

Postal Review
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UK Mail Response to OFCOM's Review of Postal Regulation dated 9th December 2021

Following publication of your Review of Postal Regulation dated 9th December 2021, UK Mail have reviewed your proposals for regulation of postal services for the next five years and this letter forms our response. UK Mail is happy for this response to be published.

Summary

UK Mail welcome the opportunity to comment upon your proposals but are overall rather disappointed that no substantive changes have been proposed and feel that Ofcom have missed an opportunity to tackle the dual scourge of increased prices and deteriorating service delivery. To allow commercial freedom of a monopolistic service provider to set their own rates, whilst unilaterally declaring a prolonged "disruptive event" to avoid any need to invest in service, is to abandon the role of Regulator in any meaningful sense. Simply extending the period over which Royal Mail's efficiency targets are viewed, without any sanctions for continued failure, risks letting the Letter side of Royal Mail's business drift forever downwards. Whilst the costs of continued inefficiencies are allowed to be covered by increasing revenue through nothing more than price hikes, Ofcom are presumably equally content to watch Royal Mail accelerate the decline of Letters volumes which in turn adds more pressure on a financially sustainable USO.

UK Mail believe it is imperative for Ofcom to take a more active stance in areas of pricing, innovation and efficiency to better promote a dynamic industry and slow the decline in mail volumes. While Ofcom maintain a hands-off approach to Royal Mail's activities, and simply monitors and reports on its failings, the structural decline of mail will continue and inevitably undermine the provision of the USO. It is no longer sufficient simply to await the outcome of Royal Mail's flawed efficiency initiatives.

Ofcom acknowledged in the Call for Input document that "reductions in letter revenues in recent years, primarily due to declining letter volumes, have not been offset by corresponding reductions in costs and efficiency improvement" (5.42).

To further quote from that document:

"3.11 ... we also recognised that Royal Mail might have the incentive and ability to increase prices or decrease service levels, to the detriment of consumers, instead of taking on the efficiency challenge. This might be done in a way that resulted in a detriment to the universal service in the longer term by, for example, accelerating the market decline of letters."

We see nothing of any substance in the outcome of Ofcom's Review to address these issues.

Efficiency & Sustainability

Ofcom's current position of a 'soft touch' on regulation and a 'wait and see' stance on Royal Mail's plans for efficiency improvements is not sufficient to protect the USO going forward. UK Mail believe Ofcom should have a more active role, including setting efficiency targets on Royal Mail that carry a penalty if not met. Monitoring RM efficiency performance against target has proved to be ineffective in the past, and simply extending that period for which a plan must be made available seems to offer little.

Within the Postal Services Act 2011, Ofcom is required to have regards to:

- (a) the need for the provision of a universal postal service to be financially sustainable, and
- (b) the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.

Whilst Ofcom regularly report on the financial sustainability of the USO, there has been very little evidence of Ofcom having a clear understanding of Royal Mail efficiency. Ofcom have had a full 10 years in which to monitor the current provider, over which time Royal Mail have manifestly failed to meet their own targets while at the same time failing to address their cost base. Continuing with a reduction in working hours agreed with the CWU while not meeting the efficiency goals that are meant to pay for this is a case in point. Adding another 5 years of monitoring seems wholly inadequate.

Increasing the requirement on Royal Mail for forecasts to cover a 5 year span rather than the current 3 years to 'provide a clearer trends and direction of travel' is merely pushing the argument further away. Surely the past 10 years has been sufficient to establish a clear trend upon which to act? Ofcom's proposals seem more in keeping with a regulator who is concerned about being able to adequately justify any efficiency targets they might choose to set if challenged by Royal Mail. If this is the case then this points to Ofcom not having invested in appropriate research to understand what an appropriate cost base and efficiency level within Royal Mail should be, and hence has fundamentally failed to satisfy this duty over the last 10 years.

The conditions Ofcom are allowed to set within the scope of the Postal Services Act to apply price controls through a price cap on 2nd Class Retail mail and a margin squeeze test on Access mail should be sufficient if Ofcom were satisfying their duties on ensuring an efficient cost base. However, without appropriate controls on costs and/or efficiency Ofcom will find themselves (as they seem to be) forever under pressure to allow an increase to the price cap to allow Royal Mail to pass through increases in their costs under the banner of maintaining the financial sustainability of the USO. Without an appropriate understanding of efficiency Ofcom become vulnerable to "the tail wagging the dog" across the current price controls.

The duties of financial sustainability and efficiency are clearly designed to work in tandem, but Ofcom's neglect in managing efficiency undermines the effectiveness of the whole regulatory regime which is built upon the presumption that both duties are carried out effectively. If Ofcom cannot set prices by applying an allowable margin to a controlled cost, then they become unable to support the basis for the price cap, and the market will fall into a vicious spiral as prices continue to rise sharply as volumes fall. This inevitably results in an unaffordable service for large businesses (who are the largest contributors to the funding of the USO) and consumers, and consequently an unsustainable service for Royal Mail.

In relation to ensuring long-term financial sustainability; stating that "{Ofcom}...do not propose to hardwire specific regulatory actions to any of these metrics falling outside a certain range" allows for further inaction in future. Extending the scope of measurement from EBIT to include cash flow and other funds and debt metrics in a 'holistic approach' may broaden the picture, which is to be welcomed, but in practical terms these measures all apply to support arguments for revenues in excess of uncontrolled costs. Ofcom need to establish and agree a true cost-to-serve against which to measure gains from efficiency and future movement in prices charged. Ten years' worth of data ought to have been adequate to do this had Ofcom had the will and committed resource to do so. Ofcom's proposals show little evidence of plans to address past failings and so, if adopted, seem likely to result in them being no better prepared to apply efficiency controls at the end of the next regulatory term as they are now.

Price

Without control of Royal Mail costs there is no effective protection for the **customers** who pay for 65% of the Letter volume delivered by Royal Mail. Ofcom has demonstrated that it is willing to allow the 2nd Class price cap to increase to allow Royal Mail to secure a reasonable return on its uncontrolled cost base so long as their research demonstrates prices remain affordable to consumers. There is no equivalent affordability test for large business users. Whilst Ofcom's primary duties are to consumers and SMEs, if Ofcom allow Royal Mail to price large users out of the market, then SMEs potentially face up to a 200% increase in prices as more of the costs have to be funded by smaller users. If Ofcom only consider this once business users have left then they become trapped between allowing prices to increase to a level that cannot be afforded by consumers or enforcing the price cap such that the USO becomes unsustainable.

Royal Mail's prices do not just impact consumers through the postage that they buy. We are ALL recipients of mail and in the end carry the cost of large mailers using mail services; as evidenced by banks and mobile phone companies now charging for paper billing, or offering better interest rates on bank accounts or cheaper tariffs on utilities for those choosing to operate online. It is often the most disadvantaged and vulnerable, who are unable to access online digital services, who end up paying most for Royal Mail's inefficiency.

Since the Call for Inputs and publication of the Review, Royal Mail have added a further 10% to the price of a Mailmark Letter (on top of the 13% from the previous year). "Commercial freedom" allows them to do this with no apparent checks or balances or indeed any relationship to service delivery. If this was truly a 'commercial' relationship with Access customers, we would all have gone elsewhere by now.

Access volumes provide a significantly greater contribution to the funding of the Royal Mail network necessary for the delivery of the USO than the USO volumes themselves. As per our submission, although a 2nd Class safeguard cap combined with a margin squeeze test should be sufficient to provide protections for Access users, we believe it necessary for Ofcom to provide a price control on the whole of the Royal Mail network at a wholesale level to force Royal Mail to control costs and drive efficiency improvement. This control, applying to both Access and USO volumes would prevent excessive pricing of Access volumes which accelerates the loss of volumes from the network and puts ever increasing pressure on Ofcom to adjust the safeguard cap for USO mail.

Quality or Service

Ofcom have chosen not to take on powers to incentivise Royal Mail to reach 'high quality of service standards' for the majority of mail handled.

During the Covid crisis, Ofcom have allowed Royal Mail to declare an "Emergency Period", during which Royal Mail were free to adjust their Operations and a reduced Quality of Service would be permitted. That time period expired on 31st August 21 and now Ofcom appear to be publicly challenging RM's poor delivery performance for stamped letters. The same level of concern is not forthcoming for Access users.

Royal Mail have used an ALC clause to declare a "Disruptive Event" to avoid any hint of compensation and deflect pressure from spending money on operational improvements. This Disruptive Event is still in place and Royal Mail have the ability to keep it for as long as they deem fit. We are yet to receive a satisfactory explanation or indeed a possible end date from Royal Mail.

Access users (and their mail receiving customers) ought to be afforded equal protection. It is not sufficient to simply say this is a commercial matter and therefore outside Ofcom's jurisdiction. With Access mail making up 65% of the volume going through a shared infrastructure, allowing Royal Mail to degrade performance for Access mail without penalty is bound to have a negative impact on their ability and desire to meet performance for USO mail. It is likely that the savings achieved from a degraded performance across 100% of the market exceed the penalties that Ofcom might impose for 35% of the market, making the Ofcom quality regime entirely ineffective.

We would expect DUSP conditions to include provisions for Ofcom to limit the ability of Royal Mail to invoke an Emergency Period and/or a Disruptive Event, to an open-ended time scale, with seemingly no intervention other than monitoring and asking for a plan (which is not enforceable and carries no penalties) and for Ofcom to require equivalent service performance to be achieved as part of the access condition as is required for USO mail. In the meantime, it must be hoped that by Ofcom applying pressure to USO QoS delivery, that would translate to an

overall improvement for everyone, but that seems unlikely whilst Ofcom tries to manage the whole network through the performance of the minority.

Parcels

UK Mail is the downstream access mail business of DHL Parcel UK Ltd who are a member of AICES. DHL Parcel UK have contributed to the AICES response to Ofcom's review of the parcels market and so would direct Ofcom to that response for answers to Ofcom's questions regarding parcels regulation.

We look forward to the opportunity to discuss our submission with you, both as 1-2-1 and in wider Industry sessions.