A PENNY ON THE POST TOO LITTLE, TOO LATE, TOO INTRUSIVE

IAN SENIOR

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Too little, too late, too intrusive

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TABLE OF CONTENTS

REF: Ian Senior/87/29-4-03/C:\PUBLICATIONS\IEA\POST OFFICE (WEBSITE ARTICLE)\PENNY ON THE POST.DOC

1 THE ROYAL MAIL GROUP IS IN DEEP FINANCIAL TROUBLE

1.1 Identity crisis

This paper is concerned with the problems underlying the main business of the Royal Mail Group ("RMG")— delivery of letter mail — and whether the regulatory regime of the Postal Services Commission ("Postcomm") is making things better or worse. The acronym RMG is used to mean the holding company and Royal Mail is used to mean the business operation that delivers letters.

What used to be known as The Post Office has changed its name twice since the turn of the century. Briefly it became Consignia, an invented name that threw away the huge value of The Post Office brand. Then, under its new chairman, Allan Leighton, Consignia became The Royal Mail Group. This is a strong brand name even if it is imprecise because RMG covers Royal Mail, Parcelforce, Post Office Counters and GLS Holdings, a German and pan—European parcel service. In fact these services have surprisingly little overlap. Only a small proportion of parcels is handed in at counters; only a moderate proportion of counter transactions relate to mail; and only a very small proportion of UK parcels carried by Parcelforce go from the UK to Germany and *vice versa*. In essence, mail, counters, domestic parcels and German parcels are all separate businesses. The three UK businesses have operated as such for 20 years or so.

1.2 Confused aims, confused management, confused stakeholders

For much of the 20th century the then "Post Office" did its main tasks to the reasonable satisfaction of the public, its customers and its owners, the government. During the '90s about 90 per cent of first class letters were delivered the next working day; there was a generous though declining network of crown offices and sub-post offices; and parcels were delivered fairly reliably though always unprofitably. Thanks to the letter monopoly the Post Office overall was profitable and was required by the government to lend its surplus cash to the Treasury. By European standards it was a success story compared with heavily loss-making postal administrations in countries such as Germany, France, Italy and Spain.

Suddenly, in the final years of the 20th century, everything unravelled. Quality of service, measured by next working day delivery of first-class mail, dropped sharply. Industrial relations deteriorated with local unofficial strikes by postal workers becoming commonplace. Above all, the once profitable Post Office started to make huge losses.

2 THE MAIN PROBLEM: POOR MANAGEMENT

2.1 From profits to losses

Table 1 following shows the operating losses of RMG for the past three years. The loss of £275m in 2000 was largely explained by a substantial write-off on Post Office Counters' Horizon project to automate counters. The proposed automation of paying pensions and other state benefits over the counter had to be dramatically scaled down when the government understandably concluded that the most efficient way to pay benefits is by electronic transfer rather than cash.

The accounts for 2002 were disastrous. The figures for mails and parcels are combined but they should not be because Parcelforce competes with the private sector. Now it is impossible to know the extent of the subsidy from letters to parcels, yet any subsidy is illegal under EU law. Together the two services moved from a profit of £237m in 2000 to a loss of £956m. Counter services, which in the '90s produced modest profits each year, made a loss of £238m. Were it not for the cash reserves that the Post Office had lent to the Treasury in the '90s, the company would have been insolvent. These reserves have been retrieved from the Treasury and have been used to plug a vast hole in the side of the then sinking ship. For a company with a monopoly of a valuable market — mail — to make a massive loss of £956m in 2002 shows highly incompetent management, ill-conceived and intrusive regulation, or both.

Table 1

RMG's results, 2000 – 2002, £m

	2000	2001	2002
Mails and parcels	237	-5	-956
Counter services	-525	-53	-238
Other businesses	13	-12	7
Group operating profit (loss)	**-275**	**-70**	**-1,187**

Source: Annual accounts

2.2 The Internet revolution and the future of "snail mail"

What caused these losses and how did they catch RMG's management unawares?

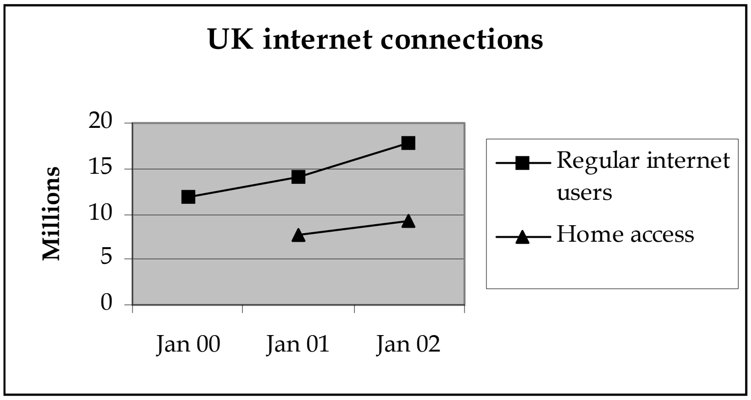
Firstly, we can exonerate the e-mail and text message revolution. In general e-mails and texts represent communications that are additional to — and not substitutes for — traditional letters. Both are substitutes for telephone calls. E-mails are usually short and text messages shorter still. E-mails are effectively costless however many are sent. Text messages sent by mobile telephone cost around 10p depending on the carrier, and their price is falling. The volume of e-mail traffic will continue to rise rapidly.

The Government's current "UK Online" campaign aims to have the total population online by 2005. Regular internet users have increased from 11.8 million in January 2000 to 17.9 million in January 2002. The number of homes with Internet access rose between January 2001 and January 2002 from 7.6 million homes (31%) to 9.3 million homes (38%).[1]

1 Continental Research. Report "Internet 2002".

Chart 1

UK. Internet regular users and home access, January 2000 -2002



All but the smallest businesses are now on e-mail and the number of private individuals connected to the Internet will continue to increase. Saturation will be reached when only the old, the poor and the illiterate do not have access to a PC and hence the Internet. Today's non-computer literate senior citizens will be replaced by tomorrow's computer literate senior citizens who will have used PCs and e-mails at work and will have come to depend on them. Thus only the poor and illiterate will remain as non-users and they send few letters anyway.

E-mails can carry attachments in the form of documents that previously would have been sent by post. These represent close substitutes for traditional letters and are reducing demand for first-class mail. The cost of sending a 100 page, fully formatted report by e-mail to 50 people is zero! The transmission time by broadband is a matter of seconds rather than minutes. Printing the report by recipients is a matter of minutes. By contrast, the same report sent by mail would cost £120 in postage. 10 per cent of the consignment of 50 envelopes would not be delivered the next working day. By e-mail, 100 per cent are delivered within seconds and a notification is sent automatically by the system about any that have not reached their addressees' in-boxes.

E-mail eliminates the inconvenience to the sender of printing, binding, enveloping and despatching 50 copies of the report. Further, many recipients may not want a hard copy of the report anyway. Some may skim it on screen and print just the executive summary. Others may store the report on a CD saving much physical storage space and waste paper. It is inevitable that e-mail will ultimately replace the bulk of individual-specific mail, leaving direct mail (sometimes called junk mail) to compete with other advertising and marketing media.

As seen in Table 2 the volume of first class mail is static but direct mail continues to grow. This growth will cushion the decline of paper-based mail which seems inevitable but which is likely to take much longer than has often been predicted.

The problem remains that direct mail itself may be overtaken as access to the world wide web becomes faster through broadband transmission. Direct marketing mail has a unique selling point: it lands the information on prospects' doormats instead of requiring prospects to search the web. At present this unique selling point counterbalances the obvious advantages of viewing information on the web.

The stagnation of first-class mail and the increasing reliance on second-class mail has been predictable for several years and is now occurring in the UK and elsewhere. The mix represents less added value overall. Before long, as the volume of first class mail falls, RMG will find its market is in decline, both in volume and value.

Table 2

Royal Mail traffic, 1996/97 – 2000/01

Category	1996/97 Billion Items	1997/98 Billion Items	1998/99 Billion Items	1999/2000 Billion Items	2000/01 Billion Items
Inland First Class	5.8	5.9	5.9	5.9	5.9
Inland Second Class	10.5	11.5	12.1	12.8	13.2
Total Domestic	16.3	17.4	17.9	18.7	19.1
International mail	0.8	0.8	0.8	0.8	0.8
	17.0	18.2	18.8	19.6	19.9
Growth		*7.1%*	*2.9%*	*4.3%*	*1.5%*

Source: Triangle Management Services. "UK Mail Report 2002"

2.3 Market liberalisation

In 1970 I argued that the letter monopoly should be abolished.[2] At the time this was considered unthinkable. The Post Office's defence remained unchanged for the next 30 years. They argued that that the monopoly was essential for the provision of universal service; that market liberalisation would permit cherry-picking by new entrants; that they would be left with a residual, unprofitable business and would cease to trade. Roughly speaking, they predicted the end of civilisation as we know it.

Only in the late '90s were cogent attempts made to quantify the net cost, if any, of universal deliveries, and the figures obtained were surprisingly small. For example a study for the European Commission in 1998 estimated the net avoidable cost of universal delivery in the UK at 1997 prices to be only €20m (£13m) with a further cost of €7-17m (£5-11m) for Braille and related items. The study made no estimates of the substantial competitive *benefits* of providing universal delivery that would have been set against the costs.[3]

In 2001 the Postal Services Commission ("Postcomm") used more detailed Royal Mail data and estimated the net avoidable cost to be about £70m per year, again without estimating the competitive benefits.[4] At a recent conference Graham Corbett, Chairman

2 Senior I. "The postal service. Competition or monopoly?". IEA background memorandum 9, 1970

3 NERA. "Costing and financing of universal services in the postal sector in the European Union.", October 1998

4 Postcomm. An assessment of the costs and benefits of Consignia's current Universal Service Provision: A Discussion Document - June 2001

of Postcomm, stated that the direct operating costs of letters were covered in all areas of the UK, including those that are most sparsely populated.[5]

Meanwhile Sweden and New Zealand went ahead and abolished the legal monopoly. Disaster did not occur. Competitors came to the market offering mainly localised services and many left. Universal delivery continued under commitments imposed on the incumbents by the authorities but these would probably have continued to provide universal service anyway because of users' requirements. Spurred by competition, incumbents made improvements in the quality of service. Staff numbers were reduced, mainly by natural wastage. Both incumbents remained profitable, though less so than when they had the letter monopoly.

2.4 The European Commission

In 1997 the European Commission issued Directive 97/67 whose purpose was to open the letters market to competition in a controlled way. The basic concept was that incumbents would retain a letter monopoly restricted to just part of the total letters market. In practice this meant the lighter weights. This "reserved area" would provide enough profit to subsidise deliveries to sparsely populated, loss-making areas.

A second key element of the directive was that incumbent post offices should not be allowed to use profits from the reserved area to cross-subsidise their services such as parcels that compete with the private sector.

A further directive was issued in June 2002[6] under which member states should open the following market segments to competition:

- from 1st January 2003:
  - delivery of letters weighing more than 100g or costing more than three times the price of a standard letter
  - all outgoing cross-border mail
- from 1st January 2006:
  - delivery of letters weighing more than 50g or costing more than two and a half times the price of a standard letter.

In the course of 2006 there will be a study of each Member State assessing the impact on universal service of full accomplishment of the internal market for postal services in 2009.

It is clear from both directives that the European Commission wishes to open up, though not necessarily fully liberalise, the EU's postal market. It aims to create a postal market that is harmonised as to the maximum reserved areas that can be permitted by member

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5 IEA postal conference, Barcelona, 17-18 March 2003

6 Directive 2002/39/EC. "Amending Directive 97/67/EC with regard to the further opening to competitions of Community postal services". 10 June 02

states. Individual states are allowed to make their reserved areas smaller or to abolish them entirely. The authorities in the UK, Germany and the Netherlands have announced that their postal markets will be fully liberalised by 2007.

2.5 Postcomm

The 1997 directive was transposed with some variations into the UK's Postal Services Act, 2000. This created the Postal Services Commission ("Postcomm") and a consumer council known as Postwatch. Only Postcomm has authority. Postwatch, as its name implies, has a watching brief. The UK may be unique in having a consumer authority specific to postal matters.

The act requires Postcomm to preserve the universal service but also to bring competition to the postal market. In a later part of this paper I discuss the way in which Postcomm is interpreting its brief. For the moment it need only be said that although Postcomm is now issuing licences for competitors to enter parts of the postal market, the licensees have barely begun operations in the field. Therefore neither they nor Postcomm can take any responsibility for RMG's lurch from profit to loss in the period 1999 to 2002.

2.6 Royal Mail's failed management

We have eliminated the e-mail revolution and the embryonic start of competition as possible explanations for Royal Mail's recent catastrophic financial performance. The buck therefore must stop with its management. Seemingly they did not notice that revenue was rising more slowly than costs. If they did, they failed to take action to raise prices, reduce costs or both.

As an example of how poor Royal Mail's management was, consider the second daily postal delivery. Most business areas and urban residential areas had a second delivery between 11.00 and 14.00. The second delivery was always much lighter than the first and frequently consisted mainly of second class mail. When Royal Mail realised that it was set to make big losses it turned its attention to the second delivery. It then discovered that the second delivery accounted for four per cent of the volume of letter mail and absorbed about 20 per cent of delivery costs. Clearly the second delivery was uneconomic and should be scrapped.[7] This finally has been done. The wonder is that Royal Mail's management was so blind to the second delivery's cost structure for so long.

What of the first (now only) delivery? Historically Royal Mail has aimed to do the delivery between 7.00 and 9.30 every morning including Saturdays. Again Royal Mail's management has overlooked the obvious point that residential customers mind far less about the time of the first delivery compared with its reliability. Those who go to work typically leave home before 8.00, and even if the mail has arrived, they have no time to deal with it. For people who do not go to work, the time the mail arrives is of little importance. Almost the only form of time-sensitive mail these days is birthday cards which may be nicer to receive at 9.00 a.m rather than in the afternoon. Yet how absurd it is to structure a delivery system around birthday cards!

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7 See Senior, I. "Consigned to oblivion. What future for Consignia? Adam Smith Institute, January 2002, p8

Perhaps for some businesses the arrival and distribution of the post first thing is part of their working practice, but they must be a dwindling number. Letters that are truly time-sensitive can now be sent by e-mail. If the original document is essential, say a legal contract, an express delivery at a premium price may be warranted. Firms such as lawyers make use of Hays DX, a document exchange system that delivers virtually 100 per cent of items to the addressees' document exchange by 9.00 a.m. For the rest, the concept of mail before 9.00 is far less important than that it will be delivered on the working day after it has been posted. Even the-cheque-is-in-the-post syndrome is of diminishing importance. Many private individuals pay by credit card over the telephone and businesses increasingly pay by credit transfer using the Internet.

Traffic of any sort is handled most economically if the process is smooth rather than lumpy. Postal deliveries could be more economical if done smoothly between 8.00 a.m. and 4.00 p.m. This would be a more efficient use of labour and more attractive to delivers who for years have considered early starts and split duties during the day to be an unsocial working practice.

Replacing the two deliveries with a single longer delivery has belatedly been adopted by Royal Mail and pilot schemes are in place. No formal announcement has been made about the time at which the single delivery will be completed.

A further change is needed so that the single delivery provides *better* value than the previous two deliveries. Every postbox in the country should be marked with the time of posting needed so that first-class letters achieve 100 per cent next day delivery. In most boxes this will be at 5.00 pm. Only in rural and very sparsely populated areas will a cut-off point around noon be necessary.[8]

2.7 Why Royal Mail's management failed to notice the obvious

What was wrong with the Post Office's management during the turn of the century? Quite simply its primary goal had remained unchanged for a century and a half: it was to preserve the letter monopoly and to fight off market liberalisation at any cost. So long as the letter monopoly remained, the Post Office could make profits. It could cross-subsidise the parcel service that had made losses for as long as can be remembered. Above all, it could lead a quiet life. It did not need to think about internal efficiency. In 2001 an internal report carried out for Consignia by Lord Sawyer, a formal general secretary of the Labour Party, stated:

> "The levels of inefficiency in the business, despite our best efforts to control them, are crippling us…We are now living beyond our means and we need to get a grip of this now".[9]

Where does the buck stop? With the chairman, the board and the CEO. The Post Office has gone from substantial profits to near catastrophic losses, and folowed a restructuring plan involving the loss of 30,000 jobs out of 218,000 (about 14 per cent),

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8 This reform of the delivery system was suggested in Senior I: "Consigned to oblivion. What future for Consignia?". Adam Smith Institute, January 2002 when the extent of Consignia's financial crisis was becoming apparent.

9 BBC News Website, 3 October 2001

and the disastrous concept of rebranding the well-known and generally liked Post Office into Consignia.[10]

In addition under its leadership the Post Office bought a number of overseas businesses which were often small and for which high prices were paid. At least one of these, CityMail in Sweden, was later sold as unprofitable. Industrial relations were deplorable with unofficial strikes and the Post Office contributing the lion's share of total days lost nationally. Unlike most other postal administrations, the Post Office made no attempt to harness the Internet's technology for its own purposes.[11]

Allan Leighton took over in January 2002 as part-time chairman. A specialist in turning round failing companies he appointed Adam Crozier as RMG's new chief executive. Mr Crozier's previous jobs were in advertising (Saatchi and Saatchi) and he was also chief executive of the Football Association. During his time at the FA the average age of its staff fell from 55 to 32.[12] Another important appointment has been that of Elmer Toime as Deputy Chairman. Previously he was chief executive of New Zealand Post and can claim great credit for NZ Post's success story.

It remains to be seen how quickly the three men can prune the executives and non-executives responsible for turning a profitable company into a loss maker, spent years trying to prevent any erosion of the letter monopoly, introduced the name Consignia and allowed inefficiency to run rife in the organisation. Many senior managers have had their contracts changed to two or three year fixed terms. This will have the effect of putting them on notice that they must deliver a better performance or leave.

3 HOW POSTCOMM IS IMPLEMENTING THE GOVERNMENT'S BRIEF

As noted, the Postal Services Act 2000 transposed directive 97/67/EC into British law. The government's main aim was to safeguard a universal service of collecting and delivering letters while allowing competition to enter the market. At the same time the Act contains some features that were not required by the directive. The main ones follow with brief comment.

3.1 Uniform tariff

The Act lays down that there should be "a public tariff which is uniform throughout the United Kingdom." The directive has no such requirement.

In the past 30 years the concept of a uniform tariff has been more fiction than fact. *Individuals* have paid a uniform tariff for letters within defined weight steps, but senders of *bulk mail* have received big discounts in particular for pre-sorted mail. Having a notionally uniform tariff is administratively convenient but there seems no necessity to write it into law. We accept that the tariff for utilities such as water, gas and electricity — which are all far more essential than mail — should vary from supplier to supplier.

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10 See Senior, I. "Consigned to Oblivion: what future for Consignia?". Adam Smith Institute 2002, p3

11 Ashworth J and Buckley C. *The Timesi* 19 April 2003, p58

12 http://news.bbc.co.uk/sport1/hi/football/2376331.stm

Why should a postal tariff be legally uniform? The answer is that politicians with rural constituencies believe that it is electorally advantageous.

The Postal Services Act does not address the technically complex question of a tariff for downstream access by big mailers to Royal Mail's final mile delivery network. Postcomm is currently grappling with this vexed issue in which Royal Mail would like to see a high tariff while other operators and potential competitors would like a low one. An important issue will be whether the access tariff finally set is uniform or is permitted to vary locally according to population densities.

3.2 Social engineering

Within the Postal Services Act Postcomm is tasked with overt social engineering.

> "The Commission shall have regard to the interests of —
>
> (a) individuals who are disabled or chronically sick,
>
> (b) individuals of pensionable age,
>
> (c) individuals with low incomes, and
>
> (d) individuals residing in rural areas,
>
> but that is not to be taken as implying that regard may not be had to the interests of other descriptions of users."[13]

Making special concessions for particular groups is a form of redistributing income, however modest. I hold to the view that any form of redistribution should be done through taxation rather than by placing obligations on Royal Mail or indeed any other for-profit concern. Many companies spontaneously make charitable donations but they should not be compelled to do so by law. Royal Mail should be no exception.

So far Postcomm has done little about its statutory requirement concerning social engineering and with luck the requirement will sink into oblivion. Expenditure on postage by individuals other than at Christmas is a tiny part of their total expenditure. Even a simple, broad-brush scheme, for example entailing cut-price stamps for pensioners, would need to be monitored to prevent entrepreneurial pensioners buying stamps in bulk and selling them on to retail outlets. Should ration books for pensioners' stamps be introduced? Or should special pensioners' stamps be printed, saleable only on presentation of an identity card with a hologram, smart chip, photograph, finger prints and DNA details? The absurdity of this section of the Act is clear.

4 A PENNY ON THE POST: TOO LITTLE, TOO LATE, TOO INTRUSIVE

4.1 Monopolies are inherently inefficient

In competitive markets the prices charged by different suppliers and the quality of service they offer are left to the market to decide. However, the examples of full postal liberalisation in New Zealand and Sweden suggest that even after 5-10 years the

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13 Postal Services Act 2000, Section 5

incumbent retains about 95 per cent of the postal market. Does it therefore follow that Postcomm should exert direct control over Royal Mail's prices and quality of service?

A core tenet of economics is that monopolies of any sort are inefficient. The theory of why this should be so is well developed and is supported by empirical work as well as casual observation. The simplistic case for having a postal regulator is simply to ensure that the incumbent does not abuse its monopoly power and that a level playing field is maintained when new entrants come to the market. A point that too often is overlooked is that if incumbents can abuse their power so too can regulators. This can be by over-intrusive regulation on the one hand or inaction on the other.

4.2 Quality of service

Quality of service in delivering first-class letters is measured by the percentage delivered on the next working day. For some time Royal Mail has had a target of 92.5 per cent as a national average. As discussed earlier, having an extended single delivery could increase the percentage to 100 per cent. The current target for second class mail is that 97.5 per cent should be delivered within three working days of posting.

Setting performance targets is a standard tool in the management of every kind of organisation these days. Royal Mail's delivery targets seem acceptable and should easily be achieved if the time-span of the single daily delivery is increased. However, Postcomm's threat — as yet not implemented — to fine Royal Mail if targets are not met is far from acceptable. The main flaw is that the fines would be arbitrary and would not benefit postal users because they would be punitive and not compensatory. Rail operating companies who fail to meet performance targets rightly compensate their passengers directly by giving rebates on their next season tickets for the inconvenience and costs incurred.

By contrast, as noted, the majority of first-class letters are not time sensitive and it is therefore hard to argue that recipients have suffered quantifiable inconvenience or damage if a letter arrives a day late. The same applies with greater force to second class mail. I suggest that while it is right that Royal Mail publishes independent data on the quality of its delivery service, the concept of fines by Postcomm is wrong in principle. Further, if fines for failure to meet targets are to be imposed they should be matched symmetrically by rewards paid by Postcomm to Royal Mail for delivery performance that exceeded the targets. It is unlikely that the Postcomm would be happy at paying cash rewards to Royal Mail for beating its targets.

4.3 Price control

Prices are signals set by suppliers of goods and services that enable markets to clear. For years price controls were the hallmark of the Eastern bloc's command economies which reduced millions to poverty before the regimes collapsed in the early 1990s under the weight of their economic failure. In the '60s British Labour governments flirted briefly with centralised planning including a Prices and Incomes Board that later was upgraded to become the National Prices Commission. Having prices controlled by functionaries proved as pointless in the UK as it did in Central and Eastern Europe.

After months of haggling and consultation, Postcomm finally granted an increase of just one penny on the basic price of first and second class mail.   The new prices were delayed to 8 May 2003 by the convoluted consultation process.

With around 80 million letters carried daily, and assuming that Royal Mail captures the increase of 1 penny in full by not changing its current prices to bulk mailers, the additional revenue per day becomes £800,000. Over the past year or more RMG has regularly announced that the group has been losing £1.0 – 1.5 million per day, so it is clear that the additional penny postage that Postcomm had granted is too little, too late.

To support this contention, Table 3 following shows the price of basic letters in a number of countries. The UK does not have a lower tariff for letters up to 20g, so the second column — letters up to 60g — is the more useful comparator. It shows that even with a first class stamp at 28p the UK's rate will still be the lowest apart from New Zealand and Spain.

The second part of Table 3 shows a simple measure of productivity: the number of addressed letters delivered per day divided by the number of staff. Unaddressed mail has been excluded because it requires no sorting. Bundles can be given to delivery offices. No delivery skill is needed and the work can be done by cheap, part-time labour.

From the table it can be seen that the US Post Office and TPG Netherlands (the Dutch incumbent) exceed Royal Mail's productivity, Deutsche Post is at about the same level and the other administrations are worse.

Table 3

Some price and productivity comparisons between postal administrations

Price of a letter, UK pennies

	Up to 60g	Up to 20g
Germany	50	39
Sweden	46	36
Finland	39	38
France	37	32
Neths	34	26
USA	28	23
UK	27	27
Spain	21	19
New Zealand	13	13

Productivity - addressed letters per employee/day

USA	157
Netherlands	143
Germany	87
UK	86
Sweden	78
France	73
Denmark	69

Source: Postcomm. "The UK Postal Regulatory Regime". 14 April 2003. www.postcomm.gov.uk/index2.html

Postcomm starts from the flawed assumption that low prices are good prices. Initially it froze prices on most of Royal Mail's services including the basic price of first and second class mail. This has been superseded by a new price control regime covering the period to March 2006. Within the overall price cap Postcomm will permit Royal Mail to increase individual prices as long as it reduces other prices to compensate. Postcomm predicts that prices then will have fallen five per cent in real terms by March 2006.[14]

The concept that some prices may be increased (decreased) providing that there is a compensating decrease (increase) in other prices may appear reasonable but is likely to be flawed in practice. The prices within each service must be weighted by the volume of traffic in each service and weight step. For example, if the volume of traffic of 200-250g fell significantly because of a change in prices or for any other reason new weights would then applied to all weight steps. If Royal Mail then tried to align its prices to the new weights, an unstable tariff would result. This would be administratively undesirable and potentially chaotic.

On quality of service, Postcomm is holding to a target that Royal Mail should deliver not less than 92.5 per cent of first class letters on the next working day. Postcomm has the

14 Postcomm. "The UK Postal Regulatory Regime". 14 April 2003. www.postcomm.gov.uk/index2.html

power to fine Royal Mail if the target is not reached. So far Postcomm has not done so because of Royal Mail's parlous position.

Further, there is discussion about making Royal Mail compensate users in delivery areas where targets have not been met. Again this sounds fine in theory but in practice may give rise to significant management time being spent on altercation with individual customers. In our increasingly litigious society there will be lawsuits by large organisations who no doubt will argue that their human rights have been abused if their mail arrives a day late! The complexity of calculating compensation on a mass-mail shot covering the country seems daunting. Though direct mail houses make much of the importance of timing some mail-shots to coincide with commercials on television, intuition suggests that a large part of direct mail, for example charity appeals and bank statements, are *not* time-sensitive to within a week or so.

4.4 Postcomm is squeezing Royal Mail's prices and profits till the pips squeak

Given that prices are being capped so that they fall in real terms while the quality of service target is to be maintained, the direct implication of Postcomm's regime is that Royal Mail will have to increase its productivity if it is to make profits. In theory this sounds desirable given the acknowledged slack in Royal Mail at present. However, Postcomm forecasts that the profit that Royal Mail will make in 2002-03 will be just £80m before exceptional items and pension costs.[15] Given that significant provision must be made for redundancy payments together with potential shortfalls in pension funds that are based on final salaries, it is clear that an operating profit of £80m will be totally inadequate and the final outturn after other items is likely to be a further loss, possibly substantial.

By contrast consider the status of some competing European postal administrations, shown in Table 4. While Royal Mail was staggering into losses its main rivals were becoming profitable, and in the case of Deutsche Post and TPG, significantly so.

Table 4

Profits of selected postal administrations

	RMG			**Deutsche Post**	**La Poste France**	**Swiss Post**	**TPG Neths**
	2000	**2001**	**2002**	**2001**	**2001**	**2001**	**2001**
Mails and parcels	237	-5	-956				
Counter services	-525	-53	-238				
Other businesses	13	-12	7				
Group operating profit (loss)	**-275**	**-70**	**-1,187**	**1,356**	**115**	**86**	**582**

Source: Annual accounts

The contrast between Royal Mail's current lack of profitability and that of Deutsche Post can be considered in the light of a recent detailed study commissioned by the

15 Postcomm. "The UK Postal Regulatory Regime". 14 April 2003. www.postcomm.gov.uk/index2.html

independent US parcel carrier United Parcel Services ("UPS") on the profits made by Deutsche Post and their importance to DP's entire business.[16] The consultants calculated the return on capital employed ("ROCE") as 50 per cent on its monopoly letter business in 2001. By contrast the cost of capital was about 11 per cent before tax. This enormous margin contrasted with an ROCE of 2.5 per cent on DP's express business and a negative return of 0.9 per cent on its logistics business, both of which compete with the private sector.

In simple terms, DP's mail operation is massively subsidising the other two divisions. Such cross-subsidies are illegal under the EU's Directive 97/67. If the European Commission takes note of this flagrant cross-subsidy it may be eight years or so before it makes a case and imposes a fine on DP. By way of case study, in 1994 UPS complained to the Commission that Deutsche Post was undercutting the prices of competitors' parcels and was able to do so only because of the profits from the letter monopoly. In June 2002 the Commission imposed a fine of €907m (£590). This is still being appealed by Deutsche Post who do not expect a final judgement until 2005.[17] Such is the European Commission's pace of administrative justice.

The German regulator has moved a little more quickly. It has ordered price cuts on DP's near-monopoly letters business which is generating large profits that are available for other parts of the business. The price cuts will reduce DP's mail revenue only by €300m (£195m) in 2003.[18] This compares with DP's profits of £1,356m in 2001 (Table 4 above) and can be considered rather modest. It will still leave DP's ROCE on its letters business massively above the cost of capital.

The conclusion to be drawn is that the European Commission is dilatory and ineffective in enforcing its postal legislation. The German regulator, though quicker to take action, is allowing DP to make substantial and excessive profits from its near-monopoly mail business.

Meanwhile, in the UK, Postcomm is doing the opposite. It is of concern that Postcomm should adopt a policy of super-stringency in relation to Royal Mail while in Germany the opposite is happening. Postcomm is handicapping Royal Mail's ability to compete in Europe and laying Royal Mail open to a takeover by Deutsche Post should RMG be privatised. By ignoring what is happening in the rest of Europe, Postcomm is failing in its duty to British taxpayers who are the shareholders of last resort if Royal Mail becomes insolvent.

Taking Postcomm's strategy as a whole we have:

- direct intervention on quality of service with the threat of fines or complex compensation if targets are not met;
- direct intervention on prices, capping them at a level that will leave them well below those of other European incumbents and threatens to make Royal Mail insolvent;

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16 NERA. "The profitability of the mail division of Deutsche Post. A report for UPS". April 2003

17 Reuters. 25 March 2003.

18 NERA. *Ibid*. See Conclusions, p32.

- a faster liberalisation of Royal Mail's domestic market than is occurring in most other EU states; and
- an isolationist strategy towards Royal Mail that takes no account of what is happening elsewhere in the EU.

Together this strategy creates a clear risk of making Royal Mail, RMG's flagship, seriously unprofitable during the next crucial years. At the same time Parcelforce remains loss-making and Counters are not only loss-making but faced with falling demand for the services they offer.

Taken together, direct intrusion by Postcomm into how Royal Mail is managed imposes a new tier of authority over and above the Royal Mail board. The regulator is assuming managerial power without responsibility. Postcomm is in danger of losing sight of its most important tasks namely:

- maintaining universal service;
- bringing competition to the domestic letters market;
- ensuring a level playing field for companies competing in the UK letters market; and
- permitting Royal Mail to compete successfully in the EU without both hands tied behind its back.

4.5 The need to convert Royal Mail, Parcelforce and Counters into separate companies and abolish RMG

There is no economic case for keeping mail, parcels and counters under one holding group. RMG's accounts now hide parcels' losses, which is illegal and unfair to the competing private sector. Parcelforce does not have to charge VAT, another unfair advantage.

The future role of Counters is crucially dependent on what governmental business it is asked to transact. There is no case whatever for profits or losses on Counters to impact on RMG. In essence, the separation of mail, parcels and counters should be made total in the form of three separate companies.

Parcelforce should be required to become profitable, failing which it should be sold off or closed down. There is no case for government to own a parcels business.

The future of Counters should be transparently determined by government decision. Counters — confusingly now renamed Post Office Ltd — currently receives a government grant of £150m per year, which will run for three years. After that, if the government of the day wishes transparently to continue the grant, that may be acceptable within the democratic process. As noted earlier, the present government is actively encouraging the British nation to get on-line in order to transact as many operations electronically rather than manually. This policy runs in the opposite direction to maintaining the present size of the counters network. A reshaped, perhaps much smaller network seems inevitable.

5 A BETTER WAY TO LIBERALISE THE MARKET

5.1 Four fully liberalised jurisdictions

So far just four countries have fully liberalised their letters markets: Argentina, Finland, New Zealand and Sweden.

Argentina

In Argentina the incumbent, Correo Argentino, was privatised in September 1997 and given a 30 year licence containing a universal service obligation. In October 2001 the company filed for Chapter 11 (protection against its creditors). It argued that it had to do so because the regulator did not ensure that competitors complied with labour legislation concerning wages and other conditions. Thus the playing field was not level. Whatever the merits of this explanation Correo's trouble happened at a time of financial turmoil in the country as a whole. It seems unwise to draw conclusions about liberalising postal markets from the Argentine experience.

Finland

The postal monopoly was abolished in Finland in 1992 but no competitors have entered the market. The underlying reason is that competitors would be required to pay as much as 20 per cent of their turnover according to the population density of the area(s) they wished to serve. This attempt to prevent "cream skimming" has nullified liberalisation of the market.

New Zealand

The letter monopoly was abolished in New Zealand in 1998 and the record of NZ Post has been an outstanding success. The nominal price[19] of letters has remained constant since before 1998 and, as seen in the earlier table, is half that of the UK. Productivity has improved and NZ Post has been consistently profitable.

As a state owned enterprise NZ Post has a rolling Deed of Understanding with the government, which owns it completely. The department concerned is the Ministry of Economic Development. The government determines the specifics that NZ post will provide under the Deed including a universal service and an obligation to accept mail from other postal operators on terms at least as favourable as for other customers. Competitors have entered the market, some with their own street posting boxes, and some have left. NZ Post still has 98 per cent of the letter market.[20] This being so, it seems that the *threat* of competition has been more effective than the competition itself. It is possible that the absence of a specialist regulator has enabled NZ Post to focus on the job of satisfying its customers.

Sweden

In Sweden the letter market was fully liberalised in 1993, five years after the government gave notice of its intention to do so . The regulator is the National Post and Telecom Agency (PTS). Posten, the incumbent, has repeatedly said that it favoured the

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19 When a *nominal* price remains constant any level of inflation reduces the *real* price of the item.

20 Postcomm. 'Key Facts in International Postal Markets' 24 June 2002, www.postcom.gov.uk

introduction of liberalisation. Today it retains 94 per cent of the market. The number of competitors operating within localised areas has fluctuated from 10 to about 100, but none has found the high profits that incumbents in the UK and elsewhere predicted would readily be available for cream-skimming. Posten has remained profitable, though much less so than before liberalisation.

Conclusion

Of the four fully liberalised but highly disparate jurisdictions Argentina and Finland can be disregarded in the present context. Of the two success stories Posten is answerable to a regulator and NZ Post to the government. From this small sample no conclusions can yet be drawn from this about the nature of regulation. However, a significant difference is that the incumbents in Sweden and New Zealand actively welcomed the abolition of their letter monopolies while the Post Office and Consignia fought tooth and nail to prevent and then to delay liberalisation. Under its new chairman RMG ostensibly welcomes liberalisation of the letter market but is repeatedly locked in heated exchanges with Postcomm about the latter's steps to bring liberalisation about.

5.2 A better way to create a level playing field

After a promising start in which Postcomm posted numerous discussion documents on its website, the regulator has now adopted the position that Royal Mail must be dealt with harshly, presumably under the principle of no pain, no gain. As noted, a one-penny price increase is badly inadequate in present circumstances and will leave Royal Mail short of cash, providing an unprofitable service with a demoralised workforce at a time when rivals such as Deutsche Post are making large, cross-subsidised, profits and using them to expand aggressively worldwide into other markets and other activities. With Postcomm intruding on prices and quality of service Royal Mail has less commercial freedom than it had before the creation of Postcomm and no solution is in sight. How could any government privatise a creaking, loss-making postal service?

There is a solution. Instead of intruding in an *ad hoc* way on Royal Mail's pricing and quality of service, Postcomm should adopt a transparent set of rules on price changes that would apply to *all* competitors, large or small, in the postal services market.

5.3 The price change limitation table[21]

A common approach among British regulators of utilities such as electricity and gas in which there is a highly dominant supplier — the former incumbent — was to devise a formula for controlling the dominant supplier's prices. Usually a compulsory downward ratchet method known as retail price index minus X ("RPI-X") was imposed on the dominant supplier. The formulae are less simple than they may appear. They give rise to extended and arcane disputes between the regulator and the regulated about the cost of capital, the legitimate return on capital employed, future cash-flow discount rates, depreciation rates, what items can be written off and over what period, the risk factor, the predicted cost of decommissioning capital assets and so on. At the end of

[21] I first put forward this concept in my Beesley lecture, "Measuring the success of postal regulators. What should be best practice in postal regulation". 12 November 2002. Publication pending

the day some number for X is agreed between the economists and the lawyers in the RPI-X formula.

In Royal Mail's case Postcomm has decided to use an RPI-X formula and an additional constraint in the form of a "tariff basket that will ensure that revenues move in line with costs in the event of any change in its production mix…"[22]

In doing so Postcomm has cut the ground from under Royal Mail's future, leaving it potentially insolvent. The government as Royal Mail's owner will have no choice but to bale the organisation out if and when insolvency threatens, as it had to do with Railtrack. For the fourth largest economy in the world to have an insolvent postal service would be unthinkable. To transform a once admired Post Office into a new Railtrack would be tragic.

The concept of the price-change mechanism that I propose is based on the following principles:

a) the market for flat items would be segmented into suitable weight segments, say 0-25g, 25-50g, 50g – 250g and above 250g. Two other segments might be non-flat items up to 100g and non-flat items over 100g;

b) the larger a supplier's share of any market segment, the longer it would have to wait to change its prices in that segment and the more limited would be the percentage by which it could change its prices;

c) above a share of 35 per cent in a given segment suppliers would be obliged to publish their tariffs;

d) above a segment share of 75 per cent, no special discounts to individual customers would be permitted;

e) below a market share of 15 per cent in a given segment, suppliers would have no constraints on pricing at all.

The system is easy to understand when set out as in Table 5. In essence, it would enable new entrants to the market to change their prices at will and without publishing their tariffs. Equally, Royal Mail could respond only more slowly and publicly. As new entrants became bigger the restrictions on their price changes would increase. This would allow the next wave of new entrants to come to the market. Conversely, as Royal Mail lost market share, its pricing freedom would be increased.

22 Postcomm's final proposals for regulating RMG's postal prices, 6 February 2003

Table 5

Price change limitation table

Share of the market segment per cent	Maximum frequency of price changes, months	Maximum change, per cent	Obligation to publish tariff	Discounts for individual customers permitted?	Deals with individual customers published?
>95	24	+ or – (RPI * 1.0)	Yes	No	
>85	24	+ or – (RPI * 1.1)	Yes	No	
>75	24	+ or – (RPI * 1.2)	Yes	No	
>65	24	+ or – (RPI * 1.3)	Yes	Yes	Yes
>55	24	+ or – (RPI * 1.4)	Yes	Yes	Yes
>45	18	+ or – (RPI * 1.5)	Yes	Yes	Yes
>35	18	+ or – (RPI * 1.6)	Yes	Yes	Yes
>25	18	+ or – (RPI * 1.7)	No	Yes	No
>15	12	+ or – (RPI * 2.0)	No	Yes	No
< 15	No restriction	No restriction	No	Yes	No

Source: Ian Senior, Triangle Management Services

Clearly, an accurate knowledge of market shares would be necessary to enforce the system. Postcomm would require all licensed operators to provide a return once a month stating the volume of their traffic within each segment. As part of this data gathering exercise Postcomm would feed back to operators their market shares in each segment — information that would be necessary to make the scheme work and would also be of immense value to managers.

The attraction of such a system is that it would be transparent to all participants and would be applied mechanically. Postcomm would intervene only if an operator broke the rules, and the penalty for doing so would be the temporary or permanent suspension of its licence.

5.4 Applying the price change limitation table to Royal Mail's present position

At present Royal Mail has at least 95 per cent of the letters market up to 300g, with the balance being taken by Hays DX, a specialist document exchange company.[23] Assuming that inflation is 3 per cent p.a. the table would allow an increase (or decrease) of under 1p on first or second class mail. However, this would be starting the system off with Royal Mail in a seriously loss-making position, which is most undesirable. An immediate correction should be allowed by permitting Royal Mail an increase of 3p on both first and second-class mail. This would make the company profitable but it would know that it could only increase (or decrease) its prices by about 1p every two years. It would have a strong incentive to increase its efficiency so that future profits would flow from increased efficiency rather than from price increases.

If Royal Mail sets higher prices competitors will find it easier to enter the market. Having set its prices every two years, Royal Mail would not be allowed to reduce them in answer to new competition and this would be a powerful incentive to make Royal Mail compete on efficiency rather than on price.

6 CONCLUSIONS

Royal Mail's current financial predicament results entirely from bad management and its historic desire to maintain the letters monopoly at all costs. That is water over the dam. The right way ahead is for Postcomm immediately to permit an increase of 3p instead of 1p on first and second-class letters. This will restore the company to profitability so that it can restructure quickly and without industrial unrest. In particular it needs to get rid of the dead wood managers who brought about the present crisis, eliminate inefficient working practices, reduce its workforce with fair redundancy payments and to build good relations with its remaining staff.

RMG, the holding company, is redundant. Its final function should be to separate its three operations — letters, parcels and counters —into freestanding companies and then wind itself up. The government should impose this task on it without delay.

Postcomm's role as a specialist regulator for the mail industry should be confined to ensuring the continuation of a universal letter service, enabling competitors to enter the market and ensuring a level playing field between them and Royal Mail. It should abandon its current intrusive approach to Royal Mail in relation to price and quality control, and instead it should adopt a simple and transparent framework for price regulation on the lines I have proposed. This will encourage Royal Mail to seek profits from efficiency.

Postcomm should also recognise the reality that Deutsche Post and possibly other European incumbents are benefiting from soft regulatory regimes and should consider the impact of its actions in starving Royal Mail's profits. The eight years taken so far by the European Commission in dealing with the still continuing Deutsche Post case in

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[23] A document exchange does not collect from or deliver to the general public. It serves a specialist customer base of companies such as law firms that wish to subscribe to the service. Hays DX is the only significant document exchange in the UK and runs document exchange operations in some other countries.

relation to the undercutting of the prices of competitors' parcels shows the Commission to be ineffectual when it comes to regulating the rapidly changing postal market.

In sum, Postcomm's current regulatory approach is intrusive, time-consuming and counterproductive. It is distracting Royal Mail from tackling its main problems. It risks making Royal Mail insolvent, thus threatening chaos of Railtrackian proportions. In such circumstances Deutsche Post with its large profits would be nicely placed to buy Royal Mail on the cheap.

Reference: Ian Senior/87/29-Apr-03/C:\Publications\IEA\Post Office (website article)\Penny on the post.doc