



National Audit Office

# Re-opening the post: Postcomm and the quality of mail services

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## EXECUTIVE SUMMARY



**1** Even in an age of increasing use of digital and electronic communications the postal service remains of vital and growing importance to the UK economy. In 2005 domestic consumers and business spent approximately £9 billion on posting letters and parcels. The mail service delivers items ranging from utility bills and bank statements to promotional material and items purchased over the internet. A National Audit Office survey of UK consumers found that 69 per cent of those questioned believed that Royal Mail offers a value for money service.

**2** Although the UK postal market has been fully liberalised Royal Mail still has a dominant position. To protect the interests of users Postcomm (the Postal Services Commission) regulates Royal Mail in the areas where there is little or no competition. It also ensures that Royal Mail provides the universal service.<sup>1</sup> Postcomm sets both the prices that Royal Mail is allowed to charge, and the quality standards it must meet in the regulated area. This mechanism is called a price control and is reviewed at regular intervals. In December 2005 Postcomm produced its final proposals for the next price control, which will run from April 2006 to March 2010. If Royal Mail does not accept the proposals Postcomm will then ask the Competition Commission to investigate the issues. The current price control will continue in the interim. This is a decision for Royal Mail's senior management, the substance and content of which is not covered in this report.<sup>2</sup>

## 1 Key facts about the UK Mail Market

The UK mail market was worth approximately **£9 billion** in 2004-05. **The regulated or licensed area** – mail that costs less than £1 to deliver and weighs less than 350 grams – **accounts for about 72 per cent of this market (some £6.5 billion)**. It is Postcomm's job to regulate that part of the mail market.

**The total letters market** (in the licensed area) continues to grow – with 20 billion items in 2004-05.

**Businesses send 87 per cent of mail**, in the UK licensed postal market – about 60 per cent of this mail goes from business to domestic consumers, and 27 per cent goes from businesses to businesses. **Domestic consumers post 13 per cent of mail.**

**Fourteen licensed operators** compete with Royal Mail. **New operators carried more than 106 million items "end-to-end"** (providing collection, sorting and delivery) in 2004-05 and their revenue rose by 121 per cent to £31 million.

**Several companies have signed "access" agreements** with Royal Mail, allowing mail they have collected and sorted to be fed into Royal Mail's network for final delivery. Total access volumes accounted for approximately 381 million items in the first half of 2005-06.

**Royal Mail still dominates postal services**, accounting for 97 per cent of mail volumes in the regulated area in 2004-05 when its revenue grew by 3.7 per cent. High market share and price increases led to increased profits.

<sup>1</sup> For the purposes of this report we use the term 'universal service'. The universal service is also referred to in the mail industry as the 'universal postal service' and the 'universal service obligation'.

<sup>2</sup> On 17 March, Royal Mail stated that it was minded to accept the price control - pending agreement on the formal amendment to its licence (Royal Mail press notice 17 March).

**3** UK regulators have a long experience of the mechanics and processes used to set prices and introduce competition. In the postal sector Postcomm has created a clear framework for setting Royal Mail's prices even though the two parties may debate extensively about the exact level of prices. The mechanics for regulating quality of service in post are less clear and Postcomm does not have a tried and tested framework which it can readily adapt from another UK regulated sector. Quality of service regulation is also the least well developed aspect of Postcomm's role. It was identified as a risk in the National Audit Office's 2002 report on postal regulation<sup>3</sup>, which concluded:

on protecting the consumer:

- Postcomm needed to ensure that customer needs were clearly identified.

on implementing performance standards:

- Postcomm needed to ensure that Royal Mail met quality of service targets and that Postwatch had sufficient information to monitor their achievement.

**4** This report examines developments in regulating quality of service since our 2002 report.<sup>4</sup> We have focussed on this occasion on quality of service in preference to price setting. Royal Mail is introducing a new pricing structure in August 2006 based on the size of mail rather than its weight. Postcomm is also proposing to allow Royal Mail to increase the price of first and second class stamps by two pence from April 2006, and a further four and three pence respectively by 2010. The combined impact of these changes on consumers is as yet unknown and we will monitor developments. A National Audit Office survey found that only 11 per cent of people consider that the prices Royal Mail charges are poor or very poor value, and only 26 per cent know the price of a first class stamp. Furthermore, Royal Mail's prices are generally lower than most of its European equivalents. Most people also receive far more mail than they send. Both domestic and business consumers are, however, concerned with the quality of Royal Mail's services and last year made over 1 million complaints. This level of complaint suggests that quality of service is a crucial aspect of value for money.

**5** The overall value for money of the quality of service regime put in place by Postcomm depends on the extent to which it protects consumers and does not over-burden Royal Mail. The regime currently in place (2001-2006) has shortcomings in protecting consumers and some elements of it over-burden Royal Mail. The proposed regime (for 2006-2010) improves the level of consumer protection. But there remains scope to improve implementation, which would further reduce regulatory burdens.

**6** The report covers Postcomm's role (Part 1), the current regime (Part 2), and an evaluation of the proposed regime (Part 3). In all three parts we examine how Postcomm protects the consumer, and how it implements the performance regime.

## Our findings

### Protecting the consumer

**7 Postcomm has put in place quality of service targets to protect the consumer.** In 2001 Postcomm recognised that a performance measurement system was needed to protect the consumer from the risk of Royal Mail abusing its dominant position. It adopted Royal Mail's existing performance system which measured the transit times for mail, i.e. how long an item of mail takes from initial posting to final delivery. Adopting Royal Mail's system in 2001 was appropriate in the absence of other performance data and the time pressure Postcomm faced to establish a system. The system also met an EU requirement for transit time targets.

**8 In the past Royal Mail missed most of its targets but performance is now improving (Figure 2).** Royal Mail's performance against its targets has recently improved. In 2003-04 it missed all its targets, in 2004-05 it met four, and in the first half of 2005-06 performance was above target for all but four products. Royal Mail's underlying performance has also been improving since regulation was introduced. For example in 2001-02 it delivered 89.9 per cent of first class letters within one day against 91.4 per cent in 2004-05. Certain postcode areas, for example North West and South East London, although showing improvement over the years, have not yet achieved the licence target levels over a full reporting year. Consumers in these areas have not benefited from the overall improvement.

<sup>3</sup> National Audit Office: *Opening the Post: Postcomm and Postal Services – the risks and opportunities*, HC 521 Session 2001-02, 24 January 2002.

<sup>4</sup> The National Audit Office report *Improving the efficiency of postal services procurement in the public sector* is published on Friday 24th March.

## 2 Royal Mail's performance against Quality of Service targets

Product	Product description	2004-05	2003-04	2002-03	2001-02
1st Class Mail	1st and 2nd class mail covers stamped and metered mail only.	X	X	X	X
2nd Class Mail		✓	X	X	✓
Mailsort 1	Mailsort products are used by bulk mailers. The companies presort their outgoing mail before it is collected by Royal Mail. The three different products correspond to different transit times.	✓	X	✓	✓
Mailsort 2		X	X	X	✓
Mailsort 3		✓	X	✓	✓
Presstream 1	Presstream is used by newspaper and magazine companies to mail out their publications.	X	X	X	✓
Presstream 2		✓	X	X	✓
1st Class PPI	PPI (Printed Postage Impressions) – Envelopes are pre-printed in order to save time and/or money for large campaigns. Payment is settled through an account.	X	X	X	X
2nd Class PPI		X	X	X	✓
1st Class Response	Response services are prepaid business reply cards and envelopes.	X	X	X	X
2nd Class Response		X	X	X	X
Special Delivery	This product offers insurance in the case of loss or damage, and compensation in the case of late delivery.	X	X	X	✓
Standard Parcels	A basic untracked second class service available at Post Offices.	X	X	✓	X
Postcode area	These targets are minimum targets that must be achieved on all the first class products throughout the year on mail between and within postcode areas.	X	X	X	X
Intra postcode area		X	X	X	X
<b>Total targets met out of 15</b>		<b>4</b>	<b>0</b>	<b>3</b>	<b>8</b>

Source: National Audit Office

### NOTES

The targets for 2001-02 and 2002-03 were for February and March only in line with Royal Mail's previous practice. Postcomm had annual targets put in place thereafter.

In 2001-02 and 2002-03 there were two other targets relating to mail delivered within 15 working days and post office queuing time. These have since been removed.

There are also tail of mail targets which cover all 13 separate products. These targets cover the amount of mail that arrives within a set period after the promised delivery period.

Figure 10 sets out the targets in more detail.

**9 The existing quality of service targets do not cover all the aspects of quality that are important to consumers.** The current system measures Royal Mail's performance against the transit time promised for each of its products (for example, 93 per cent of stamped and metered first class mail should be delivered the next day). The current system does not, however, measure all the aspects of quality that are important to consumers. For example the highest number of complaints to Royal Mail concern loss of mail. Yet this is not measured. Performance over Christmas, Royal Mail's busiest period, although measured and published, is also excluded from the targets as this is an abnormally busy period.<sup>5</sup> Royal Mail's performance on collecting and delivering by its stated collection and delivery times is also not measured.

**10 The proposed performance management system has a greater focus on what consumers view as quality.** Postcomm has proposed a measurement system to run from 2006 to 2010. The proposed system retains at its core the concept of transit times as the principal definition of quality. But the existing 15 transit time targets have been grouped into 8 targets and 4 new targets have been added, thereby reducing the overall number from 15 to 12. The new targets cover mail delivered to both the wrong address and addressee, the percentage of delivery routes and collections completed, and a transit time target for outgoing international mail. These changes reflect the consumer's perspective of service quality as identified through consumer research.

**11 Postcomm has proposed a system to report on whether Royal Mail meets its advertised collection and delivery times.** Postcomm has not proposed targets for specific collection and delivery times as this would restrict the flexibility Royal Mail needs to run the business efficiently, both in terms of its financial viability and in terms of introducing new technology. Postcomm has therefore proposed that Royal Mail publishes the percentage of deliveries completed by the latest published delivery time each day and the percentage of final collections made at or after their stated time. Should this data identify any shortcomings in performance Postcomm

can then consider a hierarchy of options for remedial arrangements ranging from voluntary to prescriptive measures. Such measures may have to involve a change to the licence which would require the agreement of Royal Mail.

## Implementing the performance regime

**12 Postcomm has proposed increasing Royal Mail's financial incentives by increasing the level of revenue adjustments.** If Royal Mail misses its targets Postcomm can reduce Royal Mail's revenue and launch an investigation to determine whether to levy a penalty. Royal Mail also has to pay automatic compensation to bulk mailers for poor performance, and there is a retail scheme for domestic consumers.

- **Revenue adjustment:** The revenue adjustment has a maximum value of 0.9 per cent of revenue earned on any non bulk mail product. The maximum value can only be levied if performance is 5 per cent below target. Postcomm and Postwatch believe that the maximum value of 0.9 per cent is too low to incentivise Royal Mail fully. Revenue adjustments in 2004-05 were some £10 million. Postcomm has proposed an increase in the revenue adjustment to a maximum of 5 per cent of revenue. Royal Mail calculates that if it missed all its targets by 5 per cent it would result in a revenue adjustment of some £140 million, representing a very significant proportion of its annual profit.<sup>6</sup>
- **Compensation:** If Royal Mail misses its targets on bulk mail products by at least one per cent it has to compensate the bulk mailers up to 5 per cent of product revenue. Compensation of £24 million was paid out in 2004-05.<sup>7</sup> Postcomm has not proposed any changes to the level of compensation. Royal Mail calculates that if it missed all its targets by 5 per cent it would result in compensation of some £190 million. Retail compensation is also payable on non bulk mail products on a case by case basis. Retail compensation of £1.1 million was paid out 2004-05.

5 Postcomm requires Royal Mail to publish its performance over the Christmas period but does not expect it to meet the annual targets during this period. To do so would require a high level of investment in extra capacity by Royal Mail. The Christmas period is defined as running from the first Monday in December until the first working day in January.

6 In Royal Mail's response to Postcomm's proposals, Royal Mail calculates that the maximum value of revenue adjustments and compensation will be some £330 million, about twice its allowable profit after including funding for its pension deficit.

7 The bulk mail compensation scheme was subject to a judicial review in December 2005. The review found that Postcomm had not interpreted the rules of the scheme correctly. Royal Mail has appealed against the decision which is in respect of around £38 million compensation. The final figure for bulk mail compensation in 2004-05 could increase pending the outcome of the appeal.



- **Financial penalties:** Postcomm also incentivises Royal Mail by investigating whether it has used ‘all reasonable endeavours’ to meet its targets. If Postcomm finds that Royal Mail fails this test it can levy a financial penalty. One penalty of £7.5 million has been levied to date in respect of missed targets. Most recently, in February 2006, Postcomm announced its intention to fine Royal Mail £13.8 million for three breaches of its licence. Of this, £271,000 was for poor quality of service at Postcode area level, with the remainder being for lost mail and breaches in agreements that allow competitors access to its network.

**13 Implementation of the financial penalty regime has placed a burden on all parties.** The investigations into whether Royal Mail has used ‘all reasonable endeavours’ place a burden on all parties and take a long time to carry out. For example, Postcomm’s investigation into Royal Mail’s 2003-04 performance took longer than the permitted duration of 12 months. As a result, if Postcomm had decided to levy a financial penalty Royal Mail could have appealed against the decision on the basis that it was ‘timed out’. Postcomm’s proposal to increase the automatic revenue adjustments to 5 per cent of revenue may reduce the number of investigations. Postcomm has proposed shifting the burden of proof onto Royal Mail, but should Postcomm then decide to investigate its process for investigations will remain broadly unchanged.

**14 Postcomm does not have all the information it needs to make decisions on quality of service levels.** In setting quality of service levels, Postcomm must balance the value consumers place on quality with the cost to Royal Mail of achieving a given quality level. There are gaps in the information that Royal Mail produces that prevent Postcomm from resolving this balance. For example although Royal Mail has produced information on consumers’ willingness to pay for increased reliability of transit times<sup>8</sup> there is no information on the cost to Royal Mail of achieving this. Similarly, there is no information on the savings to Royal Mail should Postcomm choose to reduce one of Royal Mail’s target levels.

8 *Royal Mail, Pricing Quality of Service, Final Report*, September 2005. Prepared by Accent and RAND Europe.



## RECOMMENDATIONS

**15** The UK's quality of service regime for post is already one of the most sophisticated internationally. In developing it further Postcomm needs to:

**a** In co-operation with Royal Mail, **develop the information** needed to improve implementation of the performance regime and inform the next price control:

- Universal service failures – develop a validation system for the universal service failure reporting system via an independent reporter.
- Cost of quality – identify the cost of increasing Royal Mail's performance, for example by one per cent, and the cost that could be saved by setting lower targets.
- Collection and delivery times – monitor Royal Mail's performance in meeting its stated collection and delivery times.

**b** **Improve implementation** of the regime to **reduce burdens** on Royal Mail, where appropriate:

- Investigations – Postcomm should develop a framework for investigations that details the likely circumstances in which Postcomm would investigate shortfalls in performance, the range of information it would require, and standard responses to common issues. This should be set against the need to retain discretion over responding to exceptional circumstances.
- Collection and delivery times – where monitoring information indicates that remedial action is required, Postcomm should start by considering the least intrusive response.





**c** Monitor the development of competition in the postal sector and prepare to **withdraw from detailed regulation** when competition becomes effective, by:

- Establishing criteria for adding and removing products from the universal service. This might involve balancing the cost of quality against the consumers' willingness to pay. The decision should follow the principles of Better Regulation and be transparent, accountable, and justifiable.
- In time for the next price control, carrying out further joint research with Postwatch and Royal Mail to establish the needs of consumers, how they are changing and how the universal service may be best adapted to accommodate them.

**16** The links between the recommendations are set out in **Figure 3**.

