



Response to Postcomm's initial proposals for the 2006 price and service quality review

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FOREWORD

The decisions to be taken in coming months about Royal Mail's price and service quality review will be critical both to our future success and to the success of UK postal market liberalisation. The outcome will determine how well we can compete in a market that is being opened to full competition in just four months' time and how efficient that market will be.

It's about whether we get a sensible pricing structure and the freedom to innovate so that Royal Mail can compete fairly and effectively, especially for business mail, which amounts to more than 90% of all letters. It's about whether we can invest to modernise our network as all our rivals have done and ensuring we tackle the £4 billion pension fund accounting deficit. And, above all, it's about Royal Mail's people and whether we can reward them for future success so that Royal Mail continues to have a well-motivated workforce dedicated to serving our customers.

All of us at Royal Mail take pride in our people and what they have achieved over the past three years. Group losses from operations of well over £1 million a day have been turned into a profit from operations of £2 million a day. Postmen and women are delivering the best quality of service on record. But despite our achievements, we are at base camp with a mountain still to climb.

Postcomm has recognised a number of key principles needed to build the framework of a fair price control. This gives us the basis to engage constructively with the Regulator. But the details of the proposed price control do not align with these key principles and would not create the right framework for fair and efficient competition. Royal Mail today faces enormous risks. In particular, because the UK market is being liberalised earlier than any other major European country, it is especially important that Postcomm sends the correct signals into the marketplace and supports Royal Mail in making the substantial investments it needs just to catch up with its major European competitors and modernise the business. Unfortunately, the proposals as they stand would create an under-invested and under-performing Royal Mail struggling to deliver a universal one-price-goes-anywhere service to the UK's 27 million addresses, with no account taken of the substantial risks facing the business. We trust that Postcomm will take account of the analysis in our submission to make the significant changes to their proposals that are needed.

This submission sets out Royal Mail's analysis of the challenges we have to overcome and the framework we need.

Fair prices. The proposed price control would make it even harder than it is today for Royal Mail to bring its prices into line with costs. The result would be an increased burden on UK businesses as they continue to cross-subsidise other mail. Prices out of kilter with costs will allow our competitors to cherry-pick the profitable parts of our market but would leave us with the increasing costs of providing the universal service. This may result in it becoming uneconomic to provide the universal service at all.

Rapid innovation. The current regime stifles innovation because of the length of time taken to approve new products and services. The latest proposals would still prevent Royal Mail from

introducing new products – which its customers want and need – in anything like a reasonable commercial timeframe.

Less regulation – not more. The regulator should ensure the universal service is strengthened with a simple definition: for “everyone, everyday, everywhere.” It should not include bulk mail services that are only available to large business customers. Equally, there is no reason to bring downstream access services – which are today unregulated and based on fairly negotiated contracts – into the price control.

Investment. There has been chronic under-investment in Royal Mail’s network relative to other operators now aggressively entering the UK market. An investment of £2.2 billion is needed over the next price control period if Royal Mail is to be able to increase efficiency to the levels of our European competitors who started down this road several years ago. Postcomm needs to realise that the business can only start from where it is, not from where we would all like it to be.

Pension funding. Royal Mail is technically insolvent with a balance sheet deficit of £2.0 billion as a result of the £4.0 billion pension fund accounting liability. The best way to ensure Royal Mail is in a position to fund its deficit is to create the right pricing framework.

Risk. Postcomm needs to recognise that Royal Mail’s business is no longer that of a cosy monopoly. Volume risks to the business stemming from e-substitution of letters and rapidly emerging competition make the future very uncertain indeed, risks which are magnified by the volatility of our pension deficit and the potential for disruption to quality of service as we implement major change.

Fair Return. We need to be able to make returns on the value of Royal Mail that allows us to pay a dividend to the shareholder sufficient to compensate it for its investment in the business and the risks it is bearing.

Royal Mail has long embraced the principle of efficient competition in the market with more choice for customers. We are determined to put customers at the heart of everything we do. This means creating a customer-focused business and it may be that there is so much to do that Royal Mail’s transformation can not be completed within the term of the next review. However, to start delivering this stretching vision means getting a fair price and service quality review, which I have no doubt is what Postcomm intends to deliver. It goes without saying that Royal Mail, on behalf of its customers, should not accept anything less.

Adam Crozier

1. EXECUTIVE SUMMARY

INTRODUCTION AND OBJECTIVES

1.1 Royal Mail welcomes the opportunity to set out its response to Postcomm's initial proposals for the 2006 Price and Service Quality Review. This review will be critical in shaping the development of the UK postal market over the next five years — maintaining the viability of the universal service in a competitive environment, safeguarding quality of service to customers and influencing the landscape of competition in what is set to become the most open and competitive postal market in the world.

1.2 We welcome the thoroughness of Postcomm's approach during the price control so far and the holistic framework of principles governing liberalisation and regulation which they have put forward. We also welcome the fact that Postcomm has expressed support for many of the principles Royal Mail has put forward for the next price control — including the principles of Regulatory Capital Value ('RCV'), cost reflective pricing and allowance for the pension deficit. However, we believe that Postcomm's specific proposals do not yet support these principles. We could not accept Postcomm's proposals as they stand since they represent:

- Overall price levels which Royal Mail projections suggest would lead to significant losses by the end of the price control period threatening the viability of the universal service.
- An unduly low regulatory capital value and cost of capital, compared to peers and precedent, with resulting core profit of approximately £175 million.¹
- Quality of service penalties which could significantly exceed potential core profits and which are unnecessary on those products where competition is already emerging. Furthermore, the scope of these proposals threatens Royal Mail with 'double jeopardy' since they cover an inappropriately wide set of products. In an increasingly competitive market and in the event of under performance, unhappy customers are able to move to competitors and do not need a regulator to intervene on their behalf.
- Inconsistent treatment of Royal Mail as a business — for example, the pension deficit to be eliminated over 17 years which no private sector company would do, but pay levels benchmarked to the private sector.
- A rather theoretical regulatory approach that appears to assume Royal Mail can achieve productivity levels greater than those of TNT or Deutsche Post by the end of the price control period but with limited investment in equipment or people — despite evidence that Royal Mail's network is substantially underinvested compared to those companies and despite the difficulty of engaging our people through another round of major change.
- A regulatory framework that would encourage inefficient competition to the detriment of customers by fixing prices out of line with costs and tightly limiting our

¹ Core profit defined as Regulatory Capital Value (of £2.2 billion) multiplied by cost of capital of 8%.

flexibility to rebalance prices for example between business and social customers or across different geographic areas which have very different costs to serve.

- A proposal that would cause stamp prices to fall in real terms despite losses of £235 million per annum on stamp mail today, necessitating and even increasing the economically distorting cross-subsidy from business customers.
- A regulatory burden restricting innovation through slow approval processes, and the risk of double regulatory jeopardy from proposed changes that would create overlapping powers for Postcomm and Postwatch.
- A notable increase in regulatory intervention, particularly in downstream access, despite imminent full market opening and Postcomm's stated commitment to light touch regulation.

1.3 Taken together, the current proposals if introduced would fail to set the stage for efficient competition in the UK postal sector, threaten the viability of the Universal Service, place an undue regulatory burden on the industry, and may fundamentally threaten the future of Royal Mail.

ACHIEVEMENTS

1.4 During the period of the current price control Royal Mail has made and continues to make substantial progress — significant achievements include:

- **Quality of service levels** that have improved steadily and are now the highest on record.
- Significant **operational restructuring**, having made the move to single daily delivery, reorganised its transport and logistics infrastructure, driven efficiencies in mail centres, and reduced its reliance on casual and temporary workers. Royal Mail continues to drive operational improvements such as introducing the 'Royal Mail Way', trialling walk-sequencing, automating flats sorting, and streamlining its overheads.
- Material **cultural change** ensuring that employees are treated with the highest levels of fairness, equality, care and consideration, while reducing accidents by 40%. We have substantially improved diversity levels which will be important in broadening our ability to tap into labour markets in the future.
- **Industrial action** that is now at its lowest level for many years although industrial relations remain a significant barrier to further change.
- Significantly improved financial incentives for Royal Mail **people**, with the introduction of a five day working week, basic pay rises for all front-line employees to at least £311 per week, and employees rewarded with a £1,074 Share in Success payment for their achievements over the last 3 years (which at £218 million for the Group was one of the largest profit-share payments in UK corporate history).
- These achievements have transformed Royal Mail Group into an increasingly efficient organisation, generating profits now approaching a minimum reasonable **financial return** to both employees and its shareholder with £537 million profit from

operations in the year to March 2005, an increase of £855 million on the year to March 2002 loss of £318 million. This improvement gave Royal Mail Group the ability to pay £1.6 billion into the pension fund over the Renewal Plan period.

CHALLENGES

1.5 Although recent results highlight the substantial progress that has been made during this price control period, Royal Mail has to cope with a range of major challenges to create both an attractive business today and one that is sustainable going forward. Specifically:

- **Investment.** There has been chronic underinvestment in Royal Mail's network relative to other major operators such as TNT and Deutsche Post who are now aggressively entering the UK. For example, Royal Mail sorts only about 50 per cent of its letters mechanically compared to more than 90 per cent for these competitors. Much of the network depends on obsolete equipment and the business has significant distance to close to achieve best practices and processes. Royal Mail therefore requires significant investment and substantial operational change if it is to remain not only competitive but also commercially viable in a fully-liberalised marketplace.
- **Employees and industrial relations.** Royal Mail faces a number of challenges in engaging its 176,000 people. The workforce is traditionally characterised by uneven management quality and low morale although this has improved significantly through the actions we have taken. Nevertheless workforce engagement remains in a fragile position given the pressures we are under to drive greater productivity. There is significant and effective trade union resistance to operational changes such as removing remaining restrictive practices and moving towards team-based working. Because of these factors and the imperative to maintain quality of service during periods of major change, Royal Mail necessarily pays back a substantial share of gains from improved performance to its employees, therefore limiting the unit cost savings that are achievable and the attractiveness of operational improvements.
- **Market volume.** While the letters market has experienced some growth over the price control period, volumes this year have been flat. Further, most markets around the world are in decline and it is likely that within this price control period the U.K. will experience both volume losses from the electronic substitution that is pervasive elsewhere and much slower growth in volumes of direct mail than in the past. In short, the outlook for UK postal market volumes is uncertain and represents a major risk to the business.
- **Competition and pricing.** The U.K. will be fully open to competition by January 2006 and is the only major market in the world with both end-to-end delivery competition and 'last mile' downstream access at a price reflecting cost and a reasonable profit margin. Current and proposed regulation creates a clear opportunity for inefficient competition to enter the market via 'cream-skimming' by constraining Royal Mail's ability to set cost reflective prices. By the end of this year Royal Mail could lose up to 20% market share of second-class bulk mail to downstream competitors with volumes at level similar to that Postcomm assumes for the final year of the price control period. All of this volume will be coming from Royal Mail's largest customers. No-one is competing for social customers.

- **Customers.** Customers are demanding a high quality service that meets their individual needs at competitive prices, while Royal Mail's product set has remained largely unchanged for the last fifteen years. Royal Mail now faces a major challenge to redesign its entire business product portfolio to address these evolving needs and to continue innovating much more rapidly than it ever has before.
- **Financial.** Despite the recent improvements in the business' pro-forma financial performance, Royal Mail is technically insolvent with a balance sheet deficit of £2.0 billion due to its £4.0 billion accounting pension deficit which it now has to recognise. Furthermore, this position is likely to worsen significantly as a result of changes in mortality assumptions. Additionally, significant operational investment of £2.2 billion (comprising £1.6 billion of capital investment and £0.6 billion of one-off costs) is required over the course of the price control period for modernisation of the network infrastructure as outlined above.

1.6 It is critical that Royal Mail address these challenges in order to meet customer needs, maintain the universal service, compete effectively, and provide an adequate return to its shareholder.

ROYAL MAIL'S STRATEGY TO TRANSFORM THE BUSINESS

1.7 In response to these challenges, Royal Mail has developed a strategic plan that will allow it to meet a broad range of stakeholder objectives and which, if implemented, will continue the transformation on which the business has embarked towards a successful Royal Mail in an efficiently competitive UK postal services market:

- **Vision.** Royal Mail's vision is 'To be demonstrably the best and most trusted mail company in the world'. Our mission is 'To consistently provide the highest quality dependable mail services including the universal service by:
 - Building a great brand and excellent products to win, keep and develop profitable customers
 - Collecting and delivering on time every time at low cost
 - Recruiting, equipping, developing, including and leading our people'
- **Transforming our customer offer.** Our strategy has as its foundation a market-leading set of products and services defined around customer needs rather than our operational requirements. This will require a clear focus on products that enable our customers to communicate and deliver effectively. As part of this strategy we are developing a new range of service options with our customer's most pressing needs in mind, as well as putting in place a more granular and cost reflective 'Pricing Roadmap' that delivers pricing by size, delivery density, payment channel, speed and mailing volume. We will continue to engage with Postcomm to support our transformation through a narrower definition of the USO and revised price control terms. Together these will permit greater and more appropriate commercial flexibility to rebalance prices and innovate rapidly with new products and variants of existing products, making the liberalisation of the network a success for both customers and postal operators.

- **Transforming our operations.** To deliver competitive products consistently, we will modernise Royal Mail's network through a phased investment programme that automates our pipeline and introduces uniform best practice processes to transform the capability and efficiency of our collection, sortation and delivery operations. Further, we are seeking to engage our colleagues early to identify and roll-out best practices across the organisation, and to introduce uniform operating practices to help drive greater productivity. We are planning to undertake a significant modernisation programme, requiring investment of £2.2 billion over the price control period, comprising £1.6 billion of capital investment and £0.6 billion of one-off costs. In order to capture the benefits of these investments we are planning to move to a more efficient way of delivering the mail. Collectively, our operational programme is expected to deliver improving consistency of quality of service and approximately £320 million in ongoing annual savings by 2009/10.
- **Engaging our people and transforming working practices.** We will only succeed with a transformation of the scale envisaged if we bring our people with us, engaging them in and rewarding them for business success. Critical to transforming the business is engaging with our people in order to create a culture of continuous improvement and secure critical changes in working practices. Additionally, we are planning a substantial performance review across our management ranks and the upgrading of capabilities through training to support this transformation.

- 1.8 This is an ambitious and stretching plan, covering every part of Royal Mail's business and involving significant and challenging organisational upheaval. But this will be necessary in order to bring Royal Mail to the level at which it needs to be to compete effectively in this market.
- 1.9 We are confident that implementation of this strategic plan in conjunction with an appropriate supporting regulatory regime will result in a successful Royal Mail and lead to a thriving U.K. postal industry. The productivity improvements planned would help support the universal service. A competitive market would be fostered where Royal Mail is able to compete with entrants through innovation and new product development to the benefit of our customers. Our colleagues will be involved and engaged as we continue to transform the business, and the shareholder would make something approaching a 'fair return' on its investment.

THE PRICE AND SERVICE QUALITY REVIEW THAT ROYAL MAIL REQUIRES

- 1.10 Today over 90% of Royal Mail's revenues are regulated — essentially the entirety of the Letters business except for the unaddressed Door-to-Door service and international outbound services. The regulatory framework shapes not only Royal Mail's operational flexibility but also the broader competitive landscape. Regulation is therefore a critical enabler of — and potentially a barrier to — change in the postal industry.
- 1.11 Our vision for the industry is underpinned by five objectives which the price and service quality review should take account of. These objectives have been set against the key levers of the price control, as expressed by Postcomm in its proposals. While we welcome the fact that many of Postcomm's own stated objectives are consistent with this framework, we believe that most of its specific proposals are inconsistent with their stated objectives. (See the Table at the end of this summary for further details.)

USO coverage

- 1.12 Royal Mail believes that the definition of universal service should be focused on the core social offer of unsorted stamped mail. Royal Mail is proud to be the universal service provider and looks forward to continuing to play this role as the market becomes more competitive. We believe that the definition of the universal service should focus upon the core social offer since this is the heart of the “available to everyone” service that we seek to provide.
- 1.13 For other market segments the geographically uniform price which would otherwise be required by the universal service creates distortions and encourages inefficient entry. Therefore competitive products should be removed from the definition of universal service. Postcomm appears to agree that the definition of the universal service should only include products that are widely available:

“a service available to everyone — with no restrictions on who may access the service, subject only to the payment of the ‘affordable tariff’²

and suggests that competitive products should lie outside the definition of the universal service:

“Once competition has developed...it might be appropriate to review the universal service obligation with a view to narrowing it to provide (as currently seems to be the case for parcels, for example) a more basic level of service leaving it to the competitive market to provide customers with a choice of services, including services provided by Royal Mail outside its universal service obligation.”³

- 1.14 Despite these statements Postcomm proposes leaving significant bulk mail products, such as Mailsort 2 1400, inside the definition of the universal service area. However these products are clearly not available to all users as they have a minimum posting requirement of 4,000 items. Less than 2% of Royal Mail’s account customers could meet the volume requirements necessary to use these products. Mailsort 2 1400 also requires a high degree of pre-sortation which inevitably limits the scope of its potential customer base even further. Furthermore, Mailsort 2 1400 is in a highly competitive area, illustrated by the fact that around 20% of its volumes are projected to have switched to downstream access by year-end.

Coverage of price control

- 1.15 The scope of price regulation should, over time, be restricted to those services within the core USO definition, as efficient competition is the most effective way of setting market prices which benefit consumers following the establishment of rebalanced cost reflective prices. We believe that the scope of *ex ante* regulation should be as narrow as possible since regulation itself imposes a burden on the industry both through its direct costs as well as the distortions it creates in the marketplace. Postcomm states:

“Postcomm does not believe it should price control products where competition is providing genuine choice and protecting the interests of consumers.” (S.27)

² Postcomm’s consultation document on universal postal service, April 2003, paragraph 2.26.

³ Postcomm’s consultation document on universal postal service, April 2003, paragraph 3.16.

1.16 We welcome Postcomm's proposals to remove Presstream and account Special Delivery from the price control. Similarly we welcome the proposal to keep new products outside the price control. However, we believe that over time Postcomm and Royal Mail should continue to review the scope of the price control and remove products that have become subject to competition. Indeed, given the evolving competitive marketplace Postcomm only needs to control the First Class stamp price, since the stamp price together with competition effectively places a ceiling on all business prices.

1.17 Royal Mail believes the framework for downstream access should remain the subject of commercial negotiations. Consistent with our belief that the scope of *ex ante* regulation should be as narrow as possible, we believe that the market should best determine outcomes where possible. Postcomm states that its wish is:

"To regulate (price and quality of service) only where it is necessary to safeguard customers' interests." (§2.2)

1.18 However, Postcomm proposes to include downstream access products within the price control area and to impose a punitive quality of service compensation regime on them. This is despite Postcomm's stated views that:

*"Access agreements with Royal Mail are good for customers, who are offered more choice and innovation, and good for Royal Mail which is paid a fair price for final delivery."*⁴

*"Postcomm had always hoped that access agreements would be negotiated by the parties involved rather than having to be imposed by us, so it is good news to see the industry moving decisively towards taking responsibility for its own commercial arrangements"*⁵

*"...average [access] prices between Royal Mail and UK Mail are very close to those which Postcomm would have proposed, and are within the margin of judgement inherent in such calculations."*⁶

1.19 Downstream access consists of a set of products where contracts have already been negotiated at arms length between parties without the need for regulatory intervention. These contracts already include an agreed formula for price escalation, and provisions for compensation in the event of quality of service failure. In summary there is a vibrant market emerging without the need for any regulatory intervention. This market is expected to reach close to 1 billion items this year, at prices and conditions which already satisfy the needs of market participants. And from January 2006, we expect competition in delivery to develop rapidly in urban areas making access products part of a competitive market.

1.20 Royal Mail has already introduced geographically de-averaged access prices based on cost of delivery. This is in accordance with Postcomm's stated policy that access prices should be related to actual costs.

⁴ Martin Stanley, Chief Executive of Postcomm quoted in a Postcomm, press release (7 April 2004)

⁵ "Postcomm welcomes Access Heads of Terms", Postcomm, 17 December 2003

⁶ "Postcomm publishes its observations on Royal Mail's access agreement with UK Mail Ltd", Postcomm, 31 March 2004

1.21 However, Postcomm now proposes to link the geographic structure of access prices to that of selected retail services, even though some access products do not have retail equivalents. Postcomm have not provided any rationale for what represents a substantial reversal of Postcomm's previous position. Under Postcomm's proposals for the definition of the universal service in practice this would require Royal Mail to remove the de-averaging of access prices and to override contracts that have already been agreed with customers. Clearly in this eventuality Postcomm would be requiring Royal Mail to make access prices less cost reflective.

Structure of the Price Control

1.22 Royal Mail believes the structure of the price control should meet customer needs by promoting efficient competition supported by cost reflective prices and by encouraging vigorous innovation. Royal Mail believes that a vibrant competitive market benefits postal customers by providing choice and encouraging innovation by all players. However, we also believe that it is critical that entry occur based on efficient economic signals and not simply to exploit misalignments between prices and costs created by historical and universal service constraints. Postcomm agrees with this in principle:

"[We believe] that viable competition in the long-run must be based on genuine efficiency, innovation and customer service, and not on business models that rely on Royal Mail's prices being out of line with its costs." (§5.48)

1.23 However, Postcomm then makes several proposals which prevent Royal Mail from moving towards a more cost-reflective price structure. First, two tariff baskets with no scope for rebalancing between them. Second, a constraint on prices that limits the First Class price to 34 pence by 2009/10 and the Second Class stamp price to 23 pence by the same date will perpetuate our current losses on these product categories. (Indeed, it is not clear that it would actually be possible to apply both these maximum prices due to the need to reduce prices elsewhere). Third, new restrictions on price de-averaging by delivery zone. These proposals leave Royal Mail in a position where prices will continue to be well out of line with costs and will inevitably encourage further inefficient competition.

1.24 In addition, as a consequence of the investments made in sortation equipment the cost of products is increasingly determined by whether an item is machineable or manual. For example, the full cost differential between a machineable and manual letter can range between 8-10 pence per item for identical size items. Therefore as more mechanisation is brought in over time it is essential that Royal Mail be able to adjust prices in line with these evolving costs.

1.25 Royal Mail believes that in order to innovate in this competitive market, the regulatory framework should allow market players to respond to customer needs for new products and services and to realign prices toward costs. Postcomm supports this in principle stating:

"To give Royal Mail some flexibility to respond to competition through introducing new and innovative products, setting its prices and revising its pricing structure." (§2.2)

1.26 Despite recognising our need to innovate in this market, Postcomm has now proposed an unusually slow 12-month approval process for any changes in product specifications. This approval process, which is poorly defined, would severely limit our ability to develop

new products promptly in response to our customers' needs. Further, the regulatory burden on any changes is significantly increased as Postcomm now proposes that all product changes should be independently approved by both itself and Postwatch. This needlessly increases the regulatory burden and creates the prospect of regulatory double jeopardy.

Approach to finance

1.27 Royal Mail believes that the approach to finance should ensure the provision of the universal service through appropriate returns on investment and directly address the risks faced by the business.

1.28 Following its decision to fully open the market to competition, it is imperative that Postcomm ensure the provision of the universal service and the commercial independence and financial viability of Royal Mail. Therefore it is essential that the shareholder should receive a reasonable commercial return on its investments and the risks it is assuming. This should be undertaken within a regulatory framework where the opening regulatory value reflects the tangible and intangible costs of entry. Postcomm states that it desires a regulatory regime that appropriately compensates investors:

"Retaining and attracting investment. It is important that any opening value is sufficient to recompense investors for the funds they have put into the business and thereby attract future investment into the business" (§7.46)

and which provides correct entry incentives:

"If an opening regulated asset base is set at a level that does not reflect the reasonable costs of setting up a comparable network and business, the maximum prices that Royal Mail will be able to set under the price control will be insufficient for new entrants to enter the market with the prospects of making a reasonable return." (§7.46)

1.29 We welcome this position, which brings the regulation of Royal Mail more into line with other regulated businesses, recognises that Royal Mail is a valuable national asset and — appropriately applied — encourages appropriate economic signals thus promoting an efficient and competitive market.

1.30 However, Postcomm then proposes a methodology to calculate the investments in the business which disregards the value of the intangible assets of Royal Mail's people-intensive operation. As in any people intensive service business a significant component of the value derives from the necessary investments which are made to establish its market position, reputation, and other intangibles. In Royal Mail's case, these investments, which amount to billions of pounds, include, inter alia, recruitment and training, customer acquisition, brand, reputation, the collective experience of our workforce, the development of our network architecture, operational support services, management information systems and associated IT. These significant investments have been recognised by our potential competitors and by Postcomm as substantial assets:

"The challenges for entering the UK market are already considerable...[and include]... Royal Mail's coveted brand strength." TPG Response to Price Control Proposals, January 2005

- 1.31 Despite this, Postcomm ascribes no value to these significant assets. Instead, its approach is based on an inappropriate comparison with capital intensive utilities such as gas and electricity. As such Postcomm ignores the investment, time and risk any entrant would incur to replicate Royal Mail's business. This is inconsistent with the view of the previous Competition Commission Chairman Sir Derek Morris:

"long term averages of return on the replacement cost of tangible and intangible capital is a reasonable proxy [for the cost of capital]"⁷

- 1.32 Royal Mail estimates that its intangible assets have a value of at least £1.2 billion and a reasonable estimate of the full start-up costs for an entrant to replicate Royal Mail's universal service network is approximately £6-7 billion, compared to Postcomm's proposed value of £2.2 billion. These start-up costs include tangible assets such as the delivery offices, plant and machinery, vehicles, etc as well as substantial intangible investments including recruiting and training of front line and managerial staff, marketing and brand development and property search costs.

- 1.33 Postcomm suggests it has put in place a regulatory regime able to attract and retain investment:

"...to balance the interests of the company in terms of investment signals, of customers in terms of the effect on prices and of new entrants in terms of their ability to compete with Royal Mail. Postcomm is particularly concerned to ensure that Royal Mail is able to attract and retain investment in the future." (§.15)

- 1.34 However, Postcomm's proposed real pretax cost of capital of 8% does not adequately reflect the systematic risk of Royal Mail's business that stems from its fixed cost network of universal service collection and delivery. We estimate that Royal Mail's competitors Deutsche Post and TNT have systematic risks which when used as a comparable support a real pretax cost of capital of at least 10% for Royal Mail. Over and above this, because of its lower profit margin, Royal Mail has substantially greater operating leverage than these players, the effect of which could be to increase the systematic risk of Royal Mail's cash flows still further.

- 1.35 In sum Postcomm's proposed low cost of capital, combined with its proposed low regulatory capital value, amount to a core profit of only approximately £175 million.

- 1.36 Royal Mail believes prices should be determined to achieve a sound financial basis to enable it to fulfil its obligations to customers. Postcomm recognises this need:

"...the principal objective in setting the level of the price control is to ensure that Royal Mail has sufficient revenue to provide the universal service and other licensed activities." (§8.4)

- 1.37 Overall Postcomm proposes average prices that fall by about 3.4% per annum in real terms. This compares with Royal Mail's requirement of prices that initially rise by inflation plus 8% ($P\emptyset = 8\%$) to fund the pension deficit and even out cash flows over the period. Thereafter prices remain constant in real terms ($X=0$ in RPI-X) to reflect underlying

⁷ Dominant firm behaviour under UK competition law, Sir Derek Morris, Paper presented to Fordham Corporate Law Institute, October 2003.

improvements in efficiency of 1.5% per annum against a background of declining end-to-end volumes and the cash flow requirements of Royal Mail.

- 1.38 Postcomm also argues it is putting in place a regime which encourages investment, to overcome the historical under-investment in the industry:

“Postcomm proposes to include regulatory incentives within the new price control for Royal Mail to increase its capital investment, for example through greater automation throughout its network.”

“Royal Mail is under-invested compared to leading European operators.” (§.13)

- 1.39 However, Postcomm allowed only £776 million of our proposed capital expenditure in their preliminary proposals. Royal Mail estimates that it will need capital expenditure of £1.6 billion over the next price control period to modernise the business.
- 1.40 Postcomm’s efficiency assumptions of net 3% per annum are based on unrealistic comparisons with cost reductions achieved in privatised industries. Detailed planning based on a true understanding of the business demonstrates that a figure of 1.5% would be a stretching objective given the constraints imposed by continuing industrial relations difficulties, a relatively disengaged workforce and the imperative to maintain quality of service levels during a period of very substantial change.
- 1.41 Royal Mail believes the regulatory framework should provide adequate compensation or protection for the specific risks that Royal Mail faces, in particular unforeseen changes in pension liabilities.
- 1.42 Postcomm has assumed that Royal Mail should fund the pension scheme deficit over 20 years from 2003-04 using the benchmark of Local Government Pension Schemes. Royal Mail believes this is an inappropriate comparison for a number of reasons but particularly as Royal Mail does not have any Government guarantee in respect to its business or its pension scheme commitments. Although Government is the Company’s shareholder it manages the relationship with Royal Mail on an arm’s length and economic basis. Evidence highlights that private sector companies fund their deficits over the average remaining service life of the employees, and indeed it is rare for deficits to be financed over a longer period. Royal Mail believes that it should be allowed to fund its deficit over 12 years which is the average remaining service of its employees. Royal Mail has also now assessed the potential impact on liabilities of changes in mortality assumptions and seeks allowance for these.
- 1.43 The regulatory regime as it stands in principle compensates the shareholder for the market risks it faces through the cost of capital (at an appropriate level of at least 10%). However, it does not provide any protection for specific non-market risks beyond management control. Some of these risks, such as unforeseen changes in pension liabilities, for example, due to a change in mortality assumptions, may threaten the viability of the business. For these risks Royal Mail believes a pass-through should be incorporated into the price control.

- 1.44 Postcomm recognises its duty to maintain the viability of Royal Mail:

“As part of its statutory duties Postcomm needs to be satisfied that its price control proposals will allow Royal Mail sufficient revenue to provide the universal

service and finance its licensed activities — referred to as its regulated activities.”
(§8.117)

- 1.45 However despite this Postcomm has used only a limited number of ‘financeability tests’ that are well below the level of rigour applied by other regulators. Instead it proposes to rely on the existing relatively vague ‘reopening clause’ contained in Licence condition 19 paragraph 17 to reopen the price control in the event of any substantial unforeseen risks occurring within the price control period.
- 1.46 Although this provision has been in the licence since inception, we believe that in its current form the provision is too ill defined given the material and new non-market risks that Royal Mail now faces. Specifically, Royal Mail believes that there are some specific risks to the business, which are not factored into the cost of capital calculation, that need to be addressed explicitly in this re-opener clause. Royal Mail requires a revised reopening clause which contains a specific pensions ‘cost shock’ pass through in the event any further deterioration in the pension deficit. Similarly in the event of an unexpected improvement in the pension provision, Royal Mail would pass such improvement back to customers.
- 1.47 Provided that Royal Mail’s proposals for the price control are accepted — including (interalia) an RCV of around £5 billion and a cost of capital of at least 10% — Royal Mail believes that a price control period of up to 5 years is appropriate, and will minimise the heavy management distraction costs that result from short price control periods.

Quality of Service

- 1.48 Royal Mail believes quality of service regulation should be limited in scope to only those areas that are not subject to effective competition and should not be more punitive than in other regulated industries. Postcomm state:

“that regulatory targets should be used proportionately.” (§5.6)

- 1.49 Despite this, Postcomm proposes automatic quality of service penalties which amount to a financial exposure of £280m per year, which is around 160% of Royal Mail’s expected core profit under the proposed regime. This is substantially outside the range of regulatory precedent where a typical figure is in the range of 10% to 20% and generally is not above 40%.
- 1.50 Furthermore the scope of these proposals threatens Royal Mail with ‘double jeopardy’ since they cover an inappropriately wide set of products. In an increasingly competitive market and in the event of underperformance, unhappy customers are able to move to competitors and do not need a regulator to intervene on their behalf. Under these proposals Royal Mail would both lose customers, as would be expected in a competitive market, and also face significant penalties. This represents a double jeopardy for the business which may threaten the financial viability of Royal Mail.

Pricing and Financeability Implications

- 1.51 Using Postcomm’s Financial Model with Royal Mail data, the implications of Postcomm’s proposed pricing profile, given Royal Mail’s updated plan, are very substantially negative cash flows over the plan period.

- 1.52 If however prices are adjusted to meet revenue requirements under Royal Mail's updated plan, with an increase by RPI+8.0 in the first year, and subsequent price changes by RPI, the cash flow position before dividends is around £200 million per annum on average. This is a cash flow position that RM considers as reasonable to face the risks assumed during the price control, but insufficient to offer a fair return to shareholders.
- 1.53 Finally, Royal Mail modelled the financial implications of an adverse outcome with low volume and efficiency improvements than in the central case. Under such scenario, and a price profile of RPI+8.0% in the first year and RPI in subsequent years of the control, RM's cash flows before dividends would be broadly neutral, therefore not assuming remuneration of its shareholder.

Conclusion

- 1.54 We have outlined five objectives that articulate our vision for the regulatory framework of the postal industry. We believe that a regulatory settlement aimed at delivering this vision is required in order to support transformation of the industry, promote competition and maintain a viable and sustainable Royal Mail that is able to fulfil its USO obligations. In their current form the proposals by Postcomm are in need of significant revision in order to achieve these objectives and would place the future of Royal Mail and the competitive mails market at risk.
- 1.55 We are also concerned about the methodology Postcomm has used in developing its initial proposals. As we describe below, Postcomm's modelling of the impact of its proposals is flawed. We believe, for example, that the fundamentally important X factors proposed for the four tariff baskets in its model (which are themselves inconsistent with the two tariff baskets in the proposals document) are inconsistent with Postcomm's own modelling, and that no set of realistic prices could in fact be put in place to achieve the revenues they suggest with these X factors for the four baskets. We look forward to working with Postcomm to improve the modelling process, but remain concerned that there will be little time to do so before publication of final proposals. We expect, however, that Postcomm, like Royal Mail, will not come to final conclusions until these fundamental errors of logic and modelling — which make very material differences — have been resolved.
- 1.56 We look forward to engaging Postcomm in a productive debate over the course of this consultation as we seek to promote a dynamic and competitive market, serve our customers and preserve the USO, fulfil our obligations to our shareholder and grow the Royal Mail business.

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SUMMARY TABLE OF POSTCOMM AND ROYAL MAIL POSITIONS ON THE 2006 PRICE AND SERVICE QUALITY CONTROL

Regulatory objective	Postcomm's position	Royal Mail's position
<i>1. USO coverage</i>		
Royal Mail believes that the definition of universal service should be focused upon the core social offer of stamped mail.	All major inland letter products to remain within the definition of the USO (including Mailsort 2 1400) except Mailsort 120, 700, Mailsort 3 and Presstream. Fixed network costs allocated equiproportionately across USO and non-USO products.	All bulk mail to be immediately removed from USO. USO prices should reflect true USO costs
<i>2. Coverage of price control:</i>		
The scope of price regulation should be restricted through time to the core universal service product of stamped mail – the enduring “economic bottleneck” of the network.	Account Special Delivery and Presstream to be removed from price control. New products excluded initially from price control. Broad coverage of Condition 7 with notification of price changes for all postal services. Condition 19(1) applies to all existing services. Uncertainty regarding regulation of services outside the price control.	Account Special Delivery and Presstream to be removed from price control. New products to be excluded from the price control. Condition 7 restricted to USO services. Condition 19 to apply only to regulated services. Products removed from the price control should cease to be covered by conditions 11 and 19. As prices become cost reflective, only stamped mail should be price controlled.
Royal Mail believes the framework for downstream access should remain the subject of commercial negotiations.	Downstream access (DSA) brought within price control.	Downstream access remains outside price control.
<i>3. Structure:</i>		
Royal Mail believes the structure of the price control should meet customer needs by promoting efficient competition supported by cost reflective prices and by encouraging vigorous innovation.	Two tariff baskets on inland letter products with initial proposals level based on four baskets Limited rebalancing across social and business customers: 1 st class stamp of 34 pence by 2009/10 and no increase in 2 nd class stamp. Rebalancing ceiling of 4% above tariff cap. Rebalancing only across successive years in the price control. Restrictions on zonal pricing. Substantial limitation on RM ability to introduce zonal pricing Uncertainty regarding application of representative price.	Single tariff basket for all regulated products. Cost reflective rebalancing across social and business customers: 1 st class stamp at least 39 pence by 2009/10 and 2 nd class stamp of at least 29 pence. Rebalancing ceiling of 8.5%. Rebalancing indefinitely within the price control. Royal Mail has freedom to introduce zonal pricing without ex ante application to Postcomm. Developments of existing pricing structures will continue to be included in the price control through the representative price mechanism.

	<p>12 months to approve product specification changes.</p> <p>Both Postwatch and Postcomm to approve changes to non-price terms.</p> <p>Extension of paragraphs 12 and 13 of Condition 19 to price structure changes.</p>	<p>Ability to innovate rapidly — maximum 3 months to approve product and pricing changes, and to cease non-material services</p> <p>No change to the non-price terms arrangements. Specifically, no <i>ex-ante</i> regulation and no double regulatory burden: only Postcomm to be involved.</p> <p>Paragraphs 12 and 13 of Condition 19 should not be extended.</p>
4. Approach to finance:		
Royal Mail believes that the approach to finance should ensure the provision of the universal service through appropriate returns on investment and directly address the risks faced by the business.	<p>Opening Regulatory capital value (RCV) of £2.2 billion.</p> <p>Real pretax cost of capital of 8%.</p> <p>Allowed core profit of £175 million, or 2.9% of sales.</p> <p>Property disposals deducted from the RCV at carrying value.</p>	<p>Opening Regulatory capital value of around £5 billion.</p> <p>Real pretax cost of capital of at least 10%</p> <p>Allowed core profit around £500 million.</p> <p>Property disposals deducted from the RCV at carrying value.</p>
Royal Mail believes prices should be determined to achieve a sound financial basis to enable it to fulfil its obligations to customers.	<p>Annual net efficiencies of 3%.</p> <p>Capex allowance of £0.8 billion.</p> <p>Pension deficit paid back over 17 years.</p> <p>RPI-X control.</p> <p>X factor for four baskets: captive (X=3); non-captive (X=2); access (X=6.9); miscellaneous services (X=3). Single basket equivalent X=3.4. All calculated as average revenue control.</p>	<p>Annual net efficiencies of 1.5%.</p> <p>Capex allowance of £1.6 billion.</p> <p>Pension deficit paid back over 12 years with adjustment for changes in mortality assumptions and a pass through provision to protect against pension shocks.</p> <p>RPI-X for control, in addition to a P₀ increase for pensions.</p> <p>X factor of 0% and P₀ of 8%, with price rebalancing, for prices consistent with volumes</p>
Royal Mail believes the regulatory framework should provide adequate compensation or protection for the specific risks that Royal Mail faces, in particular unforeseen changes in pension liabilities.	<p>4 year price control.</p> <p>Retention of the current reopening clause in Condition 19 that only allows a reopening if Postcomm believes there was a significant risk to Royal Mail's ability to finance its licensed activities.</p>	<p>5 year price control if Royal Mail's proposals are accepted.</p> <p>Pass through of pension costs with a guarantee on the number of years over which it is paid.</p> <p>An extended reopening clause for specific cost shocks.</p>
5. Quality of Service:		
Royal Mail believes quality of service regulation should be limited in scope to stamped mail and should not be more punitive than in other regulated industries.	<p>Quality of service penalties up to 160% of core allowed profit.</p> <p>Quality of service compensation for DSA introduced into RM's licence.</p> <p>Measurement and reporting of delivery times.</p> <p>Postcomm to determine compensation levels for loss and damage</p> <p>Failure of quality standards constitutes a breach of reasonable endeavours, with enforcement action and fines, unless Royal Mail can prove otherwise</p>	<p>Quality of service penalties no more than 15% of core allowed profit.</p> <p>DSA compensation already in contracts; no requirement for licence changes.</p> <p>Any measurement or reporting of delivery times is a commercial matter for Royal Mail.</p> <p>Compensation for loss and damage to be operated under Royal Mail's schemes or contracts with the customer, as now</p> <p>Replacement of pass/fail targets with ranges of performances. Postcomm must demonstrate that Royal Mail has not applied reasonable endeavours before it can fine Royal Mail for failing a quality standard</p>

2. ROYAL MAIL'S ACHIEVEMENTS

2.1 During the period of the current price control Royal Mail has made substantial improvements to its business in:

- Improving **quality of service** to our customers,
- Achieving **significant operational restructuring**, and
- Substantially **improving colleague engagement** to underpin future transformations

2.2 These improvements mark an essential first step in the transformation of Royal Mail into an increasingly efficient organisation - one that is able to face growing competition, to continue to invest in its people, infrastructure and quality of service, and to provide an improved commercial return to its shareholder. However, there remain substantial challenges ahead, particularly given the scale of changes in the market. Royal Mail recognises there is much to do in order to secure its long-term viability in this fully-liberalised marketplace.

Quality of service

2.3 Royal Mail aims to provide a consistently high quality of service to all of its customers. Quality of service levels have improved during the price control period and now stand at the highest on record.

- First Class quality standards published for the first quarter of this year (April – June 2005) show that 93.4% of letters arrived the day after posting, the highest level on record.
- Second Class, Mailsort and Presstream bulk mail services, and Standard Parcels, which together represent some 80% of the total mailbag, are all now performing above their target levels.

Operational restructuring

2.4 Royal Mail has achieved significant operational restructuring during the current price control period. It has:

- Made the move to single daily delivery, a change that every other major modern postal company made years ago. This involved changing working practices throughout 1,400 delivery offices and changing the jobs of nearly all our front-line people.
- Reduced reliance on casual and temporary workers, employing fewer than 1,000 except at seasonal periods such as Christmas.
- Reduced absence from August 2004 – January 2005 by 11% over the same period in the previous year.
- Significantly improved safety, illustrated for example by a reduction in accidents of 40%.

- Made significant improvements in mail centre productivity through a mail centre efficiency initiative, saving £33 million per annum after incremental staff bonuses.

Colleague engagement

- 2.5 There has been tremendous change within Royal Mail over the past few years. Such change could only have been achieved with the support of our people. Royal Mail has ensured that its people share in its success through improved financial incentives and working culture. These changes have led to a significant improvement in Royal Mail's relations with its people.
- 2.6 In order to achieve this change, Royal Mail has necessarily significantly improved the financial incentives for its people during the current price control period.
- Royal Mail has introduced a five day working week, and raised basic pay for all front-line employees to at least £311 per week. This is an increase of almost 25% since March 2002.
 - Under a new productivity bonus scheme, employees have the opportunity to earn up to 50% of any savings above budget made by their unit, with an additional 10% if Royal Mail hits its First Class performance target of 93%.
 - Furthermore, the majority of employees were rewarded with a one-time profit-share payment of £1,074 under the Share in Success scheme as a reward for meeting stretching financial targets over the last three years. This payment totalled £218 million for the Group and was one of the largest profit-share payments in UK corporate history.
- 2.7 Along with these financial incentives, Royal Mail has improved its working culture such that all employees are treated with greatly improved levels of fairness, equality, care and consideration.
- Significant improvements have been made in diversity, with the Group recently being named the most improved organisation in the public sector in this year's Race for Opportunity benchmarking report. Royal Mail has appointed diversity champions across the business, and is undertaking a programme of diversity training for everyone in the organisation.
 - Practices of bullying and harassment which were unfortunately not uncommon across the business are being eliminated. This has led to the Equal Opportunities Commission suspending its inquiry.
 - Royal Mail has improved its complaints procedures, and introduced a confidential helpline to advise and support any employees helpline who are concerned about bullying, harassment or any other issues. This helpline is staffed round-the-clock by professional, independent counsellors.
- 2.8 Employee and industrial relations have improved significantly over the price control period despite almost continuous organisational and cultural change:
- 62% of Royal Mail Group's people now enjoy working for Royal Mail, up from 57% in 2004.

- Only 866 days were lost to industrial action in the period January — March 2005, compared with 84,677 days lost in 2003.

2.9 However, industrial relations continue to be a significant barrier to change, and Royal Mail recognises that there is substantial room for further improvement on this front.

Financial performance

2.10 These achievements have begun the transformation of Royal Mail into an increasingly efficient organisation. Royal Mail Group generated a £537 million profit from operations in 2004/05, an increase of £855 million on the 2001/02 loss from operations of £318 million.

SUMMARY

2.11 Royal Mail has achieved major progress on all fronts — with its customers, in its operations, with its people and in its financial performance. However, there remains much to do to build a sustainable business. As outlined in the following chapter there remain formidable challenges facing the business as the market becomes fully competitive at the start of next year.

3. CHALLENGES FACING THE BUSINESS

3.1 Royal Mail's results highlight the progress made in improving Royal Mail's quality levels and transforming Royal Mail into a more efficient business during this price control period. However, this represents only the first step in an ongoing transformation programme. Royal Mail faces huge risks and a range of major challenges across its business, specifically:

- ***Uncertain growth in market volumes and even potential declines*** in the face of *electronic substitution*.
- ***Rapidly increasing competition in a market where prices are not aligned with costs***, resulting in inefficient competition as the market fully opens up.
- Significantly ***changing customer needs*** against a backdrop of historically little innovation in the product set.
- ***New transport legislation*** that will force Royal Mail to adjust its distribution network to maintain quality and will impose additional costs on Royal Mail.
- An ***underinvested network***, resulting in low levels of automation, inefficient working practices and almost all of Royal Mail's sorting equipment being obsolete.
- ***A continued challenge to engage with our people and improve industrial relations***.
- Significant ***financial constraints*** including an onerous and volatile pension deficit.

3.2 Royal Mail must address these challenges in order to meet customer needs, compete effectively, and provide an adequate return to its shareholder while maintaining the universal service. If Royal Mail fails to address these challenges, there are likely to be adverse consequences for the postal industry as a whole: inefficient competition, minimal innovation, and a reduction in overall quality of service for both business and social customers.

UNCERTAIN GROWTH IN MARKET VOLUMES AND EVEN POTENTIAL DECLINES IN THE FACE OF ELECTRONIC SUBSTITUTION

3.3 While the letters market has experienced some growth over the price control period, volumes this year have been flat. Furthermore, most markets around the world are in decline and it is likely that within this price control period the UK will experience the negative e-substitution impacts that are pervasive elsewhere. In short, the outlook for UK postal market volumes is highly uncertain and represents a major risk to the business.

3.4 Over the last four years, the total UK market for addressed mail volumes has been growing by an average of about 2% per annum. However, the rate of growth has been declining, from about 3% in 2000/1 to 1% in 2004/5 (with about $\frac{1}{2}$ % additional growth in downstream access). During the year to date from March 2005, volumes have been flat inclusive of downstream access.

- 3.5 If we strip out the impact of GDP, household growth and price changes we find that the underlying trend in volumes was negative at about -1% per annum over the last four years. This underlying decline in UK volumes may be partially explained by e-substitution, a trend that has been seen in other major postal markets.
- 3.6 If we examine the market growth in other major postal markets where data is available – the US, the Netherlands and Germany – we see that they have been experiencing flat or declining volumes. In the US, volumes of First Class and Standard Mail have remained unchanged over the period 2000 to 2004, where a significant decline in First Class mail has been offset by growth in Standard Mail. In the Netherlands, volumes of Total Addressed Mail have declined by an average of about 1% per annum from 2001 to 2004. In Germany, volumes of private and business mail have declined slightly by an average of 0.3% per annum from 2002 to 2004.
- 3.7 The UK market may follow these trends and experience slowing growth, or even volume decline, as e-substitution continues.

Table 1 - Mail volume growth in the UK, US, Netherlands and Germany

Market	Period	Average total market growth	Underlying market growth trend*
UK	2000/01 - 2004/05	1.8%	-1.1%
US (First & Standard Class)	2000 - 04	0.0%	-4.1%
Germany (private and business mail)	2002 - 04	-0.3%	-1.1%
Netherlands (total addressed mail)	2001 - 04	-0.8%	-2.1%

* Growth trend normalised for GDP, household growth and price changes

Source: Royal Mail analysis of public information using ILTM elasticities

INCREASING COMPETITION IN A MARKET WHERE PRICES ARE NOT ALIGNED WITH COSTS, RESULTING IN INEFFICIENT COMPETITION

- 3.8 The UK will be fully open to competition by January 2006 and is the only major market in the world with both end-to-end delivery competition and 'last-mile' downstream access at a cost reflective price. Current and proposed regulation creates substantial risk of inefficient competition via 'cream skimming' as Royal Mail is constrained in its ability to set cost reflective prices. For example, by the end of this year Royal Mail could lose up to 20% market share of Second-Class bulk mail to downstream access, all from its largest, lowest cost-to-serve customers.

Market liberalisation

- 3.9 The UK is currently the most liberalized postal market in Europe, and will be fully open to competition in all product categories by January 2006, several years in advance of other major European markets.

- 3.10 Furthermore, it is the only major market with both bypass competition, where competitors are able to set up their own end-to-end networks with a delivery capability or indeed, from January 2006, to set up third party delivery-only services, and downstream access competition at a cost-reflective price, where competitors are able to access the Royal Mail delivery network for mail they have previously collected from customers.
- 3.11 There are already multiple competitors in the UK postal market, with certain segments, such as packets, already fiercely competitive. Recent entrants into the UK market include TNT, Deutsche Post, Express Dairies, DX Express, UK Mail, La Poste and SMS. Between them these entrants offer the full range of next day, 2-3 day, guaranteed and unaddressed services.

Misalignment of prices and costs

- 3.12 Royal Mail's prices are substantially out of line with costs, partly because of the universal service which requires prices to be geographically uniform even though delivery costs vary by area, and partly for historical reasons when basic weight step stamp prices were held down below cost. Royal Mail is seeking to move prices towards cost along a number of dimensions:
- ***Size:*** Current pricing is weight based even though costs are driven more by the size of an item than its weight. For example a 20 gramme A4 sized letter drives more cost than a 20 gramme C5 sized letter since the A4 letter is more likely to require manual handling than the C5 letter, most of which can be machine sorted. Accordingly we are planning to introduce "Pricing in Proportion" in August 2006 to move pricing more in line with size than weight. Royal Mail lost £212 million from operations in 2004/5 on post that weighed under 100g per item. This represents nearly 90% of the price controlled-volumes that it has to provide under the USO, and represents 83.5% of the 22 billion items handled by Royal Mail during the year.
 - ***Channel:*** A stamped letter (as opposed to a flat or a packet) costs more to process (29 pence for a First Class item) than a meter letter (23 pence) or an account letter (22 pence). In aggregate Royal Mail loses 5 pence on every First Class stamped item (letters flats and packets) posted, a total of £106 million in 2004/5, and 8 pence on every Second Class stamped item posted, a total of £129 million in 2004/5.
 - ***Delivery zone:*** Unit delivery costs are about 10 pence lower for urban dense mail than for deep rural mail.
 - ***Speed:*** Slow speed mail such as Mailsort 3 (7 days) in principle incurs substantially lower delivery costs than fast mail (e.g., First class next day) since slow speed mail could be delivered on a reduced number of days each week. (Although for Royal Mail, unlike delivery competitors, this effect is disguised by our universal service obligation to deliver to each address every day).
- 3.13 This price / cost mismatch means that Royal Mail depends on pockets of profitability, whereby certain profitable business mail products cross-subsidise loss-making social products such as stamped mail.

Inefficient competition

- 3.14 In the face of prices that do not reflect costs it is not surprising that market liberalisation has already resulted in significant competition from a range of entrants across all profitable product segments. These new entrants are already successfully attacking Royal Mail's higher margin business flows and the largest, most-profitable customers, which represent a disproportionate share of mail volumes (Royal Mail's top 10 customers post some 3.5 billion items a year, or 17% of total Royal Mail volumes.) Such competitors are under no obligation to provide any services to unprofitable customers, or to offer services that are structurally unprofitable.
- 3.15 For example, the DSA market has grown rapidly through bilateral contracts between Royal Mail and TNT, DHL, UK Mail and others. Competitors' volumes are running at over 78 million items a month or an annualised rate of nearly 1 billion items per annum – from a zero position less than 15 months ago. For example, three of our top five business customers have already signed contracts to divert a significant amount of their volumes to Royal Mail's competitors.
- 3.16 Competitors who are building infrastructure to support their own delivery capabilities are targeting these capabilities on dense city areas where delivery costs are lower. For example, DHL is building delivery networks in major cities (in London and the North West). Similarly, DX offers a city-to-city delivery service to selected business addresses.
- 3.17 We are not aware of any competitor who is seeking to provide a universal service offer of "everyday, everywhere", demonstrating that all the emerging competition is essentially of a "cream skimming" variety aimed at exploiting existing misalignments between Royal Mail's prices and costs.
- 3.18 Royal Mail is unable to respond commercially to competition unless it is able to set cost-reflective prices and has the freedom to innovate rapidly.

CHANGING CUSTOMER NEEDS

- 3.19 Royal Mail's product portfolio has remained largely unchanged for the last fifteen years. Fundamental changes in customer demands and technological advances over that period have left Royal Mail far behind as Royal Mail struggled with an operationally inefficient business and a poorly performing product set. Royal Mail initiated a significant reversal of fortunes through the renewal plan, and now faces a major challenge in redesigning its entire product portfolio in order to address the rapidly evolving needs of its customers.
- 3.20 Royal Mail envisions not just a revised product set, but a transformation into a customer-focussed business, with the technical and managerial capabilities required to respond to customers' changing needs month by month rather than decade by decade. In order to effect this radical change, Royal Mail requires both significant cultural development and a sufficiently flexible regulatory framework, as outlined in the following chapters.

NEW TRANSPORT LEGISLATION

- 3.21 Royal Mail faces a variety of new transport legislation which will increase the challenge of maintaining quality and cutting costs.
- 3.22 The transport legislation includes an EU directive to speed restrict 7.5 tonne vehicles from January 2007. Royal Mail will reconfigure and delay the distribution network by one hour to minimise the quality and cost impact of this legislation. This will put back arrival times at delivery offices by one hour, however we do not expect to change the last delivery time.
- 3.23 Royal Mail will also be affected by the Working Time Directive which requires it to increase driver remuneration to remain competitive with other employers of drivers; by rail legislation following the Ladbroke Grove rail crash that requires black boxes to be installed in all trains; and by legislation which requires digital tachos to be implemented in all vehicles.
- 3.24 In aggregate, it will cost Royal Mail £57 million per year to comply with new regulations and minimise the impact on quality.

AN UNDER-INVESTED NETWORK

- 3.25 Royal Mail has chronically underinvested in the network relative to its peers, and has levels of automation that lag far behind its peers. As a result, productivity is also lower than its peers, as can be seen in Table 2 below.

Table 2 - Royal Mail has significantly underinvested in its network, leading to lower productivity than its major competitors

	TPG	Deutsche Post	Royal Mail
Average capital expenditure per 1,000 addressed mail items 1994 - 2003	£17	£27	£11
Proportion of letters walksorted by machine	90 - 95%	95%	50%
Proportion of letters walksequenced by machine	40%	80%	0%
Productivity (1,000 addressed letters per FTE, 2003)	156	130	117

Source: Annual reports, RM Regulation, Global Insight, FEDMA

- 3.26 Royal Mail faces many challenges as a result of underinvestment in its network:
- **Obsolete equipment:** Almost all of Royal Mail's sorting equipment is obsolete and requires replacement. Much of Royal Mail's sorting equipment was designed and installed in the early 1990s. These machines are beyond their useful life, are not supported by their manufacturers, and are likely to begin failing frequently with potential failure rates of more than 20% per year. Royal Mail's engineers have continued to maintain the current machinery from existing stocks of spare parts and opportunistic purchase of new and second-hand spares. However, these parts are

increasingly difficult to find and manufacturers do not currently support most of the equipment. This situation is not sustainable.

- **Low levels of automation:** Royal Mail has a low level of automated letter sorting and sequencing, as shown in the table above. In addition, it only has flat sorting machines in 6 out of 69 mail centres. As a consequence, Royal Mail has a manually intensive operation, with cost and quality implications.
- **Delivery offices not fit for purpose:** Royal Mail has significant issues with its delivery offices as a result of a lack of investment combined with an ageing estate and increased number of delivery points. In particular, single daily delivery has led to many practical problems of space pressure. Royal Mail is receiving an increasing number of Environmental Health Officers (“EHO”) visits (49 in the last 6 months compared to 32 in the prior 6 months), and received 38 EHO Improvement Notices and Enforcement Letters in the last 6 months to address issues such as a segregation of people and vehicles.
- **Legacy IT systems:** Royal Mail faces cost and data integrity issues with its IT systems. It has more than 100 legacy IT systems installed on 70 different servers in the mail centre network. These obsolete, and often interlinked, systems are difficult and costly to replace. Royal Mail lacks a remote data backup infrastructure, and the CRAMP software which holds the sort plans is subject to 12 month notice of cessation of support at any time from 2006.

A CONTINUED CHALLENGE TO ENGAGE WITH OUR PEOPLE AND IMPROVE INDUSTRIAL RELATIONS

3.27 Despite substantial improvement during the last few years, Royal Mail continues to face a number of challenges in engaging its 176,000 people:

- Low morale — only 62% of people enjoy working at Royal Mail (as at March 2005)
- Uneven management quality across the business
- Substantial and effective trade union resistance to operational changes, such as removing restrictive practices and moving towards team-based working
- Significant levels of unauthorised absence

3.28 As part of its strategy in tackling these challenges and because it is imperative that Royal Mail maintains its quality of service during periods of major change, Royal Mail necessarily shares a significant portion of the gains from improved performance with its employees, limiting the cost savings achieved by the business through operational improvements.

3.29 The table below shows that the benefits of improved productivity during the current price control period were largely returned to employees, resulting in unit costs remaining broadly static over the period.

Table 3 – Despite productivity increases during the last price control period, unit costs have remained static due to rising staff costs

	2001/02	2002/03	2003/04	2004/05
Productivity (Addressed items delivered per FTE)	100	102	105	108
Operational staff costs (£ per FTE)	100	103	107	119
Total unit costs (£ per addressed item delivered)	100	100	100	102

Source: Royal Mail Letters financial statements

- 3.30 Furthermore, although Royal Mail has increased pay significantly above inflation, it pays below the public sector benchmarks that the trade unions regard as more relevant comparators.
- 3.31 As Royal Mail introduces significant organisational and technical change, it will remain imperative to link compensation to productivity and efficiency gains, if these change programmes are to be embraced and successfully implemented by Royal Mail colleagues at every level. These broader business requirements will place a limit on the unit cost gains that Royal Mail is able to achieve.

SIGNIFICANT FINANCIAL CONSTRAINTS ON THE BUSINESS

- 3.32 Royal Mail Group faces two major financial challenges: its substantial and volatile balance sheet deficit and its significant requirement for capital to fund future investment. These challenges can only be met through a vibrant and commercially successful Royal Mail.

Balance sheet deficit

- 3.33 Royal Mail Group has a £2.0 billion balance sheet liability as at 27 March 2005, primarily due to its £4.0 billion accounting pension deficit which it now has to recognise. This deficit leaves the business technically insolvent and:
- ***Unable to raise any external new capital***, as external capital providers are likely to deem Royal Mail too risky a proposition, and will be unable to obtain adequate security.
 - ***Unable to offer employees broader participation*** in the success of the company.
 - ***Unable to pay a dividend*** to its shareholder under the Companies Act.
 - ***Unable to participate in any broader industry restructuring***, due to (i) lack of capital, and (ii) the unwillingness of any third party to assume such a significant and volatile liability without financial compensation.
- 3.34 The pension deficit must now be recognised on the balance sheet both under FRS 17 following changes in UK GAAP and under International Financial Reporting Standards (IFRS). Royal Mail will report its financial statements under IFRS. Furthermore, the

deficit is also likely to significantly worsen as a result of likely changes in mortality assumptions. This deficit is a new challenge — the pension fund moved from surplus to deficit between 2000 and 2003 due to adverse investment conditions and increased longevity.

- 3.35 Furthermore, the 2004 Pensions Act gives the UK Pensions Regulator powers to impose ‘financial directions’ upon companies whose pension schemes are ‘insufficiently resourced’. Although these powers are as yet largely untested, it is thought that the Pensions Regulator would prevent any significant corporate or financial transaction (such as the raising of secured finance) that put the ability of Royal Mail to fund the deficit at risk.

Significant requirement for capital

- 3.36 Royal Mail faces a significant requirement for £4.0 billion of capital to invest in both the modernisation of its network infrastructure and its people, and to fund its pension liabilities, as shown in Table 5 below.
- 3.37 Investment of £2.2 billion (comprising capital expenditure of £1.6 billion and one-off costs of £0.6 billion) is required over the next price control period to deliver the strategic plan outlined in the next chapter. This includes capital expenditure of approximately £0.4 billion for automation equipment and the move to more efficient delivery, £0.5 billion to begin replacing obsolete equipment, £0.1 billion to make the delivery network fit for purpose, £0.1 billion in processing, £0.1 billion on regular maintenance on the estate, and £0.5 billion on vehicles. This spend is required to reverse the history of underinvestment in both equipment and people, and without it Royal Mail will not be positioned to maintain the universal service in a competitive marketplace.
- 3.38 Royal Mail needs to fund its pension deficit. In line with FTSE benchmarks Royal Mail is planning to pay back the pension deficit over a 12 year period (average remaining service life of employees), which requires additional contributions of £1.8 billion over the next price control period.

Table 5 – Royal Mail requires £4.0 billion of capital during the next price control period

Area	Amount (£ billion)
Total operational investment	2.2
Royal Mail share of Group pension deficit payments	1.8
Total Capital required	4.0

Source: Royal Mail

- 3.39 As we will show in subsequent chapters, Royal Mail has developed a strategic plan which addresses these financial challenges, but Postcomm’s proposed regulatory framework does not support delivery of our plan.

4 ROYAL MAIL'S STRATEGY TO TRANSFORM THE BUSINESS

- 4.1 Royal Mail has developed a clear strategic plan to address the challenges outlined in Chapter 3 that allows it to meet the objectives of a broad range of industry stakeholders. If implemented, the strategic plan will lead to a successful Royal Mail in an efficiently competitive UK postal services market. If Royal Mail cannot implement the plan, then the future of the USO and the likelihood of an efficient and thriving postal industry in the UK might be at risk.
- 4.2 This chapter outlines:
- Key stakeholder objectives
 - Strategic plan to meet business challenges and the objectives of industry stakeholders
 - Modernising our operations
 - Engaging and motivating our people
 - Transforming the customer offer
 - The integrated nature of the strategic plan
 - Financial implications of Royal Mail's strategic plan

KEY STAKEHOLDER OBJECTIVES

- 4.3 Royal Mail must meet the objectives of a broad range of stakeholders to ensure a competitive UK market with a commercially viable and successful Royal Mail at its centre maintaining the USO.
- Business **customers** want high quality of service at low cost in a competitive market while social customers want reliable quality of service provided by a successful and respected institution.
 - The broader **community** wants Royal Mail to provide an affordable, trusted and high-quality universal service, and to be seen as a great British company, vigorously competitive and efficient, and acting with the highest ethical and environmental standards.
 - Our **people** want more involvement in building a respected Royal Mail that can offer greater earnings and career development potential, security of employment and retirement benefits.
 - Our **shareholder** requires Royal Mail to deliver a commercial return on its investment commensurate with the risks the business faces, and to build a commercially viable, sustainable and valuable business in the long-term.
 - The **regulator** expects Royal Mail to provide the universal service obligation, to improve quality of service, and to facilitate effective and efficient competition.
 - Our **trade unions** want attractive rates of pay and job security for their members.

STRATEGIC PLAN TO MEET BUSINESS CHALLENGES AND THE OBJECTIVES OF INDUSTRY STAKEHOLDERS

- 4.4 Since the December 2004 draft strategic plan, Royal Mail has developed the strategic plan to meet the business challenges and the objectives of industry stakeholders through modernising its operations, engaging and motivating its people and transforming the customer offer.
- 4.5 Royal Mail has followed a rigorous process to develop its strategic plan, building on the December 2004 draft that Postcomm has seen. In doing so, we have incorporated much of LECG's and Postcomm's feedback.
- 4.6 Royal Mail will meet its challenges and industry stakeholder objectives through an integrated strategic plan that will:
- **Modernise our operations** in a programme of automation and transformation of working practices and workplace culture. Royal Mail's vision for its operations is for more efficient delivery of the mail with new ways of working and a reliable, increasingly automated and efficient network.
 - **Engage and motivate our people.** Royal Mail will enable the transformation by continuing to invest in our people, and by increasing colleague engagement and motivation, moving away from today's situation of low morale, uneven management quality, 'us vs. them' trade union relationships and high levels of unauthorised absence and attrition.
 - **Transform the customer offer.** Royal Mail will offer a market leading set of products and services developed to support our customers' needs rather than our operational requirements.
- 4.7 If Royal Mail is unable to implement its strategic plan, the development of the UK Postal market could be jeopardised as an uncompetitive, unproductive Royal Mail would be unable to play the pivotal role required for the industry to thrive and for key stakeholder needs to be met:
- The USO could become prohibitively expensive to maintain, threatening the viability of delivery to every UK household every working day.
 - The postal infrastructure would deteriorate, severely hampering Royal Mail's ability to compete on the basis of affordable prices, quality improvements and innovation.
 - Royal Mail colleagues would have significantly less job security.

MODERNISING OUR OPERATIONS

- 4.8 Royal Mail's vision for its operations is for a more efficient mail delivery with new ways of working and a reliable, increasingly automated and efficient network.
- 4.9 Royal Mail will move to:
- **New ways of working**, eliminating the inflexible working practices of today and capturing efficiency savings in delivery offices and mail centres.

- ***A more robust network with consistent quality***, transforming an under-invested and variable quality network where the vast majority of automation equipment is obsolete and up to 70% of delivery offices are not fit for purpose.
- ***More efficient, automated and smoother flows of mail***, rather than a manually intensive operation with low levels of automation, inefficient flow of mail through the network and large variations in performance between delivery offices and mail centres, and inefficient support services.

New ways of working

- 4.10 Royal Mail will introduce new ways of working and implement delivery efficiencies in order to move away from the inflexible working practices of today which make capturing efficiency savings in delivery offices and mail centres a challenge.
- 4.11 More efficient ways of working will be introduced into Royal Mail, fundamentally redesigning every colleague's role. Almost 1,000 walk sequencing machines will be installed in approximately 300 of the largest delivery offices, each of which will sequence mail for a cluster of smaller nearby delivery offices, of which there will be approximately 1,000. Over 50,000 out of 64,000 walks will be mechanically walk sequenced. Variations in performance between offices will reduce as best practices are more commonly known and transferred between offices. There will be more part time opportunities, and more flexible working opportunities for a more diverse workforce. In addition, we could achieve greater efficiency by reorganising delivery offices into small teams of approximately 15 people, each led by working team leaders.
- 4.12 In processing, a new model will be introduced, centred on working in teams to drive productivity improvement through participation, and which will devolve accountability and responsibility for performance and problem solving to the lowest level. Mail centres could be divided into 4 units, consisting of a business mail preparation unit, a flats and packets unit, a social mail preparation unit, and a letters unit. Each unit will be further divided into small groups (no more than 15 people) led by working team leaders.
- 4.13 There will be a coordinated and focused programme to deploy best practice across delivery offices, increase the percentage of letters walk sorted in the mail centres, and install walk sequencing machines in delivery offices. This will mean a shift to more part-time delivery roles.

A more robust network with consistent quality

- 4.14 Royal Mail will have a more robust network with consistent quality, transforming an under-invested and variable quality network where the vast majority of automation equipment is obsolete and many delivery offices are not fit for purpose.
- 4.15 Almost every machine in each mail centre — many of which are already obsolete — will have been replaced and upgraded, with the range of machines in use rationalised and standardised. Royal Mail will install approximately 230 machines and invest approximately £0.3 billion (including one-off costs) to replace the obsolete equipment.
- 4.16 More than 400 delivery offices and scale payment delivery offices (SPDOs) will be refurbished, as part of Royal Mail's largest ever programme to make delivery offices fit

for purpose. We will tackle health and safety issues and critical space constraints in these offices.

- 4.17 The distribution network will be reconfigured to adjust to the new transport legislation. This will put back arrival times at delivery offices by one hour, however we do not expect to change the last delivery time. Royal Mail estimates that it will cost £57 million per year to comply with the legislation and minimise the impact on quality.

More efficient, automated and smoother flow of mail

- 4.18 Royal Mail will have a more efficient, automated and smoother flow of mail. Today's manually intensive operation with low levels of automation, inefficient flow of mail through the network and large variations in performance between delivery offices and mail centres, and inefficient support services will be transformed through automation, materials handling solutions and new working practices.
- 4.19 In collections, the majority of business and post office mail will be containerised and presented by format, with very few bags of mixed mail arriving at mail centres needing to be tipped. This will reduce manually intensive and costly tasks such as bag opening.
- 4.20 In processing, the percentage of letters sorted to walk across the network will rise from 50% today to 85%, with a 'one pass, one pass' sort plan enabled through walk sequencing. Deliveries to businesses will be sequenced in mail centres. Automated sorting of flats will increase to 70% of 1c and 100% of 2c mail, through the installation of 29 more flat sorting machines.
- 4.21 The mail centre network will provide the flexibility to continue to offer a first class service to the same specification as today, despite new working time and vehicle speed directives described above which will add at least one hour to national distribution time windows.
- 4.22 The pre-sort network will be almost entirely bag-less, with low-tech conveyors smoothing the flow of containerised mail through RDCs and mail centres.
- 4.23 In delivery, the large variations in performance between delivery offices will reduce through a programme to transfer best practices as part of the more efficient approach to delivering the mail. Almost 1,000 walk sequencing machines will be installed. New mechanical delivery methods (such as motorised trolleys) will be introduced.
- 4.24 Overhead costs will be streamlined significantly, with every component of Royal Mail's support services having been examined and tested for efficiency and effectiveness. As a result of its regular reviews of vehicle expenditure, Royal Mail has determined that it is optimal to purchase vehicles instead of leasing them — these purchases will require approximately £0.5 billion of spend over the price control period.

ENGAGING AND MOTIVATING OUR PEOPLE

- 4.25 Royal Mail will enable the business transformation by continuing to invest in our people, and by increasing colleague engagement and motivation. We will tackle head on today's situation of low morale, uneven management quality, trade union suspicion and high levels of unauthorised absence and attrition.
- 4.26 In order to equip our colleagues to execute this business transformation, training will be increased by 6 days per year, with training focused on functional, behavioural and health and safety topics.
- 4.27 Unauthorised absence rates and attrition rates will continue to be targeted for reduction, delivering incremental cost savings to the business and further improving quality and productivity.
- 4.28 People-related efficiencies will be realised taking advantage of natural attrition where possible and, beyond this, through the launch of a focused voluntary redundancy programme.
- 4.29 Management performance will be significantly upgraded through a new management review programme which will increase the capability of Royal Mail's managers to identify, coach and eventually manage-out poor performers. This program will involve behavioural training, 360-degree feedback and performance management, and a substantial injection of new talent.

TRANSFORMING THE CUSTOMER OFFER

- 4.30 Royal Mail will offer a market leading set of products and services defined around our customer needs rather than our operations requirements.
- 4.31 Royal Mail's customer proposition will be based on products that enable our customers to communicate and deliver effectively. We will leverage the trusted brands we already possess — including First Class and Special Delivery — while innovating across the entire product range.
- 4.32 The development of this new customer-oriented product portfolio will require the transformation of not only every major product category but also our innovation process itself. A static product portfolio will be replaced with dynamic product clusters, centred upon the needs of particular customers and services. Product specifications will become flexible, changing as the needs of our customers develop. This will require ongoing support in listening to customers, interpreting their needs into concrete, viable and efficient products, and communicating the advantages of product innovations back to the market.
- 4.33 As part of our renewed product range we will offer a new range of service options to meet customer needs including a new portfolio of packet products, and a range of secure services and data services for social and business customers.
- 4.34 Royal Mail's product strategy will be underpinned by a much more granular and cost reflective 'Pricing Roadmap' that includes, among others, pricing by size, delivery density, payment channel, speed and mailing volume. This new granularity in pricing is a crucial

requirement since the way we have priced historically combined with the constraints of the universal service obligation mean that today's prices are out of line with our costs, exposing Royal Mail to 'cream skimming' competition in most profitable segments and undermining our ability to provide a universal service at sustainable costs.

- 4.35 We will reinforce the competitiveness of our products and prices by radically transforming our service to customers, making it easier to do business with us and ensuring that we get paid on time for the services we provide.
- 4.36 We will engage with Postcomm to support our transformation through a narrower definition of the USO and revised terms of the price control that together permit greater and more appropriate commercial flexibility in rebalancing prices and introducing product innovations quickly, making market liberalisation a success for both customers and new postal operators.
- 4.37 We will increase marketing support in order to learn from our customers' needs and to educate our customers on Royal Mail's constantly evolving product portfolio. We will also implement product and pricing initiatives such as Pricing in Proportion and Order to Cash that are required to deliver our transformed customer offer via our salesforce, our colleagues in Post Office Ltd, and direct communication with our customers.

INTEGRATED NATURE OF THE STRATEGIC PLAN

- 4.38 Royal Mail's strategic plan consists of a number of inter-linked elements that will all be required to meet the business challenges and objectives of industry stakeholders. It is contingent upon making significant change in every stage of the network. This will be enabled by colleagues who are engaged and motivated to transform business performance.
- 4.39 The initiatives to deliver the strategic plan are strongly inter-linked. Key examples of the inter-dependencies in the plan include:
- The move to improved efficiency in deliveries with an increasing shift to a part time workforce is dependent on the implementation of walk sequencing, and is necessary to capture the savings from increased utilisation of letter sorting equipment in the mail centres and from the transfer of best practices in delivery offices.
 - It is difficult to reach 85% of letters being walk sorted in the mail centres without a 'one-pass one-pass' sorting scheme which minimises the number of sort plan changes in the inward mail centres. Such a sorting scheme can only be achieved if walk sequencing is enabled in the delivery offices. Likewise, walk sequencing is more effective if more letters are kept in the mechanical stream in the mail centres.
 - The scale of change required to implement the integrated operational plan can only be completed if Royal Mail colleagues are engaged and motivated.
- 4.40 The strategic plan will be deployed in a coordinated and focused fashion to ensure that the savings are fully captured, the impact of the plan on Royal Mail's people is carefully controlled and the operational impact is minimised.

- 4.41 Only with this strategic plan can Royal Mail deliver its vision for the business and so ensure its commercial viability. Royal Mail's success will ensure a thriving and competitive postal industry and the maintenance of the USO.

FINANCIAL IMPLICATIONS OF ROYAL MAIL'S STRATEGIC PLAN

- 4.42 The strategic plan requires investment of £2.2 billion (comprising £1.6 billion of capital expenditure and £0.6 billion of one-off costs) and will deliver consistent quality of service to Royal Mail's customers and annual cost savings of £0.3 billion by 2009/10.
- 4.43 With an appropriate regulatory settlement (as discussed in the following chapters) the strategic plan will create a financially sustainable and viable Royal Mail.

CONCLUSION

- 4.44 Implementation of the strategic plan will result in a successful Royal Mail and a thriving UK postal industry:
- The USO would be preserved through productivity improvements.
 - Royal Mail and new entrants will compete through innovation and development of new products that meet customer requirements.
 - Royal Mail colleagues will be involved and engaged in their company and feel confident in the security of their employment and retirement benefits.
 - Competitors will have access to a state of the art network and infrastructure.
 - Once the transformation of Royal Mail's domestic business is complete, it will be well positioned for 'step out' moves to participate in the broader worldwide postal sector.
 - The shareholder will make a return on its investment that approaches a fair commercial return, although the scale of competitive entry remains a major uncertainty and a material risk to future cash flows.

5 THE PRICE AND SERVICE QUALITY REVIEW THAT A LIBERALISED MARKET REQUIRES

- 5.1 Previous chapters have set out our plans to transform Royal Mail through modernised operations, a revised product and service proposition and the deep engagement of our people. These plans underpin continued modernisation of Royal Mail and indirectly the transformation of the UK postal industry.
- 5.2 Today over 90% of Royal Mail's revenues are regulated – essentially the entirety of the Letters business except for the unaddressed Door-to-Door and International outbound and contract services. The regulatory framework shapes not only Royal Mail's operational flexibility but also the broader competitive landscape. Regulation is therefore a critical enabler of – and potentially a barrier to – change in the postal industry.
- 5.3 An ambitious vision for an innovative, competitive industry is underpinned by five objectives. The price and service quality review should embrace these objectives which we have set against the key levers of the price control as expressed by Postcomm in their proposals.
- a. **USO coverage:** The definition of universal service should be focused upon the core social offer of individual unsorted stamped mail which is priced on a uniform basis, as this is the service of general economic interest which directly underpins the use of postal services by the general public and indirectly by business (as stamped mail sets an effective ceiling on all bulk mail products).
 - b. **Coverage of price control:** The scope of price regulation should, over time, be restricted to those services within the core USO definition, as efficient competition is the most effective way of setting market prices which benefit consumers following the establishment of rebalanced cost reflective prices. While Royal Mail accepts that for some time the scope of price control will be substantially broader than that due to Royal Mail's market share, the overriding presumption is that the scope of price control should diminish over time rather than broaden. Therefore, downstream access should continue to develop through commercial negotiations between commercial operators, with no ex-ante role for regulation as this is consistent with our belief that the scope of price control should be reduced not broadened and that as far as possible the market should be allowed to set prices. The fact that downstream access contracts have been successfully negotiated at arm's length, and the consequential rapid switch of customers from Royal Mail's retail products into access, demonstrate beyond doubt that the downstream access market is working satisfactorily. We also expect delivery competition to develop rapidly in urban areas from January 2006. Downstream access will then be a competitive market.
 - c. **Structure of the price control:** To the extent that a controlling prices other than the stamp price is necessary, the structure of the price control should meet customer needs by promoting efficient competitive entry, encouraging prices that reflect economic costs through a single basket and facilitating product innovation by Royal Mail.

- d. **Approach to finance:** The commercial independence and financial viability of Royal Mail needs to be ensured within a competitive environment, by ensuring that the price control sets a level of allowed revenue that meets both a reasonable return for investment undertaken by the shareholder and standard tests of financeability ratios, manages the financial exposure of industrial action, quality of service, volume loss to entrants and pensions directly and leaves the reopening clause as the third and final fall-back lever. This should be undertaken with a standard regulatory framework where the opening regulatory value reflects the tangible and intangible costs of entry.
- e. **Quality of service:** The scope of quality of service regulation should be limited to those areas that are unlikely to be subject to competition. It should not be more punitive than in other regulated industries and, as in other industries, have incentives to outperform in addition to penalties for underperformance. It should also retain the assumption that Royal Mail has undertaken all reasonable endeavours until proven otherwise.

5.4 Below we outline each of these objectives in detail.

5.5 While we welcome the fact that many of Postcomm's stated objectives are consistent with this framework, we believe that many of its specific proposals are inconsistent with its stated objectives. As we will demonstrate, the proposed regulatory framework falls short of meeting these objectives and so threatens to impede the efficient development of the industry by inhibiting Royal Mail's transformation and by distorting the competitive landscape.

USO COVERAGE: THE DEFINITION OF UNIVERSAL SERVICE SHOULD BE FOCUSED UPON THE CORE OFFER OF STAMPED MAIL

5.6 Royal Mail is the universal service provider of postal services in the U.K. and looks forward to continuing to play this role as the market becomes more competitive. The 'everyday, everywhere' collection and delivery service forms the bedrock of our operation. We believe that the definition of the universal service should focus upon the core offer of stamped mail since this is the heart of the 'available to everyone' service. Inevitably, stamped mail has a considerable indirect effect on the prices of bulk mail services in that it creates a ceiling under which all business mail prices must remain. For other market sectors the geographically uniform price that is required by the universal service would create distortions and encourage inefficient competitive entry which would be the anathema of the free competitive market which Postcomm seeks to encourage. All business products should therefore be removed from the definition of the universal service.

5.7 The requirement to collect and deliver every working day to every address substantially drives the cost of Royal Mail's national network. Rival companies are not required to make a delivery every day and they can provide a collection and delivery service with substantially lower cost than Royal Mail's simply by clustering delivery walks in certain areas – primarily non-urban ones – on selected days of the week. This gives rivals savings on the fixed cost of the postman's walk. Rivals can make further savings by not delivering – as Royal Mail does – to the door but instead deliver mail to clusters of roadside boxes, as happens in many other countries.

- 5.8 Royal Mail's 'last mile' delivery costs per letter are much lower in dense urban areas (9.2 pence per item) than in non-dense deep rural areas (19.3 pence per item).
- 5.9 In consequence any uniform tariff results in a cross subsidy from those posting to urban destinations to those posting to rural destinations, encouraging excessive entry in urban delivery and too little entry in rural areas. This distorts the competitive market.
- 5.10 While the universal service with geographically uniform pricing is perceived therefore to benefit UK postal customers it also drives substantial costs into the network and creates strong distortions in the competitive market. This has two implications for the regulatory treatment of the universal service — its scope should be narrowed and products within it should cover the true economic costs of providing the service.
- 5.11 We believe that the definition of the universal service should be focused upon the core social offer — namely individual unsorted stamped mail — which is unlikely to be attractive to competition in the short to medium term.⁸ Products that are likely to be competitive should be removed from the universal service definition in order to minimise distortions in the competitive marketplace. In particular this implies that all bulk mail should be immediately removed from the definition of the universal service as it is already exposed to significant competition:
- Mailsort 2 – the core 2 to 3 day bulk offering used primarily for statements – is already migrating rapidly to downstream access through third party intermediaries such as UK Mail, DHL and TNT. By year end 2005/06 we expect to have lost 20% of Mailsort 2 to downstream access (approximately a billion items) after only two years of competition.
 - Mailsort 3 – the slow speed 7 day bulk offer used primarily for direct mail – is highly vulnerable to competitors setting up their own end-to-end networks and delivering only 2 or 3 days a week so substantially reducing their cost structure relative to our USO-driven delivery costs. This is essentially the model that Citymail have adopted in Sweden where they hold at least a 25% share of their addressable market (bulk presorted mail to 3 major cities). Postcomm shares our view on the vulnerability of Mailsort 3 to bypass competition:

“Royal Mail will lose significant volumes of third class mail...most third class mail lost to competitors will be provided by competing end-to-end networks and not by use of Royal Mail's downstream access products.”⁹
 - Other bulk products — such as Presstream — are also highly vulnerable both to postal competition and to competition from outside the industry (e.g., retailers selling magazines).
- 5.12 Removing bulk products from the universal service definition is also entirely consistent with developments overseas, for example in the Netherlands and Sweden.
- 5.13 Postcomm appears to agree that the definition of the universal service should only include products that are widely available:

⁸ In addition there is a USO requirement to provide a registered and insured product.

⁹ Postcomm's initial proposals on price control, June 2005, Appendix 3.55.

“a service available to everyone — with no restrictions on who may access the service, subject only to the payment of the ‘affordable tariff’”¹⁰

and suggests that competitive products should lie outside the definition of the universal service:

“Once competition has developed...it might be appropriate to review the universal service obligation with a view to narrowing it to provide (as currently seems to be the case for parcels, for example) a more basic level of service leaving it to the competitive market to provide customers with a choice of services, including services provided by Royal Mail outside its universal service obligation.”¹¹

- 5.14 Postcomm recently published its decision document on the definition of the USO.¹² This proposed that essentially all letters products will remain within the definition of the universal service except:
- Mailsort 3 (“economy” product)
 - Presstream (used by publishers, so not for “everyone”)
 - Mailsort 120 and Mailsort 700
 - Downstream access
- 5.15 Disappointingly, despite the statements made above, Postcomm proposes leaving significant bulk mail products, such as Mailsort 2 1400, inside the definition of the universal service area.
- 5.16 However this product does not meet Postcomm’s stated criteria of being “a service available to everyone”. It is not available to all users as it has a minimum posting requirement of 4,000 items. Less than 2% of Royal Mail customers could meet the volume requirements necessary to use this product. Mailsort 2 1400 requires a high degree of pre-sortation which inevitably limits the scope of its potential customer base even further. In addition, Mailsort 2 1400 is in a highly competitive area, with Royal Mail projecting a 20% market share loss to downstream access by the year end.
- 5.17 Furthermore, leaving Mailsort 2 1400 inside the USO effectively rules out zonal pricing on any Mailsort 2 service, including the 120 and 700 selections that Postcomm has “removed” from the USO. This is because any zonal city discounts on 120 or 700 would suck in large scale volumes of urban 1400 mail, while rural surcharges on 120 or 700 would not be sustainable in the market as users would simply switch into the geographically uniform 1400 service. In other words, the fact that Mailsort 2 120, 700 and 1400 are completely substitutable for each other means that it is not possible to sustain both uniform and de-averaged pricing structures simultaneously in the market place. Users can simply arbitrage between products using lower, de-averaged prices in high density areas and the uniform price in low density areas.

¹⁰ Postcomm’s consultation document on universal postal service, April 2003, paragraph 2.26.

¹¹ Postcomm’s consultation document on universal postal service, April 2003, paragraph 3.16.

¹² “The universal service for bulk mailers: A decision document”, Postcomm, June 2005.

- 5.18 Postcomm's decision on the definition of the USO will therefore effectively block any zonal pricing of Mailsort 2 and potentially, by extension, block any zonal pricing of access if the pricing regimes for retail and wholesale products are linked in the way Postcomm implies. This will perpetuate prices being out of line with costs and promote inefficient entry. Similarly Postcomm's decision to retain full tariff account mail in the USO will block cost reflective delivery zone pricing and subsidise urban cherry picking by DHL, DX and others. Overall Postcomm's definition of the USO is unreasonably broad and is inconsistent with Postcomm's own stated principles of cost reflective pricing to encourage efficient entry into the market.
- 5.19 In order to encourage efficient competition it is essential that USO prices should cover economic USO costs. As we have outlined above the requirement to collect and deliver every day to every address substantially drives the cost of our network — indeed, we provisionally estimate that to provide just stamped mail as the universal service would itself require a largely unchanged network of more than 60 (albeit smaller) mail centres and over 1,000 (again, smaller) delivery offices with costs amounting to at least £1.5bn per annum. Another way of putting this is to say that if Mailsort and other bulk business mail products were removed from the universal service definition, the core network required to deliver social mail would be largely unchanged and only the incremental costs of Mailsort (including marginal costs and some Mailsort-specific costs such as the RDC network and bulk business collections) would be recovered.
- 5.20 This "USO costing" approach is entirely consistent with the approach adopted by the European Commission when considering the lawfulness of the methodology used by Deutsche Poste when pricing non-USO mail order parcels. The EC decided that:
- "Deutsche Post is required only to cover the costs attributable to the provision of mail-order parcel services. This means that these operations are not burdened with the common fixed cost of providing network capacity that Deutsche Post incurs as a result of its statutory universal service obligation"*¹³
- Those costs include the need to maintain a network that has capacity to handle the peaks and troughs of mail flows. This case therefore represents a clear precedent to support the assessment that non-USO products should be costed and may then be priced incrementally against a core USO network.
- 5.21 Preliminary analysis applying a number of variants of the "USO costing" approach to Royal Mail indicates a basic weight step stamp price of around 47 pence for First Class and around 39 pence for Second Class – but nonetheless Royal Mail is not asking for these prices. The economic USO cost of stamped mail is therefore substantially higher than current costing systems suggest (35 pence for First Class and 28 pence for Second Class) and certainly higher than today's prices (30 pence and 21 pence respectively). Through time therefore we believe that stamp prices should be moved upwards to reflect true USO costs.

¹³ European Commission (2001): (Case competition/35.141 – Deutsche Post AG).

COVERAGE OF PRICE CONTROL: THE SCOPE OF REGULATION SHOULD BE REDUCED OVER TIME TO COVER ONLY CORE UNIVERSAL SERVICES AND NOT EXTENDED

- 5.22 We believe that the scope of ex ante regulation should be as narrow as possible since regulation itself imposes a burden on the industry both through its direct costs and through the distortions it can create in the marketplace. Wherever possible therefore ex post competition law is a more appropriate mechanism for protecting customer interests than burdensome ex ante regulation (for example price and service quality control). The scope of regulation should over time be restricted to the core USO area (which we believe should be restricted to individual unsorted stamped mail) once prices have been rebalanced to reflect economic costs within a single basket.
- 5.23 This is consistent with Ofcom’s approach: *“The recent wide scale withdrawal of regulation from BT’s retail business...is in line with the strategy adopted by the European Commission, which is to impose ex ante regulation only in those markets characterised by high and non transitory entry barriers, where the emergence of effective competition is not foreseeable and where the application of ex post controls would not be sufficient to address identified market failures.”*¹⁴ We are pleased that Postcomm appears to share partially this aspiration: *“Postcomm does not believe it should price control products where competition is providing genuine choice and protecting the interests of consumers”*¹⁵.
- 5.24 In practice therefore we believe that customers’ interests will be best served by achieving a narrow scope of regulation that is restricted over time to the core USO product of unsorted stamp mail – the enduring “economic bottleneck” of the network. With stamp prices controlled there is no need to regulate business prices since these are limited by competition and (in the limit for business prices to rural recipients) by the stamp price itself.

Table 6 – Summary of Royal Mail coverage position

	USO services	Regulated Services	Non-Regulated Services
Provision of information to users of postal services (Condition 7)	✓	×	×
Promotion of effective competition (‘Condition 11’)	✓	✓	×
Obligation to continue to offer and provide regulated services (‘Condition 19(1)’)	✓	✓	×
Prices for postal services (‘Condition 19’)	✓	×	×

- 5.25 In the immediate term we see opportunities to limit the scope of price regulation as follows:
- Mailsort 2 is clearly subject to competition from end-to-end competition and to DSA and is “replicable” (in Ofcom’s language) by competitors who can bundle DSA with

¹⁴ BT’s pricing of services for business customers: statement published by Ofcom, 2005.

¹⁵ Postcomm’s Price Control Proposals, June 2005, p. 12.

upstream collection and trunking services.¹⁶ We therefore expect to see the withdrawal of ex-ante regulation in the highly competitive large business market. Examples of this withdrawal include: non publication and non notification of prices (and Royal Mail to be able to depart from published prices) in respect of bids for tenders and e-auctions for the provision of services to large businesses; and eventually the removal of Mailsort 2 once prices have been rebalanced to reflect economic costs.

- Mailsort 3 is (as we have outlined above) highly vulnerable both to postal competition and to media users switching into other advertising formats, so the withdrawal should include non publication and non notification of prices (and Royal Mail to be able to depart from published prices) in respect of bids for tenders and e-auctions for the provision of services to large businesses and eventually the removal of Mailsort 3 once prices have been rebalanced to reflect economic costs.

5.26 We welcome Postcomm's recent proposals to remove from the price control Presstream (which is subject to competition from other forms of publishing content distribution) and account Special Delivery, which competes with other players' express products. Of course the removal of Presstream and account Special Delivery from the price control will in practice offer Royal Mail minimal additional pricing flexibility, since customers can easily switch into (or from) Mailsort 1400 and retail Special Delivery. Their exclusion also restricts the potential scope to rebalance prices of controlled services, but only to a limited degree relative to the case with their inclusion within the control.

5.27 Unfortunately, however, Postcomm's recent proposals still leave the scope of ex ante regulation very broad and they seek to extend it further by bringing downstream access into the price control.

5.28 In summary the current regulatory framework has an excessively broad scope — and an increasingly broad scope despite the advent of competition. A substantial narrowing of the scope of regulation is required to reduce regulation to the "light touch" form that Postcomm advocates and that it should have in a market that is rapidly becoming competitive

*"Postcomm does not believe it should price control products where competition is providing genuine choice and protecting the interests of consumers"*¹⁷

5.29 Consistent with our approach we believe that the scope of regulation should not increase and that the market should best determine outcomes where possible. Indeed, Postcomm state that their wish is:

"To regulate (price and quality of service) only where it is necessary to safeguard customers' interests." (§2.2)

5.30 We agree with this conclusion, which is why we believe that downstream access should continue to innovate and grow outside of the price control through negotiations between willing parties.

¹⁶ Ofcom has stated that it will allow players with market power to have flexibility over pricing for large businesses even in markets where they have significant market power, if competitors are able to replicate the retail products by buying suitable wholesale products. "BT's pricing of services for business customers: statement published by Ofcom", 2005.

¹⁷ Postcomm's Price Control Proposals, June 2005, p. 12

- 5.31 Over the past 18 months Royal Mail has signed a number of downstream access contracts with the following parties: UK Mail, TNT Mail, Deutsche Post GBL Mail UK Ltd., Regional Mail Services, T Mobile UK Ltd., Royal Bank of Scotland Group, NTL Communications Ltd., Lloyds TSB Bank PLC.
- 5.32 These contracts were negotiated at arms length without the need for regulatory intervention. Each contract includes an agreed formula for price escalation,¹⁸ and provisions for compensation in the event of quality of service failure. Contracts have evolved quickly. Many variants are now available and, in particular, geographically priced contracts based on the actual costs of delivery are proving popular with mailers targeting specific parts of the country. Such zonal prices are in accordance with Postcomm's stated policy that access prices should be calculated "bottom up" and related to actual costs.¹⁹
- 5.33 However, Postcomm now proposes to include downstream access products within the price control area and to impose a punitive quality of service compensation regime on them. This is despite Postcomm's stated views that:
- "Access agreements with Royal mail are good for customers, who are offered more choice and innovation, and good for Royal Mail which is paid a fair price for final delivery."*²⁰
- "Postcomm had always hoped that access agreements would be negotiated by the parties involved rather than having to be imposed by us, so it is good news to see the industry moving decisively towards taking responsibility for its own commercial arrangements"*²¹
- "...average [access] prices between Royal Mail and UK Mail are very close to those which Postcomm would have proposed, and are within the margin of judgement inherent in such calculations."*²²
- 5.34 Postcomm has not provided any rationale for what represents a substantial reversal of its previous position. Under Postcomm's proposals for the definition of the universal service in practice this would require Royal Mail to remove the geographically non-uniform access prices and to override contracts that have already been agreed with customers. Clearly in this eventuality Postcomm would be requiring Royal Mail to make access prices less cost reflective.
- 5.35 In summary there is a vibrant market emerging without the need for any regulatory intervention. We expect that close to 20% of Mailsort 2 will have switched to DSA by year end 2005/06, almost a billion items, at prices and conditions which already satisfy the needs of the market's participants. Furthermore, we expect competition in delivery to develop rapidly in urban areas after January 2006. Access will then be competing in an open, competitive delivery market. Given the vibrancy of this market under bilateral

¹⁸ Although all current access contracts allow Royal Mail to increase prices by RPI-1 each year, in April 2005 Royal Mail actually reduced prices.

¹⁹ Para 8.36 – 8.39. Postcomm's "Notice of a proposed direction to Royal Mail on downstream access, by UK Mail, to Royal Mail's postal facilities. May 2003.

²⁰ *Martin Stanley, Chief Executive of Postcomm quoted in a Postcomm, press release (7 April 2004)*

²¹ "Postcomm welcomes Access Heads of Terms", 17th December 2003.

²² "Postcomm publishes its observations on Royal Mail's access agreements with UK Mail Ltd.", 31st March 2004.

contracting there is no case for introducing additional regulation which can only slow the pace of innovation in this emerging new sector.

STRUCTURE: THE STRUCTURE OF THE PRICE CONTROL SHOULD MEET CUSTOMER NEEDS BY PROMOTING EFFICIENT COMPETITION SUPPORTED BY COST REFLECTIVE PRICES AND BY ENCOURAGING VIGOROUS INNOVATION

5.36 Royal Mail believes that a vibrant competitive market benefits postal customers by providing choice and encouraging innovation by all players. However, we also believe that it is critical that entry occurs based on efficient economic signals, and not simply based on exploiting misalignments between prices and costs created by historical and universal service constraints. We believe that regulation should support a framework that allows market players to innovate and so respond to customer needs for new products and to rebalance prices towards costs.

Innovation

5.37 For the benefit of Royal Mail, the industry and the UK economy the regulatory environment must support innovation. By innovation we mean the ability to develop and deploy services that satisfy customer requirements flexibly and quickly. Innovation is critical for three reasons:

- Royal Mail does not operate in a zero-sum game where market size is pre-determined such that every pound of revenue lost by RM is a pound gained by competitors. On the contrary excellent customer service and products that meet customers' needs will play a critical role in expanding overall market size.
- As competition evolves there will be changes in technologies and user needs causing product life cycles to shorten. Speed and flexibility will become critical to a company's survival.
- Given the role of postal services in the UK economy, innovation in this sector is important to the UK's economic performance.

5.38 Evidence from Royal Mail customers suggests that there is an increasing requirement for a broad spectrum of products and services at a range of price points to meet a wide set of customer applications of mail. Customers are demanding more sophisticated pricing options and simplified purchasing processes. Royal Mail's Product and Pricing Roadmaps as well as specific projects and programmes within the strategic plan such as "Easy to do Business With" and "Order to Cash" are our initial responses to these customer requirements.

5.39 There is a trade-off between low prices today and faster introduction of new products and services in the future. The latter is critical for the postal market to grow given the threat of e-substitution that has resulted in decreasing postal volumes in many European countries. In the last few years this adverse impact has been countered in the UK by the growth of direct mail and fulfilment. Royal Mail played a key role in expanding these new markets. Direct mail may now be in long-term decline and the industry will have to find innovative ways to grow revenue.

5.40 From a regulatory perspective, innovation means having the opportunity to evolve products and services that are within the control both in price and non price terms. In practical terms this means that the industry needs a framework to cover the following innovations:

- *Development of replacement services:* We fully accept that the ability to evolve standard products should not be seen as an opportunity to evade a price control. In developing a service that is effectively a replacement of an existing service, we would want the existing service to be removed from the control and the new service to take its place. This process must be clear, quick and simple.
- *Removal of a replaced service:* In developing a product that is a direct substitute of an existing service, we would expect a high percentage of customers to migrate to the new service and the old service to be withdrawn. We acknowledge that for the service to be withdrawn, the new service should pass a substitution test that must be clearly defined. This test however must acknowledge that the new service may not necessarily be better in all respects and for all customers.
- *Introduction of new products:* The framework should allow Royal Mail to introduce *new products* with appropriate commercial freedom and without the automatic prospect of price or quality regulation — such as downstream access and Mailmedia.

5.41 Postcomm's processes as applied within the current regulatory framework stifle innovation through delay and uncertainty. Furthermore the regulator's recent proposals do nothing to improve the incentives to innovate:

- The process for making changes to structural changes to prices is tortuous. Although Postcomm specifically included a provision in the licence in April 2003 for the introduction of "Pricing in Proportion" and Royal Mail submitted an application within four months of the control commencing, implementation has not been allowed until four months after the start of the next control August 2006. When Royal Mail has an active interest in getting pricing in proportion in place — as evidenced by the early application — Postcomm needs to take more responsibility for the time delay that follows. Postcomm's proposals to introduce a maximum 12 month limit are too modest — a limit of 3 months maximum would be appropriate in the current competitive environment combined with a move to a clearer, rules-based approach.
- Postcomm is not addressing Royal Mail's concerns over the definition of materiality relating to non-price terms. Instead it is also proposing that this transfers from the current ex-post to an ex-ante regulation where, if Royal Mail wishes to change its non-price terms and conditions it should seek Postwatch's agreement to the changes. If Royal Mail and Postwatch agree to changes to non-price terms and conditions, Royal Mail would inform Postcomm of the agreement and Postcomm would then have a month to decide whether it wanted to veto the change or if it required further consultation before a decision could be made. These proposals add an unnecessary double regulatory burden and will substantially discourage innovation. It is entirely inappropriate for Postwatch to play the role Postcomm proposes. It should be Postcomm's role alone to review such changes to avoid duplication and this should be undertaken ex-post as is currently the case.

- Postcomm allows new products to be introduced outside the price control, but then is proposing to bring downstream access within the control. This instinct to expand the scope of regulation seems inconsistent with its stated position.
- 5.42 In summary Postcomm’s application of the current and proposed regulatory framework unreasonably restricts our ability to innovate and make the radical improvements to the product and price offer that our customers require.

Cost reflective price rebalancing

5.43 Royal Mail believes that it is critical that market entry occurs based on efficient economic signals, and not simply to exploit misalignments between prices and costs created by historical and USO constraints. Postcomm agrees: “... *Postcomm believes that viable competition in the long-run must be based on genuine efficiency, innovation and customer service, and not on business models that rely on Royal Mail’s prices being out of line with its costs.*” (5.48) Inefficient competition will simply result in excessive entry into select market segments — e.g., urban deliveries — and no entry into other segments — e.g., rural deliveries. This has been experienced in other deregulating industries where prices were not aligned with costs upfront, such as electricity where misalignments encouraged rapid and duplicative investment in generation.

5.44 The principle of efficient entry is supported by the EU Postal Services Directive, which requires prices to be “*geared to costs*”. We are pleased to see that Postcomm appears to share the same aspiration for efficient entry:

*“Postcomm has consistently said that...it supports the principles of cost reflective pricing. This ensures that there are appropriate signals for greater efficiency.”*²³

5.45 As we set out in Chapter 3, for historical reasons and because of the universal service, Royal Mail’s prices are substantially out of line with costs. We are seeking to align prices with costs along a number of dimensions, including:

- **Size:** We will be introducing “Pricing in Proportion” in August 2006 to move pricing more in line with size than weight.
- **Channel:** We have begun to introduce channel differentials in pricing for first class mail (though not yet second class): 30 pence for stamp, 29 pence for meter and account. However true cost reflectivity will require much larger differentials between stamp, meter and account to reflect existing costing system differences and ultimately true USO costs as outlined above. We believe that stamp prices will need to rise to at least 39 pence and 29 pence for First and Second Class respectively by 2009/10.
- **Delivery zone:** We have begun to introduce delivery zone pricing differentials on downstream access services, but Postcomm’s USO definition would prevent us from applying similar differentials on bulk retail products such as Mailsort and potentially on all products. It is important that we have the flexibility to preserve zonal pricing on downstream access and to extend zonal pricing to all bulk retail products and eventually to full tariff account mail as well.

²³ Postcomm’s Price Control Proposals, June 2005, p. 74

- **Speed:** We are seeking to preserve and extend differentials between the classes of mail, and the removal of Mailsort 3 from the USO should facilitate this process. We have begun to develop some work on “class costing” (see Annex 9) to try to assess how a more economically-driven approach to costing might change cost allocations by speed of mail. We believe this could be of crucial importance to sending the right economic signals in the market, and we look forward to developing these approaches with Postcomm over the coming months. As a consequence of the investments made in sortation equipment the cost of products is increasingly determined by whether an item is machineable or manual. For example, the full cost differential between a machineable and manual letter can range between 8-10 pence per item for identical size items. Therefore as more mechanisation is brought in over time it is essential that Royal Mail be able to adjust prices in line with these evolving costs.

5.46 Despite our efforts to align prices with costs, essentially all the market entry that has occurred so far and all the prospective entry is of the “cherry picking” variety. For example:

- **Channel:** Downstream access competitors such as UK Mail are targeting our top 200 business account customers who hold a disproportionate share of mail (our top 10 customers post some 3.5 billion items a year, or 17% of our total volumes).
- **Delivery zone:** DHL is building delivery networks in major cities allowing it to offer a service to “designated postcodes” only in London and the North West (including Manchester, Liverpool, Stockport and Warrington). We are not aware of any plans by DHL to offer a universal “deliver everywhere” service. Similarly DX offers a city-to-city doorstep delivery service to selected business addresses.
- **Speed:** As we describe above Mailsort 3 is highly vulnerable to competitors setting up alternate-day delivery networks that save on the fixed costs of the postman’s walk.

5.47 We believe therefore that it is critical that we are given the commercial flexibility to continue to move prices in line with costs. This is entirely consistent with best practice in other regulated industries where it is recognized that moving prices toward costs should occur *before* full market liberalization:

“Rate re-balancing occurs when prices are aligned more closely with incremental production costs. Ideally, the desired rate re-balancing should be completed at the outset of the liberalization process in order to provide appropriate signals to potential competitors about their likely returns from long-term industry operation.”²⁴

5.48 The proposed regulatory framework makes it extremely difficult, burdensome and slow for Royal Mail to move prices towards costs.

- Postcomm proposes the introduction of two tariff baskets, one for “captive” mail (e.g. 1st class public tariff, 2nd class stamped, standard parcel) with an RPI-3 cap and one for “non-captive” mail (e.g. Cleanmail, most Mailsort, Special Delivery) with an RPI-2 cap (plus separate baskets for access and miscellaneous services) although its calculations for the level of control and X-values contain four baskets (additionally,

²⁴ Mark Armstrong and David Sappington, “Regulation, competition and liberalization”, 2004, mimeo.

access at RPI-6.9% and miscellaneous services at RPI-3%). This effectively blocks cost reflective rebalancing between social and business customers, and will perpetuate losses on stamped mail (since it might not be possible to apply the maximum allowed prices of 34 pence for First Class stamps and 23 pence for Second Class stamps by 2009/10 under these proposals)

- The proposals will block any meaningful zonalisation of business retail prices by the density of delivery area and will force Royal Mail to reverse its introduction of zonal pricing on DSA which has been taken up through privately agreed contracts. This is because Mailsort 1400 will remain in the USO so effectively ruling out zonal pricing of Mailsort 120 and 700, while Postcomm's proposals on access margins will also force the access price to be geographically uniform – *"It is proposing that the margin available for each access product should not be based on zonal differences for so long as the equivalent bulk mail product is priced on a geographically uniform basis."*²⁵

5.49 The result of this framework will be the following:

- Prices will continue to be out of line with economic costs and costs developed within our costing system
- There will be an increased burden on UK businesses as they continue to cross-subsidise social customers
- Prices not aligned to costs will promote inefficient competition that will raise industry unit costs and ultimately put at risk the universal service (with DSA focusing only on business customers and bypass networks developing only in cities).

APPROACH TO FINANCE: THE APPROACH TO FINANCE SHOULD ENSURE THE PROVISION OF THE UNIVERSAL SERVICE THROUGH APPROPRIATE RETURNS ON INVESTMENT AND DIRECTLY ADDRESS THE RISKS FACED BY THE BUSINESS.

5.50 Following its decision to fully open the market to competition, it is imperative that Postcomm ensure the provision of the universal service and the commercial independence and financial viability of Royal Mail. Therefore it is essential that the shareholder should receive a reasonable commercial return on its investments making and the risks it is assuming. This should be undertaken within a standard regulatory framework where the opening regulatory value reflects the tangible and intangible costs of entry.

Regulatory Capital Value

5.51 Postcomm state that it wants a regulatory regime that appropriately compensates investors:

"Retaining and attracting investment. It is important that any opening value is sufficient to recompense investors for the funds they have put into the business and thereby attract future investment into the business" (§7.46)

²⁵ Postcomm's proposals, para 4.45.

and which provides correct entry incentives:

"If an opening regulated asset base is set at a level that does not reflect the reasonable costs of setting up a comparable network and business, the maximum prices that Royal Mail will be able to set under the price control will be insufficient for new entrants to enter the market with the prospects of making a reasonable return." (§7.46)

5.52 Postcomm's statements recognise that Royal Mail is a valuable national asset and that the applied regulation needs to appropriately reward investment and encourage appropriate economic signals – thus promoting an efficient and competitive market. However, Postcomm then derives its RCV on the basis of tangible assets only and values the Letters business at just £2.2 billion.

5.53 This position is inconsistent with Postcomm's stated view that:

"Royal Mail's brand value [...] is significant across a wide range of customers and postal users. This has been borne out by Postcomm's market research. Royal Mail's brand benefits from having a universal coverage. A further brand benefit might be derived from Royal Mail's universal network of pillar boxes and post offices, which might contribute to promoting Royal Mail and its products. Oftel found that public telephone boxes offered a similar benefit to British Telecom".²⁶

5.54 Most significantly, Postcomm sets the intangible value of the business at zero even though it recognises in other documentation implicitly that there is an intangible value and investments are necessary to establish a market position, reputation and know how. In Royal Mail's case these investments include, inter alia, recruitment and training, customer acquisition, brand, reputation, the collective experience of our workforce, the development of our network architecture, operational support systems, management information systems and associated IT. Royal Mail provides evidence to support both the principle of including an intangible value in the asset and its application.

5.55 Royal Mail provides four approaches to estimate an intangible value relating to: (1) the royalty rate of a third party using Royal Mail to attain volume, (2) value of discounts required for entrants to attain volume, (3) the value to Royal Mail of retaining volume and (4) the costs of a 'greenfield' investment. It further defends its use of a top-down analysis as a check on the combined tangible and intangible value. Royal Mail estimates the intangible value to be at least £1.2 billion, and it could be significantly more with both the third and fourth approaches yielding estimates in excess of £2 billion.

Weighted Cost of Capital

5.56 Postcomm's real, pre-tax cost of capital of 8% is unrealistically low and does not reflect the high degree of operational leverage which our business faces due to the fixed network nature of our core USO delivery capability. Postcomm's approach ignores the standard regulatory precedent which is to take into account operational leverage factors in determining the cost of capital. It also ignores the precedent of the more recent regulatory determination for the equity risk premium and assumes a level of gearing for the WACC calculation that does not reflect that of Royal Mail's main comparators.

²⁶ Postcomm, Competitive Market Review proposals, September 2004, para 4.76.

- 5.57 Royal Mail currently estimates the pre-tax real WACC to be at least 10%. This is at the lower end of the range of 10-12% presented to Postcomm in January 2005, which included some evidence through the use of Barra Betas that the WACC of the business could be higher than 10%.
- 5.58 Combining Postcomm's RCV and WACC results in a core profit of approximately £175 million (8% x £2.2 billion). This is clearly not compatible with the range of business risks and service obligations Royal Mail faces. In contrast, Royal Mail estimates the RCV to be around £5 billion and the pre-tax real WACC to be at least 10%, resulting in a core profit of at least £500 million.

Management of risk

- 5.59 Postcomm proposes to address risk primarily through the margin set by the pre-tax core profit of approximately £175 million per annum and the scope for Royal Mail to make an application to reopen, under certain conditions, the price control should it need to.
- 5.60 Unfortunately Postcomm under-estimates the level of risk its proposals would expose Royal Mail to. These risks include:
- (a) quality of service - in the presence of changes to the level of financial exposure and the obligation for 'all reasonable endeavours' and extension to the coverage of targetry;
 - (b) industrial action - in the presence of some elements of industrial action beyond Royal Mail's control and the incentive schemes necessary to facilitate change;
 - (c) pension payments - arising from actuarial reviews and Trustee requirements;
 - (d) volume loss to entrants - in the presence of costs that are not entirely variable and separate from the market volume risk that is incorporated in the operational leveraged estimate of the WACC; and
 - (e) implementing change - arising from the need for capex spend to transform the business and the uncertainty over how any capex spend will be treated in the future.

These are all very significant risks that could seriously threaten the financial viability of the universal service before any application would be made, reviewed and proposed by Postcomm under its reopening clause. Very small changes in circumstances relative to Royal Mail's central case have a disproportionate impact on the financial position of Royal Mail, particularly given Postcomm's assumptions of allowed profit.

- 5.61 The exposure to these risks is further exacerbated by Postcomm's:
- (a) reliance on LECG's top-down econometric and total factor productivity analysis that has significant discrepancies and flaws;
 - (b) assumptions on pension payments which do not take account of required and expected payment period and the volatility of the level of payment;
 - (c) approach to the financial exposure for failure of quality of service targets that not only exceeds any regulatory precedent elsewhere and but also reverses the

current requirement for Postcomm to demonstrate that Royal Mail has not undertaken 'all reasonable endeavours' to meet the targets; and

- (d) analysis of downside risks that does not reflect the magnitude of the full scale of risks of the business in the presence of low cashflow margins.

5.62 Further, this is compounded by serious errors Postcomm has made in its modeling relating to:

- (a) its reference to a 'profit' figure of £285 million per annum which does not equate to the WACC multiplied by the RCV (8% x £2.2 billion);
- (b) it forecasting volumes in a manner that leads to overall volumes being overestimated and access volumes being under-estimated for the central case;
- (c) it assuming prices and volumes that are misaligned and an inconsistent representation of the market, and inconsistent with its own proposals, whose impact it has not modelled;
- (d) its presentation of X values that do not reflect the level of disaggregation implied in its draft LC19 modification.

5.63 The price control should be the level of allowed revenue that meets both a reasonable return on investment undertaken by the shareholder and standard tests of financial ratios. It should also manage financial exposure to industrial action, quality of service, volume loss to entrants, capex and pensions directly and leave the reopening clause as the third and final fall-back lever. This would increase the commercial independence of Royal Mail and represent good regulatory practice that would ensure provision of the universal service.

QUALITY OF SERVICE: QUALITY OF SERVICE REGULATION SHOULD BE LIMITED IN SCOPE TO ONLY THOSE AREAS THAT ARE NOT LIKELY TO BE SUBJECT TO COMPETITION AND SHOULD NOT BE MORE PUNITIVE THAN IN OTHER REGULATED INDUSTRIES.

Scope

5.64 The primary purpose of any Quality of Service regulation should be to protect the interests of customers. Customers need differing levels of protection depending on whether the product or service is open to free and efficient competition. Royal Mail believes that Quality of Service regulation should be 'light touch' and limited in scope to those areas that are not likely to be subject to competition.

- Acceptable levels of quality should be developed and their costs funded through the setting of the price control.
- Quality of service regulation is, however, necessary in those areas where Royal Mail is unlikely to face competition - essentially stamped mail. The regulator, in conjunction with the service provider and customer groupings, should decide upon appropriate levels of service quality.

- As Royal Mail products use the same networks and performance is highly correlated the regulation of quality for core products and services will also underpin quality levels for other products.
- 5.65 Specific performance conditions should be set on those businesses that are subject to Quality of Service regulation. These performance conditions should not only reflect the agreed levels of service quality, but also take into account practical considerations. In general, performance conditions should be
- Set only upon measures that are directly relevant to customers (for example, upon numbers of items meeting service levels, not upon product revenues)
 - Within the service provider's direct control (for example, they should not include international delivery);
 - Taking into account ranges of performance rather than simple pass/fail;
- 5.66 Postcomm proposes to restructure and reduce the number of transit time standards from 16 at present to 6, plus a new transit time standard for international mail. Postcomm is also proposing to introduce 3 new standards covering collection, delivery and misdelivery. Furthermore, Postcomm is proposing measurement and reporting of collection and delivery times.
- 5.67 It is appropriate for existing targets to remain based upon end-to-end transit times, as this is a major consideration for customers, and robust independent measures are in place to capture this information. Royal Mail does not object in principle to products being grouped to form weighted targets as Postcomm proposes, but believes the weights must be based on volumes and on lower targets for some areas. Royal Mail proposes revisions to some of the groupings, although we note that several of the products within these baskets are already subject to effective competition and hence should not be within the scope of regulatory performance targets.
- 5.68 The delivery of international mail is already subject to substantial competition and UK performance is well above the levels set in the Directive. Hence this product should not be subject to a regulatory performance constraint beyond that already set out under the EU directive. Furthermore, the continued achievement of this standard would not be fully within Royal Mail's control. For example, Royal Mail could face penalties on the basis of industrial action or poor performance of a postal operator in another country.
- 5.69 We recognise that the proposed additional three standards covering the proportion of delivery routes completed, the proportion of collection points visited daily and the proportion of misdelivered mail all fall within the scope of the USO, and, thus within the scope of quality of service regulation. Royal Mail has already offered to measure and report annual national performance for these three areas, and would consider setting performance targets for USO collection and delivery as part of a revised package of range-based standards, subject to setting suitable levels and agreeing measurement methods.
- 5.70 Postcomm is also proposing measurement and reporting of delivery and collection times. Royal Mail notes that specific delivery and collection times are not requirements of the universal service, and so should not fall within the scope of any Quality of Service regulation. Furthermore, our delivery times are already earlier than those of most other operators. Indirect constraint and control of Royal Mail's delivery times by Postcomm in

this manner will restrict flexibility and innovation. Royal Mail believes Postcomm's proposals are disproportionate, incompatible with its efficiency assumptions under the price control and impracticable to implement.

Penalties for poor performance

- 5.71 Royal Mail believes that any system designed to incentivise Royal Mail to achieve and maintain acceptable performance should be both fair and designed to encourage higher performance standards. As such
- Penalties should not be set at levels that are unduly punitive and should take account the level of penalties set by other regulators.
 - Penalties should not be mandated in areas where it would be reasonable to expect poor performance to result in loss of business to a competitor.
 - Royal Mail should be incentivised to outperform and exceed its agreed quality of service targets through rewards for outperformance in addition to penalties for underperformance.
 - Royal Mail should not be penalised or rewarded for small changes in performance that are not important to customers.
- 5.72 Furthermore, the system for deciding whether a performance target has been breached (and if so whether a penalty should be given) should take into account certain practical considerations.
- Events that are outside of Royal Mail's direct control. For example, Royal Mail should not be penalised for missing performance targets due to unofficial industrial action, extreme weather conditions or other "Acts of God".
 - Accuracy of measurement. Royal Mail should not be penalised or rewarded for missing or exceeding a performance target by a margin that is below the tolerance of the measurement system accuracy.
- 5.73 Postcomm states that regulatory targets should be used proportionately. Despite this, Postcomm proposes that Royal Mail should continue to pay up to 5% of revenue to bulk mail customers under the bulk mail compensation scheme and that the C factor penalty should be increased to cover 5% of revenues for social products. Postcomm proposes to extend quality regulation to include downstream access. Although some form of positive incentive was supported by Postwatch and by the findings of the MORI survey, Postcomm proposes that Royal Mail should not receive any reward for exceeding the target levels as this might encourage Royal Mail to "gold plate its services beyond the requirements of its customers".
- 5.74 Postcomm also proposes that Royal Mail should continue to have to argue for mitigation in payments because of force majeure events, such as severe weather, and that it does not consider that any form of industrial action by Royal Mail or its agents should be taken into consideration.
- 5.75 Finally Postcomm proposes changes to Royal Mail's Licence to reverse the burden of proof on reasonable endeavours, which can potentially apply to any performance falling

below the target level, and to give Postcomm control of loss and damage compensation for all Royal Mail products.

- 5.76 Taken as a package, Royal Mail is exposed to some £280 million of automatic penalties per annum, not including downstream access compensation (at up to 5% of revenues), retail compensation payments for loss and damage (which are unlimited) or fines (which may be up to 10% of turnover). Royal Mail's maximum automatic penalties for quality failure represents 160% or more than one and a half years of its core allowed profit under the proposed regime. This is at odds with all regulatory precedent, where a typical figure is in the range of 10% to 20%.

Sector	Penalties as % allowed profit	Risk from competition
Electricity distribution (2005-10)	14	Low
Gas distribution (2002-07)	0	Low
BAA London airports (2003-08)	3	Low
Water (2005-10)	3	Low
NATS (2000-05)	15	Low
NATS (2006-10)	42	Low
BT	0	High
Postcomm proposals for Royal Mail	160	High

- 5.77 Postcomm's proposals are punitive and offer no upside for superior performance. Royal Mail does not believe that a regime of this severity is required to incentivise it to maintain good standards of performance. In an increasingly competitive market, in the event of underperformance, unhappy customers are able to move to competitors and do not need a regulator to intervene on their behalf. Under these proposals, which cover an inappropriately wide set of products, Royal Mail would lose both customers, as would be expected in a competitive market, and also face significant penalties. This represents a double jeopardy for the business, which may, in the worst case, threaten the financial viability of Royal Mail. The treatment of force majeure is also of particular concern since the operational efficiency targets Postcomm is considering would require Royal Mail to drive through its transformation without rewarding its people, making substantial quality of service penalties almost inevitable.
- 5.78 Moreover the proposed changes to reasonable endeavours and compensation for loss and damage are disproportionate and do not provide the high degree of regulatory certainty Royal Mail requires under the next price control. Royal Mail believes it has generous and well-operated compensation schemes for lost and damaged mail, and that there is no justification for Postcomm to control these schemes, or to control contractual arrangements concerning loss and damage. Royal Mail also believes it is appropriate for the current definition of reasonable endeavours, which permits Postcomm to exercise proper discretion over factors outside Royal Mail's full control, to remain and to be used in conjunction with a standards regime based on ranges of performance.

SUMMARY

- 5.79 Above we have outlined five objectives that articulate our vision for the regulatory framework of the postal industry. We believe that a regulatory settlement aimed at delivering this vision is required in order to support transformation of the industry, to promote competition and to ensure a viable and sustainable Royal Mail that can fulfill its universal service obligations. We look forward working closely with Postcomm over the coming months to ensure that final proposals meet these objectives. We remain concerned, however, about the amount that needs to be done in the time available, not least because of the material discrepancies in modeling that underpins Postcomm's current position.