

NEW FOREWORD TO “POST OFFICE REFORM: ITS IMPORTANCE AND PRACTICABILITY

BY IAN SENIOR¹

In 1970 I wrote a monograph titled “The postal service: competition or monopoly” and concluded: “The PO has had over a hundred years to develop its postal services. If it has anything to fear from competition, that is a reason in itself for creating it...”

The Economist in an editorial on 5 December 1970 supported my arguments. “Mr Ian Senior rightly argues that it is absurd that the post office should still have a monopoly to carry letters in Britain, especially since nobody would suggest it should have a monopoly to carry parcels or newspapers.” In political terms at the time, however, the concept that the Post Office should compete in the delivery of letters was beyond the horizon.

Today public opinion has moved forward a long way. Indeed, the question for debate is not *if* European postal administrations should have to compete in carrying letters, but *when* such competition should be introduced and what form it should take. A postal services bill is currently before Parliament. It creates a new regulatory body, the Postal Services Commission that has the remit “to promote effective competition between postal operators”. The Commission will award licences for operators to offer services that at present fall within the Post Office’s letter monopoly, which currently covers letters up to £1 or 350 grams.

What prevents the Commission from setting a date and awarding a fistful of licences for competitors to enter the market on that date? The answer is that the bill still imposes on Royal Mail a universal service obligation (“USO”), namely to provide service throughout the land at a uniform tariff. Some delivery areas, for example, are clearly uneconomic, and the oft-repeated argument of the Post Office is that competitors will cream off the profitable areas, leaving the unprofitable areas to Royal Mail.

In economic terms the answer is to permit licensed competition while leaving Royal Mail with a reduced but sufficient monopoly to enable profits to be made that allow for the USO burden. But what is the value of the USO burden?

In 1998 National Economic Research Associates (“NERA”) was asked by the European Commission to quantify the USO burden for all 15 member states. NERA’s estimate for the British Post Office’s letter burden, using 1997 data, was in the range £14m to £220m depending on whether the net avoidable cost or fully distributed cost method was used to allocate costs among the different traffics. In 1997 the Post Office’s profits before tax and the Treasury’s levy were £577m. On these figures a reduction in the Post Office’s letter monopoly area could be

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made. This could bring new competitors to the market without endangering the Royal Mail's ability to absorb the USO burden and still make a sufficient profit.

In my Adam Smith Institute monograph that follows, written in 1996, I put forward another reason why Post Office reform was necessary: the e-mail revolution. I argued then, as I do now, that the Post Office should be allowed to compete in the communications market and to do so it should be freed from Treasury control.

Despite the huge and continuing surge in the volume of e-mail, the frequently predicted demise of traditional paper-based mail has not occurred. The volume of Royal Mail's second class letters, largely advertising material, continues to climb while the volume of first class letters has remained almost static for the past five years.

Will the World Wide Web replace second class advertising mail? Simplistic predictions are likely to be wrong. Still it seems clear that there must be reform if the Post Office is to survive, let alone prosper, in the face of competition from the Web, dot.com companies, e-mail and, soon, new suppliers of paper-based mail.

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**Post Office Reform:
Its Importance and Practicability
Ian Senior**

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His previous work concerning the postal service includes:

The postal service: competition or monopoly? Institute of Economic Affairs 1970;
Liberating the letter, IEA, 1983; and *Privitization and competition*, IEA, 1989

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” Every branch of the Post Office ought, in my opinion, to defray its own expenses”.
Rowland Hill

“The Post Office is properly a mercantile project. The government advances the expense of establishing the different offices, and of buying or hiring the necessary horses or carriages, and is repaid with a large profit by the duties of what is carried. It is perhaps the only mercantile project which has been successfully managed by, I believe, every sort of government. The capital to be advanced is not very considerable. There is no mystery in the business. The returns are not only certain, but immediate”.

Adam Smith, *The Wealth of Nations*, Book V, Chapter II, Part I

Contents

| | |
|--|-----------|
| Introduction | 5 |
| Fundamentals | 7 |
| Natural and statutory monopolies | 7 |
| Privatization in the UK | 8 |
| PTTs' functions | 8 |
| Attempts to define a 'letter' | 9 |
| The British Post Office's monopolies | 10 |
| Is the market for letters contestable? | 11 |
| The Post Office's record | 12 |
| Quality of service | 12 |
| Mail and parcel operations | 12 |
| Post Office Counters | 14 |
| Financial performance | 16 |
| Comparisons with other EU postal administrations | 16 |
| Conclusion | 19 |
| The new technologies | 22 |
| Parcels | 21 |
| Counters | 22 |
| Letters and facsimile | 23 |
| E-mail | 24 |
| Conclusion | 25 |
| Practicality | 26 |
| A model for reform | 26 |
| Post Office financial controls | 27 |
| Progressive removal of the monopolies | 28 |
| A new price structure for all three services | 30 |
| Unfair to rural dwellers? | 32 |
| Removal of the monopolies and 'creaming' | 33 |
| Competition, privatization or both? | 33 |
| Interconnection to the Royal Mail | 34 |
| Public reaction | 34 |
| Need for an Ofpost? | 35 |
| Conclusion | 36 |
| Other proposals | 37 |
| The government | 37 |
| Post Office management | 38 |
| Post Office Users National Council | 38 |
| The Mail Users' Association | 39 |
| Communication Workers' Union | 40 |

| | |
|---|-----------|
| National Federation of Sub-Postmasters | 41 |
| The public | 41 |
| European Commission | 42 |
| Developments in other countries | 43 |
| Conclusion | 44 |
| Winners and losers | 45 |
| The Treasury | 45 |
| Post Office staff | 45 |
| Courier companies, parcel carriers and document exchanges | 46 |
| Urban and rural postal users | 46 |
| Conclusion | 47 |
| What Rowland Hill actually proposed | 48 |
| Did Rowland Hill advocate a uniform tariff for universal service? | 48 |
| The lagging Post Office and a technological revolution | 49 |
| Notes | 50 |

1. Introduction

In 1837 Rowland Hill published his famous treatise *Post Office reform: its importance and practicability*. I make no apology for copying his title because, owing to entirely different circumstances, the need to alter the structure of the Post Office is as urgent now as it was in Hill's day. I do not suggest for a moment that this report will have the immense and lasting impact of its predecessor. However, as seen in chapter 8, the arguments for reform that Rowland Hill put forward and his proposals are surprisingly relevant today.

In 1970 I suggested the abolition of the Post Office's letter monopoly¹, and this was supported in a leading article by *The Economist*. In 1983 I wrote *Liberating the letter: a proposal to privatize the Post Office*². At that time, Mrs Thatcher's government had already embarked on a programme of privatization that was to change fundamentally the structure of the UK economy. A series of major privatizations was already in train. The first industries chosen were those that by their nature clearly belonged to the private sector: British Aerospace (1981), Cable and Wireless (1981), Amersham International (1982), Britoil (1982), Associated British Ports (1983), Jaguar (1984), and Enterprise Oil (1984). Less obvious candidates such as the big utilities were already under consideration, notably electricity, gas, water, telecommunications and railways, all of which for years had been considered 'natural' monopolies.

What was surprising in 1983 was that the Post Office was seldom included in the shopping lists and indeed emerged only as a serious candidate when Mr Major replaced Mrs Thatcher as Prime Minister. It was said that Mrs Thatcher gave an assurance to the Queen that the Royal Mail would stay in the public sector. It was also argued that there were no precedents anywhere for transferring the delivery of letters to the private sector. Finally, at a political level, it was argued both then and now that there was no public demand for the Post Office to be privatized and it might be electorally unpopular.

The climate of opinion concerning postal services has changed since 1970 and 1983. Countries as near as the Netherlands and as far as New Zealand have liberalized or privatized their postal services, or are considering how best to do so. In December 1995 the European Commission published two important documents: a draft notice on the application of competition rules to the postal sector³ and a draft directive⁴, both of which will have significant impact on the future of postal services in the EU.

Within the UK, interest in the future of the Post Office has reawakened. There is discussion that Post Office Counters might offer travel agency services, for example. On 7 February 1996 a full-scale debate on Post Office privatization was initiated in the House of Commons by the Opposition. There was a feeling on all sides that the Post Office is currently in limbo, aware that rapid changes are taking place in its market and yet uncertain of its future.

This report is not concerned with the political will to reform the Post Office that emerged in the UK in 1993, evaporated in 1994 and now is experiencing a modest revival. Rather, I wish to show first why the Post Office should be reformed: the necessity. Next I shall suggest how reform could and should be implemented: the practicability. I shall then assess who in the UK would be the winners and the losers under my proposals. Although this report focuses on the British Post Office, the arguments may well apply with equal force to post office services worldwide.

At the end of the report I shall show that though my proposals may be seen by some as radical, they have their basis in those of Rowland Hill. As the founder of the modern postal system and the creator of the penny post, he is frequently cited in support of universal standard postal tariffs. This report argues against these and quotes Rowland Hill verbatim to show that he did not advocate them either. Therefore, if my proposals excite support or criticism, Rowland Hill must share the credit or blame.

2. Fundamentals

Natural and statutory monopolies

The arguments in favour and against monopolies, whether private or state, are well known and have been expounded by economists, politicians and others for over 200 years. Two types of monopoly are of particular interest: *natural* and *statutory*. The first is a business activity with the following characteristics: high initial investment, generally in plant and equipment, coupled with extremely low variable costs. Such activities offer large economies of scale and for this reason the market is difficult to contest by newcomers for financial, technical or other reasons.

Sewers are an example of a natural monopoly. It seems unlikely that in any economy, however liberal, two or more enterprises will lay competing drains side by side in a given road so that the public may choose who should remove their sewage. Even if there were two independent companies and the cost of transferring waste outlets from one to the other was modest, a duopoly by itself would not ensure a competitive market devoid of excessive profits.

A second form of monopoly—the statutory monopoly—is imposed by government for political or judgmental reasons. The traditional socialist-Marxist view is that the means of production, distribution and exchange should be vested in the state to maximize the welfare of the population. Non-socialist governments at various times have put statutory monopolies in place for other reasons such as national security, (for example, the production of weapons); national health (the supply of tobacco and alcohol); or for political and economic power (the control of central banks). It is also common to find that natural monopolies have been turned into statutory monopolies with the intention either of preventing them exerting monopoly power in the market or, alternatively, of enabling central government to capture the excess profits that monopoly power permits. Thus in many countries the supply of gas, water and electricity has been carried out by local or national monopolies owned by central or local government.

Other monopolies are found in which governments have imposed a statutory monopoly where there was no natural monopoly simply to raise revenue. For example, for many years in France there was a statutory monopoly of matches.

The collapse of the east European and Soviet economies and the poverty of the few remaining practising socialist states such as North Korea and Cuba have

discredited statutory monopoly as a means of wealth creation. Even states professing socialism such as China and Vietnam have taken significant steps to introduce competition in the market by selling off state industries, permitting new entrants to the market or both.

Privatization in the UK

In the 1980s and 1990s the United Kingdom led the way in Europe by transferring to the market and to private ownership a series of nationalized industries. Some were not natural monopolies and never had been. Within a fiercely competitive and deregulated world airline industry, a privatized British Airways was transformed into one of the world's most successful and profitable carriers. Rover cars, which for decades had lost market share and public money, was turned to profit by British Aerospace, who promptly developed a new British disease — the fear of success—and sold the company at a large profit to BMW.

The outcome of the utilities that were privatized with their natural monopolies largely intact was less exemplary. To counter the likely abuse of monopoly power in the supply of gas, electricity, water and telecommunications, regulatory offices were created to look after the interests of consumers who still were usually faced by a single local supplier of the product in question. Critics said that some of the new corporations managed to exploit their natural monopolies more to enhance the rewards to senior executives and shareholders than to their customers. Indeed, such was the attack on some these rewards that the public became disenchanted with privatization.

This occurred at the very time when the Post Office for the first time became a serious prospect for privatization by Michael Heseltine, then President of the Board of Trade. A government experiencing higher than normal mid-term unpopularity and faced with a dwindling parliamentary majority, could not be rallied to support his plan to sell shares in a new company comprising Royal Mail and Parcelforce. They proposed to retain Post Office Counters in public ownership anyway, thus effectively abandoning the privatization of Post Office Counters that had begun with the sale of the Girobank and was continuing with the gradual conversion of Crown (i.e. Post Office owned) post offices into privately owned sub-post offices.

PTTs' functions

The functions of postal administrations can be considered under four headings:

- letters
- parcels
- counter services
- banking

In the past postal, telecommunications and some banking services were often provided by the same administrations, sometimes called 'PTTs' because they handled posts, telegraphs and telephones. In the UK the separation of telecommunications from the Post Office took place in 1981 and banking operations, known as Girobank, were sold to the Alliance and Leicester Building Society in 1990. Girobank transactions continue to take place over post office counters, with the Post Office an agency for the Alliance and Leicester and receiving a fee for this work.

The letter and telecommunications monopolies have always been at the core of European post and telecommunication administrations. In the nineteenth century the letter was the sole means of communication and later it provided financial support to telecommunication, a fledgling industry. From its earliest days the telephone was seen as supplying a complementary part of the communications market. The letter was a permanent record, the telephone call ephemeral. There seemed a certain logic in grouping all forms of person-to-person communication under one administration.

Attempts to define a 'letter'

The historical attraction to governments of the letter monopoly from the nineteenth century onwards was as a source of revenue. It is doubtful whether letters have ever seriously been considered a natural monopoly on the criteria given earlier. In 1970 I wrote that "...a letter is nothing more than an object to be carried from one point to another and in no way differs in this respect from a parcel. The differing nature of the contents is immaterial. If anyone may carry parcels for profit, why not letters?"⁵ The argument seems as compelling today as then.

In the draft EC directive⁶ the term 'item of correspondence' is used in place of 'letter' and is defined as:

"a communication in written form on any kind of physical medium to be conveyed and delivered at the address indicated by the sender of the item or on its wrapping. Books, catalogues, newspapers and periodicals shall not be regarded as items of correspondence".

Direct mail is defined as:

"an item of correspondence consisting of the same message and sent to a significant number of addresses for advertising or marketing purposes".

The draft directive sets 350 grams as the weight above which national letter monopolies may not be permitted. However, to make quite sure that letter monopolies are secure, the directive permits the monopoly to include items of domestic correspondence "...whose price is less than five times the public tariff for an item of correspondence in the first weight step..." In the UK, under this

ruling, private carriers could provide a general letter service at five times the price of a second class letter, namely 95p per item.

Attempts to define a letter today, as in the past, have always been intended to enable the monopoly supplier to retain its 'reserved' (i.e. monopoly) rights and thus to eliminate competition. However, neither the contents, nor the shape, nor the weight, nor the speed or quality of service can alter the fact that 'letters' or 'items of correspondence' are things-to-be-carried.

The essential function of carrying any object is that by doing so, value is added to the object while the object itself is unaltered. A bottle of drinking water has very modest value at its source. Retailed in a supermarket, its value to the consumer, and hence its price, has increased significantly. Value has been added without any change to the water other than its location. In addition to being in the right place, it must be there at the right time. In many cases speed of delivery adds value to the product, as captains of the tea clipper ships knew when they raced to Europe from the orient.

Like the bottle of water or tea from China, transport adds value to a letter, parcel, direct mail advertisement, newspaper or a mail-order garment. All are things-to-be-carried. Interestingly, the European Commission noted in its decision of 1 August 1990 when considering postal markets:

*"...As they are markets for services and not products, it is not possible to distinguish between them solely on the basis of the type of object transported. The essential difference lies in the value added by the providers of the transport of goods concerned"*⁷ [emphasis added].

Under the British postal system, a parcel up to 2 kilograms, a direct mail advertisement, a newspaper or a mail order garment can all be sent by 'letter mail'. Mr Tony Benn, when Postmaster General in the 1960s, logically eliminated the distinction between 'letters' and 'printed matter' and substituted first and second class service based on speed of delivery instead of on the nature of the thing-to-be-carried. Thirty years on, the British sender still chooses the speed or other form of value added that is appropriate to his or her needs, and pays the rate at which suppliers in the market offer that service. An item up to 2kg can be sent by Royal Mail's standard or express letter services, as a parcel by Parcelforce or a private carrier, or by varied courier services. A traditional letter weighing up to 60g can be thought of as a thing-to-be-carried whose dimensions happen to make it particularly convenient to sort, transport and deliver. This being so, *any carrier should be permitted to pass on to the customer savings derived from the ease of carrying letters.*

Certainly there are economies of scale in the collection, sorting, conveyance and delivery of letters, but these economies are not so high as to deter new entrants for local service or for services between defined points. The question therefore revolves around whether a universal (that is to say, nationwide) letter service is a natural monopoly, which is discussed later in this chapter.

The British Post Office's monopolies

The British Post Office has just one statutory monopoly: the letter. Nobody may collect and deliver a letter, as elaborately defined in the British Telecommunications Act 1981, for less than £1. This allows courier companies to carry letters in small numbers, but prohibits the activities of common carriers who might wish to carry letters in bulk at a price well below £1. In addition, as discussed in chapter 3, the Post Office has a number of *de facto* monopolies in services provided over the counter. These include cashing pensions, allowances and social security benefits, issuing motor vehicle and other licences; and handling various forms of national savings.

In the UK there are three exceptions to the letter monopoly. First, document exchange operators have a general licence for their activities. Under these schemes, which are specialist and few in number, member firms take their mail to collecting points, typically in the premises of a member company. The letters are collected from that point by the operator, sorted and delivered to the addressee's nearest centre, which may also be the premises of a member company, whence each addressee collects his mail at his convenience. The purpose of a document exchange scheme is to ensure next day delivery to the appropriate centre by 9.00 am and at a price that is in line with or below the cost of the Royal Mail's first class service.

Britdoc, the best known document exchange service, has 26,000 members (of which 49% are from the legal profession), 13 sorting offices, and 600 employees. It handles about 200m pieces a year, equivalent to 1.2% of the Royal Mail's letter traffic.⁸

The second exception is that charities may deliver Christmas cards that convey "...a greeting appropriate to the seasons of Christmas and the New Year (or either of them) and no other communication relating to the personal, private or business affairs of any person"⁹. Thus by law a Christmas card delivered by a boy scout that says "Happy Christmas, Uncle Fred" is legal but one that says "Happy Christmas—I am on holiday with Uncle Fred" is not! Such is the absurdity of the letter monopoly.

The third exception is that government departments are permitted to deliver their own mail "...where the sender is a government department and the addressee is the same government department or is a different government department"¹⁰.

To date, none of these three exceptions can be considered to have made any significant impact on the Royal Mail's letter monopoly and hence the Post Office's profitability.

Is the market for letters contestable?

The question then arises to what extent the market for letters is contestable. Albon (1991) reviews the theoretical and empirical work of a number of authors

as to whether there are economies of scale in postal work and the extent to which the market is contestable and concludes: "There is some evidence of overall economies (of scale) in the UK. This evidence is rather weak and, most importantly, even if there are such economies...the evidence suggests that the market is significantly contestable... In those areas where competition has been permitted, the market appears to be highly contestable if not 'competitive' "¹¹

This conclusion is strongly supported by the speed and number of competitors that entered the letter market in the postal strike of 1971. The Conservative government allowed private postal services to operate *under licence*. The licence was evidently a formality. Within days no fewer than 562 services had been licensed up and down the country, and many others were doubtless operating without a licence. Some of these operations may have been intended more to print 'Cinderella' stamps than to carry bulk mail, but some carried significant quantities of mail. Also remarkable was the speed with which some of the newly fledged services linked up during the strike into a network called the Association of Mail Services¹².

It is clear that the remarkable experiment of lifting the letter monopoly overnight and with it any tariff restriction meant that market forces that for years had been smouldering and suppressed were allowed to burst into flame. The Union of Postal Workers realized that their service could be replaced by others in a matter of days, and settled the dispute. Any 'natural monopoly' argument was destroyed overnight and the government's Green Paper, 1994, *The future of postal services* Cm 2614, makes no pretence that letters are anything other than what they are: an antiquated yet still profitable thing-to-be-carried.

3. The Post Office's record

Human nature is to complain about goods or services when they go wrong rather than to extol them when they perform well. So the quality and quantity of service provided by the British Post Office, often criticized in the past, is a valid starting point for considering reform. These must be considered in the light of other key measures, notably the prices at which the services are provided, the Post Office's profitability and productivity, and, crucially, the extent to which its main services face competition.

Quality of service

Table 3.1 brings together some key statistics for quality of service drawn from the Post Office Users National Council and the Post Office. The most important indicator is the speed and reliability of letter deliveries. Here there has been significant improvement over the past five years. The proportion of first-class letters delivered on the next working day has risen from 78.1% to 92.0%; and of second-class letters delivered within three days from 94.0% to 98.1%. Parcelforce's record for standard parcel service deteriorated in the most recent three years to 85%. The standard of service was restated in 1992-93.

Post Office Counters has shown a falling standard of service. The number of offices has been reduced by 1,346 in five years, or 6.4%. From the customers' point of view, fewer offices means further to travel for those whose local offices have been closed. Nor has there been a compensating improvement in the standard of service at the remaining offices. In the four years to March 1994, the proportion of customers served in Crown offices within an undemanding target of five minutes remained around 97%. At a sample of sub-offices between October and December, 1994, 94.9% were served within five minutes and 56.8% were served within 30 seconds¹³. A target of five minutes seems too relaxed and should be replaced by, say two minutes and in addition, the average waiting time in post offices should be published by Counters.

It seems fair to conclude that the quality of the letter service has improved, while that of Parcelforce and Counters has worsened.

Mail and parcel operations

The nature of postal operations has been changing steadily over the past two decades. The most important change has been in the fundamental role of mail.

TABLE 3.1: QUALITY OF SERVICE INDICATORS

| | 89-90 | 90-91 | 91-92 | 92-93 | 93-94 | 94-95 | Change % pa |
|--|---------|---------|---------|---------|---------|---------|----------------|
| Royal Mail | | | | | | | |
| 1st class letters delivered next day, % | 78.1 | 85.5 | 89.8 | 91.9 | 91.2 | 92.0 | 3.3 |
| 2nd class letters delivered in 3 days, % | 94.0 | 96.4 | 97.8 | 98.4 | 98.2 | 98.1 | 0.9 |
| Collection points | 120,000 | 120,000 | 120,000 | 120,000 | 120,000 | 120,000 | 0.0 |
| Delivery points, m | 23 | | | | | 25 | 1.7 |
| Parcelforce | | | | | | | |
| Datapost 10, next day by 10.00, % | | 99 | 100 | 99 | | | |
| Datapost 12, next day by noon, % | | 99 | 100 | 99 | | | |
| Parcelforce 24, within 24 hours, % | | 99 | 100 | 98 | | | |
| Parcelforce 48, within 48 hours, % | | 97 | 99 | 97 | | | |
| Parcelforce Standard, non-guaranteed 3 days, % | | 91 | 92 | (a)87 | 87 | 85 | (1.7) |
| Counters | | | | | | | |
| Directly operated | 1,339 | 1,167 | 1,019 | 917 | 800 | 699 | (12.2) |
| Agency | 19,532 | 19,471 | 19,141 | 19,041 | 18,982 | 18,826 | (0.7) |
| Total post offices | 20,871 | 20,638 | 20,160 | 19,958 | 19,782 | 19,525 | (1.3) |
| Service within 5 minutes in Crown offices, % | | 98.1 | 97.1 | 95.6 | 97.5 | | (0.2) |

Note (a): Parcelforce standard service restated in 1992-93

Sources: *PO report and accounts, POUNC User audit and review*, various years; personal communication from PO to author

The traditional letter as piece of correspondence on a one-to-one basis is in decline and is now thought to account for only about 10% of all mail. This decline has been counterbalanced by an upsurge in 'direct' mail, an effective medium for direct marketing and sales. In addition to the traditional mail order operations such as Littlewoods, specialist offers of books, wine, unit trusts and appeals from charities proliferate.

Two factors have contributed to this proliferation. The first has been the power of the computer which allows automated, personalized, selective mailings from huge databases. The second has been the application of the postal coding to direct mail marketing.

The British postcode system was introduced by the Post Office in the mid 1960s during Mr Tony Benn's tenure as Postmaster General. Its purpose was to facilitate mechanized sorting of the mail. Unlike the postal codes used elsewhere at the time it combined numbers and alphabetical letters so that the destination could be encoded down to the final street and to a group of houses in the street. The Post Office had no inkling of just how powerful a marketing tool it was to become.

Increases in direct mail, which is sent second class, have outweighed the decline of the one-to-one letter. Table 3.2 shows that the volume of first-class letters has declined 0.4% per year over the past five years, while second-class letters have grown at 4.8%. International letters have also been increasing at 4.5% per year. To date this reflects increasing international trade, but international direct mail is already an emerging medium.

As the table shows, the number of staff required to handle letters has fallen at an average of 1.6% per year while total letter traffic has been growing. The number of letters handled per staff employed, a measure of productivity, has thus increased at 4.2% per year.

The Post Office does not disclose Parcelforce's traffic, presumably treating this as commercially sensitive information. The government's Green Paper quotes 750,000 parcels carried per day. Since there are no Saturday deliveries, and using 245 working days in the year, the number of parcels carried can be estimated at 184m per year. The staff number for parcels has grown from 12,000 to 13,000 over the period. Parcel sorting is less amenable to increased efficiency through mechanisation so, assuming only a modest increase in productivity, it appears that Parcelforce's traffic is growing at about 1-2% per year.

From table 3.2 it therefore emerges that the Post Office's letter and parcel traffic is still reasonably buoyant and that there is scope for further increases in letter productivity.

Post Office Counters

The picture for Post Office Counters' operations is otherwise. As noted above, the number of offices has declined by 1,346 in the past five years, a reduction of 1.5% per year.

Table 3.3 shows the volume of transactions for the past five years which has been increasing at 1.1% per year. The table separates the monopoly services—those that the government gives only to Post Office Counters—and the competitive services. Girobank and postal orders are classified as 'competitive' because they compete with banking services. Using this classification, it can be seen that the share of monopoly services has remained level around 75% over the period.

TABLE 3.2: SELECTED MAIL AND PARCEL DATA

| MAIL | 89-90 | 90-91 | 91-92 | 92-93 | 93-94 | 94-95 | Growth | |
|--|--------|--------|--------|--------|--------|--------|--------|-------|
| | | | | | | | pa | % |
| 1st class letters (millions) | 6,546 | 6,659 | 6,418 | 6,777 | 6,383 | 6,409 | | (0.4) |
| 2nd class letters (millions) | 8,173 | 8,647 | 8,961 | 9,168 | 9,577 | 10,342 | | 4.8 |
| Inflation adjusted tariff index | 100.0 | 99.1 | 103.3 | 103.3 | 103.7 | 104.8 | | 0.9 |
| International letters posted (millions) | 575 | 596 | 659 | 619 | 691 | 717 | | 4.5 |
| All letters, millions | 15,294 | 15,902 | 16,038 | 16,564 | 16,651 | 17,468 | | 2.7 |
| Parcels (a) | | | | | | | | |
| Staff (thousands) | | | | | | | | |
| - Royal Mail | 172 | 171 | 166 | 158 | 158 | 159 | | (1.6) |
| - Parcelforce | 12 | 13 | 12 | 13 | 15 | 13 | | 1.6 |
| - Counters | 17 | 17 | 15 | 15 | 13 | 13 | | (5.2) |
| All staff | 201 | 201 | 193 | 186 | 186 | 185 | | (1.6) |
| 1000 letters per Royal Mail staff employed | 86 | 90 | 93 | 101 | 101 | 105 | | 4.2 |

Notes

a) From 1989-90 the *Post Office report and accounts* discontinued data on inland and international parcels traffic

Source: *Post Office report and accounts*

Financial performance

As a nationalized industry, the Post Office is set financial targets by the government with individual targets for the three main operating companies. In 1994-95 the targets, expressed as return on capital before taxation, were Royal Mail: 14.5%; Parcelforce: not available; and Counters: 3.9%.¹⁴

The failure to set a financial target for Parcelforce seems curious. Since the war the Post Office's parcel service has generally made losses and the creation of Parcelforce as a separate trading entity has not changed this pattern. Indeed, the out-turn for Parcelforce in 1994-95 was worse than in the preceding three years and shows a rising trend. The other two services have compensated for these losses and have enabled the Post Office as a whole to meet or exceed its overall financial target.

Table 3.4 shows group profit before tax in 1994-95 as £423m, deriving almost entirely from Royal Mail. The loss on Parcelforce was nicely balanced by a profit on Counters. This is in line with the historical pattern by which monopoly profits on the letter are used to subsidize losses on parcels, a market in which Parcelforce competes with some 4,000 private carriers, large and small. For some three decades the Post Office has been unable to alter this pattern.

The Post Office is seen as a significant contributor to the Treasury. In 1994-95 it paid tax of £158m. In addition it also contributed cash under the arcane title of the external financing limit (EFL). As a nationalized industry the Post Office is required to obtain the capital it needs from the Treasury. In practice, thanks to the profitable letter monopoly the Post Office has been able to finance its capital needs from internal cash-flow and still have cash to spare. It is compelled to use this spare cash to buy government bonds, so reducing the amount that the government must borrow from the private sector. The Treasury sets the Post Office an annual target for EFL and the Post Office has usually been close to target.

Comparisons with other EU postal administrations

International comparisons with some key data for EU postal administrations are presented in table 3.5. Most are taken from the 1992 EC Green paper on the development of the single market for postal service and are for the years to 1989. They represent a snapshot which may have changed in the past six years but remains illuminating and deserves brief comment.

From table 3.3 it is apparent that, faced with limited growth in the number of transactions, Post Office Counters has made efforts to reduce costs by closing offices; and that Post Office Counters is heavily dependent on its monopoly of government services to maintain its present level of activity.

Inland letters, price and speed of delivery. The current price of a first class inland letter in the UK, at 25p, is just below the EU average when adjusted by purchasing power parities (PPP)¹⁵. This is a method which first converts the national price of a good into a common currency at the prevailing exchange rate and then applies a further weighting by comparing the price of a given basket of goods or services in each country. Using PPP, the price of a British first class letter in 1994 was below that of Germany, France, Italy and Ireland.

TABLE 3.3: SELECTED COUNTER DATA

| | 89-90 | 90-91 | 91-92 | 92-93 | 93-94 | Change pa. % 95-95 | |
|--|--------------|--------------|--------------|--------------|--------------|-----------------------|------------|
| Directly operated offices | 1,339 | 1,167 | 1,019 | 917 | 800 | 699 | (12.2) |
| Agency offices | 19,532 | 19,471 | 19,141 | 19,041 | 18,982 | 18,826 | (0.7) |
| Total | 20,871 | 20,638 | 20,160 | 19,958 | 19,782 | 19,525 | (1.3) |
| Post Office staff (excl. agency), (thousands) | 17 | 17 | 15 | 15 | 13 | 13 | (5.2) |
| Staff per directly operated office | 12.7 | 14.6 | 14.7 | 16.4 | 16.3 | 18.6 | 7.9 |
| TRANSACTIONS, VOLUME, millions | | | | | | | |
| Monopoly services | | | | | | | |
| Pensions and allowances | | | | | | | |
| - child benefit | 223 | 219 | 215 | 217 | 217 | 216 | (0.6) |
| - NI and pensions | 622 | 636 | 654 | 674 | 679 | 671 | 1.5 |
| - DSS orders | 68 | 70 | 85 | 93 | 96 | 82 | 3.8 |
| Sub-total | 913 | 925 | 954 | 984 | 992 | 969 | 1.2 |
| Motor vehicle licences | 32 | 32 | 33 | 33 | 33 | 33 | 0.6 |
| National savings services | 32 | 31 | 30 | 29 | 26 | 24 | (5.6) |
| Sub-total, monopoly services | 977 | 988 | 1,017 | 1,046 | 1,051 | 1,026 | 1.0 |
| Competitive services | | | | | | | |
| Girobank | | | | | | | |
| - deposits | 94 | 115 | 113 | 116 | 112 | 161 | 11.4 |
| - withdrawals | 38 | 33 | 29 | 30 | 29 | 28 | (5.9) |
| - other | 33 | 24 | 23 | 28 | 21 | 0 | (100.0) |
| Sub-total, Girobank | 165 | 172 | 165 | 174 | 162 | 189 | 2.8 |
| Telephone bills | 40 | 40 | 39 | 39 | 39 | 39 | (0.5) |
| Postal orders | 42 | 39 | 39 | 44 | 39 | 38 | (2.0) |
| Other services | 83 | 83 | 92 | 96 | 100 | 90 | 1.6 |
| Sub-total, competitive services | 330 | 334 | 335 | 353 | 340 | 356 | 1.5 |
| TOTAL TRANSACTIONS | 1,307 | 1,322 | 1,352 | 1,399 | 1,391 | 1,382 | 1.1 |
| of which | | | | | | | |
| - monopoly, % | 74.8 | 74.7 | 75.2 | 74.8 | 75.6 | 74.2 | |
| - competitive, % | 25.2 | 25.3 | 24.8 | 25.2 | 24.4 | 25.8 | |

Source: Post Office report and accounts

TABLE 3.4: THE POST OFFICE'S FINANCIAL PERFORMANCE

| £m | 90-91 | 91-92 | 92-93 | 93-94 | 94-95 | Change pa. % |
|---|-------|-------|-------|-------|-------|-----------------|
| Royal Mail | | | | | | |
| - turnover | 3,575 | 3,911 | 4,048 | 4,223 | 4,540 | 6.2 |
| - profit | 171 | 266 | 252 | 296 | 449 | 27.3 |
| Parcelforce | | | | | | |
| - turnover | 530 | 508 | 501 | 498 | 481 | (2.4) |
| - profit | (75) | (24) | (13) | (19) | (29) | (21.1) |
| Counters | | | | | | |
| - turnover | 959 | 1,028 | 1,061 | 1,089 | 1,118 | 3.9 |
| - profit | 28 | 26 | 25 | 25 | 30 | 1.8 |
| Corporate and subsidiary undertakings | | | | | | |
| - turnover | 277 | 280 | 279 | 295 | 290 | 1.2 |
| - profit | 29 | (21) | 19 | 4 | 22 | (6.7) |
| Interbusiness services | | | | | | |
| - turnover | (622) | (578) | (544) | (537) | (551) | (3.0) |
| Group | | | | | | |
| - turnover | 4,719 | 5,149 | 5,345 | 5,568 | 5,878 | 5.6 |
| - operating profit | 117 | 250 | 264 | 300 | 434 | 38.8 |
| - exceptional item (a) | (106) | | | | | |
| - profit before tax | 47 | 247 | 283 | 306 | 472 | 78.0 |
| - tax | (16) | (95) | (96) | (111) | (158) | 77.3 |
| Profit after tax | 31 | 152 | 187 | 195 | 314 | 78.4 |
| External financing limit (EFL)(b) | 0 | (74) | (80) | (181) | (235) | 47.0 |
| Tax plus EFL | (16) | (169) | (176) | (292) | (393) | 122.6 |
| Retentions after tax and EFL | 31 | 78 | 107 | 14 | 79 | 26.3 |
| Tax plus EFL as percent of profit before tax | 34.0 | 68.4 | 62.2 | 95.4 | 83.3 | 25.1 |
| Contribution to turnover from, % | | | | | | |
| - Royal Mail | 76 | 76 | 76 | 76 | 77 | 0.5 |
| - Parcelforce | 11 | 10 | 9 | 9 | 8 | (7.6) |
| - counters | 20 | 20 | 20 | 20 | 19 | (1.6) |
| - corporate and subsidiary undertakings | 6 | 5 | 5 | 5 | 5 | (4.3) |
| - interbusiness services | (13) | (11) | (10) | (10) | (9) | (8.2) |
| Contribution to profit from, % | | | | | | |
| - Royal Mail | 552 | 175 | 135 | 152 | 143 | |
| - Parcelforce | (242) | (16) | (7) | (10) | (9) | |
| - counters | 90 | 17 | 13 | 13 | 10 | |
| - corporate and subsidiary undertakings | 94 | (14) | 10 | 2 | 7 | |

Notes

a) Cost of restructuring Royal Mail and Parcelforce

b) EFL = money invested in Treasury securities

Source: Post Office report and accounts, 1994-95

In 1988-89, according to data from the EU postal administrations, the average proportion of letters delivered the day after posting was 81%. The UK in that year claimed 80% for next day delivery of first class letters. Leaving aside the clear divergence between the speed of deliveries claimed by the administrations and by independent sources, it appears that the Dutch speed of delivery was by far the best, followed by Germany and Ireland. It must be remembered that because other administrations treat all letters as 'first class', the British Post Office's figures are flattered and would have been much worse if they had included second class letters.

Mechanization. In 1989 the UK had the highest number of post offices per 100km in the EU and, with the exception of Ireland, the smallest population per post office served. Both these figures reflect well on the British Post Office from the customer's point of view. However, only 15% of post offices had counter automation compared with 99% for the Netherlands which was exceptionally advanced. Some 62% of sorting offices were mechanised, which was above the EU average of 40%.

Profitability and investment. In terms of profitability in 1988, the British Post Office headed the league with ECU159m. The Dutch Post Office also made a profit which was roughly proportional to that of the UK in terms of population. All other administrations made losses: more than ECU 1 billion in Germany and Italy, and substantial in France and Spain. In the UK, investment as a proportion of revenue in 1985-88 was highest at 10.6% with the exception of Italy.

Conclusion

On EU comparisons for 1988-89 the British and Dutch postal administrations were clearly the two leading performers. In the UK profitability has been based on the letter monopoly, but all other administrations had similar monopolies. The British letter price is in line with the EU average. Its record on the provision of post offices and of mechanizing sorting offices has been good but its record on automating post office counters at that time was average.

Since 1988-89 the Post Office's quality of service, with the exception of counters, has improved significantly. Its productivity on letters has increased and so have its profits despite losses on parcels. Financially, the Post Office is certainly not broke so the question arises: "if it ain't broke, why fix it?". The answer can be stated in two words: competing technology.

TABLE 3.5 EU COMPARATIVE POSTAL DATA

| | Belgium | Denmark | Germany | Greece | España | France | Ireland | Italy | Luxembourg | Netherlands | Portugal | UK | EU avg |
|--|---------|---------|---------|--------|--------|--------|---------|---------|------------|-------------|----------|--------|-----------|
| Inland letters | | | | | | | | | | | | | |
| - Price 1994, UKp (a) | 26 | 25 | 30 | 18 | 15 | 28 | 30 | 32 | 24 | 23 | 36 | 25 | 26 |
| - Delivered next day 1988-89, % (b) | 83 | 97 | 91 | 44 | 80 | 78 | 90 | 55 | 97 | 93 | 85 | 80 | 81 |
| - Delivered next day 1988-89, % (c) | 68 | | 81 | | 38 | 70 | 84 | 17 | | 93 | | 80 | 66 |
| Post offices 1989 | | | | | | | | | | | | | |
| - Number | 1,850 | 1,300 | 17,500 | 929 | 12,985 | 1,700 | 2,075 | 14,353 | 106 | 2,634 | 1,050 | 21,000 | 6,456 |
| - Population per post office | 5,330 | 3,939 | 3,489 | 10,728 | 2,978 | 3,258 | 1,711 | 3,987 | 3,472 | 5,550 | 9,881 | 2,704 | 4,752 |
| - Post offices per 100 sq km | 6 | 3 | 7 | 1 | 3 | 3 | 3 | 5 | 4 | 6 | 1 | 9 | 4 |
| - With cosenter automation, % | 0 | 0 | 24 | 0 | 0 | 31 | 0 | 1 | 21 | 99 | 3 | 15 | 18 |
| - With automatic teller machines, % | 6 | 0 | 1 | 0 | 3 | 5 | 0 | 0 | 4 | 5 | 0 | 1 | 2 |
| Mail employment proportions 1988 | | | | | | | | | | | | | |
| - Postmen | 61 | 42 | 59 | 66 | 72 | 55 | 42 | 67 | 80 | 81 | 60 | 80 | 64 |
| - Administrative staff | 29 | 41 | 30 | 28 | 26 | 42 | 31 | 30 | 10 | 17 | 36 | 11 | 29 |
| - Managers | 11 | 17 | 11 | 6 | 2 | 4 | 27 | 3 | 10 | 1 | 4 | 9 | 7 |
| Sorting centres 1988 | | | | | | | | | | | | | |
| - Number | 17 | 12 | 129 | 22 | 85 | 131 | 8 | 201 | 1 | 12 | 7 | 130 | 63 |
| - Mechanised, % | 41 | 8 | 39 | 0 | 7 | 67 | 0 | 15 | 100 | 100 | 43 | 62 | 40 |
| - With optical character recognition, % | 35 | 0 | 0 | 0 | 7 | 53 | 0 | 0 | 0 | 0 | 43 | 48 | 16 |
| Profit (loss) mail services 1988, ECUm | (243) | (35) | (1,210) | (23) | (308) | (498) | (1) | (1,058) | (3) | 47 | (36) | 159 | (267) |
| Investment as % of total revenue, 1985-88 | 3 | 5 | 5 | 3 | 3 | 3 | | 15 | | 5 | 9 | 11 | 6 |

NOTES

Data sourced from EC 'Green paper on the development of the single market for postal services', Com(91)476, unless otherwise stated

a) Adjusted for purchasing power parity. Source: Post Office private communication to author, October 1994

b) Results provided by postal administrations. Spain is delivery within 2 days

c) Independent survey results

4. The new technologies

The conveyance of personal information in the western world has never been entirely deregulated, but the degree of state ownership and intervention has varied widely from country to country. First there was only the letter, which was followed by telegraphy, telephone, telex, facsimile and now e-mail. As each new medium of communication arrives in the market, it establishes a share on the basis of its price and convenience. The resilience of the letter so far has been noteworthy. By contrast, the telephone replaced telegrams and facsimile has replaced telex in the developed world.

Every form of telecommunication is subject to dramatic technological advance which in less than a decade has largely vitiated the traditional technological arguments for government regulation. The frequencies available for mobile telephones are used digitally with increasing sophistication so that they are seldom the constraint on growth. The cost of producing mobile telephone handsets has fallen steadily and the price to the public has been reduced to the point where they sometimes are given as special offers, for example, with petrol or when opening a bank account. Call charges remain high but are falling sharply. The day when every person over the age of ten can afford to possess a mobile telephone along with an electronic watch and a pocket calculator may be only a decade away.

In the past ten years the fax machine has changed from a rarity in business to being as essential as the telephone. It has already become standard equipment for those who work from home. Plain paper has begun to replace thermal paper in rolls, and in the next 2-3 years the technology of computer colour printers will merge with that of facsimiles to enable colour transmission.

E-mail is a technology whose hour is at hand, stimulated by the Internet and by the arrival on the job market of the first generation of young adults whose formal education entailed familiarity with computers and for whom computer games were as normal as watching television. To send and receive E-mail you need a computer. The hardware still costs several times the price of a basic facsimile machine and learning to use the equipment is considerably more demanding than using a facsimile. However, the use of a facsimile cannot become easier, while using e-mail will become much easier as computer programmes increase in userfriendliness. The speed of data transmission by E-mail is infinitely faster than by facsimile, and will remain so.

Far from abating, the speed of technical advance in telecommunication is accelerating. How will this affect demand for the Post Office's three main services —letters, parcels and counters?

Parcels

Parcels stand to benefit from the new communications technologies. The previous chapter noted the growth of direct mail marketing. Mail-order shopping is the counterpart. If a consumer can make a buying decision at home there is no need go to a shop to collect the item. Human nature is to take the course of action that achieves a given result for the least expenditure of time and energy.

Mail order shopping is continually extending the range of products sold. Today, broadly speaking, if it can be delivered, it can be ordered by mail or by telephone. In addition to direct mail, the television screen is already in use as a sales medium that will become increasingly interactive. Consumers will control a screen catalogue much as they now control Ceefax and Oracle, will select items in more detail, and place orders from the television key-pad using credit cards or, as the next step, digital electronic money stored in 'smart cards'.

In the parcels business, Parcelforce can feel sure that it is operating in a growing market and one which the new technologies will stimulate rather than threaten.

Counters

The vast majority of counter transactions are concerned with paper items that have direct or indirect monetary value. The exceptions are the acceptance of premium mail on behalf of Royal Mail, and of parcels for Parcelforce. Contrary to what is sometimes suggested, this work is not a vital part of Post Office Counters' business. Parcels accepted at post office counters represent only 6% of Parcelforce's volume¹⁶ or about 12m parcels per year. These 12m transactions compare with an annual total of nearly 1.4 billion transactions yearly at post office counters, or less than 0.09% of all transactions. The volume of premium mail accepted at post office counters may be about the same order of magnitude. From this it can be seen how slight is the often-quoted interdependence of the three services.

Some traditional counter services have dwindled over the years. Postage stamps have been substantially replaced in business by franking machines and by bulk postage printed on the envelope. Postal orders have remained static and, along with cheques, are likely to begin terminal decline as more people use credit cards over the telephone, and remote banking by telephone.

The future of Post Office Counters lies not in handling letters or parcels or selling stamps, but in the business of money transactions. The electronic revolution that is changing the face of banking should apply with equal force to Post Office Counters but to date this part of the Post Office has been shielded from the

revolution by its monopoly of government transactions that account for 75% of all its transactions.

The monopoly serves to explain why Post Office Counters has fallen so far behind the banks and building societies in terms of technology. Until recently counter staff in both main and sub-post offices summed transactions in pencil on scraps of paper. Even pocket calculators were a rarity. Computer screens have now appeared in Crown offices but not in sub-offices. By contrast, for over ten years building societies' counters have had terminals to a central computer where cash withdrawals, deposits, transfers and balances were recorded instantaneously. Ten years ago the banks and building societies were installing networks of automated cash-dispensers, a development that has barely begun in Post Office Counters.

The reluctance of Post Office Counters to move with the times has left it with by far the largest network of offices in the land. This potential competitive advantage has been enhanced in the past five years as the high street banks have closed rural offices and the building societies their agencies. Ten years ago a modest village might have had one sub-post office, typically located in the village store, and 2-3 small bank branches. Now more commonly it has the post office and no banks. The post offices serve an ageing population, for example those who require pension books and cash in hand rather than direct transfer to a bank account; those who require stamps because they do not have a facsimile machine; the very people whom the new technologies have not reached nor ever will.

Post Office Counters cannot escape the effects of the new technologies that will minimize paper, human effort and physical cash as well. At most, it can hope that its monopoly government services will bring temporary reprieve. It is already clear that Post Office Counters could not survive in its present size or shape if its current monopoly services were made available on a competitive basis by the government through the private sector's banking system.

Letters and facsimile

As a medium of communication the letter has five attributes. It is:

- private
- easy to access ~ easy to store
- permanent
- universal

Two new communication media already compete with the letter. The best known, facsimile, has three of the letter's five attributes, lacking privacy and universality. To set against this, the transmission cost of sending a one page facsimile anywhere in the UK is the same as a telephone call of the same

duration. A single-page fax takes under one minute for the first page and about half a minute for each subsequent page, though dense material such as half-tones takes longer. Depending on the time of day, the distance of the called fax machine and the density of the material sent, a single page fax may cost as little as 5p and 5-7 pages might roughly translate into the cost of a first class letter. These transmission charges will continue to fall, while the cost of a first class letter will continue to rise. In terms of cost, immediacy, and certainty of delivery, the fax scores heavily over the letter for documents up to 5-7 pages.

In addition to privacy, a letter still has other advantages compared with a fax. It can have colour, folded sheets larger than A4, and the quality of being the original rather than a copy. These advantages, with the exception of privacy, will be steadily eroded. Inkjet technology will be applied to facsimile machines to produce pin-sharp colour print-outs on plain paper in place of today's curling thermographic sheets in black and white. Just as today a good photocopy is indistinguishable from the original, so within the next few years will be the facsimile.

As the transmission cost difference between a letter and a facsimile widens in favour of facsimile, before long almost every home will have a facsimile machine. Economies of scale and rapidly advancing technology will reduce the capital cost of facsimile machines. By contrast, letter traffic will be unable to meet the price cuts of facsimile and will meet upper limits to the possibilities of mechanization. The volume of traffic will plateau and then decline, thus imposing higher unit costs as, for example, the postman delivers fewer letters in total to the same number of addresses. The letter's privacy will then be its last defence and senders will increasingly question whether this privacy is worth its price.

Direct advertising by facsimile requires no privacy, and will become attractive when transmission speeds increase. At present these are far too slow to handle the volume of pieces that a mail-shot entails and few private houses have facsimile. However, as the penetration of domestic facsimile machines increases, direct advertising by facsimile will transfer from paper in envelopes to paper by facsimile. Thus, the most buoyant section of the letter's market is under threat.

The legal validity of documents sent by facsimile and E-mail may for a time be uncertain, but the legal profession already makes extensive use of facsimile, and documents that require, for example, original signatures and company seals represent only a minimal percentage of letter mail in general and of lawyers' correspondence in particular.

E-mail

Electronic mail, known as E-mail, competes with both the facsimile and the letter. Its capital cost is high. A computer terminal, modem, printer and suitable software in total cost about £1,500 (though prices are falling fast) compared with £250 for a cheap facsimile machine using thermographic paper. The capital outlay on a letter is zero. However, E-mail attacks the letter's primary selling

point, privacy, since to retrieve an E-mail message from its pigeon hole requires a password.

In terms of transmission speed and cost, E-mail is far superior to facsimile or letter. The volume of information that can be transmitted in, say, one minute is limited only by the modem and the connecting line. The transmission speed of these will continue to rise. Since E-mail is initially collected on screen, messages that are ephemeral do not need to be printed at all. Those required for the record can be printed at leisure. In essence, E-mail can replace all attributes of the facsimile, and it provides privacy as well. Further, E-mail messages can be encrypted to prevent interception during transmission.

In addition to the cost of the hardware, E-mail requires a certain level of computer literacy which the facsimile does not. However, today's school children are reared on computers, and the computer screen holds no fears for them. The software has been reduced to the simplicity of clicking a mouse on appropriate icons and in due course even this will be replaced by voice recognition commands. The day is already in sight when the user will simply say to the computer: "What mail is there for me today?" and the screen will immediately show it. Voice recognition will ensure that only the person with the identified voice will receive the E-mail messages. With assured privacy by E-mail, the paper-based letter's major technical advantage will have gone.

There remains the *universality* of the letter. Even in industrialized countries some households are without telephone and so do not have the primary means of connection to the public telecommunication network.

Similar concerns were raised when some 30 years ago the Post Office proposed to abolish the inland telegram service. At that time the penetration of telephones was far lower than today and the letter service was unsuited to 'life or death' urgency. Yet harsh economic logic meant that the cost of having telegrams consisting of a few words delivered individually by young lads on motorbikes rose to the point where the service could not viably be maintained. When paper based letters go into terminal decline friendly neighbours may help out with urgent incoming faxes or E-mail, and the local post-office or corner shop may provide public services for outgoing messages.

Conclusion

History shows that when a new communications technology is invented, it takes some share of the market from existing technologies and at the same time expands the total communications market. The more simple and cheap communication becomes, the more people communicate. The communications market shows no sign yet of being saturated.

A new technology sometimes eliminates an existing technology entirely just as facsimile eliminated telex in one decade. While it is premature to write the obituary of the letter, there can be no doubt that the concept of conveying paperbased information from A to B is archaic. The advantages of conveying

information electronically from A to B and then printing it if need be, are obvious. The letter's current advantages—privacy, universality and the quality and variety of its finished format—will retard its decline but the writing is on the wall. This prospect has been nicely stated by D A Kendall (1994) of the Innovations Unit, Royal Mail Research, Swindon who wrote: "There will be no conscious decision to stop sending mail. Society will fail to see the need for using traditional paper based communications when the alternatives are faster, better, cheaper, more secure and more satisfying to use"¹⁷.

5. Practicability

A model for reform

To summarize the reasons that have been presented in the previous chapters for why the Post Office should be reformed, each of the following statements seems beyond dispute:

- 1) none of the Post Office's main services —letters, parcels or counters —is a natural monopoly;
- 2) all the operations embodied in these three services can be supplied by the private sector, which already does so whenever permitted;
- 3) monopolies are inefficient in economic theory and are found to be so in practice;
- 4) for years the Post Office has wittingly cross-subsidized parcels and possibly other services using monopoly profits from the letter service;
- 5) the counters service has been shielded from competition because 75% of its transactions are monopoly based, and it has fallen far behind the technology of the private sector in money transmission services;
- 6) the UK Post Office is profitable. It provides a level of service that is good but only when compared with other protected, monopoly administrations in the EU;
- 7) letters and counter services face massive competition and change because of the revolution in electronic communication; but
- 8) a single price for mail within the UK is administratively convenient and beneficial for remote areas.

Apart from the last point, the case for reform is abundantly clear. Should the final point outweigh the other seven and prevent reform and if not, what reform is needed?

The three Post Office services are not interdependent. Economic arguments for keeping two or more of the three parts of the Post Office together—Royal Mail,

Parcelforce and Counters—in one corporate structure depend on showing technological or economic benefit for doing so. None is obvious.

The nature of the Royal Mail's operation is to handle flat objects in bulk. The collection, sorting, and final delivery of letters on foot have almost nothing in common with the collection, sorting and final delivery by van of parcels. Possibly, bulked letters in transmission between sorting centres may temporarily acquire the attributes of parcels, but this is only a small fraction of the total cost of transmitting a letter. If Royal Mail intends to continue providing a paper-based letter service, its object must be to find better ways of machine-reading and sorting of letters and of using its unique nationwide door-to-door delivery service to capacity. Its core business is in handling two-dimensional things-to-be-carried made of paper. At the margin it competes with Parcelforce in handling small three-dimensional things-to-be-carried and this competition should be encouraged.

Parcelforce contests its market with numerous carriers who compete on speed of delivery, reliability and security as well as price. It has the benefit of using Post Office Counters' network of 20,000 collection points, but it is hampered by using a uniform, nationwide tariff that cannot reflect, for example, the differing costs between urban and rural deliveries. It already pays Counters for the service they provide as collection points but there is no reason why only Post Office Counters should provide this service. The extended hours operated by small convenience stores suggest that these would be excellent collection points for parcels. They - already sell stamps in books, have scales and would presumably be happy to be a collection point for parcels if it were profitable to do so.

The technology of electronic banking and the movement of funds, which is Counters' sphere, has nothing in common with physically moving letters or parcels.

The logic for separating letters, parcels and counters into three separate services has been recognized and implemented by the Post Office, but has not been taken to its full conclusion by making them separate corporations. The need to do so is strongly reinforced by the history of cross-subsidy between the Royal Mail and Parcelforce, which allows scope for creative accounting. For example, in the Post Office's report and accounts, 1990-91, the following note appears in small print on page 69.

"The analysis of turnover (of Royal Mail and Parcelforce) is derived from measurements of volume of traffic handled by the businesses and from consequential charges where facilities are provided by one business for another....As a result of this reviewincome of £60m which would previously have been apportioned to Parcelforce has been allocated to Royal Mail."

This somewhat opaque statement suggests that over the years parcels' losses have been understated and the subsidy from letters has been that much the

larger. Only the complete corporate separation of the three services will ensure that internal cross-subsidies are eliminated.

Post Office financial controls¹⁸

The Post Office is the last of the cash cows among nationalized industries in the hands of the Treasury. Table 3.4 earlier showed that the amount taken by the Treasury rose from £16m in 1990-91 to £393m in 1994-95. On assets steady at around £2.3 billion, the Post Office earned some £1.4 billion of operating profits over the five years to March 1995. This looks like a respectable 11% average return in current cost terms, but Treasury joy might have been marred by losses of nearly £1 billion in real terms over the same period through the reserves (and hence total gains account).

Post Office accounts are described as being prepared under the alternative accounting rules as set out in the Companies Act 1985, reflecting the effect of changing prices where material and appropriate. In practice this means they continue to follow the defunct SSAP 16¹⁹ current cost accounting conventions, modified, following the introduction of FRS 3²⁰, to show total nominal gains in the new total gains statement. The target rate of return is set at the operating profit level. One of the problems of this form of accounts (as regulators of privatized utilities have generally come to appreciate) is that real holding losses due to price changes (technical progress, etc) are charged to reserves, instead of being treated as depreciation in the profit and loss account.

Figure 5.1 shows that the real profit after financial capital maintenance (FCM) of the Post Office in the past five years has been significantly less than the operating profit in every year, though the gap has been falling steadily. Indeed, in 1990-91 the Post Office made an FCM *loss* of £211m compared with a declared operating profit of £117m.

In the Post Office's case, most of the holding losses appear to relate to property, although it is not possible to detect how much represents the loss of real money spent and how much reflects the unwinding of (unrealized) gains credited in the property boom years. It is not possible, therefore, to suggest how far, or over what period, pricing policy should have reflected these losses. The conclusion may be that the returns on the property investment business should be segregated from the returns on the operating businesses in future so that the profit or loss of the Post Office's trading activity is not distorted or obscured by its accounting practices.

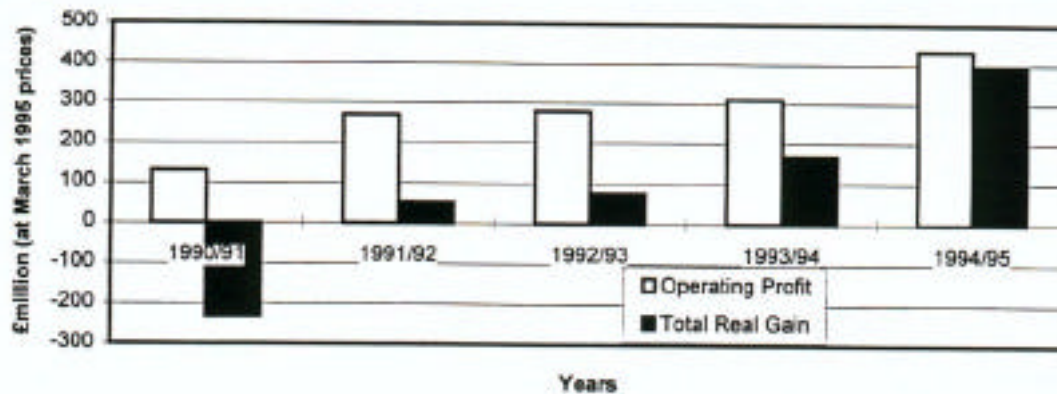
Given the tight Treasury controls on diversification and expansion, the profitability of the Post Office (at least in realized profit terms) is translated into negative external finance limits which cumulated to nearly £600m over this period (out-turns). In the absence of any mechanism for paying dividends, these surpluses in principle show up as the accumulation of financial investments, basically various *loans* to the Government. Given the constant nominal level of capital employed, it is extremely difficult to work out from the accounts where the funds went over the five years. In future, however, at present profit rates of

the order of £400m a year, these investments will build up rapidly. On present accounting policies, the nominal interest receipts from the Treasury will come to dominate the income statement. This is likely further to distort public perception of the profitability of the industry. The moral here is that, in the absence of privatization, the introduction of a more commercial balance sheet, incorporating equity dividend obligations, will become a priority.

Progressive removal of the monopolies

Since 1970 I have argued that the letter monopoly should be removed to enable competing suppliers to enter the market. To do this requires simply that the Secretary of State for Trade and Industry modifies an existing order made in 1981. No new legislation is needed. This order suspended the Post Office's postal privilege of conveying letters providing a charge of £1 or more is made. I propose that a similar order should reduce the minimum price of a competing letter to zero progressively over 3-5 years.

Figure 5.1 Comparison between Post Office's operating profit and financial capital maintenance profit



Without allowing for inflation, the minimum prices might become 75p in 1997, 50p in 1998, 25p in 1999, 19p in 2000 and zero in 2001. An instantaneous elimination of the monopoly has the attraction of simplicity, but government by sudden shock is less suitable than government by orderly transition to a free, competitive market.

A similar approach should be adopted for the removal of Counters' monopoly transactions. The government could begin with one of the smaller monopoly services such as vehicle licences, by permitting banks and building societies to issue licences in competition with Counters. Introducing competition to other services such as the encashment of government national insurance vouchers and pensions, which account for 68% of Counters' monopoly transactions, would come later. Post Office Counters, the banks and building societies would tender to provide these services at a stated unit charge per transaction.

In a medium sized town there is typically one post office and ten branches of banks and building societies. The consumer in this location would have more choice and convenience in cashing state benefits. In rural areas the ratio is probably reversed, with ten rural post offices for every one bank or building society branch. In competing for government business Post Office Counters would have a marked advantage in rural areas and could expect not only to retain this business but to charge the government a higher unit cost than previously for each rural transaction. This would make rural post offices more profitable and would assist their survival so long as government, as an act of political choice, decided that the additional cost of rural cash payments was desirable.

In addition to providing far more sites at which government vouchers can be encashed, the system would have the merit of making the costs of government transactions in each outlet clearly identifiable. The bidding process would produce the keenest possible price to the government, while the difference in price bid for the same transaction but in rural areas would ensure that the rural subsidy was clearly identifiable. This will be more efficient and transparent than maintaining the entire Post Office Counters' structure as a nationalized industry in order seemingly to ensure the continued provision of government services in rural areas.

In progressive steps, Counters' other monopolies would be opened up to competition by the banks and building societies. As with the elimination of the letter monopoly, a transitional period of 3-5 years would be appropriate. It must be stressed that the removal of monopolies and privatization are linked issues. To privatize Royal Mail or Counters while leaving them with their monopolies would give them increased incentives to make profits but without increased competition to curb the monopolies—an unacceptable combination.

A new price structure for all three services

Prices are signals that reflect the willingness of economic agents to undertake transactions in a market. Prices must in some degree reflect the costs to the supplier, but in every economic organization, private or public, some internal cross-subsidization is commonplace. When a company announces 'free' gifts or special price cuts, their cost must be recouped by increased sales of other lines. Within a market in which no supplier has a dominant position, special promotions of this sort are acceptable, not least because they are normally short lived. Further, in a competitive market, prices are set by supply and demand, not by the cost structure of a single supplier. Individual firms may be compelled to cross-subsidize particular goods or activities in order to stay in the market. They are unlikely to do so indefinitely and prefer to review the efficiency with which they provide subsidised services so that either they can make them more efficient or else discontinue them.

When, on the contrary, a major or dominant supplier in a market continually prices its goods or services in a way that does not reflect costs, market distortions

are inevitable. In particular, competing suppliers enter or leave the market on the basis of false market signals.

Since 1840 letters in the UK have been based on a uniform, nation-wide tariff and, with modest exceptions, so has the tariff for the Post Office's parcel service. As seen in chapter 8 of this report, Rowland Hill did not regard a uniform tariff as sacrosanct but simply as administratively convenient and likely to stimulate postal traffic.

The main differences in letter costs lie not in the distance the letter travels but in the nature of the area of collection and delivery. Rural areas entail far higher costs because of the scattered nature of post-boxes and houses. In 1991 Sir Bryan Nicholson, then chairman of the Post Office, said that letters could be delivered profitably in London for half the price of a first class stamp. Conversely the cost of delivering a letter to the Scottish Isles might be £7 per item²¹.

Broadly, there are three ways in which letters and parcels might recover the extra costs of rural collections and deliveries. The first is the one I proposed in 1970. Rural post boxes would have a sign that letters posted in them should bear additional postage. This would pay for the extra cost of rural collection. In addition, people living in rural areas would include a suitable letter in their postal code, indicating that those writing the amount of postage. Such a scheme has become increasingly practicable in the past 25 years. The postal code is now used on 86% of letters. Adding an extra symbol to indicate a rural address would be like adding an extra digit to telephone numbers.

How would Royal Mail ensure compliance in a system under which a letter would attract different tariffs depending on the point of collection and delivery? An effective approach would be to downgrade underpaid first-class mail to second class and to put underpaid second-class mail to the back of the work pipeline. It would be simple and just for underpaid mail to receive reduced quality of service.

Overseas senders of mail to the UK could not be expected to adjust to the concept of a differential urban/rural delivery tariff but this would not be a serious problem. Overseas mail represents 4% of letter traffic. Of this 4% perhaps three-quarters are for urban delivery, requiring no surcharge. Royal Mail could calculate the cost of rural deliveries and recover it as terminal dues from the administrations concerned.

The second way of recovering rural collection and delivery costs is to require rural dwellers to pay a flat or varied fixed sum each year to the postal administration. This method is used in New Zealand. Ideally, individual households would choose whether to have to-the-door delivery but such selectivity could cause complexity—and hence cost—to Royal Mail, the expense of which would have to be borne by households that opted into the service.

The third and simplest way is for an explicit subsidy towards rural collections and deliveries to be paid by the local community from local tax revenue.

Competing mail operators would bid to provide the service, thus ensuring that it is provided as economically as possible. This system is also applied in New Zealand where New Zealand Post, the common carrier, contracts out rural deliveries for an annual fee.

What about rural post offices? As noted in table 3, Counters is closing offices at 1.5% per year. It claims to lose money on rural sub-offices which therefore are vulnerable. An economic solution is that customers at rural post offices should be required to pay a transaction charge of say 20p, which would go directly to the postmaster and would be set by him at his/her discretion. A small post office serving 200 customers a day would gain £10,000 a year. To make the charge more acceptable to frequent users of small and rural offices, the postmaster could issue yearly season tickets or discount cards on the same principle of discount cards for off-peak travellers by rail. These are particularly suited to the elderly and students. They might be priced at £10 to individuals and £50 to businesses, since the latter's transactions are more numerous and take more time at the counter.

If rural postmasters tried to exploit a local monopoly by setting too high a transaction charge, customers could take their postal transactions to a neighbouring post office with lower charges for individual transactions and for season tickets. Post offices would be required to exhibit a tariff of their transaction charges. Enterprising postmasters could spread the load of their custom by making no charge at off-peak hours, say first thing in the morning. This would be attractive to pensioners. A peak charge could be levied in the late afternoon when custom is at its highest.

The aim of Post Office Counters must be to give sub-postmasters the freedom to be enterprising and profitable enough so that the present decline in the number of post offices is reversed. If post offices could set a surcharge reflecting the value that their local communities place on them it is possible that Counters could franchise many more than now.

Sceptics will point to the rise of superstores and the difficulties that they seem to bring for village grocers, but there is a difference. A significant attraction of superstores is the range of choice they offer. Yet village stores still survive, even though they charge higher prices, because convenience is so important to people. Rural post offices have an even greater edge. Counters' services are standard items: the range in an urban post office is no more attractive than in a rural one, so less trade is siphoned into the towns on that score. Meanwhile, the rural post office has the clear benefit of location —convenience and proximity to customers, not having to take the car out, friendlier and more human service, and shorter queues —all of which people find worth paying for.

Unfair to rural dwellers?

Any proposal for differential tariffs based on an urban/rural split immediately arouses the protest that it is unfair to rural communities. The concept of 'social solidarity' is used to suggest that it would in some way be unfair to make rural

dwellers pay more for letter, parcel and post office counter services than urban dwellers.

This approach is based on the unsupported view that rural dwellers in general are poorer than urban dwellers. Virtually all parts of the country, urban and rural, have wealthy and poorer people, often within close distance of each other. The idea that social solidarity requires uniform tariffs for letters, parcels and counter services has much less justification today, when telephones and facsimile machines are increasingly widespread. Moreover, people make free choices about where they live. That choice takes into account a wide range of variables, most of which have a direct price. Housing is priced differently in rural areas. Standard branded items may cost more in village groceries because their sales volume is low. In the hierarchy of human needs, shelter and food rank far above letters and parcels. If the prices of food and shelter are not uniform, why should the rural price of letters, parcels and counters' services be identical to those in towns?

Judgmental arguments are also advanced to suggest that to impose a new cost on rural life will weaken the fabric of rural communities. The suggestion that rural dwellers will migrate to towns if postal, parcel and counter tariffs were to be differentiated from those in towns seems far-fetched. Rural communities have houses with long drives as well as cottages without main drains. Social solidarity should be expressed through general taxation and benefit programmes drawn up by democratically elected politicians. There is no reason why social solidarity obligations should be imposed via Post Office services or that the latter's prices should be excluded from the differing price signals that determine where people live.

The Post Office has elevated its historical practice of supplying the entire country at uniform postal tariffs to the status of a social duty which in turn has justified the retention of its monopolies. The argument is circular and its real purpose is, and has always been, to shut out competition. A clear example was the Post Office's success in suppressing attempts to set up courier services. When its monopoly was removed in 1981 for letters charged at £1 or more, courier services in large numbers sprang into being, proving how the Post Office had failed to identify a significant need in the market. The courier services must be profitable to survive. By contrast, the Post Office's annual report and accounts do not reveal whether its various premier services are profitable or not.

Removal of the monopolies and 'creaming'

The Post Office has always argued, correctly, that if the letter monopoly was removed, private enterprise would at once compete in the profitable parts of the market, notably inner-urban and inter-urban traffic, leaving the Royal Mail with the unprofitable rural traffic. It therefore threatens to discontinue these rural services if its monopoly is removed. For example, the front cover of the Post Office's paper *The need for change* (summer 1994) shows a rural Royal Mail post bus standing outside a village post office with the slogan: "the services you

depend on could disappear". While it is true that private enterprise would first contest those parts of the Post Office's monopoly on which largest profits could be made, it is also true that, as shown in chapter 2, the Post Office for years has 'creamed' profits from the letter service. The 'creaming' argument suggests that the price structure should be rationalized, rather than that the monopoly should be retained. Moreover, the larger private parcel carriers deliver to rural areas as well as urban, proving that it is in their commercial interest to do so.

Competition, privatization or both?

As we have seen, of the three main Post Office services, Parcelforce faces most competition, enjoys no monopoly and has been the least profitable. Royal Mail enjoys a statutory monopoly and has been the most profitable. Post Office Counters has enjoyed an important de facto monopoly of government services and has been moderately profitable. In the light of this, it might seem that to submit the Royal Mail and Counters to full competition in their respective markets would be to ensure losses all round.

Given this fear, to attempt to privatize Royal Mail and Post Office Counters at the same time as removing their monopolies would be to offer potential investors a prospectus marred by uncertainty. Parcelforce, by contrast, could be privatized at any time but would need to eliminate its losses before becoming attractive to investors. Alternatively, it could be sold in its present loss-making state to a more efficient private carrier who could turn it around, as BAe turned the Rover Group into profit.

For Royal Mail and Counters that there should be a number of parallel actions:

- the scheduled elimination of the monopolies;
- the restructuring of Royal Mail's tariffs to enable prices to reflect costs;
- allowing Counters' post offices to introduce individual transaction charges coupled with season tickets for regular users; and
- a commitment to privatizing the three services at the end of the transitional period of 3-5 years.

During the transitional period Royal Mail should retain its obligation of delivery to every address in the land, but it would be relieved of its obligation to provide a universal tariff. It would therefore adjust its tariffs to align them with costs in the knowledge that where it was overcharging, other operators would soon contest that part of the market, attracted by the excessive profits being made there.

For those parts of the service which currently are unprofitable, Royal Mail would introduce new tariffs on the lines suggested earlier. The experience of what is practicable, and the impact of tariff changes on demand for services, will be

learned at a time when Royal Mail can still rely on the final years of the letter monopoly. Then, when the monopoly is removed, Royal Mail will have a tariff structure that reflects costs and will make it able to compete on a level playing field with competitors.

Interconnection to the Royal Mail

It is likely that even after the end of the transitional period Royal Mail will remain dominant in the market for a time and will have to be prevented from squeezing out competition by predatory pricing, for example. This could be prevented by a policy of interconnection. Royal Mail would be compelled to publish a tariff for discrete operations in each area. For example, let us suppose its tariff for collecting and delivering a local letter of 60 grams in a defined urban postal area was 15p, broken down as follows: collection 1p, outward sorting 2p, transfer 1p, inward sorting 2p and delivery 9p. Competitors would have the right to transfer standard letters to Royal Mail, fully sorted and ready for delivery, and to pay Royal Mail 9p for each delivery. Alternatively, local letter services would be set up, charging 15p or less and Royal Mail would be compelled to charge only 15p for a local letter or else lose business. Giving competitors a statutory right of interconnection or of competing would compel Royal Mail to introduce a rational tariff.

In a similar way, Post Office Counters would see its *de facto* monopoly services removed over the transitional period. The government would introduce competition in the provision of these services by allowing banks and building societies to tender for them. This could best be done on a regional basis. Post Office Counters, with its large network of sub-offices and its experience would stand well placed to win much of the business, but, as noted earlier, its counters are still poorly automated and this should enable new suppliers to contest the market.

Public reaction

Changes as fundamental as those suggested above would inevitably produce public anxiety and hostility from those who would have to pay more for the services. To facilitate change in the Post Office and to gain public support it might be necessary for the government to give the following pledges for the transitional period:

- there would be no reduction in the number of post office counters;
- though its tariffs would be allowed to vary, the Royal Mail's obligation for the universal collection and delivery of letters would also be unchanged;
- the prices of each of the three services would be subject to a price-capping formula as discussed in chapter 7; and
- pay increases in each of the three services, including those of senior managers, would be subject to a capping formula.

The business community may have mixed feelings about the changes but would find it hard to argue against a new structure that encourages efficiency and aligns tariffs to costs. The more difficult task would be to gain public support from those isolated rural communities who will feel themselves to be particularly hurt by losing the current benefits of cross-subsidization.

For people in remote communities specific compensation could be offered in exchange for, say, post being delivered one a week only: they would be offered, once only, a free or reduced price facsimile machine to compensate for a reduced postal service. Let us take Sir Bryan Nicholson's figure of £7, quoted earlier, and assume that each dwelling receives two letters per week. Then, if one delivery is made a week instead of six, a simplistic calculation suggests the cost of delivery falls to £1.17 per letter, a saving of £5.83. Fifty letters are delivered in the first 25 weeks producing a saving of £291.50. This would pay for a free facsimile machine and Royal Mail would make a massive return on its investment thereafter

Need for an Ofpost?

Although the letter service is not and has never been a natural monopoly, it would be necessary to establish a regulatory office to ensure a correct transition from a distorted monopoly market, as at present, to a correctly working market in letter and counter services. For this reason it will be necessary to create an Ofpost on the lines of the cluster of existing regulatory offices —for telecommunication, water, gas and electricity. It is unlikely that Ofpost's remit would extend to Parcelforce since, shorn of its subsidy from Royal Mail, Parcelforce will be compelled to stand on its own feet in a highly competitive market.

Since the services provided by Royal Mail and Counters are not natural monopolies, Ofpost's function will be required only for so long as the workings of the market still leave Royal Mail and Post Office Counters with a dominant position. A 50% market share might be considered to be dominance. Ofpost would be needed until the shares of Royal Mail plc and Counters plc fell below that figure in their respective markets.

Conclusion

The concept of universal tariffs for the Post Office's services is the stumbling block which for many years has prevented reform of the Post Office. Where and how we choose to live and all our daily activities are responses to price signals. There is no compelling reason why the price of letters and of counter services should be excluded from our accepted economic system. As discussed, there are several possible ways of reducing the cost of rural mail services that would impose no great inconvenience on rural residents, or which would compensate them for any loss of service quality that arose from adopting a more economical system.

6. Other proposals

The proposals in chapter 5 will inevitably invite discussion. This chapter therefore reviews reactions to the preferred solutions to the Post Office's future, made in 1994 at the time of the government's Green Paper. Although in November 1994 the government dropped its plans to privatize the Post Office, the views of certain organizations can be expected to carry across to my proposals. In each case I state briefly what appears to be the vested interest against which the views of the organizations must be judged.

The government

Politicians have two overriding aims—the election of themselves as individuals, and the election of their party to government. The welfare of their constituents or the country represents the means to these two ends rather than an end in itself.

The government's position in the Green Paper was that it is "...firmly committed to a universal letter and parcels service, at a uniform and affordable price, with a nationwide network of post offices..."²² It continued:

"For Post Office Counters the existing structure is effective and should remain...with greater freedom to widen the scope of services available in post offices...and to automate the post office network".

"For Royal Mail and Parcelforce more radical change is necessary... consistent with the introduction of more competition in the supply of postal services...The best way forward is a private sector partnership with shares owned by the public, the employees and the government".

This position was reconfirmed by Ian Lang, President of the Board of Trade, in the debate in the House of Commons on 7 February 1996. However, on 7 May 1996 the Financial Times reported that the government would include a pledge in the next Conservative party manifesto to privatize the Post Office, possibly entailing the break-up of its three businesses as a way of enhancing revenue from the sale and allaying fears over competition.

The Opposition's position at the time of the House of Commons debate was that "the government should safeguard the uniform access and uniform pricing of this country's postal services; ...and is of the view that British customers will continue to have the best opportunity of enjoying this standard of service only if the Post Office remains as a single corporation within public ownership."²³

Using the analysis of the preceding chapters, it has been seen that it is correct to separate Counters from the other two services, but there is no case for maintaining a money-transmission service in public ownership.

The government's proposal to keep Royal Mail and Parcelforce together is deeply flawed. As shown in chapter 3, parcels have made substantial losses for many years and have been subsidized by the letter monopoly. The Green Paper's proposal to impose the universal service at uniform tariff on a privatized Royal Mail and to maintain the letter monopoly was wrong in every way: from the point of view of competition, efficiency, cost allocation, pricing and survival against the onslaught of the IT revolution.

The Green Paper's proposals at best were a step in the right direction, but failed to address the main issue: letters, parcels and counters are not natural monopolies. The overlap of their business is minor and could continue as at present with arms' length payments made for services rendered.

Post Office management

Post Office managers, like those in the private sector, have the principal aim of securing their jobs and enlarging their salaries. Increasing the retained profits of the Post Office is the primary means to these ends.

The Post Office's management's view on the Green Paper is given in *The need for change*²⁴

"The Post Office welcomes the government's decision to keep Counters in the public sector, with the freedom to do a wider range of activities for private sector clients..."

"The government's preferred option...to sell 51% of the shares (in a combined Royal Mail and Parcelforce) has other big attractions...The Post Office would fully support the 51% option if the government decided to press ahead with it..."

These views conform to expectation. Managers in Counters saw a future in which they had the comfort of the monopoly services, more freedom to automate and diversify, while knowing that, as a nationalized industry, the government would always be there to pay the bill if things would wrong.

The views of the management of Royal Mail and Parcelforce are also coherent. As a semi-privatized industry, they would no longer be required to pay the negative external financing limit, thus potentially releasing more funds for investment in the business and, of course, for higher salaries as well. However, the valuable letter monopoly would be maintained as the *quid pro quo* for continuing to provide a universal service at a uniform price.

The Post Office management's view can be summarized as wishing to enjoy the benefits of maintaining the monopolies, having more commercial freedom but without significantly increased competition.

Post Office Users National Council

The 1969 Post Office Act established the Post Office Users National Council (POUNC) together with country councils for Scotland, Wales and Northern Ireland. POUNC is funded by the Department of Trade and Industry and its function is to represent the interests of users of the Post Office. It produces annually a *User audit and review of the Post Office* and other reports when necessary.

POUNC exists to represent the interests of users and is financed by a grant from the Department of Trade and Industry. As a quango POUNC could not be expected support a change to the system that might make it redundant.

POUNC report on government's Green Paper (29 September 1994) states:

"POUNC...has no particular views on the principle of privatization... POUNC does not consider that any option, and particularly the government's preferred option, can be endorsed on behalf of users without further debate...Further consideration should be given to keeping all three Post Office businesses together as a single entity."

If there is no change to the present arrangements, POUNC clearly could expect the continuation of its functions and grant, whereas if an Ofpost were created, POUNC would probably be redundant.

The Mail Users' Association

The Mail Users' Association (MUA) represents about 50 of the largest commercial users of mail services. It is a lobbying group and does not publish its members' names. Its primary aim is to obtain the best possible postal services at lowest possible prices.

The MUA "concur[s] with the view...that the status quo in our nation's postal service cannot continue without that service deteriorating in terms of quality, efficiency, price and range"²⁵. Surprisingly, the MUA continued:

- "the MUA considers that ownership of the service is not the key issue at the present time and that therefore the Green Paper is largely irrelevant..."
- "The Green Paper...fails to properly define the universal service or the reserved area"²⁶.
- "arguments...favouring a change in ownership are inadequate and the case for such a change is unproven..."

- "Post Office Counters is an integral part of the postal service indivisible from, and a valuable model of public/private sector partnership which could be equally well applied to other parts of the postal services whilst maintaining their universality".

The MUA pointed out that proposals contained in the Citizens' Charter had not been implemented, notably reducing the present £1 monopoly limit closer to the price of a first class stamp.

The confusion inherent in the MUA's arguments lay in suggesting both that change is needed and that the status quo should be maintained. The MUA supported the view that the Post Office should be allowed to diversify, modernize, invest and raise funds in the open market yet at the same time remaining a nationalized industry. No mention was made of the fundamental principle that nationalized industries cannot be allowed to raise funds in the open market, diversify and behave like private concerns because governments cannot permit them to become insolvent. Nor did the MUA mention the cross-subsidy from letters to parcels.

The MUA's conclusion was to suggest the establishment of a task force of users and service providers "...to define the minimum acceptable universal service which the postal service must provide...and the extent of the reserved service or monopoly area necessary to finance the universal service. The findings of the task force would, if accepted, form the statutory guidelines to which the proposed independent regulator would adhere".

It is inconceivable that a task force would achieve any such results least of all if, as the MUA advocates, at some future point a second (or third...) universal service provider should be licensed.

Communication Workers' Union

The reason for the CUW's existence is to preserve the jobs and enhance the pay of its members.

The CUW opposed privatization, claiming that it would lead to 50,000 jobs being lost²⁷ Or 27% of the Post Office's 186,000 staff.

Redundancies in any organization occur for the following reasons, singly or in combination:

- efficiency gains;
- reduced demand for the output concerned;
- the pursuit of increased profit margins.

On the postal side, it is perhaps unlikely that major productivity gains are possible. Sorting offices are well mechanized and 65% of mail is sorted automatically at centres nationwide. While there remains a significant balance that in theory could be machine sorted, the machines can handle only flat letters so bulky 'letters', newspapers and magazines must be excluded. Further, sorting does not alter the need for hand delivery, still the most expensive part of a letter's costs. The computer reading of addresses is yet to come but the problems of machine-reading hand-written addresses are formidable. The number of staff who currently read the address once and encode the envelope with phosphor dots for subsequent mechanical sorting is small. Replacing them by computers is a technical rather than a commercial challenge.

Falling demand for postal traffic is likely but has not yet occurred. Table 2 showed that overall demand has grown at 2.7% per year for the past five years. This may not continue, and indeed the Post Office pointed out that "...social and meter-franked mail, which accounts for 75% of the total, declined last year —the first time for a decade —and worryingly, the rate of decline is increasing this year"²⁸. The Post Office estimates that 1,500 Royal Mail jobs could be threatened for every 1% of mail business lost. Therefore, if jobs were to be lost from falling traffic only, the CUW's estimate suggests that traffic will fall by 33%. In the light of table 3.2, this seems most implausible in the next 3-5 years. If there were competing services, Royal Mail traffic might in due course fall by such an amount, but compensating jobs would be created by the other operators.

Shorn of its monopoly, a privatized Royal Mail would indeed maximize profits. The CUW's estimate that the payroll could be cut by 50,000 jobs would be possible only if currently there is massive over-employment of staff.

National Federation of Sub-Postmasters

The National Federation of Sub-Postmasters is another union whose function is to look after the jobs and pay of its members. Predictably it "...welcomes the proposal to leave the counters business in the public sector, with Post Office Counters Ltd granted much greater commercial freedom to seek new business"²⁹. The Federation also sought:

- no significant change to the nationwide network of post offices;
- clarification that the size of the network will not attract monopoly regulations which could restrict its commercial freedom;
- assurances that the counters business would not be asset stripped to benefit Royal Mail and Parcelforce.

Like other organizations quoted above, the Federation wanted the best of all worlds: more commercial freedom, a continuation of the valuable monopolies and the comfort of nationalized industry status.

The public

Who represents the public's view on reform of the Post Office? POUNC is intended to do so, and its document *The future of postal services*, 29 September 1994, includes a list of concerns expressed by users in responses to POUNC. First on the list in appendix 2 is "no need for privatization". Another 42 stated concerns follow but no mention is made of how the survey was carried out or how the questions were phrased.

According to a Gallup survey published in the Daily Telegraph in May 1994, more than 66% of respondents believed that privatization would result in a poorer service, only 14% thought that postal services would improve as a result of privatization, 82% expected costs to rise, 81% expected smaller post offices to close and 48% expected second deliveries to cease³⁰.

The perception that quality of service would suffer under a privatized Post Office is considered in more depth in a study by London Economics (1994), paid for by the CUW³¹ which concluded:

"Overall the evidence suggests that transfer to the private sector has not provided an incentive for improved quality of service, but that the regulatory environment has been largely responsible for any improvements in the quality of service among the privatized monopolies".

"...Privatization is not the driver of improved...quality of service"³².

This conclusion is too general since it is based on comparing data for the Post Office's quality of service against just two other privatized industries: water and regional electricity distribution. Both these are natural monopolies so London Economics' conclusion does not readily transfer to the case of the Post Office whose monopolies are institutional and not natural.

European Commission

In December 1995 the EC published a draft notice³³ and a draft directive³⁴. Both documents give considerable emphasis to liberalization and to the "gradual opening-up of the market". Although the documents lay down rules to enable the existing monopolies to continue, there is radical advance in the Commission's thinking:

- "consumer protection does not make it necessary to restrict freedom to provide postal services, since this objective can also be attained through free competition..." (Notice, para 3.3);
- "collection, sorting, transport and distribution should therefore be considered distinct markets, as they meet distinct needs" (Notice, para 4.5);
- "A recent report prepared for the Commission...demonstrated that...postal operators, where they are granted special or exclusive rights, let the quality of

the service decline...The exclusive rights of the postal organizations favoured this fall in quality, since they prevented other companies from entering the market...The postal organizations failed to compensate for wage increases and reduction of the working hours by introducing modern technology...and in many instances they omitted to take necessary steps to improve service quality";

- "The operators...should not use the income from the reserved area to crosssubsidize activities in areas open to competition..."(Notice, para 5.6);
- "...direct mail should, in principle, be excluded from the services which may be reserved..." (Proposal for a directive, preamble point 17).

However, far and away the most significant aspect of both documents is that both refer to 'affordable' prices but neither refers to standardized or uniform prices. Indeed the Proposal gives a succinct statement pointing in the opposite direction.

"...in order to ensure sound management of the universal service and to avoid distortions of competition, the tariffs applied to the universal service should be objective, transparent, non-discriminatory and cost-based".

Having accepted that collection, sorting, transport and distribution are separate markets and should be cost-based, the way is open for two proposals that are fundamental to my proposed reform of the Post Office:

- the right of interconnection; and
- differential pricing.

Even the future of the existing monopolies may be under a time limit:

"A general re-examination of the scope of the reserved sector is scheduled for the first half of the year 2000" (Proposal, preamble point 19)".

Should the directive be enacted without significant amendment, the impact on the UK Post Office, and even more so on some other EU administrations, will be vast. Cross-subsidies between letters (the 'reserved' service) and the competitive services, notably parcels express services, will be illegal. Direct mail may cease to be a 'reserved' service. The pricing of the reserved service will have to be transparent, and interconnection may become mandatory.

Not surprisingly, the British Post Office, and possibly other EU administrations, are concerned about the potential loss of monopolies.

"The Post Office remains deeply concerned about the proposal to remove direct mail and inward cross-border mail from the reserved area"³⁵... "The

Post Office of the United Kingdom is profoundly concerned by the way in which the draft Notice goes beyond the draft Directive in making assertions about the scope of what may be reserved³⁶.

This is hardly surprising. To lose the monopoly of direct mail could mean the loss of monopoly on first class mail also. Direct mail is invariably sent at bulk rates as second class mail. If private concerns can carry mail at a cheaper rate than first class mail, 62% of Royal Mail's domestic letter business will be at risk of competition. Assuming that private carriers gave better service, cheaper prices, or both, some first class mail would switch to second class mail. The volume might be substantial.

The EC's radical proposals, however, would be retrograde in replacing the distinction between first class and second class mail with one based on the contents of the thing-to-be carried. Direct mail is defined as: "an item of correspondence consisting of the same message and sent to a significant number of addresses for advertising or marketing purposes³⁷. It is unnecessary to stress yet again the illogicality of basing the rules concerning things-to-be-carried on their contents. If the EC directive becomes law, this point will set the clock back in the UK by 30 years. Indeed, in order to protect its monopoly of the first class letter the Post Office would be forced to monitor the content of 'direct mail' sent by private carriers to ensure that the contents of each mailing were the same. This would be difficult in practice and would amount to a new form of censorship. Even Ofpost might be unhappy at having to take on such a task.

Developments in other countries

Although the position of the British Post Office is currently on hold, developments are taking place elsewhere. The post offices of the Netherlands, New Zealand and Singapore have already been privatized. Canada Post is under a thorough review prompted in particular by complaints from courier companies about unfair competition. Post Danmark is to be set up as an 'independent public activity' similar in many respects to a limited liability company. France's La Poste has developed a network of subsidiary companies and shareholdings to meet competition. In Germany, Postdienst is a public limited company, investing in new products including facsimile and electronic mail³⁸.

The significance of these developments is that the British Post Office, widely regarded as one of the best in the world, must in future compete not only with the technological revolution and domestic suppliers from the private sector, but also with other postal administrations that may encroach further on the British market. For many years the British public has been receiving direct mail originating in the UK yet with envelopes printed 'Port pay'e Amsterdam'. This is bulk mail that has been transported out of the UK and then back in again to take advantage of favourable Dutch tariffs.

Conclusion

As noted earlier in this chapter, the government and the opposition parties still favour universal tariffs and the continuation of the monopolies, yet these may have to be abandoned by 2000 under the EC's proposed directive. Clearly, with such momentous changes potentially being forced upon the British Post Office whatever government is in power, any attempt to maintain the status quo is the worst possible option. Rather, the Post Office should be given a clear timetable, on the lines suggested earlier, to prepare itself for the changes that logic, the advance of technology and the European Commission jointly will compel upon it.

7. Winners and losers

Change invariably produces winners and losers and the privatization of the Post Office on the lines suggested in this report will do so. Who will be the winners and losers?

The Treasury

As noted earlier, the Post Office's cash surplus, known as the (negative) external financing limit, is compulsorily invested in government bonds. In 1994-95 the EFL was £235m and as seen in table 3.4, it has been growing rapidly.

The three privatized former Post Office services would pay dividends but no EFL. The value of these would be set by the directors instead of by the Treasury and might be far less than EFL. In short, under privatization, even if the Treasury remained a 49% shareholder as was mooted in the 1994 Green Paper, it would still lose a significant part of the value of the future cash flow it could have expected from the EFL. To set against this, at the time of privatization the Treasury would obtain a further, one-off gain to compensate it for the loss of EFL.

Post Office staff

The Royal Mail is already shedding staff (table 3. 2) and its future wage bill should rise no faster than wages generally. From experience with previously privatized industries we must expect, however, that after privatization senior managers salaries will increase.

In the transitional period of 3-5 years while the three services prepare for full competition and ultimate privatization, managers can be expected to seek ways to make their services more efficient. Some part of these efficiency gains should be passed to staff at all levels in the form of increased pay and other rewards for it will be important to give all staff the incentive to accept the necessary changes. Ofpost should be mandated by the government to devise a formula connected to the retail price index. Price increases charged by three services would be constrained to the retail price index minus a given percentage (RPI-X). Pay increases would be required to come from efficiency gains. Thus the services would first have to reward customers with lower prices and only then reward themselves from the balance of their efficiency gains.

Following the introduction of competition and privatization, Ofpost's role would diminish. When a fully competitive market came into being Ofpost would become redundant. Prices and pay in the three companies would be determined by market forces.

The experience of other privatized utilities the drive towards efficiency has entailed staff redundancies. In the case of the three Post Office services, these might be a lower proportion than have occurred in other services such as BT, British Gas and the electricity industry. Letters, for the time being at least, enjoy a moderately growing market for second class mail. Redundancies through greater efficiency cannot be ruled out, but redundancy from technical advance will play a lesser role.

Given the rising market for parcels, staff numbers in Parcelforce could be expected to increase provided that Parcelforce held its market share. If Parcelforce loses market share, some of its redundancies will be compensated by new jobs created by competitors. The overall effect on employment is likely to be a modest rise in this growing but low technology sector.

In the privatized Counters, much would depend on whether the differential tariff system suggested in chapter 5 led to an increase in the number of post offices and hence jobs. Working in the opposite direction on staff numbers would be the potential efficiency gains that in the banking sector generally have seen significant redundancies in staff.

Courier companies, parcel carriers and document exchanges

In the transitional period during which the minimum price of the monopoly letter will be reduced to zero, existing courier companies, parcel carriers and document exchanges will increase the letter traffic they carry. For the first two years the increases will be small because a significant price differential will remain between the price of the Post Office's first class letter and the minimum tariff. However, in the third year, when the minimum tariff falls to 25p the entire first class letter service will be contestable and a year later second class mail will be also.

It remains to be seen whether the business of the courier companies and document exchanges suffers under the IT revolution. They too are in the business of carrying physical paper. If the information in the paper they carry continues to be of high value, time-sensitive and unsuitable for transmission by e-mail or fax, they will benefit by the removal of the letter monopoly.

Urban and rural postal users

It is self-evident that rural collections and deliveries of letters are more expensive than urban because the number of items that can be dealt with per man-hour is lower. The same logic applies to rural counter service. The proposals put forward in chapter 5 for adjusting tariffs in line with costs would therefore entail lower charges for urban dwellers and higher charges for rural communities. All other

things being equal, rural dwellers will become worse off in monetary terms as the hidden subsidies disappear.

Of course, all other things are not equal. If the market is liberalized and price signals are allowed to work, both the public and service providers will find ways of mitigating the effects of the subsidy's removal. As noted in chapter 5, Royal Mail might find it cost-effective to provide fax machines in isolated dwellings in return for making less frequent deliveries of mail. In rural communities people might prefer to rent post-box numbers to save the additional premium payable by those sending them letters. Some rural users, particularly businesses, might join together to take all their outgoing mail to the nearest urban area to benefit from the lower posting tariff. Such developments will be the normal responses of people in a market.

Conclusion

If restructuring tariffs and abandoning 150 years of tradition of universal tariffs simply eliminated cross-subsidies between urban and rural customers and produced a zero net gain to the public, the exercise might be seen as equitable but not worthwhile. However, it is certain that there would indeed be efficiency gains within the Post Office's existing services taking the form of increased quality of service and choice. In the transitional period Ofpost would ensure that the benefits of these gains would be shared between users, staff and the Treasury. Thereafter, the market would determine the allocation of efficiency gains.

The analysis in this report is based on the view that suppliers of goods and services give their customers best value for money when facing competition, and that the Post Office is no exception. At a time when monopolies are being systematically dismantled and privatized in the UK, the EU and elsewhere, it seems hard to find reasons why Royal Mail's letter monopoly and Post Office Counters' monopoly of government transactions should be retained. It is even harder to find one persuasive argument to support the subsidy of Parcelforce by Royal Mail.

To set the Post Office free from the Treasury will require political vision and commitment. The most telling example that a reforming government should cite is British Telecom (BT). The benefits to consumers in terms of increased quality of service, choice and falling tariffs are clear to all. The Post Office should look to the example of BT, its former offspring who grew up and left home, as a role model.

8. What Rowland Hill actually proposed

Rowland Hill was the visionary who proposed the penny post in 1837, overcame extensive opposition to it, saw it enacted in 1840, and later became Secretary to the Post Office. The proposals in this report lie surprisingly close to his. All quotations in the present chapter are from his famous treatise: *Post Office reform: its importance and practicability* (1837).

Did Rowland Hill advocate a uniform tariff for universal service?

No, he did not. "I therefore propose that the charge for primary distribution, that is to say, the postage on all letters received in a post-town, and delivered in the same, or any other post-town in the British Isles, shall be at the uniform rate of one penny per half ounce" (p27). (His emphasis.) The key point here is that the universal charge of one penny did not include the secondary distribution of letters from the post town as a centre "...to places of inferior importance. In the present state of things, the secondary distribution of letters is in some places a source of loss. This appears to me to be undesirable: every branch of the Post Office ought, in my opinion, to defray its own expenses..."(p38).

He then went further and specifically rebutted the concept of a universal tariff irrespective of terrain. "...a limit must be drawn somewhere. No one would contend that letters are to be distributed at the minimum rate over a district such as may be found in many parts of Scotland and Wales, and even in some parts of England, where many people in the receipt of letters live two or three miles asunder"(pp38-39).

What was his solution? Precisely that rural communities should pay additionally rather than be subsidized by urban. "Let the inhabitants of any district...or other recognized authority, be entitled on paying in advance a small annual fee to the Deputy Postmaster of the town to which their letters are dispatched, to require that a bag shall be made up for the district; and let them arrange for fetching and carrying the bag, and for the delivery and collection of letters; charging the expense, which would be very trifling, upon the parochial rates, or upon each letter, as may be most convenient" (p40).

Thus Hill proposed either a block contribution to be made by the local authority through local taxation, or individual payments for each letter received. However, he added that payment for secondary distribution should "...be so managed as not, in any degree, to interfere with the simplicity of the arrangements proposed for effecting the primary distribution"(p44).

Hill further proposed that the first weight step for local mail should be 20z instead of half an ounce, a further way of making the tariff reflect costs (p29). He also remarked that "...it is perhaps not desirable that the Post Office should be encumbered with heavy parcels"(p27). Given the Post Office's perennial loss on its parcel service, how prescient he was!

The lagging Post Office and a technological revolution

Hill's perception of the Post Office's basic problem was this: "The Post Office has too generally lagged behind other institutions in the progress of improvement... For many years, while other institutions have been rapidly improving, the Post Office has again been nearly stationary and...is, at present, lamentably inefficient".

Had he been with us today, Rowland Hill would no doubt have cited the dramatic growth of national and international courier services, which for years the Post Office tried to suppress, the surge of independent operators during the postal strike of 1971, and the failure of Post Office Counters to automate as indicators of the Post Office's propensity to be "nearly stationary". Hill's paper was written against a background of an unfolding technological revolution. "The rapid extension of railroads now going on would of itself, in a short time, inevitably work a revolution in the system of the Post Office"(p45). The railway revolution was to benefit letter mails for the next 150 years. The technological revolution described in chapter 4 is set to destroy the letter mails in about 15. So his advice in 1837 carries even greater urgency today: "Let other independent changes then be made, while there is time to effect them"(p45).

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Notes

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- ² Institute of Economic Affairs, London, research monograph 38
- ³ Notice 95/ C322/03, Official Journal p3
- ⁴ CoM(95) 227 final, Official Journal C322/22
- ⁵ Senior, I.S.T., *The postal service: competition or monopoly? IEA background memorandum 3*, pl2
- ⁶ *Op cit*
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- ⁸ Private communication from BritDoc to author, 7 October 1994
- ⁹ Official Gazettes, 20 November 1981
- ¹⁰ General licences issued on 17 September, 1993
- ¹¹ Albon R., *The future of postal services*, IEA research monograph, chap 4.
- ¹² Senior I.S.T., *Liberating the letter: a proposal to privatize the Post Office*. IEA research monograph 38, 1983, p29
- ¹³ Source POUNC review of the Post Office, 1994, report no 56, August 1995 p39
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- ¹⁷ Kendall D.A. 2020: *the vision of the future in postal technology in Mail systems 2000: Proceedings of the Institution of Mechanical Engineers' international conference: Institute of Mechanical Engineers 1994-5*, pl91
- ¹⁸ For this section, the author is indebted to his colleague Graham Houston at National Economic Research Associates, London
- ¹⁹ Statement of standard accounting practice 16
- ²⁰ Financial reporting standard 3
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- ²² *The future of postal services Cm 2614, June 1994*
- ²³ **Mrs Margaret Beckett, Hansard, 7 February 1996, p 394**
- ²⁴ *Op cit*
- ²⁵ *Response to the green paper "Future of the postal services", 29 September 1994*
- ²⁶ **"Reserved area" is a euphemism for monopoly**
- ²⁷ **Alan Johnson, general secretary, quoted in *The Independent*, 19 May 1994**
- ²⁸ *The need for change, op cit, p1*
- ²⁹ *Response to the consultative document on the future of postal services, 30 September 1994*
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- ³⁷ *Proposal for a European Parliament and Council Directive, op cit*
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