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## Mail orders

### COSTING ELEMENTS OF THE POSTAL PUBLIC SERVICE OBLIGATION

*In 2007, the Postal Services Commission asked Frontier to analyse the net costs to Royal Mail of several different elements of its “universal service obligation”(USO). Of the features we reviewed, we found that only the requirement for Saturday collections and deliveries imposed a substantial net cost, and even this was no greater than the savings Royal Mail could achieve, in a four-year period, by improving efficiency by 1% a year.*

Royal Mail remains the postal regulator’s licensed “universal service provider”, with associated conditions in its licence. Rather than attempt to cost the USO in its entirety, Frontier was asked by Postcomm to carry out an analysis of some key elements of the service, in order to determine the constraints under which Royal Mail was operating, the impact on Royal Mail prices and therefore the effect on the overall service to postal customers.<sup>1</sup> We focused on five current features: the quality standard for 1st class mail; collection and delivery times; Saturday deliveries and collections; a two-class post; and the handling of bulk mail. We looked at the costs of increasing as well as reducing some of these requirements.



For each element, we sought to arrive at an estimate of the “net avoided cost (NAC)” - the cost reductions that would flow from modifying the service, minus the revenues that would be lost. Many such analyses are done on an accounting basis; ours was based on an operational model that captures the current features of Royal Mail operations in terms of the number of mail centres, delivery offices, air networks and so forth, constructed with the aid of a specialist operations consultancy<sup>2</sup>. This enabled us to build our estimates of NAC on an understanding of the operational changes that could be expected to follow from a particular modification.

A further dynamic feature of our model was that it enabled us to build into our estimates the way in which customer demand and Royal Mail's competitors would respond, and the consequent effect on Royal Mail's revenues. We also estimated “second-round effects” on competition and market share if prices changed (assuming NACs were all passed on to the customer). (However, it is important to note that the analysis is based on Royal Mail's actual structure, operations, costs and competitive landscape in 2006-07, and its planning forecasts for 2009-10, not on some hypothetical “most efficient operator”, which might instead represent the benchmark for a regulator's efficiency review.)

### IT'S IN THE POST

The table below summarises the first-round results of our analysis for the three elements that proved to have the most significant results, together with a combination of two of them.

| Royal Mail feature                              | Change                               | Net avoidable cost (NAC), annual | Price impact | Comparable efficiency target, over 4 years |
|---|--------------------------------------|----------------------------------|--------------|--|
| 93% next-day delivery target for 1st class mail | 85% target (78% for PPI)             | £76m                             | -1.4%        | 0.3% p.a.                                  |
| Two-class mail (delivered Day +1 and Day +3)    | Single-class mail (delivered Day +2) | (£278m)                          | +6.3%        | n.a.                                       |
| Six-day delivery and collection                 | No Saturday delivery/collection      | £271m                            | -4.8%        | 1.0% p.a.                                  |
| Two-class mail, six-day delivery/collection     | Single-class mail, no Saturdays      | (£44m)                           | +1.7%        | n.a.                                       |

Table 1: The net avoided costs of key elements of the Royal Mail service

Source: Frontier analysis

The most interesting feature of this table is the large negative NAC of the current two-class mail service, implying that Royal Mail would actually be worse off if 1st class were abolished (and therefore that this part of the USO is not a “constraint”). This is because, although there would be substantial savings from its abolition, it is also likely that there would be a sharp fall in revenues, as Table 2 opposite illustrates.

However, moving to a single-class mail service would give Royal Mail the opportunity to reform its transport, mail centre and delivery office network. By

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reshaping its infrastructure, Royal Mail could exceed the cost savings shown in Table 2 and more than offset the initial revenue loss. It would also have incentives to do so as a single-class mail service would be likely to trigger an increase in competition. Royal Mail would need to cut costs quickly to avoid volume losses and a spiral of higher prices leading to further reductions in volumes and price increases. So unless Royal Mail was certain that it could achieve even greater cost savings through radical restructuring, it would be likely to maintain 1st class delivery, even if not required to do so under the USO.

The most easily identifiable savings from lowering the delivery target for 1st class mail - up to £116m a year - would come from closing down Royal Mail's air network. But a poorer 1st class service would be likely to reduce revenue by triggering a switch from 1st to 2nd class mail, so the NAC is significantly less than the gross savings in costs. A further complication - not included in the NAC calculations - is that both cost and revenue changes would be affected by what it was decided to do about Special Delivery. If this was maintained as a next-day service, then part at least of the air network would have to be maintained; if next-day Special Delivery was undermined, there would be further revenue losses.

| Royal Mail service change          | Impact on costs | Impact on revenues |
|------------------------------------|-----------------|--------------------|
| 85% 1st class delivery target      | -£116m          | -£40m              |
| Single-class mail, Day +2          | -£355m          | -£633m             |
| No Saturday delivery or collection | -£326m          | -£55m              |
| Single-class mail, no Saturdays    | -£589m          | -£633m             |

Table 2: Annual change in costs and revenues

Source: Frontier analysis

However, the third element we analysed - Saturday collections and deliveries - had a substantial NAC. While the abolition of a Saturday service would permit a substantial reduction in costs, our analysis suggests that it would not lead to a significant reduction in revenue. Only about 5% of mail is posted on a Saturday, although about 17% is delivered on that day. But mail delivered to firms on Saturday mostly lies unopened until Monday; and Postcomm research indicates many businesses do not see it as an important day for mail delivery to their customers. Indeed, some engaging in marketing campaigns try to avoid the targeted mail shots arriving on Saturday, because the call centre staff they employ to deal with the customer responses are more expensive to hire at weekends.

Indeed, the second-round effects might actually include an increase in demand, if the NAC were passed on to Royal Mail customers in the form of the price reductions shown in Table 1 (cutting basic stamp prices by 1p-2p). However, the final column in Table 1 provides a sense of proportion: it shows that Royal Mail could reduce its costs by the same amount as the NAC of a Saturday service, without any reduction in service, by increasing efficiency by only 1% a year for four years. To set this figure in context, Royal Mail has been set an efficiency target by Postcomm under the current framework of 3% a year.

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The most radical service change we modelled was a combination of a move to a single class of service and the abolition of Saturday collection and delivery. This would increase the cost savings to an estimated £589m a year, without reducing revenues much more than in the single-class, six-day scenario. However, without major network restructuring, the result would still be an increase in net costs, driven by the loss of revenues associated with the abolition of 1st class mail.

Of the other options we considered, the most costly was an improvement in delivery times. Bringing these forward two hours increased net costs by £114m a year. But allowing deliveries to be made later two hours later did little for Royal Mail's finances, providing a reduction in net costs of only £16m. On the other side, making the last collection just one hour later increased net costs by £67m, but making it one hour earlier reduced them by only £3m, because savings were broadly matched by revenue losses. Finally, the specific requirement to deliver the kind of bulk mail that falls under the USO did not add significantly to costs as long as Royal Mail still has a requirement to deliver single piece mail.

Plainly, some of the changes we modelled would have a significant impact on the geographical integrity of the USO. For example, some parts of the country would suffer more than others from a reduction in the delivery target for 1st class mail, if Royal Mail took advantage of this to cut the costs of the air network: for example, most PPI (printed postage impression) mail to Northern Ireland comes from elsewhere in the UK. We didn't consider separately Royal Mail's main geographic requirement - to deliver to every house and business every day - but it could be analysed using the same approach.

## CONCLUSION

The range of uncertainties around these estimates was, of course, considerable. However, further modelling to test the direction and general scale of the effects suggested the conclusions were robust, permitting a clearer view of whether these features of the USO really acted as a commercial constraint on Royal Mail. In conclusion, therefore, the analysis suggests that of all the elements we modelled only the Saturday service had a high NAC, while at the other end of the spectrum, the abolition of a 1st class service would, without very radical restructuring of the entire Royal Mail operations, be likely to result in a deterioration in profitability rather than an improvement.

## NOTES

1. "Net costs of elements of the universal service: a report prepared for Postcomm". Frontier Economics, May 2008.
2. *Postal & Logistics Consulting Worldwide.*

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