



House of Commons
Trade and Industry Committee

Royal Mail after Liberalisation

Second Report of Session 2005–06

Volume I



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Report, together with formal minutes

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Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated in the form 'Appendix' followed by the Appendix number.

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Summary

Royal Mail has held a monopoly over the majority of mail services for the last 350 years and continues to dominate the UK postal services market. The Postal Services Commission (Postcomm) began to introduce competition to the UK postal services market in 2003. New licensed operators were able to provide 'end-to-end' services and offer 'consolidation services'. Postcomm is to end Royal Mail's monopoly by fully liberalising the market from 1 January 2006.

The evidence that liberalisation delivers an improved service for customers is compelling but we regard Postcomm's choice of dates for the move to full liberalisation in the UK postal services market to be an untimely one. Royal Mail has been asked to prepare for competition at a time of great commercial uncertainty. Postcomm is reviewing the price Royal Mail can charge for its regulated services and the company also faces huge challenges in addressing a pensions deficit and investment needs.

There has been insufficient time to investigate Royal Mail's pension fund deficit, which we became aware of during our inquiry, in sufficient detail to come to firm conclusions about the responsibility for the deficit. We also understand that under-investment in Royal Mail's infrastructure, due to the decisions of Royal Mail's management and in particular its shareholder—the Government—has left Royal Mail with a productivity gap relative to its main competitors. We understand Postcomm's acceptance that at least some of Royal Mail's pension fund deficit, and much-needed capital investment, should be funded by users through higher postage prices. However, we consider that these should also be funded by the other main stakeholders: the shareholder, through a continued commitment to take nil-dividends; and Royal Mail itself through greater management efficiencies.

We welcome Postcomm's amended price control proposals, which we understand are based on an agreement between Royal Mail and Postcomm. We note that there has to be a further three month consultation period but look forward to the adoption of proposals broadly in line with the current agreement. We may wish to return to the question of the Royal Mail's pension fund deficit at some point in the future, once Postcomm's price control proposals have been enacted.

The regulator must remain vigilant to ensure that greater competition in the postal services market does not come at the cost of the universal service. This is, after all, the regulator's main statutory duty. In particular, we emphasise that a 'universal service' is not worthy of the name if it allows for any geographical exemptions. A mechanism for an early price control review should be put in place by Postcomm as soon as is reasonably practicable to minimise the chance of the universal service being jeopardised.

1 Introduction

1. Royal Mail has held a monopoly over the majority of mail services for the last 350 years and continues to dominate the UK postal services market. Annually, over 20 billion postal items are mailed by users, which generates revenues for Royal Mail Group of approximately £6 billion a year.¹ The UK postal services market and the Royal Mail are currently undergoing a period of transformation, given full market liberalisation, the Royal Mail's price and service quality review (price control) and questions over the future ownership of Royal Mail.

2. During the current 'price control' period, Royal Mail Group has undergone some major organisational restructuring. Amongst other things it has:

- Made the move to single daily delivery, changing the working practices throughout 1,400 delivery offices and changing the jobs of nearly all its front-line employees;
- Improved mail centre productivity through its Mail Centre Efficiency Initiative, saving £33 million per annum (after staff bonuses);
- Improved industrial relations: 866 days were lost to industrial action between January and March 2005, compared with a quarterly average of 21,000 days in 2003.

3. These achievements have made Royal Mail a more efficient organisation. The Group generated just under £550 million in profits from operations in 2004/05, a turnaround of £850 million from a 2001/02 loss of just over £300 million.²

4. The UK is currently bound by EU law on postal matters. The 1997 *Postal Services Directive*,³ as amended in 2002,⁴ is aimed at opening up Member States' postal services markets to competition by 2009, while requiring a 'universal service' to be maintained. However, before finally confirming an EU-wide commitment to full market opening, a comprehensive review is required in 2006.⁵ In the UK, the *Postal Services Act 2000* gives effect to the obligations of the Directive, including the requirement to maintain a universal service and to promote effective competition.⁶ The universal service obligation in the Act follows those in the Directive and makes use of discretionary powers to require geographical uniformity of price (one price goes anywhere). The 2000 Act also established the Postal Services Commission (Postcomm) as the national regulatory authority for the UK.⁷

1 Appendix 15, para 3

2 Royal Mail, Response to Postcomm's initial proposals for the 2006 price and service quality review, paras 2.4-2.6, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

3 European Directive 97/67/EC

4 European Directive 2002/39/EC

5 Appendix 4, para 16

6 HC Library, *Royal Mail liberalisation and competition*, Standard Note SNEP-01644, 11 February 2004

7 Appendix 15, paras 6-9

5. Postcomm began to introduce competition to the UK postal services market in 2003.⁸ New licensed operators were able to provide 'end-to-end' services to large customers mailing over 4,000 items in an individual mailing. Licences were also available to operators offering consolidation services at a price agreed with Royal Mail. Following consultation, Postcomm is now to open the rest of the market up to competition from 1 January 2006 (ending Royal Mail's monopoly), three years earlier than required by the EU Directive.⁹

6. The specific issues we were interested in finding out about were: the impact of liberalisation of the postal service market on the quality of postal services; the thinking behind Postcomm's decision to open up the UK market before the rest of Europe; how Postcomm's proposals for the future of postage prices in the UK would impact on the ability of Royal Mail to compete in the open market; and the continuance of Royal Mail's universal service obligation.

7. In the course of our inquiry we took oral evidence from representatives of the Royal Mail, Postwatch, the Postal Services Commission (Postcomm), the Mail Competition Forum (MCF), the Communication Workers Union (CWU), as well as from Barry Gardiner MP, Parliamentary Under Secretary of State for Competitiveness at the Department of Trade and Industry (DTI). We express our gratitude to them and to all who contributed written evidence.

8 A chronology of full implementation can be found in Appendix 15, Annex A

9 Where mail from a number of large and/or small customers is collected and passed on to Royal Mail for delivery over the final mile.

2 Full liberalisation of the UK postal services market

8. Under the requirements of the EU Postal Services Directive, the UK postal services market has been open to partial competition for the last three years.¹⁰ The Directive requires that all mail over 50g in weight should be open to competition as of 1 January 2006. Following consultation in 2005, Postcomm decided to fully liberalise the UK postal services market, including all mail under 50g in weight, from this date,¹¹ three years earlier than laid down by the Directive.¹²

9. When we asked our witnesses about the current access arrangements, none thought the current arrangements were unfair believing them to be a commercial agreement between Royal Mail and one of its competitors. Mr Crozier, Chief Executive of Royal Mail, told us that “the market has opened up a great deal further than the regulator expected and has been very successful both for end customers, competitors entering and, indeed, the Royal Mail as it stands today, so I think ‘so far so good’”.¹³ Mr Moriarty, Director of Competition and Regulation at Postcomm, told us that “it means that customers can get new services with new operators, they will collect the mail, they will transfer the mail and then they will hand it over to the postman for the last mile, at a profit to Royal Mail. If competition comes along in that form, I think we can have a vibrant competitive market but also a safe universal service”.¹⁴

10. Royal Mail currently retains over 99 percent market share of the UK postal services market. This led Postwatch to suggest to us that “at present, effective competition is far from a reality”.¹⁵ It told us that Royal Mail had the market power of an incumbent monopolist and that there were currently barriers to entry which were high enough to prevent new operators from establishing effective competition. Without the proposed full liberalisation of the market, Postwatch suggested that it was unlikely that the competitors’ share of the upstream postal services market would exceed three to five percent over the next five years; downstream, through access agreements, it would continue to remain around one percent.¹⁶

11. Postcomm told us that opening up the remainder of the UK postal services market at this time would increase competition by giving new operators who wished to offer a full end-to-end service to all mailers, not just the largest, the opportunity to do so: “full liberalisation should extend the benefits of competition to more customers and further

10 Appendix 7, para 3.2

11 Appendix 15, para 15

12 Opening up the market was also supported by the results of Postcomm’s recent business customer survey which sought feedback from business customers. Source: Appendix 15, para 34 and Annex B.

13 Q 3

14 Q 206

15 Appendix 17, para 3.3

16 *Ibid.*

maintain the incentives on Royal Mail to improve its quality of service performance and customer focus”.¹⁷

12. Most of our witnesses (most notably Royal Mail) agreed with Postcomm that the full liberalisation of the UK postal service market was desirable.¹⁸ However, one area of contention which was highlighted by our witnesses was the pace at which Postcomm had decided to open the market, relative to the rest of the EU.

Timing of liberalisation

Table 1: Experience of market opening in Europe (selected countries)

	Experience	Full Market Opening
UK	From 2003 licensed operators able to offer “end-to-end” services to customers mailing over 4,000 items. In 2004 Royal Mail agreed the price for licensed operators offering consolidation services.	1 January 2006
Sweden	Competition has emerged in relation to pre-sorted mail (Citymail – 3 day service) and small niche operators (many ex-Sweden post).	Already fully open—1993
Finland	Licensing regime is main stumbling block to development of competition. E-substitution is main competition to mail services.	Already fully open—1994
Netherlands	Direct mail market has been open since 1990s. Sandd (5% of market) and Selekt Mail (3%) are main competitors in addressed bulk mail.	2007
Germany	Competition in relation to “high quality” services (eg timed delivery) and now consolidation.	2007
Norway (EEA country)	Competition in unaddressed mail (Norpost) 1 day a week	2007
Slovakia	Competition in unaddressed mail.	2007
Denmark	Moved to 50 grams in January 2005—a year ahead of EU requirement	
Spain	Competition has existed in local intra-city mail since late 1960s.	
Estonia	Competition in direct mail.	Already fully open

Source: Appendix 15, Annex C. From 2004 WiK and Ecorys studies for European Commission on European postal market

13. Table 1 above shows the current position of postal services market liberalisation in some European states. According to the information provided to us by Postcomm, the Swedish and Finnish postal markets have been fully open to competition since the early 1990s,¹⁹ while Estonia has no reserved areas.²⁰ A number of other EU Member States have

17 Appendix 17, para 3.3

18 For example see Appendix 17, para 3.1; Appendix 9, para 4, Appendix 7, para 3.1, and Q 15 (Mr Crozier)

19 Appendix 15, Annex C

moved to open all or part of their markets to competition, or have announced plans to do so. Postcomm told us that the Netherlands, which had what was widely regarded as one of the most efficient postal services operators (TPG Post), had faced competition in direct mail for some years.²¹ Further, Germany, the Netherlands, Slovakia and Norway had all committed to market opening ahead of the 2009 target.²²

14. Both Intellect and Postwatch²³ told us that they fully agreed with Postcomm's decision on the timing of full liberalisation: "Intellect support Postcomm's move to open the market in January 2006, ahead of the rest of Europe"²⁴ and "Postwatch has consistently supported opening up the postal service market to competition and fully supports Postcomm's decision to proceed with full market opening on the 1st January 2006".²⁵ Royal Mail also told us that they 'welcomed' Postcomm's decision to 'go early'.²⁶

15. The Mail Competition Forum (MCF) told us that it believed throughout the liberalisation process, Postcomm had moved from "stage to stage only after the most careful and thorough study, consultation and evaluation, and with self evident concern to ensure that both key elements of its remit were fully respected".²⁷ Although, perhaps understandably as the main beneficiaries of the move towards full liberalisation in the UK, it also suggested "from our members' perspective, this process, however necessary, has been excruciatingly slow at times".²⁸

16. The Direct Marketing Association (DMA) told us that it believed there was a "very strong likelihood that this date [for EU-wide liberalisation] would be a great deal later [than 2009], probably 2012".²⁹ They told us that both the Netherlands and Germany had set their market opening dates, conditional on the UK's opening of its market.³⁰ With neither country having set a specific date for full liberalisation, the CWU told us that they believed this suggested that there was no guarantee that these countries would open their markets in the near future³¹ and criticised Postcomm's "rush to liberalisation [which] will place significant additional pressures on Royal Mail at a time when it is only now beginning to recover from a period of severe financial difficulty".³² The CWU thought early liberalisation would place Royal Mail at a considerable disadvantage in comparison to the majority of other large postal services operators in the EU.³³

20 Appendix 6, para 15

21 Q 124 (Mr Carr)

22 Appendix 15, para 32

23 Q 121 (Mr McGregor)

24 Appendix 9, (Intellect), para 4

25 Appendix 17, para 3.1

26 Royal Mail Group, "We're ready" says Royal Mail as market opening brought forward, news release, 18 February 2005

27 Appendix 10, para 8

28 *Ibid.*

29 Appendix 7, para 3.1

30 *Ibid.*

31 Q 329 (Mr Hayes)

32 Appendix 4, para 6

33 *Ibid.*, para 17

17. The MCF agreed with the DMA but suggested to us that it believed the accusations that Postcomm was opening the UK market in advance of the rest of Europe might be designed to produce an emotive impact, but that they fell “some way short of reflecting reality”.³⁴ However, it accepted that an EU Directive requiring all Member States to move to liberalise their markets by a certain date might be some way off and full liberalisation would be resisted until Member States were obliged by the EU to do so.³⁵

18. Although the DMA believed that liberalisation was unlikely to happen in other EU Member States in the near future they were still in favour of the liberalisation of the UK postal services market on 1 January 2006. They told us that if Postcomm waited for liberalisation elsewhere in the EU, UK customers would suffer. The DMA also suggested that the continued absence of choice, price pressure and innovation in other markets would lead many users to switch to other media.³⁶ Competition could “only thrive in an open market with all the market and its associated volumes open. Therefore opening up the market early ensures the postal services market thrives, competition can thrive, and users can be given real choice, quality and downward pressure on prices and Royal Mail benefit from a strong market and competitive pressures”.³⁷

19. We asked the DTI what efforts the Government was making to secure full liberalisation across all 25 EU Member States. The Minister told us:

“I have met with a number of my counterparts across Europe and will be meeting with more of them to do exactly that. Obviously we support our members of the European Parliament in debates, pressing for that liberalisation as well. I am going to be having meetings with the Commission precisely to make sure that we do get full market opening for 2009. I see that as very important and all the talk that we had earlier today about ensuring the level playing field across Europe is absolutely right and we must obtain that and we must obtain it as quickly as we can”.³⁸

20. Mr Allan Leighton, Chairman of Royal Mail, told us that “either way there is no point complaining about it [Postcomm’s decision on the timing of full liberalisation], it is a fact of life, and the fact of life is that the way it has been set up is that we have to give access to our network”; early full liberalisation “gives the competition a start, it is the easy place to start”.³⁹

21. The evidence that liberalisation delivers an improved service for customers is compelling. However, we regard Postcomm’s choice of dates for the move to full liberalisation in the UK postal services market to be an untimely one—not because we believe that Royal Mail will be unfairly disadvantaged against other operators, as we have faith in the competitive strength of the Royal Mail, but because Royal Mail has also been asked to prepare for competition at a time of great commercial uncertainty.

34 Appendix 10, para 10

35 *Ibid.*

36 Appendix 7, para 3.1

37 *Ibid.*

38 Q 379

39 Q 8

Postcomm is reviewing the price Royal Mail can charge for its regulated services and the company also faces huge challenges in addressing its pensions deficit and investment needs, both of which we turn to later. Although the review process is now nearing conclusion, we believe that the difficulties for Royal Mail have already been caused.

22. An increasing number of EU Member States are committing to full liberalisation before 2009. The DTI told us that the “Government continues to press for full liberalisation across Europe to happen as soon as possible”.⁴⁰ We strongly support the Government in this approach and we recommend that they continue to push this point to provide Royal Mail with the level playing field it requires.

The advantages of a liberalised postal services market

23. To understand why Postcomm had pushed for full liberalisation in the UK ahead of the rest of the EU, we asked our witnesses what they believed would be the main benefits for the UK of a fully liberalised postal services market. The main benefits suggested by our witnesses were improved innovation and customer choice, better quality of customer service and a more efficient Royal Mail.⁴¹

Innovation and choice

24. Postcomm told us that the introduction of limited competition had already begun to benefit users in large parts of the UK postal services market. By offering different products and ‘add-ons’ such as ‘track and trace’, new operators had brought about a greater range of choices for customers.⁴² New operators had also begun innovating, introducing new services such as UK Mail’s “two-day, time-certain product”⁴³ with Royal Mail providing the final mile delivery; overnight services with early morning delivery to business addresses throughout mainland UK; and secure deliveries to both business and residential addresses of sensitive documents such as passports and credit cards.⁴⁴

25. Royal Mail had responded to new competitors and products by developing a new product range of its own which would be “better aligned with customers’ needs”⁴⁵ and which it would introduce on a phased basis, from 2006.⁴⁶ Changes in their customers’ demands and technological advances over the last fifteen years had left Royal Mail behind its competitors as it struggled with an operationally inefficient business and a poorly performing product set.⁴⁷ It now faced a major challenge in redesigning its entire product

40 Appendix 6, para 15

41 For example, see Appendix 9, para 3; Appendix 15, para 34; Appendix 12, para 4.3; and Appendix 1, para 5

42 Q 206 (Mr Moriarty)

43 Appendix 15, para 13

44 Appendix 10, para 3

45 Appendix 15, para 14

46 Appendix 7, para 3.3

47 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 3.19, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

portfolio in order to address the rapidly evolving needs of its customers.⁴⁸ Royal Mail told us that its new product range would cover every major product category as well as the innovation process itself:

“a static product portfolio will be replaced with dynamic product clusters, centred upon the needs of particular customers and services. Product specifications will become flexible, changing as the needs of our customers develop. This will require ongoing support in listening to customers, interpreting their needs into concrete, viable and efficient products, and communicating the advantages of product innovations back to the market”.⁴⁹

The earliest type of products Royal Mail had introduced included ‘Easy to do Business With’ and ‘Order to Cash’.⁵⁰ Postcomm maintained contact with many of the major mail users, the vast majority of whom, they told us, had acknowledged the benefits of more choice and felt Royal Mail had become more responsive to their needs.⁵¹

26. Intellect told us that the introduction of limited innovation in the postal services market was fundamental to support change and the postal technology sector needed to be engaged with Royal Mail.⁵² Intellect also said that they believed full liberalisation would drive up the choice of services for customers and stimulate innovation in serving customer needs. A fully liberalised postal services market would provide customers with “a business environment that would lead them to seek new products and services from providers”.⁵³ This was in contrast with the current market where they believed Royal Mail’s customers were conditioned to a ‘take it or leave it’ approach to the business.⁵⁴

Improved quality of service and Royal Mail efficiency

27. Postcomm told us that the Royal Mail had responded to increased competition by becoming more efficient and flexible and was set to continue this process following full liberalisation.⁵⁵ Royal Mail currently had at least 15 quality of service targets, which were originally agreed between Postcomm and the Royal Mail in 2001, and were conditions in Royal Mail’s licence. The targets covered Royal Mail’s key postal service products such as first and second class stamped mail.⁵⁶ Appendix 16 shows Royal Mail’s historic quality of service performance targets and results for the financial years 2001/02 to 2004/05.⁵⁷

48 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 3.19, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

49 *Ibid.*, para 4.32

50 *Ibid.*, para 5.38

51 Appendix 15, para 13

52 Appendix 9, para 4

53 *Ibid.*, para 3

54 *Ibid.*

55 Appendix 15, para 14

56 *Ibid.*, para 18

57 Appendix 16, Table 4, page 8

28. The CWU told us that recent months had seen a marked improvement in the overall quality of service provided by Royal Mail. While in 2004/05 there was only a relatively modest improvement in the number of products which achieved their cumulative annual performance targets compared to the previous year (in 2004/05 four products out of 15 reached or exceeded their full year targets) recent figures had provided stronger evidence of improvements. First quarter figures for 2005/06 showed that nine of the 15 service target levels had been exceeded—including those for first and second class letters and for a number of ‘key’ business mail products.⁵⁸ Postcomm expected this improvement to continue as liberalisation increased the incentives for Royal Mail to make service quality a priority which, they considered, for many people was more important than price.⁵⁹

29. The CWU did not, however, believe that the quality of service improvements provided evidence of the positive effects of competition is contrary to “the simplistic argument which some interested parties have attempted to promote” and they added: “instead we believe that Royal Mail has had a degree of success in addressing some of the short term issues relating to quality of service, in spite of (rather than as a result of) the additional pressures which are being brought to bear by Postcomm’s liberalisation agenda”.⁶⁰

30. The DMA told us that opening up the UK market further would have a profound effect on quality of service.⁶¹ New competitors already focussed on quality of service as one of the key features which needed to be delivered to customers. Because of this, it believed that Royal Mail had raised its standards in order to compete: “as the majority of existing competitive mail goes through downstream access, this has had a beneficial effect on Royal Mail, as they try to improve their quality of service. The overall competitive pressure on Royal Mail has led to a refocus on improving their quality of service”.⁶² The DMA suggested that fully liberalising the UK postal services market would lead to further improvement of quality of service as Royal Mail, and its competitors, reacted to new customer demand.⁶³

31. The Mail Users’ Association (MUA) told us that the benefits competition would bring to the marketplace would act as a catalyst for increased quality of service. Its members stood by this position, believing its basic principle was now beginning to come to fruition. As a direct result of Postcomm’s liberalisation timetable, mounting competitive pressure had driven Royal Mail to ‘gear up’ to become more efficient and customer-focussed, and as a consequence “quality of service has been pushed to the top of Royal Mail’s agenda”.⁶⁴

32. The Federation of Small Businesses (FSB) told us that they considered the liberalisation of the postal services market would improve the quality of postal services which Small and Medium-sized Enterprises (SMEs) experienced in the UK: “historically, SMEs have not been able to benefit from Royal Mail’s best value business services because they are only

58 Appendix 4, para 9

59 Appendix 15, para 19

60 Appendix 4, para 10

61 Appendix 7, para 2.1

62 *Ibid.*

63 *Ibid.*

64 Appendix 12, para 3.1

available to larger businesses. The majority of SMEs do not send enough mail to benefit from a lot of the bulk mail schemes (e.g.: Mailsort, Walksort, Presstream). SMEs have to pay to be able to collect their post before 8am. There is no evidence of mitigation benefits for SMEs under the new pricing in proportion scheme”.⁶⁵ The FSB used the example of New Zealand to suggest how the UK’s postal market should be allowed to develop to the benefit of SMEs. Although only seven percent of the New Zealand market had been opened up to competition, this had led to specialist small business suppliers and the creation of niche markets in certain areas, meaning postal supplies to the rural areas had not been compromised and the SME community was now getting ‘better’ deals from its postal service.⁶⁶

33. Postcomm provided us with evidence which agreed with this. They told us that while new competitors had so far targeted only large business customers, who pre-sorted the majority of their mail, new competitors were beginning to target SMEs. Investment in sorting technology by some new operators had meant that they were beginning to offer new services to SME business mailers.⁶⁷

34. Given that Royal Mail was required by Postcomm, as part of its licence, to publish its performance against targets decided by Postcomm, we were interested in finding out if our witnesses believed it would be beneficial for consumers to have access to similar performance information for Royal Mail’s competitors, and who should collate such information.

35. Postwatch believes it is vital that “Royal Mail’s quality of service measurement engenders consumer confidence. Unfortunately this is not currently the case”.⁶⁸ Users had told Postwatch that they were not satisfied that the current ‘end-to-end’ target measurement surveys were sufficiently independent of Royal Mail. Leaving performance measurement in the hands of Royal Mail also threatened to undermine new entrants’ confidence in the market and was detrimental to the development of competition. Postwatch told us that it had already recommended to Postcomm that responsibility for commissioning the performance measurement be removed from Royal Mail and passed to an independent body.⁶⁹ Postwatch did not think it was appropriate to impose such targets on Royal Mail’s competitors when they did not have ‘significant market power’.⁷⁰ However, robust and reliable information on the performance of licensed competitors was necessary to allow customers to make informed decisions.⁷¹

36. We asked our other witnesses what they thought about all postal service licensees having to publish performance targets. Dr Doherty, Policy Manager at Postwatch, told us that:

65 Appendix 8, para 2.3

66 *Ibid.*, para 2.4

67 Appendix 15, para 27

68 Appendix 17, para 2.4

69 *Ibid.*

70 *Ibid.*, para 2.1

71 *Ibid.*, para 2.3

“Royal Mail is under an obligation to measure and to publish its quality of service information. The licensed competitors to Royal Mail are under a slightly lesser obligation. From 1 January they will have to have systems in place to monitor their quality of service and then they will need to give the information resulting from the systems to us and to Postcomm and we will need to decide whether or not that should be published. For competitors, I think the important thing for us is that the information that is published, and we support the publication of quality of service data, is useful to customers because it would be used to inform switching decisions from one operator to another, so it must be meaningful to customers. The services at the moment are quite different, so we will need to think quite carefully about what we publish for customers”.⁷²

37. Ms Chambers, Chief Executive of Postcomm, told us that:

“customers do need service measurement, they do need ideally to have measures which are comparable one operator with another, it is something which regulators across all sorts of industries have been trying to grapple with for some time to get it right. What we are very keen to avoid is to put in place a very, very burdensome regime which attempts to impose uniformity on different operators, imposing uniformity in terms of what their service offering should be at a time when we do not think that would be appropriate. [...] we will be considering then what is the best way to get that out into the public domain in a way which makes sense for customers, so that customers will be able to do as much sensible comparison as they can”.⁷³

38. The views of Postwatch and Postcomm were echoed by Mr Sibbick, Director of Regulatory Affairs at the MCF, “we are discussing this still with Postcomm and Postwatch, but it is likely to be based around the services that we say we provide and how well we actually perform against what we have said we will do.”⁷⁴

39. Postcomm already informally collects evidence of quality of service targets, and performance against those targets, for each EU national postal operator.⁷⁵ We believe that this information should form the basis of a formal set of EU-wide statistics which should be produced in an independent, consistent and robust manner.

40. Few of our witnesses disputed that the arrival of liberalisation had served as a catalyst to drive through positive changes in Royal Mail. These changes have benefited users, the Royal Mail and shareholder, the Government, alike. We are aware that data on Royal Mail’s quality of service are already published and that Postwatch and Postcomm have started discussions with other licensees to ensure that similar data for them is published. We recommend that comparable quality of service and complaints data should be published to inform users of the comparative merits of all postal service operators in the UK.

72 Q 177

73 Q 224

74 Q 305

75 See Appendix 16, Table 5

41. We believe that Postcomm has to remain vigilant that the quality of such statistics is not compromised by the licensee that provides them. One way this could be achieved would be to require new operators to have their quality statistics independently audited by an appropriate body, such as Postcomm or the Office of Fair Trading, to be decided by the Secretary of State.

The advantages Royal Mail will retain

42. Postcomm told us that their experience from other utilities and postal markets abroad showed that the established national operator, in this case Royal Mail, would remain in a dominant position following full market liberalisation because Royal Mail would retain advantages that acted as barriers to entry.⁷⁶ We wanted to know a little more about these barriers and asked our witnesses what advantages they believed Royal Mail would retain following full liberalisation.

Royal Mail's VAT exemption

43. The main advantage our witnesses suggested Royal Mail would retain following full liberalisation was its exemption from paying VAT.⁷⁷ Under this, Royal Mail does not add 17.5 percent VAT to the prices it charges its customers, whereas Royal Mail's competitors are obliged to do so.⁷⁸ In the past, this has enabled Royal Mail to price competitors out of some types of business and in some cases this has forced some customers into using Royal Mail even when competitors were willing to provide a similar service.⁷⁹

44. The Association of International Courier and Express Services (AICES) told us that a universal service provider, which could provide services that were VAT exempt, had a competitive advantage over service providers that were not VAT exempt.⁸⁰ Royal Mail's competitors, would "need to offer prices which are at least 17.5% cheaper than those charged by Royal Mail if they are to be able to start to compete on price, when targeting VAT exempt customers".⁸¹ Competitors had "an almost insurmountable hurdle to overcome if they are to access these sectors".⁸² Royal Mail told us that: "The VAT thing is very interesting because it is not quite all that it seems because if you are a business and you charge VAT you can claim VAT back. It is not exactly as it seems. There are one or two customers who you know do not pay any VAT so there is an issue on the back of that".⁸³

76 Appendix 15, para 17

77 For example see Appendix 1, para 5; Appendix 8, para 3.2; and Appendix 10, para 6

78 The 6th VAT Directive of 1977 sought to harmonise the existing VAT exemption rules in the Member States of the Common Market and confirmed that service provided by the public postal services must be VAT exempt. Source: APPENDIX 1, (AICES), para 7

79 Q 350 (Mr Buswell)

80 Appendix 1, para 6

81 *Ibid.*, para 10

82 Appendix 10, para 6

83 Q 104 (Mr Leighton)

45. To find out more about the impact of removing Royal Mail's VAT exemption, we asked Postcomm, the MCF and the DTI for an explanation of the impact on the UK postal services market if VAT were introduced at 17.5 percent and a reduced rate of five percent.

46. Postcomm told us that it did not think that VAT exemption was required for the provision of the universal service, and it would continue to distort competition significantly:

“it continues to be highlighted as one of the main barriers to entry for alternative providers and one of the main barriers to switching by business customers that are VAT exempt (and cannot therefore, recover VAT paid to alternative postal operators). Alternative operators need to overcome an approximate 13% price disadvantage against Royal Mail (not 17.5% as Royal Mail's prices must cover its VAT on inputs, which it is currently unable to reclaim) before offering any discount to encourage VAT exempt customers to switch. Alternative providers are therefore at a significant disadvantage when targeting VAT exempt companies. This view is reflected in the results of Postcomm's 2005 business customer survey”.⁸⁴

A number of the VAT exempt institutions, including banks, financial institutions and some charities, had told Postcomm that they were discouraged from switching provider due to the fact that alternative providers had to charge the full 17.5 percent VAT rate, which they would not be able to reclaim.⁸⁵

47. Postcomm also told us that :

“stakeholders support a level playing field. The majority would welcome either the VAT exemption being extended to all operators, or a reduced VAT rate for postal services. The need to increase prices that would result from charging a reduced rate of VAT of 5% is likely to be broadly offset by the fact that Royal Mail would be able to reclaim VAT on its inputs, and would therefore see a fall in costs. As a result, applying VAT of 5% on postal services, including stamps, would be unlikely to result in price rises for customers that cannot recover VAT”.⁸⁶

Postcomm would support a reduced rate of five percent being applied to all postal services: “we would also support the VAT exemption being extended to all operators.” Postcomm does not, however, support the full rate of VAT at 17.5% being applied to all postal services as the resultant price increases would not be in customers' interests.⁸⁷

48. The MCF told us that it was difficult for it to make a precise analysis of the impact of the removal of Royal Mail's VAT exempt status as MCF members were not privy to most of the relevant information. However, as a VAT exempt operator, Royal Mail was unable to recover its input VAT, so that when Royal Mail was dealing with a VAT exempt customer its prices were around 13 percent cheaper than those of its competitors, all other things

84 Appendix 16, para 8

85 *Ibid.*

86 *Ibid.*

87 *Ibid.*

being equal.⁸⁸ As users demanded discounts in return for using a competitor of Royal Mail, this had had the effect of making MCF's members' services uncompetitive for VAT exempt customers.⁸⁹ The concern of MCF members was that they were unable to compete on a level playing field: "we have been advised by Queen's Counsel that all competing postal services ought to be subject to VAT at 17.5% on the basis that the current legislation breaches the principle of fiscal neutrality by treating the providers of competing services in dissimilar ways so as to distort fair competition".⁹⁰ Any 'solution' on VAT which resulted in lower prices for all customers was good for the mail market as a whole. For that reason, it believed there was "much to commend the application of a lower rate of VAT to all postal services. This would lead to an effective 12.5% price reduction of our members' services (assuming that the reduction in VAT rate would not affect the current ability to fully recover input VAT) when providing services to customers who are unable to recover VAT".⁹¹

49. The MCF also told us that Postcomm had conducted modelling on the impact of VAT on Royal Mail's prices and concluded that these (excluding VAT) would drop by 2.6 percent following retraction of the VAT exempt status, since Royal Mail would be able to recover its input VAT:

"although this would make Royal Mail's VAT exclusive prices cheaper and thus make competition marginally more difficult for the business of customers who are able to recover VAT, our objective is to secure fair competition in an undistorted market and, accordingly, we would accept this as a necessary and fair consequence. The application of a reduced rate to all postal services would, more significantly, remove an unacceptable distortion in respect of VAT exempt customers for whom the competitors' prices are subject to a 13% pricing distortion in favour of Royal Mail. The concern about this possible solution is that the application of a reduced rate of VAT (5% in the UK) depends upon [the EU agreeing to a derogation to] an EU Directive which, in turn, requires unanimity among the 25 EU Member States. Although such a Directive has been proposed by the EU Commission, it has foundered".⁹²

This was confirmed to us by the Minister: "if VAT were to be introduced it would have to be at 17.5 percent, so I think you were absolutely correct in what you said, and the only way that one could derogate from that is with the agreement of all 25 EU Member States to bring it down to the five percent level".⁹³

50. The Minister said that the Government was opposed to VAT on stamps but that the "DTI and Treasury officials meet regularly, including discussions on VAT and postal services [...] the imposition of VAT on postal services, even at a lower rate would increase

88 Appendix 11, page 2

89 Q 268 (Mr Wells)

90 Appendix 11, page 2

91 Q 386 (Minister)

92 Appendix 11, page 2

93 Q 386

postal costs for many postal users. This would impact on social users and most heavily on large volume mailers—including many charities”.⁹⁴

51. We are disappointed that the DTI failed to provide supplementary information, which the Minister had agreed to send us in his oral evidence, in good time. This has made the task of completing our Report unnecessarily difficult and we hope that this will not set a precedent for future inquiries.

52. We do not want to see stamp prices increase owing to the imposition of VAT on postal services because of the impact on those users who are not registered for VAT, especially, but not exclusively, private individuals. We understand Royal Mail’s competitors’ arguments of unfairness, because of Royal Mail’s VAT exemption, but also note that it has the unique requirement, and costs, of a universal service obligation. Moreover, we are sceptical that the UK Government would be able to secure derogation in the EU for a lower than normal rate.

The disadvantages of liberalisation for Royal Mail

53. Postcomm told us that the postal market was often perceived to be a mature market that was, or was about to be, in decline. However, both it and Postwatch⁹⁵ told us that the market was currently growing by around one to two percent per annum and that this was forecast (by both Postcomm and Royal Mail) to continue for the next few years.⁹⁶ Most growth in mail was currently coming from direct marketing. Alternative media, for example electronic substitution, were a threat to mail volumes, but there was equally a growth opportunity through the fulfilment of electronic transactions: items ordered over the internet have to be delivered. These were more profitable per unit for Royal Mail as they were typically larger or heavier weight items and, therefore, of higher value.⁹⁷

54. Royal Mail told us that the letters market had experienced some growth over this price control period but that volumes this year had been flat. This was not a trend confined to the UK market and, moreover, “most markets around the world are in decline and it is likely that within this price control period the UK will experience both volume losses from the electronic substitution that is pervasive elsewhere and much slower growth in volumes of direct mail than in the past. In short, the outlook for UK postal market volumes is uncertain and represents a major risk to the business”.⁹⁸

55. Royal Mail told us that over the last four years “the total UK market for addressed mail volumes had been growing by an average of around two percent per annum. However, the rate of growth has been declining, from about 3% in 2000/1 to 1% in 2004/5 (with about ½% additional growth in downstream access). During the year to date from March 2005, volumes have been flat, inclusive of downstream access”.⁹⁹ The evidence which Royal Mail

94 Appendix 20

95 Q 134 (Mr McGregor)

96 Appendix 15, para 4

97 *Ibid.*, para 5

98 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 1.5, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

99 *Ibid.*, para 3.4

provided to us was based upon a series of assumptions: “if we strip out the impact of GDP, household growth and price changes we find that the underlying trend in volumes was negative at about -1% per annum over the last four years. This underlying decline in UK volumes may be partially explained by e-substitution, a trend that has been seen in other major postal markets”¹⁰⁰ and later “if we examine the market growth in other major postal markets where data is available—the US, the Netherlands and Germany—we see that they have been experiencing flat or declining volumes. In the US, volumes of First Class and Standard Mail have remained unchanged over the period 2000 to 2004, where a significant decline in First Class mail has been offset by growth in Standard Mail. In the Netherlands, volumes of Total Addressed Mail have fallen by an average of about 1% per annum from 2001 to 2004. In Germany, volumes of private and business mail have declined slightly by an average of 0.3% per annum from 2002 to 2004”.¹⁰¹

56. We were concerned that the evidence given to us by Postcomm and the Royal Mail appeared to be contradictory. To get a clearer picture of what was happening to mail volumes in the UK postal services market, we asked Royal Mail and Postcomm for the evidence on which their suggestions were based. Postcomm provided us with figures which showed that volumes in the UK were growing by around one to two percent per annum. However, in 2004/05 there had been a relatively small fall in total mail volumes,¹⁰² confirming what Royal Mail had told us. Mr Wells, Managing Director of TNT Mail UK Limited, representing the MCF, told us that some mail sectors were growing but some were shrinking:

“if we look at three areas, one is transactional mail, and that would typically be bills and statements, e-banking and so on, I think there will be a decline, there will be substitution of that market, and I think that is pretty obvious. In terms of correspondence, I think we have seen what might migrate to e-mail already, so we expect that to be fairly static. In terms of the other area, what we call direct market, which is more advertising where you are competing with other media, we believe that will continue to grow, so it depends what you are talking about and what sector. In some areas I think we will see a modest decline and in other areas I think we will see some growth”.¹⁰³

Falling market share

57. The CWU told us that Royal Mail’s own information provided clear evidence that competitive pressures were already beginning to bite: “The company confirmed in the summer that ‘major contracts worth almost £50 million have already been lost’ as the likes of TNT and UK Mail secure access contracts and also take trunking work with major customers away from Royal Mail”.¹⁰⁴ The CWU believed that it was particularly worrying that this represented only the initial stages of the development of competition in the UK

100 *Ibid.*, para 3.5

101 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 3.6, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

102 Appendix 16, page 6

103 Q 281

104 Appendix 4, para 7

market and was occurring at a time when Royal Mail was only just beginning to recover from what they called its “recent difficulties”.¹⁰⁵

58. Mr Crozier, Chief Executive of Royal Mail, said that Royal Mail was already losing customers as businesses switched to using competitors to fulfil part of their business requirements: “we have lost around one billion items annually”¹⁰⁶ ‘and later’ “the current projections are of a market that is growing by 2 percent per annum. Since January we have seen almost a 1 percent decline in the market, which is what has happened in every other country in Europe”.¹⁰⁷ Royal Mail also argued that the competition which had occurred so far, and all future entry, was ‘cherry picking’. For example, downstream access competitors, such as UK Mail, were targeting Royal Mail’s top business account customers who held a disproportionately large share of postal services.¹⁰⁸ Royal Mail told us that it believed that by the end of 2006, it could lose up to 20 percent of market share through cherry picking of second-class bulk mail by downstream competitors, with volumes at a level similar to that which Postcomm had assumed for 2009/10.¹⁰⁹ The CWU said, “we strongly hold the view that the general public will not benefit from this competition”.¹¹⁰

59. The CWU also told us that it believed the potential profitability of the UK market would make it particularly attractive to competition from overseas postal operators, explaining, “this is clearly evidenced by the fact that both TNT (which owns the Dutch state operator [TBG Post]) and Deutsche Post World Net (which owns the German state operator [Deutsche Post]) have already obtained licences and are actively providing bulk mail postal services in the UK”.¹¹¹ However, Mr Crozier, Chief Executive of Royal Mail, suggested that:

“it is a fallacy that people seem to have that somehow we will lose just upstream business and that the Royal Mail will always do the final mile for everyone everywhere, because our belief is that that is not what will happen, that in fact competitors will actually set up delivery forces, for instance, in major city centres, which is where there is a lot of money to be made, and simply put the rest of the mail, the more unprofitable mail, into the Royal Mail for it to deliver, and that is what we call ‘cream skimming’, and that is one of our biggest fears on the regulatory side, that that will happen”.¹¹²

60. The DMA told us it believed that, even with the opening up of the market, the majority of competitive volumes would remain downstream through Royal Mail. Royal Mail would lose some volume but the likelihood of huge volume loss was remote:

¹⁰⁵ *Ibid.*

¹⁰⁶ Q 3

¹⁰⁷ Q 10

¹⁰⁸ Royal Mail’s top ten customers post some 3.5 billion items annually or 17 percent of its total mail volume. Source: Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations para 5.46

¹⁰⁹ *Ibid.*, para 1.5

¹¹⁰ Q 327 (Mr Ward)

¹¹¹ Appendix 4, para 18

¹¹² Q 6

“volume will stay with Royal Mail, at least within the delivery network. An alternative network to Royal Mail will take between 3 and 5 years to set up. Although some operators have flagged that they intend to launch alternative networks albeit not comprehensive, based on weekly deliveries. Based on Royal Mail’s existing volumes, any likely loss and the retention of the majority through downstream, Royal Mail will have no problem competing effectively”.¹¹³

The MCF agreed with this view,¹¹⁴ but Intellect challenged it and told us that: “1st Class mail volumes will not be affected by competition over the period of the price control is seriously questioned by Intellect as we know that many organisations are looking at the cost/delivery equation of remaining with First Class versus moving to an Access model”.¹¹⁵

61. The main concern of our witnesses for the future of Royal Mail centred on the fact that competitors would be free to ‘cherry pick’ the services which they chose to provide. It was feared that, under such circumstances, new entrants would get involved only in the most profitable parts of Royal Mail’s business and that this would impact negatively on the service provided by Royal Mail, especially the universal service, as revenues fell.¹¹⁶

Universal Service Obligation

62. Postcomm’s statutory duty to “seek to ensure a universal postal service at an affordable tariff”¹¹⁷ under the Postal Services Act 2000 is derived from an obligation on Member States in the EU Postal Services Directive. The Directive requires the universal service provider to offer at least one collection and delivery each working day, and a service for registered and insured items.¹¹⁸ After liberalisation, for Postcomm this will mean ensuring that Royal Mail continues to be able to fund its mail activities, including an affordable universal service.¹¹⁹ For reference purposes we asked our witnesses how the definition of the universal service differed in each EU country. The MCF provided us with this information in the form of a table.¹²⁰

63. In April 2003, Postcomm began a two year consultation with a wide range of users in the UK to find out what they wanted from a universal service. The consultation concluded that what users expected was a range of postal services, which met the needs of domestic, business and other customers. On this basis it was agreed “that the universal service should include 1st and 2nd class letter mail up to 2kg, a standard parcel service up to 20kg, a registered service, support services such as redirection, and international mail”.¹²¹ Users also wanted a generic bulk mail product to remain. Mailsort 1400, which required ‘pre-sortation’ by the customer, was considered the most popular, in terms of volumes, and the

113 Appendix 7, para 3.2

114 Q 278 (Mr Wells)

115 Appendix 9, para 6

116 Appendix 2, para 2.4

117 Postcomm, *Royal Mail’s monopoly to end on 1 January 2006*, Press Notice 04/05, 18 February 2005

118 Appendix 15, para 39

119 *Ibid.*, para 46

120 Appendix 11, Annex 1

121 Appendix 15, para 40

Royal Mail's bulk product which appeared to exhibit the characteristics of universality most. A number of users also made it clear that there was a risk that some smaller users would not be able to meet the preconditions of Mailsort 1400, so Postcomm also included Cleanmail.¹²² A full breakdown of the products which were included in the universal service can be found in Appendix 16.¹²³

64. In their evidence to us Postcomm told us that Royal Mail had not yet agreed the licence modification that was necessary for these changes to be made and was currently considering whether to refer the matter to the Competition Commission or to retain the present broader definition of the universal service as set out in Royal Mail's licence.¹²⁴

65. When we asked Royal Mail whether agreement had been reached since our inquiry began, Mr Leighton, Chairman of Royal Mail, told us: "No, I think we have a disagreement".¹²⁵

66. We were worried about the future of the universal service given the evidence we had received about falling volumes, cherry picking by new entrants to the market, and Royal Mail's ability to finance the universal service following full liberalisation. We asked our witnesses whether they perceived full liberalisation to be a threat to the provision of a universal service by Royal Mail. Our witnesses' views were split on this matter. The CWU and Royal Mail told us that full liberalisation was likely to undermine the Royal Mail's ability to deliver the universal service if Royal Mail lost 'significant' market share in terms of volume and/or value. Postwatch, Postcomm, the DTI, the DMA, MUA, Intellect and the MCF all suggested that full liberalisation would not be detrimental to the Royal Mail's ability to provide the universal service. In fact our witnesses—including the Government—believed the universal service should be viewed as a benefit to Royal Mail, "I believe that the Universal Service Obligation is of great benefit to the company, it is not a drawback".¹²⁶

67. The CWU emphasised that it believed that the regulator's proposals constituted a substantive material threat to Royal Mail's core business activities and its ability to finance the provision of a universal service: "the proposals would have the potential to starve the company of funds at a time when it faces the introduction of full market liberalisation for the first time in its history".¹²⁷ Nevertheless, the CWU believed that competition had the potential to increase rapidly under the less than level playing field which Postcomm was currently imposing. Royal Mail had already lost significant large customers to upstream competition as a result of third party access. While the impact of competition was still at a relatively low level, the CWU suggested that all the available evidence showed that competition was likely to continue to grow rapidly and could undermine the ability of Royal Mail to meet its universal service obligation duties as a result.¹²⁸

122 Appendix 15, para 41

123 Appendix 16, page 3, table 12

124 Appendix 15, para 42

125 Q 36

126 Q 382 (Minister)

127 Appendix 4, para 19

128 *Ibid.*, para 39

68. Mr Crozier, Chief Executive of Royal Mail, told us that “business customers have overpaid and by and large social customers have underpaid, and everyone accepts that that is part of the market that existed. The problem with that when competition comes in is that competition only targets the business mail, and that gives them a lot of headroom to steal that business and, unless we have the ability to rebalance those prices, clearly we have got a problem”. This would “really puts pressure on the USO: “Either the USO would have to go, which I do not think anyone would agree with, or stamp prices would really have to go up at that point to compensate for the loss in business mail”.¹²⁹

69. Postcomm argued that:

“if you look at the cherries in this market, the cherries have been open for picking for nearly three years and three years of cherry-picking has resulted in a loss of market share of less than three percent for Royal Mail. It is not the cherries that are being opened on 1 January, it is the bark, or whatever nasty bit of tree you want to talk about, but I will not. Cherry-picking has been available to competitors for some time and so far the inroads that they have made are very, very small and we do not regard that as being a threat, certainly not a threat to the universal service and not a threat to the profitability of Royal Mail’s business going forward”.¹³⁰

Postcomm told us, that although it was sure that there would be no negative impact on the universal service, it would remain vigilant “at any stage, if it looked as if there were any problems, we have the powers and the duty to intervene to make sure, in particular, that the universal service is safe, and that is what we will be doing”.¹³¹

70. The MCF saw no reason why Royal Mail’s universal service obligation should extend beyond the expressed statutory requirement: “if Royal Mail is thus obliged to maintain an infrastructure to meet this obligation, it will have the most powerful commercial incentive to offer a wide range of services to maximise usage of the network and thereby lower unit costs and hence its commercial competitiveness”.¹³² Postwatch argued that as the incumbent operator with the unique ability to deliver mail daily to each and every one of some 27 million addresses throughout the land, Royal Mail gained, through its universal service obligation, a “powerful and valuable advantage over its competitors in the market”.¹³³

71. Postcomm told us that competition may also bring some threats to the universal service. Royal Mail had high fixed costs which meant that a significant loss of mail volumes could jeopardise its ability to provide a universal service at an affordable price.¹³⁴

72. Postwatch held the view that competition and the universal service were compatible.¹³⁵ The main threat to the universal service came not from falling volumes but from an

129 Q 9

130 Q 200 (Ms Chambers)

131 Q 201 (Ms Chambers)

132 Appendix 10, para 24

133 *Ibid.*, para 4

134 Appendix 15, para 45

135 Q 131 (Mr McGregor)

“inefficient and failing monopoly”.¹³⁶ Their research had shown that the universal service was a net benefit to Royal Mail and not a burden as “Royal Mail has no national competitor with ubiquitous coverage”; and Postwatch had estimated that the commercial benefit of the universal service to Royal Mail’s business was in excess of £500 million per annum.¹³⁷ Royal Mail later confirmed that in 2004/05 profits from the universal service area were in the region of £400 million.¹³⁸

73. The MUA agreed with Postcomm and maintained that Royal Mail’s universal service obligation was a net benefit to them, and as such would not put them at a disadvantage against emerging competition. However, once sustainable competition had been established, the MUA’s members had suggested that Postcomm would then be in a position to review Royal Mail’s universal service obligation, and perhaps release parts of Royal Mail’s “licensed obligations to other service providers, and/or the postal network infrastructure that accompanies it”.¹³⁹

74. The DMA told us that Royal Mail had a competitive advantage in offering the universal service rather than a cost burden and that “in order for Royal Mail to finance the universal service, it is essential that the universal service reduce as competition develops, so reducing any burden to Royal Mail. Also as competition develops and offers similar services, the universal service obligation could be shared across operators. The universal service is at the fulcrum of UK postal services but it must evolve. It cannot be fixed in time, it must reflect the developing market and change accordingly”.¹⁴⁰

75. Intellect also believed that the USO was a benefit to Royal Mail and was not in conflict with market opening “as the market changed and with the continued growth in electronic alternatives to paper mail and physical products (pictures, videos and films), Intellect proposed that a thorough study and consultation should be undertaken to consider the re-definition of the USO and the drivers behind it”.¹⁴¹

76. The definition of the products which should be included in a universal service is particularly vague in the EU Postal Services Directive and Postal Services Act 2000. What is encompassed in the UK’s universal service is a matter for negotiation between Postcomm and Royal Mail but we believe that the products included in the universal service should not be unchanging, especially as postal services will evolve over time.

77. We recommend that Postcomm should continue to monitor and review the products included in the universal service, taking account of users’ changing needs and the new types of postal service products offered to the market. The universal service is rightly valued as a public service, especially in remote rural areas. Therefore, Postcomm should also have regard to the views of the Secretary of State, and, through him, of the Government, on what the definition of a universal service in the UK should be. In

¹³⁶ Appendix 17, para 5.1. This view was also expressed by Postcomm when they gave oral evidence before us, see Q 205 (Mr Stapleton).

¹³⁷ Appendix 17, para 5.1

¹³⁸ Appendix 20, para 1

¹³⁹ Appendix 12, para 6.1

¹⁴⁰ Appendix 7, para 5.1

¹⁴¹ Appendix 9, para 5

particular, we emphasise that a ‘universal service’ is not worthy of the name if it allows for any geographical exemptions.

78. The majority of our witnesses told us that opening up the UK postal services market to competition would pose no immediate threat to the universal service and we agree with this. However, the regulator must remain vigilant to ensure that greater competition in the postal services market does not come at the cost of the universal service. This is, after all, the regulator’s statutory duty.

79. It is too soon to tell if falling mail volumes are a temporary blip or a change in trend. Unfortunately, due to its choice of timing, the regulator cannot wait to find out before setting the price controls. However, we note with confidence that in its amended price control proposals, Postcomm has allowed for the possibility of an automatic price adjustment should mail volumes fall short of its forecasts.

80. We are also happy that there is a further ‘safety net’ possibility of a universal service compensation fund which would require other operators to contribute to the costs of providing a universal service, if it were in jeopardy. However, in our opinion the fund would almost inevitably come too late. Therefore, we recommend that a mechanism for an early price control review be put in place by Postcomm as soon as is reasonably practicable to maximise the chance of preventing the universal service being jeopardised in the first place.

3 The Royal Mail review of price and quality controls

81. When we began our inquiry it was not our intention to look at Postcomm's Royal Mail review and quality controls other than what the impact of Postcomm's review would be on Royal Mail with regards to full liberalisation. However, during our inquiry we received evidence which suggested there existed serious doubts over Royal Mail's ability to service a pension fund deficit and to fund the capital investment it required to modernise its operations under Postcomm's proposals.

82. Royal Mail's submission to Postcomm's price controls review, which it subsequently submitted as evidence to our inquiry,¹⁴² contained a table which gave Royal Mail's understanding about Postcomm's position on its price control proposals.¹⁴³ We subsequently asked Postcomm and Postwatch to state what their positions were, as the statutory bodies, in relation to Royal Mail's view, and Royal Mail's views of Postcomm's proposals, respectively.

Price controls

83. Postcomm periodically reviews prices and service quality for a range of Royal Mail's postal services. This 'price control' is one of the regulator's main tools for ensuring the continued provision of a universal service in the UK. Postcomm last set a price control for Royal Mail in March 2003. The next price control is due to become effective from April 2006. When we started our inquiry, Postcomm had recently put its initial proposals for the next price control period out to consultation. Consultation finished during our inquiry with the conclusions being published on 7 December 2005.¹⁴⁴

84. The price control is one of Postcomm's main tools for ensuring the continued provision of a universal service and was set in the context of a postal services market in which competition was developing.¹⁴⁵ Postcomm told us that its proposals had sought to balance the needs of customers, Royal Mail, its shareholder and new operators, and the need for the continued provision of a universal service. Its proposals were intended to protect vulnerable users but also to reward investment in the business. They were also designed to offer an appropriate return and allow Royal Mail to begin to reduce its pension deficit¹⁴⁶ while enabling Royal Mail to compete effectively.¹⁴⁷ Ultimately, the price control

142 Royal Mail, *Response to Postcomm's initial proposals for the 2006 price and service quality review*, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

143 *Ibid.*, pages 18-19

144 Postcomm, *Postcomm propose modest stamp rises to secure financing of the universal service*, Press Notice 35/05, 7 December 2005

145 Appendix 15, para 37

146 By allowing for the recovery of around £200 million per annum. Source: Q234 (Mr Stapleton)

147 Appendix 15, para 38

has to be agreed with Royal Mail. If agreement cannot be reached, the matter would be referred to the Competition Commission.¹⁴⁸

85. Postcomm proposed two price caps in its price controls based on what revenue Royal Mail needs to run its business, meet costs, invest and make a profit: one for a ‘captive tariff basket’ for domestic users (basket A) who have no alternative to using Royal Mail and one for business users, a ‘non-captive tariff basket’ (basket B). The proposed cap for the captive basket A, which included first and second class stamps, was RPI inflation minus three percent (RPI-3%). For the non-captive basket B the proposed cap was RPI inflation minus two percent (RPI-2%). Royal Mail could increase the price of individual items within each of the baskets by up to four percent above the average price control as long as the average basket price conformed to the cap. This meant that the cost of a first class stamp could increase to 34 pence by the 2009/10 financial year, but only if the prices of other items were reduced.¹⁴⁹

86. Royal Mail Group’s submission¹⁵⁰ suggested that decisions taken about its price and service quality review by Postcomm would be critical to Royal Mail’s future success and the success of postal service market liberalisation in the UK. It wanted a rise in postage prices large enough to cover a pension fund deficit and to provide capital expenditure to modernise its infrastructure to enable it to compete with its new competitors.¹⁵¹ Royal Mail told us that due to past underinvestment, it was less efficient and productive than its EU counterparts. While Royal Mail only sorted 50 percent of mail by machine, TPG (the Netherlands) and Deutsche Post (Germany) both manage to sort over 90 percent of mail mechanically.¹⁵²

87. Royal Mail said it was concerned about the methodology Postcomm had used in developing its initial price control proposals. It told us that it believed that Postcomm’s modelling of the impact of its proposals was flawed: “for example, the X factors proposed for the tariff baskets¹⁵³ (as part of the RPI-X model) in Postcomm’s model are inconsistent with its own modelling, and that no set of realistic prices could in fact be put in place to achieve the revenues they [Postcomm] suggest with these X factors for the baskets.” Royal Mail also told us that these assumptions were based on unrealistic comparisons with previous cost reductions achieved in privatised industries. Royal Mail believed that even a figure of 1.5 percent would be a “stretching objective given the constraints imposed by continuing industrial relations difficulties, a relatively disengaged workforce and the imperative to maintain quality of service levels during a period of very substantial change”¹⁵⁴ especially given that over the past three years during “the renewal plan, we ran at 2.2 percent efficiency above inflation and wage inflation and all those things. The idea

148 Appendix 15, para 38

149 Appendix 7, para 4.1

150 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

151 *Ibid.*, para 1.55

152 *Ibid.*, para 3.25

153 *Ibid.*, para 1.55

154 *Ibid.*, para 1.40

that you can sustain that every year and actually put it up to three percent, we believe is not do-able”.¹⁵⁵

88. Royal Mail told us that Postcomm proposed to place a constraint on prices which limited first and second class stamp prices to 34 pence and 23 pence respectively by 2009/10, which would perpetuate losses on these products.¹⁵⁶ Overall, Postcomm proposed average prices that fell by around 3.4 percent per annum in real terms. This compared with Royal Mail’s minimum requirement of “prices that initially rise by inflation plus 8% (PØ =8%) to fund the pension deficit and even out cash flows over the period. Thereafter prices remain constant in real terms (X=0 in RPI-X) to reflect underlying improvements in efficiency of 1.5% per annum against a background of declining end-to-end volumes and the cash flow requirements of Royal Mail”.¹⁵⁷ It wished for a first class stamp price of 39 pence¹⁵⁸ and 29 pence¹⁵⁹ for first and second class stamps respectively (including cash requested for pension deficit and capital investment).¹⁶⁰

89. The National Federation of Sub-Postmasters (NFSP) acknowledged the need for price control during the emergence of a fully competitive market, but feared that Postcomm’s proposals were too extensive and too restrictive to enable Royal Mail to compete commercially.¹⁶¹ The DMA told us that Postcomm had used a RPI-X price control, which had effectively capped prices over a period of time but offered incentives for Royal Mail to reduce its costs and maximise efficiency. Such cost efficiencies would result in greater revenues and profits for Royal Mail through the price control period. The DMA further told us that RPI-X was generally regarded as one of the “most effective price controls for large utilities, such as gas, telecoms, post and electricity. As a surrogate for competition it cannot mirror competitive pressure but it can bring pressure to force efficiencies and behaviour changes”.¹⁶²

90. We agree with Postcomm that RPI-X is the best available methodology to use to set Royal Mail’s future postage service price caps as it has proved successful for price setting with other incumbent monopolists in the past. In its amended proposals, published on 7 December 2005, Postcomm agreed with Royal Mail on a value for X of three percent, as Postcomm originally proposed.

Pension fund deficit

91. Royal Mail told us that it required higher postage charges from the price controls as it had a £2.0 billion balance sheet liability, primarily due to a £4.0 billion accounting pension fund deficit which it had to recognise under FRS 17, following “changes in UK GAAP and

155 Q 55 (Mr Crozier)

156 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 1.23, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

157 *Ibid.*, para 1.37

158 Q 46 (Mr Crozier)

159 Q 52 (Mr Crozier)

160 Q 59 (Mr Crozier)

161 Appendix 13, para 3.9

162 Appendix 7, para 4.2

under International Financial Reporting Standards (IFRS)".¹⁶³ This deficit had left the business technically insolvent and therefore unable to raise new private sector capital, as external capital providers deemed Royal Mail too risky a proposition.¹⁶⁴

Creation of the deficit

92. We wanted to find out who our witnesses believed were to blame for the pension fund deficit and consequently how they believed it should be funded and by whom.

93. The Post Office Staff Superannuation Scheme (POSSS), a final salary scheme, was established on 1 October 1969 under the terms of the Post Office Act 1969. A full valuation was carried out by an actuary as at 30 December 1972, which showed a deficit of £1,100 million. By the 31 March 1976 actuarial valuation, the deficit had increased to £1,900 million.¹⁶⁵ The Royal Mail told us that this scheme has been in surplus since 1988, and therefore it had:

“made little economic sense to continue contributions, bearing in mind there was reasonable conservatism built into assumptions used by the plan actuary. Under the Prescribed Basis (set out in Schedule 22 to the *Income and Corporations Taxes Act 1988*), employers have to take action to utilise any surplus assets above the 105% funding level on this basis either to improve benefits or to take a contributions holiday. The intention was to control the funding of the plan to below the Prescribed Basis. It did not make economic sense to continue making contributions, only to take a contributions holiday enforced under this legislation”.¹⁶⁶

94. The POSSS was closed to new entrants in 1987 and the actuary advised Royal Mail that “as the scheme was closed to new members, it was important not to over-fund the prospective benefits”.¹⁶⁷ The scheme was replaced by the Post Office Pension Scheme (POPS), again a final salary scheme, established from 1 April 1987 for all new employees. The POSSS and POPS plans were then merged to become the Royal Mail Pension Plan (RMPP) on 1 April 2000. The POPS part of the RMPP scheme moved into deficit at March 2000 and annual deficit payments of around £50 million started in March 2001. At March 2003 the RMPP was 82.5 percent funded and £2,500 million in deficit.¹⁶⁸

95. Royal Mail told us that a contributions holiday had been taken because

“companies cannot simply pump money (tax free) into fully funded schemes without allocating the funds to a benefit/liability which will in due course need to be paid out. Surplus assets cannot be returned to the employer. For a fully funded scheme, therefore, an additional payment would mean improving the level of benefits paid to members or their beneficiaries—for example by increasing lump sum benefits, or

163 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 3.33, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

164 *Ibid.*

165 Appendix 20, Section 3

166 *Ibid.*

167 *Ibid.*

168 *Ibid.*

improving the accrual rate applied to members' pensionable service—or reducing contributions. This is not a practical step to take—a downturn in the funding of the pension scheme, due to external market factors, would require a reduction in member benefits (or an increase in contributions), requiring negotiation, or would create an even bigger deficit. Improvement of benefits would also have represented a substantial increase in overall remuneration, almost certainly, for the time period in question, at odds with public sector pay policy. The only other course of action available was to suspend contributions”.¹⁶⁹

96. In order to establish if the contributions holiday had added to the pension fund problems, we wanted to find out exactly when the contributions holiday had been taken. Mr Smith, Director of Strategy at Royal Mail, told us that “the pension fund was in surplus until 2001, and in fact it was 105 percent funded, which means the company could not put any more money into it. So it was the 13 years prior to 2001 when the pension fund was, I believe, in surplus for the whole period”.¹⁷⁰

97. The evidence Royal Mail presented to the Committee suggested that the pension fund deficit was at £4,000 million and not the £2,500 million stated above. We asked Royal Mail how this figure was arrived at.¹⁷¹ It told us that the £4,000 million deficit was due to changes in the accounting methodology used to calculate its pension liabilities on its balance sheet: “there is a specified methodology to calculate the FRS17 liability which requires a set of assumptions. The assumptions used by Royal Mail are broadly consistent with those used by many of the FTSE 100 companies. The calculation is prepared by the company's actuary and audited as part of the year end Report & Accounts. For the first time in 2005-06 the FRS 17 liability will need to be recognised on our balance sheet—which will therefore show that Royal Mail has liabilities in excess of its assets. The FRS17 calculation was first undertaken in March 2002, and showed the scheme to be in surplus. By March 2003 that surplus had become a deficit, because of an Actuarial loss for the year in excess of £5 billion—mainly made up of falling equity values and an increase in liabilities due to lower assumed bond rates”.¹⁷² A more detailed breakdown of the pension fund deficit/surplus since 1984 is given in Appendix 20.¹⁷³

Funding the pension fund deficit

98. Mr Crozier, Chief Executive of Royal Mail, said that Royal Mail was currently paying “£400 million a year into the pension fund, about £140-150 million of which was historical deficit. With the change to FRS17 that payment would go up next year to about £800 million, with somewhere between £400-500 million a year of that being historical pension

169 Appendix 20, Section 3

170 Q 68

171 Q 71

172 Appendix 20, Section 3

173 *Ibid.*

deficit”.¹⁷⁴ Royal Mail told us that in total this would require additional contributions of £1.8 billion over the next price control period.¹⁷⁵

99. We were concerned about the size of this rise in contributions which was being attributed to the historic pension fund deficit and asked Royal Mail why the rise was so large. It told us that four factors were to blame: the move to a quicker repayment period, from the basis of a 40 year period to the average remaining service life of employees—12 years; a reduction in the proportion of equities in the RMPP to reduce the pension plan’s exposure to risk; higher staff salaries, which had added further liabilities; and that life expectancy was increasing.¹⁷⁶

100. When asked who they believed should fund the pension fund deficit our witnesses fell into three camps: those that believed the users of Royal Mail’s products (customers) should pay; those that believed the Government as the lone shareholder should pay; and those who believed that Royal Mail itself should fund the deficit in some way.

101. The CWU told us that Royal Mail’s pension fund deficit remained “one of the most significant areas of concern for our members. We have therefore argued that the next price control should include a clear allowance to address the pension fund deficit”.¹⁷⁷ It believed that such an allowance was justified as the current deficit was aggravated by a contributions holiday taken by the shareholder during the 1990s.¹⁷⁸ The CWU also believed that users should be made to pay for the deficit through higher postage prices as “during this period Royal Mail’s customers benefited from the artificial suppression of postal prices”.¹⁷⁹

102. Royal Mail told us that Postcomm’s price control proposals suggested that an allowance should be made in the price control which would enable the deficit to be repaid “over a 20 year period from 2003-04 using the benchmark of Local Government Pension Schemes”¹⁸⁰ rather than “over the standard commercial approach of 12 years”.¹⁸¹ This, it said, was the average remaining service of its employees, adding: “evidence highlights that private sector companies fund their deficits over the average remaining service life of the employees, and indeed it is rare for deficits to be financed over a longer period”.¹⁸² The CWU believed that Postcomm’s approach was “grossly irresponsible and implicitly accords greater importance to Postcomm’s regulatory agenda than to the livelihoods of thousands of Royal Mail Group employees once they retire. We believe that as an absolute minimum the price control should allow the repayments to take place over a 12 year period”.¹⁸³

174 Q 59

175 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 3.38, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

176 Appendix 20, Section 3

177 Appendix 4, para 30

178 *Ibid.*

179 *Ibid.*

180 Royal Mail, *Response to Postcomm’s initial proposals for the 2006 price and service quality review*, para 1.42, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

181 *Ibid.*

182 *Ibid.*

183 Appendix 4, para 31

103. The DMA told us that within the proposals for the 2006 price control, Postcomm had proposed that pension fund deficit costs should be met from the price control. The DMA objected to this, arguing: “in essence users will be paying for the pension deficit. As the chief stakeholder, the Government, who took many pension holidays and benefited from excellent dividend, should meet the pension deficit cost”.¹⁸⁴ The MUA told us that its members questioned Postcomm’s proposals to fund Royal Mail’s pension fund deficit from the price control, believing it was inappropriate for users to pay the bill for the pension fund deficit. Both the MUA and the DMA¹⁸⁵ also believed that the pension deficit had been given as the reasoning behind a number of previous postal price increases and that Royal Mail’s shareholder (the Government) should address the deficit as a separate issue, rather than users who had derived no benefit from it.¹⁸⁶

104. Postwatch told us that in relation to major pension deficits:

“the one thing they cannot do is simply go to their customers and push up the prices to pay for the deficit. If they try to do that they will lose market share and their profitability will fall even further. Royal Mail, in line with the competitive pressures, should be looking for a solution with the shareholder, who is after all one of the prime beneficiaries of the 13-year pension holiday that they had. Secondly, the management themselves should be looking to greater efficiencies in order to generate extra surpluses to put into the deficit [...] there is plenty of scope as between the shareholder and a more efficient management to arrive at a solution to the pension deficit without simply pushing up the prices to monopoly customers. Customers were not the people who created the pension deficit, it was management and the shareholder who created the deficit. Now it is management and the shareholder who are looking to customers to pay and that simply is not right”;¹⁸⁷

and they went on:

“the proposition on the table at the moment is that customers should have to meet the whole of the £4 billion pension fund deficit, with no contribution from management efficiency and no contribution from the shareholder. What we are saying is that there needs to be a much fairer balance between contributions from the shareholder and efficiency and the contributions that customers would have to make in higher prices”.¹⁸⁸

105. Mr Leighton, Chairman of Royal Mail, said that he did not believe the user should pay but that “somebody has to put in the money, it has to be paid over a longer period of time than the 12 years, which is what is in there today, or there is some partial way of taking the pension deficit down. The only way it gets solved is in some way the cash has to come from somewhere”;¹⁸⁹ and he added: “you can either put the prices up to such an extent it covers

¹⁸⁴ Appendix 7, para 4.1

¹⁸⁵ *Ibid.*

¹⁸⁶ Appendix 12, para 5.6

¹⁸⁷ Qq 148-149 (Mr McGregor)

¹⁸⁸ Q 161 (Mr Carr)

¹⁸⁹ Q 101

the pension deficit—well, that will be death for everybody, so that is not really an entity—or somebody puts the cash in. It is as simple as that”.¹⁹⁰ A similar view was also expressed to us by Mr Buswell of the MCF: “putting prices up seems like the obvious thing to do, but customers need to make sure it is cost-effective or, as David says, they will pick another medium, so it is not about just putting prices up. As a commercial organisation, price is one of the tools we have in our box and yes, we can put prices up, but if that means we lose customers by doing so, then that is the balancing act and that is clearly what Royal Mail are faced with now”.¹⁹¹ We asked Royal Mail who they thought was responsible for the pension fund deficit in the first place but they refused to be drawn on the subject.¹⁹²

106. The DTI told us that the unavoidable costs of servicing the pension fund deficit are “inherited costs of the business” and as such should be borne over a suitable period by postal service customers, not by taxpayers.¹⁹³ The Minister confirmed, “it is absolutely right, as was said earlier today, that there was a period of approximately 12 years in which there was a contributions holiday, but during that period I think the important factor that is sometimes missed in this is that if you look at the prices of postal services and the price of a first class stamp during all that period it only increased by four pence and for a second class stamp it only increased by two pence. So the net beneficiaries here were the customers; postal service costs were kept low”.¹⁹⁴

107. We agree with Mr Leighton, Chairman of Royal Mail, when he told us that the pension fund deficit was “such a big hole that it has got to be dealt with in some way, shape or form”¹⁹⁵ but there has been insufficient time during this inquiry to investigate the pension fund deficit in sufficient detail to come to firm conclusions about the responsibility for the deficit. For example, we were unable to ascertain with any degree of certainty the reliability and robustness of Royal Mail’s estimate of its future pension cost liabilities. We may wish to return to the question of the Royal Mail’s pension fund deficit at some point in the future, once Postcomm’s price control proposals have been enacted.

108. Postcomm has acknowledged the extent of Royal Mail’s pension fund deficit and has made an allowance in its revised price proposals of an average £320 million per annum. We understand Postcomm’s acceptance that at least some of the pension fund deficit should be funded by users through higher postage prices. However, we consider that in principle the pension fund deficit should also be funded by the other main stakeholders: the shareholder, through a continued commitment to take nil-dividends; and Royal Mail itself through greater management efficiencies; and improved management of the pension fund.

190 Q 102

191 Q 292

192 Qq 61-67

193 Appendix 6, para 10

194 Q 369

195 Q 60

Capital Expenditure

109. Almost all of our witnesses agreed that Royal Mail's infrastructure required capital investment because of years of underinvestment.¹⁹⁶ For example, the CWU pressed for "concrete action to correct the years of under-investment in Royal Mail. Very little has so far been done to address the underlying problems of the company's ageing infrastructure".¹⁹⁷ Capital investment would be required if Royal Mail's employees were "to deliver a state of the art postal service fit for the 21st century [...] we need to urgently tackle the legacy of generations of under-investment".¹⁹⁸

110. Royal Mail said that it believed that the only "long term method to guarantee ongoing improvements in quality of service and customer satisfaction is through a sustained targeted programme of modernisation, founded on extensive investment in the business".¹⁹⁹ Mr Crozier, Chief Executive of Royal Mail, told us that Royal Mail needed capital investment to enable it to compete with new operators who "have huge advantages because the modernisation that we are talking about embarking on they did without any competition and over a 10–15 year period. So they have already done what we have not even started, so clearly there is an advantage there".²⁰⁰ Royal Mail also told us that almost all of its sorting equipment was obsolete and required replacement, having been designed and installed in the early 1990s. It added: "these machines are beyond their useful life, are not supported by their manufacturers, and are likely to begin failing frequently with potential failure rates of more than 20% per year. Royal Mail's engineers have continued to maintain the current machinery from existing stocks of spare parts and opportunistic purchase of new and second-hand spares. However, these parts are increasingly difficult to find and manufacturers do not currently support most of the equipment. This situation is not sustainable". Royal Mail also told us that its delivery offices were not fit for purpose as a result of a lack of investment combined with an ageing estate and increased number of delivery points.²⁰¹

111. Royal Mail told us that there was a chance it would become uncompetitive, following full liberalisation, due to the under-investment in its network relative to the other major operators who were entering the UK postal services market. For example, Royal Mail sorted around 50 percent of its letters mechanically compared to more than 90 percent for competitors such as TNT and Deutsche Post. Much of Royal Mail's network depended on obsolete equipment and the business had "significant distance to close to achieve best practices and processes. Royal Mail therefore requires significant investment and

196 For example see Appendix 4, para 43; Royal Mail, *Response to Postcomm's initial proposals for the 2006 price and service quality review*, paras 1.5 and 3.28, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

197 Appendix 4, para 26

198 *Ibid.*, para 43

199 Royal Mail, *Response to Postcomm's initial proposals for the 2006 price and service quality review*, para 3.26, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

200 Q 94

201 Royal Mail, *Response to Postcomm's initial proposals for the 2006 price and service quality review*, para 3.26, Postcomm website (13 December 2005): www.postcomm.gov.uk/policy-and-consultations/consultations

substantial operational change if it is to remain not only competitive but also commercially viable in a fully-liberalised marketplace”.²⁰²

Funding requirements

112. The CWU were unable to tell us how much capital expenditure was needed by Royal Mail to modernise its infrastructure: “at this stage we do not have a precise figure on the amount of work and funding required to upgrade Royal Mail’s national delivery, sortation and distribution network”; however, they added: “Royal Mail themselves have estimated that it needs £2 billion over the next five years to provide the additional funding required”.²⁰³

113. Royal Mail told us that, in its price control proposals, Postcomm “allowed only £776 million of our proposed capital expenditure in their preliminary proposals”.²⁰⁴ This was only half of what Royal Mail estimated it would need to modernise the business “operational investment of £2.2 billion (comprising £1.6 billion of capital investment and £0.6 billion of one-off costs) is required over the course of the price control period for modernisation of the network infrastructure”.²⁰⁵ This included capital expenditure of approximately £400 million for automation equipment and the move to more efficient delivery, £500 million to begin replacing obsolete equipment, £100 million to make the delivery network fit for purpose, £100 million on processing, £100 million on regular maintenance on the estate, and £500 million on vehicles.²⁰⁶ Postcomm, in contrast, relied on the analysis made by its consultants about Royal Mail’s investment needs. The consultants had come to the view that much of Royal Mail’s proposed capital investment was not necessary and/or would not result in productivity improvements.

114. Royal Mail told us that this capital investment would be used to fund a “more efficient, automated and smoother flow of mail transformed through automation, materials handling solutions and new working practices”.²⁰⁷ This would “deliver improving consistency of quality of service and approximately £320 million in ongoing annual savings by 2009/10”.²⁰⁸

Prospective sources of funding

115. Postcomm said that through its price control review it had factored in a proposed investment for the Royal Mail of £170 million per annum from its regulated activities.²⁰⁹ The CWU told us that under Postcomm’s proposed price control this would be taken from the £285 million which Postcomm would allow Royal Mail to make as profits in an average

202 Royal Mail/Postcomm report, para 1.5

203 *Ibid.*, para 1.39

204 *Ibid.*

205 *Ibid.*, para 1.5

206 *Ibid.*, para 3.37

207 *Ibid.*, para 4.18

208 *Ibid.*, para 1.7

209 Appendix 15, Annex A

year.²¹⁰ The CWU believed that this annual profit allowance was too low: “such an allowance would allow Royal Mail a return from sales—at less than 5 percent—which is far lower than that which applies for similar activities in other companies”.²¹¹ It also questioned if the £285m profit was genuinely achievable within the range of other restrictions proposed in the price control.²¹² The CWU believed that the only method which would deliver the necessary investment in “facilities, machinery and the workforce was an RPI+Y allowance in the price controls for further defined investment [as opposed to the proposed RPI-X model]”.²¹³ Here Y would represent a percentage price increase which would be ‘ring-fenced’ to allow the modernisation to go ahead.²¹⁴

116. Mr Stapleton, Chairman of Postcomm, told us: “you pay for the investment by giving Royal Mail an eight percent, guaranteed, real return on their investment and I would like to work in a commercial company which had that sort of guarantee of return on their investment”.²¹⁵

117. The DTI said that the Government could not be expected to provide support to Royal Mail’s regulated business on a non-commercial basis.²¹⁶ We asked the Minister what support the Government would be willing to provide to Royal Mail, considering it was the only shareholder. The Minister replied:

“the company does need investment, that the company does need to make productivity gains. And what I will give the Committee is an absolute assurance that after Postcomm has taken its decision about the price we will then work with the company to look at what further commercial investment from government may be required [...] But that demands equally that the regulator respect that new relationship of a commercial shareholder expecting returns for its capital investment and not assuming that the Government as shareholder is going to simply be there as the funder of last resort on a non-commercial basis”.²¹⁷

Later he added:

“we will then look at that and see how we can go forward with the company on a commercial basis. But let me be clear again, this is not something for which the Government has infinite funds, we have to look at it not simply is it a good commercial business plan, we also have to look at that in order, with all the other priorities that Government has for its spending, and we must see that this actually is a priority within all the other calls on government spending, and that case must be made, but it must be done on a commercial basis”.²¹⁸

210 Appendix 4, para 25

211 *Ibid.*

212 *Ibid.*

213 *Ibid.*, para 26

214 Q 335 (Mr Hayes)

215 Q 212

216 Appendix 6, para 10

217 Q 361

218 *Ibid.*

118. The CWU does not believe that the existing mechanisms for re-opening the price control in the event of price shocks or other unforeseen events, which Postcomm is proposing should be retained, are fit-for-purpose.²¹⁹ We agree with this and recommend that a robust mechanism, similar to that in our earlier recommendation for protecting the universal service, should be put in place to allow for the re-opening of the price control sufficiently quickly to address any problems which could develop in this area.

119. Postcomm, in its initial proposals for the price controls, had already taken account of Royal Mail's need to make pension fund contributions and invest in new capital operations. Postcomm believed that these should be paid for by the consumer, and through some efficiency gains by Royal Mail, and in its original price control proposals allowed Royal Mail an investment of £0.8 billion for new capital operations. In its revised proposals, Postcomm has acknowledged that this figure was underestimated and has agreed a new total of £1.2 billion. We approve of this increase but do not believe that the customer should be the only stakeholder made to pay.

120. The lack of investment in Royal Mail's infrastructure has been due to decisions made by Royal Mail's management and, in particular, its shareholder over the last twenty years. The Government, as the lone shareholder, has received over £2,300 million in dividends (or—prior to 2001—the External Financing Limit) from Royal Mail since 1984. However, these dividends have been waived since 1999.²²⁰ We recommend that the Government extends the current period of nil-dividend, not only to ease Royal Mail's pensions deficit as previously recommended, but to enable Royal Mail also to invest in its network.

121. We welcome Postcomm's amended price control proposals, which we understand are based on an agreement between Royal Mail and Postcomm. We note that there has to be a further three month consultation period but look forward to the adoption of proposals broadly in line with the current agreement.

219 Q 333 (Mr Hayes)

220 Appendix 20, Annex E

4 The future ownership of Royal Mail

122. We were aware that the Government had pledged itself not to privatise the Royal Mail during this Parliament but we were interested in asking our witnesses if they believed selling shares in Royal Mail, either to the employees or on the open market, could be the answer to funding the current pensions fund deficit.

123. We asked the Royal Mail who they believed should be the future owners of the Royal Mail. Mr Leighton, Chairman, told us that “we have always felt that our people should have more of a share in the company. We have always said that because we think that the more our people are involved, basically, you get a better performance”.²²¹ He went on: “if I ask the people in the company they say; “That is what we should do; we would all like to be part of it”.²²² When pressed about the proportion of shares that would be given over to Royal Mail employees, Mr Leighton said: “We think we should start with 20 percent”.²²³

124. We asked how these shares would be distributed and about selling these shares on to third parties outside Royal Mail. Mr Leighton told us that “everybody gets the same, it does not matter who you are; that is fundamental to this. Secondly, there is no linkage at all between this and anything that might happen in terms of the pension deficit, pension schemes or any other part of the business. It is a completely different thing.”²²⁴ The shares would not be able to “be traded on the stock market because it is not a publicly quoted company. There are all sorts of different ways: you can create a trust, the shares can be bought by the trust, the trust can issue the shares to our people, our people can trade the shares within the trust, the trust never sells the shares and the trust pays a dividend”.²²⁵

125. Mr Hayes, General Secretary of the CWU told us, “We are very, very clear that any share sale would be privatisation and a breach of the manifesto commitment given by the British government to British people, and we take manifesto commitments very seriously”.²²⁶ He went on: “therefore we oppose it”.²²⁷ Mr Ward, Deputy General Secretary Postal at the CWU, reinforced Mr Hayes’ comments “it [employee share ownership] is a flawed logic. Explain to us, with all the challenges that the business has, how creating an internal market to buy and sell shares is actually going to motivate everybody to pull in the same direction? What is going to happen is it is going to create those who have shares, those who do not have shares, and ultimately our view is that all the evidence suggests that in two years the management team of the company will own that 20 percent share, not the employees. It is not about giving the employees more say and we really do seriously question the real motives of the proposition that is being put forward”.²²⁸

221 Q 73

222 Q 75

223 Qq 84 and 96

224 Q 79

225 *Ibid.*

226 Q 352

227 Q 353

228 Q 354

126. Mr Baugh, Head of Research at the CWU, told us: “I do not think we are in the business of trading off members’ future pension entitlements for an equity stake in the business; I just do not think that that is a runner. They are entitled to the benefits that they are entitled to as current scheme members and we would not want to interfere with that. I think the idea is actually a short-term idea, when on the question of pensions it is a long-term view and we should be encouraging people to save more, we should not be encouraging them to short-term quick fixes, to trade off their pensions for some short-term gain”.²²⁹

127. Mr Leighton told us that the shareholder, the Government, had already made it very clear that it would not entertain privatisation of the company²³⁰ and that “this business is not in a state where it could be privatised anyway [...]I still think that you can get all the benefits of privatisation without going the whole hog and that is why I think it is really important that you get your people to take a share of ownership in that, in some way, shape or form”.²³¹

128. Mr Stapleton, Chairman of Postcomm, would not comment on our suggestion and told us that, as the statutory regulator, “we do not want to get into the debate about who should own Royal Mail”.²³² Postwatch told us that it was a “creature of statute and as such is tasked with representing customers in line with its remit under the Postal Services Act. Accordingly, we see privatisation as an issue for the management of Royal Mail and the shareholder in the form of the DTI/Treasury to consider. We therefore have not taken a view on what form of ownership is best for Royal Mail. Whatever form of ownership is decided should not result in an erosion of regulatory safeguards for customers and should be geared towards providing better services for customers”.²³³

129. The Minister said:

“I do tend to believe that if we have a manifesto commitment then it is a good thing to stick to it and people expect us to do that. So the Royal Mail is not going to be privatised, end of story. You asked a number of subsidiary questions there which related to what you said had been a proposal put forward to an employee share scheme, which might do a trade-off between that and the pension fund in some way. Can I simply say that I have not had any such proposal put to me? It is not a proposal that I recognise at all. [...] Let me now address the issue of an employee share scheme, where I have to say I disagreed with the view that was expressed by your previous witnesses [the CWU], not because I am wedded to an employee share scheme—I am not. But am I prepared to look at one? Yes, I am. [...] there is a difference between a mutual, between having employees having a stake in the business that they work for and having an idea and a privatised company with shares on the free market. The only thing—and let me be absolutely clear on this—the only thing that the Government is prepared to look at would be an employee share scheme in which it

229 Q 349

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was not possible for any shares to be traded to anybody except those people within a Trust who work for the Post Office. So it could not be traded outside the Trust. That is what we are prepared to look at. But why? Why would we be prepared to look at it? The only reason we would be prepared to look at it is if it could do something to improve the profitability and the efficiency of the company, because that is the bottom line here. There is no merit in having an employee share scheme in and of itself; the only purpose for it would precisely be if it were able to incentivise the workforce in such a way, and in a way that other ways of incentivising them could not achieve, to achieve levels of increased productivity. That is why I am prepared to look at it, that is why the Secretary of State is prepared to look at it. But no scheme has yet been presented to it and we have not reached any decision about it".²³⁴

130. Whatever view this Committee were to take on the full privatisation of the Royal Mail at this time—either as a solution to the pension fund deficit or with the longer term aim of increasing investment to enable it to compete with the new companies that will enter the UK market following full liberalisation on 1 January 2006—we recognise that this Government has a manifesto commitment to keep the company in the public sector.

131. It would be consistent with this commitment, however, for a part of Royal Mail's equity to be separated from the current shareholder in the future as a tool to motivate Royal Mail's workforce. However, the explanations offered to us by Royal Mail's current management are far from complete and no coherent process for how these shares would be transferred or traded has been given. If Royal Mail's management still wish to pursue commercial ways of motivating their employees we believe there are less controversial ways to do this such as the current profit sharing scheme. We are sure that we will be revisiting the subject of Royal Mail's ownership in the future, as well as its pension fund deficits.

Conclusions and recommendations

Timing of liberalisation

1. The evidence that liberalisation delivers an improved service for customers is compelling. However, we regard Postcomm's choice of dates for the move to full liberalisation in the UK postal services market to be an untimely one—not because we believe that Royal Mail will be unfairly disadvantaged against other operators, as we have faith in the competitive strength of the Royal Mail, but because Royal Mail has also been asked to prepare for competition at a time of great commercial uncertainty. Postcomm is reviewing the price Royal Mail can charge for its regulated services and the company also faces huge challenges in addressing its pensions deficit and investment needs. Although the review process is now nearing conclusion, we believe that the difficulties for Royal Mail have already been caused. (Paragraph 21)
2. An increasing number of EU Member States are committing to full liberalisation before 2009. The DTI told us that the “Government continues to press for full liberalisation across Europe to happen as soon as possible”. We strongly support the Government in this approach and we recommend that they continue to push this point to provide Royal Mail with the level playing field it requires. (Paragraph 22)

Maximising the benefits of liberalisation

3. Postcomm already informally collects evidence of quality of service targets, and performance against those targets, for each EU national postal operator. We believe that this information should form the basis of a formal set of EU-wide statistics which should be produced in an independent, consistent and robust manner. (Paragraph 39)
4. Few of our witnesses disputed that the arrival of liberalisation had served as a catalyst to drive through positive changes in Royal Mail. These changes have benefited users, the Royal Mail and shareholder, (the Government) alike. We are aware that data on Royal Mail's quality of service are already published and that Postwatch and Postcomm have started discussions with other licensees to ensure that similar data for them is published. We recommend that comparable quality of service and complaints data should be published to inform users of the comparative merits of all postal service operators in the UK. (Paragraph 40)
5. We believe that Postcomm has to remain vigilant that the quality of such statistics is not compromised by the licensee that provides them. One way this could be achieved would be to require new operators to have their quality statistics independently audited by an appropriate body, such as Postcomm, or the Office of Fair Trading, to be decided by the Secretary of State. (Paragraph 41)

Royal Mail's VAT exemption

6. We do not want to see stamp prices increase owing to the imposition of VAT on postal services, because of the impact on those users who are not registered for VAT,

especially, but not exclusively, private individuals. We understand Royal Mail's competitors' arguments of unfairness because of Royal Mail's VAT exemption, but also note that it has the unique requirement, and costs, of a universal service obligation. Moreover, we are sceptical that the UK Government would be able to secure derogation in the EU for a lower than normal rate. (Paragraph 52)

Definition of the Universal Service Obligation

7. The definition of the products which should be included in a universal service is particularly vague in the EU Postal Services Directive and Postal Services Act 2000. What is encompassed in the UK's universal service is a matter for negotiation between Postcomm and Royal Mail but we believe that the products included in the universal service should not be unchanging, especially as postal services will evolve over time. (Paragraph 76)
8. We recommend that Postcomm should continue to monitor and review the products included in the universal service, taking account of users' changing needs and the new types of postal service products offered to the market. The universal service is rightly valued as a public service, especially in remote rural areas. Therefore, Postcomm should also have regard to the views of the Secretary of State, and, through him, of the Government, on what the definition of a universal service in the UK should be. In particular, we emphasise that a 'universal service' is not worthy of the name if it allows for any geographical exemptions. (Paragraph 77)
9. The majority of our witnesses told us that opening up the UK postal services market to competition would pose no immediate threat to the universal service and we agree with this. However, the regulator must remain vigilant to ensure that greater competition in the postal services market does not come at the cost of the universal service. This is, after all, the regulator's statutory duty. (Paragraph 78)
10. It is too soon to tell if falling mail volumes are a temporary blip or a change in trend. Unfortunately, due to its choice of timing, the regulator cannot wait to find out before setting the price controls. However, we note with confidence that in its amended price control proposals, Postcomm has allowed for the possibility of an automatic price adjustment should mail volumes fall short of its forecasts. (Paragraph 79)
11. We are also happy that there is a further 'safety net' possibility of a universal service compensation fund which would require other operators to contribute to the costs of providing a universal service, if it were in jeopardy. However, in our opinion the fund would almost inevitably come too late. Therefore, we recommend that a mechanism for an early price control review be put in place by Postcomm as soon as is reasonably practicable to avoid the universal service being jeopardised in the first place. (Paragraph 80)

Review of Price Controls

12. We welcome Postcomm's amended price control proposals, which we understand are based on an agreement between Royal Mail and Postcomm. We note that there

has to be a further three month consultation period but look forward to the adoption of proposals broadly in line with the current agreement. (Paragraph 121)

13. We agree with Postcomm that RPI-X is the best available methodology to use to set Royal Mail's future postage service price caps as it has proved successful for price setting with other incumbent monopolists in the past. In its amended proposals, published on 7 December 2005, Postcomm agreed with Royal Mail on a value for X of three percent, as it originally proposed. (Paragraph 90)

Pension Fund deficit

14. We agree with Mr Leighton, Chairman of Royal Mail, that the pension fund deficit is "such a big hole that it has got to be dealt with in some way, shape or form" but there has been insufficient time during this inquiry to investigate the pension fund deficit in sufficient detail to come to firm conclusions about the responsibility for the deficit. For example, we were unable to ascertain with any degree of certainty the reliability and robustness of Royal Mail's estimate of its future pension cost liabilities. We may wish to return to the question of the Royal Mail's pension fund deficit at some point in the future, once Postcomm's price control proposals have been enacted. (Paragraph 107)
15. Postcomm has acknowledged the extent of Royal Mail's pension fund deficit and has made an allowance in its revised price proposals of an average £320 million per annum. We understand Postcomm's acceptance that at least some of the pension fund deficit should be funded by users through higher postage prices. However, we consider that in principle the pension fund deficit should also be funded by the other main stakeholders: the shareholder, through a continued commitment to take nil-dividends; and Royal Mail itself through greater management efficiencies; and through improved management of the pension fund. (Paragraph 108)

Capital investment

16. Postcomm, in its initial proposals for the price controls, had already taken account of Royal Mail's need to make pension fund contributions and invest in new capital operations. Postcomm believed that these should be paid for by the consumer, and through some efficiency gains by Royal Mail, and in its original price control proposals allowed Royal Mail an investment of £0.8 billion for new capital operations. In its revised proposals, Postcomm has acknowledged that this figure was underestimated and has agreed a new total of £1.2 billion. We approve of this increase but do not believe that the customer should be the only stakeholder made to pay. (Paragraph 119)
17. The lack of investment in Royal Mail's infrastructure has been due to decisions made by Royal Mail's management and in particular its shareholder over the last twenty years. The Government, as the lone shareholder, has received over £2,300 million in dividends (or—prior to 2001—the External Financing Limit) from Royal Mail since 1984. However, these dividends have been waived since 1999. We recommend that the Government extends the current period of nil-dividend, not only to ease Royal

Mail's pensions deficit as previously recommended, but to enable Royal Mail also to invest in its network. (Paragraph 120)

18. The CWU does not believe that the existing mechanisms for re-opening the price control in the event of price shocks or other unforeseen events, which Postcomm is proposing should be retained, are fit-for-purpose. In particular, it is concerned that in Postcomm's price control proposals the scope for capital investment will depend entirely on whether Royal Mail is able to make a profit, and any fall in profit would stop much-needed investment. We recommend that a robust mechanism, similar to that in our earlier recommendation for protecting the universal service, should be put in place to allow for the re-opening of the price control sufficiently quickly to address any problems which could develop in this area. (Paragraph 118)

Future ownership of Royal Mail

19. Whatever view this Committee were to take on the full privatisation of the Royal Mail at this time—either as a solution to the pension fund deficit or with the longer term aim of increasing investment to enable it to compete with the new companies that will enter the UK market following full liberalisation on 1 January 2006—we recognise that this Government has a manifesto commitment to keep the company in the public sector. (Paragraph 130)
20. It would be consistent with this commitment, however, for a part of Royal Mail's equity to be separated from the current shareholder in the future as a tool to motivate Royal Mail's workforce. However, the explanations offered to us by Royal Mail's current management are far from complete and no coherent process for how these shares would be transferred or traded has been given. If Royal Mail's management still wish to pursue commercial ways of motivating their employees we believe there are less controversial ways to do this such as the current profit sharing scheme. We are sure that we will be revisiting the subject of Royal Mail's ownership in the future, as well as its pension fund deficits. (Paragraph 131)

The DTI

21. We are disappointed that the DTI has failed to provide supplementary information, which the Minister had agreed to send us in his oral evidence, in good time. This has made the task of completing our Report unnecessarily difficult and we hope that this will not set a precedent for future inquiries. (Paragraph 51)

Formal minutes

Tuesday 17 December 2002

Members present:

Mr Peter Luff, in the Chair

Peter Bone

Claire Curtis-Thomas

Lindsay Hoyle

Mr Mark Hunter

Judy Mallaber

Rob Marris

Mrs Maria Miller

Draft Report (Royal Mail after liberalisation), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 131 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Second Report of the Committee to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Thursday 12 January at 2.00pm]

List of witnesses

Tuesday 18 October 2005

Mr Allan Leighton, Mr Adam Crozier and Mr Alex Smith, **Royal Mail Group**

Monday 7 November 2005

Mr Peter Carr, Mr Gregor McGregor and Dr Roisin Doherty, **Postwatch**

Mr Nigel Stapleton, Ms Sarah Chambers and Mr Richard Moriarty, **Postcomm**

Tuesday 15 November 2005

Mr Nick Wells, Mr Guy Buswell and Mr David Sibbick, **Mail Competition Forum**

Mr Billy Hayes, Mr Dave Ward, Mr Jeremy Baugh, **Communication Workers' Union**

Mr Barry Gardiner MP, Under Secretary of State for Competitiveness, Mr Mark Higson and Ms Ruth Hannant, **Department for Trade and Industry**

List of written evidence

- 1 Association of International Courier and Express Services (AICES)
- 2 British Chambers of Commerce,
- 3 Campaign for Community Banking Services
- 4 Communication Workers Union
- 5 Communication Workers Union (Supplementary)
- 6 Department of Trade and Industry
- 7 Direct Marketing Association (DMA) UK Ltd
- 8 Federation of Small Businesses
- 9 Intellect
- 10 Mail Competition Forum
- 11 Mail Competition Forum (Supplementary)
- 12 Mail Users' Association
- 13 National Federation of SubPostmasters
- 14 Periodical Publishers Association
- 15 Postcomm (The Postal Services Commission)
- 16 Postcomm (Supplementary)
- 17 Postwatch
- 18 Postwatch (Supplementary)
- 19 Postwatch (Supplementary)
- 20 Royal Mail
- 21 Department for Trade and Industry (Supplementary)