

**POSTCOMM'S INITIAL PROPOSALS FOR
ROYAL MAIL'S PRICE AND SERVICE QUALITY REVIEW**

CWU SUBMISSION

1. The Communication Workers Union (CWU) represents 250,000 employees in the postal, telecoms and related industries. It is the recognised union in Royal Mail Group for all non-management grades, including those responsible for the collection, sortation and delivery of letters and parcels.

Background

2. In June 2005, Postcomm published its initial proposals to revise Royal Mail's price and service quality regulation from April 2006. It stated that its proposals "are a balanced package taking account of the interests of customers, Royal Mail (including its shareholder), Postwatch and emerging competitors". It requested views on its proposals by 1st September 2005.
3. Since the publication of its initial proposals, Postcomm has issued a number of other related documents to be taken into consideration as part of this phase of the review. This submission is a response to the central issue of the initial proposals published by Postcomm, together with the subsidiary issues highlighted in the related documents.

CWU Response

4. From the outset the CWU would like to emphasise its absolute opposition to the central thrust of the price control proposals which Postcomm has set out in its consultation document. We firmly believe that these proposals, if put into action, would constitute a material threat to Royal Mail's core business activities and to its ability to maintain the provision of a universal service. It is clear that a key result of these proposals would be to starve the company of funds at a time when it faces the introduction of full market liberalisation, arguably the most significant period of change in the history of postal services in the UK. This cannot be allowed to take place.
5. We strongly believe that Postcomm's proposals are flawed in a whole range of areas. It is clear that Postcomm's valuation of Royal Mail's regulated asset base is far too low, and ignores key elements of the company's value. It is also apparent that the proposed regulatory profit allowance is set at far too low a level to allow for an acceptable return on sales and that modifications to the compensation and financial penalty regime could, in any event, eradicate the limited profits which could be achieved for providing these core services.
6. We have particularly serious concerns in relation to the LECG efficiency report and the accompanying conclusions which the regulator has reached regarding investment and efficiency, which have led it to recommend stringent "RPI minus" price caps. In addition we do not support the proposed restrictive restructuring of the price control into two separate tariff baskets. We have also highlighted issues in relation to the scope of the control and, in particular, our opposition to the inclusion of access products within the price control.
7. Our detailed views in relation to the key elements of Postcomm's proposals are set out below.

The Conduct of this Phase of Consultation

8. The CWU has serious concerns relating to the conduct of this phase of Postcomm's price control review. The regulator published its Initial Proposals at the start of June 2005. Since that time it has released a number of additional documents relating to this phase of the price control:
 - a. Draft Modifications of the Conditions of the Licence Granted to Royal Mail (issued on 27th June 2005);
 - b. Second supplementary paper to Postcomm's Initial Proposals for the 2006 Price Control (issued on 5th July 2005);
 - c. Volume Modelling for the Price Control, A Report for Postcomm by Frontier Economics (issued on 6th July 2005);
 - d. Technology and Innovation in the Postal Sector, by Arthur D Little (issued on 4th August 2005);
 - e. Royal Mail's Pension Costs, by Hyman Roberston (issued on 4th August 2005); and
 - f. Future Efficiency of Royal Mail's Letters Business, by LECG (issued on 4th August 2005).

9. In each case these documents provide vital additional information which underpins Postcomm's initial proposals. Without this information it is impossible for interested parties to analyse and/or form an objective opinion regarding key aspects of Postcomm's proposals. Yet in the case of the latter three documents – and most notably in relation to LECG's efficiency study – this information was not made available until the 4th August 2005. Therefore key information on which the price control review was based was not released until the final weeks before the deadline for the end of this phase of the consultation.

10. Postcomm stated in a note accompanying the release of the latter three consultants' reports that:

“The key conclusions of these reports are summarised in the Initial Proposals document. Therefore, stakeholders commenting on the Initial

Proposals will have already considered the key issues in these reports, so should be in a position to respond by 1 September. As with all issues that Postcomm considers, Postcomm is always prepared to consider representations it receives even outside formal consultation periods”.

11. We do not believe that the regulator’s approach to the release of this information has been acceptable. Indeed, we believe the approach taken has undermined the review process. Given the magnitude of the issues set out in Postcomm’s document, it seems to us extremely irresponsible to expect respondents to develop an understanding of, and arrive at a detailed position in relation to, the complex issues which are set out in the consultation document in the limited time available. Postcomm’s approach does not seem to us to be consistent with good consultative practice, as set out in the Cabinet Office’s own guidance on this matter:

“The formal consultation period Should be a minimum of 12 weeks. Departments should consider the specific circumstances of their stakeholders and consider longer consultation periods at certain times a consultation period of less than 12 weeks should be the exception and should be avoided wherever possible.”

Cabinet Office Code of Practice on Consultation

12. It is clear to us that while the original consultation document theoretically provided for a 12 week consultation period, the time allowed has in reality been much shorter as a result of the absence of key sections of information on which the consultation document is based. As highlighted in our response to Postcomm’s consultation about the “Process, Timetable and Main Issues of the Review”, we believe that the current approach provides an uncomfortable reminder of the problems which were encountered during the 2003 Price Control consultations. We believe that the staggered approach which has been taken to the release of information during this phase of consultation has adversely impacted on the consultation process.

The Approach to Funding

13. In deciding on its approach to funding, Postcomm has opted for a “regulatory value” approach rather than the cash based approach which has been used in the existing price control. While we do not have a problem with the principle of utilising a “regulatory value” approach to financing we have very grave concerns regarding the methodology which Postcomm has adopted. In particular Postcomm has decided that it should calculate the opening value of the regulated asset base (RAB) through evaluating the current market value for assets. Utilising this approach the regulator has calculated (based on cost accounting valuations of property, plant and machinery, vehicles, fixtures and fittings and miscellaneous items) that the opening RAB should be in the region of £2.2bn. We believe that this valuation is simply far too low and, given the importance of the RAB within the wider price control, would have an extremely adverse impact on Royal Mail if it was calculated solely on the basis which Postcomm has utilised to arrive at its initial proposals.

14. The most significant flaws with Postcomm’s calculation of Royal Mail’s value relate to its consideration of intangible assets. The regulator has decided that it should not include a valuation for the brand value as part of its calculation. We believe that this judgment simply highlights the inconsistency of Postcomm’s approach to setting the price control. It is clear to us that the value of the Royal Mail brand, which is underpinned by the extensive knowledge and experience of its dedicated workforce, is a substantial asset which must be taken into account when setting the RAB. The value of this intangible asset becomes particularly clear when you consider the level of investment, both in terms of time and resources, which would be necessary if a private company were to attempt to build a brand value comparable to that of Royal Mail. To ignore this aspect of the company’s asset base is to grossly overlook an extremely valuable contributor to the business’s ongoing success. Accordingly we believe that a substantial brand value should be factored into the opening RAB – the value put forward by Royal Mail’s own consultants of approximately £1.2bn does not seem excessive.

15. We believe that there are a number of other important criticisms of Postcomm's existing approach to funding. First the regulator has excluded cash held by Royal Mail Group from its calculation of the regulated asset base. We are unable to understand why this should be excluded given the fact that it clearly forms an important part of the overall value of the company – Royal Mail's own figures show that it holds cash in the region of £500m.
16. Our belief that Postcomm's valuation of Royal Mail's regulated asset base has been substantially underestimated is reinforced by comparisons with the valuations of other leading European postal operators. A comparison with the examples of TNT and DHL shows that Postcomm is valuing Royal Mail at less than 20% of the value of either of these two companies, both on a per letter and on a per full time employee basis.
17. We believe that Postcomm must revisit its calculations in this area to ensure that they provide a fair reflection of the value of the company. As they currently stand we believe the initial proposals have grossly underestimated the true value of the company. We believe that a much more accurate reflection of the value of the company has already been provided by Royal Mail and its independent consultants. We are particularly keen that the value of the brand and all those employees who contribute to its continued success should be recognised.

Profitability

18. One key area in which Postcomm's miscalculation of the RAB will have a particularly serious impact is in relation to its proposals to introduce a profit allowance for the business. The CWU believes that this proposal will simply prevent the company from making a reasonable financial return on its core area of activity. In turn this will place further pressure on the business at the same time that the development of competition is expected to accelerate. Postcomm has utilised a calculation based upon a multiplication of the RAB and the weighted average cost of capital (WACC). Using this approach it has

calculated that Royal Mail would be allowed a forecast profit for its regulated activities in the region of £285m in an average year.

19. The CWU believes that this annual profit allowance is far too low. Postcomm's methodology would allow Royal Mail a return from sales – at less than 5 per cent – which is simply not in line with what would be expected for similar activities in other companies. Furthermore, given Postcomm's approach to compensation and financial penalties (discussed in more detail below), it is quite possible that even this low profit allowance could be eradicated by payments resulting from quality of service levels which do not meet the national targets. This is without even taking into consideration whether the £285m profit is achievable within the range of other restrictions proposed in the new price control.

Investment Issues and the Efficiency Study

20. In our response to the last stage of consultation we argued there was a clear need for concrete action to correct the years of under investment in Royal Mail. While the three-year renewal programme has had some success in returning the business to short-term profitability, it has done very little to address the underlying problems of the company's ageing infrastructure. Accordingly we argued that the only method which would allow the necessary corrective investment would be an RPI+Y approach, where Y represents an allowance for further defined investment. In particular we identified the need for extensive investment in facilities, machinery and equipment to allow the company to provide the services which customers require. We remain convinced that such an approach is absolutely vital to the long-term future of Royal Mail.

21. We are, therefore, absolutely opposed to the price caps which Postcomm is proposing to introduce. The regulator states that it has designed its proposals:

“to set challenging but achievable efficiency targets for Royal Mail. Postcomm's consultants' assessment of Royal Mail's costs shows substantial scope for the company to become more efficient. Postcomm

has reached this conclusion after undertaking a range of analysis from a number of different perspectives. For example, internal benchmarking between all Royal Mail's Mail Centres and Delivery Offices reveals a significant difference between the best and worst performing sites. Postcomm has also assessed evidence from Royal Mail's own plans, from the performance of mail operators in other countries and from the experience of similar organisations in other industries."

(p13 Postcomm's consultation document)

22. As a result of its analysis, Postcomm is therefore proposing that over the four years of the price control the average price cap for the "captive tariff basket" should be RPI-3% while the average price cap for the "non captive tariff basket" should be RPI-2%. We believe that the introduction of these price caps would be disastrous for Royal Mail and the wider UK postal industry.
23. Postcomm's proposals would mean that, across the course of the next price control, Royal Mail would be required to substantially reduce its overall prices for stamped products (which are already among the cheapest in Europe). We believe that such an approach would be unsustainable and significantly undermine the position of the universal service provider. We are unable to see how such an approach is consistent with Postcomm's primary duty under the Postal Service Act – to ensure the provision of the universal service.
24. The key piece of research underpinning Postcomm's proposals in this area has been the LECG efficiency study. LECG found that the scope for operating efficiency savings within Royal Mail would be within a range from 2.75% to 3.25% annually (prior to volume and mix effects). Furthermore its "top down" analysis of Royal Mail's potential efficiency savings indicate savings in an overall range of 3% to 4%. The CWU believe that the conclusions LECG have reached in this area are completely arbitrary. The consultants' analysis has not paid adequate attention to the concrete measurement of the work performed in given offices, instead preferring to utilise its own questionable internal benchmarking approach.

25. We believe that the research which informed these conclusions is fundamentally flawed. Specifically, LECG's internal benchmarking methodology – which seeks to extrapolate possible efficiency gains based on the performance of the best performing delivery offices and mail centres – seems extremely simplistic. LECG's own report acknowledges the weakness of this approach and its inability “to explain performance variations between operational areas”. Indeed, we believe there are likely to be a whole range of factors, applicable in these “best performing” sites, which cannot simply be replicated elsewhere. For example, little consideration is given to the fact that the physical layout of many of the older centres and offices is not ‘fit for purpose’. Similarly we believe that a key reason for the high performance of many of the best performing offices is that people employed there often make additional efforts (above and beyond what can reasonably be expected) to reach these higher performance levels.

26. LECG's assessment of efficiency in Royal Mail has been made on the basis of unit costs. However, such an approach does not provide a meaningful internal test to find out what factors are really driving costs and why apparently similar offices have significantly different cost bases. Looking at the example of delivery offices we believe that a whole range of factors may apply in different offices which will influence the cost base. These include, but are not confined to, the following factors:

- differing security, geographical, cultural and social issues applying in different locations;
- high levels of staff turnover increasing training and recruitment costs;
- offices not being provided with the correct equipment to perform their duties effectively;
- postal employees starting their duties in advance of the scheduled start time;
- meal breaks not being taken to ensure that deliveries are completed on time.

27. It is also important to note that in arriving at its conclusions, LECG did not take into account the full range of operational initiatives which Royal Mail had outlined as necessary in its strategic plan. Out of a total of 46 such initiatives, LECG disallowed 16 initiatives which it judged were “poorly supported ... that have significant negative impact on value. Financial case [was] not made”. Yet these initiatives accounted for by far the largest section of Royal Mail’s proposed investments, with overall one-off costs for the disallowed items amounting to £1.2bn. We believe that this decision provides a concrete example of the difficulties facing Royal Mail in the next price control – on the one hand the regulator is imposing punitive efficiency targets while on the other hand it is preventing the company from undertaking investment which it has identified as being of vital importance to the future success of the company. This will place the universal service provider at a considerable disadvantage in a competitive postal market.

28. Setting an arrangement of punitive price caps is not the way to achieve improvements in Royal Mail’s performance. The CWU firmly believes that substantial targeted investment is the solution to bring the pipeline up-to-date and to recognise the efforts of employees.

The Efficiency Study and “Human Resources”

29. The CWU have a number of detailed concerns relating to the assumptions made regarding “human resources costs”. From the outset, we would like to emphasise our grave concerns about the statement that “Royal Mail plans to reduce frontline FTEs by some 30,000 over the period 2005/06 to 2010/11”. The CWU has not been consulted at any point about these plans and we would oppose any attempt to pursue such a programme. We are similarly concerned at LECG’s conclusion that a reduction in overall headcount of 34,000 FTE’s would actually be possible or desirable.

30. Problems with the current consultation process and the nature and frequency of the excisions which have been made to the LECG report has made it difficult in a number of areas to make detailed comments in relation to the proposals

for change contained in Royal Mail's Strategic Plan or the analysis which the consultants have undertaken as a result. However, we believe it is important that we highlight the areas of concern below.

31. The CWU reject LECG's conclusion that postal workers are overpaid and that the rates of pay for many Royal Mail grades are on average above market rates across the country. LECG has reached its conclusions on the basis of inappropriate market comparators and a simplistic analysis of pay rates in the company. In particular the comparison between Operational Grades and sales and customer employees (which is the only sector showing a substantial difference for the private sector comparisons) is clearly inappropriate based on the differing skill sets and experience which are required for the roles in question. Similarly we believe that the utilisation of comparators such as bus and coach drivers, fork-lift drivers, goods handling and storage occupations and van drivers completely underestimate the knowledge, skills and responsibility necessary for effectively carrying out the OPG role.

32. LECG's consideration of sick absence and staff attrition is simplistic and does not take into account the numerous complex factors which lie behind these headline issues. We also do not believe that LECG has given adequate recognition to the interrelationship between these issues and the broader subject of appropriate remuneration and improvements to terms and conditions. We believe that it is essential that all concerned do not underestimate the importance of addressing the problems found in these areas in a constructive manner – we do not believe that LECG's simplistic conclusions in this area give due weight to the nature of the issues.

Pensions

33. It is clear that the vast financial deficit which currently exists in Royal Mail's Pension Fund is one of the most serious challenges facing the business at the present time. As Postcomm correctly observes, in its 2004 Report and Accounts Royal Mail Group reported a £4.7bn deficit in its pension fund. Needless to say the position of the pension fund is a matter of grave concern to

the CWU and to its members. The wellbeing of the company's employees once they retire is dependent on the ongoing viability of the pension fund. It is also absolutely apparent that addressing the deficit is key to securing Royal Mail's own future and in particular its ongoing ability to meet its universal service obligation.

34. We have consistently argued that Royal Mail's pension commitments should be fully funded in the next price control. It is absolutely clear to us that such funding is justified. Royal Mail's customers benefited materially from the holding down of postal prices during the period of pension contribution holidays taken over recent years. The Government of the day also benefited materially from the contribution holidays. Such benefits came not only from increased tax revenues but also through general increases to Royal Mail's profits. At the same time these contribution holidays have led to the pension fund reaching the current deficit levels. We therefore believe that it is absolutely justifiable that these repayments should be funded through the price control.

35. We are absolutely opposed to Postcomm's proposal in this area. The regulator is proposing that an allowance should be made in the price control which would allow the pension fund to be paid over a 20 year period, rather than over the standard commercial approach of 12 years. We do not believe that the regulator and its consultants have adequately justified their reasons for departing from industry norms to recommend the longer recovery period. We firmly believe that their proposals are not in the best interests of Royal Mail Group's employees, the company or, in view of the need to ensure its ongoing ability to discharge its responsibilities under the universal service obligation, its customers. Accordingly we support the incorporation in the price control of a much greater allowance for pension funding than the amount put forward by Postcomm. An approach more closely in line with the standard 12 year recovery period advocated by Royal Mail would provide a more appropriate solution.

Duration and Responsiveness of the Price Control

36. In our response to the last round of consultation we recognised that there would be some merit in implementing a price control of a longer duration than the present three years. However we based our support for an extended duration price control on the basis that it retains the existing single tariff basket structure and utilises an RPI+Y formula. We also emphasised our belief that, in any event, the new price control would need to incorporate sufficient flexibility for modifications to take place during the term of its operation. In particular we highlighted the need to include clear and robust re-opening mechanisms which would allow the price control to be amended in the event of unexpected changes in relation to the development of competition or similar factors.

37. Postcomm is proposing to set a four-year price control to run from April 2006 until March 2010 and to retain the existing price control re-opening mechanisms. We do not believe that either of these elements of the regulator's proposals is appropriate given the wider details of the planned price control. If Postcomm decides to proceed with the bulk of its initial proposals set out in its consultation document, which would constitute a significant level of change compared to the existing price control, we believe that the risks for the state operator will be significant (as discussed elsewhere in this submission). In such circumstances we do not believe it would be appropriate for the duration of the price control to be extended. Instead we believe that if Postcomm decides to proceed with the majority of its proposals unchanged then the duration of the review should be kept to a minimum to ensure that the risks to the state operator are also minimised.

38. With regard to the re-opening of the price control, the CWU does not accept Postcomm's argument that the current mechanisms included in Condition 19 of the License will continue to be sufficient for the next price control. The CWU believe that there are significant risks associated with full market liberalisation, which may adversely affect Royal Mail and its ability to provide the universal service. In such circumstances, it is essential that there are clearly defined mechanisms which will allow for the rapid reopening of the price control. The

protection of universal service provision must retain paramount importance. Accordingly we believe that Postcomm should modify its proposals in this area to permit rapid action in the event that risks outside the control of Royal Mail threaten its financial viability and/or its ability to maintain acceptable standards of service.

The Scope of the Price Control

39. The scope of the new price control is obviously a matter of significant importance for the future of Royal Mail and the wider postal industry. The CWU strongly believes that the price control should only apply to products and services where it can be clearly demonstrated that no competition will exist at, or soon after, the date at which it is due to commence. To price control products in these circumstances would put Royal Mail at a very significant disadvantage and would inevitably have a very damaging impact on the company and the wider postal market in the UK.

40. We are pleased that Postcomm's proposals have recognised the case for the removal of the Presstream and Special Delivery products from the scope of the price control. We agree that there is sufficient evidence for the development of competition in these areas to justify their exclusion from the new control. We are however disappointed that the regulator does not recognise the clear case for removing other products from the control.

41. We have serious concerns about the ability of the new price control to respond rapidly to new developments in the UK postal market. Postcomm has based its initial proposals on its belief that "there is limited evidence of actual competition in the UK postal market". The CWU acknowledges that significant competition has initially been slow to develop. However, we believe that there is a growing body of evidence which suggests that this position is likely to change rapidly once full market liberalisation has taken place in January 2006. With this in mind, we are very concerned that the process which Postcomm is proposing to introduce (to allow the removal of existing products from the price control) will not be sufficiently dynamic to react to rapid changes in the market.

42. Specifically, Postcomm is proposing that to secure the removal of price controlled products Royal Mail must make an application by 31st August each year. Such an application(s) would not allow the removal of the product until the following April at the earliest, subject to a public consultation and Postcomm's agreement. We believe that the approach which the regulator is proposing to take will not allow the universal service provider to make the necessary rapid responses to the changes which are likely to take place in the postal industry following liberalisation. Instead, we believe the regulator should set out a clearly defined set of objective criteria against which any of Royal Mail's products could be evaluated in order to make a judgment about whether or not it should be removed from the price control. Such an approach would have the advantages of: providing clarity for all interested parties; ensuring that Royal Mail is not unfairly disadvantaged for periods of up to twelve months while awaiting the removal of products from the price control; and ensuring that competition only develops in a sustainable manner.

43. With regard to the treatment of new products, we strongly support the principle that new products introduced by Royal Mail should not be subject to the price control. We believe that a failure to exclude such products from the price control could have a serious inhibiting effect on the development of innovative product offerings by the universal service provider. We therefore support Postcomm's proposal to continue to exclude the new products which Royal Mail has introduced during the period of the present price control – in particular Mailmedia, Mailsort 120 3, Special Delivery 9am, Packetsort Premium, Response Plus and Presstream Walksort. However, this apparent willingness to reward innovation in some areas merely highlights the inconsistency of Postcomm's proposals to bring access products within the scope of the price control. The CWU's views on the pricing of access products are discussed in more detail below.

Access Products

44. The CWU has strongly and consistently opposed the principle of third party access. Nevertheless, given the requirements currently set out in Royal Mail's licence, it is clear that Royal Mail is required to enter into discussions with licensed postal operators if they are seeking such access and to provide such services as a result.
45. The CWU is strongly opposed to Postcomm's proposal to bring access products inside the scope of the next price control. We are unable to see how such a modification is either desirable or necessary. First and foremost, we do not believe that the operation of the existing arrangements necessitate such an approach. The agreements which led to the development of the third party access products were the result of open commercial negotiations between Royal Mail and licensed private postal operators. These companies freely entered into these agreements and it is clear that they are already deriving significant financial benefits from them. Recent figures released by Royal Mail show that in the region of 55 million items of access mail are being carried each month – this means that the development of access has already far exceeded Postcomm's own projections and is in fact running at the levels which it had forecast would be reached some time during 2007 (as shown in Table 8.3 of Postcomm Initial Proposals document).
46. It is also clear that the terms of Royal Mail's licence already provide substantial additional safeguards in relation to access products. Specifically Condition 9 governs the terms and conditions (including those relating to price) which apply to these access products. That this licence condition provides a satisfactory basis for third party access is demonstrated by the willingness of private postal operators to enter into these agreements.
47. We are also unable to see how Postcomm's proposals are consistent with its desire for a "light touch" regulatory regime. Furthermore, the proposed treatment of the new products which have been developed in relation to access would not be consistent with the treatment of other new products (as discussed

under the section dealing with “the Scope of the Price Control” above). Instead Postcomm appears to want to merely extend regulation into this area in a way which is inconsistent with its approach elsewhere.

48. Looking at the detail of Postcomm’s proposal, we believe that the imposition of a controlled margin between access products and the corresponding retail products will materially and unfairly disadvantage the universal service provider. We believe that the utilisation of this approach illustrates particularly clearly the extent to which the regulator is prepared to go when introducing competition. It could even be argued that the regulator’s approach in this area represents an attempt to begin a de facto separation of Royal Mail’s delivery function from the remainder of the business. Such a development is not in the interests of the company, its employees or its customers.

The Structure of the Price Control

49. Postcomm is proposing that the price control should comprise two tariff baskets – one covering “captive “ customers and one covering “non-captive” customers. It is also proposing that the threshold for rebalancing *within* these two tariff baskets should be increased from the existing level of 2.5% per annum to 4% per annum. The CWU strongly opposes Postcomm’s proposal to divide the price controlled products between two tariff baskets. Although the increase to the rebalancing threshold appears to provide Royal Mail with greater flexibility in relation to pricing, we believe that any positive gains from this approach are more than negated by the inability to rebalance between baskets.

50. As set out in our response to the previous round of consultation, the CWU’s preference (given the regulator’s overall intention) is for the retention of the existing structure – a price control comprising a single tariff basket which would allow a progressive migration towards a system of pricing incorporating significant improvements to cost reflectivity. We also emphasised our belief that Royal Mail should be permitted greater flexibility to rebalance prices between controlled products in the baskets. We believe that the use of this approach would have the benefit of being easily understood by interested

parties (as it has already been in operation for almost three years), while simultaneously allowing Royal Mail the flexibility to make the necessary pricing adjustments to ensure that prices are brought more closely into line with costs. The latter requirement is all the more pressing in view of Postcomm's accelerated programme of liberalisation.

51. We believe that the utilisation of two separate tariff baskets will have a number of damaging implications for Royal Mail and by extension for the long term future of the wider UK postal industry. While Postcomm claims that its approach to the allocation of costs and the consequential allowed revenues should address any concerns which Royal Mail may have in relation to price rebalancing, we do not agree with Postcomm's arguments in this area.

52. First and foremost the CWU maintains a clear strong preference for the retention of the traditional cross subsidy arrangements which have underpinned the provision of the USO in the UK. Nevertheless, given Postcomm's rapidly approaching date for the full liberalisation of the UK postal sector, it appears to be inevitable that Royal Mail will have to bring its prices more closely into line with its costs if it is to avoid being exposed to competitors undercutting its prices in areas where prices are not cost reflective.

53. Therefore, while Postcomm's approach will allow rebalancing within the baskets, it will not permit Royal Mail to rapidly address some of the key areas in which prices will most urgently need to be rebalanced. In particular it will not permit the necessary rebalancing between the price of ordinary stamped mail items and those charged to bulk mailers. There is a real danger that if Postcomm proceeds with this approach it will, in effect, distort the market through artificially preventing the state operator from undertaking the necessary rebalancing. We believe that this in turn will expose significant areas of Royal Mail's market to unfair competition and will have a consequential negative impact on the company's financial position at a time when it is only now beginning to address the financial and service quality problems of recent years. We therefore strongly believe that a single tariff basket should be retained to allow Royal Mail the flexibility to rebalance its prices in a manner

which will most rapidly secure the greatest cost reflectivity. We believe that this is made necessary by Postcomm's own liberalisation activities, which require Royal Mail to dismantle the system of cross-subsidies which underpin its historic pricing structure.

Compensation

54. While we believe there are a number of positive elements to the actual quality of service standards which Postcomm is proposing to implement (which are discussed in more detail in the next section), we are absolutely opposed to the regulator's plans to impose even more stringent payments and penalties as part of the new price control. Postcomm's intentions in this area are made explicit in its report:

“The maximum potential financial exposure to Royal Mail under these incentives would be about £280m per year. This compares with a proposed regulatory profit before this financial exposure of about £285m on average per year. Therefore, achieving the forecast regulatory profit will depend upon Royal Mail meeting its quality of service targets.”

(p.17 Postcomm's consultation document)

55. We have made our views clear about Postcomm's approach to profitability elsewhere in this submission. We believe that even without taking these compensation measures into consideration, its approach to profitability will merely starve the company of resources at a time when it needs extensive funds to modernise all parts of its infrastructure. We believe that to increase the potential levels of compensation and related financial penalties at such a time is extremely irresponsible and will merely increase the pressure on the universal service provider at a time when it will already be facing the additional pressures of a fully liberalised market.

56. While it is clear that Royal Mail, with the assistance of its skilled workforce, is beginning to address the quality of service problems it has faced in recent years, it is not yet clear how sustainable these gains will be in the longer term.

We have very real concerns that without substantial investment in a whole range of areas, current improvements in quality of service will not be lasting. The imposition of this compensation and penalty regime simply increases the risks for the business and simultaneously endangers funds for future investment. We therefore believe that the regulator must revisit its proposals in this area, and instead put in place a regime which places less importance on punitive action and more on ensuring that current improvements in quality of service are maintained.

57. We believe there are two key areas in which Postcomm must modify its proposals to address our concerns regarding the level of penalties which Royal Mail faces. First, the quality of service banding system (discussed in more detail below) should be modified so that compensation does not become payable until performance is two per cent below the target rather than the proposed one per cent. This would retain a substantial robust financial incentive on the business but would provide a fairer arrangement than is currently being proposed by the regulator. Second, we do not believe that fines should automatically be considered at five per cent below the target. Instead we believe that fines should only be considered in the most extreme circumstances, where it can clearly be shown that quality of service standards were the result of, for example, neglect by the company rather than simply for failing an arbitrary figure.

Quality of Service

58. We generally support Postcomm's proposal to reduce the number of quality of service standards, as we advocated in our previous submission. We believe that the current number of service standards – 16 in all (or 28 if tail-of-mail standards are included) is too great to be meaningful either for Royal Mail or for its customers. At first sight it appears that there may be significant benefits – in terms of clarity and accessibility – in combining standards to rationalise the overall total. The five proposed groupings also appear to make some sense, with clearly recognisable standards for different product areas. We believe that this has the potential to be a positive development. However we are opposed

to the proposal to base these groupings on performance standards by revenue instead of volume. Such a measurement system would rob the standards of much of their immediacy and meaning, which we believe would be contrary to their purpose. As a consequence we believe the regulator should retain the existing volume-based approach.

59. We are also generally supportive of the banding approach which the regulator is proposing to adopt and which had largely been agreed between Royal Mail and Postwatch prior to this consultation exercise. We believe that this modification has the potential to represent a substantial improvement over the existing simplistic pass/fail approach. However we do not support the utilisation of automatic fines for all quality of service failures over 5%, as discussed above.

60. We are disappointed that the regulator has not decided to introduce performance standards relating to collection times (as put forward by the CWU in our response to Postwatch's recent consultation on quality of service), instead preferring a straight calculation of the overall percentage of collections which have been completed on a given day. We are also disappointed that the regulator is not proposing to reintroduce quality of service standards in relation to post office queuing times. We believe that both of these sets of performance standards would have materially benefited Royal Mail's customers and ensured the continued provision of high quality services in key areas of Royal Mail Group. We therefore believe that Postcomm should revisit its proposals in this area.

Conclusion

61. The CWU is strongly opposed to the great majority of Postcomm's initial proposals for Royal Mail's next price control. We believe that the restrictive (RPI minus) approach the regulator is proposing to adopt will materially damage Royal Mail's core business activities at a time when it also faces full market liberalisation – itself a grave area of concern. We do not believe that this is in the interests of the company itself or the wider UK postal sector.

62. The CWU has some serious concerns about the consultation process itself and the approach Postcomm has adopted during this phase of the review to the provision of supporting information. We believe that the release of vital supporting information late in the consultation period has made it extremely difficult for interested parties to reach a detailed position on the issues which are at stake. We believe that this in turn has undermined the credibility of the review process.

63. Looking at the detail of Postcomm's proposals, we believe that Postcomm's evaluation of Royal Mail's regulatory value and its proposal for the introduction of a profit allowance are both substantially flawed. We are also extremely sceptical about the conclusions which Postcomm and its consultants have reached in relation to the issues of efficiency and investment. Furthermore, we do not believe that the regulator is making an adequate (or satisfactory commercial) allowance for repayment of Royal Mail's pension deficit – a key area of concern for the CWU and its members. We also have key reservations in relation to the scope and structure of the price control which Postcomm is proposing. While we believe that there are some positive elements relating to the modified quality of service measurement regime, these are more than outweighed by the continued stringency of the compensation arrangements.

64. In view of these factors we believe that Postcomm must revisit its proposals and instead put in place a price control which places the continued provision of the universal service as the highest priority. We simply do not believe that Postcomm's current price control proposals will enable it to meet its primary statutory duty under the Postal Services Act 2000.

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