



**Treasury Minutes on the
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Reports from the Committee of
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**Presented to Parliament by the Financial Secretary
to the Treasury by Command of Her Majesty
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TREASURY MINUTE DATED 15 JULY 2002 ON THE
THIRTY-FIRST TO THE THIRTY-FIFTH REPORT FROM
THE COMMITTEE OF PUBLIC ACCOUNTS, SESSION
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Thirty-first Report

Postcomm

Postcomm: Opening the Post

On 29 May Postcomm published its decision document setting out its policy for achieving effective competition within the UK postal market. Postcomm's decision¹ followed two years of extensive research, analysis and consultations and took into account the comments from the Public Accounts Committee.

The Committee's eight main points

- **Consignia's problems have impacted on the quality of the universal postal service . . .**

Postcomm accepts the Committee's view that Consignia needs to address its problems to meet current standards of service required by the licence. Consignia is already responding to the challenge and has initiated a three year renewal plan to improve its efficiency and meet customer needs. Postcomm's final decision on opening up the market means that Consignia will retain at least 70% of the market while it implements its plan.

- **Postcomm intend to encourage improvement by Consignia by rapidly opening the market to competition, but need to be cautious about the potential consequences of their proposals on the universal service . . .**

Postcomm has taken a phased approach to the opening up of the UK postal market, which allows Consignia, other operators and customers more time to prepare for competition while at the same time providing clarity and certainty for the industry as a whole. Postcomm has also put back full market opening by one year. Postcomm will continually monitor developments in the market and their effect on the universal service, and Consignia's service standards and prices. If Postcomm finds that the universal service is being threatened for whatever reason it will take appropriate action.

- **Postcomm's proposals for the introduction of competition differ markedly from those of the European Commission . . .**

It is agreed European policy to progressively liberalise the postal market. The recently agreed European Union framework provides an indicative timetable for completion of the European postal market opening in 2009; with market opening in three stages. Postcomm's phased opening of the UK postal market builds on the approach to liberalisation adopted by the European Union. Postcomm believes that the European weight/price reduction would not on its own achieve an orderly transition to full market opening in the UK. For that reason Postcomm has decided to build on the European requirements.

¹ "Promoting Effective Competition in UK Postal Services: A Decision Document" May 2002.

- **It is not clear that Postcomm can assess the effect of competition until they have decided on the prices Consignia may charge in future . . .**

Postcomm considers that its market opening strategy is the key element of the regulatory framework. Postcomm recognises that there are other elements of the regulatory framework which need to be put in place—including the long-term price control regime for Consignia. Postcomm has a programme of work in place to determine these other elements.

- **It may prove necessary for Postcomm to allow prices to rise . . .**

Postcomm will consider very carefully any request from Consignia for a price rise in the light of its statutory duties and current plans to implement a new price control regime from April 2003.

- **Postcomm needs to develop a greater understanding of how changes to the levels and types of services Consignia provides will affect its customers . . .**

Postcomm is working closely with the consumer body, Postwatch, to ensure that customers benefit from more reliable and innovative services. Consignia has undertaken not to make any significant changes to the services it currently provides without the agreement of Postcomm and Postwatch.

- **Postcomm have a very difficult task to perform . . .**

Postcomm will continue to consult and listen to the concerns of stakeholders in regulating the postal market for users. In reaching its decision on competition, Postcomm spent two years researching, analysing and consulting on a number of options.

- **We look to both of them (Consignia and Postcomm), as public sector bodies, to move away from this strained relationship and seek to work more cooperatively from now on . . .**

Postcomm's decision on competition had a substantial input from Consignia on how the company operates and its financial situation. Postcomm will continue to invite Consignia's close co-operation and to listen carefully to its views on changes in the UK postal market. Postcomm will also look to Consignia to co-operate constructively in future work, especially in relation to the provision of information. Postcomm firmly believes that for the foreseeable future a healthy and robust UK postal industry needs a healthy and robust Consignia at its core.

Consignia's provision of a universal service and current performance

PAC conclusion (i): Consignia's prices for standard mail are cheaper than postal services in most other large economies, and surveys reveal a high level of satisfaction with Consignia. The company has some inherent strengths, including a committed workforce, loyal customers and an extensive retail network. Consignia also delivers universal service at a geographically uniform rate. Postcomm need to ensure that these benefits are not sacrificed in opening up the

market. There is evidence that these need not be sacrificed if competition is opened up in the right way.

1. Postcomm accepts the Committee's view that the current benefits of the UK postal service should not be sacrificed in opening up the UK postal market. Postcomm's analysis shows that the foremost safeguards for the universal service are the improvements in efficiency and innovation which will be stimulated by competition. Postcomm has adopted a phased approach to the opening of the market so that the effect on the universal postal service, and Consignia's service standards and prices, can be continually monitored. If Postcomm finds the universal service is being threatened for whatever reason it will take appropriate action.

PAC conclusion (ii): Consignia has, in recent years, experienced a number of problems including poor labour relations, difficulties in meeting its quality standards and rapidly rising costs. Some of these can be attributed to constraints placed on its retention of funds for investment and on its ability to increase pay rates for its postmen and women and to increase prices significantly. But there are also doubts about Consignia's efficiency, and, in opening up the market, Postcomm can reasonably look for improvement in Consignia's performance.

2. Postcomm's analysis supports the Committee's conclusion that Consignia can improve its efficiency. Consignia has already initiated a three-year renewal plan designed to save £1.4 billion of its annual costs to improve its efficiency and put it in a stronger position to meet competition from other mail operators.

3. While the Post Office was a public corporation, control of its expenditure was through a limit on the company's requirement for external financing of its activities—the external financing limit (EFL) which required the company to build up cash surpluses. During this time it was also subject to the requirements of public sector pay policy. However, under the new commercial regime established under the Postal Services Act 2000, Consignia no longer needs to secure Government approval for individual pay settlements although pay is discussed within the context of the strategic plan. The financing package announced on 13 June gives the company access to the reserves (accumulated EFLs) on its balance sheet to back the investment required to implement the renewal plan and support the post office network.

PAC conclusion (iii): Consignia's profitability has fallen rapidly and the company is currently losing around £1.5 million a day, which if sustained would put the universal service at risk. Consignia said that it had been unable quickly to adjust its costs when the growth in bulk and advertising mail volumes slowed from 12 per cent to 5 per cent a year. A well run business should have recognised the risk of such events. This Committee has been critical before of Government-owned bodies placing too much reliance on ambitious targets, for instance in connection with the assumptions made on the number of visitors to the Millennium Dome. The Department of Trade and Industry, as the Government's principal shareholder, approve Consignia's business plans and should seek to ensure that such plans apply risk management disciplines including the full range of possible scenarios for mail volumes.

4. The Government agrees that the company's strategic planning should contain an analysis of risk and has imposed risk analysis requirements on the company. Article 82(C)(iii) of the Memorandum and Articles of Association of Consignia Holdings plc requires the plan to analyse the commercial and regulatory environment in which the group operates in which, in itself, implies an analysis of risk. Also, Article 82(C)(iv)(g) requires that it should contain a "sensitivity analysis of the major risks".

PAC conclusion (iv): Consignia has responded to its recent losses by announcing up to 15,000 job losses, with possibly a further 15,000 depending on whether other financial savings can be made. The lack of clarity about future employment prospects in the industry does not inspire confidence in Consignia's planning arrangements and must be unsettling for the whole of Consignia's workforce. Consignia estimate that an additional 10–15,000 more jobs might be lost as a result of proposed increases in competition. In opening up the market Postcomm will need to be sensitive to the impact of uncertainty on the jobs of postal workers.

5. The Government recognises the uncertainties that have surrounded future job losses but invites the Committee to note that the company has now confirmed the details of its three-year renewal plan, including changes to its workforce, in its announcements on 25 March and 13 June.

6. Postcomm agrees with the Committee's conclusion that it is important for the industry and job prospects of postal workers for there to be greater certainty about the future. In adjusting its proposals for competition in the light of comments received, Postcomm made a number of adjustments with the aim of providing greater clarity and certainty for Consignia and the whole postal industry. The opening phase of competition now coincides with the reduction in threshold to 100 grams for monopoly postal services throughout the EU in January 2003. The start of phase two has been moved to April 2005 to align it with the proposed end of Consignia's renewal plan. This means that during the renewal plan Consignia will retain at least 70% of the market. Finally, full market opening has been put back from 2006 to 2007 to give more time to Consignia and others to adjust and to provide the certainty of a steady transition to full competition.

Postcomm's proposals for the introduction of competition

PAC conclusion (v): Postcomm expects competition to develop slowly under their proposals, because competitors would not have Consignia's ability to deliver to every address in the country, which business mailers such as banks would require. But this analysis appears to overlook the possibility that new entrants would just deliver the low-cost mail, while transferring the most difficult and expensive mail to Consignia for delivery. Such an erosion of Consignia's most profitable business could have a major effect on its ability to sustain the universal service at uniform price.

7. Postcomm notes the Committee's concern that rival operators might decide to take the best routes and leave the unprofitable ones for Consignia. This is an issue which Postcomm took into account in reaching its decision on competition and which it will reflect in its work on access prices. Consignia's ability to deliver to every household in the UK every working day is a clear commercial advantage. Bulk mailers such as banks, advertisers, utility

companies, government departments and credit card companies require a service that delivers to all of their customers. Only the Royal Mail has this network. Whilst it will be possible during the transition period for operators handling bulk mail to choose to deliver some mail themselves, and to hand the rest over to Royal Mail, there is no evidence that this will have a negative impact as operators will be required to pay a fair price to Royal Mail for all mail it delivers for them.

PAC conclusion (vi): In expecting competition to grow slowly, Postcomm also cite the international experience that incumbent postal companies have lost only small amounts of market share where competition has been introduced. The international precedents differ substantially from the UK market or Postcomm's proposals for opening up the market. In Sweden, where the market has been completely opened, prices for domestic users and small businesses have risen, and the incumbent company is now making losses. Postcomm needs to be more explicit about the inferences they draw from overseas experience, and how they distinguish the wider lessons from market-specific factors in the countries concerned.

8. Postcomm's decision on competition reflects two years of research and analysis of postal issues, including looking at the experience of the postal markets in other countries. One of the key lessons of the experience in other countries is that entry to the market tends to be limited even where there is full liberalisation. National operators tend to hold on to well over 90% of the market because of a range of factors such as economies of scale and customer loyalty. Potential entrants have therefore adopted a number of approaches to gain a foothold in the market, often building on existing services and networks or starting on a very small scale. The national operators have in turn strongly contested entry to the market by legal challenge, by restricting access to the network, or by aggressively responding on prices. In Sweden, for example, the Swedish regulator did not have the power initially to control individual prices. Under Consignia's licence, Postcomm has the power to ensure that Consignia is not able to take unfair advantage of its size or position as the dominant player in the market. Postcomm expects that postal users will benefit from more reliable and innovative services.

PAC conclusion (vii) The Comptroller and Auditor General's Report emphasised the importance of robust analysis for managing the risk that Postcomm face in introducing competition. But while Postcomm estimate the net cost of providing universal service to be £81 million a year, Consignia's modelling, using a different approach, suggests that it could lose up to £750 million in profitable business from the current proposals for competition. And Postcomm and Consignia do not agree on the volume of business exposed to competition in the first stage of Postcomm's proposals for market opening. Greater effort needs to be applied on both sides to reaching a shared analysis of the impact of market opening on Consignia's ability to sustain the universal service.

9. Postcomm agrees that it is important that, as far as possible, all key stakeholders in the postal industry should agree on the information underpinning the decision on competition. The assessments made by Postcomm and Consignia referred to above seek to measure different aspects of the postal services market. The Postcomm assessment is of the current cost of

providing the universal service in a monopoly market whilst the Consignia assessment is of the impact of competition on Consignia's profits. Where there have been differences of view, as was the case over the amount of the market expected to be opened up to competition in the initial phase, Postcomm has subsequently discussed the matter with Consignia to clarify matters. Postcomm adjusted its competition proposals to ensure that the volume of business opened up to competition in the first phase will be as close as possible to 30% (by revenue) as originally intended.

PAC conclusion (viii): Postcomm's ability to discharge their duties credibly depends on having a thorough knowledge and understanding of the industry. Postcomm have made use of expert consultants, but these are not a substitute for in-house expertise. Postcomm had no staff with direct experience of the postal industry when the Comptroller and Auditor General reported, and should seek to recruit such staff.

10. Postcomm agrees that it is important that Postcomm Commissioners and staff have knowledge and experience of the postal industry. Commissioners and staff have undertaken an extensive familiarisation programme to ensure that they understand the postal services market. This has included attending Consignia's residential course, visits to a wide range of Consignia's facilities, meetings with Consignia management and staff as well as with other operators, suppliers, customers and their representative bodies. Several of Postcomm's staff have worked in the postal services market and a further number have experience of regulation in other business sectors.

Postcomm's decisions on the prices Consignia may charge

PAC conclusion (ix): The most significant form of competition is likely to be from firms entering the market to provide specific services, which would use Consignia to deliver mail to the addresses they cannot profitably serve themselves. The success of this form of competition depends on the price and terms set for access to Consignia's network. Too high a price for access to Consignia's network would deter potential competitors, while if the price is too low Consignia's viability may be threatened. Postcomm therefore need to obtain a better understanding of what would be a reasonable price for access to Consignia's operations and make clear how such access will be facilitated and on what kind of terms.

11. Postcomm agrees that the effective operation of a competitive postal market depends upon establishing arrangements enabling operators to access Consignia's network at a reasonable rate. Postcomm included in Consignia's licence a requirement that Consignia allow competitors access to its network on the basis of a "reasonable allocation of costs". If these cannot be negotiated in good faith between the parties, Postcomm can be asked to make a determination. In addition Consignia's licence makes provision for an access code to be established. Postcomm will be issuing a consultation document seeking views on access arrangements later this year.

PAC conclusion (x): Consignia's ability to respond to competition depends on whether it can rebalance its tariffs. In particular, Consignia argues that it could only compete in some markets by reducing the tariffs it charges and increasing other charges, such as to domestic customers, to compensate. It is unclear, however, whether Postcomm would allow such rebalancing within the requirement

to provide a universal service at a uniform price, and within what timescale. The resulting uncertainty over Consignia's permitted responses to competition is damaging both to Consignia and potential entrants, and Postcomm should give clear guidance on this issue in advance of further market opening.

12. Postcomm believes that its decision on opening up the market has brought much needed certainty to the postal industry about how competition might develop. In respect of tariffs, at present Consignia has a virtual monopoly in letter post and until competition develops Postcomm will control Consignia's prices to protect postal users. In those parts of the market where there is competition Postcomm does not control Consignia's prices. Postcomm notes the Committee's recommendation and will be considering the question of Consignia's concerns about rebalancing as part of its work on pricing.

PAC conclusion (xi): In the longer term, Consignia's financial performance and hence its viability as competition grows depends on the price control applied by Postcomm. The price control regime may act as a further constraint on Consignia's ability to respond to competition, particularly if prices are set lower than necessary to finance the services its customers want. The fact that Postcomm has not yet made any final decisions on Consignia's future price control is a further source of regulatory uncertainty.

13. Postcomm recognises that its market opening strategy is the core element of the regulatory framework but that there are other elements which need to be established. Consignia's existing price control regime is expected to end in March 2003 and be replaced by a new price control. Postcomm is currently gathering information and will soon be consulting on the new price control regime. In the meantime, Postcomm will continue to control Consignia's prices to prevent it taking unfair advantage of its monopoly position. In due course, as competition becomes established, Postcomm hopes to gradually remove price controls.

Quality of service

PAC conclusion (xii): Consignia is considering abandoning its target of delivering mail to domestic customers before 9.30 am, and under the oversight of Postwatch it is piloting different standards in a few areas. Consignia thinks this would help to achieve the efficiency gains it believes it needs. There is a risk that unless implemented sensitively, however, small businesses and people working from home could be disadvantaged. Before agreeing to changes of this nature, Postcomm, with Postwatch, should define and implement reasonably consistent standards of universal service across the range of postal customers.

14. Postcomm is committed to securing the universal service and ensuring that all customers benefit from more reliable and innovative services as well as the cost savings from improved efficiency. Postcomm's decision on competition is based on current standards of service required by Consignia's Licence. Consignia's performance against these quality standards is regularly reviewed by Postcomm and Postwatch. The company is looking at reducing its cost base and improving its delivery structure in an effort to provide customers with a better and more cost-effective service. Consignia has confirmed that it will not make any significant changes to the delivery times without the permission of Postcomm and Postwatch.

PAC conclusion (xiii): Consignia has failed over the last five years to meet its own target of delivering 92.5 per cent of 1st class mail the next day, although its performance has been closer to this level in recent months and performance has varied substantially across the country. Postcomm, with Postwatch, should require Consignia to explain how and when it plans to eliminate areas of particularly poor performance. It should use the performance of successful universal service providers in overseas postal markets as a benchmark in determining what higher standard postal customers in the UK can reasonably expect.

15. Postcomm welcomes the effort that Consignia is already making to improve its overall performance and to meet delivery targets, Consignia achieved 91.6 per cent performance for first class mail for the financial year ending March 2002 against a Licence target figure of 92.1 per cent. Unfortunately, at some local levels (particularly in London) performance is well below the national targets. Consignia's Licence requires it to put in place action plans to deal with the poorest performing areas, Postcomm and Postwatch are currently reviewing Consignia's performance against its targets.

PAC conclusion (xiv): Postcomm recognise that to fine Consignia when it fails to meet its targets would simply represent a transfer from one public sector body to another. They prefer the introduction of a compensation scheme, through which users of postal services who suffer from poor service, such as late or failed delivery of mail, receive payment from Consignia. Such a scheme has been under negotiation since March 2001, but Postcomm have not yet reached agreement with Consignia on the details of such a scheme. They should do so without further delay.

16. Consignia advised Postcomm on 26 September 2001 that it had been unable to agree the terms of a compensation scheme with Postwatch. Postcomm therefore started work on preparing a consultation document setting out the terms in which it was minded to determine a compensation scheme. However, Consignia and Postwatch asked that Postcomm delay publication of the consultation document in order to allow time for further discussions aimed at agreeing a scheme. It is expected that Postcomm will shortly consult on the terms of a compensation scheme.