APPENDIX 4F

COMMENTS ON EFFICIENCY ISSUES WITHIN POSTCOMM'S 'PROPOSAL FOR A SECOND PRICE CONTROL' CONSULTATION DOCUMENT AND THE WS ATKINS 'EFFICIENCY STUDY OF ROYAL MAIL'S LETTERS BUSINESS'

CONTENTS

Editorial note: the name Consignia became Royal Mail in November 2002; all references to 'Consignia' have therefore been changed to 'Royal Mail', and for convenience this has been done even where 'Consignia' would be more accurate because the reference is to historical actions, documents or quotations.

SUMMARY

I. Context

Postcomm quotes Opex projections made by WS Atkins (WSA) as projections "that Royal Mail should be able to achieve", and lists reasons why there are differences from Royal Mail's projections. Postcomm do not formally incorporate these projections in their price control proposal, but they use them to support an argument that the price proposals provide an appropriate balance of risks. However, we question whether Postcomm have correctly interpreted WSA and we also question the methods that WSA have used to overlay further efficiencies.

II. The 'efficient operator' concept

The question of the realism of WSA's projections is bound up with their concept of a hypothetical efficient operator and they emphasise that this concept is "fundamental to their review". We consider it a serious omission that this is not made clear in the consultation document. Nowhere in their report do WSA claim that the projections for a 'hypothetical efficient operator' represent a realistic assessment of what Royal Mail can achieve during the price control period. We consider it a serious omission that WSA do not provide any reasoned discussion in their report of the realism and achievability of their overall projections, when the capability of Royal Mail, or indeed

any labour intensive business, to carry out successfully and in the planned timescales such a comprehensive major change programme as is planned is clearly a critical issue.
The concept may provide an aspirational target, but, since no evidence is provided as to how far that target is from a realistic benchmark, we believe the concept is of limited value. Its use certainly casts doubts on the applicability of WSA's projections.

III. WS Atkins' efficiency overlays – general efficiency factor

WSA make 2 significant overlays on Royal Mail's projections: those arising from an operational review by Canada Post International Ltd (CPIL); and a generalised efficiency factor of 1% per annum applied to total operating expenditure from 2003/4 onwards.

We consider first the general 1% overlay. In our view the approach of using a generalised efficiency factor might be appropriate in a case where no detailed analysis of the cost base of a business had been possible. However, WSA have examined Royal Mail's projections for each element of the letters business cost base and moreover have employed CPIL to examine further operational opportunities. Royal Mail have provided to WSA full details of their Strategic Plan and Renewal Programme which involves major change initiatives relating to virtually every part of its letters cost base. WSA have in most cases confirmed the reasonableness of the projections, and in some cases, through the CPIL work, suggested further savings. A further overlay in these circumstances may be appropriate for any small areas of the cost base not considered, but we consider it totally unjustified and unprecedented to apply it to the total cost base - a clear case of 'having your cake and eating it'.
To justify the overlay WSA draw comparisons with levels of efficiency improvement in other regulated industries. We consider this approach to be severely flawed for the following reasons:

a. effectively WSA have examined in detail Royal Mail's planned cost projections, considered other industry benchmarks and calculated an overlay factor by taking the difference; this means it is the benchmark figure that drives their projections; so the detailed work of examining Royal Mail's plans, carried out at great expense over the last year, and reported at length in the rest of their report, is effectively discarded in favour of a crude benchmark;

b. the other industries which WSA have chosen to benchmark are primarily water and power; these are highly capital intensive and therefore inappropriate benchmarks. Postcomm themselves do at least recognise some of the problems with using other regulated industry benchmarks;

c. Postcomm quote comparative benchmarking based on unit cost trend comparisons; but unit cost trends are only meaningful if a unit stays as a unit; this is not the case with Royal Mail; units are defined as letters, but letters constitute a bundle of products with widely ranging prices and profitability levels which vary considerably depending on how and where an item is collected and delivered; as a result, unit cost trends are greatly impacted on by changes in mail mix, and these will be significant in future as the most profitable types of mail are evidently those that will be the prime target for competition; in these circumstances any unit cost trends calculated on the basis of 'letters' as the unit are of very limited value as indicators of performance.

WSA chose to ignore other benchmarking evidence provided by Royal Mail: their report refers to benchmarking documents that they reviewed, but they failed to report on the conclusions of this review. This evidence suggests that UK letters have had an excellent track record of price constraint (and by implication efficiency) when compared with other countries, other sectors of the UK economy, particularly the more labour intensive sectors, and even competitive businesses in the same sector.

Postcomm also suggest that Royal Mail's plans are predicated on what may be seen as a reduction in service quality. In doing so they do not give a balanced view. No mention is made of the demanding Quality of Service improvements (% meeting due delivery date) which the plan necessitates, and the fact that Postcomm are proposing a compensation regime which is arguably more stringent than exists for any other country's postal services.

Postcomm also argues that Royal Mail's savings are unambitious based on a comparison with staffing reductions achieved in other countries. But the only reductions quoted that imply a faster rate of reduction than in Royal Mail's plans are for Deutsche Post, where the data they quote includes a very serious error with start and end point not based on a like with like comparison.

On the question of whether Royal Mail's plans and projections are ambitious we would finally also note that Graham Corbett is reported in the FT of 11 October 2002 as saying, in relation to Allan Leighton's renewal plan, "we would like to encourage him to push down that very ambitious track".

IV. WS Atkins' efficiency overlays – efficiency opportunities

The process by which the findings have been fed through into the projections presented in the consultation document has been an unsatisfactory one, preventing some obvious flaws being corrected in time to affect what was published. Our criticism of the process concerns the following points:

- their analysis contained significant flaws and was therefore misleading;
- the WSA report was not finalised at the time when the consultation document was made public; WSA projections within the consultation document are therefore based on a flawed draft within which some agreed amendments have not yet been included;
- other flaws in their analysis have been pointed out which in our view remain uncorrected;
- these aspects of their report could have been sorted sooner if there had not been needless delay between March and September 2002 in making it available to Royal Mail

We believe that this whole process is not consistent with good regulatory practice, and may have misled Postcomm, as well as all consultees, regarding the scope for further efficiencies.

Our comments on the specific items are as follows:

Tailored Delivery Services (TDS)

A higher ultimate savings figure from TDS is proposed but a slower build-up of savings. In terms of timecales we would agree that our plans are challenging; some initial slippage is probable but the aim is still to finish implementing the changes by the planned completion date. With regard to the estimation of ultimate savings we find that the CPIL approach was considerably flawed in view of:

- an implicit assumption of only 5 day a week delivery
- failure to take account of existing part-time staff
- failure to compare addressed mail volumes for Canada versus UK when assessing mail preparation work

- an assumption that deliveries can continue until mid-afternoon, which is later than Royal Mail is proposing; there is no discussion of whether this would be acceptable to customers.

If correct calculations had been used the results of this benchmark approach would have led to savings lower than those assumed by Royal Mail.

Flat sortation

It is suggested that the projected programme of flats automation should be accelerated compared with that which was projected (though not yet financially authorised) in Royal Mail's plan.

Firstly we would note that the WSA projections quoted are incorrect; they are based on the WSA draft at end of September but do not include the impact of an arithmetical error, pointed out by Royal Mail and agreed by WSA in correspondence. This should change the total of the WSA projections to approximately £134m against the £191m quoted. However, there are other significant faults in WSA/CPIL's thinking concerning this project:

- they assume a profile of machine installation which assumes 6 machines in operation from April 2002, a self-evident impossibility, and completely ignores the timescale for the current single machine pilot to be evaluated, the contractually agreed lead times for further production and the time for installation work; these factors alone make their assumptions quite unrealistic;

- they ignore the fact that Royal Mail's projected number of machines for the first phase of flats automation was based on the number of Mail Centres where there was room available to install them; to extend beyond that number would require significant re-building or new property acquisition. These machines are huge. No allowance has been made for such building costs, which in many cases may be such as to destroy the financial viability of the investment. It would be grossly financially imprudent to commit to such building work before reasonable confirmation of the benefits from the first phase of installation had been gathered. It would certainly not, in our view, represent the behaviour of "an efficient operator".

Collections

We regard the approach and conclusions of WSA/CPIL in relation to potential savings from rationalising collections as unacceptable, being based on guesswork and totally ignoring customer impact. We know that of the projected savings WSA/CPIL made a totally arbitrary estimate of £66m arising from cancelling all collections after 1800. We estimate that the correct figure would be at most £10m. However, provision of later collections from post boxes in areas with many business customers is an important part of our service to customers. The specification has been agreed with Postwatch and Postcomm and reviewed and confirmed with them. Ceasing post-1800 box collections would have a significant, detrimental impact on the level of service to our customers and their satisfaction with our service. We are unclear whether Postcomm are now recommending cessation of collections after 1800.

Upstream savings

In the consultation document annex there is an incorrect difference line, and an incorrect total in the 'efficiency study line'. An error agreed by WSA in correspondence, has, however, been correctly carried through into the annual figures.

With regard to the ultimate savings we have found some difficulty in understanding exactly what is proposed and how the savings have been calculated. We would have welcomed the chance (not provided) to explore their ideas with CPIL in order to investigate whether their ideas could be developed into genuine opportunities.

Other opportunities

There is a suggestion that, because of limitations of time, data and budget, various other identified savings opportunities were not evaluated. We consider that this is an easy statement to make because it cannot be disproved, and will always be true to some extent. However, we should point out that CPIL initially produced at the end of January 2002 a list of potential savings opportunity areas (without analysis) on which Postcomm asked us to comment. We responded, noting that a number were already included in our plans as part of other initiatives, and that some were not allowed under Royal Mail's licence. We assume this response was used to determine the priority areas for CPIL's attention.

V. Unit cost movements

Postcomm suggest that "Royal Mail's cost projections are somewhat less ambitious" and in the Technical Annex reference is made to the fact that as volumes decline "by around 20%" the unit cost performance is "less impressive". As discussed at III.c. above, Postcomm's consideration of unit cost trends is inappropriate; in particular, mail mix will be affected by Postcomm's competition policy which promotes the loss of low cost Mailsort business. We also note the following points.

Firstly, the 20% is an overstatement; the Royal Mail Version 4 plan shows a decline of around 16%. Secondly, in arriving at the WSA view in table 6.3a a higher level of volumes has been used contradicting the significant conclusions made by WSA regarding volumes and the impact of competition. And thirdly, in calculating the cost per mail item for the higher volumes Postcomm have assumed a cost elasticity with respect to volume of 0.6, totally ignoring the fact that the lower volumes used by Royal Mail reflect the impact of liberalisation which will inevitably be accompanied by cream skimming by competitors.

Having arrived at their conclusions Postcomm do, later on, acknowledge (in para A2.27) the fact that "declining volumes are likely to increase per unit operating expenditure…".

To summarise, the consultation document fails to provide a very meaningful analysis of Royal Mail's projected efficiency improvements. We would note that, ignoring volume-related effects, the underlying efficiency improvement in Royal Mail's projections from a 2000-1 or 2001-2 base to 2005-6 is approximately 3% per annum.

VI. Capital

The conclusions of WSA regarding capital we found to be completely lacking in balance. For example, we would note that:

- there is inadequate recognition of the strict authority processes which Royal Mail uses to prevent wasteful capital expenditure;

- there is no evidence produced that current capital projects are not soundly managed;
- there is no evidence that Royal Mail's procurement processes are anything other than competitive, stringent and exacting;
- there is no specific evidence of how any savings could be achieved from improved asset management.

All the general efficiency overlays which WSA apply to Royal Mail's capital projections are unsupported. In carrying out these overlays WSA failed even to distinguish capital spend which is already contractually committed; this is an elementary error. Overall we believe that little credence can be placed on WSA's projections.

Royal Mail was not claiming to be perfect in its management of capital; we are actively seeking improvements in a variety of areas, and are reviewing the capital programme.

VII WS Atkins final report

Although it is suggested in the annex to the consultation document that the final WSA report was received by Postcomm in September, the complete final report was not in fact issued until 13 November. The consultation document is based on a draft report and therefore is not fully consistent with the final report, and contains a number of inaccuracies; we comment below on such differences where they are of substance.

1 . EFFICIENT OPEX

<u>Refs</u>

C	consultation
CA	document
	annex
S	summary to
	WSA
else	WSA

1.1 The 'efficient operator' concept and WS Atkins' efficiency overlays	
In paragraph 6.30 of the consultation document Postcomm quotes projections made by WSA as projections "that Royal Mail should be able to achieve", and lists reasons why there are differences from Royal Mail's projections. At para 6.34 they claim that Royal Mail' projections are not ambitious compared with what WSA "considers achievable". Postcomm do not formally incorporate these projections in their price control proposal, but they use them to support an argument that the price proposals provide an appropriate balance of risks: for example, in para 6.68 they say that they expect Royal Mail to deliver greater cost savings than it currently projects. However, we question whether Postcomm have correctly interpreted WSA and we also question the methods that WSA have used to overlay further efficiencies.	C6.30 C6.34 C6.68
The question of the realism of WSA's projections is bound up with their concept of a hypothetical efficient operator. WSA (para 1.11) emphasise that this concept is "fundamental to their review". Oddly, this is not made clear in the consultation document. Nowhere in their report do WSA claim that the projections for a 'hypothetical efficient operator' represent a realistic assessment of what Royal Mail can achieve during the price control period. We find it odd that WSA do not provide any reasoned discussion in their report of the realism and achievability of their overall projections. There are, however, some specific references: for example, in relation to Royal Mail's projected labour efficiency improvements (measured by an indicator called EP) they say (para 6.35) "it is risky to assume target, or perhaps even significant EP rises, will inevitably be attained within the plan period"; and in relation to alternative sourcing (para 6.32) "it may have been more realistic to allow for higher implementation costs and a slower build-up of benefits". We wonder why there is no more general discussion of achievability when WSA have spent a year examining the business and when the capability of Royal Mail, or indeed any labour intensive business, to carry out successfully and in the planned timescales such a comprehensive major change programme is clearly a critical issue.	1.11 6.35 6.32
WSA attribute to Postcomm the definition of an "efficient operator" as "a business which minimises financial inputs with respect to the outputs required by statute or the licence". While this is clearly an ideal, no evidence is provided as to how closely any business is able to achieve the ideal. The concept clearly provides an aspirational target, but, since no evidence is provided as to how far that target is from a realistic benchmark, we believe the concept is of limited value. The use of the concept certainly casts doubts on the applicability of WSA's projections.	6.30 CA2.5
WSA make 2 significant overlays on Royal Mail's projections, referred to in para 6.30 and A2.5 of the consultation document: those arising from an	

operational review by CPIL; and a generalised efficiency factor of 1% per annum applied to total operating expenditure from 2003/4 onwards. We comment on the former in para 1.2 below. We consider here the general 1% overlay. Firstly, we consider that the approach of using a generalised efficiency factor might be appropriate in a case where no detailed analysis of the cost base of a business had been possible. However, WSA have examined Royal Mail's projections for each element of the letters business cost base and moreover have employed CPIL to examine further operational opportunities. Royal Mail have provided to WSA full details of their Strategic Plan and Renewal Programme which involves major change initiatives relating to virtually every part of its letters cost base. Key examples are: delivery, the largest single cost area, where savings from a complete revision of deliveries to remove the second delivery have already been augmented in Royal Mail's plans by assumed benefits from method changes; transport where a complete change to the trunk transport network is planned; mail processing where, in addition to several key automation projects, underlying labour efficiency is planned to improve to levels higher than that currently achieved in any single Mail Centre; support services which are subject to a significant outsourcing programme. WSA have in most cases confirmed the reasonableness of the projections, and in some cases, through the CPIL work, suggested further savings. A further overlay may be appropriate for any small areas of the cost base not considered, but we find it totally unjustified and unprecedented to apply it to the total cost base - a clear case of 'having your cake and eating it'. The addition of such a "top-down" factor to a detailed "bottom-up" approach is spurious and without precedent. To justify the overlay WSA draw comparisons with levels of efficiency improvement in other regulated industries. We consider this approach to be severely flawed for the following reasons:	
a. effectively WSA have examined in detail Royal Mail's planned cost projections, considered other industry benchmarks and calculated an overlay factor to bridge the difference, building this into their overall projections; so the detailed work of examining Royal Mail's plans, carried out at great expense over the last year, and reported at length in the rest of their report, is effectively discarded in favour of a crude benchmark;	6.24-6.25 15.5-15.6 CA2.26
b. the other industries which WSA have chosen to benchmark are water, power and rail (WSA paras 6.24-6.25, 15.5-15.6); Postcomm in their consultation document annex para A2.26 consider water and power; these industries in the main involve capital networks with labour primarily related to operation and maintenance (management) and corporate office, whereas for post, labour is primarily related to the network itself i.e. the network is primarily the labour; we would question the relevance of comparisons with industries whose nature is very different to that of the letters business, a point which Postcomm do at least recognise in Consultation annex para A2.27.	CA2.27
c. Postcomm quote comparative benchmarking based on unit cost trend comparisons; but unit cost trends are only valid if a unit stays as a unit; this is not the case with Royal Mail; units are defined as letters, but letters constitute a bundle of products with prices ranging from about 15p for a basic weight step 2nd class workshare item to £5 and upwards for Special Delivery items over 500gm; profitability levels also vary considerably depending on how and where an item is collected and delivered; as a result, unit cost trends are greatly impacted on by changes in mail mix, and these will be significant in future as the most profitable types of mail are	6.24

evidently those that will be the prime target for competition; in these circumstances any unit cost trends calculated on the basis of 'letters' as the unit are of very limited value as indicators of performance, and the use Postcomm and WSA make of them as a comparator is extremely questionable. d. a more appropriate calculation of the Royal Mail efficiency trend projections between 2000-1 and 2005-6, stripping out volume related effects, shows improvements at about 3% p.a. with WSA projecting nearer 5% (see para 1.7 below); it is noteworthy that the other benchmark comparators quoted by WSA (para 6.24) average 3% per annum efficiency improvements excluding Scottish Water, but over 4% per annum including Scottish Water; this implies that the prime justification for their additional efficiency overlay is based on a comparison between a national postal service and the Scottish Water industry - vastly different businesses and therefore, in our view, a very unsound approach; moreover Scottish Water is a particular case, being affected by merger savings of 3 different companies. e. WSA have, in our view, overstated the savings demanded by Ofgem for NGC, and all the more so if the one-off set-up costs of NETA (new electricity trading arrangements) are excluded; correcting for this, and ignoring Scottish Water would pull down their benchmark average to only about 2% p.a. f. WSA (para 6.24) draw on papers by Frontier Economics and Professors Bosworth and Stoneman. A response to the Frontier Economics paper was provided to Postcomm in June 2002 as 'Paper 2'. We would note, in relation to the Bosworth and Stoneman paper, that the quoted '25 comparator industries' were selected as a suitable sample set of comparators for the water industry and were not necessarily representative of 'UK industry' as a whole, nor, obviously, the postal sector. Moreover, WSA have chosen to ignore other benchmarking evidence provided by Royal Mail: in their summary para 41 and para 12.1 they refer to benchmarking documents that they reviewed, but they fail to report on the conclusions of this review. Evidence provided included price comparisons with other international postal services, comparisons of price trends in different sectors of the UK economy and comparisons of UK letter price trends with those in competitive courier services; this evidence suggest that UK letters have had an excellent track record of price constraint (and by implication efficiency) when compared with other countries, other sectors of the UK economy, particularly the more labour intensive sectors, and competitive businesses in the same sector. Even if WSA had disagreed with this evidence it is odd that they did not choose to report on their assessment, but chose rather to use benchmarks based on capital intensive sectors of the economy when looking to compute an efficiency overlay. Postcomm themselves do however recognise in para A2.27 of the consultation document some of the problems with using other regulated industry benchmarks. In para A2.28 Postcomm suggest that Royal Mail's plans are predicated on what may be seen as a reduction in service quality. In doing so they do not give a balanced view. No mention is made of the demanding Quality of Service improvements (% meeting due delivery date) which the plan necessitates, and the fact that Postcomm are proposing a compensation	6.24 S41, 12.1 CA2.27 CA2.28 CA2.28

regime which is arguably more stringent than exists for any other country's postal services. Postcomm also argues in para A2.28 that Royal Mail's savings are unambitious based on a comparison with staffing reductions achieved in other countries. But the only reductions quoted that imply a faster rate of reduction than in Royal Mail's plans are for Deutsche Post, and these are seriously in error because they are not based on a like with like comparison (see para 1.9 below). On the question of whether Royal Mail's plans and projections are ambitious we would finally also note that Graham Corbett is reported in the FT of 11 October 2002 as saying, in relation to Allan Leighton's renewal plan, "we would like to encourage him to push down that very ambitious track".	
<u>1.2 Other potential efficiency opportunities</u> Para A2.25 describes (2nd bullet point) amendments to Royal Mail's projections resulting from an operational review carried out by Canada Post International Ltd (CPIL). In the following paragraphs we critique their findings (summarised in WSA paras 14.35 and S54-55) in detail, and challenge the assertion (WSA 6.26) that there are substantial further savings opportunities. In this section we critique the process by which their findings have been fed through into Atkins projections presented in the consultation document. Our criticism concerns the following points: o their analysis contained significant flaws and was therefore misleading; o the WSA report was not finalised at the time when the consultation document was made public; WSA projections within the consultation document are therefore based on a flawed draft; o this aspect of their report could have been sorted sooner if there had not been needless delay in making it available to Royal Mail. The actual process which occurred was follows: o we completed our responses to detailed questioning and information provision requirements from CPIL during March 02 and were therefore of the impression that their work must have been completed then or shortly thereafter o from our conversations with CPIL we had gathered that they were expecting to share and debate their findings with us; however, no such opportunity was provided o we first received a draft of the WSA report for factual accuracy checking on 24/05/02; this contained a cross-reference to the CPIL work, entitled *Evaluation of Cost Saving Opportunities for Royal Mail* (see para 14.8 of the WSA report) o we asked to see this other report, since the summarised material in section 14 of the WSA draft was insufficient for us to check if the analysis had been based on accurate data and assumptions o on 07/08/02 WSA responded by saying they preferred not to release the report o at the end of September, well after the date that full	CA2.25 14.35, S54-55 6.26 14.8 14

- publication of Postcomm's consultation and the WSA report had been expected, WSA finally relented and sent a copy - we rapidly reviewed this, discovered a number of significant data and assumption errors and pointed these out to WSA - WSA responded on 02/10/02 agreeing a number of corrections; however, these were too late to be included in the WSA analysis in Postcomm's consultation paper which was based on the WSA draft as at end of September; WSA did not at this stage concede corrections suggested to CPIL's analysis of TDS, requiring further explanation - further explanation was provided on 03/10/02 to WSA as to why CPIL's analysis of TDS was at fault (eg they had assumed 5 day a week deliveries as in Canada) - WSA responded on 21/10/02 to say that they now agreed that the analysis had incorrectly assumed 5 day a week deliveries, but while correcting for this they would also assume further productivity improvements; (it appears to us that this was a device to avoid undue consequential changes throughout a report that was well behind due publication date); they have not exposed to us their final calculations. (See also para 1.3 below). We believe that this whole process is not consistent with good regulatory practice, and may have misled Postcomm, as well as all consultees, regarding the scope for further efficiencies. In the Consultation Annex para 2.6 it is suggested that, because of limitations of time, data and budget various other identified savings opportunities were not evaluated. We consider that this is an easy statement to make because it cannot be disproved, and will always be true to some extent. However, we should point out that CPIL initially produced at the end of January 02 a list of potential savings opportunity areas (without analysis) on which Postcomm asked us to comment. We responded, noting that a number were already included in our plans as part of other initiatives, and that some were not allowed under Royal Mail's licence. We assume this response was used to determine the priority areas for CPIL's attention.	CA2.6

1.3 <u>other efficiency opportunities: Tailored Delivery Services (TDS)</u> We should point out that paras A2.9 – A2.10 of the consultation document are based on the draft version of the WSA report, and are incorrect in terms of the figures quoted for delivery points per postman. We would also note that not all of table A2.3 adds up correctly. In their report paras 14.11-14.17 WSA/CPIL suggest a higher ultimate savings figure from TDS (by £79m) but a slower build-up of savings. In terms of timecales we would agree that our plans are challenging; some initial slippage is probable but the aim is still to finish implementing the changes by the planned completion date. With regard to the estimation of ultimate savings we find that the CPIL approach is considerably flawed. Firstly Royal Mail supplied detailed evidence on the computation of the basic savings derivable from the proposed change in service specification; 4 approaches were listed, all of which gave answers within a fairly narrow range; the asssumed savings in Royal Mail's plan projections had been the highest of these figures. *At no time have we received from WSA or CPIL any critique of our calculations*. Instead CPIL used an approach based on benchmark comparisons with delivery operations in Canada, while recognising and admitting that there were a variety of reasons why different delivery conditions should apply. We find this unprofessional as an approach, and in the outturn we perceived that it led to a substantially flawed analysis. As indicated in para 1.2 above the opportunity to see and comment on the calculations was not given until very late in the day. Our response in early October included notification of 2 significant assumption errors. We still have no information on how and whether these have been properly corrected. **5 day week implicit assumption** The CPIL analysis indicated that there was an assumption of only 5 day a week delivery, as operated in Canada. This is incorrect; in the UK deliveries are 6 days a week The estimated impact of this was that ultimate savings, using CPIL's method of calculating the savings, should be reduced by about £90m. In the note dated 21 October 2002 WSA indicated that they now recognised this was an error. However, they had now assumed that the same work could be absorbed with 1 hr less a day through productivity incentivisation to avoid the return to office for a meal break. Though we are indeed planning to do just this, we believe their analysis ignores the fact that the TDS savings estimated by Royal Mail have already added on additional incentivised efficiency savings. It also inevitably leads to an assumption whereby the UK needs to achieve a much higher rate of calls made per hour than Canada, which rather invalidates their particular approach to savings estimation, based on benchmarking against Canada's operations. Without seeing the final detailed calculations we cannot fully critique the final analysis.	CA2.9-2.10 14.11-14.17

Failure to take account of existing part-time staff CPIL made the assumption, in working up a baseline cost, that all existing town first delivery routes were manned by full-time staff. This is erroneous, and leads to an overestimate both of baseline costs and potential savings. Failure to recognise this point causes a significant error in the analysis. The impact is about £55m. It would appear that this error remains uncorrected. **Further faults in benchmark comparison** In attempting to draw parallels between the UK and Canada delivery operation, CPIL do not appear to have compared mail volume levels and their impact, in particular, on the mail preparation task done before delivery can be carried out. We find as a result that there is an underallowance in their calculations for preparation time: Canada's delivered traffic per address is comparable to that in the UK but about a quarter is unaddressed so does not require preparation sorting - impact £35m. (In UK unaddressed mail delivered by Royal Mail is much less, but anyway delivery is paid for on a unit payment basis and not built into scheduled time). Furthermore the assumption is made that deliveries can continue until mid- afternoon (7 hr work day starting at 0700 but including a meal break - see WSA para 14.13) which is later than Royal Mail is proposing. There is no discussion of whether this would be acceptable to customers. **Summary** We believe that if correct calculations had been used the results of this benchmark approach would have led to savings lower than those assumed by Royal Mail (which were calculated using actual baseline costs). We believe this would probably indicate that UK are going for higher delivery efficiency than Canada, though that would be hard to prove conclusively given the different delivery conditions which CPIL have themselves identified.	14.13
1.4 <u>Other efficiency opportunities – Flats automation</u> At para A 2.11-A2.12 in the consultation document annex (see also WSA paras 14.18-14.24 and 15.17) it is suggested that the projected programme of flats automation should be accelerated compared with that which was projected (though not yet financially authorised) in Royal Mail's plan. Firstly we would note that the table in para 2.12 is incorrect; it is based on the WSA draft at end of September but does not include the impact of an arithmetical error correction, pointed out by Royal Mail and agreed by WSA in correspondence. This should change the total of the WSA projections to approximately £134m against the £191m quoted. However, there are other significant faults in WSA/CPIL's thinking concerning this project:	CA2.11-2.12 14.18-14.24 15.17 CA2.12

- they assume a profile of machine installation which requires the following number of machines to be fully operational from the very start of each financial year as follows: April 2002: 6, April 2003: 18 and April 2004: over 40; given that WSA/CPIL were fully aware there were not and could not be 6 machines in operation from April 2002 we cannot understand the reason for such a plainly erroneous assumption; what is more, the whole profile completely ignores the timescale for the current single machine pilot to be evaluated, the contractually agreed lead times for further production and the time for installation work; these would now allow no more than 6 machines to be installed and fully operational by April 2004; - Royal Mail's projected number of machines for the first phase of flats automation was based on the number of Mail Centres where there was room available to install them, albeit, even in these, significant costs would be incurred to reorganise layouts to accommodate them; to extend beyond that number would require significant re-building or new property acquisition. These machines are large pieces of equipment - that currently being tested is 52m x 17m. No allowance has been made for such building costs, which in many cases may be such as to destroy the financial viability of the investment. It would be grossly financially imprudent to commit to such building work before reasonable confirmation of the benefits from the first phase of installation had been gathered. It would certainly not, in our view, represent the behaviour of "an efficient operator". It is worth also pointing out that the proof of concept pilot study was necessary to give essential evidence about supplier capability, operational capability (including containerisation and mail presentation) and the performance issues on the machines. The pilot included the testing of new technology in the form of the automatic tray handling system which had not been fitted on any existing sorting machines.	
1.5 Other efficiency opportunities - Collections Insofar as Postcomm have clearly checked the WSA report, we assume that they are themselves recommending cessation of collections after 1800. However, provision of later collections from post boxes in areas with many business customers is an important part of our service to customers. The specification for Post Box collections is for all Town/City boxes to be cleared between 1730 and 1830 except for those in commercial areas which are to receive final clearance between 1830 and 1930; (in practice just over 20% of town boxes have collections after 1800). The specification has been agreed with Postwatch and Postcomm and reviewed and confirmed with them. Ceasing post-1800 box collections would have a significant, detrimental impact on the level of service to our customers and their satisfaction with our service.	CA2.13-2.14 14.25-14.28

We find the conclusions of WSA/CPIL in relation to potential savings from rationalising collections to be completely lacking in foundation. The detailed report showing the calculations shows that the savings quoted of £72m per annum (consultation document A2.13-2.14 and WSA paras 14.25-14.28) include an estimate of £66m arising from cancelling all collections after 1800. Firstly, this figure is an arbitrary guess. Secondly it takes no account of the customer impact. The reason that CPIL made an arbitrary guess, was that information on the cost of collections after 1800 was not readily available. WS Atkins had indicated to Royal Mail early on in the Efficiency Review that they did not wish Royal Mail to carry out significant new data collection. However, in a case such as this where the savings claimed are very significant (£66m p.a.) we believe it would have been sensible to request a special exercise. If we had had sight of the findings at an earlier stage (than late September) we could have done just that. An exercise has now been carried out which shows that the relevant costs on a fully allocated basis are of the order of £10m. Even these costs would not necessarily be fully recoverable. In other words the WSA/CPIL estimates are grossly in error. We know from customer feedback on the recent standardised approach for final Business Collection times and Mail Centre Latest Acceptance Times that customers for whom their final collection moved to an earlier time saw this as a weakening of an important aspect of our service to customers. We would expect a similar negative reaction to any change to latest Post Box collection times. Putting these collections back to 1800 or earlier would mean many Town and Commercial customers were deprived of the standard of service they have come to expect, with which they have a high level of satisfaction and which has been agreed with Postwatch and Postcomm.	
1.6 <u>Other efficiency opportunities – upstream costs</u> We should point out that in para A2.16 table A2.6 of the consultation document there is an incorrect difference line, and an incorrect total in the 'efficiency study line'. A correction of £10m to the end year savings, resulting from a misinterpretation of data, and agreed by WSA in correspondence, has, however, been correctly carried through into the annual figures (see WSA 14.29). Of the ultimate savings, the more detailed calculations indicate that £6m relates to the proposed cessation of collections after 1800 and an assumption that conveyance costs can be reduced pro rata. We would dispute this on the same grounds that we dispute the collection savings in para 1.5 above. For the remaining sources of savings under this heading we have found some difficulty in understanding exactly what is proposed and how the savings have been calculated. We would have welcomed the chance (not provided) to explore their ideas (at WSA paras 14.31-14.32) with CPIL in order to investigate whether they could be developed into genuine opportunities.	CA2.16 14.29 14.21-14.32

1.7 Unit cost reductions	
In the Consultation document para 6.31 (and table 6.3a) Postcomm	C6.31
suggest that "Royal Mail's cost projections are somewhat less ambitious" and in para A1.5 of the Technical Annex reference is made to the fact that as volumes decline "by around 20%" the unit cost performance is "less impressive".	CA1.5
Firstly the 20% is an overstatement: the Royal Mail Version 4 plan shows a decline of around 16%. Also in arriving at the 'WSA view' in table 6.3a a higher level of volumes has been used contradicting the significant conclusions made by WSA (summary para 50). In calculating the cost per mail item for the higher volumes Postcomm have assumed a cost elasticity with respect to volume of 0.6, totally ignoring the fact that the lower volumes used by Royal Mail reflect the impact of liberalisation which will inevitably be accompanied by significant cream skimming by competitors.	S50 CA2.27
Having arrived at this conclusion Postcomm do, later on, acknowledge (in para A2.27) the fact that "declining volumes are likely to increase per unit operating expenditure…". However, there is no recognition of the effect of change in mail mix, which invalidates crude unit cost comparisons, and which will be driven in part by their own liberalisation policy, encouraging, as it does, loss of lower cost Mailsort business.	CA2.26
The figures quoted at annex A 2.26 of the consultation document fail to provide a very meaningful analysis of Royal Mail's projected efficiency improvements. If volume related cost movements are stripped out, together with one-off redundancy costs and other exogenous factors, then the underlying efficiency improvement in Royal Mail's projections from a 2000-1 or 2001-2 base to 2005-6 is approximately 3% per annum; the corresponding WSA projection, including their specific overlays and general 1% p.a. overlay, would, according to a similar calculation, be between 4.5% and 5% per annum. We would also note that the figure of 8.3% quoted in paras A2.24 and A2.29 of the consultation document are incorrect; if quoted on the same basis as the 5.4% shown for Royal Mail the figure of 8.3% should read 6.5%.	CA2.24, CA2.29
1.8 internal benchmarking	
The WSA report contains a section (chapter 12) entitled internal benchmarking. We find that the analysis contained in this section provides no added value and is in some respects misleading. The chapter is later cited in para 15.5 as evidence for the scope for further efficiencies. We consider that there is no such evidence whatever in this chapter.	12 15.5
It is worth first noting that Consgnia's plans already assume huge efficiency improvements, particularly in its poorer performing units. Royal Mail has developed highly sophisticated measures of labour productivity (effective performance – EP) which already correct for the many extraneous causes of efficiency differences between units. For	

mail centres, where the performance tends to be lowest, the plans ambitiously assume raising performance to a level higher than that currently achieved in any unit. For delivery significant incentivised improvements are already projected, on top of savings from changing the delivery structure, even though labour efficiency is already high. Chapter 12 provides no evidence whatever as to how higher performance than that targeted can be achieved. Compared with Royal Mail's own measures of labour performance, WSA's consideration of volumes, unit costs and items per hour on an area basis is highly unsophisticated. The area costs used in this analysis include delivery costs as their largest component. But delivery costs are hugely affected by the nature of the delivery area with high unit costs in rural areas and low unit costs in commercial areas. Unless effects such as these are corrected for, comparisons of simple indicators of performance are meaningless. A conclusion such as that in paras 12.8 and 12.22, suggesting that high volumes, on an area basis, lead to low costs (ie big is beautiful) can therefore be very misleading: of course Inverness has high unit costs, and of course it has low volumes because it covers a large sparsely populated area. By contrast EP evidence, supplied to WSA but not reported in this chapter, indicates that in terms of labour efficiency the opposite conclusion holds. WSA also conclude that London performance is poor, which is shown by most indicators and is not disputed. But improvements are already necessary and assumed within Royal Mail's planned targets. The report notes variations in absence levels while admitting that Royal Mail's overall plan target is currently only achieved by 3 areas. It also notes that overtime is variable, but that there is no obvious correlation with unit costs. Nowhere here is evidence of performance improvement opportunities above the ambitious levels already projected.	12 12.8, 12.22
1.9 <u>Deutsche Post head count reductions</u> The headcount reductions for Deutsche Post quoted in Annex para A2.28 of the consultation document are misleading in that they are not based on a like with like comparison. The figure of 328k quoted for 1993 relates to the whole of Deutsche Post. The figure of 135k quoted for 2001 relates only to part of the organisation and excludes, for example, parcels, counters and logistics. The relevant figure for 2001 is probably 224k which represents employment within Germany; (the worldwide figure is 276k though it would perhaps be unfair to include the impact of global expansion). Over the period 1993-1998 employment (on most measures) dropped by about 30%; while that reduction was undoubtedly a huge achievement, it needs to be remembered that, unlike in UK, in Germany large numbers of Post Offices used to be owned by the postal administration; their savings included the effects of cutting back some 6000 Post Offices between 1995 and 1998.	CA2.28
<u>1.11 Payback from IR improvements</u> In WSA para 6.29 it is suggested that reductions in days lost to	6.29

disputes would represent a significant payback on a modest investment. It should be pointed out that the direct effect of strikes can actually be to reduce costs (because employees are not paid when on strike). The payback effect is primarily one of customer service, rather than a financial one, though ultimately improved customer service should also yield an indirect financial benefit.	
1.12 <u>Charges from Post Office Ltd</u> The charges from POL for mail services are largely for the remuneration of sub-postmasters who are external agents of Royal Mail. In WSA para 6.43 it is claimed that an efficient operator should be able to make annual efficiencies in this area, after the initial round of network rationalisation. While WSA clearly have not studied the economics of running a sub-post office, it is common public knowledge that all too frequently sub-post offices are unable to survive because of reductions in government business and their own private retail business. If Royal Mail were to reduce its payments to sub-postmasters then it would be unable to maintain the network of post offices as required in its licence, except by providing a compensating subsidy (in addition to that already planned by government), which would be self-defeating.	6.43
1.13 <u>Charges from Logistics</u> In WSA para 6.47 a general efficiency overlay is also suggested relating to the costs of logistics. However, the transport review (MMR) already embraces a complete revamp of not only the transport network but also all the regional distribution centres for mailsort traffic, with all identified efficiency savings being effected within that project. WSA do not explain where other efficiencies could be derived.	6.47
1.14 <u>'Autonomous projects'</u> In WSA para 14.36 there is a comment that efficiency projects are perceived to be treated as autonomous with no strategy for pulling them together. We believe this is not a valid perception. The Service Development Team within Service Delivery are primarily responsible for all operational projects. Where there are large people issues (such as was the case with our response to Sawyer) they fall to HR. This is a pragmatic approach which reflects sphere of activity. Projects can rarely be handled in isolation as they involve various other functions and we strive to ensure our responses are integrated. We do not always get it right but believe that we are becoming more professional in our approach. No projects get to deployment without going through investment appraisal by the Finance team and if in excess of £1m spend they have to be approved by the Royal Mail Executive Board. All projects have to be integrated via the Planning Process. Any change activity has to pass through 4 gateways at Planning Forums (attended by Heads of Performance). The gateways are:	14.36

- scoping of project - trial with Areas - deployment planning - implementation Throughout these stages Areas are involved and provide feedback on realisability of proposed benefits, practicality of implementation and cohesion with other projects being implemented. All change projects have to follow this route.	

2. MAIL VOLUMES, COMPETITION AND RELATED COST ISSUES

	Refs
2.1 Serious omission from the Consultation Document We have reviewed Postcomm's consultation document together with the WSA report in respect to what both documents say about Royal Mail's volume growth projections and about the cost impact of changes in volume relating both to natural movements and those resulting from both EU and Postcomm's liberalisation policies. In doing so we find there is a significant omission in the consultation document which would appear to amount to either deliberate or accidental omission of vital relevant evidence. If deliberate it implies dishonesty; if accidental it implies gross incompetence. Either way it is a gross breach of process by the regulator. The evaluation of the cost impact of competition was a significant strand of the WSA work. The relevant section of their report (section 13) occupies 34 pages and the conclusions are clearly summarised in the management summary. Yet Postcomm's consultation document provides no summary or comment on WSA's conclusions. It would be one thing if Postcomm had summarised the conclusions in the consultation document and then argued that they disagreed with them. Not to mention the conclusions at all is a serious omission. Significant conclusions from the WSA report are: - at Summary para 50 "we conclude that Postcomm has no good reason to take its price control decision on a different set of volume projections from those put forward by Royal Mail in Version 4 of its Strategic Plan" and - at Summary para 51 "We accordingly recommend that Postcomm takes account in its price control decision of the possibility that competition will have a more serious effect on Royal Mail's profitability than is predicted in Royal Mail's interim Strategic Plan". These conclusions are in marked contrast to those used by Postcomm in developing its market opening decision of May 2002 and therefore would be a matter of significant public interest. Not only do Postcomm suppress these conclusions, they also chose to quote selectively from the WSA report in para 6.40 of the consultation document in order to question at para 6.41 Royal Mail's Strategic Plan projections and infer that volumes would be greater than in the plan.	S50 S51 C6.40 – 41
2.2 <u>Retention of market shares in New Zealand and Sweden</u> At para 6.40 of the consultation document Postcomm cite retention of market share by New Zealand and Sweden Posts to suggest that the impact of competition may be less than Royal Mail suggest. However, the situations are not exactly comparable. The pricing regime that has existed in these two countries is much more flexible than that being proposed by Postcomm for Royal Mail, and has allowed them much more scope to defend themselves against competition. UK postal prices are already amongst the cheapest in the developed world as illustrated in paragraph	C6.40 C3.13

3.13 of Postcomm's Consultation document. In Sweden prices charged for business mailers pre and post liberalisation were allowed to change substantially across the various types of mail. Whilst computer addressed mail prices fell by 43% in nominal terms between 1991 and 2000 Office Mail prices increased by 60% over the same period. For business mailers in general price cuts have averaged 20% and zonal pricing has been introduced. Sweden Post has also had to resort to very aggressive pricing strategies to protect its market share and indeed there have been 100 cases of pricing abuse against Sweden Post reported to the regulators and courts in Sweden. In very recent years Sweden Post has started to make operating losses, in part attributable to liberalisation. In New Zealand there is no sector regulator tasked with introducing competition, and competition law there is weak in comparison with the provisions of the 1998 Competition Act and the Treaty of Rome. New Zealand Post has applied a very aggressive pricing strategy which has had the effects of leading to the withdrawal of some market entrants.	
2.3 <u>Other miscellaneous points</u> At para 5.8 of the WSA report it is suggested that average prices are likely to decline over the plan period. We are unclear as to precisely the justification or relevance of this comment, but would note that the projected impact of competition is that there will be a greater loss of lower price traffic such as Mailsort traffic, invalidating this conclusion. At paras 13.33, 13.37 of the WSA report the accuracy of the MCS system is commented on, in relation to trends in direct mail volumes. While we agree the point made, we believe the contrary trends on which they comment were in part at least due to the problems with bedding in major changes to the MCS system made in 1999-2000. The conclusions concerning the Consumer Panel are not, however, correct. Doc 565, referred to in this context, only showed consumer panel data for a 12 month period; although volumes within this period were declining on a quarter by quarter basis, over the 12 months as a whole they were up 3.8% on the previous year. At para 13.80 it is suggested that for transport services, costs in the long run, and across the network as a whole, generally move with volume. This is not the case: costs are semi-variable; for example, only one driver/pilot is needed for a small lorry/plane or a large one. At paras 13.82-13.83 the constancy of the 0.6 LRMC factor is questioned. Our response to that is, firstly that we have not claimed that the figure has stayed at precisely 0.6 (different estimates made over the years have varied between 0.54 and 0.62); secondly that the explanation quoted in para 13.83 has had a significant impact in holding down what would otherwise be a rising LRMC factor; thirdly that a further counteracting factor relates to the cost structure of delivery where major cost elements such as street walking time and the proportion of addresses receiving mail become more fixed (ie less variable) as volumes increase (ie ultimately the postman walks all the streets and calls everywhere). At Summary para 48 of the WSA report Royal Mail's LRMC factor for cost-volume relationship is described as a 'rule of thumb'. Lest this should mislead we would refer to the wording at para 13.81 where the phrasing 'elaborate set of costs' is used.	5.8 13.33, 13.37 13.80 13.82-13.83 S48

3. CAPITAL MANAGEMENT AND EFFICIENCIES

3.1 General WSA have chosen to adopt virtually a blanket criticism of Royal Mail's approach to capital management. In response we feel it necessary, therefore, to point out that the impressions we gained of the competence and professionalism of WSA, in relation in particular to this aspect of their study, were not good, and we consider their report on capital matters is not of a quality that provides Postcomm with any sound basis to inform their future judgments and decisions. We found their approach on capital characterised by: - insistence, for several months, on a heavily paper-based approach, in contrast with the Opex aspects of the study where more of a 'learning approach' was adopted though regular meetings; - later in the study frequent diary problems in attending meetings offered, arising clearly from the fact that the work was being done on a very part-time basis; - compartmentalisation of the work into Opex and Capex in terms of personnel involved, which we consider cannot have helped the learning process, and which we also consider was probably inappropriate to a postal industry; - frequent evidence of lack of grasp of information provided, both in terms of repeat requests for information already provided, or evidence from meetings that material provided had not been read or noted; - little apparent attempt to understand the structure of the organisation and its processes for developing plans; instead an insistence on provision of information, in a form that seemed to be drawn from WSA's work in other, more capital intensive, industries; - no evidence of benchmarking of other appropriate industries on capital processes, such as other international post offices; (not even Canada Post whose consultants WSA were employing); - no apparent attempt to take a view of the state of Royal Mail's property asset base and whether it had suffered from underinvestment. Partly as a result, we believe, this has led to a report on Capex matters which appears to have been drafted with an intention of maximum point-scoring. It is, in our view, highly unbalanced. For example, we would note that: - there is inadequate recognition of the strict authority processes which Royal Mail uses to prevent wasteful capital expenditure; - there is no evidence produced that current capital projects are not soundly managed; - there is no evidence that Royal Mail's procurement processes are anything other than competitive, stringent and exacting; - there is no specific evidence of how any savings could be achieved from improved asset management. All the general efficiency overlays which WSA apply to Royal Mail's capital projections are unsupported. In carrying out these overlays WSA did not even distinguish capital spend which is already contractually committed	

(despite having been provided with considerable quantities of contract information); this is an elementary error. WSA do make a number of sensible suggestions amongst a lot of largely unsupported point-scoring. We shall be examining these over the coming months, though it is unfortunate that there is a considerable need to separate the wheat from the chaff if any benefit is to be derived from this work. Royal Mail was not claiming to be perfect in its management of capital; we are actively seeking improvements in a variety of areas. While it is perhaps a natural tendency of many consultants, when examining how businesses operate, automatically to recommend something different, on Capex matters we believe WSA have carried this to an unhelpful extreme, and this has limited the value of their contribution. In the paragraphs below, which pick up various issues in more detail, because of the repetitive nature of many of WSA's criticisms, we do not necessarily pick up every reference to points that we may consider questionable.	
3.2 <u>Capital vision and the importance of capital</u> WSA, at various places in their report suggest that Royal Mail consider capital to be of little importance (see, for example, WSA paras 7.3,7.7,15.9 and summary paras 23-24). Royal Mail has never said that it considers capital to be unimportant. However, with a capital spend for the letters business of about £200m per annum compared with an operating expenditure of about £5000m, the proportion of top level management time devoted to capital issues should be much lower than it would be for a capital intensive industry. WSA also comment on the perceived lack of a vision for Capex (see, for example, WSA paras 10.14, 11.18, 15.22 and summary paras 33 and 36). However, we believe that for our business it would be wrong to compartmentalise Capex by creating a separate vision, but that Capex plans should be a consequence of the overall strategy, to some extent a by-product of its own operating plans. We do not dispute the desirability of a clear directional plan for capital emerging from this process. What WSA failed to recognise, however, was the extent to which Royal Mail has being going through a process of directional change over the past year, within a highly uncertain regulatory environment. Planned short-term changes being developed during the course of the last year and currently being piloted include an entire re-vamp of mail deliveries, which will probably be the biggest change in the last 50 yrs, and huge changes to its trunk transport network. At the same time future mail volume levels are highly uncertain, with Postcomm's proposals on both competition and downstream access unknown at the time Royal Mail's plans for the period 2002-3 to 2006-7 were being written. The change management capabilities of the business will be severely tested in the immediate future through the biggest change programme ever attempted. In these circumstances, known to WSA, it was hardly surprising that longer term strategic plans for capital, including a 5 yr plan for its property requirements, were only developed in outline form. However, as a clearer picture emerges of the external factors impacting on the business's future needs, it will be possible to implement a more clearly structured approach to projecting capital requirements on not dissimilar lines to those suggested at WSA para 15.49.	7.3, 7.7, 15.9, S23-24 10.14, 11.18, 15.22, S33, S36 15.49

3.3 <u>Monitoring of capital spend – retrospective analysis</u>	
In paras A1.24 and A 2.18 of the consultation annex, it is stated that WSA note substantial variations between past budget and actual capital expenditure (see WSA paras 9.4-9.5). They note in passing that, over the period examined, the reason for what was a Royal Mail overspend related to the Counters Horizon project (and agreement with government about the treatment of this project in view of the well publicised changes in government policy on benefits payment). In view of this a more balanced comment might have been to note how Royal Mail Capex had outturned almost exactly on budget for the period 1997-2001, and in comparing that performance with a quoted typical underspend on budget of 40% for other utilities, to have regarded this as evidence of good planning and control of capital in Royal Mail rather than as merely "interesting".	CA1.24,CA2.18 9.4-9.5
Also at para A2.18 it was noted that no analysis had been provided showing reasons for cost variations for over 1500-2000 individual projects. Had such analysis been readily available centrally within the organisation, we wonder whether Royal Mail would have been accused of too much centralised bureaucracy. We would, however, recognise that central monitoring systems were a casualty of the reorganisation in 1999-2000 which led to a more devolved organisation (see related comment at 4.1 below). Improved monitoring systems were being developed within business units such as Service Delivery at the time the WSA review was being undertaken (as noted for example in WSA para 10.12).	CA2.18 10.12 9.8, S32
WSA comment also on variations in Capex from budget at a more detailed level, with an implication that variations suggest inefficiency (see, for example WSA para 9.8, and summary para 32). We find this somewhat naive: we would have thought that WSA are fully aware, for example, that expenditure within a financial year can be hugely affected by factors such as whether payments are made on 31 March or 1 April, and that financial targetry can require changes to plans within the course of a year: only the most slow moving and bureaucratic organisations fail to react to commercial realities. While we could not, following reorganisation, provide detailed histories of all projects to WSA, opportunities were provided to discuss individual major ongoing projects with their project managers.	S32
To suggest (as at WSA summary para 32) that there are no opportunities to capture 'lessons leant' is misleading: all major projects go through a PIR process and there is even a 'lessons learnt' database for project managers.	S35 9.7, 10.9, CA2.19
Also liable to be somewhat misleading are the comments at WSA summary para 35 and paras 9.7 and 10.9 (also consultation document A2.19) on the lack of computer monitoring systems: while this has been true of central group-level monitoring systems since the 2000 reorganisation, project management software is widely used by individual project managers. All projects have clear targets, including customer, employee and shareholder/financial goals, and are monitored and reported within the appropriate business unit. The fact that there has not been, in recent years, a unified computer monitoring system by which all project information can be hoovered up to Group Centre is not in any way proof that projects are ill-managed or wasteful of capital expenditure. A new central reporting system has now recently been introduced covering all major projects.	

3.4 <u>Capital planning and prioritisation</u> WSA made little attempt to understand the overall Royal Mail planning process. In recent years since the SCS reorganisation in 1999-2000, capital expenditure was not prioritised within a separate compartment, but an outcome of an overall planning and initiative prioritisation process. Their lack of understanding is typified by the somewhat strange analysis carried out in paras 11.7-11.14 of the WSA report. Here they go to some effort to compare in detail the projections in 2 successive annual capital plans. Firstly WSA are somewhat disingenuous in suggesting that plans had changed in 3 months; they were made fully aware that Royal Mail produces Strategic Plans annually as a requirement of the Department of Industry; at an appropriate date they might equally have commented that the plans had changed significantly in a single day. But more disturbing is their display of apparent ignorance regarding the extent to which Royal Mail has had to be redeveloping its plans over the last year or so to respond to its falling profitability and the threats posed by liberalisation; new plans include many major changes eg the TDS proposals for delivery; if they were unaware of these changes they must have been the only people in the country to be in such a state of ignorance, but if they were aware, why make great play of the fact that the plans had changed: the surprise would be if they had not? In relation to changes on specific projects (eg WAND and AI - see WSA para 11.16) we would note that WSA were given ample opportunity to discuss these projects with the relevant project managers. The WSA analysis does not take into account 2001-2 expenditure, nor does it show recognition of the factors that may influence the precise timing of contractual payments.	11.7-11.14 11.16
3.5 <u>Specific capital plan elements</u> *Flat sorting* (WSA para 11.10) : WSA's comments regarding the lack of rapid adoption of flat sorting are not well-balanced; in considering historical decisions, they fail to reflect doubts about the financial returns that Royal Mail could have made, they fail to mention the significant teething problems that their comparator had with the equipment then available, and they do not note the advantages that may now be possible from the availability of better state of the art equipment. WSA exhibit no evidence of understanding the postal automation market, and appear, from comments in, for example, paras 11.17-11.18 to regard all automation as a guaranteed safe financial investment. This is far from being the case. Most automation, including flat sorting, is very greedy of floor-space, which in the UK does not come cheap. (The relationship between labour and capital costs in the UK cannot be assumed the same as in, for example, USA and Canada). We believe that, had an opportunity to see the current pilot machine been taken (offered but not taken up by WSA), the mistake of assuming that the projected first phase programme could be doubled up (see para 1.4 above) would not have been made, nor would they have so readily regarded the technology as 'well-proven' in terms of its ability to make returns in a UK postal environment. *Vehicle purchasing* (WSA paras 11.23 and 15.24). Royal Mail now have a policy of leasing vehicles where financially beneficial to do so. A financial model is used to determine where it is beneficial to lease and	11.10 11.17-11.18 11.23, 15.24

where it is best to purchase, based on relative costs over the life of a vehicle. A small element of its vehicle fleet is still purchased because it is beneficial to do so. WSA recommend otherwise. This typifies their unbalanced approach on capital issues. Had we ignored the results of the model, we question whether they would not have cited that as an example of financial mismanagement and evidence of the scope for efficiencies.	11.25 11.28, S39
Walk sequencing (WSA para 11.25). WSA appear to question Royal Mail's stated position on walk-sequencing by quoting a document provided which does not reflect current policy or agreed analysis. We wonder why they do not quote Canada's position on this issue.	
Savings from speculative projects (WSA para 11.28 and summary para 39). This relates to projects that may be introduced in the later years of Royal Mail's 5 year Strategic Plan. As WSA should know from their examination of the business cases for other major automation projects, non-recurring project costs always precede savings and generally outweigh savings in the early years, the more so if redundancy costs are also included. The assumption that savings and non-recurring revenue costs cancel within the plan period is therefore optimistic. We do not consider it reasonable to expect that speculative projects 3 or 4 years out should have already been fully costed; an alternative to naming and providing broad descriptions of speculative projects within the plan would be to nominate a standard percentage of depreciation, for example, for unspecified new investment beyond the immediately foreseen capital programme. We are unclear whether WSA would have felt more comfortable with such an approach.	15.9 15.33
Comments on WAND versus other automation (WSA para 15.9). WSA imply that WAND does not benefit 'UK customers'; we believe that the efficiency of processing and quality of service given to both outgoing and incoming international mail is of great relevance to UK customers. The suggestion that the WAND concept can be extended to UK mail centres may be valid in the longer term, but for the short term ignores the physical scale and cost of the operation (developed on a new site) which could not be replicated in existing UK mail centres. It also ignores the leading edge nature of the packet sorting automation, for which WAND will very much serve as a test-bed.	
Support service share IT (WSA para 15.33). The quoted increase in spend is not a valid like with like comparison.	

3.6 <u>Capital project management</u> *PRINCE v MSP* (WSA para 10.10). As a business Royal Mail decided to adopt PRINCE as the most appropriate standard methodology for managing all major projects, after reviewing relevant alternatives. In doing so, however, the conclusion was reached that the important thing was systematically to use a recognised 'good practice' approach, while which approach was used was secondary. We would be interested for WSA to elaborate on why they would recommend MSP and whether this is because they have actual experience of using it successfully. *Resource planning* (WSA para 10.11). Resource planning is a standard part of the PRINCE project methodology, as is risk analysis where critical path issues are identified. *Timesheets* (WSA para 10.16). Internal consultants only working part-time on projects do complete timesheets. However, we have found that it does not require timesheets to pick up the costs of staff dedicated to particular projects, and are surprised that WSA, as efficiency consultants, should recommend wasteful bureaucracy. *Enterprise system programme organisation* (WSA para 10.16). This is a huge and complex programme, with many potential risks if all of the parties affected are not fully involved in its development. While we recognise that the management organisation for this programme is unusually elaborate, we would need to be convinced that this is not a worthwhile investment against the risks of project failure; other companies have had failures in this area, and in this context we would be interested in WSA's analysis of their experience and lessons learned in introducing new computer billing systems within their own organisation. *On-costs* (Consultation document annex A2.18 and WSA para 10.17). We are interested in WSA's proposals regarding so called 'on-costs', but have reservations. Given the non-standard nature of most of Royal Mail's major capital spending projects, there is a risk that adoption of standardised project overheads would encourage a lazy and inefficient approach whereby project managers always plan to spend up to the standard level regardless of the real need. Manuals WSA para 10.8 comments on the lack of a planning manual. This comment ignores the fact that Property Holdings do have a manual on the business intranet, based on process maps, examples of which were provided to WSA. Also, of course, project managers make use of standard PRINCE documentation.	10.10 10.11 10.16 10.16 CA2.18, 10.17 10.8
3.7 <u>Capital asset management – general</u> The WSA report criticises Royal Mail's asset management on the basis of (actual or alleged): variety of asset systems; lack of asset condition data and other performance data; lack of care of the asset base; failure to use whole life costing. Relevant paras include: WSA paras 7.8, 7.12, 8.24, 8.27-8.29, S25, S30.	7.8, 7.12, 8.24, 8.27-29, S25, S30

The variety of asset systems is partly an inevitable historical legacy from a time when it was fully expected that the different main businesses that form Royal Mail might be split up; however, the existence of different systems for, for example, property, vehicles and IT assets was not of itself an inhibitor of good asset management. A new SAP system is being introduced, but full functionality does not come for free, and naturally has to be prioritised along with other investments. It is misleading to suggest that care is not taken of assets or that there is no performance data. For property (ie buildings), which now constitutes almost 70% of the asset base, the condition of the portfolio is monitored on a 20% basis per annum, which includes a full survey of the sites and highlighting work to be done on a High, Medium and Low basis, with associated costs. These works and costs are evaluated in conjunction with business units and from this the National Maintenance programme is established. The programme will list property, work content, budget costs, timescales (taking into account weather conditions and business unit requirements etc) and the required authorities. The whole process is auditable, from the initial condition survey recommending the type of work and reason, to the actual completion of the work and costs incurred. For automation equipment performance data is maintained on a continuous basis. Evidence was provided to WSA of the very low level of vacant properties in relation to comparative benchmarks. This is of itself a clear indication of very active and efficient property asset management, in contrast to the impression that the WSA report conveys. But WSA chose not to quote or comment on this evidence.	
3.8 <u>Capital asset management - specifics</u> *Ownership of plant and equipment by Service Delivery* (WSA para 8.31). We believe a distinction needs to be made between assets which are used across the Group, such as vehicles and buildings, and, for example, the plant and machinery which is procured and owned by Service Delivery for their sole use (with maintenance sub-contracted). There is no other market within Royal Mail for this. The driver for such plant is improved efficiency and therefore the unit has a vested interest in optimising this. To use a third (internal) party would add bureaucracy for no perceived benefit at a time when we are committed to reducing non value-adding inter-group transactions. *Capitalisation and recording of small assets* (WSA paras 8.16-8.21, 8.36) WSA's recommendations in this area are in our view neither properly thought through nor good practice. The bulk of the relevant assets are fixtures such as post boxes. These assets are used daily at operational level; they are managed locally, but there is no need for them to be centrally accounted for; this would be unnecessarily bureaucratic and produce no added value. Efficient organisations operate de minimis levels on capitalisation policy. But not capitalising does not mean not managing. WSA at para 8.36 find it 'interesting' that we centrally record PCs but not postboxes: this is for the simple and obvious reason that PCs and portables can be stolen, and can easily disappear during a reorganisation or when people leave the business - maintenance of a central record helps prevent such potential loss; postboxes and sorting fittings cannot be	8.31 8.16-8.21, 8.36 8.20 8.16

so easily removed. At para 8.20 WSA quote an estimated gross book value of these assets; note that it is a *gross* book value and that had these assets been capitalised many by now would have been fully written down. We would also note that the first sentence in para 8.16 is misleading in that, within the letters business the approach to capitalisation of small assets has not changed. *Capitalisation of internal project costs* (WSA paras 8.22-8.23). Royal Mail's project costs are rarely concerned purely with capital. Some, such as TDS, have relatively little immediate capital impact, but even those with more significant capital spend generally have substantial people management aspects; we believe that capitalisation of our project spend would represent a somewhat dubious accounting practice, liable to inflate artificially the value of postal installations. We would note here that modern postal installations are generally in buildings that have an alternative use so that, for the property, an external market value can be determined. *Divestment and relocation* (WSA para 15.9). Over the past 18 months Royal Mail has undertaken extensive research with many organisations on various forms of property divestment and the consensus opinion is that they are not right for Royal Mail at the moment when flexibility is paramount. Ways of reducing property costs are continually reviewed, including location moves. Substantial chunks of Royal Mail's Headquarters functions are already located outside London in Chesterfield, Milton Keynes and Swindon, and there has been significant rationalisation of London properties. Any further move out of London would need to take account of the cost of consequential loss of expertise to the business as well as relevant property prices. *Vehicle lives* (WSA para 8.26). Royal Mail's vehicle replacement policy is based on whole life costs of different vehicle models. Optimum replacement policy (particularly when most vehicles were purchased) required a substantial disaggregation of vehicle types and models, because different models did show different performance levels. WSA choose to imply that the system was too complex, but doubtless would have seen scope for further optimisation had the system been less detailed.	8.22-8.23 15.9 8.26
3.9 <u>Capital efficiency overlays</u> Paras A2.21-A2.22 and A2.25 of the consultation document and paras 15.10–15.43 and Summary para 57 of the WSA report compute capital projections by imposing various efficiency overlays and specific project adjustments. It is admitted that the overlays are based on a 'qualitative assessment of the capital planning processes' which means that they are basically arbitrary; indeed the description of the adjustment process (whereby when adjustments had been made the resulting Capex profile became self-evidently too low, so that then arbitrary increases had to be allowed) makes it quite clear how soft the resulting WSA projections are. In carrying out these overlays WSA did not even bother to distinguish capital spend which is already contractually committed; this is an elementary error. Overall we believe that little credence can be given to WSA's projections; we see no sound basis for either their adjustments to specific initiatives or their general efficiency overlays. As part of the evidence figures are quoted in relation to other regulated utilities. But comparisons are only drawn with the most recent regulatory reviews of those industries. It would surely be more appropriate to compare Royal Mail, in its first regulatory review, with the initial treatment of	CA2.21-2.22, CA2.25 15.10-15.43, S57

those other industries and we wonder why this has not been done. The 2 cases quoted where figures relate to their first review include Scottish Water, where it is admitted that efficiencies included assumptions of a merger of 3 authorities, and Railtrack, where there is no discussion of the appropriateness of the projected efficiencies in the light of subsequent events. However, we would also question the relevance of comparisons with industries whose nature is very different to that of the letters business. We have some sympathy with WSA in their attempt to verify the Capex projections of a business that is in the process of undergoing such major change, and when the full expected consequences of major change programmes such as TDS are only in the process of being evaluated. Inevitably some of Royal Mail's own projections for later years of its plan are relatively soft. Our general view of WSA's projections is, however, that they would be stretching to achieve and likely to result in continuing underinvestment.	

4. INFORMATION PROVISION

4.1 General comments	**Refs**
The consultation paper comments at para 6.76 and Annex 2.2 on the quality and timeliness of the information provided by Royal Mail. We believe these comments need to be put into context:	C6.76, CA2.2
- This was the first regulatory price control review for Royal Mail. Its information systems had not yet been designed for regulatory purposes in the way that those of companies going through their 3rd or 4th price review, and with which WSA and various Postcomm officials recruited from other utilities might have been more familiar, would have been. Moreover the manner in which Royal Mail's business is split for regulatory purposes is not a simple product split, as it would be for many utilities, but one which divides up, for example, the letters business according to weight step. This is not a natural division for the commercial or operational management of the business, so it is not surprising that, at the time of this first review, some information systems, that would have made WSA and Postcomm's work much easier, were still undergoing development.	
- In 1999/2000 Royal Mail re-organised in a manner designed to increase its commercial focus. This inevitably led to data discontinuities, and a need to re-vamp various information systems, much of which work was still ongoing when Atkins did their review. The business had at that time had a choice as to whether to focus on changing information systems before reorganising or vice versa. It took a conscious decision, in view of commercial imperatives, to go for the former.	
- Royal Mail's well-publicised financial problems during 2001-2002 meant that radical new plans were in the process of development during the period when WSA did their review. Inevitably the plans WSA were tasked to examine were not all	

available to the timescales they would have wished. The fact that plans were being developed and changed as the review was carried out was understandably a source of difficulty for WSA. However, the business could not stagnate and do nothing simply because there was an ongoing efficiency review. We believe the above points, which inevitably made WSA's task more difficult, need to be recognised, and do not of themselves reflect on Royal Mail. We also believe, however, that in some areas WSA's task was hindered by their own approach. WSA commenced their task, against Royal Mail's advice, by issuing a giant information request; this was done before they had gained any understanding of the Royal Mail organisation, its cost structure and its cost drivers. The request appeared to be based on the organisational structures of another industry or industries previously reviewed. We considered it to be ill-organised, often repetitious and often unclear in its language. Adherence to this questionnaire proved an impediment for some months, in our view, to the speed at which WSA gained an understanding of the business and to the actual provision of relevant information. In all some 1100 documents, many substantial, had to be provided to WSA in what some might consider to have been an unnecessarily costly and bureaucratic process. Having made the above contextual points we would not wish to appear only defensive on this issue. We are very concerned to ensure that information within the business is appropriate and accurate, and that our information systems are cost effective. We are actively seeking to improve a variety of information systems, hopefully making the task easier when it comes to the next review.	
4.2 <u>Specific points</u> At para 2.9 of the WSA report the statement that at the beginning of December 2001 a detailed breakdown of base year opex had not been received is misleading. Full costing system outputs for 2000-1 had been previously provided in the regulated accounts (docs 200-202). They had not been provided in the specific format requested. In the same para it is also misleading to suggest that the flats automation capital case had not been provided: the case for a proof of concept trial had already been provided (Doc 368), while the case for the first stage of implementation was not due to go to the Investment Board until May 2002. It is a nonsense to complain about outstanding information from an ongoing project when that project is not yet at the required stage of development for the information to be provided. In para 42 of the summary to the WSA report there is a reference to a lack of material on internal benchmarking. We had and still have some difficulty in understanding this statement. A considerable amount of material was provided to WSA regarding the use of benchmarking for best practice sharing. As explained at para 1.8 above, if the work included in Section 12 of the WSA draft typifies what they mean by internal benchmarking, then we find much of this to be a sub-standard analysis that is potentially misleading. Royal Mail has done more sophisticated work in the development of performance measures though inevitably there is more that needs to be done.	**<u>Refs</u>** 2.9 S42 12 14.39

At para 14.39 of the WSA report, there is a comment in relation to the CPIL work on identifying efficiency improvements that they were hampered by the limited amount of detailed analysis made available to them. Such limitations are inevitable for a study of this kind: for example, as mentioned above, the flats automation implementation case, involving visits of the project team to all sites, was being developed at the time CPIL were undertaking their studies. However, in view of their comment, we find it odd that for TDS, where detailed analysis was provided, CPIL chose to ignore this analysis and work up their own figures, unfortunately using flawed assumptions. At para 14.24 of the WSA report it is stated that information on the cost of processing flats mail was not provided by Royal Mail; however, relevant information from the costing system was provided.	14.24

5. OTHER MISCELLANEOUS POINTS

5.1 Atkins final report Para A1.1 of the annex to the consultation document suggests that the final WSA report was received by Postcomm in September. This is not true. At that time Royal Mail was still in receipt of communication from WSA indicating changes they were planning to make. The complete final report was not issued until 13 November.	**Refs** CA1.1
5.2 Historical unit cost trends In para 4.8 of the WSA report it is suggested that real unit operating costs for inland letters were expected to increase in 2001-2. In the outturn this did not in fact happen.	**Refs** 4.8