Ofcom Review of Postal Users' Needs

Review of operational and cost impact of potential changes to the universal postal service

August 2012

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Executive summary

Background

1. Ofcom is currently developing its understanding of the needs of postal users and reviewing whether their reasonable needs are being met through the current Universal Service Obligation ("USO"). As part of this process, Ofcom has considered potential changes to the future scope of the USO. Ofcom has therefore:

    a) requested and received from Royal Mail ("RM") estimates of the incremental cost savings associated with a number of potential changes to the USO; and

    b) commissioned Consult Sirius ("CS") to review the methodology and underlying operational assumptions underpinning RM's estimates.

2. This report presents our analysis and findings, which are based on:

    a) estimates submitted by RM at the end of March 2012; and

    b) responses to follow up questions submitted by RM at the start of May 2012.

Approach

3. At the end of March 2012, RM submitted estimates of annual cost savings and transition costs attributable to six potential changes to the USO, based on its projected cost base in 2015/16. These scenarios were selected by Ofcom in the light of previous work done by Postcomm, feedback from stakeholders such as Consumer Focus and the Direct Marketing Association, and discussion with RM:

    a) Scenario A: earlier collection from low volume post boxes and removal of very low volume post boxes;

    b) Scenario B: later final delivery times;

    c) Scenario C1: lower first class ("1c") quality of service, based on a "low cost network" with no air linkages;

    d) Scenario C2: lower 1c quality of service, with next day delivery only for mail posted and delivered within the same Mail Centre ("MC") catchment area;

    e) Scenario D: a single class service; and

    f) Scenario E: a five day delivery and collection service.

4. RM has estimated the cost impact of potential changes to the USO through a high-level desk top exercise. It has split its cost base between the component pipeline elements (collections, outward processing, network distribution, etc), and under each scenario, considered which pipeline elements would be affected, and estimated cost savings for those pipeline elements, together with associated implementation or "transition" costs.

5. RM has estimated cost savings and transition costs using its projected cost base and mail volumes in 2015/16, the final year of its June 2011 Restructuring Plan, as the starting point. In principle, this seems a reasonable approach, as it minimises the mistaken inclusion of efficiencies which could already be achieved under the existing USO specification, and it focuses on the long term impact of changes to the USO.

6. RM has drawn attention to a number of key limitations in its analysis:

   a) estimated savings are preliminary and theoretical, and assume full deployment of the changes, although the viability of full deployment has not been considered;

   b) significant further detailed analysis would be required to should any scenario be considered for implementation, including an assessment of knock on impacts through the network and timescale for deployment;

   c) estimated savings take no account of the likely commercial impact of potential changes, including possible reductions in demand (which, we note, would tend to make effective per unit cost savings smaller, and in some cases much smaller, than suggested by RM's estimates, due to the presence of significant fixed costs in RM's network);

   d) transition costs have not been fully estimated for all scenarios; and

   e) each scenario has been modelled on a stand-alone basis, and interactions between the changes identified mean that estimated savings in the scenarios are not generally additive.

7. RM has attempted to reflect some of these uncertainties by presenting a range of savings under each scenario. The range of savings is set up to 10% above, and 30% below, RM's central savings estimate; whereas the range of transition costs is set up to 30% above, and 10% below, RM's central transition costs estimate.

8. We have reviewed the methodology and underlying operational assumptions underpinning RM's estimates. Using our experience of assessing, planning and implementing changes in working schedules and practices at RM, of managing its operations, and of reviewing operational aspects of regulatory submissions by RM and other postal operators, we have considered the reasonableness of the operational changes assumed by RM under each scenario.

9. We have also compared RM's estimates with previous Frontier Economics (FE) analysis. This has required us to roll forward FE's 2008 analysis to 2015/16, taking into account RM's main operational changes since then. We think that the roll forward provides useful benchmarks against which to compare RM's estimates and cross-check our own operational views.

10. Where we have identified potential refinements to RM's assumptions and estimates, we have attempted to estimate alternative quantifications of cost savings.

11. While our efforts are clearly aimed at assessing the reasonableness of RM's estimates, we have borne the limitations highlighted by RM in mind when conducting our work and asking follow up questions of RM. We have attempted to check that estimates are of the right scale rather than try to ensure they are highly accurate. We are conscious that seeking a high level of accuracy may not only be impractical given the starting point provided by RM's estimates, it might also be disproportionate if the customer needs against which Ofcom is planning to weigh these cost savings can only be estimated in relatively broad terms.

12. Where we provide alternative estimates of cost savings or transition costs, these should be taken as indicative only, given the high level nature of the starting point, and the limitations in the information available to us. In particular, we draw attention to the fact that although RM has been given a draft of our report and has made a small number of specific comments, which we have considered in finalising our report, it has also stated:

"*in general RM believes that CS has not misrepresented RM's analysis of high-level cost saving for each of the scenarios as they broadly agree with our ranges of cost savings. We do, however, believe that in the areas where they take their analysis further that the opinions expressed do not align to RM's collective expert view...*

We have not attempted to correct their analysis as we do not consider this an appropriate use of RM resources however we can give no endorsement or quality assurance on this information."

13. Although there does not at this stage appear to be any fundamental divergence between RM's analysis and our own, a more comprehensive response from RM could reveal new information which would lead us to make material alterations to our alternative estimates.

Summary of findings

14. The table below summarises RM's estimates of savings and transition costs by scenario, together with our alternative estimates:

Table 1 – Summary of savings and transition costs

	Scenario A Earlier collection from and removal of post boxes	Scenario B Later final delivery (2 hour delay)	Scenario C1 Lower 1c quality of service – low cost network	Scenario C2 Lower 1c quality of service – intra MC standard	Scenario D Single class of service	Scenario E Five day delivery and collection (no Saturdays)
RM						
Annual cost saving (£m)[1]	Low	Low	Medium	High	High	High
Transition cost (£m)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Discounted payback (yrs)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CS						
Annual cost saving (£m)	Low	Low	Medium	High	High	High
Transition cost (£m)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Discounted payback (yrs)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

15. It can be seen that the scale of cost savings varies widely between scenarios, and that some have the potential to generate significant cost savings. In particular:

a) Scenarios A and B, relating primarily to earlier collection and later delivery, provide only modest scope for cost savings, probably below £[✂]m each annually.

b) Scenario C1, which allows removal of the costly air network, could save around £[✂]m annually, although the regional impact of changes would be highly uneven.

[1] Using the mid-point of RM's cost estimates: "Low" cost saving impact is £0m-£50m; "Medium" cost saving impact is £51m-£150m; and "High" cost saving impact is £151m +.

c) Either Scenario C2, lowering the 1c quality of service so that next day delivery is provided only for mail posted and delivered within the same MC catchment area, or Scenario D, moving to a single class of service, could save more than £[✂]m annually, but such savings could be materially compromised by the commercial implications of such changes on demand and pricing.

d) Scenario E, the five day delivery and collection service, could save RM around £[✂]m to £[✂]m a year, a level of savings broadly consistent with previous analysis conducted by FE.

16. Each Scenario is considered in turn below.

Scenario A

17. This scenario involves removal of nearly [✂] of the 115,000 post boxes in the country, and earlier collection from nearly [✂] of the remaining post boxes. The total number of boxes with a final collection after 16:00 would fall by up to [✂]%, from [✂]to [✂].

18. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 2 - Scenario A: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

19. There is little doubt that in principle, material cost savings could result from earlier collection from post boxes. Earlier collection would allow collection from those boxes as part of a delivery round rather than as part of a dedicated collection round. This will inevitably be less costly, because the delivery round is likely to be passing close to the box in any event, and the incremental cost of collection will therefore be much lower than the incremental cost of sending a dedicated vehicle on a route planned purely to collect from boxes.

20. Cost savings could also result from the removal of very low volume boxes. Removal would clearly allow the avoidance of the incremental cost of collecting from that box altogether. However, if the incremental cost of collection on delivery is small, the savings might not be so significant.

21. In our view, the cost savings from this scenario may be marginally higher than those estimated by RM, as it appears to have overstated the incremental impact on delivery costs of moving collections onto delivery. Transition costs could be considerably lower than those estimated by RM, which appear overly conservative in respect of the need for Voluntary Redundancy ("VR"), the cost of post box removal, and planning costs.

22. Around 75% of cost savings would be achieved by earlier collection from all affected post boxes. The incremental savings from post box removal appear to be relatively modest, and to attract the majority of transition costs.

23. The analysis above takes no account of potential benefit sharing costs. In our view, these could be material. As an illustration, [✂].

24. As RM has recognised, its estimates of the number of boxes affected and the likely impact on collection times are approximate. Both would benefit from refinement to support any final decision making process:

    a) RM's estimate of the number of boxes affected is sensitive to uncertain estimates of mail volumes by post box. RM would appear to agree that more accurate volume estimates would be helpful, and has included within its estimate of transition costs a total of £[✂]m for post box traffic measurement devices.

    b) The impact on collection times appears particularly uncertain: depending on which planning model is used, RM estimates that the total number of boxes with a final collection after 16:00 would fall by either [✂]%, from [✂]to [✂], or by [✂]%, from [✂]to [✂]. However, in response to our questions, RM was unable to indicate which model's estimate is the more reliable.

25. The scale of affected boxes under this scenario is based on RM's selection of "uneconomic" boxes for which the cost of collection exceeds the revenues attributable to that box. We do not however agree with the logic underlying this selection, for two reasons:

    a) First, we do not believe that boxes can reasonably be classified as "uneconomic" in this way in the context of a uniform pricing obligation. In our view, the selection of boxes is primarily a matter of policy for Ofcom.

    b) Second, to the extent that the "uneconomic" concept has any relevance, it should be based on incremental costs, not fully allocated costs as in RM's calculations. A shift to incremental costs would significantly lower the number of affected boxes: for example, the number of removed boxes would fall from [✂] to less than [✂].

26. The scope of our work has not extended to an analysis of the geographic implications of potential post box removal, in terms of the proximity of mailing customers to remaining post boxes.

Scenario B

27. This scenario involves delaying latest delivery times to 17:00, from 15:00 in urban areas and 16:00 in rural areas. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 3 - Scenario B: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

28. Later delivery times create a longer operational window, which in principle can be used in a number of different ways to reduce costs at different stages of the pipeline. RM has estimated savings on the basis of retarding inward processing and sequencing cut-offs by two hours, and delaying the whole delivery operation by two hours in consequence. It suggests the principal benefits of such a change would be the removal of part of the air network with shorter flights, replaced by cheaper surface connections, and an increase in the level of sequencing. This seems a reasonable approach.

29. In our view, RM's estimated total cost savings for this scenario could be understated. It appears that additional opportunities of the order of £4m are available by taking advantage of later delivery times and moving some collections onto delivery, and that the estimated walk sequencing benefit may be understated by around £2m.

30. The analysis above takes no account of potential benefit sharing costs. In our view, these could be significant. A two hour delay to the shift times of the great majority of delivery workers could easily meet strong resistance, and this would require very careful consideration. As an illustration, [✂].

Scenario C1

31. This scenario involves relaxing the current 1c service specification by around [✂]%, which would allow [✂], in addition to the later delivery times under Scenario B. Quality of service reductions under this scenario would be highly uneven, with [✂] particularly affected.

32. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 4 - Scenario C1: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

33. Relative to Scenario B, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs from relaxing the 1c service specification:

Table 5 - Scenario C1: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

34. The cost savings are based on replacing all air connections with surface connections. There is no doubt that this would generate appreciable cost savings, at the cost of a poorer quality of service. It is for Ofcom to judge whether the cost savings are of a sufficient scale in the context of the significant regional impact of the changes.

35. A reduction in 1c quality of service could have negative commercial effects, prompting increased switching from 1c to 2c mail and/or reduced 1c volumes. These would reduce the net benefit of the scenario, but have not been evaluated in our analysis.

36. RM's estimated cost savings are based on a [✂]% reduction in quality of service for Special Delivery, which also relies on the air network. It might, for commercial reasons, choose to retain Special Delivery quality of service, in which case the incremental annual cost saving would halve.

37. In our view, the incremental cost savings estimated by RM are broadly reasonable. We do, however, think that [✂] costs are a little on the high side.

Scenario C2

38. This scenario involves relaxing the current 1c service specification much further to less than [✂]% next day delivery, based on next day delivery for mail posted and delivered within the same MC catchment area, and a reduction of the MC network from the [✂] MCs assumed at the end of the Restructuring Plan in 2015/16 to[✂] MCs.

39. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 6 - Scenario C2: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

40. Relative to Scenario C1, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs from further relaxing the 1c service specification:

Table 7 - Scenario C2: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

41. In principle, an intra MC 1c quality of service has some operational logic. Network costs would be reduced and MCs might be able improve efficiency with revised operational workplans, but it is not obvious that savings would be dramatic.

42. From an operational perspective, there seems to be no essential reason for further rationalisation beyond the [✂] MCs assumed in the Restructuring Plan, particularly if those [✂] MCs are of sufficient scale to achieve high levels of automation. However, with that many MCs, intra MC next day delivery would be limited to only a fraction of 1c mail, perhaps [✂]% or so. The further consolidation suggested by RM from [✂] to [✂] would therefore seem to be driven as much by a commercial need to raise the next day delivery proportion to an acceptable level as by the operational savings that would entail. Having said that, further consolidation should enable some further operational savings.

43. The customer and commercial implications of such a change could be far reaching. Significant loss of 1c volumes and switching to 2c volumes could be expected. This switching could well be exacerbated by the operational realities of the underlying arrangements, which could result in little meaningful advantage in the quality of service advertised for 1c mail over that achieved in practice for 2c mail. Maintaining that advantage would reduce available cost savings. Together with high transition costs, this could easily make the change commercially unviable.

44. From a pure operational perspective, however, we think that operational benefits could be greater than those estimated by RM, as a result of additional cost savings in collection and in MCs. We also believe that transition costs are likely to be overstated, since RM's estimate of VR costs assumes [✂], despite the need for significant additional staff at remaining MCs, and contrary to recent experience of MC consolidations.

45. We are conscious, however, that the largest single component of RM's estimate, site cost savings of £[✂]m, appears to lack adequate justification. It is not obviously unreasonable, but the limited information we have give us some concern that a more detailed analysis could yield a significantly different figure.

46. The analysis above takes no account of potential benefit sharing costs. In our view, these could be material. MC staff would be fundamentally affected by the changes, and [✂]. [✂]

Scenario D

47. This scenario involves merging the 1c and 2c services into a single class of service, retaining the reduced MC network assumed under Scenario C2. Under this scenario, around [✂]% of all mail would receive Day B delivery, and most of the remainder Day C delivery.

48. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 8 - Scenario D: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

49. Relative to Scenario C2, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs:

Table 9 - Scenario D: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

50. From an operational perspective, the main difference in Scenario D is that both 1c and 2c mail would align with the service standards reserved for 1c under Scenario C2. As discussed under Scenario C2, a merging of 1c and 2c service standards would in fact be the simplest operational solution, and so far from leading to increased costs, Scenario D would allow greater cost savings than Scenario C2, as the operational constraints put in place in Scenario C2 purely to maintain a service distinction could be removed.

51. The customer and commercial implications of Scenario D would clearly be profound, due not least to the loss of the 1c premium over 2c mail. These implications might outweigh the effects of cost savings.

52. In our view, RM's estimated incremental cost savings of £[✂]m from Scenario D, relative to Scenario C2, are likely to be understated. We believe that MC incremental cost savings are likely to be much higher than the £[✂]m estimated by RM, and could be closer to £[✂]m, reflecting a higher estimate of avoided segregation costs, and making an allowance for smoother operations with the removal of 1c/2c changeovers. On the other hand, we do not see the basis for the £[✂]m estimated benefit for network costs, which reduces our estimate of the aggregate understatement.

53. We base our assessment of cost savings on the scenario as presented by RM, i.e. a single class of service with Day B delivery for around [✂]% of mail. We note that cost savings could be significantly higher with a lower quality of service.

Scenario E

54. This scenario involves reducing collections and deliveries from 6 to 5 days a week. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 10 - Scenario E: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

55. Although much of RM's cost base is driven by traffic volumes, the cost of the single most significant element of the pipeline, outdoor delivery, is relatively traffic insensitive. In principle there would be a clear, significant, and relatively simple operational benefit from moving to a 5 day service, in terms of reduced delivery staff costs. Operators in a number of other jurisdictions, including Sweden, Australia, Singapore, Guernsey and Jersey, already have a 5 day service (although Guernsey has retained, and Jersey is considering re-introducing, Saturday packet deliveries). Reduced delivery frequency is also being considered in the US, the Netherlands, Norway and New Zealand.

56. However, while we believe available cost savings are substantial, in our view, RM's estimated cost savings of £[✂]m could be overstated by around £30m.

57. The majority of RM's estimated cost savings, £[✂]m, relate to outdoor delivery staff costs. We think it likely that these savings could be overstated by some £50m to £60m as a result of insufficient account having been taken of the impact of increased volumes on costs in the remaining 5 days. Note that this estimated overstatement is based on the 2015/16 volumes and product mix forecast in RM's Restructuring Plan.

58. On the other hand, we think that RM may have understated other cost savings by around £27m:

a) RM's £[✂]m estimate of collection cost savings may be understated by around £5m, as a result of an excessive allowance for Saturday Post Office ("POL") relief collections, and the unevaluated impact of pay mix opportunities.

b) MC savings might be closer to £[✂]m than the £[✂]m estimated by RM, due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays.

c) Indoor delivery savings closer to £[✂]m than the £[✂]m estimated by RM, again due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays.

59. We think that RM's transition cost estimate is also likely to be overstated, apart from the flow through effect of lower savings, by unevaluated opportunities to reduce staff costs through reductions in overtime in the short term, and natural attrition in the longer term.

60. The analysis above takes no account of potential benefit sharing costs. In our view, these could be significant. While an end to Saturday working could prove attractive to many staff, others might find Saturday working attractive due to its relatively light workload and effect on take home pay. As an illustration, [✂].

61. In common with RM's response, we have focused above on ceasing collections and deliveries on Saturdays. RM estimates that cost saving opportunities from ceasing deliveries on a weekday would be [✂], but notes that these would create operational complexities and be less [✂].

62. We agree that weekday cessation would add complexity, and in our view this would be likely to result in cost savings that are materially lower than those estimated above, albeit still substantial. Weekday cessation might, however, be more operationally attractive, were customer research to suggest the retention of packet and parcel deliveries on Saturdays. This would reduce cost savings significantly, to a degree which neither RM nor we have considered. Under such circumstances, complete cessation of deliveries, including packet deliveries, on a weekday, might lead to greater savings than cessation of letter deliveries, but retention of packet deliveries, on Saturdays.

Introduction

Background

63. Ofcom is currently developing its understanding of the needs of postal users and reviewing whether their reasonable needs are being met through the current USO. As part of this process, Ofcom has considered potential changes to the future scope of the USO. Ofcom has therefore:

    a) requested and received from RM estimates of the incremental cost savings associated with a number of potential changes to the USO; and

    b) commissioned CS to review the methodology and underlying operational assumptions underpinning RM's estimates.

64. This report presents our analysis and findings, which are based on:

    a) estimates submitted by RM at the end of March 2012; and

    b) responses to follow up questions submitted by RM at the start of May 2012.

Choice of scenarios

Scenarios considered

65. RM's 30.03.12 submission considers the annual cost savings and transition costs attributable to six potential changes to the USO. These scenarios were selected by Ofcom in the light of previous work done by Postcomm, feedback from stakeholders such as Consumer Focus and the Direct Marketing Association, and discussion with RM:

    a) Scenario A: earlier collection from low volume post boxes and removal of very low volume post boxes;

    b) Scenario B: later final delivery times;

    c) Scenario C1: lower 1c quality of service, based on a "low cost network" with no air linkages;

    d) Scenario C2: lower 1c quality of service, with next day delivery only for mail posted and delivered within the same MC catchment area;

    e) Scenario D: a single class service; and

    f) Scenario E: a five day delivery and collection service.

RM methodology

66. RM has estimated the cost impact of potential changes to the USO through a high-level desk top exercise[2]. It has split its cost base between the component pipeline elements (collections, outward processing, network distribution, etc), and under each scenario, considered which pipeline elements would be affected, and estimated cost savings for those pipeline elements, together with associated implementation or "transition" costs.

Base case

67. RM has estimated cost savings and transition costs using its projected cost base and mail volumes in 2015/16, the final year of its June 2011 Restructuring Plan, as the starting point.

68. This seems a reasonable approach:

    a) it minimises the mistaken inclusion of efficiencies which could be achieved under the existing USO specification; and

    b) it focuses on the long term impact of changes to the USO.

Efficiencies achievable under current USO specification

69. Any estimate of cost savings attributable to a change in the USO must compare operations and costs under the existing USO specification with estimated operations and costs under a counterfactual scenario of a revised USO specification. In estimating the counterfactual scenario, the natural inclination will be to consider the most efficient operations capable of meeting the revised USO specification. However, if the existing operations against which the counterfactual is compared incorporate material inefficiencies, then the difference between the existing and counterfactual operations will include both:

    a) savings attributable to a change in the USO specification; and

    b) efficiencies already achievable under the existing USO specification.

70. As a result, the counterfactual comparison will tend to overstate the cost savings properly attributable to the USO specification. In order to try and avoid this, one can consider a counterfactual at the same relative level of efficiency as existing operations. However, this is not an easy thing to judge, particularly if existing inefficiencies are significant.

71. The evidence suggests that existing inefficiencies are indeed significant, and that RM's current network and operations are not optimised for the existing USO specification. For example, the original and updated Hooper Reports both identified that considerable opportunities exist to rationalise the current MC network; and this has been confirmed by RM's Restructuring Plan, which forecasts a reduction in MCs from 59 to [✂] by 2015/16. The Restructuring Plan also forecasts, over the same period, increased levels of automation in processing, including walk sequencing, and a revised approach to outdoor delivery, with much greater use of trolleys and vans.

[2] Pages 4 to 5, RM 30.03.12 submission

72. Given this background, it is more difficult to have confidence that any counterfactual analysis based on current or recent operations and costs does not mistakenly include efficiencies already achievable. In this regard, we note that FE highlighted that of the cost savings it had identified:

"*many of the cost savings could be achieved without modifying the Universal Service, since the current configuration of mail centres and delivery offices is a legacy of previous decisions, and would not be necessary even under current service specifications.*" [3]

73. By using the projected operations and costs at 2015/16 as a starting point, the level of existing inefficiencies, and the risk of mistakenly including efficiencies under the existing specification, are both significantly reduced. Even with that starting point, some risk remains, and so within each scenario we have tried to ensure that the only cost savings included are those that are indeed attributable to the USO change under consideration.

Long term impact

74. A related but further benefit of using projected operations and costs at 2015/16 as a starting point is that it focuses on the long term impact of changes to the USO.

75. The changes considered are long term changes. For example, if Saturday deliveries were to cease, they would be unlikely to start again in the foreseeable future. Therefore, it is medium to long term cost savings, and consumers' attitudes to medium to long term changes, that should be considered. A 2015/16 benchmark would seem to serve that purpose reasonably well.

76. Continuing structural declines in mail volumes and changes in working practices might mean that cost savings in earlier years would be slightly higher, and that annual benefits in later years slightly lower. However, it's not clear how much extra benefit an understanding of that profile would bring, particularly in light of the broad nature of many of the estimates, and the effort that would be required to estimate such a profile.

[3] Page 66, FE 2008 report

Uncertainty around estimates

77. RM's cost saving and transition cost estimates have been calculated at a high level [✂]. RM has stressed the tentative nature of these estimates and the uncertainty surrounding them:

"*The estimated cost impacts represent the maximum theoretical potential and do not take account of the viability of full deployment*" [4]

"*The cost impact analysis provided in this response is therefore only a theoretical assessment of the scope for reductions in the cost of providing the universal service. It must not be taken in any way as an assessment of the scale of feasible or implementable cost reductions possible under Ofcom's scenarios of an amended service specification or scope of the universal service.*" [5]

"*RM would like to express significant concern about how the information provided may be used. The analysis provided does not address the many and varied practical issues which the business would need to address if changes to the scope and/or specification of the universal service were proposed. The provision of the universal service requires an integrated, extensive and complex national network. Although analysis can be undertaken on changing particular elements of this network there are inevitably many knock on impacts which have not been captured in this preliminary desk top exercise to assess at a theoretical level potential cost saving impacts. If any of these options were considered for implementation significant further detailed analysis would be required. In addition, for the avoidance of doubt the information provided here is based on theoretical cost analysis.*" [6]

78. While our efforts are clearly aimed at assessing the reasonableness of RM's estimates, we have borne these caveats in mind when conducting our work and asking follow up questions of RM. We have attempted to check that estimates are of the right scale rather than try to ensure they are highly accurate. We are conscious that seeking a high level of accuracy may not only be impractical given the starting point provided by RM's estimates, it might also be disproportionate if the customer needs against which Ofcom is planning to weigh these cost savings can only be estimated in relatively broad terms.

79. Where we provide alternative estimates of cost savings or transition costs, these should be taken as indicative only, given the high level nature of the starting point, and the limitations in the information available to us. In particular, we draw attention to the fact that although RM has been given a draft of our report and has made a small number of specific comments, which we have considered in finalising our report, it has also stated:

"*in general RM believes that CS has not misrepresented RM's analysis of high-level cost saving for each of the scenarios as they broadly agree with our ranges of cost savings. We do, however, believe that in the areas where they take their analysis further that the opinions expressed do not align to RM's collective expert view…*

We have not attempted to correct their analysis as we do not consider this an appropriate use of RM resources however we can give no endorsement or quality assurance on this information." [7]

[4] Page 4, RM 30.03.12 submission
[5] Page 5, RM 30.03.12 submission
[6] Page 4, RM 30.03.12 submission
[7] Royal Mail [✂] 27.07.12 email

80. Although there does not at this stage appear to be any fundamental divergence between RM's analysis and our own, a more comprehensive response from RM could reveal new information which would lead us to make material alterations to our alternative estimates.

Ranges of savings and costs

81. For each scenario, RM has calculated central estimates of cost savings and transition costs, and then applied ranges around those central estimates to reflect uncertainty.

82. The range applied to cost savings is up to 10% above, and down to 30% below, the central estimate. RM has explained that the downside margin of error is greater than the upside "*to reflect the risk in actually being able to realise the large scale savings highlighted*"[8].

83. The range applied to transition costs is up to 30% above, and down to 10% below, the central estimate. RM has explained that the downside margin of error is greater than the upside "*to reflect the uncertainty of exiting people from the business and the possibility that* [✂]" [9].

84. As noted by Ofcom in its March 2012 decision on RM's new regulatory framework, RM's out-turn efficiency performance has in the past been consistently below its own plans[10]. In the light of this, and the high level nature of the estimates, we think that broad asymmetric ranges of this nature are helpful in summarising the potential impact of USO changes. While we focus our more detailed analysis on RM's central estimates, where we suggest alternative central estimates, we have therefore generally applied RM's ranges to our revised figures.

Impact on demand

85. RM's cost saving estimates are based on forecast costs and volumes in 2015/16. Some of the potential changes to the USO under consideration could have an appreciable effect on customer demand. For example, lowering the 1c quality of service could accelerate the decline in mail volumes. RM acknowledges this in its response, but notes that given the timescales allowed by the RFI, it has not attempted to account for demand effects[11].

86. Since total costs are partly driven by volumes, these demand effects would cause total cost savings, in £m or as a percentage of the total cost base, to be greater than estimated by RM. However, in general the presence of significant fixed costs in RM's network, particularly in outdoor delivery, means that reductions in volume cause per unit costs to rise, as fixed costs are recovered from a smaller volume of mail. Therefore, such demand effects would cause average per unit cost savings to be smaller than suggested by RM's estimates.

87. The impact of this issue is likely to be particularly important for any scenario where total cost savings are relatively modest but demand effects could be significant.

88. The scope of our work does not extend to a consideration of demand effects, so we have not attempted to estimate the degree to which this issue might reduce effective per unit cost savings. We recommend that the issue is examined should any scenario with potentially significant demand effects (e.g. substantial reduction of 1c quality of service) become a realistic possibility. We note that FE's 2011 review of RM's Strategic Plan considered the relationship between volumes and costs (described in its report as "marginality") at some length, and that this could form the basis for such further analysis.

[8] Page 69, RM 03.05.12 submission
[9] Page 69, RM 03.05.12 submission
[10] 6.38, *Securing the Universal Postal Service: Decision on the new regulatory framework*, Ofcom, 27.03.12
[11] Pages 5 to 6, RM 30.03.12 submission

Restructuring Plan

89. RM notes that its estimates are based on the Restructuring Plan which was submitted to Ofcom in July 2011, and that a number of factors have changed since then which RM is considering as part of updating its forecasts[12]. We note, for example, that the plan anticipated [✂].

90. We acknowledge this is an added source of uncertainty.

Transition costs

91. The scale of transition costs is another pervasive and significant source of uncertainty.

VR costs

92. RM has estimated VR costs for each scenario. In general, it has assumed that [✂], given the scale of headcount reduction already planned under the current modernisation programme, which relies on natural attrition to minimise VR costs[13].

93. We think this may be a reasonable assumption in estimating the scale of VR that would be incurred if any of the scenarios were to be implemented in the short term. However, if a longer term perspective in line with the 2015/16 base case were adopted, it might be more appropriate to consider VR costs in a steady state environment after the completion of the Restructuring Plan. Under such conditions, VR costs might be substantially lower, reflecting steady state natural attrition rates. On the other hand, to the degree that VR is still needed, [✂], it may be that by 2015/16, few remaining staff will be attracted by the idea of VR, and VR rates would need to rise to reflect this.

94. The timing of any potential implementation of the scenarios therefore introduces a significant degree of uncertainty into the scale of VR costs.

Other transition costs

95. RM has estimated certain other specific transition costs for Scenario A, but it has not estimated:

    a) specific non-VR transition costs for scenarios other than A; or

    b) benefits sharing costs for any scenario.

96. The second element could be particularly important, and has the potential to reduce net savings significantly. As RM explains, when implementing change it has in the past made additional payments to existing employees:

    [✂] [14]

    "*All businesses look at the costs of change, the incentives for those changes alongside the ongoing employment costs, affordability and current/future pay agreements. Clearly change has impact and any business needs to maximise the effect of the change needed whilst seeking to take its people with it. An example of this was the mix of lower pay increases but lump sum payments in the Royal Mail BT2010 agreement to focus what cash is available in the most motivational way given the difficulties faced.*" [15]

[12] Page 5, RM 30.03.12 submission
[13] Page 66, RM 03.05.12 submission
[14] Page 6, RM 30.03.12 submission
[15] [✂] email

97. The Restructuring Plan model estimates that this will result in a total cost to the business of some £[✂]m[16].

98. The other significant example of benefits sharing that we are aware of is the cessation of the second delivery and the move to Single Daily Delivery in 2004. Royal Mail had argued that second deliveries accounted for 20% of costs but only % of volumes, and originally estimated that removing them would save around £120m per year. However, following negotiations on the sharing of efficiency savings with the workforce, RM's post-implementation estimate was that costs had actually increased by over £100m a year[17]. This suggests an implicit benefits sharing cost of up to £220m per annum.

99. Although we understand that RM may not yet feel in a position to estimate these costs, and we note that FE did not appear to attempt their estimation, given their potential scale, we think it is critical for them to be considered in an assessment of transition costs. Benefits sharing costs are by their nature difficult to estimate, and their level will depend on a number of factors, including the nature of the industrial relations climate at the time of deployment (which will be in turn influenced by factors such as the nature of RM ownership and management and the state of the postal market), and the likely level of resistance to the particular change under consideration. However, at least as a starting point for consideration of these issues, it is useful to use the 2010 payment as a benchmark, adjusted for the nature and extent of change within each scenario.

Non-pipeline costs

100. RM's estimates of cost savings cover pipeline costs only. It has not modelled any cost savings in relation to non-pipeline costs such as sales and marketing and central support overheads[18], which together account for [✂]% of the forecast cost base[19]. Nor, it would appear, has RM modelled any cost savings in relation to overheads embedded in the definition of pipeline costs[20], which account for an additional [✂]% of the cost base.

101. In the long run, one might expect overheads to show a degree of response to falls in pipeline costs. For example, lower staffing levels might lead the cost of the human resources and finance functions to fall slightly; and the simplified single class market proposition under Scenario D might allow some savings in sales and marketing costs.

102. Some additional savings may therefore be available above those estimated by RM. However, given the strong economies of scale typically associated with such functions, the savings might be rather modest and difficult to estimate. We have not therefore attempted to reflect any such savings in our work.

Revenue and commercial implications

103. Many if not all of the scenarios considered would have significant implications for RM's revenues and commercial position. These could reduce, and in some cases eliminate, the cost benefits of potential changes.

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[16] Rows 20 to 21, Staff – totals, SPM PCR4v3.xls
[17] Minutes of evidence, Select Committee on Trade and Industry, 7 November 2005
[18] Page 66, RM 03.05.12 submission
[19] Sales and marketing costs of £[✂]m, and central support overheads of £[✂]m, as a proportion of the total cost base of £[✂]m.
[20] The Illustrative RFI Cost model shows total pipeline costs of £[✂]m. This figure includes £[✂]m of costs that might be considered to behave as overheads, comprising finance, consultancy, marketing, legal, other operating and other inter-business costs.

104. RM has not considered commercial implications in its submissions[21]. Our terms of reference are to consider cost savings only, and we have not examined revenue and commercial implications as part of our work.

Non-additive benefits

105. Each scenario has been modelled on a stand-alone basis. Interactions between the changes identified mean that estimated savings in the scenarios are not generally additive[22].

Approach

Operational review

106. We have reviewed the methodology and underlying operational assumptions underpinning RM's estimates. Using our experience of assessing, planning and implementing changes in working schedules and practices at RM, of managing RM operations, and of reviewing operational aspects of regulatory submissions by RM and other postal operators, we have considered the reasonableness of the operational changes assumed by RM under each scenario. Where we have identified potential refinements to those assumptions, we have attempted to estimate, in broad terms and subject to the limitations identified above, alternative quantifications of cost savings.

Follow up questions for RM

107. Following an initial review of RM's submission at the end of March, we prepared a list of follow up questions for RM in early April. Conscious of the high level nature of many of RM's estimates, and the time constraints on the project, we focused on questions of clarification, and were asked by Ofcom to avoid requesting detailed fresh analysis.

Comparison with FE

108. In 2008, FE calculated detailed estimates of the cost savings from various potential changes to the USO, many of which were similar to those now considered by RM.

109. FE's 2008 estimates were based on 2006/07 cost and volume data. In 2010, FE updated its estimates to reflect 2009/10 cost and volume data. FE undertook two exercises to update its estimates.

110. First, FE rolled forward the 2008 estimates to reflect 2009/10 cost and volume data. It split the 2008 estimates into their constituent pipeline segments, and calculated the 2008 percentage impact on the cost of each pipeline segment. It then applied that percentage impact to the 2009/10 pipeline cost:

> "*where we had previously estimated that mail processing costs would fall by 3% and delivery costs by 5%, we have applied the same percentage cost savings to Royal Mail's current cost base, taking account of how both the level and the composition of Royal Mail's cost base has changed over time*" [23].

111. Second, FE reviewed the main changes in RM's operational changes between 2006/07 and 2009/10, to cross-check the reasonableness of the roll forward.

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[21] "*in addition to the complexities of attaining a level of cost reduction there would be commercial implications which have not been factored into this analysis*" Page 4, RM 03.05.12 submission
[22] Page 7, RM 30.03.12 submission
[23] Page 7, FE 2010 report

112. Clearly, by 2015/16 a great deal will have changed since FE's 2006/07 based estimates. However, we think an extension of FE's roll forward to 2015/16 provides useful benchmarks against which to compare RM's estimates, and cross-check our own operational views, particularly in the light of the following factors:

    a) the essential operational characteristics of RM's business are still sufficiently similar to 2006/07 for such an exercise to be meaningful: most of the operational changes are evolutionary not revolutionary;

    b) although volumes are very different, this is to a certain extent automatically corrected for under FE's roll forward approach, since pipeline segments that are particularly affected by such changes (e.g. processing with the move to access and declining volumes generally) will form a smaller part of the cost base, and percentage savings in those segments will be less significant; and

    c) certain aspects of FE's original 2008 cost modelling, for example relating to network costs and outdoor delivery costs, were at a level of detail which the current exercise cannot replicate, due to time constraints.

113. We have therefore extended FE's roll forward calculations, as best we can given the available information, to 2015/16, and calculated rolled forward estimates of cost savings, recalibrated for 2015/16. Within each scenario, we use these rolled forward estimates as a benchmark against which to compare RM's estimates and to frame our own operational assessment of RM's estimates (like FE, taking into account major operational changes which might make the rolled forward estimates less relevant).

114. The cost savings figures quoted in FE's 2008 and 2010 reports include both:

    a) cost savings resulting directly from USO changes in pipeline elements that would be affected by those changes; and

    b) volume related cost savings resulting indirectly from USO changes across all pipeline elements as a result of estimated volume losses.

115. As noted above, RM's estimates do not include volume effects. Therefore, to improve comparability, we have excluded such effects (which are explicitly identified in the FE model[24]) from the FE data upon which we perform the roll-forward.

Comparison with other information sources

116. Where possible given the information and time available, we have also compared the assumptions underlying RM's estimates with information from other sources, in particular:

    a) RM's June 2011 Restructuring Plan and supporting model;

    b) RM's November 2010 price control review submission to Postcomm;

    c) previous work commissioned by RM from KPMG and McKinsey relating to USO costs and provided with the 30.03.12 submission; and

[24] References in this report to "the FE model" are to the model(s) developed by FE to support its 2008 and 2010 estimates. We are advised by Ofcom that it has legal ownership of the model in intellectual property terms, that ownership having been transferred from Postcomm.

d) in the case of Scenario A, presentations made by RM to internal audiences and provided with the 30.03.12 submission.

117. The KPMG/McKinsey work provides some useful information, but it appears that some related materials may not have been provided by RM. In particular, the 2009 KPMG report refers to additional working documents which provide further details of the project, including a spreadsheet model of cost savings[25]. While RM has provided some additional documentation relating to the project, it does not appear to be comprehensive, and in particular does not include any spreadsheet models showing detailed calculations of cost savings. This may be worth exploring further.

[25] 9.4 and 11.3, KPMG 2009 report

Scenario A: Earlier collection times and removal of post boxes

Summary of scenario

118. This scenario involves removal of nearly [✂] of the 115,000 post boxes in the country, and earlier collection from nearly [✂] of the remaining post boxes. The total number of boxes with a final collection after 16:00 would fall by up to [✂]%, from [✂] to [✂].

119. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 11 - Scenario A: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years) [26]	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

120. There is little doubt that in principle, material cost savings could result from earlier collection from post boxes. Earlier collection would allow collection from those boxes as part of a delivery round rather than as part of a dedicated collection round. This will inevitably be less costly, because the delivery round is likely to be passing close to the box in any event, and the incremental cost of collection will therefore be much lower than the incremental cost of sending a dedicated vehicle on a route planned purely to collect from boxes.

121. Cost savings could also result from the removal of very low volume boxes. Removal would clearly allow the avoidance of the incremental cost of collecting from that box altogether. However, if the incremental cost of collection on delivery is small, the savings might not be so significant.

122. In our view, the cost savings from this scenario may be marginally higher than those estimated by RM, as it appears to have overstated the incremental impact on delivery costs of moving collections onto delivery. Transition costs could be considerably lower than those estimated by RM, which appear overly conservative in respect of the need for VR, the cost of post box removal, and planning costs.

[26] See Appendix 1 for details of how discounted payback has been calculated

123. Around 75% of cost savings would be achieved by earlier collection from all affected post boxes. The incremental savings from post box removal appear to be relatively modest, and to attract the majority of transition costs.

124. The analysis above takes no account of potential benefit sharing costs. In our view, these could be material. As an illustration, [✂].

125. As RM has recognised, its estimates of the number of boxes affected and the likely impact on collection times are approximate. Both would benefit from refinement to support any final decision making process:

    a) RM's estimate of the number of boxes affected is sensitive to uncertain estimates of mail volumes by post box. RM would appear to agree that more accurate volume estimates would be helpful, and has included within its estimate of transition costs a total of £[✂]m for post box traffic measurement devices.

    b) The impact on collection times appears particularly uncertain: depending on which planning model is used, RM estimates that the total number of boxes with a final collection after 16:00 would fall by either [✂]%, from [✂] to [✂], or by [✂]%, from [✂] to [✂]. However, in response to our questions, RM was unable to indicate which model's estimate is the more reliable.

126. The scale of affected boxes under this scenario is based on RM's selection of "uneconomic" boxes for which the cost of collection exceeds the revenues attributable to that box. We do not however agree with the logic underlying this selection, for two reasons:

    a) First, we do not believe that boxes can reasonably be classified as "uneconomic" in this way in the context of a uniform pricing obligation. In our view, the selection of boxes is primarily a matter of policy for Ofcom.

    b) Second, to the extent that the "uneconomic" concept has any relevance, it should be based on incremental costs, not fully allocated costs as in RM's calculations. A shift to incremental costs would significantly lower the number of affected boxes: for example, the number of removed boxes would fall from [✂] to less than [✂].

127. The scope of our work has not extended to an analysis of the geographic implications of potential post box removal, in terms of the proximity of mailing customers to remaining post boxes.

Details of change

128. As described by RM, Scenario A involves:

    a) earlier collection, as part of delivery rounds rather than dedicated collection rounds, from all post boxes with daily volumes of [✂] or more but less than [✂] items (referred to in this report as "low volume boxes"); and

    b) removal of all post boxes with daily volumes of less than [✂] items ("very low volume boxes").

129. In its 30.03.12 submission, RM estimated that this would see the removal of nearly [✂] the 115,000 post boxes in the country, and earlier collection from nearly [✂] of the remaining post boxes:

Table 12 - Scenario A: Post boxes affected

	Base case	Removed[27]	Remaining	Earlier collection[28]	Unaffected[29]
Daily volume		<[✂]	>=[✂]	>=[✂], <[✂]	>=[✂]
Commercial	[✂]	[✂]	[✂]	[✂]	[✂]
Town and City	[✂]	[✂]	[✂]	[✂]	[✂]
Deep Rural	[✂]	[✂]	[✂]	[✂]	[✂]
Rest of UK	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]
Commercial	[✂]	[✂]	[✂]	[✂]	[✂]
Town and City	[✂]	[✂]	[✂]	[✂]	[✂]
Deep Rural	[✂]	[✂]	[✂]	[✂]	[✂]
Rest of UK	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

130. In its 03.05.12 submission, RM explained that by 2015/16, it forecast a total of [✂] boxes already being collected on delivery within the existing access time specification, and that the incremental impact of Scenario A would be for earlier collection from a further [✂] boxes[30]. Our understanding of the operational impact of Scenario A is therefore as follows:

Table 13 - Scenario A: Operational impact

	Base case	Scenario A	Impact	% impact
Collection on delivery	[✂]	[✂]	[✂]	[✂]
Dedicated collection	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]

131. It is clear from the materials provided by RM that internal planning for a similar scenario has been under consideration for some time. An internal RM presentation from November 2010 proposed the implementation of earlier collection from some [✂] boxes by September 2012 (following a formal submission to Postcomm in December 2010), with a later implementation of box removal[31]. RM has confirmed that implementation of this initiative has not yet started and is dependent on the outcome of the Ofcom User Needs exercise, but that implementation sooner than 2015/16 is a possibility[32].

[27] Page 11, RM 30.03.12 submission, and Scenario A Q(a).xls
[28] Page 13, RM 30.03.12 submission, and Scenario A Q(e).xls
[29] Page 13, RM 30.03.12 submission, and Scenario A Q(e).xls
[30] Page 7, RM 03.05.12 submission
[31] Slide 8, 14 and 20, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[32] Page 8, RM 03.05.12 submission. Note that the November 2010 presentation also referred to a separate initiative involving optimisation of collections within existing access time specifications, which at the times was projected for completion by September 2012 (slide 8). RM's 03.05.12 submission confirms that this initiative is underway, but completion is not now expected until the end of 2013/14 (page 8).

Removal

132. As described by RM, this scenario would see the removal of nearly [✂] the 115,000 boxes in the country, and of nearly [✂]% of boxes in "deep rural" areas. RM states in its response:

[✂] [33]

133. In customer research commissioned by RM[34]:

a) [✂]% of customers strongly agreed with the statement "It is important to have a Postbox near my home address";

b) [✂]% of customers strongly agreed with the statement "A postbox is an essential facility for me"; and

c) [✂]% of customers strongly disagreed with the statement: "It would not concern me if my nearest postbox was no longer there".

Earlier collection

134. For unaffected boxes, where daily volumes exceed [✂] items, RM envisages final collection between 16:00 and 18:00 on collection routes. In addition, all boxes associated with or outside of a post office, regardless of daily volumes, would have a final collection undertaken at the same time as the final collection from the post office, typically between 16:00 and 18:00[35].

135. Business boxes would have a planned final collection time of between 17:00 and 18:00 and any box associated with a Delivery Office ("DO") or collection hub would typically have the latest collection times in the area, generally no earlier than 18:00, [✂].

136. RM explains that members of the public requiring a later collection time would be able to post at an MC, which would provide a 19:30 final collection[36]. However this will become less helpful as the number of MCs falls from 59 to [✂].

137. The information supplied by RM suggests the following latest collection times. RM's estimates are based on two different models, a "volume model" and a "network model", which it judges give equally reliable indications of the potential impact[37]:

Table 14 - Scenario A: Latest collection times

000 boxes[38]	Base case	Volume model		Network model	
		Scenario A	Impact	Scenario A	Impact
Before 12:00	[✂]	[✂]	[✂]	[✂]	[✂]
12:00 to 16:00	[✂]	[✂]	[✂]	[✂]	[✂]
Before 16:00	[✂]	[✂]	[✂]	[✂]	[✂]
16:00 to 18:00	[✂]	[✂]	[✂]	[✂]	[✂]
After 18:00	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

[33] Page 10, RM 30.03.12 submission
[34] Slide 15, Scenario A Q I Postboxes Analysis Results – Sept 2010
[35] Page 12, RM 30.03.12 submission
[36] Page 12, RM 30.03.12 submission
[37] Under the volume model, final collection times are determined by customer use, whereas under the network model, a more straightforward approach is adopted (page 15, RM 03.05.12 submission).
[38] Figure for "before 12:00" taken from RM's estimate that [✂]% of boxes on delivery would be collected pre midday (page 13, RM 30.03.12 submission). Remaining figures from page 13, RM 03.05.12 submission.

138. The table indicates a marked shift in typical collection times. In particular, the total number of boxes with a final collection after 16:00 would fall by [✂]% under the volume model (from [✂] to [✂]), and by [✂]% under the network model (from [✂] to [✂]).

139. The scale of these shifts is broadly supported by more detailed materials provided by RM relating to case study operational modelling undertaken in four different locations across the country: Edinburgh, Wakefield, Craigavon and Wrexham. The modelling suggests that more than [✂] of boxes would move to an earlier time:

Table 15 - Scenario A: Case study modelling of collection times

	Volume model		Network model	
	Boxes affected	On average earlier by	Boxes affected	On average earlier by
Edinburgh[39]	[✂]	[✂]	[✂]	[✂]
Wakefield[40]	[✂]	[✂]	[✂]	[✂]
Craigavon[41]	[✂]	[✂]	[✂]	[✂]
Wrexham[42]	[✂]	[✂]	[✂]	[✂]

140. Taking Edinburgh as an example, [✂]% to [✂]% of boxes would move to an earlier time by between [✂] to [✂] hours. We note these case studies do not cover the entire collection catchment area of either a current or future MC. We would expect the impact on an entire collection area to differ as effects will not be geographically uniform. However, RM has confirmed that no such modelling has been undertaken[43].

141. We note from RM's customer research that 45% of customers post after 15:00, and 31% of customer post after 16:00[44]. This means that earlier collections will require many customers to travel further to post a letter, or to adapt their posting habits, if they are not to lose a day's quality of service.

142. RM recognises that although it has been able to use desktop modelling to estimate the impact on changes to collections, the estimates are only approximate and a more robust technological and auditable process will be required to support any final decision making process[45]. This would seem appropriate, particularly in light of the differences between the estimates produced by the volume and network models.

Operational rationale for change

Rationale for change in principle

143. It is clear that with declining letter volumes it is sensible to review the cost effectiveness of current arrangements for post box collections.

[39] Slides 33 and 35, Scenario A – Q i and l
[40] Slides 60 and 62, Scenario A – Q i and l
[41] Slides 79 and 82, Scenario A – Q i and l
[42] Slides 102 and 105, Scenario A – Q i and l
[43] Page 14, RM 03.05.12 submission
[44] Slide 17, Scenario A Q l Postboxes Analysis Results – Sept 2010
[45] Page 15, RM 03.05.12 submission

144. There is little doubt that in principle, material cost savings could result from earlier collection from low volume boxes. Earlier collection would allow collection from those boxes as part of a delivery round rather than as part of a dedicated collection round. Collection on delivery will inevitably be less costly, because the delivery round is likely to be passing close to the box in any event, and the incremental cost of collection will therefore be much lower than the incremental cost of sending a dedicated vehicle on a route planned purely to collect from boxes. The Restructuring Plan indicates a total of [✂] delivery routes in the UK[46], which implies that this scenario would see the average number of collections per delivery route rise from [✂] to [✂].

145. The increased use of vans and trolleys under the Restructuring Plan[47] provides a further opportunity to facilitate more collections on delivery and any relaxation of collection times would assist this migration.

146. Cost savings could also result from the removal of very low volume boxes. Removal would clearly allow the avoidance of the incremental cost of collecting from that box altogether. However, if the incremental cost of collection on delivery is small, the savings might not be so significant.

147. In both cases, in theory some or all of the affected mail would be posted in other boxes instead, resulting in an increase in collection from those boxes; however in practice the additional cost of collecting say 50 letters instead of 40 letters from a box is negligible.

148. A number of other operators have removed post boxes in recent years, including the US Postal Service[48], Canada Post[49] and New Zealand Post[50].

Rationale for box selection

149. We note, however, that RM does not simply point to the general availability of cost savings as a potential rationale for the change, but rather specifically to the question of whether volumes are "*below economic levels*" [51]. The criteria adopted by RM to identify affected boxes involve comparisons of the cost of box collection with the revenue contribution attributable to box collection[52]. The underlying assumption would appear to be that collection is uneconomic where cost exceeds revenue.

[46] Slide 53, RM Restructuring Plan
[47] Slide 48, RM Restructuring Plan
[48] *Neighborhood mailboxes being stamped out*, Los Angeles Times, 18.03.09, http://articles.latimes.com/2009/mar/18/local/me-mailboxes18
[49] *Canada Post eliminates more than 1,000 red street letter boxes*, thestar.com, 06.02.12, http://www.thestar.com/news/canada/article/1126915--canada-post-eliminates-more-than-1-000-red-street-letter-boxes
[50] *NZ Post removing hundreds of mail boxes*, The National Business Review, 16.11.10, http://www.nbr.co.nz/article/nz-post-removing-hundreds-mail-boxes-133264
[51] Page 10, 30.03.12 submission. Note that this reference is to the removal of boxes, but the similarity of the criteria used for removal and earlier delivery suggests that a similar economic rationale is assumed for earlier delivery.
[52] In the case of low volume boxes, it is whether the "cost to serve" the box using dedicated collection staff is more than the revenue contribution; in the case of very low volume boxes, it whether the "cost to serve" the box using the most efficient method (collection on delivery) is more than the revenue contribution.

150. We have reservations over the validity of this assumption in the context of RM's obligation to price at a uniform tariff. Given that obligation, and the fact that the cost of mail flows is highly variable, it is inevitable that there will be many instances of cost exceeding revenue: the most obvious other example being, delivery to remote locations. It is not clear that such delivery can properly be considered uneconomic in a uniform pricing environment, the very essence of which involves an acceptance that prices are uniform in spite of, and not because of, variability in costs. An excess of cost over revenue is not an obvious rationale for stopping certain deliveries; nor it would seem, is it an obvious rationale for stopping certain collections[53].

151. The relevant criterion for post box collection would seem to be much less about the economics of individual post boxes and the relationship between their costs and revenues, and much more about questions of regulatory policy which consider the relationship between costs and customer needs. These are matters for Ofcom to consider.

152. To the degree that the economics of individual post boxes are relevant, the appropriate test for an incremental decision on a box is whether the incremental cost of collecting mail from a box is lower than the incremental net revenue, resulting from that collection.

153. This is not, however, the test that RM has applied. Firstly, the costs to serve in the test are Fully Allocated Costs (FAC)[54], not incremental costs:

    a) For very low volume boxes, RM has calculated a break-even of [✂] items a day (later rounded to [✂] for the purpose of its analysis)[55], on the basis of an FAC of collection on delivery of £[✂] per visit[56].

    b) For low volume boxes, RM has calculated a break-even of [✂] items a day (later rounded to [✂] for the purpose of its analysis)[57], on the basis of an FAC of collection on a collection route of £[✂] per visit[58].

[53] If the rationale were to be applied to collections but not to deliveries, a postal worker on a delivery round might end up in the curious position of delivering [✂] or [✂] items of mail a day to a remote "uneconomic" address, while passing a the site of a formerly centrally positioned post box which used to contain [✂] or [✂] items of mail a day but had been removed due to it being "uneconomic".
[54] Page 11, RM 30.03.12 submission,
[55] Page 11, RM 30.03.12 submission
[56] Page 13, RM 30.03.12 submission. We note that this is based on 2010/11 costs rather than 2015/16 costs (Page 12, RM 03.05.12 submission).
[57] Page 12, RM 30.03.12 submission
[58] Page 13, RM 30.03.12 submission. We note that this is based on 2010/11 costs rather than 2015/16 costs (Page 12, RM 03.05.12 submission).

154. It is not clear what relevance FAC can have to the economics of individual boxes. The only rationale provided by RM for using FAC is that it has no estimates of incremental cost[59]. However, its cost saving estimates implicitly incorporate estimates of incremental cost, and it would seem more reasonable to use the best incremental cost estimates available, despite their imperfections, than to use FAC estimates which cannot be expected even to approximate to incremental cost. The impact of running the test on the basis of incremental cost rather than FAC would appear to be significant:

a) RM's own industrial engineering based estimate suggests that the incremental cost of collection on delivery is [✂]p per box per day[60]. For very low volume boxes, this would suggest a break-even point of around [✂] items a day. We estimate that this would lower the number of affected boxes from the [✂] estimated by RM to around [✂][61].

b) RM's own cost savings estimates suggest that the incremental cost of collection on a collection route is only £[✂] per day[62]. For low volume boxes, this would suggest a break-even point of around [✂] items a day. We estimate that this would lower the total number of boxes collected on delivery from the [✂] estimated by RM to [✂][63], and the incremental number of boxes moved to collection on delivery under this scenario from [✂] to [✂].

155. The second limitation with RM's criterion is that the revenue against which costs are compared is not incremental net revenue, but the difference between price and FAC[64]. Again, it is hard to see what relevance FAC has. The information provided indicates a difference between price and FAC of around [✂]p per item[65]; the incremental net revenue, however is likely to be considerably higher than this, lowering the break-even points, and the number of affected boxes, still further[66].

156. We stress that we are not suggesting these revised break-even points and box numbers are more appropriate than those estimated by RM, because we do not believe, for the reasons given above, that analysis of the cost/revenue break-even is necessarily the appropriate approach to select affected boxes. However, they do illustrate the sensitivity of the break-even calculations to the cost assumptions adopted.

[59] Page 11, RM 03.05.12 submission
[60] See discussion of delivery costs below
[61] The data provided in Scenario A Q(a).xls and Scenario A Q(e).xls indicates total of [✂] boxes with daily volumes below [✂]. However that same data set indicates a total of [✂] boxes with daily volumes below [✂], whereas the figure estimated by RM of [✂] is[✂]% of that figure. We have not been able to identify the cause of the difference in the time available, so we have multiplied our total of [✂] by[✂]% to try and correct for the difference, generating a figure of [✂] boxes.
[62] The incremental cost, per box, is £[✂] per year (see discussion of collection costs below). This equates to £[✂] per day, assuming [✂] delivery and collection days, in line with RM's Restructuring Plan model.
[63] The data provided in Scenario A Q(a).xls and Scenario A Q(e).xls indicates total of [✂] boxes with daily volumes below [✂]. We have again applied a [✂]% adjustment factor to this figure, for the reasons noted above, generating a total of [✂] boxes either collected on delivery or removed. The number of boxes removed has been estimated above at [✂], leaving a total of [✂] boxes collected on delivery.
[64] Page 12, RM 03.05.12 submission
[65] For example, the low volume break-even point of [✂] items per day (page 12, RM 30.03.12 submission) is based on a cost of £[✂] (page 13, RM 30.03.12 submission).
[66] There would also be a smaller effect from excluding collection costs from the net revenue calculation. These are currently subtracted from revenues in order to arrive at the [✂]p estimate (page 12, RM 03.05.12 submission), but this resulting in the double counting of collection costs already considered.

157. Because we have reached no alternative conclusion on affected box numbers, we accept RM's box number estimates for the remainder of our analysis. Most of the cost savings and transition costs identified are likely to scale broadly with the number of affected boxes, so the analysis can be used to estimate the savings and transition costs associated with a different level of affected boxes[67].

Reliability of volume data

158. RM's estimates of the affected number of boxes are based on the estimated daily volumes of post boxes. The information supplied by RM regarding the process undertaken to estimate those volumes[68] suggests to us that there is material room for error in the estimates. In particular:

a) the core count data is based on the period July to September 2010, although summer posting volumes are typically below average volumes; and

b) only a proportion of boxes have been counted directly, with an unknown proportion estimated by the regular collector.

159. More accurate volume estimates could have a material impact on the number of affected boxes, depending on the criteria ultimately used to determine cut offs. RM would appear to agree that more accurate estimates would be helpful, and has included within its estimate of transition costs a total of £[✂]m for post box traffic measurement devices[69].

Cost savings

160. RM has estimated total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base[70]:

Table 16 - Scenario A: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)	Cost savings (%)
Collections	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

[67] A more precise estimate might recognise that lower volume boxes are on the whole likely to be more remote, so for example reducing the estimated number of boxes no longer collected on delivery by 50% might result in collection cost savings of slightly more than 50% of the currently estimated total. However we do not have the information necessary to estimate the scale of this effect.
[68] Page 10, RM 03.05.12 submission
[69] Page 21, RM 03.05.12 submission
[70] Cost savings are based on implementation in 2015/16. RM estimates that earlier implementation would be possible, but that cost savings and transition costs would be lower due to higher volumes, and the removal/movement onto delivery of fewer boxes (page 8, RM 03.05.12 submission).

161. We do not have a rolled forward FE figure to use as a comparator, since FE did not consider a comparable scenario[71].

162. The 2009 KPMG report briefly considered the possibility of saving costs by reducing the number of collection points, but did not examine the option in any detail, noting that previous work by RM had suggested that the cost savings were relatively small[72]. If Ofcom decides to consider this scenario in greater detail, we suggest asking for details of this previous work.

Collections

163. RM has estimated total savings of £[✂]m in collections. As noted above, the scenario involves removing a total of [✂] boxes from collection routes, so this equates to an average saving of £[✂]per box per year:

Table 17 - Scenario A: Collections cost savings

	Cost base (£m)	Cost savings (£m)	Cost savings (%)	Cost savings per box (£)
Staff costs	[✂]	[✂]	[✂]	[✂]
Staff other costs	[✂]	[✂]	[✂]	[✂]
Vehicle costs	[✂]	[✂]	[✂]	[✂]
Site costs	[✂]	[✂]	[✂]	[✂]
POL costs	[✂]	[✂]	[✂]	[✂]
Other costs	[✂]	[✂]	[✂]	[✂]
Total costs	[✂]	[✂]	[✂]	[✂]

164. An internal RM presentation from November 2010 suggested a net saving of £[✂]m from moving [✂] post boxes to clearance on delivery, without any box removals[73], equating to £[✂] per box. That figure is not directly comparable with RM's current estimate of £[✂], since it was apparently net of increased delivery costs, and would not have included the maintenance cost benefit which is attributable to box removals. However, both can be adjusted for:

a) the November 2010 £[✂] figure can be increased to reflect increased delivery costs, which it estimated at £[✂][74], resulting in an adjusted figure of £[✂]; and

b) the current £[✂] figure can be reduced by £[✂] to remove the maintenance cost benefit, resulting in an adjusted figure of £[✂].

165. Therefore, adjusted for comparability, RM's current estimate is some £[✂] a box, or [✂]%, below its November 2010 estimate.

[71] FE did consider a scenario whereby all collections were made earlier. However the benefit was reflected in air network savings rather than in moving collections onto delivery rounds.
[72] 5.8.2 and 8.7, KPMG 2009 report
[73] Slide 13, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[74] See discussion of delivery cost savings below

Staff costs

166. RM estimates a £[✂]m or [✂]% saving on annual collections staff costs, based on its case study modelling, extrapolated nationally using a weighted approach to reflect variations in delivery point density[75]. The [✂]% saving is derived from:

a) an estimated reduction of [✂]% in staff driving time costs;

b) an estimate that staff driving time costs account for 70% of outdoor collection costs, implying a reduction of [✂]% in staff outdoor collection costs; and

c) an estimate that staff outdoor collection costs account for 80% of total staff costs, implying a reduction of [✂]% in total staff costs[76].

167. We note that the case study modelling suggests staff cost savings of [✂]% or more:

Table 18 - Scenario A: Case study modelling of staff cost savings

Reduction in hours	Volume model	Network model
Edinburgh[77]	[✂]	[✂]
Wakefield[78]	[✂]	[✂]
Craigavon[79]	[✂]	[✂]
Wrexham[80]	[✂]	[✂]

168. RM has explained that these figures relate to outdoor hours only, and that benefits have been estimated at 85% of case study levels to reflect available realisation upon deployment[81].

169. We note also that when extrapolating from case study results, weightings have been applied to reflect variations in delivery point density. We do not have details of the extrapolation, but note that applying 85% to the case study results suggests outdoor staff cost savings of at least [✂]%, compared with the [✂]% assumed in RM's derivation. On the face of it, therefore, the case studies appear to support cost savings of at least those estimated by RM.

170. Divided by the boxes removed from collection routes, the £[✂]m estimate equates to £[✂] per box per year, or £[✂] per box per day[82]. RM's Restructuring Plan model indicates an average cost for collections staff of £[✂] per hour[83], which suggests an assumed time saving of 3 minutes 50 seconds per box per day.

[75] Page 16, RM 03.05.12 submission
[76] Page 17, RM 03.05.12 submission
[77] Slides 19 and 22, Scenario A – Q i and l
[78] Slide 45, Scenario A – Q i and l
[79] Slide 76, Scenario A – Q i and l
[80] Slides 98 and 99, Scenario A – Q i and l
[81] Page 18, RM 03.05.12 submission
[82] Assuming [✂] delivery and collection days, in line with RM's Restructuring Plan model.
[83] The model shows a total of [✂]m hours (row 101, Staff – totals, SPM PCR4v3.xls) at a total cost of £[✂]m (row 84, Staff – totals, SPM PCR4v3.xls), equating to an average cost of £[✂]per hour. This figure needs to be uplifted to account for the fact that working hours are lower than paid hours due to annual leave and sickness. We have estimated an uplift of [✂]% (52 weeks v 46 weeks) which generates an effective hourly cost of £[✂] per hour.

171. The time saving should cover the time taken to drive the vehicle on a detour to the box, locate the box key, exit the vehicle, if necessary lock the vehicle, walk to the box, unlock the box, remove the mail into a container, lock the box, walk to the vehicle, if necessary unlock the vehicle, deposit collected mail, enter the vehicle, return the box key to its pouch, and drive the vehicle back from the detour. Moreover, one might expect that on average, low and very low volume boxes are likely to be in relatively remote locations. In light of these considerations, an estimate of 3 minutes 50 seconds does not seem unreasonable.

172. We note that it is quite a bit higher than the figure of 2 minutes 15 seconds estimated by KPMG using regression analysis[84]; however from an operational perspective, KPMG's estimate seems somewhat low for the performance of the tasks described above. It may be that part of the difference is accounted for by the fact that KPMG's estimate is an average across all collection points, whereas low and very low volume boxes are likely to be in relatively remote locations and therefore require detours that are of above average duration.

Staff other costs

173. RM has estimated a pro rata saving on staff other costs. This seems reasonable.

Vehicle costs

174. RM estimates a £[✂]m or [✂]% saving on annual collections vehicle costs. This is similar to the estimated reduction of [✂]% in staff driving time costs noted above.

175. RM's case study modelling again suggests higher savings, of [✂]% or more:

Table 19 - Scenario A: Case study modelling of mileage savings

Reduction in miles	Volume model	Network model
Edinburgh[85]	[✂]	[✂]
Wakefield[86]	[✂]	[✂]
Craigavon[87]	[✂]	[✂]
Wrexham[88]	[✂]	[✂]

176. Applying the same 85% deployment realisation factor as assumed for staff costs suggests vehicle cost savings of [✂]% or more, compared with the [✂]% assumed by RM. On the face of it, therefore, the case studies again appear to support cost savings of at least those estimated by RM.

177. Divided by the [✂] boxes removed from collection routes, the vehicle cost saving of £[✂] equates to £[✂] per box per year, or [✂]p per box per day[89]. Applying the [✂]p to the [✂] minute estimate for staff cost savings above suggests a vehicle cost of around £6 per hour, or assuming an average speed of say 20 miles an hour, around 30p per mile. This does not seem unreasonable.

[84] 8.7, KPMG 2009 report
[85] Slides 19 and 22, Scenario A – Q i and l
[86] Slide 45, Scenario A – Q i and l
[87] Slide 76, Scenario A – Q i and l
[88] Slides 98 and 99, Scenario A – Q i and l
[89] Assuming [✂] delivery and collection days, in line with RM's Restructuring Plan model.

Other costs

178. RM estimates a £[✂]m saving on annual maintenance costs as a result of removing [✂] boxes altogether. This suggests an annual maintenance cost of £[✂] per box per year[90].

179. This does not seem unreasonable, given the need for periodic painting, mechanical and structural maintenance, and an allowance for renewal.

Mail Centres

180. RM has not included any cost savings for MCs in its estimates. Its 30.03.12 submission states: "*There are no Mail Centre savings attributable to this initiative.*" [91]

181. We would however expect earlier collection times to allow some modest cost savings at MCs. We note that RM's internal November 2010 presentation states that changes to mail arrivals "*will smooth out final clearance time profiles*" [92]. While this is unlikely to be sufficient to drive any radical change in MC operations, we would expect it to allow some MC savings as a result of the reduced pressure on the last period of the evening operation, smoother duty scheduling, and some pay mix opportunities as a result of reducing Scheduled Attendance in the evening and increasing time at normal pay rates in the afternoon[93].

182. In response to follow up questions, RM acknowledged that some MC savings of this nature may be available, "*however this has not been modelled and we do not have a view as to whether it would lead to any material cost savings.*" [94]

Outdoor delivery

183. RM has estimated additional staff costs of £[✂]m in outdoor delivery. It states that this is based on an incremental allowance, per box, of [✂] seconds per day, estimated on the basis of industrial engineering studies as being the additional detour and service time required[95].

184. The [✂] second estimate is consistent with that assumed in RM's case study modelling of Edinburgh and other areas[96], and does not seem unreasonable, considering the time required to walk on a detour to and from the box, and to collect from the box.

185. It is not clear how the incremental allowance of [✂] seconds reconciles with RM's estimated £[✂]m of incremental cost. RM's Restructuring Plan model indicates an average cost for delivery staff in 2015/16 of £[✂] per hour[97], suggesting an incremental cost of [✂]p per box per day, or £[✂] per box per year[98].

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[90] Note, the £[✂] average cost shown in the table above as an element of the £[✂] total annual saving was arrived at by dividing £[✂]m by all [✂]affected boxes. This was for the sake of simplicity in that table. In reality, the saving is attributable only to the [✂] boxes removed altogether, leading to this higher average cost per box.
[91] Page 14, RM 30.03.12 submission
[92] Slide 11, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[93] In theory there might also be related opportunities for savings on feeder journeys from DOs and/or collection hubs to MCs, and more efficient distribution between MCs. However, these are likely to be smaller than opportunities in the MCs themselves, and given the fact that RM has not even estimated the latter, we have focused on MC savings at this stage.
[94] Page 18, RM 03.05.12 submission
[95] Page 19, RM 03.05.12 submission
[96] Slides 38, 66, 89, 109, Scenario A – Q i and l
[97] The model shows a total of [✂]m hours (row 318, Staff – totals, SPM PCR4v3.xls) at a total cost of £[✂]m (row 301, Staff – totals, SPM PCR4v3.xls), equating to an average cost of £[✂] per hour. This figure needs to be uplifted to account for the fact that working hours are lower than paid hours due to annual leave and sickness. We have estimated an uplift of [✂]% (52 weeks v 46 weeks) which generates an effective hourly cost of £[✂]per hour.
[98] Assuming [✂] delivery and collection days, in line with RM's Restructuring Plan model.

186. Applied to the [✂] boxes moved onto delivery as a result of this scenario, an incremental cost of £[✂] per box per year equates to a total incremental cost of £[✂]m per year. This is around one third lower than the £[✂]m estimated by RM, which equates to £[✂] per box per year.

187. As a cross-check, we note that the RM internal November 2010 presentation estimated an incremental saving of £[✂]m as a result of removing [✂] boxes, over and above the saving available from moving those boxes onto delivery[99]. This equates to an incremental delivery staff cost of £[✂] per box per year, mid-way between the two estimates calculated above.

188. We note also two other factors that might influence the scale of incremental delivery costs:

a) if the average number of incremental collections per delivery route is indeed as low as [✂], as estimated above, the scale of the change may simply be too small to register in practical terms and result in any appreciable cost effects, with the additional work simply being absorbed; and

b) there may be some, probably small, incremental vehicle costs on van-based delivery rounds where a vehicle detour is required.

189. Thus it may be that incremental delivery costs are up to one third lower than those estimated by RM. The impact on Scenario A as a whole is minor, but a lower incremental delivery cost has a more significant impact when considering the elements of Scenario A separately, as discussed below.

Conclusion on cost savings

190. In our view, RM's estimated total cost savings of £[✂]m appear broadly reasonable. RM's estimate of the incremental impact on delivery costs of moving collections onto delivery appears overstated, but this has only a marginal effect on overall cost savings, raising them to £[✂]m.

Transition costs

191. RM has estimated total transition costs of £[✂]m:

Table 20 - Scenario A: Transition costs

	£m
VR	[✂]
Post box removal	[✂]
Planning	[✂]
Total	[✂]

[99] Slide 17, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10

VR costs

192. RM estimates total VR costs of £[✂]m:

Table 21 - Scenario A: VR costs

	£m
Collections staff cost reductions	[✂]
Less: delivery staff cost increases	[✂]
Total staff cost reductions	[✂]
VR multiplier	[✂]
Total	[✂]

Need for VR

193. RM's estimate assumes that [✂] staff cost savings are achieved through VR, and that [✂] staff costs are saved through reductions in overtime, redeployment in other parts of the business (save between collections and delivery), or natural attrition.

194. In contrast, RM's November 2010 internal presentation assumed, under a similar scenario, that only [✂] of staff cost savings would be achieved through VR, on the basis that:

a) [✂] of staff cost savings could be achieved by reducing overtime; and

b) [✂] of remaining reductions would require VR[100].

195. As a result, the VR estimate made in that presentation was around [✂] of that assumed in RM's submission, at £[✂]m[101].

Overtime opportunities

196. As noted by RM, a significant proportion of collections work is currently undertaken by staff on overtime[102]. The Restructuring Plan model indicates that [✂]% of hours are currently on overtime, and projects this to fall to [✂]% by 2015/16[103].

197. There would therefore appear to be scope for some of the collections staff cost saving, estimated at [✂]% of total collections staff costs, to be achieved through reductions in overtime. The [✂]% assumption applied in the November 2010 presentation does not seem unreasonable.

Redeployment opportunities and natural attrition

198. As noted in the Introduction section above, RM has in general assumed no reduction to the need for VR to reflect redeployment opportunities and natural attrition, given the scale of headcount reduction already planned under the current modernisation programme, which relies on natural attrition to minimise VR costs.

[100] Page 20, RM 03.05.12 submission
[101] Slide 13, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[102] Page 20, RM 03.05.12 submission
[103] Row 87, Staff – totals, SPM PCR4v3.xls

199. We think this may be a reasonable assumption in estimating the scale of VR that would be incurred if any of the scenarios were to be implemented in the short term. However, if a longer term perspective in line with the 2015/16 base case and RM's approach to estimating cost savings were adopted, it might be more appropriate to consider VR costs in a steady state environment after the completion of the Restructuring Plan. Under such conditions, VR costs might be substantially lower, reflecting steady state natural attrition rates. In this regard, we note that:

a) current natural attrition rates are [✂]% for full time frontline staff, and [✂]% for managers and administration staff[104];

b) by 2015/16, the Restructuring Plan model estimates natural attrition of [✂]% per annum for full time staff, and [✂]% per annum for part time staff[105].

c) RM's November 2010 price control submission estimated current attrition rates of [✂]% for full time employees and [✂]% for part time employees, and forecast these increasing to [✂]% and [✂]% respectively by 2016/17[106].

200. If we assume, as RM appears to do in its VR estimate, that staff can be redeployed from collections onto outdoor delivery, then natural attrition rates can be compared with the scale of aggregate staff cost savings across collections and outdoor delivery. This is just over [✂]%[107], implying that, in the longer term, savings could be achieved within a year with very little if any reliance on VR.

Conclusion on need for VR

201. We therefore think a more reasonable estimate of the need for VR would be half that assumed by RM in the short term, and an immaterial need for VR in the longer term.

VR rate

202. For staff cost savings which require VR, RM estimates VR costs at [✂]% of payroll costs based on current VR terms[108].

203. We have considered whether this assumption is consistent with VR terms generally offered by RM. The scope of our work does not extend to an efficiency review, so we have not attempted to assess whether those terms match those that would be offered by a hypothetical efficient operator, although we note that FE's 2011 review of RM's Strategic Plan characterised VR payments as high[109].

204. "Payroll costs" are defined to include costs such as overtime and employer's National Insurance and pension costs, which are not included in the calculation of VR payments. RM's assumption of [✂]% on payroll costs equates to an assumption of around [✂]%, or [✂] weeks, of basic pay[110].

[104] Page 67, RM 03.05.12 submission
[105] Rows 271 to 272, New Output, SPM PCR4v3.xls
[106] 11.2.2, RM November 2010 submission
[107] Net staff cost savings of £[✂]m, over a staff cost base of £[✂]bn.
[108] Illustrative RFI Cost model.xls
[109] Page 176, FE 2011 review of Strategic Plan
[110] The Restructuring Plan model indicates basic pay is around [✂]% of total pay (rows 12 to 17, Staff – totals, SPM PCR4v3.xls).

205. RM has explained that current VR terms offer staff a VR payment of between [✂] and [✂] weeks' pay, depending on length of service[111]. RM's implicit [✂] week assumption is near the top end of this range, implying a relatively long average length of service for those affected by VR: we estimate over [✂] years[112].

206. RM's [✂]% estimate appears consistent with the Restructuring Plan model. The model forecasts redundancy costs of £[✂]m in 2015/16[113], based on the loss of [✂] full time operational grade staff through VR[114]: an average cost of £[✂] per person. In the same year, total frontline staff costs are forecast at £[✂]m[115] for [✂] staff[116]: an average payroll cost of £[✂] per person. This equates to an average VR cost of [✂]% of payroll costs.

207. It is possible that average VR costs will fall, relative to staff costs, over time, since VR might be most attractive to, and initially taken up disproportionately by, long-serving staff. As time goes on, if the average service length of staff taking up VR falls, we would expect to see VR becoming less costly in relative terms. The Restructuring Plan model does not appear to adjust for this effect, so it is possible that by 2015/16 in particular, the [✂]% figure is somewhat overstated.

208. We also note that the [✂]% estimate is based on full time staff. However, a significant proportion of staff are part-time: [✂]% of collections staff, and [✂]% of outdoor delivery staff[117]. We would expect VR costs as a proportion of payroll cost to be lower for part-time staff, since typically they are likely to have shorter service records.

Other direct costs

Cost of box removal

209. RM has estimated a total removal cost for the [✂] affected boxes of £[✂]m, based on an estimated cost of £[✂] per box[118], which RM states is based on its experience to date of the actual average cost of removing boxes[119].

210. The estimate of £[✂] seems quite high to us on the basis of:

    a) the likely time required for removal;

    b) the likelihood that removal of [✂] boxes could be achieved at a lower unit cost than suggested by RM's recent experience of removing what we presume could only be a small fraction of that number; and

[111] Page 68, RM 03.05.12 submission. Note different terms apply to workers aged over 55 and meeting specific eligibility criteria.
[112] Terms are [✂] times Statutory Redundancy, uncapped at [✂] years (Page 68, RM 03.05.12 submission). Statutory Redundancy is [✂] weeks' pay for each complete year under the age of [✂],[✂] weeks' pay for each complete year aged [✂] or over but under the age of [✂], and [✂] weeks' pay for each complete year aged [✂] or over. A worker leaving at, for example, 50, with 22 years of service, would therefore receive a payment of [✂] weeks' pay ([✂]). Older workers would require shorter service to receive this level of payment; younger workers would require longer service.
[113] Row 48, Redundancy, SPM PCR4v3.xls
[114] Row 33, Redundancy, SPM PCR4v3.xls
[115] Rows 1052 to 1057, Staff – totals, SPM PCR4v3.xls
[116] Rows 184 to 194, New Output, SPM PCR4v3.xls
[117] Row 60, Headcount, SPM PCR4v3.xls
[118] Page 13, RM 30.03.12 submission
[119] Page 21, RM 03.05.12 submission

c) RM's internal November 2010 presentation, which estimated a maximum implementation cost for box removal of £[✂], covering not only physical removal, but also VR and planning costs[120].

211. Assuming a figure of £[✂] per box, closer to that suggested by the November 2010 presentation, would result in a total removal cost of around £[✂]m, £[✂]m less than that suggested by RM.

Planning costs

212. RM estimates total planning costs, relating to "postbox traffic measurement and project costs", of £[✂]m. It states:

[✂] [121]

213. RM has provided the following split of planning costs[122]:

Table 22 - Scenario A: Planning costs

	£m
Post box traffic measurement devices	[✂]
Geo-route and PDA upgrades	[✂]
Planning resource	[✂]
Total	[✂]

214. We believe there is a risk that RM has overstated these costs. While we appreciate the scale of the task, we note that RM has, quite independently of Scenario A, been investing heavily in route optimisation tools:

a) RM's internal presentation indicates that existing collection routes will have been re-optimised by September 2012[123];

b) RM's Restructuring Plan states: "*Royal Mail is introducing new methods designed to enable its employees to respond to the fast-moving changes in the postal market, including product mix changes for daily delivery. The vast majority of its [✂] delivery offices will introduce changes in the next [✂] months, including careful re-planning of around [✂] routes using specialised software. To date, [✂] routes have been re-planned and optimised*" [124]

c) RM's Restructuring Plan also states that once these tools are in place, delivery revisions will be repeated [✂][125].

[120] Maximum cost of £[✂] for [✂] boxes. Slide 17, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[121] Page 10, RM 30.03.12 submission
[122] Page 21, RM 03.05.12 submission
[123] Slide 8, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[124] Slide 35, RM Restructuring Plan
[125] Slide 36, RM Restructuring Plan

215. We would therefore expect that by 2012/13, and certainly by 2015/16, the vast majority of relevant collection data will have been computerised and contained within Geo-route and delivery route information on RM's Pegasus application. We note that RM's November 2010 price control submission stated that by 2015/16, 95% of collection routes would be Geo-route enabled and all delivery routes would be Pegasus enabled by 2015/16[126].

216. We are therefore surprised there is still a requirement for a £[✂]m upgrade of Geo-route under this scenario to allow planners to plan collections on delivery routes more effectively which hasn't already been purchased as 'business as usual' plus some changes to PDA functions since we would have expected the IT systems used to be well developed by 2015/16. Similarly the requirement for £[✂]m for additional planning resource, which equates to around [✂] dedicated people for a year[127], is surprising given the amount of work already undertaken in this area.

217. This appears to be confirmed by RM's internal November 2010 presentation, which indicates total planning costs for moving [✂] boxes onto delivery of £[✂]m[128]. We think this might be a more reasonable estimate of total planning costs.

Conclusion on transition costs

218. In our view, RM's estimated total transition costs of £[✂]m appear overstated, and we estimate transition costs in the region of £[✂]m to £[✂]m:

a) we estimate VR costs of half the £[✂]m estimated by RM in the short term, and no material VR costs if deployment takes place in the longer term;

b) we estimate box removal costs of closer to £18m than the £[✂]m estimated by RM; and

c) we estimate planning costs of closer to £2.5m than the £[✂]m estimated by RM.

219. These estimates are based on RM's assessment of cost savings. We have estimated further cost savings of the order of £[✂]m in respect of outdoor delivery staff costs. Adopting the same approach to VR as set out above for these further cost savings would raise our short term transition cost estimate from £[✂]m to £[✂]m, but would leave our longer term transition cost estimate unchanged at £21m.

Benefit sharing costs

220. RM has not estimated benefit sharing costs for this or any other scenario.

221. As noted in the introduction section above, however uncertain these costs are, we believe that they should receive some consideration. [✂].

Scope of change

222. The scope of the change is broad, affecting both delivery and collection staff. The Restructuring Plan model indicates a total of [✂] full time staff in delivery, and [✂] full time staff in collections in 2015/16, suggesting that payments might be required to over [✂] staff.

[126] Page 4, RM November 2010 submission
[127] Assuming a total payroll cost of around £[✂] a year.
[128] Slide 13, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10

Scale of change

223. As noted above, the effect on delivery routes is likely to be modest, with the average number of collections per delivery route rising from [✂] to [✂]. RM indicates that the changes would have a more significant impact, due to the need to add collection activities into the delivery function[129]; however, the basis for RM's view is unclear, since as it has confirmed, collection activities will already be present in the delivery function under the base case.

224. It may therefore require a much smaller payment per person than [✂].

Illustrative impact

225. A one-off payment of say £[✂] per affected staff, paid to [✂] staff, might result in a total benefit sharing cost of £[✂]m.

226. We stress that this cannot be relied on as an estimate of the likely level of benefit sharing costs; however it can at least serve as an illustrative benchmark of the potential scale of such costs.

Incremental impact of post box removal

227. The cost savings and transition costs presented by RM under Scenario A reflect the combined impact of:

a) earlier collection on delivery from [✂] low volume boxes; and

b) removal of [✂] very low volume boxes.

228. From an operational perspective, it makes sense to combine both changes in a single implementation. From a policy perspective, however, it may be that customer attitudes to box removal are likely to differ markedly from customer attitudes to earlier collection. We note in particular RM's view that:

"*Removing Post Boxes is [✂].*" [130]

229. Ofcom may therefore wish to consider separately:

a) the degree to which the cost savings under Scenario A may be available from earlier collection from all [✂] affected boxes with a daily volume of less than [✂] items that are not already collected on delivery under the base case, without the removal of any boxes; and

b) the incremental cost savings resulting from the removal, rather than earlier collection from, the [✂] boxes with a daily volume of less than [✂] items.

[129] Page 23, RM 03.05.12 submission
[130] Page 10, RM 30.03.12 submission

230. We have therefore prepared an analysis which separates these effects, based on RM's own estimates, as adjusted for the potential overstatements identified above in respect of cost savings (delivery costs) and transition costs (VR, box removal, and planning costs). The results of our analysis are presented below, and indicate that around 75% of cost savings result from earlier collection rather than removal, and that transition costs are loaded towards removal, making the payback period on incremental removal less attractive:

Table 23 - Scenario A: Separation into component elements

		Earlier collection from [✂] boxes	Incremental removal of [✂] boxes	Combined effect
Cost savings (£m)	Collection	[✂]	[✂]	[✂]
	Outdoor delivery	[✂]	[✂]	[✂]
	Total	[✂]	[✂]	[✂]
Transition costs (£m)	VR	[✂]	[✂]	[✂]
	Box removal	[✂]	[✂]	[✂]
	Project costs	[✂]	[✂]	[✂]
	Total	[✂]	[✂]	[✂]
Discounted payback (years)		[✂]	[✂]	[✂]

231. Cost savings have been separated as follows:

a) The £[✂]m of collection cost savings associated with staff and vehicle collection costs would be achieved once dedicated collections ceased from the [✂] boxes, regardless of whether some of them were then removed. Only the £[✂]m of savings relating to maintenance costs would be attributable to the incremental removal of the [✂] boxes.

b) Outdoor delivery costs would be around £[✂]m higher if earlier collection was applied to [✂] boxes rather than [✂] boxes[131].

232. Transition costs have been separated as follows:

a) VR costs are split broadly in line with cost savings[132];

b) box removal costs are attributed to removal; and

c) project costs have, conservatively, been applied to each element.

[131] This has been estimated by uplifting the £[✂]m increase identified for [✂] boxes pro rata for [✂] boxes. In reality, the uplift may need to be a little higher than this to reflect the likelihood that the lowest volume boxes are likely to be the remotest boxes, and are therefore likely to have a higher incremental cost. However, we have no information on which to make such an adjustment.

[132] To be more precise, they are split in line with the staff cost element of cost savings.

233. The split of cost savings suggested by our analysis is broadly similar to the cost savings in RM's November 2010 presentation. That presented estimates based on a two phase sequential process comparable with the split shown above[133]:

a) the first phase to involve earlier collection on delivery from [✂] boxes with a daily volume of less than [✂] items, estimated to generate a cost saving of £[✂]m[134]; and

b) the second phase to involve the removal of [✂] post boxes with a daily volume of less than [✂] items, estimated to generate incremental cost savings of £[✂]m[135].

[133] Slide 8, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10. Note that the phase labelled "Phase 1" in that slide relates to optimisation within the constraints of the current USO and so is not relevant to this report; Phase 2 relates to earlier collection on delivery; and Phase 3 relates to box removal.
[134] Slide 13, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10
[135] Slide 17, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10

Scenario B: Later delivery times

Summary of scenario

234. This scenario involves delaying latest delivery times to 17:00, from 15:00 in urban areas and 16:00 in rural areas. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 24 - Scenario B: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

235. Later delivery times create a longer operational window, which in principle can be used in a number of different ways to reduce costs at different stages of the pipeline. RM has estimated savings on the basis of retarding inward processing and sequencing cut-offs by two hours, and delaying the whole delivery operation by two hours in consequence. It suggests the principal benefits of such a change would be the removal of part of the air network with shorter flights, replaced by cheaper surface connections, and an increase in the level of sequencing. This seems a reasonable approach.

236. In our view, RM's estimated total cost savings for this scenario could be understated. It appears that additional opportunities of the order of £4m are available by taking advantage of later delivery times and moving some collections onto delivery, and that the estimated walk sequencing benefit may be understated by around £2m.

237. The analysis above takes no account of potential benefit sharing costs. In our view, these could be significant. A two hour delay to the shift times of the great majority of delivery workers could easily meet strong resistance, and this would require very careful consideration. As an illustration, [✂].

Details of change

238. Scenario B involves relaxing the latest delivery time from the current 15:00 urban /16:00 rural specification. RM states that for the purpose of its response, it has assumed a 17:00 last letter time for all mail[136], equating to a two hour delay for most mail[137] (some rural mail may only gain an hour's delay).

239. RM stresses that it has assumed this revised specification for modelling purposes only, and that the assumption does not imply that such a specification would be its preferred outcome[138].

[136] Page 19, RM 30.03.12 submission
[137] Pages 21 to 22, RM 30.03.12 submission
[138] Page 19, RM 30.03.12 submission

240. RM has estimated the following timings under the revised specification (presumed to refer to urban deliveries):

Table 25 - Scenario B: Timings under revised specification

Deliveries completed by[139]	%
15:00	[✂]
16:00	[✂]
17:00	100%

241. Because of the approach assumed for operational savings, the two hour delay would also apply to receiving customers who collect their mail early in the day directly from DOs and MCs[140].

242. RM states that under this scenario, it would "*retain the flexibility to deliver packets later into the evening* [✂]" [141].

Historical context

243. A two hour delay to deliveries would follow a series of changes to delivery times in recent years. Until 2003, delivery points in urban areas received two deliveries per day, with a standard of 09:30 for completion of first delivery. In practice, the great majority of mail was delivered on the first delivery.

244. The National Agreement on Pay and Major Change 2003 between RM and CWU, led to the introduction of Single Daily Delivery at the end of March 2004, with all urban residential routes receiving one delivery per day by 13:00, based on a 3.5 hour delivery span. The change did not affect rural areas, which had already been operating on a single delivery for many years, with a 14:00 specification for completion.

245. By the beginning of 2010, final times had been extended by one hour, and RM was operating to a completion specification of 14:00 for urban deliveries, and 15:00 for rural deliveries. We understand that these extensions followed the 2007 RM/CWU agreement, which changed normal delivery duty start times to [✂], for operational reasons including the impending imposition of a 56mph speed limit for 7.5 tonne vehicles[142].

246. Then, as part of the 2010 Pay and Modernisation agreement, both times were relaxed by one hour, to the current 15:00 urban /16:00 rural specification. The additional was introduced to allow for the deployment of walk sequencing[143], and accompanied a later start time of [✂][144].

247. Given this history of specification changes, it may be that a further relaxation of delivery times would be relatively uncontroversial for customers.

Operational rationale for change

248. Later delivery times create a longer operational window, which in principle can be used in a number of different ways to reduce costs at different stages of the pipeline.

[139] Page 19, RM 30.03.12 submission
[140] Page 20, RM 30.03.12 submission
[141] Page 19, RM 30.03.12 submission
[142] Pages 164 and 188, 3.3.23, PCR4 2010
[143] Page 20, RM 30.03.12 submission
[144] Page 24, 2010 Pay and Modernisation Agreement

249. RM has estimated savings on the basis of retarding inward processing and sequencing cut-offs by two hours[145], and delaying the whole delivery operation by two hours in consequence. It suggests the principal benefits of such a change would be:

a) the removal of part of the air network with shorter flights, replaced by cheaper surface connections; and

b) an increase in the level of sequencing[146].

250. This seems a reasonable approach. A reduction in the air network is a clear benefit for that proportion of mail which is just too distant to arrive in time for the existing inward processing cut-off, and was the principal cost saving considered by FE under a similar scenario. For inward processing operations not reliant on the affected network links, the additional time could be used to increase the level of automation, to the degree it is time constrained under the base case.

Cost savings

251. RM estimates total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base, principally from savings in network costs. This is very similar to our rolled forward FE estimate of £[✂]m:

Table 26 - Scenario B: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)		Cost savings (%)	
		RM s55	FE[147]	RM s55	FE
Collections	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

Collections

252. Although RM has estimated no savings in respect of collections costs, we believe that some opportunities exist in this part of the pipeline.

[145] Page 20, RM 30.03.12 submission
[146] Page 19, RM 30.03.12 submission
[147] Rolled forward and excluding volume effects, as described in the Introduction section

253. Some collections are already made on delivery, within existing access time specifications. We would expect that a move to later delivery times would allow more collections to switch from dedicated collection routes to collection on delivery, without requiring any change to access times. This would mean that a proportion of the savings identified under Scenario A would become available under Scenario B.

254. In response to follow up questioning, RM has suggested that since [✂]% of delivery points would receive a delivery after 16:00 under this scenario, it might be possible to collect from an additional [✂]% of post boxes on delivery under existing access time specifications[148]. That would equate to [✂] boxes. In Scenario A, we estimated cost savings of £[✂]m as a result of moving [✂] boxes onto delivery. A pro-rata allowance suggests cost savings of the order of £4m from [✂] boxes.

Mail Centres

255. RM has transformed its automated processes, with major investment to handle all formats of mail. Between 2008/09 and 2015/16, RM will have invested £[✂]m on new and refurbished equipment, and by the end of 2015/16 RM will have [✂] new, refurbished or upgraded machines as a result of this investment[149]. At the same time, RM has embarked on a major programme of MC reduction. By 2015/16 RM plans to have a network of [✂] MCs, representing an investment of £[✂]m[150].

256. RM has identified the potential to use the extended inward processing window to increase automated walk sequencing by a further [✂]%, which we consider further below. However, RM has made no mention of any potential to capture more mail through its other automated processes, given the longer inward processing window.

257. A longer inward processing window could provide opportunities to capture more mail through automated processes. Examples include:

a) volumes which might otherwise have exceeded automated capacity at the height of peak inward arrivals;

b) mail suitable for automation which had been mis-streamed into manual (either at the outward MC or on arrival at the inward MC), with time now available to identify and recover into automated processes; and

c) mail that is perfectly capable of being processed by machine, which had been rejected/ejected from automated processes incorrectly, and could now be re-run with time still available.

Letter walk sorting

258. The Restructuring Plan indicates that [✂]% of letters will be automatically walk sorted by the end of 2015/16[151]. This remains unchanged under Scenario B. Every letter that can be transferred from the manual stream into the automated processes at the outward MC and is successfully sorted to walk level eliminates up to three manual sorts (at outward processing, inward processing, and then again at the DO).

[148] Page 30, RM 03.05.12 submission
[149] Slides 51 and 52, RM Restructuring Plan
[150] Slide 51, RM Restructuring Plan
[151] Slide 48, RM Restructuring Plan

259. RM's view is that the longer inward processing window under this scenario would not allow an increase in walk sorting rates, since walk sorting potential is not limited by available time. RM has explained that its aim is to walk sort all letters, and that the main causes preventing the remaining [✂]% of letters being walk sorted are:

a) non-machineability due to factors such as address readability and Delivery Point Suffix accuracy[152]; and

b) leakage of machineable mail to manual processes[153].

260. The causes cited by RM appear reasonable. However, we do not believe that they entirely support RM's view that walk sorting is not limited by available time, since in our experience leakage or mis-streaming rates can be improved with a longer operational window. Moreover, RM's view is inconsistent with that apparently given during FE's 2011 review of its Strategic Plan. FE reported that:

"*Royal Mail has also informed us that the targeted automation rate of* [✂] *% is limited by mail centre cut off times, in order for the sorted mail to reach its destination on time*" [154].

261. The improvement opportunity from a two hour extension is likely to be relatively small, and so we have not attempted to estimate it. Cost savings of this nature are most likely to emerge from Scenario D, considered further below.

Flats sorting

262. RM has explained that under the Restructuring Plan, by 2015/16, [✂] of the [✂] MCs are expected to have flat sorting machines, with:

a) [✂]% of flats machine sorted in outward processing;

b) [✂]% of delivered flats machine sorted to DO level in inward processing (with a further [✂]% of delivered flats arriving already pre-sorted to DO level); and

c) [✂]% of delivered flats machine sorted to walks or groups of walks [155].

263. RM has not included any plans to increase the level of machine flat sorting under Scenario B. The potential saving is the cost of manually sorting flats at least twice (outward and inward MCs) to reach the DO, versus the cost of sorting through flats automation in outward and inward processing.

264. RM's view is that the longer inward processing window under this scenario would not allow an increase in flat sorting rates, explaining that the main causes preventing further flat sorting are:

a) the availability of suitable traffic for flat sorting (since it is typically uneconomic to machine sort to walk level those flats that arrive already pre-sorted to DO level);

b) the limited inward processing window; and

[152] The Delivery Point Suffix is a unique reference to each delivery point that is appended to a postcode in a tag or customer bar code
[153] Page 25, RM 03.05.12 submission
[154] Page 108, FE 2011 review of Strategic Plan
[155] Page 26, RM 03.05.12 submission

c) capacity limitations since each MC has, at most, one flat sorting machine[156].

265. The causes cited by RM appear reasonable. However, we do not believe that they support RM's view that a longer inward processing window would not allow any increase, since one of the cited causes specifically relates the "limited" inward processing window, and another, capacity limitations, is also alleviated by a longer processing window.

266. The improvement opportunity from a two hour extension is likely to be relatively small, and so we have not attempted to estimate it. Cost savings of this nature are most likely to emerge from Scenario D, considered further below.

Packet sorting

267. RM has explained that under the Restructuring Plan, by 2015/16, [✂] of the [✂] MCs are expected to have packet sorting machines, but that this number is under review as a detailed business case for packet automation is currently being prepared[157].

268. RM has not included any plans to increase the level of machine packet sorting under Scenario B. It accepts that the longer inward processing window might allow the level to increase, but states that at this stage, in the absence of a detailed business case, it is not possible to estimate the scale of this opportunity. RM explains that the main cause limiting machine sorting is non-machineability due to factors such as packet size and address quality[158].

269. The improvement opportunity from a hour extension is likely to be relatively small, and so we have not attempted to estimate it. Cost savings of this nature are most likely to emerge from Scenario D, considered further below.

Downstream Access

270. There is no reference to Downstream Access (DSA) in RM's response, which assumes that only the volumes previously carried on the cancelled air services arrive later. Under Scenario B, there could be an opportunity to extend the window for injection by DSA customers. This could, however, have implications for available cost savings, as more mail would arrive later into the inward MC than RM has considered in its calculations.

[156] Page 26, RM 03.05.12 submission
[157] Page 26, RM 03.05.12 submission
[158] Page 27, RM 03.05.12 submission

Network

271. RM estimates total network savings of £[✂]m. These savings are summarised in the Illustrative RFI Cost model and detailed in the "Scenario B Illustrative Network savings" spreadsheet. There are some differences between the categorisation of cost savings in the former, and the details provided in the latter:

Table 27 - Scenario B: Network cost savings

	RFI model £m	Scenario B £m
Air contracts	[✂]	[✂]
Airport handling and screening staff	[✂]	[✂]
Airport site costs	[✂]	[✂]
Total air network savings	[✂]	[✂]
Less additional road network costs	[✂]	[✂]
Less additional cross docking costs	[✂]	[✂]
Total	[✂]	[✂]

272. The differences appear to be presentational only, and do not affect total estimated cost savings. We have base our review on the Scenario B spreadsheet, which contains all the detailed analysis.

Removal of air network costs

273. Air network savings arise from:

a) withdrawing [✂] shorter [✂] flights from the current network; and

b) ceasing airport operations altogether at [✂][159].

274. RM estimates total savings of £[✂]m:

Table 28 - Scenario B: Air network cost savings

	£m
Cancelled air contracts	[✂]
Replacement air contracts for [✂]	[✂]
Net air contract saving	[✂]
Airport handling and screening staff ([✂] of total)	[✂]
[✂] site costs	[✂]
Total	[✂]

[159] Pages 19 to 21, RM 30.03.12 submission

Additional road and rail network costs

275. RM estimates total additional road and rail network costs of £[✂]m:

Table 29 - Scenario B: Additional road and rail network costs

	£m
Replacement links for cancelled air contracts	[✂]
Less: avoided airport feeder runs	[✂]
Net additional costs	[✂]
Additional cross-docking costs	[✂]
Total	[✂]

276. The £[✂]m benefit from avoided airport feeder runs includes a £[✂]m saving from closure of the [✂] Rail Terminal, together with road to road reductions at [✂] Airport.

Operational assessment

277. From an operational perspective, RM's estimates look to have been well thought through, with detailed calculations for both the air contract and road network savings. In support of this, the "Scenario B Illustrative Network Savings" spreadsheet contains some very well defined linkages between old and new.

278. For example, RM has specified where road and rail connections take the place of the air network, both at a high level (e.g. '[✂] cessation - additional road links between [✂] , [✂] and [✂]') and then in much more underlying detail in supporting spreadsheets (e.g. '[✂] to [✂] replacement road service, 38 tonne vehicle, 4 hrs 6 minutes running time, [✂] miles, cost per day £[✂]' etc)[160].

279. The £[✂]m saving in respect of airport staff costs is calculated on the basis of applying the percentage reduction in traffic sent by air in terms of Full York Equivalents (FYEs), estimated at [✂]%, to the total airport staff cost figure of £[✂]m[161]. This seems reasonable.

280. In overall terms, network savings look broadly comparable with those estimated by FE for a two hour delay in delivery:

a) total estimated savings of £[✂]m match our rolled forward FE figure of £[✂]m;

b) RM's estimate of a [✂]% reduction in traffic sent by air is similar to FE's estimate of a [✂]% reduction[162]; and

c) RM's estimates imply that [✂]% of flight contract costs will be avoided (£[✂]m out of £[✂]m), whereas FE estimated that [✂]% of flight contract costs would be avoided (£[✂]m out of £[✂]m[163]).

[160] We note that the road network calculations estimate a cost per journey on the basis of a cost per mile, uplifted by a factor of [✂]%. It is not clear what the uplift is intended to reflect; perhaps waiting, loading and unloading time. However, since the net impact on road costs is so small, a different uplift would be unlikely to alter estimated savings materially.
[161] Staffing Impact, Scenario B Illustrative Network savings
[162] Page 121, FE 2008 report
[163] From FE 2008 model; figures not rolled forward

281. While a detailed analysis of air route cancellations and the alternative road and rail replacements is outside the scope of this review, on the whole, the savings estimates seem well structured and soundly based.

Local distribution

282. RM has not identified any savings in local distribution.

283. RM would need to redraw its local distribution network in response to the changed flows from the MCs to DOs. In theory, with more time available for inward MCs to feed DOs, the potential exists to reduce or amalgamate runs, with tools such as Geo-route already rolled out. However, as pointed out by RM, taking advantage of this additional time by seeking savings in local distribution would be likely to reduce identified network and walk sequencing savings. We therefore think an assumption of no savings is not unreasonable.

Indoor delivery

284. RM's investment in walk sequencing automation has been extensive, and by the end of 2015/16 £[✂]m will have been spent on [✂] Walk Sequencing machines alone, quite apart from other enabling equipment such as iLSMs and IMPs, together with other supporting investment, for example Address Interpretation and traying. By that time, RM expects [✂]% of letters to be sequenced.

285. RM estimates a £[✂]m staff cost saving in indoor delivery costs, based on the extension of walk sequencing by an additional [✂]%. This is due to a longer operational window for inward processing:

"*bringing into scope those deliveries previously excluded from sequencing due to timing constraints.*" [164]

Impact of [✂]% improvement

286. RM has explained that it has estimated the impact of a [✂]% improvement in walk sequencing at £[✂]m by calculating the additional 2015/16 letter volumes that would be captured by such an improvement, and assuming a cost saving of [✂] minutes for every 1,000 items sequenced[165].

287. This calculation does not appear to be consistent with the corresponding calculation in the Restructuring Plan. Extrapolating from the [✂]% in RM's estimate to the [✂]% assumption in the Plan suggests an annual benefit of £[✂]m, but the Plan estimates an annual benefit of £[✂]m, [✂][166]. It may be that the Plan assumes a cost saving of more than [✂] minutes per 1,000 items; in our experience a higher assumption would not be unreasonable.

288. It therefore appears that RM's estimate of £[✂]m for an additional [✂]% of walk sequencing may be conservative, and that a benefit of up to £[✂]m may be achievable. We note that FE reached a similar view in its 2011 review of RM's Strategic Plan[167].

[164] Page 19, RM 30.03.12 submission
[165] Page 29, RM 03.05.12 submission
[166] Slide 52, RM Restructuring Plan
[167] Page 109, FE 2011 review of Strategic Plan

Further improvements in walk sequencing

289. This estimate assumes that a two hour delay to delivery would allow sequencing to rise by [✂]%, to [✂]%. We note that the cost savings available from the gap between [✂]% and full walk sequencing are significant, an additional £16m or so.

290. RM has explained that the main causes preventing further walk sequencing are:

a) non-machineability due to factors such as Delivery Point Suffix accuracy; and

b) some remaining remote or very small walks[168].

291. We note that the first cause also constrains the level of machine walk sorting, as noted above, which is forecast at [✂]%. This suggests to us:

a) that a walk sequencing level of [✂]% equates to sequencing some [✂]% of walks, with an [✂]% success rate per walk sequenced;

b) that a walk sequencing level of [✂]% equates to sequencing some [✂]% of walks, with an [✂]% success rate per walk sequenced; and

c) that RM's estimate that walk sequencing would rise by [✂]% under this scenario equates to an estimate that the proportion of walks sequenced would rise by [✂]% from [✂]% to [✂]%.

292. However, it is not clear that RM has made any explicit assumption of this nature, since it stated that it was unable to indicate the increase in the number of walks as a result of the [✂]% increase in walk sequencing.

293. The proportion of walks sequenced is likely to be limited both by the length of the inward processing window (affecting remote walks), and by the likelihood that some walks are simply too small to make sequencing economic. It is not therefore possible to estimate the maximum proportion that could be achieved as a result of a longer processing window, but RM's implicit estimate of a [✂]% increase is not obviously unreasonable.

Outdoor delivery

294. Since [✂]% of urban deliveries would receive a delivery between 15:00 and 17:00, we would expect higher occupancy rates to allow some savings in redelivery costs. RM appears to accept that savings would be available in principle, but does not believe they are material[169], and has not included any such savings in its estimate.

295. We agree that redelivery savings are likely to be modest. FE estimated there were 38m undelivered items in 2006/07, of which 84% are then picked up by customers from the DO[170], suggesting a total of 6m redelivered items per year. [✂].

[168] Page 30, RM 03.05.12 submission
[169] Page 31, RM 03.05.12 submission
[170] Page 63, FE 2008 report

296. As noted above, RM has estimated cost savings on the assumption that the principal benefit over later delivery times would be taken by retarding inward processing and saving on air network costs. FE did consider an alternative strategy, involving extending outdoor delivery spans from the prevailing 3.5 hour limit. In principle this would increase efficiency by reducing the relative proportion of "stem time" (travel to the start of, and from the end of, a delivery route). It estimated that in theory such a strategy could lead to higher cost savings than those available from the air network: around £30m for a one hour extension. However, it considered these savings to be more tentative, given concerns around fatigue and sick leave, and likely union resistance.

297. Delivery methods will have changed markedly by 2015/16 from those assumed at the time of FE's work, with the move to trolleys and vans set out in RM's Restructuring Plan[171]. We do not therefore share the degree of concern expressed by FE in 2008. However, we note that the theoretical premium identified by FE for an outdoor delivery focus on cost savings has been slightly eroded by the opportunities we have identified for walk sequencing.

Conclusion on cost savings

298. In our view, RM's estimated total cost savings of £[✂]m could be understated. It appears that additional opportunities of the order of £4m are available by taking advantage of later delivery times and moving some collections onto delivery, and that the estimated walk sequencing benefit may be understated by around £2m. This would increase total savings to nearer £[✂]m.

VR costs

299. RM estimates total VR costs of £[✂]m:

Table 30 - Scenario B: VR costs

	£m
Airport staff cost reductions	[✂]
Delivery staff cost reductions	[✂]
Total staff cost reductions	[✂]
VR multiplier	[✂]
Total	[✂]

300. As with Scenario A, RM's estimate assumes that [✂] staff cost savings are achieved through VR, and that [✂] staff costs are saved through reductions in overtime, redeployment in other parts of the business, or natural attrition.

Overtime opportunities

301. It may be possible to achieve some of the staff cost savings identified in delivery through reductions in overtime. In Scenario A, we note that RM had previously estimated that, in relation to a saving of the order of [✂]% in collections staff costs, [✂]% could be achieved through reductions in overtime. The proportionate saving in indoor delivery staff is much smaller, at only [✂]% of annual staff costs.

Redeployment opportunities and natural attrition

302. As discussed in Scenario A, assuming no reduction in the need for VR to reflect redeployment opportunities and natural attrition may be reasonable in the short term.

[171] Slide 48, RM Restructuring Plan

303. In the longer term, however, the need for VR might be substantially lower:

a) Redeployment should be a realistic option for many airport staff, since the skill sets in airport hub working are in principle easily transferable, e.g. loading bay or driving work, and in our experience, it is not uncommon for RM staff to move between operational units. A relatively long lead time is likely to be necessary to plan and prepare for the network changes, which should help this process.

b) It seems unlikely that VR would be required at all in delivery, given the very modest impact on indoor delivery staff costs ([✂]% of annual staff costs) and natural attrition rates of the order of [✂]%[172].

Conclusion on need for VR

304. In the short term, some reduction in VR may be available through reductions in delivery overtime. If a [✂]% reduction in delivery VR was possible, in line with collections VR in Scenario A, that would reduce total VR costs from £[✂]m to around £[✂]m.

305. In the longer term, it seems unlikely that any VR would be needed in delivery, and that VR in respect of airport staff could be reduced through redeployment. Assuming that [✂]% of the airport staff cost saving would require VR would reduce total VR costs from £[✂]m to around £[✂]m.

306. These estimates are based on RM's assessment of cost savings. We have estimated further cost savings of the order of £6m, mostly in respect of collections and delivery staff costs. Adopting the same approach as set out above for these further cost savings would raise our short term VR cost estimate to £[✂]m, but would leave our longer term VR estimate unchanged at £[✂]m.

Benefit sharing costs

307. RM has not estimated benefit sharing costs for this or any other scenario.

308. As noted in the introduction section above, however uncertain these costs are, we believe that they should receive some consideration. [✂].

Scope of change

309. The scope of the change is relatively broad, affecting local distribution staff and delivery staff (who would see all work delayed by two hours), and to a lesser extent, inward processing staff (who would see some duty re-organisation to cater for later arrivals from the network). The Restructuring Plan model indicates a total of [✂] full time staff in local distribution, [✂] full time staff in delivery, and [✂] full time staff in inward processing in 2015/16, suggesting that payments might be required to [✂] staff.

310. Collections and outward processing staff would see no real changes. Road network staff would see a modest net increase in work. The impact on air network staff is considered above under VR.

[172] As detailed in Scenario A

Scale of change

311. In our view, the scale of change among delivery staff is significant. The great majority of delivery duties, except perhaps for some rural duties, would have to start two hours later, and such a move could easily meet strong resistance. Full time employees may dislike such late finishes; a substantial proportion of these employees see relatively early finishing hours as an attraction. Part time staff (about one quarter of the delivery workforce, and likely to be increasingly important to efficiency in the longer term), who currently find the hours attractive as they fit well with their home commitments, may no longer find this to be the case.

312. [✂]

Illustrative impact

313. A one-off payment of say £[✂] per affected staff, paid to [✂] staff, might result in a total benefit sharing cost of £[✂]m.

314. We stress that this cannot be relied on as an estimate of the likely level of benefit sharing costs; however it can at least serve as an illustrative benchmark of the potential scale of such costs.

315. Regardless of the reliability of the benchmark, we feel that the issue requires very careful consideration, given the relatively modest cost savings associated with this scenario and the possibility of strong resistance.

Alternative delivery times

316. The estimated cost savings considered above assume a two hour delay to final delivery times. Clearly, a shorter or longer delay could cause these estimates to change.

317. Estimating the impact of alternative delays on network costs would be a complex exercise. RM has, however, estimated that no further flight savings would result from a further hour's delay[173].

318. A longer inward processing window might allow the proportion of walks sequenced to rise above the [✂]% we estimate above. However the increase may be modest if a significant proportion of the remaining [✂]% are not sequenced because doing so would be uneconomic, regardless of time constraints.

319. Any savings in respect of redelivery costs would also be affected, particularly if deliveries were retarded to 18:00 or beyond.

[173] Page 28, RM 03.05.12 submission

Scenario C1: Lower 1c quality of service based on "low cost network"

Summary of scenario

320. This scenario involves relaxing the current 1c service specification by around [✂]%, which would allow the air network to be closed, in addition to the later delivery times under Scenario B. Quality of service reductions under this scenario would be highly uneven, with [✂] particularly affected.

321. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 31 - Scenario C1: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

322. Relative to Scenario B, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs from relaxing the 1c service specification:

Table 32 - Scenario C1: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

323. The cost savings are based on replacing all air connections with surface connections. There is no doubt that this would generate appreciable cost savings, at the cost of a poorer quality of service. It is for Ofcom to judge whether the cost savings are of a sufficient scale in the context of the significant regional impact of the changes.

324. A reduction in 1c quality of service could have negative commercial effects, prompting increased switching from 1c to 2c mail and/or reduced 1c volumes. These would reduce the net benefit of the scenario, but have not been evaluated in our analysis.

325. RM's estimated cost savings are based on a [✂]% reduction in quality of service for Special Delivery, which also relies on the air network. It might, for commercial reasons, choose to retain Special Delivery quality of service, in which case the incremental annual cost saving would halve.

326. In our view, the incremental cost savings estimated by RM are broadly reasonable. We do, however, think that VR costs are a little on the high side.

Details of change

327. Scenario C1 involves relaxing the current 1c service specification, such that next day (Day B) delivery is only provided where possible using a "low cost" surface network, and remaining 1c "distant" mail is delivered on Day C. Under Scenario C1 the entire air network would be removed, and replaced with road services as required.

328. RM has clarified that 1c distant mail would continue to be processed with the rest of 1c mail at the outward MC on the evening of Day A; but [✂]. 1c distant mail and 2c mail would then be processed together at the inward MC[174].

329. Under this scenario, RM estimates that the proportion of 1c mail with access in principle to next day delivery would fall from [✂]% to [✂]% on a national basis[175]. However, the impact would be uneven. RM estimates that of the six Postcode Areas which cover all of [✂] and much of [✂], five would receive next day delivery coverage for less than [✂]% of mail, and the sixth for less than [✂]% of mail[176]. While these six areas represent only [✂]% of mail, it is clearly possible that those customers and communities affected would voice strong concerns.

330. The existing 1c service standard, with [✂]% of mail having access to next day delivery in principle, is 93% for next day delivery in practice[177]. RM does not provide an estimate of a revised target for this scenario, but given a [✂]% reduction in the proportion of mail having access to next day delivery, a matching [✂]% reduction, bringing the service standard down to 88%, would seem a reasonable working hypothesis. We note, however, that FE estimated that removal of the air network would cause [✂] falls in quality of service: 8% for stamped and metered mail, and 14% for PPI mail[178].

[174] Page 34, RM 03.05.12 submission
[175] Page 24, RM 30.03.12 submission
[176] The six Postcode Areas are [✂]. Page 24, RM 30.03.12 submission.
[177] The service standard is 93% for stamped and metered mail, and 91% for PPI and pre-sort mail (source: RM website as at 11.05.12).
[178] FE estimates a fall in stamped and metered quality of service from 94% to 86%; and a fall in PPI quality of service from 93% to 79% (page 47, FE 2008 report).

331. FE's estimates also give more of an indication of regional variations in quality of service reductions, indicating a significant impact in some major commercial centres such as Edinburgh:

Table 33 - Scenario C1: Quality of service reductions

Quality of service reductions for 1c mail delivered in[179]	Stamp, Meter	PPI
Birmingham	2%	8%
Bristol	4%	14%
Newcastle	19%	26%
London	4%	8%
Edinburgh	31%	70%
Cardiff	8%	19%
Belfast	30%	65%

332. It may therefore be appropriate to get further details of quality of service implications should this scenario be considered further.

333. Removal of the air network would mean that RM would no longer be able to offer a nationwide Special Delivery Next Day service. The specification would fall from [✂]% by 1pm, to [✂]% by close of business. International quality of service would also fall[180]. Both falls could be reversed by reintroducing some flights, at a cost.

334. It appears that the scenario would not have a material effect on 2c mail, which would remain a Day C/D service[181].

335. RM has based its analysis of Scenario C1 on a two hour later final delivery time, as set out in Scenario B[182]. We have considered Scenario C1 on that basis. Where possible, we avoid repeating points made in relation to Scenario B, and focus on the incremental impact of Scenario C1 over Scenario B.

336. We note that an alternative approach to Scenario C1 would be to retain the existing final delivery time. This could deliver a similar scale of cost saving and avoid some of the potential industrial relations issues identified under Scenario B, but the proportion of mail achieving Day B delivery would be further reduced by around [✂]% from that estimated above[183].

Operational rationale for change

337. There is no doubt that replacing all air connections with surface connections would generate appreciable cost savings, at the cost of a poorer quality of service. It is for Ofcom to judge whether the cost savings are of a sufficient scale in the context of the significant regional impact of the changes and likely adverse customer and community reaction. A reduction in 1c quality of service could have negative commercial effects, prompting increased switching from 1c to 2c mail and/or reduced 1c volumes, particularly if major commercial centres such as Edinburgh are affected as significantly as FE's analysis suggests. These would reduce the net benefit of the scenario.

[179] Page 43, FE 2008 report
[180] Pages 24 to 25, RM 30.03.12 submission
[181] Pages 24 to 25, RM 30.03.12 submission
[182] Page 24, RM 30.03.12 submission
[183] Page 20, RM 30.03.12 submission

338. RM has explained that its approach to this scenario would see MC processing and despatch timings essentially unchanged, with the exception that [✂]. This probably maximises the cost savings from this scenario.

339. It would be possible to adopt an alternative approach, which sought to reduce the quality of service reductions resulting from removal of the air network, with features such as [✂] for distant 1c mail (similar to those see under Scenario B) and the flexing of inward processing operations on the morning of Day B. Such an approach would improve quality of service levels relative to those under RM's approach, and reduce some of the adverse customer and commercial consequences of a reduced quality of service. However, it would have cost implications, and reduce the savings available from this scenario.

Interaction with Special Delivery

340. [✂]. If [✂], RM would no longer be able to provide a 99% nationwide guarantee of next day delivery for the Special Delivery product.

341. RM might, from a commercial perspective, wish to retain this guarantee. On RM's estimate, this would re-introduce between £[✂]m and £[✂]m of the costs saved[184]. This would reduce the estimated cost saving associated with the reduction in 1c quality of service under this scenario to:

a) between £[✂]m and £[✂]m on a stand-alone basis; and

b) between £[✂]m and £[✂]m if considered as an incremental change to Scenario B.

342. These savings might be considered small, particularly on an incremental basis, given the potential scale of customer concerns and commercial effects arising from the reduction in 1c quality of service. The rationale for Scenario C1 might therefore be significantly weaker if RM were to retain the Special Delivery service standard.

343. This implies that RM could decide, on a commercial basis, to retain the air network for both 1c and Special Delivery, and the existing 1c quality of service, even if it was no longer required to do so by the USO.

Cost savings

344. In this section we consider RM's estimates of cost savings, assuming no re-introduction of air services to retain existing Special Delivery and international quality of service. The costs of such re-introduction are considered in a separate section below.

[184] Page 25, RM 30.03.12 submission. We assume that such re-introduction would not mitigate the loss in 1c quality of service.

345. RM estimates total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base, principally from savings in network costs. We estimate that a similar scenario considered by FE, "Reduce 1st class QoS to 85%", generates a rolled forward estimate of £90m:

Table 34 - Scenario C1: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)		Cost savings (%)	
		RM s55	FE[185]	RM s55	FE
Collections	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

346. Relative to Scenario B, RM's estimates imply incremental savings from Scenario C1 of £[✂] [✂]m, or [✂]% of the 2015/16 cost base, [✂]:

Table 35 - Scenario C1: Incremental cost savings

Scenario C1 v B 2015/16	Cost base (£m)	Cost savings (£m)		Cost savings (%)	
		RM s55	FE[186]	RM s55	FE
Collections	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

[185] Rolled forward and excluding volume effects, as described in the Introduction section
[186] Rolled forward and excluding volume effects, as described in the Introduction section

Mail Centres

347. Relative to Scenario B, Scenario C1 sees no significant change to MC operations, as described by RM. The change in 1c distant despatch would cause 1c volumes processed at the inward MC during the second half of the Day A/Day B night shift to be slightly lower, and 1c volumes processed during the first half of the Day B/Day C night shift to be slightly higher. However, as the night shift would infill with other on hand traffic, e.g. 2c for Day C delivery, the change simply rebalances traffic volumes overall.

348. As noted above, an alternative approach would be to minimise the quality of service reduction associated with this scenario by flexing inward processing operations to allow for the later arrival of some distant 1c mail during the Day A/Day B night shift. This would however create a later peak in arrivals during that shift, which would be likely to introduce additional costs in the MCs, and potentially reduce the level of walk sequencing, which would introduce additional costs in indoor delivery.

Network

349. RM estimates total network savings of £[✂]m[187]. Relative to Scenario B, this implies incremental savings from Scenario C1 of £[✂]m:

Table 36 - Scenario C1: Network cost savings

£m	Scenario B	Incremental	Scenario C1
Total air network savings	[✂]	[✂]	[✂]
Net saving in/(cost of) road network	[✂]	[✂]	[✂]
Pro-rata indirect saving in staff other costs	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

Removal of air network costs

350. Air network savings arise from [✂].

351. RM estimates total air network savings of £[✂]m. Relative to Scenario B, this implies incremental savings from Scenario C1 of £[✂]m:

Table 37 - Scenario C1: Air network cost savings

£m	Scenario B	Incremental	Scenario C1
Air contracts	[✂]	[✂]	[✂]
Airport handling and screening staff	[✂]	[✂]	[✂]
Airport site costs	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

352. In principle one would expect these estimates to be reliable, as costs should be easy to identify with no need for [✂]. We note also that [✂].

[187] The savings are summarised in the Illustrative RFI Cost model and detailed in the "Scenario C1 Illustrative Network savings" spreadsheet

Impact on road network costs

353. RM estimates a net saving of £[✂]m in road and rail network costs. Relative to Scenario B, this implies incremental savings from Scenario C1 of £[✂]m:

Table 38 - Scenario C1: Road network cost savings

£m	Scenario B	Incremental	Scenario C1
Avoided airport feeder runs	[✂]	[✂]	[✂]
Less: replacement links for air contracts	[✂]	[✂]	[✂]
Net additional (cost) / saving	[✂]	[✂]	[✂]
Less: additional cross-docking costs	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

354. RM's estimate of avoided airport feeder run costs is based on a detailed journey by journey analysis[188], similar to that provided for Scenario B. The relationship between the two estimates also appears reasonable. As noted in Scenario B, RM estimates that involves around [✂]% of mail currently sent by air. Scaling up the Scenario B estimate to [✂] suggests an incremental avoided cost of £[✂]m, compared with the £[✂]m suggested by RM.

355. In contrast, RM's estimate of replacement road costs is based on a high level calculation which multiplies the [✂] daily traffic conveyed via airports, by an average daily cost per FYE for road transportation of £[✂].

356. The replacement road cost calculation assumes [✂] daily traffic of [✂] FYE, but this does not appear consistent with the figure of [✂] FYE assumed in generating the [✂]% estimate under Scenario B. The latter figure would suggest a replacement cost of £[✂]m rather than £[✂]m.

357. The assumed cost of £[✂] per FYE in the replacement road cost calculation is significantly lower than the effect average cost per FYE of over £[✂] under Scenario B[189]. The two are not directly comparable, since the former should reflect the incremental cost of [✂], whereas the latter should reflect the stand alone cost of shorter distant 1c volumes on new night-time 1c road links. Therefore we have no reason to doubt the £[✂] assumption.

358. We are conscious that a replacement road cost estimate of £[✂]m or £[✂]m is significantly lower than previous estimates under similar scenarios:

a) [✂]; and

b) KPMG estimated increase in road transport costs of £[✂]m[190].

359. However, much of this difference might be due to the significantly lower volumes of end to end mail forecast for 2015/16.

[188] Scenario C1 Illustrative Network savings
[189] A £[✂]m cost for [✂] FYE ([✂]) suggests an annual cost of £[✂] per FYE per year. Assuming [✂] days per year (since flights only operate five nights out of six), this equates to £[✂] per FYE per day.
[190] 7.2.2, KPMG 2009 report

Conclusion on cost savings

360. In our view, RM's estimated incremental cost savings of £[✂]m from Scenario C1, relative to Scenario B, appear broadly reasonable.

VR costs

361. RM estimates total VR costs of £[✂]m. Relative to Scenario B, this implies incremental VR costs from Scenario C1 of £[✂]m:

Table 39 - Scenario C1: VR costs

£m	Scenario B	Incremental	Scenario C1
Airport staff cost reductions	[✂]	[✂]	[✂]
Road network staff cost reductions	[✂]	[✂]	[✂]
Delivery staff cost reductions	[✂]	[✂]	[✂]
Total staff cost reductions	[✂]	[✂]	[✂]
VR multiplier	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

362. As with Scenario A, RM's estimate assumes that [✂] staff cost savings are achieved through VR, and that [✂] staff costs are saved through reductions in overtime, redeployment in other parts of the business, or natural attrition.

363. We focus below on the estimated incremental VR costs of £[✂]m.

Overtime opportunities

364. It may be possible to achieve some of the staff cost savings identified in the road network through reductions in overtime. In Scenario A, we note that RM had previously estimated that, in relation to a saving of the order of [✂]% in collections staff costs, [✂]% could be achieved through reductions in overtime. The proportionate saving in road network staff is much smaller, at only [✂]% of annual staff costs[191].

Redeployment opportunities and natural attrition

365. As discussed in Scenario A, assuming no reduction in the need for VR to reflect redeployment opportunities and natural attrition may be reasonable in the short term.

366. In the longer term, however, the need for VR might be substantially lower.

367. The information provided by RM indicates a total of [✂] airport staff[192]. RM's estimate assumes that [✂]. This does not seem to be a reasonable assumption.

368. [✂]. A relatively long lead time is likely to be necessary to plan and prepare for the network changes, which should help this process.

369. [✂].

370. In the light of these considerations, it might be possible to redeploy at least [✂].

[191] Excluding the cost of airport staff
[192] Staffing Impact, Scenario B Illustrative Network savings

371. It seems unlikely that VR would be required at all for road network staff, given the very modest impact on road network staff costs ([✂]% of annual staff costs) and natural attrition rates of the order of [✂]%[193]. This would reduce incremental VR costs by £[✂]m, from £[✂]m to £[✂]m.

Conclusion on need for VR

372. In the short term, some reduction in VR may be available through reductions in road network overtime. If a 50% reduction in road network VR was possible, in line with collections VR in Scenario A, that would reduce incremental VR costs from £[✂]m to £[✂]m.

373. In the longer term, it seems unlikely that any VR would be needed in road network staff, and that VR in respect of airport staff could be reduced through redeployment. Assuming that [✂]% of the airport staff cost saving would require VR would reduce incremental VR costs from £[✂]m to £[✂]m.

Benefit sharing costs

374. RM has not estimated benefit sharing costs for this or any other scenario.

375. As noted in the introduction section above, however uncertain these costs are, we believe that they should receive some consideration. [✂]

376. Considered on an incremental basis to Scenario B, the scope and scale of change are both likely to be small, since the principal additional impact would be on air network staff, considered under VR above.

377. We would not expect a significant incremental benefit sharing cost, relative to Scenario B.

Special Delivery Next Day and International

Impact on service specification

378. Removal of the air network would mean that RM would no longer be able to offer a nationwide Special Delivery Next Day service. The specification would fall from 99% by 1pm, to [✂]% by close of business.

379. International quality of service would also fall, by [✂]% for incoming mail, and [✂]% for outgoing mail[194]. RM has explained that following such falls, it would no longer be able to achieve current quality of service targets and would have to negotiate new targets with the Universal Postal Union ("UPU") and with the counterparties in its bilateral terminal dues agreements[195].

380. It seems quite possible that these negotiations would have financial implications on costs and/or revenues (through penalties in terminal dues agreements), but it is not clear what these would be.

[193] As detailed in Scenario A
[194] Pages 24 to 25, RM 30.03.12 submission
[195] Pages 27 to 29, RM 03.05.12 submission

Cost of avoiding impact

381. RM indicates that national next day coverage for Special Delivery and incoming international mail could be retained by [✂]. It estimates these would reduce savings by £[✂]m to £[✂]m[196].

382. We do not have any details underlying these cost estimates, but note that unlike RM's other cost estimates, the range does not appear to be the product of a +10% / -30% margin of error assumption. It may therefore be that the range reflects different levels of next day coverage.

383. The reduction in savings equates to the reversal of between 31% and 44% of total estimated network savings of £[✂]m. FE estimated that retaining Special Delivery coverage would add back costs of between £[✂]m and £[✂]m[197], between 28% and 67% of total estimated network savings of £[✂]m. However, we do not know whether the assumed levels of retained next day coverage are comparable.

[196] Page 25, RM 30.03.12 submission
[197] Page 46, FE 2008 report

Scenario C2: Lower 1c quality of service based on "intra MC" standard

Summary of scenario

384. This scenario involves relaxing the current 1c service specification much further to less than [✂]% next day delivery, based on next day delivery for mail posted and delivered within the same MC catchment area, and a reduction of the MC network from the [✂] MCs assumed at the end of the Restructuring Plan in 2015/16 to [✂] MCs.

385. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 40 - Scenario C2: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

386. Relative to Scenario C1, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs from further relaxing the 1c service specification:

Table 41 - Scenario C2: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

387. In principle, an intra MC 1c quality of service has some operational logic. Network costs would be reduced and MCs might be able improve efficiency with revised operational workplans, but it is not obvious that savings would be dramatic.

388. From an operational perspective, there seems to be no essential reason for further rationalisation beyond the [✂] MCs assumed in the Restructuring Plan, particularly if those [✂] MCs are of sufficient scale to achieve high levels of automation. However, with that many MCs, intra MC next day delivery would be limited to only a fraction of 1c mail, perhaps [✂]% or so. The further consolidation suggested by RM from [✂] to [✂] would therefore seem to be driven as much by a commercial need to raise the next day delivery proportion to an acceptable level as by the operational savings that would entail. Having said that, further consolidation should enable some further operational savings.

389. The customer and commercial implications of such a change could be far reaching. Significant loss of 1c volumes and switching to 2c volumes could be expected. This switching could well be exacerbated by the operational realities of the underlying arrangements, which could result in little meaningful advantage in the quality of service advertised for 1c mail over that achieved in practice for 2c mail. Maintaining that advantage would reduce available cost savings. Together with high transition costs, this could easily make the change commercially unviable.

390. From a pure operational perspective, however, we think that operational benefits could be greater than those estimated by RM, as a result of additional cost savings in collection and in MCs. We also believe that transition costs are likely to be overstated, since RM's estimate of VR costs assumes [✂], despite the need for significant additional staff at remaining MCs, and contrary to recent experience of MC consolidations.

391. We are conscious, however, that the largest single component of RM's estimate, site cost savings of £[✂]m, appears to lack adequate justification. It is not obviously unreasonable, but the limited information we have give us some concern that a more detailed analysis could yield a significantly different figure.

392. The analysis above takes no account of potential benefit sharing costs. In our view, these could be material. MC staff would be fundamentally affected by the changes, and [✂]. [✂]

Details of change

393. Scenario C2 involves relaxing the current 1c service specification, such that next day (Day B) delivery is only provided for mail posted within the catchment area of the outward MC, and remaining 1c mail is delivered on Day C. Under Scenario C2, in addition to the removal of the entire air network envisaged under Scenario C1, there would be a further consolidation of the MC network, beyond that envisaged in the Restructuring Plan, from [✂] to [✂] MCs.

394. RM has clarified that under this scenario, all mail would be outward processed overnight. All intra MC mail would also be inward processed overnight, and all inter MC mail despatched on the morning of Day B. Bulk mail and access mail would be inward processed during the day on Day B, and inter MC mail would be inward processed overnight on Day B/C and (if necessary for 2c mail) on Day C/D[198].

395. RM estimates that the proportion of 1c mail with access in principle to next day delivery would fall from [✂]% to [✂]% on a national basis[199], reflecting the estimated proportion of mail that would be posted and delivered within the same MC catchment area in the hypothetical consolidated MC network[200].

[198] Page 41, RM 03.05.12 submission
[199] Page 26, RM 30.03.12 submission
[200] Page 42, RM 03.05.12 submission

396. The existing 1c service standard, with [✂]% of mail having access to next day delivery in principle, is 93% for Day B delivery in practice[201]. RM does not provide an estimate of a revised target for this scenario, but it would seem likely to be below [✂]%.

397. This would be a dramatic change to the 1c quality of service specification. RM confirms that at this stage, it has not attempted any evaluation of the impact of such a change on customers. In addition to the overall reaction to the change, any evaluation should consider how well customers would understand the area covered by an expectation of next day delivery.

398. On the other hand, unlike Scenario C1, there is a consistent approach adopted in Scenario C2 that does not produce such unequal outcomes for certain Postcode Areas. It is possible that customers would understand and accept the logic that relatively local addresses would receive delivery before more distant addresses.

399. RM states that under this scenario, Special Delivery and inward international mail would have specifications similar to those under Scenario C1. Outward international quality of service would fall to below that under Scenario C1[202] (considered further below).

400. In principle, it appears that the scenario would not have a material effect on 2c mail, which would remain a Day C/D service[203]. In practice, however, as discussed below, much intra MC 2c mail might end up being delivered on Day B.

401. RM has based its analysis of Scenario C2 on a two hour later final delivery time, as set out in Scenario B, and on removing the air network, as set out in Scenario C1. We have considered Scenario C2 on that basis. Where possible, we avoid repeating points made in relation to Scenarios B and C1, and focus on the incremental impact of Scenario C2 over Scenario C1.

402. We note that an alternative approach to Scenario C2 would be to retain the existing final delivery time. This could deliver a similar scale of cost saving and avoid some of the potential industrial relations issues identified under Scenario B. It is not clear what the effect on quality of service would be, but as noted above, RM estimates that the proportion of mail achieving Day B delivery would be further reduced by around [✂]% in the case of Scenario C1.

Operational rationale for change

403. In principle, an intra MC 1c quality of service has some operational logic. Network costs would be reduced and MCs might be able improve efficiency with revised operational workplans, but it is not obvious that savings would be dramatic.

404. From an operational perspective, there seems to be no essential reason for further rationalisation beyond the [✂] MCs assumed in the Restructuring Plan, particularly if those [✂] MCs are of sufficient scale to achieve high levels of automation. However, with that many MCs, intra MC next day delivery would be limited to only a fraction of 1c mail, perhaps [✂]% or so. The further consolidation suggested by RM from [✂] to [✂] would therefore seem to be driven as much by an attempt to raise the next day delivery proportion to a commercially acceptable level by increasing the intra MC catchment area, as by the operational savings that would entail. Having said that, further consolidation should enable some further operational savings.

[201] The service standard if 93% for stamped and metered mail, and 91% for PPI and pre-sort mail (source: RM website as at 11.05.12).
[202] Pages 26 to 27, RM 30.03.12 submission
[203] Page 26, RM 30.03.12 submission

405. While the incremental cost savings associated with Scenario C2, compared with Scenario C1, are not obviously dramatic, the same cannot be said of the incremental loss in 1c quality of service. This would fall from 93% next day to less than [✂]% next day. A reduction of this magnitude in 1c quality of service would be likely to have significant negative commercial effects, prompting increased switching from 1c to 2c mail and/or reduced 1c volumes. These would clearly reduce, and could conceivably reverse, the net incremental benefit of the scenario.

406. The possibility of down trading from 1c to 2c mail could be exacerbated by operational realities. Although 2c mail currently operates to a Day D service standard, in practice much 2c mail is delivered before Day D. FE reported that in 2006/07, over 90% of 2c mail was delivered by Day C[204]. From an operational standpoint, it is not clear that this performance would necessarily worsen under Scenario C2 for inter MC mail. RM envisages despatching 1c and 2c inter MC mail together, and inward processing 1c and 2c mail during the same operational window. It states that the two classes would be kept in separate containers which would allow 1c to be prioritised for inward processing, but this would not prevent 2c mail being processed for Day C delivery[205]. Moreover, as discussed below, we think that day to day operational realities of processing 1c and 2c intra MC mail side by side, as apparently envisaged by RM, might result in much intra MC 2c mail being delivered on Day B.

407. This raises the possibility that there would be little difference between the advertised quality of service of 1c mail, and the effective quality of service of 2c mail. If and when it were to become known that 1c mail provided little meaningful quality of service advantage over 2c mail, the commercial implications would be profound.

408. It would be possible to maintain a distinction between 1c and 2c quality of service, but this would have significant cost implications, due to the stop-start nature of resulting operations, as considered further below.

409. The risk that commercial effects could negate operational savings implies that RM could decide, on a commercial basis, to continue the higher 1c quality of service standard implied by Scenario C1, even if it was no longer required to do so by a USO which only mandated the quality of service standard assumed for Scenario C2.

[204] Page 48, FE 2008 report
[205] Page 42, RM 03.05.12 submission

Cost savings

410. RM estimates total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base. FE did not consider a similar scenario, so no direct comparison is possible.

Table 42 - Scenario C2: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)	Cost savings (%)
Collections	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

411. Relative to Scenario C1, RM estimates incremental cost savings from Scenario C2 of £[✂]m, or [✂]% of the 2015/16 cost base. All of this saving is attributable to the further consolidation of the MC network, from [✂] to [✂] MCs. Although FE did not consider a similar scenario to C2, it did estimate savings of £[✂]m from consolidation of the MC network in the context of a scenario involving a single class of mail, and we use that estimate as a comparator to RM's incremental saving estimate:

Table 43 - Scenario C2: Incremental cost savings

Scenario C2 v C1 2015/16	Cost base (£m)	Cost savings (£m)		Cost savings (%)	
		RM s55	FE[206]	RM s55	FE
Collections	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

412. As an overall cross check, we note that the Restructuring Plan identifies annual cost savings of £[✂]m as a result of the reducing the number of MCs by [✂], from [✂] to [✂][207]. This matches the £[✂]m incremental saving estimated under Scenario C2, which involves a further reduction of [✂] MCs, from [✂] to [✂].

413. The majority of the incremental cost savings identified by RM under Scenario C2, £[✂]m out of £[✂]m, and all of the £[✂]m cost savings identified by FE, relate to site cost savings rather than processing productivity improvements. The remaining £[✂]m of RM incremental savings results from:

a) a £[✂]m saving from improved MC productivity; plus

b) a £[✂]m saving from reduced network costs; less

c) an additional £[✂]m of collections and local distribution costs.

414. We note that the £[✂]m estimate is based on RM's analysis of previous MC closures.

[206] Rolled forward and excluding volume effects, as described in the Introduction section
[207] Slide 52, RM Restructuring Plan

Collections

415. RM estimates additional collection costs of £[✂]m, based on additional collection costs of £[✂] for each of the [✂] MC closures. It states the £[✂] figure is "*based on analysis of previous business major MC cases*" [208].

416. We asked RM for supporting analysis linked to recent MC closures, but it stated it was unable to provide such details[209]. The basis of the £[✂] figure therefore remains unclear.

417. The £[✂] equates to around £[✂] per day[210], equating to around [✂] hours of collections time[211]. As the direct impact of consolidation, this seems rather low to us, representing maybe [✂] trips to bring in the entire collection proceeds from a former, and likely to be rather substantial (as one of the [✂] remaining at the end of the Restructuring Plan), MC. We would suggest that twice as many trips might be needed, suggesting additional costs of double the assumed level, at around £[✂]m.

418. On the other hand, we note that RM envisages a much later start to outward processing under this scenario. It estimates that the outward processing window (for 1c mail) would move from 12:00/22:00 to 21:30/06:10, as discussed further below. This should enable savings in collection costs, as a result of reductions in the number of relief collections required.

419. It is not clear that RM's estimate takes any account of these savings; its reference to previous MC cases suggests it has not. It is difficult to estimate potential savings without detailed modelling of machine capacities to ensure that the front end of the outward processing operation does not become a bottleneck. Moreover, as noted by RM, it would not be possible to remove relief collections entirely, due to space constraints at some customer premises and POL sites[212].

420. As a broad indication, it is possible that the number of relief collections could be halved. Associated cost savings are uncertain. We note that FE estimated that reducing relief collections from three or four to one or two could save around £44m[213]. However, it would appear from RM's internal November 2010 presentation that the Restructuring Plan already reflects a £[✂]m benefit from reduced relief collections and other optimisation measures[214]. This suggests a residual opportunity of the order of £[✂]m; assuming half of this could be saved would equate to a saving of around £[✂]m.

421. Considering consolidation and the revised outward processing window together suggests net cost savings in collection could be around £2m, as opposed to RM's estimate of an increase in collection costs of £[✂]m.

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[208] Illustrative RFI Cost model
[209] Page 44, RM 03.05.12 submission
[210] Assuming [✂] collection days per year
[211] Assuming [✂]% of the £[✂] relates to staff costs, as per RM's estimate, this equates to [✂] staff hours at an hourly rate of £[✂], as per Scenario A.
[212] Page 50, RM 03.05.12 submission
[213] Pages 124 and 136, FE 2008 report
[214] Slide 8, *Collection Strategy Review, Post Boxes, Ops Exec strategy meeting*, RM, 15.11.10

Mail Centres

422. RM estimates incremental MC savings, relative to Scenario C1, of £[✂]m[215]:

Table 44 - Scenario C2: Incremental MC cost savings

Scenario C2 v C1	£m
Staff costs[216]	[✂]
Site costs	[✂]
Total	[✂]

Staff costs

423. Total MC staff costs[217] are forecast at £[✂]m in 2015/16. RM estimates a reduction from [✂] to [✂] MCs, which implies that some [✂]% of work ([✂] out of [✂] MCs), equivalent to £[✂]m of staff costs, would be transferred from closed MCs to the remaining MCs. RM estimates, "*based on analysis of previous MC closures*", that [✂]% of these transferred costs could be saved, leading to a savings estimate of £[✂]m.

Savings arising from consolidation

424. We asked RM for supporting details linked to recent MC closures. It provided an analysis of a regional rationalisation from 6 to 2 MCs, showing a [✂]%[218] real terms reduction in total staff costs over a three year period. We estimate this equates to a reduction in transferred costs of at least [✂]%[219].

425. RM states that these savings reflect not only consolidation but also changes in traffic volumes and significant non-consolidation related efficiency improvements over the period, and that it would not be appropriate to attribute the entire reduction to consolidation[220]. It has not, however, explained how its consolidation estimate of [✂]% has been derived.

426. We accept, for the reasons advanced by RM, that it would not be appropriate to apply the empirically experienced [✂]% directly to a future consolidation. We also accept that the [✂]% is derived from a single observation, and that had RM been able to supply details of other consolidations (e.g. Thames valley or South Midlands[221]), they might have suggested different cost reductions. Nevertheless, given this empirical evidence, we are concerned that RM's [✂]% estimate remains unexplained.

427. We would in general expect "absorption" savings of this nature, and of this order of magnitude, due to transferred work volumes being able to take advantage of fixed cost processes in the receiving MC. However, we note that the savings estimate has been applied to all staff costs, including both frontline staff costs and manager and support costs. A separate consideration of those elements suggests that [✂]% might be an understatement.

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[215] Illustrative RFI Cost model
[216] Including pro-rata indirect saving in "staff other costs" of £2m
[217] Including "staff other costs"
[218] Reported staff costs fell by [✂]% from £[✂]m in 2008/09 to £[✂]m in 2011/12 in nominal terms (pages 43 to 44, RM 03.05.12 submission). RPI averaged 214.8 in 2008/09, and 237.3 in 2011/12 (source: Office for National Statistics), suggesting a [✂]% fall in real 2011/12 prices, from £[✂]m in 2008/09 to £[✂]m in 2011/12.
[219] Pre consolidation costs were, in real terms, £[✂]m across [✂] MCs. [✂] MCs were closed (net), which would equate to the transfer of £[✂]m of costs if all MCs were of a similar size, or £[✂]m if the closed MCs were say half the size of the remaining MCs. Costs fell by £[✂]m, from £[✂]m to £[✂]m, equating to a saving in transferred costs of [✂]% of £[✂]m or [✂]% of £[✂]m.
[220] Page 43, RM 03.05.12 submission
[221] Page 56, FE 2011 review of Strategic Plan

428. The Restructuring Plan model indicates that [✂]% of 2015/16 MC staff costs relate to frontline staff, and [✂]% to manager and support staff[222]:

a) For frontline staff, based on our experience, we would expect absorption opportunities of the order of 10%.

b) For manager and support staff, we would expect a much greater saving in transferred costs. Many of these costs are relatively fixed, per MC: for example, MC managers, shift managers, resourcing managers, and support staff producing traffic forecasts, performance data, automation plans for sorting selections, etc. Some costs would need to be re-invested in the remaining MCs, but a conservative estimate would be that 50% of transferred costs would be saved.

c) Applying a weighted average across both cost elements would suggest a total saving opportunity of [✂]%,[✂]% above the [✂]% estimated by RM. An [✂]% estimate is still well within the envelope suggested by the empirical evidence supplied by RM, and would suggest a staff cost saving of £[✂]m, £[✂]m above RM's estimate of £[✂]m.

429. We note that when FE considered savings available from MC consolidation in 2008, it did not estimate any absorption savings, noting:

"*Historically, Royal Mail has had difficulty extracting economies of scale in mail centres – its large ones tend to be more inefficient – but substantial changes in working practices and larger sites could provide the impetus needed.*" [223]

430. More recently however, FE's 2011 review of RM's Strategic Plan acknowledged the delivery of material benefits from recent MC consolidation[224]. That plan identified savings of £[✂]m per year as a result of the rationalisation from 59 to [✂] MCs, predominantly based on staff cost savings[225], equating to a saving of £[✂]m per closed MC. By comparison, RM's staff cost saving estimate for Scenario C2 equates to £[✂]m per closed MC, and our revised estimate to £[✂]m per closed MC.

431. In addition to the opportunities identified above, we believe that consolidation could in theory provide further opportunities for higher degrees of automation. In particular, RM has confirmed that under the Restructuring Plan, only [✂] of the [✂] MCs would be equipped with automated flat sorters[226], and only [✂] of the [✂] MCs would be equipped with automated packet sorters[227]. Under Scenario C2, with further MC consolidation, all MCs would be equipped with automated flat and packet sorters. Moreover, larger MCs could allow greater use of peripheral equipment such as conveyors. RM has acknowledged that this could in principle give rise to further savings, but has suggested they would not be significant in the case of flats, and has not evaluated the other aspects of the opportunity[228].

[222] The Restructuring Plan model shows total MC frontline staff costs of £[✂]m (rows 115 and 208, Staff – totals, SPM PCR4v3.xls), and total MC manager and support costs of £[✂]m (rows 518 and 622, Staff – totals, SPM PCR4v3.xls).
[223] Page 56, FE 2008 report
[224] Page 56, FE 2011 review of Strategic Plan
[225] Pages 52 to 54, FE 2011 review of Strategic Plan
[226] Page 26, RM 03.05.12 submission
[227] Page 27, RM 03.05.12 submission
[228] Page 46, RM 03.05.12 submission

432. We are however cautious of assuming the realisation of such savings under this scenario. As discussed below, we think processing arrangements for this scenario are likely to be challenging, and this could put pressure on RM's ability even to maintain existing automation levels. We are therefore wary of assuming that the increased availability of machinery will lead to further savings under this scenario, although we do consider the opportunity under Scenario D below.

Cost implications of revised quality of service

433. Our discussion above only considers those savings which result from consolidating existing operations into fewer MCs. A further apparent limitation with RM's [✂]% estimate is that it does not appear to reflect the impact of changes to MC operations resulting from implementation of the revised intra MC and inter MC quality of service targets, which RM expects to be substantial.

434. RM has clarified that under this scenario, it envisages that all mail would be outward processed overnight. All intra MC mail would also be inward processed overnight, and all inter MC mail despatched on the morning of Day B. Bulk mail and access mail would be inward processed during the day on Day B, and inter MC mail would be inward processed overnight on Day B/C[229].

435. Current arrangements are that the great majority of 2c mail is outward processed during that day on Day B. We therefore expect that a move to outward processing all mail overnight on the night shift, including 2c mail, would lead additional shift allowance costs, which we do not see in the RM submission.

436. It appears to us that RM's plan, under this scenario, to sort all outward mail on the night shift is driven by the later arrivals of collections into a reduced number of MCs, where catchment areas will have [✂]. This, together with volumes, would make achievement of the current 21:30/22:00 despatch no longer possible.

a) RM could try to stay with the principle of outward sorting 1c first, with outward 2c continuing to be sorted on the early shift, and that might have produced a 1c outward despatch time of around, say, midnight to 01:00 in a reduced MC network scenario. However, in order to do this, RM would probably need to move maybe 75% of its late shift staff to something like a 01:00 finish. We can see that this might be very difficult from a resourcing perspective, especially where there is a staff dependence on public transport. Alternatively, RM could keep outward 1c sorting going on the late shift, with late shift workers leaving at their usual finish times, and with a strengthened night shift to finish the 1C outward sorting and despatch. The downside here is in terms of quality and productivity, where a clear target for completion of 1c on the late shift would no longer exist. Likewise, the balance of work on the night shift would be front loaded from 21:40 to, say, 01:00, and this in turn does not lend itself well to resourcing the night shift with a traditional 22:00 to 06:00 style of duty structure.

b) By contrast, the work plan model chosen by RM (i.e. all 1c and 2c outward sorted on the night shift) is relatively straightforward to resource, and keeps a very clear target for completion of all outward sorting by shift end on nights. It would also have a more balanced workload throughout the duration of the shift.

[229] Page 41, RM 03.05.12 submission

437. This rebalancing of work from early and late shift into the night shift is however more expensive, and would lead to increased shift allowance costs. The Way of Working agreement 2001 set out a range of allowances for shift attendance, based on time of day and length of duty[230]. As far as we aware, having reviewed all major agreements since then, that basic framework has remained in place. Our observation of the agreement suggests that, at 2001 levels:

a) early shift staff in MCs are unlikely to qualify for any shift allowance;

b) late shift staff would receive £[✂] per week for finishes between 20:00 and 21:39, and £[✂] per week for finishes between 21:40 and 01:59; and

c) night shift staff, where at least 3 hours were worked between 23:00 and 05:00, would receive £[✂] per week.

438. Based on a very broad desk top analysis and without the benefit of the detailed modelling that would be necessary for a more reliable estimate, in our view each MC could see an increase in night shift staffing of the order 150 FTEs, moved from early and late shifts. At an average shift premium of around £[✂], to reflect a mix from both early shifts and late shifts and wage inflation since 2001[231], this would result in additional costs of the order of £[✂]m across [✂] MCs[232].

439. A further potential cost of the revised MC workplan relates to the separation of 1c and 2c mail. Under current MC arrangements, processing usually focuses on 1c mail during some operational windows, and on 2c mail during others. The timing of the operational windows and inter MC despatches are set so that 1c and 2c mail achieve their respective quality of service targets. Under RM's plan for Scenario C2, 1c and 2c mail would be processed during the same operational window.

440. The simplest operational solution for this traffic would be to process 1c and 2c mail together, without distinction between classes. This would still achieve the 1c quality of service target, but 2c mail would for the most part achieve exactly the same quality of service. As noted above, the commercial implications of this could be profoundly damaging.

441. If RM wished to retain a distinction between 1c and 2c quality of service, it would have to keep the two classes of mail separate during the same operational window.

442. One approach would be for the MCs to run two processing operations in parallel, one for 1c and another for 2c. It is not entirely clear from RM's response, but this may be the approach it envisages under this scenario. It is likely that such an approach would have cost implications in terms of machine capacities, utilisation rates, as running two separate operations in parallel is bound to be less efficient than running a single operation on combined traffic volumes. These are difficult to quantify but could be too great for MCs to bear from day to day on a consistent basis. We suspect that in reality there would be a strong temptation for MCs to abandon the class distinction in the face of pressures to meet daily deadlines and maximise productivity.

[230] Page 58, *Agreements Relating to Working Practices*, BPQ 3.3.23, RM 30.11.10

[231] If we assume 50 FTEs from early shift to night shift, and 100 FTEs from late shift to night shift, at 2001 rates this suggest an average shift premium of 50/150 x £[✂] + 100/150 x (£[✂] - £[✂]) = £[✂]. Assuming 2.5% wage inflation per year for 14 years suggests total wage inflation of [✂]% and an average shift premium of £[✂].

[232] 150 FTEs x £[✂] x 52 weeks x 15 MCs = £[✂]m.

443. An alternative approach would be to sort 1c and 2c mail sequentially, during both intra MC and the separate inter MC operational windows. The benefit of such an approach is that it would be much easier to maintain the class distinction between 1c and 2c. Indeed, the workplan could be actively managed so that the processing of all or some 2c mail was deliberately delayed by one day relative to 1c mail. It is likely that there would still be some blurring between the two classes, as in reality it would be difficult to maintain a strict sequential approach without any parallel running, but it should be possible to maintain a meaningful distinction.

444. However, under either approach a significant risk is inevitably presented by a night shift work plan that requires five key, and potentially overlapping, processes to be completed within the shift (1c outward, 2c outward, 1c intra MC, 2c intra MC, and from Network inward), where resources such as machines and sorting frames are at best alongside each other, or are potentially shared.

Conclusion on staff costs

445. In our view, RM's estimate of a £[✂]m saving in staff costs could understate the benefits of MC consolidation, by some £[✂]m. On the other hand, RM's estimate does not appear to take into account the increased shift costs likely to result from its envisaged work plan, which could cause additional costs of the order of £[✂]m. This suggests to us that staff cost savings could be nearer to £[✂]m than the £[✂]m estimated by RM.

Site costs

446. As noted above, most of the incremental cost savings estimated by RM from Scenario C2 are attributable to assumed MC site cost savings of £[✂]m. RM explains the £[✂]m is based on actual site costs for sites which would potentially close, but that no allowance has been made for additional costs incurred at remaining MCs[233].

447. Site costs for all [✂] MCs total £[✂]m[234], an average of £[✂]m per MC. RM's estimate of £[✂]m for actual site costs of the [✂] closing MCs suggests an average of £[✂]m for those MCs, and £[✂]m for the remaining MCs. It might be that the closing MCs are likely to be smaller than average, but even so the difference in cost seems surprising. Moreover, an assumption that closing MCs are smaller than average would be inconsistent with the approach RM has taken in estimating staff costs, where it is assumed closing MCs are of average size.

448. While these considerations might suggest that £[✂]m could be an understatement of site costs for closed MCs, the disclosure that the estimated cost saving figure does not include additional costs at remaining MCs operates in the other direction. Additional costs could clearly be significant. Existing MCs might need to be extended, some new MCs might need to be built, and additional collection hubs might be required to handle collection of mail from areas where an MC had shut down.

449. We are therefore concerned that the £[✂]m figure provided by RM does not form a robust basis for assessing the cost saving implications of MC closures, or indeed of Scenario C2 more generally.

[233] Page 47, RM 03.05.12 submission
[234] Illustrative RFI Cost model.xls

450. FE did not consider a scenario comparable to Scenario C2, but it did consider the savings available from MC re-optimisation in the context of moving to a single class of mail. FE estimated that under such a Scenario, the number of MCs could fall by 64%, from 69 to 25, resulting in cost savings of 50% of total site costs[235]. By comparison, RM is now suggesting that the number of MCs could fall by [✂]%, from [✂] to [✂], resulting in cost savings of [✂]% of total site costs. FE's estimate might therefore suggest a cost saving of more than the £[✂]m assumed by RM.

451. Therefore, while RM's estimate of £[✂]m is not obviously unreasonable, it does appear to lack adequate justification, which remains a concern given the significance of the cost saving.

Network

452. As with Scenario C1, Scenario C2 assumes that all air network costs are avoided.

453. RM estimates a net saving of £[✂]m in road network costs, £[✂]m more than the saving under Scenario C1. The £[✂]m is estimated by comparing total road and rail costs in the Restructuring Plan of £[✂]m with a green field estimate of costs under Scenario C2 of £[✂]m, so is considered here on a standalone basis rather than as an increment to Scenario C1.

454. The £[✂]m comprises[236]:

Table 45 - Scenario C2: Revised road network costs

	£m
Intra MC	[✂]
Inter MC	[✂]
Special Delivery dedicated	[✂]
Revised RDC feeders	[✂]
Total	[✂]

455. We have no details of the revised intra MC and inter MC road network costs. However, we would expect this scenario to allow material savings in network costs. Currently, MCs typically send three daily despatches (1c main, 1c final, and 2c). Under RM's plans for this scenario, there would be a single daily despatch, including all inter MC 1c and 2c mail, at 08:00. This should facilitate economies of scale by using larger vehicles.

Local distribution

456. RM estimates additional local distribution costs of £[✂]m, based on £[✂] for each of the [✂] MC closures. As with collections, it states the £[✂] figure is "*based on analysis of previous business major MC cases*" [237].

457. We asked RM for supporting analysis linked to recent MC closures, but it stated it was unable to provide such details[238]. The basis of the £[✂] figure therefore remains unclear.

[235] Page 56, FE 2008 report
[236] Scenario C2 and D Illustrative Network savings
[237] Illustrative RFI Cost model
[238] Page 44, RM 03.05.12 submission

458. The £[✂] equates to around £[✂] per day[239], equating to around [✂] hours of local distribution time[240]. Given that [✂] MCs will serve [✂] DOs by the end of 2015/16, each MC has an average of [✂] DOs in its catchment area. Each MC closure will therefore bring another [✂] DOs into its new and extended catchment area. Therefore RM has allocated about [✂] hours per day to service each of these DOs from its inward MC. That is likely to represent maybe [✂] trips per day, assuming that distances are fairly significant. This seems reasonable, given that smaller DOs will require fewer trips, and larger DOs more.

Conclusion on cost savings

459. In our view, RM's estimated incremental cost savings of £[✂]m from Scenario C2, relative to Scenario C1, are likely to be somewhat understated, as a result of additional cost savings in collection of some £8m and in MCs of another £8m. On that basis, cost savings could be nearer to £[✂]m than the £[✂]m estimated by RM.

460. We are conscious, however, that the largest single component of RM's estimate, site cost savings of £[✂]m, appears to lack adequate justification. It is not obviously unreasonable, but the limited information we have give us some concern that a more detailed analysis could yield a significantly different figure.

Transition costs

VR costs

461. RM estimates total VR costs of £[✂]m. Relative to Scenario C1, this implies incremental VR costs from Scenario C2 of £[✂]m:

Table 46 - Scenario C2: VR costs

£m	Scenario C1	Incremental	Scenario C2
MC staff cost reductions	[✂]	[✂]	[✂]
Airport staff cost reductions	[✂]	[✂]	[✂]
Road network staff cost reductions	[✂]	[✂]	[✂]
Delivery staff cost reductions	[✂]	[✂]	[✂]
Total staff cost reductions	[✂]	[✂]	[✂]
VR multiplier	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

[239] Assuming [✂] collection days per year

[240] Assuming [✂]% of the £[✂] relates to staff costs, as per RM's estimate, this equates to [✂] staff hours at an hourly rate of £[✂], as per Scenario A.

462. We focus on the estimated incremental VR costs of £[✂]m. As shown in the table below, VR costs are [✂] relative to estimated savings which are modest, suggesting a discounted payback period of over [✂] years in total. Indeed, if we focus just on comparing staff cost savings with VR costs, [✂]. This implies that [✂].

Table 47 - Scenario C2: Incremental VR costs

RM estimates	Staff costs	Other costs[241]	Total costs
Cost savings (£m)	[✂]	[✂]	[✂]
VR (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

Redeployment opportunities and natural attrition

463. The principal cause of this state of affairs is that RM has assumed [✂].

464. The Restructuring Plan model indicates a total of [✂] staff and managers in MCs in 2015/16[242]. [✂].

465. As noted by RM:

[✂] [243]

466. Since the assumed staff cost saving from consolidation is only [✂]% of transferred costs, and that has to be funded by VR amounting to [✂]% of transferred costs, this is bound to make the proposition relatively unattractive commercially, with an IRR of only [✂]%, compared with an assumed pre-tax cost of capital of [✂]%[244].

467. This is explicitly recognised by RM in its response:

[✂] [245]

468. We appreciate that many staff from closed MCs might not find travelling relatively long distances to remaining MCs an attractive option. For example, [✂] and [✂] MCs are [✂] miles apart. If one were to be closed and the other retained, that would suggest a daily commute of over 90 miles; if both were to be closed and replaced by another MC, travelling distances could be lower, but for double the number of staff[246].

[241] Comprises site cost savings of £[✂]m and vehicle cost savings of £[✂]m
[242] Staff – totals, SPM PCR4v3.xls
[243] See Appendix 1 for source of cost of capital
[244] Slide 6, RM Restructuring Plan
[245] Page 6, RM 30.03.12 submission
[246] This is based on the information provided in RM's 30.03.12 submission, which indicated the assumed retention of [✂] (MC to MC flows, Scenario C2 and D Network Savings.xls). In its commentary on our draft report, RM has suggested that its [✂] MC network would not feature an MC within 100 miles of [✂] ([✂] 27.07.12 email). This would appear to directly contradict RM's own submission, but in the absence of further details we are unable to resolve the apparent inconsistency. We have therefore continued to base our example on RM's formal submission.

469. On the other hand, available empirical evidence from the recent MC consolidation in the Thames Valley suggests that substantial redeployment is possible. That consolidation involved the closure of the Oxford and Reading MCs, affecting over 800 staff, of whom just over [✂] were redeployed in other MCs or parts of the pipeline. [✂]% of the [✂] staff were released through VR[247].

470. It is difficult to tell, from the limited information available on the nature of the MC consolidation programme, how representative this experience is of the changes required to reduce the network to [✂] MCs. If in due course RM submits more detailed estimates of such a programme, we would expect it to include an analysis of distances from existing MCs and the implications on VR, and would recommend a more extensive review of the need for VR. However, on the basis of the information currently available, the Oxford and Reading experience would appear to be the best evidence available.

471. Based on this evidence, we think that a 50% redeployment assumption might be more reasonable than RM's assumption of [✂]. This would [✂] the incremental VR cost estimate, from £[✂]m to £[✂]m.

Other costs

472. RM states that it has not quantified other restructuring costs, which would include significant investment, but that it has assumed such costs would be offset by property disposal proceeds[248].

473. The Restructuring Plan places some emphasis on the financial benefits available from property disposals, with total proceeds of some £[✂]m over the forecast period, principally attributable to MC reductions[249]. We therefore think it possible that disposal proceeds under Scenario C2 would do more than offset other restructuring costs, and potentially offset VR costs as well.

Conclusion on transition costs

474. In our view, transition costs, net of disposal proceeds, could be less than £[✂]m.

Benefit sharing costs

475. RM has not estimated benefit sharing costs for this or any other scenario.

476. As noted in the introduction section above, however uncertain these costs are, we believe that they should receive some consideration. [✂]

Scope of change

477. Considered on an incremental basis to Scenario C1, the direct effects of the change are principally limited to the [✂] retained staff in MCs ([✂] in remaining MCs and [✂] redeployed), although there are some more minor impacts on collections, network and local distribution. However, the scale of the industrial relations challenge could end up involving all [✂] staff.

Scale of change

478. The scale of change among MC staff is clearly significant, with a wholesale redesign of workplans. However even a significant level of benefits sharing with such staff would have a relatively minor effect on total costs compared with the potential costs of involving all staff.

[247] Page 56, FE 2011 review of Strategic Plan
[248] Page 27, RM 30.03.12 submission
[249] Slide 38, Restructuring Plan

Illustrative impact

479. A one-off payment of say £[✂], paid to [✂] MC staff, might result in a total benefit sharing cost of £[✂]m. If this was supplemented by a one-off payment of say £[✂] to the remaining [✂] staff, the total cost would rise to £[✂]m.

480. As explained above, the majority of incremental savings arising from this scenario relate to site costs. In this regard, [✂]. Applied to Scenario C2, that would imply a benefit sharing cost of £[✂]m. Although we are not aware of any such provision within the 2010 agreement in relation to the MC consolidation envisaged under the Restructuring Plan, we do note that RM commits to sharing detailed information relating to MC closures with the CWU[250]. At any rate, this does at least provide another benchmark of potential benefit sharing costs.

481. We stress that these cannot be relied on as estimates of the likely level of benefit sharing costs; however they can at least serve as illustrative benchmarks of the potential scale of such costs.

Special Delivery Next Day and International

Impact on service specification

482. RM states that under this scenario, Special Delivery would have a Next Day specification similar to that under Scenario C1, i.e. [✂]% by close of business. For inward international mail, quality of service would fall by the same [✂]% as estimated under Scenario C1.

483. For outward international mail, however, the quality of service reduction would be much greater than under Scenario C1. Since such mail is collected and mixed with other postings, and there is no easy way to extract it, it would suffer a quality of service reduction similar to that for inland 1c. RM estimates that the outward service specification would fall by [✂]% under Scenario C2[251], compared with [✂]% under Scenario C1.

484. As for Scenario C1, RM has explained that following such falls, it would no longer be able to achieve current quality of service targets and would have to negotiate new targets with the UPU and with the counterparties in its bilateral terminal dues agreements[252].

485. It seems quite possible that these negotiations would have financial implications on costs and/or revenues (through penalties in terminal dues agreements), but it is not clear what these would be.

Cost of avoiding impact

486. As with Scenario C1, RM indicates that national next day coverage for Special Delivery and incoming international mail could be retained by retaining some flights, at a cost of between £[✂]m and £[✂]m[253]. This would not improve quality of service for outward international mail, which would remain mixed with inland postings.

[250] Page 32, 2010 Pay and Modernisation Agreement
[251] Pages 26 to 27, RM 30.03.12 submission
[252] Page 49, RM 03.05.12 submission
[253] Page 27, RM 30.03.12 submission

Scenario D: Replace 1c/2c with single class

Summary of scenario

487. This scenario involves merging the 1c and 2c services into a single class of service, retaining the reduced MC network assumed under Scenario C2. Under this scenario, around [✂]% of all mail would receive Day B delivery, and most of the remainder Day C delivery.

488. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 48 - Scenario D: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

489. Relative to Scenario C2, RM's estimates, and our alternative estimates, imply the following incremental savings and transition costs:

Table 49 - Scenario D: Incremental savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

490. From an operational perspective, the main difference in Scenario D is that both 1c and 2c mail would align with the service standards reserved for 1c under Scenario C2. As discussed under Scenario C2, a merging of 1c and 2c service standards would in fact be the simplest operational solution, and so far from leading to increased costs, Scenario D would allow greater cost savings than Scenario C2, as the operational constraints put in place in Scenario C2 purely to maintain a service distinction could be removed.

491. The customer and commercial implications of Scenario D would clearly be profound, due not least to the loss of the 1c premium over 2c mail. These implications might outweigh the effects of cost savings.

492. In our view, RM's estimated incremental cost savings of £[✂]m from Scenario D, relative to Scenario C2, are likely to be understated. We believe that MC incremental cost savings are likely to be much higher than the £[✂]m estimated by RM, and could be closer to £[✂]m, reflecting a higher estimate of avoided segregation costs, and making an allowance for smoother operations with the removal of 1c/2c changeovers. On the other hand, we do not see the basis for the £[✂]m estimated benefit for network costs, which reduces our estimate of the aggregate understatement.

493. We base our assessment of cost savings on the scenario as presented by RM, i.e. a single class of service with Day B delivery for around [✂]% of mail. We note that cost savings could be significantly higher with a lower quality of service.

Details of change

494. Scenario D involves replacing the current 1c and 2c service specifications with a single class of service, under which next day delivery is provided for all mail posted within the catchment area of the outward MC, and remaining mail is delivered on Day C or Day D. RM estimates that coverage would be split as follows[254]:

Table 50 - Scenario D: Coverage

	%
Day B	[✂]
Day C	[✂]
Day D	[✂]

495. RM states that under this scenario, the service standards applicable to the single class of mail would also apply to Special Delivery[255]. This contrasts with Scenarios C1 and C2, which incorporate a [✂]% Day B coverage for Special Delivery. The service specification for international mail would, it appears, remain as estimated under Scenario C2.

496. RM has based its analysis of Scenario D on a two hour later final delivery time, as set out in Scenario B, on removing the air network, as set out in Scenario C1, and on further consolidation of MCs, as set out in Scenario C2. We have considered Scenario D on that basis. Where possible, we avoid repeating points made in relation to Scenarios B, C1 and C2, and focus on the incremental impact of Scenario D over Scenario C2.

497. We note that an alternative approach to Scenario D would be to retain the existing final delivery time. This could deliver a similar scale of cost saving and avoid some of the potential industrial relations issues identified under Scenario B. It is not clear what the effect on quality of service would be, but as noted above, RM estimates that the proportion of mail achieving Day B delivery would be further reduced by around [✂]% in the case of Scenario C1.

Operational rationale for change

498. Relative to existing service specifications, the customer and commercial implications of such a change would be highly significant. The scope of our work does not extend to an examination of these implications, but we mention them here in brief to provide context for the scale of potential cost savings.

[254] Page 29, RM 30.03.12 submission
[255] Page 29, RM 30.03.12 submission

499. As noted by FE, RM would lose some 1c volumes altogether, and for the remainder would lose the price premium from 1c mail over 2c mail. In principle, it might be possible to counterbalance this effect by pricing former 2c volumes higher to reflect improved Day B coverage, but this depends on the value attributed to such coverage by former 2c mailers. FE also noted that under such a scenario, RM's competitive position would probably weaken. We agree with FE that such effects could outweigh cost savings[256]. This implies that RM could decide, on a commercial basis, to continue a 1c service, even if it was no longer required to do so by the USO[257].

500. In this regard, we note that for most of its history RM only offered a single class of service, and that when the two tier system was introduced in 1968, it was apparently on commercial rather than regulatory grounds[258]; although clearly a great deal has changed in the last 45 years.

501. Relative to Scenario C2, the change could be less significant. Indeed, if in practice Scenario C2 led to large scale down trading from 1c to 2c, the two scenarios might not look that different from an outside perspective. Moreover, in view of the potential for confusion between 1c and 2c service specifications discussed in relation to Scenario C2, the customer proposition under Scenario D might be considered clearer.

502. From an operational perspective, the overall proportions of mail delivered on Days B and C might not be that different from that under the existing service specification:

a) RM estimates that under Scenario D, [✂]% of mail would have Day B coverage. We assume actual quality of service would be somewhat lower than this, say [✂]%. The Restructuring Plan forecasts that [✂]% of standard end to end mail in 2015 will be 1c[259] and therefore have Day B coverage in principle; assuming a 93% quality of service, this implies [✂]% of mail would be Day B.

b) RM estimates that under Scenario D, [✂]% of mail would have Day C coverage. We assume actual quality of service would be similar to this, balancing missed Day B deliveries with missed Day C deliveries. The Restructuring Plan forecasts that some [✂]% of standard end to end mail in 2015/16 will be 2c. Assuming that in practice 90% of 2c mail is delivered on Day C[260], this implies that [✂]% of mail in total would be Day C ([✂]% of [✂]% plus the [✂]% of mail representing missed 1c quality of service).

c) RM estimates that under Scenario D, [✂]% of mail would have Day D coverage. We assume total mail delivered on Day D would be closer to [✂]%, reflecting missed Day C deliveries. The Restructuring Plan forecasts that some [✂]% of standard end to end mail in 2015/16 will be 3c. Assuming for simplicity this and missed 2c mail will be delivered in Day D that makes a total of [✂]% of mail on that day.

[256] Pages 52 to 53, FE 2008 report
[257] Page 59, FE 2008 report
[258] *On this day, 16 September 1968: Post Office backs first class service*, BBC News http://news.bbc.co.uk/onthisday/hi/dates/stories/september/16/newsid_3067000/3067963.stm
[259] The Restructuring Plan model indicates total end to end mail of [✂]bn items in 2015/16, comprising [✂]bn 1c items, [✂]bn 2c items and [✂]bn 3c items. This excludes non standard mail such as Special Delivery and Tracked.
[260] Page 48, FE 2008 report

503. However, this distribution of deliveries would be achieved in a totally different way under Scenario D. Many of the operational implications of these changes have been discussed above under Scenario C2. Relative to that Scenario, we believe that Scenario D would offer further opportunities for operational savings, as a result of the cessation of segregation activities for 1c and 2c mail, and a significant smoothing of MC operations as a result of no longer having to switch between 1c and 2c processing.

504. We base our assessment of cost savings on the scenario as presented by RM, i.e. a single class of service with Day B coverage for intra MC mail, estimated at [✂]% of all mail. We note that cost savings could be significantly higher with a lower quality of service. For example, if the Day B target were to be dropped and replaced with a simple Day C target that might enable much longer and smoother operational windows for processing.

505. Although there are many differences of detail that make direct comparison difficult, we note that the US Postal Service has recently applied to the Postal Regulatory Commission for some widespread changes to service standards, which reflect, *inter alia*, the impact of MC rationalisation[261].

[261] Docket N2012-1, Postal Regulatory Commission website. See for example, testimony of David E. Williams, filed on 05.12.2011.

Cost savings

506. RM estimates total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base. FE estimated cost savings for a "*single two day mail product*", with no apparent Day B target, on two bases:

a) absent "*wholesale reform*" of the network, resulting in estimated rolled forward cost savings of £[✂]m; and

b) following "*more radical reform*" of the network, comprising a reduction in the number of MCs, DO property savings from overnight mail preparation, more efficient MC working, and higher penetration of walk sequencing[262], resulting in estimated rolled forward cost savings of £[✂]m.

Table 51 - Scenario D: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)			Cost savings (%)		
		RM s55	FE low[263]	FE high	RM s55	FE low	FE high
Collections	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

[262] Page 57, FE 2008 report
[263] Rolled forward and excluding volume effects, as described in the Introduction section, for both low and high estimates

507. Relative to Scenario C2, RM estimates incremental cost savings from Scenario D of £[✂]m, or [✂]% of the 2015/16 cost base, from savings in MC and network costs. Although FE did not consider a similar scenario to C2, we can attempt to separate the estimated savings under its equivalent of Scenario D into those captured by Scenario C2 (i.e. removal of the air network and MC consolidation) and those which in principle could be considered incremental to D. On that basis, our rolled forward FE estimates of incremental cost savings are between £[✂]m and £[✂]m:

Table 52 - Scenario D: Incremental cost savings

Scenario D v C2 2015/16	Cost base (£m)	Cost savings (£m)			Cost savings (%)		
		RM s55	FE low[264]	FE high	RM s55	FE low	FE high
Collections	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

508. We note a degree of ambiguity around FE's conclusions on these savings. Although the savings identified by FE were attributed to the revised service specification, FE concluded its analysis of these savings as follows:

"*However, the view of our operational experts is that many of the cost savings could be achieved without modifying the Universal Service, since the current configuration of mail centres and delivery offices is a legacy of previous decisions, and would not be necessary even under current service specifications. This is particularly so, given the investments in walk sequencing and part-time employment that should impact directly on the delivery office network, for example.*" [265]

509. It therefore appears to us that FE's savings estimates may be inflated, in our view incorrectly, by efficiencies already available under the existing service specification.

510. Moreover, as noted above, RM's cost savings relate to a single class of mail with a [✂]% Day B target, whereas FE's single class product appears to have been based on a simple Day C target. This provides a further reason for caution when comparing FE's estimates with RM's estimates.

[264] Rolled forward and excluding volume effects, as described in the Introduction section, for both low and high estimates. Note that the "FE low" estimate of £[✂]m for this scenario did not include any savings in respect of MC consolidation, whereas the "FE high" estimate of £[✂]m did include such savings. Therefore, when considering incremental savings over and above those available from consolidation, the difference between the two estimates falls.
[265] Page 66, FE 2008 report

Collections

511. RM assumes collection costs under Scenario D are the same as those under Scenario C2. As explained below, RM envisages an identical start time for outward processing for Scenarios C2 and D. We do not therefore expect any incremental cost savings in respect of collections, relative to those already considered in Scenario C2.

Mail Centre

512. Scenario D assumes [✂]% Day B coverage for all mail, similar to the coverage assumed for 1c mail in Scenario C2. In line with this, and consistent with our view that there could be little difference in practice under Scenario C2 between achieved quality of service for 1c and 2c mail, RM envisages an MC workplan for Scenario D which is essentially identical to that for Scenario C2. The only assumed difference between the workplans is the separation of 1c and 2c mail under Scenario C2, which vanishes under Scenario D[266].

Mail segregation

513. Relative to C2, the only incremental saving identified by RM under this scenario is an amount of £[✂]m for staff costs associated with segregating and delaying 2c mail, plus a pro rata saving on "staff other costs" of £[✂]m. RM stated that these costs would cover the activities of segregation and streaming of mail, checks for 1c mail in 2c streams, and porterage and storage[267].

514. The estimate of £[✂]m across [✂] MCs equates to an average of around £[✂] or [✂] hours per MC per week[268]. In our experience, this seems low.

515. Segregating 1c and 2c is a key activity in MCs. We note that in its 2011 review of RM's Strategic Plan, FE cited total mail preparation costs of £[✂]m in MCs[269]. In our experience, segregation accounts for a substantial proportion of mail preparation. Segregation is partly automated, but, in the main, it very labour intensive:

a) Whilst collections from post boxes can be tipped straight into automated equipment capable of facing letters, detecting stamps, and segregating 1c from 2c letters in the process, it will reject any items that are above standard size, or those that may be out of shape (i.e. bent etc). All such items then have to be segregated manually.

b) Apart from those ejected by machine, large flats and packets (including franked mail) need to be segregated by hand.

c) Additionally, franked mail arriving in 1c and 2c meter pouches is opened in the meter segregation area, checked for correct stream (i.e. 1c or 2c) before facing correctly with other franked items, and then presenting for machine processing.

d) PPI items receive similar treatment, but presentation standards tend to be much better, with larger business users generating sufficient volumes to warrant presentation in trays. Some checks still have to be made but it is not as labour intensive.

[266] Pages 41 and 51, RM 03.05.12 submission
[267] Page 52, RM 03.05.12 submission
[268] Assuming 51 weeks, and an hourly rate of £[✂], as per Scenario A
[269] Page 48, FE 2011 review of Strategic Plan

516. Typically, in a medium sized MC we would expect to see about 6 duties (or workload equivalent) after stripping out the stamping activity that often goes hand in hand with segregation during the first half of the late shift. They would be joined by, typically, around 40 more staff for the peak evening period (for about 2.5 hours each) on a Monday to Friday, when volumes arriving are obviously greater, and when the vast majority of business mail arrives, including meter and PPI. On a Saturday, we would expect to see in the order of 20 staff for 2 hours involved in segregation.

517. In total, this equates to around [✂] hours per week[270], around [✂]% more than that implied by RM's estimate, suggesting a total cost saving of more like £[✂]m, £10m more than the £[✂]m estimated by RM.

Related cost savings

518. We would expect the incremental cost saving opportunities from a single class of service to extend well beyond the direct cost of segregation. We note that FE reached a similar conclusion (emphasis added):

"*savings in mail centres would come from not having to segregate mail classes and, more importantly, by avoiding switching back and forth between inward and outward processing*" [271].

519. The absence of segregation has a fundamental effect on the whole MC workplan. For example, we would expect to see savings arising from the consolidation and simplification of activities such as despatch, clearing and traying of sorting frames and machine destination boxes, placing into Yorks, moving to despatch point, segregating into vehicles, and setting up work areas for the next class of mail. More generally, we would expect the absence of changeovers between 1c and 2c mail to allow a significantly smoother running of processing operations, and potentially increased levels of automation.

520. RM has acknowledged the relevance of benefits of this nature, but it appears it has not taken them fully into account in estimating the cost savings of Scenario D relative to Scenario C2:

"*In our submission the flow effect has been taken into account and was assumed to provide Royal Mail with the opportunity to more effectively use our assets. This included moving to a reduced mail centre estate but we have not yet done any detailed modelling on this.*" [272]

[270] 6 duties x 40 hours Monday to Friday = 240 hours. 40 staff x 2.5 hours Monday to Friday = 500 hours. 20 staff x 2 hours Saturday = 40 hours.
[271] Page 35, FE 2008 report. See also pages 55 and 136
[272] Page 53, RM 03.05.12 submission

521. In the absence of further information from RM, we have sought to estimate the potential scale of changeover savings at a high level. FE's review of RM's Strategic Plan estimated that [✂]% of MC staff costs relate to the direct sorting costs, as opposed to mail preparation, porterage, etc[273]. Applying that to the MC 2015/16 staff cost base of £[✂]m[274] suggests total direct sorting costs in 2015/16 of £[✂]m. In very broad terms, we estimate that perhaps some [✂]% of this could be avoided in the absence of changeovers, equating to around £20m. However, we should add that information about MC costs, as presented to us, has been extremely limited. We therefore believe that, should this scenario be pursued, a much more detailed analysis of MC costs would need to be undertaken, to ensure an accurate identification of "under the roof" activities and costs is fully identified at all stages, from consolidation through to despatch.

522. In addition, as noted in Scenario B, we think that a longer operational window could allow an increase in automation levels. Under Scenario D, time freed up by no longer having to run separate 1c and 2c plans could be used to achieve further increases:

a) A [✂]% increase in the proportion of MC posted letters walk sorted, based on lowering mis-s-streaming into manual processes, could save up to £1.6m[275].

b) A larger improvement in automation might be expected in the case of flats, reflecting the fact that, as noted in Scenario C2, that all MCs would be equipped with flat sorting machines following MC consolidation. A [✂]% increase in the proportion of MC posted flats sorted could save up to £0.6m[276]. In principle, further savings might be achievable by sorting flats to walk level. However, realisation of these savings would be heavily dependent on additional machine running time for walk sort plans, and a more detailed analysis would be required to assess whether this was reasonable. We have therefore not estimated any related savings.

c) Further savings should be achievable from higher levels of automated packet sorting, boosted as noted in Scenario C2 by the fact that all MCs would be equipped with packet sorting machinery following MC consolidation. However, we accept that RM is still developing its business case in this area, and that [✂].

523. In the light of the above, it seems likely that RM's estimate of £[✂]m is understated, and it is possible that total incremental savings could be closer to £[✂]m, £32m above this figure, based on £10m of additional savings in segregation costs, £20m of changeover savings, and £2m of automation savings.

Network

524. As with Scenario C1 and C2, Scenario D assumes that all air network costs are avoided.

525. RM estimates a net saving of £[✂]m in road network costs, £[✂]m more than the £[✂]m saving under Scenario C2.

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[273] In 2006/07, manual and mechanical processing costs totalled £[✂]m out of total MC staff costs of £[✂]m, in 2007/08 prices (Figure 31, page 48, FE 2011 review of Strategic Plan).
[274] Illustrative RFI Cost model
[275] The Restructuring Plan model indicates a total of [✂]bn MC posted letters (stamped, metered, PPI, Cleanmail, and Response Services) in 2015/16. A [✂]% increase of [✂]m items suggests a saving of up to 3 manual sorts (one each at outward MC, inward MC, and DO), or [✂]m manual sorts in total. Assuming a manual sorting rate of 1,500 items per hour, this equates to a saving of [✂] hours. At an hourly rate of £[✂] per hour, this generates a cost saving of £[✂]m.
[276] The Restructuring Plan model indicates a total of [✂]m MC posted flats (stamped, metered, PPI, Cleanmail, and Response Services) in 2015/16. A [✂]% increase of [✂]m items suggests a saving of up to 2 manual sorts (one each at outward MC and inward MC), or [✂]m manual sorts in total. Assuming a manual sorting rate of 800 items per hour, this equates to a saving of [✂] hours. At an hourly rate of £[✂] per hour, this generates a cost saving of £[✂]m.

526. £[✂]m of this incremental saving would appear to be attributable to the removal of the dedicated Special Delivery road network incorporated in the Scenario C2 green field estimate. However this saving is attributable to an assumed difference in the Special Delivery specification, not to the merging of the 1c and 2c service standards.

527. It is not clear from the materials provided where the remaining £[✂]m incremental cost saving comes from. We are not therefore clear that any incremental saving is available from network costs, relative to Scenario C2.

Local distribution

528. RM has estimated the same local distribution costs in Scenario D as under Scenario C2. As explained above, RM envisages an identical start time for inward processing for Scenarios C2 and D. We do not therefore expect any significant incremental cost savings in respect of local distribution, relative to those already considered in Scenario C2.

Indoor delivery

529. As discussed above, we would expect the absence of changeovers between 1c and 2c mail to allow a significantly smoother running of processing operations, and potentially increased levels of automation. This could include an improved level of walk sequencing.

Conclusion on cost savings

530. In our view, RM's estimated incremental cost savings of £[✂]m from Scenario D, relative to Scenario C2, are likely to be understated. We believe that MC incremental cost savings are likely to be much higher than the £[✂]m estimated by RM, and could be closer to £[✂]m. On the other hand, we do not see the basis for the £[✂]m estimated benefit for network costs, which reduces our estimate of the aggregate understatement.

VR costs

531. RM estimates total VR costs of £[✂]m. Relative to Scenario C2, this implies incremental VR costs from Scenario D of £[✂]m:

Table 53 - Scenario D: VR costs

£m	Scenario C2	Incremental	Scenario C2
MC staff cost reductions	[✂]	[✂]	[✂]
Airport staff cost reductions	[✂]	[✂]	[✂]
Road network staff cost reductions	[✂]	[✂]	[✂]
Delivery staff cost reductions	[✂]	[✂]	[✂]
Total staff cost reductions	[✂]	[✂]	[✂]
VR multiplier	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

532. In this section, we focus just on the incremental staff costs associated with Scenario D, compared with Scenario C2.

533. As noted above, the basis of RM's road network saving is unclear. However, even if there were an incremental £[✂]m staff cost saving in road network costs, we think it likely that the cost of VR could be reduced or avoided by redeployment in the longer term. We estimate that the staff cost saving equates to around [✂] people[277]. These would be predominantly drivers or loading dock/hub workers from across the country, whose skills could be put to good use elsewhere in RM operations. A relatively long lead time is likely to be necessary to plan and prepare for the network changes, which should help this process.

534. RM's VR estimate is not affected by MC staff cost savings in segregation, because these go to moderate the increases in staff that would be required in the [✂] remaining MCs.

Benefit sharing costs

535. We do not think there would be significant incremental benefit sharing issues associated with this scenario, compared with Scenario C2.

Special Delivery Next Day and International

Impact on service specification

536. RM states that under this scenario, the service standards applicable to the single class of mail would also apply to Special Delivery[278]. This implies next day coverage of only [✂]%. This contrasts with Scenarios C1 and C2, which incorporate a [✂]% Day B coverage for Special Delivery.

537. The service specification for international mail would, it appears, remain as estimated under Scenario C2.

Cost of avoiding impact

538. RM estimates that retaining next day coverage for Special Delivery and inward international mail would reduce savings by £[✂]m to £[✂]m[279]. This is £[✂]m to £[✂]m above the reduction estimated for Scenarios C1 and C2, reflecting the lower starting base of [✂]% next day coverage.

539. As for Scenario C2, this would not accelerate outward international mail.

540. We note that FE estimated retention costs of up to £80m[280].

[277] The Restructuring Plan model indicates an average 2015/16 payroll cost of £[✂] per person in "National Distribution".
[278] Page 29, RM 30.03.12 submission
[279] Page 29, RM 30.03.12 submission
[280] Page 56, 2008 FE report

Scenario E: Reduce collections and deliveries from 6 to 5 days

Summary of scenario

541. This scenario involves reducing collections and deliveries from 6 to 5 days a week. RM's estimates of savings and transition costs, together with our alternative estimates, are shown below:

Table 54 - Scenario E: Savings and transition costs

	Central	High	Low
RM			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]
CS			
Annual cost saving (£m)	[✂]	[✂]	[✂]
Transition cost (£m)	[✂]	[✂]	[✂]
Discounted payback (years)	[✂]	[✂]	[✂]

542. Although much of RM's cost base is driven by traffic volumes, the cost of the single most significant element of the pipeline, outdoor delivery, is relatively traffic insensitive. In principle there would be a clear, significant, and relatively simple operational benefit from moving to a 5 day service, in terms of reduced delivery staff costs. Operators in a number of other jurisdictions, including Sweden, Australia, Singapore, Guernsey and Jersey, already have a 5 day service (although Guernsey has retained, and Jersey is considering re-introducing, Saturday packet deliveries). Reduced delivery frequency is also being considered in the US, the Netherlands, Norway and New Zealand.

543. However, while we believe available cost savings are substantial, in our view, RM's estimated cost savings of £[✂]m could be overstated by around £30m.

544. The majority of RM's estimated cost savings, £[✂]m, relate to outdoor delivery staff costs. We think it likely that these savings could be overstated by some £50m to £60m as a result of insufficient account having been taken of the impact of increased volumes on costs in the remaining 5 days. Note that this estimated overstatement is based on the 2015/16 volumes and product mix forecast in RM's Restructuring Plan.

545. On the other hand, we think that RM may have understated other cost savings by around £27m:

a) RM's £[✂]m estimate of collection cost savings may be understated by around £5m, as a result of an excessive allowance for Saturday POL relief collections, and the unevaluated impact of pay mix opportunities.

b) MC savings might be closer to £[✂]m than the £[✂]m estimated by RM, due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays.

c) Indoor delivery savings closer to £[✂]m than the £[✂]m estimated by RM, again due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays.

546. We think that RM's transition cost estimate is also likely to be overstated, apart from the flow through effect of lower savings, by unevaluated opportunities to reduce staff costs through reductions in overtime in the short term, and natural attrition in the longer term.

547. The analysis above takes no account of potential benefit sharing costs. In our view, these could be significant. While an end to Saturday working could prove attractive to many staff, others might find Saturday working attractive due to its relatively light workload and effect on take home pay. As an illustration, [✂].

548. In common with RM's response, we have focused above on ceasing collections and deliveries on Saturdays. RM estimates that cost saving opportunities from ceasing deliveries on a weekday would be [✂], but notes that these would create operational complexities and be less [✂].

549. We agree that weekday cessation would add complexity, and in our view this would be likely to result in cost savings that are materially lower than those estimated above, albeit still substantial. Weekday cessation might, however, be more operationally attractive, were customer research to suggest the retention of packet and parcel deliveries on Saturdays. This would reduce cost savings significantly, to a degree which neither RM nor we have considered. Under such circumstances, complete cessation of deliveries, including packet deliveries, on a weekday, might lead to greater savings than cessation of letter deliveries, but retention of packet deliveries, on Saturdays.

Details of change

550. Scenario E involves reducing collections and deliveries from 6 to 5 days a week[281].

551. RM's response focuses on ceasing collections and deliveries on Saturdays, as it views the alternatives as adding complexity without offering significant additional savings opportunities[282]. We adopt the same focus in this section, and consider the alternatives in a sub-section below.

552. We understand that this change would require government approval, and that the present government has committed to retaining Saturday deliveries during this Parliament[283].

Operational rationale for change

553. Although much of RM's cost base is driven by traffic volumes, the cost of the single most significant element of the pipeline, outdoor delivery, is relatively traffic insensitive. In principle there would be a clear, significant, and relatively simple operational benefit from reducing the number of deliveries per week, in terms of reduced delivery staff costs.

[281] We note that in the section titled "Response Context", RM states that the scenario includes "*a single class of service specification*" and [✂] (page 32, RM 30.03.12 submission). However, these references would not appear to be relevant to Scenario E. We note that the "Response Context" section in Scenario E is identical to that in Scenario D, and assume for the purposes of our work that it has been replicated in error.
[282] Pages 32 to 33, RM 30.03.12 submission
[283] 02.04.12 Ofcom meeting

554. A number of other postal operators have moved to, or are considering moving to, a 5 day service:

a) In Sweden, Posten AB has been operating a 5 day service for many years, since ending Saturday deliveries in the late 1960s[284].

b) Australia Post delivers on Monday to Fridays only[285].

c) In Singapore, SingPost ended Saturday collections and deliveries in May 2010[286].

d) Guernsey Post ended Saturday deliveries of standard letter mail in March 2012[287]. The operator originally considered ending all Saturday deliveries other than Special Delivery, but as a result of initial customer feedback, it also retained Saturday deliveries for standard packets and parcels. We have discussed the change with Guernsey Post senior management, who confirm no adverse customer reaction, and that the change was popular with operational staff. Management also indicated that it believed customers were more amenable to cessation of Saturday deliveries than to cessation of deliveries on any other day of the week.

e) Jersey Post ended Saturday letter deliveries in May 2011[288]. We have discussed the change with Jersey Post senior management, who have explained that they undertook an extensive post implementation customer survey later that year. The survey confirmed a high demand for Saturday packet and parcel deliveries, and Jersey Post has therefore continued to deliver these along with premium products on Saturdays.

f) In 2010, the US Postal Service submitted a proposal to its regulator, the Postal Regulatory Commission, for the cessation of Saturday deliveries. The Commission issued a non-binding "Advisory Opinion" in 2011 which raised a number of concerns with the proposal, including some concerns relating to the Postal Service's savings estimates (considered further below)[289]. However, legislation would be required for the proposal to proceed, and that has not yet been passed[290].

g) In late 2011, the Dutch government was reported as considering allowing PostNL to move to a 5 day service by ceasing deliveries on Monday, currently its quietest day of the week[291].

h) In late 2011, the Norwegian operator Posten Norge was reported as proposing the cessation of Saturday deliveries[292].

i) In 2011, New Zealand Post's proposal to end Saturday deliveries was rejected by the government, but the operator has recently been reported as proposing reducing its service from 6 days per week to 3 days per week[293].

[284] Page 27, *Service and competition 2008*, Swedish Post and Telecom Agency (PTS), 15 April 2008
[285] *Customer Service Charter – Mail services*, auspost.com.au
[286] *SingPost implements 5-day mail collection and delivery service*, SingPost press release, 10.02.10
[287] *Guernsey Post to commence 5 day week from 26th March 2012*, Guernsey Post, 24.02.12
[288] Jersey Post press release, 10.05.11
[289] *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11
[290] *Postal Service Holds Back on Closings*, New York Times, 09.05.12
[291] *Dutch postal reforms to eliminate Monday deliveries*, postandparcel.info, 21.12.11
[292] *Norway Post seeks to abandon Saturday deliveries*, postandparcel.info, 15.11.11
[293] *NZ Post can survive – with changes*, nzherald.co.nz, 27.04.12

555. A move to a 5 day week would be a fundamental change in operations that would be difficult to reverse. This might have implications for the longer term path to other potential service changes. For example, the KPMG report included a scenario under which deliveries were made three times a week on alternate days under a 6 day operating model[294]. We have not considered such implications as part of our work.

Cost savings

556. RM estimates total cost savings of £[✂]m, or [✂]% of the 2015/16 cost base, as a result of ceasing Saturday collections and deliveries. This is slightly larger than our rolled forward FE estimate for a similar scenario of £[✂]m:

Table 55 - Scenario E: Cost savings

2015/16	Cost base (£m)	Cost savings (£m)		Cost savings (%)	
		RM s55	FE[295]	RM s55	FE
Collections	[✂]	[✂]	[✂]	[✂]	[✂]
Outward MC	[✂]	[✂]	[✂]	[✂]	[✂]
RDC	[✂]	[✂]	[✂]	[✂]	[✂]
Network	[✂]	[✂]	[✂]	[✂]	[✂]
Inward MC	[✂]	[✂]	[✂]	[✂]	[✂]
Local Distribution	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Indoor	[✂]	[✂]	[✂]	[✂]	[✂]
Delivery Outdoor	[✂]	[✂]	[✂]	[✂]	[✂]
International	[✂]	[✂]	[✂]	[✂]	[✂]
Walk bundling	[✂]	[✂]	[✂]	[✂]	[✂]
Sales and marketing	[✂]	[✂]	[✂]	[✂]	[✂]
Overheads	[✂]	[✂]	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]	[✂]	[✂]

557. RM's estimate of a [✂]% cost saving is [✂] estimated by the US Postal Service, in its 2010 submission to the Postal Regulatory Commission proposing the cessation of Saturday deliveries. The Postal Service estimated incremental cost savings resulting from the cessation of Saturday services of some $3.3bn[296], around 5% of total operating costs[297]. However, in 2011, the US Postal Regulatory Commission published an alternative estimate of $2.3bn[298], around 3% of total operating costs. The principal cause of the $1.0bn difference between the two estimates was the treatment of outdoor delivery costs, and in particular the assumed increase in weekday costs resulting from the cessation of Saturday deliveries[299]. We consider this issue further below.

[294] Page 37, KPMG 2009 report.
[295] Rolled forward and excluding volume effects, as described in the Introduction section
[296] Page 2, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11
[297] Total operating costs for 2009, the year on which the savings estimates were based (Page 2, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11), were $71.8bn (*Statement of Operations, US Postal Service Financial Statements*, year ended 30.09.09).
[298] Page 2, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11
[299] This alone accounted for $0.5bn of the $1.0bn difference (Page 37, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11)

558. Guernsey Post estimated the ending of Saturday deliveries would save around £0.4m a year[300]. This is less than 1% of Guernsey Post's reported cost base of £44.9m[301]; however Guernsey Post has a very different cost structure from RM, with over 76% of its cost base being accounted for by conveyance costs and terminal dues costs for outward international mail[302]. It also still receives a flight from the UK on a Saturday which it meets, loads and unloads. Expressed as a proportion of its internal costs, estimated from the above as £10.8m, the estimated saving equates to 4% of costs.

Collections

559. RM estimates total savings of £[✂]m in collections:

Table 56 - Scenario E: Collections cost savings

£m	Staff[303]	Vehicles	Total
Cessation of Saturday collections	[✂]	[✂]	[✂]
Less: POL relief collections, MC-DO shuttles	[✂]	[✂]	[✂]
Net savings	[✂]	[✂]	[✂]

560. RM's estimate is modest, compared with both:

a) our rolled forward FE estimate of £[✂]m; and

b) an internal RM presentation from 2009, which suggested a saving of £[✂]m on a rolled forward basis[304] as a result of stopping Saturday collections.

Gross savings

561. The staff cost base for collections is £[✂]m[305]. A simple application of a 1/6 (16.7%) saving for Saturdays would suggest a cost saving of £[✂]m. We would however expect savings to be considerably less than this, as costs incurred on Saturday collections are lower than costs incurred on weekday collections. As confirmed by both RM[306] and FE[307]:

a) much of the cost of collections relates to collections from businesses, and most business postings take place during the week; and

b) many post boxes typically cleared on collection rounds during the week are cleared on delivery rounds on Saturdays.

562. RM estimates that, as a result, Saturday collection costs account for [✂]% of the staff cost base, compared with [✂]% for the average weekday[308]. The [✂]% equates to the £[✂]m gross saving calculated by RM.

563. RM's explanation seems reasonable.

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[300] *Guernsey Post to commence 5 day week from 26th March 2012*, Guernsey Post, 24.02.12
[301] Page 19, *Guernsey Post 2011 Annual Report*
[302] Page 15, *Guernsey Post's Proposed Tariff Changes: Consultation Paper*, Office of Utility Regulation (Guernsey), August 2009
[303] Including a pro-rata saving in "Staff other costs"
[304] Slide 10 of the July 2009 Costing Steering Group presentation suggests a saving of £[✂]m. It appears this was on a 2013/14 cost base of £[✂]m (Figure 3.2, KPMG 2009 report). This equates to a cost saving of [✂]%.
[305] Including "staff other costs".
[306] Page 57, RM 03.05.12 submission
[307] Page 49, FE 2008 report
[308] Page 58, RM 03.05.12 submission. Note that the cost of Saturday collection on delivery rounds will appear within delivery costs rather than collection costs.

Reductions in savings

564. Staff cost savings are reduced by £[✂]m to allow for:

a) £[✂]m for POL relief collections[309];

b) £[✂]m for DO-MC shuttles[310]; and

c) a £[✂]m pro-rata adjustment for "staff other costs".

565. The allowance for POL relief collections is based on an assumption that all POL Saturday collections would have to be retained, due to storage constraints at POL outlets and to smooth MC work flows and avoid excessive pressure on the Monday night air network[311]. While we recognise that there may be a need for some relief collections for these reasons, it seems unlikely that these would need to capture all POL outlets. For example, we would expect that only a proportion of POL outlets would be affected by storage constraints. The £[✂]m allowance therefore appears overstated.

566. The allowance for DO-MC shuttles is for additional costs to absorb post box collection volumes which would be transferred to Mondays[312].

Pay mix opportunities

567. We believe that the proportion of Saturday collection time undertaken on structured overtime ("Scheduled Attendance"), paid at premium rates, is relatively high compared with weekdays, which would suggest some pay mix opportunities, i.e. that the proportion of costs avoided may exceed the proportion of hours avoided. RM confirms that it has not evaluated this effect[313].

Conclusion on collection costs

568. We believe that RM's £[✂]m estimate of collection cost savings may be understated, as a result of an excessive allowance for Saturday POL relief collections, and the unevaluated impact of pay mix opportunities. The overall impact of these effects could be of the order of £5m, suggesting total savings nearer to £[✂]m.

Mail Centres

569. RM estimates cost savings of £[✂]m, or [✂]% of the MC cost base, from "*shift/overhead reduction*", based on absorption and overtime reduction opportunities which would be enabled by combining lighter shifts to give a more continuous and predictable workload[314].

570. We would expect savings in three areas:

a) frontline staff costs;

b) manager and support staff costs; and

c) site costs.

[309] Page 58, RM 03.05.12 submission
[310] Page 58, RM 03.05.12 submission
[311] Page 58, RM 03.05.12 submission
[312] Page 58, RM 03.05.12 submission
[313] Page 59, RM 03.05.12 submission
[314] Page 59, RM 03.05.12 submission

Frontline staff costs

571. The impact of a move to a five day service is likely to be relatively modest for frontline MC staff costs, since although opening hours would change, the key driver for MC staffing, weekly volumes for processing, would be unaltered.

572. This is consistent with previous findings by FE and KPMG:

"*mail centre costs are unlikely to change significantly as processing time will generally shift to alternative days, although a more even workflow may make work scheduling easier*" [315].

"*Removing Saturday delivery will not impact sorting costs are they are assumed to be dependent only on volume*" [316].

573. Like RM, we would, however, expect some absorption opportunities as a result of operating on fewer days. MC workloads include a range of ancillary activities that are essentially a fixed daily cost and bear little relation to volumes, including transporting mail around the MC in trays and cages, clearing down, making up despatches, platform staff, and revenue protection. If MCs no longer operated on Saturdays, many of the fixed daily costs attributable to Saturdays would be avoided. A five day operation also has the potential for allowing a more even flow of mail throughout the week as it better aligns to normal national work patterns, allowing more regular staffing arrangements.

574. Bringing Saturday volumes into the week should therefore allow a proportion of Saturday hours to be avoided, or "absorbed". In our experience, we would expect absorption opportunities in the order of [✂]% of Saturday hours. We have estimated the potential impact of these opportunities in two ways.

575. First, on a top down basis, we estimate the MC cost base for frontline staff costs at £[✂]m[317]. If for simplicity we assume that 1/6 of this or £[✂]m relates to the current Saturday workload, absorption opportunities of [✂]% would equate to around £7m.

576. Second, on a bottom up basis we estimate, in broad terms for a typical large scale MC, a total of 3,400 hours on a Saturday[318]. Absorption opportunities of [✂]% would suggest savings of [✂] hours a week per MC, or some [✂] hours a year in total, equating to around £11m[319].

577. We think a larger absorption saving may be available in relation to walk sequencing costs, where we expect fixed daily costs to form a relatively high proportion of costs. RM has estimated these could generate additional savings, not included in its absorption estimate, of £[✂]m[320]. This is based on an assumed fixed set up costs of [✂] hours per day[321], which equates to [✂] minutes per walk sequenced[322]. This feels on the low side for setting up the machine for a new walk, loading letters and then clearing them down, and so we think savings of nearer £2m might be realistic.

[315] Page 34, FE 2008 report
[316] 6.3.2, KPMG 2009 report
[317] The Illustrative RFI Cost model shows total frontline staff costs, including "staff other costs", of £[✂]m. As noted in Scenario C2, around [✂]% of these costs, or £[✂]m, relate to frontline staff.
[318] For outward processing, 150 staff on a full shift plus 150 Associate Grades/Scheduled Attendance on half a shift (150 x 8 + 150 x 4 = 1,800 hours); for inward processing, 200 staff in total across two full shifts (200 x 8 = 1,600 hours). Note we have assumed 8 hour days, [✂].
[319] Assuming an hourly cost of £[✂]
[320] Page 61, RM 03.05.12 submission
[321] [✂] per day for each of the [✂] sequencing machines (page 61, RM 03.05.12 submission)
[322] Assuming a total of [✂] walks sequenced ([✂] walks x [✂]% sequencing rate for walks, as estimated in Scenario B)

578. This suggests total absorption opportunities for frontline staff of around £9m to £13m.

Manager and support staff costs

579. For manager and support staff, we would expect a much greater proportionate saving from the cessation of Saturdays. Many of these costs are relatively fixed, per day: for example, MC managers, shift managers, and support staff in areas such as revenue protection and work load assessment. Some costs would need to be re-invested in the remaining days, but a conservative estimate would be that [✂]% of Saturday costs would be saved.

580. We estimate the MC cost base for manager and support staff at £[✂]m[323]. If for simplicity we assume that 1/6 of this or £[✂]m relates to the current Saturday workload, absorption opportunities of [✂]% would equate to around £8m.

Saturday site costs

581. Like FE[324], we would also expect some modest savings in respect of heating and lighting costs no longer incurred on a Saturday.

Total savings

582. We therefore think it possible that MC savings might be closer to £20m than the £[✂]m estimated by RM.

Network

583. RM estimates total network savings of £[✂]m[325]:

Table 57 - Scenario E: Network cost savings

	£m
Total air network savings	[✂]
Net saving in road network	[✂]
Pro-rata indirect saving in staff other costs	[✂]
Total	[✂]

584. RM's estimate matches our rolled forward FE network cost saving estimate, also of £[✂]m.

Removal of air network costs

585. Air network savings arise from removing the Friday night air network:

Table 58 - Scenario E: Air network cost savings

	£m
Cancelled air contracts	[✂]
Airport handling and screening staff	[✂]
Total	[✂]

586. The savings, which are just over 1/6 those estimated under the "low cost network" in Scenario C1, look broadly reasonable.

[323] The Illustrative RFI Cost model shows total frontline staff costs, including "staff other costs", of £[✂]m. As noted in Scenario C2, around [✂]% of these costs, or £[✂]m, relate to manager and support staff.
[324] Page 130, FE 2008 report
[325] The savings are summarised in the Illustrative RFI Cost model and detailed in the "Scenario E Illustrative Network savings" spreadsheet

Impact on road network costs

587. RM estimates a net saving of £[✂]m in road and rail network costs:

Table 59 - Scenario E: Road network cost savings

	£m
Avoided network cost	[✂]
Less: replacement links for air contracts	[✂]
Total	[✂]

588. The estimate is based not on simply replacing Friday night airport feeder runs with Friday night road links, but on removing the entire Friday night network, and replacing it with a slower Saturday daytime network. We would expect some modest savings from such a move.

Local distribution

589. RM estimates a [✂]% reduction in local distribution costs, as a result of the partial absorption of Saturday morning volumes on weekday runs. This equates to a £[✂]m cost saving (£[✂]m in staff costs and £[✂]m in vehicle costs), compared with our rolled forward FE estimate of £[✂]m.

590. If we assume for simplicity that 1/6 of local distribution costs are incurred on a Saturday, this implies that [✂] of Saturday local distribution costs ([✂]% out of 17%) are absorbed into weekdays.

591. RM's estimate is clearly at a high level, but does not seem unreasonable, given the large fixed daily costs associated with local distribution. One might typically expect three to five waves of local distribution in the morning from MCs to DOs using 7.5 tonne vehicles, with vehicles at capacity for at least one or two of the waves. A small number of additional journeys as a result of increased weekday volumes might be expected.

Indoor delivery

592. RM estimates total savings of £[✂]m in indoor delivery, equating to [✂]% of the cost base:

Table 60 - Scenario E: Indoor delivery cost savings

£m	Staff[326]	Site costs	Total
Absorption of fixed tasks	[✂]	[✂]	[✂]
Management overhead	[✂]	[✂]	[✂]
Reduced opening	[✂]	[✂]	[✂]
Total	[✂]	[✂]	[✂]

593. FE estimated a higher cost saving, which we estimate amounts to some £[✂]m on a rolled forward basis. However, this was based on a very low penetration of automated walk sequencing, so we place little reliance on this figure in the context of the 2015/16 cost base. We therefore consider RM's estimate of £[✂]m without reference to FE's estimate below.

[326] Including a pro-rata saving in "Staff other costs"

Absorption of fixed tasks

594. RM estimates a £[✂]m saving as a result of the absorption of Saturday hours, due to the avoidance of fixed daily costs such as clearing down.

595. As with MC work, indoor delivery work incorporates a sizeable amount of associated mail work such as "setting in"[327], moving mail around the office, and "clearing down", which is essentially fixed on a daily basis. In our experience a realistic estimate of total absorption opportunities would be [✂]% of indoor hours and costs[328]. By comparison, we note that FE's 2011 review of RM's Strategic Plan identified that clearing down and bagging alone accounted for some [✂]% of indoor delivery time[329].

596. The Restructuring Plan indicates a total frontline staff costs for indoor delivery of £[✂]m per year[330]. Assuming 1/6 of costs relate to Saturday, this equates to a total absorption opportunity of [✂]% of £[✂]m, or around £12m.

597. In reality, the proportion of costs relating to Saturday will be slightly less than 1/6 due to lower volumes on that day. On the other hand, our calculations assume that Saturday hours are paid at the same rate, on average, as weekday hours. However, we would typically expect the proportion of Saturday hours to be staffed on Scheduled Attendance to be relatively high on a Saturday, as compared with weekdays. This reflects moves over the years to set the standard working week of many staff on a Monday to Friday basis, using Scheduled Attendance as one method of covering Saturday duties[331]. This suggests a pay mix opportunity from reducing Saturday hours, which RM confirms it has not evaluated[332].

Management saving

598. RM estimates a total cost saving of £[✂]m in management staff costs, based on 1/6 of a junior manager at each of the [✂] DOs. RM states:

"*Whilst this opportunity may be at the lower end of the range, it is consistent with many units being singleton manager sites where the rotating day off is covered at a lower cost than by direct substitution e.g. by a 'day off cover' manager who supports a number of units.* [✂]" [333]

599. The £[✂]m estimate equating to less than [✂]% of the £[✂]m in indoor delivery manager and support costs in 2015/16[334]. We accept that a simple 1/6 saving, which would equate to £[✂]m, would be unrealistic, for the reasons given by RM. However, we feel the opportunity is likely to be greater than that estimated by RM, since larger DOs are more likely to cover Saturdays at full manager rates. We also note RM's apparent acceptance that the £[✂]m estimate is at the lower end of a reasonable range. We estimate that savings could be closer to £10m, [✂].

[327] Bringing together walk sequenced mail, flats and manual mail for the delivery walk.
[328] This implies fixed costs of around [✂] minutes per 3.5 hour shift, which we think is realistic. We note that RM's 03.05.12 submission indicates at page 62 that its £[✂]m estimate is based on fixed costs of around [✂] minutes per day, but we are unable to determine what the minutes relates to (i.e. per shift, per walk, etc), as there is no clear link between the minute assumption and the £[✂]m figure.
[329] Page 120, FE 2011 review of Strategic Plan (% calculated as share of time, excluding meal relief).
[330] Row 270, Staff – totals, SPM PCR4v3.xls
[331] See, for example, Section 9 of the 1985 CWU agreement *Safeguarding the Future of the Mails Business* (3.2.23, PCR4 2010), which aimed to increase Monday to Friday weeks from 30% to over 60%.
[332] Page 62, RM 03.05.12 submission
[333] Page 62, RM 03.05.12 submission
[334] Row 673, Staff – totals, SPM PCR4v3.xls

Site costs

600. RM estimates a cost saving of £[✂]m for DO site costs as a result of reduced opening. This equates to around £[✂] per year for each of the [✂] DOs, or around £[✂] per DO per Saturday. This does not seem unreasonable.

Conclusion on indoor delivery savings

601. We believe that RM's estimate of £[✂]m of staff cost savings could be understated, and that they could be closer to £22m. This would raise total savings in indoor delivery to £[✂]m.

Outdoor delivery

602. RM estimates total savings of £[✂]m in outdoor delivery, equating to [✂]% of the outdoor delivery cost base. Our rolled forward FE estimate suggests total savings of £[✂]m:

Table 61 - Scenario E: Outdoor delivery cost savings

£m	RM s55	FE
Staff costs	[✂]	[✂]
Vehicle costs	[✂]	[✂]
Total	[✂]	[✂]

Staff costs

603. RM estimates a £[✂]m saving in staff costs[335], or [✂]% of the staff cost base. This equates to:

a) 1/6 of staff costs to reflect the avoided day; less

b) a [✂]% increase in remaining costs to reflect an increased level of weekday costs from attendance calls and deviation work.

604. Our rolled forward FE estimate is £[✂] or [✂]% of the staff cost base. This equates to:

a) 1/6 of staff costs to reflect the avoided day; less

b) a 4.7% increase in weekday costs to reflect an increased level of weekday costs from redistributed volumes, attendance calls, and Door to Door ("D2D") work on those days.

605. The key difference between the two estimates is that FE's estimate includes the impact of redistributed volumes, whereas RM's does not.

Redistributed volumes

606. Cessation of Saturday deliveries would cause an increase in weekday volumes, and as a result, some increase in weekday costs. The time taken to perform outdoor deliveries is relatively insensitive to traffic volumes, so we would expect the majority of cost savings from the Saturday to remain, even after any increases in weekday costs. Nevertheless, the increase in weekday costs would be material.

[335] Including "Staff other costs"

607. RM acknowledges in its response that an increase in weekday costs is likely to result from an increased weekday workload[336]. However, although RM makes an adjustment in respect of attendance calls, RM does not appear to estimate any increase as a result of volumes. As a result, we believe that RM's estimate of a [✂]% increase in weekday costs is understated, and that its £[✂]m estimate of total staff savings is overstated.

608. We have considered alternative approaches to estimating a more realistic increase in weekday costs within the available time constraints.

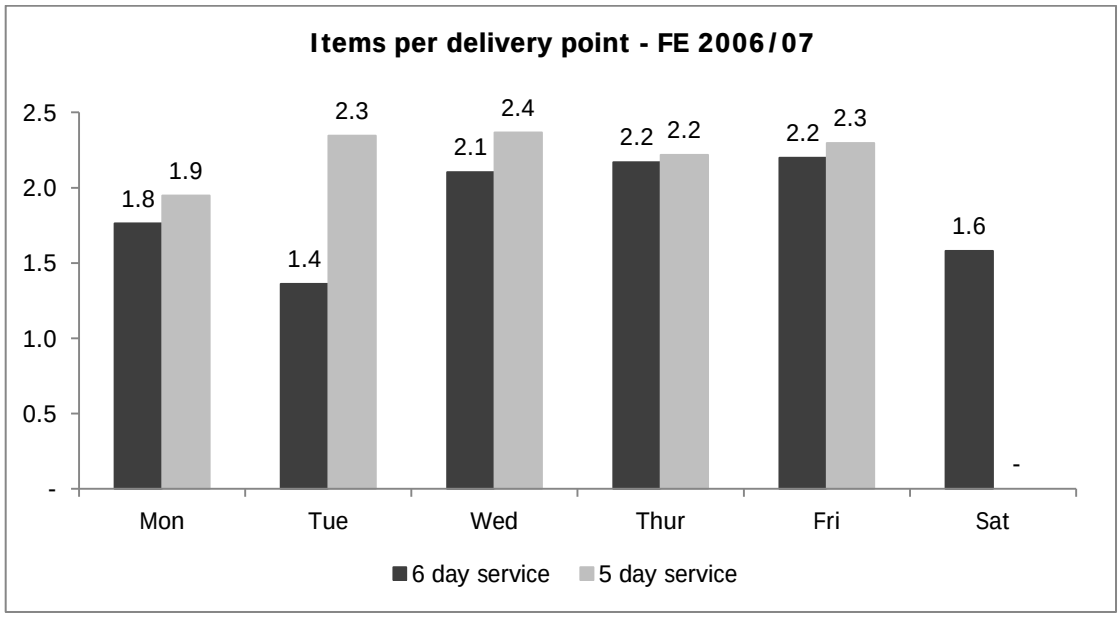
609. One option would simply be to accept FE's 4.7% increase, which has the merit of being based on detailed calculations within the FE model of how volumes would be redistributed absent a Saturday service, taking into account the mix of mail, posting profile by day, service standards, etc.

610. Within a given geography, the key cost driver for outdoor delivery costs is the call rate, i.e. the proportion of delivery points which receive mail on any given day. The call rate is strongly correlated with the average number of items per delivery point on any given day. As the average number of items per delivery point rises, the call rate rises, which raises the number of "garden path" journeys required, and the overall time and cost of outdoor delivery.

611. A redistribution of volumes from Saturday to weekdays would cause the average number of items per delivery point to rise during weekdays, which in turn would cause the call rate to rise during weekdays. This is the main reason to expect an increase in weekday costs.

612. FE's 4.7% increase was based on modelling which generated the following estimated distributions of items per delivery point, before and after the removal of Saturday services:

Figure 1 - Scenario E: FE volume distributions



[336] Page 40, RM 30.03.12 submission

613. It can be seen that the removal of Saturday services causes additional volumes across all weekdays. It is not simply a matter of Saturday volumes now being delivered on a Monday, because the removal of Saturday services has much wider implications. For example, the delivery of most 2c mail posted on a Friday would take place on a Tuesday rather than a Monday.

614. Tuesday, the quietest day of the week under a 6 day service, is forecast to become much busier, and, most importantly from a cost perspective, the busiest weekday is forecast to see an average 2.4 items per delivery point, up from 2.2 items.

615. The main difficulty with simply accepting these estimated distributions, and the 4.7% increase in weekday costs which flow from them, is that they are based on 2006/07 mail volumes, product mix, and delivery point levels. By 2015/16, all will have changed significantly, causing the level and distribution of items per delivery point to change.

616. Although RM did not provide an estimate of increased weekday costs due to volumes in its response, it did provide an estimated redistribution of volumes and items per delivery point[337]:

Figure 2 - Scenario E: RM volume distributions

[✂]

617. Another option would therefore be to base a revised estimate of the increase in weekday costs on RM's estimated distributions.

618. We are however concerned that RM's distributions are not based on 2015/16 figures either. We note that the redistribution is based on an average of [✂] items per delivery point per week, which matches the 2010/11 figure in the Restructuring Plan, but is over [✂]% above forecast delivery volumes in 2015/16. This suggests to us that the distributions also fail to reflect 2015/16 volumes, product mix and delivery point levels[338].

619. We have therefore sought to estimate distributions for 2015/16 by applying the product volume and delivery point information in the Restructuring Plan model as a revised input into the FE model. This results in the following distributions:

Figure 3 - Scenario E: Revised volume distributions

[✂]

620. Although the shape of the redistribution is similar to that suggested by RM, the average number of items per delivery point is considerably lower[339]. Again, it can be seen that the removal of Saturday services causes additional volumes across all weekdays. It is not simply a matter of Saturday volumes now being delivered on a Monday, because the removal of Saturday services has much wider implications. For example, as stated previously, the delivery of most 2c mail posted on a Friday would take place on a Tuesday rather than a Monday.

[337] Page 33, RM 30.03.12 submission

[338] Due to time constraints, we have not had the opportunity to query this with RM.

[339] Note that the total weekly items per delivery point sum to [✂], not the [✂] suggested by the Restructuring Plan. This is due to more detailed differences between the Restructuring Plan model and FE's model, including treatment of international volumes.

621. Re-running the FE model using these estimated distributions suggests a 6.6% increase in weekday costs, higher than FE's 2006/07 estimate of 4.7%, and considerably higher than the implied increase in RM's calculations of [✂]%[340].

622. The US Postal Regulatory Commission published a study of the cost savings associated with cessation of Saturday deliveries in 2011, following a 2010 proposal from the US Postal Service. The Postal Service's original calculations of estimated savings implied a 1.8% increase in weekday hours[341], whereas the Regulatory Commission's revised analysis suggested a 7.1% increase in weekday hours[342].

623. We are wary of implying any significance to the similarities between these values and those arrived at by our analysis, due to differences in both operations (mail volumes, product mix, geography) and estimation approaches (for example, the Regulatory Commission assumes that Saturday volumes all fall onto a Monday, which is already the busiest day). However, the comparison does at least give some comfort that the 6.6% increase we have calculated could be of the right order of magnitude. Equally importantly, the Regulatory Commission's approach does not appear to reveal any fundamental shortcomings in the approach we have adopted.

624. A 6.6% increase in weekday costs would suggest net savings of 11.2% of the staff cost base, or £[✂]m. This is £56m lower than the £[✂]m or [✂]% of cost savings estimated by RM, and £[✂]m lower than the £[✂]m or 12.7% of cost savings implied by the FE roll forward.

625. With more time and further information it would be possible to refine the £[✂]m estimate further. For example:

    a) The FE model is based on delivery methods in 2006/07. By 2015/16 these will have changed significantly, with far greater use of trolleys and vans, replacing pouches and bicycles. Other things being equal, one would expect this to lower the modelled increase in weekday costs, since it is partly driven by the assumed need for delivery to and collection from pouch drops, which should no longer be necessary on anything like the same scale.

    b) The FE model adopts assumptions on the extent and cost of attendance calls which differ from those underlying RM's estimate. Reflecting RM's assumptions would cause some change in the savings estimate.

    c) As noted below, experience from Guernsey suggests that customers may place a higher value on the continued delivery of packets and parcels on Saturdays, than on the continued delivery of letters. If a packet delivery service were to be retained on Saturdays, then cost savings would be significantly lower. However, we have not attempted to estimate the effect, as this is not one of the scenarios set out in Ofcom's RFI.

[340] In re-running the FE model, we have also adapted the treatment of D2D costs to reflect revised arrangements by 2015/16. FE's 2006/07 modelling assumed that total D2D costs were fixed, based on a fixed per unit payment. Under the 2010 Pay and Modernisation Agreement, D2D per unit payments have been converted into a weekly allowance (p60, 2010 Pay and Modernisation Agreement). In our revised calculations we have therefore assumed that D2D costs will flex with basic pay. The incremental effect of this adjustment is to reduce the FE model's estimate of the increase in weekday costs from [✂]% to [✂]%.

[341] Weekday hours were forecast to rise from 242.5m to 247.0m (Page 40, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11).

[342] The Regulatory Commission estimated a saving in outdoor delivery costs of 69% of that estimated by the Postal Service ($1,162m v $1,690m, page 32, *Advisory opinion on elimination of Saturday delivery*, US Postal Regulatory Commission, 24.03.11). This suggests a net saving of m hours rather than the 41.3m hours estimated by the Postal Service (page 40, *ibid.*), and an increase in weekday hours from m to m.

626. We are, however, wary of implying that the cost savings estimate can be refined to a high degree of accuracy. The main reason that the estimated level of cost savings has fallen from the £[✂]m implied by our rolled forward FE estimate to the £[✂]m suggested by our work is that traffic volumes and product mixes have changed. They will no doubt change again in future, implying a further change in estimated savings. We are conscious both of the likely long term nature of any change to the USO, and that no change is likely for this particular aspect of the USO for at least another three years. Given the pace of change in traffic forecasts, it may be more appropriate to consider our £[✂]m estimate as indicative only at this stage.

Pay Mix opportunities

627. As with indoor delivery, the above calculations assume that Saturday hours are paid at the same rate, on average, as weekday hours. There may be a pay mix opportunity from reducing Saturday hours, which RM confirms it has not evaluated[343], although in outdoor delivery it may be that some of this is undertaken by full time and part time staff on single rate pay, rather than any scheduled attendance.

Conclusion on cost savings

628. In our view, RM's estimated cost savings of £[✂]m could be overstated by around £30m.

629. The majority of RM's estimated cost savings, £[✂]m, relate to outdoor delivery staff costs. We think it likely that these savings could be overstated by some £50m to £60m as a result of insufficient account having been taken of the impact of increased volumes on costs in the remaining 5 days. Note that this estimated overstatement is based on the 2015/16 volumes and product mix forecast in RM's Restructuring Plan.

630. On the other hand, we think that RM may have understated other cost savings by around £27m:

a) RM's £[✂]m estimate of collection cost savings may be understated by around £5m, as a result of an excessive allowance for Saturday POL relief collections, and the unevaluated impact of pay mix opportunities;

b) MC savings might be closer to £[✂]m than the £[✂]m estimated by RM, due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays; and

c) indoor delivery savings closer to £[✂]m than the £[✂]m estimated by RM, again due to additional absorption opportunities for frontline staff and savings in management and support costs from no longer operating on Saturdays.

[343] Page 63, RM 03.05.12 submission

VR costs

631. RM estimates total VR costs of £[✂]m:

Table 62 - Scenario E: VR costs

	£m
Collections staff	[✂]
MC staff	[✂]
Network staff	[✂]
Local distribution staff	[✂]
Delivery staff	[✂]
Total staff cost reductions	[✂]
VR multiplier	[✂]
Total	[✂]

632. As with other scenarios, RM's estimate assumes that [✂] staff cost savings are achieved through VR, and that [✂] staff costs are saved through reductions in overtime, redeployment in other parts of the business, or natural attrition.

Overtime opportunities

633. The largest element of this estimate by far is attributable to delivery staff. To the degree that Saturdays use a higher proportion of Scheduled Attendance than weekdays, as suggested above, it should be possible to reduce delivery staff costs by reducing Scheduled Attendance, without any need for VR.

634. We note that RM has previously estimated a [✂]% reduction in the need for VR for similar reasons in respect of Scenario A. We do not have the information necessary to make a corresponding estimate in respect of this scenario, but assume a [✂]% reduction for illustrative purposes. This would reduce delivery staff cost reductions potentially requiring VR to £[✂]m, and total staff cost reductions potentially requiring VR to £[✂]m.

Redeployment opportunities and natural attrition

635. As discussed in Scenario A, assuming no reduction in the need for VR to reflect redeployment opportunities and natural attrition may be reasonable in the short term.

636. In the longer term, however, the need for VR might be substantially lower.

637. The residual reduction in delivery staff costs (after adjusting for overtime) of £[✂]m equates to around [✂]% of the delivery staff cost base. Compared with natural attrition rates of the order of [✂]% for full time staff and [✂]% for part time staff, [✂], it would seem that less than [✂] the [✂]% reduction would require VR[344].

638. With regard to the other pipeline elements, we note that estimated staff cost savings, which total £[✂]m, are relatively small proportions of the staff costs for each pipeline element:

a) [✂]% for collections staff;

b) [✂]% for MC staff;

[344] We note that part time staff that would require VR are likely to have shorter service records than full time staff and therefore have lower VR to staff cost ratios.

c) [✂]% for network staff; and

d) [✂]% for local distribution staff.

639. We would therefore expect many of these savings to be achievable through natural attrition.

Conclusion on need for VR

640. We therefore think that a more reasonable estimate of staff cost savings requiring VR would be around £[✂]m in the short term, and around £[✂]m in the longer term. At the [✂]% rate assumed by RM, this would equate to VR costs of £[✂]m and £[✂]m respectively.

641. These conclusions relate to RM's cost saving estimates. Our own estimates are of £50m lower staff cost savings in delivery, and £20m higher staff cost savings in other pipeline areas. Applying the same adjustments as above generates an estimate of staff costs savings requiring VR of around £[✂]m in the short term, and around £[✂]m in the longer term. At the [✂]% rate assumed by RM, this would equate to VR costs of £[✂]m and £[✂]m respectively.

Benefit sharing costs

642. RM has not estimated benefit sharing costs for this or any other scenario.

643. As noted in the introduction section above, however uncertain these costs are, we believe that they should receive some consideration. [✂]

Scope of change

644. The scope of the change is broad, fundamentally affecting staff throughout the business. This suggests that payments might be required to all remaining staff, some [✂] people.

Scale of change

645. The scale of change is significant, with an end to Saturday working. What is less clear is the potential scale of resistance.

646. On the one hand, as noted by RM in its response, an end to Saturday working could prove attractive to many staff:

[✂] [345]

[✂] [346]

647. This point of view is supported, albeit on a relatively small scale, by the experience of Guernsey Post (see below).

648. On the other hand, some employees may find working on Saturdays attractive:

a) for lifestyle reasons;

b) due to relatively light workloads on Saturdays, assisted, we understand by not delivering Mailsort 3c on that day; and

c) for boosting weekly take home pay to the degree staffed at premium Scheduled Attendance rates.

[345] Page 32, RM 30.03.12 submission
[346] Page 33, RM 30.03.12 submission

649. It cannot therefore be assumed that the change would not be resisted, and it would not be surprising to find some benefit sharing payment necessary. We would through expect it to be [✂].

Illustrative impact

650. A one-off payment of say £[✂] to £[✂] per affected staff, paid to [✂] staff, might result in a total benefit sharing cost of £[✂]m to £[✂]m.

651. We stress that this cannot be relied on as an estimate of the likely level of benefit sharing costs; however it can at least serve as an illustrative benchmark of the potential scale of such costs.

Special Delivery Next Day and International

Impact on service specification

652. The cost saving estimates assume no deliveries of Special Delivery on inward international mail, and no collection of outward international mail, on the ceased day[347].

653. In terms of international mail commitments, RM has explained that while real performance into and out of the UK would (in some cases) be delayed by a day, UPU measures performance based on operational days (which would fall from 6 to 5) rather than actual days[348].

Cost of avoiding impact

654. RM estimates that retaining the capability to deliver Special Delivery on the ceased day would add back £[✂]m to £[✂]m of the cost savings in delivery, processing, local distribution and network costs [349].

655. We note that should RM also retain some capability for the delivery of packets on Saturdays, some additional costs could be shared between the two product groups.

Alternatives to Saturdays

656. In common with RM's response, we have focused above on ceasing collections and deliveries on Saturdays. RM estimates that cost saving opportunities from ceasing deliveries on a weekday would be [✂][350], but notes:

a) collections and outward processing would probably continue on the weekday in question to ensure a steady flow of traffic through the network;

b) weekday cessation would involve additional operational complexity; and

c) weekday cessation would be [✂][351].

[347] Page 33, RM 30.03.12 submission
[348] Page 65, RM 03.05.12 submission
[349] Page 33, RM 30.03.12 submission
[350] FE stated that ceasing deliveries on a day other than Saturday might not be legally possible as the European Postal Directive requires collections and deliveries every working day (page 15, FE 2008 report). We have not attempted to examine the legal context for such a possibility.
[351] Page 33, RM 30.03.12 submission

657. We agree that in principle, due to the high fixed costs associated with outdoor delivery, significant savings could still be achieved by ceasing deliveries on a weekday. We note that the Dutch government is apparently considering allowing PostNL to move to a 5 day service by ceasing deliveries on Monday[352]. However, we think it likely that in the case of RM, achievable cost savings from weekday cessation are likely to be materially lower than from Saturday cessation.

658. In part, this is due to the features of weekday cessation which RM identifies, and with which we agree. The continuation of collections and outward processing on the weekday in question, the additional operational complexity, and [✂], will all have cost implications.

659. Further reductions in cost savings could come from the redistribution of delivery volumes on the remaining days of the week, and resulting increased delivery costs on those days. Cessation of Saturday deliveries would cause an increase in Tuesday delivery volumes (see Figure 3 above); but since this is the quietest day of the week, the maximum delivery volume on any single day is only slightly higher after cessation. As a result, the level of increased delivery costs on remaining days is relatively modest.

660. We think there is a significant risk that the impact of redistributed volumes would be greater following a weekday cessation. RM provided some analysis with its submission to suggest that this might not be the case[353], but as noted above, this appears not to be based on 2015/16 volumes. Preliminary adaptation of the FE model suggests that, using 2015/16 volumes, the impact would indeed be greater following a weekday cessation.

661. Quantification of these potential reductions in cost savings would require further information from RM on the precise nature of the network changes it would envisage under weekday cessation. At this stage, we think it likely that the cumulative effect of the issues discussed would lead to reductions material enough to confirm Saturday as the clearly preferable candidate for cessation from an operational perspective, other things being equal.

662. However, we are mindful that, as in Guernsey and Jersey, customers might value the continuation of packet deliveries on a Saturday, particularly as fulfilment volumes grow. If customer research were to suggest a strong desire for the retention of packet deliveries on Saturdays, it may be that complete cessation of deliveries on a weekday would deliver greater cost savings than cessation of letter deliveries, but retention of packet deliveries, on a Saturday. It might then be appropriate to examine weekday cessation in greater detail.

[352] *Dutch postal reforms to eliminate Monday deliveries*, postandparcel.info, 21.12.11
[353] Page 33, RM 30.03.12

Appendix 1 – Calculation of discounted payback period

We have calculated discounted payback periods for each scenario, as an aid to comparing cost savings and transition costs.

Calculated payback periods are based on the savings and transition costs submitted by RM, and are subject to the same limitations as RM's estimates. In particular, they do not reflect the commercial impact of potential changes on mail volumes and revenues, and do not include a complete estimate of transition costs for all scenarios.

The discounted payback period is the time taken for the present value of cumulative cost savings to equal the present value of transition costs, i.e. for the scenario to break even in present value terms. The discounted payback period takes account of the fact that the cost of capital makes a future cost saving of £100 worth less than an upfront transition cost of £100, and as a result discounted payback periods will in general be longer than simple undiscounted payback periods.

We have used the following formula to calculate the discounted payback period, n, in years:

$$n = \frac{\ln\left[\frac{1}{\left(1-\frac{rc}{s}\right)}\right]}{\ln(1+r)}$$

Where:

ln = natural log

r = real pre-tax discount rate, taken as 10% in line with the October 2011 report on the financeability of the Universal Service prepared by Cambridge Economic Policy Associates for Ofcom[354]

s= annual cost saving (assumed to occur as a lump sum, starting at the end of year 1, broadly equivalent to assuming monthly cost savings starting in the middle of year 1)

c = transition cost (assumed to be incurred at the start of year 1)

The assumed timing of cost savings is approximate. For example, in some cases staff cost savings may start immediately after VR transition costs are incurred, whereas in other cases there may be a longer delay before savings start. RM's submissions are not detailed enough to determine precise implementation timings. It may be appropriate to apply more detailed timing assumptions if and when implementation timings are considered in greater detail.

[354] Cambridge Economic Policy Associates estimate a range for the pre-tax cost of capital of 6.2% to 8.3% if RM is seen as similar to a regulated infrastructure company, and a range of 9.7% to 10.4% is estimated if RM is seen as a logistics company. However, they indicate that RM would probably not be financeable on the former basis. *Financeability of the Universal Service*, Cambridge Economic Policy Associates, October 2011

Derivation of formula

The payback period, n, is when c = PV of savings to year n.

The PV of savings to year n is given by the annuity formula:

$$s\left[\frac{1-(1+r)^{-n}}{r}\right]$$

So we are looking for n, where

$$c = s\left[\frac{1-(1+r)^{-n}}{r}\right]$$

Solving for n:

$$\frac{rc}{s} = 1-(1+r)^{-n}$$

$$\frac{1}{(1+r)^{n}} = \left(1-\frac{rc}{s}\right)$$

$$(1+r)^{n} = \frac{1}{\left(1-\frac{rc}{s}\right)}$$

$$\ln\left[(1+r)^{n}\right] = \ln\left[\frac{1}{\left(1-\frac{rc}{s}\right)}\right]$$

$$\mathrm{n} = \frac{\ln\left[\frac{1}{\left(1-\frac{rc}{s}\right)}\right]}{\ln(1+r)}$$