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Committee

The Postal Services Bill

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Oral and written evidence

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The Business & Enterprise Committee

The Business & Enterprise Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Enterprise & Regulatory Reform.

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Mr Brian Binley MP (*Conservative, Northampton South*)
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Mr Mark Oaten MP (*Liberal Democrat, Winchester*)
Lembit Öpik MP (*Liberal Democrat, Montgomeryshire*)
Mr Anthony Wright MP (*Labour, Great Yarmouth*)

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Oral evidence

Taken before the Business and Enterprise Committee on Tuesday 20 January 2009

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Roger Berry
Mr Michael Clapham

Mr Lindsay Hoyle
Anne Moffat
Lembit Öpik

Witnesses: **Mr Richard Hooper CBE**, Chair of the Independent Review Panel and **Mr Jonathan Booth**, Head of Panel Secretariat, gave evidence.

Q1 Chairman: May I begin by saying that we welcome the fact that you have come before us? It is going to be an interesting session. We have the union coming in behind you in the light of what you said. May I, as I always do, begin by asking you to introduce yourselves for the record?

Mr Hooper: Thank you very much and good morning. My name is Richard Hooper; I am the chairman of the independent review of the postal services sector. On my right, your left, is Jon Booth, who is here this morning in his capacity as head of the secretariat for the review. May I just pop in two quick thanks? First of all to the many stakeholders, people interested in the postal services sector, who helped us with the report, including you, Chairman, and Mr Mike Weir, who is not here this morning.

Q2 Chairman: I am afraid Mike Weir is no longer with the Committee; he was discharged last night.

Mr Hooper: He and you were two of something over 200 people we talked to last year. Secondly, I should just like quickly to say thanks to my team, led by the excellent Jon Booth. Civil servants often get a bad name. Well this lot were hard working, intelligent and no matter if they had to work through the night, they did it and also they were fun to work with.

Q3 Chairman: We are expecting Digby Jones in front of us in a few weeks' time.

Mr Hooper: I noted Lord Jones's remarks last week and my comments are the opposite.

Chairman: I tend to that view myself as well.

Q4 Lembit Öpik: I am the new Mike Weir. To what extent do you feel clear costings can be differentiated for the various services? It all comes from the same network. Maybe it is difficult to do that.

Mr Hooper: This is a very difficult question. We talk a lot in the report about costing and one of our main recommendations, when we recommend that regulation should pass from Postcomm to Ofcom, is that Ofcom have to get a grip of what we call the cost transparency model. We do not have sufficient costing information, which means that discussing, as we probably will later on, access prices, the cost to the user is actually quite complicated. We do not have the real figures. That is something which is

needed and it is particularly needed as you change the regulatory regime in 2010, the beginning of the next price control regime.

Q5 Lembit Öpik: Is that why Postcomm has not actually differentiated it?

Mr Hooper: No, I just think it is very, very difficult to do. There has been, as I pointed out in the report, sometimes not the best relationship between the regulator and the regulated parties and there has been quite a lot of dispute about costs which really need to be got out of the way. One of the reasons they need to be got out of the way is that competitors, UK Mail, DHL, TNT, need to make sure that the regulator is making proper decisions on the basis of real costs in different parts of the network.

Q6 Lembit Öpik: The thing which concerns me most is the access headroom question and you have referred to that as well. Royal Mail actually say—and I quote them—“Royal Mail cannot compete on price no matter how efficient our upstream operations are”. That can relate to other things too. To what extent do you think that the access headroom condition is distorting the market and do you think it is fair or unfair?

Mr Hooper: We talk about it quite a bit. It is actually quite a complicated technical area and it relates to the fact that if you have a monopoly in a particular market and you control both wholesale products and retail products and you are selling wholesale products to competitors who are then competing with you in the retail market it is possible for you to reduce your retail prices or up your wholesale prices and thus squeeze the profit margin of your competitors. That is the issue. We felt that the current regime was not necessarily the best way of handling the margin squeeze and that it was not necessarily a good way of making upstream more efficient. We have suggested in the regulatory part of the recommendations that Ofcom should take a very long hard look. Ofcom have done this—and I was on the board at the time—with BT, because the same issue of margin squeeze happened with BT wholesale and retail. They have a lot of experience of margin squeeze and I believe that they will probably come

up with a better way round it. One of those better ways round it is your very point about cost transparency.

Q7 Lembit Öpik: It does seem to me that in any other market something like access headroom would be regarded as blatantly unfair on the core provider, in this case Royal Mail. Is there a case for abandoning it?

Mr Hooper: There is not a case for abandoning it; there is a case for making sure that it is regulated correctly. I suspect that Ofcom will find ways of doing it through costing different parts of the network and making sure that those costs are transparent.

Q8 Lembit Öpik: Royal Mail do take a different and very clear view about this. How can you do what you have just described without transparency or would you say one can only achieve parity here or fairness if there is transparency for the service costs.

Mr Hooper: We say very clearly in the report that without cost transparency you cannot solve this problem. It is exactly the same with the whole question of the access price which I know is of great concern to union members and to other people about the way that the Royal Mail is regulated. There is an argument and union members have put this to us and we have had many meetings with Billy Hayes, Dave Ward and his colleagues who are on after me. They would argue that the access price effectively subsidises upstream competitors in the market. The honest truth is that we do not have the cost models to show that; it may be true and it may not be true. We have a section in the report about that. Clearly cost transparency will help us answer that question because clearly it is undesirable for the Royal Mail, which delivers 99% of all letters—99% of all letters are delivered by Royal Mail—to be in some senses subsidising competitors who are fighting them in the upstream market.

Q9 Lembit Öpik: To summarise then, you are actually saying that without cost transparency the access headroom price is guesswork and it may well be mitigating against fairness in regard to Royal Mail's competitive advantage.

Mr Hooper: That is a fair position.

Q10 Mr Hoyle: To follow up on those questions, it is quite interesting that you mention monopoly advantage. If there is a monopoly advantage, there is a monopoly disadvantage, because the USO only exists for Royal Mail; it does not exist for its competitors. If you want to break a monopoly, why do you not insist that every competitor with Royal Mail should have a USO obligation? That would be fairness. However, we all know you will not do that because they will not want to compete. What they want to do is to be allowed to cherry pick. We touched on the question that the access on bulk mail is being subsidised by the taxpayer. Not only is it Billy Hayes who does not agree with it, it is also Members of Parliament who do not agree with subsidising private companies. It is absolutely

absurd that here we are, we have a company with a great reputation, a company which is well loved in this country, which knows that Granny Smith in Chorley will get her mail delivered next day, and all that is being put at risk by allowing competitors to have an unfair advantage. What are we going to do to allow the renegotiation of the access agreement? I am interested that you did not come out and say you believe it should be 25p. Why is it I have to pay full price yet competitors do not have to pay full price to have their letters delivered? I do not know whether you will agree with me but what we have really done is to say to the market ahead of everybody else—and it is not your fault and I hope you may agree with me—“Come on in, have a share of the British market and what we'll do is subsidise it through the taxpayer”. Then, because Royal Mail has been losing money because of this, we say “Oh, my word, what a mistake we've made, why don't you have part of the ownership of the company”. Do you agree that this has been unfortunately set up and there is an unfair disadvantage to Royal Mail and all the advantages are to the competitors?

Mr Hooper: You are making two separate points: one is about access price and one about cherry picking and I will take them in that order. In answer to Mr Öpik I have already said that it is difficult to know whether the access price, which is 13p, subsidises or does not subsidise and I will not repeat that. In the report we do not tell Ofcom how to do their new job; that would be totally inappropriate and they are an extremely professional regulator.

Q11 Mr Hoyle: But you do have a bit of interest though.

Mr Hooper: At the moment the way the access price was met was a negotiation between Royal Mail and its competitors. I personally would think we would move to a situation where the regulator would set the access price, knowing the costs of delivery downstream properly, which are in the region of 40% of Royal Mail's costs—somewhere between 40% and 60%, depending on what you do with logistics costs. We are suggesting in the report that Ofcom is likely to set that access price very conscious of the points you have been making. However, there is a sting in the tail and that is that it is very important for the regulator to make sure that the delivery arm of the Royal Mail is modernised and is efficient and is best in class in terms of other postal operators. So in setting the access price, like other utility regulators, water and electricity, the regulator will almost certainly have a squeeze on in order to ensure efficiency comes in to the delivery service, otherwise you would be subsidising inefficiencies. Your second point about cherry picking. We agree with you. We state it in the report. Cherry picking leads to what we call a vicious spiral where basically you allow competitors to pick away at the juicy profitable bits of the Royal Mail without taking responsibility for the less profitable parts. We talk about that quite specifically. At the moment Postcomm has rules to stop cherry picking.

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Q12 Mr Hoyle: What level can Royal Mail come down to when it is competing for business? Is there not a cap on how far it can drop?

Mr Hooper: At the moment its prices are regulated by Postcomm.

Q13 Mr Hoyle: What sort of level can it come down to?

Mr Hooper: They are complicated RPI-X sums.

Q14 Mr Hoyle: What level can they not go below? There is a level below which they cannot drop, is there not?

Mr Hooper: Yes, there must be.

Q15 Mr Hoyle: What is it? You cannot do a report without knowing what the consequence is.

Mr Hooper: Are you talking about the current regime?

Q16 Mr Hoyle: Absolutely. We know that they have to deliver bulk mail for 13p, they are competing for the same work, what is the lowest level they can drop to? You have done the report, very interesting; you have come up with a lot of statistics. What is the answer to the cost level that they can go down to?

Mr Hooper: I am not able to answer that question.

Q17 Mr Hoyle: Oh, dear. This is a worry. It is your report.

Mr Hooper: I will come back to you afterwards with an answer to it.

Q18 Mr Hoyle: For clarification, you have done a very good report, very interesting.

Mr Hooper: Thank you.

Q19 Mr Hoyle: Some things we will agree on, some things we will disagree on. If you cannot tell us at what level the competition is for Royal Mail, how can you produce a report?

Mr Hooper: Sorry, "at what level is the competition"?

Q20 Mr Hoyle: Royal Mail cannot go below a certain level.

Mr Hooper: Because of the margin squeeze rules.

Q21 Mr Hoyle: Absolutely. So there is no competition between Royal Mail and the private companies.

Mr Hooper: There is no competition between Royal Mail and private companies in delivery anyway because Royal Mail delivers 99% of all mail.

Q22 Mr Hoyle: We might agree that the bulk of business where the profit is is the part that the private companies are competing for, yet there is a disadvantage that Royal Mail cannot drop to a certain level, even though you cannot tell me what that level is. How can we see fair competition between Royal Mail and the private companies bidding for bulk mail?

Mr Hooper: The answer very much comes back to the point about cost transparency. We do not have very good cost figures in that part of the market.

Q23 Chairman: May I ask about the universal service obligation? Are there any circumstances in which you think the taxpayer would be right to subsidise the universal service obligation?

Mr Hooper: What we say in the report is that right now the main issue with Royal Mail is that it is relatively inefficient compared with best-in-class postal operators, for example on the continent of Europe. Let me give an example of that inefficiency. In delivery offices across the land, in Worcestershire, in Chorley, in Bromsgrove this morning, between the hours of six o'clock and nine o'clock, postmen and women sat in front of a wooden frame with a pile of mail and hand sorted it into the sequence in which they are actually going to deliver that mail for something like two to three hours. If you look at best practice on the continent of Europe, 85% of that mail is walk-sequenced by a machine, thus obviously reducing and saving costs. What we are saying in the report is that the issue facing us is the relative inefficiency, lack of modernisation of the Royal Mail. Steps have been made towards modernisation.

Q24 Chairman: You also talk about the absolute decline in mail volumes caused by competition from digital technology, for example.

Mr Hooper: Absolutely.

Q25 Chairman: So there may come a time when the USO cannot be sustained in commercial terms.

Mr Hooper: We are saying that is not now. We are not arguing now for a compensation fund, we are not now arguing for a deterioration in the universal service obligation. For example, if you cut away one day of delivery from six days to five days it would save around about £270 million. We are not arguing for that, we are saying that is not necessary. Up the track it is possible that there could be a government subsidy for universal service obligation, there could be a compensation fund and so on. We do talk about that in the report. Right now that is not the issue. The issue now is *Modernise or Decline*, the title of the report.

Q26 Chairman: May I ask about this problem of cost transparency? I am very struck that in 2001 Postcomm assessed the cost of the USO was £81 million. Royal Mail estimated it more recently at £3.4 billion. This is the point where you say there is no agreement at all on basic cost information. Is this a failure of regulation or failure of Royal Mail?

Mr Hooper: One of the things we have not done in the report is to get into the blame game. There were clearly temptations to say who is responsible for what and who is to blame for what. The report is very much focused on what we should do today to improve tomorrow.

Q27 Chairman: You have said that one of the things you must do to improve tomorrow is to merge the regulator into Ofcom.

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Mr Hooper: Yes, and in order to get cost transparency.

Q28 Chairman: So that means you feel the regulator has failed in his current role for some reason.

Mr Hooper: The regulator has not achieved certain things in this current regulatory regime; that is correct. However, it is more complicated than that. The reason for making the recommendation about Ofcom is the point you have just made. The big thing that is happening to the Royal Mail is actually structural change in the market. That is to say the internet and mobile texting is significantly eroding letters' volumes. When we wrote our interim report in May we suggested that was 3% a year. When Royal Mail recently announced its first six months it talked about a decline in the letters business of 4%. We are now looking in the main report at 5% to 7%; that is a combination of structural change and cyclical change together.

Q29 Chairman: I have debated with you in private the merits of the two alternative forms of regulation which we discussed. One is moving into the communications regulator, Ofcom, regarding it as competing with the communications sector. The other one is a broader-based utility regulator, regarding Royal Mail as a utility. Why have you chosen, and why have the Government chosen to follow your advice in this respect, the communications option rather than the utilities option?

Mr Hooper: First of all because Ofcom already has responsibilities for regulating the very technologies which are significantly eroding letters volume. Incidentally there is a positive story to that which I want to come back to on e-fulfilment? That is one reason. Secondly, Ofcom has experience of what is called concurrent competition law powers. Postcomm, being a small regulator, does not have competition powers and this is a very useful addition to the regulatory armoury. The third reason is one which Dr Bowe actually gave you this time a week ago in Committee Room 16 when she was asked the question. She made the point that Ofcom of course has a lot of experience of universal service obligations in telecoms and therefore is knowledgeable about universal service obligations and the universal postal service is a form of universal service obligation. Those were the reasons for that recommendation.

Q30 Chairman: It will be tested when the legislation comes before the House. Can we turn to the pension deficit which is a very big question for Royal Mail group? Why do you think a gradual transfer of liabilities would provide an incentive on all parties to modernise?

Mr Hooper: In the report we make three big packages of recommendations. The first one, which has obviously attracted the most controversy, is the strategic partnership recommendation. The second one is the pension deficit and the third one is the regulatory regime change. We say in the report and we say to Government in that report, that those

three packages of recommendations are connected together; there is connective tissue between them. Therefore we would ask the Government not to pick and mix; this is not *à la carte*, this is a three-course meal and we would like them to eat it as a three-course meal. What we are saying about pension deficit is that clearly that should happen in a staged approach—the words we use in the report—as modernisation is delivered by the management and the unions at Royal Mail.

Q31 Chairman: So it is a carrot or a stick to beat Royal Mail with to make sure the modernisation happens.

Mr Hooper: It would be sensible for the pension deficit to be seen as something very important to happen. At the moment, something like £270 million of cash flows out of the Royal Mail to pay off the pension deficit over 17 years. This is at a time when the valuation in 2006 was £3.4 billion.

Q32 Chairman: We were told by Lord Mandelson last week that it might now be as big as £9 billion.

Mr Hooper: The trustees are doing their actuarial valuation this year, so it is anybody's guess but it could be £7 billion, £8 billion, £9 billion which would mean probably doubling the £270 million. That is the background to it. That is a very important part of this issue, the modernisation of Royal Mail. We believe that those things should be done in concert and indeed you would not get a strategic partner, recommendation number one, if you did not do something about the pension deficit in number two.

Q33 Chairman: May I just ask whether you are content the recommendations the Government have embraced from your report and the reform of the pension scheme would be sufficient to deal with the problem?

Mr Hooper: I believe that the acceptance of those three recommendations, plus the one about accountability to yourselves in relation to the universal postal service, which is the final small recommendation at the end, will be sufficient to get the modernisation of Royal Mail accelerated, which is our aim.

Q34 Chairman: And to make the pension scheme affordable for the company.

Mr Hooper: There is a second question. There are two issues about pensions. There is the deficit, which is the £3.4 billion or the £7 billion. There is also the continuing commitment to current members. That costs about £500 million of cash flowing out of Royal Mail. Last year modifications were made to the pension scheme so that the final salary scheme is closed to new members and various changes for existing members. Those have been instituted and we believe and say in the report that those are sensible changes to current pension arrangements and will be very similar to other companies in the United Kingdom suffering the final salary liability issue.

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Chairman: I am content with those answers for our purposes. Let us get on to the central question for many colleagues on the Committee which is the minority shareholder issue.

Q35 Roger Berry: You have referred to the issue of the need to modernise and improve efficiency in the service. Why are we not simply talking about changing the management then, rather than talking about some minority shareholder?

Mr Hooper: It is more complicated than just changing the management. We talk in the report about the three things which we believe are the requirements for modernisation to happen. The first one we talk about is commercial confidence. That has two arms to it. It is a requirement for the management to be able to make commercial decisions about the future of the company without what we call in the report the spectre of political intervention; that is the ability of the management to make commercial decisions in a confident way. That is linked to something we talk about a lot in the report which is the lack of engagement between the unions and the management about the future of the company. It is a fact of life that neither the management nor the unions have found ways of sitting down together and looking at what the long-term Royal Mail looks like in terms of its network and so on. That has not happened. Both parties have talked to us and the panel and both have been unable to get that level of engagement. Those two together will give you commercial confidence.

Q36 Roger Berry: It is obviously very important that management and the workforce work together. I do not quite see where the minority shareholder comes in on this. Does this not require leadership of the organisation which is fundamentally different from what we have now? I do not quite see—in fact I do not see at all—why that necessarily requires a private sector stake in the company. It is a leadership failure, is it not?

Mr Hooper: No. I was on the three Cs. The third C we talk about is access to corporate experience. It is useful in this environment to have access to a company or companies which have transformed a large network business. This is not about just replacing individual members of the management. This is about feeding in at senior, middle and junior management level, expertise, people who have actually done this level of transformation. That is behind our thinking on the strategic partnership.

Q37 Roger Berry: Why not buy in the expertise? If, despite the rather large salaries that some of the management are being paid, if they do not have this commercial expertise then I have to say it is a little late in the day for some of us to be told this but if they do not have that expertise themselves why do they not just buy it in? In both the private and public sector it is common practice.

Mr Hooper: I think you are suggesting this is only a management problem. That is not our analysis. This is a management problem; this is also a union problem. There are issues within the union structure which makes modernisation difficult.

Q38 Roger Berry: You are saying that there is a certain skills deficit in the organisation, not unrelated to the leadership presumably. If the present management cannot provide that kind of leadership which is necessary, why on earth are we not talking about buying in that expertise? Private companies, public sector organisations, often employ consultants and others who do have this expertise. You could say it is a management failure at present that we are talking in these terms, but why not buy that in. I do not see what on earth that has to do with a private sector shareholder. We are talking about a skills deficit here, are we not?

Mr Hooper: Let me give you an example in Belgium. In Belgium you have a minority private sector shareholder. What they have achieved with that shareholding is an agreement about the future strategic plan for the modernisation of the Belgian *Poste* and an agreement not to get in the way of that modernisation through political intervention. So there is what we call in the report political separation. That is part of that story of having a strategic partner. It is not just about management expertise: it is about political separation, it is about engagement with the unions, it is about capital requirements—which we will no doubt come on to—and also about experience.

Q39 Roger Berry: Could I put it to you that I do accept that there are circumstances where some may argue, because it is government policy that Royal Mail is a publicly-owned enterprise, that may impose certain political constraints on the company that would not be imposed if it were an entirely private company? I do understand that argument. However, if we talk about a minority shareholding, are you now saying that the minority shareholding would in effect bypass that element of public ownership? Is this what you had in mind?

Mr Hooper: In the report we do not actually say “minority shareholding”. As you probably know from the report, we just say “strategic partnership”. It is for the Government to decide how to implement those recommendations. Indeed Lord Mandelson has of course said that it will be a minority shareholding and that the Royal Mail will stay with a majority public ownership. We do not actually talk about that in the report; we talk about a strategic partnership as a fundamental mechanism for sorting out the commercial confidence that is required, the capital requirements and the corporate experience.

Q40 Roger Berry: Could we come to the capital issue? In your report your case for a strategic partner does rest also on the argument, in your terms, that capital can be raised more easily, faster and for a wide range of purposes. That sort of begs two questions, does it not? The first is, even neglecting present circumstances, why on earth cannot the

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financial regime for a publicly-owned Royal Mail not allow a speedier access to finance. It could be an important recommendation in your report that this should actually facilitate it. In the present circumstances, what I observe in the real world at the moment is that the private sector is just not very good at responding easily and quickly and in a wide-ranging way to the request for finance. It is actually the public sector which is having to do it. Are you confident that in present circumstances that recommendation is valid?

Mr Hooper: I am absolutely confident that, if the right strategic partner is found, there will be a greater availability of capital and a more flexible one. Let me give you an example of flexibility. The last *tranche* of taxpayers' money was £1.2 billion, which was debt to the company. That took something in the region of two years to agree and 18 months later it is still being investigated by the European Commission under the state aid rules. We on the panel and my team would say that is a quite inflexible form of funding. It is slow and it is something which is not part of a modernising company. Bear in mind that when we talk about modernisation it is not just a one-off event, you do not just do it tomorrow and then go back to some other *status quo*. It is about a constant state of investment, reinvestment and so on. Therefore the flexibility of the capital is extremely important and we think that this will be a better way of doing it.

Q41 Roger Berry: I was talking to the chairman of a major utility company in the private sector the other day who was saying to me that they wanted to invest in the infrastructure of their enterprise but the problem was that they could not actually borrow at anything approaching sensible terms from the banks and financial institutions and without government support their investment programme simply would not be able to go ahead. In the present climate, given the urgent need to modernise Royal Mail and the urgent need to invest at last on a substantial scale in Royal Mail, in present circumstances is it not a little optimistic to expect the private sector to rush forth with the extra resources needed and for perhaps the next year or two.

Mr Hooper: The proof of the pudding will be in the eating in this particular case. We have set out recommendations on strategic partnership. The Government have accepted those recommendations and indeed when Lord Mandelson and Pat McFadden spoke in the House of Lords and House of Commons they referred to a letter from TNT expressing an interest in being that strategic partner. You may very well be right but there clearly is an opportunity for a strategic partner. As we say in the report, the postal industry in Europe is consolidating and this could be part of that consolidation. It is a big industry and it is a big industry which has a significant future and one I mentioned earlier on in response to the Chairman's question. Whilst the internet and mobile phones are significantly reducing the volume of letters for what I call digitisable product, it is increasing the market for non-digitisable products, in other words

e.Fulfilment, e.Commerce, online shopping. In 2007 e.Commerce off the back of the internet was worth £40 billion and that is 860 million parcels. We do believe that there is a positive future for Royal Mail; we do believe there is a positive future for postal companies. It is not all doom and gloom. This is not a post mortem but it does require the management and the unions to grab those new opportunities. It is a supreme irony of this report that this was a command paper published by what used to be called Her Majesty's Stationery Office, now The Stationery Office, now owned, as part of its diversification strategy, by Deutsche Bundespost. It is a supreme irony and one I draw to your attention.

Q42 Chairman: I think I had forgotten that. May I just tease out this question of strategic partnership because I want to know what it means and I do not quite understand? In parenthesis, I am amused by the fact that the strategic partnership with the banks the Government now enjoy, the 70% ownership of RBS, means RBS is a private company, whereas a 70% ownership of Royal Mail makes it a public company, but that is probably not for you to comment on. I have been at DTI in the past as specialist adviser and when I was there I was aware of the fact that on behalf of the then Conservative Government the Treasury took money out of the Post Office, Royal Mail, which should not have been taken out. It was needed for investment; it was a missed opportunity in the 1980s to invest. So I have some sympathy for your view that a strategic partnership, with an agreement with Government about what could be done with investment money might actually bring stability and the opportunity for modernisation to the organisation. I have sympathy with that. However, I do not understand what a strategic partner is, if it is not an owner. You said that you did not say "ownership" and I accept that. What other form of strategic partnership would be acceptable to you and should the Government have considered before they settled on ownership as their strategic partnership model?

Mr Hooper: I honestly do not think that we in the report spelled out in detail whether that was a minority shareholding or a majority shareholding. It would have been quite unreasonable for an independent review to say that because it would tie the hands of Government when they were negotiating with a strategic partner.

Q43 Chairman: I do not want to be pedantic but "partnership" must take the form of an ownership stake of some level.

Mr Hooper: Yes.

Q44 Chairman: The level, whether it is 10% or 90% or 1% or 100% is a matter for the Government but it must involve ownership.

Mr Hooper: That is correct; that is absolutely correct.

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Q45 Roger Berry: Why?

Mr Hooper: Again, just coming back to the example I gave you in Belgium, which we do talk about in the report, the appearance of a private sector investor in the Belgian post office has allowed some degree of political separation so that, for example, there is a strategic plan which is agreed and then people are going for it. There is commercial confidence to implement that strategic plan without intervention or the spectre of intervention. That is happening with a minority shareholder.

Q46 Roger Berry: Is your view that there is no example of countries which have modernised in the way we all think is necessary within a 100% publicly-owned enterprise?

Mr Hooper: We looked at modernisation under public ownership and I believe it is right to say that when Allan Leighton became Chairman of Royal Mail modernisation under public ownership was something he felt very strongly about. Our analysis showed that the issues in public ownership such as political separation, political intervention, are so powerful that in fact it holds back the Royal Mail from modernisation and we believe that strategic partnership will help that in the ways we have described.

Q47 Chairman: The one concern I still have here is that we talk about the need for modernisation with no idea of how much it is going to cost. Lindsay Hoyle asked a very good question of the Government on this. Pat McFadden, the minister, replied that it was an operational matter for Royal Mail and he had asked Adam Crozier, the chief executive of Royal Mail, to reply directly to his honourable friend. I think it is not just an operational matter for Royal Mail. We are being asked to take quite important decisions about the future of a major strategic national company and I suspect no-one knows how much it is going to cost. Why would it not just be enough to release Royal Mail Group from its current pension fund obligations, paying off the deficit, and use the £600 million, which Lindsay Hoyle badgered the Secretary of State about last week at some length, which is lying around unspent in Royal Mail Group's coffers for modernisation? How much money is the first stage and the ongoing cost going to be? Without that information I do not see how we can take intelligent decisions.

Mr Hooper: I suspect I am going to be as frustrating for you as Mr McFadden was when he spoke. It is unwise of the chairman of an independent review and his team to try to run the Royal Mail.

Q48 Chairman: But do Royal Mail Group themselves know?

Mr Hooper: There is a strategic plan which exists and which we were able to look at in confidence. It is a confidential document and therefore there is a document which looks at the future and there will be further analysis of that. I can assure you that the capital requirement is there and is likely to grow.

Q49 Chairman: What is the order of magnitude of that capital requirement?

Mr Hooper: The Secretary of State here last week talked about hundreds of millions of pounds.

Q50 Chairman: He did.

Mr Hooper: I am really not going to be drawn on it. We have not done that analysis.

Q51 Chairman: We in the room are the shareholders of this company. I do not understand why we hide behind commercial confidence. We own the damn thing. It is ours. Should we not be told?

Mr Hooper: If you want the answer to that question and there is an answer to that question, I do not think it should come from the chairman of the independent review.

Q52 Chairman: I accept that.

Mr Hooper: It is a question you should ask directly of Government. All I can tell you is that in our experience of modernisation and our observation of modernisation it is more than you think. For example, as part of our consultations we went to sorting centres and delivery offices. I went to a delivery office in North London where the manager said that the delivery office was in a residential street, in the wrong building, in the wrong place, but capital constraints were such that they had never been able to get rid of it. So what happens? Lorries are in the residential street at six o'clock in the morning annoying people living in that street and also actually filling the street with lorries parked in the middle of the road. That was a small example of a capital requirement which clearly is not getting priority. There are lots of those examples within the Royal Mail. I mentioned walk sequencing earlier on.

Mr Booth: We talk about modernisation in two phases. The first phase is making Royal Mail efficient and the company clearly has a plan for that. It has been happening but it needs to accelerate in the current economic climate. The second phase of modernisation is diversification and the report says that in a declining market, a market which may be declining by 5% to 7% per year, it will be important, if Royal Mail is to have a stable and profitable future, to move into other services. Clearly that process too will require new investment.

Q53 Mr Hoyle: We are touching but we are going round a bit, are we not? Just so we have the facts right. You believe that there should be a sell-off of the government stake to a competitor.

Mr Hooper: To a strategic partner.

Q54 Mr Hoyle: Who else is there if they are not a competitor?

Mr Hooper: What we say in the report is to a private sector investor or investors who have had experience of the transformation of a network business. That is what the report says.

Q55 Mr Hoyle: So 3Is come along and say there is a bit of profit in that so they will put some money in it. Is that what you are looking for?

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Mr Hooper: I am not sure that 3Is would have the experience of transformation of a major network business, which is the criterion.

Q56 Mr Hoyle: They smell profit and they invest into something which will give them a profit and a return. So the only people we are really looking for are competitors because it has to be somebody who knows the business.

Mr Hooper: The person who has acknowledged their interest is TNT.

Q57 Mr Hoyle: Who is a competitor.

Mr Hooper: Who is a competitor in the UK and also the major dominant player in the Netherlands and a modernised postal operator. That is correct.

Q58 Mr Hoyle: You cannot give us a figure for how much ownership they should have because you say it is a partnership. We have to put a figure on the partnership. Would you envisage it below 50% or above 50%?

Mr Hooper: Let me repeat what I said. I thought it was inappropriate for the review to tell the Government that should be a minority or a majority shareholding. What we wanted to establish was a strategic partnership. That then allows the Government either to accept that recommendation or reject it. They have accepted that recommendation and the Secretary of State has talked about it clearly being a minority shareholding with the company staying in majority public ownership. That is the Secretary of State speaking.

Q59 Mr Hoyle: Right. So that is not the Government's view yet because the Government are still discussing it, are they not?

Mr Hooper: Yes.

Q60 Mr Hoyle: Can we clarify? It is not the Government's view but the Secretary of State's view.

Mr Hooper: It is the recommended view of the Secretary of State with the support, presumably, of the Cabinet.

Q61 Mr Hoyle: So we have got this right, you will not give us a feel for how much.

Mr Hooper: How much shareholding?

Q62 Mr Hoyle: Yes.

Mr Hooper: No, I absolutely will not; I refuse to do it.

Q63 Mr Hoyle: You refuse? So you do have a figure.

Mr Hooper: It would be silly for me to constrain Government's negotiation with a strategic partner and they have actually answered the question for you anyway.

Q64 Mr Hoyle: They did not really because I posed that it was 30%. He wobbled around it and would not give a straight answer.

Mr Hooper: I am not in the business of giving you that.

Mr Hoyle: So you are coming before this Committee and refusing to tell us. So we can put that on the record that you are refusing.

Chairman: A slightly uncharitable interpretation.

Q65 Mr Hoyle: Mr Hooper said "I refuse" so I accept that he has refused, unless he wants to reconsider.

Mr Hooper: It is not appropriate for me to constrain the negotiation and decisions of the Government on this matter.

Q66 Mr Hoyle: How much money do you believe? You have quoted once again the Secretary of State's suggestion to my question previously that an investment of hundreds of millions is required. Is that about right?

Mr Hooper: We have not put a figure for the capital requirement in the report. We have made it clear that it needs capital and yet again I would just like to emphasise that I do not think it is the business of the chairman of the review, with his team, to try to run the modernisation of the Royal Mail. That is what we are talking about.

Q67 Mr Hoyle: Okay. Let me just get it correct. You have a private paper with confidential information that we have not seen. The Secretary of State said to this Committee that it would take hundreds of millions of investment within Royal Mail. That is what is required. Do you disagree with that statement or do you agree with it?

Mr Hooper: I absolutely neither agree nor disagree with the Secretary of State.

Q68 Mr Hoyle: Do you think he has misled this Committee then?

Mr Hooper: Who has misled this Committee?

Q69 Mr Hoyle: The Secretary of State?

Mr Hooper: Why would he have misled this Committee? That is his view.

Q70 Mr Hoyle: You have the information that I do not have. You know whether it is correct or not.

Mr Hooper: That is his decision; that is his view. I cannot be drawn on giving you an answer to the question of how much capital the Royal Mail requires.

Q71 Mr Hoyle: Does anybody know what is actually needed?

Mr Hooper: I believe that the strategic plan has capital requirements in it.

Q72 Mr Hoyle: So let me get it right. We have £600 million of taxpayers' money for modernisation sitting within Royal Mail unspent. We are going to take the pension fund and dump that on the taxpayer and then you say you will find a partner. Of course you will find a partner. All the liability has gone, the taxpayer is going to invest in it, so what gain are we going to get except to give the

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profits to a competitor at the expense of the British taxpayer. I come back to my original question: do you believe in state-owned businesses? Do you believe the taxpayer should run the Post Office? Yes or no?

Mr Hooper: We say quite clearly in the report that Post Office Limited should remain 100% in public ownership.

Q73 Mr Hoyle: Royal Mail?

Mr Hooper: I also believe that Royal Mail would modernise with a strategic partner. That is a key recommendation and it brings to bear on the problem of modernisation the very issues we are talking about.

Q74 Mr Hoyle: I think you are driven by dogma and you do not like Royal Mail and you want to see them break up. When you are happy for the taxpayer to take all the liabilities but not keep the profits we have a danger here.

Mr Hooper: With respect, this is not a dogmatic document. It is not an ideological document. It sets out the case; it sets out the issues which are holding back the Royal Mail from modernisation, one of which is industrial relations.

Mr Hoyle: You do not even believe in partnership. You are saying they must have a stake in this business and they are going to have a profitable business because all the liabilities have been taken away. You are giving taxpayers' money away or your suggestion is that the Government should give taxpayers' money away to a competitor. It is not good enough and I do not accept your report.

Q75 Lembit Öpik: I understand why you would not necessarily want to specify a percentage ownership because you do not want to involve yourself in that kind of negotiation by proxy.

Mr Hooper: Correct.

Q76 Lembit Öpik: Am I right therefore in assuming that you are supporting and recommending the concept of a strategic partnership with a private company or private companies not on the basis of a principle but on the basis of observed results in other similar industries around Europe where you have seen this done?

Mr Hooper: Yes; correct.

Q77 Lembit Öpik: Moving from that then, and we have already touched on this, you are saying basically that an increase in private ownership and a reduction therefore *de facto* in public ownership will lead to improved business effectiveness and operational competence of the Royal Mail. It seems to me that the exact opposite had been done with the banks where there has been an increase in public ownership and a reduction in private ownership in order to increase the business effectiveness and operational competence of the banks. The similarity seems to me that there is a political imperative to increase lending of banks in the same way that there is a political imperative to maintain the universal service obligation in the Post

Office. Looking at it empirically, there seem to be two opposite directions, one for the banking sector and one for the Royal Mail. Do you have any observation on why they might be going in opposite directions?

Mr Hooper: It is again inappropriate for me to comment on the banking situation. I was asked by Secretary of State John Hutton almost exactly a year ago to look at and study the postal services sector and particularly Royal Mail within it. That is what the team and I have concentrated on. We have taken a large number of submissions from many parties, we have taken a lot of suggestions, we have had a lot of debate and we have come up with our conclusions on the basis of a way forward for the Royal Mail. Incidentally, those are conclusions which have had quite widespread acceptance as well. I am not commenting on the banking world out there. I am very conscious of what is happening in business markets obviously, but this is about the postal services sector, the regulation of it and about the future of Royal Mail and saying we must, as a society, modernise Royal Mail much more quickly than at the moment otherwise it faces a significant decline.

Q78 Lembit Öpik: To summarise the answer the core proposition you are making is that having private sector involvement in the Royal Mail would drive efficiency and effectiveness in the way we want to see.

Mr Hooper: It would bring the requirements we analysed in the report; it would allow them to happen and to modernise.

Lembit Öpik: The debate we need to have is to decide whether we conclude that can be achieved without private company involvement or whether that private company involvement is necessary.

Q79 Mr Clapham: You identify industrial relations as being the crucial issue.

Mr Hooper: A crucial issue, not the crucial issue; one crucial issue.

Q80 Mr Clapham: One of the crucial issues. What makes you think, that bringing in a strategic partner from the private sector is going to make industrial relations better?

Mr Hooper: Depending on who the strategic partner is, what we are looking at is a strategic partner who has done transformation and therefore has taken the workforce and the unions with them on that journey, allowing a genuine engagement between the management and the unions as to the future of the company, something which has not happened to date. Lord Sawyer in 2001 wrote a report which we talk about in here and talked about the issues of industrial relations and really nothing has happened of any great note since then.

Q81 Mr Clapham: So you do not believe that the kind of conciliation procedures that would bring engagement could actually be introduced without

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this private partner. If it is a private partner who is a competitor, is it not likely to add to disharmony rather than harmony?

Mr Hooper: When you say “it is a private partner who is a competitor” you mean presumably TNT. I would imagine the competition authorities would have to look at whether TNT operate in the UK market and clearly that is something I would not make a judgment on; it is clearly a competition issue.

Q82 Mr Clapham: You provided a private report for the Secretary of State. In that report do you suggest what kind of partner should be brought in?

Mr Hooper: This is the report which went to the Secretary of State. It is not a private report.

Mr Clapham: You said earlier that there had been a private report, private document.

Q83 Chairman: I think that was the Royal Mail Group’s strategic document.

Mr Hooper: The only thing I was referring to there was that we did have access to a document called *The Strategic Plan for Royal Mail* but that is a Royal Mail document. This is the document which went to Lord Mandelson and to Pat McFadden.

Q84 Mr Hoyle: And nothing else; no private papers, nothing.

Mr Hooper: No private papers.

Q85 Mr Hoyle: No private comments.

Mr Hooper: No, no private comments. I would not make those comments. I am sorry to be frustrating about this issue of the level of shareholding but I genuinely believe that it would be very difficult for the Government to negotiate in the taxpayers’ interest if Hooper had incidentally said it has got to be 51% or 49%. This would be silly. I also apologise for frustrating you about the amount of capital. It is not a figure that I have, that I can give you. It is actually probably a figure that will significantly change over the next year, as we get unions and management to work together and as we get a strategic partner to come in, if that is approved of course. That is the situation.

Chairman: We have two remaining areas of questioning. We are already out of time but we must pursue them.

Q86 Mr Bailey: First of all the future of the Post Office and its relations with Royal Mail. There seems to me to be a number of potential contradictions in your recommendations there. First of all, you make it quite clear that you think the Post Office is vital for Royal Mail to sustain its universal service obligation. Then you comment that it should remain in public ownership, that three quarters of its 12,000 outlets do not make a profit and can only be sustained by a direct subsidy from the Government. Effectively the future of the universal service is dependent on a state subsidised Post Office network. When we examined the Post Office one of the problems was actually ascertaining what was a profitable post office or not

because of the lack of transparency in the costing. First of all, do you not think that Ofcom must build up an adequate costing measurement so that this can be ascertained? Second, how do you think Royal Mail and the Post Office can work together to maximise the interests of both in this particular context?

Mr Hooper: I certainly think that the Post Office is part of the costing exercise Ofcom will have to do. There is a very crucial recommendation in here about Post Office Limited which is that there needs to be a long-term business agreement between the Royal Mail and Post Office Limited to make sure that there is certainty. Something like one third of Post Office Limited’s revenue comes from mail services so it is obviously an absolutely critical part of their revenue stream. In terms of the universal postal obligation, post offices are critical for access to the mail service, particularly for social customers, people like us, at home and small- and medium-sized businesses. That is the criticality of the post offices: access to Royal Mail and to the universal postal service.

Q87 Mr Bailey: The second contradiction is, if the volume through Royal Mail continues to decline and other private sector operators want to use the Post Office network, do you think that the Post Office network should in effect make its services available to private sector operators which are competitors to Royal Mail?

Mr Hooper: That is not something we opine on in the report and indeed that I think that is a policy decision that would need to be made. It is somewhat influenced by the nature of the long-term business agreement between the Royal Mail and Post Office Limited because that contract could be an exclusive contract with exclusivity on both sides. That is a possibility and that would be a matter for negotiation. The point we do make in the report—and I want to come back to it—is parcels and packets. This is a significant future for mail services and one of the things we say in the report is that we feel Royal Mail treats senders of mail, shall we say, in a more customer way than the recipients of mail. We all return home at seven o’clock in the evening to find the piece of paper—some people describe it as the dreaded piece of paper—that requires you then to go out to the delivery office or wherever between the hours of eight and twelve the following day. What we say in the report—and your Committee is looking at the future of Post Office revenue—is that there must be revenue opportunities for post offices to be places where my and your parcels and packets could be and I could go to them to pick them up rather than going to the delivery office. So there are business opportunities there in the nature of e.Fulfilment and this huge amount of Amazon books and other books coming off the internet.

Q88 Mr Bailey: The irony of this is that the Post Office Limited network, in obtaining fresh sources of revenue to ensure its sustainability, could actually be undermining Royal Mail and its sustainability.

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Mr Hooper: If it took parcels of competitors, for example.

Q89 Mr Bailey: Yes.

Mr Hooper: Which is why I think it is a major policy decision and is not a policy decision that we went into. This was not basically a review of post offices; it was a review of Royal Mail.

Q90 Chairman: We of course are doing our own review of post offices.

Mr Hooper: Yes; I appreciate that.

Q91 Chairman: One point of important clarification. You said Post Office Limited should remain 100% publicly owned.

Mr Hooper: Yes.

Q92 Chairman: You say that Royal Mail should be X% publicly owned; whatever X may be. Do you have a recommendation for the structure which underpins this? Will Royal Mail Group be an overall holding company and one of its subsidiaries will have a minority shareholding? Or will it be separated into two separate businesses?

Mr Hooper: Again I apologise for being frustrating. I do not think the corporate structure is something the review should get into. It very much depends on the strategic partner, the nature of the negotiations. There are the four main arms of Royal Mail Group as we have it today: Post Office Limited, Parcel Force, GLC and Royal Mail Letters. Those are the four arms. How the strategic partner comes into that is quite a delicate issue. It is a negotiation issue and it is not one on which we choose to opine.

Q93 Mr Clapham: You recommend that the Government should strengthen public and parliamentary accountability for the provision of the universal service. Given that you are talking about a strategic partner coming in, what role would the Government have in that kind of situation for ensuring and securing the universal service obligation?

Mr Hooper: There are two aspects to that. First of all the Government as shareholder will make it very, very clear to the strategic partner that the maintenance of the universal postal service is part of the deal. That would be clearly made in any arrival of a strategic partner. Second, if the legislation is passed moving to Ofcom, Ofcom's responsibility, its primary statutory duty which we set out in here, which is indeed the primary statutory duty of Postcomm under the Postal Services Act 2000 is the maintenance of the universal postal service. The regulator clearly has an absolutely key role. Thirdly we have suggested as our final recommendation that maybe your Committee, at the time of the annual report of the regulator being placed before Parliament, would summon the regulator and indeed you would probably summon the Royal Mail management as well to talk about how they have maintained the universal postal service.

Q94 Mr Clapham: So you are saying that there would be a contract with whoever the minority strategic partner was going to be.

Mr Hooper: I would say that no strategic partner would come into the Royal Mail without an understanding of the regulatory environment; they would not do it. They would need to have an understanding of the regulatory environment. A central issue in the regulatory environment is the maintenance of the universal postal service and we are saying clearly that we are not recommending that you degrade it, we are not going from six to five days—as quite a number of people suggested to us; we do not think that is the issue. The issue which is central is modernisation and that is the focus of our report.

Q95 Mr Clapham: So the regulator would be responsible for monitoring the universal service and reporting that to Parliament.

Mr Hooper: As Postcomm is now; yes.

Q96 Mr Clapham: Coming back to the issue of the Select Committee, you suggest that the Select Committee would work to hear from the service.

Mr Hooper: Yes, and from the regulator.

Q97 Mr Clapham: And then to report to Government. Given that Government are responsible for running the country, what kind of responsibility would the Select Committee have?

Mr Hooper: The thinking behind that was that the universal postal service is something which is extremely dear to the hearts of the legislature that put this Postal Services Act in 2000. In all my meetings, for example my meeting with Mike Weir, the key point that he made and John Thurso made it for the Lib Dems was that the provision of a universal postal service is a social and economic glue in this country. Mike Weir said to me “Richard, you have to remember that in my constituency there are small- and medium-sized businesses in rural areas, not in the city, that depend fundamentally on the Royal Mail and upon postal services. Right from the start everybody made it clear that the universal postal service is a social and economic glue of this country and we are going to keep it. This report is aimed at improving the health of the Royal Mail, modernising the Royal Mail so that it can continue to provide that service for the foreseeable future.

Q98 Mr Clapham: I understand that but I want to take forward where we would go from the Select Committee making certain recommendations because the Select Committee does not have the resource to ensure that the universal service is maintained.

Mr Hooper: No, no, predominantly that is a regulatory responsibility. Statutory duty number one: maintenance of the universal postal service. Statutory duty number two is of course competition where appropriate. Those are the two statutory duties. Clearly it is the regulator who is responsible for ensuring that but I think the

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Government as shareholder will clearly have a role in that and I think you as a scrutiny committee can make jolly sure that you hold their feet to the fire.

Q99 Mr Clapham: There could be an issue there; there could be a problem there. We do need to ensure that the Select Committee recommendations to Government regarding the universal service are actually going to be implemented and that is where the problem arises.

Mr Hooper: Yes; I understand.

Q100 Lembit Öpik: It is obvious then that for a private business the USO eats profits. By introducing private business into providing the USO one is therefore building in an internal dynamic which will create pressure to reduce the USO obligation in those parts which are loss-making.

Mr Hooper: I do not actually accept that. The universal service obligation is also a huge commercial benefit to the Royal Mail. The ability to deliver six days a week to 28.4 million houses and businesses is not just a social obligation—though there is clearly a social obligation there. There is also a fundamental commercial asset; it has huge reach. If you are sending out advertising mail, and a large section of this mail market is advertising mail, then the ability to reach that number of homes is extremely important. I would not see it just as a liability that is a nuisance to a private shareholder or to anybody else. It is not.

Chairman: That is a note on which to end. We are already half an hour behind schedule but it is important that we took those questions and we are grateful to you for your time and trouble. We may well speak to you again. Who knows? Thank you very much indeed.

Witnesses: **Mr Billy Hayes**, General Secretary, **Mr Dave Ward**, Deputy General Secretary, Postal, and **Mr Jeremy Baugh**: Head of Research, Communication Workers Union (CWU), gave evidence.

Q101 Chairman: Gentlemen welcome to this second half of the evidence session. I am sorry we went on a bit but they were important questions to be asked of the review team and I am grateful for your patience. May I begin as I always do, though we know all three of you, by asking you to introduce yourselves for the record?

Mr Hayes: My name is Billy Hayes; I am General Secretary of the Communication Workers Union.

Mr Ward: I am Dave Ward; I am the Deputy General Secretary, Postal, Communication Workers Union.

Mr Baugh: I am Jeremy Baugh, the union's Head of Research.

Chairman: I will just explain the structure of questioning, to my colleagues on the Committee as well. We are going to start by asking about the reasons for Royal Mail inefficiency, then we will move to the strategic partnership, the minority shareholder question, then we will ask about regulation, negotiation and the future of post offices in relation to Royal Mail. We will start with the reasons for inefficiency in Royal Mail.

Q102 Mr Hoyle: It is good to see you all. Billy, can we look to you. You have heard Mr Hooper expressing his views, his analysis of his report. Do you accept his reasons for Royal Mail's high cost base?

Mr Hayes: First of all may I say it is great to talk to the shareholders about the company you own and for which you are accountable to the country. In terms of efficiency, Richard makes a big thing about Belgium in terms of comparisons. Obviously there is a lot in the report that we welcome, certainly on the pensions issue, dealing with the pensions issue and getting that particular issue sorted out. One of the strange things about the report is that when he makes comparisons he is not always comparing like with like. Just now, for example, he talked about the

six-day service in the UK. That is unique to Britain. They do not have six days a week in France, they do not have six days a week in Germany and they do not have six days a week in Holland. More importantly, he mentioned Belgium and the problems of inefficiency in Belgium. Just look at Belgium. In Belgium *La Poste* delivers 110 grams first class at more than twice the cost of Royal Mail. *La Poste* delivers 50 grams first class at a price 25% more expensive than Royal Mail and *La Poste* still has a monopoly in Belgium. So when he talks about efficiency, really what he is talking about is profitability. If you look across Europe—and I can go through a whole list of figures—

Q103 Chairman: If you have the figures it would be useful if you could give them to us. Not now.

Mr Hayes: Yes, I will table the figures. It is not picked up in the report in terms of efficiency. Yes, we understand the issue of mechanisation, we understand that we need to mechanise. He keeps on about wooden frames. I have not seen a wooden frame in a delivery office for a very long time. Maybe he goes to one where they still exist. The point is that when we talk about efficiency the issue we are talking about really in terms of Royal Mail is profitability. One of the reasons why Royal Mail is not as profitable as the rest of Europe is because of pricing across Europe. Then the question was asked about whether any other postal administration was modernising in the public sector. He mentions one in his report but he does not really go into any detail. It is in a very big country, a country of just under 300 million and there is a very big event in that country today, it is called the United States Postal Service. Currently it is in the public sector and when we talk to our sister union across the pond nobody, neither Democrat, Republican nor Independent, wants to privatise and liberalise the postal sector. They are managing to modernise in a very difficult

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environment and improve efficiency. When we talk about inefficiencies, there has been a failure of under-investment in the company for years. The Chairman made mention of pensions and under-investment in the company. The Government had a 13-year pension holiday in the external financing limit, which was the amount of money that the Government took from the Post Office from about 1979 up to about 1996 and it equated to something like £2.5 billion. Essentially, in terms of modernisation and new equipment, there has been a lack of investment in the company. Five years ago everybody was telling us there was a failure to liberalise. We have liberalised and we have problems in the sector.

Q104 Chairman: Problems this Committee predicted.

Mr Hayes: Yes and all credit to the Committee in that regard. The report deals with profitability and does not compare like with like.

Q105 Mr Hoyle: May I just push you a little more on that? We know there are problems there. What are the most pressing problems at the moment and how do you think they should be addressed?

Mr Ward: In respect of efficiency?

Q106 Mr Hoyle: Yes.

Mr Ward: The thing that needs to be done as quickly as we can is for us to reach an agreement with Royal Mail on exactly how automation is going to be introduced. We are willing to do that. We have made that clear to the company for the last three or four years. One of the things which frustrates the union and our members is that when they hear this debate about efficiency there seems to be a suggestion in there that postal workers in the UK are somehow not as efficient as workers in these other companies in their home countries. We reject that analysis completely. I think that one of the problems with this report is that it does confuse efficiency with profitability. If you separate the two—and there are plenty of examples across business where you can have a very profitable company which is inefficient and you can have a company which is not so profitable but is efficient—you start to understand where the real issues are. It is actually very simple when it comes down to it. The whole issue of the future of Royal Mail as we would like to see it as a fully publicly-owned company—and we see no reason why it cannot be successful in that environment—comes down to some very simple issues. It is not complicated. One of them is to bring in machines which we know exist which will increase efficiency. It is not our members as such who are inefficient: it is the fact that they are having to compete with companies who have better equipment and better machinery. If you go abroad—and I would have this argument with anybody on a like-for-like analysis—and compare the physical demands of the job in the UK, because we do not have the best equipment, with what you see for workers abroad, our members will come out on top in every single league for actual cost per item and

efficiency. We are doing some analysis of that. The report is very weak on data to substantiate the claims it make about the efficiency. Where is the data in the report that backs that up that we can look at and compare serious like-for-like things? It is about automation, bring the machines in. What we keep asking Royal Mail and what the Committee should ask Royal Mail and what Lord Mandelson, the Secretary of State should ask Royal Mail is why Royal Mail have not brought in these machines. What they tend to do as a company is pigeonhole the union as being opposed to that. I would ask the Committee to look at our track record as a trade union. We have never opposed the introduction of automation in this industry. We have always supported the introduction of automation and we are willing to do that again.

Q107 Mr Hoyle: Are you frustrated when you know that there is £600 million which has not been spent which could automate Royal Mail?

Mr Ward: You say £600 million. Our view is that there was £1.2 billion.

Q108 Mr Hoyle: I do not disagree with that.

Mr Ward: We estimate there is more money than that. What we are struggling to understand is how a report can criticise Royal Mail as a company for lack of transparency, not just on its costs but on its overall finances when nobody can get to the bottom of this and then not suggest—your question earlier was on the button—what level of investment it is that is required. How can you come up with a solution if you do not know the answer to those two questions: one, what is the real state of Royal Mail's finances; two, what level of investment is actually required? If you cannot answer that, anything else is just somebody's personal analysis and in our view there is a dogmatic undercurrent within the report. We just want to get on with the job of modernisation and we can do that. If we have the right management and the union is willing to engage and our members are willing to face up to those challenges, which they are, then we can succeed in that environment.

Q109 Mr Hoyle: You are a taxpayer, we are all shareholders in Royal Mail, do you think it is absolutely barking, like I do, that the liability of the pension fund is handed over to the taxpayer, we have left £600 million of taxpayers' money in there which has not been spent on investment and at the same time we are trying to give what will turn it round into a profitable side to a competitor. To me it makes absolutely no sense. Why on earth are we using taxpayers' money and not keeping the profit? Is that not the right way forward?

Mr Ward: Of course it is. We recognise the pension deficit needs to be tackled and our view is that the Government have to accept their responsibility on that, in the same way that they should accept their responsibilities for introducing a failed policy on competition which is done differently in the UK from our European competitors. We are at a disadvantage; that seems to have been airbrushed out of the report when the initial report actually

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made that quite significant statement that competition had not worked. On the pension situation our view is that Government have to accept their responsibilities. Let us be clear. Do you seriously think that any of these companies are going to want to invest in Royal Mail if they do not believe they are going to make a profit? They know that despite all the challenges that the Hooper report outlines and we accept those challenges are real—modernisation, the digital revolution—despite all that, these companies know they are going to make a profit. That is why they are coming forward. TNT will not be the only one; there will be others who will want to come in to the Royal Mail.

Mr Hoyle: And that is the real reason: they see this as a cash cow. Obviously we have seen the frustration and the problems and you have quite rightly brought to our attention where you think the issues are and where things ought to change. In the case of the management should Allan Leighton stay or should he go?

Q110 Chairman: He is going anyhow.

Mr Ward: He has gone, has he not?

Q111 Mr Hoyle: What is your view? Should he stay or should all the management go and just bring in new management?

Mr Hayes: The straight answer is that we want people who are committed to a publicly-owned Royal Mail which was the promise the Labour Government made to the British people in 2005. We do not want people who are second-guessing that the company is going to be privatised and that is what we have suffered with. It has been documented in Robert Peston's book *Who runs Britain?*; there is a whole section on Allan Leighton and Royal Mail. The whole point is that we want people who are committed to the policy that the British Government have and at the moment the British Government's promise to the British people was a successful, publicly-owned Royal Mail.

Mr Hoyle: Do you believe that we can actually have a profitable Royal Mail which will deliver for the taxpayer?

Q112 Chairman: We will come back to that. Before that may I ask a couple of questions on the issue we were discussing of inefficiency? I should be interested to have a note from you about the US experience and particularly what equivalent it has of the universal service obligation and how that works. My memory of the States and Canada as well is of large stacks of post boxes where people go to collect their post, which makes it a lot easier to run. May we have a note on that? I speak on behalf of consumers for a second here. The inefficiency we all notice as consumers is very late delivery of post, particularly in rural areas but also in urban areas, and apparently random patterns of time. My post can come at any time between 11 o'clock in the morning and two or three in the afternoon except on a Saturday when it always comes about nine o'clock. What can we do to achieve more predictability about delivery times?

Mr Hayes: On the specifics, I do not know whether there are any particular developments in that technology but just in terms of the United States, which is a good example, every post box in the United States is owned by the United States Postal Service. It is a bit strange in the heartland of capitalism that they own those little apertures. The other thing is that, because of the nature of the United States, the universal service is seen as a big glue, as Richard called it. We will certainly send you some stuff on that. My point about the United States is that there is nobody in Congress champing for liberalisation or privatisation of the United States Postal Service.

Q113 Chairman: We will cover that in a minute.

Mr Hayes: In terms of reliability, in our submission we did suggest that there should be a final time for deliveries and it was the union which in 1995 put forward and has championed for many, many years, a tailored delivery service. Both I and Dave Ward in our previous roles as national officer responsible for delivery staff have often championed an early delivery. A very simple thing we suggested was dealing with what is called SOHO, small office/home office working, where you could tailor deliveries to people. The joke that the cheque is in the post, if you are a panel beater running a little company, is no joke and people, particularly in the small business community, still like to use cheques for all sorts of different reasons. There are things round that.

Mr Ward: Specifically on what we can do to improve reliability of the service, the first thing to say is that you have to invest in the people who work in the service and recognise what an asset they are. I do not think the management always see it that way. The management sometimes seems to us to have a thousand different plans running at once and they never ever seem able to implement any of them by coordinating them with the others. For example, surely any company which ultimately requires us to deliver an end product to a customer should get its rationale on the basis of the network, the collection side of the business and distribution side of the business and the sorting side of the business must be locked into the delivery specification. One of the things which has been missing from the company's plans in recent years—and we agree with Richard Hooper's analysis that there has been a lack of transparency about the company's vision for the future and we suffer from that in terms of building a relationship—is that there does not appear to be a rational approach to what is going on. For example, at the moment the company is saying to us that it has plans for the sorting side of it, the mail centres, and it wants to rationalise all these mail centres. We keep asking them to explain to us what it is they are trying to achieve at the delivery end. Our view is that you should start from the delivery offering and work backwards. Everything then fits a more reliable delivery service. The other thing we would agree with is that the company should diversify. In our view there is no reason—and we have said this at many of these meetings before and when we talk to MPs—why Royal Mail cannot grow aspects of the business

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and the service they offer to support local communities. With the infrastructure the company has already, why can it not have a same day collection and delivery service on top of its core USO offering? That is easily achievable but it comes down to a willingness to plan for the future and what you are offering the public as a service as opposed to just looking at short-term profitability issues.

Q114 Chairman: Back to Victorian days when you could send each other postcards inviting someone to tea on the same day. Fantastic.

Mr Ward: That is an advantage of the digital revolution.

Q115 Chairman: One more slightly serious point. You talked about prices earlier and I am struck by the graph on page 52 of the report which shows that Royal Mail has the highest labour costs as a percentage of revenues in 2007. There are at least two ways of cutting that. One is that that means the labour costs are appallingly high or the revenues are appallingly low. Does that mean that what you are actually calling for is a significant increase in prices?

Mr Hayes: In terms of prices, my point was that in the report itself it does not make like-for-like comparisons and it does have a graph where it talks about profitability but it does not look at the pricing structure across Europe. That is the first thing.

Q116 Chairman: But the prices in Europe are typically higher than in the UK, are they not?

Mr Hayes: Yes.

Q117 Chairman: So you are saying prices in the UK should be higher.

Mr Hayes: No. What I am saying is that you have to do a like-for-like comparison. The fact is that it is a combination.

Q118 Chairman: One way of correcting the problems we are addressing would be to increase prices.

Mr Hayes: Yes, there is an issue of price, I am not saying there is not, and there is an issue of labour costs. We are not sitting here saying to you that if we mechanise more mail there will be the same number of jobs at the end of it. That is not what we are saying. We are not simply saying you should jack up the prices. When Richard talks about inefficiency, he does not deal with price at all.

Q119 Chairman: I do not want to frighten you but you have been rather honest with the Committee just then. You used a dangerous word. You said, summarising, prices should go up and jobs will have to come down.

Mr Hayes: What I am saying is that the report says that Royal Mail is inefficient. It does not deal with the issue of pricing across Europe. That is what I am saying.

Mr Baugh: The point about inefficiency and Royal Mail's efficiency is that it is linked to a chronic lack of investment, it is linked to an unfair regulatory regime and unfair access regime which is draining Royal Mail's profits and it is also related to the point

you have just made about lower prices relative to the rest of Europe. You should look at all those three elements if you want a proper assessment of Royal Mail's relative efficiency. If you give it the added investment, invest in the machinery it needs, clearly there is going to be an impact on jobs. You need to look at the prices it charges relative to its European competitors, but you also need to do something, which Hooper ducks, about the damaging access regime which is draining hundreds of millions of pounds out of Royal Mail's coffers every year. If you addressed that, if you gave it the money it is going to be pumping into propping up a pensions deficit and you changed the access regime, we believe you would have a financial package, notwithstanding the £600 million that Royal Mail still has not spent and was meant to have spent on investment, all those elements together mean you would end up in a very different place, when you look at Royal Mail's profits and efficiency, from the slight and misleading analysis that Hooper provides which is not placed with like-for-like comparisons and that includes the stuff about pay and pensions. Again, they are just not comparing like with like, they are comparing the pay of postal workers in the UK with the pay of foreign operators and they operate different rules, they operate different arrangements, different regulatory regimes; they have minimum wage in Germany for example. There is a whole variety of factors which explain Royal Mail's relative profits and efficiency.

Chairman: I should just say that I am reliably informed that the definition of the universal service obligation in the States is actually part of the constitution and it is written with a poetry that even Barack Obama will not be able to aspire to this afternoon.

Q120 Roger Berry: Two quick questions to emphasise a couple of things for the record. Given your argument that yes, modernisation in some form clearly needs to take place to improve the service and so on. Given there is actually unspent money knocking around that Royal Mail simply has not used, running to very significant figures, as Mr Baugh just said, in essence do you believe that modernisation is possible under the present management structure and indeed personnel?

Mr Hayes: It was possible under the Conservative Government during the 1980s; a lot of change took place under a Conservative Government and there is no reason why it cannot take place under a Labour Government. I give you one example: inefficiency in London. In 1980 the Carter Commission came in and looked at inefficiency in London and, through cooperation with the union, a productivity scheme was introduced, efficiency went up almost overnight and then that was rolled out to the rest of the country. It has happened in the past and there is no reason why it cannot happen in the future. May I just say one thing on the States? There is a bit of a myth about what is taking place in terms of Royal Mail at a wider level, in terms of the decline in mail volumes. Yes, there has definitely been some decline in what is called substitution but in the States they are

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developing things like intelligent mail, which is using the whole question of the universal service. For example, you would email a letter to a delivery office and it would be enveloped and sent to an individual. That has actually helped them, if not grow the market certainly stem the decline in the market and, if you look in the Hooper report, the decline in the USA is less than what has taken place here. As Richard also recognised, some of the decline is linked to the state of the economy because advertising is a big part of Royal Mail. Can modernisation take place in the public sector? Absolutely. The key to modernisation, apart from the kit and mechanisation and the like and new products, is the involvement of the workforce and that is key. We have seen it take place in the 1980s and there is no reason why it cannot take place under the Labour Government, particularly as the Labour Government promised the British people that they want to see a successful Royal Mail in the public sector. That is not just a party commitment: that is obviously a government commitment and that is a pledge and people do not like to see pledges broken.

Mr Ward: May I supplement Mr Berry's question and Billy's answer by saying that I think you also asked specifically whether it can be done with the current management. There are two things which need to happen. The answer is yes, it can be done with the current management but two things definitely need to happen. One is that the company's business leaders need to commit themselves to the future of the industry and need to be very clear about whether they are going to see this through. That has been something that we found particularly frustrating in trying to build relationships with management and improved industrial relations. If you have a look at the number of board members who have come and gone in the last two years, very senior people within the business, it seems to us that a pattern has emerged that every time you start to build a relationship with somebody in the company, whether it is the Head of Personnel, whether it is the Head of Operations, they are there for about six months and then they leave. You said at the beginning and our understanding is that the chairman, Allan Leighton, has already decided that he is leaving at the end of his current contract. However, we need to see a commitment from the people who are running this industry that they are here for the long haul and that they are going to see this through. The second thing is that they have to be transparent about what it is they are trying to achieve. I do not know how any company or union can have a relationship based on these massive challenges, some of the biggest in British industry, but they cannot show us as a trade union that plan, nearly four years on now from when the plan was first brought about, because it is a confidential document and, if the truth be known, they are worried about what our reaction will be to it. What they are going to do is introduce it on a piecemeal basis without showing us what the future looks like. The only way you are going to succeed on that is if the company sits down with us and determines whether we can have a shared vision of what the

future looks like. Then the journey to get from A to B becomes a lot easier. It is those two things: commitment from the leadership of the company currently and we do not believe that is there in the long term; second, commitment to show exactly what their plan for the future is to the union and to the workforce.

Q121 Roger Berry: For the record, what are the really key reasons why you oppose even a minority shareholding, apart from the election manifesto commitment with which I am familiar. Apart from that, what is the fundamental reason so that we can get it on the record?

Mr Hayes: Maybe I am a bit naïve but if you promise something to the British people you should carry out your promise.

Roger Berry: Apart from the manifesto.

Chairman: I do not want to defend the Labour Government but the manifesto pledge begins "We have no plans to privatise Royal Mail". They did not then but they do now.

Q122 Roger Berry: I understand that argument. I want the other argument.

Mr Hayes: I will tell you a very simple argument and Lindsay Hoyle touched on it. Why should we nationalise the debt and privatise the profit? If you deal with the whole question of pension fund liability, everybody seems to accept now that the Government have to deal with the pension fund liability because they have benefited from it. When there was a 13-year pensions holiday the Government and the British people benefited from the pension fund holiday. So the first thing is that the Government have to honour their pensions liability. Hooper says that and we agree with him. What then happens, if you deal with that, you provide the company with about £3.4 billion, 15 years going forward, about £288 million in terms of this historic liability. What would happen, a bit like what was suggested around Northern Rock, would be that the state takes on the liability then some private sector company comes in and gets the profit. What happens is that as soon as you take the liability off the balance sheet, automatically you improve the health of the company. Why should the British people take on the liability and then see a private sector company take on the profits? I will tell you what surprised me about Richard's contribution. He talks about lack of transparency. I did not see much transparency in terms of the requirement for the company going forward, in terms of the finances of the company. It is almost as though we are playing charades here and trying to guess. This Select Committee is trying to guess the future investment needs of the company. What we can say is, if you take on the pensions liability, you are going to free up the profits of the company going forward. What will happen if a private sector company comes in such as the company which was mentioned in the paper yesterday? They will be coming in to make a profit. That is what profit sector companies do. That is what the whole point of it is. I think the British people want to see a successful Royal Mail. Why is

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it that they talk about the Dutch? Lord Mandelson said the other day that there is no gene pool in Britain to run Royal Mail. So the country which gave the universal service to the world 350 years ago has nobody in Britain to run Royal Mail. Maybe he was joking. The fact is that this country can have a successful Royal Mail and, if we deal with the issue of pensions, if we deal with the issue of modernisation, there is no reason why not. My fears are that we would nationalise the debt and privatise the profit.

Q123 Roger Berry: But you do believe that by sorting out the pensions problem the resources would then be sufficient for a competent management, competent leadership to do the kind of modernisation which is necessary.

Mr Hayes: I think so. We have to deal in guestimates, do we not, in terms of what we need for the company going forward? Is it not about time that the Secretary of State said—we can do the estimate on fag packets almost; Richard Hooper is not prepared to do it—that this is what he thinks the company needs going forward, this is what it will mean? Reference is made to it in terms of the sorting office closures, by comparison, by allusion. For example, Richard mentions the 69 major mail centres in the UK. He suggests by allusion, though he is not specific, that we need 50%. The inference is in the report but we need to be a bit more grown up in terms of the future for Royal Mail and the Post Office generally.

Mr Baugh: None of the things we need for Royal Mail, added investment, support for pensions and changes to regulation, is contingent on privatisation. There is nothing in the report which says it is and nothing I have heard this morning that explains why privatisation is the way to deliver those three things. It would be unpopular and unnecessary. It will put the focus on costs and not on the service to customers and another major reason is that it will plunge Royal Mail into a further bout of internal organisational upheaval after it has already been through a period of unprecedented turmoil. That is the last thing it needs. What it needs to be doing is addressing the market challenges and dealing with its customers better, not plunging into internal divisive rows about ownership and structure.

Q124 Mr Clapham: Just for clarification, we have heard Mr Ward say how he sees the relationship between union and management being improved. Mr Hayes referred to yesterday's newspaper article referring to a particular company who may become the minority shareholder. Do you feel, if there were a minority shareholder, particularly the company that was mentioned in the press, that industrial relations would be improved?

Mr Hayes: The first thing is that they are going to want a return on their investment, are they not? I do not know. We deal with private sector companies and we have members in the private sector and it is not beyond the bounds of our ability or our wit to deal with a private sector company. However, I am not clear and Richard was not clear how the

structure will work. We are told it is a minority stake in the company and I thought it was 25%, 30% and the dictionary definition of minority stake is being used, which I find very interesting by the way, which means it could be 49%. Richard said not more than 20 minutes ago that it is a matter for the Government and Lord Mandelson talks about hundreds of millions. It seems to me now that it is not 25% or 30%; by dictionary definition it can be 49%. As to whether we would be able to deal with a private sector company, we deal with private sector companies now and have good agreements with lots of private sector companies. We would be able to deal with them but what is not clear is what the structure is. There is no reason why we cannot modernise and go forward in the public sector. Having a good relationship is not contingent upon being in the private sector.

Q125 Mr Clapham: So you see no obstruction whatsoever to good industrial relations being achieved within the public sector.

Mr Hayes: Yes; exactly.

Q126 Chairman: It might make a change though and that would be a really good change and a welcome one.

Mr Hayes: Yes.

Q127 Chairman: We are still talking about TNT are we? There is not another company in the frame.

Mr Hayes: TNT, Deutsche Post and DHL have been mentioned. A company was mentioned yesterday which was CVC.

Mr Baugh: CVC; a private equity company.

Q128 Chairman: A private equity company. That would not pass the Hooper test of network experience. It is not just investment but experience.

Mr Baugh: Which Richard Hooper actually said, which is why I discounted it, not least the fact that I do not think there are many private equity firms in the current economic climate which are looking to pour billions and millions into Royal Mail.

Q129 Chairman: It is not just money we are talking about it is the expertise, regardless of the merits of it. There are lots of network companies, for example electricity is a network business.

Mr Baugh: I am just saying that in the current credit crunch, the idea that you can attract private investors is obviously more difficult. It is a slightly perverse timing to embrace the notion for Royal Mail just when the public sector is baling out other industries and sectors. It is a slightly incongruous position.

Q130 Anne Moffat: I loved your quote Billy when you said: "Why should we privatise the profit and nationalise the debt". If you are ever doing another report or even a headline, that is it in a nutshell. It is really good. I share your concerns that Lord Mandelson said there was no-one in the UK who could do the job. I find that absolutely bizarre and ridiculous. The things that Scottish people have

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done, British people have done, English, Welsh and Irish throughout the world are amazing achievements so I think that is all nonsense. Forget all the fancy words and even the *quid pro quo* for the pensions and whatever the reasons might be for going down this road, why do you think he wants us to do this?

Mr Hayes: I think he gave it away in the interview in *The Times* not long before he got the job. Ten years ago he came in and wanted to liberalise, brought in the Postal Services Act and he wants to see his work completed. I think essentially it is a question of dogma. When I got the report I thought at one point Richard Hooper was going to be the new *Dr Who* because he had gone back in time to 1998. It just seemed to be “Excuse me. Have you not heard of the credit crunch? Have you not heard of all these particular problems?”. He was obviously the new candidate for *Dr Who* because it is such an old-fashioned approach. This is the thing that gets me. It talks about modernisation and bring in something which is old-fashioned. I do not think the British public are sitting round in bars and watching television and saying “Do you know, I think we need a bit more private capital into Royal Mail because they are doing a rip-roaring job with our banks?”. It feels to me as though we will end up, if Peter gets his way—we already own Royal Bank of Scotland—with a chart where Royal Bank of Scotland gets 100%. It is bizarre.

Q131 Anne Moffat: Do you really think it is as basic as “I’ve started, so now I’ve got the chance, I’ve come back, I’m going to finish”?

Mr Hayes: I have not heard one convincing argument as to why you should privatise Royal Mail. You can use fancy words like strategic partnership, partner, but as I understand it, once you sell an equity stake whoever you sell it to can then go and sell it on. You can say you want to have a strategic partner who has experience in transformation. CVC for example has shares in Post Danmark, Belgium, Sweden. I guess, if the board of CVC wants to move somewhere else tomorrow, it will. I do not buy this idea that there are all these nice people out there thinking we just need to get into Royal Mail, help it modernise and transform. I think they are thinking, if the Government take over the £3.4 billion of pension fund debt, we can make a nice fat return here. It is as simple and as crude as that really. It is just dogma.

Anne Moffat: I think that Members of Parliament are going to have a real problem selling this to constituents, when they did manage to persuade them that we needed to reduce the network to maintain the network and now to go down what is seen as a possible privatisation.

Q132 Chairman: That is an observation which does not require a response. Obviously I am not prepared to write the death knell of capitalism quite yet.

Mr Hayes: It is looking very sick.

Q133 Chairman: I agree that the current short-term difficulties are challenging. May I put to you the view that with a private sector partner, if it drove up the profitability of the business and say had 30% of the business, the taxpayer would benefit as profits would flow to the exchequer.

Mr Hayes: The only thing is that the taxpayer would have taken the best part of £3.4 billion.

Q134 Chairman: Possibly more.

Mr Hayes: If it was in the public sector, those profits would come back to the taxpayer anyway. That is exactly what the Conservative Government did from about 1979 to about 1994. £2.5 billion went in external financing limit.

Q135 Chairman: That was the other point I was making. I knew you would not accept that argument. What about the argument that actually, if there were a strategic partner, you could say “Hey, we agreed you wouldn’t take the profits out of the business and deny us the possibility to re-invest”? Profits have two uses: either they go to shareholders as dividends or they are re-invested in the business. I said earlier to Richard Hooper that one of the great mistakes of that period was that profits which were being made by the business were not re-invested in the business because the Treasury demanded them. A strategic partner would say “Hey, we signed an agreement, they cannot go to the Treasury, they are coming out or being invested. You cannot actually do that”. What about that argument?

Mr Ward: It is important that we hammer home this point. The idea that somehow Royal Mail has let its business over the last 20, 30, 40 years be a drain on the exchequer is simply not true.

Q136 Chairman: It was the opposite all the time.

Mr Ward: We actually pumped money into the taxpayer and there is a balance here to be had ultimately about what you want from Royal Mail. Do you want it to be a public service? If you do, there has to be a balance and the Government have to decide what they really want the service to be and if they want to decide to maintain the USO in the current format, which we support 100%, then there has to be a balance there around public ownership framework. One hundred per cent is the best framework for a public service to operate in.

Q137 Chairman: Do you think you can constrain the Treasury from its raids on Royal Mail Group finances which were made historically?

Mr Ward: That is part of the debate we have to have about Royal Mail’s future investment requirement. What we are saying is that we are prepared to look at alternatives for how Royal Mail should be funded in the future. One of the key enablers to continue in public ownership is for the Government to accept their responsibility on the pensions. Once you take away the pension deficit you essentially transform the company’s finances from red to black overnight. You are looking at £3.4 billion.

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Q138 Chairman: Probably more.

Mr Ward: And more than that, as you say, if Lord Mandelson is correct that it is going to go up to £9 billion. That can be dealt with. The other thing to remember on that as well is that we need to see the detail of what the Government are talking about on that and I would suggest this Committee does. This is not just a question, which has been posed by some opponents of this, of the Government taking on the liabilities. There are assets in our pension scheme which even with what has happened on the Stock Exchange are still going to be in excess of £20 billion. The stakeholders in the company and our members want to know exactly what is happening to our members' pensions and what the Government's proposal is. What we do accept is that they need to take it on board. We are saying to you that there is an alternative way of funding the company. The other thing that people need to think about in terms of funding Royal Mail in the future is that there seems to be growing support, for obvious reasons with the worldwide financial crisis, around the development of Post Office Limited as the people's bank. There is no reason why, in developing that policy which we support, that that cannot also be used to underpin Royal Mail's ability to borrow money in the future.

Mr Baugh: On the specific point you made, we are short on the crucial detail. We do not know what the guaranteed rate of return is going to be to any minority stakeholder. That is a crucial piece of information. I would suggest that private finance initiative is one area which may give us an indication that would not exactly comfort our concerns about what that is going to mean. The danger is that it will be a return for the private investor and not a return for the taxpayer.

Q139 Chairman: You are saying it will be a guaranteed rate of return. I had not appreciated that.

Mr Baugh: We do not know the rate of return to the private investor.

Q140 Chairman: I imagine it would be on a risk basis. If it is not on a risk basis, that would be very serious.

Mr Baugh: Exactly. We have seen the private finance initiative, we have seen what can happen there and the danger of the taxpayer effectively subsidising corporate profiteering. There is a real risk of that.

Q141 Mr Hoyle: You have already touched on a quick way to make you profitable which is to move the pension fund away. The other quick way into profit is to charge a real going rate on the access agreement so you make a profit on every letter you deliver rather than a loss and that will be a benefit to the taxpayer. Is that not the best way forward?

Mr Hayes: Yes, it is definitely one of the ways forward.

Mr Baugh: We need to say something about the final Hooper report compared with the first report. In the interim report the cost of competition was damaging Royal Mail's finances and threatening USO. By the final report the cost of competition had been played

right down, we would suggest, to support an argument for more competition. We do not accept this £100 million estimate that Royal Mail put forward. We have heard lots about the costs. I think they have underplayed the cost of competition in the final report compared with the earlier one to suit an argument for more competition.

Q142 Chairman: One of the frustrating things this Committee feels about the whole Royal Mail debate is a shortage of agreed information and facts. That leads me on to what I wanted to ask about which is regulation. You have seen the model of regulation suggested in the Hooper report moving from Postcomm to Ofcom. Do you agree with that?

Mr Hayes: We would want to wait and see. Our view is that Postcomm has done a lot of damage but we are not clear about the benefits at the moment. There is an argument that it is part of the communications sector.

Q143 Chairman: The other half of the union is regulated by Ofcom, is it not?

Mr Hayes: Yes.

Q144 Chairman: Is your experience of Ofcom positive in that sense?

Mr Hayes: Yes; generally. By the way, I noticed in terms of Ofcom that there is talk of a support fund for broadband, so there are issues about universal service there.

Q145 Chairman: So you have no objections in principle.

Mr Hayes: No.

Mr Baugh: We welcome the fact that Ofcom has a primary duty to maintain the USO which is what Postcomm was meant to have but we believe they put competition ahead of that. Whatever satisfaction we get from seeing the end of Postcomm, we have some concerns about moving to a general regulator that you will lose the focus on postal matters. Ofcom itself is pretty pro competition and we are concerned that they are going to push competition generally even further, when we think it is time to take stock given that liberalisation has caused some serious problems.

Q146 Chairman: That leads me to another question I want to ask about regulation. Are there any changes to the regulatory regime you would like to see? In your submission you suggested that there were things you could do, for example to bear down on what you saw as unfair competition from some of the competitors Royal Mail was facing at present. Are there changes to the regulatory regime that Ofcom is likely to operate that you would like to see?

Mr Hayes: You mentioned earlier on a better definition of universal service, for example, in terms of what time mail should be there, more flexibility. You mentioned the whole question of access prices. In the UK we have the largest number of small businesses in the OECD; it is a massive community. You could regulate more tailored deliveries. There would be a time by which your mail should be there

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and we have some regulation at the moment around articles for the blind but it can be key; much more specific areas in terms of the USO and what it means for the small business community.

Q147 Chairman: Do you accept that there is no restoration of a monopoly on the cards? I suppose the essence of your position is that you would like to see more primacy given to the USO. That is the essence.

Mr Ward: In our view there needs to be a more level playing field with the competition, essentially around three things: one, the access price; one, a more sensible pricing control negotiation going forward, not on the basis of suddenly saying the solution is to whack up the prices but something which is a policy for the future on pricing that does at least reflect the value of the product which has clearly been undervalued in recent years. Finally, in our view there needs to be the development of a universal service fund. At the end of the day you cannot sustain the universal service with all these challenges unless the cost transparency is in place. When that is in place we are confident that will demonstrate that there is a need for a universal service fund and for the competitors to pay towards that.

Q148 Chairman: Immediately or at some stage in the future?

Mr Ward: It is difficult to make that argument now for the same reason Richard Hooper gives in the report that there is no transparency over the costs. Once they are established and that needs to be a priority, then you can have that debate in a much more informed way.

Mr Hayes: One quick thing about the fact that the monopoly has gone and competition is here for the foreseeable future. There is no measure of the competition. We know famously TNT lost the government child benefit records but there is no measure of the competition. There is a measure of Royal Mail in terms of QoS but there is no measure of the competition; well obviously a bit more now but that is a minor change.

Q149 Lembit Öpik: The universal service obligation. If Royal Mail were part owned by a private company, what do you think would happen to the USO in terms of whether you think there would be an erosion of the USO? Would there be pressure to reduce it? In terms of access headroom, what would you do if you were in charge, if you were Lord Mandelson for a day, about access headroom?

Mr Hayes: The pressure will be on the USO. It was kind of touched on in the Chairman's point and Roger Berry's point earlier on in terms of profits. Is the pressure not going to be that we cannot meet this? We see it a bit with Telecom in terms of broadband access, "We can't quite meet this". The pressure will be on. We have seen a bit of that. We have seen the abolition of Sunday collections even in the current environment because it just does not fit. There is going to be pressure there. I think they should look at the price in advance of 2010 in terms

of access prices because it is killing the company; there is no question about it. We say that in our submission. It is unfair competition and it is damaging. Lord Mandelson should look at that right away and I would hope that Lord Mandelson would like in the round at all these proposals and see the controversy. He is not one to shy away from controversy but there is no support out in the country for the privatisation of Royal Mail. We said in our submission to Richard Hooper that we thought it was outwith his remit actually to suggest the privatisation of Royal Mail. He came up with it and so be it. If I were Lord Mandelson, I would open the whole issue of price right now.

Q150 Mr Bailey: Post Office and its role within the proposals. Postcomm obviously argued that there should be full separation and I believe your union opposed it. Do you actually think that the logic of the Hooper proposals is that there should be full separation?

Mr Hayes: I do not think there should be full separation full stop. I do not think the question has been answered. Richard was pressed on it but he never really answered the question. If you go into a joint venture with a private company what does that mean for the future of the Post Office network? On the one hand we are being told that it is not privatisation and in the report we are told that Post Office Counters should be kept wholly in the public sector, so there is further illogicality in terms of that. I think that is what the pressure will be. We welcome what the Government did with the card account and ending the tendering process and it has probably saved about 3,000 post office counters. We do not know, we would have to see the detail, but that would be the pressure presumably in terms of separation.

Mr Ward: It was our former general secretary Alan Johnson, Cabinet Minister now, who made the point very well many years back when he talked about a natural synergy between Post Office Limited and Royal Mail. That natural synergy is that you are delivering a public service. In our view the idea that you can separate the two is just not on. What you should be doing is developing both, diversifying, being more dynamic about what they both offer but they can work together and have to work together because PO is also a key access point to the universal service. If you separate them, those pressures will grow and it will eventually lead to the undermining of the universal service as well. We see the two things being together and necessarily together. We do see a different future for them. We want to get into this debate about what the future looks like for Royal Mail and for POL. We see both of them as a public service and we see them together. We are not afraid of change, we want to be in there shaping that change and influencing it so that the customers of that service and our members have decent jobs, terms and conditions and we believe that is achievable.

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Q151 Mr Bailey: Do you not think the logic of the comments you have just made actually points to full separation? If they go on to diversify and show an entrepreneurial spirit, would you not agree that that might be better done under full separation?

Mr Ward: Certainly not. Why do you come to the point that to diversify you have to separate? What barriers exist which stop you being dynamic about the future of the company? Let me be clear. On Post Office Limited we are saying two things which we understand the Government support in principle. One is the development of a people's bank and the other is that POL becomes the shop front for government services and a more coordinated policy across Government. Why does that mean you cannot do that under public ownership? That is just a dogmatic view that you have there and we believe these things can be achieved with the companies together.

Q152 Mr Bailey: With respect, it is not. You may have heard the questions I asked earlier. There may come a situation where it is in the interests of Post Office Limited to offer services to potential competitors to Royal Mail, so there is a potential conflict there.

Mr Ward: Our view on that is that it is something which needs to be debated in the future. That does not mean you have to separate. In a way that is another access debate that may need to happen around cost transparency and things like that. It does not require separation to deal with that issue.

Mr Hayes: It is a bit of a pay point debate as well, is it not, the idea that you open up because you are in competition? The logic of your position presumably is that there would be lots of other postal administrations setting up post office counters. I do not see it.

Q153 Mr Bailey: I quite understand that you oppose the so-called privatisation of Royal Mail, but would you not agree that there is a likelihood under the existing proposals that if there is not full separation the public subsidies, which may well get larger for Post Office Limited, will end up subsidising the privately owned Royal Mail?

Mr Hayes: That is a very good argument for not privatising the company.

Q154 Mr Bailey: I understand that point but if it happens, we are talking about if this happens, is the logic then not that you actually separate them?

Mr Hayes: The problem is we are going into uncharted territories here. It is almost like we are going on a journey. We have not been told how much booty we have in the cabin, we have not been told the direction we are going in, we have been told the waters are very choppy. The lack of information in the report in terms of financial transparency and in terms of how you would do it is a bit telling, to be honest. When you say—and Richard talked earlier on about Post Office Limited—Post Office Limited should remain wholly in the public sector and Royal Mail should be in the private sector, we are not sure of the percentage. It could be up to 49%—

Q155 Mr Bailey: I am not saying that.

Mr Hayes: No, Mr Hooper is saying it in this report. You cannot just make assertions. You have to give supporting evidence and you have to paint scenarios. It is a bit strange to say we are going in this direction; we are not quite sure what it looks like but this general direction. I think you are touching on the problems in the report really. No-one has thought it through. Maybe Peter and Pat are sitting there now getting a map out and looking at the direction and all the rest of it but you are right in the sense that there are problems with what is being suggested.

Q156 Mr Bailey: Notwithstanding the issue of transparency and robust information about the cost of the services supplied by both, which obviously need to inform any future decisions, would you oppose separation, if both theoretically remained in public ownership?

Mr Hayes: Yes, we opposed separation in our submission and we would oppose separation. If I may say so, I think what is behind your point is that if the Royal Mail goes into the private sector—if I have got this wrong please tell me—once you go into a joint venture the logic of the position is that Post Office Counters has to be freestanding because of the state subsidy. I think that is your position.

Q157 Mr Bailey: Yes; ending up with a public subsidy of a private company.

Mr Hayes: I understood that was behind your question but I think all that shows up is the poor thinking in terms of what is in the report.

Q158 Mr Bailey: Do you not think there is an argument, even if they both remained in the public sector, for having separation?

Mr Hayes: Absolutely not. If you go to most post office counters, an awful lot of them, not just the Crown post offices but the small sub-post offices, particularly in the rural areas, you will often find what is called a small SPDSO in the jargon; a small sub-post office with two or three postwomen or men working out at the back. There is a synergy in organisational terms and also we were talking earlier on about the problems of people picking up mail and a post office counter is the logical place. No, we do not support the idea of separation but the points you have raised are very good arguments as to why Lord Mandelson should think again.

Q159 Mr Hoyle: The more cynical would suggest that the Government got a bloody nose when it came to tamper with the post offices. The post offices quite rightly have a great love affair with the public out there. They believe in the post office. Mr Hooper did not touch on it and I do not know but I believe the Government said "Whatever you do don't touch the post office. We're still wiping the blood from our face. Keep away from that" so the way is just to tackle Royal Mail. My issue is that they are both integral; you cannot separate the two. Not only is there a cross-working relationship, but there is a

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cross-subsidy between each part of the business to make them exist, so they have to be kept in their entirety. Is that a fair assessment?

Mr Hayes: It is a fair assessment.

Q160 Lembit Öpik: Back where we began this morning. We were talking about separating the costings for each service and without that we established this morning that the access headroom prices are guesswork. Do you believe that we can separate those costings in an objective way?

Mr Hayes: I am not an accountant but I think we can do some work on it. The first thing to do is look at the access headroom price because it is a guestimates and it is bleeding the finances of the company. There are more postwomen and postmen who deliver the so-called final mile than there were two or three years ago. A lot of that is because of

access products. What a lot of people who work in the industry, primarily our members, do not understand is why all the nice juicy bits upstream go to private companies and the final mile is delivered by a postwoman or a postman. They do not quite get that. Incidentally, in terms of the great British public, Royal Mail delivers election manifestos and I do not think our people are going to be very happy if they see their company broken up in the run-up to any general election. It will go down really, really badly. The union are portrayed as the bad boys but what I know is that Royal Mail and postal workers are very popular with the public and I do not think what is being suggested by Richard Hooper and his team is popular.

Chairman: We could go on for a lot longer; we have gone on far too long already. Billy and colleagues, I hope you feel you have had a good innings. Thank you very much indeed for your contribution.

Tuesday 24 February 2009

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
 Roger Berry
 Mr Michael Clapham
 Mr Lindsay Hoyle

Anne Moffat
 Mr Mark Oaten
 Mr Anthony Wright

Witnesses: **Mr Nigel Stapleton**, Chairman, and **Mr Tim Brown**, Chief Executive, Postcomm, gave evidence.

Q161 Chairman: Gentlemen, welcome to this session which is to examine the Hooper review and the recommendations that flow from it. It is a review which in theory brings to an end your own organisation, if what we hear about legislation is true. The House of Lords is to have such legislation before it later this week. Perhaps I may begin as I always do by asking you to introduce yourselves for the record.

Mr Stapleton: I am Nigel Stapleton and I have been chairman of Postcomm since January 2004.

Mr Brown: I am Tim Brown and have been chief executive since September of last year.

Q162 Chairman: Do you believe it is fair to make the general observation that your organisation has given primacy to competition in its statutory remit rather than protect the universal service obligation?

Mr Stapleton: I think that statement is entirely unfair in the sense we are very conscious of the fact that our primary statutory duty is to maintain the USO. We can put forward some pretty convincing evidence that competition has strengthened the USO rather than weakened it.

Q163 Chairman: Would you like to share some of that evidence with us? This Committee was concerned about what it saw as a premature rush to competition well ahead of any European requirement. That concerned us in the report we prepared three years ago.

Mr Stapleton: Clearly, the numbers show that the USO made a loss last year of £100 million. There was an equal profit from the rest of the mail business, so overall the letters business was profitable. Royal Mail's own figures indicate that it lost £100 million of profit to mail competition and five times that amount to digital competition. Our figures suggest that the amount of profit left on the table from the delay in the modernisation of the Royal Mail is also five times that £100 million. I think it shows clearly that competition is a pretty small factor in terms of what has led the USO into loss.

Q164 Chairman: But the European Commission's own directive, had you followed it, recognised the need to allow the USO operator to adapt to change. There have been decades of under-investment in post offices. It used to be an all-mail group which was ill-placed to cope with the competitive environment into which you thrust it prematurely.

Mr Stapleton: Royal Mail's own chairman said in 2006 when we fully opened the market to competition that it was ready to face competition.

Q165 Chairman: To put a more factual question, do you think from your experience as chairman and chief executive of the organisation that the regulatory framework gives you the powers you need? When legislation comes through the House very soon should we be looking for new and different powers for Ofcom when it takes on your responsibilities?

Mr Stapleton: I think the Hooper report indicates that Postcomm lacks what he calls an essential part of a regulator's toolkit, namely concurrency under the Competition Act. We also lack specific powers to deal with access. We hope that both those weaknesses in the legislation under which we are working will be addressed in the new Bill.

Q166 Chairman: You still have regulatory responsibility and you see them as weaknesses now in the toolkit available to you?

Mr Stapleton: We have made that point over the past four or five years; it is not a new issue.

Q167 Chairman: Do you accept the case for your abolition? Would you have done a better job had you had those powers?

Mr Stapleton: I do not think you would expect me to say anything different, but we believe that Postcomm has done a pretty good job in the circumstances. I will ask my colleague to pick up that point. He has been with us for a relatively short period of time and may be more objective in his answer than I might be.

Mr Brown: Over the past seven or eight years there have been quite a few improvements in terms of Royal Mail's quality of service. When we started out with regulation Royal Mail's quality was below 90%. In the four years before the strike action it was at 94%. We see a reduction by one third in the number of exceptions; that is, individual addresses that do not receive the same specification as everybody else have been reduced by a third. The number of losses has reduced. Royal Mail has delivered quite a lot of improvements in terms of quality of service over the period. We have also seen pressure on price. Independent research quoted in the Hooper report shows that the price is probably about 5% lower for larger customers than it would

otherwise be. It is important that large customers see the relevance of that because it is they who underpin the universal service. There has also been an extension of choice for smaller businesses. For example, from 1 April of next year we will see metered mail, of which big use is made by smaller businesses and is at a discount to standard tariff mail.

Q168 Chairman: We are all customers of Royal Mail Group. For me, the service has collapsed. My post came regularly at around breakfast time whereas now it comes at any time in the middle of the day. Small business people working from home just cannot rely on the post any more. To the average constituent the idea that the quality of service has improved is laughable.

Mr Stapleton: One needs to be clear as to what is in the universal service and therefore what we are duty bound to protect.

Q169 Chairman: Let me bank that question and allow others to ask about the universal service obligation. My colleagues who want to ask about USO may feel that I am treading on their territory. I want to ask about resourcing the regulator. You are resourced by the taxpayer; Ofcom is resourced by a levy on the people it regulates. How do you think the new regulator should be resourced in respect of mail services?

Mr Stapleton: The regulator comprises a little over 60 people and the budget is less than £10 million. Had we continued that would have reduced by 15% next year. Therefore, it is a relatively small levy on Royal Mail as the dominant operator and that sort of approach has worked pretty well.

Q170 Chairman: What do you think about Ofcom taking on your responsibilities? There are competing logics. You could be seen as a utility operator who should be regulating alongside the water companies and electricity networks—the Royal Mail is a network business—or you could say that you are a communications business and it is right to put you alongside telecommunications and broadcasting. Do you see the logic in the communications link?

Mr Stapleton: The important thing for us is market certainty. If there is to be a change of regulatory responsibility that should be done in a way that minimises market uncertainty. Our own submission to Hooper was that it would be better if a new regulatory framework were to be put in place when the price controls ends in April 2010 and then there was a change.

That is the reason why to the extent we can we are working with Ofcom to achieve a smooth transition, but there are limits to it. Clearly, it can act only within its *vires*. It is important that sector-specific experience is maintained within the Ofcom organisation, because practically everybody who responded to Hooper, including the CWU, has said that post is different from a capital-intensive telecommunications business. Therefore, the regulatory principles need to reflect the different characteristics of the mail market.

Q171 Chairman: It is always difficult to say goodbye to an organisation that you have cared for and cherished for a number of years, but you have no objection in principle to Ofcom becoming the regulator?

Mr Stapleton: I do not think it is for us to object one way or the other. We were created by Parliament.

Q172 Chairman: But your experience is very important. The Committee wants to see regulation of the mail market and it needs to know whether you think it will be effective under Ofcom.

Mr Stapleton: Clearly, Ofcom has a very good track record. The read-across to the communications sector is an important issue. That is an issue of which from my perspective I believe I already have experience, because I came into this role having been co-chairman of Reed Elsevier and having spent a lot of my career in the communications world. As long as the sector-specific experience is maintained and the transition is done in a way that minimises market uncertainty we are supportive of the move.

Q173 Mr Oaten: Putting it bluntly, are you saying that Ofcom does so many things that postal issues will get lost within it as regulator?

Mr Stapleton: I was not saying that but Ofcom must be careful to ensure that is something that does not happen.

Q174 Mr Hoyle: Mr Brown, you talked about the successes. You referred to big customers by which I presume you mean bulk deliveries.

Mr Brown: Large customers, yes.

Q175 Mr Hoyle: How can you judge it to be a huge success when the bulk customers get it cheaper than everybody else? I thought the idea was that we would all be treated equally, but somehow you give a preference to bulk customers who are subsidised by the taxpayer.

Mr Brown: That raises a number of points. It is important to understand the nature of the customer mix within the mail market. Eighty-seven per cent of all mail is sent by businesses; only 10% is sent by residential customers and that is mainly at Christmas. Within that make-up the top 50 customers represent 40% of mail; the top 500 represent 50%, so it is important in terms of how those large customers perceive mail as a useful medium for what they do so they continue to use it and therefore fund the universal service. Without those bigger customers there would be no universal service and no six-days-a-week delivery. Therefore, what we have seen is increasing choice and lower prices such that those larger customers continue to use mail.

Q176 Mr Hoyle: That does not add up, does it? What you are saying is that under the access agreement you must have a USO that delivers for your competitors at a loss. Does that make sense?

Mr Stapleton: Access does not involve Royal Mail making a loss on delivering the mail over the final mile. If you look at the detailed figures Royal Mail

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is making a loss on bulk mail products that it delivers end to end. If it makes a loss on that as well then it is not surprising it will also make a loss in carrying it over the last mile for its customers.

Q177 Mr Hoyle: You are saying to the Committee that it is a fact Royal Mail does not lose money under the access agreement. That is the first time the Committee has ever been told that. Everybody has stated to us that the problem is that the access agreement is so low that you cannot make money on it, and yet you are telling me that Royal Mail has been making money. Do you want seriously to consider your position on that?

Mr Stapleton: I said that access carried bulk mail. Because the bulk mail market is a very competitive one it is the bulk mailers who have most of the choice in terms of using digital communications. Royal Mail loses money on end-to-end bulk mail and also on access, so you cannot carve out access and say that it is unprofitable when the rest of the product range is unprofitable.

Q178 Mr Hoyle: I will make it simple for both of us and say it slowly. Is Royal Mail making or losing money on delivering access mail at 13p?

Mr Stapleton: It is fully covering its variable costs.

Q179 Mr Hoyle: So, you are saying it is making money?

Mr Stapleton: On that measure. I am an accountant by training and therefore I can give you four measures of cost, but I am saying to you very clearly that access is not Royal Mail subsidising the competition.

Q180 Mr Hoyle: You can go round it all day. Can we try yes or no? Is Royal Mail making money out of access delivery?

Mr Stapleton: Yes, it is covering its costs.

Q181 Mr Hoyle: So, everything that we have been told is wrong? You tell us what a good job you have done and how excellent you have been. Why is the government getting rid of you? They think that you have done a poor job. I do not know of anybody apart from yourselves who say that you have done a good job.

Mr Stapleton: In that case I do not think you have read the Hooper report very clearly.

Q182 Mr Hoyle: The government say that you have to go and Ofcom should take over because you have been a disaster. What is your answer to that?

Mr Stapleton: I have not heard the government say that.

Q183 Mr Hoyle: Do you think it is not keeping you because you have done such a good job?

Mr Stapleton: It is not keeping us for the very tangible reason that the Hooper report has made perfectly clear that mail is competing within a wider communications market. That is the key reason why there is logic in changing the regulatory responsibility.

Mr Hoyle: Everybody knows that you have been a disaster; you have been a problem to Royal Mail, and that is why the government is getting rid of you and moving to Ofcom. Let us hope that it is more successful than you.

Q184 Mr Clapham: To clarify that point, is it not a fact that when the access price is combined with the headroom obligation it creates a situation where your competitors in effect are guaranteed gross margin?

Mr Stapleton: No, it is not in the sense there is a margin within which the competition can compete with each other. Nobody will move their business away from Royal Mail unless they get a price and service advantage in so doing. There is a margin within which the competitors can compete. Because access competition has probably kept bulk mail prices down by 5% it has caused Royal Mail to carry more volume over the final mile. It carries 99.5% of all mail volumes over the final mile, so it has added to the health of the mail market, but it most definitely has not left the access operators with a guaranteed margin; it has left them with a margin on which they can compete against each other. It offers a lower price and better service to bulk mailers and increasingly to small and medium size businesses because it is now dealing with mail comprising as little as 250 items a week.

Q185 Mr Clapham: That is rather different from some of the information we have. None of your competitors in Europe or America uses the headroom concept. Why is it that it is only in the UK that the headroom concept is used?

Mr Stapleton: I will ask my colleague to explain that to you, but I must make the point that access to the last mile is not something unique to the UK postal market. The US Postal Service does not call it competition but work share because it sees it as a way to keep down the cost of mail and therefore keeping up the volume of mail handled by that service. Seventy per cent of mail in the United States is handled by another party upstream. Therefore, to suggest that with access we have done something that no other mail operator has done is absolutely wrong. My colleague can give a full answer to the question.

Mr Brown: The reason why we have introduced headroom is because Royal Mail remains dominant in the marketplace. It still has 99.5% of all deliveries. In terms of the contracts it has with customers it still handles about 75% of all bulk and access mail.

Q186 Mr Hoyle: Can you repeat that figure?

Mr Brown: Ninety-nine per cent of all addressed mail is delivered by Royal Mail.

Q187 Mr Hoyle: That includes access?

Mr Brown: Yes. Therefore, it is still a dominant player in those marketplaces. The introduction of the headroom was to prevent the potential of Royal Mail margin-squeezing its competitors, playing with both the access price and the price it charged its customers to squeeze out legitimate competition.

Q188 Mr Clapham: But has it gone too far and given your competitors an advantage?

Mr Brown: The competitors can compete only if their costs are lower than those in the headroom. As my colleague said earlier, generally they compete at a price much lower than that headroom.

Q189 Mr Clapham: One matter that causes me some concern when I look at the issue of competition is that the UK postal market is the only one to have this access regime; none of the others has the same regime. It seems to me that that access regime is one of the main obstacles.

Mr Stapleton: I have just said that the access regime is considerably more extensively applied in the United States. Every postal operator in Europe gives what it calls pre-sort discounts, ie discounts to prepare the mail and take it closer to the point of final delivery.

Q190 Chairman: I am conscious that we are already behind time. This is an interesting and important point. Can you provide a note on the comparative regimes because I was certainly not aware of this?

Mr Stapleton: The other point that needs to be made is that we acknowledged back in August 2007 when we did a strategy review as a precursor to the post-2010 price control that access headroom was a blunt instrument. Had the Hooper report not delayed the follow-through of our strategy review we would at this point in time have already been six months into consultation about an alternative to the access regime. We acknowledged its limitations and started as long ago as August 2007 to put a new system in place, and in the past two years we have also undertaken a very thorough review of Royal Mail's numbers to make sure that the access headroom is fair in terms of its amount. We have not just been sitting on our hands and saying we have got it right; we have been preparing the ground for a new system based on cost transparency and equivalence.

Q191 Mr Clapham: Referring to the USO, Postcomm set the definition which is very wide. What is the rationale for the wide definition of the USO?

Mr Brown: The six-day-a-week USO is defined in the Postal Services Act, not by us. The uniform price and the six-day-a-week service is defined there and that is the universal service we seek to operate and sustain. It is Parliament that can change the six-day-a-week service rather than us.

Q192 Chairman: As a matter of fact that is not true. The Postal Services Act says "every working day" and the legal obligation is five days. I happen to think it is right that there should be a six-day obligation.

Mr Stapleton: The directive says five days; the Postal Services Act refers to six days.

Q193 Chairman: Section 4(1)(i) of the Postal Services Act says "at least one delivery of relevant postal packets is made every working day".

Mr Brown: If you look at the definition of "working day", it says six days for letters and five days for all parcels, so the two together give us the six days. The work that we do looks at what products are classified as being within the universal service and which product fall outside it. That is done in conjunction with discussions with Royal Mail. Royal Mail makes applications from time to time to take certain products out. We review those as part of our price control, so that is where we influence what products are inside and what are outside. The products inside the universal service must be provided at a uniform price nationally. As to those products outside the USO, whilst they can still be subject to price control Royal Mail can seek to do zonal pricing or deal with it in other ways.

Q194 Mr Clapham: If went from Postcomm to Ofcom is this something that you would seek to draw to its attention with a view to reviewing the situation?

Mr Brown: I think it is Ofcom and the new legislation that will decide upon and define more clearly what the USO may look like going forward. We have been fairly clear in terms of our submissions to Hooper that we do not see any need at this point to change the definition of universal service.

Q195 Mr Clapham: So, you are quite satisfied with the USO as it stands?

Mr Brown: In terms of the six days, yes.

Q196 Mr Clapham: When you are looking at prices what is the rationale for requiring you to consult on any changes? For example, do you find that that gives an advantage to your competitors?

Mr Brown: Before we take any decision we always consult. As a regulator we have to take on board evidence and we normally consult for up to three months, so we go through a consultation process. We did that before the price controls were put in place, so there was extensive consultation on it. That sets overall price controls on Royal Mail. Within that Royal Mail has the ability to set individual prices. It has a requirement to publicise those prices three months in advance of implementation. There are some practical issues around that. People like Pitney Bowes and Neopost need a period of time to change meters and software, so it cannot happen overnight.

Q197 Mr Clapham: It is these factors that make the process take such a long time?

Mr Brown: Royal Mail announced its new prices for April in December. They come into operation at the beginning of April.

Mr Stapleton: The reason why people need quite a lot of notice is that obviously a large part of the market is accounted for by postal franking machines or software-type mechanised mailing. Therefore, changing the chips on the franking machines and so on requires notice. It is not done to help the competition but first and foremost to help the customer.

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Q198 Mr Hoyle: You said that 99% of all addressed mail was delivered by Royal Mail, but it is bound to be, is it not? The universal service obligation is only on Royal Mail, not its competitors. The reason its competitors do not deliver mail is that you make Royal Mail deliver it so cheaply that they cannot compete, so why do you throw out a fact that is obvious?

Mr Brown: Royal Mail is paid for those deliveries.

Q199 Mr Hoyle: It is paid 13p?

Mr Brown: On average it is 13p.

Q200 Mr Hoyle: How much do you pay?

Mr Brown: I pay 27p for second-class mail.

Q201 Mr Hoyle: Therefore, we are subsidising bulk mail?

Mr Brown: For example, a large direct customer like Royal Bank of Scotland would not be paying Royal Mail 27p and 36p; it would pay at a mailsort price. Therefore, those large customers already receive a discount against the price. The principle is fairly well used in other postal industries. Where a customer accounts for more of Royal Mail's work Royal Mail offers a discount.

Q202 Mr Hoyle: I understand all that, but is it not fair to say that the competitors do not have the universal service obligation imposed on them because of the cost of doing so?

Mr Brown: Royal Mail is at the heart of the USO and they pay for that delivery.

Q203 Mr Hoyle: If you want competition what you should say is that anybody who wants to compete with Royal Mail should also deliver everyone's mail. The reason you have not done it is because it would be too costly to do and, therefore, you have imposed on Royal Mail the obligation to deliver everybody else's mail and that is why it delivers 99% of mail, surely.

Mr Brown: And it delivers that at a price that Royal Mail negotiates and charges its customers.

Q204 Mr Hoyle: But it does not pick its own price; you do it?

Mr Brown: No, we do not.

Q205 Mr Hoyle: Who picked the 13p?

Mr Brown: The access price was the price negotiated between Royal Mail and its access customers.

Q206 Mr Hoyle: Can Royal Mail increase it?

Mr Brown: It can increase its price of access, yes.

Mr Hoyle: How? The minister said that it could not and he would have to look at the access agreement.

Q207 Chairman: You said it was negotiated, but am I right in saying that if those negotiations did not result in an agreement you would impose the price of 11p? Was that not the position of Postcomm?

Mr Stapleton: No. Back in April 2003 Postcomm opened up the bulk mail market—over 4,000 items—to competition. Based on that a couple of

operators, UK Mail and TNT, wanted to get into the access market. Royal Mail at that stage talked about charging them very high prices and, therefore, UK Mail came to us and asked us to do a determination of the price. We worked on that and at five minutes to midnight before the determination was finalised Royal Mail reached a freely negotiated agreement with UK Mail. It was not in any way identical to what our own determination would have been.

Q208 Mr Hoyle: You asked Royal Mail to play Russian roulette with a bullet in every chamber?

Mr Stapleton: Not at all.

Q209 Mr Hoyle: Of course you did. What you said was that if it did not negotiate you would tell it what the price would be, so it would have been less?

Mr Stapleton: In terms of a competitive marketplace that is not unreasonable.

Q210 Mr Hoyle: Do you agree that in a competitive market everything should be equal?

Mr Stapleton: I think the point you have missed is that it is the massive volumes of bulk mail that provide Royal Mail with the economies of scale and mean we can have a universal service with a 27p second-class stamp. If it were not for those economies of scale that bulk mail brought to the market we would not see the universal service being as close to self-financing as it is. The real challenge is that as those bulk mailers move to the internet Royal Mail is losing those economies of scale.

Mr Hoyle: I think you have answered the question. You said "close to self-financing", whereas before you told us that it was self-financed. CWU and the RMG claim that effectively they have been required to subsidise their competitors.

Chairman: I think you asked that question earlier.

Q211 Mr Hoyle: But CWU and RMG have also stated it. You still say that both of them are wrong?

Mr Stapleton: I made the point that Royal Mail is losing money on bulk mail that it delivers end to end. It would be hardly surprising, therefore, that on a fully allocated cost basis it would also be losing money on access because that is a piece of the end-to-end business.

Mr Hoyle: I rest my case.

Q212 Chairman: I really do not understand your evidence. Perhaps I am being very stupid. It may be there are different accounting definitions for what constitute profit and what does not, but my understanding of what you have told the Committee is that Royal Mail makes money and does not make money on it.

Mr Stapleton: It is very clear. The evidence is in Royal Mail's regulatory accounts. There are two definitions of cost. There is a definition based on fully allocated costs with all the overheads thrown in and there is a definition based on marginal or variable costs. All the mail that Royal Mail handles obviously covers the variable costs. Both bulk mail and access on Royal Mail's figures lose money on a fully allocated cost basis. That is the clear position.

Q213 Chairman: If it is truly profitable for a company it should make money on both measures, should it not?

Mr Stapleton: Yes, but at this point the choice that bulk mailers have to use electronic communication puts some constraint on that ability.

Q214 Chairman: What you are saying is that it makes no contribution to the bigger overheads of the company?

Mr Stapleton: I did not say that it made no contribution; I said that it did not totally cover those costs.

Q215 Chairman: It does not meet the full costs to the company of providing the service?

Mr Stapleton: No, and that is hardly surprising given the inefficiencies.

Q216 Chairman: You referred to what powers you did not have that you would like to have. You mentioned powers to do with access. What powers do you think you should have had to deal with access?

Mr Stapleton: The powers we would be talking about are not just what I said in terms of concurrency under the Competition Act but also powers in terms of cost transparency and accounting separation.

Q217 Mr Wright: Continuing the line of questioning about costs, what is your current assessment of the costs of the universal service obligation?

Mr Brown: Royal Mail has quoted that those products that come within the universal service we talked about earlier in answer to Mr Clapham made a loss of £100 million in 2007–08, but those products that are classified as being outside the USO but still use the network, for example things like special delivery on account, make a profit. It is our view that we look at the whole entity of Royal Mail Letters and at profitability. At the moment on Royal Mail's numbers it approximately breaks even on that basis.

Q218 Mr Wright: There is a huge disparity between what you are telling us and what Royal Mail Group suggest. RMG says quite clearly that the cost is £3.4 billion. Quite a number of zeroes are added to that figure.

Mr Brown: I think it takes us back to some of the discussions we had about costing and such like. The cost without the associated revenue is £3.4 billion. The net cost if you add back the revenue Royal Mail earns for the universal service products is the number we have given, so it is the difference between pure cost and the earned revenue for those products.

Q219 Mr Wright: But this figure must be consolidated. The Hooper review came to the view that there was a distinct lack of agreement between Royal Mail and Postcomm on even the most basic statistics. Surely, it is something that should have been sorted out a long time ago?

Mr Brown: Over the years we have worked with Royal Mail on its costings. Royal Mail's costing systems have improved. When we do the price control every three or four years we look at the financial strength of Royal Mail as a licensed entity in terms of letters, not at the individual product level. The result of the lack of cost transparency and information means that when we have conducted specific investigations and reviews we have done quite extensive and time-consuming analyses of that data. Therefore, the need for cost transparency is about speeding up the decision-making process.

Q220 Mr Wright: You suggest quite clearly that it is self-financed. Royal Mail Group wanted to be self-financed but you suggest that it is already there as far as concerns the USO.

Mr Brown: The Royal Mail Letters business and therefore all the products use the infrastructure and we take the view that we should look at the profits of all of them.

Q221 Mr Wright: So, you do not consider there is a case to answer that there should be financial support for the universal service obligation?

Mr Brown: We do not believe that that is necessary at this moment. We believe that the modernisation programme Royal Mail is undertaking and the improvement in its efficiency should fund the profitability of Royal Mail Letters.

Mr Stapleton: My colleague has already indicated—Mr Hoyle picked up the point—that Royal Mail carried 99.5% of mail over the final mile. There are three postal operators in Europe that have already lost over 10% of their mail volumes over the final mile to competitors: Holland, Germany and Sweden. All of those countries have self-sustaining universal service with no government support whatsoever, the reason being that those are mail businesses that are modernised and are highly efficient. The only threat to a self-financing universal service is lack of modernisation and the pension deficit, because none of those three services has a pension deficit of the magnitude that Royal Mail faces. Those are the differences. You do not need to take our views. What has happened already in terms of the introduction of mail competition elsewhere shows that you can have substantial end-to-end competition and a self-financing universal service, but you must have modernisation and you cannot carry the enormous burden of a pension deficit.

Q222 Mr Wright: I think the modernisation programme and pension deficit are huge problems, but as a lay person in terms of the universal service obligation I cannot accept that there is not a loss in providing that facility at the price of 27p for a second-class stamp to send a letter across the country. There must be an element of loss. I cannot figure out how you can come to the conclusion that it is self-financing.

Mr Stapleton: The reason why there is not a loss is that the volumes handled by Royal Mail are enormous and the economies of scale more than make up for the inefficiencies. If you do a rural

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round, as I try to do pretty frequently, there is probably one stamped item in a postal delivery of five or six items to each house. It is the fact that the universal service is carried by the economies of scale and the 89% of Royal Mail's revenue comes from business mail. Our major concern is about the mail that is moving over to digital alternatives, for example banks sending electronic statements and asking you to use the internet. If that goes and Royal Mail does not modernise the only alternative will be either a reduced specification of the universal service or government subsidies like those being given to the Post Office network. I do not think that either of those is an option acceptable to government.

Q223 Mr Wright: If one takes the view that it is making a loss then it is far better to accept that and for some negotiations between yourselves and Royal Mail Group, for instance, to come to that conclusion. You cannot have a situation where you say post-Postcomm that it is self-financing and then Royal Mail Groups says that it is £3.4 billion. There is a huge disparity there. I just think that in terms of the universal service obligation there is a form of subsidy in existence.

Mr Stapleton: There is total agreement that the Royal Mail Letters business last year made a profit of £3 million. As my colleague said, that was net of the loss on the universal service and the profit on the non-universal service, but there were some big items that we as regulator took out of the USO such as special delivery for businesses which transferred a profit of £40 million from one side to the other. You should look at the total picture. But our concern is that mail volumes are falling at an accelerated rate. Usually mail volumes lag GNP at least two quarters, so we have not yet seen the effects of recession. The volume is going down by 3% this year. On Royal Mail's figures it will go down by 7% next year. Price increases are not making up for that volume decline and yet costs are still going up by about 4%. Unless the cost line is attacked, what looks today like a profit for the total mail business will be a big loss in the years ahead.

Q224 Mr Oaten: How quickly do you think the loss will arise?

Mr Stapleton: If Royal Mail is talking about a 7% volume decline for next year, which is obviously a reflection of the general state of the economy and the move to digital, clearly it faces an enormous challenge in terms of changing the direction in which its costs are moving if it is to avoid moving into loss next year, even before one takes into account the distinct possibility that if the pension deficit is not removed the £280 million that is now being contributed towards funding it may be two to three times as big next year.

Q225 Roger Berry: Obviously, we did not need Hooper to tell us there was an issue about modernisation and the pensions deficit. This Committee has talked about it for years and years as have management and the trade unions. The distinct point about Hooper is the proposal for a strategic

partner, minority shareholder or partial privatisation, call it what you will. The reasons that have been given in support of that proposition boil down to two or three basic ones. The first is about the need for external expertise and new management and leadership. Why is it that external leadership, management and expertise is necessary? Why has not the existing management been able to do the job properly?

Mr Stapleton: The only point I make is that that is one of three reasons Hooper came up with and I do not see it as necessarily the strongest.

Roger Berry: I was planning to take them one at a time.

Q226 Chairman: You would not necessarily see it as the strongest reason?

Mr Stapleton: Of the three.

Q227 Roger Berry: How strong is it? You have been the regulator. Is this a criticism of existing management? Are they not up to the job? Do we need to get people from outside?

Mr Brown: Management operate within the constraints they have been given. I think that the other reasons in terms of introducing access to third parties and such like enable it to get out of those constraints. If operates under a big constraint in terms of the pension deficit. When you look at many of the incumbents in other countries those pension problems have been removed and therefore they are not subject to it. There has also been greater separation between the company and government.

Q228 Roger Berry: Management operates within constraints as we all do. I suspect that removal of the pension deficit will command almost universal support. For reasons we can go into—we do not have time—the government should pick up the pensions deficit, but in my view what is proposed by Hooper is the need for external expertise, management and leadership. Presumably, it means that Hooper and his colleagues believe that the present leadership is not up to the job. Why is it one of the three?

Mr Brown: What Hooper has asked for is expertise among those who have made a transformation and have done this sort of thing before. It is getting access to that knowledge and expertise to work with Royal Mail to make those changes.

Q229 Roger Berry: But you believed that people should be brought in to run Royal Mail. They were not people who had had expertise in the past in transforming and improving businesses. I seem to recall that that was the reason for changes at the top which I warmly welcomed.

Mr Brown: I do not speak for Richard Hooper but he makes fairly clear recommendations in terms of getting access to the expertise and knowledge of those who have done this in a network business. It is that specific expertise and access to knowledge and understanding for which Hooper calls.

Q230 Chairman: But you are allowed to disagree with Hooper; you do not have to endorse everything he says. It may be a package but you can disagree with bits and pieces of it. The question in my mind is: do we need someone with transformational expertise, a network company or a postal operator to be that strategic partner? Those are three different concepts.

Mr Brown: Our submission to Hooper was that we thought the primary point was access to network expertise and skills and experience of it.

Q231 Roger Berry: You do not believe that that can be brought in without a shareholding?

Mr Stapleton: Strategic shareholding brings a package of things.

Q232 Roger Berry: I want to turn to capital later, but on management you are saying basically that it is impossible to get new blood into the organisation, about which you apparently feel quite strongly, without private shareholding. You cannot buy in the expertise and employ consultants. I would have thought it was quite common practice in the private/public sector these days to buy in expertise that does not exist in the organisation. Are you saying that that cannot be done in this case?

Mr Stapleton: I do not think that you will draw us on the point about separating out management expertise from the division of political versus commercial considerations and access to funding. Those three come together.

Roger Berry: I have not mentioned politics yet, but let us turn to capital.

Q233 Mr Oaten: If I may intervene quickly, are you saying that a cultural change is needed which cannot be achieved by consultants coming in? You need a total change in the culture of the management?

Mr Stapleton: Correct. It is still a business which in terms of its culture goes back to the days of the 1990s; it is a very difficult culture to change. We are not critical of what the management team has achieved given the constraints under which it has been working.

Q234 Roger Berry: I think the culture today is different from when I first became a member of the Committee. I recognise that the leadership of the organisation 10 years ago was radically different and not as good as it is now, but the question is whether or not the existing management is up to the job. Clearly, you do not want to be tempted too much on that. As to the question of bringing in a private shareholder for additional finance, all the major private companies that I know these days are running in the opposite direction; they are going to government to ask for money to keep them afloat. Do you believe that getting money from a private sector organisation is cheaper now and a better deal than for government to fund it if it believes that investment is necessary?

Mr Stapleton: Mr Berry, you are aware that the £1.2 billion financing package that the government gave to Royal Mail back in 2007 is still being challenged

by the European Union in the context of state aid grants. The money that comes from the government has strings attached and clearly private sector financing is of greater flexibility in that sense.

Q235 Roger Berry: Are you saying that private companies would invest in Royal Mail without any strings attached? They have no agenda and will just give it some money and provide new management to do the job?

Mr Stapleton: Clearly, they will want to see the rewards of a successful modernisation and share with the government in the receipt of those rewards. Ofcom as regulator will make sure that with or without a strategic shareholder Royal Mail lives up to its obligations in terms of providing the universal service. I read an awful lot which says that Royal Mail needs to be 100% public owned in order to secure the universal service. It is regulation that will make sure that the universal service and competition are secured.

Q236 Roger Berry: With no disrespect, I did not ask that question. How much do you think the Royal Mail Group needs to modernise? If the responsibility for the pension deficit transfers to the government—there is a powerful argument for that—that releases £284 million a year. There is already £600 million in the pipeline. How much more is necessary?

Mr Stapleton: Royal Mail's own figures indicate that it is 40% less efficient than best in class. Hooper has a table which shows margins and comparators. In a business that is 70% labour costs you can work out, with costs of £6 billion, quite how big that number is.

Q237 Roger Berry: These comparators of efficiency are quite difficult, are they not? The cost of different businesses providing these services in Europe might depend, for example, on the amount of tax they pay. That will in turn influence their profitability. There is a whole range of difficulties in comparing one country with another. You are saying as regulator that you cannot give me any figure about how much more than £284 million a year and the £600 million in the pipeline is necessary to modernise which is what this is all about?

Mr Brown: Earlier my colleague talked about Royal Mail's forecast of volume reductions of about 6% or 7% going forward. A 7% reduction in volume could without action take £300 million straight off the bottom line of Royal Mail, so while a solution to the pension deficit will give a short-term boost to Royal Mail's profitability and cash flow in the long term with a decline at that level due to e-substitution and the recession Royal Mail's finances in the medium to long term are challenged. That does not save it in the longer term. As to how much money it needs to invest, the £1.2 billion loaned two or three years ago is part of a modernisation programme and plan that Royal Mail already has underway and is implementing, but going forward the changes in investment it will need to make—I know you will hear from Royal Mail after us—are larger than that

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and they have to continue. It is not a question of doing it and it is finished with; there must be continual investment.

Roger Berry: Mr Stapleton, you mentioned quite rightly the issue of European legislation, state aids, competition *et cetera*. Would not a strategic partner taking a shareholding in Royal Mail be anti-competitive?

Q238 Chairman: Particularly if that partner were to be TNT which is its major competitor?

Mr Stapleton: Clearly, that would be an issue for the regulator. If what I read in the papers is correct there are other parties with no presence in the UK at the present time like the Finnish, Swedish and Danish postal operators that are interested in the opportunity of a strategic shareholding. You are absolutely right that TNT is one of the two large access competitors in the UK and that would provide a competition issue that clearly would have to be addressed if they became a shareholder.

Q239 Roger Berry: Despite all the qualifications you have made about management, the cost of finance and the issue about competition you have no doubt that it is absolutely necessary for a private shareholding in Royal Mail?

Mr Stapleton: It is absolutely necessary to make significant changes to the direction in which the business has been moving over the past two to three years.

Q240 Anne Moffat: Have the British public as stakeholders been getting value for money from Royal Mail, you and everybody who has been involved in the process up to now?

Mr Brown: Every year we conduct independent research as to what consumers and residential customers think. Eighty-five per cent of all respondents say that they receive good or very good value for money and have overall satisfaction with Royal Mail services. The great British public still rates very highly the service that it gets from the Royal Mail.

Q241 Roger Berry: There are different answers from a whole variety of sources. According to the media today, the letter that went from Royal Mail Pensions Trustees Ltd to the secretary of state asserted it was absolutely essential to have a strategic partner, but if you read the letter, which in total covers one side of a sheet of A4 paper, it does not say that at all; it says that the pensions deficit needs to be addressed and recommends support for the Hooper report. Are you surprised that the letter from the pension trustees in making the case for something to be done to address the pension deficit does not explicitly support what you have been saying which is a minority shareholding in Royal Mail? It is for the media to explain how that story became slightly distorted in the coverage.

Mr Stapleton: That does not surprise me. I have not seen the letter as you clearly have. Jane Newell as chairman of the pension trustees has a very clear perspective in terms of protecting the interests of

pensioners. She is making the point that the deficit is likely to move to the sort of number that Royal Mail cannot afford to pay.

Q242 Roger Berry: But the trustees of the pension fund are not in a position to comment professionally on whether or not Royal Mail should have a private sector partner, are they?

Mr Stapleton: That is precisely the reason why I am not surprised it is not in the letter.

Roger Berry: It is interesting to note the difference between the media coverage and what we agree on.

Q243 Anne Moffat: I am still very confused by everything I am hearing. If management cannot do its job and asks for consultants to be brought in to do it is the management any good in the first place? It seems to me that it keeps throwing good money after bad. If the money had been spent more wisely it might not be in the position it is in today. To say that the whole problem is to give the most profitable of the mail service to a private concern and leave the rest of it in the wilderness is ridiculous even to contemplate. How do you feel about that?

Mr Stapleton: It is not my understanding that the government plan is to give the strategic investor a share of, in your words, the most profitable parts of Royal Mail.

Q244 Anne Moffat: Did you not say earlier when talking about the internet and new technology that that is the way forward and that is where the profit will be? Do you agree that that is the case?

Mr Stapleton: What we have said very clearly is that the profitability of Royal Mail is under threat because both recession and structural changes in the market cause mail volumes to decline. That was not foreseen back in 2006. A comment was made that we got the market estimates wrong. Our market estimates like those of any regulator were based on Royal Mail's market estimates. Our estimates and those of Royal Mail for the actual volumes in 2010 are 100m items apart on 21 billion items. Everybody has failed to see the structural change in the market, but the strategic investor will have to cope with competition and the effects of transition to digital media. That investor is not being allowed to cherry-pick the attractive parts of Royal Mail; it will try to get a profitable business in supporting the USO in this changing world.

Q245 Chairman: Your recollection of the evidence about market volumes does not coincide with mine. I will have to check the record, but I believe the evidence we have received is quite to the contrary; it disagrees with you profoundly on the judgment you reach.

Mr Stapleton: There is a difference in estimates in terms of the encroachment of access competition, but on total market volumes we are 100,000 apart.

Chairman: I believe we have received evidence that total market volumes will go down contrary to your estimate, but I must check the record.

Q246 Mr Bailey: Before I deal with my specific area of interest, I just want to follow up some of the points made about a minority shareholder. You have a situation where the most politically contentious recommendation of Hooper is that there should be a minority shareholder. In analysing the Royal Mail's lack of efficiency—it says it is 40% less efficient—it mentions the network of mail centres and delivery offices, automation, working practices and pay. At the end of the day all of those are management issues. What I cannot get my head round is why a minority shareholder and partner can transform the management culture to deal with those issues when in effect you could bring in somebody else and just change management. I do not think that central point has been adequately answered by you in the responses so far. Can you explain what it will bring?

Mr Stapleton: First and foremost, it is an answer that needs to come from the shareholder rather than the regulator. The regulator does not manage the business; it looks after the interests of customers.

Q247 Mr Bailey: But what reasons do you give for being in favour of it?

Mr Stapleton: If you go back to our strategy review published in August 2007, then you saw practically the same headline on the BBC as it gave 15 months later to the Hooper report. The headline on our strategy review was “Royal Mail needs radical change”; the BBC headline on Hooper was “Royal Mail faces call to change”. Our strategy review did not talk about ownership being part of that change but about the pension deficit and modernisation. Clearly, that modernisation has not happened. I think that with the passage of time we need to look at bolder initiatives to make it happen. Having as a partner someone who has made those changes before and has a track record must be bolder than just more of the same which was what we were looking at in August 2007.

Q248 Mr Bailey: But you could just change management?

Mr Brown: We are fairly clear that because of the third element, greater separation between Royal Mail and politics and government and allowing management to take decisions with as little political interference as possible—we see much greater separation in places like the US—you cannot take each one in isolation. That is why it is a package of those three. It is not designed to solve one thing; it is a mix of those three things. That is why we think it is important as one of the measures to support Royal Mail.

Q249 Roger Berry: At this point the government with a minority shareholding in the majority of banks is having the devil's own job changing the leadership and management culture of those organisations. In this environment I find it extraordinary that you are saying to us it is self-evidently true that a minority private sector shareholding in Royal Mail will bring about the leadership transformation that is necessary. If it is so easy to do that in the Royal Mail with 30% please tell

the government how to do it in the banking industry because it is finding it very difficult to do it. I am astonished.

Mr Stapleton: With respect, the government has had only two months to do it and we do not suggest that a strategic investor will make much difference in its first two months.

Roger Berry: I doubt that it is only the timescale.

Q250 Mr Bailey: The other issue is the political relationship. Again, that could be changed without a minority shareholding.

Mr Stapleton: Essentially, that was tried when the Postal Service Act was created in terms of setting up Royal Mail as a plc with a commercial remit. It has not happened in terms of complete transparency with management being allowed to do what it thinks is the right thing for the business. One needs to look only at what happened over the protracted period when management felt that in order to transform the business it needed 20% employee ownership. It did not happen.

Q251 Mr Bailey: Is a 30% stakeholding going to make a difference? There are unanswered questions. Basically, I still do not believe that you have made the case. Perhaps I may turn to the demerger between Post Office Ltd and Royal Mail. Normally, when companies merge the reasons given are “natural synergies, potential outlets” and so on. You have acknowledged in your comments that there is a natural synergy between Post Office Ltd and Royal Mail, but at the same time you support the demerger of the two. Why?

Mr Brown: We are in favour of Post Office Ltd staying in public hands. Post Office Ltd has been a separate limited company for over 20 years. It has had its own board and managing director for that period of time. Currently, one third of its business is postal; the remaining amount is concerned with financial services, telephony and other things. To a decreasing extent, unfortunately, it is concerned with government and public sector business. There are important relationships between Royal Mail and Post Office Ltd. The latter is an access point for postal services, but we believe there are benefits in Post Office Ltd and Royal Mail concentrating on their own businesses which are different. Post Office Ltd is a retail business delivered through about 11,500 private businesses; it delivers information and financial services, whereas Royal Mail is a distribution company. We see the differences. We also make very clear in our recommendations two other things: first, it is important to have a long-term transparent contract between Royal Mail and Post Office Ltd; secondly, there is a need for greater cost transparency in the charges made between the two. The third aspect is the need for a commitment by both central and local government to continue to use postal services going forward. We believe that in the context of all those things demerger is the right thing for Post Office Ltd.

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Q252 Mr Bailey: Could you not envisage a situation where it was to the commercial advantage of Post Office Ltd to allow access to companies that might be in competition with Royal Mail such that it undermined the viability of Royal Mail?

Mr Brown: I think there are two parts to that question. We already see other networks being created for access to packet and parcel services. DHL already has deals with people like Staples and WH Smith; recently HDN, another packet and parcel carrier, has been doing a return service through PayPoint which, as you know, has 19,000 outlets. We already see other competitors beginning to extend themselves into the retail business and having retail outlets. At the moment Post Office Ltd is excluded from that debate and discussion and does not have that access. We know there are one or two other operators who would welcome the opportunity to use Post Office Ltd. As to the second part of the question—whether that would lead to undermining the Royal Mail and the USO—we do not believe that is the case. Royal Mail is looking at other access points for its services. The innovation of SmartStamp and the accessing of stamps online has been a huge success and is a great way forward. Royal Mail already uses other outlets such as Tesco, Sainsbury and such like for access to stamps. At Costco you can get a discount on stamps. Therefore, we already see greater use of other access channels and we wholeheartedly support it because anything that improves and eases access to postal services is good news. It really illustrates the point that there are two different strategies, one for Royal Mail in ensuring access to its services including postal services and the other for the future of Post Office Ltd.

Q253 Mr Bailey: Effectively, both acting independently could engage in wider competition that undermined each other?

Mr Brown: I do not think it is a question of them undermining each other. They need to develop to support and sustain what they are doing.

Mr Stapleton: In any situation where you demerge a business that is a major customer of the other—at this point about one third of Post Office Ltd's revenue comes from mail—obviously you put in place a long-term agreement that ensures continuity of that business and a structured relationship. The key point is that the sustainability of the Post Office network requires two things: first, more revenue coming into the Post Office network; second, a closer identity with local communities. It is our feeling that that demerger direction, particularly in the context of a strategic partner in the Royal Mail Letters business, would be a good thing for the Post Office, but it requires a proper long-term agreement to make sure that what you are concerned about does not happen.

Q254 Chairman: If you are promoting all of these alternative postal service access points to Royal Mail in the interests of the consumer, which is probably good thing, and also protecting the Post Office network what is the regulatory or ownership

issue as far as Post Office Ltd is concerned? How many flowers bloomed in Mao Tse-Tung's China? You are allowing in all this competition for access to mail services. Why do we need the Post Office network in the world that you envisage?

Mr Brown: First, 70% of the Post Office's business is not mail.

Q255 Chairman: So, it is not a mail issue and is nothing to do with the regulator?

Mr Brown: Our duties under the Postal Services Act are about access to postal services, so we are interested in how the consumer accesses postal services.

Q256 Chairman: Notwithstanding the different ways to access postal services you expect Post Office Counters to remain the major way in which consumers access those services?

Mr Brown: Absolutely; I did not mean to give any impression otherwise.

Q257 Mr Oaten: In terms of accountability for the whole system and the role of government, is this something in which government should be heavily involved to ensure there is a universal service, or should it be a light touch? What kinds of controls under the new regime do you believe government should have over placing controls and demands on the future regulator?

Mr Stapleton: One of the recommendations of Hooper with which we wholly agree—obviously, Postcomm produces an annual report but it is not discussed with this Select Committee—is that there should be more accountability to Parliament by the regulator.

Q258 Mr Oaten: More of this?

Mr Stapleton: Yes.

Q259 Mr Oaten: I bet you are glad that it will not be you in the future.

Mr Stapleton: Not entirely, no.

Q260 Mr Oaten: How much government involvement has there been? What kind of pressure or relationship has there been with various ministers in your role as regulator?

Mr Stapleton: There has been a substantial amount of change. In my five years there have been four different secretaries of state, starting with Patricia Hewitt. I think there has been a very significant attitude change by government in terms of respecting the independence of regulation. There has not been as much as we might have expected in terms of government looking at the interests not just of Royal Mail but also other operators and the impact on customer values.

Q261 Mr Oaten: Would you like to see greater involvement by government in ensuring the universal service in future?

Mr Stapleton: I think the balance we have talked about is quite right, but clearly the situation we are in today arises because government has not applied

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more pressure for Royal Mail to modernise. The interaction between the shareholder and the company is clearly an issue, but I do not believe that the interaction between the government and regulator is as big.

Q262 Mr Oaten: If Hooper were to be implemented and the changes we have talked about occurred you would want government to keep a very close watch and have a greater involvement to ensure that those changes were delivered?

Mr Stapleton: Government will be a significant majority shareholder and it is probably even more important if there is a strategic partner that it does the job you would expect of a majority shareholder.

Chairman: This has been a slightly longer session than we hoped. Mr Stapleton, this is probably the last time we will have you before us; in your case, Mr Brown, it is the first and last occasion. Although final farewells are always difficult to predict, I hope it is not a “Frank Sinatra” occasion. Gentlemen, thank you very much.

Witnesses: Mr Adam Crozier, Chief Executive, and Mr Alex Smith, Commercial Director, Letters Business, Royal Mail Group, gave evidence.

Q263 Chairman: Gentlemen, we welcome both of you. I had not realised that Mr Smith had been before us some three years ago. I apologise for not remembering. As always, I ask you to introduce yourselves so we know who you are.

Mr Crozier: I am Adam Crozier, group chief executive of the Royal Mail.

Mr Smith: I am Alex Smith, commercial director of the letters business.

Q264 Chairman: To put this session into context, sometimes this Committee has been critical of the lack of transparency about Royal Mail Group’s figures. Before we begin, can you give an update of where you think you stand commercially?

Mr Crozier: To try to keep it reasonably brief, clearly over the past six years we have made some real progress. Most people know that we turned a £1 million loss per day into a £1 million profit per day. We have gone from failing quality of service targets to meeting them. We have taken out of the business about £1.5 billion of gross cost. We are 50,000 people fewer than we were. We have pretty much the lowest stamp prices in Europe and are amongst the highest quality in Europe and all of that has taken place in a declining market which has been opened up to full competition. That has resulted from a genuine effort by all our people right across the country every day and that is a great testament of what they have done. But the simple truth is that it is hard to think of where we would have been if we had not achieved all that change. Even today the simple fact is that the business does not generate enough cash to fund the investments required to modernise the business and ensure the future of the USO. If you take the period 2008 to 2011, we shall have negative cash flows in the letters business of about £1.3 billion. Clearly, that is because we are trying to modernise the business at the same time, but that is quite an outflow of cash.

Q265 Chairman: That is a negative cash flow assuming the pension deficit is funded out of that?

Mr Crozier: Yes. We have huge challenges. The first is that we have rapidly declining letters volumes. Last year it was 2.5%; this year it will be 4.5%, and we predict it will be 8% next year. As a ready-reckoner, each per cent of volume decline costs us

about £70 million in revenue. As you think of volume declines that is the rough order of magnitude.

Q266 Chairman: An 8% decline in revenue equates to approximately £560 million which is about twice the contribution to the pension fund deficit?

Mr Crozier: That is correct. This is a worldwide issue. In Holland it is predicted to be 6% to 7% this year; in the States the prediction is 9%. This is not a UK phenomenon; pretty much every single country in the world is experiencing it. It is all about the change in the way people communicate with each other. In many ways it is also not just about postal competition. The USA is a monopoly marketplace and it still predicts a decline of 9% and that it will make a \$6 billion loss this year. Therefore, it is about the wider communications market. The second huge issue is a growing pension deficit which a number of Members mentioned earlier. You will know that we tackled our future pension provision last year, but our view is that when it is revalued this year—that is done by the trustees, not the company—it will show a deficit of the order of £8 billion to £9 billion. If you bear in mind that the deficit already costs about £280 million per annum over 17 years the simple truth is that alongside those volume declines we cannot afford to pay what might be up to double that cost. Equally, we cannot afford to pass on that cost to the customer because all that will do is exacerbate volume declines. The more uncompetitive we make ourselves versus other media the more we shall drive down volumes. Therefore, the two really big problems are connected at that point. I understand and respect everyone’s right to have a view on some of the things that are proposed. For us these are not ideological or philosophical issues but real problems that the company must face up to. You would rightly ask us the very simple question: what are we doing to find a way round these problems? First, we shall accelerate the modernisation and further improve the efficiency. At no point are we saying that we are the most efficient organisation, but clearly with 50,000 fewer people than we had we have made a lot of strides on that. We are also investing £2 billion in modernising the organisation. Second, we are building new revenue streams. The simple truth is that by 2012–13 parcels will account for 50% of our

revenue and 75% of our profit because mail volumes are declining and parcels volumes are increasing on the back of internet fulfilment and all sorts of other things. But in future given our strategic direction of travel we shall be a European parcels business that uses the resources it creates to help protect and nurture the USO. Frankly, the most important thing for everyone in this room is that the quality of the USO is protected. Third, we are trying to find a pensions solution. I have said that we cannot afford the cost, nor can we pass it on. The truth is that our competitors on price do not have this problem. La Poste had this taken care of two or three years ago; TNT, Deutsche Post and others had it taken care of as part of wider changes in structural and privatisation processes in the nineties. Therefore, we are competing on an apples and pears basis where we carry a cost that our competitors do not. Clearly, in the end if we modernise we want the benefits of it to go to the customer, not this huge and continuing drain on cash. That is why our submission to Hooper in summary was basically three things. First, we needed access to equity capital. It is important to say equity capital as opposed to more loans or debt; they are not the same things. Second, we need a pension solution. Third, we need to move to the communications regulator because the simple fact is that that reflects the reality of our marketplace. Those are the people against whom we are competing as we go forward in future.

Q267 Chairman: Thank you for that introduction. We shall ask you questions about regulation, your efficiency as an organisation, the issue of minority shareholder and finally the Post Office. I was amazed that the BBC made so much of the leaked letter from Royal Mail Pensions Trustees. Lord Mandelson sat in front of this Committee a few weeks ago and said that the deficit would be between £8 and £9 billion. Do you want to speculate with me and Roger Berry about the reasons why the BBC was suddenly encouraged to reveal this as news? It was a rather tired old story to say the least, but why today?

Mr Crozier: The honest answer is that I do not know. I was aware that Jane Newell was intending to write, quite properly so, to give the trustees' view. I do not think there is anything particularly new in that letter. Even with last year's results and our happier results this year we made very clear—we sent notes to all MPs—that we expected the pension problem to double or more than double. Obviously, it is a legacy problem and not one from which the company has ever hidden.

Q268 Chairman: The BBC is unusually slow off the mark on this occasion. I begin by asking about regulation. I pick it up where Mark Oaten left off in the previous session. How did you feel about Postcomm's definition of the USO and its power to widen the postal service definition to include other products? Is that a public policy decision that should have been taken by government or an economic regulatory decision to be taken by the regulator? That is important looking forward to the new system.

Mr Crozier: I think it is very important that regulators are entirely independent in any marketplace. But in other countries governments are allowed to wear two different and entirely separate hats: one as a policymaker and the other, as in our case, as a shareholder. They are not the same thing. In other countries and markets governments give regulators a clearer brief and it is then for them to regulate entirely independently within the parameters of that brief. I believe the kind of dual objectives that Postcomm has had—in fairness, it was not what it chose but what it was given—to protect the USO and bring in competition, to paraphrase it, clearly gives rise to a lot of potential conflict between the two. I think the lack of clarity about which is the more important was deeply unhelpful.

Q269 Chairman: That is a public policy matter. Government should say what is the more important; it is not for an economic regulator to double-guess such an important matter?

Mr Crozier: I am not sure that it is for me to say that, but arguably, yes, one would set up the policy and then someone would implement it.

Q270 Chairman: What about the nature of the regulation under which you have and might labour? Can light touch regulation ever really work in a market where you are so dominant for reasons of history—that is not a criticism but an observation—and are likely to remain so? If you brought into the frame the Competition Commission, of which I am a great admirer, inevitably very detailed work is required and it takes for ever to reach a conclusion, by which time any abuse that is alleged by a competitor will have subsisted during the period and done huge damage to that competitor. Do you think the Competition Commission is really part of the answer to the regulatory approach to the mails market?

Mr Crozier: As far as I am aware since competition has come in and certainly during the six years when I have been chief executive I do not think we have ever been found by Postcomm or anyone else to have abused that position. I ought to say that for the record. We take great care to ensure that we do not abuse our market position and if we ever did that it would be a real problem. As to the Competition Commission, I think the two extremes are difficult. Clearly, for many companies one of the reasons for the threat of being taken to the Competition Commission is to ensure they do not misbehave. Equally, at the moment if we disagree with something Postcomm is doing our only recourse is judicial review which, frankly, is just as long and painful a process, if not more so. I think the current setup does not help anyone. Obviously, we are not allowed to see whatever legislation is coming forward for all sorts of reasons, but I would have thought that in the context of new legislation one of the things people ought to be looking at is what powers any regulator would have to resolve disputes and issue as they arise.

Q271 Chairman: Obviously, it is not for you as the major regulatee, which I think is the word, of the new regulator to specify what those powers should be, but it will be interesting to know what powers you think the new regulatory arrangements should have to regulate your behaviour.

Mr Crozier: I think the most important thing for me and Members of the Committee is absolute clarification on what is the most important thing that people are trying to do, ie to protect and nurture the USO. That is the thing that holds together the social and economic fabric of the country. In truth, if you do not have a healthy USO you also cannot have competition because one relies on the other. You have to start with the basic building block which says that protection of the USO is the number one priority. That is not to say we are anti-competitive because we are absolutely not, and I think we have shown that. We operate in many markets across Europe in a very competitive way, but there is need for clarity of brief which says that the USO is extremely important.

Q272 Chairman: What about the resources of Postcomm? That is an odd question to ask a person who is subject to its regulation, but do you think that in its current incarnation it has enough resources? What resource do you expect Ofcom to devote to it? How should that resource be funded in the new world?

Mr Crozier: At the moment we fund Postcomm and before it we funded Postwatch. I think that each cost about £10 million per year. I would rather answer by saying that what I think Ofcom will bring is an understanding of the wider communications market. Big companies and even individuals start by saying they want to talk to their customers, or their advertising agency says that they want to reach their customers. What they look at is relative cost and strength and whether to do it through television, the press, magazines, direct marketing or a piece of door-to-door communication. As you stand at that point you look at your relative cost competitiveness. Only once they have decided amongst all those choices to use post do they then get to the choice between different postal operators. Therefore, if you have lost the battle at that point the business has already gone somewhere else. What we need the regulator to understand is that those are the people against whom we are competing in any media. We need to be competitive against them, not the little bubble at the bottom. That is just a reflection of the fact that our market and some others are undergoing a fundamental structural shift. Everyone in this room is communicating differently; we text, phone, email and do all sorts of different things. That will not change; it will carry on into the future. Therefore, it is absolutely vital that we have to generate, like parcels, new revenue streams utilising our great skills, our network and the fact that we are everywhere every day and building new products on that. We believe that in five years' time 75% of our profit will come from parcels. That tells you in a nutshell what is happening to the letters business and in e-commerce.

Q273 Chairman: Who should pay for the regulator? At the present you pay all of it. Should your competitors make a contribution in future?

Mr Crozier: I am fairly agnostic on it. I am not sure that it is the most important thing. The most important thing is that we have the right kind of regulation.

Q274 Mr Hoyle: Is it fair to say that you have had a strained relationship with Postcomm over the period? Do you believe that you will have a better relationship with Ofcom? BT has also had a very strained relationship with Ofcom over the years. Do you see any benefits after Postcomm? Will it be better or worse or much the same?

Mr Crozier: It is always difficult to have a history where the relationship is between one company and one regulator because there is nothing else for anyone to think about. My understanding is that BT has found that to be a very different experience because it is one of a number of companies and industries being regulated. For us it is not so much about the relationship as the issues. It is always better to depersonalise it; it is not about people but issues and business. In our view part of the problem is that perhaps a gamble was taken. If you take the two priorities of the USO and the desire to bring in competition, a gamble was taken that because market volumes would continue to grow the USO would take care of itself and therefore people could concentrate on bringing in competition. That was not what happened because the marketplace declined at an increasing rate. Therefore, it is more about the issues. Alongside that, we and I believe Hooper felt that access headroom—we have said this to the Committee many times, so I guess it is nothing new—needed to change, and was an unfair piece of regulation. Effectively, keeping a continual gap between what we charged and what the competition was able to do meant that however efficient we became, even if we improved efficiency by 50%, we never became more competitive. That is an incredibly blunt tool that sometimes is used to pull in competition and in our view at times it is very unfair.

Mr Hoyle: There was a double-headed coin and you always had to have tails. You were a bit like a masochist: you were being beaten up but paying for the pleasure of Postcomm doing you up?

Q275 Anne Moffat: It is a bit like going to the dentist.

Mr Crozier: It has been a very difficult matter to explain to our people. Our people have been through a hell of a lot in the past six years. We have 50,000 fewer people. Those who remain are all working much harder. Their future pensions are reduced. Their pay has been substantially increased and they now work five days and not six, so there have been good things for them too. One hopes that the jobs are more satisfying, but it is very discouraging from their point of view that no matter how hard they work they cannot close that gap because that gap is guaranteed. That is a hard thing to get across to 180,000 people.

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Q276 Mr Hoyle: Mr Stapleton seemed to make different answers to different questions when it suited him. He started by saying that with the access agreement you made money and then he said that you might lose some money. What is the case?

Mr Crozier: On our regulatory accounts we are required to report on a fully allocated cost basis and as such we lose 2p on every item of access mail—full stop.

Mr Hoyle: That is one in the eye for Mr Stapleton.

Q277 Roger Berry: To clarify that, do you cover marginal costs?

Mr Crozier: Yes.

Q278 Roger Berry: How significant is that?

Mr Crozier: Substantially, the last mile is effectively a fixed cost network, so the marginal costs of the last mile are variable.

Mr Hoyle: There is a difference between delivering mail to John O'Groats and the centre of Manchester.

Q279 Chairman: You said that you lost 2p per item. For the record, how many items are we talking about?

Mr Smith: In terms of access mail it is about five billion.

Q280 Mr Hoyle: Mr Stapleton is not very good at his sums. He also said that everybody else was wonderful. You were pretty bad; you were the rotten core and were 40% more inefficient. I could not believe that figure was correct.

Mr Crozier: If you look across Europe in every market every incumbent, ie the original operator, is less efficient and pays more than any of the new entrants. If you think about it, that is probably true in most markets, not just in postal services. Competitors come in without the cost base and all the other obligations. You pay people less and so on. Clearly, we are more expensive; our pensions are more expensive. For example, despite all the changes we made to our future pensions the company contributions per person are still about 20%. Our competitors probably pay between 5% and 7% as we now pay for new entrants. That is a huge differential. We do not disagree that despite losing 50,000 people and improving efficiency dramatically we are still inefficient.

Q281 Mr Hoyle: Does the 40% ring true?

Mr Crozier: I am not sure that it is exactly 40%.

Q282 Mr Hoyle: Do you think it could be less?

Mr Crozier: I think it is slightly less.

Q283 Chairman: The order of magnitude is right?

Mr Crozier: It is substantial, and we have never shied away from that. So far we have improved efficiency and reached that first stage without investing.

Q284 Mr Hoyle: You suggested to the Chairman that you paid £10 million for the pleasure of Postcomm. How much will you pay for the pleasure of Ofcom?

Mr Crozier: I do not know yet.

Q285 Mr Hoyle: Is there a reduction because it is merged?

Mr Crozier: I have no idea. I guess that it will start with the legislation and its brief is and it will flow down. We genuinely do not know that.

Q286 Mr Hoyle: It could cost you even more?

Mr Crozier: I do not know.

Q287 Chairman: My concern is that we shall become so obsessed with the pension deficit and the question of part-ownership that we may overlook the regulatory issues which are of fundamental long-term importance.

Mr Crozier: Indeed; they are a big part of this, but I genuinely do not know the answer to this.

Q288 Mr Hoyle: Can you send us a note telling us what you believe you will be charged?

Mr Crozier: I really do not know.

Q289 Mr Hoyle: You paid £10 million to Postcomm but you have not had any indication of cost from Ofcom even though it is about to take over?

Mr Crozier: No. As we stand today our regulator is Postcomm. No new legislation about our regulator has appeared, so perhaps that answers your question.

Q290 Mr Hoyle: I did not know whether you would get a discount and so save a bit of money.

Mr Smith: That would be nice.

Q291 Mr Wright: I believe that the review identified a number of areas in which it considered there were inefficiencies. What do you consider to be the most urgent area to modernise to improve efficiency?

Mr Crozier: I think it goes across a whole number of areas. We shall be spending about £2 billion on modernising it. That is all about efficiency. A lot of it is about bringing in automation. People have talked about walk-sorting machines; they sort letters to the walks of each individual postman, but once you have done that phase you bring in what we call walk-sequencing machines which mean that the letters arrive with the postman in the order he does his individual round. For us that automation is absolutely critical in taking out work and improving efficiency levels. There is a danger of comparing apples and pears, in that other operators like Deutsche Post and TNT went through a process of modernisation in the early 1990s and it was funded initially either by government, in the case of Germany, or through privatisation, in the case of TNT. They have long since undergone that process and it is one that we need to deal with. We are spending money on letter-sorting equipment, walk-sequencing equipment, new vehicles and equipment for our delivery people. Parcels give rise to very

different weights from letters for delivery and so you need a different set of equipment to make that work. We need different mail centres. Clearly, we need fewer of them but more modern ones that are more applicable to the way we want to operate with machines. There is a whole series of changes to allow us to run a more efficient pipeline in totality. We are very much an end-to-end business. As you change one thing you have to change in sequence all the things that come after that. We would be very happy to send you at any stage a breakdown of where the investment is going and on what.

Q292 Mr Wright: It might be useful if we had a plan of what the progress is likely to be over the next five years. I move on to your submission to Hooper in which you say you will reduce costs in Royal Mail Letters by £1.5 billion over the next five years. What discussions have you had with the union over that? Have you got their agreement to that plan?

Mr Crozier: Effectively, the national strike in 2007 was about pay and modernisation. Clearly, at the end of that dispute we reached an agreement with the union on modernisation. Those documents are signed by ourselves and the union leaders. I believe that at the time we sent them to MPs and Members of the House of Lords. To be fair to Billy Hayes and others at the union, they recognise the need for change; they have said it themselves a number of times. I believe that their own structure does not always make it easy for them to carry that down through the union itself.

Q293 Mr Wright: What reduction in the number of jobs is represented by the £1.5 billion?

Mr Crozier: We have never given a specific number of job losses. On the other hand, we have never hidden from the fact—we have made it clear to all our people and the union—that modernisation will involve job losses, but there are a number of different options as to how some of those scenarios might be dealt with. As and when we get to them obviously we shall consult extremely widely with the union on any of those changes, and we always do.

Q294 Mr Wright: I can understand the need to negotiate and discuss with the unions, but there must be a global figure. The media put out all sorts of things in terms of proposed job losses. When you made your submissions to Hooper you said quite clearly that you would achieve a sustained cultural change by rationalising the network of mail centres, which is job losses, transforming delivery offices, which is job losses, standardising and simplifying working practices, which always means job losses, increasing levels of automation, job losses, and investing in and building the capabilities of colleagues. When you come to the figure of £1.5 billion clearly you must have in mind a global figure for the reduction in jobs.

Mr Crozier: We have never hidden from that fact. All aspects of modernisation and improving efficiency eventually result in fewer people and that is true not just of our company but of any. As we get

to each stage of the modernisation we shall re-evaluate what we are doing. We go through that stage with the union. There are always a number of different ways to skin any cat. We explain the different ways and then agree the best way forward. That is the reason we never give an overall number for jobs because it depends on how we choose to do each aspect of the modernisation. Under our agreement with the union not only would we want to discuss it with them but we are obliged to do so. As each element comes up we always do that. We have shared the overall strategy with the union many times. We have had a lot of sessions with them, sometimes extending over two days. We have taken them abroad to look at machinery and equipment and the kinds of things we do. We have trials running at various mail centres. None of this is hidden from people. These are things that we have to do and they are commonplace in modernised postal companies that have already been through it. We are not re-inventing the wheel here.

Q295 Mr Oaten: It strikes me that the process of consultation with the unions you have described must take an awful lot of your time and energy. Is it not a barrier to modernisation? Is not the fact that you have to go through such a lot of consultation with the unions one of the reasons why there is such inefficiency in your structure and service? Bluntly, it holds you up from cracking on with the modernisation. You could probably have achieved a lot of these things two or three years ago if it had not been for the unions?

Mr Crozier: I am not sure that is entirely fair. To be sure, to go through all the consultation affects the pace at which you can make change, but on the other hand there are examples where with the union's involvement we have managed to do some good and impressive things. I think the union's structure itself sometimes works against what we, and in many ways the union leadership, think needs to be done. For example, even if you come to a national agreement the union's structure is such that every branch is at liberty to decide whether or not it wants to take part in it. One matter we have suggested—I wrote to Billy Hayes about it recently—is that if, as Hooper suggested, what is needed is for the union itself to modernise its structure we shall be very happy to work with the TUC and whatever best practice might look like for the structure of the union, irrespective of its cost, we will help them to implement it and pay for it. If we get that best practice structure so that the union leaders feel we are on the same side it will be helpful not just to us but to them. The company needs to modernise but I do not think it is unfair to say, as would some within the union, that they have some modernising to do, too.

Q296 Mr Oaten: That sounds like a very polite and diplomatic way of saying that the unions have been part of the inefficiency.

Mr Crozier: I am not sure I agree.

Mr Oaten: You just said the structure was such that if you made a national agreement you had a different pattern throughout the country. You said that it needed to modernise, so clearly it must be part of the problem.

Anne Moffat: They are also part of the solution.

Q297 Mr Oaten: Indeed. The reality is that there is inefficiency and the unions are part of it.

Mr Crozier: Let me answer the question in a different way. Do I believe that Billy Hayes and others want to change and help the Royal Mail be successful? Yes, I do. Do I think there are issues with the union's own structure that sometimes prevents it, never mind me, from doing that? Yes, I do.

Q298 Mr Wright: You need to take the workforce along with you; there must be discussions and negotiations and you must be upfront and transparent about what has happened within the postal service. I think everybody from the postman right up to the chief executive accepts that change needs to happen to sustain the postal service that we have come to expect. One matter that concerns me is that in the papers we read about postmen being timed from the moment they deliver their post office to the delivery of the letters. They have to do it in a certain time. That does not do anything for industrial relations. It is certainly a two-way process. It appears to me to be a one-way process. What I am getting at is: how is the relationship with the union at the moment? What are you doing to try to rebuild the relationship which I think has been broken over time? Are you prepared to sit down with the union exclusively over the next few weeks and months to talk realistically about what change will be needed and be upfront about what is to happen with the workforce?

Mr Crozier: As we have seen over the past couple of days Royal Mail, like it or not, is an organisation that lives in a goldfish bowl where it is open to political interpretation from all sorts of different angles. Sometimes people use us as a bit of a football. Is it true that we ask our postmen to go at four miles an hour? That is absolute nonsense; it is complete tripe. Is it true, as we read recently, that there is something called Project Tiger where we plan to lose 16,000 people next week? I have here the union all-branch report which tells people that Project Tiger is not about people. Do we sometimes get used? Do things appear that are not entirely true? Yes. We are part of that political football. That said, the most important thing is that we need to take the union and our people with us, but do we also have to accept that in the situation that this company faces at the moment some of the things we need to do are not very popular? Yes. Is it popular to reduce people's future pension? Clearly, it is not. Will people like that? No. But that does not mean as a company even as it is currently funded by the taxpayer we can shy away from it. We cannot say on the one hand we insist that they improve efficiency and do much better and on the other hand not do the things that will allow us to get there. We have to take people with us but we must accept that we shall have to do

some pretty difficult things; otherwise, the company will not survive. The twin issues of declining volumes and the huge pension deficit will not go away on their own; we have to find solutions to them; otherwise, the fact is that the company, the USO and the country has a bloody big problem.

Q299 Chairman: We shall move to the issue of part-privatisation but I do not want to address that issue in putting this question. Following his appearance Richard Hooper has written to the Committee. After referring to capital issues and concluding that a strategic partnership is necessary, he says that the third issue of equal importance—it does not matter for the moment about the first two—is commercial confidence. He says that means modernising labour relations so that unions can engage in debates about the long-term future of the postal business and in turn management can press on with agreed plans free from confrontation and obstruction. I do not endorse what Mr Hooper says; I just comment that that was written to the Committee. He seems to place a good deal of the onus for the problem on the union. Anne Moffat may want to come in and ask a question to counter Mark Oaten's question, but Richard Hooper made a surprisingly strong statement to this Committee.

Mr Crozier: If I gave the impression that it is all a union issue clearly it is not. We have to improve what we do. I have already written to Billy Hayes. We have talked about the need to improve the relationship between the company and the unions. We have met with the leadership of Unite. We have a two-day session set up between the leaders of the letters business and the union, so we have lots of work to do on our side, but in my view it requires a shift. Therefore, it is a personal one. I am up for change and I am actively going to promote it in the business every day. That is what we have to shift everybody into. We have to get on with this. I said to my wife at New Year that I intended to go jogging every night to try to get fit this year. I have not been out for a single jog yet, but that does not mean I was not sincere when I said it; it is just that I have not done it.

Q300 Chairman: If we talk about change, perhaps I may be a little cheap for a minute or two. I think that the executive summary in your submission to the Hooper review talked about the need to accelerate the pace of the cultural and operational transformation. Are you happy that you have succeeded in changing the culture of Royal Mail? The people who work there say to me that that you are still "mired in the worst of the public sector". They say that the top floor is fine but communications with middle and lower management still are not working. They say that you have all got chauffeured cars and senior directors wait outside for you all day; you still tend to employ expensive contractors and consultants rather than think of the payroll. There is a lot of criticism of the culture of senior management. Is that an unfair anecdote or do you recognise some of those criticisms?

Mr Crozier: I do not. I will start where I should start. My personal belief is that the vast majority of our people are absolutely fantastic and do an amazing job, sometimes in terrible weather. I am full of admiration for what they do. As an organisation we are on a learning curve in moving to a world where we have to compete and be commercial. I think that shift has been a difficult one for our people. If you look at culture changes in any big organisation they will not happen in five years; they tend to take 10, 15 or 20 years. I speak to people at BA and BT who say that even today there are large elements of the cultures that existed in those organisations back in the 1970s and 1980s. Cultures in any organisations do not change in a short period of time. Do I think our people are willing to go on that journey? Yes. Are they genuinely concerned about what it means for them? Absolutely. I think there is a lot of fear but also recognition that we have to do it. A lot of the senior and middle management have changed. We used to have a group centre of over 11,000 managers. That group centre now consists of just over 200. The situation has changed beyond all recognition in some areas, but cultures take a long time to follow on.

Q301 Chairman: You will know this Committee has been critical in public of some of the letters that the chairman has written to staff which have a very aggressive machismo style to them. Do you believe that the flow of information within the organisation now works well?

Mr Crozier: It works a lot better than it did. When my colleague and I arrived one of the first things we did was write to our people and, naivety being a great friend sometimes, discovered that that was the first time management had ever written to them in 350 years. That seemed very strange to me as someone who had run other companies. Has it got a lot better? Yes. Is it perfect? Absolutely not. Do we need to find ways to improve it and bring people with us? Absolutely. When we look at it, what kind of expertise do we need going forward? Like all big companies, we need more and better project directors and in any situation like this people who are experienced at bringing in the kind of technology that we are about to use. This is not a kind of NHS IT issue. The machinery and technology we need to bring in exists and works so the risk is not to do with the machinery and the kit itself; it is the management capability in installing it. Do we need increased numbers and better skills in HR? Yes, we do. We know that we need to improve and we have been doing it steadily over the past few years. Like any company, we need to bring in skills at all levels of the business.

Q302 Chairman: One of your major previous roles was as a consultant to an advertising agency. I was a public relations consultant. I value consultants, but do you think that Royal Mail Group makes too much use or not enough use of consultants and contract staff at present, or do you think you have it about right?

Mr Crozier: We do not use many now. When I arrived I think one word to describe it would be "horrific". There was a ton of consultants in use; they were coming out of every door. We pared all of that back because we did not find it useful. We wanted to concentrate on the few things that would make a difference to the organisation. I am not saying that we do not use them; clearly we do in specialist areas where they can bring in skills that we really do not need to have all the time. We do not need to pay to have those skills sitting in the business day in and day out. I think that is the correct way to use consultants when they add value.

Q303 Anne Moffat: I am not particularly in favour of consultants and the need for them in the way you describe, that is, to have consultants for consultants' sake. The amount of money they charge is extraordinary. Is not one of the successes of a slight improvement, if not quite a good one, of the industrial relations between you and the workforce and unions that now you have a single goal? You all want to see the success of the company? It is all about the survival of the Royal Mail and everybody has to work to that end. If you and the unions have that agenda it must improve the industrial relations even when there are very hard decisions to make. I welcome your words and the way you are now approaching the relationship with the workforce because, as I am sure you will agree, they are the absolute backbone of the Royal Mail and they work to protect the company. I think all of us, including government, should work hand in hand to do that. Do you agree that is the philosophy of the way forward?

Mr Crozier: It almost has to be. Whatever our philosophical or ideological differences, I do not doubt that everyone in this room wants the Royal Mail to be successful and I think the support among the public for our people to do well is huge and is reciprocated by the vast majority of our people. We have to do more. The only caveat I give you is that we have done, are doing and will be doing some things that are very difficult not just for this union but any union to work with. They are hard and tough and are not things that ideally people would like to do, but they reflect the reality and scale of the challenges we face. That does not mean I disagree with what has been proposed.

Anne Moffat: I do not want to steal other people's thunder, but maybe there is no support for a minority shareholding.

Q304 Roger Berry: Believe it or not, I do not approach that question from an ideological point of view. I am quite interested in the evidence put on both sides of the argument. Why does the Royal Mail Group so passionately believe that a minority private sector shareholding is necessary for the future modernisation of the company?

Mr Crozier: As part of Hooper we said that in our view it boiled down to three requirements: equity capital, a pension solution and a change in the way we were regulated and the fairness of it in the wider market. Richard Hooper came out with a package of

various solutions. For us it is undeniable that that package of solutions would in the round leave the company in a better place tomorrow than it is today. As this debate has taken place over the past few months one interesting point that has been made—I have met various MPs—is that we have been ploughing money into the Royal Mail for years. That is not true. This is quite an important point. Undoubtedly money has gone into the Post Office. Under the system of external financing limits, which was normally an opportunity for public bodies to get funding—it was before my time—for the Royal Mail it worked in reverse. Between 1976 and 1998 the Royal Mail paid out under that system £2.4 billion. On top of that it paid about £1.4 billion in corporation tax. In the same period and since we have not had any injections of equity capital. The money put in recently by the government, as it has been at pains to explain, is very much a commercial loan that we have to pay back at a rate of interest. What this business desperately needs to make all these investments, give it a better balance sheet and provide a buffer against the huge risks it faces is equity capital. We do not need another loan or more debt, because we have more than enough debt thank you very much; we need equity. That is of great importance to us. Alongside that, we have never said anything other than that we need to continue the drive to bring better expertise into the business. As we make that journey we need that expertise to ensure that as we spend the money we run the modernisation process and get it right. We never say that we are carefree because we are far from it.

Q305 Roger Berry: There are three elements in the package. Do you agree that if the element of equity is capital injection on sensible terms it is perfectly sensible to separate the three elements of the package? You have to solve the pension deficit problem—period?

Mr Crozier: Correct.

Q306 Roger Berry: As I recall, your submission to Hooper was less gung ho on private equity investment than some of you now are and made the point that capital injection was a third pillar but it had to be on sensible terms, so is it right that the question is: what is the best source of that capital injection?

Mr Crozier: It is not for us to tell a 100% shareholder from where that capital should come. Our job is to say that we require equity capital, and it is undeniable that the company needs equity capital not just to cover all the risks it faces but for the extra investment and everything else.

Q307 Chairman: It might be helpful if I remind you of what you said in your submission. Your third point was, “Access to equity capital would reinforce commercial disciplines and enhance access to talent that would help drive Royal Mail to transform itself into a truly customer-focused business.” Therefore, access to capital would enable you to do the things that the package is supposed to achieve.

Mr Crozier: Yes.

Q308 Roger Berry: To cut to the chase, you have referred to equity capital, not private sector equity capital?

Mr Crozier: We did not in our submission.

Q309 Roger Berry: Exactly. Increased government equity would be a possibility, would it not?

Mr Crozier: It is not for us to say from where it comes.

Q310 Roger Berry: Intellectually, it would be a possibility, would it not? You have kindly pointed out that in your submission you did not talk about private equity capital but about equity capital. That is the phrase you have used repeatedly this morning. It is a matter for government to decide what to do. I do not ask you to tell government what to do, but as leader of the organisation there are three elements in the strategy with which I think we all agree, but when it comes to capital injection you are simply saying that there needs to be capital injection that does not burden you with debt that you might not be able to repay in a sensible period of time?

Mr Crozier: We along with many others made submissions to Richard Hooper and he looked at the totality of those inputs and came out with a package of recommendations. We accept that in the round that package of recommendations is undeniably the best way forward. For us a crucial part of it is whether a partnership brings capital and experience and can short-circuit the introduction of experience, and, importantly, whether it can bring new commercial opportunities. That is what a good partnership brings. Obviously, in this process government has accepted the Hooper report and, assuming it goes through, in the process of finding a partner what we shall be looking for from that partner are three things: capital, expertise and a commercial opportunity.

Q311 Roger Berry: Let us stick to the specific question. Your professional position as the leader of the company is that the third part of the package is the need for capital. You have repeatedly pointed out that you are talking of equity capital. You did not refer to private equity capital in your submission to Hooper. If the government came to you today and said that it wanted to give you x as additional equity capital would you turn it away?

Mr Crozier: How would they do that?

Roger Berry: At the moment in certain parts of the economy the question is: who is at the front of the queue? I know that you do not want to get into trouble with your major shareholder, nor do I, but you have said you want a capital injection on terms that do not burden you with loan repayments that are not sustainable. Equity capital from anywhere including government would do it. I am not asking you to say that you would prefer to do it one way or the other, but in terms of the capital part it amounts to the same thing. Now we come to the other points that you raise. You say that you want private sector involvement, even though you did not talk about

that in the submission, but there are other things. Perhaps we can deal first with expertise. You have a lot of expertise. You can get some of these consultants back; you know far better than we do how that works. You do not need a private shareholding to get expertise, do you?

Chairman: I think that what you said in your second submission to the Hooper review was that access to equity capital would enable you to access talent, so that was your view originally.

Q312 Roger Berry: You must know as I do that there are ways to get that talent other than equity capital. It happens all the time.

Mr Crozier: Please do not forget that we need timely and flexible capital and here we are four years into the process. If we look at when we started to talk to the government about needing more capital and where we are in the EU process four years later it still is not in place.

Q313 Roger Berry: We on this Committee have been talking about this issue and know what the problems have been. I share your frustration. I think you have answered the question about capital injection. If we look at the other aspect of private equity other than capital injection, expertise, I assume you acknowledge that you know how to buy in expertise without the necessity of bringing in private equity capital. Am I being too obscure? We will come to the third point in a minute.

Mr Crozier: If you ask what in our view is the most supportive way to bring in capital, expertise and commercial opportunity all at the same time in a structured way and on a reasonably full basis then a partnership is one of the best ways to do that. That goes alongside part of the wider package of pension reform and regulatory change.

Q314 Roger Berry: This really is not good enough. We all agree on pension and regulatory reform; if we do not it does not matter for the purposes of this debate. It is intellectual nonsense to say that a package consists of three things and you cannot have any of it without having all of it. I am pursuing the particular bit about the minority shareholder and strategic partner. We have dealt with the question of capital. You can go out and buy the expertise. I think the third point is particularly interesting. I absolutely understand why you might want a strategic partnership of some kind with another company that has experience in expanding the kind of operation in which you are now engaged, but presumably you would also acknowledge that you can have partnerships with companies without them having private equity share ownership?

Mr Crozier: You can of course.

Q315 Roger Berry: Given that it was not in your submission to Hooper, why do you now say that somehow this strategic partner who is a minority shareholder is so important?

Mr Crozier: The Hooper report very clearly said that here was a recommended package of solutions to fix the problems in its entirety. I may be using the wrong

words, but the government has accepted those proposals in the round and said that is the package of measures it wants to take forward. It is undeniable from the company's point of view that that package of proposals leaves the company in a better place tomorrow than it is today.

Q316 Roger Berry: I am not sure that it would leave you in a better position than it is today—I think it could be in an even better position—not least because of the grief that will be caused in certain quarters if the minority shareholding proposal goes ahead. I think that I have got all I want on the record, with respect. To put one other question, are you looking for a partner who would therefore cease to be a competitor in the UK market? Are you concerned about any anti-competitive implications of a strategic partner arrangement when there is private equity?

Mr Crozier: In any aspect of any partnership in any business one of the things you have to take into account is any competitive issue that it throws up. That would just be a matter for the company, the regulator, the Competition Commission and no doubt various other bodies. There is no doubt that a fairly reasonable range of organisations would be interested in partnering with the Royal Mail. Some of them will give rise to competition issues and some will not. Obviously, that is something of which you must take account in the round.

Q317 Roger Berry: I absolutely understand Royal Mail's position and I have a great deal of respect for the way you have presented it. My final question about the bit that was not in your submission to Hooper is whether you think there is a lot of private equity investment out there at the moment gagging to invest in Royal Mail after all we have heard this morning and in recent years?

Mr Crozier: I give two answers to that. First, do I have tremendous faith in the Royal Mail? Yes, I do.

Q318 Roger Berry: I do; we all do. Let us move on.

Mr Crozier: Do I think people would like to invest in Royal Mail? Yes. Second, is the economic climate an extremely difficult one? Clearly, yes; you would be mad not to think that, but as always for the right investment there is a market there. Obviously, if there is a process that will tell us the answer to that question. You do not know until you have conducted it, but no one can deny that it is not an easy market. But if the thought behind the question is whether it can be done, yes, I think it can.

Q319 Mr Bailey: So far you have emphasised the need for capital. You have got access to £600 million from the government. You believe that you will strip out of the business £1.5 billion in costs. You will be relieved of the annual sum £280 million for pension contributions. On the surface that would seem to be a substantial potential sources of capital in future. You say that you are on course to deliver profits that nearly double the performance in 2007–08. What is your assessment of the extra capital that you need, and what do you need it for?

Mr Crozier: I will try to answer each of the questions you put. First, to be clear we got £1.2 billion from the government, not £600 million.

Q320 Mr Bailey: The £600 million is allocated or at least not used?

Mr Crozier: It is all allocated. Those funds were there to cover a five-year period and clearly we would need to be shot if we spent all of it in the first year because we would then have no money left. Therefore, that money is allocated and we know what we are doing with it. But the £1.2 billion is part of a wider £2 billion spend on modernisation itself. Without getting overly technical, I should point out that even if the pension deficit is taken away from us in some form there is no guarantee that we will get all of the benefit of that through a system known as regulatory clawback. Any regulator may not let us keep the full benefit of that. Genuinely to take out £1.5 billion of cost we must invest a lot of money. One of the major elements of that is the cost of parting with people. Of the 50,000 with whom we have parted company over the past few years only one was subject to compulsory redundancy. We are happy that in doing a difficult thing we have managed to treat people very well. On top of all that do we still need extra capital? Yes, we do. That capital is of the order of hundreds of millions. One of the reasons I am being slightly vague, for which I hope you forgive me, is that clearly we may well be about to go into a commercial tendering process. I do not think it is particularly wise of me to try to explain to anyone who may wish to take a stake in us what it is we do or do not need. I think that would be wrong of me from a commercial point of view, and I am sure that my shareholder would not particularly like it either. I am not quite sure how to handle that part of the question other than to be as honest as I can. Referring to Jane Newell's letter, in fairness the trustees think we need capital; I do not believe the union disagrees with that. We say we need capital. Whatever one's philosophy on this, I do not think anyone believes that Royal Mail does not need capital. I hope that is a bit of a given.

Q321 Mr Bailey: Your answer is somewhat vague as you acknowledge. Commercial confidentiality is always a convenient reason for keeping answers vague. On the basis of what I have heard so far it seems to me that what is being proposed is a capital solution to what is essentially a management and cultural problem. It has been acknowledged that industrial relations have been bad and that your costs are higher. I am not altogether clear whether or not the £1.5 billion cost reduction will change the fact that labour costs are so much higher. You have also acknowledged the access to skills that will come through a minority shareholder. Basically, if there is a minority shareholder do you not believe that your days will be numbered because to make those changes you need a change in management and that can come only via the minority shareholder?

Mr Crozier: The only way to answer that question is to look at the track record. To correct one point, the £1.5 billion has already come out of the business and we need to take out another £1.5 billion.

Q322 Mr Bailey: That reinforces the point I make.

Mr Crozier: Did we move from losing £1 million a day to making £1 million a day by accident? No. I think that in general the management of the company has brought it a very long way and the track record shows that very clearly. Are we one of the few organisations around at the moment in any business sector reporting an improvement in profits? I cannot think of many. Are many of our competitors announcing vastly reduced profits? Yes, they are. I think that the management team—obviously, I would say this—has done a pretty exceptional job under very difficult circumstances, but we must accept that pensions is a legacy issue and a giant millstone round the company's neck. The management of our competitors had this taken away from them; they did not have to solve it. Clearly, we need a similar kind of solution and continue the drive to modernise the business. Companies like Deutsche Post did it over 15 years; TNT is still doing it after 18 years, and we are trying to do it in three or four years. We are playing catch-up and those are the grounds from which we started. Therefore, we have to do it very quickly.

Q323 Mr Bailey: But your costs are still 40% higher after all these changes and improvements?

Mr Crozier: Yes.

Q324 Mr Bailey: Would any private sector partner be likely to enter into a partnership without a substantial change in the management and culture of the organisation?

Mr Crozier: As a minority partner they would want to work very much hand in glove with the management of Royal Mail. They would look at the track record of that management delivery.

Q325 Mr Bailey: The track record is that after all these improvements costs are still 40% higher. Taking up Roger Berry's point, it would be very difficult to get a private sector partner to enter into an agreement on that basis without substantial changes.

Mr Crozier: I think the private sector partner would look at the opportunity to continue that modernisation and see a lot of benefit from it, and it would also look at the position of the company had it not taken out £1.5 billion of costs and it was still losing £1 million a day. Frankly, it would not be in great shape at all; I doubt that it would even be here.

Q326 Mr Bailey: Therefore, a private sector partner would not be looking at how much money it would get on its investment in future and what changes would be needed to make that money?

Mr Crozier: Frankly, the government wants a return on the investment it has put in and any private sector organisation would want exactly the same thing. Nobody invests in anything without wanting to get back the money, and hopefully a good return on it.

Q327 Mr Oaten: Referring to the three reasons why we need a private sector partner to come in, Roger Berry appeared to be trying to get from you that you could achieve it with consultants and your own skills and knowledge. My understanding of what you are saying is that the issue are so big and the change in the market so enormous that you just cannot tag on some consultants and you do not possess the necessary skills and the only way to get that expertise is to bring in a major substantial partner.

Mr Crozier: I think it is the quickest and best way to do it. We employ 185,000 people. It is not a case of bringing in the odd individual. Such an individual does not make a difference to 185,000 people; it is a bigger, wider cultural change. We have a lot of management throughout the company as you must have in an organisation of this size. The senior management is extremely well supported by the shareholder; who has made that support clear to us in no uncertain terms on a number of occasions. All interested parties have also made that clear. But we accept that what we need within the organisation is a lot of project directors and people with the technology skills to deal with the stuff that we are about to put in. To refer to Anne Moffat's point, we also need HR skills within the organisation. We need lots of things. We need to find a way quickly to satisfy the combined criteria of capital, expertise and commercial opportunities. Please do not forget commercial opportunities. If you operate in a market where your business is declining by 8% per annum and you do not find new revenue streams eventually you have a horrible problem.

Q328 Mr Oaten: You do not think that the three problems can be solved with independent solutions and the only way it can be done is to bring the three together in this package?

Mr Crozier: I do not think anyone could say genuinely that it is the only way it can be solved. What I am saying is that we think it is the best way to solve it.

Q329 Anne Moffat: I ask you a really easy question that you can answer yes or no. You said that absolutely everyone agreed you needed capital, cash, dough, money or whatever you want to call it. Given the position you are in, if money is offered to you do you mind from where it comes as long as it is legitimate?

Mr Crozier: It is a matter for the shareholder.

Q330 Anne Moffat: What is the shareholder offering you?

Mr Crozier: I think the fairly simple answer to give is: it is a matter for the shareholder.

Q331 Mr Hoyle: I think the management of Royal Mail is good; I think you have got it right and you deserve a pat on the back. Do you agree with that?

Mr Crozier: It is definitely not for me to say, but thank you very much.

Mr Hoyle: In that case you have turned the corner with £255 million profit in nine months compared with a loss of £1 million a day which is a major achievement. What expertise do you believe should come in and can do better than you have done? Why is it that the competitors you want to bring in are losing money when you are increasing them? I fail to understand what benefits will come from a company whose profits are dropping when at the same time your profits are rising.

Mr Oaten: They are going down next year.

Q332 Mr Hoyle: In fairness, so may theirs, but this is where we are at the moment.

Mr Crozier: It is a good question. Let us stick to the letters business for now because that is the bulk area we are talking about. That business makes just under a 1% profit margin. There are different regulatory regimes, but TNT probably makes a 15% profit margin; Deutsche Post, I believe, makes about the same. Although the amount of profit we make sounds like a lot of money when it is put in the context of the sheer scale of the pension problem and the volume declines frankly it is nowhere near where it should be. I know this is a very difficult subject because people say that that is a lot of money. In context it is a tiny amount.

Q333 Mr Hoyle: I accept all of that. To move on, with this deal the pension fund liability remains with the taxpayer.

Mr Crozier: In some shape or form.

Q334 Mr Hoyle: The liability is left with the taxpayer, so why does a private company want to come in? It wants to come in because it believes it can make money. It cannot come in for any other reason. Therefore, if profit is to be made I want that profit to come to the taxpayer because it is about having the best deal for the taxpayer. What we are saying is that this is the worst deal because the profits will go to a private company and a foreign government and the liability will remain with the taxpayer. I perceive this as a very poor deal. The big question is: how much money do you think you need as an investment?

Mr Crozier: If I am being honest, I am not sure I agree with your statement.

Q335 Mr Hoyle: I am a taxpayer and the liability is being left with me.

Mr Crozier: All of us seem to be agreed that the pension problem needs to be fixed.

Q336 Mr Hoyle: We fix the pension problem, but let us get down to the nitty-gritty: how much money do you believe you need to put the company right?

Mr Crozier: Perhaps I may finish my answer. If the government sells a stake in Royal Mail—let us say it is 30%—clearly it will get 70% of any upside of putting these two things together. Therefore, the

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taxpayer is not losing out; it is the opposite. The taxpayer does not have to invest any money in equity capital in the business and it is getting a 70% share of a bigger and more successful organisation that is better than a 100% share of a lesser organisation. It is not an unusual route for us. If you look at the Post Office, there is a joint venture with the Bank of Ireland which has allowed us to get into financial services.

Q337 Chairman: But it is not ownership in the Bank of Ireland?

Mr Crozier: No; we have a joint venture company; we own 50%. Partnership is a tried and tested way for the Royal Mail Group to move into markets where it has not had experience or to bring in expertise that it does not currently have. We have done it on a number of occasions.

Q338 Mr Hoyle: How much money do you need to put the company right?

Mr Crozier: I have already answered that question.

Q339 Mr Hoyle: Can you remind me?

Mr Crozier: I said that we needed of the order of hundreds of millions of pounds, but I was not at liberty to give an exact number.

Q340 Mr Hoyle: I do not mean that you should put a value on the sale.

Mr Crozier: That is the question I am answering. At the beginning of a commercial process, if it happens, it would be wholly wrong to give away to any potential buyer what sort of money the company is looking to raise. That would be a big mistake from that point of view. I know that that does not answer your question, for which I apologise.

Q341 Mr Hoyle: In part it does answer it; I think we are getting somewhere. Lord Mandelson said that hundreds of millions were needed. You have just made a couple of hundreds of millions in profit. Therefore, we are beginning to move in the right direction. The key is, surely, the loss-making access agreement. You have already said that for every letter you deliver at the moment you lose 2p, so why is it we do not renegotiate the access agreement and charge an amount that gives you the profit you require for investment including investment in the pension fund? Surely, that is a better way forward, because, first, you keep hold of the company; second, you are making money from what is at the moment a loss-making regime; and, third, the taxpayer retains its full interest?

Mr Crozier: To take the second question first, in fairness in Richard Hooper's report it is very clear that there needs to be a number of regulatory solutions as part of the package. He absolutely identifies access headroom as being one of the problems. In our view and that of Hooper that needs to be fixed, but it is one part of an overall package of support. We are making £200-odd million profit, which is fine, but we cannot keep spending the same £200 million on everything. If we have an 8% volume decline that means £560 million is disappearing. If

we have the pension problem and it doubles potentially that is another £280 million. These things need to be solved in the round. We have to find a package of solutions, whatever the right one is, that solves all of those problems.

Mr Hoyle: I think we are more or less at the answer. You accept that you lose 2p, so what does that cost you?

Q342 Chairman: It is about £100 million, is it not?

Mr Smith: It is 2p on five billion items.

Q343 Mr Hoyle: You are losing £100 million a year. Therefore, if we turn that loss into a profit by increasing it to, say, 6p that gives you an extra £300 million a year profit. Is that not sensible?

Mr Smith: It depends on what you think will happen to competition.

Q344 Mr Hoyle: Even Lord Mandelson referred to it being renegotiated.

Mr Smith: There are people who want to enter the delivery market in the UK. If that is the case is the best thing for Royal Mail to do to put up the price of its delivery service? That may or may not be the best thing to do commercially.

Q345 Mr Hoyle: Are you saying that Lord Mandelson was wrong to say that we should look again at the access agreement?

Mr Smith: No; the headroom agreement does need to be looked at.

Q346 Mr Hoyle: Therefore, we can make profits in that way as well and so it will be a benefit?

Mr Crozier: It is already part of the package of solutions that Richard Hooper proposes. He has said very clearly—I completely agree with him—that a large number of changes need to be made on the regulatory side as part of this package alongside sorting out the pension problem. It is not for us to say how the government should solve it. We have always said that it should be done in some form. The third element is bringing in capital, expertise and a commercial opportunity. I think that the solution lies in that package in the round.

Q347 Mr Hoyle: Did Lord Mandelson put you in an arm lock or head lock to agree it?

Mr Crozier: No.

Q348 Chairman: You talked about capital being timely and flexible. Referring to your defence of the case for strategic partner, to what extent is there real concern about the Treasury's reluctance to sign up to a long-term commitment to investment? The history of the period from 1976 and 1998 shows that the Treasury was not a very co-operative partner. To what extent—I do not like saying this because it is ammunition to UKIP—do the EU state aid rules have an impact? Richard Hooper placed great importance on putting the Treasury in an arm lock and compelling it to sign up to a long-term agreement.

Mr Crozier: The state aid rules have a huge impact on the way investments can and cannot be made. We see that already in that the current investment plans has not yet had approval. It will also have a big impact on any solution on pensions. Any solution on pensions is likely to take north of a year, possibly 18 months, to go through or otherwise. These are not quick processes once the EU starts them. It is not an easy process. We still have some funding from 2001 and earlier that is being considered. To be fair to the Treasury, it makes it a lot more difficult for it to provide funding. Clearly, as in the case of the recent investment it must prove that it is a commercial loan with a commercial rate of return; it is not an investment as such.

Q349 Chairman: You say that if you are to get timely and flexible access to capital EU state aid rules and the Treasury pose a problem?

Mr Crozier: Admittedly, the markets are very difficult at the moment, but by and large in normal circumstances our competitors are able to get investment at a moment's notice. They can change prices at a moment's notice and therefore they are much more agile than we can ever be.

Q350 Chairman: What structure do you expect to see for Royal Mail Holdings in the new world, if it happens? The Royal Mail part of the business will be x per cent if it happens; if there is a strategic partner it will be, say, 30%. Post Office Ltd will remain 100% state owned and Royal Mail Holdings will be above that and will hold a 70% and 100% interest in different bits of the business. Is that right?

Mr Crozier: I was slightly confused by the previous debate on this part, so I ought to make our position very clear. Post Office remains part of the Royal Mail Group.

Q351 Chairman: Holdings?

Mr Crozier: I heard the debate about separation, but the way it would work in principle is that Royal Mail Holdings will be at the top. Obviously, that is 100% owned by government. On the other side is Royal Mail letters, parcels and what have you and that will be owned x per cent, though clearly much more than 50%; and over here is POL which is 100% owned. The Post Office gets about 30% of its income from the Royal Mail, but it is probably not as well known, though arguably it is more important, that the mails business generates substantially more than half of Post Office's footfall.

Q352 Chairman: I just want to ask about the issue of ownership. There is no dispute—it is common ground between you and the government—that Post Office Ltd will remain 100% owned by Royal Mail Holdings which in turn will be owned 100% by the government?

Mr Crozier: As far as I am aware, that is correct.

Q353 Mr Clapham: Before I turn to the Post Office, I should like to make one comment having heard the exchange between you and Mr Hoyle about the way we move forward. What you said about industrial

relations tended to suggest a very understandable approach. You have a situation where a 30% partner is coming in. A company like TNT has a particular approach to industrial relations and that might upset the apple cart and make things much worse. You have to bear in mind those kinds of things. As to how things work at present, the group wants to ensure that Royal Mail remains an integral part of the business. Earlier you talked about the way you saw the business changing. You said that in 2012 50% of the business would be dealing with parcels. What is the relationship between parcels and the Post Office network? Where do the parcels come in? Is it part of the European approach to your business, is it the connection with the Irish venture or is it purely in the UK that we will see that change?

Mr Crozier: Fifty per cent of our revenue will come from parcels. Obviously, the parcel flows are from various sources. Some come in through GLS, our European parcels business; some come in from other international postal operators; some come through Parcelforce; and a huge number come through the Post Office itself. Bank of Ireland has no impact on the postal side; that is purely a joint venture in financial services. We see an increasing role for the Post Office in future from the point of view of customer convenience, for instance as a pick-up and drop-off point. One of the great reasons why people shop over the internet is for the convenience of getting everything delivered at home, but the reality is that something like 60% of people are not at home during the day. People who order goods from, say, Amazon or whoever may not want it delivered to their home but to a post office near their work or homes because it would be a more convenient place to pick them up. This was one of the things we trialed in the run-up to Christmas. Increasingly, for drop-offs and pick-ups the Post Office will have a very valuable role in what I suppose could be called the e-commerce economy as it opens up.

Q354 Mr Clapham: That vision makes it plain that the link between postal services and the Post Office will be extremely important for that kind of development.

Mr Crozier: Indeed.

Q355 Mr Clapham: If we look at Post Office Ltd, you have a good network advantage at the present time such that you will be able to use it in future to grow the business. Presumably, when we begin to talk about postal services you will seek to retain that but with modernisation of the actual framework?

Mr Crozier: Yes.

Q356 Mr Clapham: Are we likely to see postal services retained or will there be a reduction in the number of such premises?

Mr Crozier: I think you ask two different questions. If I get it wrong please correct me. The government closure programme is virtually complete and there are no plans to go through further closures. That does not mean that from time to time other post offices will not close for a specific local or individual reason, for example someone retires, but generally

there is no closure programme. Will Royal Mail continue to use the Post Office? Absolutely, yes. Although we are very much part of the same group we also have what we call an inter-business agreement that runs between the two. You need to have that for all sorts of reasons to ensure that the mail is flowing from one to the other and back again. That is a very important arrangement. Obviously, at group level I must ensure that that is one of the things that works for the group in the round. I do not see any reason why anyone would not want that to continue. The Post Office is a very important part of providing the USO and giving people access points. The best way to think of it is that it is our shop window or retail arm. I see no reason why that would change.

Q357 Mr Clapham: The delivery offices that are connected to the sub-post offices are likely to remain?

Mr Crozier: Yes. There are about 1,100 special delivery offices, which we call SPDOs. They are very small sorting offices in small post offices usually in rural areas or villages. The truth is that that is the most cost-effective way to provide that service. Maybe in the long term—who knows—there will be another way, but it has been looked at many times and it seems to work.

Mr Clapham: As to the moneys you receive, does they include an amount for the commercial advantage of the exclusive access to the Post Office network?

Q358 Chairman: Do you pay for the uniqueness of the arrangement?

Mr Crozier: No, because there is no exclusivity. I believe that Postcomm touched on something called condition 9 of its regulation. People can apply for access to post offices, so that already exists under the regulatory setup.

Q359 Chairman: To be clear, anyone can apply to use the network for rival mail services but no one has chosen to do so?

Mr Smith: Exactly.

Q360 Mr Clapham: We have talked about an organisation that depends upon sub-postmasters *et cetera*. Do you believe that the operational effects of depending on people who underpin the network and run their own commercial ventures are likely to remain? Is that an advantage or is there likely to be some change?

Mr Crozier: What that gives us is an incredibly flexible resource. In fairness to the vast majority of sub-postmasters, they have a very entrepreneurial approach and it works well. There are other countries where post offices are entirely sub-postmasters and franchises; there are others where there is a bigger proportion of what we call Crown branches. It is not the same solution in every country, but the solution we have at the moment seems to work pretty well. Certainly, the Post Office results with the help of financial services are improving. This year will be the first in many when the Post Office will make a small profit, so there is some real improvement. One thing that is very important to it is the work that this Committee will be doing in looking at what other opportunities there are within government services. You have started that process and it is a very important part of the Post Office's future.

Q361 Mr Clapham: Within the network Crown post offices are of particular importance. Presumably, there will be emphasis on retaining the present number?

Mr Crozier: Yes. The number of Crown offices has changed recently, as I am sure you know. Our view is that the balance is now about right. The ones that we have shifted over are now performing well. We also need to invest in those branches because the truth is that if you go into some of them they need modernising and upgrading better to reflect what we now do in terms of the totality of our services rather than just mail. A lot of investment in the Post Office outlets themselves is needed, and there are clear plans to do that.

Q362 Mr Clapham: The government is making available £1.7 billion up to 2011 and it is then a matter of being able to negotiate beyond that time to ensure there is underpinning for the future?

Mr Crozier: That is very important and that process really starts in the autumn of this year. Obviously, you have to do it well in advance. There are always issues on state aid and they take time. The reality is that that process will begin either in the autumn or very early next year at the latest.

Chairman: This has been a very long session. I am not very provocative from the chair. It just amuses me that Post Office Ltd is said to be 100% publicly owned, but in order for it to deliver it relies on 11,000 strategic partnerships with small businesses, except for the WH Smiths, Tesco's and Co-ops. I do not think we have asked anything from you by way of supplementary evidence, but if there is anything you want to clarify in writing subsequently please feel free to do so. I am sorry we have kept you for so long. This is a big and important subject. Thank you very much.

Written evidence

Memorandum submitted by Richard Hooper CBE

THE UNIVERSAL SERVICE AND FUTURE OF ROYAL MAIL

Thank you for the opportunity to appear before your Committee on 20 January and explain how we recommend that the universal postal service can be maintained.

You suggested that you might hear further evidence about the review before you prepare your own report. I would be very pleased to appear again, and suggest that I bring Deirdre Hutton and Ian Smith with me. Our report to Peter Mandelson was unanimous.

I was pleased to see that no-one opposes our fundamental recommendation that Royal Mail must modernise, and do so more quickly in the face of vibrant competition within the communications sector and in an increasingly difficult economic climate.

We strongly believe that strategic partnership is vital to ensure a stable future for Royal Mail—the only company with the network to deliver letters to all 28 million addresses nationwide, on six days a week. It is no surprise that this recommendation is the subject of lively debate. But I should say, too, that the recommendation emerged strongly from the evidence gathered in over 200 meetings with a wide range of stakeholders, summarised in the report.

Much of the Committee's questioning focused on the capital required to enable Royal Mail to become more efficient and to diversify, and how best to ensure that Royal Mail can draw on practical experience of transforming a network company in difficult circumstances. Those are two of the factors which led my panel to conclude that strategic partnership is necessary. But there is a third—equally important: commercial confidence. That means modernising labour relations, so that the unions can engage in debates about the long-term future of the postal business and, in turn, management can press on with agreed plans free from confrontation and obstruction.

There are two fundamental questions which I hope the Committee will be able to examine in future sessions:

- First, if Royal Mail's modernisation is possible without a strategic partnership, why has it not taken place over the last 10 years, in spite of the company's plans to do so? Do the CWU and Royal Mail accept that the current relationship between the management and unions is a constraint, and that changes are needed on both sides?
- Second, what is the CWU's alternative approach to modernising Royal Mail, since it opposes a strategic partnership? How would the union propose to remove the current constraints on modernisation and provide the company with the commercial confidence needed to secure its future in a difficult environment?

Finally, I promised to let you have a more detailed answer to Lindsay Hoyle's question about the limits on Royal Mail's ability to reduce its prices.

First, Royal Mail is bound by competition law. As a result, the company cannot reduce its retail ("end-to-end") prices or access prices (paid by competitors who collect and sort mail before injecting it into the Royal Mail network) below the long-run incremental cost of providing these products.

There are no other restrictions on how low retail or access prices can go, as long as the price difference between similar retail and access products does not fall below a given level, known as "headroom". The system is designed to prevent margin squeeze. Headroom is expressed as a percentage of the retail price. It was originally set through commercial negotiations between Royal Mail and access competitors. These "headroom" margins have since been reflected in Royal Mail's licence, granted by Postcomm.

Each of Royal Mail's six letters products has a different headroom margin. As the table from Postcomm shows (below), the lowest retail prices which Royal Mail can currently charge (taking into account current access prices) are either at, or very close to, the minimum allowed under its licence. Royal Mail could reduce its retail prices further, but only by reducing its access prices to maintain the necessary "headroom".

Analysis of difference between actual headroom (retail—access prices) and minimum headroom—letter formats, 2009–10 prices

<i>Access product</i>	<i>Access price (p)</i>	<i>Closest retail product</i>	<i>Lowest retail price (p)</i>	<i>Headroom (p)</i>	<i>Headroom (%)</i>	<i>Minimum headroom (%)</i>	<i>Maximum drop in retail prices (p)⁽¹⁾</i>
1400	14.704	M 1400 2	20.5	5.8	28.4%	28.0%	0.1
120	15.662	M 1400 (residues)	22.2	6.5	29.5%	29.5%	0.0
120 OCR	14.219	M 120 2 OCR	18.3	4.1	22.4%	21.5%	0.2
120 CBC	14.106	M 120 2 CBC	18.1	4.0	22.1%	21.1%	0.2
700 CBC	14.106	M 700 2 CBC	17.8	3.7	20.9%	19.4%	0.3
Walksort	13.995	Walksort 2	16.5	2.5	15.2%	15.2%	0.0

10 February 2009

Memorandum submitted by Postcomm

Thank you for the opportunity to appear before your Committee on 24 February and explain our views on the Hooper Report and the future of Royal Mail. There are some points that we made in the session that you asked me to clarify in writing, in addition to the question about the universal service obligation that the Clerk of the Committee asked in her letter of 25 February.

The areas we are providing further information on are:

- Access: Access mail makes a gross profit contribution, the impact on customers has been positive, there has been no “cream-skimming” by Royal Mail’s competitors, Royal Mail’s own pre-sorted bulk products are no more profitable than Access products, and similar regimes do exist in other countries;
- Access is not an unfair subsidy for Royal Mail’s competitors. In fact it has contributed to maintaining the volumes that Royal Mail deliver over the final mile. Over the past three years Royal Mail’s bulk presorted mail volumes (Access plus Mailsort) have slightly increased, whereas Royal Mail’s overall letter volumes have declined;
- Mail volumes: showing that Royal Mail’s and Postcomm’s forecast of volumes for 2009–10 were within 130 million (less than 1%);
- Universal service: providing further information on what is included; and
- Clarifying the contract arrangements between Post Office Ltd and Royal Mail: that there is an exclusivity agreement between them.

ACCESS

Royal Mail offer a number of products to customers (and have done so for many years) where customers get a lower price depending on the work undertaken by the customer in preparing the mail so that Royal Mail can handle it at lower cost. The Mailsort product range offers discounts for customers who pre-sort and deliver the mail, and the discounts depend on the level of sortation, and to which Royal Mail location the mail is delivered. Access offers customers discounts for collecting, pre-sorting and trunking mail to the mail centre closest to the final delivery point Royal Mail do, therefore, charge its Access customers for final sortation and delivery. This final sortation and delivery represents 60% of Royal Mail’s direct costs.

Pre-sorted bulk mail represents just under half of all Royal Mail’s volume. Of this volume Royal Mail retains 57% through Mailsort; a further 19% are contracts negotiated directly between Royal Mail and customers for access; and 24% is Access by other postal operators. Royal Mail has, therefore, 76% of the pre-sorted bulk mail market and over 99% of all mail is delivered by it “over the final mile”. By offering an efficient and effective delivery service accessible to all customers, including other postal operators, it is more difficult for other operators to create their own end to end networks as have developed in Germany, the Netherlands and Sweden.

Access competition has provided benefits to customers including lower prices and greater innovation. Research by Europe Economics concluded that prices are 5% lower than would otherwise be the case. Fifty-five per cent of customers believe competition has improved their choice of service, and in a rating from 1 to 10 respondents ranked the statement “I am in favour of the mail market opening up to competition” at 6.9.¹

¹ UK Postal Market Business Customer Survey 2008 (Postcomm).

A lot of focus has been placed on Access and its impact on Royal Mail and the universal service. From a customer perspective, Access has played an important role in maintaining the relevance of mail as a media to customers who are faced with ever increasing lower cost choices for communications with their customers. Access has helped to keep prices down and encouraged innovation. In terms of its impact on Royal Mail, the company itself quotes that it has lost five times as much profit to e-substitution as it has from Access.

The Committee made the point that Access is loss-making, and is therefore a subsidy to other operators. However, Access contributes substantially to Royal Mail's fixed costs. The more important point is that, in the absence of greater cost transparency, any measure of Access profit can only be an estimate. Royal Mail said in their submission to the Independent Review that they planned to introduce another costing system which achieves a more accurate attribution of their fixed costs. Royal Mail's initial estimate of the costs of Access under its proposed service costing methodology shows Access making a small profit after full recovery of fixed costs. This shows the importance of achieving much improved cost transparency.

The Committee suggested that the obligation to deliver mail at a price of 13p is the reason for Royal Mail being in a loss, and that if the price was increased, Royal Mail would become profitable. There are in fact two courses of action that Royal Mail can take if it wants to increase profit:

- (i) Improve efficiency: RM claim they are 40% less efficient than their rivals. An efficiency improvement of between 10–15% would more than cover the unrecovered fixed costs on bulk pre-sorted; or
- (ii) Increase the prices of bulk pre-sorted mail (both Mailsort and Access). Royal Mail, in their evidence to the Committee, confirmed that a substantial price increase could not be implemented without risking a further decline in volumes, which would further increase losses.

Therefore, the only feasible way for Royal Mail to improve profitability is through increased efficiency.

There have also been suggestions that Access operators are “cream-skimming” Royal Mail's most profitable business. This is not true, because Royal Mail's own Mailsort products are no more profitable than Access products. Also, if an Access operator delivers mail that does not match the national geographic fall to earth profile, then it has to pay a zonal access price which will reflect fully Royal Mail's costs of delivering to “expensive to deliver” areas of low population density.

COMPARISON TO PROFIT OF ROYAL MAIL'S BULK MAIL PRODUCTS

Royal Mail's regulatory accounts suggest that in 2007–08, under the current costing methodology with full allocation of fixed costs, their own bulk mail products lost 2p per item, the same as level of loss as for Access products. This shows that, while an Access headroom control remains in place, the current level is broadly “fair” in that the additional revenue that Royal Mail earn for retail products is approximately equal to the additional costs. The reason for the loss on both products is that Royal Mail has not been able to meet the efficiency targets assumed within the price control for downstream activities.

ACCESS HEADROOM AND THE INCENTIVE FOR EFFICIENCY IN UPSTREAM COSTS

Adam Crozier's evidence argued that the use of Access headroom meant that Royal Mail had no incentive to reduce its upstream costs. Whilst we would dispute that there is no incentive, the more important point is that the direct upstream costs of the bulk mail business are less than £250 million (or less than 5% of Royal Mail's total costs) and, therefore, the headroom constraints can only have a marginal impact on Royal Mail's total efficiency. Any disincentive to reduce costs does not apply to the remaining 95% of Royal Mail's costs.

In any case, any increase in efficiency in Royal Mail's upstream business will result in lower costs for Royal Mail and therefore improved profitability. This is the standard efficiency incentive within a price control and the presence of Access headroom does not remove this incentive.

ACCESS REGIMES IN OTHER COUNTRIES

You also asked for information on Access regimes in other countries. We pointed to the USA in our evidence, which first started using Access (which they call “worksharing”) agreements in 1976. Worksharing is defined by the United States Postal Service (USPS) as “Tasks performed by mailers that otherwise would be done by the Postal Service, such as preparing, sorting, barcoding, and transporting mail. Reduced postage rates are offered to these customers”.² So the situation is comparable to the UK.

² 2 USPS Annual Report 2008 p 69.

There are over 450 workshare discount rates that encompass all classes of mail (except priority and express) and apply to over 80% of mail the Postal Service processes.³ The USPS and the Postal Regulatory Commission say that worksharing benefits:

1. The USPS—by enabling it to improve its operations and thereby help minimize its workforce and infrastructure, and by stimulating mail volume growth that generates revenues to cover rising costs;
2. Mailers—by reducing mail-related costs and improving delivery service, and the mailing industry that performs worksharing activities; and
3. Customers—in part by lowering business costs, and in part by the associated benefits that consumers can realise.⁴

It is important to note that the Postal Directive (Directive 97/67/EC as amended by Directives 2002/39/EC and 2008/6/EC) requires incumbents to grant access to the public postal network under conditions that are transparent and non-discriminatory and all member states have formally transposed this requirement into national law. We have specific information on the Access regimes in France, The Netherlands, Germany and Spain. This information has been gained through private meetings with regulators and operators, some of whom have requested that the information be kept out of the public domain. I therefore enclose this information in Annex B, which we are happy to share with the Committee, but ask that you treat as confidential.

MAIL VOLUMES

We stated in our evidence that we forecast Royal Mail's mail volumes within 100 million of Royal Mail's own forecast at the time of the last price control. The numbers came from Postcomm's Final Proposals, December 2005. The figures below set out Postcomm and Royal Mail's respective forecasts: (for regulated mail volumes 2009–10):

Royal Mail forecast:	20,935 million (Table 9.5, page 122—sourced to Royal Mail)
Postcomm forecast:	20,805 million (Table 9.7, page 128)

So the difference was around 100m which is less than 1% difference in our estimates.

USO

The attached diagram (Annex A), which was included in our second submission to the Hooper review, demonstrates which of Royal Mail's products are within the universal service, and which are outside. All universal services require a 6-day collection and delivery service, to be priced on a uniform basis and to be affordable.

Of those outside the universal service, around three quarters are currently either price controlled, or the price is controlled through the Access headroom control. These controls do allow Royal Mail some flexibility to change the prices of the products, but the maximum increase in the average price is capped. However, around 10% of Royal Mail's revenues in the Letters business are not regulated. This includes Special Delivery for business customers, door to door (Royal Mail's unaddressed service), and various smaller activities.

Your letter indicates that you received a different impression on the scale of the universal service from our evidence. We have analysed the evidence we gave and can see no material difference between the detail provided in this letter (which is consistent with the definition on our website) and our evidence.

We did not go into detail during our evidence on the wider scope of the universal service beyond first and second class mail. However, around 80% of the universal service revenues are from single piece mail (stamps, or meters used by small businesses) including Special Delivery and international stamps, and this remains the main focus of the universal service. Whilst there are a number of other products where Royal Mail are required to provide a universal service, these are small by comparison, with the USO business mail products (Mailsort and Cleanmail) being only around 10% of universal service revenues.

POST OFFICE LTD

In the session with Royal Mail that followed ours, Adam Crozier stated that there was no commercial exclusivity between Royal Mail Group and Post Office Ltd (POL). The most recent interbusiness agreement between Royal Mail Group Ltd and Post Office Ltd to which we have been given access (dated 4 December 2007) does have an "exclusivity clause". This prevents POL from entering into discussions with third parties

³ Letter from William Lyons, Office of Inspector General, USPS (May 2008) p 5
http://www.uspsoig.gov/foia_files/CRR-AR-Q8-0Q5.pdf

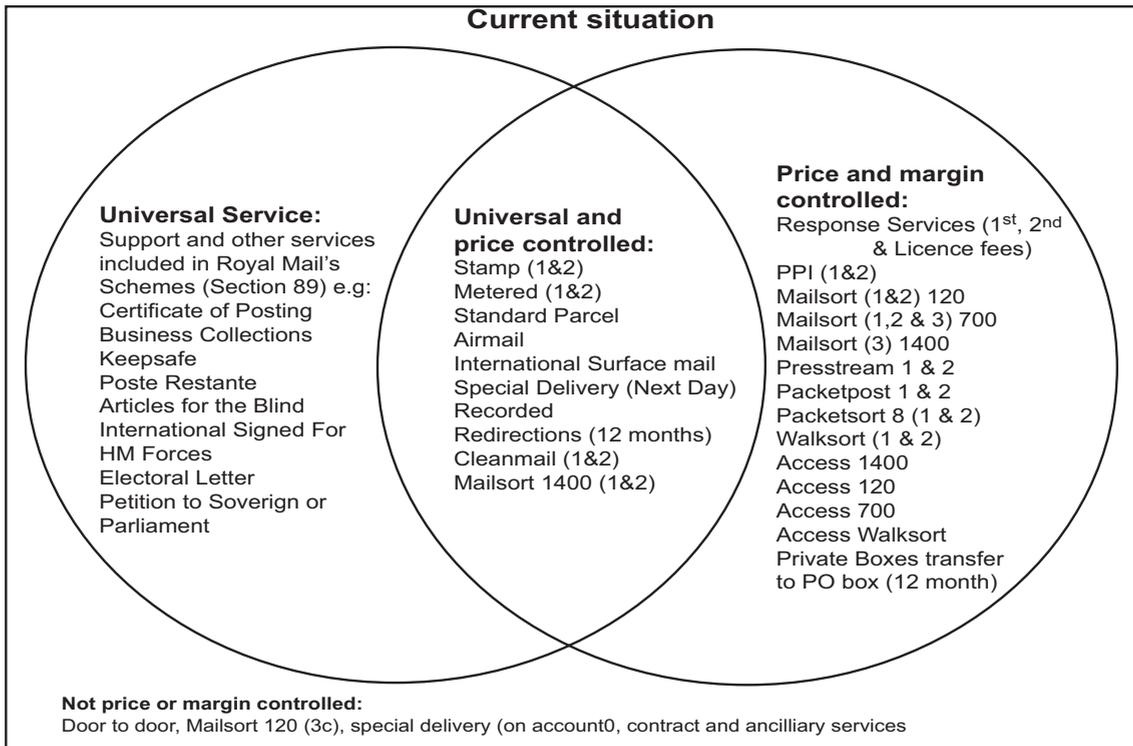
⁴ United States General Accounting Office—Report to Congress "USPS—A Primer on Postal Worksharing", July 2003.

about services or products similar to those provided for in the interbusiness agreement, unless invited to do so by Royal Mail Group Ltd. Exclusivity does not cover all aspects of Post Office Ltd's business, but it does, importantly, apply to services or products associated with the growing e-fulfillment market. Any request Post Office Ltd receives (such as, for example, providing a collection service for internet deliveries across post office counters) must be referred to Royal Mail Group Ltd.

Post Office Ltd has restrictions placed on it whereas Royal Mail Group Ltd is largely free to pursue other opportunities (we pointed in our evidence to Royal Mail not offering its services exclusively through post offices—customers can buy stamps online or from supermarkets). Thus it remains our view (supported by conversations with other operators) that this restricts the ability of Post Office Ltd to win new business in the fast growing parcels market.

Annex A

VENN DIAGRAM OF USO PRODUCTS



Notes:

1. PPI (1 & 2) are not required to be provided as universal services under Condition 2 of Royal Mail's licence. They can be classified as universal services by virtue of being provided under Royal Mail's Inland Letter Post Scheme, made under section 89 of the Act.
2. Access products are not price controlled but headroom protected.

5 March 2009

Supplementary memorandum submitted by Postcomm

Thank you for your letter of 12 March 2009.

The Venn diagram supplied to you is a guide to regulated services which are provided by Royal Mail and the nature of the regulation relevant to those services. I attach at Annex A a detailed list of the current regulated services, which also identifies those regulated services which are in the universal service. You will see when you compare the Venn diagram with the full list that some of the services comprise several variations of a service in order to take account of factors such as the readability of the address font by automated sorting equipment (eg Cleanmail OCR (optical character recognition) 1 and 2 and CBR (machine readable barcodes) 1 and 2).

Regarding your question as to Postcomm's rationale for determining the status of Royal Mail's various services, this will to some extent depend on the relevant circumstances of the service in question. However, in all cases when deciding whether services should be in or out of the universal service/regulation Postcomm has to comply with its statutory duties as set out in the Postal Services Act. Foremost among these are the duties:

- to exercise its functions in the manner which it considers is best calculated to ensure the provision of the universal postal service; and
- to exercise its functions in the manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators.

For example, Postcomm decided to remove all but two bulk mail products from the universal service from April 2006. This decision gave Royal Mail greater flexibility to compete in the bulk mail sector, paving the way for the company to alter the basis on which it sets its tariffs for those products, which it had been asking to do.

However, in order to protect customers, particularly small to medium sized business customers less able to exploit the competitive part of the bulk mail market, an overall price control was maintained for a range of bulk services and Postcomm decided that two bulk mail products should remain within the universal service:

- Mailsort 1400 (first and second class)
Which covers mail of all formats up to 2kg in weight and is pre-sorted according to the locations of the 1,400 delivery offices.
- Cleanmail (first and second class)
Which does not require users to have sorting machines and is the "entry level" bulk mail product most often used by smaller businesses.

I regret that the initial information supplied was insufficient and hope that the information provided in this letter meets your requirements.

Annex A

REGULATED SERVICES

(Universal services are in highlighted in **bold**)

- **First Class Stamped;**
- **First Class Metered**
- **Second Class Stamped;**
- **Second Class Metered**
- **Standard Parcel;**
- **Airmail Europe;**
- **Airmail World Zone 1;**
- **Airmail World Zone 2;**
- **Surface Mail;**
- Response Services 1st Class;
- Response Services 2nd Class;
- First Class Postage Paid Impression (PPI);
- Second Class Postage Paid Impression (PPI);
- **Special Delivery (Next Day) other than when sold to users having an account with the Licensee buying the service using their account;**
- **Cleanmail OCR 1st Class;**
- **Cleanmail CBC 1st Class;**
- **Cleanmail OCR 2nd Class;**
- **Cleanmail CBC 2nd Class;**
- Mailsort 120 OCR 1st Class;
- Mailsort 120 CBC 1st Class;
- Mailsort 120 OCR 2nd Class;
- Mailsort 120 CBC 2nd Class;
- Mailsort 700 1st Class;
- Mailsort 700 2nd Class;

- **Mailsort 1400 1st Class;**
- **Mailsort 1400 Residues 1st Class;**
- **Mailsort 1400 2nd Class;**
- **Mailsort 1400 Residues 2nd Class;**
- Presstream 1st Class;
- Presstream 2nd Class;
- Packetpost 1st Class;
- Packetpost 2nd Class;
- Packetsort 8 1st Class (including Flatsort 8 1st Class);
- Packetsort 8 2nd Class (including Flatsort 8 2nd Class);
- Walksort 1st Class;
- Walksort 2nd Class;
- Mailsort 700 3;
- Mailsort 1400 3 (including Flatsort 1400 3);
- Access 1400;
- Access 120 Letter;
- Access 120 Flat & Packet;
- Access 120 OCR;
- Access 120 CBC;
- Access 700 CBC
- Access Walksort;
- Proof of delivery;
- Private Boxes Transfer to PO Box 12 Months;
- **Recorded delivery;**
- Response services licence fees;
- **Redirections (12 months);**
- **HM Forces Mail;**
- Ministerial Pouch services;
- Return to sender as part of a Regulated Service;
- **Poste Restante;**
- **Petitions to Parliament;**
- **Petitions to Her Majesty the Queen;**
- **Certificate of Posting;**
- **Business Collections;**
- **Electoral Letter;**
- **Articles for the Blind;**
- **Keepsafe;** and
- **International Signed For.**

13 March 2009

Memorandum submitted by Royal Mail

ROYAL MAIL: UPDATE AND ANALYSIS OF MAJOR CHALLENGES

INTRODUCTION

In just over six years, Royal Mail has made real progress in turning a loss of £1 million every working day into a profit of £255 million for the first nine months of this current financial and dramatically improving quality of service, while at the same time around 50,000 people have left the company—all through voluntary redundancy or natural turnover. However the mails market is now in serious structural decline, the company is increasingly burdened by a huge and growing historic pension deficit, and the business does not generate enough cash to fund the investments needed to ensure that the future of the company—and the one-price-goes-anywhere Universal Service—is secure.

As part of Royal Mail's plan to transform the business we have a £2 billion investment plan partly funded through a £1.2 billion commercial loan agreed with the Government and which must be repaid, to allow the company to modernise the mails operations—as all our major rivals did in the 1990s.

Royal Mail would not have been able to invest that money effectively had we not reached agreement with our people and the unions in 2007 on modernisation and flexibility.

More than £600 million has been spent transforming the Letters business and we plan to spend every penny of the £1.2 billion commercial loan over the period of the investment plan to 2011. Almost all the automation equipment has been ordered and will be paid for when it is delivered.

In January 2006 the UK postal market was opened fully to competition—well before any other European country—with our rivals now handling almost one in every three letters posted in the UK. This change, combined with the onslaught of electronic communications and the growing pensions burden, makes it essential that Royal Mail increases the pace of its modernisation and moves more quickly to increase efficiency still further while developing new revenue streams that will help secure the future of the business and the Universal Service.

The remainder of this note focuses on the progress and challenges of Royal Mail's postal operations. The future of Post Office Ltd, which will remain 100% publically owned, is summarised in the Appendix.

ROYAL MAIL NOW FACES 4 MAJOR CHALLENGES

1. *The decline in the mails market is accelerating*

The structural decline in mails markets around the world is accelerating as people turn more and more to electronic communications including text and broadband. The overall UK mails market fell by 2.5% last year and is down by 4.5% in the current financial year with a further decline of 8% expected in 2009–10. Last year electronic communications cost Royal Mail £500 million in profits while competition from other postal operators depressed profits by further £100 million (and as the decline in volumes accelerates so will the effects on revenue). The UK market is not alone with many postal operators around the world expecting a decline in volumes and profits. For example:

The United States Postal Service which is still a monopoly, recently reported a 9% drop in volumes in the third quarter and said that the business could lose \$6 billion this year.

TNT, the Dutch postal operator expects volume decline to accelerate from 4% to 6%.

2. *Royal Mail has a huge and growing legacy pension deficit*

Royal Mail is increasingly hampered by a huge and unsustainable legacy pension deficit, which currently costs the company £280m in cash every year for 17 years and which is likely to more than double at the next valuation this spring—which Royal Mail simply cannot afford. Nor can Royal Mail pass the cost of the pension deficit on to customers as it would make the company more uncompetitive (and clearly even more so at double the amount) and would drive down mails volumes even faster.

3. *The Universal Service is loss-making*

The one price goes anywhere Universal Service, which is part of the social and economic fabric of the country—and which only Royal Mail can provide—is now loss-making and is under threat as postal rivals target our most lucrative business customers.

4. *Royal Mail needs to accelerate its modernisation plan*

The scale of these cumulative challenges means that it is necessary to accelerate our modernisation and investment programme in the interests of all key stakeholders. In order to achieve this we must continue to bring in best-in-class skills at all levels of the business. The review last year led by Richard Hooper recognised these challenges and the key conclusions of the Hooper review and the benefits of stepping up our modernisation are explained below.

THE “HOOPER” REVIEW

The review led by Richard Hooper recognised the major challenges faced by the business. The panel's recommendations, to help secure a bright future for Royal Mail and protect the Universal Service, include:

- Establishing a strategic partnership between Royal Mail's postal operations and a private sector partner, bringing in private capital and experience of modernising in similarly tough circumstances.
- Government tackling Royal Mail's historic pension deficit in some form, to enable the company and its customers to reap the benefits of modernisation.

- Ofcom regulating the postal services market to reflect the wider communications market in which the business now operates.

Why Royal Mail needs access to capital

Capital is needed for Royal Mail to protect the Universal Service which is an essential part of the social and economic fabric of the UK.

Timely and flexible access to capital is needed for Royal Mail to accelerate the modernisation of its postal business, develop new revenue streams and offset the dramatic structural decline in the world's mails markets—again to protect the Universal Service. Even now the £1.2 billion commercial loan agreed with the Government in early 2007 has yet to be approved by the EU.

As with any business it is necessary that the company has enough cash available to act as a buffer against the risks it faces.

Fresh capital is necessary if we are to invest in new revenue streams including new mails services such as “track and trace” and our iRed integrated document production and management business, and to speed up modernisation across the mails operations.

Part of the solution is the Government tackling the historic pension deficit in some form. However, even if the historic deficit is removed Royal Mail may not receive the full benefit as there is a risk that it can be clawed back under the regulatory regime—so there would still be a need for new capital to help speed up modernisation across the mails operations and offset the accelerating decline in the structural mails market.

Royal Mail needs access to capital if it is to continue to provide voluntary redundancy packages to those people who leave the business through the modernisation programme.

In an increasingly competitive mails and wider communications marketplace, and in one of the worst economic environments in memory, Royal Mail cannot simply raise prices to the degree required to pay for necessary new investment.

Our aim is to be:

- An efficient, high quality and profitable USO mails business in the UK.
- A thriving parcels fulfilment business to enable our customers to benefit from the e-economy.
- A leader in the growing parcels segment in Europe, and in mails too where this is attractive.
- A provider of integrated solutions to customers through an expanded presence along the mails value chain.
- A secure Post Office which is based on the core propositions of customer focused mails, government owned bank and a retail front end for government services.

THE BENEFITS

Our customers will benefit from:

- A strong and secure Universal Service—especially for consumers and SMEs—around the UK.
- The innovative products and services they want and expect.
- Further improvement in Quality of Service.
- Better value for money.
- Enabling both consumers and vendors to make best use of the growing e-economy.

Our people will benefit from:

- Pension security.
- Investment in their jobs.
- A more competitive and innovative Royal Mail.
- Greater job satisfaction from knowing that we will respond still more effectively to our customers
- Better long term prospects for the company's employees.

We have always been very open with our people and the unions that modernisation will mean fewer jobs and that, where there are job losses, our intention is that they should continue to be through voluntary redundancy and natural turnover—but we have also been clear that, unless we modernise, the impact on jobs will be much greater as we become less competitive and fall into inevitable decline.

The taxpayer will benefit from:

- A more financially secure Royal Mail.
- Less demands on the public purse.
- The long-term security of the Universal Service Obligation delivered in a high quality manner as a major component of social cohesion and the fabric of the UK.

And everyone will benefit from:

- Trusted Royal Mail and Post Office brands which combine the best of the public service ethos with the ability to deliver in the highly competitive communication and financial services markets.
- Increased confidence about the future.

APPENDIX

POST OFFICE LIMITED

Post Office Ltd, within the overall umbrella of Royal Mail Holdings, will remain 100% publicly owned and will continue to play an important social and economic role in communities around the UK.

Even after the Government programme to close around 2,500 post office branches—which is now near completion—the Post Office network has more than 11,500 outlets and is still the biggest retail or financial services branch network in Europe.

Royal Mail believes for Post Office Ltd to have a long term secure future and provide what customers want, the business needs:

- Calmer waters for Post Office Ltd with no further closure programmes.
- More Government services delivered through the Post Office network.
- The creation of a “people’s bank” through expanding Post Office Ltd’s range of financial services.
- An increased role for the Post Office network in providing the postal service, including the collection and drop-off of parcels and continuing the vital role it plays in providing the one-price-goes-anywhere Universal Service.

25 February 2009

Memorandum submitted by the National Federation of Sub-Postmasters (NFSP)

I am writing to inform the House of Commons Business and Enterprise Committee of the National Federation of Sub-Postmasters (NFSP) views regarding the Hooper Review on the future of UK postal services.

While we welcome many aspects of the proposals, and the subsequent legislation tabled by the Government, the NFSP has serious concerns about the impact on sub-postmasters, the post office network and in particular mailwork post offices, of the separation of Post Office Ltd (POL) from Royal Mail Group.

In view of the post office network’s role in carrying out £1.5 billion of mail transactions each year and in providing vital access points for mail services, the NFSP was disappointed not to be called to supply either written or oral evidence to the Committee’s inquiry on the Hooper Review. We have therefore supplied a short briefing document to inform the committee of our position, which we hope is of interest to you.

HOOPER REVIEW AND THE POSTAL SERVICES BILL

The National Federation of Sub-Postmasters (NFSP) represents the interests of sub-postmasters, private business people who run 97% of the national post office network.

BACKGROUND

The Government has tabled a Bill which proposes significant changes to Royal Mail Group, of which Post Office Ltd and Royal Mail are both currently part. This follows recommendations made within Richard Hooper’s report on the future of the UK postal service (the Hooper Review), which the Government has accepted in full.

Government Proposals

The Government proposes a number of changes within the recently published Postal Services Bill including:

- Royal Mail should form a strategic partnership with a private sector company able to deliver the capital and expertise required to transform the business, allowing the sale of a minority stake in the company. Ministers have suggested this should take the form of the sale of up to a third of Royal Mail to a foreign postal operator.
- Experience of other European postal operators suggests that measures to increase efficiency and modernise operations may result in the closure of a significant number of delivery offices.

- Post Office Ltd (POL) should be removed from Royal Mail Group (RMG), and established as a separate, fully state owned company. Both POL and RMG will sit under an umbrella company, Royal Mail Holdings.
- The government will assume Royal Mail's historic pension deficit.
- The regulation of postal services will transfer from Postcomm to Ofcom.
- Ofcom will have scope to extend the financial burden of operating the Universal Service Obligation from Royal Mail to include other mail operators.

Post Office Network

The post office network has reached a critical point in its history. The 18-month Network Change programme, which resulted in 2,500 post office closures, has now been completed.

Sub post office income remains worryingly low. New work needs to be brought into the post office network, increasing income for the remaining 11,500 post offices.

Changes to Royal Mail that adversely impact on the post office network risk further widespread post office closures. Many sub post offices would not survive more reductions in income.

Post Offices and Royal Mail

Income from transactions carried out in post offices on behalf of Royal Mail accounts for one third of POL income (£348 million in 2007–08) and one third of sub-postmasters' pay (£165 million in 2007–08) under the inter business agreement between the companies.

Of this, around 60% is variable income based on the level of transactions undertaken; while 40% is fixed income, based on post offices providing bricks and mortar access points for the public to access postal services.

Currently sub-postmasters only provide postal services on behalf of Royal Mail and Parcel Force. They cannot accept mail from other carriers for post or for collection by customers.

Mailwork Sub Post Offices

900 mail work post offices, run by sub-postmasters, provide premises, facilities and supervision for Royal Mail delivery staff.

Mailwork post offices are overwhelmingly based in rural areas—1 in 7 rural post offices are mailwork offices.

Mailwork sub-postmasters are paid according to the number of postmen and women they supervise. This pay is frequently around 25% of a mailwork sub office's total Post Office income.

A sub-postmaster supervising 5 postmen/women will be paid over £10,000/year. For sub-postmasters with 25 postmen/women, payments are £40,000/year.

Mailwork sub-postmasters also receive income from increased footfall, as customers coming in to pick up undelivered parcels often make other purchases in the post office.

The post office and mailwork aspects of the business are inter-dependent, to such an extent that many mailwork sub post offices would be forced to close through loss of income without their mailwork contracts.

NFSP VIEW

Postal Services Bill

The NFSP welcomes several aspects of the government's proposals. These include:

- The Government taking on the historic pension deficit.
- Greater protection for the Universal Service.
- A fairer regulatory regime under Ofcom.

However, there remain other aspects on which we have significant concerns:

POL/Royal Mail Relationship

The separation of POL and RMG into two separate companies, bound only by a loose holding company, means that the current business arrangements between the two companies may well change. Royal Mail may reconsider whether POL should remain as its preferred retail outlet.

There are strong synergies between POL and RMG and no known international precedent in separating a national mail operator from its retail arm. We believe that guaranteed major new income streams would be required for there to be any possibility that POL could be financially viable without at least maintaining current levels of Royal Mail work.

Income

Sub-postmasters are increasingly dependent on Royal Mail transactions, with over a third of sub-postmaster income coming from mail services. To lose any of that work would be catastrophic. The NFSP is therefore calling for a minimum 10-year exclusive deal for POL to handle Royal Mail and ParcelForce transactions.

Any reduction in the number of delivery offices, leading to losses of mailwork contracts, threatens one in seven rural sub post offices.

The separation of POL and RMG, and with a private company in part ownership of Royal Mail, may well lead to the renegotiation of the fixed payment aspect of the inter business agreement, which Royal Mail pays to POL for the post office network's role as an access point. This in turn would significantly threaten POL's and therefore sub-postmasters' income.

FUTURE OF MAIL SERVICES AT POST OFFICES

The NFSP believes the post office network should build on its traditional products and position as the retail arm of Royal Mail, and that the Post Office should be the place to go for all mail needs:

- The NFSP supports new mail services being introduced at the Post Office, such as Local Collect which allows people to collect undelivered parcels from a nearby post office.
- Postcomm, the regulator, has suggested that new mails operators may want to use the size and geographic coverage of the post office network to sell their products and services to domestic customers and small businesses. The NFSP agrees that if this is how postal competition develops, post offices must act as dropping off and collection hubs for all mails companies. To maintain the network's integrity, this should be agreed on a network-wide basis, rather than by arrangements with individual post offices.

FUTURE OF THE POST OFFICE NETWORK

The provision of mails-related services and the income they bring is essential to the future of the post office network. In addition, it is vital that other services offered by our post offices are extended and enhanced to improve the viability of the network:

- Current government services available at post offices should be extended so that the network can provide a comprehensive range of government-related payment transactions, information provision, and form access, checking and verification. A one-stop shop for government information at post offices, offering a face-to-face service complementing the DirectGov website, would provide convenient access to government services at the heart of local communities.
- All local authorities should also offer payment collection facilities at post offices. These should range from rent payments and council tax to meals on wheels, blue badges and leisure centre passes. Local authorities should also formalise arrangements and remunerate post offices for their informal role as communications channel providing information and signposting.
- Banking should be a major service provided by the post office network. A national bank at the Post Office, or Postbank, should be created building on the Post Office card account to provide a full range of basic, current and business accounts. This would enable increased access to banking services for individuals and businesses alike in a trusted, accessible environment.
- Post offices should also offer full access to all major high street bank accounts, providing free access to cash in local communities.
- The post office network should continue to offer a range of other financial services, bill payment facilities and travel-related services.
- The government must urgently commit to the renewal after 2011 of the Network Subsidy Scheme, the £150 million a year payment to POL which acknowledges post offices' unremunerated social and economic contribution to the communities they serve.

- Local and devolved government should offer full, automatic small business rates relief to support post offices; and provide grant funding to enable improvements in post offices and their retail businesses.
- Most post offices also operate retail outlets, usually a newsagent or grocery store. In addition, post offices are acknowledged as critical to the economic wellbeing of local high streets. Action to support small shops and champion local retail, particularly during the current economic downturn, is vital and will help support post offices too.

The post office network is a critical piece of the nation's infrastructure, and makes a major contribution to the social and economic glue that holds communities together. Decisions about the future of Royal Mail have consequences far beyond that of the company itself; its future is inextricably tied to the fate of our local post offices—it is imperative that the right decisions are made.

9 March 2009

Memorandum submitted by the Business Post Group Plc

POSTCOMM AND ROYAL MAIL

“FOR THE RECORD”

I read with interest and concern the transcript of the BERR Select Committee's hearing on 24 February, when you heard oral evidence from Postcomm and Royal Mail, and I am writing to you to put on record my views on two of the topics covered.

ACCESS HEADROOM

UK Mail (part of Business Post) was the first company to reach an agreement with Royal Mail for Downstream Access to Royal Mail's network for final delivery of mail. I was responsible for those negotiations back in February 2004, and so have first-hand knowledge of how the charges for Access were established.

The negotiations focused on “commercially” acceptable arrangements for both UK Mail and Royal Mail. In parallel Postcomm were about to give a regulatory determination of the Access price. Both UK Mail and Royal Mail had some feel for what that price would be if the negotiations failed. There is no doubt that the Postcomm rates for access would have been less attractive to Royal Mail. From UK Mails perspective, whilst Postcomm rates were probably going to be better, there was no guarantee that Royal Mail would accept them, which would only delay our business from commencing. It was therefore apparent that both parties were well placed to strike a commercial deal.

Only after agreeing that first access price did we look at how it related to the equivalent Royal Mail retail price—ie what the “commercial headroom” was—and then only so that we could agree with more prices, across the full weight spectrum for letters and packets that were at similar “headroom”.

Later in 2004 and subsequently, UK Mail agreed further prices with Royal Mail for Access services that were comparable to other retail services. Those negotiations were without any regulatory background and so, due to commercial imperatives and Royal Mail's stronger position, were agreed at prices that offered far less commercial headroom than the first Access price.

Hence, we developed by commercial agreement a set of prices for Access services that gave varying commercial headroom from the comparable retail service prices.

It was not a case of deciding Access headroom' and then working out what Access price resulted.

Access headroom became part of the regulatory framework in April 2006 when Postcomm formalised the existing commercial headroom into the Royal Mail Price Control, to give Access operators protection from price squeeze.

Therefore I would suggest that, we are where we are, through commercial history rather than regulatory price-setting.

I would also comment on the current Access prices. It is very misleading for media and others to compare an Access price of 13p with a “normal price” of 27p. For The record: the Access price is now about 14p (new rates from April for *high volume, pre-sorted mail*) and the comparable Royal Mail retail price is circa 18p, (for *high volume, pre-sorted mail*.)

ROYAL MAIL PROFIT ON ACCESS

The transcript of the Select Committee on 24 February shows Postcomm saying Royal Mail makes a profit on Access and Royal Mail saying they make a loss. Both are right because Postcomm and Royal Mail are using a different process to calculate the costs of Access.

For me, this confirms the need for a proper regulatory investigation of Royal Mail's costs and the correct allocation of them to Royal Mail's activities—and hence valid pricing.

I am encouraged by the intention that Ofcom will become the postal regulator as they are likely to apply the expertise and rigour needed to establish full knowledge of Royal Mail's costs.

UK Mail does not want a “subsidised” Access price. We want Royal Mail to make a fair profit on its Access service to us—that will encourage Royal Mail to treat us an important and valuable customer. UK Mail is the largest Access operator in the UK and will pay Royal Mail approximately £125 million this year for Access services.

What we do want is for the Access price to be based on a correct allocation of Royal Mail's costs—and for Royal Mail retail to be charged the same price as Royal Mail wholesale charges us.

For as long as Royal Mail is dominant in the market, (in Access it is 100% dominant,) it should be regulated to improve efficiency and price correctly. Development of competition can then be fair and in the best interest of the customers we serve.

9 March 2009

Supplementary memorandum submitted by the Business Post Group Plc
EXCLUSIVITY BETWEEN ROYAL MAIL AND POST OFFICES LTD

I am writing to you to raise a concern that we briefly discussed when we met on 4 March, that is the unreasonable and restrictive contractual agreement between Royal Mail (RM) and Post Offices Ltd (POL).

To the best of my knowledge, RM and POL have contracts between them which impose mutual exclusivity on each other; ie RM can only use POL as the “retail” outlet for its mail services and POL can only sell RM services.

I can understand that in the past this arrangement has underpinned the postal monopoly held by RM and the role of POL as the public interface for postal services.

But now RM no longer has a statutory monopoly and other postal service providers should be able to compete on a more equal basis. And POL should not be prevented from realising new revenue opportunities in selling other providers' services.

It seems particularly restrictive that the contracts between POL and the sub-postmasters who operate more than 90% of all Post Offices explicitly forbid them from selling services that might compete with those offered by RM.

Sub-postmasters are self employed businessmen, typically providing a Post Office as part of a general retail outlet, who are desperate for new revenue sources. But the RM and POL exclusivities actively deny them that opportunity.

We are now in a position where:

- the financial viability of the Post Office network is increasingly under threat;
- the public subsidy paid to POL to maintain that network is getting ever greater;
- legislation is before Parliament to enshrine POL full public ownership; and
- the same legislation will introduce a strategic partner in RM.

Surely now is time to remove the damaging restriction of RM—POL exclusivity?

My company (and, I believe, other postal operators) would welcome the opportunity to offer our services through Post Offices and so increase both access for postal users to our services and the revenue opportunities for sub-postmasters.

This will hopefully form part of the debate on the Postal Services Bill when it comes to the House of Commons.

9 March 2009

**Letter from the Chairman of Royal Mail Pensions Trustees Ltd to the Secretary of State, dated
19 February 2009**

POSTAL SERVICES REVIEW

Further to our meeting of 13 February, perhaps I could confirm the Trustee's views in respect of the Hooper Report, in so far as it affects the Royal Mail Pension Plan.

Let me reiterate the Trustee's position. The Trustee has a fiduciary duty to protect the benefits of the 450,000 members of the Royal Mail Pension Plan. The Trustee's prime concerns, therefore, are security of members' benefits and the strength of the covenant of the plan sponsor.

As you know, Royal Mail's position is weak in respect of its covenant and there is a significant pension fund deficit, which is a long-term drain on the company's cash. Royal Mail is already balance sheet insolvent.

If the recommendations of the Hooper Report were not implemented, the consequences could be very severe indeed for the Royal Mail Pension Plan and for Royal Mail itself. In particular, in light of the weakness of Royal Mail, the Trustee would consider it necessary to seek to significantly strengthen the funding basis for the 2009 actuarial valuation. On a self-sufficient basis this would value the liabilities far higher, resulting in a deficit that would be significantly larger than the £5.9 billion quoted in the Hooper Review, which is on the existing ongoing basis. The law gives the Trustee and Royal Mail until 30 June 2010 to agree this valuation.

Whatever its precise amount, the deficit resulting from a strengthened funding basis for the 2009 valuation is highly unlikely to be affordable by Royal Mail, with potentially devastating consequences. If this were the case, the Plan's financial resources would not be sufficient to provide the full value of benefits, which would need to be very significantly reduced. At present, in a winding-up the Plan would not even be able to provide as much as 50% of members' benefits.

In theory the Pension Protection Fund would act as a safety net for members, but I would not like to speculate on its ability in practice to absorb the Plan without putting an intolerable levy strain on remaining UK pension schemes.

Consequently, the Trustee of the Royal Mail Pension Plan, subject to obtaining satisfactory guarantees from Government, is in favour of the Hooper Report's recommendations. We very much look forward to these being implemented, as soon as possible, for the benefit of all concerned.
