POSTAL SERVICES BILL
2010

IMPACT ASSESSMENT

Title:

Postal Services Bill 2010

Lead department or agency:

Department for Business, Innovation & Skills

Other departments or agencies:

Impact Assessment (IA)

IA No: BIS0129

Date: 23 September 2010

Stage: Final

Source of intervention: Domestic

Type of measure: Primary legislation

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Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

The future of the universal postal service is under threat. Royal Mail possesses historic market power and is the only company currently capable of delivering the universal postal service, but it faces a wide range of challenges: including a
mails market in structural decline, a huge pension deficit, and, despite recent improvements, working practices that are significantly less efficient than other European operators.

Government intervention is needed to secure the future of the universal postal service. The Hooper Review1 identified a package of measures that would be required to ensure the future of the universal postal service: improved regulation of the postal services market, an injection of private sector capital and disciplines into Royal Mail, and relieving thcompany of its historic pension deficit. Hooper was clear that these measures must be done as a package and only Government is in a position to give effect to them.

What are the policy objectives and the intended effects? The main policy objectives are to sustain both the universal postal service and Royal Mail, the only company able to deliver the service for the foreseeable future. Government intends to achieve this by implementing the recommendations of the Hooper Review: allow for the injection of private sector capital and disciplines into Royal Mail; relieve the company of its historic pensions deficit; improve the regulatory regime to ensure that it fits into the wider communications market.

The intended effect is a more sustainable universal postal service, and thereby a reduced risk of the need for Government funding. This will be achieved through accelerated modernisation by Royal Mail leading to a more efficient
company, better able to deliver the universal service. It will also be achieved through a new regulatory regime for the sector, which better reflects the changes the postal market has undergone in recent years, the changing needs of consumers and the fact that postal services form part of the wider communications market.

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

The Hooper Review gathered evidence from a wide range of sources and considered a number of options. These are detailed in the 'Evidence Base' section of this impact assessment. Both the Hooper Review and the Hooper Update find broad consensus that the status quo is untenable due to the challenges faced by Royal Mail. Therefore, doing nothing is not a viable option.

The Government intends to proceed with the Hooper Review's main recommendations, which were also reiterated in the Hooper Update: to bring about modernisation of Royal Mail through introducing private sector capital and disciplines; to enable Royal Mail to reap the rewards of modernisation by removing the historic pension liability; and to
improve the regulatory framework. These recommendations, taken together as a package, will provide the best chance of a sustainable future for the universal service by ensuring a sustainable future for Royal Mail.

This document analyses the impact of these recommendations compared with a baseline scenario of doing nothing.

When will the policy be reviewed to establish its impact and the extent to which
the policy objectives have been achieved?

It will be reviewed

06/2016

Are there arrangements in place that will allow a systematic collection of
monitoring information for future policy review?

Yes

SELECT SIGNATORY Sign-off : For final proposal stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable
view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Date: 12th October 2010

1 All references to “The Hooper Review” in this document refer to the 2008 Hooper Review. This report also makes references to Richard
Hooper’s Updated Report, published on 10th September 2010. Any references to this updated Hooper Review will be to the “Hooper
Update”.

Summary: Analysis and Evidence Policy Option 2

Description: Implementing the Hooper Review package of measures

Price Base
Year 2010

PV Base
Year 2010

Time Period
Years 10

Net Benefit (Present Value (PV)) (£m)

Low: 464m

High: 4,731m

Best Estimate: 3,068m

COSTS (£m)

Total Transition
(Constant Price) Years

Average Annual
(excl. Transition) (Constant Price)

Total Cost
(Present Value)

Low

8,400m

1

33.2m

8,686m

High

10,300m

33.2m

10,586m

Best Estimate

10,300m

33.2m

10,586m

Description and scale of key monetised costs by ‘main affected groups’

New pensions provisions implementation costs (PV = £278m)

Additional Director time spent on modernisation (PV = £8m)

Transfer of historic pension liabilities / assets from RM to HMG – cost to HMG (PV = £8.4bn - £10.3bn)

Other key non-monetised costs by ‘main affected groups’

RM’s stated capital costs/management time associated with modernisation are already accounted for (non-incremental);

One-off costs of merging Ofcom and Postcomm;

The loss of publicly owned RM shareholdings (value dependent upon market conditions at the time of sale);

Longer term costs associated with diversification and expansion (outside of current analysis).

BENEFITS (£m)

Total Transition
(Constant Price) Years

Average Annual
(excl. Transition) (Constant Price)

Total Benefit
(Present Value)

Low

8,400m

1

87.1m

9,150m

High

10,300m

582.8m

15,317m

Best Estimate

10,300m

389.6m

13,654m

Description and scale of key monetised benefits by ‘main affected groups’

Efficiency savings (PV = £494m - £4,761m, mainly accruing within 3-5 years of the involvement of private sector capital and disciplines),

Regulator savings (PV = £6.7m)

Pension administration benefits (PV = £249m)

Transfer of historic pension liabilities / assets from RM to HMG – benefit to RM (PV = £8.4bn - £10.3bn)

Other key non-monetised benefits by ‘main affected groups’

Social and economic benefits of sustaining the universal postal service;

Removal of concerns surrounding the size of the pension deficit and the corresponding risks to Royal Mail’s finances

More effective ex ante regulation of the sector and ex post competition law;

Proceeds from selling publicly owned RM shareholdings (value dependent upon market conditions at the time of sale);

Possible improved industrial relations should Government be removed from the management/union relationship;

Possible reduction in management time spent on seeking regulatory consents;

Possible better labour relations and future productivity due to the employee share scheme;

Possible non-UK capital injection/investments;

Further benefits of diversification and expansion (outside of current analysis).

Key assumptions/sensitivities/risks Discount rate (%)

3.5

Assumption that incoming investors run a more efficient Royal Mail. Efficiency savings are very dependent upon the date of private sector capital involvement. It is not necessarily the case that additional private sector capital will be invested to deepen or expand efficiency savings and/or drive diversification and expansion. There is a risk that a sub-optimal shareholding sale price and/or transfer of pension assets/liabilities may eclipse the estimated net benefits of the Hooper package. The special administration regime may have an adverse effect on the cost of future debt finance. The identified costs and benefits of direct pension management are conservatively reported within the 10 year timescale. Efficiency benefits accrue from 2012 in the best estimate scenario and from 2014 under the low-end scenario.

Impact on admin burden (AB) (£m):

Impact on policy cost savings

In

New AB:
N/A

AB savings:

Not quantifiable

Net: Reduction (not
quantified)

Policy cost savings: N/A

Yes

2 Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill
apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?

UK

From what date will the policy be implemented?

From Royal Assent

Which organisation(s) will enforce the policy?

Ofcom, BIS and HMT

What is the annual change in enforcement cost (£m)?

£0.8m saving

Does enforcement comply with Hampton principles?

Yes

Does implementation go beyond minimum EU requirements?

Yes

What is the CO_2 equivalent change in greenhouse gas emissions?
(Million tonnes CO_2 equivalent)

Traded:
N/A

Non-traded:
N/A

Does the proposal have an impact on competition?

Yes

What proportion (%) of Total PV costs/benefits is directly attributable to
primary legislation, if applicable?

Costs:
100%

Benefits:
100%

Annual cost (£m) per organisation
(excl. Transition) (Constant Price)

Micro
0

< 20
0

Small
0

Medium0

Large
0

Are any of these organisations exempt?

No

No

No

N/A

N/A

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?

Impact

Page ref
within IA

Statutory equality duties2

Statutory Equality Duties Impact Test guidance

No

p48

Economic impacts

Competition Competition Assessment Impact Test guidance

Yes

p45

Small firms Small Firms Impact Test guidance

Yes

p47

Environmental impacts

Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance

No

Wider environmental issues Wider Environmental Issues Impact Test guidance

No

p47

Social impacts

Health and well-being Health and Well-being Impact Test guidance

No

p48

Human rights Human Rights Impact Test guidance

No

p48

Justice system Justice Impact Test guidance

No

p47

Rural proofing Rural Proofing Impact Test guidance

No

p48

Sustainable development

Sustainable Development Impact Test guidance

No

p47

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in References section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.

Legislation or publication

1

'Modernise or decline: Policies to maintain the universal postal service in the UK' (The Hooper Review) Cm 7529

2

'Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector' (The Hooper Update) Cm 7937

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the Annual profile of monetised costs and benefits (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

The salient and significant annual profiles of monetised costs and benefits (in 2010 constant prices) are presented for cost efficiency in the Options appraisal section and for pensions costs in Annex A. For the non-monetised costs and benefits see the summary pages and main evidence base section.

3 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom"

4 Royal Mail Holdings plc Annual Report (2010) p4.
http://www.royalmailgroup.com/portal/rmg/content1?catId=23300505&mediaId=23300508#44400260

5 Royal Mail Holdings plc Annual Report (2010) p5.

6 "Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector" p16.

Evidence Base (for summary sheets)

Following impact assessment guidance, this assessment considers the economic impact of the proposed package of measures on all sectors of the economy - including business, consumers and taxpayers

1. Background

1.1 Government is committed to securing a sustainable future for the universal postal service, and to ensuring a healthy Royal Mail, through the injection of private sector capital and disciplines.

1.2 At present, legislation governing the postal services sector is contained in the Postal Services Act 2000. Since then, however, the communications sector has undergone significant changes. The digital media revolution is offering consumers unprecedented choice in how they communicate, resulting in a structural decline in the letters market. At the same time that same media revolution offers new opportunities and challenges for mails service providers.

1.3 It was against this changing communications landscape that Government commissioned an update of the 2008 independent review of the postal services sector, by Richard Hooper CBE. The objective of the Review's update was to provide a refresh of the original independent analysis of the postal services sector and to consider whether the original recommendations on how best to maintain the universal postal service were still relevant given the changes to the postal market in the period since. The first Hooper Review panel engaged a wide range of stakeholders, including consumers and their representatives, postal companies, trade unions, political parties, government departments, the devolved administrations and regulators. The original report was refreshed, with the same range of stakeholders invited to provide contributions and updated views. This updated Review will be referred to in the body of this document as "The Hooper Update" to distinguish it from "The Hooper Review" which was the original 2008 Review. The Hooper Update was published on 10 September 2010.

2. The problem

2.1 The Hooper Review3 identified the main challenges and opportunities facing the postal sector and Royal Mail. The growth in digital media has prompted an unprecedented decline in the letters market. Although Royal Mail handles 71 million items of mail per day, this is 13 million fewer items than five years ago, caused by competition from other forms of communication4. Indeed, in 2009-10, Royal Mail handled 7.3% less mail than it did in the previous year5. The Hooper Update notes that postal authorities worldwide are predicting declines over the next five years of 25-40% in letter volumes6. Alongside these challenges, the digital revolution has opened up new areas of growth, such as the delivery of internet purchases (but this is not sufficient to fully replace the revenues Royal Mail has lost due to the decline in mail volumes).

2.2 The Hooper Review analysed Royal Mail's position in this changing market and identified five major factors which constrain Royal Mail's ability to respond:

7 The measures included in the Bill will also ensure that the UK is fully compliant with the 3rd EU Postal Services Directive. The two over-arching aims of the Directive are to secure the provision of a universal service and to liberalise the postal services market. In both respects the UK is already compliant. Provisions within the Bill will ensure that any outstanding requirements are met (for example, ensuring that all postal operators have a simple complaints procedure in place).

8 For letters; parcels are delivered 5 days per week.

9 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p48

i. Inefficiency. Royal Mail is much less efficient (and profitable) than its main European peers. Despite recent improvements, this remains the case 18 months on.

ii. Pension deficit. Royal Mail's historic pension deficit is one of the largest in the UK and is a major drain on the company's cash.

iii. Pricing. Increasing postal prices are no longer guaranteed to generate sufficient revenues to offset falling volumes as businesses and social consumers are increasingly price sensitive.

iv. Labour relations. The relationship between Royal Mail's management and the Communications Workers Union has historically been extremely difficult. Whilst this situation has been improving given the Business Transformation Agreement reached in 2010, the latter half of 2009 saw national industrial action – the second national strike in two years.

v. Relationship with the regulator. The relationship between the company and its regulator, Postcomm, was difficult. Again, there is now a better working relationship between both parties. However, the need for a regulatory framework that is better suited to the market, administered by a different regulator is still considered to be vital to the sustainability of the universal postal service.

2.3 The Hooper Review found broad consensus among postal companies, business users, consumer organisations, unions and the regulator that the status quo was untenable. The Hooper Update found that the same broad conclusions applied.

3. Policy objectives

3.1 The Government is committed to securing a sustainable future for the universal postal service.7 The service is of unquestionable economic and social importance to the UK. Many customers depend on the service for their communication and business needs and place a high value on its key features of a uniform, affordable tariff and a six-day-per-week collection and delivery service8.

3.2 Royal Mail is the only company currently, and for the foreseeable future, capable of providing the universal postal service throughout the UK9, but it is facing significant financial difficulties in the face of a declining market. There is thus a strong social and economic rationale for addressing the financial and organisational challenges facing the company that are holding back modernisation and putting at risk its ability to deliver the universal service in the long-term. Without intervention now, Royal Mail's finances will continue to decline, placing the future of the universal postal service and the company under threat.

3.3 It is important to distinguish between Royal Mail and the Post Office. Royal Mail Letters business is different from the Post Office. Royal Mail is the company that collects and distributes mail, and is responsible for delivering the universal postal service. The Post Office operates the nationwide network of retail outlets through which many people pay

10 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p66-68

for and post their mail, and use other services. The Bill does not impact the specifics of services provided by the Post Office, or the accessibility and coverage of the network. As such, these are not considered as part of this Impact Assessment.

4. Options

4.1 The Hooper Review and Hooper Update found a broad consensus that "the status quo is untenable". Government therefore considers that action has to be taken now to secure the sustainable future of the universal postal service. Doing nothing is not a viable option.

4.2 Section 3 of the Hooper Review considered options for addressing the difficulties facing Royal Mail. It concluded that all but one of these options alone were short-term solutions and that none would be sufficient on their own to address the fundamental problems in the longer term, or achieve the desired objectives (how to develop a vibrant postal market which can respond quickly to the changing needs of consumers; how to reduce the risks currently facing the taxpayer; and most important, how to maintain the universal postal service). The options considered were10:

i) short-term cash-saving measures:

Royal Mail could respond to current financial pressures with short-term cash saving measures. The Hooper Review concluded, however, that this would offer only limited, short-term relief and would not resolve Royal Mail's financial difficulties in the long term. Without addressing the fundamental problem of Royal Mail's inefficiency, there is a strong likelihood that the company would require ongoing subsidies, representing poor value for money for the taxpayer.

ii) the introduction of a compensation fund to share the burden of the provision of the universal service:

One option is to share the financial burden of providing the universal postal service across the market as a whole. This could be achieved by requiring postal companies or the users of postal services to contribute to a fund, or by directly subsidising Royal Mail with taxpayers' money. Implemented now, this option would fail to address the underlying sources of Royal Mail's financial difficulties. It would not help to reduce the company's cost base in the face of falling demand and revenue. In the present situation, the Review considered that compensation, from any source, would be counter-productive as it would considerably weaken the incentive for Royal Mail to adapt to changes in the market.

iii) downgrading the universal service to reduce the demands on Royal Mail.

Another option is to reduce the demands placed on Royal Mail by the universal service obligation. This is only feasible to the extent that standards set in the UK are higher than those required by the relevant European Directives. The service for letters, for example, could only be reduced from six days to five. And while the uniform tariff could be abolished altogether, prices would still need to be affordable. Although reducing the basic requirements of the universal service could realise savings for Royal Mail, the Hooper Review concluded that this option would not address the underlying need for Royal Mail to modernise and could accelerate volume decline in the mail market.

iv) modernisation – transformation to improve efficiency and reduce costs, and diversification and expansion to address the rapid structural decline of the letters market.

11 “Saving the Royal Mail’s universal postal service in the digital age: An update of the 2008 independent review of the postal services sector” p41-42

12 Indeed, Postcomm’s current regulatory framework consultation is looking at the issues of accounting separation and cost transparency.

13 “Saving the Royal Mail’s universal postal service in the digital age: An update of the 2008 independent review of the postal services sector” p32

Given that a structural decline in the letters market is already underway, Royal Mail must be able to respond quickly and flexibly to the changing circumstances. This means modernisation, which the Review defines as transformation to improve efficiency and reduce costs, followed by diversification and expansion to address the rapid structural decline of the letters market. To achieve this, the constraints identified by the Hooper Review need to be addressed swiftly and effectively.

Royal Mail Constraints

4.3 To tackle the constraints faced by Royal Mail, a package of measures was recommended. The Hooper Update confirms this package: sale of shares in Royal Mail, thus allowing private sector capital and disciplines to flow into Royal Mail; transferring the historic pension liabilities to Government; and changes to the regulatory framework.11 In addition, the Government is committed to exploring opportunities for employee ownership in Royal Mail.

4.4 Bringing in private sector capital and disciplines will help drive modernisation and increase efficiency, helping Royal Mail to accelerate the pace of change. Private capital will also help Royal Mail to operate without the threat of perceived political interference as the Hooper Review highlighted. It also offers the opportunity for employees to have a real stake in the business, aligning the interests of employees and the company and allowing them to benefit from the growth and performance of the modernised business.

4.5. To maximise the benefits of modernisation and then further enable Royal Mail to invest in diversification and expansion, the company also needs to be relieved of the pension deficit and its associated financial and balance sheet constraints. The recommendation, provided that the barriers to modernisation have been addressed, is that the Government should take responsibility for the company’s historic pension liabilities.

4.6 Finally, Ofcom should be appointed to regulate the postal market, reflecting the connection between mail and the broader communications sector. Ofcom will need a new set of tools to regulate the sector: appropriate powers, formal market analysis, and a significantly improved understanding of Royal Mail's cost base12.

4.7 The Hooper Review and the Hooper Update make clear that these recommendations are a package: each element is vital to secure the future of the universal postal service and Royal Mail. Private sector capital and disciplines will enable Royal Mail to modernise at pace, adapting to the changing market and the needs of consumers. The Hooper Update also notes that it is easier for a regulator to drive efficiencies through the price control regime if a company is in the private sector, as shareholders will demand that these efficiencies are achieved or bettered.13 Addressing the historic pension liability will enable the company to reap the rewards of modernisation and invest further in diversification. Relieving Royal Mail of the deficit without also securing the involvement of private sector capital and disciplines would reduce the company's incentive to modeand not represent value for money to the taxpayer. The proposed changes to the
regulatory framework will place postal services in their rightful context, as part ofwider communications market. More effective regulation, with protection of the universal
postal service at its core, will not only ensure consumers are protected but will encoincreased efficiencies and remove regulatory burdens from postal companies as well as
meeting the UK's obligations under EU law.

14 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p104

15 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p59

16 "Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector" p6

17 Hooper's first report cited two other reasons for a reduction in Royal Mail's revenues since 2005: introduction of postal competition, and substitution to cheaper products (from first to second class mail for example). It is worth noting that revenue lost to competition from digital media was five times the amount lost to competition from other operators.

18 Royal Mail Holdings plc Annual Report (2010)

19 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p59

4.8 The Government firmly believes that this package of measures is the only viable option to secure the future of the universal service. No single element of the package can achieve the necessary modernisation or tackle the fundamental difficulties facing Royal Mail. Each measure will play a vital part in removing the constraints on Royal Mail and enabling the company meet its current challenges, and securing the sustainable future of the universal postal service.

5. Options appraisal

This section compares the status quo (i.e. do nothing) with the Government's proposed option – implementing the package recommended by the Hooper Review and the Hooper Update. The Government will, however, approach this implementation on a sequential basis rather than legislate and seek private sector interest at the same time.

5.1 Option 1: Do nothing

5.1.1 The Hooper Review explored a number of objectives: "how to develop a vibrant postal market which can respond quickly to the changing needs of consumers; how to reduce the risks currently facing the taxpayer; and most important, how to maintain the universal service". Hooper commented that "the status quo will meet none of them"14. As mentioned above, the Hooper Review found broad consensus among postal companies, business users, consumer organisations, unions and the regulator that the status quo is untenable. According to Postcomm, "without extensive change, the Royal Mail's business model will become unsustainable"15. The title of the Hooper Review - "Modernise or Decline" - also reflects his assessment that, in the absence of Government action, Royal Mail and the postal sector are not sustainable.

5.1.2 The UK letters market is already in structural decline caused by the growth of digital media and communications. The Hooper Update considers that letters volumes are likely to decline worldwide by 25-40% in the next five years16.

5.1.3 Royal Mail's financial position is not viable. Over the past few years, revenue from its letters business has fallen17 and despite some recent reductions in operating costs, Royal Mail made a post tax loss of £320m in 2009/10, with a net trading cash outflow of £517m18.

5.1.4 In addition, overall Group revenues dipped for the first time in a decade (down 2%). Royal Mail remains reliant on Government for both debt and equity finance, competing with other public spending priorities in these times of fiscal stringency.

5.1.5 In its submission to the Hooper Review, 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”19.

20 We do note that in the Hooper Update (p35), Postcomm forecasts a current short-term inelastic demand for stamps.

21 In fact, if a price rise leads to a fall in demand, this can actually lead to a reduction in economic welfare in the short term (‘deadweight loss’) as the combination of higher prices and lower demand means that some customers who value the good at more than the cost of producing it, but less than the cost of purchasing it, will not consume the good.

22 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p64

23 In relation to emergency financial support, the first Hooper Review acknowledged that “because no other company is currently able to provide the universal service, there would be strong policy reasons for the Government to meet such a request”. Owing to the requirements of rescue and restructuring aid, Hooper also noted that the implications could include accelerated rationalisation; the sale of (profit-making) subsidiaries; and compensatory measures to reduce any distortive effects on competition.

5.1.6 It is possible that Royal Mail’s April 2010 price increases could offset the lost revenue from falling volumes. Indeed a comparison of first-class stamp prices (by weight) with other EU countries indicates that prices in the UK are relatively low.
Stamp prices June 2010 - standard letter (20 grams)

1.8

Source: National Operators' Websites

5.1.7 That said, Royal Mail's potential ability to increase revenues in this way (within the Price Control) depends on the elasticity of demand: the extent to which demand for postal services will fall in response to the increase in price. The 2007-8 product price rises of a weighted average of 5% saw revenues fall slightly. Generally, demand will be more sensitive to changes in prices the easier it is for customers to substitute to other providers or to other products. It is clear that there are alternatives to post, demonstrated by the effect which digital media has increasingly had on postal volumes. Customers may also switch to less expensive postal products (such as second-class mail). It is a plausible argument, therefore, that in the future demand for mail would be increasingly responsive to a change in price.20 That could make price increases unprofitable in the medium to long term.

5.1.8 It should also be noted that increases in price (without any efficiency gains or improved service) represent a transfer from customers to Royal Mail with no net gain to the economy.21 This indicates that the future emphasis increasingly needs to be on reducing costs.

5.1.9 According to the Hooper Review, "without policy changes, financial pressures on Royal Mail will mean that emergency financial support is likely to be needed"2223. This implies that, in the absence of Government intervention, Royal Mail's financial situation would

24 "Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector", p16-17

25 The independent review of the postal services sector: First submission by Postcomm, the industry regulator.

26 Because the universal service is a legal requirement under European law, not only would the UK lose the benefits associated with such a service, but it could also face infraction proceedings.

27 Page 6

28 This deficit is proportionately larger than any other company scheme in the UK. The deficit figure is from the recently agreed March 2009 triennial valuation exercise which forms the basis of funding contributions by Royal Mail to the RMPP.

continue to decline over time. Resources the company expects to invest in modernisation would still be spent, but with potentially less focus or impact on performance.

5.1.10 Indeed, the Hooper Update notes that the overall financial health of Royal Mail has worsened over the last 18 months, despite improvements in operating profit. It also argues that the 2009/10 Annual Report of Royal Mail shows clear risks of the company not generating sufficient cash to fund the required modernisation24.

5.1.11 One could argue that Government intervention (at a later date) to provide some sort of emergency financial support represents the true 'counterfactual'. Since we do not know what such a scenario would involve (and the possibilities could vary significantly depending on Royal Mail's financial position and the state of the postal services market), it is not feasible to use this as a baseline or a basis for comparing other options. For the purpose of this Impact Assessment, therefore, the 'do nothing' option is no further Government intervention in any form.

5.1.12 Although it is not possible to estimate what the provision of a subsidy at a later date would involve, it is very likely that the costs would be higher than those associated with the proposed package of measures, and very likely that the benefits would be correspondingly lower. Providing such a subsidy would not address the fundamental problems Royal Mail currently faces; nor would it achieve the objectives set out in the Hooper Review. In this sense, the proposed package of measures can be seen as superior to the provision of a later subsidy. As a result, subsidy is not considered further in this impact assessment.

5.1.13 In terms of delayed modernisation, Postcomm found25 at the start of the 2006-10 price control that Royal Mail had significantly under-spent both on restructuring costs and on new equipment to modernise. Without investing funds effectively to transform the business, improving efficiency, reducing costs and then diversifying and expanding its postal services, the continued ability of Royal Mail to provide a universal postal service is at serious risk.26

5.1.14 Royal Mail's 2010 Annual Report27 notes that: "Royal Mail has continued to modernise its operations, with a further £500 million invested in the last 12 months largely in new technology and equipment for our postmen and women, bringing the total to over three quarters of the £2 billion investment programme since 2006. Continuing to invest in our business will be essential to keep up the pace and progress of modernisation." However, this investment is still to show fully in unit cost reductions for Royal Mail; as will be considered in detail later in this Impact Assessment. Therefore, modernisation will need to be even deeper in order to keep pace with the decline in letter volumes.

5.1.15 The size of the pension deficit, which is calculated at Annex A to be £10.3bn as a point figure from the 2009 triennial valuation28, relative to Royal Mail's business and assets is so high that the company is balance sheet insolvent and the pension is a constant drain on cash resources. Consequently, the company's directors are under legal constraints which force them to consider decisions on the basis of short-term cash effects rather than

29 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p83

30 http://www.royalmailpensionplan.co.uk/57/recent-pension-communications

31 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p104

longer-term factors, hampering efforts to focus on investment.29 This could have a significant impact on Royal Mail's ability to achieve the necessary levels of modernisation. In addition, the Pensions Regulator has expressed concerns about the size of the pension deficit and the agreement reached between Royal Mail and the pension trustees regarding on-going funding on the Royal Mail Pension Plan (RMPP).30

5.2 Option 2: Implement the package of measures recommended by the Hooper Review and Hooper Update – injection of private sector capital and disciplines, relief of the historic pension deficit, and reforms to the regulatory regime

Benefits

5.2.1 The previous Government asked the Hooper Review to consider a number of objectives: “how to develop a vibrant postal market which can respond quickly to the changing needs of consumers; how to reduce the risks currently facing the taxpayer; and most important, how to maintain the universal service”31. In order to achieve these objectives, the Government proposes to implement a package of measures, which includes: the introduction of private sector capital and disciplines; transferring the historic pension liabilities to Government; and changes to the regulatory framework.

5.2.2 The benefits associated with achievement of these objectives will accrue to the wider economy: to taxpayers; to those sending mail in terms of a better value service; and to the majority of Royal Mail’s employees in terms of their long-term job security. Securing the sustainable future of the universal postal service will also benefit the wider economy – in particular businesses and consumers.

32 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p32

Table 1 : Summary of benefits associated with the proposed package of measures

Description of Benefit

Estimated value (PV over 10 yr
period)

Benefits of transformation

Sustaining the universal service

Not quantified

Increased efficiencies, based on the following accelerated ultimate savings in costs p.a. (assuming injection of private sector capital occurs in 2012):

- £860m (if fixed costs are 60% throughout)

- £3,875m (if fixed costs are 60% until the point of sale and 40% thereafter)

- £5,975m (if fixed costs are 40% throughout)

£726m

£3,098m

£4,761m

Pension deficit / admin benefits

£10.3 billion (one-off transfer, HMG to Royal Mail) / £249 million

Possible improved industrial relations should Government be removed from the management/union relationship

Not quantified

Possible reduction in management time spent on seeking regulatory consents

Not quantified

More effective regulation (removing requirement for Royal Mail and other operators to get specific regulatory agreement before launching new products or services, possible economies of scale)

Market regulation - not quantified

Potential regulator cost savings - £6.7m

Proceeds from sale of shareholding

Not quantified – dependent upon market conditions at the time of sale

Benefits of diversification and expansion

Not quantified

Sustaining the Universal Postal Service

5.2.3 The Government’s first priority is to maintain the universal postal service. It has a number of economic and social benefits, as identified by the Hooper Review32:

• The national network strengthens social cohesion by ensuring that everyone, whether in urban, rural or remote areas, has an accessible, reliable means of communication and the capacity to send and receive physical goods. It also enables access to other services, such as internet shopping.

• The universal service is important to the UK economy for precisely the same reason: it enables trade. Companies of all sizes rely on the postal service to build their business, supply goods and receive payment.

• A uniform tariff protects those who use the postal service rarely or who live in areas of low population density. They might otherwise face a connection charge, higher prices or less convenient services.

33 The Needs of Users of the Postal Service: Customer Service Report, Postcomm 2007

34 Postal Universal Service Obligation: Value to the Citizen, prepared for Postwatch by Accent 2008

35 The provision for a special administration regime to maintain the universal service obligation, should a universal service provider face bankruptcy, will ensure that the benefits to the wider economy arising from the universal service can still accrue. In addition, such a regime would avoid the UK being subject to EU infraction proceedings.

• An affordable service protects the ability of vulnerable consumers and those with lower incomes to send and receive goods, without the need for means testing.

5.2.4 Only 13% of residential customers are familiar with the concept of the universal postal service, but the public values the individual features which it comprises. In research commissioned by Postcomm33, 90% of respondents believed that a uniform tariff was very important or fairly important; 82% of residential customers and 73% of businesses said that a six-day-a-week service is either important or fairly important; and 82% of residential customers wanted a guaranteed next-day service to be provided. A separate report by Postwatch34 (now part of Consumer Focus) warns of strong opposition to any move away from uniform pricing.

5.2.5 It is difficult to estimate the value to the wider economy, in monetary terms, from maintaining the universal service. But the research referred to above (supported by evidence submitted directly to the panel during the Hooper Review) implies that maintaining the service is of paramount importance to UK citizens and businesses and therefore the economy more generally as an enabler of trade.

5.2.6 The Government believes that the package of measures proposed by the Hooper Review should enable Royal Mail to overcome all of the previously identified constraints (apart from pricing) which currently undermine Royal Mail's ability to respond sufficiently quickly to the declining market and, ultimately, its ability to provide the universal service.35

5.2.7 The benefits associated with overcoming each of these constraints are discussed separately below, with the exception of pricing. As discussed earlier, Royal Mail may be limited in its ability to raise prices owing to the effect this could have on volumes (as customers switch away from post to substitutes such as digital media). This puts more emphasis on reducing the cost base and achieving real efficiencies, thus developing increased margins between costs and prices to allow continuing investment feedback into modernising the business. Notwithstanding the fact that Royal Mail may be limited in its ability to increase prices, a price rise (without any efficiency gains or improved service) would simply represent a transfer from customers to the Royal Mail, with no net gain for the wider economy (unlike the efficiencies associated with cost-savings considered below). Because enabling Royal Mail simply to increase prices would not necessarily result in benefits to the UK, the proposed package of measures focuses on overcoming the remaining four constraints.

5.2.8 It is also expected that the proposed package will deliver additional benefits including: benefits from Ofcom regulating the sector (including economies of scale); deregulation in terms of moving to a general authorisation regime; and benefits to customers in terms of increased choice of services that are better suited to their needs. These are discussed in more detail below.

Tackling Inefficiency

5.2.9 The Hooper Update recommends the introduction of private sector capital and its disciplines into Royal Mail. Such an injection of capital, and the disciplines it brings, should help to drive effective modernisation of Royal Mail more quickly, and ensure that it becomes an efficient, innovative and viable business. Royal Mail started a transformation programme a number of years ago and, as the Hooper Review makes clear, progress

36 Royal Mail Annual Report 2010

37 Price control and access, Annex 4 (May 2010)

38 Price control and access, Annex 4 (May 2010)

39 Despite its cost base having been under modernisation since 2006/7.

40 ONS (0.5% - April 09-10) – Postcomm use RPI to proxy Royal Mail's cost inflation.

has been very slow. As discussed above, the postal services market is currently in structural decline and continuing falling volumes will further undermine the ability of the company to transform its business in the absence of immediate action by Government.

5.2.10 The process of modernising a company such as Royal Mail can be divided into two distinct phases. The first is 'transformation' which involves improving efficiency and reducing costs. The second is 'diversification and expansion', which could be achieved by: extending the range of services offered; extending the geography covered; or by expanding into related services. This second phase of modernisation will obviously provide benefits (in terms of greater choice and services which more closely reflect customer requirements), but as there is some uncertainty at this moment in time about what the second phase of modernisation will involve, this Impact Assessment focuses on the first stage: transformation.

5.2.11 We need to define the salient counter factual: what are the likely benefits that would be achieved given no further Government intervention? These benefits can then be weighed against those forecast to be achieved under the proposed package of measures.

5.2.12 It is impossible to predict the policy of any future shareholders of Royal Mail in terms of spending on modernisation. This analysis, therefore, is based on Royal Mail's existing spending plans for modernisation explained earlier.

5.2.13 In estimating Royal Mail's cost efficiency gains over the last year, we can start with its reported 2009 to 2010 cost savings of £206m36. However, as Postcomm note37: "We would expect some reduction in Royal Mail's costs simply in response to the lower volumes being handled, rather than as a specific outcome of implemented efficiency initiatives".

5.2.14 It is thus important to take the recent falls in volumes into account. In the first instance we do this by applying Royal Mail's view (now accepted by Postcomm38) that the short-term marginality of its current network means that 40% of its costs are avoidable with reduced volumes in the short-run (i.e. in the short-run, 60% of its costs are fixed)39.

5.2.15 Royal Mail's 2010 annual report shows an annual decrease in volumes of 7.3%. We thus take 7.3% of its 2009 Letters business cost base (£6,649m defined as revenues less profit) and then, in the first instance, 40% of this figure to give us the cost savings for 2010 expected to be driven by reduced volumes. The resulting number is then uplifted by 0.5%40 to account for 2009/10 inflation to leave it in 2010 prices. This yields a figure of £195m of cost reductions due to contracting volumes to be netted off Royal Mail's overall cost reductions to yield the outcomes of their modernisation efficiency savings.

5.2.16 It is also important to recognise the wider effect of inflation on Royal Mail's cost base. Its cost base of £6,649m in 2009 needs to be uplifted by RPI to inform us of the further cost removals achieved between 2009 and 2010 to be added to the annual report's stated nominal cost savings. Adding the annual RPI uplift (0.5%) to the 2009 cost base gives £6681m – so a further £32m of costs have been saved.

5.2.17 In total this yields £43m of net efficiency saving achieved by Royal Mail from 2009 to 2010 (in 2010 prices).

41 Royal Mail Annual Report 2010

42 “Saving the Royal Mail’s universal postal service in the digital age: An update of the 2008 independent review of the postal services sector” p27

43 But our estimations here suggest that at their current pace Royal Mail will not achieve the modelled cost efficiency target within the time frame of analysis.

44 Under the price control, the regulator’s target for Royal Mail was set at 3% per annum for the period to 2006-10. The regulator considered this to be a feasible target.

5.2.18 Conducting the same operation for Royal Mail’s 2008 cost base, its 2009 volume decline of 5.5%41, it’s accounts’ 2008-9 cost savings of £184m and an annual 2008/9 RPI of 3% (ONS) - we arrive at a net efficient saving for 2008 to 2009 of £233m (in 2010 prices).

5.2.19 Whilst for Royal Mail’s 2007 cost base, its 2008 volume decline of 3.2%, it’s accounts’ 2007-8 costs increased by £112m and an annual 2007/8 RPI of 4.1% (ONS) - we arrive at a net efficient saving for 2007 to 2008 of £78m (in 2010 prices).

5.2.20 Taking the average of these three net efficiency savings (beyond volume effects) achieved for 2007/8 to 2009/10 we obtain a figure of £118m in 2010 prices. For the analysis to follow we shall round this to £120m.

5.2.21 As noted, this average figure is very dependent on the share of costs which are fixed in the short-run. The Hooper Update highlights that Postcomm's work on cost transparency is not yet complete and without this, it is not possible to accurately estimate costs and cost allocations (such as the costs of the universal service).42

5.2.22 Indeed, prior to the publication of its price control and access document in May 2010, Postcomm had believed that fixed costs accounted for just 40% of Royal Mail's cost base in the short-run. Inputting this figure of 40% fixed costs into the above calculations produces an average efficient saving over three years of £45m in 2010 prices.

5.2.23 As either the 60% or 40% figures for the share of fixed costs applies to Royal Mail's cost base only in the short-run, this share should fall as the analysis of Royal Mail's cost base enters the medium-term. However, as explained below, in constructing our best estimate scenario of efficiency gains, we start with the 60% fixed cost share and then assume that we enter the medium-term at the point of sale; at which time the 40% fixed cost figure is taken to represent a conservative estimate of the proportion of fixed costs in the medium-term.

5.2.24 In 2008 Royal Mail provided Postcomm with a Strategic Plan outlining its plans for cost reduction and implementation of the overall Transformation Plan for the period 2008-2015. Postcomm notes, in its Price control and access, Annex 4 (May 2010), that: Royal Mail has now provided an update on its performance in implementing the initiatives within the Strategic Plan. "Most are now being implemented as planned, and some initiatives have been expanded, though some important initiatives are now expected to be completed later than provided for in the original phasing."

5.2.25 As noted in Royal Mail's 2008 Annual Report, the Chairman and Chief Executive state that: "Daunting challenges remain but the Group is now implementing plans to modernise the Letters business…".Given this we will here model Royal Mail as being in the midst of a planned eight-year modernisation programme starting in 2007/843. In the absence of better information we will use the 2006-10 price control's 3% annual cost reduction efficiency target (excluding volume effects)44. Such that over the remaining seven years represented by the 2008 Transformation Plan, successful achievement of the annual 3%

45 In addition Royal Mail should be in a position to make further efficiency savings due to the cost reductions associated with the moves away from more expensive end-to-end services towards bulk mail and access services – but these are not accounted for here.

46 In Postcomm's first submission to the Hooper Review, the regulator said that Royal Mail was forecast an annual unit cost reduction of 0.6% (2007-9) against the target of 3% per annum.

47 Royal Mail before the share sales is estimated to have driven out £480m of the target efficiencies by 2011 – again assuming a continuation of their 2008-10 average trajectory

48 The Government does not consider that the stake of Royal Mail held by private sector investors will affect the pace of modernisation.

target would yield a cumulative 18.7% reduction in the (2008) cost base in the seventh year – this equates to a £1,320m cumulative annual cost reduction in 2010 prices45.

5.2.26 In comparison to Royal Mail's historically slow pace of cost efficiency realisation46, private sector capital and disciplines are likely to enable the potential benefits from modernisation to be realised more quickly as the private sector possesses the scope and even more incentives to go faster and possibly even further.

5.2.27 We thus argue that the modernisation of Royal Mail and its associated cost efficiency savings can be achieved in as little as five years after the introduction of private sector capital and disciplines. Indeed, the technology to enable greater automation, for example, has already been developed and is commercially available and it is being rolled-out by Royal Mail and market forces are also exerting considerable pressures to modernise.

5.2.28 For the purposes of this assessment, therefore, we assume that the rate of modernisation is increased to be fully effective within five years of private sector capital and disciplines' involvement, and that improved efficiency is achieved at a uniform rate over this period.

5.2.29 We have modelled three scenarios of continued efficiency gains in the absence of intervention:

1. Royal Mail continues at its average 2008-10 cost reduction rates based on 60% fixed costs

2. Royal Mail continues at its average 2008-10 cost reduction rates based on 60% fixed costs up until the point of sale, after which we enter the medium-term and the share of fixed costs falls to 40%. This is our best estimate scenario.

3. Royal Mail continues at its average 2008-10 cost reduction rates based on 40% fixed costs

5.2.30 If Royal Mail's private sector capital and disciplines begin in, for example, 2012, then below we model this as yielding an increased rate of uniform cost reduction of £170m per annum for five years in scenarios 1 and 2 (i.e. the target, £1320m less where Royal Mail had reached in 2011, £480m (of cumulative annual savings)47 – leaving £840m left to achieve over five years; thus uniformly £170m a year, for the five years), and of £230m per annum in scenario 3.48

49 In 2010 prices

50 See risks section for further details

Royal Mail Efficiency Cost Savings (£m)

2008

2009

2010

2011

2012

2013

2014

2015

2016

2017

2018

2019

2020

Sc 1

No Hooper Package

120

240

360

480

600

720

840

960

1080

1200

1320

1320

1320

Hooper Package

120

240

360

480

650

820

990

1160

1320

1320

1320

1320

1320

Sc 2

No Hooper Package

120

240

360

480

525

570

615

660

705

750

795

840

885

Hooper Package

120

240

360

480

650

820

990

1160

1320

1320

1320

1320

1320

Sc 3

No Hooper Package

45

90

135

180

225

270

315

360

405

450

495

540

585

Hooper Package

45

90

135

180

410

640

870

1100

1320

1320

1320

1320

1320

5.2.31 Based on this modelling, the present value49 of the benefits of the increased speed of attaining the available cost efficiencies over the eight year period with private sector capital and disciplines involved in Royal Mail are estimated at £726million, £3,098m and £4,761m respectively. Whilst our best estimate is for a sale in 2012, should the involvement of private sector capital be delayed, sensitivity analysis shows that the present value of these efficiency savings would decline to £600m for 2013 and £494m for 2014 under scenario 1, £2,421m and £1,833m under scenario 2, and £4,337m and £3,927m under scenario 3.50

5.2.32 As mentioned in section 5.1, the legal constraints faced by Royal Mail's directors may mean that the level of efficiency gains modelled in the absence of the Hooper package cannot be achieved, particularly if the company's financial position continues to deteriorate. The company is already balance sheet insolvent and is repaying the pension deficit over 38 years, allowing it to continue to trade. However, this arrangement will be reconsidered at the next triennial valuation in 2012. Should circumstances change such that the Pension Trustees increase repayments or crystallise the deficit, this would affect Royal Mail's ability to trade (if no further support from the shareholder was forthcoming). In such a case, the efficiency savings arising from the involvement of private sector capital and disciplines will be significantly higher. As Royal Mail's future financial position cannot be known, we are not able to quantify this effect.

5.2.33 The estimates above illustrate the scale of the efficiencies that would be attributable to the proposed package of measures. But it does not give an indication of how exactly such efficiencies would be achieved. For illustration, we here consider three areas where efficiency may be improved, although the information has not been available to estimate, in monetary terms, the scale of the potential efficiencies in each area.

51 "Modernise or Decline: Policies to maintain the universal postal service in the United Kingdom" p50

52 "Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector" p24

53 "Modernise or Decline: policies to maintain the universal postal service in the United Kingdom" p51

54 "Saving the Royal Mail's universal postal service in the digital age: An update of the 2008 independent review of the postal services sector" p24

i) Automation

5.2.34 Walk-sorting is the process of sorting letters into groups which correspond to the addresses covered by a postal worker's round. Royal Mail's figures now show that it uses machines in its mail centres to sort 83% of letters into walks. Although this is a significant improvement compared with 50% four years ago, it is still lower than the 95% managed by leading European companies, indicating that further efficiencies could be achieved by further automation of walk-sorting.

5.2.35 Walk-sequencing is the process of putting the letters in the right order for delivery. At Royal Mail, this process is currently carried out mainly by hand, taking each postal worker 2-3 hours per working day. Royal Mail is in the process of buying and installing machines with the aim of sequencing 75% of letters automatically by 201351. This compares to around 85% for the leading European competitors and in the past two years, Royal Mail has only achieved an increase in automated walk-sequencing to 8% of letters (up from 0%)52. Again, this implies there are many further efficiencies to be achieved from further automation of walk-sequencing.

ii) Working practices

5.2.36 The Hooper Review also highlighted a number of working practices which restrict Royal Mail's efficiency53:

• "Early finishes. It has been common practice that postal workers go home when they have finished their round. In the summer or on certain days of the week when volumes are low, this can be up to three hours before their paid hours have ended. If, however, additional time is needed to complete a round, overtime can be claimed or the round not completed.

• "Covering for absence. Employees will on occasion not carry out a colleague's deliveries without being paid overtime to do so, even when their own workloads are relatively light. So a postal worker who is paid until 2.00 pm and finishes his or her own route at 11.00 am may still claim overtime to cover a colleague's deliveries, even though they could be completed within paid hours.

• “Equipment. In some locations, the CWU has instructed its members not to use new technology (such as machines for sorting larger letters and hand-held devices to track mail) until there is both a national and local agreement about their use.

• “Demarcation. Employees in some mail centres have been known to refuse to work in the delivery office, for example, even though both are on the same site”.

5.2.37 In the main, these inefficient working practices have been addressed and changes are being taken forward throughout the UK. Royal Mail currently has 64 mail centres, five fewer than two years ago, and is consulting on the future of a further 17.54 However, there is opposition to such closures. The Business Transformation Agreement between Royal Mail and the CWU should address any outstanding issues on working practices. This agreement is a huge step forward in industrial relations in the company but until it

55 ONS Occupational Pensions Schemes Survey (October 2009)

has been implemented over the next few years, we will not know how successful it has been in bringing about a lasting improvement in industrial relations in the company.

5.2.38 Indeed, some of these efficiency related issues help to explain why when compared to postal service companies across Western Europe, Royal Mail’s labour costs are still relatively high.

Labour costs as a percentage of revenues in 2009

Source: Capital IQ

iii) On-going pension contributions

5.2.39 The schedule of contributions agreed as part of the Royal Mail Pension Plan (RMPP) triennial valuation is 17.1% of pensionable pay from April 2010. This reduction from 20% of pensionable pay at the time of the first Hooper Review reflects a number of reforms such as the increase of the Normal Retirement Age to 65. But this figure still remains about twice more expensive than schemes based on defined contributions55.

5.2.40 Royal Mail has already made changes to its pension scheme. New employees are offered a defined contribution scheme; the calculation of benefits for existing members will be based on a career average; and as noted the pensionable age has increased from 60 to 65. The Hooper Review considered that “over the next few years, these changes are expected to reduce Royal Mail’s costs associated with current service to levels that are broadly consistent with industry averages.”

5.2.41 With this in mind, it is not expected that the proposed package of measures will lead to any additional benefits in terms of ongoing pension contributions, which Royal Mail will continue to fund. The proposed package of measures relates only to the historic liabilities, which is dealt with in the section below.

Pension deficit

5.2.42 As set out in Annex A, the Government is proposing that all liabilities relating to pensions accruals after a cut-off date (to be specified in secondary legislation) will remain with the RMPP, along with assets to meet the expected cost of those liabilities. All other liabilities will be transferred to a new pay-as-you-go public sector scheme, with the remaining

36.7%
43.3%
48.3%48.8%
53.4%
57.2%
60.5%61.5%
70.0%
33.8%33.5%
0.0%
20.0%
40.0%
60.0%
80.0%

56 This deficit is proportionately larger than any other company scheme in the UK. The deficit figure is from the recently agreed March 2009 triennial valuation exercise which forms the basis of funding contributions by Royal Mail to the RMPP.

57 In line with Impact Assessment guidance, this document only assesses the first-round effects of the pension transfer

58 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p56

assets transferred to Government and sold over a number of years. This is the preferred option because it will address the massive deficit in the RMPP and also reduce the size of the on-going plan to a more manageable level which is sustainable for Royal Mail on an on-going basis. The creation of a new pay-as-you-go public scheme is consistent with the position in other public sector schemes and avoids Government taking on investment risk.

5.2.43 The transfer of historic liabilities and assets from Royal Mail to Government results in a benefit to Royal Mail, which is calculated at Annex A to be £10.3bn as a point figure from the 2009 triennial valuation56. Because there is a corresponding cost to Government and the taxpayer, however, this does not result in any net economic gain or loss because the deficit is no larger or smaller than before the change57. At the March 2010 annual valuation update, the deficit had reduced to £8.4bn (but it should be noted that this does not impact on Royal Mail’s contribution levels).

5.2.44 Estimated benefits with a present value of £249m (calculated over a ten year period) will accrue owing to the reduction in investment costs of the RMPP and a reduction in the value of the Pension Protection Fund (PPF) levy payable by the scheme. A full breakdown of benefits is attached at Annex A.

Labour relations

5.2.45 The Hooper Review noted that industrial relations at Royal Mail were in 2008 “poor” and had been the subject of a previous review by Lord Sawyer in 2001. It found that “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”58.

5.2.46 The relationship has been characterised in recent times by the nationwide strikes in 2007 and 2009, but has begun to improve since the Modernisation Agreement between the CWU and Royal Mail in March 2010.

5.2.47 The Modernisation Agreement offers a three year modernisation deal (2010-13), and is being introduced progressively across the country. Despite the complexity of the agreement, all indications are that the management and union are engaging more positively, and there have been no reports of a reduction in service since the agreement was reached. So although the latter part of 2009 experienced industrial action, there is now a real chance of achieving stable industrial relations for the years to come.

5.2.48 This commitment to co-operation could be cemented should the route of “escalating” disputes to Government, for both management and the union, be removed via the share sale. Furthermore, employee shares should offer the chance of a step change in the relationship between the company and its employees, bringing a real sense of ownership for employees and aligning their interests with the company.

5.2.49 This is important because industrial action represents a real cost to the economy in terms of lost production and it can also create uncertainty for customers (which will occur even if action is planned and subsequently cancelled). Industrial action could also have adverse knock-on effects for the postal sector more generally. If the post is viewed as unreliable because of disruption through strike action, then customers will look to other

59 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p57

60 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p58

61 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p87

forms of communication to meet their needs. The Hooper Review referred to evidence that suggests “some companies using the postal service for transactions and advertising decided to use other media on a permanent basis after strikes in 2007”.59 During the industrial action in 2009, leading Royal Mail customers, especially those involved with parcel delivery, drew up plans to use other operators to ensure that their deliveries were not affected during the run up to Christmas.

Relationship with the regulator

5.2.50 At the time of the Hooper Review the relationship between the company and its regulator, Postcomm, was also difficult. The Hooper Review commented that “there is a lack of trust on both sides…these tensions act as a constraint on Royal Mail by diverting management attention from the main task at hand”60.

5.2.51 As with the union, the relations with the current regulator have improved since the publication of the Hooper Review report. However, Hooper’s rationale for moving regulation to Ofcom, with its deep understanding of the communications sector and expertise in a range of markets, still stands. Ofcom’s oversight of the new regulatory regime as set out below will ensure more effective and certain regulation of this sector going forward where the only currently feasible universal service provider will soon possess private sector capital and disciplines.

5.2.52 As we do not know the current extent of management’s time spent on seeking regulatory consents inefficiently (and thus being diverted away from running the company), it is not possible to estimate these potential benefits. It is clear, however, that further certainty with the regulator should enable Royal Mail to focus more fully on modernisation. As Royal Mail's 2010 Annual Report notes: "As we enter the next stage of our evolution it is against a backdrop of regulatory uncertainty with our regulator, Postcomm, shortly to conduct a Licence review, the result of which will have profound implications for the Group."

More effective regulation of the sector

5.2.53 All sectors of the UK economy are subject to regulation to protect consumers. Most sectors are subject to ex post regulation, whereby the competition authorities have powers to tackle anti-competitive practices (abuse of dominance or anti-competitive agreements). Such regulation generally relies on the application of competition legislation after the anti-competitive behaviour has taken place. Other specific sectors and sub-sectors are subject to ex ante regulation, usually because one or more companies inherently hold a dominant position in the market. Ex ante regulation seeks to recreate the efficiency benefits of competition for consumers and aims to stop undesirable outcomes before they take place. An example of this type of regulation currently includes the setting of access prices (now being considered by Postcomm in consultation) in the postal sector to ensure that Royal Mail's competitors have fair access to the company's infrastructure. Both types of regulation protect consumers.

5.2.54 The Hooper Review recommended that Ofcom: "should be appointed to regulate the postal sector, reflecting its connections with the broader communications sector…the regulator needs a new set of tools to regulate the sector: wider reaching regulatory powers, formal market analysis, and a significantly improved understanding of the costs of Royal Mail's business".61

62 The NAO report, The Creation of OFCOM: Wider lessons for public sector mergers of regulatory agencies – Table 14

63 http://www.psc.gov.uk/postcomm/live/about-postcomm/annual-reports-and-plans/postcomm-annual-report-2009-10/2010_07_15_Postcomm_Annual__Report_09-10.pdf

64 Although these benefits could also accrue under regulators other than Ofcom.

5.2.55 As the Regulator with responsibility for communications, Ofcom has deep understanding of communications markets and has developed expertise which it can bring to bear in the postal market. We propose to transfer regulatory responsibility for postal services to Ofcom and wind-up Postcomm, achieving twin aims of reforming regulation in the sector and reducing the number of bodies which operate at arms length from Government.

5.2.56 Whilst the recommendation to make Ofcom responsible for the regulation of the postal sector (instead of Postcomm) is not made from the point of view of administrative cost saving, it is likely that transferring regulatory responsibility to Ofcom will result in some economies of scale. For example, the fixed costs associated with running the organisation (such as human resources and facilities management) will now be spread over a larger workforce. Ofcom currently has 865 staff compared to around 50 at Postcomm.

5.2.57 As a regulator with a wide range of responsibilities, Ofcom can be more efficient in allocating resources to meet the most difficult and time-consuming aspects of its work, such as price control negotiations. Should the approximate 10% operating cost reduction achieved in creating Ofcom compared to its previous constituent parts62 also apply to Postcomm's current spending, there is a potential saving of approximately £0.8 million per annum. Postcomm's 2009/10 Annual Report63 forecasts outturn spend of £7.8m.

5.2.58 The move to Ofcom64 will also reduce the administrative burden on businesses, as the current regime requires operators to have a licence from the regulator to operate in the market. The new regime will be built on general conditions for operating in the sector. This means that operators wishing to innovate will only have to ensure that their new services are consistent with the general conditions set by Ofcom, rather than seeking individual and specific clearance from the regulator before being able to launch that service. However, it has not been possible to quantify these reductions.

5.2.59 The Hooper Review makes clear that Ofcom's primary duty in relation to postal services should be to ensure provision of the universal postal service. As such Ofcom will be given a new key duty to secure the provision of the universal postal service. Ofcom's duties will make it clear that competition, whilst beneficial, should not undermine the universal postal service. In making its decisions Ofcom will have to take into account the financial sustainability of the universal service. This will not mean that Ofcom will protect an inefficient Royal Mail to the detriment of consumers.

5.2.60 Ofcom will also be able to take action if they find the burden on Royal Mail of providing the universal service is unfair – either to initiate a compensation fund to contribute towards the service from among existing providers and/or users; to see if another operator can provide a particular aspect of the universal service more cheaply; or, potentially, to recommend to Government, after a review of users' needs, that the requirements of the universal postal service are changed, but only after conducting a review into user needs.

5.2.61 However, the Government wants to ensure that Royal Mail undergoes a proper transformation and increased efficiency process. It is important that these protections do not undermine this or discourage competition and new entrants to the postal market. For that reason, it is sensible that the regulator will not be allowed to begin an investigation into the costs of the universal postal service for three years. Nor should the regulator

65 In line with the provisions of the Third EU Postal Services Directive

66 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p92

67 Whilst the introduction of such a complaints procedure may impose some costs to operators, these are estimated to be negligible.

68 Indeed, a regulator’s price control regime designed to improve cost efficiency is much more likely to be successful under private than public shareholdings where these private shareholders directly benefit from the company achieving or bettering the implied savings.

recommend changes to the requirements of the universal postal service without an investigation into the needs of postal consumers. Whilst the requirements of the universal postal service in the UK go beyond the requirements as set out in the European Postal Services Directive, the Government and Parliament will need to agree if there are to be any changes to them. The regulator will also, from time to time, carry out a review of the designation of a universal service provider65 to ensure the provision of an efficient universal service.

5.2.62 The Hooper Update also makes clear the importance of a new regulatory framework for postal services, guaranteeing regulatory certainty and offering greater deregulation going forward.

5.2.63 If Ofcom were to conduct a formal market analysis to determine the extent to which Royal Mail has significant market power in each salient market, it could start by designing a regulatory regime that focuses ex ante regulation on those areas. In addition, Ofcom has concurrent competition law powers and there will be benefits to consumers and competitors as these flexible powers to investigate anti-competitive behaviour are applied to the wider postal services sector. According to the Hooper Review there would also be benefits for Royal Mail because: “competition law powers would remove a barrier to future deregulation. The regulator is better equipped to remove products and services from the ex ante price control if it has the assurance that it can take suitable action in the case of a dominant company abusing its market power”66. Over time, this deregulation would reduce the bureaucratic burden not only on Royal Mail, but the sector more widely.

5.2.64 An improved understanding of Royal Mail’s costs would also bring benefits as set out in the Hooper review. It would provide information to enable more effective regulation of the company; it would enable more effective regulation of the sector; and it would also help ensure that access prices are not uncompetitive. Indeed, Postcomm’s current regulatory framework consultation is looking at the issues of accounting separation and cost transparency.

5.2.65 In the longer term, greater competition will bring benefits to consumers in the form of lower prices (if prices were above competitive levels previously), improved quality and/or greater choice. Consumer protection is also strengthened in compliance with requirements of the 3rd Postal Services Directive, which requires all postal operators to have a simple complaints procedure for postal users.67 However, at this stage it is not possible to quantify these benefits.

Private sector capital investment

5.2.66 The involvement of the private sector, an injection of private sector capital (by a potential variety of routes) and associated private sector disciplines will enable Royal Mail to deliver much more rapid efficiencies, to focus better on customer needs, and to respond quickly to opportunities arising from the changing dynamics of the communications sector68. Such a capital injection could represent a transfer from the UK private sector. Indeed, in the current fiscal environment, additional public sector capital investment is much less likely to be forthcoming than is private sector capital. However, if such an injection comes from overseas, this would in itself represent a net benefit to the UK economy.

69 The Government will also have to consider the value for money implications of any proposed schemes.

70 Lampel, J; Bhalla, A; Jha, P, 2010. http://www.johnlewispartnership.co.uk/Display.aspx?MasterId=53505afb-6ed5-4f19-923e-30b06cd31a9a&NavigationId=549

5.2.67 In addition to its more likely supply in the short term than public capital, private sector capital is also more flexible than Government funding. It can be raised more quickly, it does not require lengthy State Aid clearance and private investors can take a more sophisticated view on investment risks.

5.2.68 Given the Government’s commitment to securing a sustainable universal postal service for the good of the economy and society; the problems facing Royal Mail (and thus making the universal service vulnerable) also provide a risk to the public finances (should Royal Mail fail) that is no longer acceptable. Private sector capital investments and their associated disciplines are now required to reduce both the risks to and claims on the public finances.

5.2.69 At this stage we do not know the potential purchase price of shares in Royal Mail as this will be dependent upon market conditions at the time of sale, and are therefore unable to quantify the potential tax payer benefit of sales to set against the loss of this shareholding.

Employee share scheme

5.2.70 The Government is proposing to provide employees with the opportunity to participate in the ownership of Royal Mail as part of the process of bringing private sector capital into Royal Mail. The exact form of this employee share scheme is yet to be decided beyond the Government's commitment to at least 10% of the shares in Royal Mail being made available to employees, with the details of the interaction of this scheme with any sale to be developed in due course. The Government will discuss further with the company, union representatives, employees and, as appropriate, potential buyers before the scheme is established alongside a transaction to sell shares in Royal Mail69. However, its rationale is that of increased incentives and engagement for Royal Mail's workers thus aligning the interests of employees and the company, encouraging further commitment and quality whilst maximising the benefits for workers of improved efficiency/productivity.

5.2.71 By allowing the employees of Royal Mail to share in the success of the company going forward (via increasing share prices and/or dividend payments as well as salary) there is the increasing scope for employee buy-in to modernisation initiatives and ongoing productivity enhancements. The aim is for employees to have both a sense of ownership and participation, and to be structured such that it has a significant degree of longevity to ensure the long term alignment of incentives.

5.2.72 Partial employee ownership can yield organisations with better informed workers as firms may be more transparent in the financial and operational information they present to their staff (listed company rules allowing).

5.2.73 Furthermore, employee ownership in organisations may make them more effective in responding to market change as the employees are even more committed and better understand the company's performance. Indeed, workers may also feel more prepared to make short term concessions for some longer term benefits.

5.2.74 A recent Cass Business School Report (commissioned by the John Lewis Partnership), Model Growth: Do employee-owned businesses deliver sustainable performance?70, conducted surveys which found that employee-owned businesses tend to be perceived

71 The report considered employee-owned businesses with employee shares from 32%-100%, with a mean of 64%.

72 Although, the e-fulfilment growth market seems to offer an important expansion opportunity for traditional postal

service providers, whilst new digital businesses may be a route to diversification.

as more robust. Survey indicators such as “lower risk of business failure” are reported as a key benefit of being employee-owned71.

Longer term benefits of diversification and expansion

5.2.75 As mentioned above, the Hooper Review identifies two stages of modernisation: transformation (improving efficiency and reducing costs); and diversification and expansion (finding new sources of revenue). There is currently a high degree of uncertainty about the form which diversification and expansion may take72. For this reason, the current Impact Assessment focuses on the impacts associated with transformation.

Costs

5.2.76 Table 2 summarises the costs associated with the proposed package of measures. Each cost is explained in more detail in the sections below.

Table 2: Summary of costs associated with the proposed package of measures

Description of Cost	Estimated value (PV over 10 yr period)
Transformation	
Financial costs of transforming the network	Additional spend not quantified
Staff time	

£8 million

Costs associated with changing regulators

Not quantified

Pension deficit / admin costs

£10.3 billion (one-off transfer, Royal Mail to HMG) / £278 million

Foregone shareholding

Not quantified – dependent upon market conditions at the time of sale

Diversification and expansion

Not quantified

Financial costs of transforming the postal network

5.2.77 Restructuring Royal Mail’s national network of mail centres, distribution centres and delivery offices will require investment and staff time. Royal Mail is already expecting to invest significantly in new machinery and improved facilities over the next five years. This is funded by cash generated by the business and credit facilities provided by the Government.

5.2.78 However, the mail market decline is uncertain. If it increases rapidly, this will impact on the cash generated by the company; Royal Mail’s headroom position as identified in the Hooper Review is already extremely tight over the next few years.

73 “Modernise or Decline: policies to maintain the universal postal service in the United Kingdom” p73

74 Royal Mail’s Annual Report 2009-10

75 Of course some will have anyway been spent on modernisation. This point is mainly illustrative.

5.2.79 In the absence of intervention, it is possible that some of this money is diverted to keeping the company afloat, and this money is spent less effectively without the benefit of private sector capital and disciplines. As a result, there are not expected to be any additional costs associated with modernisation under the proposed package of measures.

Loss of shareholding in Royal Mail

5.2.80 The Government proposes to sell shares in Royal Mail. The price at which these shares will be sold will depend on the market's expectations of future Royal Mail returns. The salient discounted cash flow/profitability valuation will need to take into account future sector prospects and the influence on Royal Mail's efficiency which private sector capital and disciplines will help drive.

5.2.81 With this in mind, it could be argued that a continued 100% Government shareholding in Royal Mail (in the case of "do nothing") would not be worth the same as the value of the company with private sector investment. This is because the value of the shares depends crucially on the success of this proposed package of measures to transform Royal Mail into a viable and more successful business; private sector involvement will play a crucial role in modernising the business.

5.2.82 At the point of a share sale, the market will help the Government determine the compensation the taxpayer should receive for the loss of its relevant shareholding in Royal Mail, i.e. the price any purchasers pay for these shares.

Investment of staff time required

5.2.83 The Hooper Review compared the management challenge of modernising Royal Mail to that of "modernising the telecommunications trunk network by BT in the 1980's. Consultation with staff, planning for the transition to a new network structure, and the adaptation of working patterns demand a major investment of time and expertise at all levels of the organisation"73.

5.2.84 It is likely that a significant amount of senior management time will be dedicated to modernisation over the next few years. In 2009-10, Directors' annual salaries and fees at the Royal Mail Group level were worth £1.9 million74. If we assume that all of these Directors' time is now additionally75 dedicated to modernisation over a period of 5 years, the present value of this is estimated at £8 million.

5.2.85 In the absence of this intervention, a proportion of staff time will be dedicated to modernisation. However, by further improving the relationships with the Union and regulator it is likely that even more time at all levels of the organisation would be spent on modernisation activities; meaning that the figures given above would be an underestimate.

Costs associated with transferring regulatory responsibility to Ofcom

76 http://www.nao.org.uk/publications/0506/the_creation_of_OFCOM_wider_l.aspx

5.2.86 Expanding Ofcom's remit to include the postal sector could result in economies of scale over time, but there will inevitably be some one-off costs associated with transferring responsibility in the short term. Such costs include training staff moving to Ofcom and amalgamating systems. The NAO report, The Creation of OFCOM: Wider lessons for public sector mergers of regulatory agencies76, considers the costs associated with setting up a new regulator by merging five entities; but it is difficult to draw meaningful one-off cost parallels with the planned regulatory transformation in the case of the postal sector. However, Ofcom and Postcomm are currently seeking to provide more accurate figures relating to this transfer.

Costs associated with new pension arrangements

5.2.87 The transfer of historic liabilities and assets from Royal Mail to Government results in a cost to Government, noted at Annex A to be £10.3bn. Because there is a corresponding benefit to Royal Mail, however, this does not result in any net economic gain or loss for the UK because the deficit is no larger or smaller than before the transfer. In addition, the Government will assume certain risks currently carried by the scheme (and ultimately Royal Mail), including longevity risk in respect of the transferred liabilities.

5.2.88 In addition, estimated costs with a present value of £278m (calculated over a ten-year period) will be incurred owing to the costs of implementation, administration, and the disposal of the scheme's assets that are transferred to Government. A full breakdown of the costs and risks is attached at Annex A.

The longer term benefits of diversification and expansion

5.2.89 The second phase of modernisation will similarly involve capital expenditure. As discussed above, there is currently a high degree of uncertainty about the form which diversification and expansion may take. This Impact Assessment focuses on the impacts associated with transformation.

Special administration regime to protect the universal service

5.2.90 In addition to the above measures, the Bill will also establish a new regime applying to designated universal service providers. The Secretary of State or Ofcom (with the SoS) could apply to the court for a postal administration order. This would pre-empt an ordinary administration or other insolvency procedures; in a postal administration, the objective of the administrator would be to ensure that the universal service continues to be provided thereby meeting the Government's obligation under the Directive to do so.

5.2.91 The Bill says the objective of a postal administration is:

(a) that a universal postal service is provided in accordance with the standards set out in the universal postal service order, and
(b) that it becomes unnecessary, by one or both of the following means, for the postal administration order to remain in force for that purpose.

5.2.92 Those means are:

(a) the rescue as a going concern of the company subject to the order, and
(b) relevant transfers (i.e. from the insolvent company to another company or companies).

5.2.93 The postal administrator would have to exercise and perform powers and duties in the way which would, so far as it is consistent with the objective of the postal administration to do so, best protect:

(a) the interests of the company's creditors as a whole, and
(b) subject to those interests, the interests of the company's members as a whole.

5.2.94 The creation of a special administration regime represents a significant change to the normal rights that creditors would otherwise enjoy under relevant insolvency legislation. In particular it restricts the rights of creditors to enforce security (where debt is secured on the assets of the company), for winding-up orders to be made, or for an administrator to be appointed by the holder of a qualifying floating charge. During the administration, the normal rights of creditors to challenge the actions of the administrator are constrained, and there is less of a role in the approval of the administrator's proposals. Finally, because of the super-priority for rescue funding advanced by the Secretary of State during the administration, returns to other creditors in any distribution could be adversely affected.

5.2.95 The other costs involved in the making of a postal administration order are at this stage unquantifiable. The principal cost is likely to be involved in the financial support to company in administration to enable continuity in the provision of the universal service. In addition there will be the costs associated with the postal administrator, and the involvement of the court. These costs are likely to be significant, although much would depend on the financial state of the company, and the duration of the administration. It is not possible to predict either of these variables.

5.2.96 However, the clear policy intention is that these are powers of last resort. The Government would only use these powers if a universal service provider was going into administration and there was no other way to maintain the universal service. The Government would not, of course, have to use them if other postal operators could and were willing to pick up the services that the failing company can no longer provide. Anyway the Government expects that the other elements of the Bill will ensure the health of the Universal Service's provision, therefore the probability of a special administration regime being required is very low.

6. Risks

6.1 The Hooper Review recommendations are interlinked and form a coherent package. If implemented together, they are capable of bringing about the structural changes needed to ensure a sustainable future for the Royal Mail. None of the three main elements will be sufficient on its own. Implementing only one or two of the recommendations will not enable Royal Mail to swiftly and effectively modernise and will leave the universal service under threat.

6.2 The regulatory risks centre on the regulator's primary duty to secure the provision of the universal postal service, balanced with its need to set price controls and regulate competition. If incorrectly administered, consumers could be charged higher prices than necessary or, conversely, Royal Mail may be placed under a greater financial strain than is desirable. This risk is intended to be mitigated by the appointment of Ofcom and the new regulatory framework. Ofcom has successfully managed regulation in the telecommunications sector during a period of significant market change, and has experience of concurrent competition law powers.

6.3 The Bill requires Ofcom to carry out a market analysis and provides powers to encourage greater cost transparency. It also provides Ofcom with a range of actions they can take if

it is found that the provision of the universal service represents an unfair burden on Royal Mail. Ofcom may require other postal companies or users to contribute towards the cost of the universal service if, after modernisation, it appears that the burden on Royal Mail is unfair. Or they may invite other postal operators to see if they can provide the universal service more cheaply. Or they can recommend that the requirements of the universal service be changed, subject to a further review of into the needs of users from a universal service and that any reduction in the minimum requirements cannot change the universal nature of the service – the Bill states that the service and the price must be the same across the UK (and subject subsequently to the Secretary of State laying an order and Parliament agreeing). The Bill also provides a route of appeal to the Competition Commission for price control decisions and judicial review to the Competition Appeals Tribunal in respect of other regulatory decisions.

6.4 The transfer of the pension deficit will be subject to scrutiny by the European Commission under the rules on state aid. The Government believes that it can put forward a robust case for taking on the pension liabilities as part of a package of measures which include private sector involvement and investment. It is crucial to the net beneficial nature of the Hooper package that the appropriate level of assets/liabilities is transferred to the Government. A sub-optimal transfer would potentially eclipse the estimated benefits of the package.

6.5 The private sector involvement has many risks. Firstly, there can be no guarantee that buyers willing to invest at an appropriate value will be found, whether because of concerns about regulatory certainty or because of the continuing challenging global market conditions. The Government will of course monitor market conditions before embarking on any transaction route and it will be imperative that shareholdings are sold for the correct price.

6.6 Whilst not directly affecting the estimated net benefits of the Hooper package in this IA, it is clearly desirable that additional private sector capital is invested, both in the modernisation phase (above that envisaged by Royal Mail) and the subsequent diversification and expansion phase. However, there is a risk that this would not occur.

6.7 If the year in which private sector capital becomes involved is later than 2012, the present value of the efficiency savings will decline. The table below shows the sensitivity of savings to this timing, and the impact of the overall net present value of the package of measures.

77 http://www.thameswater.co.uk/cps/rde/xbcr/corp/bonds-report-twul-poors-aug-2007.pdf

Table 3: A sensitivity analysis of efficiency savings

Scenario	Year of Sale	Number of years with private sector investment	Efficiency savings (PV, £m)	Overall NPV (£m)

Low-end - 60%
fixed costs
throughout

2012

5

726

696

2013

4

600

570

2014

3

494

464

Best estimate -
60% fixed costs
until point of sale,
40% thereafter

2012

5

3,098

3,068

2013

4

2,421

2,391

2014

3

1,833

1,803

High-end - 40%
fixed costs
throughout

2012

5

4,761

4,731

2013

4

4,337

4,307

2014

3

3,927

3,897

6.8 There is a risk that the buyers may not meet the expected target improvements in the business. The Government has employed UBS to help consider and identify the best transaction route to achieve the Government's objectives for Royal Mail. Uncertainty about the detail of regulation will be minimised through communications from Ofcom which will be able to demonstrate its achievements in regulating the UK's telecommunications sector.

6.9 The existence of a Special Administration Regime will be a factor in debt providers' risk assessment when considering whether to lend to a universal service provider and what conditions should apply. It may also be a relevant for others who may provide other forms credit (such as trade suppliers). For example, there is some evidence that this consideration has occurred in other sectors where there is already a special administration regime in place, such as the water industry in England and Wales.77 However, there is no evidence that this has had a negative impact on the ability of those companies to finance their activities. Decisions on the provision of future debt finance for universal service providers will be taken on a commercial basis that will reflect all the circumstances of the company. That assessment will factor in this additional risk, and there may be an adverse effect on the cost of any debt finance obtained. But we believe that the effect is likely to be marginal and the risk to the long-term availability of credit to any universal service provider is likely to be low.

6.10 Even if the Government's proposals are implemented fully, there is a risk that mail volume will decline at a faster rate than is currently forecast. But this risk would be greater if the "do nothing" option were followed. It is mitigated by the Hooper proposals which are designed to drive transformation at a faster pace.

7. Enforcement

7.1 The regulatory proposals seek to abolish the regulator Postcomm and make Ofcom responsible for the regulation of the postal sector in the future. Ofcom already has a duty to perform its functions in line with the five principles of better regulation which state that any regulation should be transparent, accountable, proportionate, consistent and targeted only at cases where action is needed.

78 “Reducing administrative burdens: effective inspection and enforcement”, March 2005 - http://www.berr.gov.uk/files/file22988.pdf

79 “Regulatory Justice: Making Sanctions Effective” – November 2006 - http://www.berr.gov.uk/files/file44593.pdf

7.2 BIS, working in conjunction with the Better Regulation Executive, already works towards using targeted measures to simplify and improve existing regulation. This includes communicating more clearly with businesses to help them understand what they must do to comply; carefully assessing the impact of any new regulations; and working with the EU to improve European guidelines. The transfer of regulation from Postcomm to Ofcom meets with the overarching aim of simplifying and improving existing regulation since it will lead to a reduction in the overall number of regulatory bodies and the new regime brings the prospect of deregulation over time.

7.3 The regulatory proposals are also in line with the Hampton Review78 which considered how to reduce unnecessary administration for businesses without compromising the UK's regulatory regime.

7.4 As well as having a duty to perform in line with the five principles of better regulation, Ofcom has its own regulatory principles. Ofcom will:

• regulate with a clearly articulated and publicly reviewed annual plan, with stated policy objectives;

• intervene where there is a specific statutory duty to work towards a public policy goal which markets alone cannot achieve;

• operate with a bias against intervention, but with a willingness to intervene firmly, promptly and effectively where required;

• strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;

• always seek the least intrusive regulatory mechanisms to achieve its policy objectives;

• research markets constantly and will aim to remain at the forefront of technological understanding;

• consult widely with all relevant stakeholders and assess the impact of regulatory action before imposing regulation upon a market.

7.5 The Macrory Review79 made a number of recommendations to ensure that regulators have access to a flexible set of sanctioning tools which are modern, fit for purpose, and consistent with a risk-based approach to enforcement outlined by the Hampton Review. The first Hooper Review acknowledged that, in regulating the postal sector, Ofcom would need to adopt a risk-based approach to protection of the universal service, particularly given the inherent uncertainty of the market. This would involve planning a regulatory response to a broad range of scenarios, from the rapid development of end-to-end competition, to a more limited increase in the number of companies providing upstream services. Ofcom will also need to plan for the market to decline at various rates, particularly as the combination of cyclical and structural change makes volumes more difficult to predict.

7.6 Extending Ofcom's existing concurrent competition law powers to include post will help with this risk-based approach by giving the regulator a more powerful set of tools with which to investigate anti-competitive behaviour, should the need arise. This should bring benefits to the sector as a whole, and should also reduce the need to micro-regulate Royal Mail.

8. Recommendation and summary table of benefits and costs

8.1 Based on the evidence given in section 5, the Government's preferred option is the package of measures recommended by the Hooper Reviews: the introduction of private sector capital and its disciplines; transferring the bulk of Royal Mail's historic pension liability to Government; and changes to the regulatory framework, including transferring responsibility for the postal services sector from Postcomm to Ofcom.

Table 4: Summary table of benefits and costs:

Benefits

Description of Benefit

Estimated value (PV over 10 year period)

Benefits of transformation

Sustaining the universal service

Not quantified

Increased efficiencies, based on the following accelerated ultimate savings in costs p.a. (assuming injection of private sector capital occurs in 2012):

- £860m (if fixed costs are 60% throughout)

- £3,875m (if fixed costs are 60% until the point of sale and 40% thereafter)

- £5,975m (if fixed costs are 40% throughout)

£726m

£3,098m

£4,761m

Pension deficit / admin benefits

£10.3 billion (one-off transfer, HMG to Royal Mail) / £249 million

Possibly improved industrial relations should Government be removed from the management/union relationship

Not quantified

Possible reduction in management time spent on seeking regulatory consents

Not quantified

More effective regulation (removing requirement for Royal Mail and other operators to get specific regulatory agreement before launching new products or services, possible economies of scale)

Market regulation - not quantified

Potential regulator cost savings - £6.7m

Proceeds from sale of public shareholdings

Not quantified – dependent upon market conditions at the time of sale

Benefits of diversification and expansion

Not quantified

Costs

Description of Cost

Estimated value (PV over 10 year period)

Transformation

Financial costs of transforming the network

No additional spend planned

Staff time

£8 million

Costs associated with merging regulators

Not quantified

Pension deficit / admin costs

£10.3 billion (one-off transfer, Royal Mail
to HMG) / £278 million

Foregone public shareholdings

Not quantified – dependent upon market
conditions at the time of sale

Diversification and expansion

Not quantified

8.2 The estimated effects of the Hooper Package (that constitute the main policy option under consideration) are net beneficial to Royal Mail in terms of its cost base. As such, when introducing this Bill, there is no requirement for BIS to identify a compensatory business cost reducing regulation to be removed for the purposes of the Government's One-In One-Out regulatory policy.

9. Implementation

9.1 The Postal Services Bill 2010 gives effect to the Government's chosen policy option.

9.2 The Bill will provide for the transfer of regulatory responsibility for the postal services sector to Ofcom. It will specify that Ofcom's primary duty in relation to the postal sector will be to maintain the universal service taking into account the financial sustainability of an efficient service, and bring into force new and wider-ranging regulatory powers.

9.3 The Bill will provide for the creation of a new pension scheme into which the historic liabilities and a proportion of the assets of the Royal Mail Pension Plan will be transferred. Government will work closely with the Royal Mail Pension Plan Trustee when making of Orders under this part of the Bill.

9.4 The Bill will remove restrictions on the ownership of Royal Mail which will enable access to private sector capital and disciplines.

9.5 In an already declining market and with revenues threatened further by the impact of the continued global economic slowdown, Royal Mail needs private sector involvement now more than ever. Taken as a whole, the package of measures will make a real difference to the company’s ability to create a sustainable future for its employees and deliver better services to customers.

9.6 The Government is confident that the recommendations are the right steps to take and legislation will enable them to be implemented.

10. Monitoring and evaluation

10.1 Ofcom will be required to regulate Royal Mail and the sector in a manner which it considers will secure the provision of a universal postal service in the UK and as regulator will monitor modernisation (via the regulatory cost base). Ofcom itself will be monitored by Parliament. It will provide an annual report to Parliament on its responsibilities in ensuring the provision of the universal service and can be called to appear before the BIS Select Committee.

10.2 BIS's Information Economy team will retain overall responsibility for the postal services sector and ensuring that the policy and legislative framework continues to deliver the Government's policy and legal obligations.

10.3 To the extent that Government retains a shareholding in Royal Mail, the Shareholder Executive in BIS will monitor Royal Mail’s performance and the pace of modernisation from a shareholder perspective.

10.4 A Post Implementation Review (PIR) will be undertaken five years after the Bill receives Royal Assent to ensure that the measures taken to improve the regulation of the postal services industry are achieving the desired objectives and to examine progress that has been made in the sale of shares in Royal Mail. This review will also satisfy the requirements for Post Legislative Scrutiny and the statutory review of Parts 3 and 4 of the Bill. A PIR plan can be found in Annex C.

Annexes

Annex A: Pensions

This Annex provides a summary of the options, costs and benefits in respect of the proposed measures on pensions set out in the main Impact Assessment.

Policy Objective

A1. As set out in the main Impact Assessment, The main policy objective is to sustain both the universal postal service and Royal Mail, the only company able to deliver the service for the foreseeable future. Tackling the pension deficit enables the company to reap the benefits of modernisation. The pension deficit is a barrier to external investment by the private sector and therefore the Government regards action to address the historic pension liabilities as essential to achieving modernisation of Royal Mail. Tackling the pension deficit on its own would not be sufficient to achieve modernisation and would not represent value for money for the taxpayer.

Background

A2. Royal Mail is the sponsoring employer of three UK occupational pensions schemes: the Royal Mail Pension Plan (RMPP); the Royal Mail Senior Executive Pension Plan; and the Royal Mail Retirement Savings Plan. These proposals concern only the RMPP. No changes are proposed in respect of the other two schemes.

A3. The Royal Mail Pension Plan (RMPP) is a private sector trust-based occupational pension scheme which provides pensions and other benefits to members. The Royal Mail Group Ltd is the principal employer participating in the plan. The RMPP is contracted-out of the State Second Pension and is a registered scheme for tax purposes under part IV of the Finance Act 2004.

A4. Royal Mail, with the agreement of the Trustee and after consultation with its employees, has changed the benefits the plan provides for service from April 2008. The RMPP was closed to new members from 31 March 2008 and employee members' pension changed from Final Salary to Career Salary Defined Benefit for service from 1 April 2008. In April 2010, the normal retirement age changed from 60 to 65, for service from that date.

A5. The total membership of the RMPP in June 2010 was 436,000. This comprised 137,000 employee members, 183,000 pensioner members, and 116,000 members with preserved rights – principally former employees of Royal Mail who have yet to reach retirement age. The active members comprise employees working in Royal Mail Group's main UK businesses: Royal Mail Letters, Post Office Limited, Parcelforce Worldwide, Romec and Quadrant.

A6. The last triennial actuarial valuation of RMPP was made as at 31 March 2009. Table One overleaf, sets out the assets and liabilities of the RMPP at this time.

80 The actuarial basis is the valuation basis used by the Trustees and RM when agreeing the funding requirements relating to the benefits earned by members. This is therefore considered the most appropriate valuation methodology (as compared to other methodologies such as an accounting basis).

81 As the proposed measures could constitute an aid to Royal Mail, they will require clearance from the European Commission. The Commission's decision will only be made after it receives a notification of the proposals, and has carried out a formal investigation. This process has not yet taken place.

Table One: Funding Position of the Scheme (Actuarial Basis80)

Actuarial funding basis

31 Mar
2009

£ bn

Market value of assets

20.2

Technical provisions for accrued liabilities

30.5

Surplus (deficit)

(10.3)

Funding level

66%

Source : Triennial Agreement: Royal Mail and the Pension Trustees (2010)

A7. As forecast during the 2009 Postal Services Bill, this deficit has significantly worsened since the previous triennial valuation. At March 2006 it stood at £3.4bn with assets valued at £21.9bn. This provides an illustration of both the worsening surplus within the RMPP and the volatility of the value of the assets and liabilities in the plan.

Benefits

A8. The principal economic benefit of the proposal is to enable private sector involvement in Royal Mail and thus an accelerated modernisation of the company. These benefits are described and quantified in the main body of the Impact Assessment.

Options – Costs and Risks

A9. In developing its proposed measures, the Government’s approach has been to find a solution that will enable the required benefits at the best value for money to taxpayers. In addition, the Government has considered the need for approval from the European Commission for any measures under state aid rules[81].

A10. The two key considerations are: -

(a) the proportion of the scheme's assets and historic liabilities remaining with the company-backed pension scheme;

(b) the practical mechanism chosen for any new, Government-backed arrangements

Proportion of liabilities and assets remaining with the company-backed scheme

A11. The transfer of historic liabilities and assets from Royal Mail to Government results in a benefit to Royal Mail (£10.3bn – point figure from 2009 triennial valuation), and a corresponding cost to Government (and the taxpayer). This does not result in any net economic gain or loss because the deficit is no larger or smaller than before the transfer. The net economic impact of this aspect of the proposal in itself is therefore nil.

A12. Nevertheless, in making the transfer to Government, it is important that the option adopted can be demonstrated to deliver value for money, both in terms of costs to the taxpayer, and risks. In accordance with this objective, the Government will not take on all the pension liabilities of Royal Mail but will significantly reduce the burden on the

company to a level appropriate for a company of its size. Government will also look to ensure that the scheme remaining with Royal Mail will be left with sufficient assets to meet the liabilities remaining with the RMPP. Government intends that the ongoing liability left with Royal Mail will be broadly similar to the level of liability outlined during the passage of the 2009 Postal Services Bill. The company-backed arrangements will meet any liability in respect of the final salary link where that exceeds the liabilities provided for in the Government-backed arrangements - thus isolating the new public sector scheme from any future salary actions undertaken by Royal Mail.

A13. Should the RMPP be wound-up shortly after the implementation of Government support to the plan then the assets left with the RMPP to fund the remaining salary link element would no longer be needed. However, for a number of reasons, the Government considers that this scenario is unlikely. These are that the level of surplus assets left in the plan after a wind-up decreases rapidly over time and also that the Trustees would need to agree to such a wind-up.

A14. The Government's proposed option will look to ensure that the minimum level of liabilities are assumed by the taxpayer compatible with ensuring that Royal Mail is left with a scheme that gives rise to an acceptable level of risk for the company, and does not represent a threat to its financial stability going forward. It is also the minimum that is compatible with achieving modernisation through private sector share ownership and involvement.

Choice of Mechanism

A15. The options set out below describe the different mechanisms through which the historic pensions liabilities could be addressed:

A One off payment from Government to the scheme to make good any deficit; but no further changes to the distribution of assets and liabilities in the scheme;

B Relevant liabilities and assets transferred to a separate scheme (or a separate section of the existing scheme), with Government issuing a guarantee in respect of those liabilities, and assuming the role of the sponsoring employer – including making payments to the scheme to make good any deficit;

C Relevant liabilities are transferred to Government and met through the establishment of a new, pay-as-you go public sector scheme. Assets transferred to Government are in due course sold over a period of time.

A16. Based on the March 2009 valuation of the scheme, option A would result in an estimated payment by Government of £10.3bn to the scheme. But even if it was fully funded on the actuarial funding basis, the scheme would still be of a size that would give rise to significant ongoing volatility disproportionate to the size of the company. We do not consider that this option is compatible with our objective of modernisation through private sector share ownership and involvement, and would therefore represent poor value for money. The following analysis therefore focuses on the remaining options (B and C) only.

82 Scheme funding: An analysis of recovery plans and clearance applications, The Pensions Regulator, December 2008, Table 3.3.2b page 39. http://www.thepensionsregulator.gov.uk/pdf/SchemeFundingAnalysis2008.pdf

Analysis of Risks

A17. Options B and C will involve a transfer of risk between the stakeholders, including to the Government. There are potential risks in the following areas:

o longevity;

o investment;

o inflation;

o implementation;

o moral hazard risk or incentive risk.

The following paragraphs compare options B and C in terms of these risks.

A18. Longevity: If the pension scheme members, or their surviving dependents, live longer than expected the costs of paying their pensions will increase. Government would bear the extra costs in respect of the liabilities transferred to new Government-backed arrangements under both options B and C. The value of the liabilities in Table One is calculated using the mortality assumption adopted by the RMPP Trustees at the last formal actuarial valuation. This assumption is in line with the mortality assumptions adopted by the vast majority of pension schemes for such valuations82.

A19. Investment: If a fund of assets is used on a long term basis to back the liabilities in the new Government-backed arrangements (as under option B) and the investment performance of these assets is worse than expected then the costs to the Government will increase. As noted earlier, investment returns can be very volatile.

A20. The very substantial size of the downside risk to Government demonstrates the significance of the investment risk assumed by Government under option B. Because the new Government-backed arrangements would guarantee to provide the benefits to members regardless of investment performance, Government (and the taxpayer) would bear the full investment risk. There would be no risk sharing between Government and members of the scheme. In the light of the very significant additional costs that could result from poor investment performance, the Government does not feel that taking on investment risk under option B would represent value for money for the taxpayer.

A21. Under option C Government is not exposed to investment risk once the implementation of the new arrangements has been completed. This is consistent with the position in other public sector pension schemes, where historically Government has taken the view that the best way to fund public service pension schemes is on a pay-as-you go basis rather than Government taking investment risk with taxpayer’s money. The public service pension schemes for the Civil Service, Teachers, the NHS, the Police, Fire Service and the Armed Forces all operate in this way and have done so for many decades.

A22. Inflation: The benefits payable from the new Government-backed arrangement increase in line with inflation, or in line with inflation up to a maximum limit. If inflation is higher than expected the costs of paying these benefits would increase and Government would bear the extra costs under both options B and C. The value of the liabilities in Table One above is calculated using the inflation assumption adopted by the RMPP Trustees at the last formal actuarial valuation.

A23. Implementation risk: The implementation of a new Government-backed arrangement carries risks: the liabilities and assets will need to be segregated, appropriate benefit payment systems will be required, the changes will need to be communicated to members, etc. It is important that this implementation is well-managed. Although the implementation risks could be significant they are not a key factor in differentiating between the options.

A24. Moral hazard risk or incentive risk: Moral hazard risk occurs where ‘perverse’ incentives exist so that one party is incentivised to act in way which other parties would consider to be inappropriate. Option B carries the risk of creating moral hazard. The Government would be exposed to investment risk on the scheme’s assets, but the investment policy would be set by the Trustee. The Trustee would also have some control over the expenditure from the Government-backed scheme but, because there was a Government guarantee, incentives on the Trustee to minimise risks and control costs would be weakened. Option C avoids the potential moral hazard because the scheme is controlled by the Secretary of State and would not be fettered by any changes to RMPP rules made by the Trustees. This provides an appropriate balance between the legitimate interests of the members of the new Government-backed arrangement and those of the taxpayer.

A25. This analysis demonstrates that in terms of risks, option C is significantly more attractive than option B. It provides a much lower risk option for Government and for taxpayers because there is no exposure to investment risk after implementation and no moral hazard / incentive risk.

Analysis of costs and benefits

A26. For completeness, we have also compared the estimated costs and benefits option B and C in Table Two below. This comparison is limited to the incremental costs and benefits of both options in terms of implementation and administration. It does not include a quantification of the risks described above. The potential scale of the risks – particularly in relation to investment risk, which could amount to several billion pounds - means that in practice they are likely to outweigh any difference in administrative costs.

83 Source: Deloitte estimate of overall administrative cost of changes to RMPP and (as applicable) establishment of new scheme, including legal / actuarial advice for all parties

84 Source: UBS estimate. Cost of disposal averages 1% of asset values based on current asset mix, excluding property using illustrative asset base for RMPP as at May 2010 (Source: RMPP Trustees)

85 Source: Deloitte estimate based on discussions with Royal Mail. 2009 scheme administration costs £7-£10m per annum. Increases in total scheme administration costs have been assumed due to additional complexity. It is intended that costs should be minimised through linking administrative arrangements closely to existing scheme arrangements

86 Source: Deloitte estimate. Annual saving of £20-25m against 2009 scheme investment costs of £30m due to fall in the size of the assets held by the scheme

87 Source: 2009/10 RMPP accounts (note 4, p25) http://www.royalmailpensionplan.co.uk/56/plan-report-and-accounts

88 Best estimates. Net benefit figures may not exactly match the difference between the figures for costs and benefits due to rounding

Table Two: Comparison of costs and benefits options B and C

Option

B- Funded Scheme (or section), with guarantee

C – Pay-as-you-go public sector scheme

Costs

£m

£m

One off implementation costs

- administration and professional advice

- disposal of assets

10 - 15

Nil

10 - 1583

24084

Increase in annual recurring costs

- scheme administration

2 - 4

2 - 485

Benefits

£m

£m

Decrease in annual recurring costs

- reduction in scheme investment costs

- saving on PPF levy

Nil

6.4

20 - 2586

6.487

A27. This comparison demonstrates that the up-front costs associated with option C (the pay-as-you-go mechanism) are higher than B, due to the cost of disposal of the assets transferred to Government. However, over time these are offset by the ongoing saving in annual investment costs due to the much lower level of assets held by the company-backed scheme. The effect of these savings is demonstrated by the summary of the net present value of costs and benefits for the two options, in Table Three below.

Table Three: Net Present Value of costs and benefits88 under options B and C

Option

B- Funded Scheme (or section), with guarantee

C – Pay-as-you go public sector scheme

Net Present Value – measured over 10 years

£m

£m

Total Costs

Total Benefits

Net Benefits

38

55

17

278

249

-30

Net Present Value – measured over 20 years

£m

£m

Total Costs

Total Benefits

Net Benefits

57

94

38

297

425

128

A28. Table Three demonstrates that in terms of the costs and benefits associated with implementation and administration of the new arrangements, the net benefits associated

with option C are significantly larger than those of option B when measured over a 20 year period. These findings support the Government’s choice of option C as its preferred approach, although the potential scale of the risks described above, particularly in relation to investment risk, are in practice a much more significant factor.

Conclusion

A29. The Government’s preferred option for pensions (in the context of a private sector share transaction) is:

- In terms of the distribution of assets and liabilities, for liabilities relating to accruals after a specified cut-off date to remain with the RMPP along with assets to meet the expected cost of those liabilities, with all other liabilities and assets transferred to new Government-backed arrangements; and

- In terms of the mechanism to be adopted for the Government-backed arrangements, the liabilities to be transferred to a new pay-as-you go public sector scheme, with the assets transferred to Government and sold off over a period of time.

A30. This is the preferred option because it will help ensure financial stability for Royal Mail in future, and maximise the economic benefits of the Government's wider proposals for private sector share ownership, whilst doing so at the lowest risk and overall cost to the taxpayer going forward.

89 Postcomm Annual Report 2010, p20.

90 The Hooper Review makes clear that the greatest threat to Royal Mail's ability to deliver the universal service comes less from competition in the traditional postal market, and more from the impact of digital media and communications which have left the UK letters market in structural decline. The Review does cite both the introduction of postal competition and substitution to cheaper products (from first to second class mail for example) as factors in the reduction of Royal Mail's revenues since 2005. But the revenues lost to competition from digital media were then five times the amount lost to competition from other postal operators.

Annex B: Specific Impact Tests

Competition Assessment

B1. Since 2001, the UK has been active in promoting effective competition within the postal sector where appropriate, whilst maintaining the provision of a universal service at an affordable and uniform tariff.

B2. In addition to Royal Mail, there are currently 50 licensed postal service companies in the UK89. These other providers now account for 21% of upstream volumes (Postcomm: October 2009) and it is estimated that upstream competitors now supply 40% of the bulk mail market. However, end-to-end delivery competition still remains slow to emerge in the UK with Royal Mail continuing to deliver 99% of all addressed mail.

B3. The package of measures explained in this Impact Assessment has the potential to make a significant impact on the conditions for, and nature of, competition within the postal services market.

B4. The proposal to change the regulator of postal services and to apply competition law as well as ex-ante regulation, where appropriate, has the potential to affect the competitive situation and incentives.

B5. The scope of the potential impact of the proposals for competition is currently unquantifiable, on the basis of existing market analysis. As the Hooper Review notes, there has not yet been a formal analysis of the salient markets within the postal sector (although Postcomm are undertaking some market studies to inform their forthcoming price controls). Without an existing understanding of these markets, BIS cannot seek to accurately estimate the impact of the proposals. When it undertakes a market analysis, Ofcom will be mindful of increasing scope for substitution between postal services and the wider communications sector and thus the rate of sector decline driven by e-substitution90.

B6. It seems likely in the first instance that Royal Mail will continue to possess significant market power / dominance in some aspects of postal services in the UK. Once Ofcom has undertaken a formal analysis of postal services activity in the UK, it will be in a position to understand the extent to which Royal Mail has market power in the salient markets.

B7. With this future understanding, the regulator can design appropriate ex ante regulations and pricing (retail and wholesale/access) controls / regimes to apply to these markets where the incumbent possesses non-transitory significant market power. Such regimes could allow/mandate cost recovery and protect the final consumer. They may also be designed to allow access to network elements by competitors as appropriate.

91 It is possible that too rapid an increase in competition in the short term would act to further threaten the universal service provided by Royal Mail. As such Ofcom will need to balance the requirements of universal service provision and advancing competition carefully. The Bill is clear that Ofcom's primary duty is securing the universal service and it must have regard to its financial sustainability in all regulatory decisions on post.

B8. The Hooper Review recommends that the existing downstream access regime should be retained but also suggests that, in the light of a market analysis, Ofcom may wish to review access pricing and any implications for competitor network development in the face of "make or buy" decisions. Indeed, Postcomm's current regulatory framework consultation is considering possible access pricing flexibility.

B9. Following a market analysis, certain markets may not require ex ante regulation and could instead rely on existing competition law. Under the Government's proposals, the regulator's powers of investigation would no longer be restricted by Royal Mail's licence.

B10. If Royal Mail's shares were to be purchased by one of its existing competitors, such a sale may have the effect of increasing Royal Mail's effective market share in some markets. If this were the case, EU/UK competition clearance may be needed and certain conditions, such as divestments, might be placed on the transaction.

B11. It is important to assess any likely competition impacts of the proposed package on the universal postal service. Both the Hooper Review and BIS consider that increased competition, where appropriate91, can help to support the universal service by providing Royal Mail with further incentives to modernise, innovate and to become increasingly efficient, in turn providing more resources to maintain the universal service. Indeed, the Review notes that "in its submission (to the Review), Royal Mail welcomed competition. It argued that – by accelerating modernisation – the company could finance the universal service from profits in spite of liberalisation and structural decline in the volume of letters."

Entry Barriers

B12. The proposed move from a licensing system towards general authorisations is likely to reduce the cost and marginally increase the speed of market access.

B13. The wholesale access price is the price paid to Royal Mail by its competitors who collect, sort and transport mail before injecting their mail into Royal Mail's network for delivery over the 'final mile'. Under the current price control, Postcomm requires that there must be a fixed 'headroom' between a set of access prices and their Royal Mail "reference" retail prices. If the headroom is too high, it could encourage inefficient entry for some products. If it is too low, it could discourage efficient entry for other products. Only if the headroom is directly related to the costs which Royal Mail incurs when collecting, sorting and transporting mail will it encourage efficient entry, bringing benefits for consumers. At present, it is disputed whether or not the fixed headroom is at the correct level and the Hooper Review recommends that this is an area that Ofcom should investigate as a priority, as Postcomm are indeed now starting. Of course the regulator will also need to ensure that regulated access does not undermine the universal postal service.

B14. Thus, further access price analysis and more transparent accounting systems (as Postcomm are also now consulting on) may either increase or reduce network entry prices. By providing increased data to the market and by allowing faster and more transparent decisions from the regulator regarding access pricing, future entry barriers may be reduced.

92 FSB News Release: Friday 16 July 2010.

Small Firms

B15. Securing the universal postal service is of disproportionate importance to small firms. The Hooper Review found that over 50% of small businesses send over three quarters of their bills and invoices through the post.

B16. The recent FSB-ICM ‘Voice of Small Business' panel survey found that 94% of respondents want a UK-wide postal service and 59% want to continue to receive mail deliveries six days a week92. Securing the future of the universal service will be of significant benefit to these companies.

B17. The 2010 Postal Services Bill seeks to ensure a sustainable future for the Universal Postal Service. It does not seek to alter the service – although there will be the flexibility (subject to agreement by Parliament) to amend it following a review by Ofcom of the needs of users. The provisions of the Bill do not apply to small firms (outside the postal sector) directly, nor do they introduce any new costs or administrative burdens on small firms. We do not consider that maintaining the universal service will have any detrimental impact on the current performance or operations of small firms.

B18. Changes to an authorisation regime will reduce the administrative hurdle for new postal service companies entering the market. In future, the new general access conditions will allow smaller firms to access, not just Royal Mail’s infrastructure, but that of other providers, allowing more opportunities and greater flexibility.

Sustainable Development

B19. The main objectives of the Bill are to secure the long-term future of Royal Mail and the universal service. Intervention is needed to enable Royal Mail to better modernise its business in the face of declining volumes of letters owing to structural change in the market and difficult economic conditions. We therefore consider that the Bill supports the principles of sustainable development.

Legal Aid

B20. There will be no impact on Legal Aid because the Bill does not create new offences or sanctions for individuals. The Bill will create new powers for the regulator of the postal services sector, but these will apply to postal services providers only.

Environment and Carbon

B21. We do not consider that the Bill will have a significant impact on the environment or on greenhouse gas emissions.

B22. One of the policy objectives of the Bill is to put in place the conditions to allow Royal Mail to modernise and thrive in the changing communications market. The first Hooper Review analysed the changing market and identified green solutions as one possible area of innovation in the postal sector, citing the example of a carbon neutral initiative developed by TNT Post. It is possible that a modernised and more efficient Royal Mail will be better placed to develop such innovative green projects.

93 For letters; parcels are delivered 5 days per week

Health

B23. We do not consider that the Bill will have any impact on health or well-being.

Equality Impact Assessment

B24. After initial screening as to the potential impact of this policy/regulation on race, religion and belief, disability, gender, age, gender reassignment, pregnancy and maternity, and sexual orientation equality, it has been decided that there will not be a major impact upon minority groups in terms of numbers affected or the seriousness of the likely impact, or both.

B25. The Bill seeks to preserve the universal postal service: that is, to maintain the current service which applies equally to all customers in the UK. The key features of the universal service are a uniform, affordable tariff and a six-day-a-week collection and delivery service93. This is important to social cohesion, ensuring that everyone has access to reliable means of communication and the capacity to send/receive goods (incl. internet shopping). The single, affordable price protects the ability of vulnerable and low-income consumers to send and receive goods without the need for means testing. The universal service is therefore disproportionately important to those with disabilities, the elderly, and those on low incomes. The Bill maintains the current statutory provision for the universal service and therefore we do not consider that there will be any adverse impact on equality, nor will there be any reduction in existing inequalities.

Rural Proofing

B26. The universal postal service is disproportionately important to rural communities. Without a universal service obligation, rural communities would be more likely to suffer a degraded postal service as the costs of collection and delivery are higher compared to those for urban communities.

B27. The Bill seeks to maintain the collection and delivery of letters on six days a week, rather than amend the specification of the universal service. As a result, we do not consider that the Bill will have any specific impact on rural communities.

Human Rights

B28. We have considered the Human Rights Act and believe that the Bill is compatible with the provisions of that Act.

Annex C: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review:

There is a political commitment to review the policy five years after it achieves Royal Assent. The Bill also includes a statutory requirement to review Parts 3 and 4 at this time.

Review objective:

The review is intended to ensure that the measures taken to improve the regulation of the postal services industry are achieving the desired objectives. The review will also examine progress that has been made in the sale of shares in Royal Mail. Although the review will examine all aspects of the policy, only those results relating to Parts 3 and 4 of the Bill will be applicable for the statutory review.

Review approach and rationale:

The final review will be relatively light touch as officials will be closely monitoring progress of the various elements of the policy on an on-going basis after they are introduced.

Baseline:

Baseline data can be found in the 2010 Annual Reports for both Royal Mail and Postcomm, and in the Hooper update, which was published in September 2010.

Success criteria:

As explained in this IA, the policy involves implementing the recommendations arising from the Hooper review. Therefore, measures of success include: an injection of private sector investment into Royal Mail and subsequent progress in modernisation; a transfer of the pension deficit to a pay-as-you-go public scheme; an improvement in Royal Mail's efficiency; and the publication of an in-depth analysis of the postal services market by Ofcom, focusing on the sustainability of the universal postal service.

Monitoring information arrangements:

Ofcom will publish bespoke market analysis documents which will include information on the conditions in the postal services market. Information relating to Ofcom's duty to ensure the sustainability of the universal postal service will be published in their annual reports. Within BIS, the Shareholder Executive will monitor the process of the sale of shares in Royal Mail, and the Information Economy team will monitor the performance of the regulatory aspects included within the Bill to assess whether or not they are achieving the desired objectives.

Reasons for not planning a PIR: N/A