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Dear Mike,

Financial implications of quality of service failure due to industrial action – 2009-10

This letter sets out Postcomm's response to Royal Mail's request that the Bulk Mail Compensation Scheme be suspended and the C-factor be adjusted where industrial action, caused by Royal Mail transforming its business, leads to quality of service failures in 2009/10.

In this letter –

'the C factor' means the customer service quality factor within Royal Mail Group Ltd's price control, set out in Condition 21(12) of the Licence, providing for an automatic adjustment, of up to 5%, of allowed revenues in a Formula Year for its stamped and metered mail, outbound international Airmail and Surface mail, and Standard Parcel products if Royal Mail Group Ltd's performance exceeds certain targets for those services, in that Formula Year.

'the Bulk Mail Compensation Scheme' means the provisions (excluding paragraphs 3 – 13) of the Standards of Service Compensation Scheme of Royal Mail Group Ltd annexed to the determination of the Commission dated 7th October 2003, in respect of which Royal Mail Group Ltd is obliged to meet its obligations by virtue of Condition 4(15) of the Licence.

'2007-08' is the year 19 March 2007 to 16 March 2008.

'2008-09' is the year 17 March 2008 to 22 March 2009.

'2009-10' is the year 23 March 2009 to 21 March 2010.

'Royal Mail' means Royal Mail Group Ltd, the company registered in England and Wales as company number 4138203.

'transformation' is defined at Annex 1 of this letter.

'strike action' means the refusal by Royal Mail staff to work their contracted hours, which results in Royal Mail not paying those staff for time that they are contracted to work.

This letter is necessarily forward-looking, based on the information Postcomm currently has. It is designed to give Royal Mail an indication of the likely exercise by Postcomm of its discretionary powers, in the event that certain events occur. It should not, however, be read as a definitive statement of future action. Postcomm cannot so fetter its discretion as to be unable to exercise its statutory powers properly and in accordance with its statutory duties.

Background

In June 2007, Postcomm sent Royal Mail a letter setting out the decision it was minded to make in relation to Royal Mail's request to suspend the Bulk Mail compensation scheme and adjust the C-factor where transformation-related industrial action caused Royal Mail to fail quality of service targets in 2007-08.

Postcomm was minded to decide that, except in the light of exceptional circumstances, the Bulk Mail Compensation Scheme should be suspended and the C-factor adjusted where Royal Mail demonstrated that the industrial action in relation to which it sought relief:

- arose as a result of carrying out a transformation activity and not for some other reason; and
- had a direct causal link to quality of service failures.

At the end of 2007-08, Royal Mail submitted its application for relief and Postcomm held an Open Meeting at which stakeholders were invited to share their views on Royal Mail's application. After considering stakeholder input and advice from consultants, Postcomm made a decision to largely accept Royal Mail's application and to grant relief accordingly.

In April 2008, you wrote to Postcomm asking for a repetition of the arrangements that were in place for 2007-08. Postcomm provisionally agreed to that request in August 2008, subject to the consideration of a number of factors at the end of the year, should Royal Mail make an application for relief. Royal Mail made no such application, so Postcomm did not consider giving any relief for industrial action-related quality of service failures in 2008-09.

In February 2009, you wrote to Postcomm again, once more asking for a repetition for 2009-10 of the arrangements that were in place for 2007-08.

Postcomm's position

Postcomm has considered your request and has sought views from other stakeholders on its 'minded to' decision to provisionally agree to Royal Mail's request. Stakeholder responses to Postcomm's consultation letter are on our website.

Postcomm has taken into account Royal Mail's financial position and the fact that it considers that there is a significant risk of strike action being taken in 2009-10 in relation to Royal Mail transforming its business. We are also mindful of the need for

Royal Mail to transform its business and consider that Postcomm should facilitate this transformation. We are aware that quality of service failures caused by strike action in 2009-10 could have a significant adverse impact on Royal Mail's finances.

Bearing in mind Postcomm's duties:

- to exercise its functions in the manner best calculated to ensure the provision of a universal service;
- to further the interests of postal users, wherever appropriate by promoting effective competition between postal operators; and
- to have regard to the need to ensure that licence holders are able to finance the activities authorised or required by their licences,

Postcomm considers that it is necessary for Royal Mail to continue to transform its business and that it is appropriate for Postcomm to facilitate this transformation. If transformation causes strike action in 2009-10 it may be appropriate for Postcomm to grant Royal Mail the relief it has requested. In taking this view Postcomm has had regard to:

- the need for Royal Mail Group Ltd to achieve greater efficiencies in a market where overall volumes are declining and where it faces threats from electronic media;
- the likely impact of quality of service failures on mail users, bearing in mind the impacts on mail users in 2007-08;
- the likely impact of a suspension of the compensation arrangements for bulk mailers and adjustment to the C-factor arrangements for retail users; and
- the extent to which other operators may be affected if the request is granted.

Postcomm's provisional decision in relation to Royal Mail's request is therefore that the Bulk Mail Compensation Scheme should be suspended, and the C-factor adjusted, where Royal Mail demonstrates that strike action (but not other forms of industrial action) in 2009-10:

- arose as a result of transformation and not for some other reason; and
- has had a direct causal link to quality of service failures in 2009-10.

A final decision will not be taken until after the end of 2009-10. In taking its final decision, Postcomm will consider a number of other factors which could determine, fully or partly, the relief given to Royal Mail. These are likely to include, but not be limited to:

- demonstration by Royal Mail of reasonable efforts to avert and mitigate the effects of strike action;

- the effectiveness of Royal Mail's communications with customers during periods of disrupted services;
- any cost savings made by Royal Mail during strike periods, for example those made by not paying wages to striking staff;
- demonstration of progress made by Royal Mail in transforming its business, and the consequent benefits to customers;
- demonstration by Royal Mail of an appropriate link between employee incentive payments such as bonuses (including Directors' bonuses) and quality of service during the year; and
- the reliability of quality of service figures used in Royal Mail's application for relief.

Royal Mail will need to submit an application for relief at the end of the year, as it did in relation to the year 2007-08, including such evidence as it considers supports its case for relief. In making that application, Royal Mail should have regard to Postcomm's decision in relation to Royal Mail's 2007-08 application. In particular, Royal Mail should have regard to the length of post-strike 'recovery periods' considered reasonable by Postcomm and the expectation that Royal Mail can learn from its 2007 experiences to reduce the recovery periods needed in 2009-10. For the avoidance of doubt, Postcomm does not consider it necessary for Royal Mail to submit an interim application.

Royal Mail should ensure that the methodology or models employed by it when calculating the impact on quality of service of industrial action caused by transformation activities and other general events affecting its business have been assured by an independent assessor. Postcomm intends to convene an Open Meeting to consider Royal Mail's application and expects Royal Mail to participate in it.

You should note that the list of relevant factors above is not intended to be exhaustive. Postcomm may seek whatever evidence it considers is relevant to its decision and will expect Royal Mail to provide that evidence promptly. In addition, as with 2007-08, the Commission will exercise the judgement it deems appropriate in reaching its decision.

Yours sincerely,

Sean O'Hara

Director, Universal Service and Customer Protection

Annex 1 – Definition of transformation in 2009-10

Where the activities listed below, and their component activities are undertaken:

- Solely or primarily for the purpose of the longer-term improvement in Royal Mail's operational efficiency or financial position,
- With a view to consequent improvements in value for customers or in security of services,

they constitute transformation for the purposes of this letter.

Automation: including walk-sequencing national deployment, IMP refurbishment, LSM and CFC replacement, automation utilisation, and automation pilot studies.

Working practice revisions: including Delivery Best Practice 2009/10, Delivery Operations Productivity System and changes in staffing arrangements and delivery methods, tools and arrangements.

Mail Centre and Delivery Office rationalisation

Pension Reform: including increasing the normal retirement age from 60 to 65.

Transport efficiency maximisation: including vehicle telemetry and introduction of digital tachographs.

For the purposes of this letter, strikes directly relating to transformation as defined here should be taken to constitute transformation-related strikes.

Annex 2 – Process for applying for relief

- 1) In order to be granted relief, Royal Mail will need to submit an application at the end of the year setting out:
 - The strikes in relation to which it seeks relief;
 - The adjustments it is seeking to:
 - the amount of compensation it must pay to bulk mail customers for quality of service failures during the year, and
 - the amount of revenue Royal Mail is allowed because of its quality of service performance during the year.
 - Evidence that the strikes were caused by transformation and not some other factor.
- 2) In preparing its application, Royal Mail should have regard to the format of application agreed with Postcomm for 2007-08. It should seek to address the kind of questions that Postcomm and stakeholders raised in relation to that application, and should consider the kind of evidence that Postcomm accepted and did not accept as adequate in relation to that application.
- 3) The application should also seek to address the factors that Postcomm has listed in this letter as examples of the issues that Postcomm may take into account in making its decision on whether, and the extent to which, Postcomm should grant relief to Royal Mail for 2009-10.
- 4) Postcomm expects that Royal Mail will submit any application it wishes to make, subject to end of year quality of service and revenue adjustments, by 30 April 2010.
- 7) Postcomm may require additional information from Royal Mail and other parties before making a decision. It will also convene an Open Meeting, similar to that held in 2008, within one month of receiving Royal Mail's final application.
- 9) Postcomm will seek to make a final decision in relation to Royal Mail's application within three months of receiving that application.
- 10) Postcomm may vary this process at its discretion to take account of the circumstances.