

The Trade and Industry Committee

The Trade and Industry Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department of Trade and Industry.

Current membership

Peter Luff MP (*Conservative, Mid Worcestershire*) (Chairman)
Roger Berry MP (*Labour, Kingswood*)
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Mr Peter Bone MP (*Conservative, Wellingborough*)
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Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/parliamentary_committees/trade_and_industry.cfm.

Committee staff

The current staff of the Committee are Elizabeth Flood (Clerk), Grahame Allen (Inquiry Manager), Clare Genis (Committee Assistant) and Joanne Larcombe (Secretary).

Contacts

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Eleventh Special Report

The Committee published its Second Report¹ of Session 2005–06 on 20 December 2005. The Government's response was received on 15 February 2006 and that from Postcomm was received on 17 February 2006. They are published as Appendices to this Special Report.

Appendix 1: Government Response

Introduction

The Government welcomes the Committee's report on Royal Mail after liberalisation. The decision taken by Postcomm to fully open the postal services market from 1 January 2006 has attracted much public debate and it was highly appropriate for the Committee to investigate.

The Government's ambition is to see a publicly owned Royal Mail fully restored to good health, providing customers with an excellent service and its employees with rewarding employment.

Responses to Conclusions and Recommendations

Below we have set out our responses to the conclusions and recommendations that are directed towards Government and where we believe that it would be appropriate for Government to respond. We reproduce the conclusions and recommendations as they appear in the report. Our response is set out below each of them.

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)

We confirm that the Government will continue to push for full liberalisation in the European Union as early as possible and welcome the Committee's support. Indeed, Barry Gardiner has very recently been having meetings in Brussels with other Member States and the Commission to promote this outcome. We will be doing so in the context of European Postal Commission proposals due to be submitted to the European Parliament and Council by the end of 2006. The indicative date for full liberalisation remains 2009.

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)

¹ Second Report from the Trade and Industry Committee, *Royal Mail after liberalisation*, Session 2005–06, HC 570-I

We agree that it is important for Royal Mail to benchmark its performance against other national postal operators in the European Union. The establishment of a formal set of EU-wide statistics on the quality of postal services is an issue that would be best discussed in the context of the next Postal Services Directive. DTI will seek to ensure that the issue forms part of the deliberations for the new Directive.

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)

The opening of the postal services market will give customers new choices between operators, and they should be able to do so in part on the basis of operators' record on quality of service. But they will only be able to do so effectively if customers of licensed postal service operators have full confidence in any statistics on quality of service published by those operators. The operation of the market is a matter for Postcomm and the Secretary of State would look to the regulator to ensure that quality of service targets published by licensed postal operators are robust and reliable. The regulator should consider all options to ensure this is done effectively.

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)

As we have previously informed the Committee, the Government is opposed to the imposition of VAT on stamps. As the Committee is aware, any changes to the EU VAT Directive, which provides exemption for services provided by the 'public postal services', would require the unanimous agreement of all Member States.

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)

The Government ensured that the provision of the universal postal service was at the heart of the reforms introduced under the Postal Services Act 2000. The provision of the universal postal service is indeed Postcomm's primary duty and must be fully taken into account in all its decision making. The Government agrees that the regulator must remain vigilant in fulfilling its primary duty. Postcomm has assured Ministers that the full liberalisation of the postal services market will not adversely impact on the provision of the universal postal service.

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)

DTI is currently working with Royal Mail to assess the impact of Postcomm’s final price control proposals and to identify, if any, the company’s future funding requirements. The Government, as shareholder, will only consider investing in Royal Mail if there is a commercial case for doing so. The Government will also have to assess the affordability of any investment against other Government priorities. As part of this process, the Government will consider whether the continuation of the nil-dividend policy, introduced at the beginning of Royal Mail’s renewal plan in 2002, would be appropriate for the shareholder and the company.

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)

Under the External Funding Limit arrangements, “dividends” were not paid to the Government. The accumulated EFL surpluses and cash generated by the business were retained on the Post Office balance sheet in the form of deposits with the National Loan Fund and Government gilts. In 2002, the Government announced that it had agreed to forego the projected dividend for 2001/2 and to suspend the current dividend policy during the three years of the renewal plan.

The Committee has heard different views on Royal Mail’s financial position from the company and Postcomm. As mentioned above, the Government will, in the context of Royal Mail’s overall future funding requirements, consider whether the continuation of the nil-dividend policy would be appropriate for the shareholder and the company. We would also have to consider this in the context of the state aid rules.

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)

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)

We are interested in non-privatisation options that could increase workers' involvement. One possibility might be an employee stake. We think this is at least worthy of examination in the context of publicly owned business where employee shares could not transfer to non-employees. The Government has not received any firm proposals from the company about an employee share scheme and would need to see a sound investment case showing that such a scheme would improve productivity levels in the company.

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)

The Department apologises that the fact that the timing of the submission of supplementary information made the preparation of the report more difficult. This was not our intention and we can assure you that future requests for information will be dealt with promptly and will comply with any deadlines given.

Appendix 2: Postcomm Response

Introduction

Postcomm welcomes the Committee's report on Royal Mail after liberalisation. We are pleased that the Committee recognises the real benefits that competition is already bringing to postal services and supports the way we are formulating our price control proposals, particularly in relation to the pension fund deficit. We would like to confirm our determination to create a competitive postal market that delivers real benefits to customers, with a healthy Royal Mail at its heart.

A number of the conclusions and recommendations relate to the DTI. We have dealt solely with those conclusions and recommendations that are relevant to Postcomm, using the numbering as it appears in the report.

Timing of liberalisation

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)

Postcomm welcomes the Committee's assessment that liberalisation is already delivering an improved service for customers. We believe that Royal Mail's proposed price control, which is due to come into effect on 1 April 2006, will give the company the commercial certainty it needs to move forward in a liberalised market. Indeed the current price control proposals allow Royal Mail over £1bn for capital investment.

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 comparative merits of all postal service operators in the UK. (Paragraph 40)

Postcomm agrees with the Committee's view that availability of information to customers and potential customers will be essential to the development of effective competition. However, postal operators need the commercial freedom to be able to respond to customers' demands for different types of products with different levels of performance.

New postal operators are required by their licence to establish systems adequate for measuring (using sampling methods if appropriate) and recording their performance in achieving their contract targets. They are also required to establish systems for recording, analysing and responding to complaints in respect of failure to achieve the contract targets and in respect of services provided generally.

Postcomm will continue to work with licensees and Postwatch on how best to provide information which is useful to customers, does not damage the ability of licensees to compete in the market, does not distort the market, and is not too costly to provide. Postcomm understands that Postwatch intends to publish information on performance standards and complaint handling once an appropriate format has been satisfactorily agreed.

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)

Postcomm is sensitive to the Committee's concerns, however, in line with the Government's policy on Better Regulation, we do not want to impose undue regulatory burdens on new operators. Getting statistics audited independently is likely to impose administrative and financial costs on new operators. At present, we do not believe that a mandatory requirement to get quality statistics audited is proportionate, given the lack of evidence of customer harm in this area. However, we will monitor this arrangement while working with licensees and customers to establish a common approach to such statistics.

Royal Mail's VAT exemption

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)

Postcomm does not 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. However, we consider Royal Mail's unique VAT exempt status to be a significant distortion of the market, and not necessary for the continued provision of the universal service. This view is reflected in the results of Postcomm's 2005 business customer survey.

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)

Postcomm supports the Committee's view that the universal postal service should evolve over time. Our recent decision on the definition of the universal service (on which we are still awaiting Royal Mail's response) was the result of a two year consultation process with a wide range of stakeholders about what they want. As time goes by, customers' needs change and technology progresses, meaning that the universal service definition will require periodic review to ensure it continues to reflect customer needs.

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)

As mentioned above, Postcomm will periodically review the definition of the universal service, listening to all stakeholders. In addition to this, we plan to review the very limited exceptions to the requirement on Royal Mail to provide a daily collection and delivery nationwide to ensure that the arrangements meet the needs of customers.

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)

Postcomm welcomes the Committee's assessment that opening the market does not pose an immediate threat to the universal service. Acting in a manner best calculated to ensure the universal service is our statutory duty and we carefully consider the potential impact of every policy decision on the universal service. We also monitor Royal Mail's financial viability on an ongoing basis, and remain ready to respond to any threats to the universal service.

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)

We are pleased to report to the Committee that since the hearings in autumn 2005, Royal Mail has notified us that mail volumes rose again for the period. However, this is an area of uncertainty that will always be present. To recognise this, Postcomm has, as the Committee has noted, proposed an automatic mechanism to adjust revenues if volumes deviate significantly from its forecasts. This means that customers will benefit through lower unit prices if volumes are higher, while Royal Mail will receive additional revenue per

unit if volumes are lower than forecast. Postcomm understands that the broad rationale for its proposal is supported by Postwatch and Royal Mail.

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)

The current price control and Postcomm’s proposed new price control include mechanisms that allow Royal Mail to ask for the price control to be re-opened if its financial position is significantly adversely affected, and particularly if this puts at risk the continued provision of the universal service. Postcomm would assess any such request from Royal Mail as a matter of priority.

Review of Price Controls

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)

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)

Postcomm welcomes the Committee’s support for the RPI-X form of price control. Postcomm believes that this form of control provides a strong incentive for Royal Mail to make efficiency savings where these are available, as has been demonstrated during the current price control, which Royal Mail has out performed, and in other regulated industries.

Pension Fund deficit

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 fund deficit at some point in the future, once Postcomm’s price control proposals have been enacted. (Paragraph 107)

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)

Postcomm welcomes the Committee’s views and recommendation on this issue. The pension deficit is a crucial issue for the ongoing financial position of Royal Mail. Postcomm has recognised this, and the need for the issue to be addressed, by asking customers, within the price control proposals, to contribute over £300m a year to reducing the deficit. In addition to this very significant contribution by customers, Postcomm believes that other stakeholders need to contribute to addressing the issue, and in particular, if Royal Mail generates free cashflow/ profit then it would be prudent for at least some of this cash to be used to make additional contributions to reduce the pension deficit, in a similar way to other companies with large pension deficits.

Capital investment

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)

Postcomm welcomes the Committee’s support for Postcomm’s proposal to allow additional capital expenditure for Royal Mail. The principal reason for the additional allowance in the final proposals is that Royal Mail provided much better quality information to show that it had properly assessed its investment requirements and developed financial cases to support the investments. Postcomm’s price control proposals do not assume a specific contribution from other stakeholders to fund this investment over the period of the price control.

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)

The current price control and Postcomm’s proposed new price control include mechanisms that allow Royal Mail to ask for the price control to be re-opened if its

financial position is significantly adversely affected, and particularly if this puts at risk the continued provision of the universal service.

Postcomm's price control proposals allow Royal Mail to make substantial capital investments, with an allowance for £1.2bn over the period of the price control. If Royal Mail's financial cases for each investment are robust then it will be able to fund these investments. If the investments are not expected to deliver a positive financial return then Postcomm would not expect Royal Mail to implement the investments.