

ANNUAL REPORT 2007/08



ABOUT POSTCOMM

▶ Postcomm – the Postal Services Commission – is an independent regulator. Our job is to ensure the provision of a universal postal service and to further the interests of postal users in the UK by introducing choice through competition. We were set up by the Postal Services Act 2000 and are classified as a non-ministerial Government department.

Our policies are steered by a board of independent Commissioners, headed by our chairman, Nigel Stapleton. Between them they have considerable experience of competition, business, consumer issues, regional matters, UK and overseas mail operations, trade unions, Government and regulation.

Postcomm's vision is *a range of reliable, innovative and efficient postal services, including a universal postal service, that is valued by customers and delivered through a competitive postal market.*

Postcomm has required Royal Mail to continue to provide a universal postal service, has introduced competition and licensed a number of companies to compete with Royal Mail. Because Royal Mail still has a hugely dominant position in the letter post market, we also regulate some of the prices that it can charge and its quality of service.

Postcomm is also charged with monitoring and giving advice to Government on the post office network. It does this by making annual reports to the Department for Business, Enterprise and Regulatory Reform (BERR).

POSTAL SERVICES COMMISSION

Annual Report 2007/08

To: Rt Hon John Hutton MP, Secretary of State for Business, Enterprise and Regulatory Reform

I enclose the Commission's report for the 12 months ending 31 March 2008
as required by Section 45 of the Postal Services Act 2000.

Nigel Stapleton
Chairman, Postal Services Commission

Presented to Parliament in pursuance of Section 45 of the Postal Services Act 2000

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www.psc.gov.uk

POSTCOMM'S STRATEGY

UNIVERSAL SERVICE

Ensure the continued provision of an affordable universal postal service.

PROTECTING CUSTOMER INTERESTS

Where they have little effective choice, Postcomm will ensure customers benefit from an affordable universal service and adequate protection in terms of prices and service quality.

PROMOTING SUSTAINABLE COMPETITION

We aim to provide customers with choice through efficient and sustainable competition between postal operators.

ADVISING ON THE POST OFFICE NETWORK

We aim to ensure that Government decisions on the future of the post office network are informed by Postcomm's research, information and advice.

BUILDING EFFECTIVE STAKEHOLDER RELATIONS

Our stakeholders range from major mail customers and operators to Government departments, trade unions, Postwatch, Parliament and the devolved administrations. We aim to maintain and support strong relationships with all stakeholder groups through proactive communication and the sharing of information.

USING AND DEVELOPING RESOURCES EFFECTIVELY

We want to be an effective, efficient organisation, with a highly committed and motivated staff that is continually regarded as 'best in class' in comparison with our peer group of other regulators.

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CHAIRMAN'S STATEMENT



THE CHANGING MAIL MARKET

The rate at which mail users are switching to email and the internet has accelerated markedly since 2005 and this is a major reason why in 2007/08 there was, for the second consecutive year, a contraction in mail volumes. Most people firmly believe that mail can hold its own in the digital world but for this to be the case all mail operators need to raise their game in terms of price competitiveness, service quality and product innovation. Royal Mail is, however, not well placed to cope with these challenges because of the legacies of under investment in its network, a huge pension deficit that adds still more to its cost base and a culture that does not easily embrace innovation.

In 2007 two thirds of the total working days lost in the UK through strikes were attributable to the series of stoppages at Royal Mail while the company sought to gain support from its workforce for the initiatives required to become more cost competitive. As a consequence, its service quality deteriorated significantly and we know that this prompted some large customers to accelerate the move away from mail to other communication media. It is to be hoped, therefore, that after this period of severe disruption Royal Mail's transformation can now progress at a more rapid rate and without further industrial disputes.

A more positive feature of the past year is that more mail users are now being offered a choice of using either Royal Mail or one of the new entrants to the market. In 2007/08, a fifth of all mail volumes were collected from the customer and handled upstream by another operator, with Royal Mail still delivering almost all mail over the last mile.

Although initially these new Access operators have focused only on the larger mail users, they have recently installed sortation equipment which should allow them to offer a choice for smaller businesses which are also significant users of mail. Feedback from these customers shows a high level of satisfaction with the new service providers and independent research has concluded that competition in the bulk mail market has kept prices around 5% lower than they would otherwise have been. With Royal Mail still delivering more than 99% of addressed letters over the final mile it is apparent that delivery competition has, as yet, hardly developed and we believe that it is unlikely to do so while other operators remain so much disadvantaged by Royal Mail's VAT exempt status.

THE REGULATORY FRAMEWORK

In 2007/08, Royal Mail reported a loss of £100 million from those products that comprise the much valued, one-price-goes anywhere, universal service. The company also achieved only a break-even position overall from its addressed letters business. This is the first time in recent memory that the universal service has been unprofitable and it is clearly a matter of considerable concern to Postcomm, as well as to Royal Mail, given that our primary statutory duty is to secure the provision of a universal service.

To help Royal Mail in addressing its financial problems, Postcomm has in the past year relaxed a key feature of the current price control, thereby allowing bigger increases to the prices of certain products where currently prices are below their fully allocated costs. Also Postcomm has indicated that it is minded to suspend during 2007/08 the compensation that would otherwise be due from Royal Mail to its customers when quality of service drops below the licence standards. This compensation would only be suspended for quality of service failures that can be attributed to industrial action over Royal Mail's transformation plans.

Royal Mail believes that Postcomm should be doing still more to help secure the universal service either by relaxing price regulation further still, or by acting on what it sees to be the unfair aspects of Access competition. However, given the increasing customer resistance to higher prices, we believe that Royal Mail's problems can only be resolved through urgent and rigorous action on Royal Mail's part, both to reduce costs, and to introduce new products which will position mail more strongly in the digital world. Access competitors have won upstream business from Royal Mail by virtue of their superior efficiency and it can be demonstrated that they are neither 'cream-skimming' Royal Mail's most profitable business nor failing to pay a fair price for delivery over the final mile. So we can see no justification for reining back on the development of mail competition, when thus far it has secured tangible benefits for so many mail users and has provided the main impetus behind Royal Mail's efforts to improve efficiency and quality of service.

Despite the challenges that Royal Mail is facing, Postcomm is firmly committed to using all its powers and influence to ensure that residential customers can continue to enjoy a high quality universal service, which fully reflects their changing needs.

A FORWARD LOOK

In August 2007 Postcomm published, for consultation, a paper setting out our emerging thoughts from a year long strategy review, which had considered carefully the likely impact of all these changing conditions in the mail market and the responses required from the independent regulator. The review forms the basis for the much more detailed work, which we have now started, to develop a new regulatory framework which will replace the current price and service quality control that extends to April 2010. Changing market conditions mean that we can envisage that the new framework will include a considerable reduction in the scope of price regulation, a narrowing in the scope of the universal service and further measures to promote the development of both Access and delivery competition.

We warmly welcomed the Government's announcement last December of the appointment of an independent panel, with wide ranging terms of reference, to look at the changing nature of the mail market, to assess the impact of liberalisation and to identify the measures needed to secure the universal service. The panel is looking at these issues from the perspective of the

three major customer groups (large users, small businesses and residential users), Royal Mail and the new mail operators. The panel issued an interim report in early May 2008, setting out its perspectives on the challenges and opportunities and concluding that for Royal Mail the status quo was untenable. Postcomm's evidence to the panel had argued that in the absence of some bold policy initiatives, Royal Mail faced a near term outlook of accelerating decline.

It is now likely that the review panel will not publish its final report until this autumn. This means we will not have the benefit of this additional input, alongside the views we are collecting from other stakeholders, before we need to publish this summer the consultation document which will enable us to develop the post-2010 regulatory framework. However we are seeking to work closely with the review panel so that we can take full account of its emerging thoughts.

POSTCOMM'S PEOPLE

Last September, Simone Bos left the Commission after completing a slightly extended three year term and in December Richard Moriarty stepped down as a Commissioner and Deputy CEO. During her time with us Simone made a most valued contribution to our deliberations, helped also by her deep knowledge of the mail industry, not just in the UK but also in Europe. Her successor, who joined the Commission in January 2008, is Ulf Dahlsten who is highly knowledgeable about both the mail industry – having served for a time as CEO of the national operator in Sweden – and other communications media. Richard, who has given most valuable service as a senior member of our executive team since 2001, felt that he should leave Postcomm to broaden his career experience and before that to see the world, including from 8500 metres at the top of the Himalayas.

Since Postcomm was formed in 2001 we have been working closely with the consumer body Postwatch, which like ourselves was created by the Postal Services Act. At times during this period our relationships have been difficult but, in the main, we have derived much value from the perspectives that Postwatch has given to us, most recently under the chairmanship of Millie Banerjee. From the end of September 2008 Postwatch will exist no more, with the majority of its duties being assumed by a restructured National Consumer Council. I do, therefore, want to take the opportunity of thanking Postwatch Council members and their executive team for their valuable input to our work.

It has been a particularly demanding year for the Postcomm team, given that in parallel with a heavy routine work programme we have had to finalise the Strategy Review and also to make detailed submissions to the Independent Review Panel. Everybody has risen admirably to the challenge and has shown a high degree of commitment and professionalism. My fellow Commissioners join me in offering our thanks and admiration for what they have achieved.



Nigel Stapleton

CHIEF EXECUTIVE'S REPORT



Last year was a difficult one for the postal services market. Stamp prices rose and mail volumes fell as competition from electronic media – emails, text messaging and internet advertising – increased.

Royal Mail's quality of service for first class mail fell to its lowest level since we began taking records in 2001/02. During this period there was industrial action which caused widespread disruption to mail services in the summer and autumn. The Government announced the compensated closure of 2,500 post offices, with new access criteria to ensure the remaining post offices are within easy reach of customers, and an annual subsidy of £150 million to support the network until 2011.

However, there were some bright spots: a simplified licensing regime brought some new postal operators to the market and a new compensation regime will make it easier for the general public to claim redress if their post is lost, damaged or delayed.

Two useful barometers of the state of the mail market are our annual *Business Customer Survey* and *Competitive Market Review*.

Our 2007 *Business Customer Survey* had some encouraging pointers. It showed that businesses strongly favour competition and that competitive mail services – initially targeted at large mailers – are beginning to trickle down to smaller businesses.

But the survey confirmed that business mailers are exploring alternatives to mail. Just over one in five medium businesses and 17% of small businesses said they had used more than one mail provider in the previous 12 months.

The *Competitive Market Review* showed that mail volumes were down 2% on the previous year, although there were indications that some sectors of direct mail were growing. End-to-end competition from independent operators declined by four million items, but mail collected by Access operators and delivered by Royal Mail more than doubled and represented around 20% of revenue-derived mail volumes.

STRATEGY REVIEW

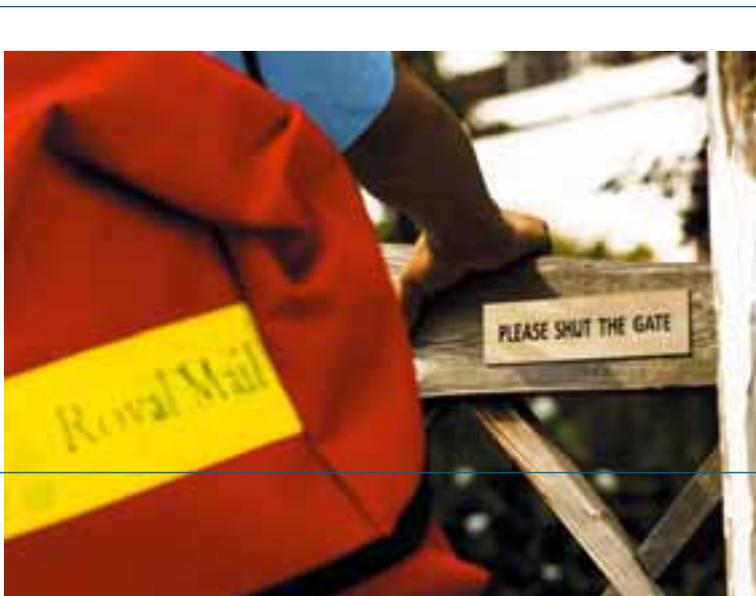
We published the emerging themes from our *Strategy Review*, which looks at the evolving needs of postal users in the UK in the lead-up to 2010 and beyond. This showed that:

- ▶ While customers are benefiting from competition, Royal Mail is finding its impact and the growth of electronic media difficult to cope with – partly because of its slow progress in improving efficiency and developing new services
- ▶ Mail operators in the UK are not as advanced as their counterparts in Europe and North America at grasping the opportunities of new communications media. Mail has important characteristics – such as personalisation and hand delivery – which differentiate it from digital communications, and provide opportunities for fulfilment and convergence between electronic and paper mail. If operators focus on how their products can add value for users, there is no reason to accept a bleak future for mail
- ▶ If Royal Mail can improve its cost transparency and respond better to the changing market, Postcomm should be able to scale back its regulatory regime from 2010 onwards
- ▶ The basic right to post a stamped letter anywhere in the UK for the same price will remain at the centre of the universal service. However, Postcomm is responding to Royal Mail's request to remove business products from the universal service.

EXTRA PRICE FLEXIBILITY FOR ROYAL MAIL

When we agreed Royal Mail's current price control in 2006, there was a mechanism for a review if Royal Mail's financial situation deteriorated. In response to a request from Royal Mail, we reviewed some aspects of the control and in August we gave the company extra flexibility to increase some retail prices.

Among other things, our decision allowed Royal Mail to increase prices on some loss-making products in April 2008 and April 2009 by more than originally agreed. The changes allow the company to raise the price of a second class stamp, if it wishes, to 29p by 2010 subject to inflation; the original price cap was 26p.



ZONAL PRICING

Royal Mail also made an application to charge bulk mailers higher prices for deliveries in London and rural destinations and lower prices elsewhere – what it calls ‘zonal pricing’.

The application covered business mail products that generated around £350 million a year – about a quarter of the £1.4 billion of Royal Mail’s total regulated revenue the previous year. It did not affect stamp prices or those bulk mail products which are included in the universal service.

The pricing structure appeared to us to have a number of discriminatory features and we felt it would be introduced in a way that would lead to unreasonable changes for Royal Mail customers, so we rejected the application. In April 2008, we received notice that Royal Mail intends to seek a judicial review of our decision.

We have not ruled out any future moves towards zonal pricing for products outside the universal service if Royal Mail proposes an alternative approach that avoids the problems presented by the recent application. We are generally supportive of pricing that reflects costs.

LICENSING

We introduced a simpler licensing framework to make it easier for small and medium-sized companies to enter the market. The changes included reducing the application fee from £1,000 to £50 and the removal of a requirement that all licensees have guarantees and contractual arrangements in place to ensure delivery of mail if an operator fails. In a competitive market it is better that operators respond to demands of the market rather than regulatory requirements.

COMPENSATION

Royal Mail’s first and second class services are not intended for transporting items of great value. For valuable items there are other, insured services. But while there are not great sums involved, it is important that retail customers (effectively those who are not sending bulk mail) get some compensation if their letter gets lost, damaged or delayed.

After work with Royal Mail and Postwatch, we proposed a simplified compensation scheme for retail customers. In essence it says:

- ▶ If mail posted with Royal Mail gets lost, damaged or delayed, where it has no intrinsic value (it’s simply a letter) and where a first time claimant cannot provide proof of posting, there would be compensation of six first class stamps.
- ▶ Loss or damage to items of value, with proof of posting and value (a receipt for example) will entitle customers to a postage refund plus compensation for actual loss up to market value or the current statutory maximum of 100 first class stamps (currently worth £36) whichever is the lower.



Sarah Chambers

POSTCOMM'S COMMISSIONERS



Postcomm's seven Commissioners collectively set the policy framework for Postcomm's regulatory and advisory functions. Commissioners are appointed by the Secretary of State for Business, Enterprise and Regulatory Reform (BERR). They meet around eleven times a year and are responsible for setting and amending Postcomm's strategy and for approving all licences, enforcement orders, financial penalties and all significant policy proposals and decisions.

They also approve Postcomm's business plan and monitor performance against business plan objectives. Day-to-day operational issues are delegated to the chief executive and Postcomm staff.

Apart from Postcomm's chief executive, all Commissioners, who are listed below, work part-time on Postcomm business.

Nigel Stapleton has been Postcomm's chairman since January 2004, when he was appointed for an initial three-year term. In November 2006 this was extended for a further four years. He works two and a half days a week for us, combining this role with others as non-executive director of the London Stock Exchange Group plc, and non-executive director of Reliance Security Group. He is a Fellow of the Chartered Institute of Management Accountants and has a degree in economics from Cambridge University.

Tony Cooper was appointed on 1 June 2000. His appointment has since been extended twice and now continues to May 2009. Currently a non executive director of the Nuclear Decommissioning Authority and chairman of the Combined Nuclear Pension Plan Trustees Ltd, Mr Cooper is the former joint general secretary of Prospect, the union for engineers, scientists, managers, professionals and specialists. He is also a former member of the General Council of the TUC, a former chairman of the Nuclear Industry Association and Forestry Commissioner.

Ulf Dahlsten was appointed a Commissioner for a three year term on 1 January 2008. He is a former director of Emerging Technologies and Infrastructures at the Directorate-General Information Society of the European Commission. He is also a former president and chief executive of Posten, the Swedish postal service provider and former chairman of the holding company of TNT Express Worldwide.

Wanda Goldwag BSc (Econ) was appointed as a Commissioner in April 2005. Her appointment has since been extended until April 2011. With more than 25 years' experience in direct marketing, she is now a venture capitalist, and works for a variety of companies in the human resources, printing and music businesses.

Professor Stephen Littlechild B Com, Ph D, D Sc (Hon), D Civ Law (Hon), who was appointed on 1 July 2006 for three years, was the first UK director general of electricity supply and head of the Office of Electricity Regulation (OFFER) from 1989-98. An international consultant on regulation, competition and privatisation, he is an emeritus professor at the University of Birmingham and senior research associate at the Judge Business School, University of Cambridge.

Simon Prior-Palmer, who was appointed on 1 July 2006 for a three-year term, spent 32 years until 2005 in a variety of investment banking roles. He is a board trustee of Macmillan Cancer Support and a director of Gabriel Resources Ltd, a Toronto listed natural resources company, and of Burani Designer Holding NV, an Italian luxury goods company. Mr Prior-Palmer is a Fellow of the Royal Society of Arts (FRSA) and a member of the RSA council.

Sarah Chambers was appointed chief executive of Postcomm in November 2004 for a four-year term. She began work at the Department of Trade and Industry in 1979. Her career since then has included spells as head of the department's Automotive Unit; director of the Strategy and Competitiveness Unit; head of the team reviewing the structure of Post Office Counters and director of licensing at Oftel, the first telecommunications regulator. Ms Chambers is a permanent civil servant, and works full-time for Postcomm.

Simone Bos retired as a Commissioner in September 2007.

Richard Moriarty, deputy CEO and a Commissioner, left Postcomm in December 2007.

OUR PEOPLE



Denise Bagge director, network, communications and international affairs, heads the team responsible for advising the Government on the future of the post office network. She is also responsible for European and international issues and for delivering Postcomm's communications strategy.

Tim Brown director, market development, joined us in January 2008 heading the team responsible for monitoring developments in the UK postal market and for promoting effective competition. The market development directorate provides a contact point for Postcomm's many stakeholders – especially mail customers and new or prospective operators.

Stephen Gibson director of economic policy, heads the newest policy directorate in Postcomm. This leads on anti-competitive complaints about Royal Mail's activities as well as developing Postcomm's policy on cost transparency and other economic policy questions.

Fran Gillon director of universal service and customer protection, is responsible for monitoring Royal Mail's provision of a reliable universal service, its compliance with its obligations to customers and its quality of service.

Jenny Howard, director of finance, heads the team dealing with Postcomm's finances and resource accounting.

Colin Sharples, Postcomm's director of resources, is responsible for administrative matters, including personnel, training, finance and business planning, programme management, procurement, IT, office services and accommodation.

William Sprigge, legal director, is chief legal adviser and heads Postcomm's legal team.

Peter Swattridge, director of regulatory finance, leads the teams responsible for the design and implementation of Royal Mail's price control and for formulating some of its major economic policy decisions. These policies include appropriate access arrangements for third parties to use Royal Mail's network. This team works closely with the Economic Policy team.

John Ivers, director of market development, left Postcomm in October 2007.



MARKET PROFILE

The UK postal market is now in its third year of full competition, following liberalisation in January 2006. Postcomm monitors the market to understand the impacts and opportunities that competition brings with it, and also to appreciate market dynamics such as mail volume trends.

MARKET SIZE, TRENDS AND SHARE

Total mail volumes in 2006/07 were down 2% on the previous year totalling 21.9 billion items¹. Volumes reported by Royal Mail for 2007/08 have continued to decrease, and figures point to a decline of around 3% for the year². Royal Mail continues to deliver over 99% of mail in the UK.

Businesses continue to send around 87% of all mail, and the mail market remains highly concentrated. In 2007/08 Royal Mail reported a decline of 7.4% in volumes of direct mail compared to 2006/07. There were 4.65 billion items of direct mail sent last year. This is 800,000 fewer items than at the peak of direct mail volumes in 2003.

MARKET ENTRY TO DATE

In January 2008 Postcomm made changes to the licensing regime in order to facilitate market entry. At the end of March 2008 there were 18 long term licence holders including Royal Mail, as the end of May 2008 there were 21.

The main form of competition that these operators engage in is downstream Access. This means that the alternative operator collects and sorts the mail before transporting it to Royal Mail for final delivery. Large mail customers can also set up direct Access agreements with Royal Mail, inputting their own mail into Royal Mail's nationwide delivery network.

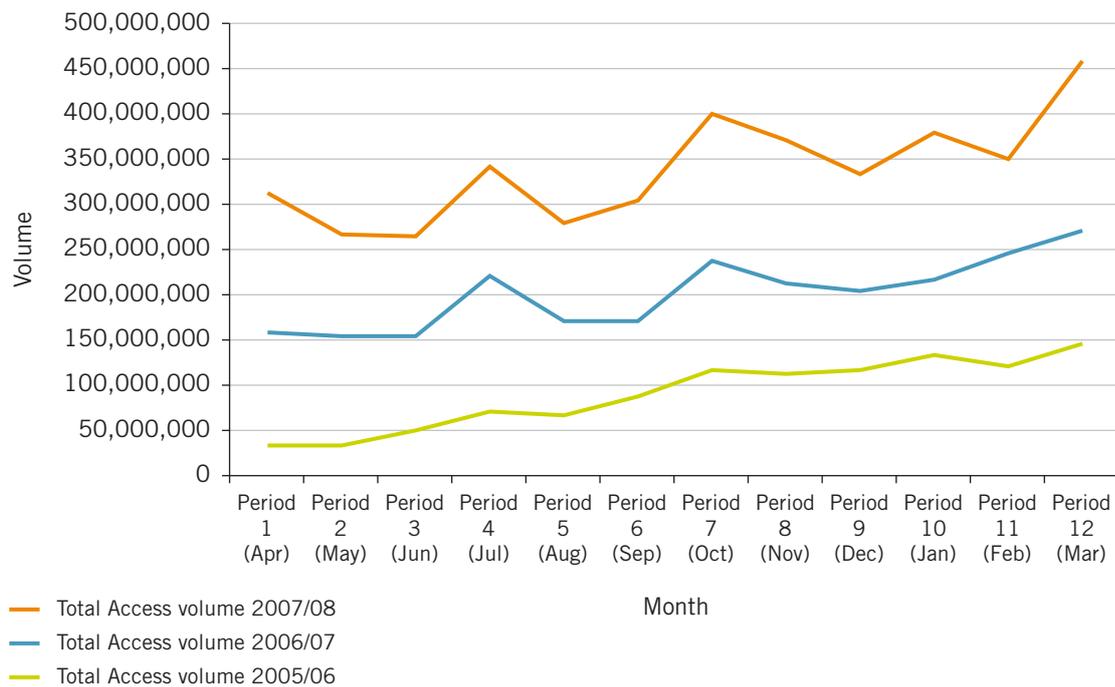
1 Based on Royal Mail operational volumes, including Access. Includes all regulated and non regulated mail, excludes door to door and international. 2006/07 volumes are based on operational measurement. For the financial year 2007/08 and going forward, Royal Mail volumes will be measured on a revenue derived basis, as agreed between Postcomm and Royal Mail.

2 Working day adjusted figures based on Royal Mail revenue derived volumes.

ACCESS VOLUMES

Alternative postal operators handled 4.1 billion items in 2007/08 through Access agreements, this makes up 21.2% of Royal Mail's volumes. In 2006/07 Access accounted for around 12% of Royal Mail's volumes. Just under half (43%) of these 4.1 billion items enter the Royal Mail network through customer direct Access agreements; operator Access accounts for the remaining volume. The graph shows that overall there has been steady growth in Access volumes since market opening.

Total Access volumes 2005/06 vs 2006/07 vs 2007/08



END-TO-END VOLUMES

The second form of competition is end-to-end delivery competition, where the alternative operator not only collects and sorts mail but also delivers the mail to the end customer. This has been slow to emerge in the UK.

The volume of mail delivered end-to-end by alternative operators in 2007/08 fell to 25.9 million items which was a decrease of 14.6% compared to 2006/07. As yet the UK has seen only limited growth of end-to-end networks, however some of the newer licensees entering the market are starting up small local networks, and one of the more established Access operators is beginning geographically targeted end-to-end trials.

ROYAL MAIL'S PRICES, VOLUMES AND REVENUES

The table opposite compares Royal Mail's pricing behaviour to changes in its volumes between the years 2005/06 and 2006/07. It shows that in those parts of the mail market where competition has developed, volumes are growing but Royal Mail has lost share. In all other parts of the letters market, where Royal Mail is not yet challenged by competition, mail volumes have declined over the period, suggesting that customers are resisting the higher prices that the company has charged to recover its costs.

Royal Mail's prices, volumes and revenues 2005/06 – 2006/07

Product Group	Average Price Change % (see Note A)	Volume Change %	Revenue Change %
First class standard tariff	5.7	-7.0	-1.7
Second class standard tariff	2.8	-4.9	-2.3
Presstream	4.8	-13.3	-9.1
<hr/>			
Mailsort Bulk	-0.2	-11.4	-11.6
Downstream Access Bulk	2.0	111.1	115.3
Subtotal – Bulk Mail (see Note B)	0.4	5.1	0.6
<hr/>			
Door to Door	4.0	-4.3 (see Note C)	-0.4
Standard Parcels	8.3	-1.3 (see Note C)	6.9
<p>Note A: In calculating average price changes for individual product groups, we have assumed a constant volume mix across years. Note B: In calculating price changes for bulk mail, because of the huge mix changes between retail and Access products, we have used a weighted average of the average price changes for each of the constituent product groups. Note C: It is estimated that the 'leaflet market' grew (in volume) by 4% in 2006 following a trend of significant growth (according to Letterbox Consultancy Ltd, August 2007). Parcel and packet volume generated by on-line shopping increased by over 50% in the last 12 months (according to IMRG).</p>			

Postcomm's 2006/10 Price Control set Royal Mail the target of increasing its efficiency by 3% in each year of the control. Using Postcomm's measure of efficiency, it has been calculated that Royal Mail achieved a 1.9% efficiency improvement in 2006/07 and its most recent forward projections target an improvement averaging 0.6% per annum over the remaining three years of the price control.



GOVERNMENT REVIEW OF THE POSTAL MARKET

In December 2007 the Government announced a review of the UK postal services market. Its terms of reference were:

1. To assess the impacts to date of liberalisation of the UK postal services market, including on Royal Mail, alternative carriers and consumers
2. To explore trends in future market development and the likely impact of these on Royal Mail, alternative carriers and consumers, and
3. To consider how to maintain the universal service obligation in the light of trends and market developments identified.

The review panel asked for submissions in two stages, the first covering its first two terms of reference on liberalisation and market trends, followed by a second, later, submission on the universal service obligation. It will report in the autumn of 2008.

Postcomm made its first submission on 27 March 2008, which highlighted the positive impact for customers since the addressed letters market was opened fully to competition on 1 January 2006. It pointed out:

- ▶ Larger customers have enjoyed lower prices and increased innovation
- ▶ Residential mail users have experienced record levels of service quality from Royal Mail, and
- ▶ Smaller businesses and public sector customers are also now beginning to reap the benefits of choice.

Postcomm made its second submission to the review on 15 May 2008. This said:

- ▶ With the mail market in structural decline because of the increasing impact of email and the internet, Royal Mail needs access to private capital and a stronger set of incentives to enable it to restructure and become more profitable
- ▶ Partnerships with the private sector, such as we are seeing in some European countries (see box), could serve as a catalyst for more rapid transformation and greater efficiency from the universal service provider
- ▶ As competition develops in segments of the market, it can replace regulation as the force which protects customers' interests. This – and the need for much more transparency about the breakdown of the costs of Royal Mail's business – will be a major theme of Postcomm's proposals for the regulatory framework from April 2010
- ▶ Successful transformation of Royal Mail should ensure a more dynamic mail market that can respond quickly and effectively to changing customer needs as mail increasingly is challenged by electronic media.

Postcomm believes competition and liberalisation should continue as they are delivering far better customer focus and strong incentives for all mail operators to innovate and to become more efficient. The submission also called for the removal of artificial barriers to postal market entry – including the removal of new entrants' VAT disadvantage – which could encourage wider competitor involvement in the collection, sorting and delivery of mail.

The Danish and Swedish postal services will be combined with the intention of forming a more competitive operation. The Swedish state and the employees of Posten would own 60% of the new company, while the Danish state together with the employees of Post Danmark and CVC Capital Partners will own 40%. The postal businesses in Sweden and Denmark will continue to operate as national entities using the same brands they use today.

ZONAL PRICING

During the previous year Royal Mail made an application to Postcomm to charge higher prices for retail deliveries in London and rural destinations and lower prices elsewhere.

Royal Mail's application did not affect stamp prices or those bulk mail products that are included within the definition of the universal service. It covered retail business mail products that generated about 25% or £1.4 billion of Royal Mail's total regulated revenue in the previous financial year.

Royal Mail currently prices almost all its bulk mail retail products at geographically uniform prices. It says that zonal prices would help it align prices more closely with its costs.

In its application to Postcomm, Royal Mail divided more than 27 million delivery points around the UK into five zones: Greater London; business districts; and areas of high, average and low population density, with different delivery tariffs in each zone.

Royal Mail wanted to introduce this new pricing structure to the following business mail products:

- ▶ Mailsort 120 – first, second and third class, OCR and CBC;
- ▶ Mailsort 700 – first, second and third class;
- ▶ Mailsort 1400 – third class;
- ▶ Presstream – first and second class; and
- ▶ Walksort – first and second class.

In January 2008 Postcomm rejected the application because the pricing structure appeared to have a number of discriminatory features and would have been introduced in a way that would lead to unreasonable changes for its customers. In April 2008 we received notice that Royal Mail intends to seek a judicial review this decision and has now made an application to the court.

Postcomm has not ruled out any future moves towards retail zonal pricing for products outside the universal service should Royal Mail propose an alternative approach that avoids the problems presented by last year's application. Postcomm is generally supportive of pricing that is more reflective of costs.

UNIVERSAL SERVICE EXCEPTIONS: UPDATED GUIDELINES

In April 2007 Postcomm published updated guidelines on exceptions to the universal postal service. The universal service includes more than 27 million addresses, which receive mail six days a week.

An exception to the service may be allowed where access to an address can only be reached across difficult or dangerous terrain (a health and safety exception) or on islands which do not have a daily ferry service (a difficulty of access exception).

The original guidelines on exceptions first came into effect in 2003 and were due to expire on 30 June 2007. We contacted all addresses excepted from the universal delivery service to assess whether the limited number of appeal cases we had received gave a true picture of the postal users' satisfaction with the policy.

A combined initial assessment by Postcomm, Postwatch the consumer body, and Royal Mail indicated that the original guidelines have worked well – in particular reducing the number of exceptions from 4,323 to 2,697 immediately after their publication.

The updated guidelines contain a number of amendments. The main change is that Royal Mail's delivery sector manager will be responsible for assessing and issuing a decision on a customer's initial appeal against Royal Mail's decision to except an address from the universal service.

MANAGEMENT OF ADDRESS INFORMATION

We announced new safeguards for the future management of the postcode and address data contained in Royal Mail's Postcode Address File (PAF).

PAF lists details of every postal address and postcode in the UK. It is a valuable asset for Royal Mail, because many other organisations – including new postal operators, banks, insurance companies and firms offering home delivery – need to use the information it contains.

Postcomm's document, *Royal Mail's future management of PAF*, published in April 2007, covered four key issues:

The definition of PAF

We consider that PAF data is not only made up of postcode details, but also includes other information needed to allow users to identify specific addresses.

The creation of an advisory board

Royal Mail has agreed to set up an advisory board, led by an independent chairman to represent the views of PAF users.

Ringfencing of PAF

As competition develops in the mail market it is crucial that Royal Mail ringfences PAF from its other activities in order to avoid potential conflicts of interest.

Profits

There is increasing demand for PAF data from a wide range of organisations, which rely very heavily on the information it provides. This puts Royal Mail in a very powerful position where setting prices is concerned. Although PAF does not fall within the price control that Postcomm uses to set a pricing and service quality framework for Royal Mail, the company has agreed to aim for an operating profit margin in the range of 8-10%. If profits exceed this range, the excess would be either returned to customers or reinvested in PAF.

Royal Mail agreed to implement all the decisions outlined in the report. A PAF Advisory Board was established, a chairman appointed and the board meets at least once every quarter.

EARLY COLLECTIONS

In June 2007, Postcomm published proposals on Royal Mail's collection and delivery times. Evidence from our consultation and research indicated that most customers were satisfied with the postal service they received from Royal Mail, including price, collection and delivery times in most areas, and their ability to post items including parcels.

However Postcomm recommended that Royal Mail take action to restore early rural collection times to levels more acceptable to customers. Royal Mail agreed to review all collection points with a final collection time before midday Monday to Friday with a view to putting back the final collection time to as close to midday as possible, where this was reasonable.

ROYAL MAIL'S REQUEST TO SUSPEND BULK MAIL COMPENSATION DURING INDUSTRIAL ACTION

In June 2007 Postcomm indicated that it was 'minded to' agree to Royal Mail's request to suspend until the end of its current financial year the payment of compensation to bulk mail customers, and to ensure that the company was not subject to a downward adjustment to its allowed revenues (known as the 'C factor'), where industrial action has taken place and quality of service figures have dropped.

The reason for this decision was that Postcomm wished to ensure that – against a background of Royal Mail's current financial position, including its substantial pension deficit – the possibility of having to pay compensation and/or earning reduced revenue next year did not discourage the company from taking the steps needed to modernise its business, which will be to the benefit of all mail users.

Postcomm's agreement to these suspensions was subject to some important safeguards for customers:

- ▶ A final decision on the amount of any relief will not be made until after the end of the 2007/08 financial year (31 March 2008) when Royal Mail's final quality of service figures will be known. In making its decision at that point, Postcomm will expect Royal Mail to be able to demonstrate that the industrial action arose as a result of carrying out its transformation plans and not for some other reason, and had a direct causal link to quality of service failures
- ▶ After the end of the financial year, Postcomm will convene an open meeting at which Royal Mail will present the main points in its application. Participants will be able to ask for further explanation of the justification for agreement by Postcomm to Royal Mail's request.

It is important to note that this money is not a 'fine' payable to HM Treasury; it is money that would otherwise have benefited Royal Mail's customers. In the case of bulk compensation, it is money that would have been payable to companies who use Royal Mail's bulk mail products.

The 'C factor', is any adjustment to Royal Mail's allowable revenue under the price control that would – for some products, including stamps – result in lower prices next year than would otherwise be the case.

Royal Mail says that the total amount of money at issue could be as much as £300 million.

INDUSTRIAL ACTION AT ROYAL MAIL

Between June and October 2007, the Communication Workers Union took industrial action on pay, conditions and Royal Mail's business plan. The first national strikes, in June and July, each lasted 24 hours. Action in July and August disabled various parts of Royal Mail's pipeline and between 4 and 10 October there were two 48-hour strikes. There were also several incidences of local level industrial action in different parts of the country between June and November.

The action substantially delayed mail. For example, a quarter of first class stamped and metered letters posted on 4 October were still in Royal Mail's pipeline a week later; and one in five first class stamped and metered letters posted on 11 October had not been delivered four days later. In a survey by The British Chamber of Commerce, 88% of its members said that they had experienced significant impacts on their businesses, including cash flow problems and loss of sales.

In the financial year 2007/08, which included the 2007 strikes, Royal Mail failed 9 of its 12 quality of service targets.

PRICING IN PROPORTION AND PACKETPOST RETURNS

Packetpost Returns is a service that allows a packet to be returned by recipients with the postage cost borne by the original sender. It is used for such things as returns to catalogue retailers.

Royal Mail made an application to extend Pricing in Proportion (PiP) to Packetpost Returns. Under PiP, the cost of sending mail takes account of its size as well as its weight.

After consultation we decided in June 2007 to allow Royal Mail to apply its PiP structure to Packetpost Returns, but required Royal Mail to give at least three months' notice of the price changes following this decision.

REVISED PROPOSALS FOR ROYAL MAIL REDIRECTIONS

In the fully competitive market, where rivals of Royal Mail are also able to offer their own collection and delivery services, redirection arrangements need to be broadened to allow those rivals to redirect mail. Postcomm consulted on how this could be achieved within the constraints of data protection rules.

Every year, around 1.3 million households and businesses use Royal Mail's redirections service, and there are approximately 800,000 redirections 'live' on the company's books at any one time.

Following consultation, Postcomm's recommendations included the following:

- ▶ Royal Mail be required to share the redirections data with other licensed operators who wish to provide a redirections service
- ▶ Once an operator chooses to access redirections data, it must provide a redirections service for its area of operations
- ▶ Royal Mail shares the data with other licensed operators from its business diversion service (which Postcomm considers is essentially a subset of the redirections service)
- ▶ Other operators wishing to provide a redirections service should be allowed to update their senders with the new address of their customers where the appropriate consent has been given, and
- ▶ All licensed operators will be able to not redirect mail if they have explicit instructions to that effect from the sender.

Royal Mail now proposes to develop its own Redirections data product and has offered to share its proposals with Postcomm. We will be taking up Royal Mail's offer and will be assessing the extent to which the proposed new product, including its terms and pricing, meets the needs of other operators before deciding on next steps.

ROYAL MAIL'S SPECIAL DELIVERY NEXT DAY SERVICE

In September 2006 Postcomm published a consultation document on an application from Royal Mail to introduce a two-tier Special Delivery service in 2007. The company wanted to exclude valuable items such as cash and jewellery from the existing next day service, and at the same time introduce a new (and more expensive) service for high value items, with compensation of up to £2,500 for loss or damage.

The consultation drew a substantial response when it was published – particularly from jewellers who used the service extensively. As a result, after discussions with users in the jewellery trade and others, Royal Mail modified its proposals and a revised application was made to Postcomm in January 2008.

This set out a three-tier system: Special Delivery, Special Delivery 1000 and Special Delivery High Value (SDHV). Royal Mail proposed that Special Delivery, as now, should carry a maximum compensation level of £500; Special Delivery 1000 would have maximum compensation of £1,000; SDHV would carry a maximum compensation level of £2,500.

Royal Mail is required to provide an insurable service for high value items as part of the universal postal service.

In a document published in March 2008, Postcomm decided to allow Royal Mail's latest application.

BUSINESS CUSTOMER SURVEY AND COMPETITIVE MARKET REVIEW

Postcomm prepares and commissions the *Business Customer Survey* and *Competitive Market Review* as part of its monitoring of the UK postal market. The *Competitive Market Review 2007* looks at the state of the mail market in the UK, while the *2007 Business Customer Survey* is based on market research prepared for Postcomm by Quadrant Consulting and BMG Research. We published both documents on 30 October 2007.

The *Business Customer Survey* showed that:

- ▶ Although smaller businesses are beginning to benefit more from competition, more progress is needed
- ▶ Mailers are exploring alternatives to mail, reconfirming the need for more innovation
- ▶ Businesses are strongly in favour of competition in the postal services market
- ▶ Although Royal Mail remains the dominant operator, around one in five small and medium mailers and more than a third of large mailers are using more than one mail provider
- ▶ One in five respondents have explored alternatives to mail and have moved some of their mail to other media in the past 12 months which confirms the need for all postal operators to place more emphasis on customer service and innovation, and
- ▶ More than half of respondents agreed that competition has improved choice and more than a third believe competition has improved Royal Mail's quality of service.

Key findings of the *Competitive Market Review 2007* included:

- ▶ Mail volumes in 2006/07 were 2% down on the previous year but there are indications that there are growth areas such as e-fulfillment and customer magazine publishing
- ▶ In 2006/07 end-to-end competition declined by four million items compared to the year before and stands at less than 1% of total mail volume. Mail volumes collected by Access operators and delivered by Royal Mail have more than doubled and during the period April to August 2007 represented 19% of Royal Mail volumes³.

Our research showed that a larger number of small businesses are beginning to benefit from competition. However, much more needs to be done before small businesses begin to experience the full benefits of competition that larger mailers have enjoyed since the market was opened. Awareness about the opportunities created by competition among all businesses is growing and many mailers are now using more than one provider. Indeed, our research found that businesses were overwhelmingly in favour of competition in the postal services market.

The *Business Customer Survey* reaffirmed the need for all mail operators to continue to innovate to meet the challenges raised by alternative media. Although respondents still value mail as a communications medium, in the past year, more businesses have moved some of their mail to other media such as email.

SIMPLIFYING ROYAL MAIL'S COMPENSATION SCHEMES

In December 2007 we proposed changes to Royal Mail's compensation schemes for lost, damaged and delayed mail to make them fairer and more suited to customer needs.

The proposed changes followed a public consultation and work with Royal Mail and Postwatch, all aimed at simplifying and ironing out inconsistencies in Royal Mail's current compensation schemes for retail customers.

3 Royal Mail revenue derived volumes.

Royal Mail's retail customers should face less difficulty in pursuing their claims because, for retail mail that has been lost, damaged or delayed, the proposals aim to simplify and align the processes for making a claim; the evidence required to support a claim; and the compensation payments themselves. The following compensation has now been agreed for retail customers from 1 August 2008:

- ▶ Where the item was posted with Royal Mail, compensation will be six first class stamps for first time claimants for loss, damage and delay where an item has no intrinsic value (for example, it is a letter) or where a claimant cannot provide proof of posting
- ▶ Loss and damage to items with an intrinsic value, with proof of posting and value, will entitle customers to a postage refund plus compensation for actual loss up to the market value of the item or the current statutory maximum of 100 first class stamps, (currently £36) whichever is the lower
- ▶ Monetary compensation payments for delay and substantial delay will be removed, along with the substantial delay category for non-Special Delivery items; and
- ▶ Users of the Articles for the Blind service will be able to claim compensation for loss, damage and delay.

Postcomm also proposed removing bulk mail from the regulated compensation scheme for delay because we considered that competition for bulk mail customers had developed to a point where it is more appropriate to move towards a market driven option allowing the growth of schemes which reflect the differing needs of large mailers. A decision will be made later in 2008.

APPEAL COURT UPHOLDS £9.62 MILLION FINANCIAL PENALTY

In February 2008 the Court of Appeal upheld the £9.62 million financial penalty imposed on Royal Mail by Postcomm for failing to protect adequately the mail in its care, following an appeal of the penalty by Royal Mail. The judgment reinforces Postcomm's position that the penalty is proportionate and reflects the loss suffered by customers.

In a unanimous judgment, the three judges confirmed that Postcomm had a broad discretion to determine the amount of the penalty and that, in reaching its determination, it had made the best assessment it could, given the evidence available to it.

Royal Mail did not dispute Postcomm's finding that it breached its licence requirements to keep mail safe and secure, nor that this breach was serious; it appealed only against the level of the financial penalty.

The appeal relates to a decision taken on 24 August 2006 to impose a financial penalty of £9.62 million on Royal Mail for breaching its licence by failing to properly protect the mail in its care. The penalty followed a review of Royal Mail's mail integrity procedures, during which Postcomm found that some important features of Royal Mail's procedures were not being applied across the business. Royal Mail previously challenged the penalty in the High Court but, following a hearing, the court ruled in favour of Postcomm. The Court of Appeal has now upheld the earlier decision of the High Court.

The most significant weakness found was the poor management of the recruitment and training process for non-contract (agency) staff. In addition, the framework and information systems that Royal Mail had put in place to prevent the loss, theft and damage to mail were not operated effectively. These weaknesses significantly reduced Royal Mail's ability to protect its customers' mail.



EXTRA PRICING FLEXIBILITY FOR ROYAL MAIL

In January 2008, in response to a request from Royal Mail to review some aspects of the 2006/10 price control, Postcomm decided that Royal Mail should be given extra flexibility to increase some retail prices but decided to leave Access margins unchanged.

Royal Mail will be allowed to increase prices on certain loss-making products in April 2008 and April 2009 by more than was originally agreed when its four year price control was set. If it wishes, Royal Mail will be able to raise the price of a second class stamp to 29p by 2010, subject to inflation (the original price cap was 26p). The price cap on a first class stamp was not affected by these proposals.

At the same time Postcomm rejected requests from TNT and UK Mail to widen the margin between Royal Mail's prices for bulk mail products and the amount Royal Mail charges them for access to its network and delivery of bulk mail over the 'final mile'. Royal Mail had also made an application on Access, to narrow the margin. However we decided that the company had not provided sufficient evidence to support its application and was unable to justify the level of loss it claimed it was making on Access mail.

"Postcomm is giving Royal Mail all the help it can to tackle its deteriorating financial situation; the ball is now firmly in Royal Mail's court to address urgently its very high cost base," said Nigel Stapleton, Postcomm's chairman. "Reining back on competition, which is providing some growth momentum to the mail market, is not the answer. We have always supported a successful transformation of Royal Mail and, more importantly, the continued health of a universal service that reflects customer need. Accordingly, Postcomm is providing help by giving Royal Mail greater pricing flexibility from April 2008 to align the prices of some loss-making products more closely with costs."

POSTCOMM'S REVIEW OF STRATEGY

Postcomm's *Strategy Review*, started in the previous financial year, was designed to stimulate further debate about the evolving needs of postal users in the UK in the lead-up to 2010 and beyond, and how mail operators and ourselves can best adapt to meet those changing demands.

In August 2007 we published emerging themes from the review which, among other things, discussed the growing competition to post from electronic media such as email, text messaging and internet communications. The document called on Royal Mail to continue to raise its game and urged all operators to promote the strengths of mail versus other communications media.

The principal theme of the review, on which Postcomm sought further feedback, was that mail operators must make the most of the opportunities presented by the changing mail market.

Key messages from the review included:

▶ **Customers are benefiting from competition**

However, Royal Mail is finding the impact of competition and of new media difficult to cope with, partly because of its slow progress in improving efficiency and developing new services

▶ **More innovation is needed in order to exploit the changing mail market**

Mail operators in the UK are not fully grasping the opportunities – or facing up to the challenges – of new communications media to the extent that some of their European and North American counterparts are. Mail has some important characteristics, such as personalisation and hand delivery, which valuably differentiate it in a digital world. If operators focus on how their mail products can add value for users, there is no reason to accept the prospect of a contracting mail market

▶ **Postcomm reaffirmed its aim to move to less detailed regulation**

If Royal Mail can improve its cost transparency and respond better to the changing market, Postcomm should be able to significantly scale back the regulatory regime from 2010 onwards

▶ **The universal service will be secure in a changing mail market**

Postcomm wants to promote a wider debate as to how the scope and specification of the USO should adapt to changing social, economic and technological conditions. However, the basic right to post a stamped letter anywhere in the UK for the same price will remain at the centre of the universal service.

ACCESS REVIEW

Access arrangements enable mail users (usually big business users) and licensed postal operators to make commercial agreements with Royal Mail allowing them to use the company's staff and facilities to carry post for part of its journey. The first Access agreement was entered into in 2004 between Royal Mail and UK Mail.

Following a commitment made in our *Strategy Review*, in January 2008 we announced a consultation as part of a review of Access, and in particular the way Access arrangements work. The consultation aims to identify any problems that may exist with the current arrangements. Later phases will consider whether remedies are needed and if so, how to implement them.

REGULATION OF ROYAL MAIL FROM 2010

Postcomm is already considering how, and to what extent, it should regulate Royal Mail from 2010 onwards, when its current price control is due to be replaced.

In January 2008 we began the process by taking a 'top down' approach, based on what was learned from the *Strategy Review* by publishing an industry letter on the future regulatory framework. We will focus on detail later on. In particular, we want to consider whether adopting a different approach could allow a significant reduction in the scope of regulation, while maintaining sufficient protection for customers and operators in those areas where Royal Mail has substantial and enduring market power.

In the initial letter to stakeholders, we set out a number of possible approaches and sought feedback on the advantages and disadvantages of each of them. Postcomm is also looking for stakeholders' views as to what other measures might be needed to ensure that any proposed approach would be effective.

Postcomm will consider responses to this consultation before publishing initial proposals for changes to the regulatory framework in the summer.

A SIMPLER LICENSING FRAMEWORK

During the year Postcomm made changes to the licensing regime to make it easier for some small and medium sized mail operators to enter the postal services market.

Following consultation in May 2007, we altered the licensing framework to make it less prescriptive for those seeking to enter the market. Several of the amendments are aimed at eliminating unnecessary regulation and encouraging effective competition.

The changes include:

- ▶ A reduction in application fees from £1000 to £50, which it is hoped will help encourage small businesses to enter the market, and
- ▶ The removal of the licence requirement on all licensees to have guarantees or contractual arrangements in place to ensure the delivery of mail if their business fails so that, in future, other operators can respond directly to what the market demands, rather than to regulatory requirements.

Postcomm believes that effective competition will better protect the interests of postal customers than monopoly or regulation and aims to ensure that its licensing rules support the developing competitive market. Nothing being proposed will affect Postcomm's ability to enforce licence conditions or lead to any substantial reduction in protection for mail customers.

FINANCIAL PENALTY POLICY

Under the Postal Services Act 2000, Postcomm has the power to impose a financial penalty on a licence holder that has contravened – or is contravening – one or more of its licence conditions. Postcomm must prepare and publish a statement of policy in relation to imposing a penalty and the amount of that penalty.

In May 2007 the High Court quashed a £1 million penalty imposed by Postcomm on Royal Mail, although the judge confirmed that Postcomm had decided reasonably and properly that a financial penalty should be ordered.

The £1 million penalty was quashed because of a technical difficulty in our policy for calculating financial penalties in certain cases. The judge decided that Postcomm could not depart from its published penalty policy in the circumstances of the case.

The penalty was originally imposed on Royal Mail in 2006 for failing to take adequate steps to ensure it could not gain an unfair commercial advantage over its competitors in the Access market.

Postcomm's first statement of policy was published in February 2002. Since then, we have imposed four financial penalties on Royal Mail and there have been a number of significant changes in the postal services market, including the full opening of the market in January 2006 and the adoption of a new price control for Royal Mail in April 2006.

At the time the statement of policy was introduced, we said we would consider revising it in the light of experience in its application and we consulted on this in August 2007. The revised policy was published in April 2008.

ENFORCEMENT PROCEDURES

In August 2007 Postcomm published for consultation its first stand-alone document setting out enforcement procedures relating to possible licence contraventions. The guidance explains procedures likely to be followed by the postal regulator when we consider complaints, investigate licensed operators, take enforcement action or impose financial penalties.

Until now, these procedures were set out in several Postcomm documents. The aim of bringing them together is to provide greater transparency.

COMPLAINT HANDLING AND REDRESS

Under the Consumers, Estate Agents and Redress Act ('the CEAR Act'), given Royal Assent on 19 July 2007, Postcomm has a statutory duty to make regulations on complaint handling standards that would apply to all licensed operators. The act also allows for the Secretary of State for Business, Enterprise and Regulatory Reform to require regulated postal operators to belong to a Postcomm-approved redress scheme.

In January 2008 we published two consultation documents: *Complaint handling standards for licensed postal operators* and *Criteria for the approval of redress schemes in postal services*. Both sought views on Postcomm's proposals for appropriate standards and schemes in postal services.

ROYAL MAIL PRODUCT TRIALS

As a condition of its licence, Royal Mail must give three months notice of any trial of a new service it wishes to provide. Royal Mail argued that in some cases this resulted in an unnecessary delay to the start of some trials, delaying tests of some services and holding back innovation.

After consulting stakeholders, in August 2007, Postcomm published a direction setting out a new approach to pre-notification of trials for new products from Royal Mail. Among other things, the direction limits Royal Mail to 10 trials per year, but reduces the notice period to one month. The aim is to provide a pragmatic approach that benefits users and encourages innovation without hampering the development of effective competition in postal services.

ROYAL MAIL'S EXEMPTION REQUESTS

If Royal Mail wants to make changes to any of its regulated or non-regulated services it is required, under the terms of its licence, to notify Postcomm and publish details of the changes three months prior to the changes coming into effect. These changes include details of prices, standards of service and compensation arrangements as well as general terms and conditions.

Royal Mail applied to Postcomm for exemption from the three month pre-notification requirements in its licence, and requirements to publish information about contracts won through competitive tenders, in relation to the following services:

- ▶ Special Delivery on account
- ▶ Parts Express Service

Royal Mail also applied to Postcomm for exemption from certain aspects of its licence regarding publishing on its website particular details relating to:

- ▶ Tailor Made Incentives
- ▶ Sameday Service

As the Sameday Service had already been exempted from the requirement to notify to Postcomm and publish details of changes to the service three months prior to changes coming into effect, Royal Mail's new request was approved following an informal consultation of major stakeholders and a direction was issued on 10 April 2008.

On the remaining three applications Postcomm wrote to stakeholders and is studying responses. Decisions will be made in the next financial year.

Royal Mail also applied for an exemption from the notification requirements in its licence for changes to the company's international bulk mail service. After consultation Postcomm allowed this.

LICENSING

Including Royal Mail, 18 operators held Postal licences during the period of this report. In the first few weeks of the new financial year, we granted three new licences. These have been included in the licensees listed on page 37 and bring the total, including Royal Mail, to 21 on 8 May 2008.

POST OFFICE NETWORK

In May 2007, following consultation, the Government announced, subject to state aid clearance, investment of up to £1.7 billion, including an annual subsidy of £150 million, to support the UK network of post offices until 2011.

It also announced the compensated closure of 2,500 post offices over an 18 month period from September 2007; new access criteria to ensure the remaining post offices were within easy reach of customers and the establishment of 500 new 'Outreach' outlets for small remote communities. These would include mobile post offices and services in village halls, community centres and pubs.

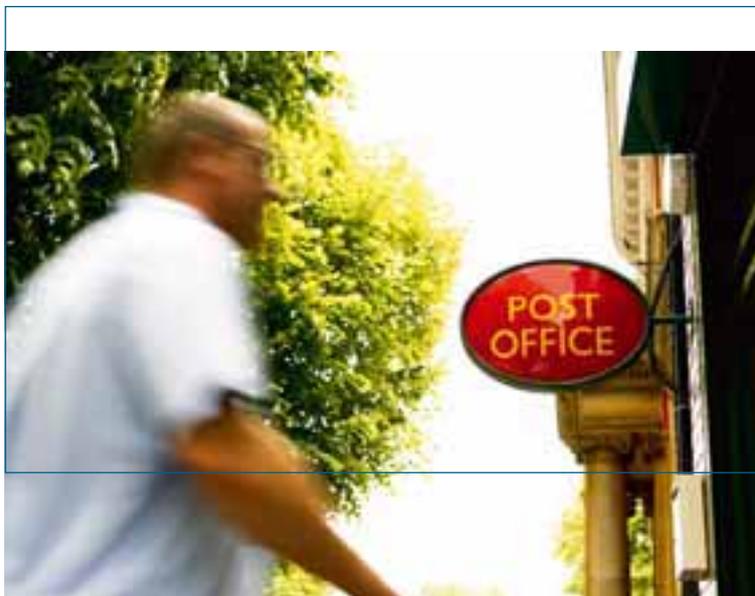
The network change programme, which implements the decision to close 2,500 post offices, is currently on-going. The last public consultation on post office closures is scheduled to start at the end of August 2008.

Postcomm does not make decisions on the future of the network or any individual post office. Our role is to monitor developments in the network and provide advice to the Secretary of State for Business, Enterprise and Regulatory Reform. We fulfil this function by publishing an annual report on the post office network.

Our 2007 network annual report, published in October, called on the Government and Post Office Ltd to make the sustainability of a viable post office network their top priority once the closure programme has been completed.

Among our recommendations, we said that the network needed:

- ▶ A clear vision and a combination of commercial products and services that can attract and retain new customers – for example, Post Office Ltd has run trials with Argos, where customers were able to collect online purchases from their local post office, and is working on other propositions



- ▶ More links with commercial partners who recognise and can benefit from Post Office Ltd's brand strength – such as its joint venture with Bank of Ireland to sell financial services which is attracting 50,000 new customers every month
- ▶ Stronger links with communities to identify ways in which they can work with Post Office Ltd and the Government to help sustain local postal services.

“Keeping things as they are today is not an option,” said Postcomm chairman Nigel Stapleton. “Post offices need strong leadership, the right mix of products and services, and well-motivated staff in order to create a sales environment that will attract and keep the customers they need to survive.”

The report also said:

- ▶ At the end of March 2007 there were 14,219 post offices in the UK (including satellites and sites where the mobile vans stop once a week), an overall reduction of 157 from the previous year
- ▶ In the year ended March 2007, Post Office Ltd made an operating loss of £99 million, compared to a loss of £111 million in 2005/06. Post Office Ltd receives £150 million from Government to offset losses in the rural network
- ▶ Despite the 458 crown offices making up only 3.22% of the total estate they were responsible for £70 million of the £99 million 2006/07 losses. In 2005/06, they made a £50 million loss.

Research carried out for Postcomm by NERA, the market research organisation, found that:

- ▶ Eighty per cent of people perceive themselves to be within a mile of a post office and more than 90% perceive their branch as easy to reach
- ▶ Fortythree per cent of people said that they used a post office at least once a week to access postal services, and
- ▶ More than 75% said that they expect to continue to use the same level of postal services in future.

Customers (particularly in urban areas) said that longer opening hours, shorter queues and more convenient locations would make them use their branch more, whereas rural customers said they would like a wider range of services. The research also found a high level of trust among postal users to use the network to collect packets and parcels rather than alternative locations.

On the Government's access criteria, the research found the requirements in Royal Mail's licence are based on straight line measurement, whereas the Government access criteria expect Post Office Ltd to take account of local conditions such as motorways, rivers and mountains. Postcomm agrees that access should be calculated using the most accessible route and will need to agree with the company adjustments to Royal Mail's licence.

In December 2007 we published on the Postcomm website *Post office networks abroad*, a study of networks in 24 countries. Among other findings, we reported that a common trend in recent years across the post office networks in all the 24 countries has been the need for restructuring and modernisation to respond to changes in the way that customers use the networks.



BUILDING EFFECTIVE STAKEHOLDER RELATIONS

Postcomm's active programme of visits and contacts with stakeholders throughout the UK enables us to understand market development and the key issues affecting our stakeholders and to sound out opinions, collect information and take account of feedback from interested parties in order to inform the regulatory process.

Our major stakeholder event is the annual Postcomm Forum to which we invite a variety of speakers and delegates representing all areas of the postal market. The event is structured to enable delegates to question speakers and Postcomm staff about regulatory developments.

This year's event, held in London in June, also included a session dedicated to Royal Mail's zonal pricing proposals (see page 17), which sparked diverse views and strong feelings.

Royal Mail pointed out that with strong competition and customer choice established, Postcomm should allow the market to decide on prices, and allow the company to introduce zonal pricing for bulk business mail – if business customers wanted it.

TNT Post chief executive Nick Wells said businesses were not in favour. He told the Forum: "Zonal pricing is bad for everyone – both consumers and businesses alike. It is complicated, reduces transparency and creates a tremendous amount of uncertainty. No one is asking for it, and it will threaten deliveries to the millions of people who live in rural areas."

Representatives from Postwatch, the consumer body asked why Royal Mail was proceeding with zonal pricing, "an initiative that has received no customer support whatsoever." Highlighting the potential impact on customers and the wider postal market, Postwatch identified positive and negative features within Royal Mail's proposals, but concluded that the time was not right to change to such a pricing structure.

During the year we hosted face-to-face meetings with stakeholders during roadshows in London, Edinburgh, Glasgow, Kilmarnock, Dumfriesshire, Aberdeenshire, Belfast, Newry, Chester, Stoke-on-Trent, Tunbridge Wells, Cardiff, Aberystwyth, Exeter and Truro.

We also increased our contacts with a number of special interest groups for vulnerable customers in order to learn their views and their requirements in the changing postal market.

POSTCOMM'S WEBSITE

Following a major overhaul in 2005, Postcomm's website has attracted a steady growth in unique visitor numbers. All our documents are published on our website and during the year work has continued on improving the usability and accessibility of the considerable amount of information it contains. This has included a home page refresh where news and information on our latest documents sit at the top of the page. We have also developed an online reply form for our events, and the public register section has been revised.

*COMMe*ntary

Postcomm's free news magazine *COMMe*ntary, published in the spring, autumn and winter, is available by post in A5 format or can be downloaded from our website.

SEMINARS AND CONFERENCES

Postcomm staff spoke at the following conferences and seminars in 2007/08:

- ▶ May 2007, World Mail & Express European Conference, London: John Ivers.
- ▶ June 2007, Institute of Economic Affairs Postal Conference, London: Sarah Chambers.
- ▶ March 2008, Institute of Economic Affairs 10 Annual Conference, Berlin: Sarah Chambers.

Our stakeholders

Postcomm's stakeholders include mail customers, postal operators, industry suppliers, small and medium-sized enterprises, trade associations, trade unions, representatives of domestic customers and vulnerable groups, subpostmasters, Government departments, MPs, devolved administrations and the consumer body Postwatch.





USING AND DEVELOPING RESOURCES EFFECTIVELY

Postcomm aims to be an effective and efficient organisation, continually improving and regarded as 'best in class' in comparison with our peer group of other regulators.

In particular we aim to:

- ▶ Remain a small organisation compared to other regulators, but ensure we have excellent people who work well together and are supported in both their work and their personal development
- ▶ Maintain a friendly, supportive and open culture, so that we get the best ideas and solutions from staff at all levels
- ▶ Ensure that all staff have the best business tools, technology, training and support. We have initiated an Information Management Strategy that aims to improve our methods of managing our knowledge and information to increase our efficiency and effectiveness, and
- ▶ Learn constantly from experience about our business, our market and our stakeholders, so we can react swiftly to protect customer needs and create the right policies to foster a dynamic postal market in the UK.

STAFFING

Postcomm recruits on the basis of fair and open competition and selection on merit, in accordance with the Recruitment Code laid down by the Civil Service Commissioners. Internal and external checks are carried out to ensure compliance with this code.

Postcomm recruited 15 members of staff between April 2007 and March 2008. On 31 March 2008, excluding two agency staff members and our six external Commissioners, Postcomm employed 66 people. The table shows a breakdown by gender, ethnicity and disability.

1. Staffing (as at 31 March 2008)

	Men	Women	Ethnic minority	Disability	Total staff
Chief executive and directors	5	3	0	0	8
Other staff	24	34	9	2	58
Total	29	37	9	2	66

PROGRAMME, PROJECT AND RISK MANAGEMENT

Risk management is an integral part of Postcomm's business planning process and is proactively managed at corporate, project and operational levels within the organisation.

Postcomm has developed a business model that incorporates risk and programme management within its programme office function. All staff involved in delivering projects are trained in project management, planning and risk assessment.

The programme office reports every month to the programme board and Commission and quarterly to Postcomm's audit committee on key risks and any problems with the internal control framework.

FINANCE

Postcomm is funded mainly by licence fees paid by Royal Mail, which has the largest share (more than 96%), of the licensed market. Our budget and forecast outturn for 2007/08, compared with the outturn for 2006/07, is summarised in the table opposite (these figures are subject to audit). Our statutory accounts are due to be published in July 2008.



Postcomm budget and outturn

	2006/07 Actual outturn £000	2007/08 Budget £000	2007/08 Forecast outturn £000
Staff costs ¹	3,811	4,315	4,191
Agency staff	101	66	177
Other running costs ²	1,936	1,801	2,064
Outside consultants, lawyers etc ³	2,325	3,000	2,526
Sub-total	8,173	9,182	8,958
Depreciation etc ⁴	616	771	258
Cost of Capital	(26)	15	(48)
Total	8,763	9,968	9,168
Capital expenditure	152	460	389

1 Relates only to those staff on the payroll and excludes the cost of agency staff to provide cover for holidays, sickness or vacancies.

2 The costs of the building, IT support, telephones, finance, payroll, etc.

3 The cost of those external economists, lawyers, and other specialists used to supplement the in-house teams.

4 Relates to the non-cash cost of depreciation and permanent diminution of fixed assets.

The underspend on consultancy relates in part to the stated preference element of market research work for the universal service not proceeding as the work was undertaken by Postwatch; greater use of internal resources rather than external consultants for anti-competitive complaints and the withdrawal of the second phase of amendments to the licensing regime. The contingency provision was not used. The overspend on other running costs relates in part to recruitment campaigns to fill vacancies. The underspend on staff costs is the result of an exceptional number of vacancies across the organisation in the first nine months of the year.

SUSTAINABILITY

Postcomm has continued its efforts to improve sustainability and the energy efficiency of its offices by:

- ▶ Installing duplex units to all printers and setting double-sided printing as the default to reduce the amount of paper we use.
- ▶ Installing more energy efficient photocopiers, with duplex printing set as a default.
- ▶ Using glasses in the office instead of disposable plastic cups.
- ▶ Installing time switches on computer screens to switch them off after hours.
- ▶ Setting the timers on our air conditioning controllers to switch the units off at night.
- ▶ Improving the quality of overhead lighting, to reduce the need for additional desk lamps.
- ▶ Replacing bottled water with tap water.
- ▶ Using infrared sensors to control the low energy lighting throughout the office, which switch the lights off after a period of inactivity.
- ▶ Purchasing low grade recycled paper for everyday draft printing, with better quality paper for use on final version prints.
- ▶ Increasing the number of recycling bins for waste paper by approx 30%.



LICENCES GRANTED BY POSTCOMM

All standard licences issued by Postcomm:

- ▶ allow the licensee to provide all types of postal service
- ▶ are issued for a rolling ten year period
- ▶ require the licensee to comply with codes of practice on mail integrity (safety and security of the mail) and common operational procedures (designed to ensure the multi-operator market works well in practice).

At the end of March 2008 there were the following 18 licensed operators, including Royal Mail, the universal service provider:

Citipost AMP Limited (formerly Alternative Mail and Parcels Limited)

16 Gunnery Terrace, Cornwallis Road, Royal Arsenal, London, SE18 6SW

City Link Post (trading name of Target Express Parcels Limited)

Woodlands Park, Ashton Road, Newton Le Willows, Warrington, WA12 0HF

CMS (trading name of Royale Research Limited)

Record House, 236 Record Street, London, SE1 1TL

DHL Global Mail (UK) Limited

4-8 Queensway, Croydon, Surrey, CR0 4BD

DHL Express Limited (formerly Securicor Omega Express) (interim licence)

Document Outsourcing Limited

Document House, 3 Phoenix Crescent, Strathclyde Business Park, Belshill, ML4 3NJ

DX Network Services Limited

DX House, Ridgeway, Iver, Bucks, SL0 9JQ

FedEx UK Limited (formerly ANC Limited)

Parkhouse East Industrial Estate, Newcastle-under-Lyme, Staffordshire ST5 7RB

Intercity Communications Limited

64-70 Vyner Street, London, E2 9DQ

Lynx Mail (trading name of Red Star Parcels Limited)

St Davids Way, Bermuda Park, Nuneaton, Warwickshire, CV10 7SD

The Mailing House Group (trading as Northern Mail)

Nelson Park, Nelson Way, Cramlington, Northumberland, NE23 1JY

Racer Consultancy Management Services Limited

101 Legacy Centre, Hanworth Trading Estate, Hampton Road West, Feltham, TW13 6DH

Royal Mail

Customer Services, Freepost, RM1 1AA

Secure Mail Services Limited (formerly Special Mail Services Limited)

PO Box 390, Northampton, NN3 6YG

Secured Mail Limited

Unit 4A, Bechers Drive, Aintree Racecourse Business Park, Liverpool L9 4AY

TNT Post UK Limited

Unit 1, Globeside Business Park, Fieldhouse Lane, Marlow, Berkshire, SL7 1HY

UK Mail Limited

Express House, Wolseley Drive, Heartlands, Birmingham, B8 2SQ

Zip Mail Limited

47 Chancery Lane, London WC2A 1RF

In the first few weeks of the new financial year, a further 3 licences were granted, to make a total of 21 by 8 May 2008. The new licensees are:

LDS Cambridge Limited

Peoplepost Limited

Post 123 (trading name of Mr Aaron Leitner)



POSTCOMM PUBLICATIONS

Royal Mail's proposal to charge large mailers by delivery location 'zonal pricing' – stakeholder letter	Apr 2007
Postcomm 2007/08 Business Plan	Apr 2007
New licence issued to The Mailing House Group	Apr 2007
Royal Mail's future management of the PAF – decision document	Apr 2007
Policy review of exceptions to Royal Mail's universal delivery service – decision document and direction	Apr 2007
Amendment of the 2006 licensing framework – consultation	May 2007
The needs of postal users – customer survey	Jun 2007
Royal Mail's collection and delivery times: the way forward – consultation	Jun 2007
Postcomm annual report 2006/07	Jun 2007
Financial implications of quality of service failure due to industrial action – letter to Royal Mail	Jun 2007
Enforcement guidance for considering and investigating complaints in relation to licence contraventions – consultation	Aug 2007
Condition 11 of Royal Mail's licence: the promotion of effective competition. Business Mail Secure – final report	Aug 2007
Statement of policy in relation to financial penalties – consultation	Aug 2007
Review of Royal Mail's pricing flexibility and the level of Access headroom (the interim review of the 2006-2010 price control) – proposals	Aug 2007
Direction in relation to trials conducted by Royal Mail	Aug 2007
Postcomm's proposals to reject the Royal Mail's zonal pricing application – consultation	Aug 2007
Postcomm's strategy review, The postal market 2010 and beyond: emerging themes – consultation	Aug 2007
Royal Mail's request to stop Sunday and bank holiday collections	Aug 2007
Postcomm's resource accounts 2006/07	Aug 2007
Memorandum of understanding between Postcomm and the Office of Fair Trading	Sep 2007
Postcomm's response to BERR's consultation on the scope of redress schemes	Oct 2007
Postcomm annual report on the post office network	Oct 2007
Postcomm's revised proposals on Royal Mail's redirections service	Oct 2007
Business customer survey 2007	Oct 2007

Competitive market review 2007	Oct 2007
Postcomm's review of collection and delivery times – decision	Nov 2007
Postcomm's disability equality scheme	Dec 2007
Royal Mail's compensation schemes for delay and loss and damage – proposals	Dec 2007
Postcomm confirms rejection of Royal Mail's zonal pricing application	Dec 2007
Post office networks abroad (website publication)	Dec 2007
Direction in relation to Royal Mail's international contract (bulk mail) services	Dec 2007
Direction in relation to Royal Mail's Branch Direct service	Dec 2007
Royal Mail's pricing flexibility and the level of Access headroom (the interim review of the 2006-2010 price control) – decision and direction	Jan 2008
Regulatory framework for postal services from 2010 – industry letter	Jan 2008
Amendment of the 2006 licensing framework – decision	Jan 2008
Postal licence applications – guidance for applicants	Jan 2008
Access review – consultation	Jan 2008
Direction in relation to Business Mail Secure, Royal Mail Tracked, Cleanmail Advanced and Royal Mail Heavyweight	Jan 2008
The price control and substantially similar services – background document	Jan 2008
Criteria for the approval of redress schemes in postal services	Jan 2008
Complaint handling standards for licensed postal operators – consultation	Jan 2008
Notice of a proposal to grant a licence to Document Outsourcing Ltd	Feb 2008
Request for an exemption from notification requirements for the Royal Mail Special Delivery on account service – consultation letter	Feb 2008
Royal Mail's retail zonal pricing application for non-universal service bulk mail products – decision	Feb 2008
Request for an exemption from notification requirements for the Royal Mail Parts Express service – consultation letter	Feb 2008
Notice of a proposal to grant a licence to NDS Cambridge Ltd	Feb 2008
Notice to revoke licence granted to Challenger Security Systems (Admin) Ltd	Feb 2008
Royal Mail's application to exempt Tailor Made Incentives from Condition 7 licence requirements – consultation letter	Feb 2008
Royal Mail's proposed changes to its Special Delivery Next Day Service – decision	Mar 2008
Licence granted to Document Outsourcing Ltd	Mar 2008
The independent review of the postal services sector. First submission by Postcomm	Mar 2008
Postcomm forward work plan 2008/11	Mar 2008



STATUTORY REPORTING REQUIREMENTS UNDER SECTION 45(2) OF THE POSTAL SERVICES ACT 2000

GENERAL SURVEY OF DEVELOPMENTS

A general survey of developments over the year is given by the report of the chief executive; this should be taken with the chapters in this report covering *Universal service and customer interests, Competition and regulation* and *Post office network*.

COMPLIANCE WITH OBLIGATIONS UNDER THE POSTAL SERVICES DIRECTIVE

The UK's obligations under the Postal Services Directive are given effect through conditions in the licence granted to the universal service provider, Royal Mail Group Ltd. The Third Postal Services Directive entered into force on 27 February 2008 and the UK has until 31 December 2010 to transpose the provisions of the Directive into domestic law. Postcomm proposes to report on progress in this regard next year.

With Postwatch, Postcomm monitors Royal Mail's compliance with its licence obligations, including for services provided to meet the universal service obligation under the Directive.

Postcomm has consulted on its policy for geographical and other exceptions to the universal service obligations to provide daily delivery and collections, and has concluded that existing arrangements should continue, subject to minor amendments. A Direction was issued on 24 April 2007 and came into effect on 1 July 2007 to apply until 30 June 2011.

Postcomm has continued its work on arrangements that are needed in a multi-operator environment. Postcomm is proposing that Royal Mail shares redirection data with other licensed operators, in a manner that is consistent with the Data Protection Act 1998, to enable other licensed delivery operators to redirect mail. Postcomm's consultation on its revised proposals closed on 23 January 2008. Postcomm is currently assessing the responses to consultation and will meet with interested parties as required. In January 2008, Postcomm published a decision document, which detailed a number of changes to the licence application procedure. More information on all of these issues is set out in the chapter entitled *Universal service and customer interests*.

Royal Mail has prepared and submitted accounts which comply with Article 14 of the Directive.

ACHIEVEMENT OF SPECIFIED STANDARDS OF PERFORMANCE BY EACH LICENCE HOLDER

As reported in previous years, only Royal Mail holds a licence with detailed requirements for the setting and monitoring of standards of performance. To set standards for other operators would be disproportionate given the nature of their operations and that setting standards for Royal Mail ensures that other operators have to provide services of comparable quality if they are to be able to compete.

Royal Mail has not met 9 of its 12 Quality of Service targets in the financial year 2007/08. Royal Mail has applied to Postcomm for suspension of the bulk compensation scheme during the periods of industrial action and adjustment to the calculation of earned revenue under the C factor. Postcomm is currently considering the extent to which these quality of service failures can be said to result from the industrial action during 2007 and the extent to which that industrial action arose from Royal Mail's transformation activities.

FINAL AND PROVISIONAL ORDERS MADE DURING THE YEAR

No final or provisional orders were made during the year.

PENALTIES IMPOSED DURING THE YEAR

Royal Mail appealed against the imposition of both the £9.62 million and the £1 million penalties imposed following the conclusion of, respectively, the mail integrity and zonal access investigations mentioned in the report for 2005/06. In May 2007 the High Court quashed the £1million penalty, concluding that in the circumstances Postcomm could not depart from its published policy on the Imposition of Financial Penalties. In February 2008 the Court of Appeal upheld the £9.62 million penalty confirming Postcomm's broad discretion to determine the amount of the penalty and reinforced the view that the penalty was proportionate and reflected the loss suffered by customers.

PROGRESS OF PROJECTS DESCRIBED IN THE FORWARD WORK PLAN

Progress on the projects listed in Postcomm's forward work programme for the year is reported in the Chief Executive's report and in the chapters headed: *Universal service and customer interests*, *Competition and regulation*, *Post office network* and *Building effective stakeholder relations*.

REPORTS ON OTHER MATTERS REQUIRED BY THE SECRETARY OF STATE

Postcomm's seventh report on the Post Office network, *A Sustainable Customer Focused Network* was published in October 2007 and its main conclusions are summarised in the chapter entitled *Post office network*.



REPORTING PURSUANT TO PARAGRAPH 17.5 OF THE GUIDANCE GIVEN BY THE SECRETARY OF STATE UNDER SECTION 43 OF THE POSTAL SERVICES ACT 2000

PERFORMANCE IN RELATION TO SOCIAL AND ENVIRONMENTAL ASPECTS OF POSTCOMM'S WORK

Universal service: Postcomm's consultation on the universal service delivery obligation in exceptional geographic and other circumstances was concluded and the policy was extended. Appeals were considered under that policy against exceptions in relation to specific properties

Affordable prices: competition is increasingly ensuring that prices for bulk business customers remain affordable; for individual customers, expenditure on postal services continues to be a very small proportion of their overall outgoings. In August 2007 Postcomm published a decision on its interim review of Royal Mail's price control whereby it allowed Royal Mail to increase the price of a second class stamp to 29p, subject to inflation, by 2010.

Environmental: the incentives to efficiency in Royal Mail's price control continue to be the most important means by which Postcomm contributes, indirectly, to reducing the adverse environmental effects of postal operations. Postcomm has reviewed its efforts to reduce the environmental impact of its own operations and these are described in the section entitled *Sustainability* in the *Using and developing resources effectively* chapter of this report.

PROVIDING CUSTOMERS WITH CLEAR AND READILY AVAILABLE ADVICE AND INFORMATION ON ITS WORK

Responsibility for the provision of advice to customers on postal services lies in the first instance with Postwatch. In addition Postcomm publishes a number of Factsheets and has a comprehensive website. Over the last seven years, Postcomm has relied on Postwatch to interpret its papers to, and to present the views of customers. The Consumers Estate Agents and Redress Act 2007 (the 'CEAR' Act) abolishes Postwatch and transfers many of its functions to the National Consumer Council. Postcomm will be working towards establishing a similar constructive relationship with the NCC. The chapter entitled *Competition and regulation* provides further information on Postcomm's responsibilities under the CEAR Act.

In August 2007 Postcomm published for consultation its first stand alone document setting out enforcement procedures relating to possible licence contraventions. This is explained further in the chapter *Competition and regulation*.

Similarly in August 2007 Postcomm consulted on a revised financial penalties policy and published its revised policy in April 2008.

THE SITUATION OF VULNERABLE CUSTOMERS

There has been no change in the provision by Royal Mail of free services to the blind.

There has been no change in the licensing requirements setting standards for proximity of letter boxes and post offices to users.

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