

A2 Economics – Business Economics
COMPETITION IN ACTION
ROYAL MAIL PRIVATISATION

Vertical Integration

Labour costs for the Royal Mail are a high percentage of operating costs

Collection



Processing



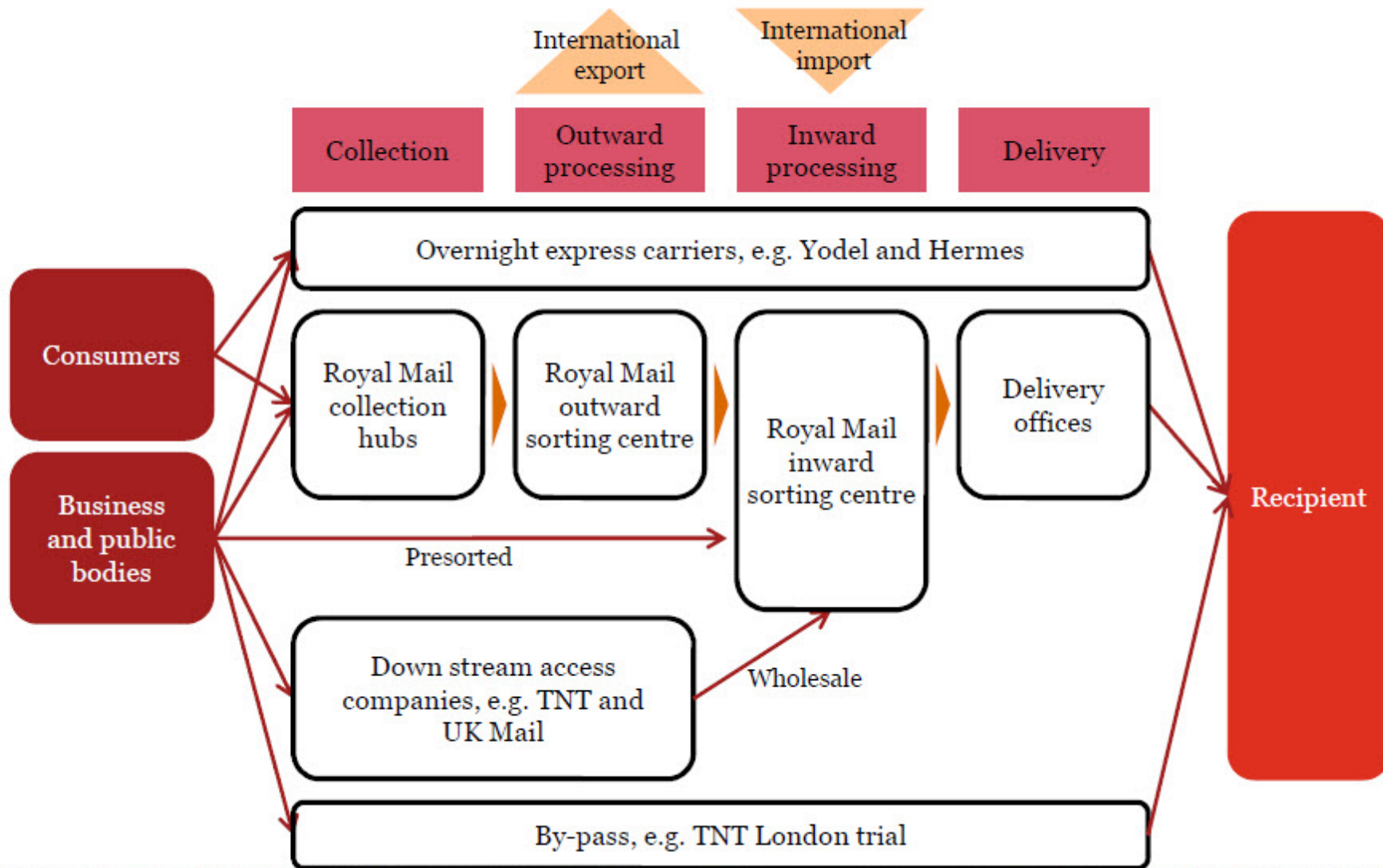
Delivery



Increasing competition

- **Access competition** is where the operator collects mail from the customer, sorts it and then transports it to Royal Mail's Inward Mail Centers, where it is handed over to Royal Mail, who are paid to deliver it. Nearly 40% of mail is now covered by access competition
- **End-to-end competition** – this is where an operator other than Royal Mail undertakes the entire process of collecting, sorting and delivering mail to the intended recipients. TNT Post (Whistl) began trailing end-to-end delivery operations in West London in 2012 but suspended this in April 2015

Covered in our projection: the UK letter and parcel delivery market



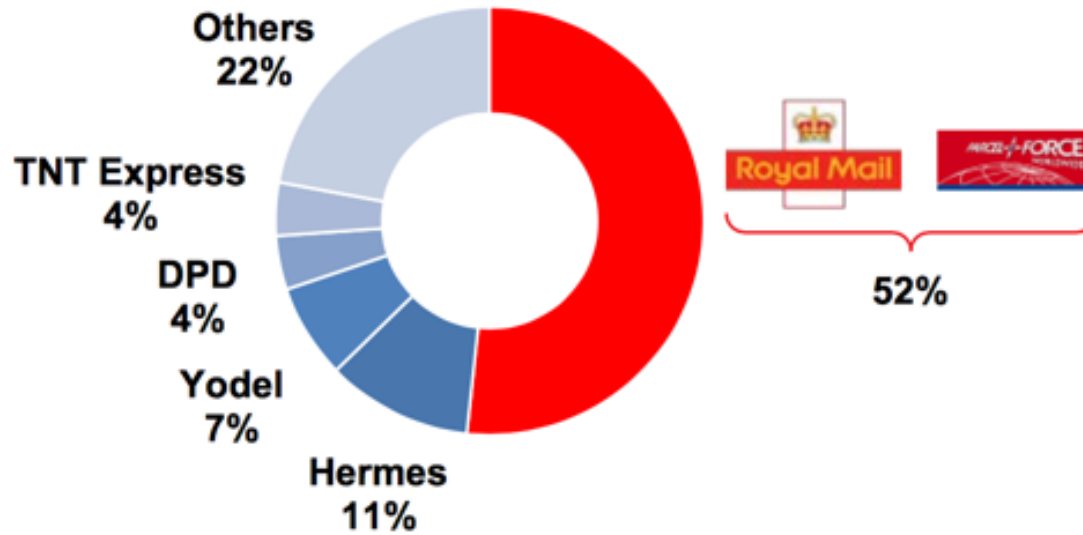
Vertical integration is clear here – the Royal Mail has an extensive supply network from post boxes to sorting centers and delivery offices.

Privatisation of the Royal Mail

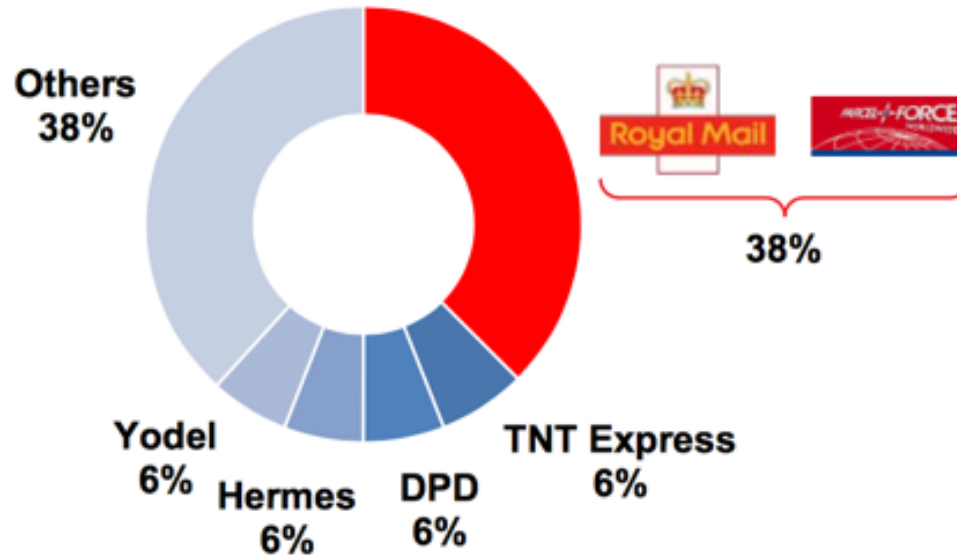
- The government privatized Royal Mail by **floating the company** on UK stock market to allow retail investors to buy shares in the business
- On 10 October 2013, the Government published its announcement of the **Offer Price** setting the price of the shares at 330p per share
- Government retained **30% of shares** in Royal Mail
- 10% of the shares given free to **Royal Mail employees**
- Total proceeds of the sale were £1.9 billion
- Royal Mail also owns **Parcel Force**

UK Parcels Market Share¹

Volume



Revenue



Amazon launches same-day delivery service in the UK

Gill Plimmer

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[Amazon](#) has launched its first same-day delivery service in Britain in a move that is expected to intensify competition in the postal market

The online retailer will deliver parcels to local newsagents and high street shops within 12 hours using [Connect Group](#), the newspaper distributor formerly branded Smiths News. Demerged from [WHSmith](#) in 2006, the group delivers 40m newspapers and 14m magazines a week to its 30,000 UK customers including supermarkets, independent retailers and petrol stations.



- Royal Mail - allocation of shares at offer price
- Shares (million) and %
 - Individuals 172m (17%)
 - Financial Institutions 428m (43%)
 - Employee Free Offer 100m (10%)
 - Government 300m (30%)
 - Total 1000m (100%)

Royal Mail Ordinary Share Price

Daily Closing Price



Building the Case for Privatisation

1. Floatation **raises income** for the government (£2bn)
2. Listing the Royal Mail allows the business to **access equity markets** to finance capital investment
3. Employee-share ownership will improve **productivity** and reduce the risk of costly strikes
4. Operating in the private sector will lead to improvements in efficiency over time – e.g. stock market pressure to **control costs**
5. Royal Mail is in an increasingly contestable industry and needs to be free to make **commercial decisions**
6. A more efficient and profitable Royal Mail will pay increased **corporation tax** in the long run

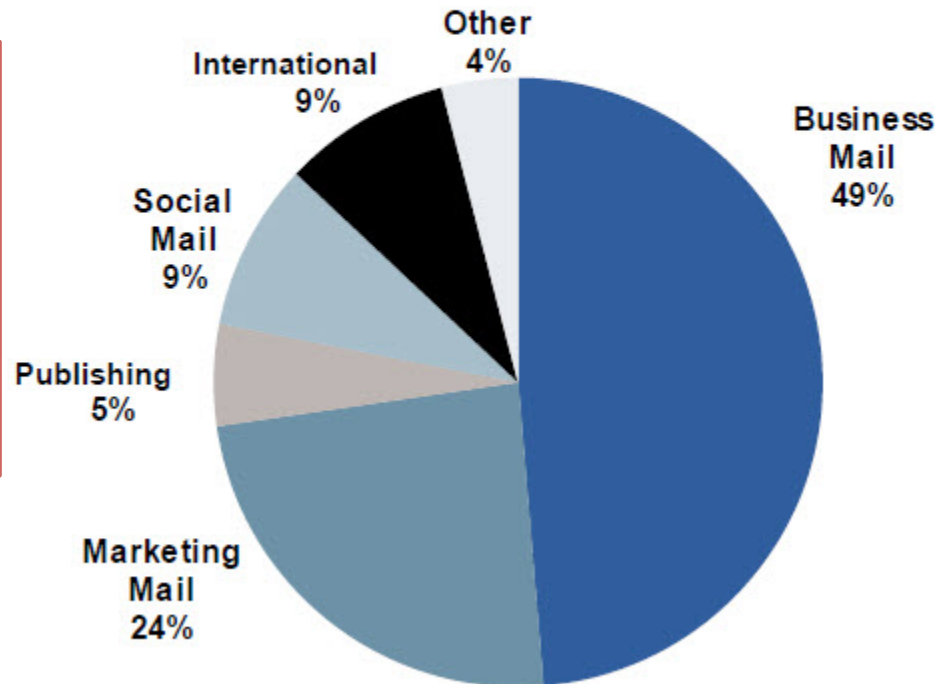
Critics of Mail Privatisation

1. Privatisation was strongly opposed by the Trade Unions
2. Surge in price post floatation led some to argue that the Royal Mail was sold off too cheaply
3. Transferring the Royal Mail into the private sector will cost thousands of jobs as they look to cut their costs
4. The government took over the pension debt of the Royal Mail at the time of privatization
5. **Universal service obligation** is best provided by a government-owned business (i.e. social ownership)
6. The Royal Mail can improve their performance and profitability **inside the public sector** – e.g. from better management – it does not need to be privatized
7. Government can also provide the funding for the investment needed to make Royal Mail more productive

A declining market for letters

Total Letter Revenue – 2013-14

UK inland letter volumes declined by 3.1% p.a. from 2005 to 2008, and by 6.3% p.a. from 2008-2013, as the economic downturn increased the rate of decline



UK parcel volumes grew by 4.3% p.a. from 2005 to 2008 and by 3.7% p.a. from 2008-2013, mainly reflecting increasing use of online shopping by consumers

Annual decline in the volume of addressed letters in the UK is around 4% - this is a major challenge for a privatised Royal Mail

Universal Service Obligation (USO)

- Royal Mail has a legal obligation to deliver letters everywhere in the country with a delivery to each postal address once per day
- Increasing competition in direct mail deliveries from rivals such as TNT (operating in London) are eating into Royal Mail's market share in more profitable urban areas
- Royal Mail must still deliver to rural areas where the service runs at a substantial loss

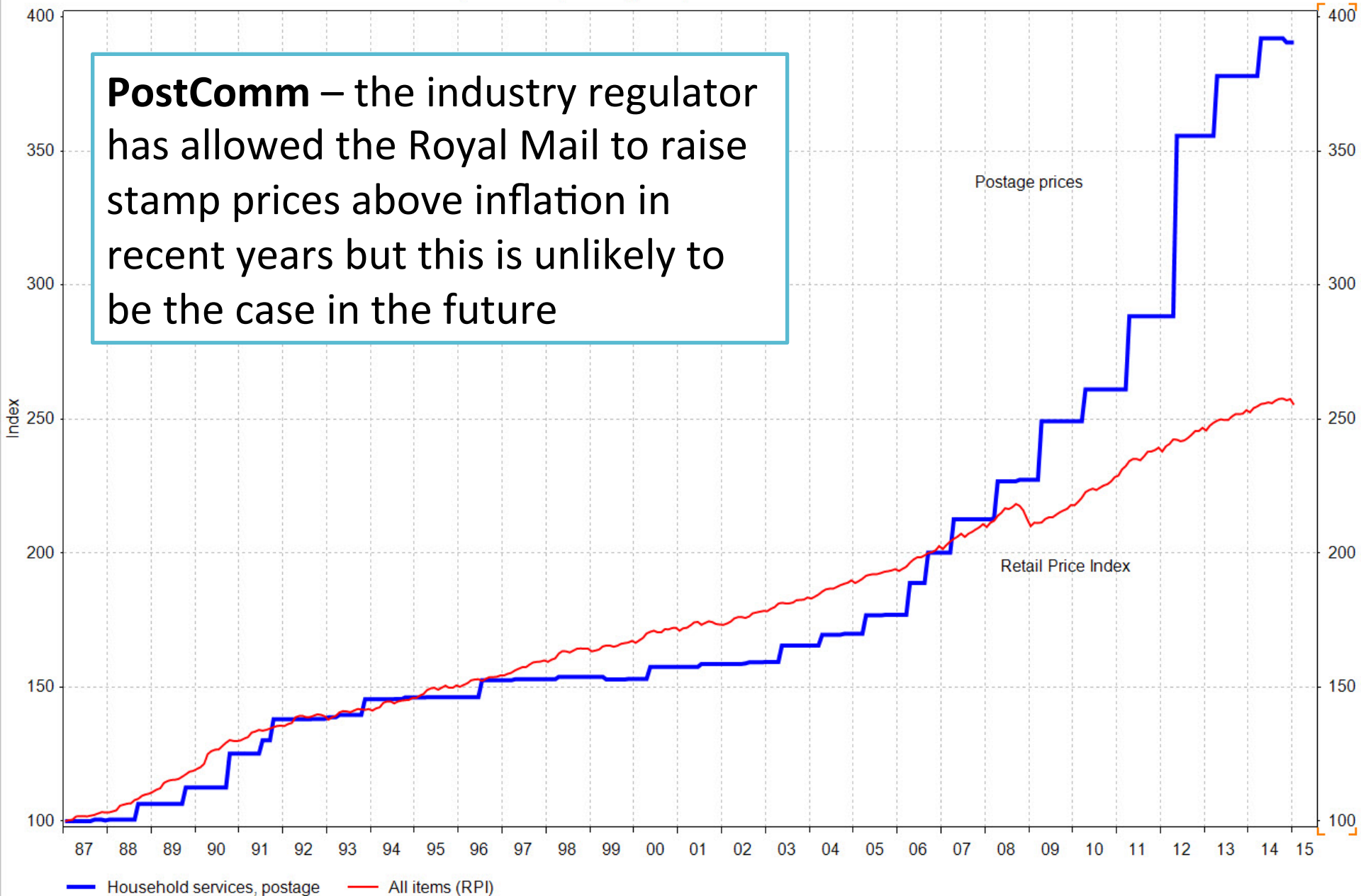
Quality of Service Obligation

- Royal Mail's latest Quality of Service report reveals that the company beat its Second Class target for the first three quarters, delivering 98.9 per cent within three working days against a target of 98.5 per cent.
- For the same period, Royal Mail delivered 92.9 per cent of First Class mail the next working day. Adjusted for exceptional events outside Royal Mail's control, the company achieved the 93.0 per cent First Class mail target.
- Royal Mail has the highest universal service specification of any major European country

Retail Price Index (RPI) and Index of Postage Prices

Index, 1987=100, monthly data, source: UK Retail Price Index

PostComm – the industry regulator has allowed the Royal Mail to raise stamp prices above inflation in recent years but this is unlikely to be the case in the future



Economic efficiency in mail industry

- Allocative efficiency
 - Pricing close to marginal cost of supply
 - Competition helps to keep real prices down
- Productive efficiency
 - Achieving lowest unit operating costs in SR and LR
 - Minimising waste and inefficiency in supply
- Dynamic efficiency
 - Meeting fast-changing needs and wants of customers
 - Business users and millions of households
 - E.g. Tracked delivery for all letters and parcels
 - Secure postage services given fears over internet security

Competitive challenges for Royal Mail

- **Retailers and e-retailers**

- Amazon own-delivery network adds capacity equivalent to a new operator
- Same day delivery services bought by eBay
- Retailers e.g. Tesco developing in-house Click & Collect / returns services
- Third party Click & Collect continues to grow

- **Contestable parcels industry – rival parcel/mail firms**

- DPD and Hermes announced Sunday deliveries
- Yodel launches courier collection for online traders
- TNT has started direct delivery of mail in some UK cities

Competitive challenges for Royal Mail

- **Other challenges to Royal Mail volumes and revenues**
 - E-mail and secure cloud storage – substitutes for handling mail – long term decline in the volume of addressed letters sent in the UK
 - 3D printing at home / business may reduce parcel volumes
 - Shift of marketing to social media reduces volumes of direct mail
 - Advanced screen technology and increased e-cards / biometrics reduces need for banks to send out new cards

Private Finance Initiative (PFI)

- Privatisation is a **transfer of ownership**
- **The PFI is not traditional privatization**
- PFIs are a type of Public Private Partnership (PPP) in which the government and the private sector both contribute to the creation or renewal of infrastructure.
- PFI schemes have existed since the early 1990s e.g. used to build and run hospitals, schools and prisons among other things

Analysis Diagrams in the Exam

- Draw a diagram to explain why the letters delivery business for Royal Mail makes losses
- Draw a diagram to show internal economies of scale for a business such as Royal Mail
- Draw a diagram to show how increasing contestability might lead to a reduction in X-inefficiency
- Draw a diagram to show a satisficing price and output equilibrium for Royal Mail (contrasted with profit maximization)

Royal Mail Privatisation



A2 Business Economics

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