of business.

Regulatory recommendations

This update recommends that a two stage approach to regulation should be adopted and that the task of regulation should be transferred from Postcomm to Ofcom on a sensible timescale that did not slow up decisions or increase regulatory uncertainty.

Stage one would focus ex ante regulation much more tightly on the monopoly and universal postal service parts of Royal Mail, as Postcomm is proposing, put in place a new access regime and deregulate outside the monopoly.

Stage two would allow Ofcom, building on Postcomm's current work, to use its powers under Section 6 of the Communications Act 2003 to review whether the continuation of any ex ante access regulation makes the universal postal service unsustainable. The evidence for such a change needs to be gathered and evaluated. For example, without cost transparency, it would be difficult for any regulator to make the judgement. Compliance with EU Directives would also need to be taken into account.

The Government should consider whether market uncertainty would be reduced by setting an agreed date for this review by Ofcom of ex ante access regulation in the postal market.

This two stage approach is likely to be the most viable and most future-proof. Ofcom must be given the tools and duties to focus regulation on providing a sustainable and efficient universal postal service, meeting users' needs, whilst deregulating more quickly in competitive parts of the market. Ofcom's experience and track record of removing ex-ante regulation progressively in telecommunications will be useful here.

Ofcom should of course build on the valuable work that Postcomm has undertaken since 2008 and the outcomes of their current consultation. The 2008 report recommended that Ofcom should start from scratch to build the new regulatory framework. Today, however, this would not be sensible. It would cause further investment uncertainty if the new price control regime was delayed. Delays will be reduced if Postcomm and Ofcom work closely together to ensure a seamless transition on a sensible timescale.

Postcomm and Ofcom should also have appropriate regard to the wider considerations around the need for private sector investment in Royal Mail. Investors will need certainty from regulation on an agreed timetable.

The following principles will underpin the new regulatory framework:

- the primary duty of the regulator must be to secure the efficient provision of the universal postal service and there must be regard to the financial sustainability of the universal service;

- competition can be beneficial to users of postal services so long as the universal service is adequately protected;

- competitive parts of the market should be deregulated as quickly as possible;

- regulation of access should be focussed on economic bottlenecks and access prices should reflect costs, but users should not pay for inefficiency and competitors should not be subsidised;

- ex ante access regulation will be reviewed to establish whether it is damaging the delivery of the universal postal service;

- the true cost of the universal postal service obligation must be identified and agreed;

- the regulator must have enhanced statutory information gathering powers.

It will be important that the proposed changes to the regulatory regime have some degree of future proofing. Ofcom must have flexibility yet must also be responsible for giving as much regulatory certainty as possible to all those who participate in the market. The existing regime is barely 10 years old, yet market conditions are already dictating that there should be significant regulatory change.

Future regulatory options

When in future years Royal Mail is judged to be modernised to best in class status using the comparator group of best in class international postal companies, and if at that time the provision of the universal postal service places an unfair and unsustainable burden on Royal Mail, there will need to be policy options available for dealing with this in order to safeguard the universal service.

The three options are:

- reducing the scope of the universal postal service
- creating a compensation fund
- procuring some or all of the universal postal service from one or more alternative providers

There is no case today, for example, for **reducing the scope of the universal service**. The 2008 report rejected this on the grounds that such an option should not be considered until the Royal Mail had fully modernised and that remains the view of this updated report today.

A fully modernised Royal Mail, with private sector capital and disciplines, freed from the burden of the pension deficit, operating within a properly constructed regulatory framework that has as its primary aim to secure the universal service, will be able to sustain the universal service.

However, with the enormous structural changes that are happening in the market and the fast-changing needs of business and consumers, changing the specification for the universal postal service might be justified and acceptable to mail users. In the telecommunications sector, the rapid rise in the ownership and use of mobile phones has changed forever the nature of BT's obligation to provide public pay phones. The US, German and Dutch postal companies have already talked about reductions being required in the scope of the universal postal service, for example reducing the number of days for collection and delivery. This would be a core social and economic decision here in the UK which should, of course, be a matter for Parliament and Government rather than the regulator but would also need to take account of European requirements.

The 2008 report also concluded that a **compensation fund**[10] would be counter-productive whilst Royal Mail had still not sufficiently modernised. This conclusion is still judged valid today but a compensation fund should be included in the regulatory tools available to the regulator to deal with threats to the universal service should they arise.

Royal Mail is the only operator capable of providing the universal service on a nationwide basis today and that remains true for the foreseeable future. But in future years, there might need to be the option to **procure some or all of the universal service from other organisations** in a way that benefits users of the service. This should not, however, be done in a way that is detrimental to the provision of the universal service to the same standards throughout the UK. The regulator and the Government should have the tools to be able to deal with these situations. They are not for use now but in the future when there may be a need to act quickly to deal with developments in the postal sector.

The need for regulatory certainty

Finally, it needs to be re-emphasised that what is absolutely required is the speedy end to regulatory uncertainty so that investment in the postal sector is strengthened in general, and Royal Mail becomes an investable proposition in particular. The Government needs to set a framework for the new regulator which reflects the interests of consumers and citizens but also creates a credible investment proposition at a time of market uncertainty.

The postal services sector has for too long been “in a state of suspended animation” in the words of one stakeholder. At a time when the digital media continue to disrupt sector after sector at an ever quickening pace, sucking revenues and profits from long established providers and long established markets, doing nothing on the regulatory front is just not an option.

[10] A compensation fund could be financed by postal competitors to help subsidise the universal postal service if and when required.

Summary of recommendations

All the following three recommendations should be taken together and implemented together, as was strongly emphasised in the 2008 report.

The introduction of private sector capital

In order to maintain and sustain the universal postal service - the key policy objective in 2008 and in 2010 - the introduction of private sector capital into Royal Mail is strongly recommended. This could be in the form of a sale to a partner/trade investor or an IPO.

Private sector capital will accelerate the all-important task of modernisation since it will:

- ensure that cash is available when needed to fund the accelerated modernisation programme on a commercial basis;
- inject private sector disciplines into the business;
- reduce the risk of political intervention in commercial decisions;
- encourage Royal Mail to develop a more customer-focussed commercial strategy/diversification for the digital age.

In addition to these reasons for private capital, there are today two new "external" factors.

First, the state of the public finances means that Royal Mail will find it ever harder to compete for Government capital against other public spending priorities.

Secondly, the Government has made employee ownership a key aspiration alongside the introduction of private capital. This could have the benefit of encouraging greater employee engagement within Royal Mail.

Pension deficit reform

The Government should relieve Royal Mail of its pension deficit as part of a wider package of measures. This will significantly help the sustainability of the universal postal service and the viability of Royal Mail. The need for that action is now greater than ever. Without such action, Royal Mail's pension deficit will continue to threaten the universal postal service and will remain a barrier to the private sector investment and discipline which it desperately needs.

Regulatory reform

This update recommends that a two stage approach to regulation should be adopted and that the task of regulation should be transferred to Ofcom, but without delaying the much needed regulatory reform from 2012.

Stage one would focus ex-ante regulation on the monopoly and universal postal service parts of Royal Mail, put in place a new access regime and deregulate outside the monopoly.

Stage two would allow the regulator to review the effectiveness of ex ante access regulation in relation to the sustainability of the universal postal service. The Government should consider whether market uncertainty would be reduced by setting an agreed date for this review of ex ante access regulation in the postal market.

Ofcom must be given the tools and duties to focus regulation on providing a sustainable and efficient universal postal service, meeting users' needs, whilst deregulating more quickly in competitive parts of the market.

Ofcom should build on the valuable work that Postcomm has undertaken since 2008 and the outcomes of their current consultation so that the new regulatory framework can be firmly in place from 2012. This would give certainty to investors in the postal sector in general and in Royal Mail in particular.

The primary duty of the regulator must be to secure the efficient provision of the universal postal service and there must be regard to the financial sustainability of the universal service provider.

Conclusion

Today, as was true in 2008, there must be no let-up in the pressure on Royal Mail management, workforce and unions to accelerate the pace of modernisation. The need for Royal Mail to get up to best in class as rapidly as possible remains. This is the key priority, alongside the need to give Royal Mail access to private capital, pension deficit relief and a change of regulator and regulatory framework. The recommendations above, if taken forward together, will establish a platform upon which this can be achieved.

If all these policies are implemented without further delay, and Royal Mail modernises to best in class with management, workforce and unions working together, then despite the very real market difficulties the company has a healthy future. Building on its unique ability to visit 28m addresses on a daily basis, it can aspire to be the delivery company of choice for a wide range of physical mail from letters to parcels. At the same time it has the opportunity to develop new digital businesses for its huge customer base of senders and receivers in response to the erosion of the traditional letters business by the internet and mobile phones.

ANNEX A
Summary of original 2008 report Modernise or Decline

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.

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.

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.

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.

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

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.

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.

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.

Sustaining the universal service depends fundamentally on modernising Royal Mail.

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

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.

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.

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

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

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.

Parliamentary accountability for providing the universal service should be strengthened.

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.

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

ANNEX B

Summary of replies by stakeholders in response to the invitation to give views on the current situation

Stakeholders who contributed to the original Review were asked to send in their further views in light of developments since the original report was published, and specifically to comment on two questions:

1. To what extent, looked at from today's vantage point in the summer of 2010, does the 2008 Report's diagnosis of the problems facing the Royal Mail and the universal postal service (pages 30-60 of the report) need updating in terms of the current state of the UK postal market and the issues being faced by Royal Mail as the universal service provider?

The respondents who specifically answered this question acknowledged that the 2008 Report's diagnosis of the problems facing Royal Mail had stood the test of time, and were not significantly different in the summer of 2010. However, there were comments from all emphasising some key issues that the postal market and Royal Mail, faced that were potentially more desperate than in 2008, as well as some encouraging developments.

Specific issues:

Letter volume decline - respondents acknowledged that letter volumes in the UK are still in long term structural decline, with the predicted letter volume decline in the 2008 Report having been borne out. Many respondents also noted that the longer term effects of the recession are still to be fully understood - there is no guarantee, for example, that this decline would be offset when the economy recovers.

Electronic substitution – respondents noted that the postal market is even more vulnerable to substitution from electronic forms of communication as consumers continue to make increasing use of electronic media. Respondents also acknowledged that the decline in letter volumes would not be made up by the growth in parcels and packets as a result of e-fulfilment, given the fast pace and very competitive nature of this market. Two respondents remarked on Royal Mail's inability to respond sufficiently quickly to the declining market, including lack of commercial responsiveness to customers' needs, and little innovative movement in the packet and parcels market.

Universal Service Obligation – six respondents specifically questioned the continued sustainability of the universal postal service at the current service obligation. Continued decline in letter volumes would not justify the six-day a week collection and delivery obligation that currently exists. It was noted that the service level in the UK already exceeds that stipulated in the European Directive, and that many countries, for example, USA, Netherlands, New Zealand and Jersey have already reduced, or are considering reductions, in the universal service. However, two respondents stipulated that no change to the universal service should be made at this time.

Regulation: more reform needed – respondents acknowledged that whilst market conditions have deteriorated, there has been no change to the current regulatory regime, and as such it is no longer fit for purpose. Given market conditions, a new regulatory framework is urgently needed. There was acknowledgement that Postcomm was put in a difficult position given the postponement of the 2009 Postal Services Bill. There was wide support for the efforts Postcomm has since made to re-invent itself and progress a forward work plan, as well as address the challenges set out in the 2008 report's regulatory recommendations.

A small number of respondents made some specific comments about the regulatory issues that need to be dealt with. These included - the need for accounting separation to determine costs to enable consideration of how headroom between wholesale and retail prices can be regulated in the future; de-regulation where competition exists; the reliance on competition law to control improper market behaviour; appropriate safeguards over downstream access; a new price control from 2012. However, it was also acknowledged that these issues were being addressed by Postcomm, with respondents urging that any development of a new regulatory regime should not be undermined or held-up as a result of a change in regulator.

Encouraging developments:

Modernisation – acknowledgement that Royal Mail has progressed the first phase of its modernisation programme since the 2008 report.

Improved relationship with the regulator – acknowledgement that the relationship between Royal Mail and Postcomm had improved, and that Postcomm had worked hard to re-invent itself since the postponement of the 2009 Postal Services Bill, as well as address the issues outlined in the regulatory recommendations of the 2008 Report.

Improved industrial relations – acknowledgement that the Business Transformation Agreement had paved the way for more positive engagement between management and the union, and offered a strong chance of achieving stable industrial relations.

2. Do you agree with the main recommendations set out in the report to resolve the problems diagnosed (pages 70-104) and the situation it presents today:

- Royal Mail needs access to capital, greater commercial confidence and expertise through the introduction of a strategic partner or partners;
- Royal Mail's historic pension deficit;
- A new regulatory regime should be put in place including a merger between Postcomm and Ofcom?

Of the twenty six responses received, eleven agreed the main recommendations set out in the 2008 report. A further six supported the recommendations on access to capital and dealing with the pension deficit, but noted that whilst they supported the regulatory recommendation in principle, concerns were raised at the timing of any merger of Postcomm and Ofcom, as they felt the focus should be to allow the current regulator to continue its work. If a merger was to happen sooner rather than later, then a seamless transition should be ensured, and the transfer of expertise should be actively encouraged. Two respondents supported the regulatory recommendation but expressed no specific view on who should regulate.

Two respondents said they had no specific views on the issue of ownership as they felt this was a matter for Government. Three respondents supported the recommendations on the pension deficit and regulation, but did not support the recommendation on access to private capital. One respondent commented only on their support for the recommendation on the pension deficit. One other respondent only offered support for access to private capital.

ANNEX C
HM Revenue & Customs VAT:Postal Services
(BN 41, 22 June 2010)

Who is likely to be affected?

1. The only business directly affected by the changes is Royal Mail Holdings plc, the universal service provider (USP) of public postal services in the UK. Some customers of Royal Mail purchasing the relevant services will also be affected, as they will now have to pay VAT.

2. Social mail, including stamped mail, remains exempt from VAT so private individuals should largely be unaffected.

General description of the measure

3. This measure will apply VAT at the standard rate to certain postal services provided by the USP.

4. The zero-rating for passenger transport services will also be updated to reflect the status of the provider of a passenger transport service made in conjunction with its postal services.

5. The Government will legislate for this measure in a Finance Bill to be introduced as soon as possible after the summer recess.

Operative date

6. The measure will have effect for supplies made on and after 31 January 2011.

Current law and proposed revisions

7. Currently a VAT exemption applies to the conveyance of postal packets, and services connected to the conveyance of postal packets, by the Post Office company, including any wholly owned subsidiary of the Post Office company. In practice, this means Royal Mail (including Parcelforce).

8. The VAT exemption under Group 3 of Schedule 9 to the VAT Act 1994 (VATA) will be amended to restrict the scope of the exemption to supplies of public postal services and incidental goods made by the USP. The exemption will only apply to supplies of services made under a licence duty, including those where – pursuant to a licence duty – the USP allows private postal operators access to its postal facilities.

9. Supplies of services that a USP is not required to make under a licence duty (such as those made by Parcelforce), and services provided on terms and

conditions that have been freely negotiated, will in future be subject to the standard rate of VAT.

10. Zero-rating applies to the transport of passengers by the Post Office company (i.e. Royal Mail), including any wholly owned subsidiary of the Post Office company. The provision has historically only been used for rural bus services – known as the "Postbus" – that Royal Mail provides in conjunction with its postal delivery services, although it applies to other modes of transport, such as aircraft and ships. Item 4(b) of Group 8 of Schedule 8 to VATA will be amended to zero rate passenger transport provided by a USP. There is no change to the scope of the zero-rating.

Further advice

11. This measure was previously announced at Budget 2010 and a version of this note was published as BN48. This note supersedes that version.

12. Further guidance on the scope of the exemption was published in the Technical Note (VAT – Postal Services) issued on 24 March 2010. VAT Notices 700 *The VAT Guide*, 700/24 *Postage and delivery charges* and 744A *Passenger transport* will be updated to reflect the amendments.

13. If you have any questions about these changes, please contact the VAT Helpline on 0845 010 9000. Information about Budget measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

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