



RESPONSE TO POSTCOMM'S CONSULTATION DOCUMENT
“REVIEW OF CONSIGNIA PLC'S PRICE AND SERVICE QUALITY
REGULATION – PROPOSAL FOR A SECOND PRICE CONTROL”

Appendices

Appendix 4A

List of responses made by Royal Mail to Postcomm on issues and impact of competition and Postcomm's proposals and decision in this area

Ref.	Title	Source
321	Dis-aggregated Letter Traffic Demand in the UK	John Nankervis, Sophie Richard, Soterios Soteri, Frank Rodriguez
322	Re-estimating and extending the inland letter Traffic Model – Analysis and Results	John Nankervis, Sophie Richard, Soterios Soteri, Frank Rodriguez
324	Entry Pricing	Consignia
325	Estimates of the cost of the USO using the EP approach	Paul Liddiard, Richard Robinson, Frank Rodriguez
326	Alternative Approach to Estimating the cost of the USO in posts	Rodriguez/Storer
327	Assessing the Cost and Benefits of Providing the Universal Service	The Post Office
328	Competition in Posts	Ian Reay and Frank Rodriguez
329	Updating the EPM, February 2001	The Post Office
	Postcomm's decision document on promoting effective competition in UK postal services – a response by Consignia on Technical issues and Management of Risks, August 2002 ¹	Consignia

¹ This document makes reference to a series of related documents and includes in Annex 1 "Response to Postcomm regarding Oxera paper 'Deriving a base case NPV for Consignia'" by Oxera consulting Ltd, August 2002.

Appendix 4B

THE ALLOWED PROFIT OF THE INLAND MAILS BUSINESS BY COMPARISON WITH TPG'S MAILS BUSINESS

Executive summary

Papers 3² and 4³ of Royal Mail's July 2002 submission to Postcomm set out an approach to determine the allowed profit for the regulated postal market by comparison with other international Universal Service Providers. Papers 3 and 4 calculated the allowed profit from the regulatory asset base (RAB) and weighted average cost of capital (WACC). The RAB value was calculated from the trading value of a universal service provider (USP) and the WACC was estimated, from amongst other factors, the OPEX/RAB ratio. Papers 3 and 4 estimated the RAB and WACC using a Group average trading value adjustment (TVA) for 2001. This Appendix develops this approach further using the trading value for the mails business (rather than Group) for TPG. Appendix 4C develops a similar approach by consideration of the trading value of the mails business (rather than Group) of Deutsche Post.

Papers 3 and 4 illustrate the estimation of the RAB and WACC using a Group average trading value adjustment (TVA) for 2001. For the period 1999 to 2001, the TPG Group average ratio of the TVA (the trading value to net asset value) was 3.2 and for 2001 was 2.5. The TVA relates to TPG Group and not specifically to the TPG mails business. Since 1998, the return on turnover was about 20 per cent for TPG's mails business and less, at about 9.5 per cent, for TPG Group as a whole. This would suggest that the TPG businesses outside of the mails business earn a lower return than the mails business and thereby have a lower TVA than the mails business. Consequently, the TVA of TPG's mails business is at least the value of TPG Group at 2.5.

This Appendix uses information in a brokers report to derive a TVA of 6.2 for TPG's mails business. This TVA is then compared to a figure derived by taking the netting out the net asset value of the non-mails businesses from the trading value of the TPG of 6.5. The TVA of 6.2 is then adjusted to 5.2 by assuming constant future profit levels. This adjusted TVA figure is then used to estimate the allowed profit in the each year of the price control for the UK inland mails business. For a net asset value of £1.5bn the allowed profit for the Total USO in the UK is estimated to be about £0.65bn per annum. This is consistent with the view expressed in Paper 3 that the allowed profit should be at least £0.4bn.

² "Allowed Profit I: cost of capital - for the UK inland mails business of Consignia", Consignia, July 2002.

³ "Allowed Profit II: regulatory asset base - for the UK inland mails business of Consignia", Consignia, July 2002

1. Introduction

This Appendix estimates the trading value of TPG's mails business and thereby the RAB, cost of capital and allowed profit for the UK inland mails business. The TVA of the TPG mails business is estimated from broker's reports. This valuation is compared with an estimate derived by netting out the net asset value of the other TPG businesses from the market value of the Group. The estimate of the TVA is adjusted to assume constant future levels of profit. This TVA is then used to estimate the allowed profit for the Total USO area of the UK inland mails business.

2. Estimating the TVA for TPG mails business

2.1 Stockbroker's report

Stockbroker reports evaluate the trading value of separate businesses within the Group. In a stockbroker's report for TNT Post Group⁴ the trading value of the TPG mails business is estimated to be E 9.0bn with a Group TPG trading value of E.14.0. Hence, the TPG mails business is about 65 per cent of the Group Value.

For 2001, the Group TPG trading value is £13.4bn. For the mails business, the trading value is about E. 8.7bn (i.e. 65 per cent of E. 13.4bn) and the net asset value of £1.4bn. This implies a TVA for the TPG mails business of about 6.2.

2.2 Benchmark comparator

In the absence of market information from stockbrokers, a benchmark estimate of the trading value of a regulated business within a Group can be formed by deducting the book value of the non-regulated businesses from the trading value of the Group.

For TPG Group in 2001 the trading value averaged E⁵ 13.4bn and the book value of net assets was E 5.4bn. For the TPG mails business the book value of net assets was E 1.4bn and hence the book value of net assets for the non-mails business was E 4.0bn. Since the non-mails business is in a well-established competitive market, its trading value should, on average, reflect the book value of net assets. Hence, the trading value of the mails business can be estimated from the trading value for the Group less the trading value for the non-mails business. For TPG mails business, the trading value is estimated at E 9.4 bn. The TVA calculation is summarised in Table 1. For TPG mails business, with a book value of net assets of E 1.4 bn, the TVA is estimated to be 6.6.

⁴ Report by Morgan Stanley on TNT Post Group, 25 April 2002.

⁵ Euros

Table 1: TVA calculation for TPG mails business in 2001

	Value
Trading value – Group	13.42 bn
Net asset value - Group	5.46 bn
Net asset value – Mails business	1.42 bn
Net asset value – Non-mails business	4.04 bn
Estimated trading value – Mails business	9.38 bn
TVA – Mails business	6.6

NB. All values excluding the TVA are in Euros (E).

2.3 Comparison of results

The two TVA estimates in subsections 2.1 and 2.2 are broadly similar. The difference between the approaches is likely to reflect the trading value for the non-mails businesses exceeding the net asset value rather than being equal to the net asset value as assumed in subsection 2.2.

This Appendix proceeds to use the TVA of 6.2 from the broker’s report to derive the allowed profit of the UK inland mails business, with the corresponding valuation for a TVA of 6.6 included in the footnotes.

3. The adjusted TVA

3.1 Methodology

A standard approach to the derivation of the allowed profit is firstly to derive the RAB by multiplication of the TVA by the net asset value and then by multiplication of the RAB and WACC. The UK WACC estimate is derived as set out in Paper 3. When applying this WACC estimate to derive the allowed profit for Royal Mail’s business, it is important to ensure that its RAB value is consistent with the WACC estimate. When the RAB value for the Royal Mail’s mails business is derived from TPG’s mails business data, this requires an adjustment to the RAB that is outline below and applied in Section 3.2.

The actual profit equals the RAB value multiplied by the actual return on the trading value - where the actual return on the trading value does not necessarily equal the WACC. Similarly, the actual profit also equals a “WACC adjusted” RAB value multiplied by the WACC - where the “WACC adjusted” RAB is an adjustment made to the RAB value such that, when multiplied by the WACC, it derives the actual profit. The allowed profit for the Royal Mail’s mails business can then be estimated as follows:

- (i) Given the actual profit, WACC and RAB (trading value) for TPG’s mails business, it is possible to derive the “WACC adjusted” RAB value for TPG’s mails business;
- (ii) Given the “WACC adjusted” RAB value and net asset value for TPG’s mails business, it is possible to derive the “WACC adjusted” TVA for the TPG’s mails business;

- (iii) The “WACC adjusted” TVA for TPG’s mails business can then be multiplied by the net asset value of Royal Mail’s mail business to derive a “WACC adjusted” RAB value for Royal Mail’s mail business;
- (iv) The “WACC adjusted” RAB value can then be multiplied by the WACC for Royal Mail’s mails business to derive the allowed profit for the Royal Mail’s mails business.

This is set out in more detail below.

The actual return on the trading value (A) reflects the actual profit P divided by actual trading value TV_1 such that:

$$A = P / TV_1 \quad (1)$$

The expected WACC is B from Paper 3. The trading value consistent with B and profit P is TV_2 such that:

$$P = B \times TV_2 \quad (2)$$

Substituting for P in equations (1) and (2) yields the equation (3):

$$TV_2 = (A/B) \times TV_1 \quad (3)$$

and dividing this equation by the net asset value derives the equation (4):

$$TVA_2 = (A/B) \times TVA_1 \quad (4)$$

Hence if $A < B$ then $TVA_2 < TVA_1$ i.e. the trading value adjustment is deflated by the WACC adjustment.

In addition, if $TVA_2 < TVA_1$ then multiplying through by B yields equation (5):

$$P = B \times TVA_2 < TVA_1 \times B = Q \quad (5)$$

where Q is an indication of the expected future level of profit. This indicates that the unadjusted trading value (TV_1) reflects an expectation that the level of profit increases in the future and the adjusted trading value (TV_2) from equation (3) reflects an expectation that the level of profit remains constant.

The adjusted TVA of TPG mails business, consistent with an assumption that the future profit is constant, can be combined with the projected net asset value for each year of the price control period to derive the allowed profit for the UK mails business for the each year of the control.

3.2 Application

The methodology of the previous section (Section 3.2) is applied using TPG mails business data.

The expected level of WACC for TPG mails business can be estimated from information in the Annual Accounts and Reports of the companies, using the approach in Paper 3. For TPG Group, the debt premium is about 2.1 per cent, the

gearing is about 0.4 and the level of tax is 35 per cent. The asset beta value is estimated using the approach set out in Paper 3 to be 0.5⁶. Table 2 shows the expected WACC calculation for TPG mails business. The expected WACC estimate for TPG mails businesses is 10.0 per cent. In comparison, in 2001, the actual return on trading value for TPG mails businesses is 8.7 per cent.

The factor for adjusting the TVA to make it compatible with the application of the UK WACC is 0.87⁷. The factor is less than unity thereby implying that the unadjusted TVA includes an expectation that profit will *increase* in the future relative that in 2001. When this factor is applied to the unadjusted TVA of 6.2 it yields a WACC-adjusted TVA of 5.4.

Table 2: WACC estimate for TPG mails business in 2001

Parameter	TPG mails business
Risk free rate	4.85
Debt premium	0.28
Cost of debt	5.31
Equity risk premium	4.00
Asset beta	0.5
Equity beta	0.9
Post-tax cost of equity	8.57
Tax Wedge	1.54
Pre-tax cost of equity	13.18
Gearing	0.4
WACC	10.0

For illustration, the TVA figure of 5.4 derives a RAB of £8.1bn for the UK Total USO area and a UK WACC estimate of 8.2 per cent for the UK mails business - using the principles outlined in Papers 3 and 4 and the assumption that the level of allowed profit is held constant into the future. For a UK RAB of £8.1bn and UK WACC estimate of 8.2 per cent, the allowed profit is estimated to be £0.66bn per annum for the Total USO area.

4. Conclusion

This Appendix has shown the following:

- (a) The Group average TVA underestimates the value of the mails business.
- (b) The trading value for TPG Group appears to be inflated by the trading value of the non-mails businesses exceeding their combined net asset value;
- (c) The trading value for TPG mails business appears to be inflated by an expectation that profits will increase in the future;

⁶ This is estimated using the approach set out in "Allowed profit I: the cost of capital - for the UK inland mails business of Consignia", Consignia, July 2002.

⁷ The figure equals 8.7/10.0.

- (d) On a comparable basis of analysis the allowed profit for the Total USO in the UK is estimated to be about £0.65bn per annum. This is consistent with the view expressed in Paper 3 that the allowed profit should be at least £0.4bn.

Appendix 4C

THE ALLOWED PROFIT OF THE INLAND MAILS BUSINESS BY COMPARISON WITH DEUTSCHE POST'S MAILS BUSINESS

Executive summary

Papers 3⁸ and 4⁹ of Royal Mail's July 2002 submission to Postcomm set out an approach to determine the allowed profit for the regulated postal market by comparison with other international Universal Service Providers. Papers 3 and 4 calculated the allowed profit from the regulatory asset base (RAB) and weighted average cost of capital (WACC). The RAB value was calculated from the trading value of a universal service provider (USP) and the WACC was estimated, from amongst other factors, the OPEX/RAB ratio. Papers 3 and 4 estimated the RAB and WACC using a Group average trading value adjustment (TVA) for 2001. This Appendix develops this approach further using the trading value for the Mails Business (rather than Group) for Deutsche Post (DPWN). Appendix 4B develops a similar approach by consideration of the trading value of the mails business (rather than Group) of TPG.

1. Introduction

This Appendix estimates the trading value of DPWN's mails business and thereby the RAB, cost of capital and allowed profit for the UK inland mails business. The TVA of the DPWN mails business is estimated from broker's reports. This valuation is compared with an estimate derived by netting out the net asset value of the other DPWN businesses from the market value of the Group. The estimate of the TVA is adjusted to assume constant future levels of profit. This TVA is then used to estimate the allowed profit for the Total USO area of the UK inland mails business.

2. Estimating the TVA for DPWN mails business

2.1 Stockbroker's report

Stockbroker reports evaluate the trading value of separate businesses within the Group. In a stockbroker's report for DPWN Group, the trading value of DPWN mails business is estimated to be about 52 per cent of the Group value¹⁰.

For 2001, the Group DPWN trading value is £21.2bn. For the mails business, the trading value is about E. 11.1bn (i.e. 52 per cent of E. 21.2bn) and the net asset value of £3.6bn. This implies a TVA for the DPWN mails business of about 3.1.

2.2 Benchmark comparator

In the absence of market information from stock brokers, a benchmark estimate of the trading value of a regulated business within a Group can be formed by deducting the book value of the non-regulated businesses from the trading value of the Group.

⁸ "Allowed Profit I: cost of capital - for the UK inland mails business of Consignia", Consignia, July 2002.

⁹ "Allowed Profit II: regulatory asset base - for the UK inland mails business of Consignia", Consignia, July 2002

¹⁰ Report by Commerzbank on Deutsche Post World Net, 2 January 2001.

For DPWN Group in 2001, the trading value¹¹ averaged E 21.2bn and the book value of net assets was E 17.2bn. For the DPWN mails business, the book value of net assets was E 3.5bn and hence the book value of net assets for the non-mails business was E 13.7bn. Since the non-mails business is in a well-established competitive market, its trading value should, on average, reflect the book value of net assets. Hence, the trading value of the mails business can be estimated from the trading value for the Group less the trading value for the non-mails business. For DPWN mails business, the trading value is estimated at E 7.5bn. The TVA calculation is summarised in Table 1. For DPWN mails business, with a book value of net assets of E 3.6bn, the TVA is estimated to be 2.1. Consequently, the TVA for the mails business is significantly greater than that for of the Group average. However, the figure of 2.1 is also significantly less than that of the TPG at 6.5.

Table 1: TVA calculation for DPWN mails business in 2001

	Value
Trading value – Group	21.27 bn
Asset value - Group	17.25 bn
Asset value – Mails business	3.55 bn
Asset value – Non-mails business	13.70 bn
Estimated trading value – Mails business	7.57 bn
TVA – Mails business	2.1

NB. All values excluding the TVA are in Euros (E).

2.3 Comparison of results

The two TVA estimates in subsections 2.1 and 2.2 are quite different. An explanation of this difference in results could be that the trading value of the non-mails business is below its net asset value reflecting market uncertainty that Deutsche Post can get value out of its non-mails assets. The Group trading value would be greater if the market believed that the trading value of the non-mails business was at least its net asset value. DPWN Group has expanded its non-mails business activities and has yet to develop the synergies associated with such expansion. Consequently, it is quite likely that the trading value of the non-mails businesses could be less than the net asset value as implied by the brokers report rather than equal to the net asset value as assumed in the above approach. Consequently, this Appendix proceeds on the basis that the brokers report is a more accurate reflection of the trading value for the mails business than that estimated above.

3. The adjusted TVA

3.1 Methodology

A standard approach to the derivation of the allowed profit is firstly to derive the RAB by multiplication of the TVA by the net asset value and then by multiplication of the RAB and WACC. The UK WACC estimate is derived as set out in Paper 3. When applying this WACC estimate to derive the allowed profit for Royal Mail's business, it is important to ensure that its RAB value is consistent with the WACC estimate. When the RAB value for the Royal Mail's mails business is derived from DPWN's

¹¹ The trading value equals the market value plus the book value of debt net of cash.

mails business data, this requires an adjustment to the RAB that is outline below and applied in Section 3.2.

The actual profit equals the RAB value multiplied by the actual return on the trading value - where the actual return on the trading value does not necessarily equal the WACC. Similarly, the actual profit also equals a “WACC adjusted” RAB value multiplied by the WACC - where the “WACC adjusted” RAB is an adjustment made to the RAB value such that, when multiplied by the WACC, it derives the actual profit. The allowed profit for the Royal Mail’s mails business can then be estimated as follows:

- (i) Given the actual profit, WACC and RAB (trading value) for DPWN’s mails business, it is possible to derive the “WACC adjusted” RAB value for DPWN’s mails business;
- (ii) Given the “WACC adjusted” RAB value and net asset value for DPWN’s mails business, it is possible to derive the “WACC adjusted” TVA for the DPWN’s mails business;
- (iii) The “WACC adjusted” TVA for DPWN’s mails business can then be multiplied by the net asset value of Royal Mail’s mail business to derive a “WACC adjusted” RAB value for Royal Mail’s mail business;
- (iv) The “WACC adjusted” RAB value can then be multiplied by the WACC for Royal Mail’s mails business to derive the allowed profit for the Royal Mail’s mails business.

This is set out in more detail below.

The actual return on the trading value (A) reflects the actual profit P divided by actual trading value TV_1 such that:

$$A = P / TV_1 \tag{1}$$

The expected WACC is $WACC_2$ from Paper 3. The trading value consistent with $WACC_2$ and profit P is TV_2 such that:

$$P = B \times TV_2 \tag{2}$$

Substituting for P in equations (1) and (2) yields the equation (3):

$$TV_2 = (A/B) \times TV_1 \tag{3}$$

and dividing this equation by the net asset value derives the equation (4):

$$TVA_2 = (A/B) \times TVA_1 \tag{4}$$

Hence if $A > B$ then $TVA_2 > TVA_1$ i.e. the trading value adjustment is inflated by the WACC adjustment.

In addition, if $TVA_2 > TVA_1$ then multiplying through by B yields equation (5):

$$P = B \times TVA_2 > TVA_1 \times B = Q \tag{5}$$

where Q is an indication of the expected future level of profit. This indicates that the unadjusted trading value (TV₁) reflects an expectation that the level of profit decreases in the future and the adjusted trading value (TV₂) from equation (3) reflects an expectation that the level of profit remains constant.

The adjusted TVA of DPWN mails business, consistent with an assumption that the future profit is constant, can be combined with the projected net asset value for each year of the price control period to derive the allowed profit for the UK mails business for the each year of the control.

3.2 Application

The methodology of the previous section (Section 3.2) is applied using DPWN mails business data.

The expected level of WACC for DPWN mails business can be estimated from information in the Annual Accounts and Reports of the companies. For DPWN Group, the debt premium is about 1.6 per cent, the gearing is about 0.25 and the level of tax is 40 per cent. The asset beta value is estimated using the approach set out in Paper 3 to be 1.1¹². Table 2 shows the expected WACC estimate for DPWN mails business. The expected WACC estimate for DPWN mails businesses is 10.5 per cent. In comparison, in 2001, the return on trading value for DPWN mails business in 2001 is 17.7 per cent.

Hence the factor for adjusting the TVA to make it compatible with the application of the UK WACC is 1.7¹³. The factor is greater than unity thereby implying that the unadjusted TVA includes an expectation that profit will decrease from that in 2001 in the future. When this factor is applied to the unadjusted TVA of 3.1 it yields a WACC-adjusted TVA of 5.2.

Table 2: Expected WACC calculation for DPWN mails business in 2001

Parameter	DPWN mails business
Risk free rate	3.30
Debt premium	1.61
Cost of debt	4.61
Equity risk premium	4.00
Asset beta	0.8
Equity beta	1.1
Post-tax cost of equity	7.51
Tax Wedge	1.66
Pre-tax cost of equity	12.50
Gearing	0.25
WACC	10.5

For illustration, the TVA of 5.2 derives a RAB of £7.9bn for the UK Total USO area and a UK WACC estimate of 8.2 per cent for the UK mails business - using the principles outlined in Papers 3 and 4 and the assumption that the level of allowed profit is held

¹² This is estimated using the approach set out in "Allowed profit I: the cost of capital - for the UK inland mails business of Consignia", Consignia, May 2002.

¹³ The figure equals 17.7/10.5.

constant into the future. For a UK RAB of £7.9bn and UK WACC estimate of 8.2 per cent, the allowed profit is estimated to be £0.65bn per annum for the Total USO area.

4. Conclusion

This Appendix has shown the following:

- (a) The trading value for DPWN Group appears to be deflated by the trading value of the non-mails businesses being less than their net asset value;
- (b) The trading value for DPWN mails business appears to be deflated by an expectation that profits will decrease in the future;
- (c) When the TVA is adjusted to reflect the view that profit levels will be constant into the future, the allowed profit for the UK inland mails business on a comparable basis of analysis is £0.65bn – very similar to those derived from TPG data in Appendix 4B. This is consistent with the view expressed in Paper 3 that the allowed profit should be at least £0.4bn.

Appendix 4D

A REVIEW OF THE EXISTING LICENCE CONDITION 19.6

1. Background

The Postal Services Act 2000 requires that

The Commission shall exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service.¹⁴

Subject to this, Postcomm

should exercise its functions in the manner which it considers is best calculated to further the interests of user of postal services, wherever appropriate by promoting effective competition between postal operators;¹⁵

and

shall exercise its functions in the manner which it considers is best calculated to promote efficiency and economy on the part of postal operators.¹⁶

In exercising its functions in relation to the licence holders, Postcomm

shall have regard to the need to ensure that such licence holders are able to finance activities authorised or required by their licences.¹⁷

The present Condition 19.6 recognises the need for:

- (i) Royal Mail's licence to establish the process and procedures to ensure that the duties under the Postal Services Act are fulfilled by Postcomm and Royal Mail;
- (ii) a process and procedure to deal with changes to the impact of competition on the financial viability of Royal Mail;
- (iii) a process and procedure for dealing with changes in the provision of UPSs.

More specifically, Condition 19.6 of Royal Mail's licence establishes that Royal Mail may apply for releasing the price constraint on the basis of the following:

- if there is a significant risk to Royal Mail's ability to meet its UPS obligations;
- if there is a significant risk to Royal Mail's ability to finance the activities authorised or required by the licence; or
- competition in the provision of a service in question is sufficiently developed to protect consumer interest.

¹⁴ Paragraph 3 (1), Part I.

¹⁵ Paragraph 5 (1), Part I.

¹⁶ Paragraph 5 (3), Part I.

¹⁷ Paragraph 5 (4), Part I.

In the first two cases, Postcomm would need to be satisfied that Royal Mail is an 'efficient operator', or that it is 'using all reasonable endeavours to become an efficient operator'. In the last case, Royal Mail should provide evidence that competition in the provision of the service is sufficiently developed to protect the interest of consumers.

2 Specific issues

In practice, Royal Mail has submitted an application under Condition 19.6 within the last two years. This application and the subsequent decision by Postcomm to open the market to competition highlighted some significant weaknesses of the present condition. These are discussed below.

- (a) *It does not set out a measurable and clear set of criteria to trigger an application for an interim determination and does not set out well-defined guidelines as to how the determination decision will be approached and made*

The Condition only provides a means of releasing the price constraints, but it does not provide an explicit link to deal with an interim review. Indeed, the approach adopted, which focuses on Royal Mail making representations rather than a mechanistic policy operated through the licence, results in greater and unnecessary discretion being given to the regulator. This, in turn, generates additional uncertainty, associated with regulatory risk. This absence of specification of the detail for an interim review can be contrasted with the case of the water industry.

Of all the sectors subject to economic regulation, the water industry has perhaps the most sophisticated and refined set of procedures relating to interim determinations. In each company's licence, a number of specific 'shocks' are listed, which may lead to actual expenditure or receipts, or later expected values, diverging from the levels assumed at the periodic price control review, and can therefore trigger an interim determination.

When a company makes an application to Ofwat for a change to the price limits, there are a number of steps that Ofwat must take, as prescribed in the licence. Initially, it is necessary to determine what the likely impact will be, over time, of the relevant item of the costs that can be reasonably attributed to the relevant item, and also the receipts and savings connected with the relevant item.

When determining these separate amounts, the licence states that no account should be taken of:

- any trivial amounts;
- any costs which would have been avoided by 'prudent management action';
- savings beyond those that 'prudent management action' would have achieved;
- amounts already allowed in the price cap.

This out-turn profile of costs and revenues is then compared with a materiality threshold.¹⁸ If the materiality threshold is exceeded then the regulator must adjust the price cap so that, until the next periodic review, expected revenues will be sufficient to cover the expected profile of costs.

If Ofwat finds that the magnitude of the effects have been insufficient to breach materiality then there remains an additional procedure for some element of capital expenditure (CAPEX) cost pass-through, known as 'logging up'. Appendix E of the Final Determinations sets out how Ofwat will deal with increases in CAPEX relating to additional water quality improvements and other unanticipated changes in environmental standards, by rolling these costs into the closing regulatory asset base (RAB) value for the end of the control period.

In addition to these specific measures, some companies have a further provision relating to unspecified substantial adverse or favourable effects, more commonly known as the 'shipwreck clause'. Subject to a higher materiality threshold, this allows either the company or Ofwat to apply for a change in the price cap to deal with effects that could not be avoided or attributed to 'prudent management action'.¹⁹

- (b) *It uses terms such as 'significant risk', 'competition sufficiently developed', or 'efficient operator' that are not well-defined. These are then open to interpretation and the discretion of the regulator in a manner that is excess for the interim determination approach.*

It is not clear from the licence condition what is meant by financial viability. Condition 19.6 leaves a significant degree of discretion to Postcomm to determine whether Royal Mail is at financial risk in providing services authorised or required by the licence.

Satisfying Postcomm that competition in the provision of specific services is 'sufficiently developed' creates the same regulatory uncertainty as described above. The licence condition does not provide explicit criteria to assess whether competition is developed, or specify under which circumstances Royal Mail would be entitled to apply for an interim review. In particular, the condition does not contemplate thresholds related to different indicators, such as the number of players in a particular postal market, market shares, and the size of undertakings. Without a set of pre-defined indicators, Postcomm may exercise excessive discretionary power to determine whether Royal Mail can be exempted from the price constraints.

In addition, proving that the postal-service operator is 'efficient' or that it has used 'all reasonable endeavours to become an efficient operator' is not straightforward. Again, this gives significant discretion to Postcomm to judge

¹⁸ The water regulator set this threshold at 10% of the turnover of the water company for the last complete reporting year. In addition, only 'non-trivial' items are taken into account when assessing the triggering of the interim determination. An item will be 'trivial' if the net present value (NPV) of a *specified* change is less than 1% of the company's turnover for the last reporting year.

¹⁹ The shipwreck clause takes into account the substantial (adverse or favourable) effect on the company, or on its assets, liabilities, financial position, or profits or losses. Substantial is quantified as an effect of a magnitude greater than 20% of the previous year's turnover, calculated as the NPV of the change in operating costs measured over a 15-year period, or the NPV of the change in capital costs over a five-year period. See Ofwat (2001), 'Modification of Conditions of Appointment: Proposals about Condition B, Part IV (Interim Determinations)', MD Letter 168, April 11th.

whether Royal Mail's efforts to improve efficiency have been sufficient to trigger an interim review process. Indeed, there is neither a clear definition of what 'efficiency' encompasses, nor of what defines the efficiency improvement required to apply for an interim review.

If Royal Mail were to successfully reduce costs by a certain amount, this would represent an increase in its productivity. However, if that reduction in costs were followed by a similar reduction in volumes (eg because of entry of a new postal operator) then Royal Mail's productivity would show no improvement, despite the cost reductions. Nevertheless, this does not mean that Royal Mail has not used all 'reasonable endeavours' to become efficient. Condition 19.6, as it stands, provides no clear answers as to how Postcomm should judge efficiency improvement made by Royal Mail.

- (c) *It does not directly address the uncertainty to Royal Mail's cash flow position that is caused by volume loss to competition.*

The Condition does not effectively distinguish between changes in operating expenditure (OPEX) and changes in volumes. Uncertainty is about revenues and costs, and this is an aspect that is not fully acknowledged in the Condition. One of the main challenges Royal Mail is facing is that most regulators have not encountered the prospect of a significant fall in volume for the regulated business and automatically allowed for an increase in prices in line with the expectation of significant reductions in volume. The majority of comments on interim determinations by other regulators is connected with costs shocks (with the exception of NATS' case), and, in particular, those caused by additional legal obligations, while a major concern for Royal Mail relates to demand shocks brought about by Postcomm's decision to open the market to competition.

Postcomm has, in the past, interpreted the price control as providing an additional efficiency incentive as volume falls. However, achieving efficiency is not about reducing every possible cost category. If operating costs have been reduced to a level at which there is no realistic scope for further reduction, an exceptional fall in revenues would directly risk the possibility of financing OPEX if a modification of the charge control were not allowed. The ability to finance OPEX has a direct impact upon the quality and range of postal services.

In addition, some CAPEX will be needed in order to expand capacity and offer new and improved services, but it also needs to be financed either through revenues or through the capital markets. If access to capital markets is not an option, then it is important that the revenue stream is sufficient to finance the required investment. Reduction of necessary expenditure is likely to result in additional capacity constraints, which in turn will involve increased operating expenses in the short to medium term.

Therefore, the regulator's duty to promote efficiency requires it to operate economic regulation in a way that allows the regulated business to have an income stream that enables it to finance the necessary OPEX, and make investments to increase its efficiency in the medium and long term. Moreover, the duties of furthering users' interests and promoting efficiency are not inconsistent with re-opening the price cap. Indeed, users' interests are not exclusively served by minimising charges; the quality and range of services are

also essential. Insolvency of Royal Mail would have serious adverse consequences for postal services users.

3. Conclusion

Postcomm has transferred the existing licence condition 19.6 into the draft licence condition 19.5 of the October document is ill-defined and not transparent. Royal Mail believes that significant change is needed to condition 19 as a whole (and including this clause in the condition) (i) to make the licence more transparent and (ii) to address explicitly the risks facing the regulated business in the changing market environment proposed by Postcomm (e.g. with end-to-end competition, third party network access and performance improvements).

Appendix 4E

A REVIEW OF DRAFT LICENCE CONDITION 19

The following table sets out a number of issues that Royal Mail believes need to be addressed if the draft licence condition 19, within the October document, is to be taken forward. The list is made specifically with regard to the content of the draft licence condition. In some cases there are issues raised in the main document that are not listed in the table (e.g. treatment of cost shocks). Hence the table should also be read with the main response document.

The Royal Mail referred to many of the issues in the table below in its main response in Chapters 4 and 5. Some of these issues are taken forward in Appendices 5D and 5E, in the economic briefs for the draft licences of the two approaches set out in Chapter 5 of the main response.

Paragraph	Issue
1.	<p>Presstream is not a product within the universal service obligation. There is no obligation to provide this service in the Act. The licence should not be written to make this service an obligation on the Royal Mail.</p> <p>The process by which Royal Mail can change service specification, and the associated appeals process, should be set out for transparency. This should be geared to facilitate change rather than obstruct it.</p>
2.	<p>The level of MP_t is insufficient to meet the revenue requirement in the plan and for funding. (see Chapter 2 of the main response).</p> <p>The definition of RPI_t should reflect average over 12 months rather than a single month and RPI_x rather than RPI; (see Section 4.3.2 of the main response).</p> <p>The value of X should potentially be RPI_t and not 2.5, consistent with a nominal price freeze. (see Section 4.6 of the main response).</p> <p>The restriction on F_t being less than unity should be removed to allow an increase in allowed revenue if targets are exceeded. In addition there are some missing summation signs. (see Section 4.2.1 of the main response).</p> <p>The definition of K_t should not be dependent on an unknown term V_t.</p> <p>The formula should address changes to that maximum allowed average revenue as end-to-end volume declines and as third party access increases. (see Section 4.2.1(a) and 5.5 of the main response).</p>

3.	The secondary cap should be loosened (see Section 4.2(c) of the main response)
4.	Pouch services (bespoke) should be removed. (see Section 4.5.4 of the main response)
5.	The re-opening clause needs to be made significantly more transparent. (see Appendix 4D).
6.& 7.	Information on prices and volumes needs to be significantly less onerous on the regulated business. (see Section 4.5.3 of the main response).
8.	The term “sufficient supporting information” is not sufficiently well-defined. The required information and procedures for deriving that information needs to be defined. (see Section 4.3.1(f) and 4.5.3 of the main response).
9.	This clause does not recognise the limitations of information and accuracy of information. (Alternatives are outlined in Appendices 5D and 5E).
10.- 15.	<p>The price control should have a termination date of 31 March 2006. (See Section 4.3.3 of the main response).</p> <p>An appeals process needs to be established in instances where a well-defined process is unable to resolve an important and significant issue for the business. (This is outlined further in Appendices 5D and 5E).</p>
16.	<p>New Controlled Service should be explicit about the treatment of new network access products. (See Section 4.2.1(d), 5.4 and 5.5 of the main response).</p> <p>The products covered in the control should be defined from the Regulated Accounts to avoid confusion and increase regulatory consistency.</p> <p>The coverage should reflect the difference groupings of products and weights that have distinct controls. (See Section 4.2 of the main response).</p> <p>Retail price index should be redefined as stated above. (See Section 4.3.2 of the main response).</p>

Appendix 5A

THE HYBRID AVERAGE REVENUE CONTROL

1 Introduction

Postcomm's October document (2002) advocated a single average revenue control with coverage for the whole of the regulated business's products. It also set out specific licence modifications for this proposal.

The Royal Mail identified several issues with the specific proposal in the period leading up to its publication and subsequently. This document reviews some of those issues in the context of the hybrid average revenue control and no downstream access in line with a presentation made to Postcomm on 21 October 2002.

2 Definitions

The hybrid average revenue approach is defined such that part of the allowed revenue in any year is set, independent of volume, while the total allowed revenue is the sum of this fixed part and a variable part that depends on volume outturn. Prices are then set to be no greater than the allowed revenue with any over or under-recovery in one year leading to a correction to the allowed revenue in the subsequent year. An interest penalty for over-recovery encourages the regulated business to set prices that do not exceed the allowed revenue. Hence, rebalancing and restructuring of prices are permitted but are subject to the limits of allowed revenue.

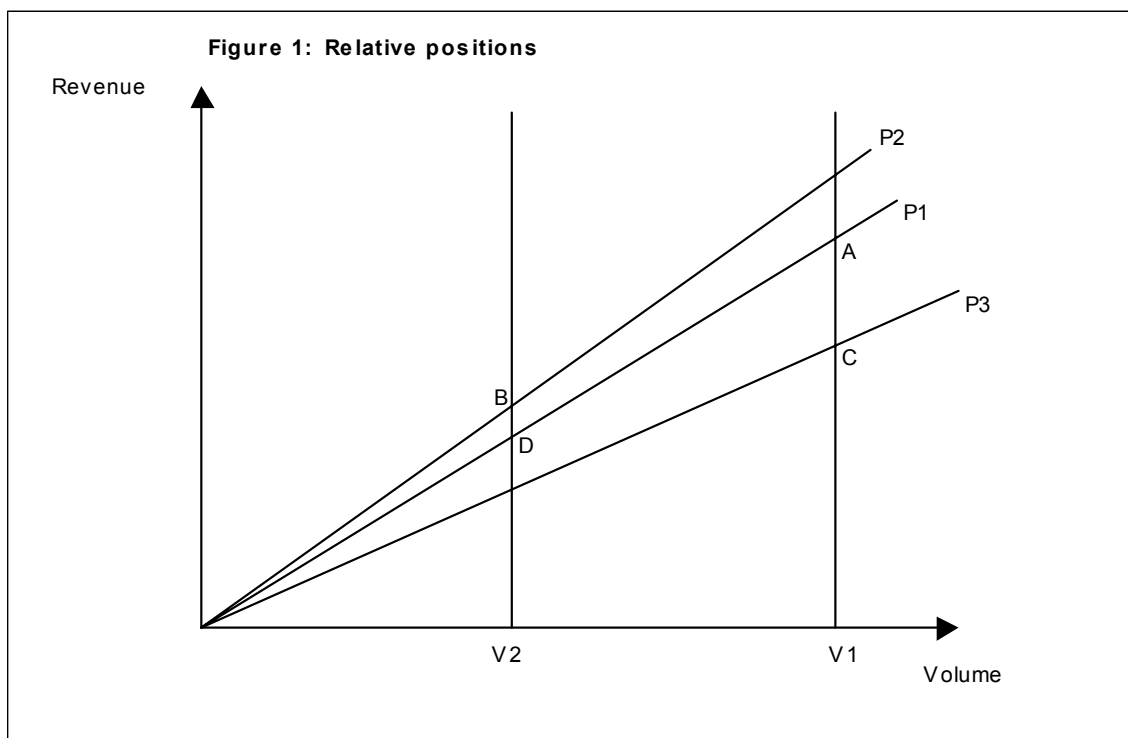
Postcomm's correspondence following publication of its October document set the hybrid average revenue control in the context of a variable component of 0.6, equal to the long-run cost elasticity with respect to volume. Postcomm concluded from this definition that the hybrid average revenue control would not cause the cash-flow position to improve with increased volume, and thereby did not have incentives for volume growth or improve service performance.

While this may be the case for the specific definition of the hybrid average revenue control used by Postcomm in the context of a pre-liberalised market, the definition is over prescriptive. In effect, the hybrid average revenue control has the flexibility for the fixed portion of allowed revenue to be anything between zero (equivalent to the average revenue control) and unity (equivalent to a total revenue control). Paper 5 of the Royal Mail's July 2002 submission stated that, pre-liberalisation, if the long-run elasticity is 0.6 then the variable component of the hybrid should be set at a marginally higher value than 0.6 to retain the incentive for volume growth. Paper 6 of the Royal Mail's July 2002 submission indicated that the variable component of the hybrid average revenue control could be set at a level that retained the incentive for volume growth and that, in the presence of cream-skimming, could be less than 0.6. Consequently, the hybrid average revenue control has the flexibility to be set in a manner that retains the opportunity to improve cash flow with volume and thereby retain the incentives for volume growth and improvements in service performance.

At the same time the hybrid average revenue control defines the allowed revenue and thereby retains incentives to cut costs. It also provides some protection for cash flow, as is discussed later in this Appendix.

3 The level of the allowed revenue

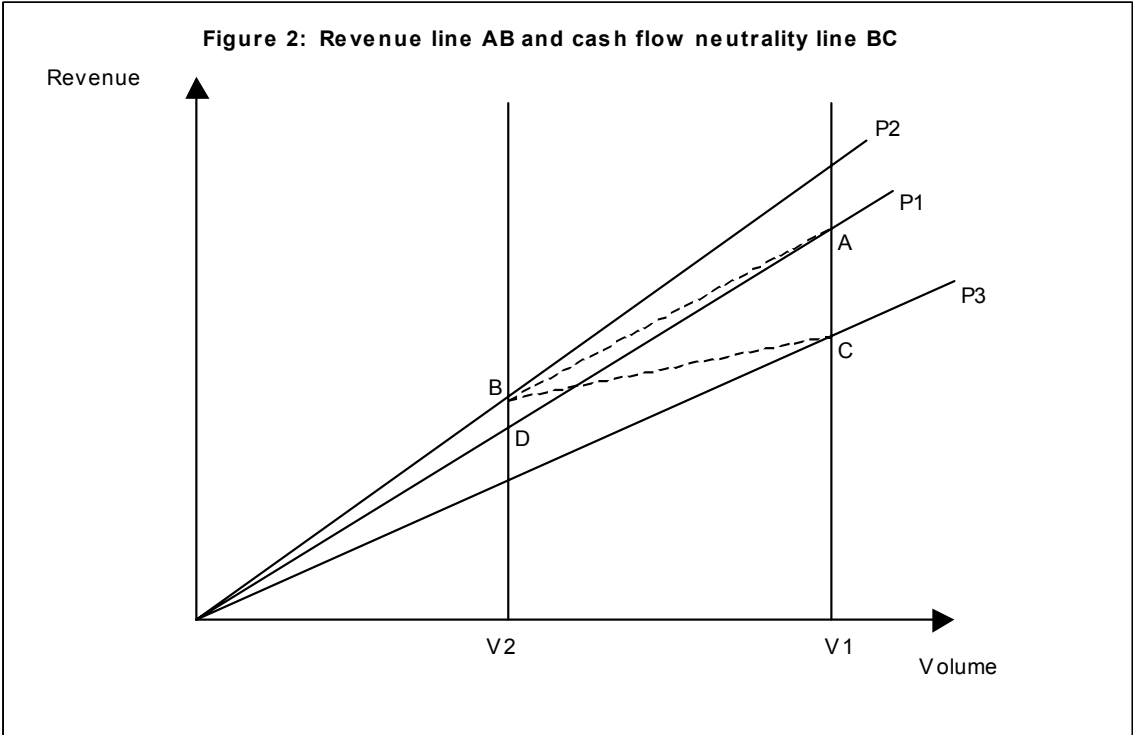
On the specific issue of the level of allowed revenue, the difference between Postcomm's proposal and Royal Mail's view is illustrated in Figure 1. Postcomm proposed an average revenue P1 for volume V1, represented by point A. Royal Mail's plan was based on a level of allowed revenue equivalent to an average revenue P2 at a volume V2, below V1, represented by point B. At volume V1, point C represents the point at which the cash flow is the same as at point B. At volume V2, point D represents Postcomm's proposal with an average revenue of P1. The revenue and cash flow at point B are worse than the revenue and cash flow position at point A arising from the volume loss associated with the impact of competition. The revenue and cash flow at point D are worse than the revenue and cash flow position at point B arising from Postcomm's proposal for the allowed average revenue.



The hybrid average revenue control provides a means of resolving the differences over the level of the control. This is illustrated by Figures 2 and 3:

- In Figure 2, the line AB represents the regulated business's revenue line and the line BC represents the regulated business's constant cash flow line. BD represents the cash shortfall for Royal Mail at V2. AC represents the cash advantage for Royal Mail at V1. In practice, AC exceeds BD.
- In Figure 3, the hybrid average revenue structure is represented by the line EF. The hybrid average revenue structure provides the opportunity to trade off some of the cash flow advantage AC at V1 to secure an allowed revenue line EF through B at V2.

Since the allowed revenue is defined by EF, the control is not dependent on a single view of the forecast volume. To the extent that F is above point C then the cash flow increases with volume and the incentive to increase volume is retained. The incentive to improve service performance is also retained.



In summary, a reduction in allowed revenue from A to F at V1 could be achieved in such a manner as to have:

- incentives for volume growth and improvements in service performance by enabling the cash flow position to improve with increased volume (as represented by point F above point C);
- the allowed revenue at point B for volume V2, thereby allowing for the allowed revenue in Royal Mail’s plan;
- some protection for the cash flow position of the regulated business if volume falls below V2.

Postcomm’s October document (2002) states that it believes volumes to be about V1. In contrast, Royal Mail’s plan forecasts end-to-end volumes about V2. Given that Postcomm attaches a higher probability of volume being at V1 than V2 and Royal Mail has attaches a lower probability of volume being at V1 than V2, a reduction in the allowed revenue at V1 to increase allowed revenue at V2 could be a means forward.

4 Protection of the cash flow position of the regulated business.

The primary statutory duty of Postcomm is to ensure the provision of the USO with national coverage at uniform and affordable prices for public tariffs and, thereby, have regards to ensuring the financial viability of the Licensee. Postcomm has not demonstrated any analysis or consideration of the cash flow impact of a fall in volume below that in Royal Mail's plan (i.e. V2 in Figures 1 to 3). Instead, its proposal focuses only on the improvement in cash flow for volume above that that in Royal Mail's plan.

Postcomm's October document states that the regulated business is likely to remain the only universal service provider for the period of the control. This statement, when combined with Postcomm's statutory duties, requires Postcomm to ensure the financial viability of the Royal Mail over the price control period.

Postcomm's October document also states that the regulated business should be treated as an independent, commercial business. This is a further reason to ensure that the financial viability of Royal Mail is independent of the need to (a) borrow off the shareholder more extensively than presently planned during the period of the price control and (b) rely on re-opening the price control. These are discussed below.

(a) Allowed profit

Postcomm's proposal references £1.8bn of gilts as if borrowing against this sum is a means of ensuring the financial viability of the regulated business. The DTI and Royal Mail have indicated to Postcomm the limits of this form of borrowing for the regulated business. Fundamentally, though, it is the level of allowed profit, rather than the source of borrowing, that should be the primary concern of an independent regulator to provide a return for investment and protect the financial viability of the universal service provider.

Postcomm's October document does not place the context for setting the allowed revenue within a standard regulatory framework. It is standard regulatory practice to review the level of allowed revenue in the context of allowed operating and capital expenditures and allowed profit. Postcomm provides no analysis of allowed profit and no review of the work presented to it on the subject. Postcomm therefore provides no reliable framework to analyse financial risk and issues of regulatory uncertainty.

It is standard practice for regulators to derive the level of allowed profit from estimates of the regulatory asset base and cost of capital and, where these are not readily available, from similar information on relevant comparators. Royal Mail used this approach in Papers 3 and 4 of its July 2002 submission to indicate that the level of allowed profit for the universal service should be about £0.4bn p.a.. Since that submission, Royal Mail has undertaken further work included in Appendices 4B and 4C which indicates that the allowed profit for the USO should be at least £0.4bn p.a. on a comparable basis to the inland mails businesses of TPG and DPWN.

This analysis provides the basis for the setting the allowed profit in a pre-liberalisation scenario. This allowed profit for the pre-liberalised market may then be compared with the cash flow position as volume is lost to competition in a post-liberalised market environment.

(b) Re-opening the control

The draft licence modifications in the proposal document and those of the existing price control do not address the issue of volume risk explicitly within the control.

Postcomm's treatment of volume loss on the regulated business is unclear and increases the level of uncertainty faced by the business unnecessarily. This is discussed further in Appendix 4D.

The financial viability of the business is threatened by the exposure to volume loss arising from the opening of the market to competition. In the presence of significant volume loss financial viability could only be maintained through significant additional savings to those in the plan. However, the volume loss is projected to be caused by cream-skimming entry which would have two effects:

- (a) a direct and significant reduction on the contribution to a positive cash flow; and
- (b) a very limited reduction in costs as the universal service still needs to be retained.

In a pre-liberalised market, a 10% increase in volume would increase revenue by about 10% and costs by about 6% (see Paper 5). In a post-liberalised market, cream-skimming means that a 10% decrease in volume could reduce revenue by about 10% and costs by significantly less than 6% (see Paper 6). Costs will reduce with the effective implementation of Royal Mail's business plan but are not fully flexible and will not change in proportion to revenue. Hence, the cash flow position of the regulated business is sensitive to volume outturn. The price control needs to protect the cash flow position by ensuring that:

- (a) if the outturn volume equals the volume in the plan, the cash flow position would be no worse than that in the plan;
- (b) if the outturn volume is less than the volume in the plan, the cash flow position would be protected by an ability to increase prices.

In its February and July 2002 submissions, Royal Mail raised the need for the price control to address volume risk explicitly within the price control. The CAA has proposed a similar change to the price control of NATS. The hybrid average revenue control provides some protection for the cash flow position of the regulated business if volume falls below V2 (as stated in the final bullet point in section 3 to this Appendix).

In summary, the statutory obligation requires protection of the cash flow position of the regulated business from volume change. This obligation should override any other criterion, including whether the regulated business's revenue or customer prices should be constant. Postcomm's proposal and draft licence provide no clear and satisfactory means for re-opening the control. Royal Mail requires a more transparent and automated approach to address the issue of financial viability around volume risk. The hybrid average revenue control is a means of providing some protection of the cash flow.

5 Implementation.

The proposal document defined the line P2 in Figure 1. The hybrid average revenue control requires the line EF in Figure 3 to be defined within a licence modification. The line EF could be set:

- using pre and post liberalisation data on revenues, costs and volumes; and

- information on the trade-off between AC and FC, including that illustrated in Paper 6 of the Royal Mail's June submission.

The control requires outturn volume to derive the allowed revenue and outturn revenue to derive any over or under recovery with respect to the allowed revenue. The volume required is aggregated data for the products covered by the control. The use of only aggregated data removes the need for disaggregated volume data.

There are several different measurement approaches to volume. For example, business planning uses revenue derived data while the regulated accounts publish operational data. Typically, operational data exceeds that of revenue derived data. One of these methods, or a weighted combination of the two, could provide a measure of the outturn volume for use in the control. The allowed revenue line EF would be the same independent of the volume measure but, in setting the control, the revenue increment with respect to volume would need to take account of the method of measurement for volume chosen for the control (i.e. the revenue increment may need to be reduced if operational data is used instead of the planning, revenue derived figures).

A correction factor for over and under-recovery would act as an automatic disincentive on the regulated business, through the interest rate penalty, to overstate prices. The potential penalty and limit on allowed revenue reduces the need for Postcomm to investigate the consequences of any proposed changes on revenue. This would enable Postcomm to have the "light touch" regulatory approach to pricing that is used by other regulators (e.g. Ofgem for the distribution and transmission businesses). This improves the efficiency of the regulator and reduces the uncertainty for the regulated business.

With volume risk explicitly addressed through the structure of the hybrid control, the present re-opening condition would be retained as it would no longer be the primary means of addressing the impact of competition.

6 Related issues.

(a) Secondary caps

Postcomm's proposal document advocates secondary caps that limit the maximum change in any price between years to RPI.

The Royal Mail notes that:

- (i) since the hybrid average revenue control effectively limits the overall level of revenue, the secondary caps are not necessary to control the level of revenue. Instead, the caps are primarily used to limit the degree of price rebalancing;
- (ii) Postcomm's proposed limit of RPI would not necessarily provide sufficient headroom to enable the regulated business to rebalance its charges to be cost-reflective within the price control period. The degree of rebalancing required for cost-reflective charging could significantly exceed this limit. Any limit on price increases for rebalancing needs to ensure that firstly the allowed revenue could be attained and secondly prices recover costs by the end of the price control period;

- (iii) though not stated in its October document, Postcomm has expressed the view that the secondary caps act as a means of limiting the extent to which the Royal Mail could reduce some prices in response to competition. That is, by limiting the extent to which some prices increase, Postcomm limits the extent to which prices could fall and still retain the maximum allowed revenue. This is a spurious line of argument for defence for the RPI cap, since it does not directly address the issue of price reductions. If the specific concern of Postcomm is one of potential market abuse through reducing prices then this is addressed directly through the Competition Act which prohibits anti-competitive behaviour and Postcomm's powers of over access to information within the Licence. It is not necessary for the price control to address this issue.

(b) Coverage

Royal Mail believes that:

- Special delivery and USO parcels should be under a separate control to reduce the risk of product mix changes - primarily because the average price for these products is significantly different from the average price of the Inland 6²⁰;
- USO International should be under a separate control - primarily because it is driven by cargo weight rather than volume;
- Presstream should be taken out of the control - primarily because primary duty relates to ensuring the uniform and affordable prices for USO products not non-USO products and the Presstream product is competitive;
- Products outside the Licensed Area should be outside of the control - because they have already been taken outside of the existing control.

This is discussed further in the main response document.

(c) Other related issues

Royal Mail believes that the cash flow position for the pre-liberalisation case can be compared with the allowed profit levels indicated in Papers 3 and 4, and further analysis in Appendices 4B and 4C, to place the control in a standard regulatory setting. That is, these papers and Appendices indicate the level of allowed profit and thereby cashflow in a pre-liberalised market and thereby establish a reference point from which to trade off revenue in a pre-liberalised market (high volume scenario) for more revenue protection in a post-liberalised market low volume scenario). This amounts to moving point F from A towards C in Figure 2. At the same time, though, it is necessary to retain some incentives for volume growth. This is achieved by moving point F from C towards A in Figure 2. The hybrid control could be set to balance these issues and in the context of the level of the allowed profit.

These issues are discussed, along with other detailed issues, in the main response document and taken forward into the economic brief on the licence modification for the hybrid average revenue approach in Appendix 5D.

²⁰ Inland 6 refers to First Class, Second Class, Mailsort, Walksort, PacketPost and Response Services.

7 Summary

For Postcomm, the approach builds on Postcomm's proposal's document and:

- provides an effective framework for Postcomm to deliver its primary statutory duty at the same time as opening up of the market to competition;
- allows "light touch" regulation towards prices by controlling the level of allowed revenue;
- requires only relatively small amounts of information while also allowing rebalancing (subject to any secondary caps) with no additional regulatory input.

For customers, the approach also:

- reassures customers of the continued provision of the universal service;
- allows price rebalancing to improve cost reflectivity;
- provides incentives for cost reduction, volume growth and service improvements to remain in place;
- allows specialist USO products (such as special delivery) to be treated under separate controls to provide comfort to customers that these continue to be price controlled.

Appendix 5B

THE SIMPLIFIED APPROACH WITH FLEXIBILITY

1 Introduction

Postcomm's October document (2002) advocated a single average revenue control with coverage for the whole of the regulated business's products. It also set out specific licence modifications for this proposal.

Postcomm's proposal did not define a simplified approach within flexibility. The approach has emerged as one that Postcomm is actively considering following the publication of its proposal. This document reviews this approach in the context of no network access in line with a presentation made to Postcomm on 24 October 2002.

2 Definitions

Royal Mail defines the simplified approach with flexibility as having these properties:

- (a) There are caps on individual prices;
- (b) The regulated business can rebalance prices subject to an ante revenue neutrality rules;
- (c) The regulated business can restructure prices subject to an ex post revenue neutrality test;
- (d) The regulated business can increase prices when volume (or revenue) falls below a specified level, whereby the trigger mechanism, additional allowed revenue and criteria for approval by Postcomm are fully transparent.

This approach further develops the approach of the present licence condition 19 to:

- (i) Make the revenue and cash flow position of the regulated business less sensitive to reductions in volume when costs do not change in direct proportion to volume; and
- (ii) Allow for the rebalancing and restructuring of prices.

Fully transparent are required to minimise the regulatory uncertainty associated with the approval process by Postcomm on price rebalancing or restructuring and price changes associated with volume change.

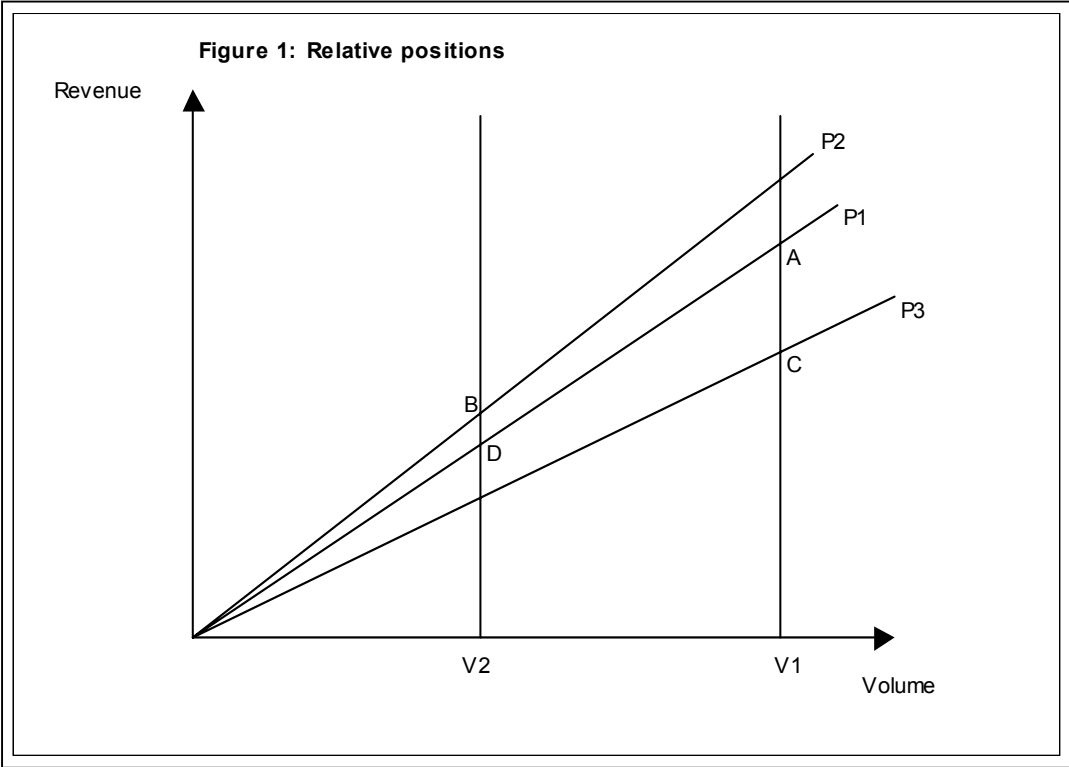
Royal Mail has experienced Postcomm's use of discretion and decision making in respect of:

- (a) an application under Condition 19.6 being turned down;
- (b) significant delays in the introduction and implementation of a project related to mailsort;
- (c) erroneous economic analysis in respect of the discount factor that was used in assessing the impact of competition.

The regulated business does not accept that it is necessary for Postcomm to retain discretion over applications to rebalance prices, restructure prices or change prices in response to volume changes.

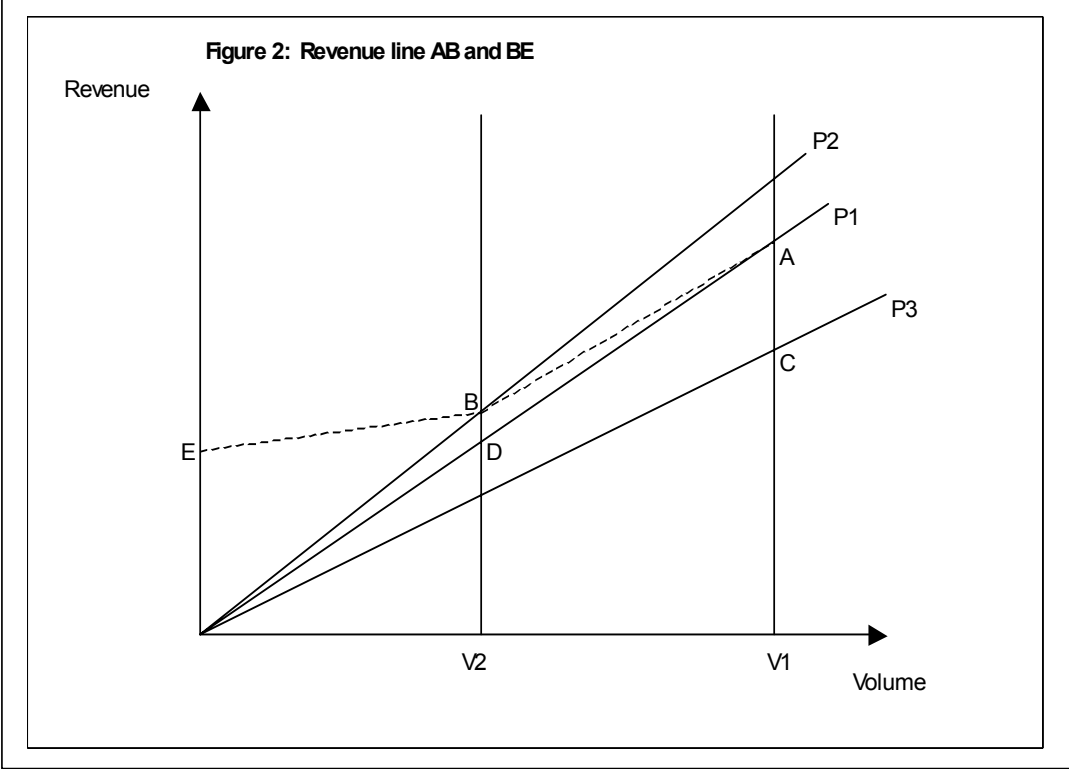
3 The level of the allowed revenue

On the specific issue of the level of allowed revenue, the difference between Postcomm’s proposal and Royal Mail’s view is illustrated in Figure 1. Postcomm proposed an average revenue P1 for volume V1, represented by point A. Royal Mail’s plan was based on a level of allowed revenue equivalent to an average revenue P2 at a volume V2, below V1, represented by point B. At volume V1, point C represents the point at which the cash flow is the same as at point B. At volume V2, point D represents Postcomm’s proposal with an average revenue of P1. The revenue and cash flow at point B are worse than the revenue and cash flow position at point A arising from the volume loss associated with the impact of competition. The revenue and cash flow at point D are worse than the revenue and cash flow position at point B arising from Postcomm’s proposal for the allowed average revenue.



The simplified approach with flexibility provides a means of resolving the differences over the level of the control. This is illustrated by Figure 2. In Figure 2, the line AB represents the regulated business’s projected revenue line between V1 and V2. The structure would allow a different revenue line to emerge with a different product mix outcome to that in the plan. The flexibility to rebalance and restructure prices would amount to a rule that retained the revenue line to that which actually emerges. The flexibility to change prices as volume changed would amount to a rule to change prices and revenue along line BE if volume fell below V2. The approach would amount to defining the line ABE while retaining price flexibility.

Since the allowed revenue is defined by ABE the control is not dependent on a single view of the forecast volume. Since point A is above point C then the cash flow increases with volume and the incentive to increase volume is retained. The incentive to improve service performance is also retained.



In summary, the simplified approach provides:

- incentives for volume growth and improvements in service performance by enabling the cash flow position to improve with increased volume (as represented by point A above point C);
- the allowed revenue at point B for volume V2, thereby allowing for the allowed revenue in Royal Mail's plan;
- some protection for the cash flow position of the regulated business if volume falls below V2.

4 Protection of the cash flow position of the regulated business

The primary statutory duty of Postcomm is to ensure the provision of the USO with national coverage at uniform and affordable prices for public tariffs and, thereby, have regards to ensuring the financial viability of the Licensee. Postcomm has not demonstrated any analysis or consideration of the cash flow impact of a fall in volume below that in the Royal Mail's plan (i.e. V2 in Figures 1 to 3). Instead, its proposal focuses only on the improvement in cash flow for volume above that that in Royal Mail's plan.

Postcomm's October document states that the regulated business is likely to remain the only universal service provider for the period of the control. This statement, when combined with Postcomm's statutory duties, requires Postcomm to ensure the financial viability of Royal Mail over the price control period.

Postcomm's October document also states that the regulated business should be treated as an independent, commercial business. This is a further reason to ensure that the financial viability of Royal Mail is independent of the need to (a) borrow off the shareholder more extensively than presently planned during the period of the price control and (b) rely on re-opening the price control. These are discussed below.

(a) Allowed profit

Postcomm's proposal references £1.8bn of gilts as if borrowing against this sum is a means of ensuring the financial viability of the regulated business. The DTI and Royal Mail have indicated to Postcomm the limits of this form of borrowing for the regulated business. Fundamentally, though, it is the level of allowed profit, rather than the source of borrowing, that should be the primary concern of an independent regulator to provide a return for investment and protect the financial viability of the universal service provider.

Postcomm's October document does not place the context for setting the allowed revenue within a standard regulatory framework. It is standard regulatory practice to review the level of allowed revenue in the context of allowed operating and capital expenditures and allowed profit. Postcomm provides no analysis of allowed profit and no review of the work presented to it on the subject. Postcomm therefore provides no reliable framework to analyse financial risk and issues of regulatory uncertainty.

It is standard practice for regulators to derive the level of allowed profit from estimates of the regulatory asset base and cost of capital and, where these are not readily available, from similar information on relevant comparators. Royal Mail used this approach in Papers 3 and 4 of its July 2002 submission to indicate that the level of allowed profit for the universal service should be about £400m p.a. on efficient costs. Since that submission, Royal Mail has undertaken further work included in Appendices 4B and 4C which indicates that the allowed profit for the USO should be at least £0.4bn p.a. on a comparable basis to the inland mails businesses of TPG and DPWN.

This analysis provides the basis for the setting the allowed profit in a pre-liberalisation scenario. This allowed profit for the pre-liberalised market may then be compared with the cash-flow position as volume is lost to competition in a post-liberalised market environment.

(b) Re-opening the control

The draft licence modifications in the proposal document and those of the existing price control do not address the issue of volume risk explicitly within the control. Postcomm's treatment of volume loss on the regulated business is unclear and increases the level of uncertainty faced by the business unnecessarily. This is discussed further in Appendix 4D.

The financial viability of the business is threatened by the exposure to volume loss arising from the opening of the market to competition. In the presence of significant volume loss financial viability could only be maintained through significant additional

savings to those in the plan. However, the volume loss is expected to be caused by cream-skimming entry which would have two effects:

- (b) a direct and significant reduction on the contribution to a positive cash flow; and
- (b) a very limited reduction in costs as the universal service still needs to be retained.

In a pre-liberalised market, a 10% increase in volume would increase revenue by about 10% and costs by about 6% (see Paper 5). In a post-liberalised market, cream-skimming means that a 10% decrease in volume could reduce revenue by about 10% and costs by significantly less than 6% (see Paper 6). Costs will reduce with the effective implementation of the Royal Mail's business plan but are not fully flexible and will not change in proportion to revenue. Hence, the cash flow position of the regulated business is sensitive to volume outturn. The price control needs to protect the cash flow position by ensuring that:

- (b) if the outturn volume equals the volume in the plan, the cash flow position would be no worse than that in the plan;
- (b) if the outturn volume is less than the volume in the plan, the cash flow position would be protected by an ability to increase prices;

In its February and July 2002 submissions, the Royal Mail raised the need for the price control to address volume risk explicitly within the price control. The CAA has proposed a similar change to the price control of NATS. The simplified approach with flexibility, as defined above, provides some protection for the cash flow position of the regulated business if volume falls below V2 (as stated in the final bullet point in section 3 of this Appendix).

In summary, the statutory obligation requires protection of the cash flow position of the regulated business from volume change. This obligation should override any other criterion, including whether the regulated business's revenue or customer prices should be constant. Postcomm's proposal and draft licence provides no clear and satisfactory means for re-opening the control. Royal Mail requires a more transparent and automated approach to address the issue of financial viability around volume risk. The simplified approach with flexibility, as defined above, is a means of providing some protection of the cash flow.

5 Implementation

Postcom's October document defined the line P2 in Figure 1. The simplified approach with flexibility requires the line ABE in Figure 2 to be defined within a licence modification. The line AB would be defined in the licence through individual price caps, assuming no change to the existing products. The line BE would be defined in the licence by stating the incremental revenue allowance for volume loss below V2.

The simplified approach with flexibility defines the allowed revenue as:

- (i) the outcome of product mix for end-to-end volumes between the pre-liberalisation and post-liberalisation volume in the plan; and
- (ii) the outcome of product mix and additional revenue allowances for end-to-end volumes below the post-liberalisation volume in the plan.

Having defined the individual caps it is then necessary to define the additional allowed revenues for end-to-end volumes below the post-liberalisation volume in the plan. In addition, it is necessary to define a correction factor adjustment for allowed revenue to allow for price restructuring and product re-specification.

For transparency, this approach requires the licence to define (i) a revenue neutrality test for the rebalancing of the prices for existing products; (ii) a revenue neutrality test for the restructuring and/or re-specification of the products; and (iii) a test for triggering and defining the additional allowed revenues. These are discussed in turn below.

(i) a revenue neutrality test for the rebalancing of the prices for existing products

A test is required to demonstrate that the prices, if rebalanced, are revenue neutral. The regulated business should be required to show that, using t-1 volume data, the expected revenue from the new prices in t equals the out-turn revenue in t-1. This ex-ante test would apply only to the prices of products that existed in both t and t-1. The test would require the volume data in t-1 to be accepted by Postcomm.

(ii) a revenue neutrality test for the restructuring of the prices for existing products

A test is required to demonstrate that the prices, if restructuring prices or re-specifying products, are revenue neutral. The regulated business would be required to satisfy a revenue neutrality test when restructuring its prices. It is not possible for the restructuring of prices to undergo the same test as that for the rebalancing of prices because the volume and price data in t-1 relates to the old structure and the volume and price data in t relates to the new structure. The regulated business should be required to show that the outturn average price of the new structured products in t was equal to the outturn average price of the old structured products in t-1. This ex-post test would apply only to the prices of products that were restructured between t-1 and t.

(iii) a test for triggering and defining the additional allowed revenues.

To protect the cash flow position of the regulated business, additional allowed revenues would be triggered in the event volumes (or revenues) of end-to-end products falling below that of the post-liberalisation scenario in the plan. In each case a pre-condition would need to be satisfied for the regulated business to change prices associated with a volume change. A trigger test would need to be satisfied whereby the outturn of a measurable item would need to contravene a test of acceptability and thereby precipitate the need for change. For example, if the level of outturn volume (or revenue) of end-to-end products in any year fell below the projection in the plan, there would be an additional allowance to increase prices. The allowance would be defined as the extent to which outturn volume was less than the forecast volume multiplied by a price xp.

The allowance could be split by the relative revenues in t-1 for products that exist in both t-1 and t and those that are restructured between t-1 and t. For products that exist in t-1 and t, the regulated business would be required to show ex ante that, using t-1 volume data, the expected revenue from the new prices in t equals the out-turn revenue in t-1 plus

additional allowance. For products that are restructured between t-1 and t, the regulated business would be required to show ex post that the outturn average price of the products in t-1 equals the outturn revenue less additional allowance divided by outturn volume of the products in t.

The licence would need to specify this test including the trigger test and the allowance xp.

In addition to these tests, Postcomm has indicated the need for other tests (as yet unspecified) to be satisfied before the prices could be met. In general, the regulated business recognises the need for Postcomm to have regard to the public interest. However, Royal Mail believes that the price control must be transparent. To achieve this it believes that (a) wherever practically possible the process and decision criteria should be defined and automated and (b) wherever it is not practically possible a transparent appeals process is established.

In the case of the ex-post test for restructuring and product re-specification the correction factor for over and under-recovery would act as an automatic control on the revenue and prices of the regulated business, as the interest rate penalty would penalise overstated prices. The potential penalty and limit on allowed revenue reduces the need for Postcomm to investigate the consequences of any proposed changes on revenue. This would enable Postcomm to have the “light touch” regulatory approach to pricing that is used by other regulators (e.g. Ofgem for the distribution and transmission businesses). This improves the efficiency of the regulator and reduces the uncertainty for the regulated business.

With volume risk explicitly addressed, the present re-opening condition (i.e. draft licence condition 19.5) would no longer be the primary means of addressing the impact of competition.

6 Related issues

The related issues of secondary caps and coverage are broadly the same as those for the hybrid average revenue approach set out in Section 5.2(c) above. The simplified approach with flexibility would need to separate out products in a similar manner to that of the hybrid average revenue approach, in order to allocate correctly the allowed revenue entitlements through the period of the control.

During the presentation on 24 October Royal Mail raised the following related issues:

- with caps on individual prices, the form of cap should depend on the whether the services were prospectively competitive or non-competitive;
- no caps on individual prices should be applied to services that are competitive, new or outside the universal service obligation;
- a change of specification requires an ex ante application by the regulated business for approval by Postcomm. The licence would need to clarify whether this change in specification includes a change in structure. If it does then there is an ex-post test for a restructuring of prices. The licence then needs to set out the data requirements and criteria for the approval of a change in specification;

- the timescales for the approval process would need to be defined in the licence, with defaults if these timescales expire;
- since the outturn figures in any financial year are not known until June of the subsequent financial year, there would need to be scope to change prices several times a year to reflect the need to rebalance prices, restructure prices or adjust prices for volume changes.

These issues are discussed, along with other detailed issues, in the main response document and taken forward into the economic brief on the licence modification for the simplified approach with flexibility in Appendix 5E.

7 Summary

For Postcomm, the approach builds on Postcomm’s proposal’s document and:

- provides an effective framework for Postcomm to deliver its primary statutory duty at the same time as opening up of the market to competition;
- allows “light touch” regulation towards prices by controlling the level of allowed revenue;
- requires only relatively small amounts of information while also allowing rebalancing (subject to any secondary caps) with no additional regulatory input.

For customers, the approach also:

- reassures customers of the continued provision of the universal service;
- allows price rebalancing to improve cost reflectivity;
- provides incentives for cost reduction, volume growth and service improvements to remain in place;
- allows specialist USO products (such as special delivery) to be treated under separate controls to provide comfort to customers that these continue to be price controlled.

Appendix 5C

THE HYBRID AVERAGE REVENUE CONTROL AND SIMPLIFIED APPROACH WITH FLEXIBILITY WITH DOWNSTREAM ACCESS

1. Introduction

The regulated business is presently reviewing the options for the control in the light of the Postcomm's proposal and recent correspondence. Two options under consideration are the simplified approach with flexibility and the hybrid average revenue control without downstream access (DSA). These approaches were defined and discussed in two presentations made to Postcomm on 21 and 24 October 2002 and are set out in Appendices 5A and 5B.

This Appendix assesses the impact of downstream access on the two options as presented to Postcomm on 15 November 2002. This presentation followed a correspondence in October from Postcomm to Royal Mail indicating that Royal Mail should undertake modelling of the effect of DSA on its revenue and cash flow position.

The Appendix makes reference to a series of diagrams, which illustrate the impact of DSA. It looks at the impact of DSA on end-to-end revenue and cash flow and then the impact of DSA on the overall revenue and cash flow. Having assessed the impact of DSA on the revenue and cash flow it proceeds to discuss how the two approaches of the simplified approach with flexibility and hybrid average revenue control would be modified to address the issue of DSA.

2 Review of two approaches without DSA

Figure 1 summarises the position without DSA of the simplified approach with flexibility. The revenue line is shown by ABE.

In Figure 1 the cash flow neutrality line is shown by BC between V1 and V2. The improvement in the cash flow from V2 to V1 is shown by the shaded area between BA and BC.

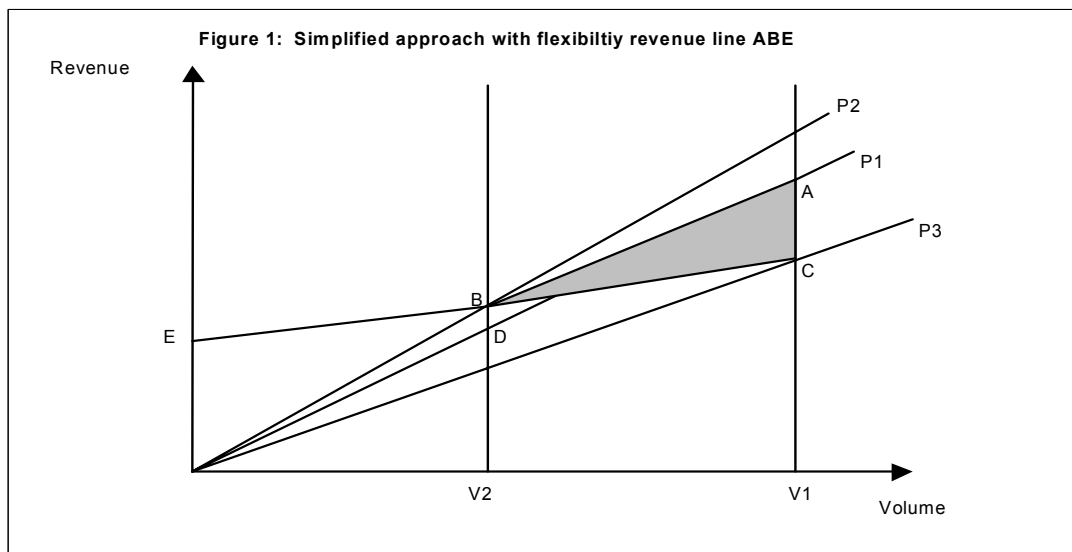
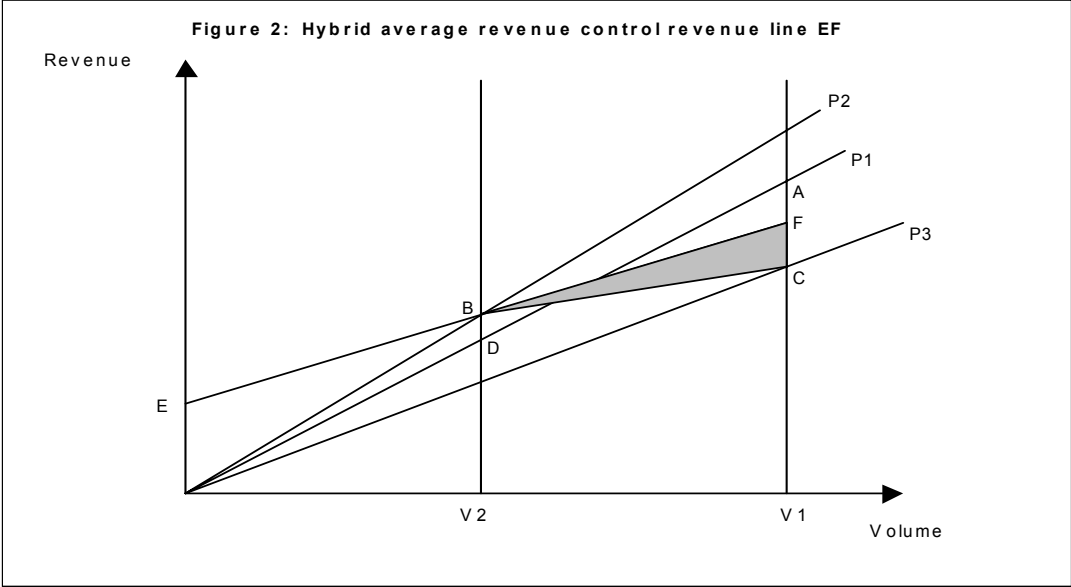


Figure 2 summarises the position without DSA of the hybrid average revenue control. The revenue line is shown by E(B)F. The cash flow neutrality line, whereby the cash flow is the same as at point B, is shown by BC between V1 and V2. The improvement in the cash flow from V2 to V1 is shown by the shaded area between BF and BC.



3. Background

For illustration, the focus of the subsequent diagrams is on changes between V1 and V2, although change below V2 would also need to be considered in setting the control. Some useful background to these illustrations is set out below.

(a) Cashflow neutrality line:

The cash flow neutrality line is the revenue line that would derive the same cash flow as point B in the plan. It reflects the changes in revenue needed to cover any changes in cost (e.g. from volume changes).

For example, if costs increase then the cashflow neutrality line would move upwards in the diagram to reflect the increased revenue needed to recover the additional costs. Conversely, if costs decrease then the cashflow neutrality line would move downwards in the diagram to reflect the decreased revenue needed to recover the reduced costs.

Moreover, if the revenue line is above the cashflow neutrality line then the cash flow is above that in the plan. Conversely, if the revenue line is below the cashflow neutrality line then the cashflow is below that in the plan.

This approach is used throughout the illustrations in this presentation.

(b) Simplifying assumptions

For simplification, the illustrations in this presentation assume that (i) the end-to-end volume reduces from V1 to V2; and (ii) volume increases to some level between V2 and V1 through downstream access. Changes in the end-to-end volume above and below V2 would also need to be considered in setting the control.

For simplification, the illustrations compare, in turn (i) the revenue line and cash neutrality line for end-to-end volume between V1 and V2 in the presence of DSA; and (ii) the revenue line and cash neutrality line for overall volume between V1 and V2 in the presence of DSA. In practice, modelling work and the price control would need to address the two impacts simultaneously.

(c) Cashflow position

The cashflow position should be no worse than that in the plan to secure funding and the financial viability of the regulated business. If DSA has the effect of reducing the revenue line is below the cashflow neutrality line then the cashflow is below that in the plan – undermining the funding and the financial viability of the regulated business.

The illustrations in this Appendix show that, using simple principles and assumptions, DSA causes the revenue line to be below the cash neutrality assumptions.

3 Impact of DSA on end-to end revenue and cash neutrality lines

A uniform access price encourages entrants to post high weight (high price) products into Royal Mail’s downstream network where DSA costs exceed the DSA price. The loss of high weight volume reduces the end-to-end average price. The slope of the revenue line increases about point A from AB to AB1 as shown in Figure 3.

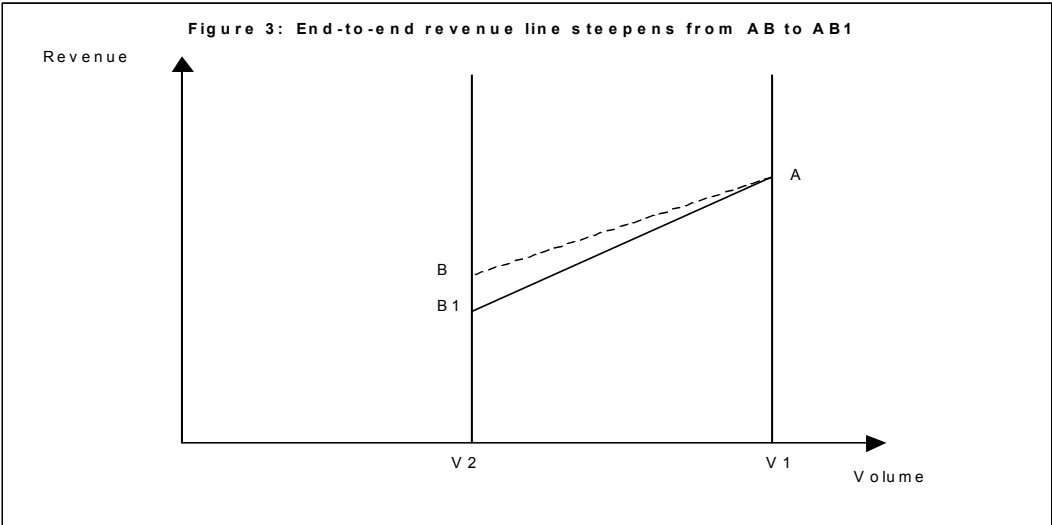


Figure 4 shows the impact of DSA on the end-to-end cash flow neutrality line. A uniform access price encourages entrants to post high weight products into Royal Mail’s downstream network where DSA costs exceed the DSA price. The loss of high weight (high DSA cost) volume reduces the end to end average cost. Entrants not only take account of the high DSA cost of a product, but also the potential for high upstream profits through the identification of volume with an upstream price above upstream marginal costs. Consequently, the slope of the cash flow neutrality line increases about point C from CB to CB2 in Figure 4, but the movement is less than in the case of revenue because the entrants’ incentives to cream-skim upstream profits limits the extent to which costs reduce from end-to-end volume loss.

Furthermore there are additional costs for introducing DSA services. The cash flow neutrality line shifts upwards from CB2 to C1B3 to reflect the additional revenue required to cover the additional costs.

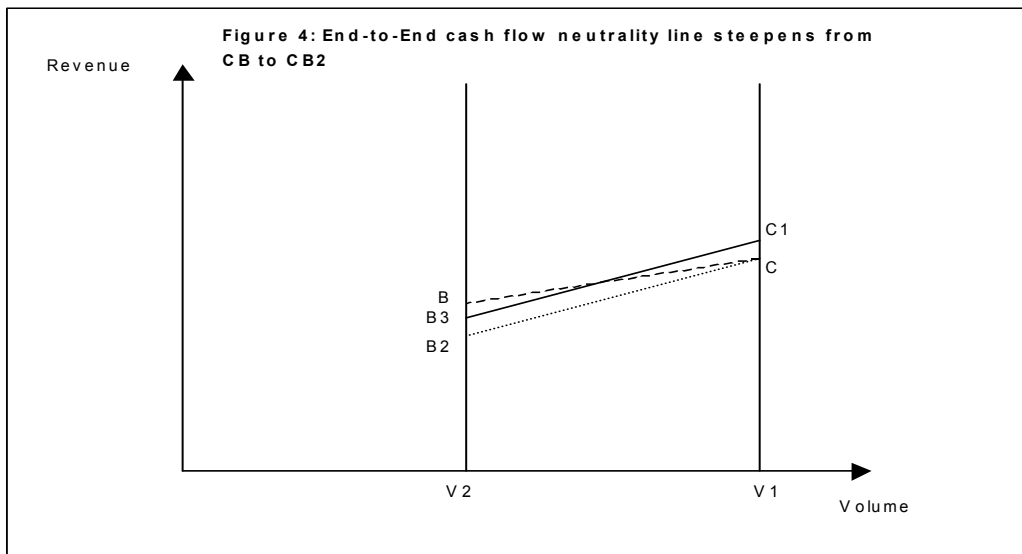
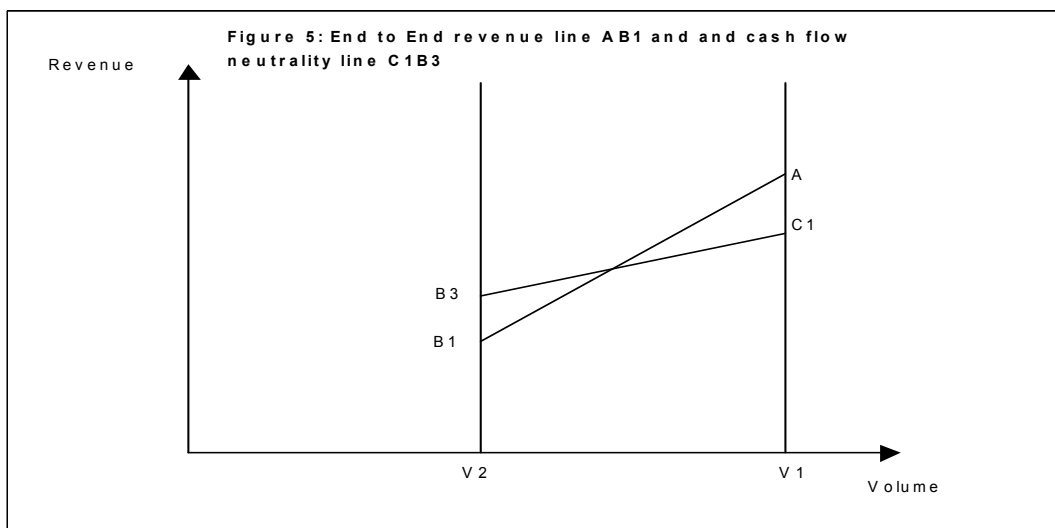


Figure 5 shows impact of DSA on the end-to-end revenue and cash flow neutrality lines. The revenue line AB1 and cash flow neutrality line B3C1 are shown to intersect between V1 and V2 in Figure 5. The cash flow position worsens the greater the volume loss below V1 since the revenue line AB1 is steeper than the cash neutrality line B3C2. At V2 the cash flow position is below the cash neutrality line and is worse than point B3 (which has an equivalent cash flow to point B in Figures 1 and 2 having adjusted for the impact of DSA on end-to-end products).



4 Impact of DSA on overall revenue and cash neutrality lines

Figure 6 shows the overall revenue line, taking account of the impact of revenue on end-to-end products from V1 to V2 and then the impact on revenue as DSA increases above V2. The access price is below the end-to-end price. Consequently, the slope of the revenue line reduces about point B1 from B1A to B1A1.

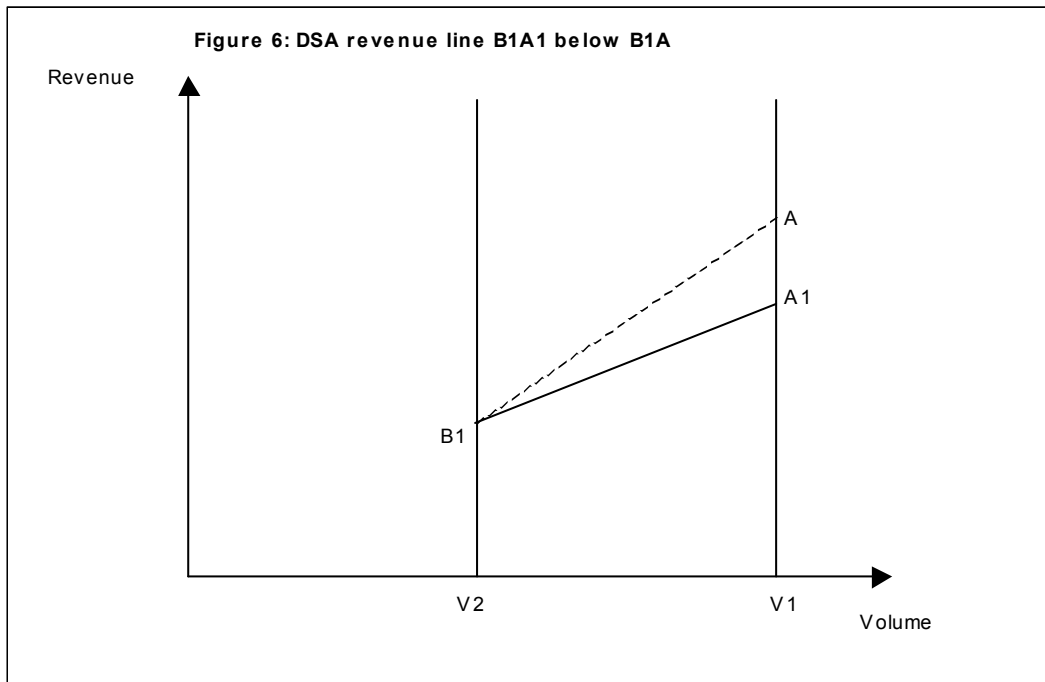
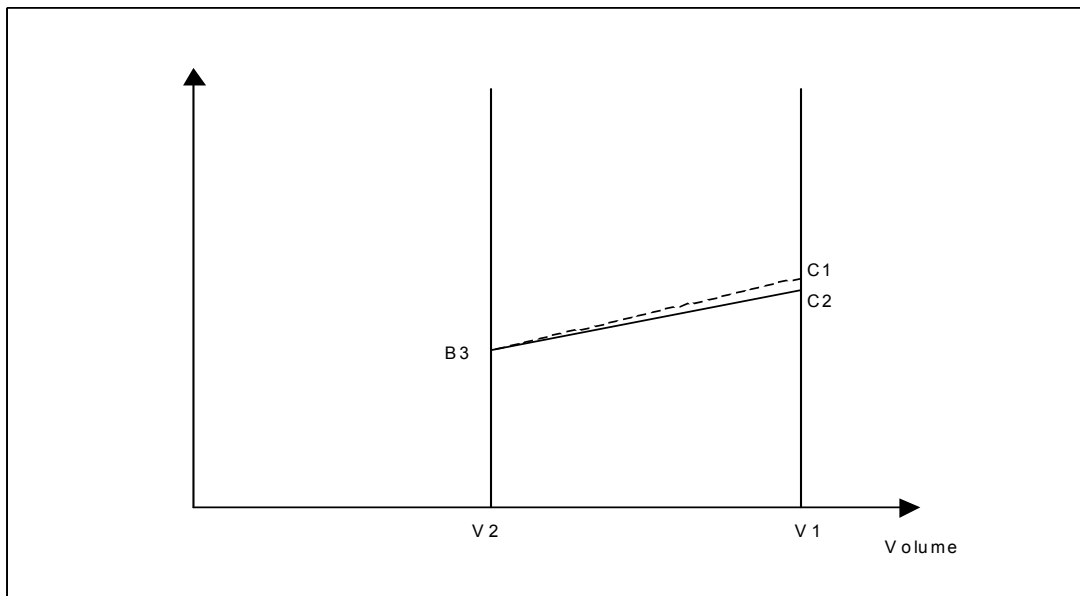


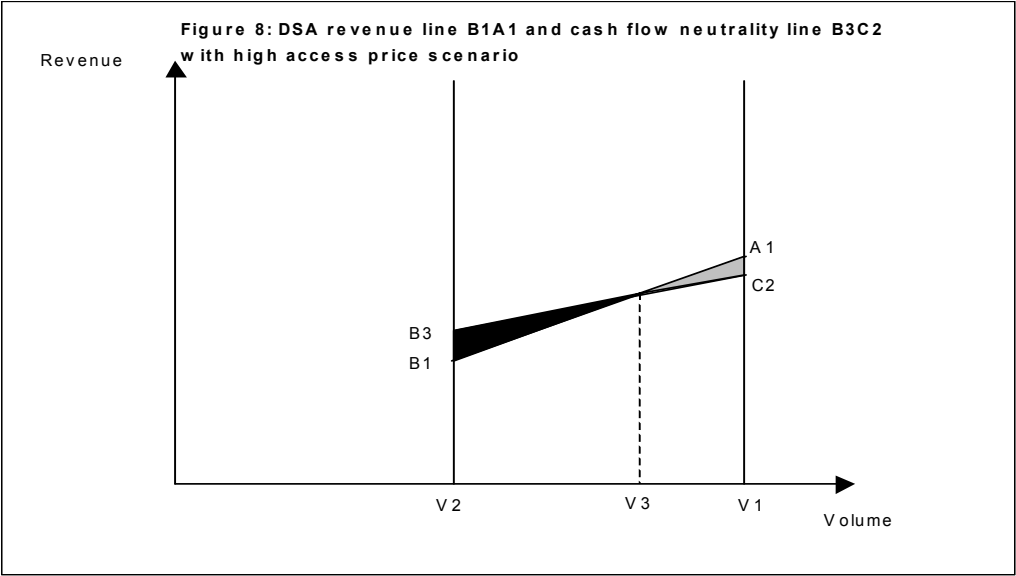
Figure 7 shows the overall cash flow neutrality line, taking account of the impact of costs on end-to-end products from V1 to V2 and then the impact on costs as DSA increases above V2. The marginal cost of DSA volume is below the marginal cost of the end-to-end price because of avoided upstream costs. The slope of the overall cash-flow neutrality line reduces about point B3 from B3C1 to B3C2 to reflect the change in cost.



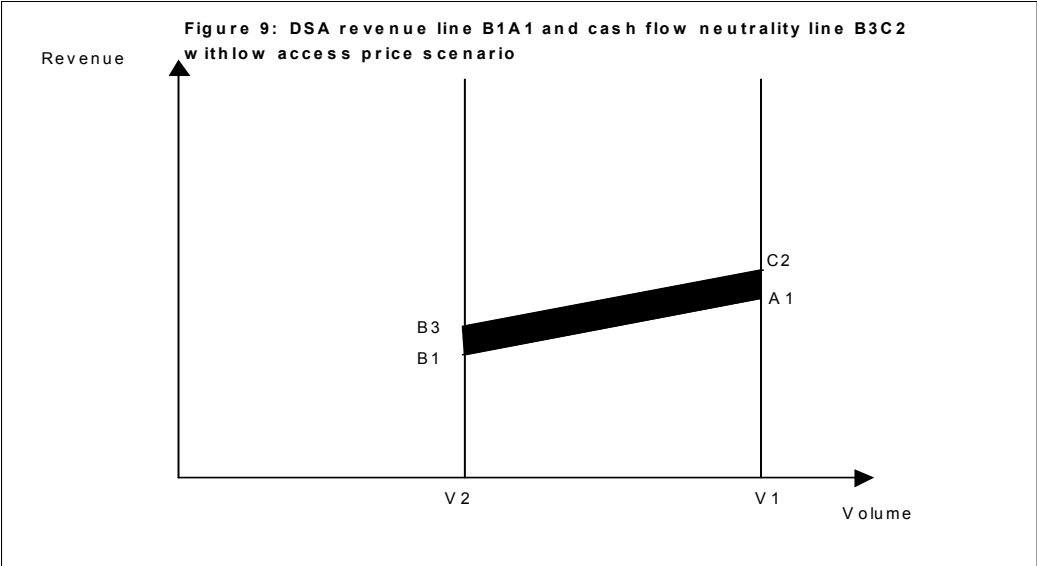
The outcome depends on the DSA pricing which is illustrated by the line B1A1 in Figures 8 and 9 for a high and low access price scenario respectively.

In Figure 8 the overall revenue line B1A1 intersects the cash-flow neutrality line B3C2 at V3 between V1 and V2. If volume outturn exceeds V3, outturn revenue would be above the cash-flow neutrality line and hence the cash flow would be better than that

in the plan. If volume outturn is less than V_3 , outturn revenue would be below the cash-flow neutrality line and hence the cash flow would be worse than that in the plan. The cash flow position between V_1 and V_2 would worsen relative to that in Figure 1.



In Figure 9 the overall revenue line the overall revenue line B_1A_1 does not intersect the cash-flow neutrality line B_3C_1 between V_1 and V_2 . Outturn revenue would be below the cash-flow neutrality line and hence the cash flow would be worse than that in the plan. The cash flow position between V_1 and V_2 would worsen relative to that in Figure 1. Indeed, Figure 9 illustrates the case whereby the access price recovers the incremental cost of downstream access, but does not recover the loss in contribution to cashflow from the loss of end-to-end volume.



5 Interim results and conclusions

The main results from the above illustrations are as follows:

- DSA reduces the cash flow position of the regulated business between V1 and V2;
- DSA exposes the regulated business to a cash flow position that is worse than that in the plan for volume between V1 and V2;
- the cash flow position of the regulated business worsens, the greater is the volume loss below V1;
- the cash flow position of the regulated business could be worse than that of the plan for volumes below V1, dependent on the access price, and would certainly be worse than that in the plan for volume below V2.

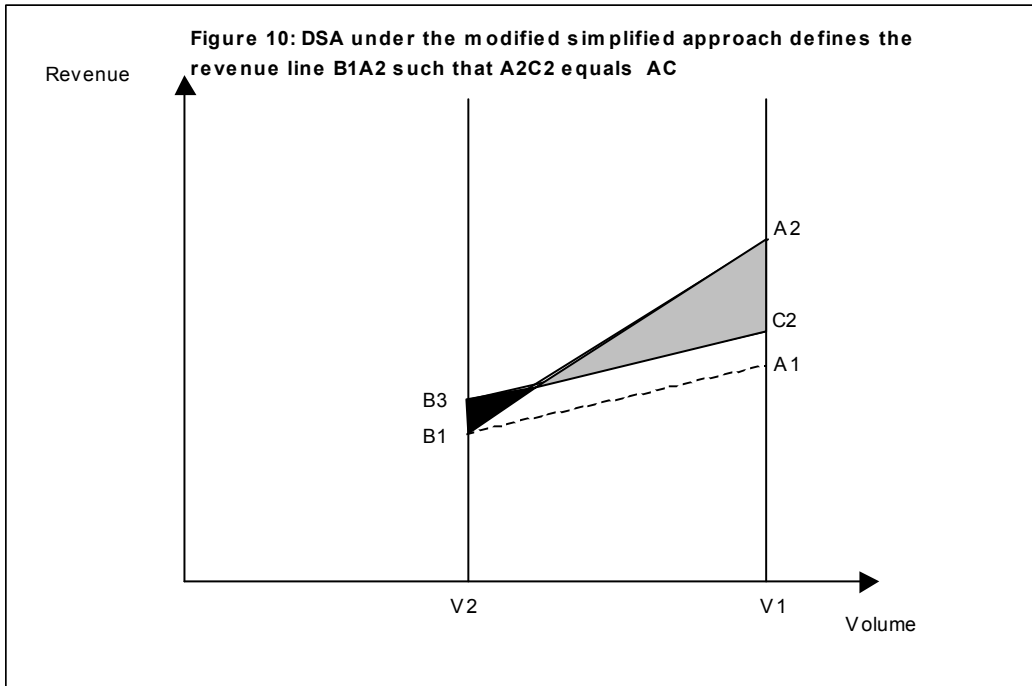
The main conclusions from the above illustrations are that:

- since DSA potentially worsens the cash flow position of the regulated business it is necessary to modify the price control to address it and ensure the cashflow position in the plan and thereby the financial viability of the regulated business;
- to achieve this, in setting the control, there is a need to define a reference point whereby the expected outturn cash-flow reflects the appropriate level of allowed profit for the regulated business (effectively at pre-liberalisation volume V1);
- once the appropriate level of allowed profit is defined, it should be possible to identify the modifications to the simplified approach with flexibility and hybrid average revenue control that are needed to meet the expected outturn cash flow position at the reference point. These modifications are discussed below.

6 The modified simplified approach with flexibility

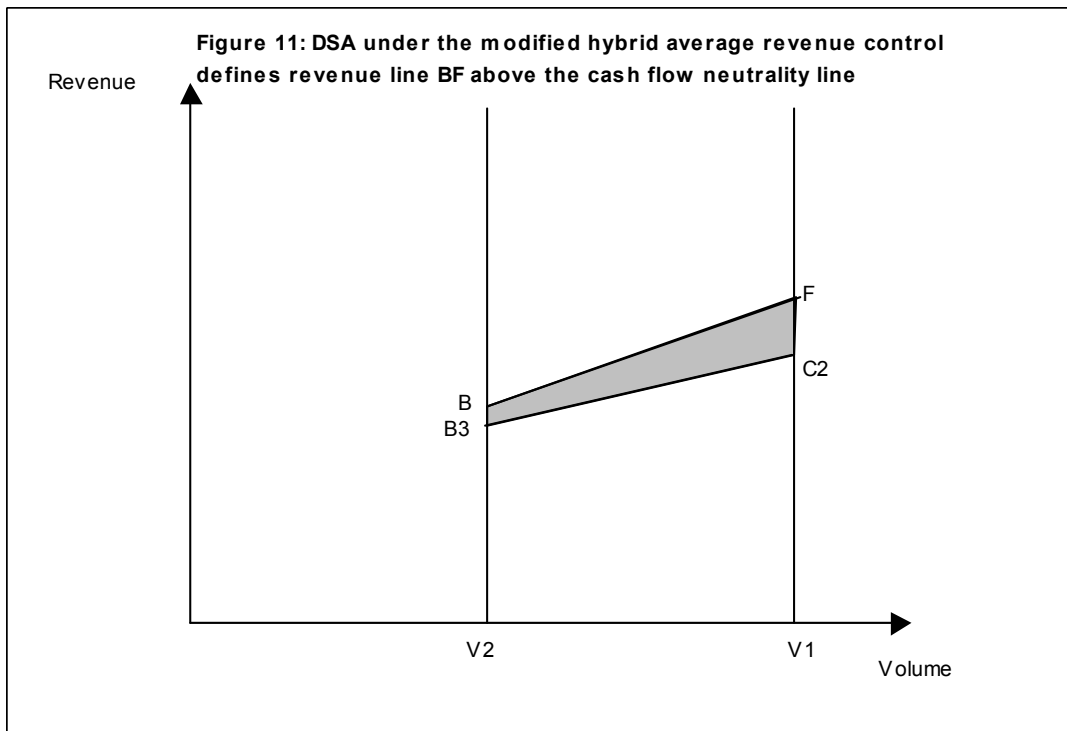
The simplified approach with flexibility without DSA in Appendix 5B would need to be modified to take account of the need to meet the expected outturn cash flow position at the reference point with DSA. In a similar way to the revenue allowance applied to volume below V2 in the simplified approach with flexibility (see Part B), an additional revenue allowance in year t would be defined by multiplying the DSA volume in year $t-1$ by a factor z_p . This would result in the overall revenue line tilting about B1 from B1A1 to B1A2 as shown in Figure 10. The value attributed to z would need to be set to ensure the reference cash flow position at V1 is met, e.g. such that A2C2 in Figure 10 equals AC in Figure 1. This would need the access price to be known. In addition, any secondary caps would need to be set in such a manner as to allow sufficient price flexibility to meet the revenue line B1A2.

As shown in Figure 10, this would improve the cash flow position as volume increased from V2 to V1, but would still leave the regulated business in a worse cash flow position than the plan around V2. One means of addressing this would be to introduce a fixed component into the additional revenue allowance around DSA volume



7 The modified hybrid average revenue control

The hybrid average revenue control without DSA discussed in Appendix 5A would need to be modified to take account of the need to meet the expected outturn cash flow position at the reference point with DSA.



In the most straight forward approach, the DSA products, corresponding to the end-to-end products in the hybrid average revenue control, would be included in the coverage of the hybrid average revenue yield. The revenue line would be defined by BF between V1 and V2 in Figure 11 (in a similar way to that in Figure 2). The selection of point F (and the slope of the BF line though point B) could (but need not necessarily) take account of the avoided costs of DSA illustrated by the move in the cash neutrality line from B3C1 to B3C2 in Figure 7. This would be in addition to the factors of volume incentive and trade off of cash flow over volume that were raised in Appendix 5A for the hybrid average revenue control without DSA. In addition, any secondary caps would need to be set in such a manner as to allow sufficient price flexibility to meet the revenue line BF. Consequently, the hybrid average revenue control could allow for third party access without the need to define the access price although knowledge of the level of access price could be necessary to assess whether any secondary caps are sufficiently high to allow the allowed revenue to be attained.²¹

8 Conclusions

In conclusion, without adequate protection of the cash flow position:

- DSA reduces the cash flow position of the regulated business between V1 and V2;
- DSA exposes the regulated business to a cash flow position that is worse than that in the plan for volume between V1 and V2;
- the cash flow position of the regulated business worsens, the greater is the volume loss below V1;
- the cash flow position of the regulated business could be worse than that of the plan for volumes below V1, dependent on the access price, and would certainly be worse than that in the plan for volume below V2.

The cash flow position can be addressed through the price control as follows:

- since DSA potentially worsens the cash flow position of the regulated business it is necessary to modify the price control to address it and ensure the cashflow position in the plan and thereby the financial viability of the regulated business;
- to achieve this, in setting the control, there is a need to define a reference point whereby the expected outturn cash-flow reflects the appropriate level of allowed profit for the regulated business (effectively at pre-liberalisation volume V1);
- once the appropriate level of allowed profit is defined, it is possible to identify the modifications to the simplified approach with flexibility and hybrid average revenue control that are needed to meet the expected outturn cash flow position at the reference point;
- when DSA is introduced, the modifications needed for the hybrid average revenue are potentially more straight forward to implement than those for the simplified approach with flexibility.

²¹ Alternatively, the DSA products, corresponding to the end-to-end products in the hybrid average revenue control, could be excluded from the coverage of the hybrid average revenue yield. In this approach, the end-to-end revenue line would be defined by BF between V1 and V2 in Figure 11 (in a similar way to that in Figure 2) and an additional allowance for DSA volume would be defined similar to that between B1A1 and B1A2 in Figure 10. Any secondary caps would need to be set in such a manner as to allow sufficient price flexibility to meet the revenue line B1A2.

Appendix 5D

ECONOMICS BRIEF OUTLINE FOR A DRAFT LICENCE CONDITION 19 USING THE APPROACH OF THE SIMPLIFIED APPROACH WITH FLEXIBILITY

Condition 19: Prices for postal services

Obligation to continue to offer and provide universal postal services

1. The Licensee shall for the duration of the control –

(a) offer the full range of universal postal services that it, or its predecessor as a notified universal service provider in the United Kingdom, offered on 31 December 2002, and

(b) offer that range of universal postal services on as wide a basis within the United Kingdom as they were offered on that date;

unless Postcomm issues a direction to remove a universal postal service or Postcomm approves an application from the Licensee to change to the specification of any universal service from that on 31 December 2002 under paragraph 8.

2.(a) For Category I products below 350g, the Licensee shall set prices P_i^h for all price points i (from 1 to n) on 1 April and 1 October such that :

$$1 \quad | \quad 1 \quad | \quad + \quad - \quad + \quad -^2$$

[where the first term in square brackets acts as a neutrality test for rebalancing (when the definition of the product does not change but the price does change), the R-term relates to an additional allowed revenue if end-to-end revenue falls below the level in the plan; the K-term is a correction factor for an ex-post revenue neutrality test for restructuring/respecification (when the definition of the product changes as well as the price), and the DSA-term is an additional allowed revenue for network access volume]

where –

A_i is 0 (zero) if the product is below 100g and 1 (one) if the product is 100g to 350g;
 RPI_i^{h-2} is the percentage change in the average Retail Price Index excluding the mortgage interest payments over the six months defined by $h-2$;
 h is the financial half year such that $h=1$ for 1 April 2003/04 to 30 September 2003/04;
 n is the number of price points, where a price point is defined at the weight step level
 P_i^h is the price of price point i for half-year h
 V_i^{h-2} is the volume of price point i conveyed for half-year $h-2$
 P_i^{h-2} is the price of price point i for half-year $h-2$
 R_{Cover}^{h-2} is the additional allowed revenue for the Licensee for half-year $h-2$ that can be recovered in half-year h in the event that outturn revenue for the half-year R^{h-2} falls below the trigger level $R_{Trigger}^{h-2}$ for half-year $h-2$ such that:

$$R_{Cover}^{h-2} = 0 \text{ if } R^{h-2} \geq R_{Trigger}^{h-2}$$

and

$$R_{Cover}^{h-2} = (R_{Trigger}^{h-2} - R^{h-2}) \times 0.6 \text{ if } R^{h-2} < R_{Trigger}^{h-2}$$

where

R^{h-2} is the outturn revenue for the Licensee for the category of products in half-year h-2

$R_{Trigger}^{h-2}$ [defined for each half-year consistent with end-to-end volumes in the plan for the products covered in 2(a)]

K^{h-2} is the over-recovery revenue with respect to the case of re-specification/restructuring between periods h-4 and h-2 [where the case of re-specification and restructuring is that of a price change where the definition of the product is altered as well as price] is defined as:

$$K^{h-2} = \sum_{i=1}^m p_i^{h-2} V_i^{h-2} - \left[\sum_{i'=1}^{m'} p_{i'}^{h-4} W_{i'}^{h-4} \right]$$

and is zero for products where there is no re-specification/restructuring between h-2 and h.

where, for the products subject to re-specification and restructuring –

m is the number of price points before the change, where a price point is defined at the weight step level

m' is the number of price points after the change, where a price point is defined at the weight step level

P_i^{h-2} is the price of price point i for half-year h-2 for volume V_i^{h-2} under the old specification

V_i^{h-2} is the volume at price point i conveyed for half-year h under the new specification

$P_{i'}^{h-4}$ is the price of price point i' for half-year h-4 for volume $W_{i'}^{h-4}$ under the old specification

$W_{i'}^{h-4}$ is the volume at price point i' conveyed for half-year h-2 under the old specification.

[The correction factor may also need to be adjusted for interest changes before inclusion in the main equation]

DSA^{h-2} is the additional revenue allowance with respect to the case of network access in half-year h and is defined as:

$$\sum_{j=1}^j \left[\sum_{j=1}^j \right]$$

and is zero where there is no network access volume in h-2.

where

$LSUM_j^{h-2}$ = [set value based on fixed revenue allowance for network access price j]
 A_j = [set value based on the incremental revenue allowance for network access price j]
 DV_j^{h-2} = the outturn downstream access volume conveyed for network access service j in half-year h-2
 m = the number of different network access prices.

(b) For all Category II products below 350g, the maximum allowed revenue TIR_t in year t is:

$$TIR_t = Y_2 [IP(1+(RPIX_t-X)/100)W] + (1-Y_2)[IP(1+(RPIX_t-X)/100)W] - IK_{t-1}$$

for t = 1,2,3.

where

Y_2 = [];

\bar{IP} equals [];

\bar{W} equals []

[representing the average price by weight and total weight of the included products];

W_{t-1} =

and where, for t=1,

$IK_{t-1} = 0$; and subsequently

$IK_{t-1} = (IR_{t-1} - TIR_{t-1})(1+(I_{t-1}+ [])/100)$ if $IR_{t-1} > TIR_{t-1}$ or

$IK_{t-1} = (IR_{t-1} - TIR_{t-1})(1+(I_{t-1})/100)$ if $IR_{t-1} < TIR_{t-1}$.

where IR_{t-1} = the outturn revenue for the covered products for year t-1.

(c) For all Category III products and Category I products above 350g , the maximum price PP_{ti} in year t for price point i of:

$$PP_{ti} = PP_i [(RP_{t-1})/(RP_{base})].(1+B_i)^t$$

where

t is the year commencing 1 April whereby t=1 for 2003/04;

PP_i is the price of price point i on 30 September 2002;

RP_{base} is the average RPI index for the 12 months to September 2001;

RP_{t-1} is the average RPI index for the 12 months to September in year t-1;

B is 0.

Secondary caps

3. The products subject to paragraph 2 are also subject to a maximum price PP_i in year t for price point i of:

$$PP_t^i = PP^i [(RP_{t-1}) / (RP_{base})] \cdot (1 + B_2)^t$$

where

- PP^i equals [] [the price of price point i on 30 September 2002];
- RP_{base} is defined in paragraph 2;
- RP_{t-1} is defined in paragraph 2;
- B_2 equals 0.05.

other than for products that change in product specification [or restructuring] under paragraph 7 between years t and t-1. For products with a change in specification between October in year t-2 and September in year t-1, the price PP_j is defined on 30 September in year t-1 and for subsequent years the RP_{base} is the average RPI index for the 12 months to September in year t-1.

Coverage

4(a). Paragraphs 2a shall apply to the following Category I products in Columns 1 and 2 of the Regulatory Accounts :

Mailsort	PacketPost	Response services	Walksort
First Class	Second Class	Cleanmail	Response service fees
Recorded delivery fees	Redirection services		

(b). Paragraphs 2b shall apply to the following Category II products in Columns 1 and 2 of the Regulatory Accounts:

Airmail Public Tariff	International Surface Public Tariff	British Forces	Import Services
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(c). Paragraphs 2c shall apply to the following Category III products in Columns 1 and 2 of the Regulatory Accounts:

Inland standard stamped and metered parcels	Export standard stamped and metered parcels	Special Delivery
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Price information

5. The Licensee shall, in respect of prices that have no change in service specification (or price restructuring) submit prices to Postcomm for the approval not later than 3 months before a price change. The Licensee shall provide this information to Postcomm along with volume figures by price point in a manner that shows that the change is in compliance with paragraphs 2 and 3. Provided the prices are compliant with paragraphs 2 and 3, the Licensee will be permitted to implement the price changes.

6. The Licensee shall, not later than 3 months before a price change, publish indicative prices, if applicable, relating to third party network access.

7. The Licensee shall publish its final prices in accordance with standard industry practice.

Re-specification and price restructuring

8. The Licensee shall submit an application for the approval of Postcomm for any change to the service specification (including price rebalancing) of any product identified as being covered by the control under paragraph 4. The Licensee shall publicly consult its customers on any proposed change of service specification (including price rebalancing), setting out the reasons for the change and illustrating the projected effect on prices. The Licensee shall submit in its application detailed information on cost and volume data and the responses to its consultation. This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 2 months of submission of the application. Postcomm will not disapprove of the proposed unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest. If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Removal of products from the control

9. The Licensee may submit an application for the approval of Postcomm to remove a product from the price control. The Licensee shall submit in its application detailed information of the change to the competitive market that has occurred since 31 December 2002 and a proposed licence modification. This application shall be made no later than 5 months ahead of the proposed implementation date for the removal of the product. Postcomm shall notify the Licensee of its view and reasons for its view within 2 months of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest. If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Material changes

10. In the event of any change of circumstances (relating, for example, to "cost shocks") outside the control of the Licensee that adversely affects or is projected to adversely affect the cashflow of the Licensee by more than 1% of turnover in any year or cumulated over consecutive years, the Licensee may submit an application to Postcomm setting out its case in detail, including quantification of the adverse effect or projected to adverse effect and a proposed licence modification. This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 2 months of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or against the public interest. If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 2 months there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Change to the secondary cap

11. The Licensee may submit an application for the approval of Postcomm to change the value of B_2 (and lift the secondary caps) defined paragraph 3. The Licensee shall submit in its application (i)

detailed information demonstrating that the effect of the B_2 in paragraph 3 and pricing policy of the regulated business obstructs the regulated business recovering the additional allowed revenue defined by K^{h-2} , DSA^{h-2} and R^{h-2}_{Cover} in paragraphs 2(a) and 2(b) and (ii) the required change to the value of B_2 . This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 2 months of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest or does not prohibit the regulated business recovering the additional allowed revenue defined by K^{h-2} , DSA^{h-2} and R^{h-2}_{Cover} in paragraphs 2(a) and 2(b). If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Close of year information

12. The Licensee shall, not later than 31 May and 30 November of each year, provide to Postcomm a statement showing the outturn volume figures used in paragraphs 2 and 3 for the preceding half-year to 31 March and 30 September respectively.

13. The Licensee shall, not later than 30 June and 31 December, provide to Postcomm a statement showing the figures for K^{h-2} , DSA^{h-2} and R^{h-2}_{Cover} in paragraphs 2 and 3 for the preceding half-year to 31 March and 30 September respectively.

14. The Licensee shall cause the statements and information referred to in paragraph 13 to be audited by competent third parties, approved by Postcomm, who shall be required to report to Postcomm on whether, in their opinion –

- (a) those statements support the values of the parameters referred to in them, and
- (b) that information has been obtained, recorded, processed and presented in a manner that ensures that it is the most accurate information available and is not misleading.

The termination of condition

15. This condition shall apply so long as this Licence continues in force but shall cease to have effect on and after 31 March 2006.

Appendix 5E

ECONOMIC BRIEF OUTLINE FOR A DRAFT LICENCE CONDITION 19 USING THE APPROACH OF THE HYBRID AVERAGE REVENUE CONTROL

Condition 19: Prices for postal services

Obligation to continue to offer and provide universal postal services

1. The Licensee shall for the duration of the control –

(a) offer the full range of universal postal services that it, or its predecessor as a notified universal service provider in the United Kingdom, offered on 31 December 2002,
and

(b) offer that range of universal postal services on as wide a basis within the United Kingdom as they were offered on that date;

unless Postcomm issues a direction to remove a universal postal service or Postcomm approves an application from the Licensee to change to the specification of any universal service from that on 31 December 2002 under paragraph 8.

Allowed revenue

2. (a) For Category I products below 350g, the maximum allowed revenue TR_t in year t is:

$$TR_t = Y_t [\bar{P} (1 + (RPIX_t - X)/100) \bar{V}] + (1 - Y_t) [\bar{P} (1 + (RPIX_t - X)/100) V_t] - K_{t-1}$$

For year $t = 1, 2, 3$ where $t = 1$ when for the financial year 2003/04.

where

$Y_t =$ [value between 0 and 1]

\bar{P} equals []; and

\bar{V} equals []

[representing the average price and total volume of the included products of either the post-liberalisation or pre-liberalisation scenario and based on either operational volume, revenue derived volume or some weighting of the two];

$RPIX_t$ = the average annual percentage change in the Retail Prices Index without Mortgage Interest Payments over the 12 months to September in year $t-1$;

X equals []

V_t = the outturn volume in year t [which is either operational volume, revenue derived volume or some weighting of the two];

and where, for $t = 1$,

$$K_{t-1} = 0$$

and subsequently:

$$K_{t-1} = (R_{t-1} - TR_{t-1})(1+(I_{t-1}+[])/100) \quad \text{if } R_{t-1} > TR_{t-1} ; \quad \text{or}$$

$$K_{t-1} = (R_{t-1} - TR_{t-1})(1+(I_{t-1})/100) \quad \text{if } R_{t-1} < TR_{t-1}.$$

where R_{t-1} = the outturn revenue for the covered products for year t-1
 I_{t-1} = average annual base interest rate over the 12 months to September for year t-1.

(b) For all Category II products, the maximum allowed revenue TIR_t in year t is

$$TIR_t = Y_2 [\bar{IP} (1+(RPIX_t-X)/100)\bar{W}] + (1-Y_2)[\bar{IP}(1+(RPIX_t-X)/100)W] - IK_{t-1}$$

for t = 1,2,3.

where

$$Y_2 = [];$$

\bar{IP} equals [];

\bar{W} equals []

[representing the average price by weight and total weight of the included products];

$$W_{t-1} =$$

and where, for t=1,

$IK_{t-1} = 0$; and subsequently

$$IK_{t-1} = (IR_{t-1} - TIR_{t-1})(1+(I_{t-1}+ [])/100) \quad \text{if } IR_{t-1} > TIR_{t-1} \quad \text{or}$$

$$IK_{t-1} = (IR_{t-1} - TIR_{t-1})(1+(I_{t-1})/100) \quad \text{if } IR_{t-1} < TIR_{t-1}.$$

where IR_{t-1} = the outturn revenue for the covered products for year t-1

.....

(c) For all Category III products and for Category I products below 350g, the maximum price PP_t^i in year t for price point i is:

$$PP_t^i = PP^i [(RP_{t-1})/(RP_{base})] \cdot (1+B_i)^t$$

where

PP^i equals [] the price of price point i on 30 September 2002];
 RP_{base} [the average RPIX index for the 12 months to September 2001];
 RP_{t-1} is the average RPIX index for the 12 months September in year t-1;
 B_i is 0.

Secondary caps

3. The products subject to paragraphs 2(a) and 2(b) are also subject to the maximum price PP_t^j in year t for price point j defined as:

$$PP_t^j = PP^j \left[\frac{RP_{t-1}}{RP_{base}} \right] \cdot (1+B_2)^t$$

where

where

PP^j equals [] [the price of price point i on 30 September 2002];
 RP_{base} is defined in paragraph 2;
 RP_{t-1} is defined in paragraph 2;
 B_2 equals 0.05.

other than for products that change in product specification [or restructuring] under paragraph 7 between years t and t-1. For products with a change in specification between October in year t-2 and September in year t-1, the price PP^j is defined on 30 September in year t-1 and for subsequent years the RP_{base} is the average RPI index for the 12 months to September in year t-1.

Coverage

4(a). Paragraphs 2a shall apply to the following Category I products in Columns 1 and 2 of the Regulatory Accounts:

Mailsort	PacketPost	Response services	Walksort
First Class	Second Class	Cleanmail	Response service fees
Recorded delivery fees	Redirection services		

(b). Paragraphs 2b shall apply to the following Category II products in Columns 1 and 2 of the Regulatory Accounts:

Airmail Public Tariff	International Surface Public Tariff	British Forces	Import Services
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(c). Paragraphs 2c shall apply to the following Category III products in Columns 1 and 2 of the Regulatory Accounts:

Inland standard stamped and metered parcels	Export standard stamped and metered parcels	Special Delivery
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Price information

5. The Licensee shall, in respect of prices that have no change in service specification (or price restructuring) and in accordance with paragraphs 2 and 3 submit indicative prices to Postcomm for the approval not later than 5 months before a price change. The Licensee shall provide this information to Postcomm along with volume figures in a manner that demonstrates that the change is projected to be in compliance with paragraphs 2 and 3. Provided the prices are compliant with paragraphs 2 and 3, the Licensee will be permitted to implement the price changes.

6. The Licensee shall, not later than 6 months before a price change, publish indicative prices, if applicable, relating to third party network access.

7. The Licensee shall publish its final prices in accordance with standard industry practice.

Re-specification and price restructuring

8. The Licensee shall submit an application for the approval of Postcomm for any change to the service specification (including price rebalancing) of any product identified as being covered by the control under paragraph 4. The Licensee shall publicly consult its customers on any proposed change of service specification (including price rebalancing), setting out the reasons for the change and illustrating the projected effect on prices. The Licensee shall submit in its application detailed information on cost and volume data on the re-specified or restructured products and the responses to its consultation. This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 1 months of submission of the application. Postcomm will not disapprove of the proposed unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest. If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Removal of products from the control

9. The Licensee may submit an application for the approval of Postcomm to remove a product from the price control. The Licensee shall submit in its application detailed information of the change to the competitive market that has occurred since 31 December 2002 and a proposed licence modification. This application shall be made no later than 5 months ahead of the proposed implementation date for the removal of the product. Postcomm shall notify the Licensee of its view and reasons for its view within 1 month of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest. If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Material changes

10. In the event of any change of circumstances (relating, for example, to "cost shocks") outside the control of the Licensee that adversely affects or is projected to adversely affect the cashflow of the Licensee by more than 1% of turnover in any year or cumulated over consecutive years, the Licensee may submit an application to Postcomm setting out its case in detail, including quantification of the adverse effect or projected to adverse effect and a proposed licence modification. This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 1 month of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or against the public interest. If Postcomm states its disapproval of the application, Postcomm and

the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an external third party for resolution.

Change to the secondary cap

11. The Licensee may submit an application for the approval of Postcomm to change the value of B (and lift the secondary caps) defined paragraph 3. The Licensee shall submit in its application (i) detailed information demonstrating that the effect of the B₁ in paragraph 3 and pricing policy of the regulated business obstructs the regulated business recovering the maximum allowed revenue defined in paragraphs 2(a) and 2(b); and (ii) the required change to the value of B₁. This application shall be made no later than 5 months ahead of the proposed implementation date. Postcomm shall notify the Licensee of its view and reasons for its view within 5 months of submission of the application. Postcomm will not disapprove of the application unless the application is, in Postcomm's view, not compliant with the Licence or any UK and EU law or is against the public interest or does not prohibit the regulated business recovering the maximum allowed revenue defined in 2(a) and 2(b). If Postcomm states its disapproval of the application, Postcomm and the Licensee will enter discussions to seek to resolve any differences. If at the end of a further 1 month there is no resolution on an issue of public interest, then the matter can be referred to an independent external third party for resolution.

Close of year information

12. The Licensee shall, not later than 30 June after the end of each year, *t*, provide to Postcomm a statement showing the outturn values for the parameters in paragraphs 2 and 3 with sufficient supporting information to enable it to demonstrate that it has complied with paragraph 2 and 3 for that year.

13. The Licensee shall cause the statements and information referred to in paragraph 11 to be audited by competent third parties who shall be required to report to Postcomm on whether, in their opinion –

- (a) those statements support the values of the parameters referred to in them, and
- (b) that information has been obtained, recorded, processed and presented in a manner that ensures that it is the most accurate information available and is not misleading.

The termination of condition

14. This condition shall apply so long as this Licence continues in force but shall cease to have effect on and after 31 March 2006.

Appendix 6A

CRITIQUE OF POSTCOMM'S PROPOSED COMPENSATION SCHEME

1. Background

Condition 4 (10) of Royal Mail's Licence requires Royal Mail to establish a standards of service compensation scheme, the terms of which are to be agreed between Royal Mail and Postwatch. If there is no agreement, the Licence provides that the terms of the scheme shall be as determined by Postcomm after considering representations from Royal Mail.

For the reasons set out at section 2 below, it is not within Postcomm's powers to require Royal Mail to establish a compensation scheme and therefore Condition 4 does not apply.

Moreover, under the proposals for modification of Licence Condition 4 Postcomm would be given power to determine alterations to the agreed scheduled standards of service and compensation scheme (in so far as such a scheme falls under Condition 4) outwith any reopening of the price control or need to have those decisions referred to any other agency. The financial risk to Royal Mail is immense and therefore unacceptable.

Royal Mail compensation scheme

However, Royal Mail has long possessed a compensation scheme and has taken the opportunity offered to conduct one of the periodic reviews of the continued appropriateness of its current scheme. To this end it has entered into discussions with Postwatch and Postcomm about its compensation arrangements, with a view to establishing a voluntary compensation scheme. Such a scheme would not fall under the auspices of Condition 4 of its Licence. The details of this scheme are set out in a separate document which is presented to Postcomm with this response. In the event that Postcomm does not accept Royal Mail's position on the former's powers, we request that the Royal Mail proposal document is treated as part of these representations in response to Postcomm's compensation proposal.

During the period of discussions with Postwatch in 2001, Royal Mail undertook research to determine how its arrangements compared to those provided by domestic and global competitors and other cross sector organisations providing low value/high turnover services. The features of Royal Mail's scheme were consistent with industry and cross sector benchmarks. They were also significantly greater than those offered by other regulated postal administrations who responded to the research survey. Only Finland had a scheme of the same scale as that proposed by Royal Mail to Postwatch. A summary of the benchmarking is attached as at Annex 2. This information was previously supplied to Postcomm and Postwatch in September 2001 as part of Royal Mail's submission on Licence Condition 4 paragraphs 10 and 11.

Following six months of detailed and intensive negotiations between Royal Mail and Postwatch, it has not been possible to reach full agreement on all the terms of a voluntary compensation scheme. Differences of view with Postwatch were not over the fundamental principle of the desirability of compensation, but on the specific details and scope of compensation. Both organisations then put forward their proposals to Postcomm and Postcomm have published their proposals for a compensation scheme under Condition 4 of the Licence. Royal Mail has sought to work with Postcomm and Postwatch towards the development of a voluntary scheme that is fair and reasonable, whilst protecting its legal rights under the Postal Services

Act 2000. Royal Mail's aim throughout has been to develop a compensation scheme which meets users needs in terms of appropriate levels of compensation and transparency of operation, and which reflects best industry and utility regulatory practice.

Statutory Framework

Royal Mail believe that Postcomm in the preparation of their compensation proposals have failed to give due consideration of the existing statutory framework that relates to compensation. Postcomm have also failed to provide any clear rationale as to why their proposals are necessary or why the existing compensation scheme provided by Royal Mail or the statutory protections that ensure adherence to service standards are insufficient.

Royal Mail is of the view that the correct approach to the consideration of a compensation scheme needs to begin with an understanding of the context of the statutory framework and the existing Royal Mail compensation scheme that applies to compensation.

Article 19 of the Postal Services Directive²² (as amended) requires Member States to ensure that transparent, simple and inexpensive procedures are drawn up for dealing with users' complaints, particularly in cases involving loss, theft, damage or non-compliance with service quality standards. It goes on to require the adoption of measures to ensure that those procedures enable disputes to be settled fairly and promptly with provision, *where warranted*, for a system of reimbursement and/or compensation.

The Postal Directive has been implemented in the UK through the Postal Services Act 2000, with Sections 89 to 92 transposing Article 19. Those sections impose limitations on the liability of universal service providers for loss suffered by any person in connection with the provision of the universal postal service. As a consequence Royal Mail, as a universal service provider, has no tortious liability in respect of its provision of a universal postal service. The only exception to this statutory immunity is created by Section 91 (1): Royal Mail is liable where there is relevant loss of or damage to a posted item but this is subject to the limits provided for under the Act. S. 92 (5) states that such liability is limited to the market value of the item posted or the maximum payable under a scheme made under S.89 of the Act.

It is clear that the Government has considered its duties to comply with the Postal Directive and Parliament has given clear guidance as to what compensation is warranted where a postal provider fails to deliver postal items correctly. This limitation of liability for universal service providers is necessary because of the nature of a universal postal service whereby it is available to all at a low, uniform price and is easily accessed, with no real scope for the universal service provider to decline to carry items or check or otherwise be aware of their content.

Royal Mail has separate Schemes in respect of parcels and letters made under S. 89 of the Act. The Schemes set out a number of criteria, restrictions and exclusions relating to mail accepted for delivery, including listing items which it is prohibited to send through the post and establishing restrictions on the way in which certain items may be posted. RM must necessarily rely on the customer to comply with these.

²² Directive 97/67/EC of the European Parliament and of the Council on common rules for the development of the internal market of Community postal services and the improvement of quality of service

2. Postcomm's Powers

(a) Vires Of Condition - The General Issue

Those provisions of Condition 4 of the Licence which purport to allow Postcomm to determine a standards of service compensation scheme are ultra vires. To understand why it is first necessary to set out or refer to the material legislation, which is set out in Annex 1.

Section 13(1) and (3) of the PSA confer a broad power on Postcomm to include conditions in a licence granted under section 11. But it is established law that a general power conferred on an executive body (for example to make secondary legislation) cannot ordinarily be used in such a way as to render nugatory rights which are created by primary legislation. See *R v Secretary of State for Social Security, ex p. Joint Council for the Welfare of Immigrants* [1977] 1 WLR 275 (CA, by a majority) at 290A-B (Simon Brown LJ) and 293E (Waite LJ). This is referred to as “the JCWI principle”. Sections 89-92 of the Postal Services Act 2000 create the right for a universal service provider to benefit from limited liability in tort.

The JCWI principle was accepted as being applicable in principle in the regulatory context in *R v Secretary of State for Trade and Industry, ex p. Mercury Personal Communications Ltd.* (QBCOF 1999/0934/4, 14 October 1999, CA). In that context the Court of Appeal rejected the argument only because the licence obligation under challenge did not in fact interfere with existing rights under primary legislation.

The JCWI principle was also accepted in *R v Secretary of State for Trade and Industry, ex p. Orange Personal Communications Ltd.* (CO/4231/1999, 25 October, Sullivan J): see in particular para. 70 of the judgment.

The crucial question in the present context is whether Condition 4 in the licence, in particular any attempt to impose a compensation scheme by Postcomm, would render nugatory the rights created by Parliament in section 89-92 of the PSA. The correct interpretation is clear:

- (a) Section 90(1) confers an immunity from liability in tort for a universal service provider which is very broad. It uses the phrase “loss or damage”, which is broader than physical loss or damage: where Parliament wished to refer to the latter concept, it used the phrase “loss of, or damage to, a packet” as in section 91(1). Furthermore, the immunity relates to loss or damage suffered by any person “in connection with” the provision of a universal postal service, which is again a broad phrase. Finally, the loss or damage in relation to which immunity is conferred must have been because of “anything done or omitted to be done in relation to any postal packet in the course of transmission by post” or “any omission to carry out arrangements for the collection of anything to be conveyed by post.” These words are broad enough to include, for example, delay in the transmission of a packet and indeed anything relating to the quality of the service provided.
- (b) The only exception to this statutory immunity in liability for tort is created by section 91(1). But this relates only to “relevant loss of, or damage to, an inland packet”. This is a reference to physical loss or damage of a packet itself, rather than a reference to the legal concept of loss or damage generally. Where there is relevant loss of, or damage to, a packet, then liability is created (in principle) by section 91(1) but this is subject to the limitation as to quantum in section 92(5) and (6), i.e., either the market value of the packet or the maximum payable under a scheme under section 89. That there can be such a limitation as to quantum is further confirmed by section 89(4), which cross-refers to section 92(5) and (6).

- (c) The clear effect of these provisions read together is that there can be no legal liability in tort for the quality of the postal service and in particular for delay in the transmission of a packet.
- (d) Moreover, in relation to loss of, or damage to, packets, section 91(1) makes it clear that proceedings can lie only under that section: it expressly provides “but not otherwise”. It should be noted that section 91(1) is not in terms confined to proceedings for a tort: it simply refers to “proceedings”.
- (e) Since the general immunity created by section 90(1) and the more limited immunity created by section 91(1) are conferred by primary legislation, the JCWI principle applies and it is unlawful for a licence condition to render that immunity nugatory because the acts of the executive cannot undermine or frustrate the will of Parliament.
- (f) Furthermore, the power to make a scheme under section 89 is conferred on the universal service provider and on no one else. It is an elementary principle of public law that a discretion cannot be fettered nor can it be abdicated to another person. Yet Condition 4.21 of the licence seems to do just that: it purports to bind Royal Mail not to use statutory power in section 89 in a way which is incompatible with its licence obligations under Condition 4, whereas the correct legal position should be that nothing in the licence can be incompatible with the powers and immunities conferred by primary legislation.

(b) Extent Of Postcomm's Power To Determine A Standards Of Service Compensation Scheme (Assuming Vires)

Even if Condition 4 were lawful, certain of the provisions of the draft scheme would be unlawful unless there were modifications to Conditions 4 and 8. of Royal Mail’s licence. Royal Mail’s licence can only be amended with its consent, which consent has not been given, or following a reference to the Competition Commission under section 15 of PSA.

The remainder of this section sets out the legal position applicable unless and until Condition 4 remains unmodified.

It is first necessary to set out the material parts of Condition 4:

- (a) Paragraph 1 defines “scheduled services and standards”, “scheduled services” and “scheduled standards” as meaning the minimum services and standards of service to be established pursuant to paragraph 3 and 4 of Condition 4.
- (b) Paragraph 3 provided for Royal Mail and Postwatch to agree, inter alia, a schedule of minimum services to be provided to users and of the minimum standards of services to be achieved by Royal Mail in the provision of those services.
- (c) Paragraph 10 required Royal Mail to establish a scheme to be known as the standards of service compensation scheme. Paragraph 11(e) required the standards of service compensation scheme to be agreed between Royal Mail and Postwatch and for Postcomm to determine the standards of service compensation scheme in the absence of agreement.
- (d) The agreement reached between Royal Mail and Postwatch in accordance with paragraphs 3 and 4 of Condition 4 is the annex to Condition 4 headed “Minimum Targets to be Incorporated in the Licensee’s Schedule Services and

Standards". Annex 4 has not been modified or added to since. The annex lists some 18 products/services with agreed percentage targets.

Retail Services – Delay

Condition 4.10 of the licence requires Royal Mail to establish a "compensation scheme". Similarly what Condition 4.11(e) empowers Postcomm to impose, in the absence of agreement between Royal Mail and Postwatch, is a "compensation scheme". The provisions of a compensation scheme must either compensate a user for his actual loss or provide for compensation representing a genuine pre-estimate of loss. It is not permissible for Postcomm to determine a scheme whose provisions impose a penalty upon Royal Mail for service failure. Postcomm's compensation proposals are extravagant and clearly punitive for the following reasons. The compensation proposals: (1) are effectively a form of consequential loss, (2) are lacking in any sense of proportionality between transaction price and "compensation", (3) do not reflect the fact that the current price is not designed to carry financial risks from consequential loss claims, (4) at the current levels proposed are out of line with standard industry compensation for premium (express / guaranteed) services, let alone standard mail services.

Retail Services – Loss and Damage

The wording of Condition 4 is not apt to cover items which are lost or damaged. This point was conceded in a letter of 21 January 2002 from Postcomm's legal adviser to Royal Mail's legal adviser.

Notwithstanding the fact that Postcomm have already conceded this point, Royal Mail wish to make it clear that in our view the proposals to include loss or damage in the retail scheme go way beyond what is necessary. As outlined elsewhere in this submission, the interests of users where items have been lost or damaged have been considered and catered for in sections 89-92 of the Postal Services Act. The proposals made by Postcomm are clearly disproportionate to the price paid for the service, punitive in nature and given the fact that Royal Mail has no way to establish the contents of mail items it cannot be said to be a genuine pre-estimate of loss.

Keepsafe and Redirection

Postcomm does not have power to determine a scheme in respect of these services since they are not listed in the annex to Condition 4. Royal Mail has not agreed to their inclusion in any determination by Postcomm.

In addition Postcomm's proposals are punitive, see above.

3. Commercial Appraisal

Without prejudice to Royal Mail's comments on the lack of legality in respect of Postcomm's proposals, we are setting out in this section for completeness, our commercial comments on Postcomm's draft proposal.

(a) Commercial appraisal of Postcomm Proposals for a Retail (Social) Scheme

While the desirability of an adequate compensation scheme is universally accepted, a more fundamental question is whether the compensation model proposed by Postcomm, clearly borrowed from other regulated industries, is applicable to users of stamped and meter mail and other products.

The problems with the Postcomm scheme have required Royal Mail to consider a practical and legally robust alternative scheme that will drive performance improvement, but not incentivise organised and opportunistic fraudulent claims or expose Royal Mail to huge punitive payments. Royal Mail is willing, as it always has been, to discuss its ideas for a voluntary scheme with Postwatch and Postcomm.

Proportionality

The high levels of payment put forward by the retail scheme are disproportionate to the price paid by the customer. The proposed minimum payment for delay is over ten times the cost of a first class stamp and 16 times the cost of a second class stamp. The proposed maximum payment of £14 is 51 times the first class stamp price and 74 times the second class stamp price. It is additionally proposed that customers of these products also receive some recompense for poor performance through reduced prices via the C factor in the Price Control – so Royal Mail could be penalised twice for the same service failures.

Royal Mail recognise that, given the low value of the transaction, a more proportionate relationship between value and compensation may in some circumstances be considered insufficient, and ineffective in terms of acting as an incentive to Royal Mail to improve performance, or unfair given the transaction costs customers incur in making a complaint about poor service performance. However it must also be recognised that this is in the context that there may be little or no proof of either the transaction or the problem. Customers should also be aware that there are alternative services available which may be more suitable to their requirements than the standard letter service and which offer faster or guaranteed delivery times, more security of handling and / or higher compensation.

Postcomm's stated intention is to reflect the severity of the service failure to the customer, take account of the likely financial impact on Royal Mail and avoid providing unnecessary incentives to fraud. We do not believe that their proposals reflect this.

Severity of Service Failure

Royal Mail's expectation is that on the whole customers will complain where they have experienced repeated delay or where an individual incident of delay or loss has caused particular inconvenience. Postcomm have published Royal Mail's figures of 130 thousand complaints about delay for 2001/2. Almost 40% of these complaints concerned Special Delivery, leaving less than 100 thousand complaints about other products. This is a very low rate of complaint. Similarly, in 2001/2 Royal Mail reported 883 thousand complaints about. Again this is a very low rate of complaint, particularly as it does not exclude complaints about items not actually lost by Royal Mail.

The low level of complaint strongly suggests that these problems are not an issue for most customers at current levels of service provision. Customers requiring a higher degree of assurance can use Special Delivery or one of the alternative express or secure services offered by Royal Mail's competitors.

Under the criteria put forward by Postcomm, the number of potential complaints can be expected to be much larger. For example, the service standards upon which the delay criteria are based are designed to capture a 0.1% failure rate. Although a tiny fraction of mail handled, the large volumes carried add up to a huge number of potentially legitimate complaints. The high level of payments proposed by Postcomm will in themselves encourage a higher complaint rate irrespective of the severity of the problem or whether or not Royal Mail meets its scheduled standard targets.

Incentive to Fraud

Unlike other regulated industries, it is difficult, if not impossible in the vast majority of cases for Royal Mail to prove the existence of a transaction or to determine whether or not a service failure has taken place as Royal Mail does not have a direct contractual relationship with the sending customer. For example, how does it prove that a particular packet was or was not posted at all or on a particular date? Royal Mail has repeatedly explained the practical consequences of these proposals to Postwatch and Postcomm..

Coupled with the proposed high level of payments, this lack of evidence of a transaction provides major opportunities for organised or opportunistic fraud.

Comments on Specific Problem Areas

Delay Compensation for Stamped & Metered Mail and Standard Parcel

Royal Mail is not liable to pay compensation for delay in delivery of standard mail and parcels.

In so far as it is prepared to consider a voluntary payment for delay, as discussed above, Royal Mail believes that the level of compensation payment suggested by Postcomm would be too high in relation to the price paid.

Although Postcomm have worked hard to present their proposals in a user-friendly format, the proposals for different levels of daily payment are difficult for customers to follow and would doubtless lead to much argument. They would also be time-consuming and expensive to operate, as Royal Mail would need to attempt to establish the exact length of delay, not just whether delay has occurred.

The definitions of delay do not take account of the Christmas period, when the usual service standards are recognised not to apply, or where items have been redirected or diverted, when an additional day is added to the service standard.

Special Delivery Delay Compensation

Royal Mail's position is that the current refund of fee arrangement is sufficient for this product. Special Delivery is included in the scheduled services and standards because it fulfils the obligation to provide a registered post service. It is also a guaranteed express product, operating in a highly competitive market. A refund of fee is one of the more generous arrangements for a product of this type in the industry. A requirement to offer more is therefore unnecessary and unreasonable.

Postwatch's proposals to Postcomm in September 2001 (Consignia Licence Compensation Scheme Postwatch Proposals) also stated that the current arrangements were acceptable. However Postwatch have since changed their position to support Postcomm's proposals. They have given no reason for this.

Postcomm's argument for their Special Delivery proposals is based on parity with their proposals for stamped and metered mail. This does not mean that the current delay compensation for Special Delivery is inadequate. It suggests rather that Postcomm's proposed levels of compensation for the other social products are too high.

Loss

Under s. 91 of the Postal Services Act 2000 Royal Mail is liable for loss of postal packets in respect of which it accepts liability under its statutory Letter / Parcel Schemes, where such loss is due to any wrongful act of or any neglect or default of Royal Mail. Such amount payable is not to exceed the lower of the market value of the item lost or the maximum set out in Royal Mail's Letter / Parcel Schemes (S. 92 (5) of the Act). The current Inland Letter Post Scheme provides for payment of a maximum of £27 or the market value of the item lost, whichever is the less.

Thus compensation should be related to the loss suffered, or be a genuine pre-estimate of loss. Postcomm's proposals do not meet this requirement. Irrespective of this, a minimum high level of payment for lost items would be sufficient to incentivise fraud. Both the £14 payment proposed by Postcomm and the £17 payment proposed by Postwatch are high enough to do this.

Damage

Under s. 91 of the Postal Services Act 2000 Royal Mail is liable for damage to postal packets in respect of which it accepts liability under its statutory Letter / Parcel Schemes, where such damage is due to any wrongful act of or any neglect or default of Royal Mail. Such amount payable is not to exceed the lower of the market value of the item damaged or the maximum set out in Royal Mail's Letter / Parcel Schemes (S. 92 (5) of the Act). The current Inland Letter Post Scheme provides for payment of a maximum of £27. or the market value of the item lost, whichever is the less.

Keepsafe

Royal Mail has not agreed that Postcomm may include this service within its compensation scheme, although Royal Mail has agreed to include it within its own scheme.

Royal Mail currently offers a refund of fee for a Keepsafe failure on a goodwill basis as it is not legally liable to do so. All the benchmark evidence points to single fee refund being the commercial norm and maximum for an added value product of this kind. Excessive compensation payments will add to the product costs and ultimately impact on prices.

Postcomm's proposal does not make it clear as to whether compensation would be paid per postal packet or per failure.

Redirections

Royal Mail has not agreed that Postcomm may include this service within its compensation scheme, although Royal Mail has agreed to include it within its own scheme.

Royal Mail's current compensation scheme makes payments equivalent to those set out in Postcomm's paper, on a goodwill basis, as it is not legally liable to do so. There is therefore no disagreement between Postcomm, Postwatch and Royal Mail on the level of payment that should be offered, but these would be offered under a voluntary goodwill arrangement.

Comments on Details of Scheme

Compensation Procedures

A requirement for Royal Mail to pay cash, given the difficulties of proving the existence of a failure or transaction, is again in itself an incentive to fraud. Where proof of purchase is absent, cash should not be paid.

Postcomm agree in paragraphs 3.29 to 3.31 that claims should be supported by some information about the circumstances of service failure and that customers should provide a declaration that they have provided true and correct information. Royal Mail considers that this does not go far enough to protect Royal Mail from fraudulent complaints, and that further evidence might be required. In particular, repeat complaints from individual posting or receiving customers may indicate an underlying problem. They may also be a result of fraud. More stringent proof should therefore be required for repeat complaints.

Claim Periods

Under the Postal Services Act, customers are allowed to commence proceedings up to twelve months after posting for claims for lost or damaged postal packets. The Postcomm scheme allows customers to claim within three months of receipt and within 12 months of posting. This period is incompatible with the Act for lost or damaged postal packets, and is too long a period for delay. Claims made soon after a problem has arisen are easier to follow up and, in the case of a lost item, stand more chance of recovering the item for the customer.

Exclusions

The exclusions put forward by Postcomm are not exhaustive. For example, they do not cover the situations below:

- Mail posted outside the terms of the relevant Letter / Parcel Scheme.
- Delay (or loss based on arrival over 15 days late) to mail for USO exception addresses receiving less than daily delivery.
- Loss or damage where a customer has been notified that their delivery point is insecure or is likely to result in damage and has not made suitable alternative arrangements. Examples would be multiple delivery points with a history of loss issues or un-weatherproof customer-provided boxes.
- Items forwarded from the delivery address stated on the item.

Industrial Action

Any compensation scheme should exclude the requirement to pay compensation where the service failure is caused by events beyond Royal Mail's control, including industrial action by its staff. Postcomm's own consultants, Deloitte and Touche, have recognised that it is industry practice for force majeure to include industrial action ("A Report on the Operational and Financial Issues to be Considered in granting UK Mail Access to the Consignia Postal Pipeline and facilities following an Interim Determination under Condition 9(1) of Consignia's Licence", paragraph 5.14). The implications of exposing Royal Mail to compensation payments in the event of industrial action are severe and the financial impact has not been assessed or considered by Postcomm.

(b) Commercial Appraisal of Postcomm Proposals for an Industry (Bulk) Scheme

The industry compensation scheme proposed by Postcomm on Postwatch's advice is effectively a penalty scheme for poor performance. There is no credit for good performance. Royal Mail believes that the scheme should reward achievement above target in a way that mirrors the penalty payments.

The scheme does not take account of the level of precision with which performance is measured. The confidence limits for some products are not accurate enough to warrant a compensation payment for a small shortfall.

The scheme also exposes Royal Mail to potentially punitive levels of compensation, which could seriously impact on its financial position. This is in contrast to the capping of the quality element within the proposed price control formula.

The scheme is being introduced at a time when major operational change is likely to temporarily depress performance.

Exclusions

There are no exclusions allowed under the proposed Postcomm scheme. Whilst some are not relevant, some allowance for force majeure and other events should be made. Consideration also needs to be given to the state of the customer's account.

We suggest that it would be appropriate to consider exclusions, including but not limited to the following

The impact of force majeure (as defined in the social scheme and including industrial action) upon the industry scheme products could be calculated and the performance result used to pay compensation adjusted accordingly. This can be verified by the quality of service measurement auditors if required.

Where an account customer was in default of credit terms, Royal Mail would retain the discretion to either a) delay payment of the credit until such time as the account was in order, or b) refuse the credit due to ongoing issues with the account.

Revenue spend on postings that were not compliant with the product specification, e.g. presorted mail which has reverted to standard letter tariff, would not be included as revenue spent on that product.

(c) Financial Impact of the social and industry scheme proposals

Postcomm have a primary duty to ensure the provision of a universal postal service (S. 3 (1) Postal Services Act 2000). It also has a duty to exercise its functions in such a way as to ensure that licensees can finance the functions authorised or required by their licences (S. 5 (4)). Royal Mail considers that Postcomm's proposals for the retail and bulk schemes do not take proper account of the impact of the proposals upon Royal Mail's ability to finance its licensed activities, and in particular its ability to provide the universal postal service. Insufficient analysis of the financial implications has been carried out, conflicting with Postcomm's duties under the Act.

Postcomm acknowledge in section 4 that the costs of the proposed bulk (industry) scheme could be substantial and the costs of the retail (social) scheme are difficult to assess.

The combined effect of incentivisation and fraud could increase the amount of compensation paid out by the social scheme substantially above the current levels, without any change in underlying performance. Unlike the industry scheme, Royal Mail could still have to make substantial payments irrespective of whether the scheduled standards have been met.

The relatively low costs quoted by Postcomm assume that complaints remain at current levels. It is not difficult to construct a scenario under which annual payments for the social scheme rise to the £60m levels quoted for the bulk scheme, for example, complaint levels of 10% for delay and loss with a 5% rate of fraudulent claim.

4 Implementation and Review

A considerable amount of work would be required to make changes to Royal Mail's compensation scheme. Such changes would involve large amounts of retraining and alterations to major computer systems. There would also be implications for Royal Mail's customer handling procedures. These and the related targets would need to be changed to reflect any new scheme. A grace period would also be required for query handling and resolution targets to allow any new ways of working to become established.

Royal Mail would not therefore be able to implement any scheme changes by 1 April 2003 if these were not finalised by 1 January 2003.

Royal Mail would require customer handling targets to be suspended for a month from the date of implementation.

Postcomm's proposal recognises at paragraphs 3.41 and 3.42 that a new or revised compensation scheme will not necessarily be workable and effective from the outset and that interim reviews will be required prior to the first formal review under the Licence.

Benchmarking with other regulated companies indicates that a rise of up to 40% in complaint levels is to be expected following the establishment of a regulatory compensation scheme. However such companies differ somewhat from Royal Mail in the degree of evidence that exists of both purchase and problem. They are less vulnerable to spurious or fraudulent claims as there will be proof of any contract between them and the customer and also objective confirmation of whether a problem has occurred.

Royal Mail will review its complaint levels very closely following the introduction of any changes to its compensation scheme. In the event that complaint levels rise in excess of 30% above previous levels, taking into account any changes in underlying performance, Royal Mail will require an immediate review of the scheme.

For any changes agreed as part of a Postcomm scheme under Condition 4 (but on this point see section 2 above), Royal Mail would require the Licence to include a mechanism for triggering an interim review.

Annex 1: Relevant Legislation

- (a) Section 6(1) of the Postal Services Act 2000 (“PSA”) prohibits any person from conveying a letter from one place to another unless he holds a licence authorising him to do so. Section 7 creates certain exceptions to this general requirement for a licence.
- (b) Section 11(1) of the PSA confers power on Postcomm to grant a licence to do anything which would otherwise contravene section 6(1).
- (c) Section 13 of the PSA, so far as material, provides:
- “(1) A licence may include such provisions as the Commission considers appropriate; and a provision need not relate to anything authorised by the licence.
...
(3) Such provisions of the licence as the Commission considers appropriate may be expressed as conditions.
...”
- (d) Sections 22-29 of the PSA deal with enforcement of licences where a licence condition is breached. They establish a scheme for the making by Postcomm of a provisional or a final order, with procedural safeguards for those affected.
- (e) In two places these provisions relating to enforcement orders make reference to loss or damage being sustained by consumers of postal services.
- (i) Section 23 of the PSA, which deals with the making of a provisional order, in subsection (3) requires Postcomm to have regard to “the extent to which any person is likely to sustain loss or damage as a result of anything likely to be done or omitted in contravention of the licence condition before a final order may be made.”
- (ii) Section 29 of the PSA addresses the effect of enforcement orders and, as far as material, provides:
- “(1) The licence holder to whom a final or provisional order relates shall have a duty to comply with it.
(2) The duty shall be owed to any person who may be affected by a contravention of the order.
(3) Any breach of the duty which causes such a person to sustain loss or damage shall be actionable by him.
...”
- (f) Section 89 of the PSA, so far as material, provides:
- “(1) A universal service provider may make a scheme under this section in relation to the services provided by him in connection with the provision of a universal postal service or any of those services.

- (2) A scheme under this section is a scheme for determining any or all of the following (so far as not otherwise agreed) –
- (a) the charges which are to be imposed in respect of the services concerned,
 - (b) the other terms and conditions which are to be applicable to the services concerned, and
 - (c) procedures for dealing with complaints of persons who use the services concerned.
- ...
- (4) Subject to section 92(5) and (6), no provision may be made in any scheme under this section –
- (a) for limiting the liability of the universal service provider concerned for loss or damage, or
 - (b) for amending the rules of law relating to evidence.
- ...
- (6) A scheme under this section may –
- (a) make different provision for different cases or classes of case determined by, or in accordance with, the provisions of the scheme,
 - (b) modify any previous scheme made under this section.
- ...”
- (g) Section 90 of the PSA, so far as material, provides:
- “(1) No proceedings *in tort* shall lie ... against a universal service provider in respect of *loss or damage* suffered by any person *in connection with* the provision of a universal postal service because of –
- (a) anything done or omitted to be done in relation to any postal packet in the course of transmission by post, or
 - (b) any omission to carry out arrangements for the collection of anything to be conveyed by post.
- (2) No officer, servant, employee, agent or sub-contractor of a universal service provider shall be subject, except at the suit or instance of the provider, to any civil liability for –
- (a) any *loss or damage* in the case of which liability of the provider is excluded by sub-section (1), or
 - (b) any *loss or, or damage to, an inland packet* to which section 91 applies.
- ...
- (5) This section is subject to section 91”. (Emphasis added)
- (h) Section 91 of the PSA, so far as material, provides:

- “(1) Proceedings shall lie ... against a universal service provider under this section, *but not otherwise*, in respect of relevant *loss of, or relevant damage to*, an inland packet in respect of which the universal service provider accepts liability under this section in pursuance of a scheme *made under section 89*.
- (2) The references in sub-section (1) to relevant loss or damage are to loss or damage so far as it is due to any wrongful act of, or any neglect or default by, an officer, servant, employee, agent or sub-contractor of the universal service provider while performing or purporting to perform in that capacity his functions in relation to the receipt, conveyance, delivery or other dealing with the packet.
...
- (4) A universal service provider shall not be liable under this section in respect of a packet of any description unless such conditions (if any) as are required by a scheme under section 89 to be complied with in relation to packets of that description at the time when they are posted have been complied with in the case of the packet.
...
- (6) In this section ‘inland packet’ means any postal packet which is posted in the United Kingdom for delivery at a place in the United Kingdom to the person to whom it is addressed.” (Emphasis added).

(i) Section 92 of the PSA, as far as material, provides:

- “(5) The amount recoverable in any proceedings under section 91 in relation to a packet of any description shall not exceed –
 - (a) the market value of the packet at the time when the cause of action arises, or
 - (b) the maximum amount payable under a *scheme made under section 89* for compensating the person aggrieved in respect of a packet of that description.
- (6) For the purposes of sub-section (5)(a) the market value of a packet shall not include –
 - (a) any message or information which it bears, or
 - (b) any item which, in relation to packets of that description, is excluded from the operation of this section by a *scheme under section 89*.
- 7. For the purposes of any proceedings under section 91, it shall be presumed, unless the contrary is shown, that *loss of, or damage to*, the packet was due to such conduct as is mentioned in sub-section (2) of that section.
...” (Emphasis added)

(j) Section 102 of the PSA empowers the Secretary of State to make such provision as he considers appropriate to ensure that a Community obligation under the Postal Services Directive (Directive 97/67/EC) is or will be complied with.

(k) Article 19 of the Postal Services Directive, so far as material, provides:

“Member States shall ensure that transparent, simple and inexpensive procedures are drawn up for dealing with users’ complaints, particularly in cases involving loss, theft, damage or *non-compliance with service quality standards*.”

Member States shall adopt measures to ensure that those procedures enable disputes to be settled fairly and promptly with provision, *where warranted*, for a system of reimbursement and/or ...” (Emphasis added)

Annex 2: Benchmark comparisons

During the period of discussions with Postwatch in 2001, Royal Mail undertook research to determine how its proposed scheme compared to those provided by domestic and global competitors and other cross sector organisations providing low value/high turnover services. The features of Royal Mail's proposed scheme were consistent with industry and cross sector benchmarks. They were also significantly greater than those offered by other regulated postal administrations, who responded to the research survey. Only Finland had a scheme of the same scale as that proposed by Royal Mail.

Postal sector benchmarks

Royal Mail wrote out to a number of postal administrations and asked four questions related to the areas where Postwatch felt Royal Mail should improve its scheme. To test acceptability and regulatory good practice, a fifth question was added in respect of what had been agreed with the domestic regulator. The questions asked were:

- do you pay compensation for loss, damage, and delay for ordinary letters?
- do you operate a goodwill scheme?
- do you require proof of claim?
- do you offer additional compensation to large users for failure to meet Quality of Service standards?
- Is your approach agreed with your regulator?

Of the ten administrations that replied (USA, Canada, New Zealand, Germany, France, Spain, Italy, Ireland, Holland and Finland), nine said they did not pay compensation for loss or delay and eight said they did not pay compensation for damage. Four administrations said they only paid compensation for registered or declared value items. However, five administrations said they operated some form of a discretionary goodwill system. The remainder considered the low transaction value as justification for offering little beyond a standard letter of apology.

In respect of making a claim for redress, four administrations require physical proof [a receipt or the envelope] three said they operate on trust and three said the issue did not apply as they offered no redress at all. Of those who did not require proof, it must be remembered that this related to their registered or declared value products, where "proof" was provided by the actual process.

In terms of large users only two indicated they did anything additional for Quality of Service failures. (Canada offered claims based discretionary goodwill payments, France has a scheme which is based on La Poste's self measurement of failure and offers some sliding scale redress).

In terms of the acceptability of other administrations' arrangements, seven indicated they had been agreed with their domestic regulators, two said not and one said it was not appropriate as they did not have a regulator.

Competitor benchmarks

In the letters market, the Hays' DX system is the nearest comparable low cost current alternative. They do not offer any compensation for the basic product "timed non definite", but will refund the fee for their "timed definite" if that item is lost or delayed.

In the wider commercial sector of timed guaranteed packets and parcels, the arrangements for loss and damage are limited to the value of the goods, or a pre set price per kilo. In respect of delay, as the products are time guaranteed, refund of fee is the norm.

Proportionate compensation

The table below seeks to compare utility compensation payments with those made under the Royal Mail Scheme. In order to draw analogies which are as close as possible to the postal services sector, Royal Mail has concentrated on the minimum payments available under these schemes (those available to the customer in the event of interruptions to supply or non-availability of the service). The higher maximum payments are in fact only available in protracted or grave cases. The annual expenditure shown for gas and electricity is a median figure - this is because a customer's choice of payment method (for example direct debit, cash, quarterly etc) leads to a different average annual expenditure.

Utility	Average spend per customer p.a.	Compensation available to the customer	Compensation as a % of annual spend
Water	£245	£10 -1000 ²³	8.2%
British Telecom	£324	£10 - 1000 ²⁴	4.0%
Gas	£261	£10 -20	3.8 - 7.6%
Electricity	£237	£20 - 50	8.4%
Royal Mail	£17	£27 (100 x 27p)	158.9%

Unlike many of the other utility sectors however, expenditure on the postal service is arguably more discretionary. In this respect it is perhaps more analogous to the railway industry. Compensation schemes in the competitive de-regulated railway market are varied, as indeed is annual expenditure nation-wide. However, one overriding factor is that the customer purchasing an annual season ticket for use on London Underground at £756, receives a refund of £1.90 (or 0.25%) for each service failure. Even allowing for a service failure every single month, this amounts to compensation of £22.80 per annum, or 3% of an annual zones 1-2 season ticket costing £756.

It is apparent from the results of this research, that compensation for service failure in the utility schemes is around 5-10% of average individual spend on the basic utility service. The maximum level of compensation offered under the Royal Mail Scheme amounts to nearly 159% of average individual expenditure on postal services (although in practice many claims are currently settled at less than this maximum and to the satisfaction of the majority of customers who have complained to Royal Mail).

Cross sector benchmarks

A poll was taken of high volume/low value service providers in three other sectors, transport, food retailers, general retailers. All required some proof of transaction and none offered redress beyond the value of the item or service involved in the complaint.

Relative position of Royal Mail scheme

This research shows that the relative generosity of the Royal Mail scheme is consistent with industry and cross sector benchmarks, and significantly greater than both those of other regulated postal administrations, who responded to the research survey and those of other regulated industries. Only Finland has a scheme of the

²³ the maximum payment of £1,000 would only be available in exceptional circumstances, eg where sewerage enters a customer's home.

²⁴ the maximum payment of £1,000 would only be available if an appointment or fault was missed/not repaired over a continuous period of 100 days.

same scale as that proposed by Royal Mail. On this basis there is no compelling commercial argument to increase the arrangements proposed under the Royal Mail scheme. Indeed to go further would distort the markets that exist now and in the future as competition increases.

Appendix 6B:

Proposed Licence Changes

Royal Mail accepts the need to make some changes to Condition 4 and 8, for example to incorporate the new service standards. Indeed Royal Mail had agreed the proposed changes to scheduled service standards in the Annex to the proposed condition. However the other proposed changes go far beyond what is actually required. Moreover, Royal Mail believes that the proposals reintroduce issues that Royal Mail rejected when the original Licence was negotiated, and which there is no new evidence from the operation of its Licence to justify. Royal Mail believes that such unnecessary and unjustified Licence conditions create an additional bureaucratic regulatory burden upon the licensee, which is not ultimately in the interests of the customer.

As indicated in the Price Control document, Royal Mail has therefore raised a number of serious objections to the proposed Licence Condition changes with Postcomm.

Royal Mail is very disappointed that although Postcomm has acknowledged its objections and the absence of any Royal Mail input to the proposals, Postcomm has decided to include them in the Price Control documents. In Royal Mail's view this lends the proposals a credibility they do not deserve.

Section 14 of the Postal Services Act 2000 requires modification of the Licence to be with the consent of any Licence holder unless a reference is made to the Competition Commission under Sections 15 to 19 of the Act. Royal Mail does not and will not consent to these changes and therefore the proposed modifications to Conditions 4 and 8 cannot be included in any determination. Furthermore, any determination issued by Postcomm could not be based on these revised versions of the Condition (as the current draft is)²⁵. Royal Mail must also put on record its view that any Licence condition (and any determination under it) which was inconsistent with the statutory provisions would be unlawful and unenforceable.

Royal Mail has proposed its own drafts of Condition 4 and Condition 8, which are appended to this Annex, and which amendments it would be prepared to accept.

The rationale behind these and Royal Mail's detailed objections to the published proposals are set out below.

Definitions (Condition 8 Para 14)

The definitions of loss, stolen mail, damage and unlawful interference are suitable only in respect of Condition 8, and therefore should not be included at Condition 1. In respect of Condition 4 (compensation) these terms will be subject to legal interpretation as they are terms used in the Postal Services Act or other legislation. It is not appropriate for Postcomm to seek to define them in this context. In any event, the definitions are not required in the context of Condition 4 unless Royal Mail agrees Postcomm's proposed modifications to that Condition – which it does not. For completeness we have tried to comment on the definitions from the point of view of their use solely in Condition 8 and more generally.

There remain issues about how the definitions in Condition 8 should apply to postal packets posted with other suppliers who access Royal Mail's services. Royal Mail would not pay direct compensation to a poster or recipient of items posted with a

²⁵ Recital (2) of the draft determination states that Condition 4 (10) requires a compensation scheme to be established for compensating users for "other service failures". The current Condition 4 (10) is limited to "failure to meet the quality standards applicable in accordance with the scheduled standards".

third party and lost or damaged whilst within Royal Mail' control. (Any compensation or other penalty for third party access items lost, damaged or delayed should be paid to the third party carrier in accordance with the contract between Royal Mail and that third party.) However, it might be suitable for Condition 8 estimates to include such items.

Royal Mail's principal concerns are:

Term	Comment
Bulk mail products	The term "Bulk" is already used in the context of competition with a different definition to that used in the compensation scheme. The term "industry" is Royal Mail's preferred alternative. The definition also uses the incorrect product name for PPI. (The correct term is Printed Postage Impressions).
Damage	To be used in condition 4, the definition would need significant amendments to encompass various exclusions, including damage due to inadequate packaging, as Royal Mail does not pay compensation in these circumstances. To be used in condition 8 the definition needs to be compatible with the agreed definition used in the condition 8 estimation methodology - i.e. "items damaged in such as way that they might have lost part or all of their contents". Postcomm should also be aware that Royal Mail delivers to the address, not the person to whom the postal packet is addressed, and that the proposed definition is incorrect in this respect.
Loss	To be used in Condition 4, the definition would need significant amendment to incorporate the relevant exclusions in the compensation scheme. It would also need to specify that loss takes place before any handover to a third party, to cover the situation where a third parties has upstream access Failure to deliver should refer to "attempted delivery". The definition of undelivered mail should remain at over 15 working days after due date of delivery. Postcomm should also be aware that Royal Mail delivers to the address, not the person to whom the postal packet is addressed, and that the proposed definition is incorrect in this respect..
Delay	A revised definition should be included for the Christmas and New Year period. For use in Condition 4, the definition should incorporate the exclusions in the compensation scheme.

Condition 4

Paragraph numbering refers to the Postcomm proposal unless stated otherwise.

Royal Mail's principal objections to the draft Condition are:

- Paragraphs 10 and 12 of Condition 4 extend Postcomm's ability to determine on compensation to include Loss, Damage, Keepsafe and Redirections. Postcomm is seeking to extend its remit, but this lies outwith Postcomm's legal powers (see section 2 of Appendix 6A).
- Paragraphs 21 and 22 of Condition 4 give Postcomm the power to determine alterations to the agreed scheduled standards of service and compensation scheme, at the behest of Postwatch.

The financial risk to Royal Mail of these proposals is immense. Service performance targets have already been discussed and agreed with Postwatch for 3 years in line with the price control. Non-achievement of these and any loss reduction targets would expose Royal Mail to industry compensation payments, enforcement action, potential penalties and third party actions. Such targets must be agreed and incorporated in business strategy; they cannot be externally imposed at the will of Postcomm.

Detailed comments are set out below.

Paragraph	Comments
7b	Royal Mail requires an amendment to paragraph 7b to require the Council (Postwatch) to provide Royal Mail with a copy of the audit reports on its Quality of Service measurement systems within two months of the end of the period to which the audited results relate. Although Postwatch (funded by Royal Mail) has commissioned a very extensive audit of the Royal Mail Quality of Service measurement systems, Royal Mail and its agents have received no formal feedback and almost no informal feedback on the outcome of the audits from Postwatch or the auditors. For this reason Royal Mail was not able to include any statement about the audit of its results in its 2001/2 Report and Accounts. This creates a nonsense situation in which more money and effort are being spent on auditing these results, but Royal Mail and hence its customers have less information than before on the outcome of the audit. The proposed Licence amendment would rectify this situation.
10(a)(b)(c) 12(c)	These sections should be dropped. Postcomm does not have the legal powers to determine on these issues as part of its compensation scheme and is trying to remedy its lack of powers under the Licence to do those things which the current compensation proposal is seeking to do. Royal Mail is prepared to discuss a voluntary compensation system.
13	Royal Mail believes that paragraph 13 as drafted gives Postcomm too much flexibility to determine a compensation scheme.
16	Royal Mail is content to use complaints instead of claims.
21, 22	These paragraphs should be dropped. Royal Mail cannot agree to accept proposals that would give Postcomm sweeping powers to make further determinations on targetry and service standards. The financial consequences for Royal Mail are of such magnitude that any changes can only be agreed in the wider context of pricing, access and competition, not unilaterally imposed by Postcomm.

Condition 8

Paragraph numbering refers to the Postcomm proposal unless stated otherwise.

Postcomm has recently published its Standard Licence for other operators. Royal Mail notes that Condition 5 (Integrity of Mail) contains requirements almost identical to those in Condition 8 of Royal Mail's current licence. However, apart from the two references to sections 83 and 84 of the Act it does not include any of the changes proposed in the draft Condition 8. Postcomm has not put forward any rationale as to why more now appears to be expected of Royal Mail.

Postcomm have also stated their desire to establish industry standards and an industry forum for security and integrity issues. Royal Mail therefore expects any changes to Condition 8 of its Licence to be included in Standard Licence Condition 5 for all licensees. Royal Mail will not agree to any modifications not included in the Standard Licence.

Royal Mail's principal objections to the draft Condition are:

- Paragraphs 7 and 8 of Condition 8 give Postcomm the power to determine alterations to Royal Mail's mail protection procedures, at the behest of Postwatch, who have no legal responsibility and no expertise in this area. This is unnecessary, intrusive and in direct contradiction to Postcomm's own proposals for industry-wide security compliance. There are no such requirements in the Standard Licence for other operators.
- Paragraphs 10 to 13 of Condition 8 set standards for reductions in mail loss, theft and damage and require Royal Mail to use reasonable endeavours to achieve these reductions. It is also proposed that the estimates of loss are formally audited, although it is not possible to audit estimates of this nature.

Detailed comments are set out below.

Paragraph	Comment
2(b), 3(c)	These clauses have been included in Condition 5 of the Standard Licence Conditions for all long-term Licences. Royal Mail is therefore content with this proposed modification.
2(b), 9(d).	Although this is covered by the definition, Royal Mail would prefer references to "interference" etc to remain as "unlawful interference".
7, 8	Royal Mail will not accept the proposed changes. Paragraph 7 should revert to the current wording and paragraph 8 be removed. Postwatch have no expertise in security; neither do they have any responsibilities under the Act for this area. Postwatch may make suggestions on security as part of the review and Royal Mail will consider any such suggestions seriously but should not be under any obligation to implement them. Postcomm have told Royal Mail that they intend to take a hands-off approach to enforcing security compliance with all licensees and have put out a consultation paper "Enforcement Policy for Criminal Offences" (July 2002) to this effect. The recently published Standard Licence Condition 5 for Mail Integrity is almost identical to the current Condition 8 of Royal Mail's licence. The proposed changes to condition 8 are in direct contradiction to this approach. Royal Mail employs an experienced and professional security team and should be left to determine its own security procedures. Postcomm and Postwatch have not provided Royal Mail with any evidence that additional controls are required in this area. As Postcomm's own Guidance Notes for Mail Integrity Procedures make clear, there are already sufficient incentives to Royal Mail (and

Paragraph	Comment
	other operators) in the form of compensation and possible financial penalties for Royal Mail to maintain good security without the need for Postcomm to become involved in this level of detail.
9	<p>It is not possible for Royal Mail to split the estimates according to the precise definitions of loss/stolen/damaged/unlawfully interfered with proposed at paragraph 14. For example it is not possible under some circumstances to distinguish whether items have been damaged or unlawfully interfered with, or whether they have been stolen rather than lost. Royal Mail therefore questions the usefulness of this distinction.</p> <p>The reporting will need to remain at the current level, i.e. lost/stolen and damaged/unlawfully interfered with.</p> <p>Royal Mail is willing to produce a further breakdown of the estimates for Postcomm and Postwatch outside the formal Licence requirement, provided Postwatch and Postcomm formally accept the overlaps and inconsistencies in the estimation procedure.</p>
10 (a)(ii), (b) 11	<p>Whilst Royal Mail is committed to reducing the number of postal packets in each of the four causes specified, Royal Mail will not be able to accept any targets for reductions, or any commitment to use reasonable endeavours to achieve such targets. These sections should be removed.</p> <p>Reductions cannot be in terms of absolute numbers. If Royal Mail handles more items, it may lose more even if security has improved and vice versa.</p> <p>It is not possible to measure loss accurately, hence the use of estimates rather than measures. These estimates will not be accurate enough to detect small changes in underlying numbers. Moreover Royal Mail may not be able to reduce some areas of loss, particularly if losses are small and subject to random fluctuation. For example, theft is an unusual event and therefore subject to big variations regardless of the effectiveness of Royal Mail's security. One major theft during the year could cause overall losses to increase, even with improvements in underlying security levels. Royal Mail cannot agree to any target reduction on aspects of mail loss and damage that do not lie fully within its control.</p>
12	<p>This paragraph should be dropped.</p> <p>Royal Mail has already told Postcomm and Postwatch as part of the Condition 8 reporting that it is not possible to provide the overall estimates more frequently than annually. Some of the major elements can only be estimated annually.</p> <p>As many elements of loss etc are estimated and because they are due to rare events affecting a small proportion of postal packets it may not be possible to detect genuine changes over short time periods.</p> <p>It is proposed in this paragraph that the extra reports go to Postwatch rather than Postcomm - again a direct contradiction with Postcomm's proposals for standard conditions and security compliance and Postcomm's interpretation contained therein of its legal obligations under Part V of the Act.</p> <p>Royal Mail has already agreed quarterly reporting of some crime-related statistics to Postcomm, outside its Licence, as part of the development of an industry standard. This information will also be shared with Postwatch.</p> <p>Royal Mail will not accept the inclusion of this or any other additional reporting as part of its Licence unless it is an agreed industry standard applicable to all licence holders.</p>
13	This paragraph should be dropped.

Paragraph	Comment
	<p>There are a large number of problems with getting estimates of this nature professionally audited. As part of the Condition 8 report Royal Mail has made it quite clear to both Postcomm and Postwatch that the data in many areas is soft and subjective – hence the use of estimates and not measures. It would not be acceptable for anyone other than Royal Mail to appoint any auditor, who would need access to sensitive security data within the organisation. The auditors must also report to the organisation that appoints them. However it is not clear how a conventional auditor can deal with this as part of a formal audit and what value this will add to the estimation process. Postcomm and Postwatch have told Royal Mail that they did not intend a formal audit; Royal Mail nevertheless believes that the drafting of the paragraph requires this. Royal Mail has made a considerable amount of effort, going beyond the requirements of its Licence, to share with Postcomm and Postwatch its approach and data sources for the 2001/2 Condition 8 estimates. Both Postcomm and Postwatch have confirmed that they were happy with this approach, which Royal Mail proposes to continue, but that they wish to maintain a similar level of assurance for future years. Royal Mail believes this should be easily resolved between the three organisations without the need for an additional Licence condition and consequent burden upon Royal Mail.</p>
14	Covered under definition proposals

Appendix: Draft Wording For Licence Condition 4

Condition 4: Services standards of service and compensation

1. In this condition “scheduled services and standards” means the minimum services and standards of service to be established pursuant to paragraphs 3 and 4 as those services and standards are amended pursuant to paragraphs 18 and 19 and “scheduled services” and “scheduled standards” shall be construed accordingly.
2. The Licensee shall use reasonable endeavours –
 - (a) to collect postal packets –
 - (i) from its customers as agreed with them, and
 - (ii) on a regular and reasonable basis from any post office letter boxes it uses, and
 - (b) appropriately to deliver, or to procure the delivery of, any postal packets it receives in the course of its business as a postal operator within a reasonable time.
3. The Licensee shall at all times –
 - (a) maintain a schedule in writing of the minimum postal services to be provided to users and of the minimum standards of service to be achieved by the Licensee in the provision of those services, and
 - (b) ensure that Postcomm and the Council are provided with up to date copies of the schedule and minimum standards maintained in accordance with paragraph (a).
4. The scheduled services and standards shall –
 - (a) deal with routing times and the regularity and reliability of services to be achieved;
 - (b) lay down quality standards for national mail that are compatible with those laid down for intra-Community cross-border mail;
 - (c) provide quality standards for intra-Community cross-border mail services in a manner consistent with the Annex to the Postal Services Directive²⁶;

²⁶ Annex A to the Postal Services Directive provides:

“The quality standards for intra-Community cross-border mail in each country are to be established in relation to the time limit for routing measured from end to end for postal items of the fastest standard category according to the formula $D + n$, where D represents the date of deposit and n the number of working days which elapse between that date and that delivery to the addressee.

Quality standards for intra-Community cross-border mail

Time limit	Objective
D + 3	85% of items
D + 5	97% of items

The standards must be achieved not only for the entirety of intra-Community traffic but also for each of the bilateral flows between two Member States.”

- (d) be no less beneficial to consumers than those described in the standards notified to the European Commission by the United Kingdom Permanent Representative to the European Union on 24 May 2000, and
 - (e) incorporate targets for the delivery and improvement of services that are no less demanding for the Licensee than the targets set out in the Annex to this condition.
5. The Licensee shall not make any change to the scheduled services and standards other than in accordance with paragraphs 18 and 19.
 6. Except as Postcomm may by direction determine, the Licensee shall use all reasonable endeavours to provide the scheduled services and meet the scheduled standards.
 7. The Licensee shall –
 - (a) monitor its compliance with the scheduled standards using a testing methodology that –
 - (i) is representative of the range of services to which and customers for whom the scheduled standards are relevant and capable of providing results with measurable statistical significance,
 - (ii) is applied independently of the Licensee, and
 - (iii) is compliant with Article 16 of the Postal Services Directive, and
 - (b) permit and cooperate with audit of its monitoring pursuant to paragraph (a) by persons appointed by the Council with the agreement of the Licensee which shall not be unreasonably withheld, and
 - (c) be provided by the Council with a copy of the audit reports so produced within two months of the end of the period to which the audited results relate.
 8. The Licensee shall –
 - (a) submit written quarterly reports on its compliance with the scheduled standards to Postcomm and to the Council, not later than two months from the end of the quarter to which they relate setting out the Licensee's performance against each of the scheduled standards, and
 - (b) include with every fourth report submitted under paragraph (a) a statement of the action the Licensee intends to take in the following period of twelve months in order to meet the targets referred to in paragraph 4(e).
 9. Before the expiry of six months from the commencement of this Licence the Licensee shall establish and submit to Postcomm and thereafter shall comply with a code of practice for identifying the incidence of, and addressing the causes of, significant failure to meet the scheduled standards in postcode districts within postcode areas in which the scheduled standards overall are met.
 10. The Licensee shall –
 - (a) before the expiry of six months from the commencement of this Licence establish a scheme to be known as the standards of service compensation

scheme for compensating users of postal services affected by failure to meet the quality standards applicable in accordance with the scheduled standards to any postal packet posted by them, and

(b) until the establishment of the standards of service compensation scheme, operate a scheme which provides as minimum benefits to users of the Licensee's postal services the benefits provided for in –

- (i) Part 5 of the Post Office Inland Letter Post Scheme 2000,
- (ii) Parts VI, VII and VIII of the Post Office Inland Parcel Post Scheme 1989,
- (iii) paragraphs 33, 36 and 37 and Schedule 9 of the Post Office Overseas Letter Post Scheme 1982, and
- (iv) paragraphs 23, 24 and Schedule 3 of the Post Office Overseas Parcel Post Scheme 1982,

in each case as amended to 1 January 2001.

11. The standards of service compensation scheme shall –

- (a) provide for the Licensee paying to any such person as is mentioned in paragraph 10 such compensation as may be specified in the scheme as being appropriate,
- (b) provide, where a dispute arises between a person claiming compensation under the scheme and the Licensee as to whether compensation is due or whether the compensation is appropriate, provide for the Licensee to inform the person claiming compensation of his right to refer the matter to the Council.
- (c) be in such terms as may be agreed between the Licensee and the Council, provided that if –
 - (i) there has been no such agreement between the Licensee and the Council within the period of six months from the commencement of this Licence, and
 - (ii) Postcomm has given the Licensee not less than 28 days notice in writing that it proposes to make a determination as to the terms of the standards of service compensation scheme, and
 - (iii) Postcomm has given to the Licensee the opportunity in that period of not less than 28 days to make representations to it in relation to its proposal to make such a determination, then

the standards of service compensation scheme shall be in such terms as may be determined in writing by Postcomm.

12. The Licensee shall not make any change to the standards of service compensation scheme other than in accordance with paragraphs 18 and 19.

13. The Licensee shall meet its obligations under the standards of service compensation scheme.

14. The Licensee shall submit annual reports on the operation of the standards of service compensation scheme to Postcomm and to the Council, not later than three months from the end of the year to which they relate, setting out for the United Kingdom as a whole and, except as Postcomm may agree otherwise in writing, for each of the postcode areas –

- (a) the number of complaints that were received,
 - (b) the number of complaints in relation to which compensation was paid, and
 - (c) the amount of compensation (including any payments in lieu of compensation) that was paid,
- in each case broken down by not less than ten of the main causes of the complaints.
15. The reports submitted pursuant to paragraph 14 shall be accompanied by a statement of the action the Licensee intends to take in the year following submission of the report to address the causes of claims for compensation.
16. The Licensee shall –
- (a) publish the schedule of established services and standards, particulars of the standards of service compensation scheme, the reports required to be submitted under paragraphs 8 and 14 and the statement required to be submitted under paragraph 15 in such manner as will ensure reasonable publicity for them,
 - (b) not assert copyright against, or otherwise oppose, any publication arranged by Postcomm or by the Council of the schedule, reports and statement, and
 - (c) make copies of the schedule, reports and statement available free of charge to any person requesting them.
17. The Licensee shall –
- (a) offer to review the schedule of established services and standards and the standards of service compensation scheme with the Council in the years ending on the first and second anniversaries of this Licence and thereafter in every second year ending on the anniversary of the Licence, and
 - (b) shall discuss in good faith with the Council and endeavour to agree modifications to the scheduled standards and services and to the standards of service compensation scheme that are appropriate in the interests of users of the Licensee's postal services for the period until the next review.
18. The schedule of established services and standards and the standards of service compensation scheme may be amended by the Licensee at any time with the agreement of the Council or of Postcomm provided, in the case of amendments agreed with the Council, that not less than three months' notice of the proposed amendments has been given to Postcomm and Postcomm has not within two months of being notified directed that the proposed amendments be not made.
19. If the Council recommends to Postcomm following a review under paragraph 17 that the schedule of established services and standards or the standards of service compensation scheme should be changed and if Postcomm advises the Licensee in writing that it is of the view that the changes recommended by the Council should be made, or made with modifications, then the Licensee shall either –
- (a) alter the schedule of established services and standards or the standards of service compensation scheme in the manner recommended by the Council with any modifications advised by Postcomm, or
 - (b) advise Postcomm in writing that it has declined to alter the schedule of established services and standards or the standards of service compensation scheme as aforesaid and provide to Postcomm, and

publish in such manner as Postcomm may direct, a full explanation of its decision.

20. The Licensee shall appoint an official reporting directly to a member of its board of directors and charged with responsibility for monitoring the Licensee's compliance with the scheduled standards and for meeting representatives of the Council on not less than two occasions per year to discuss the schedule of established services and standards, the standards of service compensation scheme, the reports submitted pursuant to paragraphs 8 and 14 and the statement required to be submitted under paragraph 15.
21. The Licensee shall not –
 - (a) establish any scheme under section 89 of the Act, or
 - (b) include any provision in such a scheme, that is incompatible with any of the Licensee's obligations under this condition.

ANNEX TO CONDITION 4

Minimum targets to be incorporated in the Licensee's scheduled services and standards

Financial years 2001/2002 and 2002/2003

PRODUCT/SERVICE			TARGET (%)	
No	Name of product/service		To end of March 2002	To end of March 2003
1	1 st Class mail	Note 3	92.1	92.5
2	2 nd Class mail	Note 3	98.5	98.5
3	Mailsort 1	Notes 4 & 5	92.1	93.0
4	Mailsort 2	Notes 4 & 5	97.6	98.5
5	Mailsort 3	Notes 4 & 5	98.5	98.5
6	Presstream 1	Note 4	91.0	92.5
7	Presstream 2	Note 4	97.6	98.5
8	1 st Class PPI	Notes 4 & 11	90.0	92.5
9	2 nd Class PPI	Notes 4 & 11	97.0	98.5
10	1 st Class response services	Notes 4 & 6	90.5	92.5
11	2 nd Class response services	Notes 4 & 6	97.0	98.5
12	Special delivery		99.0	99.0
13	Tail of mail on all products: % to be delivered within 3 days of the due day of service for services 1 to 12 above and within 7 days of that date for service 17 below		99.9	
14	Lost mail/substantial delay: % regarded as undelivered if not delivered within 15 days of due day of service		90.0	100.0
		Note 7		
15	Postcode area targets: all stamped and metered posted mail		90% in 83% of areas	90% in all areas
		Note 8		
16	Postcode area targets: Intra area mail		92.5% in all areas	92.5% in all areas
		Note 9		
17	Parcels – 3 day standard service		88.0	90.0
18	Customers queuing no longer than 5 minutes in post offices for postal services		94.0	95.0
		Note 10		

Notes:

- The products and services referred to above are those products and services as may be more fully defined by reference to a table of definitions approved by Postcomm for the purpose of this Annex with the agreement of the Licensee.
- The percentages to be achieved in the two right hand columns above are to be achieved on average in the United Kingdom as a whole (except for the postcode area minimum target) in the periods of 2 months ending at the end of March in each of the years shown.

3. The 1st Class and 2nd Class targets are national targets for all stamped and metered 1st Class and all stamped and metered 2nd Class mail; they may reflect relative volumes and different targets for intra, neighbouring and distant postcode conveyance.
4. If the Mailsort 1 and 2, Presstream, PPI and response services targets reflect relative volumes for intra, neighbouring and distant postcode conveyance that differ from those for all stamped and metered mail then the measurement of performance against targets for Mailsort 1 and 2, Presstream, PPI and response services may be calculated using the relative volumes applicable for all stamped and metered mail.
5. Any reference to Mailsort 1, 2 or 3 includes all the Mailsort services described in the table approved for the purpose of Note 1 with suffixes 1, 2 and 3 respectively.
6. The response services referred to in the table approved for the purpose of Note 1 are offered through both 1st and 2nd class post.
7. The lost mail/substantial delay target is intended to define when mail is to be regarded as not delivered for the purpose of end-to-end monitoring.
8. The postcode area targets are minimum targets to be achieved on average in each postcode area (except HS, KW and ZE) throughout the periods of 12 months ending at the end of March in each of the years shown, excluding the Christmas and New Year period.
9. The intra postcode area targets are minimum targets to be achieved on average in each postcode area throughout the period of 12 months ending at the end of March in each of the years shown, excluding the Christmas and New Year period.
10. The counter queuing targets are for national average performance of all counters.
11. The services offered for 1st Class and 2nd Class PPI (Postage Paid Impression) are substantially the same services as other 1st Class and 2nd Class services. Separate performance targets are applicable because of slightly different arrangements for the receipt of mail under PPI services by the Licensee as compared with other services.

Financial years 2003/2004 to 2005/2006 inclusive

PRODUCT/SERVICE			TARGET (%)		
No	Name of product/service		To end of March 2004	To end of March 2005	To end of March 2006
1	1 st Class mail	Notes 1 - 5	92.5	92.5	93.0
2	2 nd Class mail	Notes 1 - 5	98.5	98.5	98.5
3	Mailsort 1	Notes 1 - 7	92.5	92.5	93.0
4	Mailsort 2	Notes 1 - 7	98.5	98.5	98.5
5	Mailsort 3	Notes 1 - 8	98.5	98.5	98.5
6	Presstream 1	Notes 1 - 7	92.5	92.5	93.0
7	Presstream 2	Notes 1 - 7	98.5	98.5	98.5
8	1 st Class PPI	Notes 1 - 6, 9	92.5	92.5	93.0
9	2 nd Class PPI	Notes 1 - 6, 9	98.5	98.5	98.5
10	1 st Class response services	Notes 1 - 6, 10	92.5	92.5	93.0
11	2 nd Class response services	Notes 1 - 6, 10	98.5	98.5	98.5
12	Special delivery	Note 14	99.0	99.0	99.0
13	Tail of mail on all products: % to be delivered within the specified number of days of the due day of service for services 1 to 12 above and 16 below		99.9 within 3 days of that date for services 1 to 12 and within 7 days of that date for service 16		99.9 within 3 days for all these services
14	Postcode area targets: all stamped and metered posted mail Note 11		90.5 in all areas	91.0 in all areas	91.5 in all areas
15	Postcode area targets: Intra area mail Note 12		92.5 in all areas	92.5 in all areas	92.5 in all areas
16	Parcels - 3 day standard service Note 13		90.0	90.0	90.0

Notes:

1. The products and services referred to above are those products and services as may be more fully defined by reference to a table of definitions approved by Postcomm for the purpose of this Annex with the agreement of the Licensee²⁷.
2. The percentages shown for products/services numbered 1 to 4 and 6 to 11 above show the percentage of letters that should meet the service requirements of delivery the next working day for 1st class services or by the end of the third working day after collection or receipt by the Licensee for 2nd class services. The services numbered 1, 3, 6, 8 and 10 are 1st class services. The services numbered 2, 4, 7, 9 and 11 are 2nd class services.
3. The percentages to be achieved are to be achieved on average in the United Kingdom as a whole throughout the periods of 12 months ending at the end of March in each of the years shown, excluding the Christmas and New Year period.
4. The Christmas and New Year period is the period commencing on the first Monday in December in any year and ending at the start of the first working day after the New Year public holiday or, in Scotland, at the start of the first working day immediately after the Scottish New Year public holiday.

²⁷ Approval given 23 March 2001. Available on Postcomm public register and website.

5. The 1st class and 2nd class targets are national targets for all stamped and metered 1st class and all stamped and metered 2nd class mail; they may reflect relative volumes and different targets for intra, neighbouring and distant postcode conveyance.
6. The Mailsort 1 and 2 and 3, Presstream, PPI and response services targets do not reflect the differences between their relative volumes for intra, neighbouring and distant postcode conveyance and those for all stamped and metered mail, therefore the measurement of performance against targets for Mailsort 1 and 2 and 3, Presstream, PPI and response services will be adjusted to take account of the different mail distribution profiles. This adjusted measure will reflect the quality of service that would have been experienced by bulk mail services, if they had a similar pattern of mail distribution to stamped and metered mail. The reduction in target for Mailsort 1 between 2003 and 2004 is reflected in an equal reduction in the distance adjustment for this product. There is therefore no real reduction in the performance expected for this product.
7. Any reference to Mailsort 1, 2 or 3 includes all the Mailsort services described in the table approved for the purpose of Note 1 with suffixes 1, 2 and 3 respectively.
8. The percentages shown for the product/service numbered 5 show the percentage of letters that should meet the service requirement of delivery by the end of the seventh working day after collection or receipt.
9. The services offered for 1st class and 2nd class PPI (Postage Paid Impression) are substantially the same services as other 1st class and 2nd class services. Separate performance targets are applicable because of slightly different arrangements for the receipt of mail under PPI services by the Licensee as compared with other services.
10. The response services referred to in the table approved for the purpose of Note 1 are offered through both 1st and 2nd class post.
11. The postcode area targets are minimum targets for delivering first class mail the next working day after receipt or collection to be achieved on average in each postcode area (except HS, KW and ZE) throughout the periods of 12 months ending at the end of March in each of the years shown, excluding the Christmas and New Year period (see note 4).
12. The intra postcode area targets are minimum targets, for delivery of mail posted and delivered in the same postcode area, to be achieved on average in each postcode area throughout the period of 12 months ending at the end of March in each of the years shown, excluding the Christmas and New Year period (see note 4).
13. The percentages shown for the product/service numbered 16 show the percentage of parcels that should meet the service requirement of delivery by the end of the third working day after collection or receipt.
14. The percentages show the percentage of letters to be delivered within the delivery specification for the service purchased by the sender.

Appendix: Draft Wording for Licence Condition 8

Condition 8: Protecting the integrity of mail

1. The Licensee shall at all times establish and maintain procedures, which shall be known as the Licensee's "mail protection procedures", for the purposes set out in paragraph 2.
2. The mail protection procedures shall be established and maintained for the purposes of –
 - (a) minimising the exposure of postal packets conveyed by the Licensee to the risk of loss, theft, damage or unlawful interference,
 - (b) minimising the risk of offences under sections 83 and 84 of the Act occurring in relation to postal packets and mailbags conveyed by the Licensee, and
 - (c) improving the performance of the Licensee in relation to the matters referred to in paragraphs (a) and (b).
3. The Licensee's mail protection procedures shall deal with the following matters –
 - (a) the selection, vetting, initial training, follow-up training, provision of incentives to and disciplining of its staff, agents, sub-contractors, directors and officials,
 - (b) the security of its buildings and vehicles,
 - (c) avoiding, identifying and taking action in respect of offences under sections 83 and 84 of the Act in relation to postal packets and mailbags conveyed by the Licensee,
 - (d) ensuring that its agents and sub-contractors have and apply appropriate procedures in relation to their staff, buildings and vehicles, and
 - (e) the collection and analysis of statistics on the achievement of the purposes set out in paragraph 2.
4. The Licensee shall use all reasonable endeavours at all times to apply its mail protection procedures.

5. The Licensee may make modifications to its mail protection procedures at any time provided that –
 - (a) the mail protection procedures, with the proposed modifications will, in the reasonable opinion of the Licensee, better facilitate the achievement of the purposes set out in paragraph 3,
 - (b) the Licensee has given not less than 3 months' notice in writing of the proposed modifications to Postcomm and to the Council, and
 - (c) Postcomm, within that period of notice, has not served notice in writing on the Licensee requiring that the proposed modifications be not made.
6. The Licensee shall offer to review its mail protection procedures with the Council not less than once in every second calendar year ending on the anniversary of this Licence and shall cooperate with the Council in the conduct of any such review.
7. If the Council recommends to Postcomm following a review under paragraph 6 that the Licensee's mail protection procedures should be changed in order to better facilitate the achievement of the purposes set out in paragraph 3 and if Postcomm advises the Licensee in writing that it is of the view that the changes recommended by the Council should be made, or made with modifications, then the Licensee shall either –
 - (a) alter its mail protection procedures in the manner recommended by the Council with any modifications advised by Postcomm, or
 - (b) advise Postcomm in writing that it has declined to alter its mail protection procedures as aforesaid and provide to Postcomm a full explanation of its decision.
8. The Licensee shall submit annual reports on the operation of its mail protection procedures to Postcomm and to the Council, not later than three months from the end of the year to which they relate, setting out for the authorised area as a whole its estimates of the number of postal packets –
 - (a) lost or stolen, and
 - (b) damaged or unlawfully interfered with.
9. The Licensee shall submit to Postcomm and to the Council, with each annual report submitted under paragraph 8, a statement of the measures that the Licensee intends to take, in the period of twelve months from the submission of the report, to remedy any patterns of failure in achieving the purposes set out in paragraph 3.
10. The terms and expressions in the left hand column in the table below shall, unless the context otherwise requires, be interpreted in the manner set out next to them in the right hand column in that table

“damage”	means any damage to a postal packet posted in accordance with the requirements set out in the Inland Letter and Parcel Schemes, other than damage caused by unlawful interference, such that the postal packet might have lost part or all of its contents, occurring after the time of acceptance of that packet by the Licensee and before either its handover to a third party or its delivery to the premises to which it is addressed, or any alternative delivery point agreed with the receiving customer.
“loss”	<p>(a) means the physical loss of a postal packet, other than as a result of having been stolen, at any time after the acceptance of that packet by the Licensee and before either its handover to a third party or its delivery to the premises to which it is addressed, or any alternative delivery point agreed with the customer, and in relation to any postal packet shall be deemed to include a failure by the Licensee to deliver or attempt to deliver that packet as aforesaid within 15 working days of its due day of delivery.</p> <p>The following shall not constitute loss.</p> <ul style="list-style-type: none"> i. Postal packets that are not received by the intended recipient because they are incorrectly addressed. ii. Postal packets that have been officially disposed of in accordance with the Inland Letter and Parcel Schemes iii. Postal packets undelivered because they have not been posted in accordance with the Inland Letter or Parcel Schemes, for example, because they are unpaid or underpaid.
“incorrectly addressed”	means that the postal packet is addressed to the wrong premises for the named recipient, or that the postal packet does not have the correct postal address for the premises
“postal address”	means for any premises the address, including the postcode, maintained by Royal Mail from time to time as corresponding to those premises in the Postcode Address File.
“unlawful interference”	means unlawful interference with a postal packet in the course of its conveyance, whether by a member of staff of the Licensee or by any other person, as (respectively) defined at sections 83 and 84 of the Act;
“stolen”	a postal packet shall be taken to have been stolen if it appears that it has been misappropriated in the course of conveyance by the Licensee contrary to section 7 of the Theft Act 1968, whether by a member of staff of the Licensee or by any other person.