Part 13

MT

Confidential Filing

Future of the Post Office and British Telecom
Mercury Communications
Telecommunications Policy

In folder attached: Duopoly Review: Draft consultative document

POST AND TELECOMMUNICATIONS

Pt 1: May 1979

Pt 13: July 1990

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~9.7.90~~							
~~12.7.90~~							
~~20.7.90~~							
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~~15.11.90~~							
12.2.91							
Part Ends							

PREM 19/3509

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PART 13 ends:-

HHH to Sarah Hogg 28.2.91

PART 14 begins:-

SS/DTI Statement 5/3/91

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SARAH HOGG

28 FEBRUARY 1991

SALE OF BT

The Treasury had wanted to aim for a July sale. We argued against that and the proposal was abandoned. It was left that a September sale was perfectly possible without limiting Peter Lilley's or Brian Carsberg's freedom of manoeuvre during the final stages of the discussions with BT about the duopoly review. Given that BT has now accepted their proposals, September should be fine even though the detailed revision of the BT licence remains to be done.

However, Treasury officials are suggesting that the intention to sell BT shares could be announced in the budget.

There is no practical need to move so quickly but the bigger issue is that Peter Lilley has always argued that we should leave our intentions unclear for as long as possible so that Labour's threat to renationalise would continue to be an issue in its own right. We have just seen them restating it in their document on industrial policy. The duopoly review is a really big achievement with significant benefits for consumers. I think we should use every opportunity to compare it with Labour's extraordinarily old-fashioned approach and not let them off the hook too quickly by saying that we intend to sell the Government's shareholding - quite apart from the fact that an early announcement of the sale does slightly detract from the impact of the review itself.

Incidentally, could I ask you how the Prime Minister himself will comment on the duopoly review?

Howell

HOWELL HARRIS HUGHES

CONFIDENTIAL AND MARKET SENSITIVE

cc Mr Potter, No10

cctu?

dti

the department for Enterprise

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The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

Prime Minister ②

'X' overleaf sets out Mr Lilley's persuasive case for not announcing the sale of further BT shares in the Budget.

BHP ✗ 1/3

The Rt Hon Norman Lamont MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AQ

Department of Trade and Industry
1-19 Victoria Street
London SW1H 0ET
Enquiries 071-215 5000
Telex 8811074/5 DTHQ G
Fax 071-222 2629

Direct line 071-215 5622
Our ref PE2379
Your ref
Date 28 February 1991

cc

attached

Dear Norman

Thank you for your letter of 22 February proposing that you should announce in your Budget Statement on 19 March a further sale of BT shares.

I continue to think that it is vital that further consideration of the appropriate timing of a sale takes place before any announcement. As you know both from our meeting on 20 February and my subsequent minute to the Prime Minister, I have long doubted the supposed electoral benefits of a BT sale before the election. A sale would enable Labour to escape from its commitment to renationalise BT which, incidentally, was the only specific nationalisation commitment repeated in this week's Labour industrial policy document.

Labour's pledge to renationalise BT is a narrow and conditional one. Their policy document, 'Looking to the Future' says "If the public stake in BT's equity remains at 49%, we shall buy sufficient shares at a fair market price to take that stake to 51%."

A sale would make it harder for us to brand Labour as the 'party of nationalisation'; and the 1.2 million existing BT shareholders would not be so readily mobilised in our support by fear of a Labour victory. I do not believe that Labour would reaffirm their pledge to build a 51% stake if we reduced the government shareholding substantially. We should not, therefore, lightly let Labour's frontbench off this damaging hook.

P.M. agreed no minute. BHP 5/3

Barry, Minute as follows:

When PM & Ch. X discussed a poss. B. ann. of sale of BT in Sept, PM was content if Mr. Lilley saw no real diff. Mr L. note suggests he still challenges desirability of that sale. The Ch. X. discussed this further with PM. If not, cd. he do so. PM will chair meeting if no agreement is reached.

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dti

the department for Enterprise

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I have no desire to foreclose the option of a September sale, but I do not believe that an announcement on budget day is necessary. I, of course, accept that we need to allow proper time for a sale to be organised. However one option you were previously considering was for a July sale with a 7 March announcement to coincide with the ending of the review. If we were to make an announcement of a share sale once the essential modifications have been made to BT's licence, then we would still have longer than if we had proceeded with the July option.

We have made good progress in our negotiations with BT and I have secured Sir Bryan Carsberg's agreement to his announcing the necessary licence modifications on the same day as I announce the outcome of the review. If we can keep everybody to this timetable then it should be possible to have the licence modifications in place by about mid-April. If, however, there were to be a share sale announcement in the meantime then this may well not be the case. As you appreciate, Sir Bryan Carsberg would come under considerable pressure to take longer over his consideration of representations. It is also entirely possible that BT would seek to re-open some of the detailed points. Tactically we would then find ourselves in a very difficult position having publicly committed ourselves to a share sale.

As I said in my minute to the Prime Minister, the position will be quite different once the licence modifications are in place. The uncertainty faced by BT on the central issues of the review would then have been finally resolved. This would provide a firm basis on which to mount a share sale.

'X' I think that the outcome of the duopoly review will be seen as an important and successful example of the benefits which can flow from the Government's policies of liberalisation and privatisation. It would be unfortunate if your proposed announcement on a share sale, which would come little more than a week after my own Statement, diluted any favourable response to the conclusion of the Review.

With such a short interval between the two announcements, we would clearly be open to the charge that we had reached an agreement with BT for the purpose of selling the shares. Your letter suggests that the Opposition would be unable to take advantage of this because they would have made their position clear in response to my announcement. I do not agree. It seems to me that they could well take a view on a share sale and relate this in a critical way to the conclusion.

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In the light of these arguments, I hope you will agree that we need to consider these matters further and we should delay your proposed announcement about a share sale.

Yours ever

Peter

cc Mr Potter, No10

chex.jf/tt1/3

CONFIDENTIAL

TO: MR SMITH TP

FOR ADVICE (AND DRAFT REPLY IF APPROPRIATE) PLEASE BY: 26/2/91

IF DEADLINE CANNOT BE MET PLEASE PHONE RAMMI MAINI ON 215 5425

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JR
SPE
MR LANE
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MR MICHELL
MR BROWN CF
MR PHILLIPS
MR TEMPLE
MR BRADBURY
MR SOANE
MR MAYHEW

SECRETARY OF STATE FOR TRADE AND INDUSTRY
25 FEB 1991

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

22 February 1991

Rt Hon Peter Lilley MP
Secretary of State for Trade
and Industry
Department of Trade & Industry
1-19 Victoria Street
London SW1H OET

Dear Secretary of State,

TELECOMMUNICATIONS DUOPOLY REVIEW: PROPOSED SHARE SALE

In the light of Barry Potter's letter of 14 February, I have considered further the timing of a sale of our holding of BT shares.

I appreciate your desire to avoid the announcement of such a sale immediately after his statement on 7 March on the outcome of the duopoly review. Equally it is highly desirable that we allow proper time for a sale to be organised. The last comparable sale was BP in 1987 and, for that, there were seven months between announcement and sale. We will be rightly criticised if we are thought to be cutting corners in the preparatory work.

Against this background I consider we should have a sale in September 1991. We do not need to decide now whether to sell our entire holding, or only a substantial part of it. This will depend on market conditions nearer the time, and on the needs of public finances.

I propose to announce this sale in my Budget Statement on 19 March. This will provide a sufficient time for the Opposition to have made clear their response to your announcement on 7 March. As you say, the duopoly review is likely to be a highly popular demonstration of our policies of increasing competition and promoting consumer choice, and the Opposition will find it very difficult to criticise. Having made their response in the days after Peter's announcement, the Opposition could not credibly change their stance following my Budget Statement.

I appreciate this would mean my announcement would come before Sir Bryan Carsberg had completed his statutory consultations. The distancing I propose between your announcement and my own will

CHANCELLOR OF THE EXCHEQUER

help to create the right environment for his consultations. He will also be helped by your intention that the outcome of his review will be agreed with OFTEL and BT. I do not, incidentally, believe BT would seek to reopen such an agreement following the announcement of the share sale. It would not be in their interests to cast uncertainty over the sale in this way.

I hope you can agree to these arrangements. They will reduce the period of preparation for the sale to less than 6 months but I think this is tolerable in the circumstances.

[signature]

pp **NORMAN LAMONT**

[Approved by the Chancellor of the Exchequer and signed in his absence]

Sw
cc PU

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 February 1991

Dear Rosalind,

TELECOMMUNICATIONS DUOPOLY REVIEW

The Prime Minister was grateful for your Secretary of State's minute of 22 February, indicating the conclusions of the telecommunications duopoly review which your Secretary of State proposes to announce on 7 March. Attached to your Secretary of State's minute was a draft white paper setting out future policy in detail.

Subject to comments from colleagues on the detailed drafting of the white paper, the Prime Minister is wholly content for your Secretary of State to proceed as proposed.

I am copying this letter to the Private Secretaries to members of E(A), the Foreign and Commonwealth Secretary and to Sir Robin Butler.

Yours,

Barry

(BARRY H. POTTER)

Miss Rosalind Cole,
Department of Trade and Industry.

cc Howell Harris Hughes

Content / 26.2 (but a word with Howell sometime)

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY

Attached is a minute from Mr. Lilley describing his proposals and those of the Director-General of OFTEL for future telecommunications policy. The proposals reflect the outcome of the consultations on the duopoly review paper issued in November.

Also attached are notes from the Treasury commending the proposal and from Howell Harris Hughes also endorsing the proposals in the proposed draft White Paper "Competition and Choice".

The four policy proposals which will catch the headlines are as follows:

(i) Price capping on domestic telephone charges will be tightened from RPI minus 4.5 per cent now to RPI minus 6.25 per cent from 1 August.

(ii) International call charges will be reduced by 10 per cent as soon as practicable.

(iii) The present duopoly should end and new applicants allowed to come forward for licences to run Telecom systems.

(iv) The cable companies will also be encouraged to enter local competition with BT. But BT will not be allowed to provide television programmes over its network for at least ten years.

The proposals should be well received as the Government pursuing effective supply side policies.

Content to endorse the DTI proposals subject to any further comments from colleagues?

BHP

BARRY H POTTER

26 February 1991 c:\economic\telecomm (ecl)

fst.sw/fst/25s.02.91

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FINANCIAL SECRETARY TO THE TREASURY

wN

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Lilley MP
Secretary of State for Trade
and Industry
1-19 Victoria Street
LONDON SW1

26 February 1991

Dear Peter

TELECOMMUNICATIONS DUOPOLY REVIEW

You sent the Chancellor a copy of your minute of 22 February to the Prime Minister, and I am replying on his behalf.

with BP?

This is an excellent outcome, which will be a strong signal of the Government's continuing concern to improve the supply side of the economy. I am therefore happy to endorse the proposals set out in the draft White Paper. I note the practical constraints on early liberalisation of the international market, but I understand that our officials have discussed the scope for a more positive presentation of our willingness to pursue this, and I am sure that the UK should lead a continuing effort to tackle this problem.

I am copying this letter to recipients of yours.

Yours
Francis

FRANCIS MAUDE

CONFIDENTIAL AND MARKET SENSITIVE

MR POTTER 25 February 1991

TELECOMMUNICATIONS DUOPOLY

The Prime Minister may endorse with confidence the proposals set out in the draft White Paper "Competition and Choice" and the conclusions which Mr Lilley sets out in his covering note. The package does indeed represent a very positive outcome for policies of increased competition and consumer choice.

The proposals generally follow the line taken by the DTI and OFTEL in the Consultative Document. But important changes have been agreed in two areas.

(a) **Tariffs**

The negotiations on price controls have been particularly successful. The cap on domestic charges will be increased to 'RPI minus 6.25%' from the 1st August from 'RPI minus 4.5%' now; and international prices will be reduced by 10% as soon as practicable. There will be no general rebalancing of tariffs although BT will be able to introduce modest increases in rentals and connection charges for large business users as well as offering them "tariff packages"-linked to a new scheme which will also provide much greater benefit to low-users of whom there are more than two million.

(b) **Cable Entertainment**

The other major change in the final draft of the White Paper is on cable entertainment. There will be no definite time limit for the ban on BT providing television programmes over its main network. There will just be a 'review' in ten years time. As originally recommended, BT will be allowed to convey television programmes after ten years (with a review at seven). But, taken together, these decisions will give the greatest possible encouragement to the growth of fixed local networks run by the cable companies in competition with BT.

INTERNATIONAL SERVICES

The Secretary of State follows the line of the Consultative Document on international services but puts a clearer emphasis on reciprocity. He will announce the ending of the duopoly in international services and also that he will allow a company to lease circuits from international operators and resell capacity to third parties - but that both steps will be subject to the opening up of overseas markets to British operators.

CONCLUSION

The BT Board meeting called to approve the agreement between the company, the DTI and OFTEL takes place tomorrow (26 February). Subject to its final decision, Mr Lilley should be congratulated on avoiding an MMC reference and achieving a highly competitive outcome to the review which will be widely welcomed.

Howell Harris Hughes

HOWELL HARRIS HUGHES

hhh.telcom

cc SG

Copy no 1 of 16.

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW

(This minute contains market sensitive information and should only be seen by those with a strict need to know).

On 13 November I presented to Parliament a consultative document setting out my proposals and those of the Director General of Telecommunications, Sir Bryan Carsberg, for our future telecommunications policy. We gave people until 14 January to comment. We received over 200 written responses. Sir Bryan and I have now considered these and I am proposing to make a statement to Parliament on 7 March announcing our conclusions. At the same time I intend to publish a White Paper explaining our future policy in detail. This minute seeks your agreement to the main conclusions which are set out more fully in the attached draft of the White Paper.

sent to Policy Unit 25.2.91

New telecommunications licensees

2 My key proposal is that we should end the present duopoly policy and allow new applicants to come forward for licences to run telecommunications systems. This was what I proposed in the consultative document. It was strongly supported by

the vast majority of those who responded.

3 The implications of this decision are likely to be different in different areas of the market. I expect there will be a number of significant applications to run new trunk networks. In the local area, however, the costs of installing a new network are much greater relative to the returns from carrying calls. We will therefore need to look to the existing cable television companies and cellular radio operators to provide competition to BT by extending their networks rather than to expect major new operators to enter the market. Sir Bryan and I have accordingly reached conclusions, as explained below, that will encourage such developments.

Greater freedom for existing licensees

4 At present the cable television companies can only provide a voice telephony service as an agent of BT or Mercury. The proposal in the consultative document, which was again strongly welcomed in the public responses, was that they should in future be able to provide voice telephony in their own right. Sir Bryan has therefore concluded that we should proceed on this basis. We will also be making other proposals aimed at encouraging the cable operators to develop their networks.

5 I have further decided that we should proceed, again as proposed in the consultative document, with letting the present mobile networks provide a greater range of services. We already have the most dynamic mobile communications market in the world. My proposals will allow cellular radio networks to provide a wider range of services and also to extend the use of Telepoint, a low cost means of accessing the public network, so as to provide services to business and residential customers.

Cable entertainment

6 The consultative document proposed that BT should be allowed to provide television programmes over its main network in 10 years' time, or after seven years if the Director General advised that it would promote greater competition. In the light of comments received on the document, I have decided that we should adopt a tougher position with respect to BT. I do not think we should offer the prospect of them being able to provide such services at any specific time in the future. All that I am prepared to do would be to review the position in 10 years' time, in the light of our broadcasting and telecommunications policies, if the Director General advised that it would be likely to lead to more effective competition in telecommunications. This conclusion will be strongly welcomed by the cable companies.

7 BT had also pressed to be allowed to convey television services over its main network on conclusion of the duopoly review. I am not persuaded by their arguments. It is important, as we recognised in the consultative document, to encourage the growth of fixed networks to compete with BT. The only real prospect for this in the foreseeable future is from the cable companies. The cable companies could be expected to take a far more cautious view of investment if they knew that BT was able to convey entertainment services. I have therefore decided that we should keep to my original proposal in the consultative document that BT should only be allowed to convey entertainment services after 10 years, with a possible review after seven years if the Director General advised that it was likely to encourage greater competition.

British Telecom's tariff structure

8 A central issue for future competition and consumer benefit is the tariffs which BT will be able to charge in future. BT has made a strong case for being able to rebalance tariffs so as to charge more for line rentals and connections and less for carrying calls. In the consultative document Sir Bryan said that he was not persuaded of this case but that he would be prepared to consider allowing BT greater flexibility in the tariffs they could charge, particularly to high volume business users. Sir Bryan's conclusion, which I support, is that the present price caps for residential customers should

remain until they fall for review in mid-1993. He is, however, prepared to allow a modest increase in rentals and connection charges for larger business users, although he expects this will be more than offset by reduced call charges. He has also decided that BT should be able to introduce tariff packages, subject to important provisos to ensure that BT cannot compete unfairly with Mercury. The introduction of these packages will also be linked to a new scheme which will provide much greater benefit than at present to low users. The scheme will cover some two or three million customers, many of whom rely on the telephone as a lifeline.

9 Sir Bryan and I have also taken the opportunity to negotiate a much tighter price control for BT. Sir Bryan had previously made clear that he intended to put a price cap on BT's international call charges. We have now combined this with a revision to the main price cap for domestic charges which presently stands at RPI-4.5. BT have agreed to reduce their international prices by 10% as soon as practicable and to increase the main price cap to RPI-6.25 from 1 August 1991. I am very pleased with this outcome which I expect to be widely welcomed when I announce the conclusions of the review.

Other issues

10 We have made considerable progress in other areas. One of the most important is the introduction of equal access

whereby a customer can express a choice as to the trunk operator that carries their call. This facility has been available in the United States for several years. We will be taking the necessary powers in BT's licence to ensure that it will be introduced progressively in this country. This will depend in part on the continued modernisation of BT's network and the development of competing trunk networks. It will start to become available in the next year or so and I would hope that the majority of people in the UK will be able to benefit from it within the next five years.

11 We have developed further the proposals in the consultative document for greater liberalisation of international services. I will be announcing the ending of the duopoly in this area as well as for domestic services, although I do not envisage granting new licences in the short term. I will also announce that, subject to the appropriate licensing arrangements, we will permit international simple resale whereby a company can lease circuits from international operators and resell capacity on them to third parties. Both of these steps will, however, be subject to our first securing a more open market for our own operators overseas. Otherwise they will not be able to compete effectively and, because of the international accounting arrangements, will lose significant revenues which would in turn impair their ability to provide a service in the UK. I shall also be confirming the proposal in the consultative document for liberalising

private satellite services.

Conclusion

12 Further work is required on a number of detailed points. In addition to the final drafting of the White Paper, we have yet to settle the text of the modifications to BT's licence. The BT Board will also not be meeting to give their final approval to the settlement Sir Bryan and I have reached with their Chairman until 26 February. In order to meet our agreed our 7 March deadline, however, the White Paper will need to be finalised by close on Monday 25 February.

13 The above package represents a very positive outcome for our policies of increased competition and customer choice. In a number of key areas the conclusions go further than I had thought possible when I issued the consultative document. The proposals in the document were widely welcomed. I confidently expect that the future telecommunications policy I shall be announcing will be equally well received. I invite you and colleagues to endorse these conclusions.

14 I am copying this minute to members of EA, to Douglas Hurd and to Sir Robin Butler.

Anne Bishop pp P B L

22 February 1991

(Approved by the Secretary of State and signed in his absence)

DEPARTMENT OF TRADE AND INDUSTRY

CONFIDENTIAL

SRW.

pa ①

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

14 February 1991

Dear Martin,

TELECOMMUNICATIONS DUOPOLY REVIEW: PROPOSED SHARE SALE

The Prime Minister was grateful for your Secretary of State's minute setting out his concerns about the possibility of a further sale of BT shares in either July or September this year.

The Prime Minister understands why your Secretary of State sees a need for space between the announcement of the outcome of the duopoly review on 7 March, and an announcement of a proposed sale of further BT shares. He also appreciates, however, the Chancellor's wish to keep open the possibility of a sale some time this year.

Accordingly the Prime Minister would be grateful if your Secretary of State, in consultation with the Chancellor, could agree whether keeping open the possibility of a BT share sale in September, rather than July, would meet their respective concerns.

I am copying this letter to John Gieve (HM Treasury).

Yours,

Barry

(BARRY H. POTTER)

Martin Stanley, Esq.,
Department of Trade and Industry.

✓6

CONFIDENTIAL

Prime Minister
In view of this advice, content to allow September sale of further BT tranche? Treasury do need the proceeds to meet their targets.
BHP 13/2

Sept. is fine.

PRIME MINISTER

13 February 1991

TELECOMMUNICATION DUOPOLY REVIEW

The DTI proposals form a package which BT should be able to accept. But you had asked which of the main issues were most contentious for BT and which were capable of becoming a reference to the MMC if no agreement could be reached with BT. The first three points (Annex A) are the most critical and they are closely linked. They all relate to BT's main argument that the existing price controls should be phased out. They are:

(a) that present price controls should remain until 1993 but that we should allow flexibility by way of optional tariff packages;

(b) that we introduce a major new proposal for implementing "equal access";

(c) that BT's licence is amended to introduce a firm price cap on international call charges.

Point (a) is very contentious for BT which argues that calls are overpriced and that lines are underpriced, so they are easily undercut. But they made an agreement with OFTEL and only Sir Bryan Carsberg can release them from it.

On proposals (b) and (c), the boot is on the other foot. OFTEL has to get BT's agreement to change its licence.

In the worst case, BT might withhold its agreement and only the MMC could alter the licences after an inquiry. In practice, proposal (b) for "equal access" is not very immediate. It would take at least two years for the technical preparations to be completed and by that time the present price controls will have lapsed anyway. OFTEL has made it clear that it will consider the whole issue of rebalancing tariffs then.

However, the price cap on international calls would take effect from October 1991. BT says that its international business should not be segregated and that its profits are needed to balance the losses on domestic lines. BT might refuse to have its licence amended on this point unless OFTEL did agree to a general review of price controls before they run out in 1993.

Sir Bryan Carsberg would not want to back down on this issue, at which he has been looking since 1988. But a lot of work has been done on it so an MMC inquiry should be quite fast. BT is defending margins of 80-90% on its international calls and a cap would be popular with business.

Although BT professes to believe that the MMC might find for them, the odds are against them.

So we should not be too nervous about the risk of BT refusing to have its licence amended on one of these issues, nor about the timing or likely outcome of a reference to the MMC.

Howell Harris Hughes

HOWELL HARRIS HUGHES

(089)#

ANNEX A

Reference ....

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Taking the main issues in the Annex, we are proposing to:

(i) stand firm on the present BT price controls but to allow flexibility by way of optional tariff packages;

(ii) introduce a major new proposal for implementing equal access;

(iii) amend BT's licence so as to introduce a firm price cap on international call charges;

(iv) seek a licence amendment to require BT to disclose publicly greater financial information;

(v) amend BT's licence to prevent them from acting anti-competitively in regard to numbering and access to databases;

(vi) not to allow BT to provide entertainment services nationwide for at least 10 years but to offer greater freedom for BT to convey such services provided by others;

(vii) not to agree to BT's proposal in regard to radio tails; and

(viii) to make clear the need for UK operators to have greater access overseas before we open our own international services market.

10 Taken together, our assessment is that this package will present a tough challenge to BT but one which ultimately they will be prepared to accept. They do not get any greater tariff rebalancing prior to 1993 but a firm indication that it should proceed thereafter. The flexibility they will be allowed on packages is a significant improvement and will enable them to compete more directly with Mercury for high volume business customers. In the light of this we would expect them to accept a demanding international price cap. Our proposals on conveyance of entertainment and on international services should be generally welcomed by BT and, we believe, sufficient to offset the changes we are proposing elsewhere, notably on equal access.

(1)

A word with Howell re C (Annex A) later today, please. 13.2

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW: PROPOSED BT SHARE SALE

The Chancellor raised this issue this afternoon. You agreed to look at the papers and perhaps let him have a view over the telephone tomorrow evening.

The starting point in Mr Lilley's note (Flag A) is his intention to announce the conclusions of the Duopoly Review on 7 March. He wants a gap between that announcement and the announcement of the sale of another tranche of BT shares, for three reasons:

i) It would avoid accusations that the Government had fixed the Duopoly Review outcome in favour of BT, to maximise sale proceeds.

ii) It would give Sir Bryan Carsberg, Director General of OFTEL, time to consult on the Duopoly Review and begin to negotiate revisions to the BT licence.

iii) The supposed electoral benefits of the BT share sale before the election are doubtful. Indeed Mr Lilley favours leaving the Opposition "on the hook" of renationalising BT. So there is no electoral need - whatever the fiscal case - for a sale in 1991.

The truth, Not much of a hook. They'll announce they take only 2%. That won't frighten the children!

At Flag B is a Treasury note. As the Chancellor made clear he has some sympathy for Mr Lilley's concerns. He would regard an announcement of the BT share sale in time to enable sale in September as acceptable.

At Flag C is a note from Policy Unit. This too concludes that a September sale is possible and should follow OFTEL's consultation on the licence amendments.

Conclusion

Treasury are not pressing to keep open the July sale date option. Everyone thus seems to accept:

- that September 1991 is the earliest acceptable date for the share sale;

- that an announcement of a September sale would have to come after OFTEL's consultation on the Duopoly Review outcome;

- that a negotiated settlement with BT on revised licence conditions is preferable to an MMC inquiry - which might delay any sale into 1992.

Content to minute out on this basis?

BHP

Barry Potter

12 February 1991

c: Duopoly (MJ)

CONFIDENTIAL AND MARKET SENSITIVE

C

MR POTTER 12 February 1991

BT SHARE SALE

The Treasury note raises issues about the substance of the Duopoly Review and about the timing of a share sale.

Substance of the Duopoly Review

The Treasury wants to avoid a reference to the MMC caused by BT's refusal to agree to licence changes because it would rule out a July or September sale.

Annex A sets out the principal issues on which negotiation is now beginning and it notes the DTI view that BT should be able to accept this kind of package. Preliminary discussions have been "constructive".

However, BT's discussions with OFTEL have been more difficult and Professor John Kay has just resigned as BT's consultant on the grounds that his academic work had been quoted in support of propositions which he could not endorse. That may teach BT a lesson but it <u>might</u> mean that BT is getting a bit reckless in defence of its position. If so, Mr Lilley will have to be very firm and, in the last resort, he would have to accept a reference to the MMC rather than compromise on policies designed to curb BT's market dominance and get some more competition in.

The DTI does not want an MMC reference because its outcome is uncertain. But that would be preferable to having to make significant concessions with the sole aim of selling the shares sooner than later. A reference to the MMC need not take six months; if it all went through within three months, the sale of shares in fiscal 1991/2 would still be possible.

BT does sense that the Review has been accelerated and assumes that is because we want to sell some shares. We cannot throw the MMC card away without some risk to the fundamental objectives of the Duopoly Review itself.

Timing

Mr Lilley argues that, even if agreement on licence amendment is reached in principle, Sir Bryan Carsberg's detailed negotiations with BT would become much more tricky if a July share sale had already been announced. I think that is right; if we could delay making the announcement until everything was signed and sealed it would be better. That rules out a July sale. Conversely, deferring the announcement would probably speed the process and a September target would be a bit easier to hit.

Mr Lilley also says that an early announcement of a share sale would make it look as though we had "fixed" the Duopoly Review with that in view. That obviously depends on the precise nature of the decisions; if we have to concede a lot of ground to avoid an MMC reference, it will be very obvious and damaging. If the present package is accepted, I do not think it would matter.

However, his argument that we should not rush the share sale so as to leave the Labour Party on the renationalisation hook for a bit longer makes a lot of sense. It is not just a question of what the 1.2m shareholders think about it; it will focus attention on the economic objectives of the whole privatisation programme. That argues for a September target too.

Conclusion

(a) That we should rule out a July sale so that OFTEL's position on renegotiating the licences is not compromised and that the political issue of renationalisation is left open over the summer. The announcement of a September sale should follow OFTEL's consultation on the licence amendments.

(b) that in the worst case we should not exclude the possibility of an

MMC reference if BT proves to be very difficult. It need not be inconsistent with a sale within the fiscal year, even though its outcome from a policy point of view lacks certainty. We must not be seen to compromise on the main aims of our competition policy for telecommunications.

Howell Harris Hughes

HOWELL HARRIS HUGHES

hhh132

ANNEX A

Reference ....

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Taking the main issues in the Annex, we are proposing to:

(i) stand firm on the present BT price controls but to allow flexibility by way of optional tariff packages;

(ii) introduce a major new proposal for implementing equal access;

(iii) amend BT's licence so as to introduce a firm price cap on international call charges;

(iv) seek a licence amendment to require BT to disclose publicly greater financial information;

(v) amend BT's licence to prevent them from acting anti-competitively in regard to numbering and access to databases;

(vi) not to allow BT to provide entertainment services nationwide for at least 10 years but to offer greater freedom for BT to convey such services provided by others;

(vii) not to agree to BT's proposal in regard to radio tails; and

(viii) to make clear the need for UK operators to have greater access overseas before we open our own international services market.

10 Taken together, our assessment is that this package will present a tough challenge to BT but one which ultimately they will be prepared to accept. They do not get any greater tariff rebalancing prior to 1993 but a firm indication that it should proceed thereafter. The flexibility they will be allowed on packages is a significant improvement and will enable them to compete more directly with Mercury for high volume business customers. In the light of this we would expect them to accept a demanding international price cap. Our proposals on conveyance of entertainment and on international services should be generally welcomed by BT and, we believe, sufficient to offset the changes we are proposing elsewhere, notably on equal access.

chex.ps/tt/39

B

cc HMH

CONFIDENTIAL AND MARKET SENSITIVE

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

11 February 1991

Barry Potter Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Barry

BT SHARE SALE

The Chancellor hopes to discuss the possibility of a residual BT share sale during 1991 and alternative timetables at his bilateral with the Prime Minister tomorrow.

... I attach a short note setting out the issues.

Tancred Tarkowski

T TARKOWSKI
Private Secretary

btss

BRITISH TELECOM (BT) SHARE SALE

The Government owns about 48% of BT shares, worth some £8½ billion.

2. The Prime Minister will recall that, last summer, there was discussion in the Treasury of selling some (but probably not all) of these shares in 1991. At the time Mr Major was keen to dispose of the shares in this Parliament. He saw attractions in a sale in July 1991.

A. Duopoly Review

3. There is a link with DTI's current review of the BT-Mercury duopoly. The timetable for the review was set with a possible share sale in mind. In November 1990, Mr Lilley agreed an extension to the timetable with the then Chancellor. In line with this agreement DTI are working towards an announcement of the outcome of the review on 7 March.

4. There are two links to this review. First, a share sale would require a clear cut outcome to the review. The review will lead to changes in BT's licence. The licence can only be changed in two ways - either with BT's agreement or, in the absence of such agreement, after a report by the Monopolies and Mergers Commission (MMC). Such a report would take 3-6 months and so rule out a share sale in 1991. There is, therefore, a need to reach agreement with BT.

xx

5. Second, even after agreement with BT, the Director General of OFTEL (Carsberg) would have to go to public consultation on the drafting of the licence amendments. The period of consultation is 28 days and Carsberg would need a couple of weeks to reflect on a response. In fact this procedure should be mechanistic if we are successful in getting an announcement on 7 March which is agreed by DTI, BT and OFTEL.

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B. BT sale

6. A major share sale normally takes about 6 months to do. Decisions are needed now on :

(a) should there be a sale in 1991?; and if so

(b) should it be in July or September?

A share sale could obviously bring in a lot of money. Our 1991-92 target for privatisation proceeds could in fact be met without a sale. A sale would allow the target to be raised. If we sell BT now, we will have fewer assets to sell in later years and we are set to run out of privatisation proceeds in the mid 1990s.

7. Any BT sale would be directed at widening and deepening share ownership. There is no point in selling only to the City institutions. Clearly a successful sale could be popular. It would also lift the renationalisation threat from BT.

8. There is an argument that the Opposition should not be given an easy way out of its commitment to renationalise BT. The renationalisation risk also brings home to BT shareholders where their political interests lie.

C. Timing of Sale

9. Time is very tight for a July sale. The last major sale of a residual shareholding was BP in 1987. For that sale, work started in February and the sale took place in October. Treasury officials do consider that a BT sale could be organised for July but :

(a) it would distract investors attention from the privatisation of Scottish electricity in June;

(b) the logistics of the sale, e.g. capacity in the printing industry, may be a constraint. This will not be known until work can start;

(c) the rushed timetable could lead to criticism that the sale will not secure proper value for the taxpayer.

10. Peter Lilley is concerned that a July sale would have to be announced immediately after his 7 March announcement of the outcome of the duopoly review. He thinks this will lead to criticism that the outcome of the review has been compromised in the interests of the sale. As the outcome of the review is likely to be, and to be seen as, highly pro competitive, it is hard to see how such criticism could sustained. Mr Lilley also believes this would put pressure on Carsberg in his period of consultation (para 4 above).

11. Mr Lilley would prefer to delay the announcement of a sale until after Carsberg completes this consultation i.e. until the end of April. It is hard to believe this will reduce any criticism of the sort he fears. It would definately rule out a July sale. It would make a September sale very tight.

12. September would obviously be better for those organising the sale <u>if</u> an announcement were made in early March. It would still be tight by past standards. There would be reasonable clear water after Scottish electricity. The longer period should open the way for a bigger sale. At present Treasury officials think a July sale should be no more than about £2 billion. September could be £5 billion or even more.

<u>Conclusion</u>

13. Decisions are needed on :

(a) should there be a sale of our BT shares in 1991;

(b) should this be in July or September?

(c) do Ministers agree that the announcement of the sale should be made in March immediately after the announcement on 7 March of the results of the duopoly review?

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SCPV.

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MARKET SENSITIVE

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW : PROPOSED BT SHARE SALE

I am aiming to announce the conclusions of the Duopoly Review on 7 March. I understand from Norman Lamont that he wishes to keep open the possibility of a further BT share sale in either July or September. I have two major concerns about this which I have discussed with Norman. He said he would raise them with you but you may find it helpful for me to set out how I see the position.

The Need for Space between Duopoly and Share Sale Announcements

A July option would necessitate a public announcement of the sale immediately after I had announced the outcome of the Duopoly Review on 7 March. I am confident that the outcome will be a highly popular demonstration of our policies of increasing competition and promoting customer choice. The Opposition would find it very difficult to criticise on its own. However, if a sale were announced more or less simultaneously, the Opposition would argue (plausibly enough for cynical commentators to echo them) that we must have fixed the Duopoly outcome in favour of BT to maximise its share value. We could present strong factual arguments to the contrary but presentationally we would have lost the initiative.

It will also be necessary after 7 March for Sir Bryan Carsberg, the Director General of Telecommunications, to go out to statutory consultation on the necessary amendments to BT's licence. These will be of fundamental importance to the company and the future telecommunications environment. If we had already announced a share sale then Sir Bryan would be under extreme pressure to demonstrate that he had taken due account of all representations. This could delay the conclusion of the final licence amendments which in itself could create uncertainty about BT's future. Moreover, there is a risk that, however well we had prepared the ground prior to the conclusion of the Review, BT would use the announced sale in order to reopen the negotiations on detailed points. This would be most unsatisfactory from my point of view and would also place us in a difficult tactical position since we would by then be publicly committed to a sale.

Conversely, if an announcement had not been made, Sir Bryan would be able to conclude his consideration of representations much more quickly. Once an amended licence was in place, this would provide a firm basis on which to announce in, say, mid April a September sale. This would still leave at least as much and probably more time to prepare the sale than would be the case for the July option.

<u>The Pros and Cons of a Pre-Election Sale of BT</u>

Quite apart from the duopoly considerations, I have long doubted the supposed electoral benefits of a BT sale before the election.

This is because a sale would enable Labour to escape from its present commitment to renationalize BT. As a result, it would be harder for us to brand Labour as 'the party of nationalisation'. And the ~~1½~~ 1.2 million existing BT shareholders would not be so readily mobilised in our support by fear of a Labour victory.

Labour's pledge to renationalise BT is a narrow and conditional one. Their most recent document 'Looking to the Future' says "If the public stake in BT's equity remains at 49%, we shall buy sufficient shares at a fair market price to take that stake to 51%".

I do not believe they would reaffirm the pledge to build a 51% stake if we reduced the government shareholding substantially.

They have found the existing pledge an embarrassment even though it was deliberately framed very narrowly to avoid charges of costly pledges or fears of expropriation. Significantly Labour have not made any commitment to take the 40% stake in the generators back over 50%.

Labour's pledge to renationalise BT is undoubtedly their highest profile and most damaging nationalisation commitment. If we let them slip off that hook they would only remain committed to renationalising the (unquoted) national grid and water.

At present the ~~1½~~ 1.2 million BT shareholders are likely to be apprehensive of a Labour victory.

A BT sale would increase the number of shareholders (though the core of investors would probably be existing shareholders). But the likely abandonment of the threat to renationalise would mean these voters could be more relaxed about a Labour victory.

I recognise the importance that Norman attaches to a further BT share sale. In the light of the above arguments, however, I think we need seriously to consider postponing this until after the next election or, at the very least, not to be constrained by the July option.

I am copying this minute to Norman Lamont.

P B L
8 February 1991

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CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Lord Hesketh
Minister for Industry and Consumer Affairs
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1P 3AG

15 November 1990

Dear Alexander

PARCELFORCE RECOVERY PLAN

Thank you for your letter of 25 September 1990, which our officials have discussed.

Flag

2. The papers you attach show a serious situation. I understand that those going to the Post Office Board in October may show that the position is worse still. I welcome the openness and thoroughness with which both your Department and the Post Office have approached these problems, and I look forward to seeing the Post Office Board's views on the Recovery Plan in due course. The Plan should, of course, ensure the achievement of the agreed financial targets.

3. As I am sure you have recognised, the figures call into question the whole future direction of Parcelforce. The Recovery Plan may be the best way forward but, before we are in a position to agree this, we do need to consider the alternatives. You will, no doubt, already have your views on the options to be thought about. Those which I would like to see considered are:

> i. a managed rundown in the Post Office's parcels business, leaving low volume parcels from individuals and small businesses to Royal Mail Letters while high volume parcels are handled by the private sector, and Parcelforce's surplus assets sold; and
>
> ii. disposal of all or the bulk of the parcels business as a "going concern". This could be to the existing management and staff, to an existing parcels carrier or to a new owner from outside the Parcels sector. The timing of disposal would need further consideration.

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3. We should aim to be in a position to consider the Recovery Plan alongside the other options by end January 1991. Urgent consideration should be given to the retention of outside advisors - perhaps management consultants - to provide advice on the relative merits of the options. The work should set out the costs, risks and benefits of each option including the Recovery Plan. I should be grateful if your officials would keep in touch with mine on the selection of consultants and the work programme.

4. The use of outside consultants may also have presentational benefits as a response to the criticism of unfair trading which are likely to arise once the private sector carriers find out what has been going on. I recognise that in 1988 E(A) Committee had expressed reservations about Parcelforce privatisation both in principle and in particular at that time. The new evidence of cross-subsidy, and the consequent risk of damage to private sector carriers' profitability, requires us to re-examine our strategy.

5. While the consultants are at work, it is important that only those parts of the Recovery Plan are implemented which do not prejudice the other options. Officials should seek to agree which these are.

6. We must also avoid nugatory expenditure. Until we have taken a decision on the options I do not believe it would be appropriate for Parcelforce to enter into commitments on capital expenditure which could prove to be inappropriate or unnecessary if a run-down option were chosen. Parcelforce should restrict commitments to those which are essential and which would be value for money whatever option was eventually chosen. Again our officials should work out the details of the control system.

7. Finally I would be grateful if you would consider setting up a monitoring system which can deliver key monthly figures soon after the end of the month to provide early warning of any deterioration in Parcelforce's financial position and hence any threat to the EFL.

8. I am copying this letter to the Prime Minister, Eric Forth, James Douglas-Hamilton and to Sir Robin Butler.

Yours ever
Norman

NORMAN LAMONT

POST + TGLG : Future PTB

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dti
the department for Enterprise

7.S.P.M
BHP
22/10

CC PX
(letter only)

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

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MARKET SENSITIVE

Department of
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Barry Potter Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Direct line 071-215 5623
Our ref PE10226
Your ref
Date 22 October 1990

Dear Barry,

TELECOMMUNICATIONS DUOPOLY REVIEW

Your letter of 8 October confirmed that the Prime Minister was content with the proposals for the duopoly review set out in my Secretary of State's minute of 26 September. You also asked for the text of the consultative document to be circulated for information after it had been finalised. I am therefore attaching a copy of the document as it has been sent to the printers.

I am copying this letter the and the document to the Private Secretaries to Members of E(A), Stephen Wall (FCO), Colin Walters (Home Office) and to Sir Robin Butler.

Yours

Rosalind Cole

ROSALIND COLE
Private Secretary

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Recycled Paper

POST + TELG : Future PT13

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cc PU

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discussion.
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PRIVY COUNCIL OFFICE
WHITEHALL. LONDON SW1A 2AT

16 October 1990

Dear Peter

POST OFFICE STRATEGY

flag

Alexander Hesketh's letter of 18 September set out your views on the Post Office Corporate Plan and invited comments from E(A) colleagues. I have also had a further look at the strategy paper that Nick Ridley circulated on 2 July. I understand that you are shortly to circulate your own thoughts on this subject as a basis for discussion in E(A). Several general points have struck me, and I thought I should feed them in at this stage.

The detail in these analyses makes for very depressing reading, of a kind with which we have been all too familiar with the major nationalised industries. Six or seven years ago, the mis-match between service targets and public expectations on the one hand and resources available and labour force constraints, including restrictive practices, on the other hand, would have been seen as strongly reinforcing the need to consider speedy privatisation, rather than as reasons for it being premature.

I know that when we last considered the Post Office as a candidate for privatisation, problems with the letter monopoly, and also the "Royal" element in the title, seemed to present major difficulties. But I am now less convinced about the first of these, given the much greater use of communication by fax machine (and perhaps also the freeing up the sort of services that BT can provide in the context of the Telecommunications Duopoly Review). Surely the Post Office is now increasingly one of a number of alternative providers of a service for conveying information from point A to point B; and surely therefore monopoly considerations are no more an obstacle to privatisation than they were in the case of British Gas?

The position would be greatly eased anyway if we were to decide to adopt the suggestions in Nick Ridley's earlier paper for abolishing the monopoly for letter post items under £1. But even if we can decide on desirable changes of that sort, why should we then rule out more radical measures which have proved themselves in so many other cases? We are bound to have presentational problems with any reform package of whatever kind. So it should help to make clear that they are part of a longer term strategy to apply to the Post Office the same sort of market disciplines and stimuli that have worked so well in other areas. So we should surely not exclude the privatisation option?

There are other issues for discussion as well in E(A). I agree with the need to widen the range of level of service, and consequently cost of services available, so that for customers who complain there is the choice of paying more to get the sort of service they claim to want.

I am certain, whatever we decide, that it is unacceptable to be dissuaded from reform by the threat of union opposition.

As to the timing, I agree that this issue is best addressed in the first session of a new Parliament. And I hope very much that a short Bill can be preferred; we should avoid a long Bill consolidating earlier legislation unless this is genuinely essential to the policy objectives.

I am copying this letter to the Prime Minister, other members of E(A), David Waddington and Tony Newton, and to Sir Robin Butler.

GEOFFREY HOWE

The Rt Hon Peter Lilley MP
Secretary of State for Trade and Industry

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 October 1990

Dear Martin,

BRITISH TELECOM: PRICE CAP ON INTERNATIONAL CALLS

The Prime Minister has seen your Secretary of State's further letter of 11 October about the line to take in the consultation document for the Telecommunications Duopoly Review on OFTEL's public support for a price cap on international telephone calls.

The Prime Minister sees attractions in the line set out by your Secretary of State. It is clearly desirable for the Government to support action against apparent monopoly pricing. At the same time, the Prime Minister also appreciates the concern that an MMC reference might make it difficult, if not impossible, to proceed with the sale of a further tranche of BT shares next year.

On balance, the Prime Minister agrees with your Secretary of State's view that the Government should give a general endorsement to the OFTEL line in the consultation document for the Duopoly Review. She also agrees that the issue of the MMC reference itself would have to be handled flexibly in the light of BT's reaction to the Government endorsement of the price cap for international calls.

Finally, the Prime Minister also understands that the Chancellor is now broadly content to accept the line proposed by your Secretary of State.

I am copying this letter to the Private Secretaries to members of E(A), Richard Gozney (Foreign and Commonwealth Office), Colin Walters (Home Office) and to Sonia Phippard (Cabinet Office).

Yours ever,

Barry

Barry H. Potter

Martin Stanley, Esq.,
Department of Trade and Industry.

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cc PU

n. b. P.M,
BHP
15/10

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

15 October 1990

Rt Hon Peter Lilley MP
Secretary of State for Trade
and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

Dear Secretary of State

with BP?

Thank you for your letter of 11 October.

I agree that we need to be seen to support Bryan Carsberg, particularly to avoid signalling any difference of view which BT could exploit. Given the Director General's independent position, there perhaps may be a risk that he will take a view on international calls which is not in line with our own preferences. I am particularly concerned to preserve the share sale option, but having identified this particular angle we must do what we can to manage the risk. For the present, we can as you suggest use the fact that the Government will want to take account of views expressed in public consultation, and that the Director General is himself doing further analytical work on the subject.

I am copying this letter to the Prime Minister, members of E(A), to Douglas Hurd and David Waddington and to Sir Robin Butler.

Yours sincerely

pp **JOHN MAJOR**

[Approved by the Chancellor of the Exchequer and signed in his behalf] cc PU.

n.b. P.M
BHP
16/10

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Oddi wrth Ysgrifennydd Gwladol Cymru

The Rt Hon David Hunt MBE MP

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From The Secretary of State for Wales

CT/12424/90

12th October 1990

Dear Peter

- MAP

Thank you for copying me your minute of 26 September to the Prime Minister, outlining the 'preferred options' you wish to include in the consultation document on the Telecommunications Duopoly Review.

I am content with your proposals and I understand that my officials have cleared a draft text of the consultation document with officials in your Department.

I am copying this letter to members of E(A), David Waddington and to Sir Robin Butler.

Yours ever

David

The Rt Hon Peter Lilley
Secretary of State for Trade and Industry
Department of Trade and Industry
Victoria Street
LONDON SW1

POST + TELECOMS: Future Pt 13

16.10. 1130

PRIME MINISTER

BRITISH TELECOM: PRICE CAP ON INTERNATIONAL CALLS

There is one issue still outstanding from the recent exchange on the Telecommunications Duopoly Review.

Sir Bryan Carsberg, Director General of Oftel, has now publicly called for a price cap on BT's international calls. This is hardly surprising. As the attached letter from the Industry Secretary makes clear, BT is making a rate of return of 80 per cent or more on its international operations.

The problem arises from a potential conflict between two policy objectives:

- the desirability of capping BT's international call charges;

  and

- the sale of more BT shares next year.

Depending on the course of events, there is a danger that BT's international call charges could be referred to an MMC enquiry. If that happened, there would be uncertainty about the future return to investors from BT shares. The merchant bankers would then advise postponement of the proposed sale of shares till that matter was settled. MMC enquiries take at least 6 months.

Policy Unit (note attached) have explored how significant the impact of an MMC enquiry would be. After all, investors in BT ought to realise that such monopoly pricing was bound to be investigated and acted against at some stage. And the revenue from international call charges is only a small part of BT's total income.

That said, Treasury are adamant, on City advice, that it would be very difficult to float the shares, if BT's call charges were at the time subject to MMC reference.

The conclusion seems to be that the Government should aim to avoid BT call charges being referred to the MMC.

But it does not make sense for the Government to say nothing at all given Sir Bryan Carsberg's statement, as Treasury initially proposed. Instead, Mr. Lilley's advice is that the Government should give a general endorsement to the Director General's line in the consultation document for the Telecommunications Duopoly Review.

That would not bind the Government to supporting an MMC reference - the matter would have to be handled flexibly in the light of BT's reaction. But the Government would be seen to support action against monopoly pricing.

Content to support Peter Lilley's proposed handling?

BHP

B. H. POTTER
12 October 1990

Yes ~~[illegible]~~ but don't. We're going against the Chancellor. Could we ask him to consider Peter Lilley's proposals again [illegible]

c:\economic\bt (kk)

CONFIDENTIAL AND MARKET SENSITIVE

PRIME MINISTER 11 October 1990

DUOPOLY REVIEW

A PRICE CAP ON INTERNATIONAL CALLS

Mr Major has argued that the Government should remain silent on Sir Bryan Carsberg's intention to seek a price cap on international tariffs.

He points out that a price cap would involve a change in licence conditions which requires BT's agreement. Without it, the issue would have to be referred to the MMC and that would complicate plans for a sale of the Government's shareholding.

Mr Lilley now reiterates the case for supporting Sir Bryan's position in the consultative document on The Duopoly Review.

MONOPOLY PRICING

It is very important to avoid ending up with an MMC enquiry. But it is equally important to find ways of dealing with a problem of monopoly pricing, about which the business community in the City feels very strongly.

THE DANGERS OF SILENCE

The danger in Government silence about the possibility of a price cap is that it will encourage BT to be intransigent.

BT will see it as a sign of timidity and seize the chance to protect this enormously profitable line of business. We shall have given away one of our most powerful bargaining counters in the overall negotiation.

Nor will City analysts' views of BT's future earnings be much influenced by a signal that the Government is not necessarily committed to a price cap now. OFTEL has reviewed this issue before and would do so again. Ultimately these monopoly profits will be removed and the share price has to discount the perceived risk. The powerful thrust of the DTI's argument is that it is in the national interest for the problem to be tackled sooner than later.

A STRONGER LINE OF NEGOTIATION

Government support in the consultative document for Sir Bryan's general approach to monopoly pricing on international calls does not pre-empt the outcome of his further research and discussions. But it does strengthen his hand in negotiation.

At the end of the day, we shall certainly want to be flexible and to seek compromise about the actual level of price capping - but what do we gain by running away from the issue at the outset?

CONCLUSION

An MMC reference would make the mechanics of a Government share sale more difficult. It is the most cumbersome way of promoting something which is agreed to be in the national interest.

But Government silence on the issue will encourage BT not to give ground and perhaps make an MMC enquiry more likely than less.

Better to support the OFTEL approach and make it clear that it is an issue of real significance for the Government. That in no way prevents us from being very flexible about the terms of an actual agreement on this specific issue in the end.

RECOMMENDATION

That we should support Mr Lilley's original recommendation and indicate support for OFTEL's wish to look at the possibility of price capping international calls.

Howell Harris Hughes

HOWELL HARRIS HUGHES

cc PU

dti

the department for Enterprise

CONFIDENTIAL
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The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

Rt Hon John Major MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
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Department of Trade and Industry

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Direct line 071-215 5621
Our ref PE10125
Your ref
Date 11 October 1990

Dear Chancellor

TELECOMMUNICATIONS DUOPOLY REVIEW

Thank you for your letter of 5 October endorsing the ~~the~~ Flow proposals outlined in my minute to the Prime Minister of 26 September.

You raised a point concerning the handling of a price cap on BT's international tariffs and its relation to the timing of a possible share sale. I think we share the same objective of wanting to see a satisfactory price cap agreed by BT as part of the overall outcome of the duopoly review early in the New Year. We need to consider carefully how best to achieve this.

You are right to point out that, since the Government cannot, short of primary legislation, guarantee the imposition of a satisfactory price cap, we need to avoid being irrevocably committed to one. At the same time, however, for us to stand back from the position Sir Bryan Carsberg has now taken publicly would send a clear signal to BT that there was a gap between us and would encourage them to resist a price cap far more strongly than they might otherwise. This would clearly prejudice the preferred outcome towards which we are working. It might also undermine Sir Bryan's confidence in our position. For the reasons I have explained in earlier correspondence, we need to work closely with Sir Bryan during the course of the review. For the Government to distance itself at this stage on such an important issue could make it more difficult subsequently to gain

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his support for the outcome we want.

BT will not find it easy to defend itself against proposals for a price cap. Sir Bryan's investigations suggest that it is making a very high rate of return, perhaps 80% or more, from its international operations. This is of course being paid for by its customers. Sir Bryan has said publicly that he believes there is a strong case for a price cap. I think it would be wrong for us to stand back from the interests of the consumer in such an important area.

The issue of an international price cap will form part of the negotiations we will need to have with BT towards the end of the review. Much will turn on the level of the price cap and the other issues that are relevant at the time. As regards the level, BT's latest tariffs for international call charges for the coming year are approximately equivalent to RPI-11. This compares to Sir Bryan's confidential advice to me that he would envisage a price cap in the range RPI-15 to RPI-20. The gap between BT's present level and the bottom end of Sir Bryan's range is therefore not that great. It is too early to take a firm view but I would not wish to dismiss the prospect of reaching agreement without reference to the MMC.

For these reasons, I think the Government's interests are best served by supporting Sir Bryan's position. The important point is that, because of our separate statutory responsibilities, it is for Sir Bryan rather than me to pursue the case. The Government can therefore indicate, as we do in the consultative document, that we support Sir Bryan's inclination to seek a price cap on BT's international services. The final outcome will then depend on the responses that are received to the consultative document and on the further detailed work which Sir Bryan has said publicly is necessary before he can take a final view.

I am copying this letter to the Prime Minister, members of E(A), Douglas Hurd and David Waddington and to Sir Robin Butler.

Yours sincerely
Martin

(Approved by the Secretary of State
and signed in his absence.)

POST + TGLG: Futurum PT13

11.10. PM 90

cc PU

CONFIDENTIAL AND MARKET SENSITIVE

hk.

n. b. P.M
BHP
9/10

Department of Employment
Caxton House, Tothill Street, London SW1H 9NF

Telephone 071-273 5803
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Secretary of State

The Rt Hon Peter Lilley MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H OET

8th October 1990

Dear Peter

TELECOMMUNICATIONS DUOPOLY REVIEW

Thank you for copying me your minute of 26 September to the Prime Minister, enclosing a summary of the proposals to be contained in the consultative document on the telecommunications duopoly review. I understand that my officials have also seen a copy of the full draft text.

I welcome your proposals to end the present duopoly, liberalise the market and further open it up to new entrants, thus reducing the dominant position of BT and, so far as it exists, of Mercury. Further exposure to market forces should not only spur BT and Mercury (and other operators) to improve their efficiency and customer services, but should also encourage them to make their labour practices and pay arrangements more flexible and market-oriented, with a beneficial effect on labour costs and ultimately on prices.

As you indicate in your minute, it is particularly important that BT is pressed and encouraged in this direction, because of the disadvantages associated with its monolithic structure, which of course we agreed not to address in the consultative document.

I am copying this to the Prime Minister, members of E(A), David Waddington, and Sir Robin Butler.

Yours ever

Michael

MICHAEL HOWARD

POST + TELS : Future Pt 13

CONFIDENTIAL

Tel
EA

cc PU

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 October 1990

Dear Martin,

TELECOMMUNICATIONS DUOPOLY REVIEW

The Prime Minister was grateful for your Secretary of State's minute of 26 September setting out his further proposals for conducting the Telecommunications Duopoly Review. She has also seen the letters from the Home Secretary (4 October) and the Chancellor (5 October) on this subject.

The Prime Minister is content to pursue the strategy on the Duopoly Review set out by your Secretary of State, and for the text of the consultation document to be finalised and circulated to colleagues.

I am copying this letter to the Private Secretaries to members of E(A), Colin Walters (Home Office) and to Sir Robin Butler.

Yours ever,

Barry

BARRY H POTTER

Martin Stanley Esq
Department of Trade and Industry

CONFIDENTIAL

EA

chex.ps/tt/77 **CONFIDENTIAL AND MARKET SENSITIVE**

SCPU

8

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

5 October 1990

Rt Hon Peter Lilley MP
Secretary of State for Trade
and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H 0ET

Dear Secretary of State,

DUOPOLY REVIEW

WITH BP!

I have seen your minute to the Prime Minister of 26 September.

I am broadly content with the proposals which you outline, and our officials are settling the final text of the consultation document.

But I should raise with you a concern about the handling of international tariffs. You say that you propose to support Sir Bryan Carsberg's inclination to seek a price cap on international tariffs, but you also point out that the price cap is almost certain to be resisted by BT, and that this could only then be imposed by an MMC reference with a favourable outcome. Sir Bryan Carsberg hinted at this when he announced his interim view on a price cap on 1 October. As you note, such a reference would raise timing difficulties in relation to a future share sale. Although Sir Bryan Carsberg will need to act in the light of his own statutory responsibilities, I think that it could be unwise for the Government to commit itself to supporting the idea of a price cap at this stage - and I note that this is in effect what you say in the text of the consultation document. I think we are agreed therefore that the Government should remain silent on the point at this stage, and if asked should simply note that the Director General has expressed an interim view on the point.

I am copying this letter to the Prime Minister, to members of E(A), to David Waddington and to Sir Robin Butler.

T. Tarkowski

pp JOHN MAJOR

[Approved by the Chancellor of the Exchequer and signed on his behalf.]

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW

E(A) considered the Telecommunications Duopoly Review in July. The Committee concluded that the review (to which the Government is committed) should start with the issue of a consultative document early in November. The aim would be to complete the review quickly so that there could be a further sale of BT shares in 1991.

The attached minute (flag A) from Mr. Lilley sets out his proposals for the consultative document. The main themes are to end formally the present duopoly policy; to be prepared to license new telecommunications operators; but not to press for a break-up of BT at this stage.

There are four main issues to be considered.

(i) At the local level, the cable franchise companies need to be free to offer telephone services independently of BT and Mercury. They are already beginning to do so. Mr Lilley wants to encourage this by ending the duopoly.

(ii) However BT want to provide entertainment services over its local telephone network. This would compete with the new cable companies. There would be a danger of BT not only swallowing up cable companies entertainment businesses, but also preventing effective competition on local telephone services. Accordingly Mr. Lilley proposes restrictions on BT providing entertainment services for at least seven years.

Mr. Waddington (Flag B) is not convinced this is long enough. But he is prepared to accept mention of the seven year period in the consultation document.

(iii) On trunk services, the end of the duopoly is again expected to help. But OFTEL will need to ensure that it will be possible to inter-connect amongst networks.

(iv) The most difficult issue is international services. The structure of charges is determined by international agreement. OFTEL have proposed price capping of BT charges. This might damage UK interests in the short term; but over the longer term it should ensure better competition.

There is a drawback however as the Chancellor's letter (flag B) points out. If the OFTEL proposal for price capping were to go to the MMC, this might delay the date at which BT shares could be sold next year. Accordingly he and Mr. Lilley have agreed that the Government should not commit itself to supporting the idea of price caps at this stage.

Conclusion

The Policy Unit note (flag C) and Treasury (flag D) broadly support Mr. Lilley's strategy. They are content to finalise the draft consultation document on the above basis.

Content to go ahead as planned (the next step would be to see a draft of the consultation document)?

BHP

(BARRY H. POTTER)
5 October 1990
c:\economic\telecomm (ecl)

CONFIDENTIAL & Market Sensitive

B

HOME SECRETARY

QUEEN ANNE'S GATE LONDON SW1H 9AT

4 October 1990

CCPU

Dear Secretary of State

TELECOMMUNICATIONS DUOPOLY REVIEW

will BP?

Thank you for sending me a copy of your minute of 26 September to the Prime Minister.

I would be content for the consultation paper to be published in its present form, subject to one or two minor points which my officials have passed to yours. I am pleased that it has proved possible to dovetail the timetable for the review with that for the privatisation of the IBA's transmission network.

The one point on which I have doubts is the timing of the proposed removal of the restriction on BT carrying entertainment services over its main network. It is common ground that this restriction should be removed as soon as the cable industry is sufficiently robust to face competition from BT. It is clearly a difficult matter of judgment to predict when that position will have been achieved. I agree that we need to give the cable operators an incentive to install their networks; and they can, of course, be expected to press for a longer period of protection than would be warranted. I am nevertheless slightly concerned that your proposal - which effectively guarantees their position for only seven years - may not provide sufficient certainty for an industrey which has such a long pay-back period. I am content for this proposal to appear in the consultation paper. But we will need to consider carefully the responses on this point, and be prepared to adjust our proposals if necessary.

I am copying this reply to the Prime Minister, members of E(A) and to Sir Robin Butler.

Yours sincerely

Sam Dear

(Approved by the Home Secretary and signed in his absence.)

The Rt Hon Peter Lilley, MP.
Secretary of State for Trade & Industry
1 - 19 Victoria Street
LONDON, S.W.1.

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CONFIDENTIAL AND MARKET SENSITIVE

PRIME MINISTER | **3 October 1990**

TELECOMMUNICATIONS DUOPOLY REVIEW

Mr Lilley seeks the agreement of colleagues to his proposals on the main issues which emerge from the consultative document prepared by his officials and by the Office of Telecommunications (OFTEL). It is intended to publish the consultative document early in November and to complete the Review itself by the end of February 1991 when the final decisions will be taken.

- The great liberalisation introduced by the 1984 Telecommunications Act has been an overwhelming success. **But the duopoly regime has not done enough to put pressure on BT** whose performance is in general poor (and reflected in its share price).

- The aim of Mr Lilley's proposals is to maximise competition by ending duopoly but also by seeking ways to restrain BT's ability to abuse its position of dominance in the market. **We should strongly support them.**

- BT accepts the urgent need for a massive internal reorganisation and greater competition. But the Review will increase pressure on its management and they will resist many of its proposals. **Changes in licence conditions can only be IMPOSED after an MMC enquiry.**

- Such enquiries would complicate the timetable for a possible sale of the Government's shareholding in BT. BT management wants that to happen, so we should aim to avoid involving the MMC at this point if possible. **Compromise in negotiations eg on the precise level of international price capping need not threaten the main impact of the Review.**

Objectives of the Review

The primary objective is to promote vigorous competition. As a result business and private consumers will have the widest possible choice of high quality services at competitive prices. Changing the regulatory regime which has operated since 1984 would not be enough to achieve that. The major distortion which needs corrective action is the overwhelming dominance of BT although an actual break-up of BT was excluded from the Review by the decision of E(A) at its 21 June meeting.

The second objective is to clear the way for a possible sale of the Government's 49% shareholding in BT, now worth about £8 billion.

The Recommendations

The recommendations should be welcomed. They promote competition by allowing new telecommunications operators to be licensed. And they propose specific measures to curb BT's market dominance.

Local Services

At the **local level,** ending the duopoly allows new companies to apply for licences to run networks. But the key issue is that the cable franchise companies will be free to offer telephony services **independently** of BT and Mercury. They are now actually beginning to install their networks so competition is latent in an area where BT still has 97% of the market. Its successful development depends on a second decision about the restrictions which prevent BT from providing entertainment on its network.

If the Review permits BT to provide entertainment over its fixed local network now, the cable companies will in many cases pull out because they will not be able to justify their huge capital investment in networks. BT will be under no pressure to develop the service for consumers, and when ultimately it does, it will have a near monopoly. Mr Lilley is right to recommend that the restrictions on BT providing

Entertainment should run for another 10 years (with a review after 7). **It should be the minimum period.**

Trunk Services

For **trunk services,** the ending of duopoly will attract new competitors. The Utilities, in particular, are well placed to offer services. However, this is an area in which the Regulator will still need to be vigilant to stop cross-subsidies from firms' other activities and especially **to make absolutely sure that one provider of services can get interconnection with other networks on the right terms.** Mr Lilley's proposals recognise this.

International Service

Business users of **international services** are being overcharged. But the structure of charges is a matter of international agreement. Sir Bryan Carsberg has said however that (a) BT's prices should be capped and (b) competitors should be allowed to lease capacity from it in bulk and retail it to their customers.

(a) Price capping could add to the UK balance of payments deficit if international companies start their telephone calls in London. We will collect less here and pay the same wherever the calls are delivered. But it will stimulate activity here with lower costs and **the balance of the argument is with OFTEL's proposal.**

(b) The resale idea can only work if it is limited to countries which offer UK companies the same freedom - the US, perhaps Japan but not the EC. **But the scope for competition is tremendous** - one company has already announced that it will offer calls to the US for 73 cents a minute against BT's current $1.

The Way Forward

Most of the recommended options can be implemented without primary legislation through licence changes agreed with the Director General of Telecommunications. However, if BT did not reach an agreement with OFTEL or the Secretary of State on a specific issue, a reference to the MMC would be the only way of resolving that problem.

Mr Lilley notes that BT will almost certainly resist the OFTEL recommendation that its international charges should be capped. Sir Bryan Carsberg has announced that he would, if necessary, refer that issue to the MMC. **It is to be hoped that negotiation can avoid that.** We cannot be absolutely sure that the MMC would be able to do its work in time for a decision to be incorporated into the final outcome of the Duopoly Review. If it dragged on, it would complicate preparations for a possible share sale. The risk should not be over-stated because City analysts will have a pretty fair idea of the possible range of outcomes but the clear objective must be to minimise uncertainty.

BT management wants the Government to sell its shareholding. But it is in the throes of a major reorganisation and may be tempted to hold out for MMC enquiries on some of the proposed changes in the licence conditions as a defensive measure.

What BT wants

BT wants to be able to convey and provide cable entertainment services over its main fixed network. It recognises that the cable operators will not make the massive investment required of them if BT is given that freedom at once. The issue is about the length of the period of protection which the cable companies should be given. BT will argue against a 10-year period with a review after 7. **No concession should be given on this issue** - as Mr Lilley makes clear, effective competition on the local networks awaits the development of the cable company network over which telephony will ultimately be offered to private consumers.

BT also wants to be able to offer tailor-made packages of services to large corporate clients. At the moment, Mercury is able to undercut BT tariffs for big users and BT alleges a large cross-subsidy to domestic consumers. OFTEL says that BT cannot offer packages unless it can show that they represent genuine cost savings. BT says it cannot provide enough information to satisfy OFTEL; **we should be very cautious about allowing packaging** until they do.

In principle, BT would extend that argument to say that it should be allowed **to rebalance the whole of its tariff structure,** but because that implies higher charges for ordinary households, BT accepts that **we are not likely to change the agreed 'RPI-4.5%' formula** before it comes up for review in 1993.

BT wants more flexibility to use radio technology in conjuction with its fixed network. At present, it is restricted to prevent unfair competition with the cellular and Telepoint operators. Within radio frequency parameters to be determined by the Radio Communications Agency, there would be a case for allowing more flexibility because in specific areas, the use of radio links would allow BT to offer a better service more cheaply. **Mr Lilley makes it clear that he is open to discussion on this issue.**

What BT does not want

BT does not wish to be broken up. We had previously accepted that consumers might well suffer from the dislocation caused by break-up and, equally, that the sale of the Government's stake would be postponed. However, **Mr Lilley makes it clear that he wishes to prevent abuses made possible by BT's vertical integration and market power, by promoting much greater transparency in its various operations to prevent cross-subsidies and to give the Regulator better information about particular sectors which it is difficult for new competitors to penetrate.** This could be achieved by much more detailed disclosure of internal accounting information to OFTEL, or by putting the different businesses into separate Companies Act companies. **BT will resist both options but this is an issue of fundamental importance on which we must insist.** BT intransigence leading to an MMC reference could only be a delaying tactic but we should aim to avoid it because it would complicate the possible sale of Government shares.

BT will oppose the setting of a price cap on its international services, as noted above. **It will resist the proposal for licensing new international operators and the recommendation that we might allow full satellite liberalisation.** In practice, it would be some time before new competitors established themselves so these issues are much less important than the price cap.

Conclusion

We should support Mr Lilley's proposals strongly.

BT can be expected to resist many of them. The aim must be to avoid references to the MMC as a way of imposing solutions. That would limit the scope for selling the Government's shareholding.

Howell Harris Hughes

HOWELL HARRIS HUGHES

dti
the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

CCPU
(letter only)

COVERING CONFIDENTIAL

Dominic Morris Esq
Private Secretary to the
Prime Minister
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Our ref JW9174
Your ref
Date 1 October 1990

Dear Dominic

TELECOMMUNICATIONS DUOPOLY REVIEW

WITH BP/DM?

My Secretary of State minuted the Prime Minister on 26 September inviting agreement to the main proposals which should be included in the duopoly review consultative document to be issued in early November. In this minute he said that the text of the document would be cleared with officials in departments, which is my purpose in writing.

I attach a copy of the draft consultative document. - in folder attached. I would be grateful if you and copy recipients would arrange for the appropriate officials to send any comments on the document to Peter Smith in our Telecommunications and Posts Division, Room 422 Kingsgate House, 66-74 Victoria Street, London SW1. His telephone number is 215 8099. It would be helpful to have these comments as soon as possible, but no later than close of play on Thursday 4 October.

Copies of this letter go to the Private Secretaries of the members of E(A) and PS/David Waddington and PS/Sir Robin Butler.

Yours sincerely

Martin Stanley

RC

ROSALIND COLE
Private Secretary

Recycled Paper

ECPU

n.b.P.M
- until E(A)
discussion.

Department of Employment
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Secretary of State

Lord Hesketh
Minister of State
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

1A October 1990

at flop

Dear Alexander

You circulated a memorandum outlining your views on the Post Office's Corporate Plan for comments.

I agree with the general line of most of your recommendations, which are sensible and constructive, and I look forward to the forthcoming discussions in E(A) about future Post Office strategy. You do, however, mention that you intend asking the Post Office to begin work on costings in advance of the E(A) discussion and it will be important to bear in mind the concerns we have that any alteration in the basis on which deliveries are made should not lead to a damaging reduction in the standard of service for small firms located in residential areas. We will of course be returning to this and other concerns at E(A).

I would also like to make a few comments about your proposals on pay.

An explicit pay and earnings strategy is of course of major importance, especially in those parts of the Post Office businesses where competition is indirect. Such a strategy needs to address not only the absolute costs of the postal services, but also their efficiency and responsiveness to consumer demand.

Your memorandum, instead of supporting the Post Office's plan to increase basic pay by 0.5% in real terms during the period, says that the aim should be to contain basic pay rises within RPI. Whilst I would support this against the Post Office's preferred approach, I am concerned that it does seem to make an explicit

Secretary of State
for Employment

indexation link with the RPI. I would hope that this would, if at all possible, be avoided. Rather, preferred parameters on pay should be "well within" the RPI - which allows at least the possibility of increases below the rate of inflation.

A related problem for the Post Office is the high proportion of labour to other costs. Simply containing basic pay increases will not of itself be enough to achieve a resolution of recruitment and retention problems, and improve efficiency. There could be merit in pursuing a strategy which seeks to reduce the <u>proportion</u> of basic pay in total earnings, and concentrates more on raising the proportion of performance - related and supplementary pay; the latter building on the existing regional pay provisions. This would take account of the need for flexibility, which until recently has been almost totally lacking in the Post Office's approach and still needs to be given far greater emphasis.

I am copying this letter to the Prime Minister, members of E(A), David Waddington, Tony Newton and to Sir Robin Butler.

Yours ever
Michael

MICHAEL HOWARD

cst.ps/dr/5nl27.9

n.b. P.M. BHP 3/10

CONFIDENTIAL

Treasury Chambers, Parliament Street SW1P 3AG

Lord Hesketh
Minister for Industry and Consumer Affairs
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1P 3AG

28 September 1990

Dear Alexander

POST OFFICE CORPORATE PLAN

Thank you for your letter of 18 September 1990.

2. I am grateful to you for your helpful memorandum on the Post Office's well-prepared corporate plan. I am broadly content with the line you mean to take, but I do have a few suggestions which I should be grateful if you would consider before you write to the Post Office.

3. On the separate costing of the first and second class letter streams, we should as a first step ask the Post Office to cost out the preparation of separate cost-accounts; only if we are then agreed that the benefits are worth the cost should the Post Office be asked to implement the proposal.

4. I welcome your wish to encourage Royal Mail to reduce its dependence on labour. Mechanisation has a part to play. But one of the Post Office's core labour problems is industrial disruption. It would therefore be worth considering whether to encourage the Post Office to look at ways of contracting out core letters functions.

5. I also welcome your intention to ask the Post Office not to plan to increase basic pay in real terms this year and note that settlements have already been agreed on this basis at both Counters and Parcelforce. This is also consistent with the negotiating remit recently agreed for Royal Mail Letters. Future settlements will need to be judged on their merits. But earnings growth will depend crucially on productivity growth. You may also wish to emphasise in your recommendations the desirability of reducing basic pay as a percentage of earnings and the further separation of pay negotiations within Royal Mail.

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CONFIDENTIAL

6. For Counters, I am not sure of the benefit of waiting until the Post Office have reached what they envisage to be a core network of 650 offices before we press them to go further. If we are agreed on the objective of a smaller and preferably all-Agency network, then we could make this clear to the Post Office now so that this objective forms part of their planning and informs their sales strategy. Also, we should discourage Counters from retaining ownership of premises when a Crown Office is converted; the question of whether agencies are viable is a matter of agency terms, not land ownership.

7. We should also be wary of Counters' reasoning on priced options. Counters is an agent, not a principal. Recognition of customers' need for agency services is a matter for the client, not for Counters. If clients do not value the delivery of services in particular areas then it is not for Counters to substitute its own judgement. I understand there may be a concern for some marginal offices. But we should not let Counters' desire to keep up its network lead to extra costs for clients. I am therefore pleased that your officials are discussing this further with Counters, and I should be grateful if they would keep mine in touch.

8. On TVL, I welcome your wish to study privatisation further. My own preference would be to sell TVL from April 1991 if it wins all or part of the BBC business, and to leave it to the new owner to take any steps to develop the business. I look forward to receiving your proposals in due course.

9. I understand that Parcelforce are undertaking major cost-cutting, including reductions in management tiers, in response to problems identified through the discrete income project. The Post Office should recognise that, if there is scope for such extensive cost-cutting in Parcelforce, there is likely to be scope for similar useful action at Royal Mail and elsewhere; timely implementation of such action would help improve efficiency and perhaps serve to reduce the need for tariff rises.

10. On tariffs, I agree that it is important both to protect the financial targets and public expenditure limits and to help the Post Office's incremental approach to improving service quality by increasing the differential between first and second class post. Our first choice is greater efficiency leading to lower costs. But if it should prove necessary, then I welcome the changing mix of tariff assumptions which underpins your recent IFR bid: increases on first/second class of 3p/1p in October 1991; a reduced rise of 1p/0p in October 1992; and 1p/1p in 1993.

11. Copies of this letter go to the Prime Minister, members of E(A) Committee, David Waddington, Tony Newton and Sir Robin Butler.

NORMAN LAMONT

POST + TELS: Future Pt 13

DEPARTMENT OF SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 071-210 3000
From the Secretary of State for Social Security

Lord Hesketh
Minister of State
Department of Trade and Industry
1-19 Victoria Street
London
SW1H 0ET

27 September 1990

Dear Alexander,

POST OFFICE CORPORATE PLAN

Thank you for copying to me your letter of 18 September to Norman Lamont enclosing a memorandum setting-out your views on the Post Office's Corporate Plan for 1990-1995.

The new profit targets for the Post Office are potentially in conflict with my own Department's targets for efficiency savings. Thus unless the Post Office are able to bring forward measures to secure reductions in operating costs it will become increasingly difficult to reach agreement on a fee which enables both targets to be achieved. I am therefore, pleased that you intend to encourage the Post Office to proceed quickly with Crown Office conversions and to extend Mailsort. Both these initiatives should be helpful to my Department in seeking to reduce unit costs.

I am copying this letter to the Prime Minister, Norman Lamont, members of E(A), David Waddington and Sir Robin Butler.

Tony

TONY NEWTON

POST + TELG : Future PT13

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the department for Enterprise

CONFIDENTIAL AND MARKET SENSITIVE

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW

Minutes attached

At its meeting on 21 June, E(A) agreed that we should issue a consultative document as the formal start of the telecommunications duopoly review setting out the issues and, where appropriate, the Government's preferred options. It was further agreed, in correspondence, that the document should be published early in November and that we should aim to complete the review quickly, if possible by the end of February 1991, so as to leave open the possibility of a further sale of BT shares later that year.

I have now completed a detailed draft of the consultative document. In order to meet the target publication date of early November, the text will need to be finalised very shortly. The purpose of this minute is to seek your agreement and that of colleagues to my proposals on the main issues. We do not need to take final decisions on them at this stage but only on our preferred options as a basis for consultation. My proposals, summarised below, are entirely consistent with the position endorsed by E(A). They also reflect the views of Sir Bryan Carsberg who will play a key role in implementing the outcome of the review.

<u>Substantive issues</u>

The duopoly review provides an opportunity for us to take a major step forward in promoting greater competition and a more open market in telecommunications. This approach was endorsed by E(A) and I have sought to develop it further in preparing the consultative document.

My central recommendation is that, on completion of the review, we should formally end the present duopoly policy and be prepared to license new telecommunications operators. This in itself would be a significant market opening measure and will, I believe, be widely welcomed. It is likely to have a different impact in the three main sectors of the market - local, trunk and international. I should like to deal with each of these in turn.

With the ending of the duopoly, new companies would be able to apply for licences to run local telecommunications networks. We have already set in train major developments in this sector of the market and for this reason, as well as the significant level of investment that is needed to establish a local network, I doubt that many new entrants will wish to come forward, at least on a large scale. This is not, however, a reason for not giving them an opportunity to do so. Indeed, I believe that the very fact that further entry to the market would be possible would itself put pressure on the present operators to provide a better service.

The position of the cable television franchise companies deserves particular mention here. They are only now beginning to install their networks, with a build programme that will typically take at least five years to complete at a total cost of approximately £2-3,000 million. At present cable companies may only provide a telephony service as the agent of BT or Mercury. BT has shown no interest in using the cable companies as their agents for telephony since it would effectively be competing with itself, while Mercury has shown only limited interest even though it currently has virtually no presence in the local network. Consequently, only three cable operators at present offer telephony services and only on a very limited scale - in total about 1,000 subscribers, mainly businesses. I hope to increase this greatly by allowing them to operate independently of BT or Mercury. I am therefore proposing to indicate this preference firmly in the consultative document.

For its part, BT would like to be released from the present restriction on providing entertainment services over its main network. The argument in favour of removing the restriction is that customers would ultimately benefit from the greater efficiency of integrating telephony and entertainment services. The cable companies also need to feel under some pressure to install their networks and establish a presence in the market. But to remove the restriction too soon would drive away the investment interest in cable franchise companies. We need to strike a balance. I am therefore proposing that we should remove the restrictions on BT after ten years but that we would be prepared to reconsider the position after seven years provided that the Director General of Telecommunications advised that removing the restrictions would be likely to promote effective competition. The cable companies would then have at least seven years, and possibly longer, in which to establish themselves, while BT would know that there would come a point when they would be allowed to enter the entertainment market.

In contrast to local networks, I believe the removal of the duopoly constraint in the <u>trunk</u> network would lead to new operators coming forward. This would provide important competition with BT and Mercury who have tended not to compete strongly with each other. At the same time I would wish to ensure that there were satisfactory arrangements for interconnection between different operators' networks and for accessing one network via another. These would largely fall to Sir Bryan Carsberg under the terms of the existing operators' licences.

In the area of international telecommunications,the present arrangements allow BT and Mercury to make excessive profits. I propose recommending two steps to bring down prices: for Sir Bryan Carsberg to seek a price cap (of the RPI - x type) on this aspect of BT's business; and for me to issue a new licence to permit "simple resale" whereby companies could in effect set up a business to compete with BT and Mercury by leasing capacity from them and reselling it to third parties. It is important to note, however, that a price cap will almost certainly be resisted by BT and Sir Bryan would only be able to impose it following a favourable reference to the MMC. Such a reference could raise timing difficulties in relation to a future share sale and we would therefore need to consider the issue carefully at the time.

Looking to the longer term, I intend to indicate our willingness to consider, as in other sectors of the market, licensing new entrants to run international networks. We have to recognise, however, that most countries in the world are less liberal in their approach to telecommunications than we are and for a variety of reasons this factor is likely to limit the effectiveness of any new competition in this area.

British Telecom

It was agreed at E(A) that the possible break up of BT should not be mentioned in the consultative document. It is important, however, to put greater pressure on BT to become more efficient and to provide a better service to customers. A key issue here is BT's wish to be allowed to restructure its tariffs more quickly than it can at present so as to increase exchange line rentals and connection charges and to reduce call charges. Superficially this may appear attractive as a means of encouraging competition at the local level by increasing the available margins on installing a competing network while helping to bring call charges more into line with costs. In practice, however, it would reduce pressure on BT's local network, where its inefficiencies are greatest, and would be politically unpopular because many ordinary customers may have to pay more for their telephone. I am therefore proposing that we would not wish to see restructuring take place more quickly than is provided for under the present price controls.

Other issues

In previous correspondence, David Waddington drew attention to the timing of the review in relation to the privatisation of the IBA's transmission network. This has been reflected in the timetable I have outlined above. My officials are keeping closely in touch with David's on this. He also noted the potential implications for national security and the prevention of serious crime. These issues have been addressed by a separate working party chaired by Home Office officials and its conclusions taken into account in drafting the consultative document.

Conclusion

There is well-justified pressure for further liberalisation of the telecommunications market. I believe my proposals will be well received not only by companies wishing to enter the market but by business and residential customers alike. We have one of the most open telecommunications regimes in the world and I am determined that we should build on this so as to provide further benefits to our economy.

I should be grateful for your agreement to the proposals set out above. My officials will then finalise the text of the document in consultation with other departments that have a main interest.

I am copying this minute to members of E(A) and David Waddington, and to Sir Robin Butler.

P B L
26 September 1990

[approved by the Secretary of State and signed in his absence]

DEPARTMENT OF TRADE AND INDUSTRY

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Direct line 071-215 4301
Our ref AM6
Your ref
Date 25 September 1990

Dear Norman

PARCELFORCE RECOVERY PLAN

My memorandum to colleagues on the Post Office Corporate Plan sent to you on 18 September outlined the problem on discrete income which faces the Post Office. I am writing to let you know about the recovery plan which the Post Office Board has approved tackle the effect of discrete income on Parcelforce.

You will recall that a more accurate method of dividing the stamp and postage meter income attributable to Parcelforce and Royal Mail proved necessary to satisfy the more rigorous requirements for separate auditable accounts. The previous system has significantly over-estimated the income due to Parcelforce within a range of £40m to £55m pa and hence underestimated the income due to Royal Mail. While the net effect of this on the Post Office's bottom line is nil at worst, it has major implications for Parcelforce's profitability and its ability to meet its financial targets. These cannot be fully quantified until the Post Office is clearer on the exact extent of misattributed income and until a number of other factors, such as the outcome of negotiations on inter-business charges, are known.

The outline recovery plan for Parcelforce will be worked out in detail for Board consideration in October. The plan aims to recover £80m pa, taking the most pessimistic view of income misattributed to Parcelforce (£55m) and allowing for £25m of trading risks resulting from higher inflation and lower volumes. The Board believes that major price increases would prove counterproductive but Parcelforce will charge what the market will bear. It will aim for income improvements, for example, through more frequent, but not necessarily greater price increases in line with the practice of most of its competitors. The main focus of the recovery plan is on cost reduction, through reduction in business overheads, structural reductions in network costs, operating economies and reduced use of inter-business services which will result in lower (inter-business) charges. Parcelforce staff is expected to be reduced by 2,800 by 1992/93, which is 18% fewer staff than forecast in the Corporate Plan. Improved revenue collection will make a further contribution. The attached appendix summarises the impact of the recovery strategy on profitability compared to the Corporate Plan (your officials have further details).

Structural reductions in network costs will offer the largest single contribution to the projected savings - £17m, £33m and £33m between 1991/92 and 1993/94. These will affect the strategy for rapid separation of Parcelforce's standard service Network 1 from Royal Mail, on which Eric Forth wrote to you on 10 November. Rapid separation was intended to give Parcelforce direct control of about 80% of collection and delivery in Network 1 by 1993/4 through investment in its own main parcels concentration offices (pcos) to be served by local parcels depots (lpds) and its own vehicles. The recovery plan will accelerate closures of pcos to achieve 11 closures by the end of 1991/92 instead of 10 by the end of 1993/94. No decision has yet been taken on investment originally planned for five new pcos. Development of 156 lpds will for the time being stop at the 85 already planned for completion by the end of 1990/91. However, this includes the strategic core of 60 lpds intended to safeguard service to Parcelforce's main customers in the event of another Royal Mail strike. Parcelforce will then itself provide 50% of its services, compared with the planned 80% and against the projected savings must be offset redundancy costs and some loss in efficiency gains. The need for further lpds will be reviewed in the light of progress on the recovery plan. Parcelforce believes that this programme should not harm customer confidence.

The recovery plan is a rigorous one and represents a major effort by the Post Office to tackle the problems revealed by the discrete income exercise. The Post Office Board and Parcelforce acknowledge that there are risks - for example, the plan assumes full co-operation from the workforce - but nevertheless they believe that it is achievable. Clearly, the need for a recovery plan, coupled with later introduction of

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separate accounts in 1991/92, is a setback to the prospects for privatisation of Parcelforce. As you are aware, any initial negative effect on the EFL from Parcelforce's recovery plan should be more than offset by the windfall gain to Royal Mail from the corrected attribution of income.

I am copying this letter to the Prime Minister, Eric Forth, James Douglas-Hamilton and Sir Robin Butler.

Yours ever.

Alexander

LORD HESKETH

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APPENDIX

PARCELFORCE RECOVERY PLAN

RECOVERY STRATEGY - INDICATIVE IMPACT ON PROFIT

(At constant prices)	1990-91 (£m)	1991-92 (£m)	1992-93 (£m)	1993-94 (£m)
1990 Corporate Plan profit forecast		24	34	49
Discrete Income & Trading Risks exposure		(80)	(80)	(80)
Updated Corporate Plan forecast		(56)	(46)	(31)
Income improvement (Appendix 1)		8	9	10
Cost reduction (Appendix 2)		55	80	80
Revenue collection		10	10	10
Impact of Recovery strategy		17	53	69
Reduced network operating savings from LPD re-phasing		(7)	(14)	(19)
Recovery strategy planning costs (contingency)		(3)	(3)	
Revised profit, before exceptional items		7	36	50
Exceptional items - redundancy costs	(9)	(12)	(7)	
- asset write offs	(9)	(2)	(4)	(10)
Revised profit, after exceptional items		(7)	25	40

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Direct line 071-215 4301
Our ref AM5
Your ref
Date 18 September 1990

Will send only if required (v. bulky)

Dear Norman

not attached

I attach a memorandum setting out our views on the Post Office's Corporate Plan for the period 1990-1995 which was submitted to this department earlier in the year. Your officials have been involved in discussions with the Post Office on the Plan and the attached paper has been cleared in draft with them.

I intend to write to Sir Bryan Nicholson in the near future to let him know our views on the Corporate Plan and to give the Post Office adequate time to take our comments into account in formulating next year's plan. I would be grateful for your agreement to the recommendations in the attached memorandum by Wednesday 3 October. Comments from other colleagues would also be welcome but unless I hear from them within the same period, I shall assume that they are content.

I am copying this letter to the Prime Minister, members of E(A), David Waddington, Tony Newton and Sir Robin Butler.

yours ever.

Alexander

LORD HESKETH

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POST OFFICE CORPORATE PLAN 1990-1995

MEMORANDUM BY THE MINISTER OF STATE AT THE DEPARTMENT OF TRADE AND INDUSTRY

Introduction

1. The Post Office has submitted its Corporate Plan for the five year period 1990-95. The Plan outlines the key issues for the Post Office throughout this period and examines the prospects for its businesses, principally Royal Mail (formerly Letters), Parcelforce, Post Office Counters Ltd and TVL. The Plan does not include Girobank which was transferred into private ownership on 2 July.

2. As you know, Nicholas Ridley had undertaken a review of our strategy towards the Post Office and at the same time the Post Office itself has been reviewing the structure of its letter delivery services. His conclusions were set out in his letter of 2 July to the Prime Minister and are due to be discussed by E(A) shortly. The present Plan has therefore had to assume that the letter monopoly will remain at its present level and the structure of and services provided by Royal Mail will continue much as they are. The outcome of the reviews will need to be addressed in the next Plan. A further issue which arose too late to be addressed in this Plan but is expected to have a significant impact on the businesses during the Plan period is the effect of moving to a more accurate method for attributing income between Royal Mail and Parcelforce. These factors mean that the detailed plans for Royal Mail and Parcelforce this year are somewhat artificial. Nonetheless, there is much that is useful in the Plan.

3. Against this background, the Corporate Plan addresses a number of points which the Post Office Board regards as key issues for the Plan period. These are: the need to improve quality of service in the Post Office businesses; pay and earnings strategy and other labour issues; business organisation; "shareholder issues"; and the prospects for the liberalisation of the postal market in Europe as part of the development of the single European market. It also covers the Post Office's proposals for higher capital investment than it planned last year in pursuit of improved quality of service. Discussions on this last issue are taking place in the context of the Investment and Financing Review (IFR).

4. Higher than expected levels of inflation and the slowdown in the economy have meant that long term strategic planning has become subject to greater uncertainty than was foreseen at the time the plan was written. Many of the assumptions, for example on GDP growth and inflation, on which the Post Office based the Plan were already out of date by the time it was delivered to my Department. The Gulf crisis increases the

increases the uncertainty attached to all economic assumptions.

5. A summary of the main points from the Plan for each of the businesses is at annexes A to D. The major issues are considered below.

KEY ISSUES IN THE CORPORATE PLAN

Post Office finances

6. Profit projections for the Post Office and its major businesses as set out in the Plan are at annex E. The Corporate Plan is aimed at meeting the targets for return on capital employed (ROCE) and real unit cost reduction (RUC) which we set for the three years to 1991/2 (further details of targets are at annex F) and for Royal Mail and Counters maintaining returns thereafter at levels equivalent to the 8% required rate of return. Parcelforce, unlike Royal Mail and to some extent Counters, operates in a competitive market and may therefore attempt to achieve higher returns if it can.

7. These profit projections are subject to uncertainty on a number of counts.

8. Since the Plan was drawn up the Post Office has completed a revaluation of its property in line with the change from valuing buildings for specialised use to open market valuation. Partly because of the present depressed property market, this has resulted in a lower value for the Post Office's asset base. It follows that the profits required to meet ROCE targets are proportionately lower (by about £40 million per year). The effects are largely confined to Royal Mail, which holds most of the fixed assets.

9. In addition the Plan is in line with the assumptions about inflation in 1991/2 and 1992/3 which the Post Office was required to make in last year's IFR round. It is now clear that RPI this year will be more like 9-10% than the 5.7% on which the Plan is based. This will have a significant effect on costs this year, which will feed through to later years. At the same time Royal Mail's tariff increase (2p on both first and second class from 17 September) remains at the level assumed in the IFR round and the Plan. We have asked Royal Mail to make the economies necessary to meet the 1990/1 EFL and it expects to do so. However, it may be necessary to consider higher than planned tariff increases in future years (planning assumed a 1p/1p tariff increase late next year) to meet the continuing costs and we will be considering this in the 1990 IFR. We shall also be considering whether it is right to continue to plan for similar increases in both first and second class stamp prices, thus narrowing the percentage differential, when Royal Mail has argued that high volumes of first class mail constrain its ability to improve productivity

and quality of service. About three-quarters of Royal Mail's costs are accounted for by staff costs. Staff reductions may be resisted. There may be scope for savings in the light of the strategy review of Royal Mail - indeed the Plan assumes productivity improvements being found from the review - but the extent to which such savings might contribute to the problem in the short term is very limited.

Quality of service

10. There has for some time been widespread public concern about the quality of the first class letter service. Royal Mail now sets itself end-to-end quality of service improvement targets, agreed with the users' council POUNC, for first class mail on a district by district basis. In 1989-90, the overall level of quality of service (the proportion of first class letters delivered the day after posting) improved by more than the average 3% target but there were districts, notably in and around London, where quality actually declined. New district-by-district targets for 1990/1 have been set for first class mail with particularly challenging targets set for offices with a poor record. They again imply an average 3% improvement. The Plan also includes average targets for the remaining years of the period, by the end of which the number of first class letters arriving the following day should have risen from about 78% in 1989/90 to 88.6%. Even at the levels planned for the end of the period this means about 4 million first class letters a day will not be delivered the day after posting. This falls short of public expectations of a near 100% service and Royal Mail's long standing longer term target of 90%. We can therefore expect that public dissatisfaction with the service will continue if more is not done. Royal Mail argues that there is little more it can do within the constraints of the present service specification, which requires a first delivery before 9.30 am, and with the present volumes of first class mail (about 45% of the total). Nicholas Ridley's strategy paper for discussion in the autumn covers the Post Office's proposals for moving to a single delivery a day taking place (except for businesses) between about 9 am and 2 pm. This together with a much higher-priced premium service would, the Post Office believes, enable it to offer a much more reliable service. Nicholas' paper recommends, however that such changes should be left until after the next election, when they can be combined with increased competition in the market. In the meantime, it seems to me that some improvement might be brought about by widening the differential between first and second class stamp prices and we shall be looking at this in the IFR round.

11. The second class service, for which the target is the more modest one of delivery on the third day after posting, comes much closer to achieving its target. Overall more than 90% of second class mail achieves the target and this rises to 95% for intra-district mail. The second class service would,

however, play a vital part in the changes to service structure proposed in Nicholas' paper on the strategy review. I am anxious that it should be of good and regular quality and if possible a two rather than three day service. I therefore intend to encourage the Post Office to publish improvement targets where appropriate for second class mail.

12. The importance of improving quality is not confined to Royal Mail. All the businesses face competition though for standard letters this is indirect and all need to have regard for customer requirements. Counters has undertaken several measures to improve quality for both its clients and for the customers. Plans for further improvements include reducing queuing times in post offices further and introducing quality of service elements into the contract with sub-postmasters. Counters is also looking at more flexible opening hours to better suit local shopping habits. Quality is especially important in Parcelforce, which operates in an extremely competitive environment. Parcelforce has set itself targets for both Network 1, the ordinary parcel service and for Network 2 and Datapost, its express services. For the standard service it aims to reach 90% delivery on the second day after posting by 1993/94. I shall want to encourage the Post Office to continue to attach a very high priority to the quality of service of all its businesses.

Employee issues

Pay and earnings

13. In line with the strategy of greater separation, the Post Office businesses now have separate pay structures, settlement dates and pay strategies. By far the biggest in terms of numbers of staff is Royal Mail. In the two years 1987/8 and 1988/9 postmen's earnings increased by some 10 to 12 percentage points less than national average earnings, whereas in previous years they had generally kept pace. Last year's Corporate Plan proposed significant real increases in pay in the South East to allow postmen's earnings to catch up some of the lost ground and in other parts of the country increases sufficient to maintain the differential. It was envisaged that this would include significant increases in real basic pay. In responding to the Plan we indicated that we could not endorse a medium term strategy of continuing real increases in basic pay. The present Plan proposes that Royal Mail earnings should increase in line with the national average earnings figures during the Plan period, but that there should be no attempt to catch up the lost ground. The Post Office proposes that basic pay should be increased by 0.5% per year in real terms during the period. Pay strategy for Royal Mail last year was upset and confused by the requirements of the water privatisation coming at a difficult point in the pay round. This is set to happen again this year with the electricity privatisation. Against the background of such short term

pressures, it is difficult to carry through a coherent strategy. Nonetheless and in spite of the arguments put forward by the Post Office for modest increases in basic pay once again this year I intend to ask Royal Mail not to plan to increase basic pay in real terms.

14. There is, however, some scope for increases in real earnings which would help Royal Mail to remain competitive. The introduction of regional pay has helped to reduce high wastage rates in parts of London and the South East but there is a need to reduce such wastage further. Of the 12.5% increase in real earnings which the Post Office proposes for Royal Mail during the Plan period, some 5.3% is intended to be targeted on regional pay. Royal Mail intends also to focus in the Plan period on productivity pay.

15. In the longer term the separation of Royal Mail into smaller profit centres (see paras 19-20 below) and the separation of the delivery organisation envisaged in the strategy paper will provide the opportunity for further separation of pay negotiations within Royal Mail. This is already happening to some extent with the established profit centres such as the catering organisation Quadrant and is a very welcome development. It will need to be considered further in the next Plan along with the outcome of the strategy review.

16. I was encouraged by the assurances given by both the Counters business and Parcelforce that they will seek to contain basic pay within RPI during the Plan period. Further, I note with interest Parcelforce's desire to reduce basic pay as a proportion of total earnings. This is very much in line with our thinking on public sector pay.

Dependence on labour

17. Royal Mail is highly dependent upon labour. At the same time it has an unenviable record of unofficial industrial action which reflects badly on the quality of service as perceived by the consumer. I intend to encourage Royal Mail to continue its efforts to reduce its dependence on labour - by for example increased mechanisation - and in doing so to improve its productivity levels. I shall encourage it to show the link between new expenditure proposals and the reduction in the requirement for labour as well as improvement in the quality of service.

Productivity

18. Royal Mail has set itself a target to increase labour productivity by 18% during the Plan period of which it is estimated that 8% will be found from economies of scale which the Post Office believes will be generated by the projected 24% increase in mail volume. The remaining 10% will depend on

direct productivity measures. How it will be achieved has not yet been made clear and the Post Office says will depend to a considerable degree on the outcome of the strategy review. In view of Nicholas' recommendations, this may not in the event offer much help to Royal Mail within the Plan period. I propose to indicate to the Post Office that it should not simply rely on the strategy review to provide the necessary productivity improvements. Rather it should press ahead as quickly as possible with such measures as the introduction of a standards-based productivity scheme, as recommended in successive reviews, the most recent an MMC report as long ago as 1984 and piloted by Royal Mail during 1989/90 with the aim of national implementation in 1990/1. Counters has now implemented such a scheme.

Business organisation

19. As part of its long term aim to develop a fully commercial and market-led approach to its business the Post Office is taking steps towards further decentralisation of its structure, which will, I am confident, lead to greater efficiency and cost-consciousness. Profit centres are being developed where appropriate (two are already in place in Royal Mail and more are planned) and where possible internal markets - for example in the provision of IT services to the businesses - will be opened up to external competition. Progress may be hampered by the Post Office's VAT status which gives its internal suppliers an automatic price advantage of about 12% over their external competitors. It is not clear that anything can be done to remedy this problem in the short term since any change in the Post Office's VAT status would require an amendment to an EC Directive. We have, of course, made clear our views on the Post Office entering into new areas of external competition with the private sector and will expect to see the profit centres' activities remaining within the Post Office's existing powers.

20. Nicholas Ridley's strategy paper envisages taking this process further, with the separation of the local delivery network from Royal Mail. Nicholas also suggested that the Post Office should proceed rapidly with developing separate rigorous costings of the first and second class letter streams in advance of and in preparation for the more far reaching changes to the letter service structure which he envisaged for the next parliament. Although colleagues are not due to discuss the strategy paper until the autumn, I intend, when responding to the Post Office on the Plan to request it to begin this work. I see it in any case as being consistent with the Post Office's policy of developing profit centres and thereby better establishing its cost base. It is also consistent with our support for cost-based charging for both reserved and non-reserved services in the discussions leading up to the Community Green Paper.

Post Office capital structure

21. The Post Office Board has used the Plan to convey to Government its view that the nature of the financial relationship between the Post Office and the Government - and in particular the EFL mechanism - is not a suitable means of control and that the time has come for change. It recommends the replacement of the present system of external financing limits with an alternative regime which would lead to greater commercial freedom for the Post Office and give proper commercial signals to its managers. An alternative regime is not formally proposed but the Post Office Board maintains that its intention is not to seek an easier regime. It is suggested that an alternative might take the form of an annual dividend to Government comprising either a fixed sum each year for a given number of years or a fixed percentage of profits each year. This line of thinking further develops the ideas of the Select Committee on Trade and Industry which, in a report on the Post Office[1] published last November, recommended that the Post Office should be set up with a "proper debt/equity structure" with the sponsoring department as sole or majority shareholder.

22. The Post Office has not yet convinced me that there is any real advantage, certainly to the Government, in what is proposed as compared with the present EFL regime. My officials have, however, indicated to the Post Office that we would be prepared to consider its proposals for an alternative regime but that any such proposals must be in line with the normal rules of classification and provide adequately for the control of public expenditure. Some of the proposals in Nicholas Ridley's strategy paper, eg the possibility of an independent Regulator, may in any case lead us to look again at what is the most appropriate structure for the Post Office.

Development of postal services in the single European Market

23. The European Commission is aiming to publish a Green Paper on postal services in the single market at the end of the year and has been seeking the views of a group of senior officials over the last year. We have argued strongly for the minimum level of reserved services and flexibility for individual member states to allow greater competition and this line appears to have some support from the Commission. The UK position is, however, considerably more liberal than that of other member states so that getting the right regime is likely to prove difficult. If we succeed, Royal Mail views the prospective liberalisation of postal services as part of the move towards a single market as a major commercial opportunity and intends to establish the UK as the natural gateway for

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[1] Select Committee on Trade and Industry: Sixth Report (session 1988-89); the Post Office.

mailing operations into Europe for mail users' worldwide. Prospects for Parcelforce are less encouraging since the international market is already fully deregulated and dominated by large multinationals. It expects to lose competitiveness and market share in Europe during the Plan period.

<u>Parcelforce separation: issues arising from the development of a system to determine the discrete income of Parcelforce</u>

24. We asked the Post Office some time ago to begin work on separate auditable accounts for Royal Mail and Parcelforce. These were expected to be in place from 1990/1. However, the Post Office Board is currently considering an issue which has arisen from work undertaken to introduce a more accurate method of separating the income attributable to Parcelforce and Royal Mail. There is a single income stream for most letters and parcels because stamps and postage meters can be used for both. It has become apparent that the previous, less accurate income attribution system may have been significantly overestimating the income due to Parcelforce (and hence underestimating the income due to Royal Mail Letters). The new measurement system is at an early stage of development and we shall have to await further progress before we can be confident of the true scale of the problem. The net effect of this on the Post Office's bottom line should be nil at worst but the implications for the future of the separate parcels business and its ability to meet its targets are considerable. The gain for Letters is less significant because the amounts involved are small in relation to the total Letters business. Introduction of full separate accounts is not now expected until 1991/2.

25. The Post Office Board has approved an outline recovery plan for Parcelforce and will be considering the detailed plan in October. The purpose of the plan is to ensure that Parcelforce takes rigorous action immediately to recover the revenue reduction it expects to suffer. This will include extensive cost-cutting measures which will affect its plans for rapid separation of its main Network 1 from reliance on Royal Mail. The issues arising from discrete income were identified too late to be taken into account in the 1990 Corporate Plan. I will expect next year's Corporate Plan to embrace the discrete income issue, the effects of which should be much clearer by then.

<u>Privatisation of TVL</u>

26. A summary of the main points in TVL's business plan is at annex D. In November 1988 when he was Chancellor of the Duchy of Lancaster Tony Newton asked the Post Office to give urgent consideration to the prospects for early transfer of TVL into the private sector. This led to a study produced by Ernst and Young for the Post Office which concluded that the

prospects for TVL developing new business during the next five years were not good and did not, therefore, examine further the possibility of privatisation. The report concluded that TVL could expect to generate the equivalent of only 20-28% of its TV licence work income through new business. In fact the figures were miscalculated and the true figure is probably about a quarter of this.

27. The Post Office accepted, however, the view of the Ernst and Young report that the most sensible way forward for TVL was to diversify its business, thus becoming more attractive to potential purchasers in the private sector. The main area identified for diversification was subscription management. This course of action will probably involve TVL seeking greater powers and it has asked whether we might consider a form of consent which would provide a broad framework of areas within which TVL could seek new business. TVL already has power, in addition to its power in respect of TV licensing, to perform services for satellite and other broadcasters. We have indicated to TVL that we are willing to look at any suggestions it may have for a fairly restrictive form of words but that we would prefer to consider each case for the extension of powers on its merits. The Post Office is, of course, aware of our major reservations about extending its powers in areas where there is private sector competition. We have made clear to the Post Office that wider powers are unlikely to be approved unless early privatisation is planned. It could be argued that it would be better to leave diversification to a private sector purchaser but this would almost certainly mean selling it for a low price.

28. Recently my Department received an approach from a private sector organisation interested in acquiring TVL. In considering the proposal Nicholas Ridley decided that TVL should not be privatised whilst TV licence fee evasion remained a criminal offence. In the meantime, the Home Office has been considering decriminalisation in the light of the Criminal Justice Bill. In a recent minute to the Prime Minister, David Waddington came to the conclusion that the criminal sanction should remain but this remains to be discussed further after the summer break.

29. In light of this I shall wish to consider again whether to pursue the privatisation of TVL. An important point to bear in mind is that from April 1991, responsibility for TV licensing passes from the Home Office to the BBC, which will then be free to contract out this work to whomever it pleases. The BBC has indicated that it expects to rely on TVL's services but it is possible that in the longer term alternatives may be taken up. In any case there is a longer term risk to this work. We have indicated that we would like to see the licensing system replaced eventually and the renewal of the BBC Charter in 1996 will provide an opportunity to review this.

RECOMMENDATIONS

30. This paper covers the main points arising from this year's Corporate Plan: further detail may be found in the annexes. I should be grateful if colleagues would endorse the general line I propose to take with the Post Office which is:

a. welcome the plan which sets out clearly the Post Office Board's main concerns and its view of the direction which the Post Office and its businesses should take in the medium term, subject to the conclusions of the strategy review;

b. encourage the Post Office to continue to attach a very high priority to the quality of service of all its businesses including continued improvement in the first class letter service;

c. encourage the Post Office to publish district-by-district, improvement targets, where appropriate, for second class mail;

d. ask the Post Office not to increase basic pay in real terms; commend the assurances given by both the Counters business and Parcelforce that they will seek to contain basic pay within RPI during the Plan period;

e. encourage Royal Mail to continue its efforts to reduce its dependence on labour;

f. commend the move towards smaller profit and business centres; and ask the Post Office to put in hand work on the separate rigorous costing of the first and second class letter streams and on establishing the local delivery network as a separate business within the Post Office;

g. tell the Post Office that we are willing to consider constructive proposals for an alternative to the EFL regime provided that any such proposals take full account of the Treasury's concerns about classification and control of public expenditure;

h. request that next year's Corporate Plan deals with strategic changes in Royal Mail and the discrete income issue;

i. tell the PO that I intend to consider further our position on the privatisation of TVL;

j. encourage the Post Office to proceed as quickly as possible with the programme of Crown office conversions; and

k. encourage the Post Office to extend its Mailsort scheme to allow major users to put their own mail into the network at the point of their choice down to local delivery offices in return for suitable discounts.

Issues of resources will, of course, be a matter for further discussion in the context of the IFR.

ANNEX A

ROYAL MAIL

Employee and pay issues

This is a key area for Royal Mail given the labour-intensive nature of the business and the recent history of poor industrial relations and difficulties with staff recruitment and retention. Royal Mail's strategy will be to reduce dependence on labour; to encourage the recruitment of part time workers, women, older people, people from the ethnic minorities and the disabled; and generally to improve the attractiveness of working in the Royal Mail. High voluntary quit rates are a problem in the South East and are worsening elsewhere: only 8 out of 63 District Offices have avoidable quit levels below 5%. To help Royal Mail remain competitive in the labour market a strategy of increasing earnings via the introduction of regional pay supplements, greater use of scheduled overtime and productivity pay has been developed. Over the Plan period, staff numbers are forecast to remain broadly constant. In order to improve staff flexibility and reduce the problems associated with demarcation, proposals have been developed to restructure postal staff grading with the introduction of a single, basic mails grade paid at a single rate with allowances for specific tasks. However, the proposals involve fundamental changes in working practices and will not be easily negotiated.

Market plan

The forecast volume growth for inland mail over the Plan period is 24%, an increase of 5 points on last year's Plan. The Plan forecasts that indirect competition to Royal Mail within the communications market will continue to intensify particularly in areas of new technology. Royal Mail aims to defend its share in markets which represent the largest volume of business (financial and commercial mail) and to expand its share of the rapidly growing Direct Mail market.

Implementation of a package of improvements designed to improve the quality of service known as the New Deal, linked to the 1988 tariff increase, was postponed due to the postal strike in September 1988. The implementation of the New Deal is regarded by Royal Mail as a central feature of the Plan. Postal Planners, giving service details, have been delivered to every household and the reintroduction of Sunday collections, which began last November, has now been completed. The sale of postage stamps has also been extended to some 40,000 non-Post Office outlets.

Through its Mailsort and Presstream services, Royal Mail plans to improve service for pre-sorted mail and generate volume growth in this area. There is scope for extending the Mailsort scheme to allow major users to put their own mail into the network at the point of their choice down to local delivery offices in return for suitable discounts and I shall be encouraging the Post Office to do so quickly. Royal Mail sees premium mail as a key area for service development and considers there to be a major gap in its services portfolio for a guaranteed next day service given the shortcomings of the first class service. Royal Mail intends to evaluate ways of filling this gap.

<u>Quality of service</u>

On the recommendation of the Post Office Users' National Council (POUNC), Royal Mail changed the way the quality of service for letters is measured. The new measurement system, based on the end-to-end delivery time and calculated for each letter district, replaced a national average measurement which gave less relevant and less accurate information. Based on this new measurement system, Royal Mail, in agreement with POUNC, last year set itself a target of an overall 3 per cent improvement in the quality of service for first class mail. It recently announced that in the face of increasing mail volumes, in the year to March 1990, first class letter service quality showed an overall improvement of 3.6 per cent against the previous year, beating the 3 per cent target. Royal Mail has again this year committed itself to an average 3 per cent performance improvement for first class mail. Over the Plan period, an 11 percentage point increase in first class quality of service is targeted.

Royal Mail intends to improve the transport of mail by prioritising heavy flows and correcting or replacing failure-prone arrangements. During the Plan period, Royal Mail intends to reduce its dependence on British Rail - in view of BR's poor service - by maximising rail to road transfers.

In sorting offices, space and staff are being separated into clearly defined, operational phases so as to focus attention on clearance targets, define accountability more sharply and avoid failure during one phase affecting the subsequent phases. Control systems are to be introduced to ensure that these new arrangements work according to schedule. Offices identified as poor performers are to have examples of best demonstrated working practices transferred to them from the more successful offices. More fundamental changes to improve quality of service will be addressed in the Post Office's Strategic Review of letter services.

ANNEX B

PARCELFORCE

Separation of Network 1 from Royal Mail

The September 1988 strike in Royal Mail had a major impact on Parcelforce's Network 1 which was heavily reliant on Royal Mail for collections and deliveries. To avoid any possible recurrence it was decided to speed up the separation of Network 1 from reliance on Royal Mail as far as possible and the rapid separation project was approved by Ministers last November. The Plan identifies separation of Parcelforce's Network 1 from Royal Mail as the key to Parcelforce's survival and development in a very competitive market place. The Plan envisaged that by 1993-94, Parcelforce would control around 80 per cent of its collections and deliveries directly. The remaining 20 per cent of deliveries and collections, mainly in rural areas, would continue to be carried by Royal Mail. As noted in the main paper, the project is likely to be affected by the discrete income problem. It is now expected that, at least for the moment, Parcelforce will not continue with the introduction of further local parcels depots after this year.

Network 2

Parcelforce aims to consolidate the strong growth achieved by Network 2 business-to-business services by strengthening the infrastructure of Network 2.

Datapost separation

Datapost volume and growth prospects were badly affected by the September 1988 strike. The Plan mentions that restoration of customer confidence and longer term recovery prospects depend on Parcelforce's ability to safeguard the separation of the service from the effects of industrial action in Royal Mail. A Post Office feasibility study, produced last year, supported the case for separation and studies are now underway to assess how Datapost traffic could be handled through Parcelforce's Network 2 and the additional investment that would be required. The case for separation will need to go before the Post Office Board's major projects sub-committee and is likely to require prior Government approval. No allowance for expenditure or accruing benefits was made in this year's Plan, as separation planning is taking place in the current financial year. Consideration of the project is likely to be deferred as a result of the discrete income problem.

Quality of service

Business separation is seen as the key to improving the quality of service, thereby enabling Parcelforce to control the vast majority of its collection and delivery services in Network 1 which are currently undertaken by Royal Mail under contract. The limit to improvement under the Plan period was set by the fact that Royal Mail would continue to collect and deliver about 20 per cent of traffic for Parcelforce. Under the recovery plan this is likely to remain at about 50 per cent. During the Plan period, Parcelforce intends to widen the definition of quality as speed and reliability to embrace a more user-friendly collection and delivery service to include more convenient and flexible delivery times and the introduction of tracking and tracing systems.

Employee issues

Parcelforce's employee relations strategy is expected to build on the initiatives developed over the last three years which have been aimed at increasing efficiency and productivity whilst retaining staff satisfaction and loyalty. A new pay and grading structure (unigrading) has been implemented and performance based incentive schemes for all basic grade staff are in operation.

The staffing problems faced by Parcelforce are not as acute as those faced by Royal Mail. This is principally because more staff are drivers and consequently the average recruitment age is higher than in the other Post Office businesses. Schemes are being introduced to improve recruitment among women and the ethnic minorities. Manpower requirements are expected to increase progressively over the Plan period as a result of the separation of Network 1 and the growth of Parcelforce's own engineering field force.

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ANNEX C

POST OFFICE COUNTERS LTD.

Quality of service

The main issue for customers is speed of service. The key quality target given in the Plan for Counters was that 95 per cent of customers at all Crown Offices should be served within five minutes. This target was not completely met, although 97 per cent of Crown Offices were meeting target by the year end. For the future, Counters will probably expand the system of AA offices (these offices are set more demanding customer service targets and aim to serve 95 per cent of all customers within three minutes and 100 per cent within five minutes). However, this system will be kept under review to ensure a balance between the costs involved in meeting such targets and the level of customer satisfaction.

Pricing strategy

All of the services offered by Counters are facing major competition from automated cash transfers and other delivery methods. The Plan envisages that, as a commercial reaction to this, market based pricing will continue with selective real price reductions focused on those areas where new business is likely to be won and to help retain threatened business volume.

In 1988 the MMC recommended that Counters should offer priced options to major clients (offering differential pricing to clients based on their use of different parts of the network). Last year's Plan indicated that prices would be increased for greater use of city centre and rural offices and for peak times and reduced for other clients. This year's Plan stressed that priced options would not be easy to implement because the network decisions of any client would have a knock-on effect into the costs charged to others. Counters developed an activity costing model as part of its detailed examination of the priced options concept and in the light of this Counters is now convinced that the priced options strategy is unworkable because:

i. it places management of the network in the hands of clients and makes no allowance for the requirements of customers. Rural sub-offices are very likely to be early victims with no regard for the needs of the customer;

ii. Counters would need to renegotiate all major contracts so as to start from the same date;

iii. each time a priced option was changed there would need to be an immediate re-settlement of all other major clients;

iv. if an acceptable and profitable network profile could be produced all contracts would have to be for identical periods to ensure a common starting point for the next round.

My officials will be discussing this further with Counters.

Extension of powers

One of the key assumptions on which the Plan projections are based is that business development will continue to be constrained by the withholding of Government consent for wider powers for Counters, thereby denying opportunities to maximise the commercial potential offered by the network of post offices. Implementation of our 1986 commitment to an extension of Counter's powers has been deferred because of our reluctance to increase the size of the public sector and the concern to avoid possible unfair competition.

Network changes

Over 65 per cent of Counters business volume and 90 per cent of outlets are in the agency sector and the conversion of Crown offices to agency status is the main source of cost reduction in Counters. Last year's Plan stated that 250 Crowns would be transferred in 1989-90. Progress has been disappointing and this figure was not met (at 8.8.90 the figure stood at 182) due, we are told, primarily to the deterrent effect of high interest rates on would-be purchasers and Counters' wish to avoid mass compulsory redundancies. This year's Plan gave a target of 200 conversions for 1990-91. However, Counters now considers that given the continuing difficult economic conditions this figure may be optimistic. In the longer term Counters is planning to retain a core of 650 Crown offices. However, this figure is by no means inviolable and will be reviewed when the conversion programme is nearer completion. We will then wish to press Counters to reduce the Crown network further. In the meantime, I shall be pressing the Post Office to make every effort to speed up the implementation of the present conversion programme.

ANNEX D

TELEVISION LICENSING (TVL)

New core-business

The new PAYGO budget payment scheme, giving customers the opportunity to pay the licence fee in quarterly instalments during its period of currency, was introduced last September. The number of licensees paying by this method is forecast to grow from 0.3m in March 1990 to 6m at the end of the Plan period. The scheme is available only by direct debit and involves a considerable transfer of work from Post Office Counters to TVL. This work is being undertaken by Subscription Services Ltd (SSL), a wholly owned subsidiary of the Post Office. The PAYGO scheme should, in the medium term, be a cost effective way of increasing TVL revenue albeit at some cost to Counters.

Business diversification

As with all other parts of the Post Office, TVL's powers are limited by the Post Office Act 1969 and the British Telecommunications Act 1981, and only by amending existing legislation can TVL be granted new powers. However, SSL (as a subsidiary company) can be given new powers by Ministerial consent. SSL is, therefore, TVL's driver in seeking new opportunities for diversification with the aim of privatisation. SSL's overall objective is to develop as a diversified, commercially driven and profitable business capable of competing effectively with private sector organisations. It intends to achieve this by identifying and addressing new business opportunities in subscription management and related fields, developing a portfolio of market related products and services and establishing a commercial unit committed to high standards of customer service. Subscription management business has been sought but with little success at present. We have indicated that we would be prepared to consider requests for wider powers on a case by case basis.

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ANNEX E

CORPORATE PLAN PROFIT PROJECTIONS

LETTERS	1990-91	1991-92	1992-93	1993-94	1994-95
Income	3,560	3,934	4,313	4,688	5,071
Expenditure	3,479	3,727	4,081	4,427	4,774
Profit before interest and tax	81	207	232	261	297
Interest	45	40	44	47	48
Tax	(23)	(82)	(89)	(100)	(113)
Profit after interest and tax	103	165	187	208	232
PARCELFORCE					
Income	667	740	816	904	994
Expenditure	650	704	771	838	910
Profit before interest and tax	17	36	45	66	84
Interest	(4)	0	1	2	4
Tax	(1)	(7)	(8)	(15)	(22)
Profit after interest and tax	12	29	38	53	66
COUNTERS					
Income	956	999	1,041	1,085	1,128
Expenditure	952	996	1,039	1,082	1,123
Profit before interest and tax	4	3	2	3	5
Interest	19	20	23	24	25
Tax	(8)	(12)	(11)	(14)	(15)
Profit after interest and tax	15	11	14	13	15
POST OFFICE					
Income	4,834	5,335	5,843	6,349	6,858
Expenditure	4,725	5,084	5,557	6,009	6,460
Profit before interest and tax	109	251	286	340	398
Interest receivable current year	58	61	69	74	78
Interest on past surpluses	22	10	7	8	12
Tax	(46)	(114)	(121)	(144)	(169)
Profit after interest and tax	143	208	241	278	319

ANNEX F

POST OFFICE TARGETS 1989-90 TO 1991-92

There have been several changes to the Post Office's target regime for the current period. Firstly, the profit target, which used to be based on return on turnover is now based on return on capital employed (ROCE). This change was requested by the Post Office and agreed by Government. It is more in line with practice in the private sector. In addition, ROCE is targeted after interest in the current year (but excluding interest on past surpluses) because we have recognised that this provides an incentive to the Post Office (in particular, Counters) to earn the maximum return on its cash.

Secondly, we have recognised that Parcelforce, unlike Royal Mail does not have the protection of a monopoly and operates in a very competitive environment. We therefore agreed not to set Parcelforce an RUC reduction target (although we retained the option to reintroduce this target should we feel it to be necessary). Consequently no Posts RUC targets were set and so targets are now set only for Counters and Royal Mail (Letters). The RUC targets set for these two businesses were designed to take full account of the efforts being made to improve quality of service.

The Post Office's ROCE targets announced in January are as follows:

	1989-90	1990-91	1991-92
Post Office	2.4%	6.3%	10.6%
Royal Mail	1.0%	6.3%	11.8%
Parcelforce	2.5%	5.0%	10.0%
Counters	6.0%	7.0%	8.0%

Counters ROCE target for 1989-90 was subsequently adjusted to 9.4% to take account of movements in interest rates. Interest is a major contributor to Counters profits but the other businesses were not significantly affected. For 1990-91 the targets have also been adjusted to reflect the expectation of higher interest rates and are now 6.8% for Royal Mail, 4.7% for Parcelforce and 9.5% for Counters.

The real unit cost reduction targets are for a cumulative reduction between 1989-90 and 1991-92 of 1% for Royal Mail and 2% for Counters.

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the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

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Mr Heywood
Private Secretary to
 the Chief Secretary to
 the Treasury
Parliament Street
LONDON
SW1P 3AG

Direct line 071 215 5622
Our ref JW9017
Your ref
Date 11 September 1990

Dear Jeremy

POST OFFICE INVESTMENT AND FINANCIAL REVIEW

My Secretary of State wrote to the Chief Secretary on 10 September in a letter which unfortunately contained some wrong figures. These have now been amended and I should be grateful if you would destroy that letter and replace it with the attached corrected version dated 11 September. My apologies for this error.

attached

I am copying this letter to Barry Potter and Sonia Phippard.

Yours

Sue Bishop

SUE BISHOP
Private Secretary

Recycled Paper

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the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

The Rt Hon Norman Lamont MP
Chief Secretary to the Treasury
Parliament Street
LONDON SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Enquiries
071-215 5000

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Direct line 071 215 5622
Our ref PB9034
Your ref
Date 11 September 1990

Dear Chief Secretary

POST OFFICE INVESTMENT AND FINANCING REVIEW

I sent you the Post Office's final bid on 6 August. I have now had an opportunity to study this and to consider the scope for saving.

There are two main reasons for the Post Office's increased need for funding compared with baseline and with the proposals in its Corporate Plan. It now assumes inflation in 1990/91 will be 9% compared with the 5% you asked it to assume in calculating baseline and the 5.7% it assumed for the Corporate Plan. It also now believes that it needs a much larger programme of capital expenditure in order to improve the quality of service about which there is widespread public concern; major elements of this programme are to switch more trunking of mail from rail, which it finds undependable, to road, and to replace vehicles more quickly in line with their most economic operating life.

However in view of the public expenditure constraints this year I propose savings and changes in the Post Office's re-bid as follows:-

a) additional tariff increases of 3p/1p in October 1991 (instead of 1p/1p in November 1991) and 1p/0p in October 1992 (instead of 1p/1p in NOvember 1992) and 1/1p in October, rather than November 1993. The rebid assumed all additional costs £m (74, 82, 90) resulting from inflation in 1990/1 at 9% instead of the 5.7% assumed in the Corporate Plan would be met by unspecified tariff increases. Our tariff proposals would contribute £m (-64, -46, -8) towards these costs; the balance has to be found from other savings discussed below. In proposing these tariff increases I am seeking to widen the differential between the 1st and 2nd class basic rate; if people want the higher quality service offered by the 1st class when they have a choice, they should be prepared to pay for it. The net effect of the higher inflation assumption less the tariff increases compared with the Post Office's re-bid would be £m(10, 36, 82).

b a cut in the Post Office's proposed capital investment in 1991/92 offset by a smaller increase in 1993/4. This cut would fall mainly on vehicles but these would have to be replaced shortly in any case and if the cut were maintained it would fall on the building programme in 1993/94. A cut in the building programme would be likely to have significant local effects on quality of service. The net effect is £m (-27, 2, 20).

c Parcelforce and Counters are expected to undertake programmes to recover from the effect of the discrete income problem. There will be a cost to Parcelforce of £15m in 1991/2 but Royal Mail will have a windfall gain of £45m a year. The net effect for the Post Office is £m (-32, -45, -40).

d I propose to ask Royal Mail to maintain part of the efficiency savings we had asked it to make in 1990/91 in order to meet its target. I also propose to ask it not to increase basic pay faster than RPI although half the saving would need to be returned in the form of other increases like regional or productivity pay. The net effect of both these savings would be £m (-28, -15, -17).

e There should be miscellaneous savings the largest of which is to clawback most of the £51m windfall gain the Post Office made from our agreement last year to exclude paybill creditors from the EFL. However because

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the Post Office made a surplus on its EFL in 1989/90 of £11m, I propose to clawback £40m during the IFR period. The net effect of the miscellaneous changes would be £m (-24, -27, -31).

The net effect of these changes compared with the Post Office's re-bid would be £m (-102, -50, 14) and compared with baseline £m (29, 35, 66).

I have pressed the Post Office to quantify the effects of cutting its proposed capital investment on quality of service. At present it does not collect this information and prioritises its projects on their financial return. The effects it can identify on quality of service are very small spread over the whole country but they are likely to be more severe locally. I am pressing the Post Office to identify the effect of its projects on quality of service and if it can demonstrate a serious effect, I would wish to reconsider the figures we agree for 1992/93 and more likely 1993/94.

In proposing these changes I have had to watch the effect on Royal Mail's ROCE. Its target rate of return is 11.8% and we have always taken the line that as a monopoly it should not overshoot its target at the expense of its consumers. The proposed changes would result in ROCE for Royal Mail in the IFR period of (12.9%, 12.8%, 11.9%) (after ring fencing the windfall gain to it from discrete income fully in 1991/2 and half in 1992/3, which is too high but I would prefer this to offering further cuts in capital investment.

My officials would be happy to give yours more information about these proposals if you need it.

I am copying this letter to the Prime Minister and to Sir Robin Butler.

Yours sincerely

Anne Bishop

(Approved by the Secretary of State
and signed in his absence.)

Recycled Paper

POST OFFICE INVESTMENT AND FINANCING REVIEW 1991/92-1993/94

Ref	(£m, outturn)	Achieved 89/90	90/1	IFR Period 91/2	92/3	93/4
	Summary of Post Office Bid and DTI Savings Options					
	External Financing Requirement/ (External Financing Limit) Baseline			(65)	(66)	(68)
	Capital Expenditure (fixed assets) Baseline		331	370	408	418
	Total Post Office Rebid					
	Capital Expenditure (fixed assets)			90	72	98
	Internal Resources (and other capital expenditure)			41	12	(46)
	Shortfall/(Surplus) relative to baseline			131	84	52
	Letters' ROCE (PO rebid)	2.2%	6.8%	11.8%	11.8%	11.8%
	DTI Savings Options					
	Effect of 90/1 inflation (9% v 5.7%)			10	36	82
	Capital Expenditure			(27)	2	20
	Discrete Income			(32)	(45)	(40)
	Improved Letters Efficiency			(28)	(15)	(17)
	Miscellaneous			(24)	(27)	(31)
	Shortfall/(Surplus) relative to baseline			29	35	66
	Total DTI Savings			(102)	(50)	14
	New EFR/(EFL)			(36)	(31)	(2)
	DTI Bid					
	Capital Expenditure (fixed assets)			50	54	109
	Internal Resources (and other capital expenditure)			(21)	(19)	(43)
	Shortfall/(Surplus) relative to baseline			29	35	66
	**assumes paybill creditors recovered through working capital*					
	Letters' ROCE (DTI bid)		6.8%	12.9%	12.8%	11.9%
	Key Assumptions in DTI Bid					
	RPI (12-month average)		9.0%	5.0%	5.0%	5.0%
	GDP		1.5%	3.0%	3.0%	3.0%
	Letters staff costs increase		11.9%	9.2%	7.2%	6.7%
	Letters average earnings increase		10.9%	10.5%	7.2%	6.1%
	Letters Tariffs		2p/2p mid-Sep	3p/1p Oct	1p/0p Oct	1p/1p Oct

Prime Minister

Mr Lilley is working hard to reduce his PES bids in this & other areas. That will be very welcome to the Chief Secretary. Most of the action proposed involves higher letter tariffs (~~widening~~ widening the gap between 1st & 2nd class mail) but not till October 1991; and cuts in investment, but mainly ~~following~~ falling on vehicle replacement.

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dti
the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

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The Rt Hon Norman Lamont MP
Chief Secretary to the Treasury
Parliament Street
LONDON SW1P 3AG

Direct line 071 215 5622
Our ref PB9034
Your ref
Date 10 September 1990

Dear Norman

POST OFFICE INVESTMENT AND FINANCING REVIEW

Flag

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There are two main reasons for the Post Office's increased need for funding compared with baseline and with the proposals in its Corporate Plan. It now assumes inflation in 1990/91 will be 9% compared with the 5% you asked it to assume in calculating baseline and the 5.7% it assumed for the Corporate Plan. It also now believes that it needs a much larger programme of capital expenditure in order to improve the quality of service about which there is widespread public concern; major elements of this programme are to switch more trunking of mail from rail, which it finds undependable, to road, and to replace vehicles more quickly in line with their most economic operating life.

However in view of the public expenditure constraints this year I propose savings and changes in the Post Office's re-bid as follows:-

a) additional tariff increases of 3p/1p in October 1991 (instead of 1p/1p in November 1991) and 1p/0p in October 1992 (instead of 1p/1p in November 1992) and 1/1p in October, rather than November 1993. The rebid assumed all additional costs £m (74, 82, 90) resulting from inflation in 1990/1 at 9% instead of the 5.7% assumed in the Corporate Plan would be met by unspecified tariff increases. Our tariff

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the department for Enterprise

The net effect of these changes compared with the Post Office's re-bid would be £m (-102, -38, 11) and compared with baseline £m (29, 47, 63).

I have pressed the Post Office to quantify the effects of cutting its proposed capital investment on quality of service. At present it does not collect this information and prioritises its projects on their financial return. The effects it can identify on quality of service are very small spread over the whole country but they are likely to be more severe locally. I am pressing the Post Office to identify the effect of its projects on quality of service and if it can demonstrate a serious effect, I would wish to reconsider the figures we agree for 1992/93 and more likely 1993/94.

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Yours ever

Peter

Recycled Paper

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	Total Post Office Rebid					
	Capital Expenditure (fixed assets)			90	72	98
	Internal Resources (and other capital expenditure)			41	12	(46)
	Shortfall/(Surplus) relative to baseline			131	84	52
	Letters' ROCE (PO rebid)	2.2%	6.8%	11.8%	11.8%	11.8%
	DTI Savings Options					
	Effect of 90/1 inflation (9% v 5.7%)			10	36	82
	Capital Expenditure			(27)	2	20
	Discrete Income			(32)	(45)	(40)
	Improved Letters Efficiency			(28)	(15)	(17)
	Miscellaneous			(24)	(27)	(31)
	Shortfall/(Surplus) relative to baseline			29	35	66
	Total DTI Savings			(102)	(50)	14
	New EFR/(EFL)			(36)	(31)	(2)
	DTI Bid					
	Capital Expenditure (fixed assets)			50	54	109
	Internal Resources (and other capital expenditure)			(21)	(19)	(43)
	Shortfall/(Surplus) relative to baseline			29	35	66
	**assumes paybill creditors recovered through working capital*					
	Letters' ROCE (DTI bid)		6.8%	12.9%	12.8%	11.9%
	Key Assumptions in DTI Bid					
	RPI (12-month average)		9.0%	5.0%	5.0%	5.0%
	GDP		1.5%	3.0%	3.0%	3.0%
	Letters staff costs increase		11.9%	9.2%	7.2%	6.7%
	Letters average earnings increase		10.9%	10.5%	7.2%	6.1%
	Letters Tariffs		2p/2p mid-Sep	3p/1p Oct	1p/0p Oct	1p/1p Oct

POST + TEL future pt 19.

CCPU.

dti
the department for Enterprise

MBPM
CBS

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

PS/Chief Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
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Enquiries
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Fax 071-222 2629

Direct line 071 215 5623
Our ref JW1AVZ
Your ref
Date 17 August 1990

Dear Jeremy

POST OFFICE STRATEGY

-ref. here

My Secretary of State has asked me to thank the Chief Secretary for the constructive suggestions in his letter of 27 July. He considers that these are a helpful contribution to the basis of the forthcoming E(A) discussion. In the meantime, we will be looking further at some of the Chief Secretary's suggestions.

I am copying this letter to the Private Secretaries of E(A) members and to Sir Robin Butler.

Yours
Rosalind Cole

ROSALIND COLE
Private Secretary

Recycled Paper

POST & TELEC: Future pt 13

6

cc PM

dti
the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

PS/Secretary of State for Employment
Department of Employment
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071-215 5000

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Direct line 071 215 5623
Our ref JW1AWA
Your ref
Date 17 August 1990

Dear Martyn

POST OFFICE STRATEGY

My Secretary of State has asked me to thank Mr Howard for his letter of 23 July and will get in touch with him about the points that he raises upon returning to the office.

I am copying this letter to the Private Secretaries of E(A) members and to Sir Robin Butler.

Yours

Rosalind Cole

ROSALIND COLE
Private Secretary

Recycled Paper

POST & PEREC . Future pr 13

NO NB/M CC PM Pa

dti
the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

Rt Hon Norman Lamont Esq MP
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Direct line 071 215 5623
Our ref JW1AVT
Your ref
Date 6 August 1990

Dear Chief Secretary

POST OFFICE INVESTMENT AND FINANCING REVIEW

I attach copies of the Post Office's final investment and financing review (IFR) bid for 1991/2-1993/4.

It is significantly above the present baseline, partly because the baseline was agreed under the assumption of 5% inflation during this financial year and partly because of demands for extra capital expenditure.

I am still familiarising myself with my new Department and have not yet had the opportunity to meet Post Office Board members to discuss the bid or wider matters with them. When I do so, I will make absolutely clear to them the approach that is needed in this year's PES round.

I will investigate the scope for savings bearing in mind the implications for service quality; the unwelcome inflationary signals and widespread public criticism of letter tariff increases; the need to avoid excessive profits from the letter monopoly; and the need to maintain a smooth service during the forthcoming electricity area board privatisation.

My aim is to have the operational and financial effects of significant savings options agreed both by our officials and by the Post Office before our bilateral.

Copies of this letter go to the Prime Minister, and to Sir Robin Butler.

Yours sincerely
Rosalind Cox.
[approved by the Secretary of State and signed in his absence]

Recycled Paper

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM Table 1A

IFR 1990 : REVISED BID

PROPOSED FINANCING REQUIREMENTS 1991-92

Industry POST OFFICE

	£million cash	1991-92 BASELINE	CHANGE FROM BASELINE	TOTAL PROPOSED FINANCING REQUIREMENTS
		FINANCING REQUIREMENTS		
01	Expenditure on fixed assets in UK	370.0	+90	460
02	Other capital expenditure	3.0	+ 3	6
03	Working capital - stock	-		
04	Working capital - other	23.0	-54	-31
05	TOTAL CAPITAL REQUIREMENTS	396.0	+39	435
06	Current Cost Profit (Loss)	265.0	-50	215
07	Interest	54.0	+15	69
08	PDC Dividend	-		
09	Tax	-46.0	-23	-69
10	Depreciation	140.0	-21	119
11	Other adjustments	-		
12	Sales of fixed assets	28.0	—	28
13	Capital receipts - govt	-		
14	Receipts - other	-		
55	PO Special Disposal Programme	20.0	-13	7
15	TOTAL INTERNAL RESOURCES	461.0	-92	369
16	Grants - revenue	-		
17	Grants - capital	-		
18	PDC etc	-		
19	NLF Loans - gross	-		
20	NLF Loans - repayments	-		
21	Overseas borrowing - gross	-		
22	Overseas borrowing - repayments	-		
23	Market borrowing (excl temp)	-		
24	Net temp borrowing/lending	-65.0	+131	66
25	Leasing	-		
26	TOTAL EXTERNAL FINANCE	-65.0	+131	66
27	Turnover	4865.0	—	4865
51	Net Temporary Borrowing	-		

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM Table 1B

IFR 1990 : REVISED BID

PROPOSED FINANCING REQUIREMENTS 1992-93

Industry POST OFFICE

	£million cash	FINANCING REQUIREMENTS		
		1992-93 BASELINE	CHANGE FROM BASELINE	TOTAL PROPOSED FINANCING REQUIREMENTS
01	Expenditure on fixed assets in UK	408.0	+72	480
02	Other capital expenditure	3.0	+3	6
03	Working capital - stock	-		
04	Working capital - other	21.0	-29	-8
05	TOTAL CAPITAL REQUIREMENTS	432.0	+46	478
06	Current Cost Profit (Loss)	301.0	-54	247
07	Interest	57.0	+16	73
08	PDC Dividend	-		
09	Tax	-93.0	-7	-100
10	Depreciation	158.0	+7	165
11	Other adjustments	-		
12	Sales of fixed assets	55.0	-	55
13	Capital receipts - govt	-		
14	Receipts - other	-		
55	PO Special Disposal Programme	20.0	-	20
15	TOTAL INTERNAL RESOURCES	498.0	-38	460
16	Grants - revenue	-		
17	Grants - capital	-		
18	PDC etc	-		
19	NLF Loans - gross	-		
20	NLF Loans - repayments	-		
21	Overseas borrowing - gross	-		
22	Overseas borrowing - repayments	-		
23	Market borrowing (excl temp)	-		
24	Net temp borrowing/lending	-66.0	+84	18
25	Leasing	-		
26	TOTAL EXTERNAL FINANCE	-66.0	+84	18
27	Turnover	5208.0	-	5208
51	Net Temporary Borrowing	-		

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM Table 1C

IFR 1990 : REVISED BID

PROPOSED FINANCING REQUIREMENTS 1993-94

Industry **POST OFFICE**

	£million cash	FINANCING REQUIREMENTS		
		1993-94 BASELINE	CHANGE FROM BASELINE	TOTAL PROPOSED FINANCING REQUIREMENTS
01	Expenditure on fixed assets in UK	418.0	+97	515
02	Other capital expenditure			6
03	Working capital - stock			
04	Working capital - other			-6
05	TOTAL CAPITAL REQUIREMENTS			515
06	Current Cost Profit (Loss)			300
07	Interest			79
08	PDC Dividend			
09	Tax			-107
10	Depreciation			195
11	Other adjustments			
12	Sales of fixed assets			64
13	Capital receipts - govt			
14	Receipts - other			
55	PO Special Disposal Programme			—
15	TOTAL INTERNAL RESOURCES			531
16	Grants - revenue			
17	Grants - capital			
18	PDC etc			
19	NLF Loans - gross			
20	NLF Loans - repayments			
21	Overseas borrowing - gross			
22	Overseas borrowing - repayments			
23	Market borrowing (excl temp)			
24	Net temp borrowing/lending			16
25	Leasing			
26	TOTAL EXTERNAL FINANCE	-68.0	+52	-16
27	Turnover			6349
51	Net Temporary Borrowing			

Table 2

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM

IFR 1990 : REVISED BID

ANALYSIS OF FIXED ASSET EXPENDITURE

Industry POST OFFICE

£ million cash

		1991-92	1992-93	1993-94
36	Dwellings			
37	Other new construction	95	93	98
38	Land and existing buildings	113	108	115
39	Vehicles (including ships and aircraft)	128	147	151
40	Plant and machinery	124	132	151
41	Nuclear fuel			
42	Capitalised interest			
43	Capital value of new leased assets			
01	TOTAL EXPENDITURE ON FIXED ASSETS IN UK	460	480	515
	MEMO: SALES OF FIXED ASSETS (i) Land and existing buildings			
12A	(a) land			
12B	(b) empty housing			
12C	(c) other buildings			
12D	(ii) Vehicles,plant and machinery			
12E	(iii) Other			
12	TOTAL SALES OF FIXED ASSETS	35	75	64

MEMO: DISPOSAL OF UNUSED AND UNDERUSED LAND

(Acres)

Held at 31 March 1990	1990-91 expected disposals		Expected Disposals		
			1991-92	1992-93	1993-94
28.4	–	Unused and underused land (See text of accompanying letter)	–	–	–

Notes

1. Row 12A should include receipts from sales of all land whether or not entered on Department of Environment Registers.

2. Memo item relates to land covered by the Department of Environment Registers in England plus equivalent holdings in Wales and Scotland.

RBIFR Table 2 16 Jan 1990

Table 2!

UNUSED AND UNDERUSED LAND

	ACRES
ROYAL MAIL	
5 sites vacant. Schemes in preparation for sorting offices.	24.4
COUNTERS	
Birmingham site to be used for coin centre.	
Stevenage Town Square site - potential for office development. Temporary use for stores	
Tonbridge BO (Kent) - retail development with local council.	
	4.0
PARCELFORCE	NIL

TOTAL	28.4

Table 3

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM

IFR 1990 : REVISED BID

ANALYSIS OF CHANGES IN WORKING CAPITAL

Industry POST OFFICE

£ million cash

		1991-92	1992-93	1993-94
03	Stock and work in progress			
48	Debtors	3	(17)	(18)
30	(Creditors)	28	25	24
49	Hire purchase and instalment credit			
50	Other (please specify below)			
	TOTAL CHANGES IN WORKING CAPITAL	31	8	6
48A	Memo : Average length of repayment (Days) (i) debtors	16	16	16
30A	(ii) creditors	40	38	37

Notes

1. Average length of debtors and creditors should be calculated on a FIFO basis using sales in the last period of the year.

Note: All figures exclude Payroll Creditors

Table 4

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM

IFR 1990 : REVISED BID

OPERATING EXPENDITURE

Industry POST OFFICE

£ million cash

		1991-92	1992-93	1993-94
28	Wages and associated costs	3455	3714	3950
45	Raw materials (processed and unprocessed)			
46	Other operating costs (including energy costs)			
	TOTAL OPERATING EXPENDITURE	5134	5627	6089
47	Memo: Manpower (no)	204	203	203

Notes

1. Wages and associated costs should include total cost of salaries,wages,national insurance,and employers pension contributions.
2. Manpower should be average number of employees expected each year.
3. Operating costs should include all costs (direct and indirect) charged before operating profit/loss is struck.

Table 5

NATIONALISED INDUSTRIES FINANCIAL INFORMATION SYSTEM

IFR 1990 : REVISED BID

ASSUMPTIONS

Industry POST OFFICE

	ASSUMPTIONS	% change			
		1990-91	1991-92	1992-93	1993-94
A	GDP	1.5	3.0	3.0	3.0
B	Retail Price Index	9.0	5.0*	5.0*	5.0
C	Average earnings (whole economy)	9.5	8.5	8.0	8.0
D	Average earnings (own industry) see table below				
E	Tariffs (overall) See accompanying letter				
F	Tariffs (domestic)				
G	Tariffs (industrial)				

Notes

* Rebid based on these assumptions but latest forecast is 1% higher, i.e. 6.0%.

1. % change should be calculated on a year-average basis.

2. Tariff assumptions should be expressed in nominal terms and not contain a volume element.

	Memo:	1990-91	1991-92	1992-93	1993-94
H	% Expected return on net CCA assets	As original bid			
I	% Expected change in real unit costs	As original bid			

Please explain the basis of calculation of Memo items:

ASSUMPTIONS D

		90-91	91-92	92-93	93-94
Average Earnings: % increase in earnings per man (nominal)	ROYAL MAIL	10.6	10.5	7.2	6.1
	PARCELFORCE	9.5	6.4	7.0	6.5
	COUNTERS	8.0	5.8	5.6	5.7
	GROUP	10.3	9.8	7.0	6.1

cst.ps/dr/14nl25.7

CONFIDENTIAL

Prime Minister

To note. A useful early indication that Treasury are broadly supportive of DTI strategy for the Post Office. No action needed – DTI strategy paper will be considered in E(A) in the autumn.

BHP 30/7

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Peter Lilley MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 - 19 Victoria Street
London
SW1

27 July 1990

Dear Secretary of State,

POST OFFICE STRATEGY

Nicholas Ridley copied to me his minute of 2 July 1990 covering a memorandum on the Post Office Strategy Review; I have also seen the Prime Minister's private secretary's letter of 9 July 1990. I thought that it might be helpful to set out my initial reactions before E(A) consider the paper in the Autumn.

2. I welcome the thorough and constructive document which Nicholas put forward. I agree that changes are likely to be controversial, and that on timing we should aim for legislation in the first session of the new Parliament.

3. Subject to the comments below, I agree broadly with Nicholas' view of the way ahead.

4. First, on Post Office letter products, before authorising the Post Office to take significant or costly action I think it would make sense to obtain much more detailed costings and financial projections than have so far been prepared. I hope that you will agree to put this in hand before decisions are taken. In particular, we must ensure that the Post Office's service improvements will be viable even if "Once over the Ground" does not go ahead.

5. I am sure it is right to undertake market research into what customers want from postal services and are willing to pay for. I suggest that we should broaden this to cover an examination of the economic value of improved postal services to the functioning of the economy. In addition we could consider how far high quality postal services underpin the competitive economies of the EC, USA, Canada and Japan.

6. We should also consider what actions to take in the interim in order to maintain quality of service without requiring a subsidy. From the evidence brought forward on the problems caused by an excessive volume of first class mail, we should consider asking the Post Office to widen the differential between first and second class post in the next tariff round. As I said in my letter of

8 February 1990, I feel strongly that we should test what the market wants by adjusting the Post Office's tariffs gradually, rather than going for a big-bang change in price and service.

7. Turning next to the market for postal services, I think we should commission more work on whether a monopoly is indeed necessary to ensure a universal service. Nevertheless I agree that deregulating the premium service market is likely to be the best route for obtaining competition and innovation, and that it is likely to be preferable to limited licensed competition along the lines of the telecoms duopoly.

8. It might also be worth exploring whether there is early scope for additional licences to permit activities falling within the monopoly - the delivery by 3rd party carriers of utilities' bills, DSS giros, direct mail and so on.

9. I particularly welcome Nicholas' proposals to allow large users to bypass the Post Office's collection, sorting and trunking network, and to take their mail direct to the Post Office's local delivery network. We will need to ensure that any discounts given by the Post Office do reflect genuine and realisable operational savings.

10. I accept that it will probably be necessary to allow the Post Office into the deregulated premium market and that this would necessitate separate and rigorous costing of the two streams. But producing this information could well be costly, and we need to see a fully worked-up scheme before we could agree it. Separating out the assets would of course be even more expensive.

11. Third, it is important to consider the consequences for the Post Office. The latter remains heavily unionised and prone to strikes and disruption, and this would be a cause of concern for competing postal operators and large users feeding mail to local Post Office delivery networks.

12. Nicholas proposed separating the delivery network in preparation for privatisation. While this is welcome, I am not confident that it would go far enough. I suggest that we should in addition consider directing the Post Office to contract out the operation of its individual local delivery offices to competing private sector firms. The process would not go down well with the unions. But, once achieved, the vulnerability of the network to strikes should be much reduced.

13. Copies of this letter go to the Prime Minister, other Members of E(A) Committee, and to Sir Robin Butler.

Yours sincerely,

[signature]

NORMAN LAMONT

[Approved by the Chief Secretary and signed in his absence]

POST & TELECOMS: FUTURE Pt 13

Prime Minister

The proposals at 'X' may be worth exploring. (Background note attached).

But Peter Lilley may have his own ideas on the P.O.

Content to await P. Lilley's response?

BHP 23/7

Department of Employment
Caxton House, Tothill Street, London SW1H 9NF

Telephone 071-273 . . . 5802
Telex 915564 Fax 071-273 5821

Secretary of State

The Rt Hon Peter Lilley MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H OET

23rd July 1990

Dear Peter

POST OFFICE STRATEGY

I have seen Nicholas Ridley's minute of 2 July to the Prime Minister covering proposals for a strategy for postal delivery services for the 1990s, and the reply from her Private Secretary dated 9 July.

I agree with Nicholas that changes are needed. I also feel that the Post Office's proposals would lead to a reduced service at a higher price and should be resisted whilst the present monopoly position is maintained. We are particularly concerned by the "once over the ground" proposals which would disadvantage both residential users and those business users operating from residential areas.

However, I feel that Nicholas' alternative proposals for a reduced monopoly may not go far enough in opening up competition only above the volume letter business, and should be carefully considered in the light of our overall policy approach to maximise competition wherever possible. I wonder whether a fresh look might be made into alternative strategies broadening discussion from the narrow remit to deliver to every address in the country at a uniform affordable price. For example the options on competitive tendering might be further considered, such as the proposals made by TNT, or consideration given to abolishing the requirement for a uniform letter rate, before the discussion at E(A).

Secretary of State
for Employment

When the proposals are to be reconsidered it will be also be important to insist that the Post Office develop a clear and comprehensive pay and industrial relations strategy - after all some 75% of Post Office costs are labour related. Such a strategy should address questions about future pay machinery, regional and performance pay variations and the risks and consequences of industrial action.

I am copying this to the Prime Minister and members of E(A).

Yours ever

Michael

MICHAEL HOWARD

POST + TBCG: Future PT13

dti

the department for Enterprise

The Rt. Hon. Peter Lilley MP
Secretary of State for Trade and Industry

CONFIDENTIAL AND MARKET SENSITIVE

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Our ref PB5AGA
Your ref
Date 20 July 1990

Dear Barry

You wrote to Martin Stanley on 12 July giving the Prime Minister's agreement to the Duopoly Review timetable proposed in my Secretary of State's minute of 9 July.

I would be grateful if you and copy recipients would note that it should be classified both confidential and market sensitive in view of the possible sale of BT shares.

I am sending copies of this letter to the Private Secretaries to the members of E(A), the Foreign Secretary and the Home Secretary and to Sir Robin Butler.

Yours

Rosalind Cole

ROSALIND COLE
Private Secretary

Recycled Paper

POST & TELEC: Future pt 13

PA 5/20 cc

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

n.b. P.M
BHP
24/7

The Rt Hon Chris Patten MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

18 July 1990

Dear Chris,

IMPLEMENTATION OF THE EC LARGE COMBUSTION PLANTS DIRECTIVE: EFFECTS ON ELECTRICITY PRIVATISATION

I am aware that discussions have been going on for some time now about the contribution of the electricity industry to meeting the overall UK commitments on reducing emission limits under the Directive.

Like you, I am most anxious that we should meet those commitments and be able to demonstrate effectively to the Commission that we have done so. I think that we can best do that by constructing an emission limits regime which is in harmony with our objectives in restructuring the electricity industry as a contribution to the creation of a more competitive energy market. Certainly it is essential to avoid any conflict between these two important elements of our programme, particularly in the period preceding flotation of the electricity companies.

I start from the point that Scotland should have a very good story to tell on emissions. The high proportion of nuclear and hydro generation in Scotland will allow us to meet some 60% of our own electricity consumption from non-fossil fuels when Torness is fully operational. The prospects for future gas burn will decrease our reliance on coal burn even further.

However, at a UK level there is a good case for ensuring that coal burn in Scotland can be used to help meet demand in England. In view of the relatively low sulphur content of Scottish coal, the substitution of electricity generated in Scotland for an equivalent amount in England & Wales, where much higher sulphur coal is generally produced, would result in a net benefit for overall UK emissions.

In addition to the environmental case for the export to England of coal fired electricity generated in Scotland, there are important considerations related to ensuring competition within the newly created market for electricity. Our electricity privatisation proposals were predicated on the assumption that cross border competition would be encouraged. To inhibit electricity exports would undermine the case which we presented on the shape of the privatised industry. It would also seriously weaken the position of the Scottish companies, and will undoubtedly influence the perceptions of investors and could well damage the prospects for and proceeds from flotation.

In order to avoid a conflict of objectives we must ensure that the emission limits regime is sufficiently flexible to allow for agreements for the export of electricity generated in Scotland.

In securing flexibility in the emissions limit regime I think that we need a mechanism which links commercial and environmental considerations. I believe that this would be best met by a system of tradeable permits for emissions, such as is proposed in the draft Environment White Paper for industries other than the ESI. This would enable extra headroom to be created for exports utilising low sulphur coal but only on the basis of exports being justified on commercial grounds and of a commercial assessment of the merits of burning low sulphur coal against all other options for generating the electricity.

I am copying this letter to the Prime Minister, Geoffrey Howe, John Major, Douglas Hurd, John Wakeham, Peter Brooke and to Sir Robin Butler.

Yours ever,

Malcolm

MALCOLM RIFKIND

CC PU.

dti

the department for Enterprise

n.s. P.M.
BHP
18/7

The Rt Hon Peter Lilley MP
Secretary of State for Trade and Industry

Department of
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Norman Lamont Esq MP
HM Treasury
Parliament Street
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Direct line 071-215 5623
Our ref PE2AYU
Your ref
Date 18 July 1990

Dear Norman

You copied to Nicholas Ridley your minute to the Prime Minister of 18 June. flag PT 12

The Post Office Users' National Council (POUNC) is now considering the proposed increase and will report its findings to me and to the Chairman of the Post Office in due course.

I note your comments on the length of the consultation period which POUNC is given. My officials will consider what steps might be taken to reduce this period, but as you point out there may be difficulties with this. Certainly there seems little scope for shortening the period this year, although my officials have consulted the Post Office on this point and will let yours know the outcome.

I am copying this letter to the Prime Minister, other members of E(A) Committee and Sir Robin Butler.

Yours ever

Peter

888-355

POST + TELS: Future of Post Office Pt 23

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12 July 1990

Dear Martin,

TELECOMMUNICATIONS DUOPOLY REVIEW

The Prime Minister was grateful for your Secretary of State's minute of 9 July.

The Prime Minister is content with the proposed timetable as the fastest practical in the circumstances. She also understands that the proposed timetable would be consistent with a further sale of BT shares in 1991-92.

I am sending copies of this letter to the Private Secretaries to the members of E(A), the Foreign Secretary, the Home Secretary, and to Sir Robin Butler.

Yours ever,

Barry

BARRY H. POTTER

Martin Stanley, Esq.,
Department of Trade and Industry.

CC BS. ①

dti

the department for Enterprise

CONFIDENTIAL

Prime Minister

Mr Ridley - Chancellor agree this is the fastest practicable timetable. It is consistent with a further sale of BT shares early to mid 1991-92.

Content on this basis?

BHP 9/7

Y co ms

PRIME MINISTER

TELECOMMUNICATIONS DUOPOLY REVIEW

At E(A) on 21 June we agreed that we should aim to complete the duopoly review in less than 6 months and that I should examine the possibility of starting the review before November.

Having looked carefully at the options, I think it should be possible to reduce the 6 month timescale for the review by at least 2 months and to aim to reach Ministerial decisions during or by the end of February 1991. I would not, however, wish to be committed at this stage to starting the review before November. As I explained in E(A)(90)8, attached the review raises a large number of complex issues, many of which will require the close co-operation of Sir Bryan Carsberg. In my view the best way to achieve an early and successful outcome is to prepare the ground carefully in advance.

My present proposal is based on our issuing a consultative document, giving a steer as to our preferred options, as near as possible to the beginning of November rather than later in the month when the original 7 year commitment to the duopoly will fall due. This would allow us to require comments by the end of the year. We could then tackle the post-consultation

dti

the department for Enterprise

analysis with Sir Bryan Carsberg and, having cleared emerging conclusions with colleagues, seek to reach agreement with the main operators on any significant changes to their licences, with a view to reaching financial decisions by the end of February.

Such a timetable will significantly stretch resources both in my Department and at OFTEL, and it will require the rapid agreement of BT and perhaps Mercury to what may be major and unpalatable pro-competitive changes in their licences. If they are not prepared to agree to these changes then Sir Bryan could only impose them after a favourable but time consuming MMC reference. I may also need to look to colleagues to reach early decisions on my preferred options for the consultative document and, subsequently, the conclusions of the review.

I understand John Major would be content to proceed on this basis. If you are also content I will indicate our aim of completing the review relatively quickly when I announce how it will be conducted.

I am copying this minute to members of E(A), Douglas Hurd and David Waddington and to Sir Robin Butler.

NR

N R

9 July 1990

NP1AYB

Recycled Paper

CONFIDENTIAL

FILE

KK

c/Economic/Post

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 July 1990

Dear Martin,

POST OFFICE STRATEGY

The Prime Minister was grateful to your Secretary of State for his minute of 2 July covering a paper setting out proposals following his strategic review of the Post Office.

The Prime Minister is broadly content with the overall thrust of the strategy put forward by your Secretary of State. She considers, however, that the proposed approach should be considered further in collective discussion among Ministers. Accordingly, the Prime Minister would be grateful if Cabinet Office could make arrangements for the paper to be considered at E(A) early in the autumn.

I am copying this letter to the Private Secretaries to Members of E(A) and to Sir Robin Butler.

Yours ever,

Barry

(BARRY H. POTTER)

Martin Stanley, Esq.,
Department of Trade and Industry.

CONFIDENTIAL

(1)

PRIME MINISTER

POST OFFICE STRATEGY

I attach at Flag A a minute from Mr. Ridley covering a paper setting out proposals for ending the Post Office monopoly on first class letter traffic and improving the efficiency of the Post Office.

There are three main proposals in Mr. Ridley's minute.

i) Reduction of the present Post Office statutory monopoly (from a £1 tariff) to a figure between the first and second class letter rates: this amounts to abolishing the monopoly on first class mail.

ii) A move to "once over the ground" (OOG) delivery whereby the Post Office would make only one call a day (instead of two, as at present) to domestic customers. This proposal is also favoured by the Post Office itself.

iii) The first of these changes would need to be backed by primary legislation. The second might be initially unpopular both with customers and the workforce. Accordingly, Mr. Ridley proposes no action until after the next election.

Policy Unit (note at Flag B) consider Mr. Ridley's approach is broadly sensible - though detailed consideration has not yet been completed. The immediate questions on handling are about the timing and forum for collective discussion.

Cabinet Office (Flag C) propose that consideration should be held over until the autumn; and that the paper should then go before a Ministerial Committee (E(A)). Policy Unit agree.

It would be difficult to find a slot for a collective discussion before the Summer Recess.

i) Content to handle this as a matter for E(A)? Yes

ii) Content to postpone discussion until the autumn? Yes

iii) Or; do you prefer to establish an ad hoc Ministerial group?

BHP

BARRY H. POTTER
6 JULY 1990

c:\wpdocs\economic\Post(MRM)

CONFIDENTIAL

B

PRIME MINISTER

5 July 1990

THE POST OFFICE : A STRATEGY FOR THE 1990s

Mr Ridley recommends that we should prepare for a major Post Office Bill **after** the election.

REDUCING THE MONOPOLY

You made it clear at the last election that we were committed to maintaining a universal letter delivery service at a cheap standard price. But the consumer is not satisfied with the first class service and Mr Ridley is right to say that a reduction in the level of the monopoly to introduce competition for first class mail is by far the best way to tackle the problem. That does need primary legislation which might be quite complex.

POST OFFICE REORGANISATION

It also entitles the Post Office to reorganise to meet competition. But that reorganisation will mean fewer deliveries and higher charges for first class mail and will be unpopular with the unions and consumers at the outset.

We cannot know how quickly competition will develop and we need four or five years for liberalisation to produce concrete results for the consumer. Trying to do something **before** the election risks a lot of criticism without concrete results.

INTERIM MEASURES

Mr Ridley sets out a number of important interim measures which the Post Office is willing to undertake in preparation for the coming of competition - in particular the setting up of the delivery network as a separately costed business. It is important that these are taken forward now.

PARCELS AND COUNTERS

Royal Mail Parcels is already a largely separate business for which accounts will be produced for the first time in 1990/91. Privatisation, perhaps through a management buy-out should then be possible. However, some form of regulation would be needed for the business and Mr Ridley might prefer to deal with all the regulatory issues in one Bill in the new Parliament.

The Counters business is in the early stages of "unbundling" its charges to its four big clients (DHSS, Treasury, Giro and postal services). The size of its cross subsidy from urban to rural post offices is also under examination but we have a clear commitment to maintaining the rural network whatever the ultimate outcome of these changes.

RECOMMENDATIONS

(a) That we accept Mr Ridley's advice that changes by primary legislation to the monopoly level in postal services be deferred until after the election.

(b) That the Post Office should defer any changes to the delivery services and charges until that legislation is introduced.

(c) But that the Post Office should carry through the interim charges in accounting and organisation which would prepare the way for competition in first class mails.

(d) And that Mr Ridley be asked to consider what statement should be made in the Manifesto about his plans.

My personal view is that it is important to re-state the commitment to preserving a universal delivery, standard tariff letter service and a continuing network of rural post offices whilst promising competition everwhere else.

Howell Harris Hughes

HOWELL HARRIS HUGHES

CONFIDENTIAL

C

Reference: Letter from Mr Ridley to Prime Minister dated 2 July 1990

From: P F Owen
5 July 1990

P 03701

SIR ROBIN BUTLER

cc Mr Burr
Mr Potter
Mr Quilty

POST OFFICE STRATEGY

1. I mentioned to you this morning that the attached paper had now arrived. Mr Ridley indicates that he will be happy to discuss with colleagues but does not actively seek to do so.

2. Two central issues are discussed in the paper:

i. Mr Ridley would like to reduce the present Post Office monopoly to a figure between the first- and second-class letter rates;

ii. the Post Office would like to change their arrangements for delivery of letters, making only one call a day instead of two as at present (with other related restructuring).

3. Mr Ridley believes that a change in the monopoly would need to be backed by legislation to avoid the risk of a successful legal challenge. He also considers that the implementation of the changes proposed by the Post Office would be initially unpopular with customers and the workface, with benefits flowing through only on a longer time scale. For both these reasons he argues that any further action should be deferred until the first session of a new Parliament.

4. The issues are weighty and would warrant consideration in a ministerial committee. But if Mr Ridley's view on timing is accepted there is no particular urgency. If you agree I will look for an E(A) slot in the autumn.

P F OWEN

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the department for Enterprise

CONFIDENTIAL

PRIME MINISTER

POST OFFICE STRATEGY

at flap

As foreshadowed in my letter to you dated 13 June, I now enclose a paper giving my fuller conclusions and recommendations from my strategic review of the Post Office. I shall, of course, be happy to discuss, should you or colleagues so wish.

Copies go to Geoffrey Howe, John Major, Malcolm Rifkind, Peter Brooke, Michael Howard, David Hunt and to Sir Robin Butler.

NR

N R

2 July 1990

NP1AXG

Recycled Paper

THE POST OFFICE: A STRATEGY FOR THE 1990s

Issue

1. The formulation of a strategy first to better supply the needs of customers of postal services during the 1990s, and less importantly to enable the Post Office both to meet the constraints and take advantage of the opportunities during the decade.

Recommendation

2. I invite colleagues to endorse the broad strategy summarised at paragraphs 14-16 below; and to consider the various constraints, especially those which bear on timing.

Argument

3. I have been looking at ways of introducing a greater element of competition into the provision of letter services without undermining the fundamental requirement for a postal service which delivers to every address in the country at a uniform affordable price. There are also a number of important structural and accounting changes that I would like to see within the Royal Mail Letters (RML) business of the PO. The PO Board agree with me on some of these. The PO, for its part, would like to make certain fundamental changes to existing delivery patterns so as to improve the reliability of the first class letter service in particular, and ease the problem of recruiting postmen for very early morning duties. The PO would like thereafter to reposition the present 2-tier service, making the overnight delivery stream substantially more expensive than the present and (less reliable) first class stream.

The Competition Considerations

4. I have considered a number of possible models for introducing competition; and I have talked to a wide range of potential entrants to the letter delivery market, who have generally shown a disappointing lack of enthusiasm for competing with the PO at the volume end of the market except in conditions of regulated and restricted competition.

5. I conclude that the most promising answer still appears to be a radical reduction in the present monopoly level (£1) to a new level just below that of the PO's first class letter rate, but clearly above that of the PO's second class letter rate. This would allow competition to develop in the market for overnight or other value-added delivery, whilst retaining for the second class stream the monopoly protection needed to ensure continued universal delivery at a cheap standard price.

6. It is hard to predict how the market might respond to the opportunity created, but I strongly favour the creation of a framework within which competitors are free to find their own market above the monopoly price level rather than attempting through a strictly regulated licensing regime to decide the competitive services that are to be provided. Further work should be put in hand to gain a better appreciation of the nature of the market than exists at present, and it would be helpful to have the results of this before attempting to reach final decisions.

7. There is however an important constraint which affects timing. Although I have powers under existing legislation to suspend (though not to abolish) the monopoly to a lower level by Order, there is a risk that such action could be the subject of judicial challenge on the grounds that it prevented the PO from fulfilling its statutory duties to break even

taking one year with another, and of providing postal services that meet reasonable demands for them. The risk of a successful challenge increases the further the monopoly is reduced towards (or below) the PO first class letter rate, and the longer the period of suspension sought. I conclude that primary legislation will in practice prove necessary, for as long as the uncertainties of a probable legal challenge remain it is most unlikely that any serious player would be willing to commit the necessary resources to enter the market in a meaningful way.

8. Further, the Postmen's union, the Union of Communications Workers (UCW), has recently published a booklet defending the letter monopoly, and has voted to employ industrial action to resist change, including the sort of alterations in service structure outlined in paragraph 10 below. Early and radical action on the letter monopoly would put us immediately on a collision course with the UCW, which has already sought to pre-empt the high ground of public opinion as the defender of a valued public service. I conclude that we need primary legislation, and that the timing is all important if we are to avoid industrial strife.

9. I have also looked again at whether there might be attraction in an early but less radical reduction in the monopoly, say to 50p. Although it is not possible to predict with certainty how the market might react to an opportunity of this kind, all the available evidence suggests that there is little prospect of competition to the PO at this level (which is indeed precisely why such a move would be less likely to be challenged in the Courts). I fear - and this is a view firmly shared by senior PO management - that it would be widely seen by the PO workforce and others, especially after months of speculation about genuinely radical changes, as little more than cosmetic, and as a tacit admission by the Government that

the PO letter monopoly was in practice impregnable. Additionally, it might lessen the impact of any subsequent further reduction in the monopoly as a force to drive changes in service structure through workforce and management resistance.

The Post Office Proposals

10. The PO Board have sought my support in principle for two important and linked changes to the letter service. Subject to the findings of a proposed major public consultation exercise, they would first like to replace the present pattern of two deliveries a day (except in rural areas) - the first completed by around 9.15am - by a single, later letter delivery to all residential addresses, starting at perhaps 9.30am, and extending through until 2.30pm. There would be special arrangements for large-volume users such as businesses, for whom such a "once-over-the-ground" (OOG) delivery pattern would clearly be unacceptable. Second, they would like thereafter to reposition the existing 2-tier letter service, offering instead an overnight service with around 95% reliability (as compared with 80% or less for the present 1st class service) priced at perhaps 35p-40p, and a second class service, also with high reliability, which would be delivered generally within 2 days rather than the present 3, priced at perhaps around 18p.

11. OOG has considerable attractions for the PO. A single delivery in place of the present two gives obvious cost savings, and could reduce the need for postmen by 7,000-10,000 (5-7%). The much later start eliminates three-quarters of pre-dawn working (for which premium payments have to be made), and enables the PO to recruit from a much wider pool of labour. It also adds crucial hours to the period available for the overnight trunking of mail, and this both allows the

PO to make greater effective use of mechanised sorting equipment, and makes an important contribution to a much higher reliability of next-day delivery.

12. The substantial disadvantage is that those residential customers who at present receive their mail before leaving for work in the morning, and so have an opportunity to act on it that same day, will no longer do so under OOG. They may argue that at least under the existing system they receive 80% of their mail before leaving home in the morning, whereas under OOG they will receive none of it. For these customers, OOG will have substantially worsened their postal service, yet they will be asked to pay a great deal more for a first class stamp. My view is that the changes proposed by the PO may prove highly unpopular with a significant minority of customers, at least initially. A further disadvantage is that whilst later deliveries may help the PO in its recruitment of new staff, they will prove decidedly unpopular with existing delivery postmen, many of whom have second jobs or other commitments later in the day. I have referred in paragraph 8 above to the stance already adopted by the UCW.

13. These changes will thus generate initial perturbations for both customers and staff in return for benefits that will only flow, or be perceived, somewhat later. This suggests that if such changes are to be permitted, they will best be introduced at an early stage of a new Parliament, and accompanied by the competition produced by dropping the monopoly price, so that subsequent electoral judgement can be based on the resulting benefits of the whole new package with its improved service. Since we cannot drop the monopoly price before legislation, we are virtually forced to wait until after the General Election to introduce the competition elements of the package.

The way forward

14. These are complex and inter-related issues, and I have set them out at greater length, together with the wider background and the main alternative option considered, at Annex A to this paper. I believe that our policy towards the PO should be driven by the need to introduce competition where possible in order to put pressure on both staff and management to improve responsiveness to the needs of customers whilst at the same time driving down costs. With some reluctance I conclude that it would be both unwise and impractical to make changes to the letter monopoly in advance of the General Election. I propose instead that we should now begin to prepare for a major PO Bill in the first Parliamentary session thereafter.

15. Further, I consider that we should rightly be open to criticism if we were to acquiesce in major PO changes to the structure of their letter services, which may prove highly unpopular with many customers, whilst they still have the full protection of the monopoly. And, as I have argued above, such changes are anyway better introduced in the early stages of a new Parliament. I therefore propose to confirm to the PO Board that I am opposed to any such moves until after the General Election, when I should be willing to look at their proposals again against the background of changes to the monopoly.

16. In the meantime, there remains much useful progress that can be made. In particular I am anxious that the PO should move rapidly towards setting up the local delivery-office-to-doorstep network as a separately costed business within the PO, and towards establishing separate and rigorous costings for the first and second class letter streams. The PO are keen to do both things. These changes are essential

precursors to the introduction of competition in the overnight letter market to counter accusations of cross-subsidy between the monopoly-protected and the competitive streams, and will take some time to achieve. To carry credibility they will need to be overseen by some form of independent arbiter of standing. I shall also continue my pressure on the PO to allow major customers, in return for suitable discounts from their normal contract prices, to make their own arrangements for trunking mail to local delivery offices. Such a move will I know be greatly welcomed by many of the PO's largest customers and could cover up to a quarter or more of all mail, yet should have no significant adverse impact on PO finances. The PO are content to do this.

Legislative Consequences

17. The precise nature of the legislative measures needed to give effect to these policy objectives have yet to be identified in detail, and are likely to depend on the competition model chosen. Thus my preferred option of a straightforward reduction of the monopoly to below the price of a first class stamp, but with continuing monopoly protection for the second class, could at least in theory be achieved with a very short bill. In practice, however, to avoid internal inconsistencies within the legislation and the practical difficulties to which these might in time give rise, consequential changes which, for example, matched the reduction in the PO's monopoly privileges by perhaps a relaxation of their statutory obligations in respect of first class letters would be needed. As noted at paragraph 16 above, some form of independent arbiter will be needed to ensure that the PO are competing fairly in first class letters, and I see much advantage in enshrining this role in the legislation to provide a <u>simple</u> form of continuing regulation.

18. Alternatively, any form of licensed competition <u>within</u> the monopoly (for example a duopoly) would almost certainly require more fundamental changes to the basis of the present legislation, which marks out a unique and privileged position for the PO. Indeed, in the interests of levelling the playing field as far as possible, such changes may on further examination also prove desirable with my preferred option at paragraph 17 above. Whichever model is chosen, however, there will be a strong case and much pressure to use the opportunity of new legislation both to consolidate existing PO legislation (at present split between the Post Office Acts of 1953 and 1969, the British Telecommunications Act, 1981, and various secondary legislation), and to introduce a number of second order measures. Together, these probably add up to the major PO Bill referred to in paragraph 14 above.

The European Dimension

19. Finally, as part of the backdrop to these considerations, is the gestation within the European Commission of a Green Paper on postal Europe. The latest estimate is that the Green Paper, which as a minimum will seek to reserve certain postal services from the normal rules of a free and competitive market, will emerge towards the end of this year. If we are to combat effectively the reactionary pressures from almost all other Member States, it will be important for us to have as clear an idea as possible of our own strategic objectives in relation to the PO and more widely.

ANNEXES A-G

CONTENTS

TABLES AND CHARTS

Annex A The Post Office: The Development of a Strategy for the 1990s

The Problem

1. The Post Office first class letter service has long been the subject of widespread public complaint that it fails to meet the need for a reliable overnight delivery service for letters and packets (see Chart 1[1], page 2). The modest improvement targets the Post Office has set for itself (see Chart 2[2], page 3) would still leave around one fifth of all first class letters failing to achieve next-day delivery. Many customers regard that as wholly unacceptable, yet even these targets will become more difficult and expensive to sustain in the face of the forthcoming demographic downturn.

2. At present, traffic is fairly evenly split between the first and second class streams (45%/55% respectively), and this creates for the Post Office an intensive and expensive peak of activity each evening to collect, sort and dispatch all first class mail (other than the 40% which is purely local) so that it can be transported overnight to the 1,500 or so delivery offices for delivery to the doorstep the following morning. The size and sharpness of this peak reduces the use that can be made of mechanised sorting equipment, the economics of which are undermined if the equipment stands idle or underutilised for long periods of time. Given the sheer scale of the problem – 54 million items collected each night from 100,000 collection points for delivery to 24 million addresses – coupled with the limited scope for mechanisation, it is difficult to see how sustained quality of service improvements could be achieved within the present service structure.

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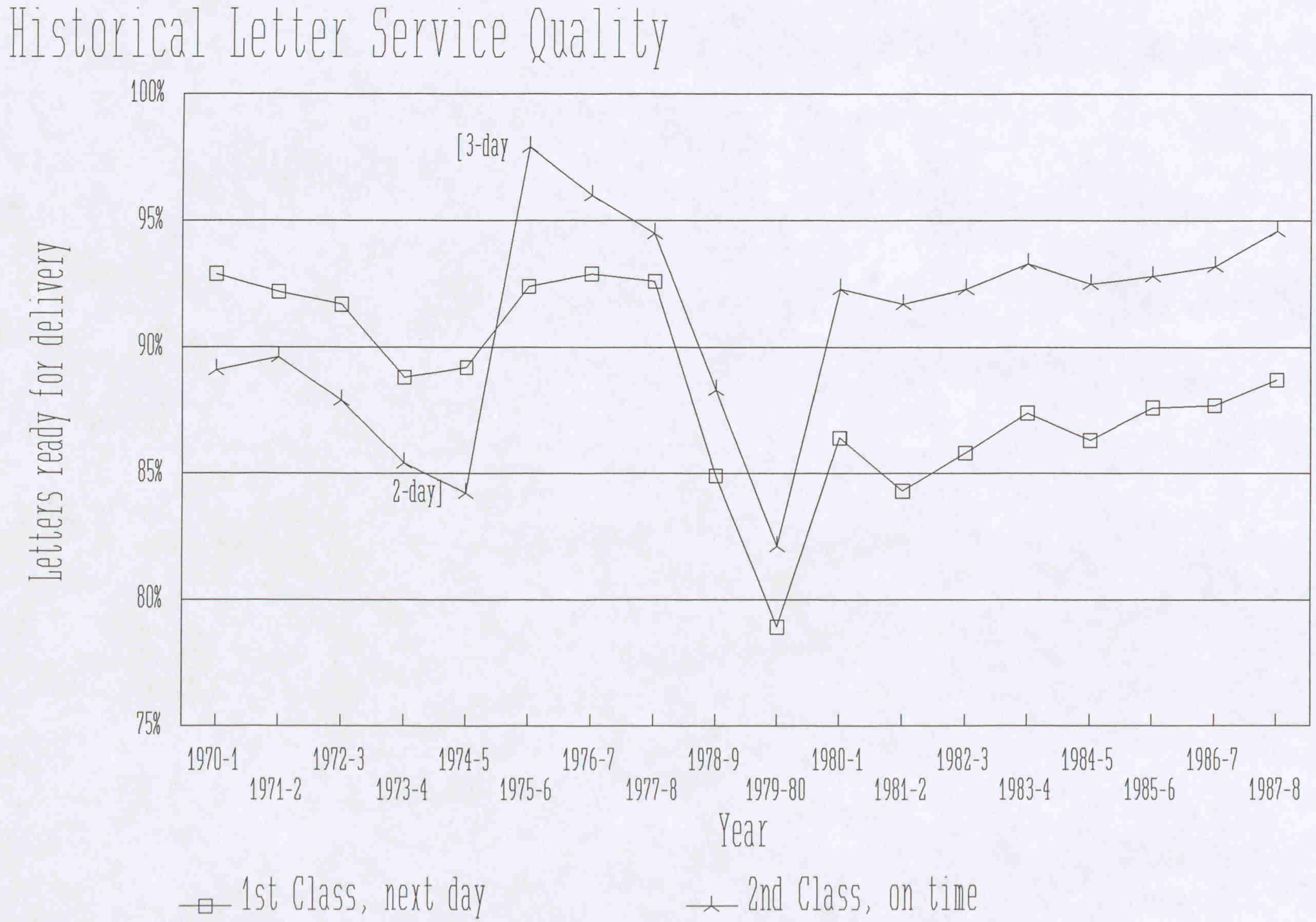
[1] It is difficult to get a run of comparable figures because the basis of performance measurement changed in several ways between 1971 and 1988:

The 1st Class figures for 1971-78 are the percentages of letters ready for delivery on the *day after posting*; for 1979-88 they are the percentages ready for delivery on the *working day after collection*. The figures exclude the February-March 1971 strike period.

The 2nd Class figures for 1971-75 are the percentages of letters ready for delivery by the *second day after posting*; for 1976-1978 they are the percentages ready for delivery by the *third day after posting*; for 1979-88 they are the percentages ready for delivery by the *third working day after collection*.

A completely new measurement system was introduced in May 1989 (see footnote 2).

[2] Between 1979-88 the Post Office used the time between *franking* and being *ready for delivery* as the basis for service performance measurement. In May 1989, the Post Office changed the basis to the time between *posting* and *final delivery*, so that the performance experienced by a postal service user was measured more accurately. Performance under the new measurement system was 10-15 percentage points worse than under the old one.



Source: Post Office Report & Accounts

Chart 1: Past Letter Service Quality

Chart 2: Future service quality

3. A second problem concerns the pattern of local delivery-office-to-doorstep deliveries. The four main stages in the transmission of a letter are collection, sorting, trunking (except for local mail) and delivery. Unlike almost all our continental neighbours, we have become accustomed to an early morning (ie, pre-9.00 am) delivery, followed in most non-rural areas by a second delivery later in the morning. Under existing arrangements the second delivery serves primarily as a safety net to deal with mail which arrives at delivery offices too late for inclusion in the first delivery. The second delivery is invariably much lighter than the first (on average where there are two deliveries 84% of mail is delivered on the first delivery, and only 16% on the second), and this in turn leads to a poor utilisation of labour. This pattern of deliveries is expensive to sustain (in excess of 40% of the cost of a letter is incurred after its arrival at the local delivery office). No less importantly, the early delivery requires postmen to start work at perhaps 5.00am to prepare for door-to-door delivery ("walk sort") the mail that has arrived overnight. Whilst these very early starts – or more probably the early finishes that flow from them – are popular with many existing Postmen who may have second jobs or family commitments during the remainder of the day, they greatly restrict the pool of labour, for example married women during the hours that children are at school, from which the Post Office would otherwise be able to recruit.

4. In parallel with Post Office consideration of these problems, and against the background of the widespread dissatisfaction referred to above, Ministers have been looking at the scope for introducing competition, particularly into the overnight letter service. At present, those who cannot afford to risk the one-in-four chance that their first class letter will fail to reach its destination the following day have little alternative (except where an electronic means such as fax can be used) but to resort to a courier service at a cost of £8 or possibly much more. Most courier companies appear to be geared to dealing with regular account customers only, and show a marked reluctance to accept one-off consignments from private customers.

5. Although the limit on the Post Office letter monopoly has been reduced to £1 for nearly a decade now, very little competition has in practice emerged at or around that level. The difficult trick is to allow access to the area at present covered by the monopoly in such a way as to provide an attractive opportunity to would-be competitors without putting at risk the continuation of a universal delivery service to every address in the country at a uniform, affordable price. This in effect precludes access to the monopoly on any basis that would allow the Post Office's competitors to skim off all the easy, profitable routes, leaving the Post Office with unacceptably high average costs for providing service to the remainder. There is a fine judgement to be made on the extent

to which gains in efficiency brought about by exposing the Post Office to competition might be offset, or more than offset, by reductions in efficiency stemming from loss of economies of scale. A further important consideration is that although international comparisons (Annex E) are notoriously difficult – for example some other countries impose on their Post Offices obligations to deliver newspapers, books and government mail without specific subsidy – the evidence suggests that the UK Post Office provides a letter service that equals or exceeds the best within Europe. Germany, which traditionally comes closest, has tariffs which are some 50% higher (see Annex E). Yet despite this, the UK Post Office is unusual in that it operates without subsidy (see Chart 3, page 6). It is readily apparent that it would be all too easy to change things for the worse.

6. Against this background Ministers and officials have held extensive discussions with the organisations who seemed most likely to show interest if the existing postal market were to be liberalised by one route or another, and the recommendations below take account of the views expressed.

The Post Office Proposals

7. Subject to the results of further extensive public consultation, the Post Office would like to make two linked and fundamental changes to the existing pattern of letter services. The first would be a move to a single delivery per day spread from perhaps 9.30am to 2.30pm, though with special arrangements to cater for the needs of businesses and other large users. This pattern of a single, later delivery (known within the Post Office as "once over the ground" or "OOG") carries with it the potential for a number of important benefits for the Post Office and their customers. OOG would eliminate some three-quarters of pre-dawn working, and would enable the Post Office to gain access to a much wider labour market, including particularly married women whose children are at school during the morning and early afternoon. The Post Office estimate that OOG should reduce the need for postmen by some 7,000-10,000 (5%-7%) and result in financial savings of around £75 million per year. Later deliveries would also allow more time for the overnight mail to arrive each morning. This in turn would enable the Post Office to eliminate at least some of the expensive back-up facilities they at present maintain, would enable a more effective use to be made of mechanised sorting equipment, and above all would be a major factor in enabling the Post Office to improve the reliability of next-day delivery of first class letters from a present best of around 80% to perhaps as high as 95%.

8. The second, and consequential change would be a repositioning of the present two-tier letter service. There is evidence that the 3-day service specification of the present second class letter stream, together with its "second class" nomenclature, is unpopular with many customers. The

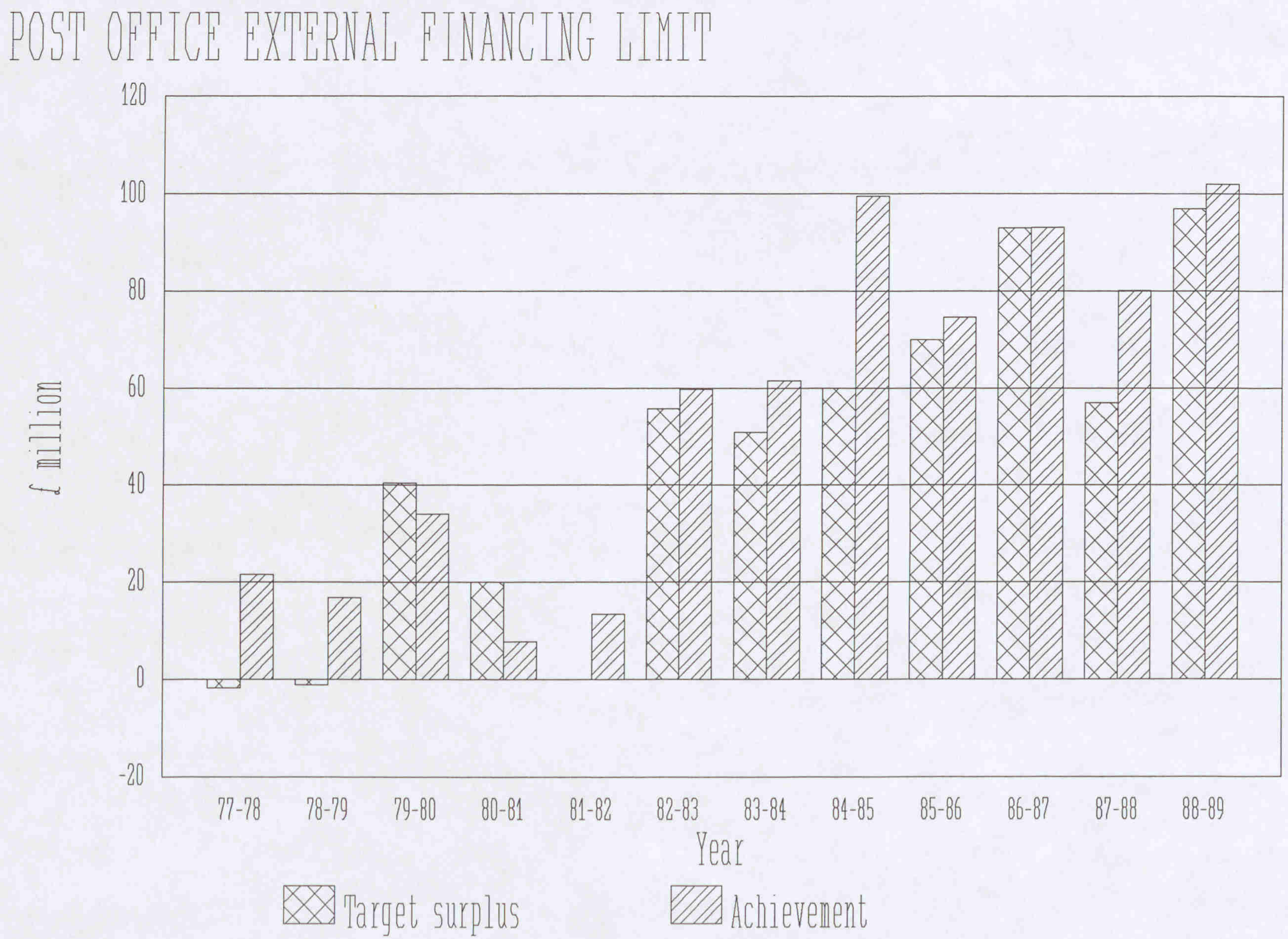


Chart 3: Post Office External Financing Limit

Post Office would in presentational terms telescope the existing first and second class services into a single, "standard" service priced at around 18p and probably offering next-day delivery of local letters, with 2-day delivery of the remainder (except perhaps to the most remote areas). They would simultaneously launch the new, highly reliable next-day service to all areas (again except to the most remote), priced at perhaps 35p. Because only about 15%-20% of traffic might use the new, higher priced next-day service (as compared with nearly half at present), the existing evening peak would be dramatically smoothed, and would become much more manageable, which in turn should help the Post Office to achieve greater reliability. Additionally, the correspondingly increased volume of mail in the less time-critical standard stream should optimise for the Post Office the scope for mechanised handling in sorting offices.

9. Thus there are cogent and coherent arguments for the package of changes sought by the Post Office. There are, however, also some major areas of concern. No matter how skilfully presented, it seems certain that the package will prove highly unpopular – at least initially – with a sizeable minority of the Post Office's customers. Many may see the repositioned first class service as a near-doubling of the price of the service they believe they are today entitled to expect (and for the most part actually get) for 20p. Worse, many may feel that OOG represents a substantial deterioration of the present service. These will be primarily customers who at present receive their mail before leaving for work in the morning, and so have an opportunity to respond to it that same day. Under OOG, their mail would be available to them only on their return home in the evening. Unanswered questions remain on the extent to which the Post Office would be able to make adequate and acceptable arrangements for the growing number of small businesses operating from domestic or other premises in residential areas. Indeed, past Post Office research suggests that as many as one-third of their customers would be unhappy with a change to OOG. A near-doubling of price for mail perceived by many as arriving effectively a day later than hitherto seems guaranteed to arouse considerable hostility.

10. The second area of concern is the likely effect on Post Office industrial relations. Whilst, as noted earlier, OOG offers the Post Office the substantial benefit of a much wider pool of labour from which to recruit delivery postmen, a move away from present delivery patterns would be enormously unpopular with the existing workforce, many of whom are known to have second jobs or other commitments later in the day. At their annual conference last month the postmen's union, the Union of Communications Workers (UCW), voted to use industrial action to resist any move by the Post Office to dispense with second deliveries in rural areas (in effect, to introduce OOG). The Post Office have long recognised that much of the savings from OOG would in practice need to be deployed to "buy off" the resistance of the existing workforce. They claim

however that these payments could be kept away from any enhancement of basic pay, and structured instead to incentivise the pay of delivery postmen. This in turn would help to weaken the monolithic power base of the UCW, and would serve to promote a change of culture amongst delivery postmen in preparation for separation of the delivery network from the rest of Royal Mail Letters (RML), and its possible eventual externalisation. If the Post Office have underestimated the resistance of the UCW or of the workforce to OOG, the result could be widespread and prolonged industrial action with disastrous consequences for Post Office revenues in the short term, and for customer confidence (and therefore future traffic and revenue growth) in the longer term. There would also be the wider costs of the disruption to the economy generally, and the long-term effects on relations with the workforce and union.

11. The Post Office proposals are therefore not without considerable risk, and the Post Office Board have made it clear that they would not wish to embark on the changes unless they commanded the full support of the Government. It is also worth noting that the financial savings from OOG would at best be relatively modest even if they were not to be largely ploughed back into the delivery postmen's remuneration package. Thus £75 million represents less than ½p on the price of a stamp, or no more than about 2½% of RML expenditure.

12. Despite this, the Post Office have long been attracted to the concept of OOG. It has been proposed by them on a number of occasions over the past quarter of a century, for example to the Select Committee on Nationalised Industries in 1967 and to the Carter Committee a decade later, although in the context of a search for efficiency savings. Both firmly rejected it as a deterioration of service not justified by the relatively modest savings claimed for it. Annex D gives a brief chronology of Post Office service changes and other landmarks since 1965. Circumstances change, however, and the Post Office argument for OOG today is that with burgeoning traffic and a shrinking of their traditional labour market they risk declining service quality in certain key areas of the country – notably in and around London and the South East, but with ripple effects on the rest of the network – coupled with escalating costs if they do not initiate radical changes to delivery patterns now.

The Scope for Introducing Competition

13. If Ministers attempt to dissuade the Post Office from making the changes they seek, the Post Office Board may well feel justified in trying to pin on the Government the responsibility for any subsequent deterioration in service quality. At the same time, there must be serious reservations about countenancing changes which may be interpreted as the entrenched monopolist abandoning any attempt to maintain

services and opting instead for the easy life *unless* Ministers are able to announce at the same time that the Post Office's hitherto captive customer base is henceforth to be given access to rival postal services who will have every incentive to offer the standards the Post Office no longer can.

14. To this end, and against a strong belief that some element of competition in the inland letter services is long overdue, Ministers have been exploring the scope for introducing competition *in ways which will not endanger the continued provision of a letter delivery service to every address in the country no matter how remote, at a uniform affordable tariff*. This constraint has been taken to be a fundamental and absolute political necessity. Within it, two very different broad lines of approach have emerged.

<u>Unrestricted competition within first class letters only</u>

15. This approach would permit unrestricted competition in what is at present the Post Office's first class letter stream, but would leave the second class or standard letter stream protected by the statutory monopoly. There are strong arguments in favour of this approach. It could be achieved by a simple reduction in the letter monopoly from its present level of £1 to a point somewhere between the first and second class letter tariffs. Entry to the market on a limited scale would be cheap and easy, and might well prove attractive to, for example, small groups of existing Post Office staff who would probably set up local services in the first instance. The most successful and entrepreneurial of these could be expected to gradually extend their coverage. This process might be facilitated by allowing competitors access to the Post Office's delivery network on a fair and arm's length basis, since it is here that major costs and the greatest economies of scale lie. There would be no need to impose particular coverage obligations on the new services, since the safety net of universal coverage would still exist through the Post Office's monopoly-protected second class service.

16. With no need for coverage obligations there would equally be no need for a complicated licensing regime, nor for a specific regulatory authority to vet applicants, to hold beauty contests, or to police observance of the licence conditions, all of which would be necessary in conditions of restricted competition. However, there would need to be some form of expert and independent oversight or regulation to ensure, in ways that would carry public conviction, that the Post Office was not subsidising its competitive overnight stream from the monopoly profits of its second class stream. The Government would in turn need to accept that the Post Office should be free to respond to the loss of traffic on its more profitable first-class routes by introducing differential pricing within that service (but not of course within the monopoly service) should they wish to do so.

17. The Post Office have said that they would welcome the introduction of competition on this basis (though they would clearly have views on the exact positioning of the monopoly boundary) *provided* that the Government will support them on the introduction of OOG. Their argument is that none of their competitors would operate an early morning plus later second delivery – because it is far too expensive, and only a minority of customers want it – and that without a change to OOG, the Post Office would be forced to compete under a severe and demoralising handicap. With the Government's blessing for OOG, however, the introduction of competition on this basis would serve as a positive force to gain the acceptance of the UCW and the workforce for the service and other changes sought by the Post Office

18. The major concern with this first route is the extent to which serious competition to the Post Office would in practice emerge. Discussions with all the major carriers and international couriers have led to the conclusion that none of them would be interested in entering the UK overnight letter market on the basis outlined above (though most have admitted that they might find themselves forced to respond to customer pressure to do so). In particular, all have said that they would find no attraction in using the Post Office's delivery network. Each stressed the need to retain full end-to-end control of service quality, the expectation of customers that the organisation would take responsibility for mail throughout its entire journey, and the fact that the delivery officer was the chief visible manifestation of the organisation. Each also stressed that it would be impossible to even approach Post Office prices without something at least approaching the economies of scale available to the Post Office, and that the necessary traffic volumes would simply not be available in an unrestricted and fragmented market. Most were generally complimentary about the Post Office's performance in handling vast numbers of individual items of mail. A more detailed summary of the various discussions with the couriers and others is at Annex F.

<u>Restricted competition licensed within the existing monopoly</u>

19. The second broad approach to introducing competition stems directly from the discussions referred to above. It is to leave the existing monopoly, or something like it, essentially in place, but to license a strictly limited number of competitors to operate across its whole area subject to an obligation to deliver to every address in the country, and at a uniform price. Clearly, without such an obligation entrants would have a strong incentive either to offer service only in the easy-to-serve areas in which they would find it easy to undercut the Post Office standard tariff, or to deter traffic to the rural areas by punitive differential tariffs. Either way, the Post Office might quickly find that its average costs had risen substantially, which in turn would call for corresponding tariff increases, or subsidy. A number of major

Post Office customers have emphasised that they see this as a very real and unpalatable risk. For the reasons described in paragraph A...15 above, some form of "OFPOST" to oversee and regulate such a regime would appear essential. Collusion between the new entrants as they sought to make headway against the entrenched Post Office seems a particularly likely outcome.

20. Nevertheless, the approach is not without its attractions. At least two of the major existing carriers, TNT and Securicor, have said that they would in principle be very interested in entering the UK letter market in conditions of restricted competition across the whole of the Post Office monopoly. Both believe that with access to a share of *all* the Post Office's letter traffic - including notably direct mail advertising which has shown much the strongest growth of any sector of the postal market, and where there has been particular criticism of the performance of the Post Office in recent years - sufficient traffic volumes could be generated to produce the necessary economies of scale needed to justify the expensive nationwide collection, sorting, trunking and delivery infrastructure. Because only major organisations would have the resources to take on the obligation of universal delivery, undue fragmentation of the market would be avoided. Although the entry into the market of perhaps two or three large and well-established organisations would effectively preclude opportunities in this area for young and dynamic new entrants, the restricted competition model does have the important presentational advantage of offering a greater assurance that credible and visible competition to the Post Office would emerge within a given timescale.

Legal and Timing Considerations

21. There are important constraints on how much could be achieved without the need for primary legislation, and these are set out more fully in Annex B. They have major implications for the timing of future strategy towards the Post Office. Essentially, the monopoly was suspended at the £1 level for a period of 25 years in 1981 by means of an Order made under Section 69 of the British Telecommunications Act 1981. The same route could be used now to reduce the level still further for a finite period (but not to abolish it altogether). However, in 1981 the Select Committee on Statutory Instruments reported to both Houses its view that this was an "unexpected use of the power" which placed a "strained construction" on the drafting. The legal advice now is that if the Secretary of State used his power to reduce the monopoly to a point which allowed competitors to bite into the Post Office's profitable higher price/weight step traffic (see Annex G) he could be subject to judicial challenge on the grounds that he was preventing the Post Office from fulfilling its statutory obligations to break even taking one year with another while continuing to serve all parts of the United Kingdom, providing such letter services as meet all reasonable

demands (except where they are provided by others). Primary legislation would be needed to put the position beyond doubt. Similar considerations apply in the case of a licensing regime which could in the first instance be introduced, albeit in simplistic form, without recourse to Parliament at all.

22. The reality must be that so long as the uncertainty of a possible legal challenge remained - and the Post Office and their unions would doubtless not be slow to draw the attention of would-be competitors to it – the necessary commitment to serious entry to the market will simply not be forthcoming. Primary legislation for the licensing regime would in any event be needed to create the necessary powers to control it properly through a specific regulatory framework and authority.

23. Whereas the legislation to accommodate the requirements of a licensing regime would necessarily prove substantial and complex, a straightforward suspension of the monopoly down to, say, 20p might in theory be achieved by means of a very short Bill. However, because the existing legislation is permeated with the implicit assumption that there is a Post Office with the exclusive privilege (and duty) to convey mail, it seems inevitable that many consequential changes would be necessary or desirable, not least to ensure that the playing field is as level as is possible. Significant further detailed legal study will be required to determine the extent of such changes. The legislation would also need to make provision for some form of continuing independent regulation, though the requirement would certainly be a great deal more substantial in the case of a licensing regime. Furthermore, there would also be strong pressure from a variety of sources to use a rare opportunity of legislation on the Post Office to sweep up a wide range of consequential issues, unrelated second order issues, rationalisations and imperfections in the existing legislation.

24. The legal constraints appear somewhat less inhibiting if applied to a suspension of the monopoly to a figure some way *above* the present first class tariff, for example to 40p or 50p – although Post Office legal advice is that the risk of challenge would remain very strong. It is widely believed that little real competition to the Post Office would emerge at this level (just as almost none has emerged at £1 over the past decade, though within that period there has been a proliferation of courier services currently charging from about £8 upwards). The argument is that at 50p any rival service would be more than twice as expensive as the Post Office, as such could not hope to generate the volume of traffic needed to produce the economies of scale that in turn would be needed to make a price of 50p an economically viable proposition for the service provider. Thus although a suspension of the monopoly to 40p or 50p could still be the subject of judicial challenge (as indeed could the present level of £1), the motive for – and therefore the likelihood of

– such a challenge is thought to be much less, and the defence that it was not inhibiting the Post Office from carrying out its statutory duties would be a robust one, especially if, notwithstanding its legal advice, it was supported by the Post Office.

Conclusions: Features and timing of a balanced package

The competition options

25. The Government's freedom of manoeuvre in the short-term is powerfully circumscribed by the need for primary legislation. A reduction in the monopoly to perhaps 50p in advance of primary legislation *might* escape legal challenge, but seems to have little else to commend it. Although it is impossible to predict with any certainty how the marketplace might react, such a reduction is widely thought unlikely to result in any real additional competition for the Post Office, and the lack of competition at or around £1 appears to lend strong credence to that view. It would be seen by the workforce in particular as a tacit admission by the Government that, after months of deliberation and discussion with potential private sector competitors, "their" monopoly was in effect impregnable. Senior Post Office management are for this reason vehemently opposed to what they see as a purely cosmetic reduction with highly regrettable side-effects.

26. The remaining competition options, of which there are four main variants, are all at this stage almost certainly best thought of in a time frame of post-General Election legislation. For completeness the four variants are:–

a. to allow unrestricted competition in both first and second class letters (ie, effectively to abolish the letters monopoly);

b. to allow unrestricted competition in first class letters only, leaving second class protected by the letters monopoly (ie, to suspend the monopoly down to, say, 20p);

c. to allow restricted and strictly licensed competition, with universal coverage obligations, in both first and second class letters (ie, to license across the full span of the present letter monopoly);

d. to allow restricted and strictly licensed competition, with universal coverage obligations, in first class letters only (ie, to license within part only of the present letter monopoly).

A fifth variant might have been the privatisation of all or part of the Post Office's letters business, but this was ruled out by the Prime Minister during the last General Election campaign when she gave a much publicised commitment that the Royal Mail would not be privatised. A variation of option (b) would be to disallow the Post Office from providing a next-day service, to avoid accusations of unfair competition. However, this would, at least in the short-term, create a vacuum, leaving much of the country without access to a next-day service. Such steps would undoubtedly result in the total withdrawal of cooperation from the Post Office Board. There would be a loss of Post Office scale economies (to the extent that the total volume of Post Office traffic declined) resulting in higher second class tariffs. Finally, it would be difficult to draft the legislation that would prevent the Post Office from providing a next-day service, particularly as it would always be capable of offering one for local mail, as it now proposes to do with its standard class.

27. Of the four options, the grounds for summarily dismissing (a) and (d) are strong. In particular, option (a) carries far too great a risk of a major fragmentation of the market, with the newcomers picking off all the profitable traffic and leaving the Post Office with a massive loss of economies of scale and all the expensive and difficult routes to serve. The UCW's recent forecast that in these circumstances the price of a letter to outlying rural areas might need to rise to 75p does not sound implausible.

28. If option (a) is therefore too radical, the case against option (d) is that it is unnecessarily timid and restrictive. If licensees are to be required to provide universal coverage at a uniform charge, there seems no good reason for restricting them to one particular class of mail only. Indeed, the universal coverage obligation is likely to impose such very high costs of entry in the creation of a nationwide collection, sorting, transport and delivery infrastructure that a share of all the available traffic will be needed to justify it. Restriction to one class of traffic would require a highly ambitious target of the percentage of traffic that could be won from the Post Office in that class, and would act as a unnecessary deterrent to potential competitors or their financial backers.

29. The arguments for and against the remaining options were set out in some detail at paragraphs A...15-A...18 above. The much tighter and more comprehensive regulation required under option (c), and in particular the imposition on competitors of the same, or similar, obligations as rest on the Post Office, seem likely to lead to two or more mirror-image Post Offices, competing at the margins of price, speed and reliability with essentially similar services. Option (b) holds the promise of a lower level of regulation, and a freedom of manoeuvre which should at least in theory encourage a much more diverse and innovative series of approaches to meeting the perceived needs of the market place, whilst leaving intact and in place the safety net of the Post Office's second class (in due course upgraded to standard) service.

30. However, whereas option (c) offers some certainty that within perhaps two or three years of the passage of the necessary legislation, there would be one or more substantial and probably enduring competitors to the Post Office, option (b) offers no such certainties. Discussions with many of the obvious potential players in this market have produced a virtually uniform lack of enthusiasm for the market that would be created under option (b), in contrast to some limited but strong interest in the market under (c). A judgement on the relative merits of the two approaches will therefore be substantially influenced by personal conviction, or the lack of it, in the propensity of the marketplace to respond to opportunities created in ways which are positive and innovative, yet which cannot perhaps be quantified – or indeed even identified or predicted – in advance. In this context, the lack of competition at around £1, counterbalanced by the explosive growth of the courier industry generally in the £8-£15 bracket, was probably by no means the outcome predicted by those who suspended the monopoly down to a level of £1 a decade ago. Yet few would today challenge the value to UK business and the economy generally of the purely market-led development which ensued. Some of those with whom discussions have been held grudgingly admitted that they might well find themselves reluctantly forced under pressure from their existing client base to enter the market under scenario (b).

Some further considerations on timing

31. One of the incidental benefits of the need to wait until after the General Election for legislation is that it will allow more time for further research into the nature of the market for postal services at less than £1 before final judgements need to be made on the relative merits of options (b) and (c). There are several further benefits. Changes to the competitive environment of the Post Office will inevitably take some time to work through into better services and wider choice for the consumer. In the short-term, considerable negative reaction from, for example, sections of the press and the Post Office workforce may be expected. Changes of this kind are therefore generally made with advantage in the early stages of a new Parliament, in order to allow the maximum time for the resulting benefits to manifest themselves.

32. Considerable further thought will be needed on the form and nature of regulation needed under either option. Under the licensing regime of option (c), a fairly direct translation of OFTEL would at first sight look to be the right answer, though it would clearly need to take into account the wholly public-sector nature of the Post Office as well as the wholly private sector nature of the competition. Given the unrestricted nature of the competition within the first class letter service envisaged under option (b), it might be argued that no additional external regulation would be called for. Such an argument is probably specious. It will be essential to ensure that the Post Office is not only competing as fairly

as possible in the market for first class letters, but that it is widely and convincingly seen to be doing so. There will inevitably be accusations from the Post Office's competitors and others that the Post Office is using its monopoly-protected second class service to subsidise its first class service and to gain competitive advantage thereby. Given that the first and second class streams use common facilities throughout much of their processing, accusations and disputes of this kind will be difficult and messy. The Government, with its major role as Post Office shareholder, would be poorly and uncomfortably placed to arbitrate. The value of an independent regulator has been convincingly demonstrated time and again in recent years, but in the case of the Post Office the relationship between the regulator and the Government – not just as shareholder but as the setter of financial and other targets, with its influence on tariff setting, with its answerability to Parliament – would need to break new ground. A further complication stems from the fact that only one part (ie, first class letters) of an essentially integrated network would be competing with the private sector, whilst the remainder would remain a traditional public sector monopoly.

33. A number of important changes to Post Office organisation and structure need to be put in place before a competitive framework can be introduced. These will inevitably take some time to bring about, but they do not need – and must not be allowed – to await legislation. The time between now and legislation can therefore be profitably used to plan for and implement these changes. Of these, the two most important are to separate the cost and revenue structures of the first and second class letter streams; and to separate the delivery-office-to-doorstep network from the remainder of Royal Mail Letters and to establish it as a separate business within the Post Office. For the reasons explained in the preceding paragraph, it will be important, not least for reasons of wider credibility, that the first task in particular is guided and overseen by some form of expert and independent arbiter. The natural assumption might well be that arbiter would in effect be, or would develop into, the embryo Regulator whose formal existence would need to await the legislation.

34. There are strong organisational reasons for wishing to see Royal Mail Letters divided into a number of separate service and activity-based business centres, and a recognition of this already exists within the Post Office. From the standpoint of the future introduction of competition the particular incentive for separating the delivery network from the remainder of the upstream operation is two-pronged. First, it would again help to allay the inevitable fears that the Post Office would be competing unfairly against the private sector. Some 40% or more of the total cost of a letter is incurred between its arrival in the delivery office and its entry into the addressee's letterbox. As an independent business within the Post Office, operating at arm's length from Royal Mail Letters, the delivery business

could offer access to its network to the Post Office's rivals on exactly the same published terms (again overseen by the Regulator) as it charges the Post Office for similar work. Although, for the reasons given in paragraph A...18 above, the Post Office's main competitors seem in practice unlikely to take advantage of this facility, the fact that it is available to them should they choose to use it should pre-empt many of the accusations of unfair advantage that would otherwise be levelled against the Post Office. Second, there may in the rather longer term be scope for spinning off the delivery business into the private sector, and a number of years spent as a separately managed business within the Post Office, with its own trading accounts, should serve as useful preparation. Similar considerations apply to other activities such as collection, trunking and possibly sorting, perhaps with a longer-term view to the Post Office contracting them out.

<u>The Post Office proposals</u>

35. There are several strong arguments for deferring until after the General Election decisions on the linked Post Office proposals for a change to a once-over-the-ground delivery pattern and a subsequent repositioning of the two-tier letter service (paragraphs A...7-A...12 above). First, as noted earlier, there should be considerable presentational advantage for the Government if changes by the Post Office which are likely to prove, initially at least, highly unpopular with a sizeable minority of customers are accompanied by changes by the Government to the competitive environment which will allow others the opportunity to step to provide the services which the Post Office no longer can (or will), thereby giving customers a choice. Second, the Post Office changes will obviously need a period of time before the hoped-for yields of much improved reliability and containment of costs can be harvested. Initially, there will inevitably be disruption and public hostility to the changes. This also argues for introduction in the early stages of a new Parliament. Third, the intervening time between now and the General Election can be used to gain a better appreciation of the balance between the undoubted potential benefits of OOG and the risks and costs inherent in its introduction (see in particular paragraphs A...9-A...11 above), as well as allowing the Post Office to carry out further customer research and consultation.

<u>A short-term improvement to benefit large users</u>

36. One important change that the Post Office could introduce within the existing legislative framework would be to extend the system of published discounts available to large users in return for certain presorting, postcoding, etc – the Mailsort service – to cover users who would prefer to make their own arrangements to transport their mail as far as the final delivery office. This latter move would mean that a quarter or more of all mail could be handled outside the Post Office

system on all stages of its journey other than final door-to-door delivery. It would give a clear signal to the Post Office unions that inefficiencies in the sorting office would result in lost business, yet economies of scale in delivery, especially rural delivery, would remain unaffected. It is known that such a move would be highly welcome to many of the Post Office's largest customers, and by removing some of the congestion from the Post Office system should result in the remaining, and largely individual items securing a better service. This change should have little if any adverse effect on Post Office finances because what the Post Office would give back in additional discounts would be no more than the savings that would accrue from the work that would be saved.

EC Green Paper on Postal Europe

37. This strategic review of Post Office has taken place against the background of an emerging EC Commission Green Paper on postal Europe. The discussions within Europe are continuing, and the latest expectations are that the Green Paper is unlikely to be finalised much before the end of this year. Its fundamental objective will be to reserve from the normal rules of a free and competitive market within Europe certain basic postal services, though it will also inevitably look to various areas of possible harmonisation. A prime United Kingdom objective in these discussions has been to preserve Ministers' freedom of manoeuvre in relation to the various options, particularly on the introduction of competition, set out in this paper. As the European debate moves forward, it will be important for us to have as clear an idea as possible of our own strategic objectives both in relation to the Post Office and more widely.

Annex B Legal Considerations

1. The legal and legislative questions as to reduction or elimination of the monopoly fall into three basic parts:-

Secondary Legislation

2. Without the need for primary legislation, the Postal Privilege (Suspension) Order 1981, S.I.1981/1483, could be amended so as to reduce the figure of £1 which at present is the lower limit of the suspension. However, it must immediately be stressed that this route could be vulnerable to legal challenge. The original Order, when made in 1981, was criticised by the Joint Committee on Statutory Instruments on the ground that it was an unexpected use of powers. This was because the Committee considered that suspension for 25 years was tantamount to permanent abolition of the privilege, and that the Order placed a strained construction on the concept of suspension in section 69 of the British Telecommunications Act 1981. And if the Joint Committee take that view, it is possible that a court could find the Order (or another Order amending it) to be *ultra-vires*.

3. In Committee on 26 February 1981 the Under-Secretary of State for Industry said in relation to the powers of suspension:

> "The intention behind the use of these powers is to ensure the best service to the customer by allowing others to provide services where the Post Office's performance is not satisfactory. I repeat, where it is not satisfactory."

4. The risks in pursuing this course are therefore (a) the political embarrassment of provoking another critical report from the Joint Committee; and (b) the possibility of a successful challenge in the courts. One way of reducing this risk would be to reduce the period of 16 years which the Order still has to run, as well as reducing the monetary figure £1 to, say, 50p.

5. It would be the overall effect of the Order which could render it subject to legal challenge rather than the period of "suspension" in isolation. The relationship between the substituted figure and the current first-class tariff would therefore be crucial. The question for the court would be how deep the suspension would bite into the monopoly and how great in consequence would be the effect on the Post Office's ability to fulfil its functions, taking into account the extent to which private operators may fill any gap left by the Post Office.

6. In the event of a challenge, the court would have to consider whether the decision to make the Order was legitimate. This would involve consideration of the context of the legislation as a whole, which clearly envisages the continuation of the Post Office's monopoly more or less intact, subject to the exceptions permitted by sections 68 and 69.

7. If the effect of suspension of the monopoly was likely to be that certain profitable services were creamed off by competition, leaving the Post Office less able to fulfil its statutory duty to provide throughout the United Kingdom such services for the conveyance of letters as satisfy all reasonable demands for them (except as far as they are provided by other persons), the Order would be more likely to be capable of being successfully challenged. The Post Office's own views as expressed on consultation would be a very relevant, though not ultimately decisive, factor in this equation.

8. As to the mechanism for reducing the period of the suspension, it would be possible to revoke the 1981 Order, and replace it by another Order specifying a new lower limit of, say, 50p, and which would have a maximum duration of two or three years. Further, it would be possible to renew or further amend or replace that Order at any time up to its expiry. Or it could be overtaken by new primary legislation.

9. As an alternative to an Order under section 69, the issue of licences under section 68 of the 1981 Act could be contemplated. However it can be foreseen that licensing on any significant scale would lead to problems in the absence of a regulatory body. Licensing would, though, have the advantage of enabling conditions to be imposed on those entering the field of competition, rather than allowing a free-for-all as under a suspension.

Minor Primary Legislation

10. The second main area of consideration is a short Bill which would abolish the monopoly, in whole or in part. Use of primary legislation would avoid the risk of challenge arising from the use of delegated powers under section 69 of the 1981 Act. A relevant question is how short a Bill could effectively achieve the single object of abolishing the monopoly; and how many unavoidable consequential amendments to other parts of the legislation (in particular the Post Office Act 1953) would follow. Equally important is the question of how such a Bill, even if very short, could be included in the legislative programme (otherwise than by sacrificing a DTI Bill which had already been offered a place). Alternatively, Cabinet colleagues would have to agree that an additional place should be found for such a Bill.

Major Primary Legislation

11. The third option, inevitably on a longer timescale, would involve full-scale amending legislation. This could include the creation of a regulatory body ("OFPOST") and other control mechanisms such as have been included in recent privatisation measures. The timescale for preparation of such a Bill inevitably places it beyond the next General Election.

12. Were such a Bill to be drafted, it would no doubt be sensible to take the opportunity to consolidate the Post Office legislation, which at present is spread between the 1953, 1969 and 1981 Acts. This in itself would be a fairly major piece of work, since it is believed that there are some 500 references to the Post Office in legislation other than the main Post Office statutes.

13. The detailed contents of the Bill would, of course, only be settled in the course of the preparatory work. However, at this stage the major changes are envisaged as being the re-definition of the scope of the Post Office's monopoly, and the setting of guidelines within which competition in the excluded areas should develop. A likely model is a licensing regime akin to that of BT and Mercury, although whether a new regulatory body "OFPOST" should be created is for decision. There would in any case need to be a mechanism for ensuring a level playing field for all those in competition with each other, either by lifting some of the obligations imposed on the Post Office or privileges granted to it, or imposing obligations on the new licensees, or by a combination of all three. In particular, this is likely to involve radical amendment of the 1953 Act, much of which dates back to the beginning of the century.

14. Another factor which may influence the shape of a bill for introduction in 1992/93 could emerge from the EC Commission's initiative on "Postal Europe". Although at this stage the UK's existing regime is more liberal than that of other Member States, and we are pressing for more liberalisation, any resulting harmonisation measure which imposed restrictions on our domestic law freedom would of course have to be taken into account in the new Bill. The most obvious area is in relation to incoming and outgoing international mail, and the terminal dues payable between postal administrations.

15. A problem which is likely to loom large in the reform process is that all the existing legislation, and the UPU international convention, and talks in the EC, are all based on the historical concept of a single national postal administration. Once competition is allowed, so that there may be two or more "postal administrations" within the UK, that whole concept has to be rethought.

Annex C The Letter Monopoly

Introduction

1. This annex surveys the national and international framework of legal constraints on the freedom of the Secretary of State to introduce competition into the area at present covered by the Post Office's letter monopoly.

National Legislation

Statutory Definition of the Monopoly

2. The "exclusive privilege of the Post Office with respect to the conveyance etc. of letters" is defined[3] as follows:

> "...the Post Office shall have throughout the United Kingdom the exclusive privilege of conveying letters from one place to another and of performing all the incidental services of receiving, collecting and delivering letters",

where[4] "letter" means any message imparting or exchanging visible information which:-

a. is directed at a specific person or address; This excludes, for example, unaddressed advertising delivered to all premises within a particular area from the scope of the monopoly.

b. relates to the personal, private or business affairs of...either correspondent; and

   This excludes, for example, books, maps, newspapers, magazines and literary scripts from the definition of "letter".

c. neither is to be nor has been transmitted by means of a telecommunications system.

   This excludes, for example, hard copy of electronic mail, telegrams, telexes, etc.

[The definition of "letter"]...includes a packet containing any such communication. So a parcel containing a letter is a letter, a newspaper wrapped around a letter is a letter, as is a book sent with a letter.

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[3] S.66(1) of the British Telecommunications Act 1981.

[4] S.66(5) BT Act 1981.

3. The definition of letter is new to the 1981 Act; no previous Act had defined the term since the institution of a postal service by an Act of 1660 and no case law exists since there have been no prosecutions this century for infringement of the monopoly.

4. The requirement that the letter be written excludes from the scope of the monopoly, for example, computer data and sound recordings, provided, of course, that these are not accompanied by a letter.

<u>Exemptions from the Monopoly</u>

5. Statutory exemptions to the privilege[5] include conveyance and delivery of a letter

a. *personally* by the sender;

b. *by a personal friend* of the sender;

c. *by a messenger sent specially* by either correspondent;

   This means that an organization could, in principle, carry out its own deliveries, but it could not carry others' mail. Local authorities, and utilities are probably the main examples of organizations for whom own delivery could make financial sense because of their need to deliver to every local household.

d. to an *air courier*;

e. issuing out of a *court of justice*, or a reply to such a letter;

f. for or from a *ship or aircraft* owner by his ship or aircraft, provided that no payment is received;

g. *accompanying goods*, concerning those goods (eg, an invoice);

h. to a *post box in another area*;

i. by someone who has a *business interest* in the letter;

   This allows private companies to convey and deliver letters relating to the company's business both between branches of the company and to outside parties.

j. which is a *banking instrument*;

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[5] S.67(1) BT Act 1981.

This allows the major banks to operate an efficient "clearing system";

k. which is a *coupon, or entry form* (eg, for a football pools, or a spot-the-ball competition).

6. For the sake of brevity, some caveats have been omitted from the list.

<u>Secretary of State's Powers in Respect of the Monopoly</u>

7. Two new features of the 1981 Act are powers for the Secretary of State (subject to consultation with the Post Office):

a. to *issue licences* for activities falling within the monopoly[6]; and

Two such licences have been issued:

i. Charity cards at Christmas;

ii. Document exchanges.

General licences open to anyone may not be issued. Nor may a series of licences be issued which would amount to a suspension of the monopoly, because suspension is subject to Parliamentary procedure, while the issuing of licences is not.

b. to *suspend the monopoly*[7] (by order subject to the negative resolution procedure).

This power has been used to suspend the monopoly in respect of time-critical mail until 2006, provided that at least £1 is charged.

It is unclear what "suspension" means. It has been argued that the suspension means the removal of the monopoly for a specified period of time. However, the Joint Committee on Statutory Instruments criticised the suspension over £1 as being "tantamount to permanent abolition of the privilege" and as placing "a strained construction on the concept of suspension".

These powers had resided with the Post Office (subject to consultation with the Secretary of State) in previous Acts.

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[6] S.68 BT Act 1981.

[7] S.69 BT Act 1981.

Post Office Policy On Enforcement of the Monopoly

8. In 1975 the Post Office were on the point of prosecuting Mercury Despatch for breach of the monopoly but the PO Management Board eventually noted that:

> the threat of legal proceedings could endanger the monopoly if the Courts found against the Post Office on the argument that it was failing to provide a service that was evidently practicable and in demand.

As a result the Post Office started to pursue the development of premium delivery services and the idea of legal proceedings was swept into the background. In the 1979/80 Corporate Plan the Post Office said that the business would generally protect its monopoly in the market place rather than in the courts.

9. The "fuzziness" in the precise limits of the monopoly probably works to the Post Office's advantage and is possibly one reason why they have refrained from having it clarified by prosecuting any of the myriad of generally minor infringements of their monopoly.

The International Dimension

Outgoing Mail

10. The domestic letter monopoly covers items conveyed in the UK, even if their final destination lies abroad. Unless at least £1 is charged, the conveyance of letters within the UK will contravene the monopoly:

a. if the items are collected by the carrier as a matter of routine; and/or

b. there is any sorting of letters before they are despatched by aircraft; and/or

c. they are despatched from the UK other than by aircraft.

11. There are a number of companies which take bulk overseas from the UK and other countries for consolidation and despatch in a "hub" country such as Holland (an activity known as remail). Remail breaches the Post Office's letter monopoly, but the Post Office has chosen not to prosecute, for the sort of reason already described.

The Universal Postal Union (UPU)

12. The UK is a member of the Universal Postal Union, established by inter-government treaty in 1874 to rationalize a set of complex bilateral arrangements. The UPU is now a specialized agency of the United Nations and membership is open to any *country* belonging to the UN.

13. The *Constitution* contains the UPU's institutional provisions. It is a permanent multilateral treaty subscribed to and ratified by the member countries. The objective of the UPU is to allow the formation of "a single postal territory [consisting of the member countries] for the reciprocal exchange of letter-post items[8]". The *Universal Postal Convention* and *Detailed Regulations of the Convention* contain the remunerative and operational provisions deemed necessary to provide such an international postal service. These are phrased in terms of requirements on postal administrations. Although the term "postal administration" is never defined by the UPU, since it is governments which are signatories to the Convention, it is presumed that national postal administrations can be controlled sufficiently closely by their government to allow, for example, the free passage of mail (even in times of war).

14. The specific question of monopoly is not addressed by the UPU. However, if private sector operators in the UK were to handle incoming mail they would presumably need to comply with UPU rules.

<u>EEC</u>

15. In 1986 European Community postal administrations agreed to set their tariffs for international mail within the EEC up to 20g at the first inland weight step. Not all have yet done so.

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[8] UPU Constitution, Article 1, Paragraph 1.

Annex D The Letter Post Services since 1965

May	1965	Reduction of Letter deliveries in London (except for most central areas) from three to two (and one on Saturday).
Oct	1966	Post-coding of UK begins in Croydon (based upon earlier Norwich experiment).
	1966	Introduction of post bus services (following Jack report on rural transport).
	1967	**House of Commons Select Committee on Nationalised Industries reports on the PO. Concluded against OOG. Two-tier service, garden gate deliveries and nests of boxes in flats were not objectionable in principle.**
16 Sep	1968	**Two-tier service structure introduced (replacing next-day and printed matter services).**
1 Oct	1969	**PO ceased being a Government Department and became a public corporation following passage of Post Office Act.**
	1969	Implementation of national mechanised letter office plan began.
20 Jan-8 Mar	1971	National postal strike followed by Hardman Committee of Inquiry acting as arbitrator between PO and UCW. Made recommendations on the PO's approach to financial and productivity matters, including acceleration of the mechanisation programme.
	1971	PO losses reach 20% of revenue.
15 Feb	1971	Decimalisation.
	1972	Completion of post-coding of all UK addresses.
Aug	1972	**Central London deliveries reduced from three to two on weekdays, in line with 1965 changes.**
Nov	1973	PO survey shows that withdrawal of second delivery would have been opposed by 56% of businesses and 42% of private users (65%, if the single delivery was spread throughout the day). Garden boxes were opposed by 40% of private respondents, box clusters by 78% of flat dwellers (3.5% of the population).
	1975	After losses of £100m, postal tariffs doubled. Traffic began to decline. Government

		established Carter Committee in response to public pressure.
Aug	1975	Bank holiday collections ceased.
	1975 -6	Government endorses Select Committee on Nationalised Industries' support of the letter monopoly principle.
Jan	1976	**2nd Class became a three-day (not two-day) service.**
2 May	1976	**Sunday collections and London late restricted collection ceased.**
	1977	First profitable year since 1969.
	1977	**Carter Report (PO Review Committee). Made similar criticisms to Hardman on financial matters. Came out against OOG, for the monopoly. Recommended that PO should offer discounts for bulk and look at restoring Sunday collections.**
	1978	Letter traffic started on present upward trend after three-year decline.
	1979	Real tariffs had increased by 40% since 1969.
	1980	**Service quality reached all-time low: 79% of 1st class letters reach delivery office next day, against 90% target. (79% under the old measurement system corresponds to about 65-70% under present end-to-end measurement system.)**
	1980	**MMC report on Inner London Letter Post. Recommended modification of the monopoly to allow:** **a. private express services;** **b. bulk mail to be carried by third parties from London to other places for input into PO system;** **c. document exchanges.**
	1980	**Commencement of Household Delivery Service for unaddressed mail.**
1 Oct	1981	PO separated from British Telecom.
	1981	Telegram service ceased, replaced by Telemessage.

Nov	1981	**Letter monopoly restricted to items below £1, enabling the creation of the courier industry. Document exchanges permitted, following passage of British Telecommunications Act.**
Sep	1984	**MMC report on PO Letter Post Services. Observed that recurrent themes in Hardman and Carter reports had been that productivity measures should be introduced, based on work measurement and that the mechanisation programme should be accelerated.** **MMC were concerned to find how little change had resulted from these repeated recommendations. Also recommended introduction of better budgetary control and understanding of costs. Suspended judgement on whether the PO was operating in the public interest.**
Dec	1985	Completion of mechanised letter office programme started in 1969, due to have been completed in mid-1970s.
May	1986	PO reorganised into separate businesses: Royal Mail Letters, Royal Mail Parcels, Post Office Counters Ltd and Girobank plc.
	1987	**"Delivery Restoration" programme started, restoring delivery timings and providing additional second deliveries to 400,000 addresses which had previously been classified as rural.**
Sep	1988	National postal strike.
May	1989	**Introduction of end-to-end service quality monitoring. Service, as perceived by customer, shown to be 10-12 percentage points worse than under previous system.**
	1989	**Reintroduction of Sunday collection started, due to be completed Autumn 1990.**

Annex E International Comparisons

Delivery

1. The Post Office surveyed postal delivery in eight European countries (France, Germany, Holland, Belgium, Sweden, Switzerland, Spain, Portugal) in late 1989. They found that:

   a. All aimed to offer a domestic next-day service, except for Spain (offers 1- to 2-day) and Portugal, (not next-day for fringe areas).

   b. All offered only one delivery a day to all business and residential areas, except for Paris which offered two business and three residential deliveries and Lisbon where OOG is planned.

   c. Most countries started delivery between 8am and 10am (cf, 7am in the UK at present).

   d. France, Germany, Switzerland and Holland delivered on Saturdays (as does the UK). The others did not.

Tariffs

2. International tariff comparisons are particularly difficult because the services provided are not completely comparable and the obligations that accompany each post office's monopoly vary. For example, Royal Mail Letters has a particularly generous first weight step (60g, compared to the more usual 20g or 40g abroad). Many countries do not offer the equivalent of our 2nd Class service, but offer a "printed matter" rate instead. Price rankings also depend on the exchange rate measure used. Chart 4 (page 31) compares the UK 1st Class letter price in October 1989 (20p) with similar services in other countries. The comparison is based upon purchasing power parity[9], exchange rates[10] (relative to the $US) and the time required to earn a stamp. The rank is based upon the average of the three measures. The comparison does not show what a typical private consumer or firm might spend on postage.

Obligations

3. In many other countries the post office is obliged to carry mail which lies outside the area covered by its monopoly[11]. For example, the French Post Office is obliged

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[9] Main Economic Indicators, OECD, July 1989, page 173. Purchasing power parity based on private consumption.

[10] OECD Main Economic Indicators, July 1989, page 27. Daily spot rates for the $US on national markets converted to £ sterling.

[11] During UK elections candidates are allowed one free mail shot to voters, but the Post Office is remunerated from the Consolidated Fund for providing this service.

Domestic Letter Prices Relative to UK

October 1989

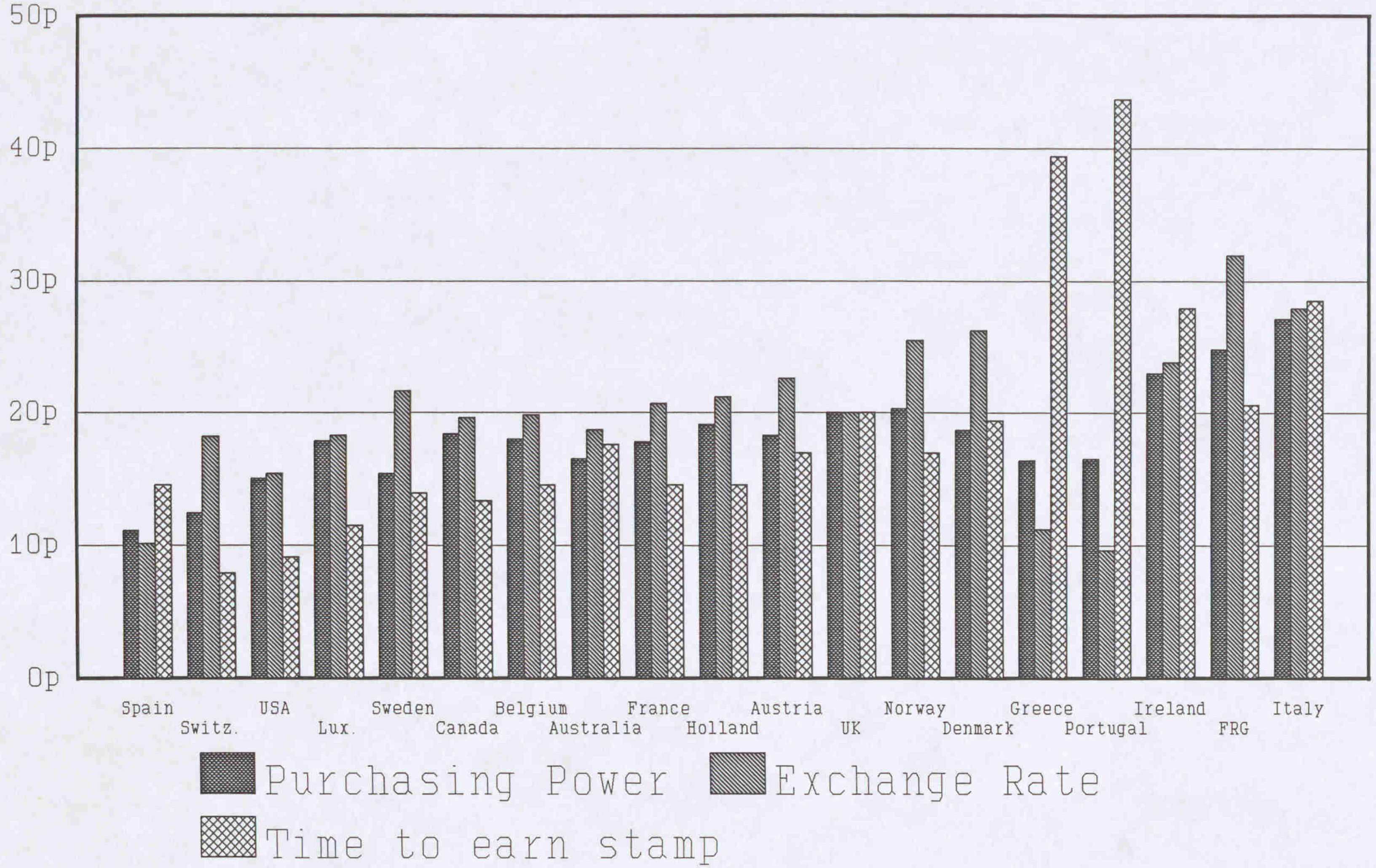


Chart 4: International Letter Prices

to deliver newspapers and cultural, technical, scientific, and political material—some 8% of postal business—at well below cost. The French monopoly does not extend to addressed advertising material. We have not sought to impose such obligations on our Post Office, although, unlike most others, it has a duty to break even, taking one year with another.

Service Performance

4. In April 1989 the Post Office commissioned independent research into the quality of the next-day service in six European countries, including the UK. The research involved posting 3500-4300 fully addressed items (6600 items in the UK) spread over Monday to Saturday. Performance was measured for five categories of mail:

a. *District* (to same city);

b. *Neighbouring* (to between same city and 100km (200km in Italy and 600km Spain));

c. *Long Distance* (further than 100km (200km in Italy, 600km in Spain); and

d. *Private*; and

e. *Business*.

5. Approximately 20% of the items posted were not of the size preferred by each country's post office. The posting samples were mixtures of stamped and metered traffic, except in Germany, where they were only stamped.

6. The results (see Chart 5, page 33) are favourable to Royal Mail Letters. The Bundespost slightly outperformed them, but had an expensive letter rate of about 31p (DM1) or 52p for non-Bundespost-preferred size. The Bundespost is also heavily loss-making. Holland, which also did well, is a relatively small country and starts delivery at 11am.

7. The Post Office repeated the exercise in March 1990, but with a far larger UK sample size (15,000 items). This indicated that German long-distance performance was worse and Spanish performance better than in 1989. However, the survey coincided with industrial action in France, so the full results are not quoted here.

Chart 5: European End-to-End Quality of Service

Source: Survey commissioned by Post Office, April 1989

Annex F Conclusions from Soundings of Private Sector Operators

Introduction

1. Two companies showed a positive interest in the provision of letter services: TNT and Securicor. Initially, both said that they required protection from further market entry to reach the volumes that would be necessary to be able to supply a national service at a uniform price. Since a duopoly was not considered attractive, they have revised their positions and we now have three specific proposals:

Presorted Bulk Mail

2. The Post Office offers discounts for conveying presorted, bagged, bulk mail. The discounts are equivalent to part of the direct cost savings to the Post Office from not having to sort such mail. The bulk mail industry would like further discounts if they also trunked (eg, by TNT) the presorted, bagged, bulk mail directly to final delivery offices, or if they presorted to a finer level. It would be possible for the Post Office to offer such services without any change to the monopoly, but it would be difficult to require them to do so formally.

Competitive Tendering

3. TNT's current proposal is to

a. introduce competitive tendering for collection, sorting and trunking;

b. separate the delivery function from Letters and, to help maintain scale economies, allow only one licensed competitor to each local delivery office, unless that office under performs.

This proposal might work, but would require major legislation, since it involves the total reconstruction of the Post Office.

A Universal Service

4. Securicor consider that they could provide a high-quality 25p next-day service in competition with Letters' 1st Class on 10% of the present 1st Class traffic. They could do this whether, or not, they were also able to offer a 2/3-day service, provided that only a small number of competitors to the Post Office were licensed.

b. issuing licences with obligations such as universal service provision.

The latter course would probably be more susceptible to Parliamentary or judicial challenge and the licence conditions would be difficult to enforce effectively without an accompanying regulatory structure; the only possible sanction—revocation of the licence—would be too blunt.

Reasons for Non-Entry

6. Neither DHL, nor UPS, nor several of the smaller firms to which we spoke had any interest in the provision of letter services. The main reasons given were that it would be fruitless to compete with the Post Office who enjoyed substantial scale economy advantages and had a massive existing infrastructure; they preferred to invest in more profitable areas, such as international or premium express services, for which demand is forecast to grow rapidly. Another reason must be that these companies would not wish to undercut their existing high-quality, high-price services, entering a market whose size and profitability are difficult to determine. Of course, this does not mean that no one would enter the market, and that existing service providers would not extend the range of services that they offered to protect their customer bases.

7. Customers are prepared to pay a high price for assured delivery of time-critical mail, particularly when the cost of conveyance is a small proportion of what is at stake (eg, with contracts or art work). Inter-City Couriers, a small London-based company, offers a service called Penny Black based upon 1-4 collections per day from each customer, at agreed times, for which annual fixed charges are payable. There is a further charge of £1 for each item conveyed. The service is just about breaking even. However, there are many customers which, having subscribed to Penny Black, still make regular use of Inter-City's much more expensive on-demand courier services, even when they have no real need for the only slight speed improvement that they provide.

Delivery Network

8. Allowing access to Letters' delivery network was not generally attractive because of the loss of the dedicated end-to-end control that was required to offer a reliable service. Doing their own delivery would allow companies to establish a visible presence to their customers.

Timing

9. Securicor thought that it would take about two years of detailed planning before serious investment could take place. It is likely that potential market entrants would wait to see what the next Government's policy towards the postal services before making significant investments. For example, they might not take up licences with obligations if they thought

that the next Government might bring in legislation to open parts of the letter market to all comers, without obligation, by lowering the monopoly limit.

Annex G Financial and Operational Background

The Post Office: Royal Mail Letters

Key 1989/90 Letters' Data	
Traffic Volume	55 million letters/day plus 2 million overseas letters/day
Manpower	160,000 full-time staff, plus 19,000 part-time staff.
Network	81 main mechanised sorting centres, 1400 Crown sorting and delivery offices, 1800 small rural delivery offices.
Transport	Long distance movements by rail and air; short (and increasingly middle) distance movements mostly by road: 29,000 vehicles.
Capital Employed	£1500m
Capital Expenditure	£144m (60% of Posts')
Estimated Outturn	
Income	£3156m
Expenditure	£3120m
Profit	
Inland letter profit	(£62m)
Stamps/philately	£31m
Interest	£35m
Overseas letter profit	£32m
TOTAL PROFIT	£36m

Table 6: Basic Information about Royal Mail Letters (1989/90)

1. The Post Office comprises four distinct businesses: Royal Mail Letters, Parcelforce, Post Office Counters (collectively "Posts") and Girobank (in the process of being sold to the Alliance and Leicester Building Society). This strategy review is concerned only with Letters, which is by far the largest of the Post Office businesses, representing 63% of Posts' turnover. Letters is a high volume, low margin, labour-intensive service industry.

2. About 60% of Letters' total expenditure is on operational staff, 15% on non-operational staff and 25% is non-staff expenditure. Chart 7 (page 39) shows a breakdown of the operational staff element. Outward processing is mainly sorting at the collection office. Inward processing is mainly sorting at the delivery office. Preparation is final sorting into walk order. Letters delivers a falling proportion of parcels (particularly in rural areas) and some subpostmasters, who are mainly private shopkeepers working under contract to Counters, supervise their local postmen.

3. About 94% of 1st class letters and the same proportion of 2nd class letters fall into the first weight step (60g). However, the first weight steps account for only 86% of inland letter revenue. Letters' costs do not vary with weight, but with the size and bulk of the letter or packet and with the amount of presorting done by the customer. For example, handling a packet, or a large (A4, say) flat item involves about twice as much work as handling an unpostcoded letter; a presorted letter involves four-fifths of the work. Because Letters does not know exactly how much of each type of traffic falls into each price/weight step, it is hard to assess the profitability of each step precisely. Nevertheless, it is evident that Letters makes a loss on its core letter business and is only profitable because its it is able to make money on the small proportion of higher weight mail[12], on philately, interest (stamps are a form of prepayment) and overseas mail.

4. Cumulative 1st and 2nd Class mail volumes are graphed against tariffs in Chart 8 (page 40).

Royal Mail Letters' Market Share

5. Royal Mail Letters defines the total market for communications in terms of the constituent parts of the discrete sectors in which letter services operate. These are:-

a. *Social:* Social exchange (main competition: British Telecom)

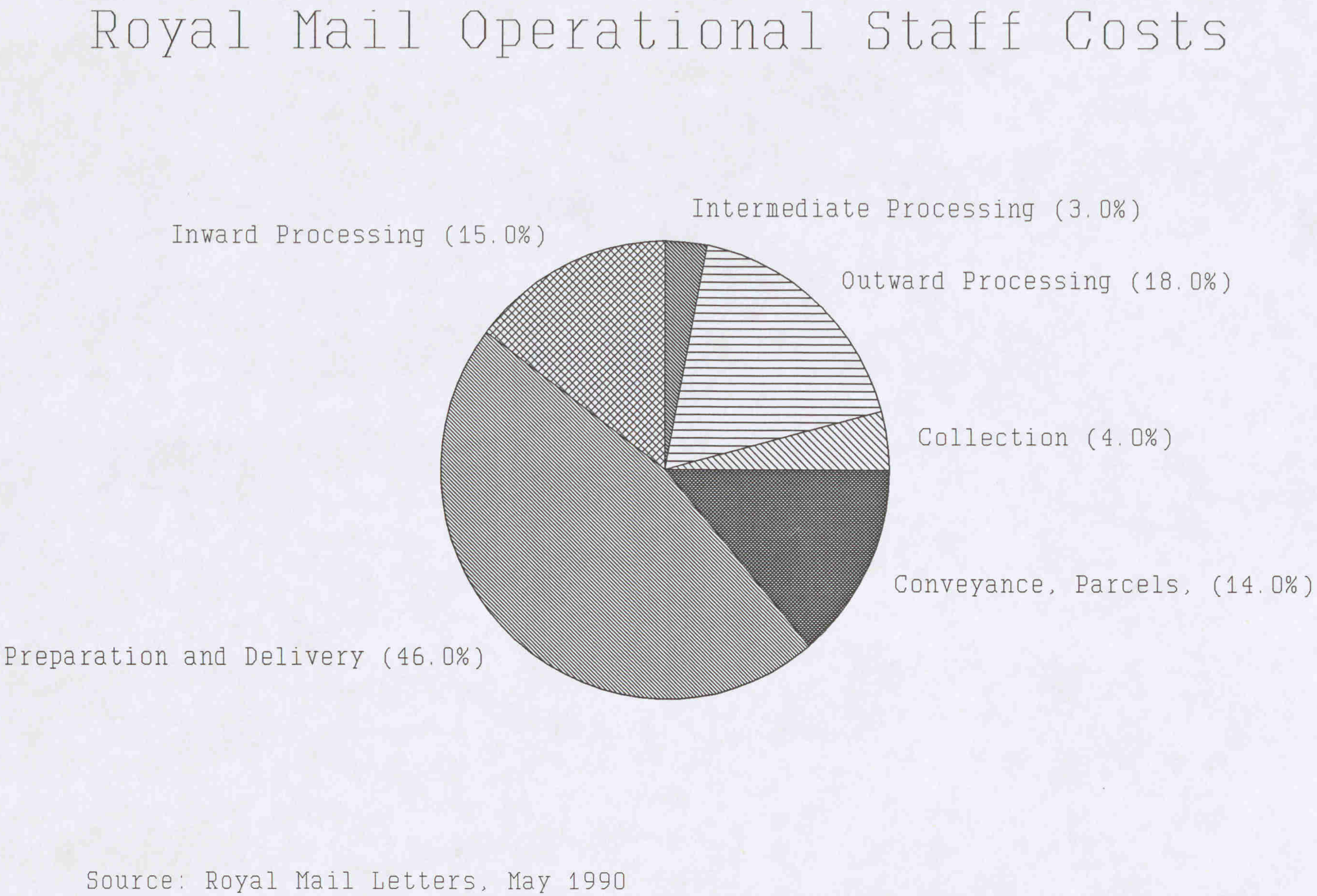
b. *Direct:* Advertising (main competition: TV, press, radio)

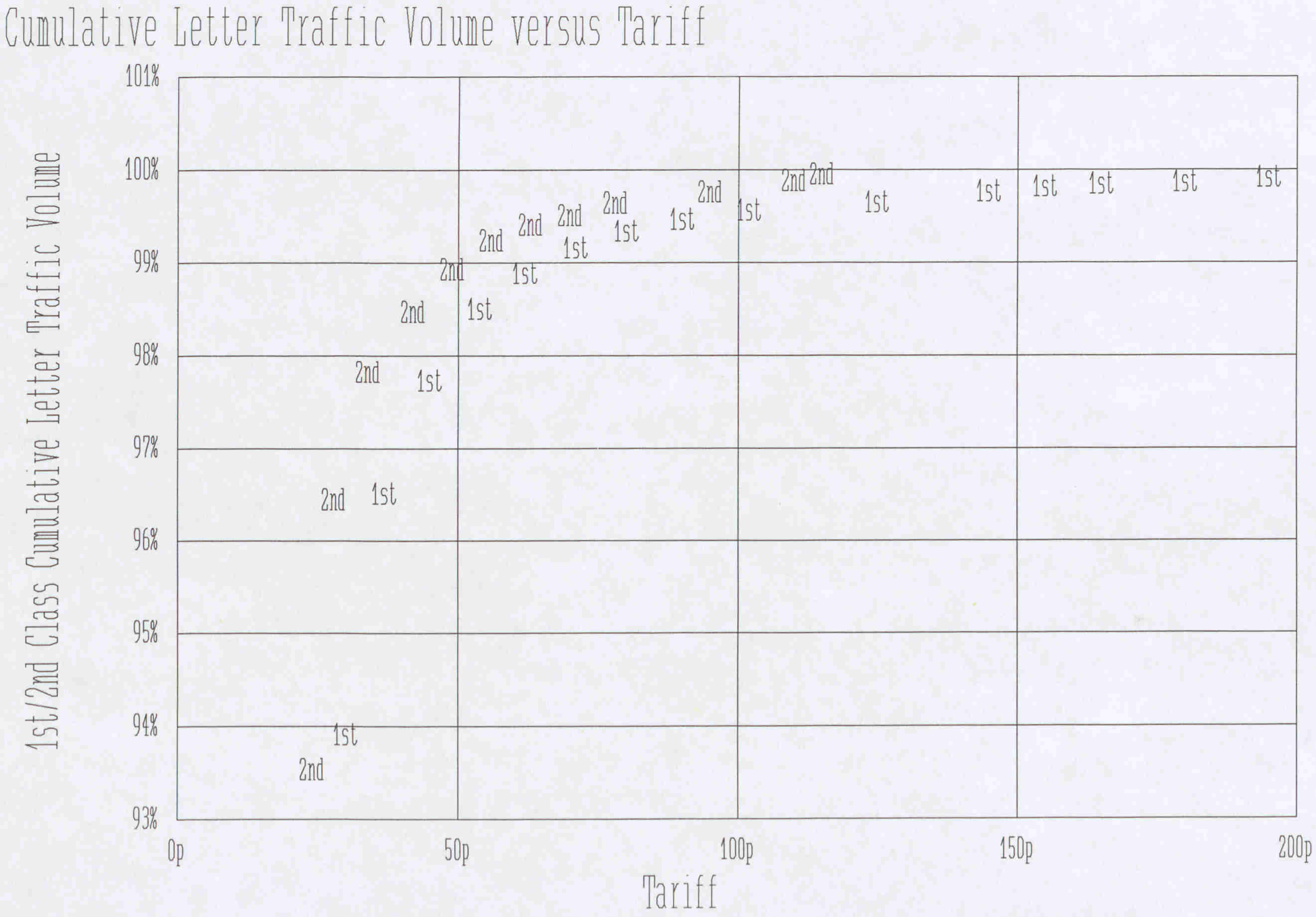
c. *Financial:* Non-cash consumer payments and trade transactions (main competition: banks)

d. *Commercial:* Non-financial business exchange (main competition: British Telecom)

[12] Letters estimates that in 1989/90 it made a notional loss of about £120m on first price/weight step traffic and a notional profit of about £60m on higher weight step traffic.

Chart 7: Letters' Operational Staff Costs





Source: Royal Mail Letters, May 1990

Chart 8: Cumulative Letter Traffic Volume versus Tariff

e. *Premium:* Time-critical and value-added communication (main competition: couriers, fax, telex)

This total communications market has been growing at 11%[13] per year since 1983-4. This compares with 8% per year for Royal Mail Letters. Royal Mail Letters' share of the communications market in 1989-90 (13%) and a 5-year projection of market growth are tabulated in Table 9 (page 42). The Table also shows the proportions of Royal Mail Letters' inland letter revenue which come from each market sector. Unaddressed mail is not included. The main growth in the letter market is expected to come in the "Direct" and "Premium" sectors.

6. Chart 10 (page 43) shows a breakdown of the items (including unaddressed items) falling through an average consumers' letter box in 1989. About 60% of addressed mail is sent to consumers, 40% to businesses. Private senders account for about 70% of 1st Class traffic. The remaining 30%, or so, is sent by businesses. These usage proportions are almost exactly reversed for 2nd Class traffic.

Financial Sensitivities

7. Table 11 shows the effects on Letters' profitability of a 1% change in various parameters. Letters estimates that a 1% variation in traffic results in a 0.6% variation in costs.

Full-year effect on Letters' profits of a 1% change in	
Pay (per capita earnings)	£26m
Volume of business	£12m
Productivity (assuming 50% payback to staff)	£10m
Non-staff costs	£8m
Interest rates	£3m
Return on Capital Employed targets	£20m
Inland prices (assuming no change in volume)	£30m

Table 11: Short-Run Sensitivities (1989/90 prices)

[13]Just under 7% in inflation-adjusted terms.

ROYAL MAIL LETTERS' MARKET SHARE

Source: 1990-91 - 1994-95 Corporate Plan

The Total Communications Market

	1989-90 Value £m	% growth pa	1994-95 Value £m
Social	2,778	9%	4,205
Direct	7,202	6%	9,667
Financial	2,840	5%	3,540
Commercial	3,814	8%	5,574
Premium	2,566	12%	4,533
TOTAL	19,200	8%	27,519

Direct Mail figures relate to postage costs (ie, they exclude industry production costs which, if they were included, would increase the market size threefold).

Constant 1989-90 Prices

Royal Mail Letters' Share of Total Market

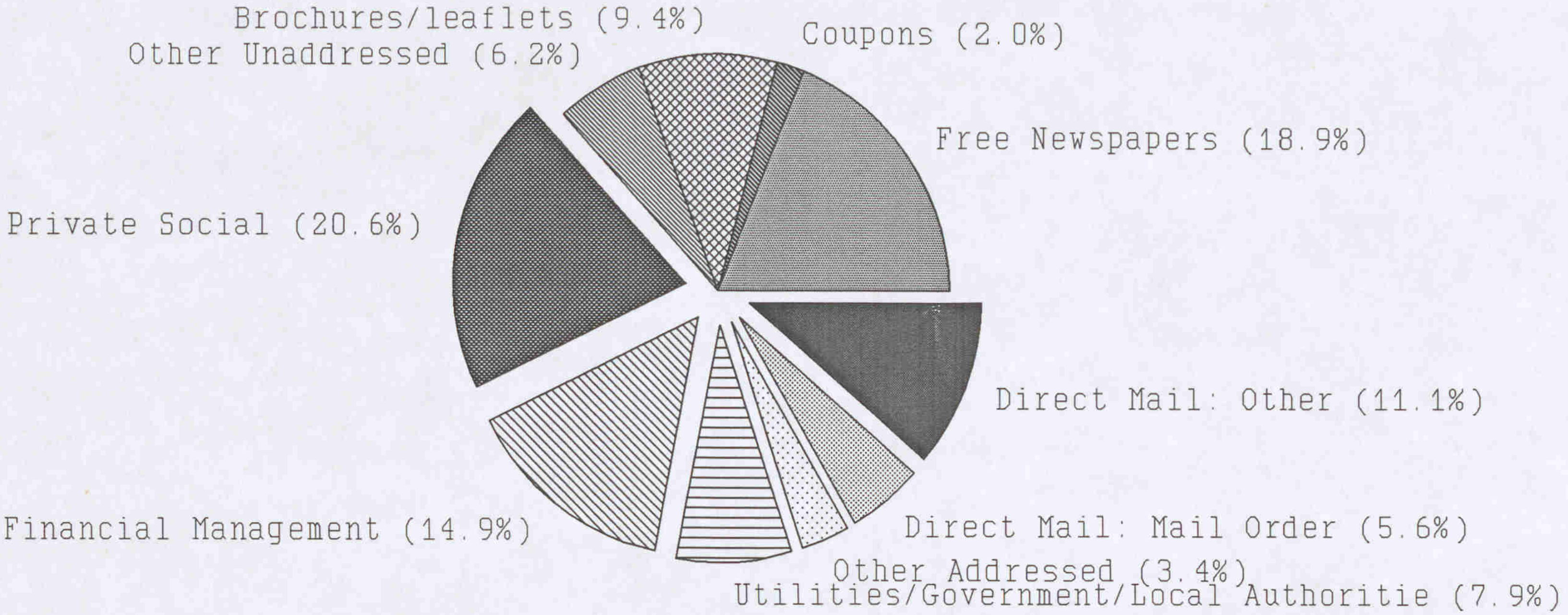
	1989-90 % share of Total Market	1989-90 Value £m	% growth pa	1994-95 Value £m	1994-95 % share of Total Market
Social	11%	302	3%	345	8%
Direct	4%	295	12%	526	5%
Financial	39%	1,107	4%	1,328	38%
Commercial	21%	788	4%	969	17%
Premium	2%	53	15%	105	2%
TOTAL	13%	2,545	5%	3,273	12%

% Share of Royal Mail Letters' Market by Sector

	1989-90 % share	1994-95 % share
Social	12%	11%
Direct	12%	16%
Financial	44%	41%
Commercial	31%	30%
Premium	2%	3%
TOTAL	100%	100%

Letterbox Profile

1989



Source: Royal Mail Letters via Direct Mail Information Service
April 1990

Mailsort

Background

8. In 1977 the Carter Post Office Review Committee reported that the Post Office had argued that it could not adopt short-run marginal cost pricing (eg, to offer discounts for handling presorted mail) because it was restrained by Section 11(4) of the Post Office Act 1969. This stated that if the Minister considered that the Post Office was discriminating unduly among its customers either in the charges or in the terms and conditions for accessing its monopoly services, the Minister could, after consulting the Post Office, direct it to desist. Since no Minister had ever issued such directions, the Committee found it difficult to believe that Section 11(4) had been intended to imply that short-run marginal costing – which would improve the economic performance of the whole postal system – would constitute undue preference.

9. Subsequently the Post Office introduced a range of bulk mail systems with a variety of *negotiable* charges and terms and conditions. In 1989 these were replaced by Mailsort, which has *published* charges, access standards, and terms and conditions. The Post Office says that it is trying to move customers to Mailsort as their old contracts expire. Some of the largest mailers such as the Utilities and Local Authorities are at present on specialist contracts which require a much greater level of presorting than Mailsort. Letters are looking at the possibility of extending Mailsort type terms to a "Walksort" service for such customers.

Service Specification

10. Mailsort is a range of letter services (detailed in Table 12, page 45) for large volume[14] *presorted* mail contracts. Chart 13 (page 46) shows a breakdown of presorted bulk traffic (including non-Mailsort contract traffic). Presorted bulk traffic comprises one quarter of all traffic.

Pricing Structure

11. The public tariffs are used as the base Mailsort tariffs for items up to 60g (the first public weight step). The base Mailsort tariffs increase in direct proportion to weight thereafter. Mailsort offers discounts on these base tariff for presorting, machine-readable addresses, large volumes and early posting (see Table 14, page 45).

[14]The minimum volume requirement for access to Mailsort is 4000 letters (2000 if they are all to the same postal area) or 1000 packets.

Service	Targeted for delivery	Items Carried
Mailsort 1	next working day (1st Class)	Letters
Mailsort 2	within 3 working days (2nd Class)	Letters
Mailsort 3	within 7 working days, or over a 5-day period within 28 days	Letters
Presstream 1	next working day	Periodicals published and posted weekly, or more often
Presstream 2	within 3 working days	Periodicals published and posted at least twice a year.

Table 12: Mailsort Service Specification

Mailsort Discounts	**Presorted to local delivery office**	**Presorted to county, or large town**		
		Standard discount	Machine-readable addresses	Total
Mailsort 1				
Standard	13%	0%	+2%	=2%
Posted before 1pm	15%	2%	+2%	=4%
Mailsort 2	13%	8%	+2%	=10%
Mailsort 3				
Up to 250,000 items	25%	15%	+2%	=17%
Between 250,000 and 1 million items	28%	15%	+2%	=17%
Over 1 million items	32%	15%	+2%	=17%
Presstream 1				
Standard	13%	0%	+2%	=2%
Posted before 1pm	15%	2%	+2%	=4%
Presstream 2	13%	8%	+2%	=10%

Table 14: Mailsort Discounts

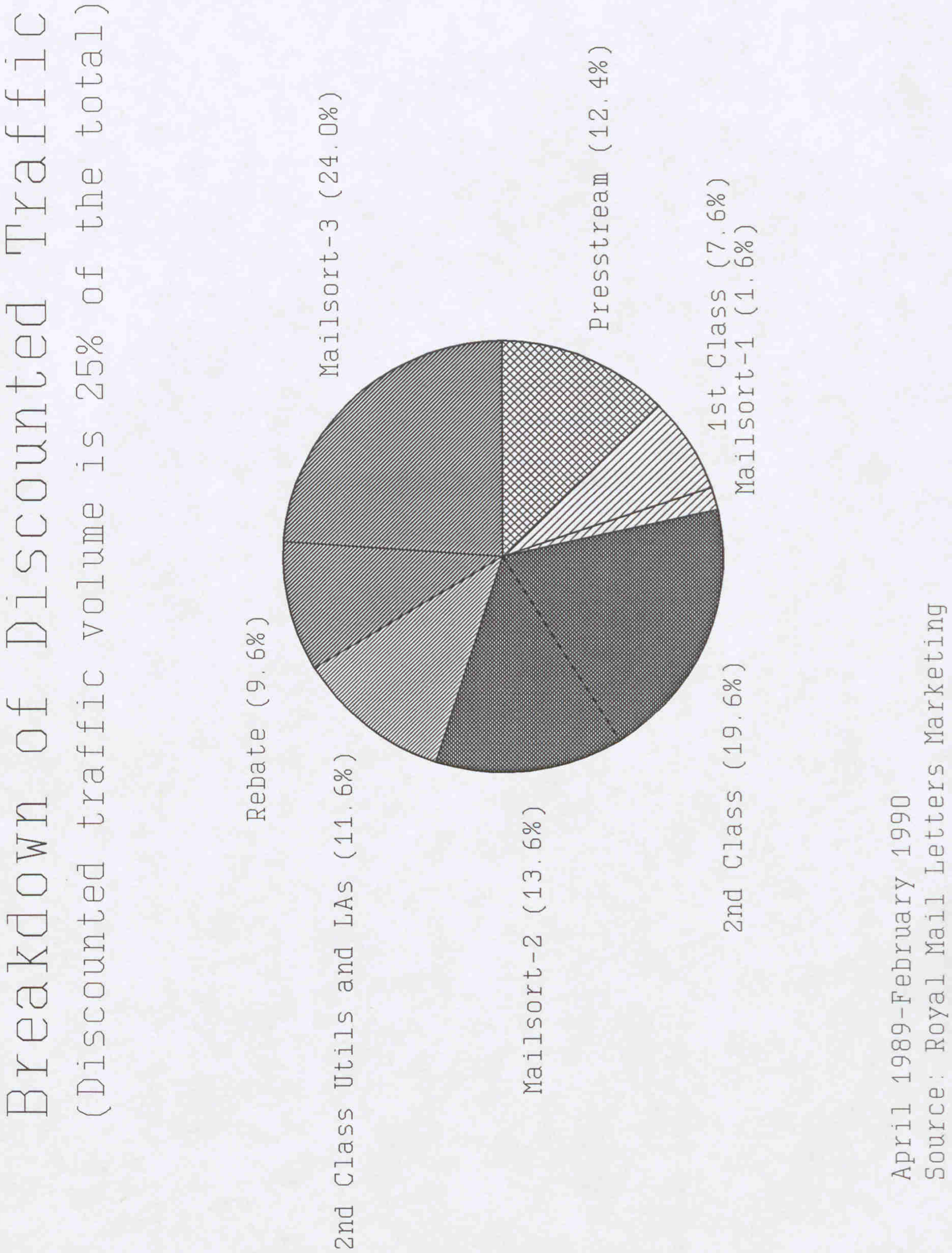


Chart 13: Discounted Traffic

PART 12 ends:-

H3 to PM 20 6 90

PART 13 begins:-

180 to PM 6 7 90