



**Government Response to the
House of Commons Business and Enterprise
Select Committee Report on the
Postal Services Bill
(Fifth Report of the session
2008-09: HC 172-1)**

**Presented to Parliament by the Secretary of State
for Business, Enterprise and Regulatory Reform
by Command of Her Majesty
May 2009**



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Business & Enterprise Select Committee

The Postal Services Bill

Government response

Introduction

1. We welcome the Committee's report as a contribution to the debates currently taking place in Parliament. We also welcome the Committee's support for the majority of the Government's analysis and proposals, including that:
 - the status quo is not an option;
 - clear recognition that Royal Mail Group is "significantly less efficient than its competitors" and that "any decision about the company's future has to address this";
 - an acknowledgement that the modernisation of Royal Mail will require change on the part of both management and unions; and
 - agreement that the Government's proposed measures on regulation and Royal Mail's historic pensions' liabilities are important elements of a solution to sustain the universal service.

2. The Government rejects the Committee's opinion that it has yet to make the case¹ that a strategic partnership is necessary to modernise Royal Mail. We believe that the case was clearly set out in Richard Hooper's review², and the Government's response to it. In particular:
 - the universal postal service is important for society and the economy;
 - but the service is under threat because of the unprecedented change in the communications market. The number of letters and packages which we send each year is falling quickly. Royal Mail predicts an 8% decline this year;
 - Royal Mail is critical for the future of the universal service. Only Royal Mail has the national infrastructure to provide a six-day collection and delivery service;

¹ House of Commons Press Notice 35, 1 April

² Modernise or Decline, Cm 7529, 16 December 2008

- but the company is inefficient compared to its leading European counterparts and is heavily constrained in responding to current market circumstances;
 - to sustain the universal service, Royal Mail must modernise more quickly;
 - to do so, it needs (i) commercial confidence; (ii) access to capital; and (iii) access to wider corporate experience of managing change;
 - all three factors matter. Tackling access to capital and corporate experience on their own will mean that modernisation is slower than required and will not provide the conditions in which there can be constructive engagement between management and the unions. As the Select Committee itself has acknowledged, commercial confidence will require change on the part of both management and unions;
 - while there are good arguments for action on regulation and market change, these measures will not achieve the modernisation of Royal Mail. Tackling the pension deficit, for example, will enable the company to benefit from efficiency savings in future, but provides no direct incentive to actually achieving those efficiency savings by reducing costs or moving into new areas of business;
 - conversely, it would be irresponsible to ask the taxpayer to take on the burden of Royal Mail's pension deficit without an assurance that the company can be transformed to have a stable and profitable future; and
 - while the Government will consider any alternative models suggested in addition to those examined as part of the review, our assessment so far is that partnership offers the most convincing mechanism to modernise Royal Mail and secure the future of the universal postal service.
3. Those conclusions are based on the solid foundation provided by Richard Hooper's year-long, independent review of the postal sector. Hooper's conclusions were constructed from evidence taken from a wide range of stakeholders, including consumer organisations, businesses, postal companies, unions, regulators and Government Departments.
4. The Committee states that it is 'entirely unacceptable' for Parliament to be asked to approve the partnership proposal unless it is known how much the company needs to modernise. The Government strongly rejects this view on the basis that the Select Committee assumes modernisation is a one-off event.

5. In our view, modernisation must be an ongoing process of driving down costs and finding new sources of revenue. This is particularly true in the case of Royal Mail which operates in a highly competitive, and fast-moving, communications environment.
6. Modernisation is about responding to a dynamic market place: evolving the business to ensure it can meet the challenges posed by the digital revolution; compete successfully; and hence deliver what consumers want, as the only company capable of delivering the universal service.
7. In addition to purchasing and introducing new machinery and reviewing the structure of Royal Mail's delivery network, modernisation must involve:
 - the development of new products and services which better meet customer needs and hence keep pace with, or better, pre-empt, competitor innovations;
 - the introduction of new and flexible working practices; and
 - a transformation of the relationship between management and the workforce.
8. The cost of modernisation will, therefore, depend on the business plan agreed with any partner. It will depend on how far reforms are taken, the speed with which they are implemented and the extent to which Royal Mail seeks to become a leader in the communications market. Given Royal Mail's falling revenues and limited profits over the next few years, and pensions fund deficit, clearly Royal Mail will not be able to fund this investment alone. Additional capital will be required and this could be hundreds of millions of pounds, in addition to the funding we have already provided.
9. Just as important, partnership is not just about injecting capital into Royal Mail. Partnership will help provide a fresh start for Royal Mail, building on its strengths, while equipping the company to respond more effectively to both immediate and future challenges.

10. Partnership will:

- generate proceeds which will be used to fund modernisation;
- provide the company with practical, corporate experience of transforming a network company;
- ensure that this experience can be used effectively as and when it is most needed during each stage of the transformation process and at every level of the company. Appointing consultants or changing the senior management will not suffice;
- accelerate implementation of the company's existing modernisation plans and ensure that Royal Mail is prepared to go further as necessary, responding much faster to a rapidly changing market;
- provide an opportunity for unions and management to make a fresh start;
- give Royal Mail management at all levels the commercial confidence they need to press ahead with plans to modernise, working constructively with the company's employees and unions, without the perception of Government intervention; and
- help to support a sustainable network of Post Office branches throughout the UK, as a consequence of transforming Royal Mail.

11. In short, Government takes the view that there are strong reasons to justify partnership as the most effective and convincing approach to transform Royal Mail. Action on pensions and regulation alone will not modernise Royal Mail. It provides no incentive for Royal Mail to change and no external drive to push it to happen. Government will consider all of the alternative options suggested so far, and will publish a detailed assessment of them before the Bill reaches debates in the House of Commons. In our view, none of the alternatives to partnership proposed to date offers such a convincing path to securing change in Royal Mail. We continue to believe that only the full package of measures in the Postal Services Bill is capable of delivering the Government's fundamental objectives: to ensure a successful future for Royal Mail in public ownership, and to sustain the universal service.

Response to the Committee's conclusions

1. The Government's response to each of the Committee's conclusions, as listed in pages 51-58 of the Committee's Report, is set out below. The conclusions are in the shaded areas, with the Government's response following.

Royal Mail efficiency

1. Although there are disputes over the extent and causes of Royal Mail Group's inefficiency, it is clear that Royal Mail Group is less efficient than its competitors. Clearly, any decision about the company's future has to address this. (Paragraph 27)

2. The Government agrees that Royal Mail is less efficient, like for like, than its leading European counterparts.
3. Other leading EU operators are highly automated. 85% of their mail is placed in the correct order by machine for delivery (walk-sorting). At Royal Mail, this is carried out almost entirely by hand with each postal worker spending between 2 - 3 hours each morning doing this before starting delivery.
4. Leading EU operators began radical restructuring of their networks in the early 1990s - halving the number of mail centres and significantly reducing the number of delivery offices. This has not happened at Royal Mail.
5. The Royal Mail's former Chairman suggested that the company's competitors were 40% more efficient³. This means that Royal Mail's costs are higher and profits lower than they could be. As a result, the company has less money to invest and to grow its business. Significant cost reduction is required. Royal Mail itself has identified £1.2 billion of annual cost savings achievable over the next seven years - a fifth of Royal Mail's total current costs.

³ Allan Leighton, Sky News, 1 October 2007 & Royal Mail Group's Accounts, 2006-07

Labour relations

2. Whether or not the Postal Services Bill [Lords] is enacted in its current form, the country needs a modern, efficient Royal Mail Group. Good labour relations are essential to achieve this. It is clear to us, from our previous experience as the Trade and Industry Committee, that in the past there have been faults on both sides. If Royal Mail Group is to have a prosperous future, whether or not it remains in the public sector, both sides must change. Royal Mail Group must ensure that its current rhetoric is matched by its actions. The unions must accept that negotiations on working practices are not a matter for Government, and that national agreements should be honoured. We emphasise that this relates to matters of day-to-day management; it is of course legitimate for the union to raise matters such as the ownership of Royal Mail Group with the shareholder – Government – and therefore with Parliament. But both Government and Parliament must be confident that the management issues can be properly addressed by the company itself. (Paragraph 32)

6. We welcome the Committee's conclusions on labour relations. The challenges facing Royal Mail pose significant risks to the company, its employees and the future of the universal service. Good labour relations - which notably have been absent in the past - are essential in providing the conditions in which those challenges can be addressed. As Hooper put it, "*the modernisation of the business will only be achieved if industrial relations are modernised*" (paragraph 129).
7. The Government accepts that responsibility for improving labour relations rests primarily with Royal Mail's management and with its unions. But as the Committee also points out, Government must be confident that the management issues can be properly addressed by Royal Mail.
8. In this respect, neither Hooper's analysis, nor the experience of the Committee and its predecessors, support the view presented in the Communication Workers' Union's evidence⁴. In reality, the issues around labour relations are long standing, and have in the past proved intractable. In the last two years alone there has been a national

⁴ Paragraph 31 of SC report: '....when the CWU was asked "do you believe that modernisation is possible under the present management structure and indeed personnel?" Mr Hayes responded as follows: '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.'

strike which was followed by further threats of industrial action over pension reforms and changes to mail centres. This pattern is debilitating for Royal Mail, it reduces the company's confidence to make necessary changes to its business, and damages customer perceptions of the reliability of the postal service. It also calls into question how much store can be set by claims from the CWU about being up for change. Positive action, not just exhortations for change, is required.

9. Hooper found that Royal Mail needs "*commercial confidence*" - greater clarity over its objectives in the short and long term, and increased political separation - to help create the conditions in which labour relations can be improved. The Government accepts this diagnosis and the need for action. We believe that our proposals for a strategic partnership for Royal Mail are an essential step in providing the company with this vital commercial confidence, creating the conditions in which the long standing problems in labour relations can be tackled successfully by all the parties.

Royal Mail Group and the universal service obligation

3. We make this Report in the confident assumption that the universal service obligation for postal services is necessary for the United Kingdom. There is no doubt that, as the Independent Review of the Postal Services Sector said, "the ability to deliver items toward 28 million business and residential addresses in the UK is part of our economic and social glue." (Paragraph 34)

10. The Government welcomes the Committee's support and has put maintenance of the universal service obligation at the heart of the Postal Services Bill.

4. Royal Mail Group is charged with the universal service obligation, and if the obligation is to be sustained, Royal Mail Group needs a suitable financial and regulatory framework. The Independent Review concluded that these were not currently in place, and we agree, in the words of its report, that the status quo is not an option. But that does not mean that the package of changes proposed by the Government is the only way forward. (Paragraph 35)

11. The Government agrees with the Committee on the need for regulatory change, but rejects the Committee's view that it has yet to make its case and that the proposals in the Bill cannot be seen as a package. The case is clear:

- the universal postal service is important for society and the economy;
- but the service is under threat because of the unprecedented change in the communications market. The number of letters and packages which we send each year is falling quickly. Royal Mail predicts an 8% decline this year;
- Royal Mail is critical for the future of the universal service. Only Royal Mail has the national infrastructure to provide a six-day collection and delivery service;
- but the company is inefficient compared to its leading European counterparts and is heavily constrained in responding to current market circumstances;
- to sustain the universal service, Royal Mail must modernise more quickly;
- to do so, it needs (i) commercial confidence; (ii) access to capital; and (iii) access to wider corporate experience of managing change;
- all three factors matter. Tackling access to capital and corporate experience on their own will mean that modernisation is slower than required and will not provide the conditions in which there can be constructive engagement between management and the unions. As the Select Committee itself has acknowledged, commercial confidence will require change on the part of both management and unions;
- while there are good arguments for action on regulation and market change, these measures will not achieve the modernisation of Royal Mail. Tackling the pension deficit, for example, will enable the company to benefit from efficiency savings in future, but provides no direct incentive to actually achieving those efficiency savings by reducing costs or to moving into new areas of business;
- conversely, it would be irresponsible to ask the taxpayer to take on the burden of Royal Mail's pension deficit without an assurance that the company can be transformed to have a stable and profitable future; and
- while the Government will consider any alternative models suggested in addition to those examined as part of the review, our assessment so far is that partnership offers the most convincing mechanism to modernise Royal Mail and securing the future of the universal postal service.

5. There is a choice between ensuring the Universal Service Obligation (USO) covers all those services which are socially and economically necessary, without reference to the market or limiting the USO to only those products which the market will not provide. In the first case, it is likely the USO will be self financing; in the second it is possible that

extra costs will need to be met, either by a levy on industry or directly from the taxpayer. Parliament may wish to reflect on whether it or the regulator should make that important choice. (Paragraph 51)

12. The minimum requirements of the universal service obligation are set out in the Postal Services Directive which states that:

“Member States shall take steps to ensure that the universal service is guaranteed not less than five working days a week...”

13. The UK’s implementation of the directive goes further than the minimum requirements of the Directive in that the domestic universal service requires the collection and delivery of letters on a Saturday.
14. Parliament already takes a general view on what type of postal service is socially and economically required, as it decides the minimum requirements of the universal service. These are set out on the face of the Bill at Clause 29.
15. It is right that Ofcom, as the guardian of the universal postal service, will decide in more detail which services should be provided as part of the universal postal service. Ofcom will be able to make a robust, evidence-based decision on the universal service obligation after a full and comprehensive market evaluation and consultation, focusing on the needs of users.

Price controls

6. *Modernise or decline* recommended a full evaluation of the access price control regime. We agree; we have great doubts about its continued operation. We are sure its problems have been increased by the poor relationship between Royal Mail Group and the regulator, and the lack of clarity on both sides (Paragraph 63)

16. We note the Committee’s agreement on this point. Ofcom will target its regulatory interventions in the light of its market evaluation. This evaluation will include consideration of the access price control regime.

7. Given that full cost transparency may be unachievable, we are surprised that when faced with evidence that the USO provider was losing access market share at twice the rate predicted, and that end to end competition had actually declined, Postcomm did not reassess its regime, particularly since e-substitution was also affecting Royal Mail's business. (Paragraph 67)

8. In suggesting that Royal Mail Group could improve its position by increasing prices, Postcomm appears to have overlooked the fact that competition in the mail market is not just between rival mail carriers, but also between post and other methods of communication. The purpose of regulation is to benefit the customer; indeed, this is the rationale for introducing competition into the market. Something is seriously wrong when a regulator proposes measures which would increase the cost to the customer, and might even risk reducing the size of the market overall. (Paragraph 70)

Effect of competition

9. We share Postcomm's concern that it is important Royal Mail should not abuse its market position. We also agree that competition can act as a spur to improve performance, and has done so for Royal Mail Group. We have no doubt that further efficiencies are possible and desirable. However, the reason why the EU postal service directives advocated gradual market opening was to allow time for incumbent universal service providers to adapt. In its submission to the regulator's consultation on price control, the Government noted that "the regulatory risks to Royal Mail should be kept at a minimum otherwise Royal Mail may be at a disadvantage to other operators." The Trade and Industry Committee warned that market opening was ill timed. Royal Mail Group asked for price control to be reviewed because of its rapid loss of market share. In retrospect, Postcomm has paid too much attention to market opening, and to using price controls to increase Royal Mail Group's efficiency, and too little to the need to preserve the universal service obligation. (Paragraph 72)

This answer covers conclusions 7-9.

17. The Government's first priority is a strong universal service. Competition can bring important benefits for customers and can be a valuable policy tool for improving the efficiency with which the universal service is provided. However, competition is not the only means of encouraging efficiency and must be fair and not pursued at the

expense of the universal service. The Postal Services Bill therefore makes it explicit that protection of an efficiently provided universal postal service takes precedence over the promotion of competition.

18. Regulation for postal services needs to respond to the reality that postal services are increasingly interchangeable with electronic communications services. This is why the Bill provides that Ofcom should take on responsibility for regulating the postal sector. Furthermore, the Bill improves upon current postal regulation by clearly setting out, and for the first time bringing on to a statutory basis, the grounds that Ofcom must have regard to when imposing access conditions. The Bill gives Ofcom the power to impose accounting separation requirements on Royal Mail and, taken with the obligation on Ofcom to complete a market assessment and the information requirements, will mean costs can be better determined, and prices set, more accurately. Any resulting access terms can be set objectively and proportionately.
19. In addition, when taken in conjunction with the overriding duty to secure the universal service, Ofcom cannot require Royal Mail to price below its efficient costs. A balance has to be struck by Ofcom, ensuring that Royal Mail does not provide an unfair subsidy to other access operators, while at the same time ensuring that inefficient costs are not locked in for the long term. It will ensure that the terms on which other operators access the Royal Mail's network do not amount to an unfair subsidy. Where Ofcom imposes access terms, those terms will take proper account of Royal Mail's costs and will be set objectively and proportionately, through a transparent process.

Government role

10. The relationship between the Government and regulator when a regulated company is publicly owned is complex. The history of the pricing review demonstrates that there is a thin line between the Government's role as shareholder, and its role in setting policy. Some of the principles the Government set out in its submission to the pricing review have been respected, but Postcomm's regulatory regime has left the taxpayer with no return on assets, and Royal Mail has been exposed to significant regulatory risks. Economic matters for which the regulator should be responsible can overlap, or even conflict, with wider policy matters, where Government has a legitimate right to expect its views to be taken into account. (Paragraph 76)

11. It also seems to us that the regulator may have treated the shareholder more harshly than it would have done if the shareholder had not been the government. Even though the final outcome of the price review was not as severe as the first proposals, a regulator faced with a private sector pensions deficit of the scale of that of Royal Mail, and a company which had not paid a dividend for some time, might have found it harder to put forward a pricing regime which expected that much of the cost of the pension deficit would be borne by the company, and not passed on to customers. (Paragraph 77)

This answer covers conclusions 10-11.

20. The Government is mindful of the importance of its responsibilities as the shareholder in Royal Mail, and in setting the policy framework for postal services more generally. Government is focused on the primary importance of securing the universal service on an efficient and sustainable basis, bringing together the interests of postal users and the taxpayer.

21. As the Committee recognises, it is important that there is a relationship of mutual respect and understanding between the regulator and the Government. This is true in any area of economic regulation - Government will always retain responsibility for the policy framework within which the regulator operates, and there will always be issues at the margin which will need to be handled with sensitivity and mutual understanding. The Government is confident that it can establish such a relationship with Ofcom in its new postal capacity, as it has already done so in its existing areas of responsibility.

Regulatory Framework

12. Given the changing structure of the communications market and, more particularly, the regulator's inability to work effectively with Royal Mail, we support the abolition of Postcomm and the transfer of responsibility to Ofcom. (Paragraph 78)

22. The Government notes the Committee's support for the transfer of postal services regulation to Ofcom. Ofcom is well equipped to regulate the postal market and secure the universal postal service for several reasons:

- the regulatory framework required to support the industry today is significantly different from that which Postcomm has had to operate under. Ofcom has the

resources, scale and experience to implement the regulatory model recommended by Hooper, which the Government wholly endorses;

- Ofcom has a proven track record of effective regulation of markets undergoing rapid technological change;
- Post is increasingly seen as part of the wider communications market. Use of internet, text and e-mail and other new media are the main competition faced by Royal Mail. Ofcom has a deep understanding of the communications market; and
- Ofcom will have a better set of regulatory tools with which to protect the universal service effectively.

13. The House will need to examine the details of the regulatory structure set out in the Postal Services Bill [Lords] carefully, but, on our reading, it is more likely to result in targeted regulatory conditions. The Bill allows regulation to be loosened if this is appropriate. In principle, we welcome the increased flexibility that the Bill will provide. (Paragraph 79)

23. The Government welcomes the Committee's conclusion and its recognition of the flexibility required for efficient, and targeted, regulation.

14. We consider the House should consider carefully whether it is appropriate to remove the current power to change the definition of the universal service by affirmative order. If the Bill is left as it stands, then any change will require primary legislation. On a more detailed point, we would like an explanation of how the requirement to set the universal service by reference to users' reasonable needs fits with the provisions relating to the designation of the universal service providers, where continuing designation is linked to the imposition of conditions on the provider. (Paragraph 81)

24. No power currently exists to change the definition of the universal service by affirmative order. Instead, there is a power in Section 8 of the Postal Services Act 2000 to change the exemptions provided by the Act. The power suggested by the Committee would, therefore, be entirely new.

25. The Government's first priority is to secure a strong universal postal service. We believe that it is right that the minimum requirements should only be able to be

changed by primary legislation, as this will provide full scrutiny and agreement by Parliament.

26. The Bill does allow for flexibility in the regulatory structure. Should Ofcom in the future determine that the market is not meeting the reasonable needs of customers, it may add specific detailed services to the universal service. Ofcom could in turn impose conditions on the designated universal service provider to provide the universal service where necessary.

15. We recommend that the Government clarifies exactly what restrictions will be placed on the regulator in practice. For example, why are the conditions the regulator can place on access different from those it can use in its general price setting powers? Is it the Government's intention to prevent Royal Mail Group from being forced to provide services to other postal operators at less than cost? If it is, does the Bill satisfactorily reflect that? (Paragraph 85)

27. The Bill explicitly set outs, in Clause 28, that Ofcom's ability to impose any access conditions is subject to its primary statutory duty to secure the provision of a universal postal service. The Bill also clearly sets out, and for the first time brings on to a statutory basis, the grounds that the regulator must have when considering imposing a universal service provider access condition.

28. Furthermore, Schedule 6 of the Bill specifically ensures that any conditions will only be imposed, or modified, if Ofcom is satisfied that the condition, or modification, is:

- objectively justifiable;
- not unduly discriminatory against particular persons;
- proportionate; and
- transparent.

29. Against the backdrop of a rapidly changing market, and what we hope will be an accelerated programme of modernisation for Royal Mail, Ofcom will need to ensure that access prices are set neither too high nor too low. If access prices are too low, and below cost, this damages Royal Mail's ability to provide the universal service. Conversely, if access prices are too high, in the long term this is likely to encourage users to move to digital media more quickly, which could further accelerate the

decline in letter volumes, again damaging the ability for Royal Mail to deliver the universal service. The idea that Royal Mail can overcome its challenges simply by increasing prices fails to take into account that mail now competes with other communication technologies.

30. Clause 34 of the Bill is explicit in stating that Ofcom cannot impose an access price control unless it appears that the universal service provider might set its prices excessively high or impose a price squeeze, adversely affecting users. When taken in conjunction with the overriding statutory duty to secure the universal service, Ofcom cannot require Royal Mail to price below efficient costs. Ofcom will need to take into account that it will take time, and expense, in order to reach an efficient cost base. In the intervening period Ofcom has to strike a balance, ensuring that Royal Mail does not provide unfair subsidy to other access operators while at the same time ensuring that inefficient costs are not locked in for the long term as both these outcomes would damage Royal Mail's ability to provide the universal service.

Vulnerable users

16. We are concerned about the extent to which Ofcom will be required to take into account the interests of vulnerable or marginal members of society in provision of postal services. Under the Bill their interests would have to be taken into account as part of Ofcom's duty to review whether the universal service provider is meeting the reasonable needs of users, but members of particular groups may feel better protected if the requirement to address their needs is listed expressly on the face of the Bill, or if the Government can give an assurance that the advisory committees of the Communications Act 2003 will be expected to advise on postal services in addition to their existing tasks. (Paragraph 88)

31. Vulnerable members of society are provided protection in relation to postal services by the application of existing provisions in the Communications Act 2003 (s.3(4)). Under those provisions, Ofcom is required to take into account the needs of the same categories of customers as presently provided for under the Postal Services Act 2000 - including the disabled, the elderly, those on low incomes and those living in rural areas, as well as a number of other groups.

32. The amendments in Schedule 10 to sections 14, 16 and 26 of the Communications Act extend Ofcom's consumer research, consultation and publication obligations to postal matters. Section 16 governs Ofcom's Consumer Panel, which will be given functions in relation to post. Similarly, Ofcom's Advisory Committee on the elderly and disabled, and its advisory committees for different parts of the UK, will be expected to advise on postal services.

The Competition Commission

17. The Government should explain why the power for the regulator to make references to the Competition Commission has been removed. We welcome the fact that the Bill includes the right for the universal service provider to appeal to the Competition Commission against price conditions imposed by Ofcom, but would like to know the reason why this right of appeal is not extended more generally to other conditions that are imposed by Ofcom. (Paragraph 90)

33. It is right to say that the Postal Services Act 2000 allows for Postcomm to make a reference to the Competition Commission requiring the Commission to investigate and report on whether certain matters operate against the public interest and, if so, to report on whether this could be prevented or remedied by changing the licence conditions. Whilst the Bill removes the power of the regulator to refer such broad matters to the Competition Commission, it provides that Ofcom must refer any appeal on price control matters made in accordance with clause 48 to the Commission. The appeals processes proposed for Ofcom in its postal capacity have been carefully designed to balance the need to provide for proper challenge with the need for the regulator to be able to respond effectively to the rapidly changing market conditions in post.
34. Decisions taken in relation to postal services may involve not just economic considerations but wider social considerations. It is the government's view that decisions incorporating such factors are most appropriately considered by the High Court in the context of judicial review proceedings. The exception to this is price control decisions. We do not consider that judicial review would be an adequate route of appeal in relation to price control matters because of the detailed and complex factual matters involved in such regulatory decisions. The Competition Commission is the appropriate body to consider such decisions.

Funding of the USO

18. Although *Modernise or decline* considered that a levy on all postal service operators would be inappropriate because it would in effect reward Royal Mail for inefficiency, the Bill contains powers for Ofcom to establish a mechanism for operators to share costs. We welcome this, although we agree that, given Royal Mail's current inefficiency, such a levy is not yet appropriate. We would like the Government to provide more detail about the circumstances in which it considers such a levy should be imposed. We draw the House's attention to the fact that, as the Bill currently stands, the decision to impose a levy will rest with Ofcom alone. (Paragraph 92)

35. Royal Mail needs to become more efficient. This will enable Royal Mail to meet the costs of the universal service from within its own resources.
36. As noted by the Hooper Report, a universal service fund would be counter-productive in the present situation. It would weaken the incentive for Royal Mail to adapt to changes in the market, when it urgently needs to modernise. We welcome the Committee's support for this conclusion.
37. We believe that it is right to plan ahead and provide for the possibility of a universal service fund in the longer term - but we also believe that the proposals in the Postal Services Bill will make a universal service fund unnecessary for the foreseeable future. The possibility of such a fund is provided precisely to guard against those scenarios in the longer term in post which cannot now be foreseen.
38. The Bill provides assurance that such a levy will only be imposed in appropriate circumstances. It requires specific steps for Ofcom to follow:
- a review of the financial burden of universal service obligations;
 - an audit of this review;
 - the publication of its conclusions;
 - an assessment of whether this burden is unfair; and, if necessary,
 - the set up of a fund.

39. Any universal service fund scheme must work in an objective, proportionate and transparent manner, must not be unduly discriminatory, and must avoid or minimise distortion of competition.
40. Finally, the procedures and safeguards specified in section 403 of the Communications Act 2003 apply to the exercise of these powers relating to the creation of a universal service fund by Ofcom, via Clause 53 of the Bill. Section 403 of the Communications Act 2003 imposes, amongst other things, duties on Ofcom to consult, publish notices of their proposals and consider representations made.

Relationship between the regulator and Royal Mail Group

19. The Bill gives the regulator greater powers to require financial information, and to specify the information that should be provided. This has been a weakness in the current regulatory system, and we welcome its rectification. However, the Postal Directive sets out the method by which costs are to be allocated to different services. We think it is vital that Ofcom's regime is compatible with European requirements, and that the universal service provider will not be required to produce two sets of figures. (Paragraph 93)

41. Through the Bill, we have given effect to our Postal Services Directive obligations in respect of accounting separation (in particular the requirements of Article 14 of the Directive) by giving the appropriate powers to Ofcom. The requirement to act in accordance with the Directive in carrying out its obligations is placed on Ofcom. As a public authority, Ofcom must not, in any event, act in a way that is contrary to European law requirements.
42. Ofcom will take into account the cost-calculation mechanism set out in annex 1 of the Postal Services Directive, '*Guidance on calculating the net cost, if any, of the universal service*'. There will be no need for the universal service provider to produce multiple sets of figures unless it is appropriate to do so.

Accountability of the Regulator

20. Even though the regulatory structure to be brought in by the Postal Services Bill [Lords] has the potential to be far more satisfactory than current arrangements, we do not believe that legislation will end the need for Government to monitor and indeed make policy on such an important area. The events of the past few years should demonstrate

that. There is a need to find a mechanism which will preserve the regulator's economic independence, while allowing the Government to intervene on matters of legitimate policy concern without requiring primary legislation. We note that this is being examined as part of the Digital Britain report. We recommend that if as a result of that work Government and Parliament agree it is legitimate for Government and Parliament to have powers to ensure policy is implemented by Ofcom, those powers should extend to mail services as well as digital communication. (Paragraph 99)

43. As the Committee recognises, it is important that there is a relationship of mutual respect and understanding between the regulator and the Government. This is true in any area of economic regulation. Government will always retain responsibility for the policy framework within which the regulator operates, and there will always be issues at the margin which will need to be handled with sensitivity and mutual understanding. The Government is very confident that it can establish such a relationship with Ofcom in its new postal capacity, as it has already done so in its existing areas of responsibility.

The role of Post Office Ltd

21. We believe there should be more information about the practical consequences of separating the affairs of Post Office Ltd and Royal Mail Group. (Paragraph 104)

44. The two businesses are not being separated. Post Office Ltd will remain part of the Royal Mail group of companies. The Government's stakes in Royal Mail Group Ltd and Post Office Ltd will both be owned via its 100% ownership of Royal Mail Holdings plc. However, they are distinct organisations that provide different services to the public and face different challenges.

45. This group reorganisation will benefit both companies regardless of a partnership transaction for Royal Mail. It enables more direct and robust scrutiny of Post Office Ltd via a new self-standing Board, and improves further transparency within the group.

46. The companies and Government have been in discussions about making these changes for some years. In fact it was discussed with, and indeed welcomed by, the European Commission during the State Aid application for the Post Office network in 2003.

47. Furthermore, a strategic partner will invest in the letters business and will have no involvement in the Post Office's affairs, or those of Royal Mail Holdings plc. In addition, one of the Government's key objectives for the transaction is to ensure that the implementation of a partnership will not impact the existing commercial relationship between the Post Office and Royal Mail, on which both businesses rely. Post Office Ltd will continue to offer Royal Mail Group Ltd's services throughout its network. The existing, arm's length, commercial arrangements will be maintained. This will help support the future of Royal Mail Group Ltd, Post Office Ltd and individual sub post offices. More information about the steps Government is taking to ensure Post Office and Royal Mail continue to work successfully together, and the impact of the corporate reorganisation, is contained in *annex I*.

Questions at paragraph 105

Reasonableness of users

How will Ofcom make the assessment of the extent to which the access network meets the needs of users?

Types of access points

In making its assessment, will Ofcom be required to take account of the quality of "access points" such as unmanned post box that is limited in size of letters that can be accepted versus a staffed weighing counter at which different sized stamps can be purchased?

Given *The Future of the Universal Postal Service in the UK's* assurances that Royal Mail will retain a relationship with Post Office Ltd, is it correct to assume that post offices will continue to be access points?

Section 42

Postcomm has the power to consider and advise the Secretary of State on the Post Office network, although it does not have direct regulatory powers. This is to be removed. But if the Post Office network provided by Post Office Ltd is to remain a key part of the universal service, then why is the regulator's duty to advise in relation to the number and location of post offices being removed? Surely the regulator will remain well placed to comment on this issue, particularly as Ofcom will be required to assess whether Royal Mail is meeting the reasonable needs of end users under clause 29(2)?

Third party access

Will Ofcom have the power to require use of the Post Office network by companies other than the universal service operator?

Reasonable needs of users

48. How the assessment of access points is undertaken is a matter for Ofcom. The test is whether the network meets the “reasonable” needs of users. However, Ofcom has substantial experience in addressing questions of this sort in relation to, for example, the network of phone boxes, the Television Access Services Code and the allocation of the radio spectrum to meet changing economic and social priorities. In carrying out this duty, as with all of its duties, Ofcom will rely on evidence, and will apply proportionate, transparent and targeted regulation to protect the universal service.

Types of access points

49. In assessing access point requirements, Ofcom will need to consider every part of the obligation. Access points include both post boxes and Post Offices. Ofcom’s will need to ensure collections of postal packets up to 20 kilograms, which cannot necessarily be sent from post boxes. Access to Royal Mail services has been available through post offices for centuries and this will remain the case.

Section 42

50. Section 42 of the Postal Services Act 2000 requires Postcomm to provide advice and information about the number and location of post offices. The Committee is right that under the Bill this specific power is not being transferred to Ofcom. By virtue of its general functions, Ofcom would have the power to investigate the role that the Post Office plays supporting the universal service. However, the Government believes that there is a distinction between postal services and post office services. While post offices are vital in providing access to Royal Mail’s postal services, they also have a much wider social and economic role - for example in providing access to cash and benefits in local communities. The Government does not therefore believe that it is, or should be, within Ofcom’s remit to regulate everything the Post Office does.

51. However, we agree that both the Government and Parliament require robust information about the network of Post Offices and their accessibility to consumers, particularly the most vulnerable, throughout the UK. Amongst other things, this will

enable both Government and Parliament to take a view on the social and economic value of the Post Office. We have therefore proposed an amendment to the Bill to impose a new duty on Post Office Ltd to provide an annual report to the Secretary of State on precisely these issues, and any other information the Secretary of State specifies. The Secretary of State will in turn be required to lay this report before Parliament. In addition, Consumer Focus, the body which represents consumer interests, already has statutory powers to investigate the number and location of post offices.

Third party access

52. Finally, it is, as it has always been, possible for third party mail providers to use the Post Office network if appropriate and beneficial commercial terms are agreed. Indeed, as announced on 21 April, the Post Office signed a deal with DX Group, enabling DX's customers to collect items from Post Office branches that could not be delivered. This is the first time that a private mails company has offered access to its services via the Post Office network. There is no restriction on the Post Office preventing it selling products offered by mail providers other than Royal Mail. However, under the proposed changes to the regulatory regime in the Bill, Ofcom would have the power to oblige access to Post Office Limited for other mail providers in certain circumstances, as long as it does not jeopardise the provision of the universal service.

22. The Postal Services Act 2000 says “‘post office’ includes any house, building, room, vehicle or place used for the provision of any postal services”. We note that the Postal Services Bill [Lords] changes this, and defines “post office” as “premises in the United Kingdom from which postal services, or services provided under arrangements with a government department, are provided directly to the public”. This could imply that the link between post offices and postal services may gradually diminish. The Government should explain what in this definition will distinguish a post office from another government office, such as a Job Centre. (Paragraph 106)

53. While post offices are vital in providing access to Royal Mail's postal services, they also have a much wider social and economic role - for example in providing access to cash and benefits in local communities. Trying to capture the breadth of that varied and evolving role in legislation is not an easy task. The Postal Services Act 2000 is focussed purely on the provision of postal services, so the narrower definition of Post Offices

used in that Act is appropriate. However, the Government's ownership controls in this Bill (which are the only provisions to which the definition in clause 14 relates) are driven not only by the Post Office's role in providing postal services, but the full range of its activities.

54. On the Committee's specific concern about a diminution in the link between post offices and postal services, Government will ensure that the Post Office is not adversely affected by the introduction of a strategic partner for Royal Mail. The Post Office will continue to offer Royal Mail's services throughout its network. The existing, arm's length, commercial arrangements will be maintained. The threat to the Post Office's mails revenue would be if Royal Mail was unable to transform and to meet the competitive challenges of the communications market: a partnership for Royal Mail is therefore absolutely in the network's best interests. More information about the precise steps Government is taking to ensure Post Office continues to provide mails services is contained in *annex 1*.
55. In relation to the Committee's concerns about distinguishing a post office from another government office, it is important that the definition is read in the context within which it works. While government offices offering other services would theoretically be caught by the definition, this would be irrelevant. The definition is only applicable in the context of the ownership restrictions in clause 2 of the Bill. For example a Job Centre would not meet the other criteria required to be met for the ownership restrictions to apply. So if a Job Centre, or any other form of government office, was not also a subsidiary, or former subsidiary, of Royal Mail Holdings plc, the definition would have no effect.

23. The material published so far does not give nearly enough detail about the rationale for a separation of Post Office Ltd and Royal Mail, or its practical consequences. We will explore these issues further in our related inquiry into post offices. We recommend that the practical consequences of such a separation be explored in scrutiny of the Bill.
(Paragraph 107)

56. We are not separating Post Office Ltd and Royal Mail Group Ltd. They will remain part of the same group of companies under the overall ownership of Royal Mail Holdings plc. We welcome the Committee's interest in the impact of the Government's proposals on

the Post Office network. Further information about the detailed consequences for Post Office Limited and the broader Post Office network are set out at *annex I*.

Royal Mail pension plan

24. Over many years the Trade and Industry Committee warned about Royal Mail Group's pension deficit. Competitors coming later to the United Kingdom market have not been burdened by such historic deficits. We note that in other countries the pension deficits of the universal service operators have been dealt with as part of the preparation for postal market opening. We agree that Royal Mail Group's pension deficit needs to be tackled as a matter of urgency (Paragraph 115)

57. Government fully agrees with Hooper that Royal Mail's historic pension deficit needs to be addressed. However, tackling the pension deficit alone would not be sufficient to remove the current constraints of Royal Mail's modernisation. What is needed is to both secure the pension fund and ensure that Royal Mail can transform quickly to compete in a fast changing market. It would be irresponsible to ask the taxpayer to tackle the pensions issue without also giving the taxpayer confidence that a plan is in place that enabled Royal Mail to address the other challenges it faces. That is why the pension deficit can only be addressed in the context of a strategic partnership.

25. We consider that the approach set out in *The Future of the Universal Postal Service in the UK* to allocating responsibility for Royal Mail Group pensions between the taxpayer and Royal Mail Group itself is basically sound. Royal Mail Group will retain responsibility for future liabilities; the taxpayer will deal with historic liabilities (Paragraph 117)

58. We welcome the Committee's conclusions on this point. The Government's proposals balance its objectives of protecting the universal postal service, protecting members of the pension scheme and protecting the interests of taxpayers. Given this, we think it is right that Royal Mail should continue to remain responsible for all pension benefits earned by members after the cut-off date and also the pension liabilities which are linked to salary growth (which is in the control of Royal Mail).

26. In our view a strong case can be made for state aid clearance for removal of part of RMG's pension liabilities without radical restructuring or compensating competitors. (Paragraph 120)

59. We believe that the Committee has misunderstood the arguments in the Hooper report concerning state aid clearance. In respect of the pension proposals, because the Government is proposing measures that would relieve Royal Mail of a very significant burden - and therefore potentially raise issues in relation to its effect on competition - state aid clearance will be required from the European Commission. But that is different from the issues around restructuring aid. Restructuring aid was discussed by Hooper in a quite different context involving the provision of emergency financial support to the company, as could be required if the Government failed to act on Hooper's recommendations.

Scheme amendments

27. The new scheme cannot be amended at a later date in any way that would adversely affect the position of scheme members. However, this restriction does not apply where either a) scheme members consent to the amendment is secured or b) where "the scheme is amended in the prescribed manner" (which means amended in accordance with the new scheme as created by the Secretary of State). We believe the House should explore what rules the Secretary of State intends to introduce in relation to amendments. (Paragraph 122)

60. Clause 19 in Part 2 of the Bill sets out the restrictions on the Secretary of State in terms of being able to make amendments to the new public service scheme. The new scheme can only be amended in a way that would adversely affect members' accrued benefits if a member consents or prescribed steps are taken. The latter is intended to protect members in a similar way to the protection they currently have in the Royal Mail Pension Plan, under section 67 of the Pensions Act 1995. The mechanism for making changes to the scheme is based on provisions in the Armed Forces scheme (a similar non-trust based scheme).

Transfer of liabilities

28. The private sector partner will enter an agreement with the Government, conditional on the pensions' liabilities being transferred. Parliament will then be faced with an artificial choice between allowing the pensions transfer, and with it the private sector partnership, to progress, or blocking the private sector partnership by refusing to transfer pension liabilities to the new scheme. (Paragraph 124)

61. The Government has made it clear that it accepts Hooper's recommendations as a package in the way they were proposed. We are not going to select one to the exclusion of another. All three recommendations - on partnership, pensions and regulation - are required to be implemented if the challenges facing Royal Mail are to be successfully addressed and the universal postal service secured.

62. Tackling pensions on its own would not be a panacea for Royal Mail's difficulties - indeed it would be irresponsible for the Government to tackle the pensions issue alone without having the policies in place to ensure that Royal Mail can transform quickly to compete in a fast changing market.

A private sector stake in Royal Mail

29. The regime proposed by the Postal Services Bill [*Lords*] in one sense restricts the government power to dispose of assets, by explicitly requiring the Government to maintain a majority stake. There is no such provision in current law. However, we note that the definition of a majority holding would be satisfied by holding 50.1 per cent. This new restriction is balanced by the removal of the requirement for each disposal to be approved by resolution. When it discusses the relevant clauses of the Postal Services Bill [*Lords*], the House should bear in mind that the law already provides for private sector partnership in Royal Mail Group, and would even permit a majority shareholder from the private sector. However, as the law currently stands, Parliament has to approve each disposal of shares, and has to be given details of the proposed disposal. (Paragraph 127)

63. The Committee is right that the current Postal Services Act 2000 allows, in section 67, for a sale of shares in Royal Mail in certain limited circumstances, if needed to cement a joint venture. This provision was included in the Act to enable Royal Mail management to pursue opportunities for expansion in Europe. It could only be utilised, however, if management came forward with a proposal, and if the proposal in question was for a joint venture. In this instance, the partnership has been proposed by Government as Royal Mail's shareholder. The Government decided that it was more appropriate to give Parliament the opportunity for a more thorough scrutiny of proposals for any minority sale of shares through the passage of a Bill, as opposed to a single debate on the issue as provided for under the current legislation. In this way,

the minority share sale could also be considered, properly, as part of a package and in the round, along with proposals on pensions and regulation.

64. In addition, section 67 of the existing Postal Services Act permits a disposal of shares in Post Office Limited to a third party. This is inconsistent with the Government's policy, endorsed by Hooper, that Post Office Ltd should remain entirely owned by Government. For that reason, we propose the repeal of section 67 in the Bill currently before Parliament. This will not affect the Post Office's commercial freedom to enter into joint ventures and other collaborative arrangements, where appropriate, to maintain and further develop its range of products and services. But it will ensure that it is no longer possible to sell shares in Post Office Ltd itself.

65. Under our proposals, Royal Mail will be able to enter into a partnership that will secure its future. We believe that this is a good deal for the taxpayer. The Bill provides the additional protection, as highlighted by the Committee of requiring that Royal Mail will continue to be publicly owned.

30. It is entirely unacceptable for Parliament to be asked to approve such fundamental changes to Royal Mail Group when there is no indication of how much money Royal Mail Group needs for investment and while the Government appears to have no business plan and has not indicated the use to which any private sector cash would be put. In fact any partner may see the need of considerable investment above and beyond that capable of being generated by Royal Mail Group. The House is entitled to demand clarity on these points before the Bill receives its second reading. (Paragraph 144)

Conclusion

31. We are unconvinced by the argument Lord Mandelson put forward for seeing the proposals of the Postal Services Bill [*Lords*] as a package. The regulatory framework needs to be changed as a matter of urgency and in its own right. Similarly, the problem of the pensions' deficit needs to be addressed. However the Government already has powers to dispose of shares in Royal Mail, and would have those powers even without the Postal Services Bill (Paragraph 147)

32. There might be a case for seeing the deal as a package if it were clear that Royal Mail would need more funding even after reform of the regulatory system and removal of

responsibility for the pensions deficit. However, there are grounds for believing that the reforms in Part 2 (Royal Mail Pension Plan) and Part 3 (Regulation of Postal Services) of the Bill, particularly the potential elimination of access headroom, would release enough cash to fund Royal Mail's modernisation, and that the proceeds from any sale are very likely to go straight to the Treasury. It would be helpful to know if any prospective partner shared that view. (Paragraph 148)

33. Whatever other arguments there might or might not be for private equity stake in Royal Mail Group, a capital injection cannot be relied upon. (Paragraph 149)

This answer covers conclusions 30 to 33.

66. A successful, modernised Royal Mail is crucial to secure the future of the universal postal service. This is the Government's key objective and why we are introducing the package of measures covered by this report: partnership, pensions and regulatory reform.

67. As the Hooper Report set out in stark terms, and as the Committee acknowledges, Royal Mail is facing significant challenges in its business with mail volumes declining at an unprecedented rate. Royal Mail recognises that the global economic turmoil has exacerbated this structural decline and the UK letters market is now declining between 8-10%, with every 1% decline in volume reducing Royal Mail's income by £70m. Competition from electronic communications has accelerated in recent months and the company expects this trend to continue. The parcels' market is now also under pressure due to the economic situation and over capacity leading to prices and margins to decline sharply.

68. Modernisation is not, of course, a static process requiring a one-off investment, nor is it simply about the purchase of some new machines. Modernisation is about responding to a dynamic market place: evolving the business to ensure it can meet the challenges posed by the digital revolution; compete successfully; and hence deliver what consumers want, as the only company capable of delivering the universal service.

69. In addition to purchasing and introducing new machinery and looking at the structure of Royal Mail's delivery network, modernisation must involve:

- the development of new products and services which better meet customer needs and hence keep pace with, or better, pre-empt, competitor innovations;
- the introduction of new and flexible working practices; and
- a transformation in the relationship between management and the workforce.

70. The cost of modernisation will, therefore, depend on the business plan agreed with any partner. It will depend on how far reforms are taken, the speed with which they are implemented and the extent to which Royal Mail seeks to become a leader in the communications market. Given Royal Mail's falling revenues and limited profits over the next few years, and pensions fund deficit, clearly Royal Mail will not be able to fund this investment alone. Additional capital will be required and this could be hundreds of millions of pounds, in addition to the funding we have already provided.

71. Government will inform both Houses of the payment for the shares and how it will be distributed when the consideration is received. The proceeds from the proposed transaction will be used to fund modernisation.

72. The Committee believes that implementation of parts 2 and 3 of the Bill (dealing with pension reform and changes to the regulatory regime) will provide sufficient funding for Royal Mail to modernise. This may release some pressure on Royal Mail but its exact financial impact is not known. For example, Royal Mail receives an allowance for pension deficit recovery (£280m) under the current price control agreed with Postcomm. How this is dealt with in the next price control, if the Government takes responsibility for the company's historic pension liabilities in the context of partnership, will be a matter for Ofcom in discussion with Royal Mail. Ofcom will need to reach its decision considering the issues in the round - including the efficiency of Royal Mail, its financial position at the time and how mail users would respond to significant price increases.

73. Importantly, though, partnership is not just about injecting capital into Royal Mail. As the Committee's report recognises it is about much more than this. Partnership will:

- provide the company with practical, corporate experience of transforming a network company:

- ensure that this experience can be used effectively as and when it is most needed during each stage of the transformation process and at every level of the company. Appointing consultants or changing the senior management will not suffice;
- accelerate implementation of the company's existing modernisation plans and ensure that Royal Mail is prepared to go further as necessary, responding much faster to a rapidly changing market;
- provide an opportunity for unions and management to make a fresh start;
- give Royal Mail management at all levels the commercial confidence they need to press ahead with plans to modernise, working constructively with the company's employees and unions, without the perception of Government intervention; and
- help to support a sustainable network of Post Office branches throughout the UK, as a consequence of transforming Royal Mail.

74. In short, partnership offers a fresh start for Royal Mail. It is the best way of meeting the requirements for transforming Royal Mail highlighted by Hooper and which Government accepts: commercial confidence, access to capital and experience of managing change. This transformation is crucial if we are to create a Royal Mail fit to meet the challenges of the future. Action on pensions and regulation alone will not modernise Royal Mail. It provides no incentive for Royal Mail to change and to external drive to push it to happen. Only the full package of measures which Government proposes will deliver our objectives in full, and secure the universal postal service.

34. It is unlikely that the best price for any shares in Royal Mail would be obtained now, although we acknowledge that the deal could be structured over several years and payments could reflect current market conditions as those payments were made. (Paragraph 150)

35. Whatever one thinks of a private sector partnership, is the Government's position which is to say that there will be no removal of the pensions deficit until such a partnership is concluded, justified? Is it in fact more rational to remove the deficit as quickly as possible and revisit the question of whether a private sector partnership is desirable when there has been time to see if Royal Mail (and its workforce) can continue to improve their performance? (Paragraph 152)

This answer covers conclusions 34 and 35.

75. The Secretary of State has made clear in debates on the Bill that Government will not do a deal on any terms. Value for the taxpayer is hugely important and if it cannot be achieved Government will not press on regardless. However, as the Committee acknowledges, partnership is not solely about injecting money into the Group and maximising proceeds. As importantly, it is about securing the expertise and skills of a partner with experience in a postal or other networks business to help transform Royal Mail's business and deliver the step change in approach which is required to meet the challenges the business now faces. As the Committee's report sets out, while partnership would leave the taxpayer with a reduced stake in Royal Mail, it is better for the taxpayer to benefit from an increase in those profits thanks to the introduction of a partner, than to retain all of the profits (if any) of a less successful business and the risk of further calls on the taxpayer.

76. It would be irresponsible of Government to delay in taking action to reform Royal Mail and secure the future of the universal postal service. Funding of £3.2 billion of taxpayers money has already been provided to the business, including most recently £1.2 billion to fund modernisation. Some of this money has yet to be spent, although the company believes it will be utilised in full over the next 2 years. In spite of Government investment the company has failed to transform fast enough or far enough to respond to the challenges of the digital revolution. The market within which Royal Mail operates has changed irrevocably and continues to evolve. There is simply not the time to wait to see whether the company in its current form can now rise to its challenges.

77. It would be wrong for Government to meet the burden posed by Royal Mail's pension deficit without confidence that the company can reform without the need for further financial intervention.

36. The next question is what is the justification for the size of the partnership? Thirty per cent was the figure cited by Lord Mandelson at second reading, but why? It may be that it is linked to the provisions requiring companies with shares to offer to buy out other shareholders; but that would not apply in this case. Although Mr Hooper cited a case where a minority shareholder had produced beneficial effect, in many cases, minority shareholders find themselves in the frustrating position of providing cash without

effective control. Interestingly, no one appears to be putting the case for a sale of a majority stake in Royal Mail. (Paragraph 153)

78. The Government is clear that any partner should have a real stake in the company ensuring a proper alignment of interests around the transformation of the business. As the successful public-private partnership for the UK's air traffic control provider (NATS) demonstrates, introducing a partner with a real investment in the future fortunes of a company ensures a commonality of objectives and that all sides are properly incentivised to ensure that a business is transformed.

79. Importantly, with an equity investment a partner will only see a return on their investment if the company is transformed. It is this transformation which will ensure the universal service is protected for the future, that customers see an improvement in services and that the taxpayer, due to Government's ongoing majority shareholding, also reaps the benefits of an improvement in Royal Mail's performance.

80. Government has cited a shareholding in the region of 30% as one which would be sufficient for the partner to have a strong economic interest in Royal Mail and to align the partner's interest with Government. It would give the partner sufficient influence on the operational aspects of the business to ensure that modernisation was delivered, whilst leaving the Government with majority control. However, the precise level of any stake will be a matter for negotiation with the partner.

37. The third question is how much openness there will be about the partnership agreement which will set out such controls as the minority partner will have. This is likely to include the right to appoint a certain number of directors. However, the influence available by this route will presumably be limited by Lord Mandelson's undertaking to the House of Lords that "public ownership carries with it the voting rights and economic benefits appropriate to a majority shareholder." The agreement will also, we presume, set out arrangements for the partnership to be dissolved if the minority partner wishes. Normally this would be done either by selling shares on the open market, or by a firm undertaking that the majority stakeholder would buy out the minority partner if that was desired. Such agreements can also include clear statements as to whether and how the minority partner can increase its stake in the future. What will be the arrangements here? What will be the arrangements for GLS, the most profitable part of

Royal Mail's business? Under the current scheme, Parliament will not have any right to see that agreement before the Government enters into it (or indeed, afterward). Is the Government prepared to make such details public before a partnership is agreed? Why does it feel it needs to change the law so that specific Parliamentary approval for each disposal is no longer needed? (Paragraph 154)

81. While negotiations with potential partners are ongoing, it would be damaging to publish further details of the proposed agreements, both to value for money and to the achievability of a deal. The details of transactions are properly a private and confidential matter between the parties concerned. It would be commercially unprecedented for transaction documentation to be published. The Secretary of State has, however, committed to keep Parliament informed about important developments as the negotiations progress, and to report to Parliament on the detail of the deal and how it meets Government's criteria.
82. During debate on the Committee stages of the Postal Services Bill (Lords) he explained that the partnership will be subject to a shareholders agreement which will be a legally binding contract between the Government as seller (through Royal Mail Holdings) and the buyer. That document will make clear what the buyer can do (for example on Board appointments) and what it cannot do (for example by placing restrictions on sale of its shares).
83. The shareholder agreement will reflect that this is a partnership. The Government will have greater control rights than the partner, appropriate for the majority shareholder. But the Government is keen to ensure that, in certain areas, there will be shared responsibility with the partner. This will give the partner sufficient rights to enable it to influence the decision-making process in the company. There is no point in having such a partner without having the influence needed to play a strong, positive role in transforming the business. For example, Government expect to agree with the partner, the company's business plan and future strategy. To deliver the transformation required in this business it will be essential that, in particular, on operational matters - including modernisation of working methods, introduction of technology and product innovation - the partner has a meaningful say in the running of the business.

84. The shareholder agreement will also set out the structure of the Board for Royal Mail Group Ltd. The structure will reflect that this is a partnership, in which Government will retain ultimate control. Our current expectation is that the Government will appoint the Chairman and the majority of the non-Executive Directors. The partner would be able to appoint a minority of the non-executive directors. The Government and the partner will have shared responsibility over the appointment of the Chief Executive.

85. The shareholder agreement will also include further protections for Government should the partner subsequently sell their shares. For example, it will ensure that they are tied into the business for an appropriate period - to meet our objectives for modernisation.

86. The focus is on finding the right strategic partner for Royal Mail to help it modernise its core UK business. We are therefore looking for a partner for Royal Mail Group Limited. GLS has played an important role in the Group's strategy and provides options for future expansion of the business. Our intention is that GLS will continue to be a subsidiary of Royal Mail Group. Through its minority stake in Royal Mail Group a partner will have an indirect minority stake in GLS.

87. The Postal Services Bill ensures that Post Office Limited must remain owned its entirety by the Crown and that Royal Mail Group Limited must be publicly owned. To change this would require primary legislation and the full and thorough parliamentary scrutiny which goes along with that.

38. In the proposals to separate Royal Mail and Post Office Ltd, account must be taken of the operational independence between Post Office Ltd, Royal Mail and individual postmasters. At the moment the Post Office provides access and delivery points to Royal Mail Group letters and parcels. Will this continue if the proposal to separate them takes place? (Paragraph 155)

88. We have of course taken account of the inter-dependence between the Post Office Ltd, Royal Mail Group Limited and individual sub postmasters. While there is to be a group reorganisation the two businesses are not being separated. See the response to

conclusion 21 and *annex I* for more detail on the reorganisation and its practical consequences:

- Post Office Limited will continue to offer Royal Mail Limited's services throughout its network. The existing, arm's length commercial arrangements to be maintained;
- Royal Mail Group Limited will remain publicly owned, and this is on the face of the Bill; and
- the two businesses will remain in the same corporate group.

89. Royal Mail Holdings plc, as controlling shareholder of each business, will, of course, wish to exercise its rights to ensure that Royal Mail and the Post Office continue to work together in a mutually beneficial manner. A partnership for Royal Mail Group Limited will therefore not damage its commercial relationship with Post Office Limited. Similarly, there is no reason why a partnership would have any impact on the commercial arrangements in place between individual postmasters and Post Office Limited. But moreover, a successful, competitive Royal Mail is vital to the future sustainability of the Post Office network.

90. The National Federation of Sub-Postmasters has highlighted a particular concern around Royal Mail Group Limited's use of Mailwork centres, which are facilities used by Royal Mail that are provided by local sub postmasters, largely in rural areas. These arrangements will not be affected by the proposed changes to the structure of the Royal Mail group of companies. Any changes to Royal Mail's use of mailwork centres will be driven by its need to modernise and improve its efficiency, not the introduction of a strategic partner. We welcome the Committee's agreement that '*it is clear that Royal Mail Group is less efficient than its competitors*'. Decisions on the continued viability of individual Mailwork centres will therefore be an operational decision for management. However, we note that the Managing Director of Post Office Ltd, Alan Cook, told the Committee on 21 April 2009 that he doubted that Royal Mail could find alternative solutions to Mailwork centres.

39. When the Government announced its acceptance of the proposals in the Independent Review on 16 December, it also made it clear that TNT, a major competitor to Royal Mail, had expressed an interest in entering a strategic

partnership with the company. The fifth question is whether if the recommended partner turns out to be an existing major competitor of Royal Mail the loss of competition that would inevitably result is a price worth paying for the equity stake? (Paragraph 156)

91. Until the Government has chosen a potential partner, we cannot assess the impact of any partnership on the broader market place. However, if a partner is chosen who already has a UK postal operation, or any overlapping business interests, then any partnership arrangement would need to be cleared with the relevant competition authorities. It is rightly a matter for the expert competition authorities to determine the effects of any corporate transaction on the relevant markets. We are satisfied that they will of course take into account all relevant factors and if they then clear the arrangements there would not be a damaging impact on the broader market place.

40. Finally, the challenges faced by Royal Mail are huge – the decline in the letters market is enormous. That is why the Government is inserting a provision for a possible future levy to fund the USO. It is an heroic assumption to imagine that cash generation or debt finance will be attractive routes for securing the additional investment that will be needed in the medium term to open up new markets and diversify, even with a profitable letters and parcels business. The House should not make that assumption without firm evidence. (Paragraph 157)

92. Government welcomes the Committee's recognition of the huge challenges facing Royal Mail. It is precisely due to these challenges that we are pursuing the full package of measures put forward in Richard Hooper's report.

93. We also welcome the Committee's recognition that it is not possible in the short to medium term to rely on the company's own resources or additional debt funding (which at the present time the company can ill afford) to fund modernisation and diversification. This is certainly not an assumption which the Government is making. Indeed it is one of the reasons why we believe a partnership represents the best route to address Royal Mail's challenges. In addition to the experience of delivering change in a network business which the partner will provide and the commercial confidence the new structure will engender it provides the opportunity to introduce capital into the business.

41. More money may well be required. This can really only come from three routes – cash generation within the business, debt finance or new equity injections from the public or private sector. But if additional equity investment is needed, with a 30% partner, either the Treasury will still provide 70% of that investment – which will then be subject to all the same state aid rules which we are told the company is seeking to escape – or it will come entirely from the private sector partner, who will expect an increased stake in the business as a reward for the extra risk capital supplied to the business. We note that the definition of “publicly owned” in the Bill would apply even where the private sector held a 49.9% stake. Some will have no problem with this steady increase in the privately owned proportion of the company – but others will. (Paragraph 158)

42. We are left with the conclusion that either the Government has not fully thought through its position about future share sales, or that it has done so and is refusing to reveal its hand. Either case is worrying. In any event, if shares are sold to a new strategic partner, a stake of 30% does not look like an end-game to us. (Paragraph 159)

This answer covers conclusions 41 and 42.

94. Government has a fully considered position on the share sale and has no hidden agenda. As outlined in our response to conclusion 35, the precise stake to be sold as part of any partnership is subject to negotiation with bidders. What is important is that there should be no doubt as to Royal Mail remaining publicly owned - that is that Government must own more than half of it. This will ensure that Government retains majority ownership and majority shareholder control over the business recognising its important and ongoing public role. However, an element of flexibility within that is important. For example, as has been discussed during the Lords Committee stages, it is possible that in future some element of employee share ownership might be contemplated and the legislation should allow for this. Of course it would need to demonstrate good value for money for the taxpayer.

95. Any future investment provided by Government alongside a partner could be subject to scrutiny by the European Commission. However, because the Government could demonstrate that a private sector partner was investing on the same basis, any

concerns regarding state aid should be much more easily dealt with than is the case at present.

Post Office Limited - structure

Introduction

1. The Select Committee requested further information about the practical impact of the Government's proposals for Royal Mail on the Post Office. This note is intended to provide it.

The Post Office, Royal Mail and Hooper

2. The Post Office network was not included in the terms of reference for the Hooper Report for good reason. Royal Mail Group Ltd and the Post Office Ltd are distinct organisations that provide different services to the public, and face different challenges. The Hooper report was about how to safeguard the universal postal service, in line with the Government's manifesto commitment to review the impact on the Royal Mail of market liberalisation.
3. Post Office Ltd plays a critical role in helping Royal Mail Group Ltd to deliver the universal service. However, mails services are only one element of the vital services post offices provide in our communities. The Government's policy on the Post Office network was set out in May 2007⁵ following a 12-week national public consultation on the future of the network. The Government remains committed to maintaining a post office network with national coverage, underpinned by minimum access criteria to protect, in particular, vulnerable consumers in deprived urban, rural and remote areas. We want to see a stable and sustainable network for the future. The Government has since made clear that it will not support a further programme of Post Office closures.
4. Despite their different challenges, the success of the Royal Mail and the Post Office remains very much connected. If we are unsuccessful in reversing the decline in Royal Mail's business, the Post Office's business will decline too. If the Post Office required even further subsidy to make up for it, that funding would need to be balanced against other spending priorities, not least any extra funding required to support an untransformed Royal Mail. So it is in the interests of both Post Office Limited and its network of post offices to see the finances of the Royal Mail turn round and the business

⁵ <http://www.berr.gov.uk/files/file39479.pdf>

transformed. That makes the implementation of this Bill and the transformation of Royal Mail critical for the Post Office and its network.

The current position

5. Post Office Ltd has been a standalone company within the Royal Mail corporate structure since the 1980s. The establishment of Post Office Counters Ltd (as Post Office Ltd was then called) as a separate business reflected the wider role played by post offices in the communities they serve, as described above.
6. Because it is a separate company, Post Office Ltd has its own directors, responsible for taking decisions in the interests of the company. But because Post Office Ltd is part of the wider Royal Mail corporate group, it is able to share the cost of some central services with other companies in the group - for example, Royal Mail Group Ltd and Post Office Ltd share a group legal function and a group treasury function.
7. Since 2001, Government's ownership of both companies has been through its 100% stake in Royal Mail Holdings plc - the parent company of the group. Currently, Royal Mail Holdings plc owns 100% of Royal Mail Group Ltd, which in turn owns 100% of Post Office Ltd.

Current structure⁶:



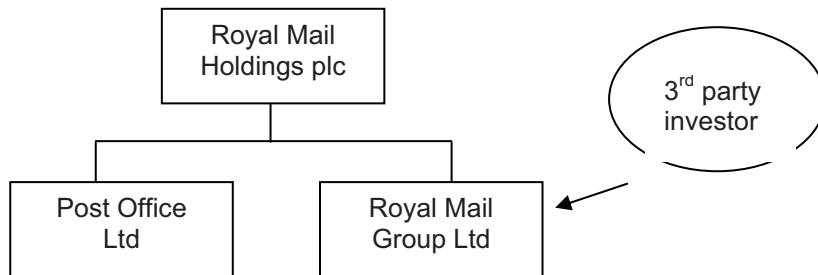
Corporate reorganisation

8. Nothing in the Government's current proposals to reorganise the Royal Mail group of companies will change the ultimate ownership of Post Office Ltd. Post Office Ltd will remain in the same corporate group as Royal Mail Group Ltd. The Government's stakes in Royal Mail Group Ltd and Post Office Ltd will both still be owned via its 100% ownership of Royal Mail Holdings plc.

^{6, 3} Note that the structure charts have been simplified so that they only reflect the relationship between Royal Mail Holdings plc, Royal Mail Group Ltd and Post Office Ltd. Other companies in the corporate group have been omitted for simplicity.

9. Royal Mail Group Ltd and Post Office Ltd are not, therefore, being separated, They will remain in the same corporate group: Post Office Ltd will simply move from being a subsidiary of Royal Mail Group Ltd to being a direct subsidiary of Royal Mail Holdings plc - and a sister company to Royal Mail Group Ltd.

Future structure:



10. This structure also ensures that any strategic partner would invest directly into Royal Mail Group Ltd and would have no involvement in Post Office Ltd's affairs (or those of Royal Mail Holdings plc). A purely commercial network would be around one third of its current size. But the network does not exist for commercial reasons alone. The Government therefore believes that it should remain entirely in Government ownership.
11. The group reorganisation will, however, benefit both companies irrespective of the introduction of a strategic partner for Royal Mail Group Ltd. It will allow Royal Mail Group Ltd and Post Office Ltd to focus on the very different challenges they face, while retaining the benefits of being part of the same group of companies. For precisely these reasons, the companies and Government have been in discussions about making exactly these changes for some years. Indeed it was discussed with, and welcomed by, the European Commission during the Government's application to provide state aid funding to Post Office Ltd as long ago as 2003.
12. Alongside the group reorganisation, Government will take other steps to better equip Post Office Ltd to meet the challenges and opportunities ahead, and ensure that both Government and Parliament have appropriate oversight of its activities:
- we will create a new Board for Post Office Ltd, with a non-executive Chair. This will provide a new level of support and challenge for Post Office Ltd's management team;
 - staff who work in Post Office Ltd are currently on secondment from Royal Mail Group Ltd and are not formally employed by Post Office Ltd. As part of the group

reorganisation, they will be transferred to become direct employees of Post Office Ltd on exactly the same terms and conditions as they enjoy now. The Postal Services Bill includes provisions to confirm that the employment law protections offered by the TUPE Regulations will be provided to staff affected by this transfer;

- Post Office Ltd will be under a new duty to publish its annual accounts, and for those accounts to be laid before Parliament. This will address the Committee's longstanding concern about the transparency of Post Office Ltd's finances; and
- in addition, we have proposed an amendment to the Bill to require Post Office Ltd to produce an annual network report, again laid before Parliament. This will provide information on the number and location of Post Offices and their availability to consumers, particularly the most vulnerable.

Post Office and the mails market

13. The Government believes that Royal Mail Group Ltd and Post Office Limited should be able to focus attention on their own divergent problems. It is, however, important not to lose sight of the clear commercial ties between the two businesses. Income from Royal Mail Group Ltd currently accounts for around 30% of Post Office Limited's total revenue, and the nationwide network of post offices provides vital business for Royal Mail Group Ltd from consumers and small businesses: approximately three-quarters of Royal Mail Group Ltd's retail business is sourced through Post Office Ltd. The commercial relationship between the two businesses is therefore of vital importance to both companies.
14. As the Managing Director of Post Office Limited, Alan Cook, has confirmed to the Committee, Post Office Ltd will continue to offer Royal Mail Group Ltd's services throughout its network. The existing, arm's length commercial arrangements will be maintained. And as controlling shareholder of each business, Royal Mail Holdings plc will wish to exercise its rights to ensure that Royal Mail Group Ltd and Post Office Ltd continue to work together in a mutually beneficial manner.
15. A partnership for Royal Mail Group Ltd will therefore not damage its commercial relationship with the Post Office.
16. Post Office Limited is not, however, standing still in the mails market. It is, as it has always been, possible for third party mail providers to use the Post Office network if appropriate and beneficial commercial terms are agreed. Indeed as announced on 21 April, the Post Office signed a deal with DX Group, enabling DX's customers to collect items from Post Office branches that could not be delivered. This is the first time that a private mails

company has offered access to its services via the Post Office network. The contract was signed on the same terms as the Royal Mail Group Ltd pays for access to the post office network, and as Alan Cook told the Committee, *“this further vindicates this lack of transparency that has been alluded to by the Chairman in the past on the pricing [of the mails contract] and demonstrates that actually third party mail providers find the service of sufficient value”*.

17. However, as a fail safe measure, the proposed regulatory regime allows Ofcom to oblige access to the Post Office’s network for other mail providers in certain circumstances.
18. The Government notes the concerns of the Committee’s Chairman about striking the right balance between allowing Post Office Ltd freedom to provide services on behalf of 3rd party mails providers, but also ensuring continuity of its relationship with Royal Mail Group Ltd. We believe that allowing Post Office Ltd the commercial freedom to sell the products of any mails provider, but from within a corporate structure that maintains its strong commercial ties with Royal Mail Group Ltd, provides the best platform for Post Office Ltd’s future success in this market.

The Sub Post Office network

19. The Government welcomes the Committee’s interest in the viability of the post office network, as distinct from Post Office Ltd as a company. 97% of the network are privately owned businesses.
20. The success of Royal Mail is just as important for this network of private businesses as it is for Post Office Ltd as a company. Transforming the Royal Mail through the introduction of a strategic partner is therefore equally critical to the sub post office network. We are committed to ensuring that the transaction in no way damages the sustainability of the network.
21. The Committee has expressed particular concern over Royal Mail’s future use of Mailwork centres (sub post office premises used by Royal Mail to sort mail in rural locations). These will not be affected by the proposed changes to the structure of the Royal Mail group of companies. Indeed, the Managing Director of Post Office Ltd, Alan Cook, told the Committee on 21 April that the model used for the Mailwork centres has proven to be the most effective model for these areas. He therefore doubted that RM could find a more cost effective alternative solution to Mailwork centres in these rural areas.
22. Separately to the impact of the transaction and group reorganisation, we recognise the concern from all parties to further improve the sustainability of the network. The

National Federation of Sub Postmasters and other organisations have put forward suggestions for how this might be achieved. We welcome these additions to the debate, and would like to reassure the Committee and other stakeholders that Government is committed to a stable and sustainable future for the network. That is why we have provided £3.7bn to the Post Office over the period from 1999 to 2011. We will continue to subsidise the network beyond 2011, and will not support any further programme of closures. As the Secretary of State said during Committee in the House of Lords, *“the Government has been, is now, and will continue to be, committed to subsidy, investment and the expansion of the Post Office’s services”*.

23. However, there will always be natural exits in a network which is 97% privately owned and operated. Neither Government nor Post Office Ltd can commit to maintain an absolute number of offices at any given time. We are therefore working across Government to identify new opportunities to sustain the network. With new revenue opportunities for Post Office Ltd, of course also come new revenue opportunities for the sub postmasters upon whom the network relies. The more sales of new, profitable Post Office Ltd products are generated through their post offices, the stronger the viability of sub postmasters’ businesses.

Further opportunities for the Post Office network

24. We are determined that the Post Office should build on this Government’s important decision to award it the contract for the new POCA contract in November last year. We have been working within Government to see what new opportunities there might be, and have held an inter-Departmental meeting on this issue. We are grateful for the Committee’s own efforts to investigate this issue and look forward to hearing their conclusions later in the year.
25. We believe that the network has a strong role in improving financial inclusion, particularly in the current economic conditions. For example, the Chancellor announced at the Pre Budget Report in November that the Saving Gateway scheme would be available through the Post Office network. Post Office Ltd is also in discussion with the Association of British Credit Unions to see what opportunities there might be for the two organisations to work together more closely.
26. The Government is also about to consult on a range of measures to sustain town centres and the provision of retail services in both urban and rural communities. These include changes in planning policies to make them more flexible and to facilitate the future sustainability of local economies.

27. Furthermore, a range of prospective opportunities for the Post Office to act as the 'Front Office for Government' have been identified. The Department for Transport announced last month that the Post Office would provide the face-to-face service for the 10-year renewal of photo driving licences. And, as the new generation of passports (and possibly in the future identity cards) is developed, there is similarly, a large potential stream of work for Post Offices in identity verification, data capture and electronic processing and transfer. The DVLA contract announced last month will allow Post Office Limited to undertake a multi-million pound investment in ID verification technology, making it one of the very first Post Offices anywhere in the world to offer this type of service to its customers.



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