

Royal Mail

Royal Mail's response to Ofcom's Proposed Annual Plan 2019/20

February 2019



Contents

Executive Summary	3
Ofcom Project - Royal Mail Cost model	5
Ofcom Project - Royal Mail cost allocation review.....	7

Executive Summary

Royal Mail is the proud provider of the Universal Postal Service. A modern and contemporary Universal Postal Service is vital to the UK economy. It is the delivery backbone of e-commerce in the UK. The high fixed cost Universal Service network is funded by the market. The economics of the Universal Service are fragile. **We need a supportive regulatory environment that will help to keep the Universal Service market funded. We ask Ofcom to engage with us on this.**

There is more that can be done to reduce the substantial cost of regulation. Since 2012/13, Royal Mail has paid nearly £30 million to Ofcom in regulatory fees. Ofcom's programme of activity needs to be right-sized and not impose significant costs. **Ofcom's proposed Annual Plan sets out four key priorities – Post does not fall within them.** Accordingly, we expect an appropriate reduction on Ofcom's regulatory fees, borne by Royal Mail and Access Operators, that reflects Ofcom's focus. We welcome that Ofcom has acted to ensure a more appropriate recovery of regulatory fees for Ofcom and Consumer Advocacy Bodies (CABs) across the postal market.

With the above context, we make the following points in relation to four projects in Ofcom's proposed 2019–20 plan that relate to Post:

- **Royal Mail Cost model.** Royal Mail and Ofcom have invested significant time to create this model, including the provision of significant detailed financial and volumetric information from Royal Mail. **We believe it is premature to extend the cost model before the value of the existing model is understood by stakeholders.** We cannot comment meaningfully on the value of extending the modelling as we have not seen the existing model or its results. First and foremost, Ofcom should review the existing model with us to ensure the data has been correctly interpreted and applied. Following this exercise, we envisage Ofcom undertaking a wider exercise to socialise its insights with all postal stakeholders to obtain their feedback.
- **Royal Mail cost allocation review.** This activity is nearly concluded. We are pleased that Ofcom "*found that the new allocation methods better reflect the operation reality of the new delivery methods.*" We agree that this project should conclude promptly in the next financial year.
- We note that Ofcom is continuing its ongoing projects – the **Postal Monitoring Report** and **Cross sector data on the Communication market**. We do not cover this any further in our response.

Royal Mail is the proud provider of the Universal Postal Service. It is in the interests of all stakeholders that the Universal Service remains market funded. We need a supportive regulatory environment to achieve this.

- i. Royal Mail is the designated Universal Service Provider (USP) in the UK. We provide a six-day-a-week service to more than 30 million addresses. We recognise that our role comes with important obligations as the USP. What we do is vital to the UK economy – we are the delivery backbone of the vibrant e-commerce economy. In turn, the market funds the high fixed cost of the Universal Service network. It is in the interests of all stakeholders – consumers, Access Operators, parcel operators and Government – that the Universal Service remains market funded.
- ii. However, **the finances of the Universal Service are fragile**. We are not a traditional utility characterised by relatively stable volumes and steady income streams. The UK is Europe's most competitive parcels market.¹ Addressed letter volumes, excluding the impact of elections, for the nine months ended 23 December 2019 fell by 8%.² We expect addressed letter volume decline, excluding the impact of elections, to be in the range of 7-8% for 2018-19.
- iii. Like many other posts, **Royal Mail is facing a tough operating environment**. Consequently, we are taking action. Royal Mail is undertaking significant strategic reviews. These include an assessment of the productivity and efficiency opportunities under our Agreement with the CWU and a review of the UK Network. 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 propose that there is **meaningful engagement between Royal Mail and Ofcom on the need for a supportive regulatory approach to maintain the market-funded Universal Service**.

Ofcom's attention is on telecoms, content and the BBC. We welcome the action that Ofcom has taken to ensure a more appropriate recovery of regulatory fees. More can be done to reduce the financial burden of regulation on the postal sector.

- i. Ofcom has visibly shifted its focus to telecoms, content and BBC. In its overview of the proposed Annual Plan, Ofcom set out four priorities for 2019-20.³ **Post is not referred to once**. We expect to see an appropriate reduction in Ofcom's fees in 2019-20 that reflects the limited scale of Ofcom's planned activities.
- ii. We believe that there is more that can and needs to be done to reduce the financial burden on the postal sector. In line with the Regulator's code⁴, Ofcom should minimise the costs borne by the Postal industry in discharging its duty. **Ofcom's programme of activity needs to be right-sized and not impose significant costs**. Since 2012-13, Ofcom's fees representing its activities on Post has reached nearly £30 million.⁵ This is a considerable sum.
- iii. We welcome the new framework for the recovery of regulatory fees for Ofcom⁶ and CAB⁷ postal costs. Ofcom is right that the costs of regulation should be borne across the postal sector. While we consider that the cost should be spread even more widely – including parcel operators contributing to Ofcom's fees – Ofcom has taken a step in the right direction to address the unfairness that Royal Mail faces.

¹ Royal Mail, Annual Report and Financial Statements, 2017-18, Page 7.

² Royal Mail, Trading Update for the nine months 23 December 2018, Page 1.

³ Ofcom, Proposed Annual Plan 2019/20, Pages 1-2.

⁴ Department for BIS, Better Regulation Delivery Office, Regulators' code, April 2014.

⁵ Ofcom's postal fees from 2012/13 to 2018/19.

⁶ Ofcom, Recovering postal regulation and consumer advocacy costs, March 2018.

⁷ Ofcom, Recovering consumer advocacy costs, January 2019.

Ofcom Project – Royal Mail Cost model

Ofcom has proposed to extend the cost modelling work on Royal Mail's delivery costs to other parts of Royal Mail's pipeline. Royal Mail has invested considerable time and resources to support Ofcom in creating its delivery cost model.

We consider any extension to be premature. **Nothing has been shared to date on the outcomes of the delivery cost modelling.** We expect that this model will require input from Royal Mail, and from other postal operators to help refine the accuracy and reliability of Ofcom's delivery cost model. We suggest that:

- Ofcom reviews the model's output with Royal Mail to confirm it provides a reliable and accurate view of our delivery network (as appropriate for a strategic tool).
- Ofcom then engages with the wider postal industry on the tool.
- In light of any feedback, Ofcom can review and enhance its model. We believe this should be undertaken before the cost modelling work is extended to other parts of Royal Mail's pipeline.

Ofcom has gone beyond the remit originally proposed and consulted on. **The benefits to consumers from Ofcom's proposed new activity are very unclear.** The case – objectives, outputs, justification, consumer benefits etc. – for extending the delivery cost model needs to be shared with stakeholders prior to engaging in this activity.

Royal Mail has invested considerable time and resources to support the creation of Ofcom's delivery cost model. Ofcom now intends to extend its cost modelling work

1.1 In Ofcom's proposed Annual Plan, it explains its project on Royal Mail cost modelling as set out below.

- **“Royal Mail Cost Model:** We will extend our bottom up cost modelling work of Royal Mail's delivery network to cover other parts of Royal Mail's operations. This work will support our assessment of Royal Mail's efficiency”.⁸

1.2 Ofcom originally consulted on this project as part of the 2017-18 Annual Plan. In that plan, the cost modelling activity was described as **“Post cost modelling: build a costing model to help develop our own view of the costs of Royal Mail's delivery network.”**⁹ Ofcom stated in the same statement that Ofcom will **“complete our work on reviewing Royal Mail's regulatory financial reporting and cost modelling of its delivery network”**.¹⁰

1.3 In Ofcom's 2017-18 proposed Annual Plan consultation, a number of stakeholders commented on Ofcom's activities. Ofcom's process is to consult on its activities for the coming year with all stakeholders to provide transparency and clarity on its activities. This is

⁸ Ofcom, Proposed Annual Plan 2019/20, Page 25.

⁹ Ofcom, Annual Plan 2017/18, Page 27.

¹⁰ Ofcom, Annual Plan 2017/18, Paragraph 5.5.

in line with the Regulators' code that sets out "*Regulators should ensure that their approach to their regulatory activities is transparent*".¹¹

- 1.4 Royal Mail has worked with Ofcom over many months to support Ofcom in **creating its delivery cost model**. Ofcom has required Royal Mail to provide detailed financial, volumetric and reference data on our delivery activities. Royal Mail has spent significant resource – including at senior levels – preparing, reviewing and submitting this information to Ofcom. Using this information together with its understanding and insights on Royal Mail's delivery operations, Ofcom has spent considerable time building its delivery cost model. We are disappointed that Ofcom intends to extend its cost modelling now for several reasons as we set out below.

Nothing has been shared to date on the outcomes of the delivery cost modelling. It is important to understand the current insights before extending it.

- 1.5 It is extremely difficult to comment on Ofcom's proposal to extend the delivery cost model in a constructive way. We simply do not know how well Ofcom's existing cost model reflects the operational complexity of Royal Mail's delivery network. We also do not know the insights the model brings in terms of potential efficiency opportunities. **This model has not been shared with us or with other stakeholders.**
- 1.6 **We expect that this model will require input from Royal Mail, and other postal operators, to help refine the model's accuracy and reliability.** This activity would benefit all postal stakeholders as Ofcom's insights on Royal Mail's delivery network – which is used by Royal Mail and Access operators – would be more informed. As set out above, Royal Mail has provided a significant volume of detailed and complex data. Some of this data may require manipulation, cleansing or further interpretation for robust usage. We suggest the following steps:
- Ofcom engages with Royal Mail to ensure that the model provides a reliable and accurate view of Royal Mail's delivery network (as appropriate for a strategic tool).
 - Ofcom engages more widely across the postal industry to share its approach and conclusions (while retaining confidentiality of Royal Mail data).
 - Ofcom reflects on feedback from the industry to enhance its understanding and update its delivery cost modelling as appropriate. This may be an iterative process.
 - Only then, we suggest, that Ofcom considers extending the cost model to other parts of the pipeline, if this is appropriate.
- 1.7 We believe that Ofcom's new modelling tool on Royal Mail's delivery costs **could help Royal Mail identify new opportunities for efficiency or confirm Royal Mail's own understanding of its opportunities for future efficiency.** It would be very helpful for these learnings to be shared. This was the approach that Ofcom adopted as part of the Fundamental Review of Regulation. During the FRR, Ofcom undertook a detailed review of efficiency in delivery and processing.¹² This review concluded that additional regulation was not required and noted that "*Royal Mail has made some efficiency improvements in recent years*".¹³

¹¹ Department for BIS, Better Regulation Delivery Office, Regulators' code, April 2014, Paragraph 6.

¹² See, for example, the Deloitte Report, Econometric benchmarking in the UK postal sector, 24 May 2016.

¹³ Ofcom, Review of the Regulation of Royal Mail, 1 March 2017, Paragraph 1.12.

The benefits to consumers have not been set out. The case for extending this work needs to be clarified.

- 1.8 Ofcom's Annual Plan does not set out the benefits to consumers of extending the modelling work across the pipeline. Ofcom has not consulted – until now – with stakeholders on the remit for this extension to its delivery cost modelling work. Ofcom's consultation does not explain the value of extending the modelling beyond that it will “*support our assessment of Royal Mail's efficiency*”.¹⁴
- 1.9 **Transparency of Ofcom's activities is helpful to all postal stakeholders.** We suggest that before Ofcom extends the bottom up delivery cost model to other parts of the pipeline, Ofcom should pause to reflect on the feedback from all stakeholders.

Ofcom Project – Royal Mail cost allocation review

In the proposed Annual Plan, Ofcom intends to “*complete our assessment of the approach used by Royal Mail to allocate costs to different markets it serves.*” Ofcom is currently consulting on this activity, with a closing date for responses of 27 February 2019. In our response to Ofcom's cost allocation review, we will provide our detailed feedback.

For the purposes of Ofcom's Annual Plan, we agree that the cost allocation review should indeed conclude.

We summarise below some of our initial thoughts on Ofcom's review.

- Ofcom has reviewed Royal Mail's detailed cost allocation changes over the previous eighteen months. It has been a rigorous review, culminating in proposed targeted changes to the costing rules within Ofcom's Regulatory Accounting Guidelines (RAG).
 - The vast majority of the work has already been performed. We agree that Ofcom should conclude this activity. We do not see a need to extend (or continue) this review.
 - We welcome Ofcom's finding that “***As a result of our work, we found that Royal Mail's changes are consistent with the NCRs in the RAG. In particular, we found that the new allocation methods better reflect the operation reality of the new delivery methods.***”¹⁵
 - We also welcome Ofcom reviewing the transfer pricing rules. We agree that FAC+10% is not appropriate in all instances.
- 1.10 We will submit a detailed response to the cost allocation review consultation. We note that once this project completes, the only postal project (excluding ongoing monitoring) is Ofcom's proposed activity to extend the Royal Mail cost model.

¹⁴ Ofcom, Proposed Annual Plan 2019/20, Pages 25.

¹⁵ Ofcom, Proposed Annual Plan 2019/20, Pages 25.