

## **Consultation on Postcomm's Initial Proposals for the 2006 Royal Mail Price and Service Quality Review**

*Response from National Federation of SubPostmasters*

### **1 The National Federation of SubPostmasters**

1.1 Postcomm has opened for consultation its initial proposals for new price and quality of service controls for Royal Mail. This is the National Federation of SubPostmasters' response to the proposals.

1.2 The National Federation of SubPostmasters (NFSP) is the only body representing the interests of 15,000 subpostmasters throughout the United Kingdom. Sub post offices make up 97% of the national network of post offices and are run by private business people, subpostmasters.

### **2 The Proposals**

2.1 The new price and quality of service controls are proposed to run for four years from the expiry of the current arrangements in April 2006.

2.2 Postcomm proposes to restructure the current single tariff basket covering all regulated products into two baskets;

- Basket A – the captive basket, for products where prospects for competition over the next four years are limited or weak (mostly public tariffs) – to be set at RPI-3%
- Basket B – the non-captive basket, for products where prospects for competition are stronger (mostly bulk business tariffs) – to be set at RPI-2%

It is proposed that Royal Mail can re-balance prices within each basket but not between baskets.

2.3 New products will continue to sit outside of price control and the proposals create scope for products to be removed from price control within the duration of the new arrangements. Postcomm also proposes to include within price control Royal Mail charges to other operators for downstream access to its network, and to permit Royal Mail to price on a geographically differentiated basis on non-universal service products within the price control.

2.4 Postcomm proposes to reduce the number of quality of service targets from 16, within the current arrangement, to 10 and to increase compensation charges to Royal Mail on failure to meet the targets from the current less than 1% to 5% of revenue for the relevant products.

### **3 Implications for Royal Mail**

3.1 NFSP is principally concerned about the impact that the controls will have on the revenues of Royal Mail Group. Clearly these price controls will be key in determining Royal Mails profitability. With Royal Mail products and services now the major source of income for Post Office Limited since the introduction of direct payment of state benefits and pensions, this will in turn significantly impact on the future of the national post office network, subpostmasters and the quality of postal service Royal Mail is able to offer to customers.

3.2 NFSP fully acknowledges the need for price control during the emergence of the competitive market and believes that any new regime must strike a balance between protecting the Universal Service, enabling competition but also giving Royal Mail the opportunity to operate at profit, which can in turn be invested in the post office network through the business-to-business arrangements between POL and Royal Mail.

3.3 Instead, we fear that the proposed combination of an excessively far reaching price control, an effective cap on Royal Mails profits and the proposed five-fold increase in compensation payments risk resulting in Royal Mail struggling to generate revenue.

3.4 A less profitable Royal Mail would impact directly on the post office network and on its other operations, and therefore on its ability to be competitive; NFSP believes that this would also inevitably undermine Royal Mail's ability to meet its Universal Service obligations, leading to difficulties both with current staff and with the ability to recruit new staff in the future.

3.5 Looking at some of the specific proposals, we very much welcome the fact that new products remain outside of price control and also applaud the proposal that there should be the facility within the new system to allow products to be removed from price control within the duration of the arrangement, should competition develop during that period. However, we share the concerns expressed by others that this facility is insufficiently flexible to allow it to deliver and be genuinely commercially reactive. We also support the proposals to allow Royal Mail to introduce cost-reflective pricing by pricing on a geographically differentiated basis on non-universal service products, as this offers more of a level playing field between Royal Mail and competitors.

3.6 We oppose the proposals to introduce two separate price controlled baskets, between which Royal Mail could not rebalance prices. This loss of the historic cross-subsidy, coupled with profitable business customers being "cherry picked" by competitors leaving Royal Mail with the unprofitable social mail due to its Universal Service obligations, would inevitably lead to the need to increase the price of social mail to more closely reflect costs. Royal Mail claims that the proposed maximum permitted price increases over the four years in 1<sup>st</sup> class mail to 34p and in 2<sup>nd</sup> class mail to 23p will not enable it to achieve this.

3.7 Instead, NFSP believes that only products where there is not and there is unlikely to be competition should be covered within price control; and that if Royal Mail is to be able to compete on a genuinely level playing field (and therefore engage in a genuinely competitive market) Postcomm must permit Royal Mail to make social mail more cost-reflective than is currently proposed.

3.8 We also strongly oppose bringing charges for downstream access into price control – Royal Mail must be free to negotiate agreements for downstream access with its competitors. These proposals represent undue regulatory interference.

3.9 NFSP is deeply concerned about the proposed quality of service targets and compensation payments. While we support the need for a meaningful set of performance targets, we believe that rather than offering the stated intention of “stronger financial incentives” for Royal Mail, the new proposals are excessive and punitive. The possible £280million in compensation payments to be faced by Royal Mail if it fails by 5% or more to meet all of the proposed quality of service targets risk wiping out the £285million at which permitted Royal Mail profits will effectively be capped. These profits are much needed to ensure a commercially viable Royal Mail and therefore post office network. We believe that, rather than significantly reducing or potentially wiping out resources which through business-to-business arrangements between Post Office Limited and Royal Mail could help provide badly needed investment within the post office network, Postcomm should instead set a framework which strikes a balance between setting incentives for Royal Mail to meet service targets and ensuring that Royal Mail and therefore the national post office network are not at risk of having no profits to invest in its operations.

3.10 While NFSP is not in a position to form an independent view on how the proposals will affect Royal Mail Group’s financial position, we note with concern the £2.5 billion variance between Royal Mail and Postcomm’s valuation of the asset base. This significant disparity in estimates must inevitably call into question the basis of the rest of the calculations within proposals. This comes at a time when a range of other significant factors come into play within the postal services market – first and foremost a fully liberalised market from 1 January 2006; also the future ownership of Royal Mail, and the impact in profit, volumes and, in time, other resources of the Pricing in Proportion system. Viewed as a whole, NFSP believes that this range of unknown variables during a critical period for the UK postal services and the post office network means that, while a price control clearly has to be set, Postcomm should take a more balanced and less radical approach in order to safeguard the future of Royal Mail and the post office network.

#### **4 Implications for the Post Office Network**

4.1 The post office network is the largest retail branch network in the UK. With over 14,500 branches, it is bigger than the major bank and building society networks combined. Post offices currently offer a range of 170 different postal,

government and commercial services. An estimated 28 million people make 41 million visits a week.

4.2 However, the network has faced some very serious challenges in recent years. Over 2,500 urban post offices have been closed under the Governments Network Reinvention Programme, while the future of the rural network comes under review in early 2006 with further closures likely. The change to direct payment of Government pensions and benefits has led to significant loss of income for subpostmasters, which the range of new products and services introduced by Post Office Limited has yet to offset.

4.3 The critical state of the post office network is illustrated by the fact that, while Royal Mail Group registered record profits of £537 million in 2004-05, losses incurred by Post Office Limited rose by 7% during the same period to £110m.

4.4 NFSP wants to see proper investment in and support for our national post office network to enable our vision of providing the public access to bigger, better and brighter post offices, with a wide range of services, delivered by trained, qualified and rewarded subpostmasters. Royal Mail profitability is key to achieving this, with business transactions with Royal Mail now the biggest income source for Post Office Limited, and post offices acting as the public face of Royal Mail and as a key point at which the public access a range of postal products. We are therefore concerned about the impact of any new price control on Royal Mail Group revenues, as these will have a direct bearing upon the transactions between the businesses within Royal Mail Group and therefore on investment within and sustainability of the national post office network.

4.5 Under Postcomm's initial proposals, we fear that Royal Mail's reduced scope for profit generation will lead directly to less business for Post Office Limited, which in turn will lead to further deterioration in and reduction of the post office network. This would have serious consequences for communities and for vulnerable and marginalised individuals across the country that are dependent upon the Post Office® to access a range of postal, community, financial and Government services.

4.6 This adverse impact applies across the network and includes the approximately 1000 Scale Payment Delivery Offices (SPDOs, also widely known as "mailwork sub post offices"); post offices run by subpostmasters which also provide premises, facilities and supervision for Royal Mail delivery staff. We are concerned that a significant drop in profits will restrict Royal Mail's ability to properly remunerate SPDO-based subpostmasters for the work they do on Royal Mail's behalf and to ensure the much needed investment in those premises.

4.7 Sub post offices have a strong product dependency on Royal Mail. In addition, post offices and subpostmasters act as the public face of Royal Mail, a largely unacknowledged role. Over-stringent quality of service targets may well lead to the network handling more complaints. This, together with the

real risk that competitor's mail will still be considered by the public to be Post Office® mail for complaints within the newly liberalised market, means that these proposals could see post offices facing greater pressures from the public while gaining less or no income from a Royal Mail unable to generate sufficient profit.

## **5 Conclusions**

5.1 NFSP welcomes Postcomm's efforts to propose a new price control and quality of service arrangements.

5.2 However, while there is much to commend within the proposals, we are deeply concerned that as a whole package they are too extensive and too restrictive to enable Royal Mail to compete commercially, as it is charged to do by its shareholder. This will severely impede Royal Mail's ability to generate revenue, which in turn will affect the business-to-business arrangements between Royal Mail and Post Office Limited; income from which enables POL to invest in the post office network. We have grave concerns that this reduction in Royal Mail's profits will lead to further reduction in the network.

5.3 NFSP would stress that the post office network is a hugely valuable resource to the Government, as well as to individuals, communities and the nation as a whole. Experience demonstrates that it is far harder to re-open post offices than to retain existing ones and it is certain that if permanent damage is done to the national network, there will be no opportunity to go back. NFSP therefore urges Postcomm to ensure that its proposals are modified to better balance competition, protection of the Universal Service and Royal Mail's ability to generate profit, which helps sustain the national post office network.