



Unite CMA response to the BERR Review of the Postal Services Sector

1. Executive Summary

- 1.1. This response is submitted by Unite Communication and Managers Association Sector. Unite is the UK's largest trade union with 2 million members across the private and public sectors. The union's members work in a range of industries including manufacturing, financial services, print, media, construction, transport, local government, education, the health service and not for profit sectors.**
- 1.2. The Communication Managers Association (CMA) Sector of Unite represents some 11,000 communications professionals of whom the majority are managers in the Royal Mail Group, PO Ltd, Parcelforce, Guernsey Post Limited, Jersey Post and Isle of Man Post Office. It is the only union recognised for managers in Royal Mail and represents all grades. A large percentage of its members work in joint ventures with Royal Mail or outsourced companies such as Romec, Quadrant, Capita, Atos Origin, CSC, Xansa. The CMA also has members in other postal operators such as Deutsche Post.
- 1.3. Unite believes that there is a clear and present social and political need for a sustainable Universal Service Obligation (USO) in postal services. At present the drive by the regulator (Postcomm) to introduce competition into the postal sector is putting the USO at risk. Unite believes that there is a need for the combination of a more realistic pricing structure and subsidies to fund the USO. These subsidies could be provided by a levy placed on each licence holder or an increase in the cost of a licence from the current £50.
- 1.4. Postcomm is legally obliged to ensure the provision of the USO and subject to this duty to further the interests of users of postal services, wherever appropriate by promoting competition. Its actions to date have been to promote competition with no apparent regard to its impact on the provision of the USO, which is clearly in contravention of its obligations under the Postal Services Act 2000. This paper illustrates these failings and shows that the consequences of these actions have grown beyond the detrimental effect to the USO.
- 1.5. Unite believes that Postcomm's insistence on the continuance of headroom on Downstream Access at its current level is serving to benefit of the competition who can cream off the more profitable areas of the sector, leaving the more expensive areas to the incumbent. Headroom also removes the potential for growth in end to end competition as it is often cheaper and easier to use the incumbent for the final mile.

- 1.6. Unite calls on Postcomm to fulfil its obligations in the correct order prescribed and not blindly follow a path towards liberalisation despite the introduction of a European Directive in this area. Liberalisation of the postal sector in Europe has a long way to go before it reaches the levels seen in the UK. One can only hope that the lessons can be learned from this exercise and similar problems avoided.
- 1.7. Unite Communication and Managers Association members are both the providers and, as part of our wider membership, users of postal services. Due to the restrictions and penalties placed on Royal Mail by Postcomm, Royal Mail has introduced cost cutting measures which are severely affecting staff morale and working conditions. Measures that have been forced upon Royal Mail have caused the company pension scheme to be revisited to reduce overheads. The squeeze on budgets is restricting innovation and causing many members of staff to leave.
- 1.8. Unite believes that the regime that currently exists cannot continue if we are to have a six day per week service at current prices. Without further investment and a level playing field the USO and the working lives of those employed by the present incumbent are at risk.

2. Introduction

- 2.1. Unite feels that the review is welcome and timely given the challenges faced in respect of the Universal Service Obligation (USO), its incumbent provider and the introduction of further restraints on its activities.
- 2.2. In the press announcement the Review's terms of reference are identified as follows:
 - assess the impacts to date of liberalisation of the UK postal services market, including on the Royal Mail, alternative carriers and consumers.
 - explore trends in future market development and the likely impact of these on Royal Mail, alternative carriers and consumers.
 - consider how to maintain the Universal Service Obligation in the light of trends and market developments identified.
- 2.3. The USO is a requirement on the Royal Mail which allows anyone in the UK to post letters and parcels to any other part of the country at the same affordable rates. The USO guarantees daily delivery of mail for every UK household and business, six days a week, and one collection per day, every day except Sunday, for a uniform tariff. The USO is also driven by the European Union (EU) to apply the same minimal standards across Europe.
- 2.4. To provide this service at the same affordable fixed rate throughout the country requires considerable cross subsidies from locations where the delivery point is very easily accessible at less than the cost to deliver to help pay for deliveries to remote locations where the amount paid does not meet the cost.
- 2.5. Due to the drive for the liberalisation of the postal market, the incumbent operator, which in this country is the Royal Mail, is obliged to provide a final mile service, allowing the competition access to feed into its delivery system the mail and packages it has collected for a fee. This is often referred to in the industry as Downstream Access (DSA).
- 2.6. All postal service operators are required to be licensed in the UK which carries with it the obligation to ensure the integrity of the post collected and delivered. There is no obligation for the provider to complete the transfer of post from customer to customer, often referred to as end to end (e2e) business. Recently, however, some of Royal Mail's competition is beginning to explore this possibility on a limited basis.
- 2.7. Although the communications industry is growing, worth an estimated £50 billion per annum, market forces and the availability of alternative methods of communication have caused a rapid decline in the volumes of post in the system. The only area where growth has been seen is in the transit of packages, fuelled by the growth in internet shopping in particular.
- 2.8. The combination of the decline in the volumes of items sent via the mail, the speed of growth in competition and DSA and the scope of the intervention by Postcomm has caused the Royal Mail to suffer losses. These factors are starving the USO incumbent of the resources to enable innovation to flourish and are in turn putting the operation of the USO at risk.

- 2.9. The transition from letters to packages and parcels is also creating logistical issues for the postal delivery system. This change has, for example, made the role of the postal delivery person more cumbersome and complex.

3. Regulator's Blind Promotion of Competition

- 3.1. The regulator objectives, set out in Section 3 and 5 of the Postal Services Act 2000 (PSA 2000), are to:- *"primarily exercise its functions in a manner best calculated to ensure the provision of a universal postal service and subject to this duty as set out in section 3, to exercise its functions in a manner which will further the interests of users of postal services, wherever appropriate by promoting competition under section 5"*.
- 3.2. In this endeavour Postcomm is succeeding only in blindly promoting competition to the detriment of the security of the USO and hence is acting beyond the provisions of the Act. The PSA 2000 states, very clearly, that the regulator should only promote competition *"wherever appropriate"* if it *"will further the interests of the users of postal services"*. Postcomm has repeatedly ignored this limitation on pro competition activities and ignored warnings and calls for assistance by the Royal Mail in its efforts to provide the USO in a sustainable fashion.
- 3.3. The Royal Mail currently provides a service to a country with considerable transport issues not faced by mainland Europe for the price of a stamp which is by far cheaper than all but one of its European neighbours. The UK is an island nation comprising of 290 inhabited islands, 95 of which are in Scotland¹. North of a line from Dunoon, Perth and Dundee lies around 25% of the British land mass but less than 2% of its population. In these locations the population drops to an average of just 8 people per km²². None the less, the Royal Mail offers a minimum of a three day delivery service even to some of these very remote areas. The Royal Mail has achieved this and managed to ensure that 94.1%³ of its mail arrives on time and the next day even though the section 4 definition of the USO only requires delivery and collections to occur daily.
- 3.4. Ofcom's 2007 report⁴, highlighted significant gaps in the availability of communications services in areas with larger rural populations such as Northern Ireland, Wales, Scotland and the South West. An example of this is in the area of internet access. Domestic connections to the Internet tend to rely on cable, ISDN broadband services and dial-up connections. The quality of ISDN and dial-up connections decreases significantly over distance from the telephone exchange and only a limited number of urban areas are served by fibre optic cable. The resulting absence of high speed communications to the web means that, in these areas, the postal network is that much more important.
- 3.5. Royal Mail collects from around 130,000 post boxes and post offices and delivers to around 27 million address points every working day. This provides around 3 trillion (3 million million) different routes, all for the cost of a 34p stamp. In real terms stamp prices have decreased in value over the last 20 years.

¹ Source Ordinance Survey.

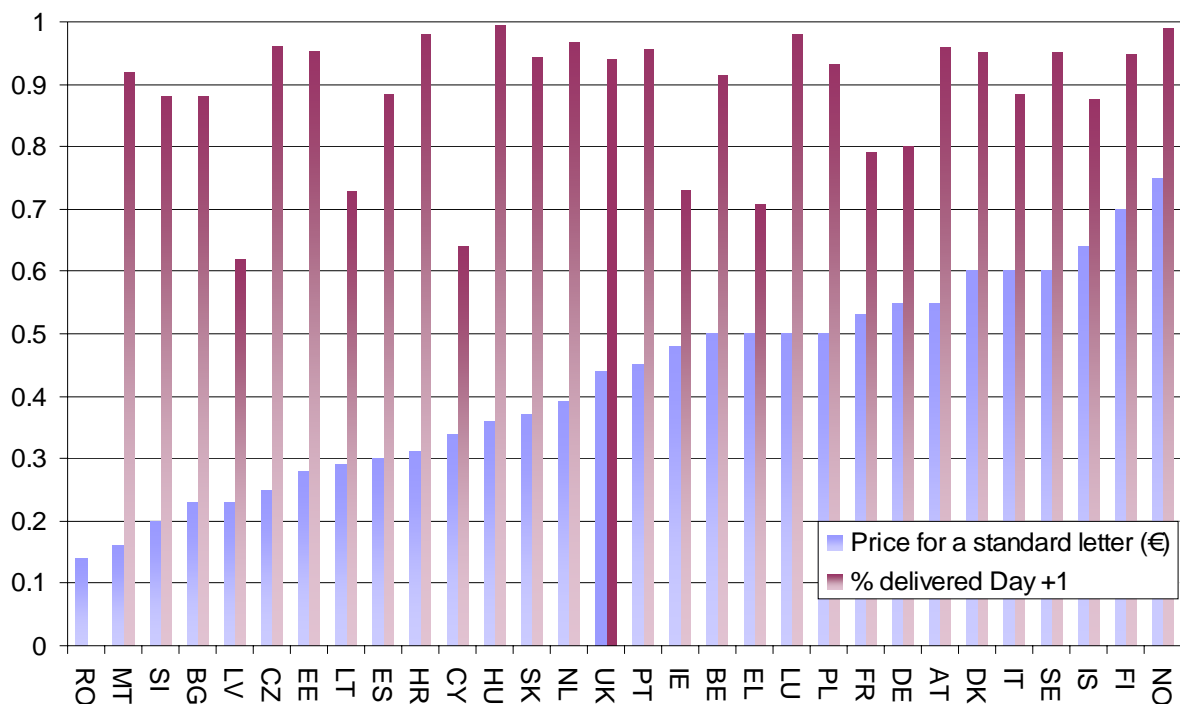
² Office of National Statistics - local government population density.

³ The figure dropped in the most recent quarterly report due in the main to the long running postal strike.

⁴ The Nations & Regions Communications Market 2007 (May)

- 3.6. Regional difficulties are not just limited to rural areas. The high cost of living in some locations, particularly London, has created a situation where the salaries paid to staff are insufficient to meet local housing costs. The resulting additional expense incurred in transporting staff into and out of areas and their initial lack of local knowledge of the locality has also contributed to additional overheads for the Royal Mail making the cost of delivery far greater than the revenue raised from the price of a stamp.
- 3.7. These regional differences in the cost of providing the USO, were addressed in 2006 when Royal Mail called for an increase in the cost of a stamp. Other measures included a call for the introduction of zonal pricing for bulk mailing houses. These calls were blocked by the regulator, however.
- 3.8. The price of a standard 20g letter or postcard sent by first class post varies widely across Europe, with the Royal Mail sitting somewhere in the middle (see Fig 1 below). The price then escalates very rapidly within the 50g to 100g band (which is still covered by the USO) in some countries whilst the Royal Mail price stays the same. These rapid climbs mean that while Royal Mail charges the equivalent of €0.44 an item some countries charge as much as €1.11. Within the 50g to 100g bracket the Royal Mail is only undercut by the Irish postal network. Weighting the cost by GDP per capita also reveals that the UK postal network currently provides exceptional value for money, (see appendix 2).

Fig 1 – Price and performance comparison of USO 20g standard post across Europe



Source : http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BW-07-001/EN/KS-BW-07-001-EN.PDF

- 3.9. The collection of post and parcels from post boxes around the UK is far more expensive than the cost of collecting bulk mail from a business, especially if it is pre-sorted - so called clean mail. Whilst a logistics company could technically make a profit from collecting mail from post offices, if they did so whilst making

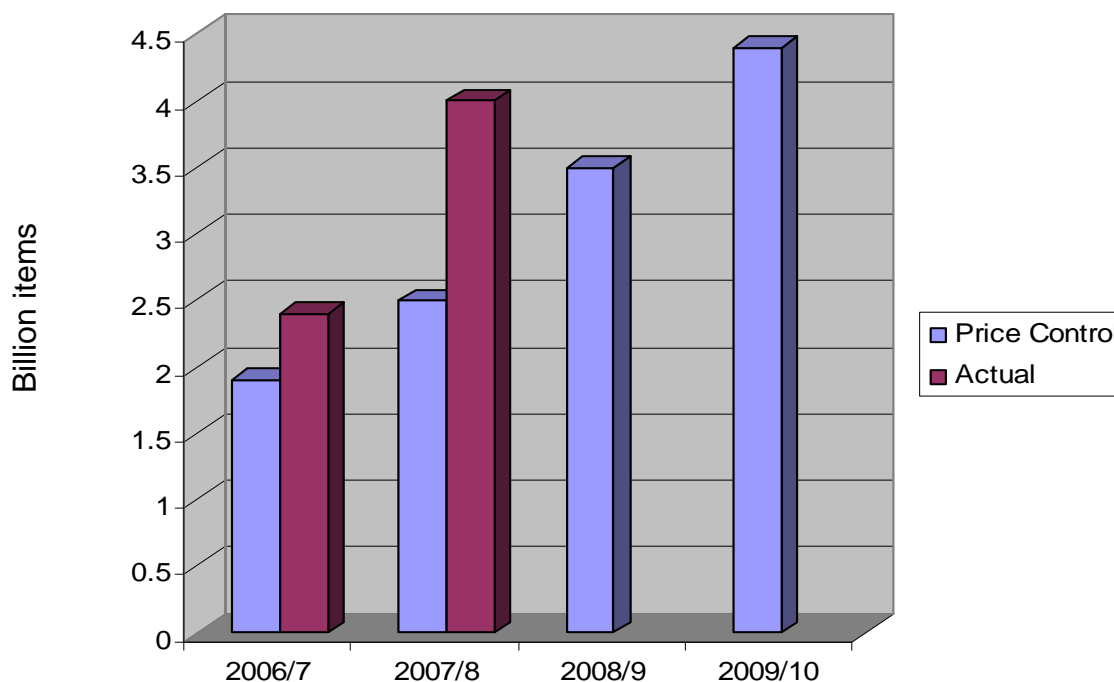
such a journey for other reasons, the distribution of post boxes would not readily make collections a commercial venture unless it was heavily subsidised.

- 3.10. Previously collections from bulk postal businesses helped offset the cost of the USO. With the introduction of DSA headroom provisions and competition in the collection business, the Royal Mail service is being undercut. This situation is further unbalanced by the differential between Royal Mail costs and the lower headroom cost. Upstream efficiency gains that lead to lower prices of Royal Mail products lead in turn to a reduction in the price of DSA. This means that savings gained have to be passed directly to competitors even though it has no impact on the DSA service.
- 3.11. The headroom requirement on the cost of DSA is forcing Royal Mail to charge less to the competition than they can charge the market for the same service. The idea of the need to provide headroom was introduced within the licence to prevent there from being a margin squeeze. It would appear, however, that its effect has been to place a squeeze on the incumbent's profits as the competition are able to considerably undercut the prices offered by Royal Mail. Headroom also removes the potential for growth in end to end competition as it is often cheaper and easier to use the incumbent for the final mile.
- 3.12. Competitive behaviour legislation prevents the Royal Mail, as the organisation with the dominance in the market, from offering discounts that cannot be matched by the competition. Additional edicts from the regulator have introduced limits above and beyond the legislation that prevent even the potential for such activity. These edicts have created further problems for the incumbent as they have far reaching implications which are surplus to requirements and only help the competition make larger profits.
- 3.13. The price controls brought in by the regulator are based on its predictions of market trends and have scope to cover 88% of the Royal Mail's revenue stream. 51% from the operation of the USO and 37% on a range of additional products provided by the Royal Mail (see appendix 1) which are closely related to the USO provisions. Price Control 3 which runs until 2010 carries with it predictions which have been proven by the Royal Mails experience to date, to have no foundation in reality.
- 3.14. Royal Mail products face the hurdles of price controls, at levels that are not cost reflective, with associated target penalties, whereas its competitors face no such obligation.
- 3.15. Postcomm's predictions suggested that in 2006/7 the Royal Mail would make £779 million profit when in reality the incumbent of the USO lost £12 million. Postcomm suggested that there would be a 1% to 2% growth in postal market volume when in reality the market has shrunk by 2% to 3% in the period⁵.
- 3.16. The growth in down trading has of itself caused losses of around £150 million last year when the regulator predicted it would be cost neutral. It is surprising that Postcomm could not predict that business would be led by their budgets rather than by quality of service. As can be seen from the graph below, the volumes that now enter the system via DSA, have grown so rapidly that levels for 2007/8 are more akin with predictions for the levels Postcomm had suggested would not happen until 2009/10, (see fig 2 below).

⁵ Source Royal Mail

- 3.17. This transition has far reaching implications, yet when the Royal Mail complained that the headroom was too large, Postcomm decided to listen to the numerous calls from the competition for larger profits and kept the headroom margin exactly where it had been previously.
- 3.18. Unite would consequently wish to see either the removal of headroom or for it to be reduced substantially.

Fig 2 - Growth in Downstream Access by Volume



Source: Royal Mail.

- 3.19. Whilst Postcomm is failing to introduce competition in the more costly areas of the service, it is happy to see the introduction of more companies, cherry picking the most profitable business post. At no time has it insisted that these carriers contribute to the cost of delivery of this post to remote and expensive areas of the country and support the USO.
- 3.20. It is recognised that the Royal Mail had a monopoly over all aspects of the postal collection and delivery network, but this situation has changed and is placing the staff and management of the network under considerable pressure to cut costs. Whilst removing unnecessary cost would normally be to the benefit of a business, these efficiencies are passed on under DSA to the competition due to the need to provide headroom as stated earlier.
- 3.21. The EU's proposal to create an obligation on all licence holders to pay into a central fund to support the USO would assist the USO incumbent licence holder (who ever that may be) to perform its obligations but may face heavy resistance from the industry. Such a fund to subsidise the USO, if created, would have the potential to make the position of the USO licence holder, more financially secure.

- 3.22. If the aim is to open up the postal sector to competition, a large enough subsidy would potentially make the position of USO licence holder one which could be economically attractive to the competition. This subsidy need not come from government but could be an integral part of the licence. As there is no reason to suppose that the Royal Mail will always retain the USO licence, such a move may also stimulate a growth in end to end activity if a correct balance is struck between a potential increase in the cost of a stamp and subsidies. Currently the service provided by the Royal Mail, under the Postcomm regime, is not a viable financial proposal. Unite believes measures need to be taken to address this situation.
- 3.23. If the USO licence is transferred to a separate company, whose principle obligation would, after all, be to its shareholders, the size of this support fund would need to be substantial. Funding of this support mechanism for the USO may require a government contribution.
- 3.24. The minimum requirements of the European directive provide that the incumbent licensed company should provide a five day a week service rather than the six day service provided by Royal Mail. The relative cost to the Royal Mail of providing a Saturday collection and delivery service in addition to this minimum standard is considerable.
- 3.25. The losses sustained by the Royal Mail have caused them to consider a consequential reduction in the delivery service from a six day collection and delivery service, to this EU minimum. This clearly would not “*further the interests of users of postal services*”.
- 3.26. The withdrawal of this service would have a devastating effect on the staff that provide this service and on businesses who work to a six day operational schedule. The decline in the service would cause a rationalisation of staffing levels and working conditions not just in the Royal Mail but elsewhere in the economy.

4. The legal barriers

- 4.1. In addition to anti competition legislation which restrict the Royal Mail’s activities, Postcomm has a series of ex ante regulatory controls established in the licence which are aimed at assisting the competitive market. These require the Royal Mail to provide a three month consultation period on the introduction of new products and nine months notice to withdraw and replace products. Even after this process has taken place it is the regulator who provides the final clearance. These requirements are not faced by the competition and hence stifle innovation by the Royal Mail.
- 4.2. Until recently the provision of government subsidies to support the USO was frowned upon due to EU legislation but this position has been overturned allowing governments the ability to subsidise if they wish too. Drives toward a pure market economy are severely misplaced and the idea that the USO could in the UK be self sustaining given its obligations and high overheads is naive. The network support is clearly needed in the UK which will never be a cash cow for any incumbent.
- 4.3. The Postal Services Act 2000 made it necessary for businesses wishing to operate in the collection and delivery of mail costing less than £1 (or weighing

less than 350 grams) within the UK (subject to a few niche exceptions) to first obtain a licence from Postcomm.

- 4.4. Nothing in this licence stops the introduction of e2e business by Royal Mail's competition and in recent months TNT has piloted a service to deliver post into the high density areas of Liverpool, Glasgow and Bristol twice a week. Clearly such a service will be far cheaper than the 6 day a week service and as it is only available to these high density areas there are economies of scale. Yet again businesses entering the market will cherry pick the best areas for delivery which have a greater profit potential. Currently savings made in these locations are used to subsidise those areas where losses are sustained.
- 4.5. Postcomm has been given powers of investigation and enforcement, including the power to impose monetary penalties for breach of licence conditions by the operators. In recent times the regulator has lowered the cost of a licence from £1000 to just £50 enabling the 'person with a van' style operations to enter the market, provided they meet minimum requirements. Although this will mean that such operations will still need to conform to minimum requirements, the terms of reference are far less stringent than that imposed on the Royal Mail or any other utility entrant.
- 4.6. Postcomm's obligation is to introduce competition into the market place, to act as a true alternative to the Royal Mail. They should, therefore, ensure that an e2e service is provided within the same terms of reference i.e. not just two days a week to the most profitable areas but also to the most remote and expensive areas on the same frequency basis. If these requirements are not put into place the USO incumbent just becomes the dumping ground for the most expensive parts of the obligations, while the competition reap the benefits of casting off the overheads.

5. The Regulatory Regime

- 5.1. Royal Mail has from the outset faced a much tougher regulatory regime than other denationalised companies in other industries.
- 5.2. British Gas, although it operated under an RPI-2% price control for its first five years after flotation, operated amid inflation running between 3% and 10.9%. It was, therefore, able to increase its prices.
- 5.3. Between 1987 and 1992, BG had a franchise over all supplies less than 25000 therms. In 1990/91 the tariff (franchise market) accounted for 65% of BG's gas sales, 80% of its sales revenues and 80% of gas business profits. Competition for customers consuming between 2500 and 25000 therms was introduced in 1992 and full scale competition from 1997 (rolling phase). However, BG was from 1998 able to compete with electricity suppliers and offer electricity contracts and dual fuel contracts from this date e.g. it was able to offset gas losses due to competition by competing in the electricity market.
- 5.4. The only way competitors could enter the gas market was by making use of British Gas's pipeline and its local distribution networks. In contrast, almost any small enterprising company, never mind aggressive highly profitable international companies like TPG and Deutsche Post, can set up mail operations at relatively low cost.

6. The effect on staff morale

- 6.1. Staff at the Royal Mail are not well paid when compared to other industries. Moves to block salary increases in line with inflation, to cut overheads, are therefore, causing staff to migrate away from the service. The resulting drain of experienced staff is leading to a breakdown in the morale of those remaining and a loss of key skills. Additionally the resulting drain on resources needed to retrain staff to fill the vacancies, has proved that a tight reign on staff salaries and benefits is a false economy. There is a clear link between pay and quality of service.
- 6.2. The recent strike by postal workers served to illustrate the frustration among staff. Industrial action is seen by the unions as a last ditch option where all else has failed to achieve their goals.
- 6.3. The market's move from mainly letters to packets and standard parcels, has altered the way in which the delivery offices operate. This shift has made the role of the delivery post person far more cumbersome and complex.
- 6.4. In Germany a minimum wage for postal workers has been enshrined into legislation to ensure that employees, in the postal sector, are not exploited. None the less, the Dutch giant TNT is currently challenging the validity of this legislation and continues to pay staff on a lower rate than prescribed.
- 6.5. These lower rates at TNT have led the Royal Mail to claim that their staffs are overpaid in the UK, an issue clearly contested by the unions. This sentiment has been echoed by Postcomm and others. No evidence has been forthcoming from the Royal Mail to substantiate these claims. Unite wants to ensure a secure, professional and well respected postal service in the UK.

7. The Break up of Royal Mail

- 7.1. The proposal to split the Royal Mail into two, dividing up the collection and delivery parts of the network, would create further disharmony and increase costs. Additionally, the logistics of the operation would mean splitting the USO itself so that no one operation was responsible for the collection and delivery. New terms of reference would therefore be needed to ensure control over performance levels of e2e transit.
- 7.2. Economies of scale would also be lost. Instead of one vehicle making the journey to the remote location, delivering the mail, then making the reverse journey collecting the post on the way, two vehicles would be needed, one for the collection and one for the delivery. The co-ordination of such a separated service would also potentially limit the potential for same day return of postal communication.
- 7.3. The break up of such a well known and trusted brand will also cause confusion among the core domestic customer base, including the elderly.
- 7.4. For these reasons Unite strongly opposes any such proposals.

8. Conclusion

- 8.1. Unite is very concerned that the regulatory controls placed on the Royal Mail are creating an environment where huge losses are occurring. These losses are threatening the security of the Royal Mail and its obligation to provide the USO. The regulator is continually stating that the incumbent would not be in such a mess if it improved efficiency. Every time the bar is raised, however, the obligation to provide DSA headroom causes the savings to be passed on to the competition.
- 8.2. Unite believes that the resultant pressures on staff and their pensions have reached breaking point and urgent action is required to remedy the situation.
- 8.3. Unite would like to see security which enables the incumbent, who ever that may be, to deliver on its obligations and provide a sustainable USO. Under the current environment the obligation, price controls and restrictions are making the USO a poisoned chalice, which neither secures its continuance nor makes it attractive to the competition.

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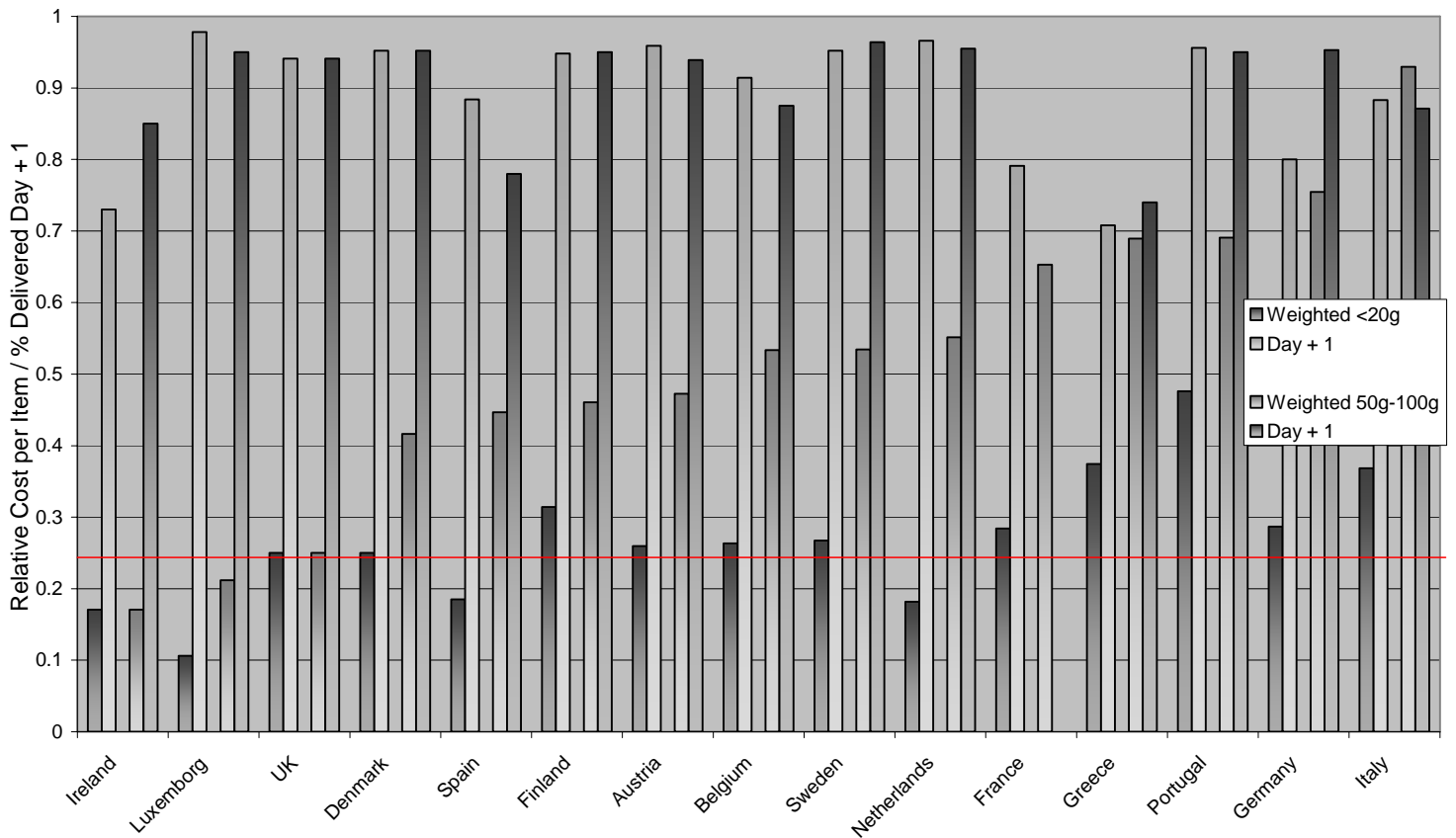
Appendix 1

Controlled services within the Licence which are NOT covered by the USO

First Class Metered
Response Services 1st Class
Response Services 2nd Class
First Class Postage Paid Impressing (PPI)
Second Clas Postage Paid Impression (PPI)
Mailsort 120 OCR 1st Class
Mailsort 120 CBC 1st Class
Mailsort 120 OCR 2nd Class
Mailsort 120 CBC 2nd Class
Mailsort 700 1st Class
Mailsort 700 2nd Class
Presstream 1st Class
Presstream 2nd Class
Packetpost 1st Class
Packetpost 2nd Class
Packetsort 8 1st Class (including Flatsort 8 1st Class)
Packetsort 8 1st Class (including Flatsort 8 2nd Class)
Walksort 1st Class
Walksort 2nd Class
Mailsort 700 3
Mailsort 1400 3 (including Flatsort 1400 3)
Access 1400
Access 120 Letter
Access 120 Flat & Packet
Access 120 OCR
Access 120 CBC
Access 700 CBC
Access Walksort

Appendix 2

Relative Cost per Item and Delivery Performance Against Day + 1 Target Performance.



Source : http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BW-07-001/EN/KS-BW-07-001-EN.PDF and ftp://ftp.royalmail.com/Downloads/public/ctf/rm/Postcomm_Strategy_Review_v31_Final.pdf

n.b. No figures are available for French postal performance against Day + 1 in the 50g to 100g bracket.

The relative cost has been calculated by weighing actual cost in euros against national GDP per capita figures supplied by the CIA World Book. Although the cost of postage in Luxembourg is almost double that in Ireland, the relative cost when weighed against GDP per capita, results in it being among the cheapest, for less than 20g letters and cards. Italy has the most expensive postal system by relative GDP per capita charging €1.11 for a 50g to 100g item by comparison.