

CHAPTER 6

Evidence of the Post Office

Historical background

6.1. As indicated in paragraph 2.1, postal franking machines have been in use in the United Kingdom since the 1920s when the use of the first machine was sanctioned by the Post Office. The revenue the Post Office collected via postal franking machines in 1984-85 amounted to some £770 million, approximately 31 per cent of total mail revenue. The number of franked letters posted in 1984-85 was 4,413 million and this amounted to 35 per cent of total letter traffic. The Post Office estimates that about three-quarters of the revenue from postal franking machines is paid in respect of letter traffic, the remainder being accounted for by parcel traffic, overseas mail and a range of other postal services, including registered mail and the redirection service, for which franked impressions are valid as payment.

6.2. Over the last ten years the percentage of mail revenue the Post Office collected via postal franking machines as a proportion of total mail revenue has grown only slightly, from 29.4 per cent in 1974-75 to 31.4 per cent in 1984-85. Over the same period franked letter postings have risen from 3,602 million in 1974-75 to 4,413 million in 1984-85, an increase of 14.2 per cent. As a proportion of total letter postings, franked letter postings have increased from 34 per cent in 1974-75 to 35 per cent in 1984-85.

The Post Office's views on growth in the market

6.3. The Post Office told us that there had been a study in the mid-1970s which estimated the total potential of the market for postal franking machines at around 200,000 as compared with the 138,000 in use at present. It told us that both France and Germany had more machines installed but less meter traffic. Average throughput per machine in the United Kingdom had declined over the last ten years and this was attributed to a greater use of machines by small businesses.

Handling of franked mail

6.4. The Post Office has special arrangements for handling franked letters. Users are either required to deliver the mail, segregated between first and second class and overseas mail and by size of envelope or packet, to a designated local post office, or mail will be collected by the Post Office similarly presented. Outside of post office opening hours users may, by special arrangement, post limited quantities of franked mail in a larger envelope in a designated pillar box. At the sorting office franked mail is examined to check that it has been properly sorted by the user and that the correct date and the appropriate values have been franked. As the mail has already been franked with the date and sorted for class of service and size, it is not necessary for these processes to be carried out again at the sorting office. This enables franked mail, after its initial check, to pass directly to the second stage of the

sorting process which in large mechanised sorting offices involves coding of the mail prior to automatic sorting. The Post Office liaises with users by telephone and if necessary by visits to explain its requirements and to help users with any mailing problems that they might have.

Benefits of franking machines

6.5. As briefly set out in paragraph 2.5, the Post Office derives financial benefits from the widespread use of postal franking machines. At our request the Post Office undertook a cost benefit analysis which estimated that the annual saving it currently derives from the use of postal franking machines could be as high as £7.5 million, if postage stamps (for which cost information was readily available) were taken as the basis for comparison. But the Post Office stressed that it did not see postage stamps as the only alternative to postal franking machines. The Post Office also told us that if postal franking machines ceased to exist it would probably develop other methods of payment so that the financial benefits would not be lost but it did not give any indication of what those other methods might be.

6.6. The financial benefits estimated by the cost benefit exercise derived from savings in the costs of facing and cancelling of production and distribution of stamps. In addition there was a net flow benefit as postal franking machine users reset their machines less frequently than the average user of postal services purchased stamps. Set against these savings were the costs the Post Office incurred in maintaining and operating the postal franking machine system. The Post Office told us that such benefits as it received from the use of postal franking machines were generally not incremental. It would not gain materially from an increase in franked mail although an increase in the number of users would increase benefits in areas where Post Office costs were variable.

Post Office discount programmes

6.7. The Post Office told us that it offered all large commercial mail posters a variety of discount programmes. Three of the schemes involved pre-sorting. In addition incentive discounts were available to large posters who increased their annual expenditure on inland letter mail. All these discount schemes were available to users of postal franking machines provided that they complied with the requirements of the scheme but the Post Office did not offer postal franking machine users any special discount in recognition of the benefits it received from the use of the machines.

6.8. We asked the Post Office to consider whether it would be justified in seeking to attract potential users of postal franking machines by means of a discount. The Post Office told us that, in its view, to be effective any discount would need to be substantial. It would find it difficult to restrict such a discount to new users and in practice would have to grant similar discounts to existing users of postal franking machines and to users of other means of paying for postage such as Postage Paid Impressions which also result in cost savings. The Post Office considered that making its current discount schemes available to all customers, including postal franking machine users,

represented a sounder commercial approach to the encouragement of greater traffic volume than specific discounts for postal franking machine users and enabled it to share mutual cost benefits with all its customers.

The Post Office regulations

6.9. The Post Office told us that its approach to postal franking machines had always been to use a regulatory system to protect its revenue and to allow any company able to supply machinery of an appropriate standard to do so. The Post Office had never manufactured or supplied machines itself, nor did it see any advantage in doing so. No overseas postal administration manufactured or supplied postal franking machines and all of them employed some form of regulatory system.

6.10. The Post Office regulations which apply to the supply, maintenance and use of postal franking machines in the United Kingdom are summarised in paragraphs 2.14 to 2.19. The specification relating to supply and maintenance was last amended in 1981. The conditions of use were laid down by the Post Office under the powers conferred on it by section 28 of the Post Office Act 1969.

Security of revenue

6.11. The Post Office told us that its main concern in regulating the supply, maintenance and use of postal franking machines was to ensure that the large amounts of revenue it collected via the machines were safeguarded. It considered that those aspects of the regulations relating to maintenance were of particular importance in safeguarding revenue. Loss of revenue could arise either from failure of the machines or from fraud. The general reliability of machines from the user's standpoint was very much a secondary consideration to the security of the Post Office's revenue.

6.12. We asked the Post Office about the extent of fraudulent misuse of postal franking machines. The Post Office told us that only one major instance of fraud had been detected in recent years. This had come to light not as a result of the periodic maintenance checks specified in the regulations but was discovered as a result of the vigilance of a postman sorting the mail who noticed that the impression was very poor. As a result of this case the Post Office amended its technical specification and modifications were made to machines to prevent recurrence of fraud by the same means. The Post Office stressed that although it was unable to estimate the amount of revenue it lost through fraud, the theoretical potential was substantial.

Technical specifications and testing

6.13. The Post Office told us that the technical specification with which machines had to comply was reviewed regularly to reflect technological advances, particularly in electronics. It was last changed in 1981 to cover the introduction of electronic postal franking machines. Testing of machines was generally carried out at the Post Office Engineering Laboratory, though some tests in relation to electronic postal franking machines had had to be carried out by third parties under Post Office supervision.

6.14. The Post Office told us that it bore the cost of the tests it carried out. It estimated that in 1983 the cost of maintaining its testing facilities (including the cost of work carried out by third parties) amounted to £34,000. The cost of testing carried out by third parties was met by the manufacturer or distributor.

6.15. The Post Office explained that testing consisted of checks that the machine conformed to the Post Office's design requirements, had adequate security and was compatible with the Post Office's operating procedures for postal franking machines. In addition electronically controlled machines were subjected to a series of 17 environmental tests. All new types of machine were usually subjected to 1 million cycles of operation and the value controls were operated through a cycle of 50,000 settings at the maximum speed.

Effect of the regulations on the market

6.16. We asked the Post Office about the effect of its regulations on the market for postal franking machines and in particular whether its regulations might inhibit competition or discourage or act to prevent new entry either by manufacturers not at present supplying the United Kingdom market or by distributors of other types of office equipment or second-hand postal franking machines.

6.17. The Post Office did not consider that its regulations had any effect on competition between the different suppliers already in the market, as all machines had to meet the same technical specification and all suppliers the same standard. Nor did the Post Office consider that entry to the market by new manufacturers was in any way inhibited by its regulations. Two overseas manufacturers, Frama and Francotyp-Postalia, had obtained approval for their machines in 1982 and 1983 respectively and had entered the United Kingdom market supplying through distributors. The Post Office told us that although it was its policy to look favourably on an open market situation, it was by no means an easy task to pursue actively an increase in the number of manufacturers supplying in the United Kingdom. The number of manufacturers of postal franking machines in the world was limited and the majority of them were already in the United Kingdom market.

6.18. We discussed with the Post Office the effect of its testing procedures on potential new entrants and in particular the length of time taken by the testing of one particular new machine. The Post Office expressed concern that its testing procedures might be viewed as a deterrent by potential new entrants. In its experience the length of time involved in testing, whilst not always welcomed by the company concerned, had not deterred any potential new entrants. The Post Office told us that between 1983 and 1985 it had tested four meters and four peripheral devices. In addition 12 modifications to existing machines were approved. The time taken to complete testing of meters ranged from two months to two years but was on average ten months. Meters which were variations of existing meters required the shortest testing times whereas new meters using different technology required much longer times as new testing procedures had to be developed. Testing of peripheral devices took an average of two to five months.

6.19. We asked the Post Office whether it had considered the possibility of streamlining its testing and approval procedures in the interests of enhanced competition and of encouraging greater use of postal franking machines, perhaps by accepting the results of testing carried out by other postal administrations. The Post Office told us that it had not considered this and that testing work carried out overseas was not necessarily applicable to the United Kingdom and could not be used to determine whether or not a machine was acceptable in the United Kingdom.

The bond agreement

6.20. The Post Office told us that suppliers of postal franking machines were currently required to enter into a bond agreement with the Post Office. We asked whether, as the bonds were hardly ever called upon, they were still considered to be an essential part of the revenue protection system and, if not, whether there might be other methods by which the Post Office could protect itself against the effects of fraud. We also asked whether it would be prepared to bear the risks itself.

6.21. The Post Office replied that the fact that the bonds were hardly ever called upon demonstrated the effectiveness of its security measures. It did not think that it would be appropriate for the Post Office to arrange one insurance policy covering all approved suppliers or to bear the risks itself. The risks involved related to the loss of revenue to the Post Office as a result of negligence on the part of the supplying companies. Suppliers at present had freedom to negotiate with an insurance company of their choice and the Post Office considered this was preferable to a single insurance policy.

Alternative distribution methods

6.22. The Post Office accepted that its regulations effectively prevented the supply of postal franking machines by distributors of other office equipment and the supply of second-hand machines through second-hand dealers. It told us that the development of greater choice in the distribution of postal franking machines involving perhaps office equipment dealers and independent suppliers of second-hand postal franking machines would not be a matter of significant concern to it provided that it could still protect its revenue without undue cost both to customers and to itself. It would need to approve additional suppliers and make some amendments to its regulations in order to provide for this.

Maintenance requirements

6.23. As set out in paragraph 2.19, the Post Office's regulations require users of postal franking machines to have them regularly inspected and maintained by the supplying company (or by its agent). We raised with the Post Office two issues on its maintenance requirements: first, the requirement that the maintenance be undertaken by the supplier or by his agent (the maintenance tie); and secondly, the frequency of maintenance visits required by the Post Office.

6.24. The Post Office accepted that its regulations had the effect of tying maintenance of postal franking machines to the supplier of the machines or to its agent but told us that it was already examining the feasibility of independent maintenance before the references were sent to the Commission. It considered that the maintenance tie had probably had some restrictive effect and the lack of competition from third party maintenance companies had probably resulted in higher charges than might otherwise have been the case.

6.25. We were told by the Post Office that it was not aware of any third party maintenance companies interested in entering the business of maintaining postal franking machines but it did not consider that the continued existence of the maintenance tie was essential to maintaining security of revenue.

6.26. If any third party maintenance companies wished to provide such maintenance services, the Post Office told us it would need to amend its regulations, and it thought this would be feasible. It would need to be satisfied that independent maintenance companies were reputable and competent and there would have to be some kind of bonding arrangement to indemnify the Post Office against any loss of revenue due to negligence on the part of the independent maintenance companies.

Frequency of maintenance inspection

6.27. The frequency of maintenance inspections required by the Post Office regulations varies from two inspections in every period of six months to three per year in the case of well-established machines. In exceptional cases the number of inspections can be reduced to two per annum. The Post Office told us that it had reconsidered its policy on the number of visits required and was considering relaxing this to two per annum for all machines. We asked it to assess the risk involved in doing so and also to consider the implications of eliminating the visits altogether and to compare its present standard requirements of four visits a year with the requirements of other postal administrations.

6.28. The Post Office told us that despite three to four inspections per year, faults involving under-recording (which are the faults which put the Post Office's revenue at risk) averaged 110 in 1983 and 1984. While the Post Office considered that in many cases the revenue at risk was not material, there was, in its view, a risk of substantial losses unless faults were detected.

6.29. In the Post Office's view total elimination of maintenance visits would lead to a significant increase in the amounts of revenue at risk. But it was reasonably confident that a reduction in the number of visits to two per year would not constitute a serious risk to the revenue. The Post Office told us that it would wish to see how such a system operated before considering whether any further reduction was possible.

6.30. The Post Office told us that it was apparent from its enquiries that its present maintenance requirement of four inspections a year was more

stringent than that imposed by other postal administrations regulating large numbers of postal franking machines. Appendix 6.1 summarises the level of inspections in those administrations. The Post Office's proposed reduction in inspections to two per year would bring United Kingdom requirements into line with those of the postal administration in the United States of America which is the largest postal franking machine market in the world.