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## **AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE: A CAUTIONARY LESSON FOR THE U.S. POSTAL SERVICE FROM GREAT BRITAIN'S ROYAL MAIL**

### *Executive Summary*

In December 2008, the British and American governments issued major reports on their nations' postal services.

The Hooper panel in the United Kingdom described Royal Mail as a behind-the-times enterprise that needs to invest more in automation but is hobbled by a massive pension debt. The panel recommended the government take over the pension liability (a taxpayer bailout) and that part of Royal Mail be sold to a private company to inject capital and provide greater business expertise. The leadership of Britain's Labour government supports the findings.

In the United States, the Postal Regulatory Commission (PRC) examined the U.S. Postal Service's universal service obligation (USO) and postal monopoly. The PRC did not recommend any major changes, although it suggested that the USO remain flexible so that, if the need arises, the Postal Service can adjust the USO to keep mail service economical.

Many factors contributed to the vote of no confidence in Royal Mail and the vote of confidence in the U.S. Postal Service. One major difference is that the Postal Service is not plagued by strikes. The Postal Service has also benefitted because it has been a leader among the world's posts in two key efficiency-enhancing areas: it has long invested heavily in automation, and it indirectly opened up much of upstream mail processing to competition a generation ago.

The combination of global recession and electronic diversion is placing enormous strain on mail volume and revenue. A nonrigid USO will help the Postal Service cope. In addition, future mail service in this country will be stronger if Congress allows the Postal Service more flexibility in rationalizing its distribution network and more control over employees' wages and benefits. An incentive for Congress to permit this flexibility is that, as the comparison of Royal Mail and the U.S. Postal Service shows, modest reforms taken early can sometimes avert more drastic changes needed later.

# **AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE: A CAUTIONARY LESSON FOR THE U.S. POSTAL SERVICE FROM GREAT BRITAIN'S ROYAL MAIL**

Within several days of each other in December 2008, the British and American governments issued major reports on their nations' postal services. The findings are starkly different. The American report expressed confidence in the U.S. Postal Service and did not recommend major changes, although it repeatedly stressed that the Service needs operational flexibility to respond to evolving conditions. The British study concluded that Royal Mail is foundering and urgently requires major reforms, including partial privatization. The contrasting findings offer lessons for the United States: they throw light on some past actions that have benefitted mail service in this country, and they point to several challenges for the Postal Service that should be addressed sooner rather than later.

## **The two studies**

Concerned by the shaky finances and declining service quality of Royal Mail, the British government appointed a panel to examine the organization. Richard Hooper, the former Deputy Chairman of the British communications regulator Ofcom, headed the review. The panel found "a general consensus that the status quo is untenable."<sup>1</sup> "First and foremost," it wrote, "Royal Mail is much less efficient than many of its European peers."<sup>2</sup> Additional serious problems are "a large and volatile pension deficit," "poor labour relations," and a "difficult relationship with the [postal] regulator."<sup>3</sup> The description of labor relations as poor is an understatement: "In 2007, the postal sector accounted for 60% of the days lost to industrial action across the whole [British] economy."<sup>4</sup> The Hooper panel also noted that most Western European posts achieved healthy profits in 2007; Royal Mail was the only major Western European post to lose money.<sup>5</sup>

In January 2006, the United Kingdom ended the mail monopoly (a process known as liberalization in Europe). Competitors now handle about 20% of

upstream mail processing, but in almost all cases they turn the mail over to Royal Mail for delivery in the "final mile".<sup>6</sup> The panel cited an estimate that liberalization "reduced Royal Mail's operating profit by £100 million in 2007-8."<sup>7</sup> However, it judged that the real financial "threat" is the "explosion of digital media – internet, email, mobile text and broadcasting – [which] has prompted an unprecedented decline in the letters market."<sup>8</sup> The panel added, "Until now, this structural decline has been moderated by economic growth," but a sharper volume decline is now to be expected because of the current worldwide economic slump.<sup>9</sup>

The Hooper panel concluded that Royal Mail cannot successfully modernize on its own due to falling mail volume, escalating pension costs, and acrimonious labor relations that frequently erupt into strikes. Furthermore, Royal Mail cannot simply go to the government for a financial bailout because of European Union rules on state aid. "A radical reform of Royal Mail's network is inevitable," the panel wrote.<sup>10</sup> Its main recommendations are:

- Partially privatize Royal Mail by selling a stake in it to a private-sector enterprise, likely one of the other European posts.<sup>11</sup> The sale would inject capital and, it is hoped, greater business expertise.
- Have the U.K. government assume responsibility for Royal Mail's pension obligations.
- Replace the regulator.

One might suppose that the U.K.'s Labour government, which counts on union support, would be appalled by these suggestions. In fact, however, the party leadership supports the recommendations as unpleasant but necessary. Lord Mandelson, the government's Business Secretary, said to the House of Lords, "[T]he Government agrees with Hooper's analysis and the recommendations... Royal Mail and the postal market can thrive in the future – provided

that decisive action is taken now."<sup>12</sup> Many backbench Labour Members of Parliament, though, oppose partial privatization and are trying to block it.

In the United States, in response to a directive from Congress in the Postal Accountability and Enhancement Act of 2006 (PAEA, P.L. 109-435, sec. 702), the Postal Regulatory Commission (PRC) has produced a major study examining the Postal Service's universal service obligation (USO) and its statutory monopolies on letter delivery and mailbox access.<sup>13</sup> The report carefully traces the histories of the USO and the monopoly, noting how they have changed over time. It estimates the cost to the Postal Service of the USO and the value the agency derives from the monopoly.

The report explains that the USO has often shifted in the past based on what is financially consistent with economical postage rates. The report strongly urges that the USO continues to be flexible in the future, especially because of the financial strains to be expected from the current financial downturn and future electronic diversion. Observing that most people are relatively satisfied with the status quo, the report does not recommend any major changes in the monopoly or the Postal Service's public ownership. In the Commission's words, "The message the Commission received through comment and testimony is that the system works, most mailers and recipients are satisfied, and not to propose any radical changes."<sup>14</sup>

In 2003, the bipartisan President's Commission on the U.S. Postal Service similarly found, "More than two-thirds of respondents indicate they are generally satisfied with the service and value they receive from the Postal Service."<sup>15</sup> Further evidence of the favorable attitude is that for several years in a row a public opinion survey has found the Postal Service to be the most trusted federal agency.<sup>16</sup>

### **Why are perceptions in the two countries so different?**

Many factors undoubtedly play roles, but four seem especially significant: strikes, modernization, pension funding, and comparisons with other posts.

Strikes. Postal strikes occur in many nations, but those in the United Kingdom have been unusually frequent and prolonged, creating severe disruptions in the quality of mail service. The work stoppages have frustrated mail users, eroded public confidence in Royal Mail, and made people think more seriously about alternatives. The U.S. Postal Service has escaped a comparable hit to its reputation because strikes by federal employees are illegal in this country.<sup>17</sup>

Modernization. Royal Mail, which was arguably the world's greatest postal service during the Victorian era, has been slower to modernize than many other European posts. The Hooper panel wrote, "At Royal Mail, postal workers sequence all their letters by hand before setting off on their delivery rounds. By comparison, European operators sequence 85% of their letters by machine."<sup>18</sup> Furthermore, "[s]ince the 1990s, Royal Mail's national distribution network is virtually unchanged, whereas modern European companies have reduced the number of mail centres by around 50% to optimise their operations."<sup>19</sup> Not surprisingly, then, Royal Mail is a high-cost organization with weak productivity, 40% less efficient, it estimates, than its European rivals.<sup>20</sup> In contrast, the U.S. Postal Service is a world leader in the automation of mail processing, although Congressional resistance has slowed its efforts to rationalize its distribution network.

Pension funding. Royal Mail's pension deficit was £5.9 billion as of March 31, 2008,<sup>21</sup> but more recent estimates are in excess of £7 billion. That is over 100% of Royal Mail's annual revenue (i.e., roughly one entire year's gross revenue would have to be set aside to cover this future liability).<sup>22</sup> The Postal Service has no pension deficit. The Postal Service, though, is not completely out of the woods: it has an unfunded liability of \$53.5 billion (about 70% of one year's gross revenue) for retirees' health care benefits.<sup>23</sup>

International comparisons. European nations frequently look at each others' performance because of their geographic proximity, the large flows of capital, labor, and trade within the block, and the

political and economic integration brought about by the European Union (EU). As indicated above, Royal Mail scores poorly in the comparisons. Moreover, the comparisons send the strong message that Royal Mail should do better, based on the success of some of its rivals. International comparisons are less common in the United States because of this country's vast size, both geographically and economically. When international comparisons occasionally are made here, the U.S. Postal Service points out that its productivity is higher than that of posts in most other country's and that it delivers about 40% of the world's mail, although it lags in profitability. The Postal Service also argues that mail delivery may be more challenging here than in the average European country because distances are longer and population density is lower.

An additional factor is the perceived quality of management. The Hooper panel and the British government believe Royal Mail is less well managed than several European posts and would benefit from the infusion of new management talent that partial privatization would bring. In the United States, the Postal Service's current top management is highly regarded in terms of knowledge of postal operations and general competence. While certainly not perfect, it is seen as one of the Service's strengths; virtually no one wants to replace it with a new management team.

### **The impact on current performance of past decisions**

The efficiency differences between the U.S. Postal Service and Royal Mail are largely explained by actions the Service took years ago and Royal Mail has not taken until recently.

Since the 1970s, the Postal Service has invested heavily to automate an increasing share of mail processing. Some mistakes were made along the way, but the efforts are now paying large dividends in terms of higher reliability and lower costs. In contrast, Royal Mail was a laggard in the 1990s when some other European posts were heavily

mechanizing. If Royal Mail had acted sooner, it would have avoided much of the productivity gap it now faces.

For 13 years, Royal Mail took a "pension holiday" during which it made no pension-funding contributions.<sup>24</sup> By the time it ended the "holiday" earlier this decade, it had dug itself a huge financial hole. The U.S. Postal Service avoided a similar predicament because, as required by law, it made the contributions needed to fund its pension obligations. (The Postal Service does have a large unfunded liability for health benefits to retirees, and is in the process of paying it down.)

Different paths towards liberalization have also worked in the U.S. Postal Service's favor. European leaders generally believe that opening mail markets to competition will ultimately be good for mail users and European economies. However, the road to liberalization has been rocky for Royal Mail, although the Hooper panel judges that the organization's main problems lie elsewhere. In addition to losing some business and income in upstream mail processing, Royal Mail claims that the access fees for mail entering its system in the "final mile" are too low and do not cover costs. (Royal Mail's regulator disputes the latter claim.) In the United States, the Postal Service began, almost by accident, a limited, backdoor form of liberalization in the 1970s. To reduce mailers' objections to a rate increase, the Service began offering so-called workshare discounts to mailers who help with preliminary mail processing. The size of the discount is based on how much the mailers reduce the Postal Service's costs. Provided the discounts do not exceed the Service's avoided costs, both sides gain. The Service's net income on each piece of mail is at least as high as before and it can profit from a workshare-induced rise in mail volume. Mailers save money if they are more efficient than the Postal Service at upstream mail processing. The economy wins because more mail processing is done by the most efficient producers. Years before liberalization began in Europe, worksharing was spurring innovation and greater efficiency in the American mailing industry. (For worksharing to operate as

intended, it is vital that the regulator continue vigilantly to monitor workshare discounts to be sure they are not excessive, a precaution called for in section 201 of PAEA.)

### **Royal Mail's missed opportunities**

One should be careful not to overstate Royal Mail's problems. Its postage rates are among the lowest in Europe.<sup>25</sup> Mail usually arrives promptly, although its on-time-delivery performance is lower than those of the U.S. Postal Service. Royal Mail generally delivers to front doors, not to the less convenient cluster boxes or curbside or roadside mailboxes that the U.S. Postal Service often uses. Royal Mail came close to breaking even in 2007-08, despite increased competition, high pension costs, and acrimonious strikes. Mail deliveries frequently occur late in the day and delivery times often vary from day to day, but those are complaints in this country, too.

Since 2002, the Royal Mail Group has trimmed its workforce by over 40,000 to reduce costs, although the current workforce of nearly 200,000 may still be on the high side relative to revenue.<sup>26</sup> In early 2008, it reformed its employee pension system prospectively, which will eventually yield large cost savings.<sup>27</sup> The Royal Mail Group has recently closed many lightly-used post offices, and Royal Mail has begun working to consolidate its network of distribution plants. (These actions have triggered protests similar to those seen in this country when the U.S. Postal Service attempts to consolidate or close facilities.) Despite a sharp downturn in mail volume, Royal Mail has swung to a slight operating profit so far in 2008-09, as a result of its cost cutting.<sup>28</sup>

Indeed, it is plausible that Royal Mail might by now have become one of the stronger posts in Europe if, a decade or so ago, it had started making larger investments in automation, done more to trim its distribution network, and contributed more toward its pension liabilities. Royal Mail's finances would certainly be healthier if it had reformed its pension system a decade earlier rather than waiting until 2008. These actions would have been modest

compared to the changes the Hooper panel is now recommending. Yet, if they had been made some years ago, they could have maintained Royal Mail's quality of service and protected British taxpayers from being forced to bail out Royal Mail's pension plan. The sweeping changes now being considered would probably be off the table.

### **A warning for mail service in the United States**

In this country, the PRC's suggestion that the USO remain somewhat flexible is consistent with historic precedent and seems financially prudent. It is especially sensible in light of the deepening recession and the continuing diversion of potential business to electronic alternatives, both of which are placing intense pressure on the Postal Service's mail volume and revenue.

The PRC mentions the economic slump in its report and adds approvingly that the Postal Service "is responding... [It] continues to streamline its network and labor force to maintain universal service, but at a lower cost."<sup>29</sup> Nevertheless, the PRC is plainly worried by the financial pressures and recommends that Congress in the future be willing to "consider and balance all the features of universal service as part of any review of changes necessary to preserve a financially viable Postal Service."<sup>30</sup>

The experience of Royal Mail, where modest reforms taken sooner could have headed off the more painful choices now required, suggests Congress should also be flexible regarding other ways in which the Postal Service could better manage its operating costs. The Service has a sprawling nationwide network of distribution facilities. Congressional resistance has slowed efforts to rationalize that network. Many studies have concluded that postal workers, on average, receive somewhat higher wages than those of comparable workers in the private sector, and that postal benefits are much higher. Statutory restrictions, however, limit the Service's ability to control wage and benefit levels. If Congress were to show greater flexibility in the future regarding network rationalization and postal compensation, the Service would be better able to respond to financial challenges. That would help

protect the Service's long-term viability; an outcome similar to that at Royal Mail would be less likely. A bonus is that with more efficient operations the Postal Service would have less need to lower universal service standards, which would benefit mail

users and permit the Service better to fulfill its government-assigned mission.

Michael Schuyler  
Senior Economist

*This is another of a continuing series of IRET papers examining the U.S. Postal Service. IRET began its work in this area in the mid 1990s. Norman Ture, the organization's founder, believed that growth and prosperity are advanced by restricting government to a limited set of core functions. From this perspective he was concerned about the activities of government owned and sponsored businesses. The Postal Service stands out among government businesses because of its size — it employs about 30% of the federal government's civilian workforce. For many years — but fortunately much less so under the current Postmaster General — it was also notable for aggressively trying to expand beyond its core mission.*

### ***Endnotes***

1. Richard Hooper, Deirdre Hutton, Ian R. Smith, "Modernise Or Decline: Policies To Maintain The Universal Postal Service In The United Kingdom," December 16, 2008, p. 6, accessed at <http://nds.coi.gov.uk/imageLibrary/downloadMedia.asp?MediaDetailsID=260625>.
2. *Ibid.*, p. 10.
3. *Ibid.*, p. 49.
4. *Ibid.*, p. 10.
5. *Ibid.*, p. 11.
6. *Ibid.*, p. 48. Royal Mail's delivery share in the "final mile" is 99%.
7. *Ibid.*
8. *Ibid.*, p. 8.
9. *Ibid.*
10. *Ibid.*, p. 6.
11. It is speculated that the U.K. government would initially sell 25%-33% of Royal Mail. The leading contender is reported to be the Dutch Post, TNT. Post offices are separate and would not be sold.
12. Lord Mandelson, House of Lords Statement on The Future of Royal Mail, Department For Business, Enterprise And Regulatory Reform, News Release, (2008/312) issued by COI News Distribution Service, December 16, 2008, reprinted in "Mandelson accepts partnership proposal for Royal Mail," *The Scotsman* (Edinburgh), December 16, 2008, accessed at <http://news.scotsman.com/latestnews/Mandelson-accepts-partnership-proposal-for.4797977.jp>.
13. Postal Regulatory Commission, "Report On Universal Postal Service And The Postal Monopoly," December 19, 2008, accessed at <http://www.prc.gov/prc-docs/home/whatsnew/USO%20Report.pdf>.
14. *Ibid.*, p. 234.
15. President's Commission on the United States Postal Service, *Embracing The Future; Making The Tough Choices To Preserve Universal Mail Service*, July 31, 2003, p. 18, accessed at <http://www.treas.gov/offices/domestic-finance/usps/pdf/report.pdf>.

16. Ponemon Institute, "Ponemon Institute Announces 2008 Privacy Trust Rankings of U.S. Government Agencies," April 7, 2008, accessed at [http://www.ponemon.org/press/Ponemon\\_2008%20Govt%20PTS%20Study%20FINAL.pdf](http://www.ponemon.org/press/Ponemon_2008%20Govt%20PTS%20Study%20FINAL.pdf).
17. The old U.S. Post Office Department did suffer an illegal strike in 1970 that devastated mail service, resulted in the National Guard being called up to help process mail, and led to an emergency suspension of the postal monopoly. (See Smithsonian National Postal Museum, "Postal Strike and Reorganization: Reinventing the System," accessed at <http://www.postalmuseum.si.edu/AfricanAmericans/p11.html>.) Perhaps not entirely coincidentally, Congress passed legislation several months later that transformed the Department into the U.S. Postal Service.
18. Hooper Report, p. 10.
19. *Ibid.*
20. *Ibid.*, p. 49.
21. *Ibid.*, p. 54.
22. It is about 75% of the annual revenue of government-owned Royal Mail Holdings, which includes businesses other than Royal Mail. (For revenue numbers for Royal Mail and other members of Royal Mail Holdings, see Royal Mail Holdings plc, "Report and Accounts, Year ended 30 March 2008," p. 4, accessed at [ftp://ftp.royalmail.com/Downloads/public/ctf/rmg/2007-08Group\\_Accounts\\_19-05-08Final.pdf](ftp://ftp.royalmail.com/Downloads/public/ctf/rmg/2007-08Group_Accounts_19-05-08Final.pdf).)
23. U.S. Postal Service, *Annual Report, 2008*, pp. 37, 66, accessed at [http://www.usps.com/financials/\\_pdf/annual\\_report\\_2008.pdf](http://www.usps.com/financials/_pdf/annual_report_2008.pdf).
24. Michael Harrison, "Royal Mail Warns Cost Of Pension Fund Will Soar To Â£800m," *The Independent*, November 19, 2004, accessed at <http://www.independent.co.uk/news/business/news/royal-mail-warns-cost-of-pension-fund-will-soar-to-acircpound800m-533816.html>.
25. Hooper Report, pp. 55-56.
26. For the workforce reduction number, see *Ibid.*, p. 49. For total employment at Royal Mail and the other businesses in the Royal Mail Group, see Royal Mail Holdings, Annual Report, pp. 13-14. It is a very rough comparison, but Royal Mail has about 25% more employees per dollar of revenue than does the U.S. Postal Service (converting £ into \$ using the average currency exchange rate in 2008).
27. Royal Mail Holdings, Annual Report, p. 5.
28. Royal Mail Group, "Royal Mail Group Third Quarter Trading Update," News Release, January 21, 2009, accessed at [http://www.news.royalmailgroup.com/news/articlec.asp?id=2469&brand=royal\\_mail\\_group](http://www.news.royalmailgroup.com/news/articlec.asp?id=2469&brand=royal_mail_group). The news release states that "for first time in almost 20 years" all four of the main businesses in the Royal Mail Group were "in profit", including Royal Mail, which is by far the largest business in the Group.
29. PRC, USO Report, pp. 170-171.
30. *Ibid.*, p. 192.