

# **The challenges and opportunities facing UK postal services**

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**An initial response to evidence**

May 2008

**An independent review of the UK postal services sector**

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# Preface

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## The purpose of the review

An independent review of the postal services sector was announced by the Secretary of State for Business, Enterprise and Regulatory Reform on 17 December, 2007. The decision was taken in the context of significant developments in the market since the introduction of the Postal Services Act 2000. They include the growth of digital communications, liberalisation leading to the rapid growth of competition in some areas of the market, and changes to Royal Mail's operations.

The review is independent of Government and is conducted by Richard Hooper CBE, Dame Deirdre Hutton and Ian R Smith. The panel will report to Ministers later this year. Its terms of reference are:

- ▶ 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; and
- ▶ consider how to maintain the universal service obligation in the light of trends and market developments identified.

## The purpose of this paper

*We define consumers to include: large businesses, small and medium sized enterprises, and domestic users.*

The panel has set out to generate an active and constructive debate across the widest possible range of stakeholders with an interest in the future of the postal service. This includes consumers and their representatives, companies providing postal services, trades unions, political parties, Government Departments, the devolved administrations and regulators.

In doing so, the panel's aim is to establish a body of evidence which has widespread support as a basis for evaluating the full range of choices open to policy makers over the short and long-term. In the first three months of the review, the panel has already received formal submissions from 35 organisations and 6 individuals on the first two of its three terms of reference.

This paper is part of an iterative consultation process. It summarises the main points of the evidence received so far on terms of reference 1-2 and gives the panel's initial response. The panel wants to establish a broad level of agreement about the challenges and opportunities facing the postal sector as a basis for stakeholders submitting evidence on terms of reference 3: how best to maintain the universal service. Comments and reactions to this paper will be welcome, as will further evidence if circumstances change during the review, or if new data comes to light.

When the review was established, the Government asked for evidence to be submitted by 29 March. To ensure that the challenges and opportunities facing the postal sector were given sufficient attention, we extended the deadline for evidence on terms of reference 3. So that organisations can reflect on this paper

before providing further evidence, the new deadline for submissions is 19 May 2008.

### **The structure of this paper**

Rather than tackle each of the components of our terms of reference in turn, we have structured the paper in a way which describes an unfolding story about the postal market. It is designed to be accessible to a wide audience without a technical knowledge of the mail business. Specialist terms which are unavoidable are defined in the glossary in Annex 2.

We begin with a basic description of the market, before explaining how developments in the wider communications sector are affecting the demand for postal services. We explore the impact of liberalisation which, it now seems, has coincided with the start of a decline in the letters market. Finally, we look at the challenges ahead for Royal Mail and the implications for the universal service.

### **Acknowledgements**

We are grateful to the following organisations for their valuable evidence and contributions during the course of the review so far: Cass Business School, Citipost, Communication Workers Union, Conservative Party, CVC, DHL Global, Direct Marketing Association, DX Group, The Economist, E.ON UK, Federation of Small Businesses, Financial Services Authority, H Bauer Publishing, Haymarket Media Group, HSBC, IMRG, Institute of Directors, IPC Media, La Poste, Liberal Democrats, Lloyds TSB, Mail Competition Forum, Mail Order Traders Association, Mail Users Association, MBNA, Merrill Lynch, Morgan Stanley, National Federation of Sub-Postmasters, Neopost, Ofcom, Oxford University, Periodical Publishers Association, Pitney Bowes, Postcomm, Postwatch, Publicis, Redwood Publishing, Reed Business Information, Rothschild, Royal Bank of Scotland, Royal Mail, Royal Mail Pension Trustees, Scottish Consumer Council, Scottish Nationalist Party, Strategia, TNT Post, UK Mail, Unite, UPS, Warwick University Business School and Williams Lea.

A number of Government Departments and public bodies have already supported the review with resources, evidence, ideas and expertise. We are grateful to the Department for Business, Enterprise and Regulatory Reform, HM Treasury, the Shareholder Executive, Cabinet Office, the Scotland Office, the Scottish Government and the Assembly of Wales.

We are grateful to all the Royal Mail staff who have assisted the panel and secretariat during their visits to see postal services in action so far. Thanks go to staff at the Royal Mail Centre at Greenford, the Princess Royal Distribution Centre, Northolt Delivery Office and East Finchley Delivery Office; to Harry Koorstra and his team at TNT Post, Amsterdam; and to John-Paul Forceville and his colleagues at La Poste, Paris.

The secretariat is led by Jon Booth. Its members are Sue Bide, Stephanie Dales, Rob Faull, Martin Hall, Alistair Rawson, Michael Ridley and Duncan Tessier.

## Executive summary

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Post matters. It is important for the productivity of the economy and for social cohesion. Maintaining the universal service is at the heart of this review: ensuring collection from pillar boxes and post offices and delivery to all addresses.

In evidence to the panel, everyone has recognised that the regulation of the UK's postal services, their funding, structure and their capacity to modernise and innovate are serious issues. They are the means to an end. Our primary focus is on consumers: large businesses, small and medium sized enterprises and individuals.

Our vision is that the UK benefits from a strong, competitive, innovative and cost-effective postal services market focused on meeting the needs of its customers.

### **An uncertain future**

The market is changing and faces an uncertain future. In more challenging economic conditions, companies are looking to drive costs from their business. There is a greater awareness of environmental issues. And, crucially, there has been an explosion in the use of digital media.

Understanding the impact of the digital revolution on various types of mail is complex. The future partly depends on whether postal companies can develop new, higher-value services, including delivering goods ordered on-line. But there is an emerging consensus that the letters market is at the start of a long-term decline.

Liberalisation is a substantially more difficult exercise in a sector already facing such significant change. We have visited international postal companies and can learn from their experience. But we recognise that the UK faces a unique set of challenges.

### **The impact of liberalisation**

In the two years since 2006, competition in the collection, sorting and transportation of bulk mail from businesses has expanded rapidly – and much more quickly than even the regulator had anticipated.

There is virtually no competition to Royal Mail in the delivery of addressed letters. Yet some 60% of the company's costs are located in this "final mile". There are mixed opinions about the prospects of end-to-end competition in the future. Some believe that alternative carriers already have the volumes necessary to invest in delivery, perhaps twice a week, in urban centres. Others point out significant barriers to entry. We will need to consider this further, along with the risk that more extensive competition could make the universal service unsustainable.

The 50 companies which make most use of the postal service account for 40% of the market. They, and other large businesses, have seen clear benefits from liberalisation: choice, lower prices and more assurance about the quality of the mail service.

We have frequently heard that Royal Mail is focused more on regulation and price competition than on the needs of its customers. Large businesses want deals which reflect their needs and constraints – but are confused about the flexibility which Royal Mail has, under the regulatory framework, to meet their requirements.

There have been no significant benefits from liberalisation for smaller businesses and domestic consumers. They believe that Royal Mail's service offers good value for money as it stands. But they have no choice in provider and are paying higher stamp prices. The introduction of a pricing methodology based on weight and dimensions makes life more difficult.

While Royal Mail's performance against its quality of service targets is at record levels, the abolition of the Sunday collection and the move to a single daily collection have been more visible to small business and domestic consumers. Both changes are perceived as a reduction in service, particularly for small businesses who want earlier and more predictable delivery times.

Competition is based predominantly on price. While the open market is still very new, there has been less innovation than might have been expected. Digital communications offer new opportunities for more flexible, targeted services at a higher value.

The incumbent, its competitors and the regulator have fundamentally different expectations of the regulatory regime. Royal Mail calls for deregulation, while competitors and some business users want greater protection. The regulator wants Royal Mail to become much more efficient. All believe that the regulatory framework must reflect the changing nature of the postal market.

### **The challenges ahead**

We believe that a healthy, efficient and profitable Royal Mail is critically important for the future of the sector. Currently, only Royal Mail has the network needed to provide a universal service which lies at the core of the postal services market in the UK.

But the company faces many challenges. In 2006-07, Royal Mail's regulated business (including both the universal service and price-controlled products) made a loss (of £29 million) for the first time. In its submission to the panel, Royal Mail estimated that, in 2007-8, the universal service itself will be loss-making for the first time. It is constrained in its ability to raise revenue by increasing prices, owing to market developments. And it is less efficient than its competitors and many of its European counterparts.

Modernisation has been slow. In the future, modernisation will be more difficult still as volumes fall. Royal Mail is limited in the way it can access capital. Industrial action and a £3.4 billion pension deficit – one of the largest in the UK – also pose constraints. Changes in the market and competition have arrived at a testing time.

**Next steps**

There is now a substantial threat to Royal Mail's financial stability and, therefore, the universal service. We have come to the conclusion, based on evidence submitted so far, that the status quo is not tenable. It will not deliver our shared vision for the postal sector.

There is a strong case for action. The policies needed to establish a sustainable future will be the focus of our report later this year. As we see rapid changes in the way people communicate, the way in which the postal sector is regulated will also need to change. And we need to establish how best to create the incentives for Royal Mail to modernise its operation, providing a stable, financial future. Most important of all, policies must provide a high standard of service for consumers.

We look forward to receiving further evidence on potential future courses of action on 19 May 2008.

## Introduction

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*This introduction summarises the importance of the mail sector to the UK economy and society, and offers a vision for a modern postal service.*

### The postal sector and the UK economy

*The postal sector has an important role in the productivity of the UK economy ...*

1. The Government's central economic objective is to achieve high and stable levels of growth and employment. The productivity of workers and the level of employment are the main determinants of economic growth and therefore of living standards and quality of life for UK citizens.
2. Internationally comparable data in relation to the postal sector is limited. But research suggests that the US and German postal industries were 25 per cent and 9 per cent more productive respectively than the UK postal industry in 2002<sup>1</sup>. Improving productivity in the postal sector would help reduce the productivity gap<sup>2</sup> between the UK and other countries, both directly and by helping increase the productivity of firms in the economy. Some 87% of letters sent through the network are generated by companies. Many rely on the postal service to sustain and develop their business.

### Social objectives of the postal service

*... and its social cohesion.*

3. As a labour-intensive network business, mail is unlike utilities in many ways. But it has one important feature in common. Consumers value mail – as they do energy or water – not only when using the service, but also because the service is available to use at any time, as and when needed.
4. The postal service enables daily communications across all 28.4 million business and household addresses in the UK, regardless of their location, and beyond. It helps social cohesion by linking rural communities with more densely populated areas of the country, and ensures that older people and those with disabilities have an accessible, reliable means of communication and the capacity to send and receive physical goods. It is the means by which most of the nation's 4.5 million<sup>3</sup> small and medium-sized businesses carry out basic transactions with their customers and suppliers, receive income and distribute their products. These small businesses are responsible for turnover approaching £2,600 billion: almost 52% of the nation's total.

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<sup>1</sup> *Cross-Country Productivity Performance at Sector Level: the UK Compared with the US, France and Germany*, BERR Occasional Paper No.1, February 2008.

<sup>2</sup> The role of individual sectors in explaining the productivity gap is discussed further in *Productivity in the UK 7: Securing long-term prosperity*, HM Treasury & BERR, November 2007.

<sup>3</sup> *Small and Medium-sized Enterprises Statistics*, BERR, August 2007.



5. In a recent survey<sup>4</sup>, the UK was found to have the most positive attitudes towards the postal service. No fewer than 96% of respondents said that receiving mail was an important part of their everyday life, and more important than telephones or holding a current bank account. Some 89% attached importance to sending letters.

#### A vision for the postal market

*We believe that the UK will benefit from a strong, competitive, innovative, cost-effective postal service market, with a healthy and profitable Royal Mail.*

6. In our view, the UK will benefit from a strong, competitive, innovative and cost-effective postal services market focused on meeting the needs of its customers. We believe that a healthy, efficient and profitable Royal Mail is critically important in realising this vision.
7. Royal Mail is currently the only company which operates a nationwide network for the collection of mail from domestic consumers and small businesses, and the delivery of letters and packages to any of 28.4 million addresses across the country. It has the responsibility for providing the universal service which is at the heart of European and UK postal legislation.

#### **Box 1: the Universal Service.**

The universal service is a set of requirements set out in the European Postal Services Directive, transposed in UK law by the Postal Services Act 2000. Some aspects of the universal service are unique to the UK.

Royal Mail has the responsibility for providing the service. The regulator, Postcomm, defines the obligation in detail.

The universal service obligation applies to letters, packets and parcels up to 20 kg in weight, and comprises:

- at least one collection from all access points; and
- at least one delivery to all addresses in the country

on six days per week (for letters) and five days (for parcels). Delivery must be directly to the letter box, and provided at an affordable, uniform tariff across the country. Royal Mail is also required to offer a registered service.

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<sup>4</sup> Special Eurobarometer 2007, Survey 260: *Consumers' Opinions of Services of General Interest.*

# Today's postal market

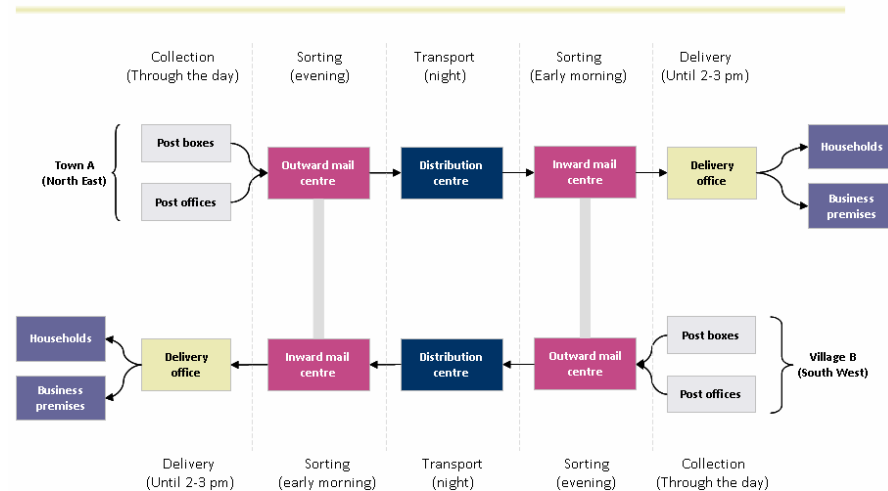
This section describes the postal market in the UK and considers the impact of change in the wider communications sector.

## How is mail delivered?

8. The mail process typically has five stages: collection, sorting by region, transportation, sorting into “walks”, and delivery. Figure 1 is a basic guide to Royal Mail's operation.
9. Collection takes place from one of the nation's 115,000 post boxes, 12,000<sup>5</sup> post offices and around 87,000 business addresses. After initial sorting during the evening at one of 69 mail centres, letters pass through one of 9 distribution centres, on their way to a second mail centre. Each of the mail centres receives mail from different parts of the country, sorts letters at local level, and transfers them to one of 1403 delivery offices. There, they are put into the right sequence and delivered to the door.

Figure 1

### The 24-hour mail process



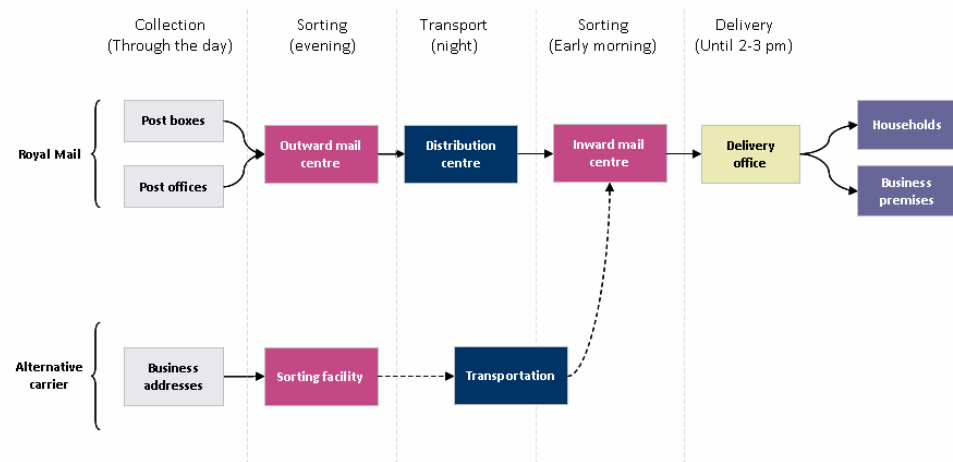
Each of the 69 mail centres has an “inward” and an “outward” function at different times of the day. Mail is also collected from some business addresses. Bulk mail handled by Royal Mail which has been pre-sorted is taken directly to one of the nine distribution centres.

10. Since liberalisation, many companies (including Royal Mail) are free to carry out collection, sorting, transportation, and delivery services under a licence issued by the regulator, Postcomm. A number of alternative carriers take advantage of downstream access arrangements. They collect mail in bulk from businesses, sort and transport it, before handing it over to Royal Mail at one of the “inward” mail centres for delivery over the “final mile” of the journey. (Figure 2.) In some cases, Royal Mail has a contract with alternative carriers to collect, sort and transport bulk mail on its behalf.

<sup>5</sup> This will be the number of post offices nationwide after completing the network change programme.

Figure 2

## Access arrangements

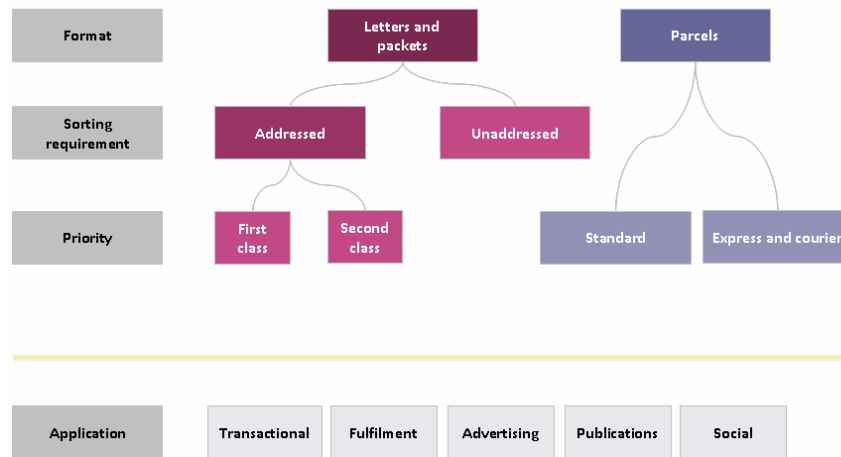


### Definition of the market

11. There are two main ways to categorise the mail market. It can be broken down by the **type** of mail.
  - ▶ Letters. Addressed letters, large letters and small packets which are small enough to be posted through letterboxes.
  - ▶ Unaddressed. Items which can be posted through letterboxes but do not contain an address, such as leaflets, catalogues, brochures and magazines.
  - ▶ Express and courier. Items which are guaranteed to arrive on a particular day or time, and / or which require a signature on delivery or “track and trace” facility.
  - ▶ Standard parcels. These items are not guaranteed to be delivered by a specific time and cannot be posted through letter boxes.
  
12. Mail can also be classified **by application** into five groups:
  - ▶ transactional mail: generated by businesses used in a financial transaction (such as bank statements and credit card bills).
  - ▶ fulfilment: goods ordered by mail, internet or telephone which need to be delivered to the consumer.
  - ▶ advertising mail: mail advertising products or services, sent to a named member of a business or household.
  - ▶ publications: periodicals and magazines delivered to the consumer.
  - ▶ social mail: mail originating from domestic consumers, such as birthday cards.

Figure 3

### Mail: A basic classification

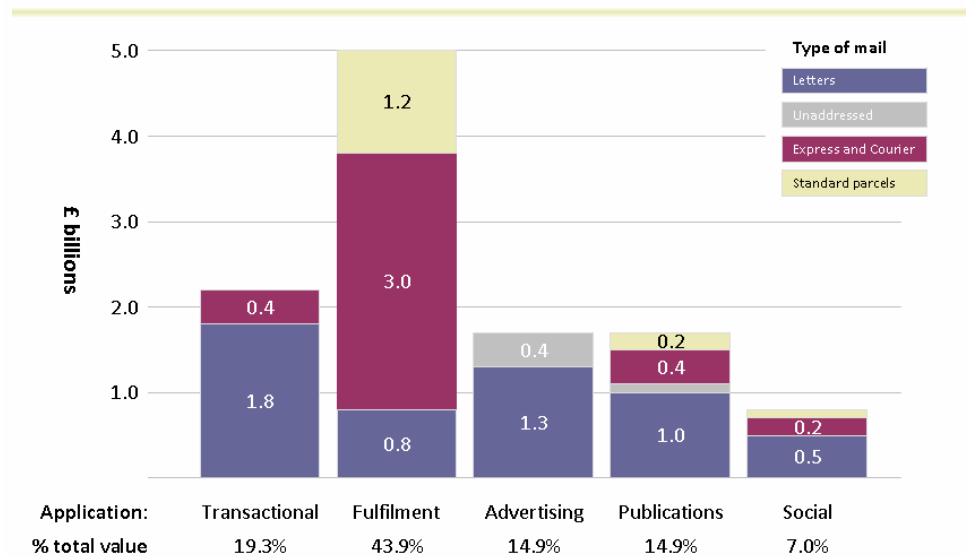


Note: Express and courier and unaddressed are not regulated markets.

Figure 4

### Value of the UK postal market (£11.4 billion)

(by type and application)



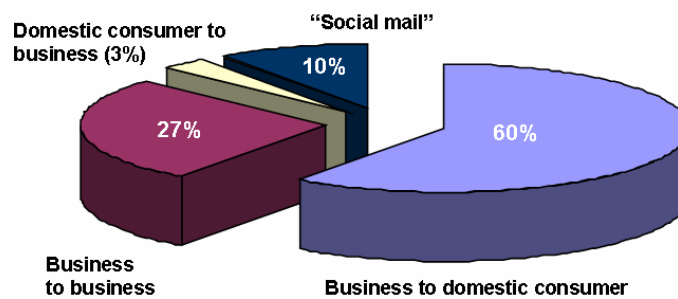
Source: Postcomm

### Who sends and receives mail?

13. While important, social mail represents a surprisingly small part of the overall market. Only 10% of all letters are sent between households, the majority of which are sent over the Christmas period. Including letters to businesses, the average household spends 50p per week on mail<sup>6</sup>. Figure 5 provides a full breakdown of the letters market by sender and recipient.

Figure 5

### Segmentation of the letters market (volume) by sender and recipient



14. By far the largest proportion of mail is generated by business and received by domestic consumers. The 50 companies<sup>7</sup> which make the most extensive use of the postal service account for 40% of the mail market. They comprise financial service companies, utilities and major retailers. But smaller enterprises are also regular users, and are often dependent on the postal service in carrying out their business. A survey by the Federation of Small Businesses<sup>8</sup> found that:

- ▶ 88% of respondents send post every day, 59% delivering goods and services and 69% sending invoices;
- ▶ 41% of businesses use the postal system to order goods which enable them to carry out their business.

### A declining market

15. There is an emerging consensus amongst those with a direct interest in the postal service that the letters market is now in decline. Evidence suggests that letter volumes reached their highest point around 2005,

<sup>6</sup> *Family Spending 2007*, Office of National Statistics

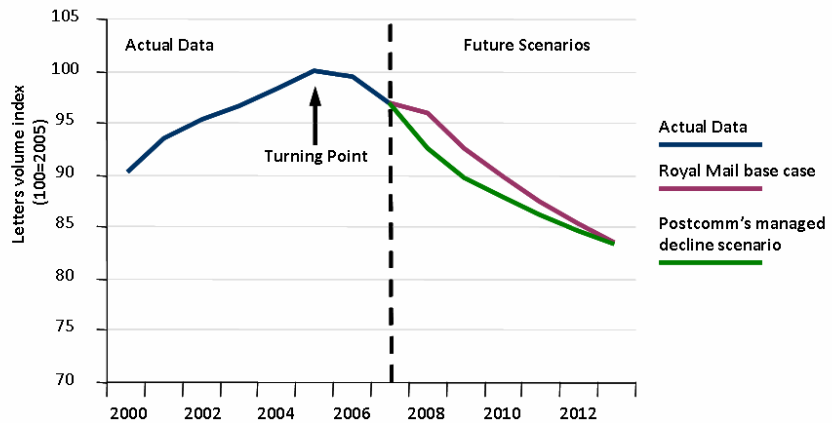
<sup>7</sup> Table 1, Postcomm's published evidence to the Review Panel.

<sup>8</sup> *Small Businesses and the UK Postal Market postal survey: First Past the Post*, FSB, January 2007. The survey had responses from 3,356 small businesses.

and have been declining since then. In each of the three years from 2005-6, volumes have fallen. The continuous decline in the letter market<sup>9</sup> over this period is unprecedented at least since the 1970s<sup>10</sup>, and represents a fundamental change in the market.

Figure 6

UK letters market, 2000 to 2012



16. In their submissions to the panel, Royal Mail and Postcomm provided scenarios for the development of the UK mail market in future, assuming that there are no changes to postal policy. Their scenarios (represented in Figure 6) suggest that the letters market is beginning a long term decline in which volumes fall in the region of 1-3% per year. The panel will examine in more detail to what extent this decline could be moderated by postal operators developing new products.
17. The UK's experience of declining volumes is consistent with trends in mature mail markets across the world:

**Table 1: Growth (reduction) in volumes of national postal operators<sup>11</sup>**

Country	Growth per year	
	1995-2000	2005- 2006
UK	3%	-1.5%
France	2%	-1.1%
Germany	3%	-2.6%
Western Europe Total	2%	-0.7%
United States	3%	+0.7%

<sup>9</sup> The “letters market” is defined as items that can fit through letterboxes, including packets, delivered by any carrier. It excludes unaddressed mail, international mail, standard parcels, express and courier services. The scenarios assume a policy status quo.

<sup>10</sup> Data available to the review panel begins in 1970.

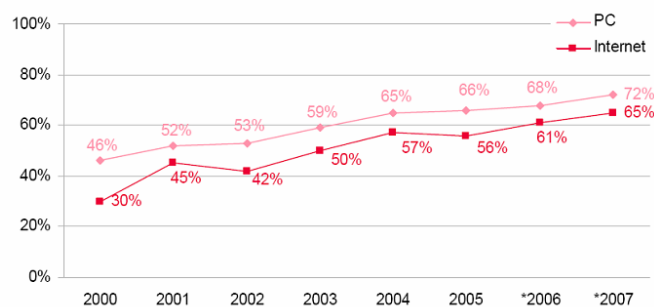
<sup>11</sup> Source: Fouad Nader and Michael Lintell, Mail Trends Update, Background Paper No. 2008-1, February 2008 (page 9).

## Developments in the communications market

18. The challenges and opportunities facing postal services need to be seen in the context of a much wider communications market. Broadband internet, email and text messaging offer alternative ways for people to keep in touch, carry out business transactions and advertise.
- ▶ In 2000, 30% of UK households had access to the internet. By 2007, this figure had more than doubled: 65%. (Figure 7).
  - ▶ 60% of internet users go on-line on a daily basis.
  - ▶ Three in every four residents owned a mobile phone in 2005-6<sup>12</sup>.

Figure 7

### Access to PC and internet in UK households, 2000-7



19. The rapid rise of digital technology is an important factor driving the decline of the postal market. While on-line commerce brings new opportunities for the postal service (e-fulfilment), the immediacy, flexibility and low marginal cost of electronic media make them attractive as alternatives to mail (e-substitution).
- ▶ Automatic payments (such as direct debit), on-line services, telephone and text messaging are replacing transactional mail.
  - ▶ Alternatives to social mail include email, internet social networking, telephone calls and text messages.
  - ▶ Advertisements are made through newspapers, TV, magazines, internet searches and display, radio, cinema and billboards, as well as mail.

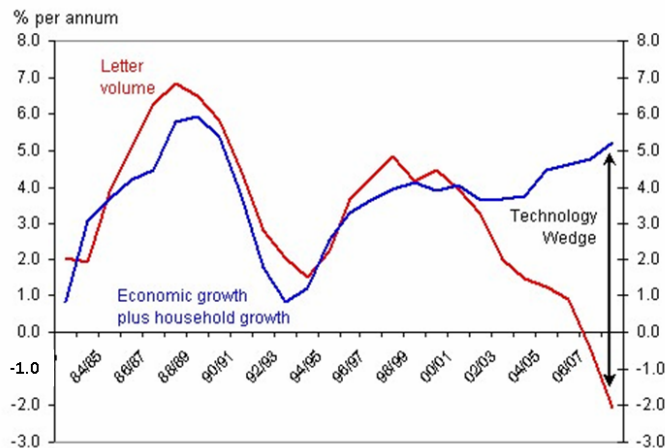
<sup>12</sup> The Mobile Life Youth Report is the second from a forum established by The Carphone Warehouse with the London School of Economics. Polling organisation YouGov surveyed more than 1,250 young people aged 11 to 17.

## Economic growth

20. Traditionally, the growth in UK mail volumes has moved in line with economic and demographic growth. Since 2003, however, the relationship has become more complex. E-substitution is driving a wedge between economic growth and the demand for letters. This wedge has been increasing over time in the UK and appears slowly to be eroding mail volume growth rates<sup>13</sup>.

Figure 8

Growth trends of UK addressed inland letter traffic, versus economic and demographic growth trends.



21. Whilst the direct relationship between GDP and mail volume growth has been broken, GDP remains an important driver of mail volumes. Particularly when faced with more challenging economic circumstances, companies will look to reduce their communication costs, by promoting electronic billing, for example, and thus driving down volumes further. Analysis of volume trends indicate that a 1% change in GDP leads to around a 1% change in mail growth rates, all other factors being equal<sup>14</sup>.

## The environment

22. Consumers and businesses are increasingly aware of environmental issues. In a recent survey, 66% of customers said that they wanted to know the carbon footprint of the products which they buy, and 70% said that they wanted business to take more action to tackle climate change.<sup>15</sup> Royal Mail estimates that customers switching to other media because of environmental concerns could reduce mail market revenues by a total of £350 million<sup>16</sup> by 2011-12. In any case, advertising mail which consumers do not want to receive or read is quickly discarded.

<sup>13</sup> In Figure 8, Letter traffic growth rates are adjusted for number of working days. Economic growth refers to GDP growth weighted by letter demand. Data in the chart uses three year moving average annual growth rates. Source: Royal Mail.

<sup>14</sup> Royal Mail submission, pg98, analysis based on regression techniques.

<sup>15</sup> IPSOS MORI poll 2007. Quoted by Royal Mail, page 98 of evidence to the panel.

<sup>16</sup> Royal Mail, submission to panel. Page 95.



## Changes in demand for postal services

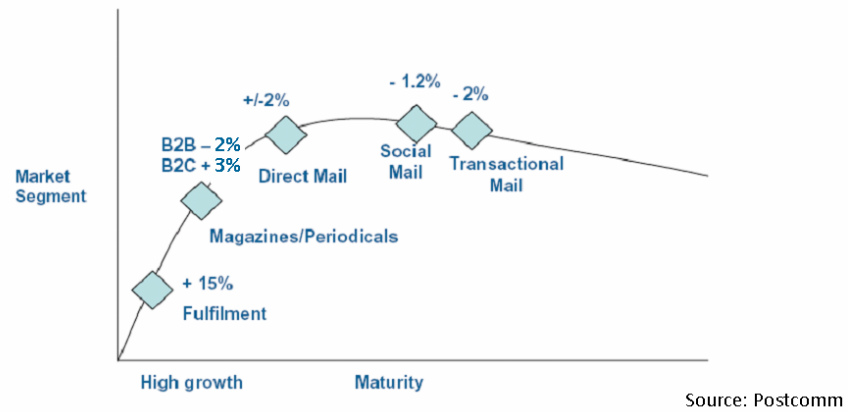
23. We will examine the impact of these issues in more detail for the panel's final report. Figure 9 gives a general indication of the potential for growth and decline for each mail application.
- ▶ **Transactional mail.** Large companies, such as utilities, are offering their customers significant financial incentives to receive statements and pay bills on line, as part of their campaign to reduce costs. As a result, transactional mail seems very likely to be in long-term decline. While companies remain committed to offering customers a choice, however, the largest mailers are likely to use bulk mail products for a number of years yet.
  - ▶ **Social mail.** Mobile telephones are now widely used as a means of sending short, immediate messages to family and friends at a low marginal cost. Some 57 billion messages were sent in 2007, with 6 billion in December alone: almost 5,000 per second<sup>17</sup>. That said, greetings cards account for a large proportion of social mail. And most consumers continue to attach value to giving and receiving greetings cards in paper rather than electronic form.
  - ▶ **Publications.** Some 700 million copies of magazines are circulated through the postal service each year. The demand for magazines, like newspapers, is falling, owing to the availability of information on the internet. That said, sales by subscription are increasing, relative to copies sold from the shelf. And because journals are more easily read in physical form, and can be passed to family and friends, publishing companies believe that the scope for e-substitution is limited. Customers often use printed catalogues to make decisions about what to buy, before ordering on line.
  - ▶ **Fulfilment.** British consumers spent £42 billion on-line in 2007. The number of packets handled by the postal sector is growing as a result. With spending expected to increase to £78 billion by 2010, this trend seems secure. Packets have a relatively high margin, compared to letters.
  - ▶ **Advertising mail.** Companies using large mailshots to generate new customers have seen the return on their investment fall in recent years. Advertising companies suggest that websites have become more attractive as a modern and less expensive means of advertising. But falling volumes need not imply reduced revenue. The combination of digital print and sophisticated data handling offers the potential to personalise mail to an unprecedented degree. Carefully targeted campaigns have strong potential and reduce waste. Moreover, mail has a strong role to play when businesses want to communicate with their existing customers. Although one-page leaflets can easily be transferred to the internet, longer publications with colour images, such as catalogues, tend to be more successful in print. Mail also offers a guarantee that companies' messages will be received, at a time when filters are becoming increasingly successful in blocking unsolicited email.

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<sup>17</sup> Mobile Data Association, 2007

Figure 9

### Indicative stages of the life cycle for different mail applications



#### Likely overall trends: E-substitution versus e-fulfilment

24. Overall, evidence seems to suggest that new (fulfilment) volumes created by e-commerce are unlikely to match the reduction in volumes of transactional, advertising and social mail. Because unit prices for fulfilment are higher than for traditional mail, however, there may be growth in the value of the postal services market as a whole, in spite of a decline in total volume. Carriers which are able to capitalise on the opportunities that e-fulfilment present are more likely to prosper. Handling bulkier items, however, usually requires different systems and equipment than for letters.

# The impact of liberalisation

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*This section responds to Terms of Reference 1. It describes the main impact of liberalisation for consumers. It also considers the impact of the regulatory regime on Royal Mail and alternative carriers.*

## Liberalisation

25. The First European Postal Services Directive in 1997 introduced common rules for the development of an internal market for postal services and the improvement of quality of service. The Directive aimed for the controlled and gradual introduction of competition into the market coupled with independent regulation. It recognised the importance of postal services for the economic and social cohesion of the Community and provided for a universal postal service at affordable prices.
26. The main elements of the Directive were transposed into UK legislation in the Postal Services Act 2000. The Act gives Postcomm a primary duty to ensure the provision of a universal service at an affordable uniform tariff, and to promote effective competition where appropriate. Since 2003, the regulator has introduced competition into the UK market in a number of stages: through niche licences, by staged opening of the bulk mail market; and then by full liberalisation on 1 January 2006.
27. Some European countries have yet to open their markets. The Third European Postal Services Directive<sup>18</sup> passed earlier this year maintains the principles of the First Directive and sets out a framework for the liberalisation of the European market by 2012. Returning to the days of statutory postal monopolies is not a policy option in the European Union.

## The impact of liberalisation on the economy

28. Economic theory suggests that consumers, firms and the wider economy should benefit from competition over a period of time as new companies enter the market. These benefits are likely to be relatively small in the early years after the postal sector is opened fully to competition<sup>19</sup>. Because the market is declining, it is particularly difficult to compare recent developments to what would have happened if Royal Mail had retained its monopoly.

## The extent of competition

*Competition has developed much more quickly than anyone expected.*

29. Since full liberalisation, 19 companies have been licensed to provide postal services in the UK in addition to Royal Mail. Almost all competition in the letters market is focused in the “upstream” area: the collection, sorting and transportation of mail, with delivery by Royal Mail.

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<sup>18</sup> The Second European Directive in 2002 set out a phased approach to market opening by weight step and an indicative date (2009) for full liberalisation.

<sup>19</sup> Recent research by Europe Economics found that, since the process of market opening began in 2001, a total of 3,300 new jobs have been created and the overall benefit to the economy has been £229 million.

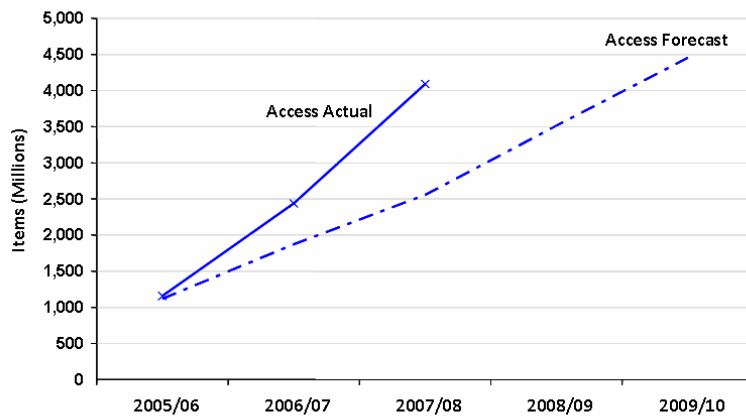
*New entrants have focused exclusively on upstream services.*

As figure 10 shows, new entrants have gained market share much more quickly than predicted. Together, they have acquired a 20% share of the total upstream market, and 40% of bulk mail sent by businesses to other companies and domestic consumers.

- 30. Regardless of the speed at which upstream competition has emerged, barriers may still exist. Systems used by supply companies, such as mailing houses, for example, have been designed and modified over many years to fit Royal Mail’s own business model. Likewise, the conditions associated with downstream access, set by Royal Mail, are perceived by some competitors to create additional costs. Other barriers include the need to segregate mail handled under different types of agreement, the need to forecast volumes likely to arrive at mail centres, Royal Mail’s exemption from VAT (see paragraph 34), and credit arrangements.

Figure 10

**Access competition: Actual and Postcomm’s forecast**



*Delivering letters to the door, however, remains a service almost exclusively provided by Royal Mail.*

- 31. There is virtually no competition in providing a full “end-to-end” service (collection to delivery) for addressed mail in the UK. Liberalisation has not yet achieved that objective. Almost all letters processed by alternative carriers are injected into Royal Mail’s network at one of its 69 mail centres. As a result, around 99%<sup>20</sup> of letters sent to addresses in the UK are delivered through letterboxes by postal workers employed by Royal Mail.
- 32. It would have been surprising to have seen the rapid expansion of “end-to-end” competition so soon after the market’s full liberalisation. But submissions have highlighted a divergence of opinion about the prospect of this kind of competition emerging in future.
- 33. Some argue that a 20% share of the upstream market would give alternative carriers sufficient volume to generate the economies of scale needed to make delivery services profitable. Companies developing new

<sup>20</sup> Figures vary. This figure is quoted from Postcomm’s Strategy Review: Emerging Views. Royal Mail calculates its share of the end-to-end market to be 98%.

delivery services would most likely begin in urban areas with a high population density and relatively large number of mail items for each address, perhaps on the basis of two or three deliveries per week.

- ▶ TNT Post is conducting a limited end-to-end trial in Liverpool.
- ▶ Royal Mail forecasts that, in 2009-10, there will be 446 million items of mail handled end-to-end by alternative carriers, rising to 4.4 billion items by 2016-17.
- ▶ Postcomm's estimate is more modest: 200 million items by 2009-10, compared with 35 million in 2006-7<sup>21</sup>.

34. Those who remain sceptical cite various barriers to entering the end-to-end market.

- ▶ The cost of establishing a national delivery network is high. The "final mile" is a labour intensive business and represents 60% of Royal Mail's costs<sup>22</sup>.
- ▶ European VAT agreements provide a mandatory exemption for public postal services (including Royal Mail). But they do not allow this exemption, or any reduced rate of VAT, to be applied to postal services provided by alternative carriers. Many have argued that this is a significant distortion in the market. Alternative carriers are certainly at a disadvantage in securing business with that part of the postal market which is unable to reclaim all of the VAT charged to it. This includes financial institutions and charities: some of the most extensive users of the postal service.
- ▶ There is uncertainty about the future of the market, making it difficult for companies to assess the likely return on their investment. Falling volumes, developments in new technology and regulation of the postal sector at the end of the current price control, including zonal pricing, are all difficult to predict.
- ▶ Royal Mail's economies of scale and scope give the company a significant advantage over competitors for delivery, where high costs are spread over a large volume (around 80 million items per day).
- ▶ Some carriers believe that any investment in a delivery network would be threatened by Royal Mail's ability to impede competition in the future.

## Innovation

35. Competition is focused predominantly on price. There have been some new products, but less innovation across the sector as a whole than might have been expected, even allowing for the fact that this is a relatively new market. Some have questioned how much scope there is to innovate in a network business which involves transporting physical

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<sup>21</sup> Page 74 of Postcomm's submission to the panel, 2007 forecast

<sup>22</sup> This figure includes all of Royal Mail's transport costs.

objects. But it seems possible that new ideas may emerge by using new technology in at least three ways:

- ▶ **Complementary services.** Mail is often considered to be in competition with other media. Yet internet advertising can create new volumes such as the despatch of catalogues, which in turn lead to e-commerce and the need for fulfilment. There may be opportunities for postal companies to work in partnership with internet companies, and others, in planning major advertising campaigns for example.
- ▶ **Hybrid solutions.** Some mail companies are looking to exploit the advantages of the internet to reduce the costs of transporting information in physical form. The I-mail service recently launched by UK Mail is an example. It enables the sender to email letters to one of UK Mail's national network of sorting where it is printed, enveloped and transferred to Royal Mail's network for delivery.
- ▶ **Increasing the quality of service for recipients of mail.** Currently, choice lies mainly with the sender of mail who pays for the service. But other funding models are possible. Mobile telecommunications, and the use of encrypted data on letters, provide new opportunities to offer the recipient greater flexibility about the timing and location of delivery. More flexible solutions may enable the postal company to increase the rate at which it is able to deliver packages and letters which need a signature at the first attempt.

## Impact of liberalisation on consumers

### Large businesses

*There is no doubt that liberalisation has generated benefits for some consumers, mainly large businesses.*

36. Since the 50 companies which make the most regular and extensive use of the postal service account for 40% of the mail market, their business is the subject of keen competition. Since liberalisation, they have a choice of services, greater flexibility in negotiating contracts and greater assurance about the quality of services. Those which use alternative carriers are able to track their mail at all stages from collection until it is transferred to Royal Mail.
37. Large businesses have also benefited through lower prices. On average, Royal Mail's prices for second and third class bulk mail products have fallen by 1% and 3% respectively since 2005. Across the market as a whole, Europe Economics<sup>23</sup> estimates that prices are 5% lower than might otherwise have been expected without competition.
38. Some large companies which continue to use Royal Mail have told the panel that the company is still not customer-oriented, in spite of competition. They want to negotiate contracts which suit the particular requirements and constraints of their business, but have found this difficult to achieve. They are left confused about the flexibility which Royal Mail has under the regulatory regime after talking to both the regulator and the company.

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<sup>23</sup> *The Benefits of Competition in the UK Mail Market*, Europe Economics, March 2008.

39. While large companies acknowledge the benefits of downstream access, some believe that the system has done all it can for them. Having taken advantage of discounted upstream prices, they are looking for new ways to reduce the costs of their business. They believe that there are opportunities to do so in the delivery of mail. Yet, having exercised their choice in selecting a different provider, these companies no longer have any direct leverage over Royal Mail's delivery operations.

### **Box 2: Responding to the needs of customers**

The largest single cost of the publishing industry, for non-news stand products, is postal services. Given the time-sensitive nature of weekly journals, publishers place much more emphasis than other companies on the need to deliver their products on the day after despatch. Because publishing companies are constrained in their flexibility to adjust prices of their own products during the lifetime of a subscription, they are looking to reach an agreement about predictable, incremental prices over a number of years.

Companies using the postal service to advertise products want to maximise potential sales while minimising costs. The date on which their letters are delivered can be critical, particularly if it coincides with staffing arrangements for call centres. These companies want to negotiate a contract which closely fits their particular business model.

In both cases Royal Mail believes that the process governing the price control imposes constraints on its ability to agree flexible terms and thereby meet these customer needs.

### **Small and medium sized enterprises**

*There have been no significant benefits for small businesses yet as a result of liberalisation.*

40. By contrast, small businesses have relatively little choice. The vast majority use Royal Mail's services<sup>24</sup>. Their dependence on Royal Mail seems to reflect an assumption that they are unable to attract alternative carriers, particularly if located in rural areas, based at home, or do not have high volumes to offer. Penetration by alternative carriers in the small business sector will increase over time, as owners have more information about their choices, are able to set out their needs, and new products are designed.
41. Surveys show high levels of satisfaction for the quality of service offered at today's prices. Some 83% of small businesses believe that first class mail offers good value for money. The response is higher still for medium sized enterprises: 92%. But they do not believe that the service fully meets their particular needs. In some cases, recent changes in collection and delivery have made it more difficult to carry out their business.

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<sup>24</sup> A survey by FSB generated 3,356 responses. Some 94% replied that they were customers of Royal Mail.

42. In spite of advances in technology and online banking, many small businesses are dependent on the postal network to organise financial transactions. Over 50% of companies surveyed by the Federation of Small Businesses send over three quarters of their bills and invoices through the post. When profit margins are tight, the ability to receive payment and avoid penalties for the late settlement of bills is vital. With that in mind, small companies want later collections and earlier, predictable delivery times. Liberalisation has not delivered this yet.
43. The introduction of a new cost-reflective pricing structure for letters, based on weight and dimension (“Pricing in Proportion”) means that consumers are more likely to need advice about sending their letters. Small business representatives, in particular, have expressed concerns about the growing complexity of sending mail. These changes will have greatest impact on those who work and live in more rural areas, as well as domestic consumers unable to travel to the nearest post office, including the elderly and those with disabilities.

#### Domestic consumers

*Domestic consumers have no choice.*

44. The views of domestic consumers about the postal service might best be summarised as “satisfied indifference”. Recent studies<sup>25</sup> suggest that only 13% are familiar with the concept of the universal service. When explained, however, consumers are likely to defend the need for an obligation, particularly a delivery on six days per week.
45. Comments about Royal Mail’s service were positive. Taking into account that first and second class stamp prices have increased by 7% and 14% respectively in real terms since 2005:
- ▶ 86% believe that Royal Mail’s first class service provides good value for money; rising to 90% in rural areas.
  - ▶ 84% believe that second class mail offers good value for money.

Measured according to standards set by the regulator, Royal Mail’s performance is at its highest on record. The company met 11 of its 12 quality of service targets in 2006-7 (allowing for variations in quality, mainly in London and some other major cities).

46. At the same time, domestic consumers have been affected directly by a series of changes over recent years. Royal Mail discontinued Sunday collections in October 2007 and reduced the number of daily deliveries from two to one in 2003-4. In 2003, Royal Mail aimed to complete the first delivery by 9.30 am. The company now aims to deliver mail to 2.00 pm for most consumers, and 3.00 pm in outlying areas of the country.
47. The introduction of a single daily delivery preceded liberalisation. It is difficult to establish whether the other changes are a direct result of market opening. New delivery deadlines, for example, are partly a response to changes in transport legislation. There are good arguments that changes which help to make Royal Mail more efficient are in the best, long-term interests of the sector as a whole. But they are not

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<sup>25</sup> Postcomm, 2007.



perceived as a benefit by consumers and are more visible than the 12 targets for quality of service set by Postcomm.

#### Postal companies and the regulatory system

*Companies operating in the postal market have different expectations of the regulatory regime, leading to confusion for business consumers.*

48. The “access” system of regulation has its justification in the benefits which should accrue to consumers over the long term, by encouraging the development of strong competition.
49. In any sector, the incumbent has a strong and rational incentive to defend its decisions according to a static view of the market. Postal services are no exception. Royal Mail argues that the “headroom” which Postcomm requires the company to maintain between its access and retail prices has been set at a level which provides an artificial incentive for companies to enter the postal market, even when providing upstream services which are less efficient than those of Royal Mail. It also argues that the “headroom” regulation creates no incentive for Royal Mail to reduce the costs of its upstream operations.
50. While Royal Mail claims it is over-regulated, its competitors and some business customers claim that they need stronger regulatory protection from an operator which retains a very significant share of the upstream market, and has control over deliveries. The regulator inevitably occupies a difficult position between Royal Mail and its competitors at this early stage of the market’s development.
51. This situation is not unique to the postal market. Some have drawn comparisons with the relationship between BT and Oftel in the early days of competition in the telecommunications market.

## Challenges facing Royal Mail

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### Profitability

52. Postal companies point to the universal service as an asset which offers an unparalleled reach and unique selling point. For Royal Mail, this view depends on the obligation being self-financing. In 2006-07, Royal Mail's regulated business (including both the universal service and price-controlled products) made a loss (of £29 million) for the first time. In its submission to the panel, Royal Mail estimated that, in 2007-8, the universal service itself will be loss-making for the first time.
53. Resolving the mismatch between the revenue from the universal service and its underlying cost depends partly on the extent to which it can innovate and bring new products to the market. Otherwise, there are two main factors: prices and Royal Mail's ability to make its operations more efficient.

### Pricing

54. There is evidence to suggest that the price elasticities<sup>26</sup> associated with postal services have increased. When Royal Mail raised the price of its products in 2006-7 by a weighted average of 4%, for example, revenues remained broadly unchanged. New alternatives to mail, competition and a decision by customers to downgrade to cheaper mail products may all contribute to this effect. As a result, Royal Mail's ability to increase revenues in future simply by increasing prices across the board is likely to be weakened. This places even more emphasis on reducing costs in the business.

### Efficiency

55. Royal Mail has taken steps to improve efficiency in recent years. In its submission to the panel, the company said that it had removed £1.5 billion in costs and 48,000 from the workforce since 2002. It also recognised the need to improve efficiency still further by removing another £1.5 billion of costs in real terms over the next 10 years. This is particularly challenging in the context of falling volumes.
56. In its accounts for 2006-07, Royal Mail estimated that it was 40% less efficient than its rivals for two main reasons: because competitors had already invested in technology to modernise their operations, and because competitors operating in the UK provided 25% less in pay and benefits than Royal Mail. These differentials in pay are similar to those faced by other European postal operators in their home markets, such as Germany.

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<sup>26</sup> Price elasticities describe the relationship between changes in price for a product and changes in demand for that product. High price elasticities (other things being equal) mean that increasing the price for a product can actually reduce total revenues because the higher price leads to an offsetting fall in the product's sales.

57. In 2006-07, Royal Mail Letters generated an operating margin of 2.8%. This compares to margins in the region of 13-15% produced by TNT Post and DHL in Netherlands and Germany. The comparison is significantly affected by the costs of the Royal Mail pension, but Royal Mail's relative inefficiency remains an important factor too.
58. A £1.2 billion debt facility was established by the Government in March 2007 to help modernise Royal Mail's letters business. The company recognises that it is only part way through its commercial and operational transformation and has some way to go to be "best in class". For example, Royal Mail uses automated sorting for only 50% of its items, compared with 63% in La Poste (France), 85% in TNT Post (Netherlands) and 89% in Deutsche Post (Germany)<sup>27</sup>. There remain questions about the company's capacity to press ahead with the investment needed sufficiently quickly to realise efficiency savings.

### Access to capital

59. Royal Mail, unlike most regulated businesses in the UK, remains wholly owned by the Government. By creating the Shareholder Executive in 2003, the Government set out to establish a relationship between the shareholder and company which, in part, replicates the disciplines of the private sector. Nevertheless, public ownership places a constraint on Royal Mail's ability to raise external capital. Investment from Government is subject to European State Aid regulations which makes it less flexible than other forms of capital. Perhaps the most important constraint on investment from Government is that there are many competing demands on the public purse.

### Pension

60. Royal Mail's legacy pension deficit is among the largest of any UK company. In the company's accounts for 2006-7, assets stood at £23.6 billion and liabilities at £28.6 billion, leaving a deficit (calculated on an accounting basis) of £5.0 billion. When the last triennial valuation was performed by the Actuary to the Trustee in March 2006, under more favourable market conditions, the deficit (calculated on an actuarial basis) was £3.4 billion. Royal Mail has an agreement with the Trustees to repay the pension deficit over 17 years at a rate of approximately £260m per year, adjusted for inflation.
61. As part of the refinancing in 2007, the Government put £850 million in escrow for the benefit of the pension fund Trustee in the unlikely event that the company would fail. On this basis, the Trustee decided to allow the deficit to be paid back over 17 years rather than the more normal upper limit of 10 to 12.
62. The deficit is subject to considerable volatility driven by the market value of the assets and the discount rates and mortality assumptions used to derive liabilities. Between 2004-5 and 2005-6, for example, the (accounting) deficit increased by £1.6 billion.

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<sup>27</sup> UBS, European Mail Liberalisation, July 2006, quoted in Postcomm's evidence to the panel, page 65.

63. The impact of the pension deficit and the size of regular pension contributions on Royal Mail's profit and cash flow is considerable. In 2006-07:
- ▶ a pension charge of £722 million reduced operating profit for the whole company (before exceptionals) by 76% from £955 million to £233 million.
  - ▶ Royal Mail paid £786 million into the pension plan, before payments relating to redundancy. This payment comprised £543 million in regular pension contributions and £243 million to fund the pension deficit.
64. Together, the current service costs and deficit repayments represent a significant financial constraint on Royal Mail. It has agreed a series of amendments to its pension scheme: to close its defined benefit plan to new members; to raise the pensionable age from 60 to 65; and to make final pension calculations on the basis of a career average salary. Over time, this will reduce the impact of pensions on Royal Mail.
65. The outcome of the next triennial valuation of the pension in 2009, however, is not certain. There remains a possibility that the deficit will have increased. The payment schedule for the deficit may also be accelerated. Both factors could require increased contributions to the pension plan.

### Labour Relations

66. Any business facing such significant changes as Royal Mail needs effective engagement with the unions. In its submission to the panel, the Communications Workers Union recognised the need for Royal Mail to modernise its operations and improve efficiency. It also acknowledged that the necessary changes would entail a significant reduction in jobs, while making a strong case for maintaining employees' terms and conditions of service.
67. There is evidence to show that industrial action can accelerate a decline in the postal market. Over the past decade, disputes between Royal Mail's management and the Communication Workers Union have had a major impact on the company's ability to implement change and make progress in transforming the business. In 1996, the total number of employee days spent in dispute was 818,612. There were 84,664 in 2003 and 314,626 in 2007.
68. Industrial action in recent years has promoted discussion about the reliability and cost of postal services to boardroom level in major companies. There is evidence to suggest that some companies using the postal service for transactions and advertising have since decided to use other media on a permanent basis.

### Regulation

69. Postcomm has a number of regulatory duties, some of which have the ability to be in conflict with each other. Some industry participants have,

in particular, noted that the duty to protect the universal service obligation and the imperative to promote competition, could conceivably be in tension. It will be important in this fast-evolving market to ensure that these duties are balanced appropriately.

70. Evidence supplied by Royal Mail highlights that 91% of its revenues from letters are subject to price controls, either through the uniform tariff (part of the universal service obligation) or by price-cap regulation.
71. This reflects the relatively early stage of market development and Royal Mail's strong market position. Ex ante regulation does, however, impose a constraint on Royal Mail's ability to respond quickly to market changes and the particular needs of customers, either by introducing new products or withdrawing old ones. This is particularly true in a declining market, with increasing competition and customers down-trading products. The lack of agreement between the regulator and Royal Mail about the company's costs hinders decisions about the regulatory regime.

### Competition

72. Access volumes have grown rapidly. It is estimated that 4.1 billion items were handled by alternative carriers in 2007-08.
73. There is currently mixed opinion about the prospect of end-to-end competition emerging in the future. Companies with aspirations to develop an end-to-end service are most likely to target the most profitable delivery routes by pricing below the universal tariff, and offering a service on two of three days a week. We will consider the extent to which end-to-end competition might develop, and the extent to which such development might threaten the universal service.

### Financial outlook

74. In its submission to the panel, Royal Mail indicated that its "overall financial situation is becoming increasingly difficult" and that the "forecast headroom against the company's financing facilities allows little margin for error".
75. Because of Royal Mail's high fixed-cost base<sup>28</sup>, even slight changes to volumes will have a significant impact on operating profitability in the short term. Royal Mail estimates that every 1% decline in revenue could impact both profit and cash flow by up to £70 million. The company also predicts that its volumes could decline by 3.5 to 4.4 per cent per year over the next 10 years, depending on market scenarios.
76. Postcomm believes that "without extensive change, the Royal Mail's business model will become unsustainable". A "managed decline scenario", which assumes no policy changes, suggests there are risks that:

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<sup>28</sup> For example, regardless of the number of mail items to be delivered on any particular day, Royal Mail is obliged to ensure that a postman is available to cover all the addresses on his walk.

- ▶ its letters business could become operationally unprofitable in 2009-10 onwards, and cash flow negative from 2007-08.
- ▶ by 2012-13, the annual negative cash flow could be in the region of £400m, annually.

Since the regulator has a primary duty to maintain the universal service, it is for the Royal Mail board and Postcomm to work closely together to manage these risks and ensure that the company has the cash to run its operations in a sustainable manner.

## Next steps for the review

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### An emerging consensus about the need for change

77. The panel will continue to gather evidence about the challenges and opportunities facing the postal sector as part of the review. But it seems to us that there is already good evidence that:
- ▶ the letters market is in decline, although there are opportunities to innovate in providing higher value services
  - ▶ upstream competition has grown much more quickly since liberalisation than anyone predicted
  - ▶ Royal Mail's transformation still has a long way to go.
78. These developments present a substantial threat to Royal Mail's financial stability and, therefore, the future of the universal service. As the business mail market becomes more and more competitive, so the cross subsidy by Royal Mail into the universal service becomes more and more difficult to maintain.
79. **We believe that there is a broad, emerging consensus among postal companies, business users, consumer organisations and the regulator that the status quo is not tenable: it will not achieve the vision we set out at the beginning of this paper. There is, therefore, a compelling case for action.**

### Criteria for analysing policy options

80. This paper provides the context for the next phase of the review. Over the coming months, we will focus on the regulatory framework and other policies needed to ensure that the universal service is sustainable. The future regulatory framework will depend, for example, on whether we believe that end-to-end competition is realistic.
81. We look forward to receiving evidence from stakeholders on 19 May. The evidence which they have submitted so far suggests a clear set of criteria by which to evaluate policy proposals that maintain the universal service. They are:
- ▶ a high standard of service for consumers;
  - ▶ an appropriate regulatory regime to protect consumers where barriers to entry mean that there is limited competition and choice;
  - ▶ a regulatory framework which encourages fair and innovative competition where no barriers exist;
  - ▶ a stable, financial future for Royal Mail; and
  - ▶ the incentive for Royal Mail to modernise its operation, making it much more efficient, and change its culture.

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## Annex 2: Glossary of technical terms

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<b>Access</b>	The arrangement by which mail users and licensed postal operators can use Royal Mail’s facilities to carry their post for part of its journey. For example, a company might collect bulk mail directly from a utility, sort and transport it to one of Royal Mail’s mail centres, and then contract with Royal Mail to deliver these items over the “final mile”. See “downstream access” and “operator access”
<b>Access point</b>	The point at which mail is fed into the Royal Mail network. This can be pillar boxes, post offices, collection from a sender’s premises, for example.
<b>Advertising mail</b>	Mail for marketing and advertising purposes, sent by businesses to consumers. Sometimes called “direct mail”.
<b>Addressed mail</b>	Mail with a named recipient.
<b>Alternative carriers</b>	Postal companies other than Royal Mail.
<b>Application</b>	The mail market can be broken down by application into five categories: transactional mail, advertising mail, publications, social mail and fulfilment.
<b>Bulk mail</b>	A large number of mail items of the same format, posted by a single user, from a single site.
<b>Bypass</b>	The collection, sorting, transportation and delivery of mail using a network other than Royal Mail’s.
<b>Communications market</b>	This includes post, email, internet, broadcasting and telecommunications.
<b>Consumers</b>	Large businesses, SMEs and domestic consumers, both those who send mail and those who receive it.
<b>Cost-reflective pricing</b>	The practice of calculating the price of a service according to the cost of the operations needed to provide that service.
<b>Delivery office</b>	A Royal Mail facility at which mail is sorted into the right sequence for delivering to addresses.
<b>Direct mail</b>	Mail for marketing and advertising purposes, sent by businesses to consumers. This paper uses the term “advertising mail”.

<b>Domestic consumers</b>	Those who send mail for reasons other than their business. This includes letters, cards and packages to family and friends.
<b>Door to door mail</b>	Mail posted in bulk with no named recipients. This is also called unaddressed mail.
<b>Downstream</b>	The delivery of mail to addresses.
<b>Downstream access</b>	The arrangement by which alternative carriers have access to Royal Mail's distribution systems at an inward mail centre.
<b>E-commerce</b>	Trading by the use of electronic media, particularly the internet.
<b>E-fulfilment</b>	The successful delivery of mail containing goods ordered via the internet.
<b>Elasticity</b>	Price elasticities describe the relationship between changes in price for a product and changes in demand for that product. High price elasticities (other things being equal) mean that increasing the price for a product can reduce total revenues because the higher price leads to an offsetting fall in the product's sales.
<b>End-to-end</b>	A service which comprises all parts of the postal service chain: collection, sorting, transportation upstream and delivery of mail to its final destination.
<b>E-substitution</b>	The effect of a decision by consumers to use electronic alternatives to the postal service.
<b>Ex-ante regulation</b>	Requirements designed to prevent anti-competitive behaviour before it arises.
<b>Ex-post regulation</b>	Regulation designed to resolve cases of anti-competitive behaviour in the course of events.
<b>Final mile</b>	The process of delivering mail from one of Royal Mail's delivery offices to one of the 28 million addresses in the UK. GN
<b>First mile</b>	The process of collecting social mail from one of Royal Mail's pillar boxes or post offices.
<b>Fulfilment</b>	The delivery of mail containing goods ordered by mail order, telephone or the internet.
<b>Liberalisation</b>	The process of creating a market in which companies can compete to offer postal services. In the UK, liberalisation has been achieved under the regulatory framework set by the Postal Services Act 2000, and rules laid down by Postcomm.

<b>Licensed area</b>	The area of postal activity for which postal operators must have a license: letters weighing less than 350g and costing less than £1 to post.
<b>Mail centre</b>	Royal Mail facility at which mail is sorted and sent to a delivery office.
<b>Packet</b>	An addressed item of mail enclosing large documents, normally sent in padded or sturdy envelopes.
<b>Postcomm</b>	The regulator of the postal sector.
<b>Price cap regulation</b>	Regulator places a ceiling on the prices that Royal Mail is allowed to charge
<b>SME</b>	Small and medium-sized enterprises with fewer than 250 employees.
<b>Social mail</b>	Mail sent from non-business consumers to other non-business consumers.
<b>Structural developments</b>	Changes outside the postal market which have an impact on mail volumes. These include the increased use of alternative forms of communication.
<b>Letters market</b>	The market which excludes parcels and courier services.
<b>Transactional mail</b>	Mail generated by business which is conducting a financial transaction with consumers (such as credit card bills or bank statements).
<b>Unaddressed mail</b>	Mail without a named recipient, such as a leaflet or flyer.
<b>Uniform tariff</b>	A single price for the collection of mail and its conveyance and delivery.
<b>Universal service obligation</b>	Postal products and associated minimum service standards that must be made available to all 28 million addresses in the UK.
<b>Upstream</b>	The collection and sorting of mail, and transportation to one of the Royal Mail's mail centres.
<b>Zonal pricing</b>	A system of pricing which takes account of the different costs of sending letters or parcels to different parts of the country.

## Annex 3: Members of the panel

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### **Richard Hooper CBE (Chair)**



Richard Hooper is currently Chairman of Artilium plc , Senior Independent Director of VocaLink Ltd, and a non-executive Director at YELL Group plc. He stood down as Chairman of Informa plc in May 2007. He was Deputy Chairman of the Office of Communications (Ofcom) between 2002 and 2005 and Chairman of the Radio Authority for three years until 2003.

Previous directorships include non-executive director of MAI plc (1993-6), non-executive director of United News & Media (1996-7), non-executive director of Superscape plc (2000-2) and non-executive Chairman of IMS Group plc (1997-2002). He was also Director, Prestel, at Post Office Telecommunications (1980-81) and Chief Executive Value Added Systems and Services, BT (1982-86).

Dame Deirdre Hutton was appointed Chair of the Food Standards Agency in 2005. She has served on a number of public bodies and has considerable experience of corporate governance, risk-based regulation and consumer policy. She was a Board member, including Deputy Chair, of the Financial Services Authority between 1997 and 2007. For five years, she was Chair of the National Consumer Council, having formerly chaired the Scottish Consumer Council. Prior to her appointment at the Food Standards Agency, she had been a member of the Better Regulation Task Force since 1999.

### **Dame Deirdre Hutton**



### **Ian R Smith**



Ian Smith was Chief Executive of Taylor Woodrow prior to its merger with George Wimpey. He was appointed Chief Executive Officer of the General Healthcare Group in September 2004, was previously CEO, Europe for Exel, Group Commercial Director of Ocean Group (before its merger with NFC to form Exel) and prior to that, Managing Director of Monitor Company Europe, a strategy consulting firm. Ian began his business career with ten years at Royal Dutch Shell Group, working mainly in the Middle East. He has undertaken ad hoc advisory work for Government on industrial policy. He is a non-executive Director of Galiform.