Privatizing Royal Mail: Will It Lead To Further Efficiency Improvements?

By Stuart Holder and Helen Smith

Background

The postal industry is changing. Many national postal operators face falling demand as consumers switch to electronic communications and as competition within the industry grows (often from firms serving only part of the market, e.g., bulk mail). These challenges threaten the sustainability of the universal postal service, as well as the financial viability of existing postal businesses.

In the UK, the Postal Services Act was passed in 2011 with the aims of securing the long-term future of Royal Mail and the Post Office, and preserving the universal service. In response to the perceived failure of the previous regulatory regime and the unsustainable financial position of Royal Mail, the Act allowed the sale of up to 90 percent of Royal Mail, and passed responsibility for economic regulation from Postcomm to Ofcom, which has put in place a new regulatory framework (see box below). The UK government launched an Initial Public Offering in October 2013, including creating an employee share scheme placing 10 percent of the company in employee ownership.

Will privatization help secure the future of the universal service? Holder and Smith (2012) examined the potential benefits from privatization, drawing on evidence from a range of other regulated industries. This paper revisits this evidence in the light of recent developments. We present reasons why a privately owned firm might perform better than a publicly owned firm, and assess the available evidence across a wide range of regulated industries. We consider how these insights can be applied to the UK postal industry.
Box 1. **New Regulatory Framework for UK Postal Market**

The seven-year regulatory framework that Ofcom introduced in 2012 gave Royal Mail greater pricing flexibility and commercial freedom. It eliminated most price controls, though a “safeguard cap” on second class products remains, and gave Royal Mail more operational freedom (including the ability to change the terms and conditions of its products more easily). These changes came alongside the replacement of licensing with a general authorization regime.

Alongside deregulation, Ofcom put in place a number of safeguards. These include measures to ensure that universal services remain available and affordable to all and, where appropriate, to promote effective competition. Ofcom is monitoring Royal Mail’s financial performance (particularly with respect to the universal service), operational performance (i.e., efficiency), customer and consumer metrics such as quality of service and affordability of universal services, and competition. It may consider re-regulation if the incentives to deliver greater efficiency are demonstrably failing.

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**Differences between Publicly and Privately Owned Firms**

One reason why some privatizations might lead to efficiency improvements is that governments may not have exercised control over firms as effectively as private sector shareholders. Whereas private shareholders have clear objectives (to maximize the returns they make from holding the shares), some governments may let political objectives affect their decisions, for example in relation to industrial relations issues or the number and timing of job losses. And government departments may lack the necessary expertise to oversee the management and operation of large and strategically important firms.

To try to avoid such problems, governments can set clear commercial objectives for state-owned firms and control them on an arm’s length basis. The UK government, for example, established the Shareholder Executive to exercise its role as owner of Royal Mail and other publicly owned firms. Even where governments attempt to mimic the behavior of private sector shareholders, however, firms may face additional constraints as a result of public ownership. For example, there may be restrictions on their ability to access debt finance (as this would add to government debt). And there may be formal or informal constraints on the remuneration packages that they can offer to senior managers.

A public sector firm with clear commercial objectives, managed on an arm’s length basis, willing to implement politically unpopular policies, and able to raise finance and decide its own remuneration policy would still face some potential disadvantages compared with an equivalent private sector firm. Both public and private sector owners face the challenge of ensuring that the firm’s managers act in the owners’ interests, monitoring their effort and effectiveness in pursuing these objectives, and taking remedial action if they identify significant shortcomings. Economists refer to this as the “principal-agent problem”. But private sector managers may be better equipped to deal with this problem. Among other things:
• a firm’s share price provides an additional tool, unavailable to the owners of public sector companies, to monitor the performance of individual firms and their managers; and

• offering managers shares, or future share options, will help to align the interests of owners and managers, and may also allow private sector owners to offer opportunities for high earnings (i.e., if the shares rise in value) that would be difficult for a public sector owner to match. Added to likely constraints on the basic salaries of public sector managers, this means that the private sector may be able to employ better quality and more highly motivated managers.

Equity and debt financing of private sector firms also means that they face the possibility of takeover, if managers or owners are thought to be underperforming, and ultimately bankruptcy (or some form of special administration, for strategically important companies) in the event of sustained poor financial performance. Public sector firms do not face these pressures, as there is no public sector equivalent to the threat of takeover, and it is difficult for governments to commit to a “hard budget constraint” that would reduce or remove the likelihood that they would rescue a struggling firm.

There are a number of reasons, therefore, why privately owned firms are likely to have the incentives, skills, and flexibility necessary to operate more efficiently than publicly owned firms. Even a corporatized, well-run state enterprise, run at arm’s length from the government and facing a credible hard budget constraint is unlikely to be able to achieve the efficiency of privately owned firms. Privatization improves firms’ flexibility to invest and reorganize, adds the pressures of takeover and bankruptcy, and offers a wider set of tools to ensure the firm is run efficiently.

What Evidence Exists on the Impact of Privatization?

To determine whether there are benefits of private ownership in practice, we consider the experiences of post and other regulated industries, which have undergone different reforms including privatization, liberalization, industry restructuring, and regulatory reform, often simultaneously.

Evidence from the postal industry suggests there have been some benefits, but it is limited by the small number of privatizations that have taken place. Following privatization and market liberalization in Germany and the Netherlands, the incumbents have operated profitably and made efficiency improvements. Service quality has remained high, and both continue to provide universal services without compensation (with Deutsche Post doing so even without a legal obligation).

Evidence is also available from a number of other network industries, covering a range of different situations:

• Full or part privatization of national telecommunications operators has occurred in all OECD countries. In most cases, this has been accompanied by deregulation and rapid technological change (affecting existing fixed line networks and also introducing competition from mobile networks and now from the Internet), making it difficult to isolate the impacts of privatization. But there is evidence that the combination of deregulation and privatization has delivered net benefits;
• At least part of the electricity industry has been privatized in a number of countries. These industries have often undergone extensive restructuring, including the separation and liberalization of generation and sometimes also supply activities. There is some evidence for improvements in labor productivity following privatization;

• Some water industries have been privatized, generally without the structural changes that have accompanied privatization in other industries. There is some evidence that privatization has led to improvements in operational performance and efficiency;

• There are fewer examples of rail industry privatization, though there is some evidence from countries such as the UK, Switzerland, and Canada. International evidence supports the hypothesis that privatization has a positive impact on productivity. And in the UK, there is some evidence of improvements in train operators' efficiency following privatization, though causality is unclear.

Cross-section international comparisons of airlines provide a further useful source of potential evidence, as there are a number of publicly owned and private firms operating in a fairly similar environment. There is strong evidence that privately owned airlines are more efficient.

Table 1 summarizes the findings from some of the most relevant studies of these other industries. There is strong evidence of efficiency improvements following privatization in conjunction with restructuring or liberalization of these markets. However, in many cases it is difficult to identify the impact of privatization separately from other reforms. In some industries, the evidence suggests there is a separate (and positive) “privatization effect”, but evidence is mixed in other industries, particularly water supply and telecommunications, with some studies finding evidence for a positive impact of privatization on efficiency, and others finding little or no evidence for such an impact.
Table 1. **Evidence on the Impact of Privatization**

<table>
<thead>
<tr>
<th>Relevant studies</th>
<th>Evidence</th>
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<tr>
<td><strong>Telecoms – evidence mixed</strong></td>
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<tr>
<td>Kwoka (1993)</td>
<td>Privatization responsible for an increase in BT’s total factor productivity (TFP) of nearly 5 percentage points after 1984.</td>
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<tr>
<td>Daßer et al (2002)</td>
<td>Finds little evidence that privatization has had a reliable and favorable effect on economic performance in the absence of market liberalization.</td>
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<tr>
<td>Boylaud and Nicoletti (2001)</td>
<td>Inconclusive evidence on the impact of ownership structure or expected changes in the degree of state ownership.</td>
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<td><strong>Water – evidence mixed</strong></td>
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<tr>
<td>Peda et al (2013)</td>
<td>Ownership structure does not affect the efficiency of Estonian water utilities.</td>
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<tr>
<td>Ofwat (2009)</td>
<td>Twenty years after privatization, prices 30 percent lower than otherwise would have been in England and Wales water industry.</td>
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<td><strong>Electricity – improvements in labor productivity following privatization</strong></td>
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<tr>
<td>O’Mahoney and Vecchi (2001)</td>
<td>Increase in labor productivity growth following UK reform, but no improvement in TFP.</td>
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<td><strong>Rail – some evidence that privatization has a positive impact on productivity</strong></td>
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<tr>
<td>Pollitt and Smith (2002)</td>
<td>Efficiency savings of 2 percent per year in UK rail industry in years following privatization.</td>
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<td>Cowie, 1999</td>
<td>Switzerland - evidence that privately owned railways are more efficient.</td>
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<tr>
<td>Boardman et al (2013)</td>
<td>Improved sales, profit, and productivity following privatization of a large Canadian rail carrier, and large social welfare gains from privatization.</td>
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<tr>
<td>Ramamurti (1997)</td>
<td>Improvements in labor productivity, lower costs, and improved quality in Argentine railways could not have been achieved without privatization.</td>
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<td><strong>Airlines – strong evidence that privately owned airlines are more efficient</strong></td>
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<tr>
<td>Ehrlich et al (1994)</td>
<td>A sample of international airlines over the period 1973-1983 found that full privatization can increase long-run annual rate of TFP growth by 1.6 to 2 percent</td>
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<tr>
<td>Ng and Seabright (2001)</td>
<td>Ten percent increase in the proportion of privately-owned shares would be expected to reduce costs by 6.5 percent</td>
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One of the difficulties in considering the relevance of evidence from other industries is the lack of research into the specific reasons that privatization causes improvements in performance. There are several important differences that mean that the impacts of privatization in the postal industry could differ from those experienced in other industries:

- **Postal networks are more labor intensive** – as a result, it might be easier to reconfigure the network than in other industries if this will improve efficiency. But there is a greater risk that opposition from trade unions could limit potential gains;

- **More competition before privatization in the postal industry** – whereas liberalization in other industries often occurred at the same time as, or subsequent to, privatization, many national postal operators have already been exposed to competition both from new postal operators and from other forms of communication. In theory, this could mean that some of the efficiency improvements observed in other industries may already have been realized;

- **Demand for postal services is falling** – this could lead to increased pressure on private sector managers to improve efficiency and service quality. However, it may also make efficiency improvements more difficult to achieve, for example because there may be more resistance to changes in labor practices if the workforce has already experienced cuts due to falling demand; and

- **The postal industry needs to modernize** – this could mean that the potential efficiency gains from postal privatization are larger than those in other industries, as postal operators can benefit from both modernization and the more general improvements that firms have been able to realize following privatization.

Furthermore, the nature of Universal Service Obligations (USOs) is another source of difference between post and other industries. Postal USOs set out products to be made available and associated minimum service standards, typically including the provision of nationwide postal services at a uniform price and an obligation to collect and deliver five or six days a week. These obligations are different from USOs in other industries, which are generally associated with a physical network. Postal operators face a greater risk of competitors “cherry picking” profitable services, as entrants can compete to provide services that are part of the USO, which might threaten its viability.

**Conclusions**

Both economic theory and empirical evidence suggest that privatization can lead to large efficiency gains. In private firms, the profit motive, greater flexibility, and shareholder pressure may lead to greater efficiency, and there are likely to be benefits over public ownership even if national governments run publicly owned firms relatively well (for example, having the expertise required to exercise effective control and ensuring the firm is free from political influences). In practice, evidence from a range of industries strongly suggests that privatization can help to improve efficiency as part of a package of reforms, some of which already been implemented in the UK postal industry.
In the light of this evidence, privatization seems likely to lead to improvements in Royal Mail’s efficiency. Some improvements have already been achieved, reflecting the impact of liberalization, pressures on overall demand, and efforts to improve performance ahead of privatization. But the experience from other industries suggests that significant further improvements should be possible, provided Royal Mail can overcome the challenges associated with falling demand and possible trade union resistance.

The efficiency improvements generated by privatization will also help Royal Mail to sustain the universal service in its current form, one of the biggest challenges faced by postal operators. The combination of falling demand and increased competition within the postal industry may put upward pressure on unit costs, due to the loss of economies of scale and density (particularly in the delivery function), and could lead to price increases and further volume declines. Efficiency gains following privatization will help offset these changes, and private ownership will give Royal Mail the best chance of adapting to developments in the industry, and maintaining the universal service.

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