



# **Ofcom's Proposed 2018-19 Annual Plan: Royal Mail response**

9 February 2018

**Royal Mail welcomes the opportunity to comment on Ofcom's Draft Annual Plan for 2018-19. In recent years, there has been an unprecedented level of regulatory activity in post. This has generated uncertainty and had a chilling effect on the business. We therefore welcome the proposed reduction in regulatory activity planned for 2018-19. This should translate into significantly lower regulatory fees.**

**We are, however, disappointed that Ofcom is not working with us on our proposed positive, pro-active sustainability framework. This includes addressing the lack of a level playing field that exists in the delivery sector caused by "gig economy" employment models and the absence of minimum consumer protection standards. Maintaining a market-funded Universal Service is firmly in the interests of consumers.**

With the above context, we make the following points in response to the areas highlighted in Ofcom's proposed 2018-19 Plan:

- **Post cost modelling** - Ofcom proposes to complete its review of cost allocation between letters and parcels in Q4 2018-19. This will cause significant ongoing commercial uncertainty. Royal Mail already operates in a tightly controlled regulatory environment. We follow the extensive framework and detailed methodology that Ofcom put in place some years ago. If Ofcom wishes to consider cost modelling in the context of cross subsidy, it should actively engage with us on our long run average incremental cost (LRAIC) model (Section 2).
- **Second Class Safeguard Caps** - Given Ofcom's decision to extend the safeguard caps to 2022, it is vital that it undertakes this work as soon as possible. The products covered are an essential revenue pool to secure the ongoing sustainability of the Universal Service. However, the proposed timing of Ofcom's decision - Q4 2018-19 - does not take account of the commercial realities we face in setting tariffs. In particular, it fails to build in sufficient lead time to enable our customers and partners to respond to any price changes. As such, we ask Ofcom to accelerate the timing of its decision to early September 2018 (Section 3).

Two further areas - not specifically highlighted in the proposed Plan - require Ofcom action (Section 4):

- Ofcom can play a vital role in **safeguarding and promoting UK postal industry interests throughout the Brexit process**, particularly when it comes to changes to how taxes and duties are collected on postal imports.
- Ofcom has committed to re-consult on reforming the **margin squeeze control**. We encourage that review to include design aspects alongside reporting and compliance.

## **1. Pressing need for a positive, pro-active sustainability framework**

**In recent years there has been an unprecedented level of regulatory activity in post.**

- 1.1 Ofcom undertook a comprehensive review of the regulatory framework when it took over responsibility for postal regulation. In 2012, it introduced a new regulatory framework. This framework should have been in place for seven years, providing the universal service provider with a period of regulatory certainty. In fact, since 2012, **Ofcom has undertaken 18 regulatory reviews, including the Review of the Regulation of Royal Mail, and over**

**50 individual information requests. This has generated uncertainty and had a chilling effect on the business.** The chilling effect of regulation means that we take a very conservative approach to our interpretation of the regulatory conditions.

- 1.2 **As we set out in our 2016-17 Annual Report, intense competition in parcels and ongoing structural decline in letters makes the postal sector very challenging.<sup>1</sup> We face downside risks.** We face significant competition from companies with established delivery capabilities and from new entrants. Growth available in the UK parcels market continues to be impacted by Amazon's activities. The growth in parcel revenue has not offset the decline faced in letters over the last three years.

**Ofcom's proposed 2018-19 Annual Plan indicates a substantial reduction in regulatory activity. This should translate into significantly lower regulatory fees.**

- 1.3 **Ofcom's 2018-19 plan signals an overall reduction in postal work relative to previous years.** There is a clear shift in focus to regulatory activity covering telecoms and the BBC. Of the 43 areas identified by Ofcom, only three directly relate to the postal industry – see the table below. In light of Ofcom's planned reduction in postal work – and its overarching objective to achieve a real terms decrease in its budget – we expect to see a significant reduction in fees in 2018-19. More broadly, Royal Mail believes there is a pressing need for greater transparency, and fair apportionment, in regard to postal regulation fees – for Ofcom and the consumer advocacy bodies (CABs).

#### Ofcom's work on postal services including the associated fee

	2016 - 17	2017 - 18	2018 - 19
Fundamental Review of the Regulation of Royal Mail		Post regulatory financial reporting review	
		Post cost modelling	Post cost modelling <sup>2</sup>
		Cross-border parcels	Advice on regulation for cross-border parcels
		Quality of service review	Review of the Second Class safeguard caps on Universal Service letters and parcels
		Review of the funding of postal regulation and consumer advocacy bodies	
		Parcel surcharging	
	<b>Ofcom fee: £4.42m<sup>3</sup></b>	<b>Ofcom fee: £2.86m<sup>4</sup></b>	<b>Ofcom fee: TBC</b>

**The apportionment of fees within the postal sector must be adjusted as a matter of urgency.**

- 1.4 Ofcom consulted on reforms to recovering postal regulation and consumer advocacy costs in July 2017. **This presents an opportunity to put in place a framework which is fit-for-**

<sup>1</sup> Royal Mail, Annual Report and Financial Statements 2016-17, May 2017, page 12.

<sup>2</sup> Referred to as "Post regulatory financial reporting review" in the 2018-19 proposed plan.

<sup>3</sup> Ofcom Tariff Table 2016-17, Page 18.

<sup>4</sup> Ofcom Tariff Table 2017-18, Page 19.

**purpose for the here and now, as well as for the future.** Ofcom is right to extend charges to operators who provide single piece end-to-end letter delivery services or Access services. This addresses some of the unfairness present now. But, its proposals do not go far enough. We note, from the responses published on Ofcom's website, that there was support for requiring parcel operators to contribute to CAB costs at the very least. In both cases, **we would welcome Ofcom making its decision this financial year so that the new arrangements can go live in 2018-19.** Any delays, which result in Ofcom's decision falling into next year, will unfairly penalise Royal Mail.

**The regulatory focus should now shift to ensuring the sustainability of the Universal Service.**

1.5 **The current regime – parcel competition, e-substitution and shareholder discipline – creates all the necessary incentives to drive efficiency.** Encouraging even greater competition simply drives volumes down. This volume loss would significantly impact Royal Mail due to our high, fixed cost structure. A material loss of demand would have a greater impact on revenues than on costs. It takes time to remove costs – it requires major structural change. Royal Mail would have very few options available to maintain revenue pools that support the Universal Service.

1.6 There is no need for the regulatory framework to incentivise further efficiency or competition. The market is doing its job. It is with regard to sustainability where regulatory action is needed. Central to this is the **urgent need to develop a positive, pro-active sustainability framework** to help secure a market-funded Universal Service. This should cover three key pillars:

- **Sustaining revenue pools that underpin the Universal Service.** This should include keeping the scope of the Universal Service relevant, contemporary and in line with consumer preferences.
- **Focusing on the financial sustainability of the Universal Service.** This should include reforming the quality of service regime to ensure it is fit-for-purpose.
- **Creating a level playing field** by raising consumer standards across the industry and engaging in the live debate around “gig economy” employment models – see below.

1.7 If the financial sustainability of the Universal Service were to come under threat, there is little that Ofcom could do to return the business to profitability. We are therefore very disappointed that Ofcom has decided not to proceed with a sustainability framework. **We would urge Ofcom to look again at the package of measures that we have proposed.** A sustainability framework provides the best solution to underpinning the Universal Service. Maintaining a market-funded Universal Service is firmly in the interests of consumers.

**“Gig economy” employment models and the absence of minimum consumer protection standards in the delivery sector have created an unfair playing field.**




1.8 **Royal Mail is proud to be a responsible employer. We offer the best pay and terms and conditions in our industry.** The vast majority of our employees are employed on permanent contracts. Our permanent employees are paid above the Living Wage which, in

turn, is above the legal minimum set by the UK Government. They also receive the additional benefits associated with permanent employment, such as paid holidays and a good pension.

1.9 We believe there is, however, a public policy issue around fictitious self-employment and poor labour standards in the delivery sector. **We believe there is a key role for Ofcom in the debate around labour standards given the direct implications for Royal Mail's ability to compete fairly.** A level playing field is needed as a foundation for the ongoing sustainability of the Universal Service.

1.10 In addition, the development of the parcels sector has outpaced consumer protection regulation. **Most operators are subject to little or no consumer protection standards.** Major new players are not recognised as postal operators and so not subject to any regulatory consumer protections. Established operators (other than Royal Mail) are only required to provide consumers with a basic complaints process.

**There is no, or little, regulatory consumer protection facing most parcels operators.<sup>5</sup>**

Operator type	Operators <sup>4</sup>	Total number of requirements <sup>6</sup>	Mails integrity standards	Publication of complaints data	Complaints process standards	Access to a redress scheme	Provision of compensation
DUSP <sup>1</sup> (Royal Mail)		32 <sup>7</sup>	✓ Ofcom sets out a code of practice	✓ Provides quarterly complaints data to Ofcom	✓ Ofcom prescribes detailed complaints process	✓ Notifies consumer of access to Alternative Dispute Resolution scheme	✓ Compensation on USO services. £20 for standard mail. £50 for signed-for mail
Other parcels operators <sup>2</sup>		1	✗ No requirement	✗ No requirement	✓ Required to provide a basic and cost effective complaints process	✗ No requirement	✗ No requirement
Major new delivery operators <sup>3</sup>		0	✗ No requirement	✗ No requirement	✗ No requirement	✗ No requirement	✗ No requirement

<sup>5</sup> Footnotes in table:

1 DUSP: Designated Universal Postal Operator.

2 Established parcel operators: Defined by Ofcom as Unregulated Postal Operator - these operators are only required to provide a basic and cost effective complaints process under Article 19 of the EU Postal Services Directive.

3 Regulation and definitions were transposed from the Postcomm regime. They do not recognise major new delivery operators.

4 Non-exhaustive, except for Royal Mail, which is the only DUSP.

5 Argos provides 'Single Piece' type parcel services through its partnership with UK Mail, primarily for eBay sellers.

6 Other than standard EU/UK consumer protections.

7 Split as 8 in mails integrity, 3 in the publication of complaints, 16 in the complaints process, 1 in redress and 4 in the provision of compensation.

1.11 Ofcom should apply a minimum set of regulatory consumer protection standards to all major parcels operators. We believe Ofcom should:

- Broaden the definition of “Relevant Postal Operator” to include all major players.
- Extend the mail integrity and complaints handling process requirements to all ‘Relevant Postal Operators’.
- Extend the requirements to provide a redress process and ADR scheme, and appropriate financial compensation (in the event that something goes wrong), to all UK parcel operators providing ‘Single Piece’ type parcel services.<sup>6</sup>
- Extend letters protections to all major operators – access and end-to-end.

## **Specific response to Ofcom’s proposed plan**

### **2. Post cost modelling**

**Building a cost model is an unnecessary regulatory burden. It will create substantial uncertainty for a prolonged period of time.**

2.1 **We are disappointed that Ofcom is planning to undertake a cost allocation review.**

Ofcom has noted potential concerns about cross-subsidisation<sup>7</sup> and a risk of Royal Mail unfairly leveraging<sup>8</sup> our letter position into the parcels sector. As previously set out, these potential concerns are unfounded.<sup>9</sup> The parcels sector is highly developed and competitive. Royal Mail rigorously ensures that our pricing is fully compliant with competition law. There is no need for regulatory intervention. We believe it is disproportionate.

2.2 **Royal Mail already operates in a tightly controlled regulatory environment.** We follow the extensive framework and detailed methodology that Ofcom put in place some years ago. Ofcom has complete visibility on how costs are allocated. The Universal Service Provider Accounting Condition (USPAC) and the Regulatory Accounting Guidelines (RAG) have detailed obligations, rules, timetable and formats. This includes extensive oversight of our cost allocation, with changes reported quarterly to Ofcom in line with Ofcom’s change control process. We also regularly review our costing approach in line with our regulatory requirements to make sure that it reflects operational reality. Our approach is set out in the Costing Manual and Accounting Methodology Manual. They provide Ofcom with detailed insight into our operations and our cost base.

2.3 **A cost allocation review of our delivery network will create unnecessary uncertainty for a prolonged period of time.** It will be a detailed, time-consuming, and costly process. A review of BT’s cost attributions took significant time, around two years.<sup>10</sup> The work in

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<sup>6</sup> Single Piece” as defined in Annex 4 of Royal Mail’s August FRR response – CP3.1.2 (o). “[S]ingle piece postal service” means a service provided to a relevant consumer for the purpose of the conveyance of a single parcel, where the provision of that service is not governed by individually negotiated contracts between the consumer and the relevant postal operator.

<sup>7</sup> Ofcom, Press Release – 25 May 2016 <http://media.ofcom.org.uk/news/2016/royal-mail-review/>

<sup>8</sup> Ofcom, Review of the Regulation of Royal Mail, 25 May 2016.

<sup>9</sup> Royal Mail, Response to Ofcom’s Regulatory Financial Reporting Consultation, June 2017, page 8.

<sup>10</sup> Royal Mail, Response to Ofcom’s May 2016 Fundamental Review of the Regulation of Royal Mail, August 2016, paragraph 4.5.

collating and reviewing the data requested will divert a significant amount of senior management and subject matter expert time from across the business – at a time when we are facing a tough operating environment. It is critically important that Ofcom does not create more regulatory uncertainty.

- 2.4 Rather, if Ofcom wishes to consider cost modelling in the context of cross subsidy, it should **actively engage with us on our long run average incremental cost (LRAIC) model**. As Ofcom have previously acknowledged, setting prices in relation to LRAIC provides the correct signals for entry in the market.<sup>11</sup> We have highlighted to Ofcom on a number of occasions that we are keen to continue discussions on our LRAIC model. We believe it would be beneficial to have an ongoing dialogue on the appropriate modelling approach.

### 3. Review of Second Class Safeguard Caps

**Given Ofcom's decision to extend the safeguard caps to 2022, it is vital that it undertakes this work as soon as possible.**

- 3.1 Ofcom has decided to extend the Second Class Safeguard Caps to 2022. It is vital that it undertakes this work as soon as possible. The products covered by these caps are an essential revenue pool to secure the ongoing sustainability of the Universal Service. **It is vital that we maintain sufficient commercial flexibility to respond quickly to customers' needs and changes in market conditions.** This requires there to be adequate headroom in the caps.
- 3.2 **Tariff setting is a lengthy process. It requires sufficient lead time to enable our customers and other stakeholders to respond to, and implement, any price changes.** As such, the process formally starts internally in July every year. Alongside building in adequate notice for our customers and partners (eg the Post Office and shipping solution providers), the associated analysis and modelling is sophisticated. Highly complex interdependencies exist between different product lines (including with non-USO services), which mean we cannot make decisions in isolation. We need to collate all the relevant data including product elasticities, have in place rigorous assurance processes, model the revenue projections and obtain senior-level approval on the commercial strategy.
- 3.3 **We are therefore concerned that the proposed timing of Ofcom's decision – Q4 2018-19 – fails to take account of the commercial realities we face in setting tariffs.** We have raised the issue of the timing of the consultation on a number of occasions over the last year. Most recently, we stated in our June 2017 response to Ofcom's Regulatory Financial Reporting consultation: "*We ask Ofcom to consult on the level of the 2c Safeguard cap early in 2018. We need regulatory certainty for our commercial price setting. It is possible that our 2c stamp letter pricing will be constrained in 2019-20 by Ofcom's safeguard caps*".<sup>12</sup>
- 3.4 **To enable us to take into account the revised caps for the 2018-19 tariff-setting decision, we need regulatory certainty from Ofcom by early September 2018.** This is likely to require a consultation by May 2018 at the latest. As Ofcom has decided not to

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<sup>11</sup> Ofcom, Securing the Universal Postal Service, March 2012, page 160.

<sup>12</sup> Royal Mail, Response to Ofcom's Regulatory Financial Reporting Consultation, June 2017, page 53.

proceed with the planned review of the quality of service regime in 2017-18, we would welcome the work on the Second Class Safeguard Caps being accelerated.

#### 4. Other important workstreams

##### **Ofcom can play a vital role in safeguarding and promoting UK postal industry interests throughout the Brexit process.**

4.1 A key priority for Ofcom's engagement in Europe is safeguarding and promoting UK business interests throughout the Brexit process. The changing nature of our relationship with the EU could impact the postal industry, particularly in relation to the smooth passage of parcels across borders. Royal Mail has a long standing working relationship with Government based on shared objectives – facilitating trade, maximising revenues, reducing fraud, raising compliance and maintaining security. We act as an agent on behalf of the state, only releasing parcels from outside the EU which are subject to taxes and duties to the end recipient when the recipient has paid the relevant charges. **Royal Mail is looking to Ofcom to support the legitimate business interests of the UK postal industry throughout the Brexit process, particularly when it comes to changes to how taxes and duties are collected on postal imports.**

##### **Ofcom's commitment to re-consult on reforms to the margin squeeze control is an opportunity to remove unnecessary regulation.**

4.2 In its December 2017 Statement on Regulatory financial reporting for Royal Mail, Ofcom set out its decision to revise its March proposals in respect of reporting and compliance with the margin squeeze control contained in USPA 6. It intends to consult on new proposals in 2018-19. **We welcome this and encourage Ofcom to ensure this consultation goes beyond simply reporting and compliance reforms to include fundamental design aspects.**

4.3 **We have a track record of fair, reasonable and prudent pricing in letters and parcels. Market forces are doing their job.** Consumer satisfaction remains high in contrast to other sectors of the economy.<sup>13</sup> Ofcom has recognised that access competition continues to perform well and meets the needs of large senders of mail.<sup>14</sup> In this context, we encourage Ofcom to fundamentally review the design of the USPA 6 margin squeeze test. While regulating the pricing of individual contracts may have made sense when the Access market was in its nascent stages, it is now disproportionate and overly prescriptive. Ofcom should remove the contract level test. The market level test is sufficient to facilitate competition. If the contract level test is retained, the appropriate cost standard, as recognised by Ofcom, is LRAIC. As an interim step, our latest data and information on the variability of our cost base suggests that the current standard – 50% of FAC – is inconsistent with operational reality and therefore unreliable.

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<sup>13</sup> Ofcom Consumer Experience Report 2015. Research Annex, page 67.

<sup>14</sup> Ofcom, Review of the Regulation of Royal Mail, March 2017, Page 1.