



House of Commons

Business, Innovation and Skills
Committee

Competition in the postal services sector and the Universal Service Obligation

Ninth Report of Session 2014–15

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*Report, together with formal minutes relating
to the report*

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Business, Innovation and Skills Committee

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Committee staff

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Contacts

All correspondence should be addressed to the Clerk of the Business, Innovation and Skills Committee, House of Commons, 7th Floor, 14 Tothill Street, London SW1H 9NB. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is biscom@parliament.uk

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Summary

The Universal Service is a postal service available to everyone living in every part of the United Kingdom, delivered at the same cost and with the same standard. It comprises of at least one delivery of letters every Monday to Saturday, at least one collection of letters every Monday to Saturday, at least one collection of other postal packages every Monday to Friday, and a service of delivering postal packets and registered items from one address to another, by affordable and geographically-uniform prices throughout the United Kingdom. It is an essential service to many people and the majority of our evidence highlighted the benefits of this service to people living in rural areas, to those less able to travel, to older people, and also to blind and partially-sighted people, who benefit from a free postal service.

Our inquiry concentrated on the concern expressed by many, including the current Universal Service Provider, Royal Mail, that the Universal Service is under direct and immediate threat. Given the fundamental importance of the Universal Service, we were surprised that Royal Mail could not provide a regional breakdown of the cost of the Universal Service, and that Royal Mail and Ofcom—the postal services regulatory—could not agree on what constitutes the cost, revenues and profits of the Universal Service. We recommend that both Ofcom and Royal Mail should agree on an accurate costing of the Universal Service, and that Royal Mail provides a geographical analysis of where the Universal Service is profitable, and where it is not. The Secretary of State should direct Ofcom to review the net cost of the Universal Service, in accordance with the Postal Services Act 2011.

We do not believe that the Universal Service is under immediate threat, but we recognise that market conditions are changing rapidly. Ofcom has the regulatory power to place conditions on other postal operators in order to protect the Universal Service. These are the General Universal Service Obligation, which takes six to nine months to implement, and the Universal Service Compensation Fund, which involves a much longer process. We recommend that Ofcom should have in place both a timeline for implementation of obligations that they can place on postal operators at short notice, and an assessment that that timescale is fast enough to avoid a failure in the Universal Service, even in the short term.

While we accept that Royal Mail has done much to improve efficiency, it still has to match the technical innovations introduced by many of its competitors—innovations that more clearly match the expectations of consumers, as well as contributing to the efficiency of competing postal operators. However, while such improvements may increase costs, Royal Mail should not increase postal and package prices simply in an attempt either to increase its own profit levels or to protect the Universal Service Obligation, without increasing the efficiency of its operations.

Royal Mail's competitors either deliver post end-to-end, without any assistance from Royal Mail, or they pay Royal Mail to deliver their post the final distance—what is known as 'the Final Mile'. Royal Mail offers two types of pricing plan for its competitors: either national average prices (when competitors never deliver end-to-end) or zonal prices (when

competitors ask Royal Mail to deliver in certain geographical zones only). We support Ofcom's consultation on the level of zonal pricing to be set by Royal Mail, and any recommendations arising from that consultation must balance the need for Royal Mail to retain the freedom to set its own prices, dependent on the cost of delivering in that area, with the benefits of retaining an open market and increasing competition. Royal Mail is free to set zonal pricing, but it should be based on actual costs of delivering to those zones, and not as a device to deter, or even stifle, competition.

It is unacceptable that the delivery of the Universal Service should require downward pressure on the terms and conditions of staff delivering that service. We are opposed to a 'race to the bottom' of postal sector employees' wages, terms and conditions, and such a race should not be an inevitable result of greater competition in the postal sector. If standards of pay in the postal sector, as in other sectors, decline, then the taxpayer is left to make up the difference. We recommend that Ofcom investigates the impact on customers, and the service provided to customers of any downward pressure on wages, terms and conditions of postal sector staff. We also recommend that Ofcom's remit should be extended to include labour conditions and standards.

We recognise that Ofcom has a difficult role in ensuring that the provision of a Universal Service is both financially sustainable and efficient. The sector is changing quickly, and Royal Mail has now moved from the public to the private sector. Ofcom's overriding obligation is to ensure the protection of the Universal Service Obligation but, if necessary, there should be changes in the regulatory framework to enable it to do so. Ofcom should provide our successor Committee with quarterly updates on the state of the Universal Service, and must be able to respond quickly if the Universal Service is under threat.

The postal sector is working within a constantly changing market, with declining volumes of letters, and a sharp increase in parcel volume arising from the rapid growth of internet shopping. There is a fine balancing act to be set between ensuring that the minimum standards of the Universal Service are maintained while encouraging a competitive market in the postal sector. While we would not want to stifle competition, we are adamant that the principle of the Universal Service should be upheld. We are not persuaded that the Universal Service is a burden for Royal Mail, but is rather an obligation that brings revenue and status to the organisation.

Glossary

Access competition: The collection, sorting and transporting of letters around the UK carried out by providers other than Royal Mail, on behalf of a company. Those providers then pass the letters onto Royal Mail, and pay them to deliver to customers' addresses. Also known as 'final mile delivery'.

Bulk mail: Business mail services, which are not subject to regulatory requirements.

Designated Universal Service Provider (DUSP): A status subject to conditions, such as satisfying the Universal Service Obligation, meeting performance targets of each of the specified services, and publishing certain information, including delivery and collection times, and performance data. The current DUSP is the Royal Mail.

Direct Delivery: When postal operators other than the DUSP (Royal Mail) collect and deliver letters themselves, without using Royal Mail's network. (Also known as "end-to-end delivery", "bypass competition" and "downstream access").

Downstream Access (DSA): Mail that has been collected and distributed by a competitor, but then handed over to Royal Mail centres, for final delivery.

End-to-end delivery competition: See 'Direct Delivery'.

Final mile delivery: See 'access competition'.

General Universal Service Condition (GUSC): Requirements that could be imposed by Ofcom on any postal operator, requiring new entrants to deliver mail more days per week, and/or over greater geographical areas. This condition would not replicate the requirements of the Universal Service.

Inward Mail Centre (IMC): An operator collects mail from the customer, sorts it, and then transports it to Royal Mail's Inward Mail Centres, from where it is delivered to addresses by Royal Mail.

Ofcom: Ofcom is the Communications Regulator. It was established by the Office of Communications Act 2002 and received its full authority from the Communications Act 2003. On 1 October 2011, Ofcom took over responsibility for regulating the postal services industry from the Postal Services Commission (Postcomm), as a result of the Postal Services Act 2011.

Outward Mail Centre (OMC): where mail is sorted for delivery, and mail destined for the specific geographical area of the mail centre is retained, and mail intended for other mail centres is dispatched.

Reported Business: The subset of the Royal Mail Group Ltd core UK business that is regulated by Ofcom. It includes Network Access, and excludes Parcelforce Worldwide and Royal Mail Property Unit. It is the part of the Royal Mail Group that uses the Universal Service Network for collection, sorting, transportation or delivery of postal packets (both letters and parcels).

Royal Mail plc: A postal service company in the United Kingdom, which is also the Designated Universal Service Provider. It was state owned, but following the Postal Services Act 2011, the majority of shares of Royal Mail were floated on the London Stock Exchange on 15 October 2013. The Government hold a 30% stake in Royal Mail through Postal Services Holding Company Limited.

The Postal Services Directive 1997: Obliges all EU Member States to ensure that a Universal Postal Service covering a minimum range of specified services is provided.

Postal Services Act 2011 (PSA 2011): Sets out Ofcom's duty to secure the provision of a Universal Service, in order to comply with the minimum legal requirements as set out in EU law. Ofcom's duty to secure the provision of the Universal Postal Service must be given priority if there is a conflict with Ofcom's principal duty set out in the 2003 Act.

Postal Services (Universal Postal Services) Order 2012: Sets out the universal services in more detail.

The third Postal Services Directive 2008: Requires all EU postal markets to be opened to competition.

Universal Postal Service: Postal products and associated minimum service standards that must be available to all addresses in the UK. Ofcom's primary duty is to secure the provision of a Universal Postal Service. Also known as the Universal Service.

Universal Service Obligation (USO): The obligation to provide the Universal Postal Service, imposed on the Universal Service Provider by Ofcom, under Section 36 of the PSA Act 2011. Royal Mail (currently, the only USO provider) delivers to all 29 million addresses in the UK, irrespective of whether another postal company is delivering there as well. This service is provided six days a week. (EU law specifies a minimum of five days a week).

Universal Service Provider (USP): Any postal operator designated by Ofcom as the provider of the Universal Service, under the PSA 2011. Currently, the USP is Royal Mail.

Whistl: A postal delivery company, formerly known as TNT Post (and a wholly owned subsidiary of the Dutch company PostNL, which is the Dutch universal service postal provider). Currently, Whistl is the only rival to Royal Mail, with regard to end-to-end competition in the UK.

Zonal access pricing: Royal Mail can charge access operators different prices for delivery to different parts of the country, according to four zones.

Zones: The geographical zones that Royal Mail divides the United Kingdom into, based on the density of delivery posts, and the proportion of business delivery points of postcode sectors: Zone A (Urban): Zone B (Suburban): Zone C (Rural): and Zone D (London).

1 Introduction

Post matters. It is important for the productivity of the economy and for social cohesion. [Richard Hooper]¹

1. The universal postal service has its genesis in the Penny Post—a stamp costing a penny, which assured the postage of a letter anywhere in the United Kingdom—which was introduced in the Postal Act of 1840. Today, the minimum requirements of the Universal Postal Service—set out in the 2011 Postal Services Act—include the following:

- At least one delivery of letters every Monday to Saturday, and at least one delivery of other postal packets every Monday to Friday;
- At least one collection of letters every Monday to Saturday;
- At least one collection of other postal packets every Monday to Friday;
- And a service of delivering postal packets and registered items from one address to another by affordable and geographically-uniform prices throughout the United Kingdom.²

2. The Universal Postal Service is vital to many people living in the United Kingdom. The majority of our evidence highlighted the benefits of the Universal Service to many people, including older people, people living in rural and remote communities (where internet connections can also be sporadic or non-existent), and those less able to travel.³ The Universal Postal Service also provides a free postal service to blind and partially-sighted people.⁴ The National Federation of Occupational Pensioners (NFOP) wrote of the benefits of the Universal Service to its members.

The members of the NFOP rely on postal communications to remain in touch with relatives and friends and it provides a vital lifeline and contributes to avoiding loneliness. Although there is an increased use and accessibility to electronic communications the elderly and most vulnerable are often excluded from access either through cost or disability.⁵

1 Richard Hooper ([USO 06](#)) para 2

2 Section 31, Postal Services Act 2011

3 Written evidence highlighting the benefits of the Universal Service included: Cornwall Chamber; the Farmers' Union of Wales; the Scottish Chambers of Commerce; the Consumer Council; the National Federation of SubPostmasters; the Welsh Local Government Association; the Scottish Council for Development and Industry; the South Wales Chamber of Commerce; the National Federation of Occupational Pensioners; the Civil Service Pensioners' Alliance; the Institute of Directors Wales; the Countryside Alliance; the Rural Services Network; the Royal National Institute of Blind People; the Campaign for the Protection of Rural Wales; the Council of the Isles of Scilly.

4 The Postal Services Act 2011, Section 31

5 The National Federation of Occupational Pensioners ([USO 11](#)) para 3

3. The Citizens Advice Service also described the essential role that the Universal Service provides to wide numbers of groups:

Consumers still rely on and value the universal service as a communications tool and the USO acts as a critical safety net to avoid social exclusion and the potential lack of services due to market failure. Traditionally, rural consumers value and appear to have a greater reliance on postal services than users in other geographical locations and recent research published by Ofcom in their user needs review, also showed that other categories of users such as older, disabled or housebound users, are more likely to use post and to feel cut off from society if they could not send or receive post. Access for vulnerable and rural consumers (at affordable rates) must be maintained as this is becoming increasingly important for their effective participation in the economy.⁶

4. Royal Mail is the only postal company currently designated to provide the Universal Service. However, the postal sector as a whole covers more than the Universal Service, and Royal Mail is working within an increasingly competitive postal industry, with competition from many rival companies. We received evidence which argued that such competition is driving down standards, driving down terms and conditions of staff, and driving down the quality of service to customers.⁷ Indeed, during the course of this inquiry, the effects of this competition were clearly demonstrated, when the postal operator City Link was placed into administration on 24 December 2014. This resulted in up to 5,000 of City Link's employees, employed drivers and third party workers losing their jobs and contracts with City Link.⁸ We have held joint evidence sessions on this with the Scottish Affairs Committee.⁹

The Social Market Foundation wrote about the current state of the postal services market:

The postal services market has seen substantial change over the past decade. It has become more competitive. The regulatory regime has changed, and with it, Royal Mail has been given more flexibility to set its own prices. And, most recently, Royal Mail has been privatised. In many ways, these changes are similar to those experienced in other sectors such as telecommunications, gas and electricity, although there are important differences too. So the postal services market has started to look much more like a private sector market. But in common with many other sectors that have followed the same path, regulatory intervention has been needed to ensure that wider social objectives continue to remain at the heart of the market.¹⁰

6 The Citizens Advice Service ([USO 18](#)) para 5.1

7 For example Unite the Union ([USO 17](#)) CWU ([USO 18](#)) Royal Mail ([USO 37](#))

8 Scottish Affairs Committee oral evidence session, *Impact of Closure of City Link on Employment in Scotland*, 13 January 2015, Q67

9 Scottish Affairs Committee, [inquiry into the impact of the closure of City Link on Employment](#), accessed 5 March 2015

10 The Social Market Foundation ([USO 19](#)) page 1

5. There has been a decline in the volume of letters in the United Kingdom for several years, with volumes falling by 6.3% per year from 2008 to 2013, at the same time as a burgeoning parcels market, largely in response to the growth of e-trading, which according to Ofcom increased by 3.7% per year over the same time period.¹¹ Ofcom has been the regulator of the postal market, including the Universal Service, since 2012, and Ed Richards, the Chief Executive of Ofcom until December 2014, highlighted uncertainties in the postal sector:

It is an unusual case. In some of the other areas we work, the story has been just of growth and growth and more growth. This is an unusual and difficult case, because you have obviously a decline of our propensity to send letters, but you also, on the other hand, have the revolution of e-commerce and the delivery of parcels, so it is a complicated beast with a very subtle balancing act.¹²

6. This balancing act—ensuring that the minimum standards of the Universal Service are maintained, while encouraging a competitive market—is the main issue that will be explored in this inquiry. It should also be noted that since privatisation, Royal Mail is a private sector company.

7. On 24 September 2014, the Committee asked for written evidence on the following terms of reference:

The BIS Committee will conduct an inquiry into Competition in the UK postal sector and the Universal Service Obligation.

The inquiry will consider:

- access and end to end delivery of mail;
- Parcel delivery services and the impact of competition in these services on the Universal Service Obligation.

We received 59 written submissions, and two oral evidence sessions were held on 26 November 2014 and 10 December 2014, where we heard representatives from: Royal Mail; Whistl; UK Mail; TNT UK; Amazon; the Communication and Workers Union; Community; the Mail Users Association; Citizens Advice; and Ofcom. We would like to thank everybody who gave written and oral evidence, and who informed this inquiry.

11 Ofcom, [Royal Mail access pricing review](#), 2 December 2014, para 3.3

12 Q204

2 The Universal Service Obligation

The ability to receive the same standard of service at the same cost in rural areas is of fundamental importance to residents and, in particular, businesses in rural communities. The USO is a good example of how ‘rural proofing’ of policies can work. It protects rural areas and effectively spreads costs across all areas so that all areas experience the same service. [The Welsh Local Government Association, Rural Forum]¹³

Definition of the Universal Postal Service

8. Royal Mail has always provided a ‘Universal Postal Service’ (also known as the Universal Service). The legislation that empowered the Government to privatise Royal Mail—the Postal Services Act 2011—also named Royal Mail as the Universal Service Provider. Section 31 of the Act included the following:

- To abolish the criminal offence of conveying certain letters without a licence, which had been contained in the Postal Services Act 2000;
- Ofcom to take over regulatory responsibility for postal services, from Postcomm;
- Royal Mail’s and the Post Office’s historic pensions liabilities to be transferred to the Government;
- Royal Mail Group and the Post Office to become separate entities;
- The Government put in place plans to offer shares in the Royal Mail Group before April 2014, and to move the Post Office into a mutual structure before 2015.¹⁴

9. Section 31 of the 2011 Act describes the “minimum requirements” of the Universal Services, which include:

- at least one delivery of letters every Monday to Saturday, and at least one delivery of other postal packets every Monday to Friday;
- a service of conveying postal packets from one place to another by post at affordable, geographically uniform prices throughout the UK;
- a registered item service at affordable, geographically uniform prices throughout the UK.¹⁵

13 Welsh LGA – Rural Forum ([USO 24](#)) para 3

14 Postal Services Act 2011, Section 31

15 Postal Services Act 2011, Section 31

10. Royal Mail's own website provides more details on the Universal Service requirements, set out in the 2011 Act:

- At least one delivery of letters every Monday to Saturday to every address in the UK;
- At least one collection of letters every Monday to Saturday from every access point in the UK that is used to receive letters and postal packets for onward transmission;
- Postal services at an affordable, uniform tariff across the UK;
- A registered items service at an affordable public tariff;
- An insured items service at an affordable public tariff;
- A free-of-charge postal service to blind or partially sighted people;
- Free carriage of legislative petitions and addresses;
- Postal Packets up to 20kg.¹⁶

Who uses the Universal Postal Service (UPS)?

11. The PostalGroup—an organisation of three companies: Mail Matters Direct Ltd; Regional Mail Services Ltd; and PostalSort Ltd—highlighted the importance of customers when considering the Universal Postal Service:

We feel it's important that the focus of the inquiry should be on the customers of the postal services and specifically on how the industry should look in the future if it is to provide products and services that will complement the needs of the country. A free flowing delivery network will allow the UK to take advantage of the country's competence in e-commerce. An industry that is dogged by infighting will only stifle its potential.¹⁷

Customers are not only residential users, sending personal letters, presents, birthday cards and Christmas cards. Customers of the UPS are also businesses that send communications to their customers, including direct mailing, banking and financial mailing. The Federation of Small Businesses described its members' use of postal services:

The last survey conducted by the FSB on how members use postal services showed that they are used for: ordering goods, mail shots and publicity, delivering goods and services, information for employees, delivering supplies, sending invoices, sending parcels and paying suppliers, among others.¹⁸

16 Royal Mail [Universal Service Obligation](#), accessed 5 March 2015

17 ThePostalGroup ([USO 38](#)) page 4

18 Federation of Small Businesses ([USO 12](#)) para 5

12. TechUK—representing over 850 companies and technologies, the majority of which are small and medium-sized businesses—stressed the need for such businesses to be taken into account:

It is small and medium businesses which commercially underpin the USO and make it viable, as opposed to residential users. The Select Committee’s focus should be ensuring the requirements of such businesses are met and the Royal Mail service to them is secure.¹⁹

The Mail Users’ Association, whose members “generate more than 10% of annual postal traffic in the UK”,²⁰ wrote of business *Super Users*:

Super Users of mail regularly spend in excess of £1 million a week on mailing activities, and as such form the backbone of the UK’s postal system in terms of contribution. One MUA member has quoted a spend in 2013 with Royal Mail of £83 million, and another as delivering annualised postal volumes in excess of 640 million items into the network. Members would therefore argue that the future of the universal service is inextricably linked to the needs and wants of these mailers, and they have a vital contribution to make in informing debate on the wider issue of how best to sustain the universal service in the long term.²¹

The Universal Service and constituent parts of the United Kingdom

13. We received several submissions from interested parties in Scotland, Northern Ireland, and Wales about the importance of the Universal Service to them, due to the high percentage of rural addresses in those areas. The Scottish Chambers of Commerce (SCC), representing a network of 11,000 businesses throughout Scotland, wrote:

It is imperative that all businesses in Scotland have access to a universal service with regards to mail. While SCC supports competition, it is essential that this is not conducted in a way which could threaten the continuation of the universal service and therefore add unfair cost burdens to businesses in rural areas throughout Scotland.²²

The Northern Ireland Chamber of Commerce and Industry wrote that: “the one-price-goes-anywhere universal service has particular significance for Northern Ireland given the high percentage of rural addresses and the fact that it is the only region to be entirely served by air and sea”.²³

19 techUK ([USO 30](#)) page 3

20 Mail Users’ Association ([USO 23](#)) para 1.1

21 Mail Users’ Association ([USO 23](#)) para 3.1

22 Scottish Chambers of Commerce ([USO 32](#)) para 2

23 Northern Ireland Chamber of Commerce and Industry ([USO 36](#)) page 1

14. The Welsh Local Government Association made the point about how the USO is subsidised geographically:

The ability to receive the same standard of service at the same cost in rural areas is of fundamental importance to residents and, in particular, businesses in rural communities. The USO is a good example of how ‘rural proofing’ of policies can work. It protects rural areas and effectively spreads costs across all areas so that all areas experience the same service.²⁴

Regional differences, in respect of rural and urban populations, highlight the cross-subsiding nature of the Universal Service, to ensure the provision of the same service for all in the whole of the United Kingdom.

Cost of the Universal Service Obligation to Royal Mail

15. The USO comes at a cost. The Social Market Foundation argued that the USO was sustainable as it was cross-subsidised, both geographically and by product:

The USO is currently funded by Royal Mail. Whilst the costs of delivering across the UK vary substantially, from the cheaper, more densely populated urban areas to the more expensive, sparsely populated areas, retail prices must be the same, regardless of where mail is being sent within the UK. The USO is effectively funded through some customers paying more to subsidise others. This cross-subsidy occurs both by geography and product type. But the financing of the USO is likely to come under substantial pressure in the future.²⁵

16. However, the Social Market Foundation noted the cost of the USO to Royal Mail was difficult to quantify :

There is little transparency over the actual cost of the USO, and therefore how much cost is being imposed on different groups of consumers or businesses. This makes the sustainability of the current model hard to assess; and without fully understanding where the costs fall also makes it difficult for policy-makers to make well-informed choices about potential measures to ensure sustainability, both now and in the future.²⁶

17. Richard Hooper—the author of three reports on the future of the postal services sector in 2008 and 2010²⁷ and currently an adviser to the CEO of Royal Mail—based his assessment of the costs of the USO on the following definition:

The USO is also defined by Ofcom as that set of products which are inside the USO, for example parcels up to 20kg. It is better in my view to look at the

24 Welsh Local Government Association – Rural Forum ([USO 24](#)) para 3

25 The Social Market Foundation ([USO 19](#)) para 3

26 The Social Market Foundation ([USO 19](#)) para 8

27 *The challenges and opportunities facing UK postal services*, May 2008; *Modernise or Decline*, Cm 7529, 16 December 2008; and *Saving the Royal Mail’s universal postal service in the digital age*, Cm 7939, September 2010

USO as a total network embracing ‘first mile’ and ‘last mile’ with a strong element of fixed costs irrespective of volume. Your postman or postwoman has to deliver to your house or flat or business six days a week whether he or she has one letter for you or twenty.²⁸

This definition was used by Moya Greene, the CEO of Royal Mail, when she estimated the cost to be £7.2 billion.²⁹ However, Ed Richards, the then CEO of Ofcom, offered a different method of calculating the cost of the USO:

We have taken a different approach to it. That is the cost of the whole network, but of what goes over that network of that £7.2 billion, only 20% is USO defined—80% of what is carried over the network is not. When one then asks what costs should be associated with which area, the numbers are quite different. For example, in the Royal Mail’s own regulatory financial statements, which it has to submit to us, the allocation from the USO, or the cost of the USO, is not £7.2 billion but £2.7 billion. They are very different numbers.³⁰

18. Ed Richards went on to describe the profits that Royal Mail makes from the Universal Service Obligation:

The audited 2013–14 regulatory financial statement from Royal Mail to us—so audited externally—reports an operating profit of £484 million on universal service mail after transformation costs, which are one-off costs. If you omit transformation costs, the operating profit on the universal service was £556 million, so half a billion pounds of profit on the universal service in the audited regulatory accounts for 2013–14.³¹

Ofcom’s written evidence also highlights VAT benefits and economies of scale and scope for any Universal Service Provider:

It has economies of scale and scope in relation to its historical position as the Universal Service Provider and potentially benefits in relation to brand recognition and trust. Royal Mail also does not have to charge VAT for any of its universal service or access products and this gives it an advantage over its competitors for VAT exempt business customers (such as banks and other financial institutions and charities) and for consumers and small businesses.³²

19. We invited Royal Mail to explain the discrepancy between its figure of £7.2 billion and Ofcom’s figure of £2.7 billion. Royal Mail’s supplementary evidence stated that:

28 Richard Hooper ([USO 06](#)) para 2

29 Q22

30 Q155

31 Q156

32 Ofcom ([USO 29](#)) page 2

Both figures are taken from Royal Mail's 2013–14 Audited Regulatory Accounts.³³ Both numbers, £2.7bn and £7.2bn, are calculated in line with the Regulatory Accounting Guidelines specified by Ofcom, which Royal Mail must abide by. An explanation of what each figure represents is as follows:

£7.2bn:

This figure represents the cost of maintaining a network that is capable of delivering the Universal Service, is the appropriate cost measure to focus on when considering 'the cost of the Universal Service'. This view is also held by Ofcom, as it uses the margin earned on this £7.2bn cost when assessing the financial sustainability of the Universal Service.

Ofcom defines the costs associated with the Universal Service network as the 'Reported Business'. The 'Reported Business', as defined by Ofcom, includes:

"The costs and revenues of both regulated and unregulated products that depend on the core universal service activities for their efficient provision. This includes all universal service products, [and non-USO] retail bulk mail products and access products"

£2.7bn:

The £2.7bn figure is the proportion of the £7.2bn 'Reported Business' cost, which is allocated to Universal Service products that are delivered through Royal Mail's network.

Importantly this figure does not represent the full cost of running a network capable of delivering the Universal Service.³⁴

Cost of the Universal Service to Royal Mail, region by region

20. We also asked Royal Mail for a more detailed analysis of the cost of the Universal Service, broken down into geographical areas across the United Kingdom, region by region. Royal Mail replied with the following evidence:

Royal Mail's Universal Service network is designed and run to serve the whole of the UK with a uniform service specification as efficiently as possible and maximising economies of scale. Much of its cost is comprised of national overheads which cannot be meaningfully broken down into regional costs. For example, the overnight road and air transport costs that allow Royal Mail to deliver the First Class service cover the whole of the UK.

Royal Mail is required, by Ofcom, to maintain a zonal costing model. This model assesses the variation in cost of delivering mail in 4 zones (London, Urban, Suburban, and Rural). It does not calculate cost by geographic region.

33 Royal Mail Group Limited [Regulatory Financial Statements 2013-14](#), June 2014

34 Royal Mail ([USO 56](#)) para 1

This model only considers downstream cost which may vary by zone. It therefore does not include key elements of the £7.2bn 'Reported Business' cost base that enable the end-to-end universal service. For example, central overheads, collection, sortation and distribution of mail around the country are not covered by the model. The results from this model are therefore not well suited to assessing an accurate regional cost of the universal service.

However, taking this model as an indication of delivery costs only, it shows that rural deliveries have a significantly higher cost than suburban or urban deliveries, as may be expected. Sustaining the Universal Service network relies on revenues from some areas of the country contributing to its overall costs.

Also, as Ofcom disclosed, London is the most costly area for Royal Mail to deliver according to the zonal costing model. This is due to factors including the higher costs attributed in the model to property in London, as well as higher wages paid to staff in the capital.

21. This supplementary evidence did not help us to understand the regional variations in the cost of the Universal Service, but did corroborate the evidence we heard in a different Inquiry. In our Inquiry into the Implications of Scottish Independence on Business, Higher Education and Research, and Postal Services, in June 2013, the Director of Postal Policy and Regulation at Consumer Futures, Jonathan Millidge, answered a question about the cost of delivering mail in Scotland:

There are networks that go between Scotland and England and Wales and Northern Ireland and so on and we do not disaggregate those. We have an obligation to deliver mail at a uniform price everywhere across the UK. We do not separate out the cost for Scotland in doing that. [...] We have 10,000 post boxes in Scotland that we collect from, for example, and 6,174 delivery routes. It is true that it is more expensive to deliver in rural areas than it is to deliver in urban areas. There are massive rural areas in Wales, for example, and also in England and Northern Ireland. So I could not give you a breakdown of what it is in Scotland. We do deliver about three times as much mail in Scotland as is posted in Scotland. So Scotland is a net importer of mail and that mail obviously then is delivered throughout the 16 postcodes that make up Scotland. But I am afraid I cannot say what the profitability of Scotland is.³⁵

22. Given the fundamental importance of the USO, we were concerned to note that Royal Mail were unable to provide a regional breakdown of the cost of the Universal Service Obligation (USO). In addition, given the responsibility of Ofcom to protect the USO, we were surprised to learn that there is no consensus between Royal Mail and Ofcom over what constitutes the cost, revenues and profits of the USO. We recommend that both Royal Mail and Ofcom should, as a matter of urgency, agree a set of financial metrics

35 BIS Committee, *The Implications of Scottish Independence on Business; Higher Education and Research; and Postal Services*, HC 378-1, June 2013, Q72

against which the costs should be measured. If necessary, this should be carried out by the National Audit Office (NAO) or a mutually-agreed body of experts.

23. We recommend that Royal Mail—the Designated Universal Service Provider—using these figures, provides a geographical analysis of where the Universal Service is profitable and where it is not. Such detailed analysis and financial monitoring of the Universal Service would provide the evidence to assess the long-term sustainability of the Universal Service. This breakdown of costs should be included in Royal Mail’s Audited Regulatory Accounts. If Royal Mail declines to provide these figures, we recommend that the Government should consider extending the remit of Ofcom, to enable Ofcom to enforce this requirement.

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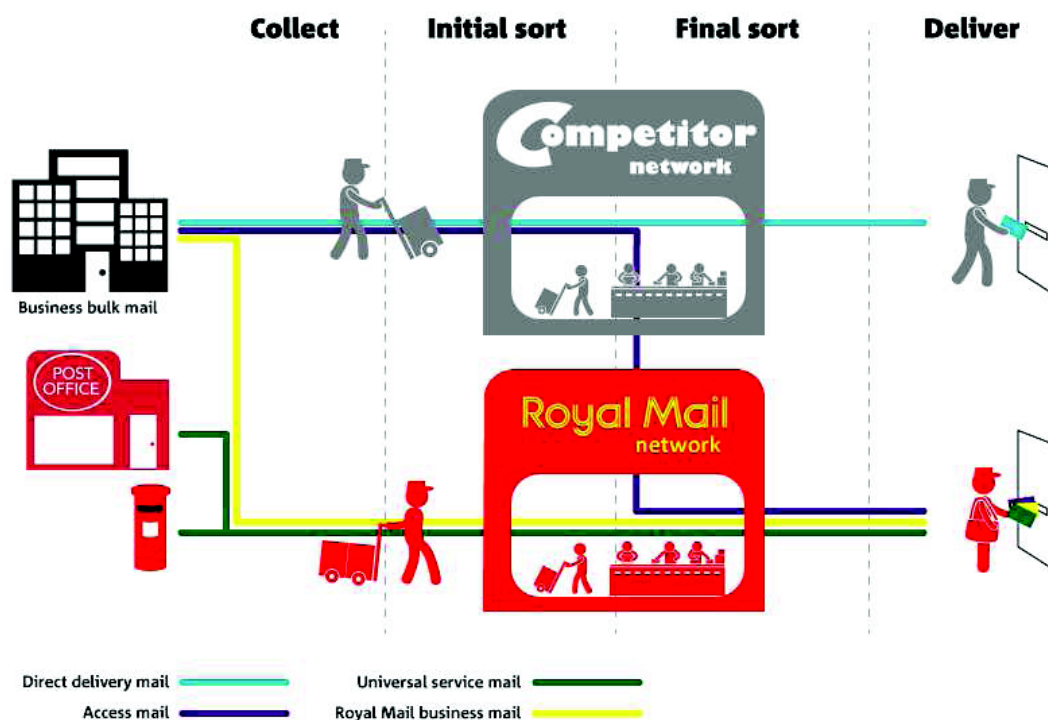
3 Access mail and Direct Delivery mail

End-to-end competition can present either a risk to the viability of the USO if managed poorly or, conversely, an opportunity if competition is managed by Ofcom in a fair and reasonable fashion. [techUK]³⁶

Introduction

24. There are two types of competition in the postal services sector, Access mail and Direct Delivery mail. Access Mail, also known as Downstream Access or Access Competition, is when mail is collected and distributed from customers by a postal company other than Royal Mail, but is then handed over to Royal Mail, for the final processing (known as Final Mile delivery). Direct Delivery, or end-to-end delivery, is when postal operators other than Royal Mail collect mail from customers and also deliver them through their own network.

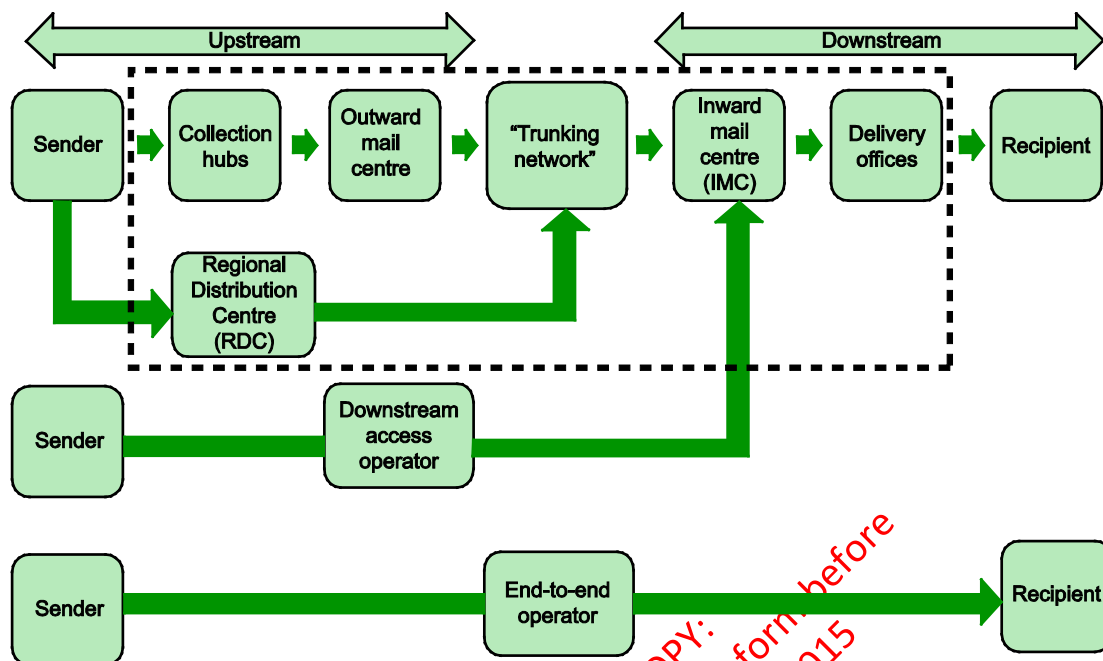
25. The following diagram sets out clearly the different routes that letters and parcels can take, from sender to receiver, by using either part or all or none of Royal Mail's infrastructure:



Ofcom: news release, 2 December 2014

36 techUK ([USO 30](#)) para 4.6

Ofcom’s *Royal Mail Access Price Review* illustrates the same routes, but in more detail:



Ofcom: Royal Mail Access Price Review, 2 December 2014³⁷

Direct Delivery—a threat to the USO as a result of cherry picking?

26. ‘Cherry picking’ is a phrase frequently used to describe the effects of Direct Delivery. Richard Hooper wrote that Royal Mail uses cross-subsidisation to support the financial viability of the USO, and that cherry picking undermines that cross-subsidy:

The USO’s financial viability is built on cross-subsidies from higher volume cheaper-to-deliver areas of the UK to lower volume more expensive-to-deliver areas of the UK. Cherry picking happens when an alternative carrier such as Whistl direct delivers to the higher volume, cheaper-to-deliver areas and requires Royal Mail to take the rest of their letters to the lower volume, more expensive-to-deliver areas.³⁸

Moya Greene told the Committee that conditions should be placed on competitors who offer Direct Delivery:

In other countries we have seen Governments put conditions on end-to-end players, saying things like, ‘they must cover at least 80% of the land mass in all of the regions within a very finite period of time’. That helps, because it signals that you shall not be allowed to just cherry-pick the high-volume, high-density, low-cost-to-serve areas at the expense of the universal service.³⁹

37 Ofcom, [Royal Mail access pricing review](#), 2 December 2014, page 20

38 Richard Hooper ([USO 06](#)) para 3

39 Q41

Royal Mail's written evidence explained in more detail the principle of cherry picking:

The UK's economic geography makes the Universal Service challenging to sustain. It also creates an attractive environment for cherry picking. In the EU, the UK has the highest concentration of large, dense urban areas. These are very attractive to a cherry-picking strategy: the densest 15% of the population live in just 1% of UK landmass. Conversely, the UK has a significant proportion of costly-to-serve rural areas: just 15% of the population live in low density areas equating to 63% of the total UK landmass. Direct Delivery is not, therefore, level playing field competition. It is cherry picking arbitrage that both exploits the Universal Service and puts its future at risk.⁴⁰

27. However, others refuted the significance of action described as 'cherry picking'. The Citizens Advice Service wrote that the current level of Direct Delivery is of such insignificance that the Universal Service could not be under threat:

The slower growth rate of end to end competition means that these operators deliver less than 1% of total addressed mail and Ofcom estimates that end to end competition is less than 0.4% (although acknowledging that the number of items carried by alternative operators represents a six-fold increase on 2011 mail volumes). Royal Mail still remains the largest player in the UK postal market and retains market power in the letters delivery market and in the delivery of lower weight parcels, although it is becoming less preponderant in relation to the market as a whole and delivery of higher weight parcels is generally more competitive.⁴¹

Royal Mail's submission to Ofcom

28. Royal Mail wrote to Ofcom in June 2014, highlighting its concerns over the future of the Universal Service. Its letter, *Direct Delivery: a threat to the Universal Postal Service*, stated that, as a result of unfair competition from companies offering Direct Delivery, the Universal Service was in danger, and that "Direct Delivery is in reality not level playing field competition that brings benefits to consumers."⁴² Royal Mail's written evidence stated that "the Universal Service is precious. But, it is also fragile and is becoming more so".⁴³

29. Royal Mail's submission highlighted what it believed to be the impact of Whistl's⁴⁴ plan to deliver letters to around 43% of UK addresses by 2017:

Direct delivery could undermine our ability to finance the USO: Direct delivery entails cherry picking urban areas, easier-to-handle mail and

40 Royal Mail ([USO 37](#)) paras 1.15 and 1.16

41 The Citizens Advice Service ([USO 20](#)) para 3.4 and 3.5

42 Royal Mail plc, [Direct Delivery: a Threat to the Universal Postal Service Regulatory Submission to Ofcom](#), June 2014, extracts from executive summary

43 Royal Mail ([USO 37](#)) 1.9

44 Royal Mail's letter used the name of TNT Post, which was the former name of Whistl and the correct name at the time of Royal Mail writing to Ofcom.

offering a less frequent service. This removed from Royal Mail revenues that are currently deployed to support the costs of the USO. It puts at risk the current system of funding the USO.⁴⁵

However, Nick Wells, the CEO of Whistl, refuted the claim of cherry-picking:

We are also a by-product of the liberalisation of the postal market and we signed an access agreement in 2004. Where we started to do the collection, trunking and sorting, but we handed over all our mail to Royal Mail. In 2012 we started doing our own end-to-end deliveries. [...] It is impossible for us to cherry-pick because of an arrangement we made four years ago with Royal Mail called zonal pricing.⁴⁶

30. In its June 2014 letter, Royal Mail asked Ofcom to carry out a full review of Direct Delivery and its impact on the USO, and wrote that regulatory changes would be needed in order to protect the Universal Service.⁴⁷ In evidence to us, Moya Greene set out the reasons behind this position:

We are not asking for subsidy; we are asking for the underlying economics of the universal service to be recognised and for the rules of the game to be fair.⁴⁸

However, Citizens Advice Service did not believe that Royal Mail had made a sufficient case for action to be taken:

Although Royal Mail's recent regulatory submission to Ofcom suggested that the USO is under threat on the basis of end-to-end competition in the market, this submission does not provide compelling, robust evidence based reasons for immediate intervention to protect the sustainability of the USO.⁴⁹

Ofcom's response

31. On 2 December 2014, Ofcom published its *Review of end-to-end competition in the postal sector*, setting out the results of its review of whether the Universal Service was in danger. It stated that "at the heart of Royal Mail's submissions is its claim that that unless Ofcom takes regulatory action in relation to end-to-end competition, Royal Mail's ability to finance the Universal Service will be undermined".⁵⁰ It described the Review in the following terms:

In this review, we have considered the evidence available to us, including the most recent information from Royal Mail's 2014 Business Plan, the latest

45 Royal Mail plc, [Direct Delivery: a Threat to the Universal Postal Service Regulatory Submission to Ofcom](#), June 2014, executive summary

46 Q4

47 Royal Mail plc, [Direct Delivery: a Threat to the Universal Postal Service Regulatory Submission to Ofcom](#), June 2014, executive summary

48 Q26

49 The Citizens Advice Service ([USO 20](#)) para 6.4

50 Ofcom, [Review of end-to-end competition in the postal sector](#), 2 December 2014, executive summary

results from our ongoing monitoring programme and Whistl's rollout plans. We have also considered the argument in Royal Mail's June 2014 Submission. We have assessed whether, in light of the evidence, the impact of end-to-end competition from Whistl is likely to pose a threat to the provision by Royal Mail of a financially sustainable and efficient universal postal service. To this end, we have assessed the forecast financial position of the universal service, and the arguments which Royal Mail and other stakeholders have put to us about the likely impact of end-to-end competition on that financial position.⁵¹

32. Through its ongoing monitoring of the postal sector, Ofcom receives formal notifications from Whistl, under the Notification Condition, which requires any operator to give three months' notice of its intention to enter or expand its letter delivery service. Such operators are also required to provide Ofcom with their future volume forecasts, operational and business plans, and any future geographical areas to be entered, with a timetable for such entry or expansion, subject to minimum additional volume requirement of 2.5 million items per quarter.⁵² Ofcom's review stated that it had "informed itself of the developing position regarding end-to-end letter competition since Whistl commenced its trial".⁵³

33. While assessing the evidence, Ofcom wrote that it considered "whether the legal tests in the Postal Services Act 2011 for imposing regulatory conditions on end-to-end operators are met, and/or whether we should be undertaking any other work in light of our duty to secure the universal service".⁵⁴ The review document is littered with redacted paragraphs, due to commercial sensitivity. However, Ofcom stated that:

While the significant majority of information provided to Ofcom by Whistl is commercially confidential, it has publicly stated that its rollout plan is behind schedule. By the end of 2014, it had expected to be delivering to around 15% of the country but it is currently only delivering to around 7%. (For example, it had planned to also be delivering in Edinburgh, Glasgow, Birmingham and East London by now). As set out in our annual monitoring update, Whistl only delivered around 0.5% of the total addressed letter mail market in 2013–14.⁵⁵

34. Having considered the relevant evidence cited above, Ofcom decided that, for the time being, the Universal Service Obligation was not under threat:

For the reasons set out in this document, we do not consider it necessary at this time to exercise our regulatory powers under the Postal Services Act 2011 to impose regulatory conditions on Whistl in order to secure the ongoing provision of a universal postal service. We do not consider that the

51 Ofcom, [Review of end-to-end competition in the postal sector](#), 2 December 2014, para 1.7

52 *Ibid*, para 2.17 and footnote 11

53 *Ibid*, para 2.17

54 Ofcom, [Review of end-to-end competition in the postal sector](#), 2 December 2014, para 1.8

55 *Ibid*, para 2.18

provision of the universal postal service is under threat, and as a result we do not consider that the legal tests for imposing such regulatory conditions are met.⁵⁶

However, Ofcom included the following caveat:

Our decision not to intervene at this point does not imply that we are ruling out such a course of action at some point in the future, if circumstances change. As we set out in our March 2013 end-to-end Guidance, we consider we could implement GUSCs within six to nine months if it was necessary to secure the provision of a universal postal service. To this end, we will continue to monitor the situation closely.⁵⁷

Regulatory intervention

General Universal Service Obligation

35. Although Ofcom concluded that the viability of the USO was not under immediate threat, it was not beyond the remit of Ofcom to place conditions on other postal operators at any point in the future. Ed Richards told us of the two main conditions that could be imposed:

There are two most obvious ones. One is an obligation to deliver over a specific geographic area and the other is to deliver on a specific number of days. In other words, there are service obligations, which would have an impact upon the underlying cost structure of the new entrant. Those are the two most obvious and clear ones.⁵⁸

36. In supplementary evidence, Ofcom wrote that such a General Universal Service Condition could be imposed on any postal operator (under Section 42 of the Postal Services Act 2011) within six to nine months:

In our March 2013 guidance on end-to-end competition we said that the most likely requirements of such a GUSC would be to require new entrants to deliver mail more days per week and/or over a greater geographic than it had planned.

However, a GUSC cannot replicate the requirements of the Universal Service i.e. they may not require a person to:

- Deliver or collect letters six days per week (packets five days per week);
- Provide a service throughout the UK; or

56 *Ibid*, para 1.9

57 *Ibid*, para 1.12

58 Q153

- Provide a service at an affordable price which is uniform throughout the UK.⁵⁹

Universal Service Compensation Fund

37. The other regulatory intervention available to Ofcom, in accordance with Section 44 of the Postal Services Act 2011, is the creation of a Universal Service Compensation Fund. Ofcom's supplementary evidence described the longer process required to create such a fund:

First, prior to October 2016, the Secretary of State for Business would need to direct Ofcom to review the net cost of the universal service (after this time, we could choose to undertake a review at our discretion);

Second, Ofcom would need to review the net cost of the universal service;

Third, if that review established that complying with its universal service obligations imposes a financial burden on Royal Mail, Ofcom would have to determine whether it considered that financial burden to be unfair, and if so, to what extent it was unfair;

Fourth, if Ofcom did determine that the universal service imposed an unfair financial burden on Royal Mail, it would have to report to the Secretary of State setting out recommendations as to the action, if any, that Ofcom consider should be taken to deal with the burden;

Fifth, the Secretary of State would have to direct Ofcom to set up a fund; and

Finally, Ofcom would have to design, consult and then establish the fund.⁶⁰

38. However, Royal Mail was not convinced that Ofcom could intervene as quickly as it had suggested:

Ofcom has said that it could intervene quickly if needed. However, even to undertake a review of direct delivery could take a year or more. Any subsequent interventions could take many years to design, implement and take effect.⁶¹

In particular, Royal Mail argued that any compensation fund “could take at least 3-4 years to put in place” and would be of “doubtful value thereafter”.⁶² This point was supported by techUK, which argued that a universal service compensation fund would take too long to set up and “does not effectively mitigate the threat to the USO”.⁶³

59 Ofcom ([USO 54](#))

60 Ofcom ([USO 54](#))

61 Royal Mail ([USO 37](#)) para 1.4

62 *Ibid*

63 techUK ([USO 30](#)) para 4.15

39. *Cherry picking is a phrase often used in postal services to describe the easy, most profitable sections of mail services taken by Royal Mail's competitors. Cherry picking is available to Royal Mail competitors but, at the moment, affects only a very small percentage of Royal Mail's total business. This could change quickly, given the ambitions of some of Royal Mail's rivals in the market. Both Royal Mail and Ofcom need an evidence base upon which to gauge the potential threats to the sustainability of the USO in the event of a higher level of market penetration by other providers. We note the decision by Ofcom that, currently, the level of the threat does not justify intervention. We also note that Ofcom is mandated to monitor the situation.*

40. *Ofcom has the power to impose a General Universal Service Obligation on postal operators other than the Universal Service Designated Provider (Royal Mail), in order to protect the Universal Service. We have yet to be convinced that Ofcom could impose the General Universal Service Obligation within the predicted six to eight months. We recommend that Ofcom publish a more detailed timeline for its implementation and an assessment that the timescale is fast enough to avoid a failure in the Universal Service, even in the short term.*

41. *The alternative regulatory condition—the Universal Service Compensation Fund—involves a lengthy delay in implementation. To avoid such a delay, we recommend that the Secretary of State directs Ofcom to review the net cost of the Universal Service, in accordance with the Postal Services Act 2011.*

Views of the Universal Service should it change?

42. A number of our witnesses saw some scope in reviewing or changing the requirements of the Universal Service Obligation. Nick Wells, the CEO of Whistl, had an open-minded view:

Most countries in the modern world are currently reviewing their universal service obligations. For example, Italy and the Netherlands have reduced that to five days a week. I am not advocating this. In Moya's own country, Canada, they will stop delivering to letterboxes in the next five years and only go to community post-boxes. That is certainly not something that we would want to see, but the point here is that it will need reviewing.⁶⁴

43. Adam Scorer, Director of Consumer Futures at Citizens Advice, also saw the possibility of reducing the current six days a week service,⁶⁵ while Alan Halfacre, Chairman of the Mail Users Association, argued that the first-class postal service was not as important as some would suggest:

If you need to get something to an individual the following day, there are mechanisms. They are expensive for physical items, but are they the only way the citizen can communicate? We come down to, 'I want to send my birthday card'. Well, try to remember to do it the day before rather than the last day.

64 Q37

65 Q115 and 116

You have been getting round to it for a long time, but, no, you have to do it two days before instead of one day before. [...] It is not a social stigma to put a second class stamp on a letter.⁶⁶

44. However, despite emphasising the cost of the USO to Royal Mail, Moya Greene said that Royal Mail was “very committed to the universal service in its current form” and did not see the need to change it.⁶⁷

45. *There has already been an extensive debate about the requirements of the Universal Service Obligation. The Committee strongly believes that it would be inappropriate to change the current requirements of the Universal Service Obligation.*

Price to customers

46. In March 2012, Ofcom introduced a new regulatory framework and provided Royal Mail with greater freedom on pricing for the majority of its services. Ofcom’s *Royal Mail Access Pricing Review* described the intention and risks attached to this decision:

Our objectives were to grant Royal Mail sufficient pricing flexibility to ensure it could continue to provide the universal service on a sustainable basis and sufficient commercial freedoms to adapt to the changing market environment. We also aimed to maintain the benefits of competition in supporting the efficient provision of the universal service.

We recognised that removing price controls would come with serious risks. We considered the most significant of these to be the risk that Royal Mail would not take on the challenge of improving efficiency and would rely solely on pricing to return itself to profitability, potentially excluding vulnerable customers and precipitating a more rapid decline in the mail market.⁶⁸

47. Safeguards were therefore put in place by Ofcom, including capping the price of second class letter stamps at 55p, and capping large letters and small parcels (up to 2kg) at a 53% increase, to ensure a basic universal service is available to all.⁶⁹ In its latest annual monitoring update, Ofcom wrote that customers were generally satisfied with the cost of stamps and service, stating that “the latest ONS data shows weekly household expenditure on postal services to around 0.1% (60p) of total expenditure based on 2012 prices. This is a little less than the current price of a single First Class stamp”.⁷⁰ It also wrote that:

In terms of *customers and consumers*, our research indicates the vast majority of consumers are satisfied with their postal services and that prices remain affordable for almost all consumers. Whilst First and Second Class stamp letter and large letter prices did not increase in 2013, prices of these increased

66 Q119

67 Q37

68 Ofcom, [Royal Mail access pricing review](#), 2 December 2014, paras 3.24 and 3.25

69 Ofcom, [Royal Mail access pricing review](#), para 3.25 and [Annual monitoring update on the postal market, 2013-14](#), para 5.9

70 Ofcom, [Annual monitoring update on the postal market, 2013-14](#), para 5.30

above inflation in 2014. However the safeguard cap on Second Class stamps will continue to protect vulnerable consumers in the future. Royal Mail significantly improved its quality of service, following a number of failed targets in the last year. First and Second Class national targets were met, however the Postcode Area (PCA) target was missed, albeit narrowly. We will nonetheless continue to monitor Royal Mail's progress on quality of service performance.⁷¹

48. Ofcom's Annual Report also highlighted its monitoring of affordability in the future:

We will continue to use our quantitative consumer survey for residential consumers and businesses [...] to enable us to monitor use of postal services, and to assess the affordability of services in the universal service, value for money and satisfaction with post and postal prices.⁷²

49. We note that Royal Mail has again increased its prices this year. Royal Mail should not increase prices in an attempt either to increase its own profit levels or to protect the Universal Service Obligation, without continuing to increase the efficiency of its operations, thereby reducing its costs and enabling it to improve its standards of service.

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71 Ofcom, [Annual monitoring update on the postal market, 2013-14](#), para 1.6

72 *Ibid*, para 5.31

4 Competition and efficiency

Royal Mail is the dominant incumbent and has huge efficiencies of scale. It has a massively trusted brand. It has so much going for it. The extent to which it will maintain that level of dominance or market power will depend on how it is able to deliver products [...] that will enable it to win in what will become a very competitive market. [Adam Scorer, Citizens Advice Service]⁷³

Competition in the postal sector

50. The third Postal Services Directive 2008 requires all EU postal markets to be opened to competition, and the Postal Services Act 2011 reflects that requirement. Our written evidence highlighted the benefits of such competition. BBC TV Licensing wrote that:

Continued development of competition with the proviso the universal service is not impacted, will lead to continued improvements in quality of service, continued downward pressure on prices, greater choice and continued product innovation. As a mailer who mails across the UK on a regular basis such developments are vital to our activity and can go some way to protecting our budgeted expenditure on mail. Such a development is extremely important as our activity is funded from the public purse.⁷⁴

The Mail Users' Association wrote that competition in the postal sector had enabled sustainability in the market and that competition had benefited "an otherwise declining commercial scenario".⁷⁵ Not surprisingly, this view was supported by Royal Mail's competitors. Nick Wells, the CEO of Whistl, argued that without competition there was "no catalyst to keep prices low",⁷⁶ while UK Mail believed that competition was "a vital spur to improved choice for mail users, and to increased efficiency by all operators, including Royal Mail".⁷⁷

51. Ofcom also highlighted the benefits of competition in the postal sector:

There are a number of potential benefits from other postal operators competing with Royal Mail in the delivery of mail. Most importantly entry can strengthen the incentives on Royal Mail to improve efficiency and reduce its costs.

In addition, if end-to-end competition results in lower prices for certain types of users, it may reduce the rate at which volumes decline for the whole

73 Q135

74 BBC TV Licensing ([USO 16](#)) paras 3.1.1. and 3.1.3

75 Mail Users' Association ([USO 23](#)) para 2

76 Q27

77 UK Mail ([USO 27](#)) para 1.4

industry. Competition may also benefit customers through increased innovation and value added services.⁷⁸

Royal Mail efficiency

52. Under Section 29 of the Postal Services Act 2011, Ofcom has to have regard to: “the need for the provision of a Universal Provider Service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times”.⁷⁹ In its discharge of that duty, Ofcom monitors both those services provided by the USO and Royal Mail’s so-called ‘Reported Business’, which means that it has a duty to comment on the efficiency of services that are in Royal Mail’s Reported Business, but not necessarily within the USO.

53. In evidence to us, Ofcom clarified what the term ‘Reported Business’ covered:

The ‘Reported Business’ is that part of Royal Mail Group that uses the universal service network (also known as the core network) for collection, sortation, transportation or delivery of postal packets (both letters and parcels). As such it includes both Universal Service products such as First and Second Class letters and parcels, Special Delivery Next day, etc. and non-Universal Service products such as Royal Mail retail bulk mail, access mail, unaddressed mail, etc. The Reported Business is part of Royal Mail’s UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of ParcelForce International and Royal Mail Estates Ltd.⁸⁰

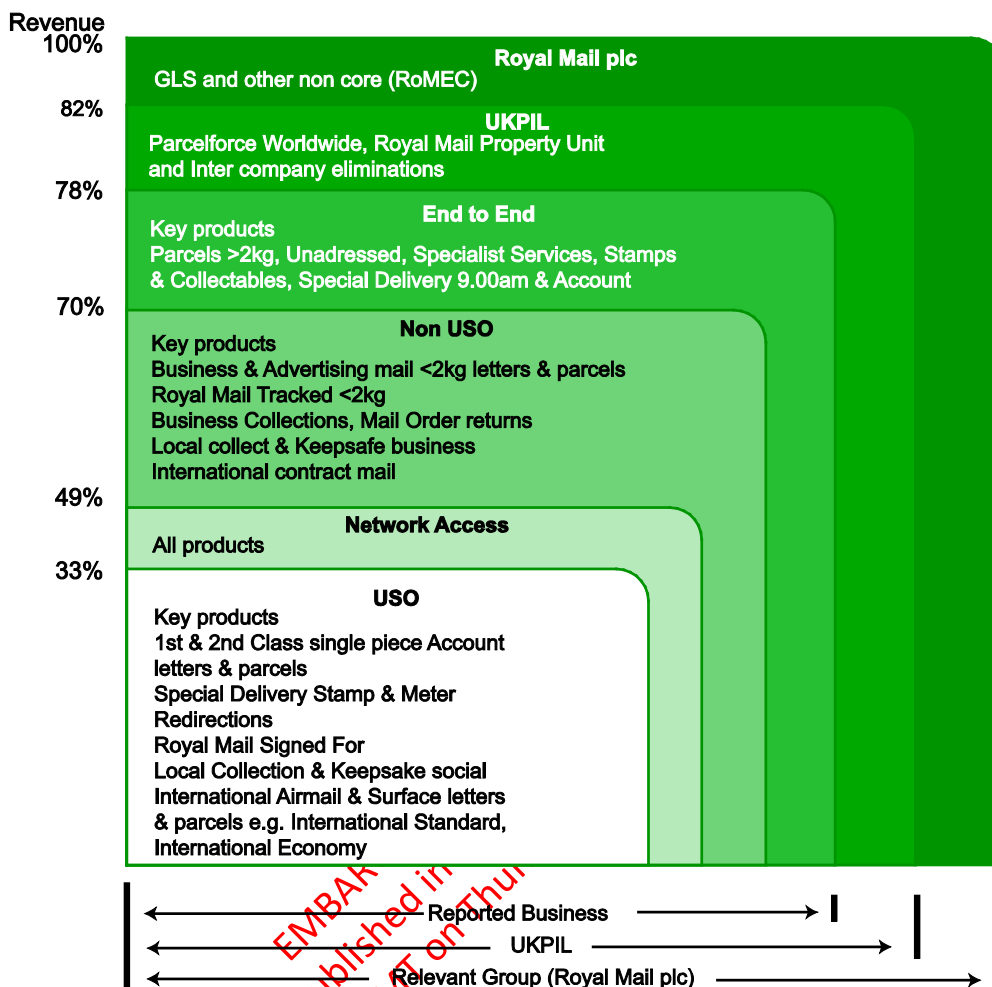
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78 Ofcom, [End-to-End competition in the postal sector: final guidance on Ofcom’s approach to assessing the impact on the universal postal service](#), 27 March 2013, paras 3.15 and 3.16

79 Section 29, 3b, the Postal Services Act 2011

80 Ofcom ([USO 57](#))

54. Royal Mail’s regulatory financial statements for 2013/14 provides a graphic of its products included in the Reported Business:



Royal Mail Group Regulatory Financial Statements 2013-14 ⁸¹

55. In its Report, *Review of end-to-end competition in the postal sector*, published in December 2014, Ofcom returned to the matter of Royal Mail’s efficiency in relation to the viability of the Universal Service:

Beyond the next few years, our assessment of the sustainability of the universal service becomes less certain. However, to a significant extent, this uncertainty is due to factors other than end-to-end competition, including Royal Mail’s ability to reduce its costs to reflect the reduced workload, and deliver efficiency savings, and the success of its parcels strategy. Relatively small changes in parcel volumes, hours worked, pay increases or pension

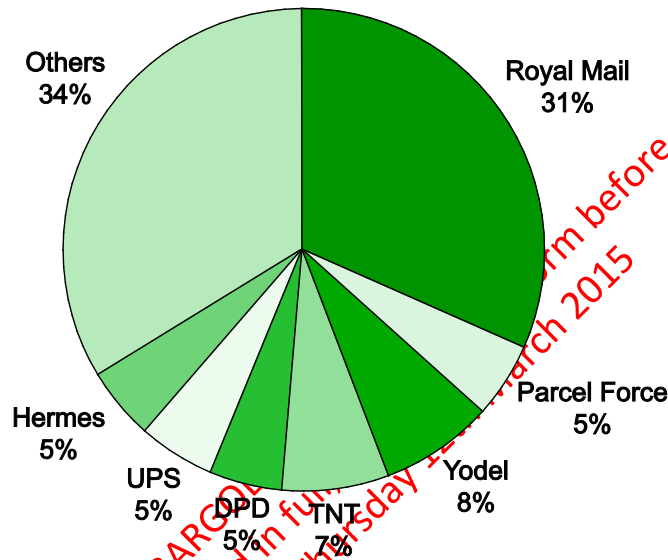
81 Royal Mail, [Regulatory financial statements](#), 2013-14

costs could significantly affect its future EBIT margins by as much as, or more than, the impact of end-to-end competition.⁸²

UK parcels market

56. Ofcom described the three priorities contained in Royal Mail’s overall strategy: being a successful parcels business; managing a decline in letters; and being customer focused.⁸³ The chart below, included in Ofcom’s written evidence, highlights the competitive nature of the UK parcel market:

UK domestic parcel revenue market share



Source: UBS / Triangle, 2014⁸⁴

57. Ofcom cited RBC Capital Market in July 2014 describing ‘parcels, not Ofcom, as its biggest concern’⁸⁵ and described Royal Mail’s own uncertainty surrounding parcel revenues:

As noted by Royal Mail, the parcels market is very competitive and competition has recently intensified, particularly from UK Mail, DPD, Hermes and Amazon’s roll-out of its own delivery service, which started in January 2014. [...] Parcel operators compete with Royal Mail both on price, and technological and service innovations. Many operators are using digital technology to drive innovation. Royal Mail notes, in its June 2014 submission, that innovation is a key feature of the UK parcels market. For example, earlier this year, Parcelforce launched an interactive service enabling customers to arrange for a parcel to be delivered on a different day or to a different address by SMS or email. In March 2014, parcel operator

82 Ofcom, *Review of end-to-end competition in the postal sector*, 2 December 2014, paras 3.105 to 3.107

83 Ofcom ([USO 29](#))

84 BIS Committee analysis of UBS data, Ofcom ([USO 29](#))

85 Ofcom ([USO 29](#))

DPD also announced enhancements to its 'Predict' service, which notified recipients of the time of delivery to within a 15 minute window.⁸⁶

58. But Royal Mail's competitors have gone further, as explained by evidence from the Mail Competition Forum:

Competitors to Royal Mail have also brought innovation to mail services in vital areas such as hybrid (physical-to-electronic) mail. Hybrid mail combines electronic communication (including mobile telephony and the internet) with physical communication to allow business and social users to send items using the electronic devices common in everyday life. [...] The MCF believes these benefits from competition have had an important (if unmeasurable) impact in mitigating the decline in mail volumes, by encouraging continued or even new use of mail.⁸⁷

59. Royal Mail is free to respond to competition in the bulk-mail market and the parcel market (over 20kg) in any way it sees fit, as those areas are not included in the Universal Service Obligation. However, in November 2014, Royal Mail published its Financial Report for the half year (from April to September 2014), and highlighted the fact that parcel revenue was down by 1 per cent:

At £1,461 million, UKPIL parcel revenue was down one per cent. This was primarily due to the impact of a change in the mix of the parcels we carry and the highly competitive environment in the UK parcels market. We estimate Amazon's own delivery network will reduce the annual rate of growth in the UK addressable market to 1–2 per cent for approximately two years. UKPIL parcel volume grew by two per cent.

Its trading update for the nine months ended 28 December 2014 showed an increase in volume of UK parcels by 3%, but revenue stayed flat.⁸⁸

60. Written evidence from the Mail Competition Forum (MCF) stated that:

The Mail Competition Forum believes and provides evidence that Royal Mail has persistently failed to achieve reasonable productivity improvement and it is that inefficiency, rather than the commercial effect of efficient competition, which represents the major threat to USO provision.⁸⁹

61. The Citizens Advice Service told us:

Competition has not benefitted all groups of social consumers equally, particularly those in rural and remote areas who have limited choice and are more reliant on the USO. We have a significant body of evidence of detriment to rural and remote consumers in a parcels market including non-

86 Ofcom, *Review of end-to-end competition in the postal sector*, 2 December 2014, paras 3.84 and 3.86

87 Mail Competition Forum ([USO 01](#)) paras 2.4 and 2.5

88 Royal Mail [trading update for the nine month ended 28 December 2014](#)

89 Mail Competition Forum ([USO 01](#)) executive summary

deliveries, delivery surcharges and lengthy journeys to collect undelivered items.⁹⁰

UK Bulk Mail

62. Ed Richards, the then CE of Ofcom, told us that bulk mail was not supervised by the regulator and that it was “a commercially-determined service”,⁹¹ which was determined by business decisions:

When they go to Whistl, for example, or others, they say, ‘We are content with a three-day-a-week service’, which is precisely why Whistl has offered a three-day service. If business users wanted a six-day service for their bulk mail, Whistl would have to offer it, so there is a big difference.⁹²

Chris Rowsell, Competition Policy Director at Ofcom, highlighted the fact that this approach worked efficiently in the Netherlands and Denmark, where the USO items are delivered on the required days, but non-USO items were delivered in larger quantities, on fewer days.⁹³ Ed Richards summarised this point:

Business users can determine their needs in the way that normal commercial arrangements are determined, and we need to make sure that developments in that area are consistent with the USO and the six-days-a-week delivery.⁹⁴

63. The evidence that we received suggest that Royal Mail still has to match the technical innovations introduced by many of its competitors. These innovations more clearly match the expectations of consumers, as well as contributing to the efficiency of competing postal operators.

Royal Mail’s price structure for national average prices and zonal prices

64. Royal Mail’s price structure varies depending on whether the postal operator asks Royal Mail to deliver the Final Mile, across the United Kingdom, or whether the postal operator asks Royal Mail to deliver to certain parts of the United Kingdom only. Written evidence from Ofcom explained the difference between the pricing:

Royal Mail offers two types of pricing plan for access: national average prices and zonal prices. To qualify for national average prices an access operator must be asking Royal Mail to deliver mail across the whole of the UK, in the same geographical pattern as Royal Mail delivers. If an access operator is asking Royal Mail to deliver in just certain areas or geographies of the UK,

90 The Citizens Advice Service ([USO 20](#)) para 4.4

91 Q178

92 Q174

93 Q183

94 QQ 186 and 187

Royal Mail can set zonal prices which reflect the costs in those geographic areas.⁹⁵

65. Zonal pricing helps to protect Royal Mail against any artificial competitive advantage from its competitors. For example, it ensures that Whistl must have a genuine source of competitive advantage over Royal Mail in the areas it chooses to enter. While this is a useful safeguard, Adam Scorer, from Citizen’s Advice, cautioned that it should not be used for restrictive reasons and that “Royal Mail does not protect its incumbent position in unfair ways”.⁹⁶

66. In January 2014, Royal Mail proposed several changes to its zonal charges which reduced the charges for the Urban and London Zones, while significantly increasing charges for the Suburban and Rural Zones. Moya Greene, the CEO of Royal Mail, told the Committee:

What I will say about the zonal pricing that we had attempted to put into the market is that it was meant to partially offset this threat of siphoning off the very, very high-volume urban mail, siphoning it out of the Royal Mail system, so that neither that traffic nor the revenues that go along with it would be available to underpin the economics of a Universal Service.⁹⁷

67. On 2 December 2014, Ofcom announced that it would be reviewing Royal Mail’s proposed increase in zonal access pricing because it was concerned that the changes could “act to discourage and potentially prevent entry and expansion into bulk mail delivery by another operator” and therefore have a negative impact on consumers.⁹⁸ Ed Richards told us that Royal Mail’s proposed zonal pricing had the potential to skew its access prices in order to inhibit competition:

What we have said on zonal pricing is that Royal Mail has the freedom to set its margin as it chooses. However, what we have said to ensure that, that is consistent with a fair approach for the market overall, is that that should be consistent from zone to zone, and that the prices should be reflective of the costs in the zones. That seems, to us, to be a reasonable and fair basis. In other words, where Royal Mail has higher costs, it is able to charge a higher price, but it is not able simply to select a price that suits its ability to inhibit, or to risk inhibiting, competition when that competition can offer something useful for consumers and the market.⁹⁹

95 Ofcom ([USO 29](#))

96 Q137

97 Q34

98 Ofcom, [Royal Mail access pricing review](#), 2 December 2014, para 1.4

99 Q162

68. *We support Ofcom’s consultation on the level of zonal pricing set by Royal Mail. Any recommendations arising from that consultation must balance the need for Royal Mail to retain the freedom to set its prices, dependent on the cost of delivering in that area, with the benefits of retaining an open market and increasing competition. Royal Mail are free to set zonal pricing, but it should be based on actual costs of delivering to those zones, and not as a device to deter, or even stifle, competition. There is a fine balancing act to be set. Ofcom must set out the timetable for this consultation, and when a decision will be made.*

Labour costs

69. The major part of the costs in the postal sector are labour costs because letters and parcels have to be delivered by a person. Adam Scorer, from Citizens Advice, was concerned that recent developments could lead to a “race to the bottom” in terms of services:

We have seen it in lots of other markets on the customer services side. [It] inevitably leads to a lower level of service, higher degrees of complaint and a lack of trust and confidence in engaging in those markets. I could see clear detriment, if that was done as a necessary kneejerk, fast response to the growth of competition.¹⁰⁰

That said, greater competition does not necessarily require cutting labour costs. As supplementary evidence from the CWU highlighted:

All the evidence is that if you pay people well and if you have a collaborative approach to solving problems, it makes for a successful company. Decent terms and conditions of employment will help to maintain a committed, motivated workforce leading to higher productivity and a better quality postal service for customers.¹⁰¹

70. Evidence from Royal Mail also highlighted these points about labour terms and conditions:

Royal Mail believes that industry standards need to be improved and that this can be best achieved through either an industry-wide quality standard and/or regulation. We believe that current basic requirements would help to ensure the parcels industry delivers a better service for consumers.¹⁰²

100 Q132

101 CWU ([USO 55](#)) para 2

102 Royal Mail ([USO 37](#)) para 4.7

Royal Mail's written evidence then went on to highlight differences in terms and conditions between their own staff and staff from other companies:

Proposed Standard	Current Practice
- Delivery staff required to declare past criminal convictions	- Royal Mail ensures all staff are CRB checked. We do not believe this is the case for most other companies
- Requirement to provide appropriate driver training to delivery staff	- Royal Mail provides appropriate driver training for the type of vehicles staff are expected to use. Some operators use private vehicles for delivery
- All operators required to adhere to standardised alternative delivery options when the recipient isn't available	- Royal Mail is already subject to strict regulation on where it can deliver parcels in the event the recipient is out - This requirement does not apply to other parcel operators
- Requirement to publish complaints handling schemes	- Royal Mail is required to publish its complaints handling scheme as well as the number of complaints it receives. Other parcel operators are not required to do so
- Requirement to adhere to good employment standards	- Royal Mail pays a living wage, invests in its people and ensures high quality jobs with appropriate training. Some other large parcel operators opt for a self-employment model

Royal Mail written evidence¹⁰³

71. CWU's written evidence contrasted the terms and conditions of Royal Mail employees with those of its competitors:

In the parcels sector, several carriers including Hermes and Yodel use low-cost lifestyle couriers who are treated as self-employed and are therefore not entitled to the National Minimum Wage. They are routinely paid a rate per successfully delivered item which often makes it impossible to earn a reasonable rate of pay. In one company, rates are as little as £0.20–£1.20 per successful delivery, equating to only £3.70–£5.30 per hour.¹⁰⁴

72. However, supplementary evidence requested by the Committee from Royal Mail's competitors would seem to question Royal Mail's assertion. TNT UK Ltd has one employee on a zero-hours contract, out of a total of 9,000 staff.¹⁰⁵ UK Mail wrote that they

103 Royal Mail ([USO 37](#)) table 1

104 CWU ([USO 18](#)) para 24

105 TNT UK Ltd ([USO 51](#))

have no employees on zero-hours contracts.¹⁰⁶ Whistl gave detailed information on its staff's terms and conditions: at the time of writing, there were: 6.9% of staff who had contracts for under 13 hours per week (predominantly Saturday workers and students); all employees who had completed three months' service were paid above the adult national minimum wage (excluding some apprenticeships); employees' basic pay range is £6.50 to £6.57 (outside London) and £7.10 to £7.37 (London); CRB checks are made either when staff are engaged or on a random basis after employment; Nearly half of all Whistl employees (48%) are on zero hour contracts.¹⁰⁷ In reference to those on zero-hour contracts, Whistl's supplementary evidence stated that:

Whistl has recently reached agreement in principle with its recognised Trade Union, Community, that an employee will be offered an alternative, fixed hours contract after the end of an appropriate probation period. The employee may elect to remain on a flexible (zero hours) contract.¹⁰⁸

73. However, as Ed Richards, pointed out, Ofcom has no responsibility in this area::

Labour costs, and employment law and the regulation of the price of labour—the minimum wage and all those sorts of things—are clearly not part of our remit. We cannot deal with that. We are very much a creature of statute. We do what the statute tells us to do, and it is very clear that that is not part of our duties.¹⁰⁹

When he was asked whether Ofcom would study the quality of service across the entire postal industry, not just those of Royal Mail, he replied:

Quality of service is something that we look at, and we will, I am sure, have a further discussion with Royal Mail about whether there are issues to do with quality of service or mail integrity—all those kinds of things—that we need to look at on a forward-looking basis. We would be very happy to do that.¹¹⁰

74. Ofcom has rules on mail integrity, which require regulated postal operators to ensure that their mail is protected against loss, damage or theft, and is delivered to its intended destination. We asked the different postal operators who gave oral evidence about the number of prosecutions and complaints they had experienced. TNT Express UK could not answer the Committee's question about the number of formal complaints relating to staff, for the following reason:

TNT UK Ltd does not hold data to record the number of complaints specifically relating to its staff which it receives from its customers and is therefore unable to assist the Committee with this question.¹¹¹

106 UK Mail ([USO 50](#))

107 Whistl ([USO 49](#))

108 *Ibid*

109 Q200

110 Q201

111 TNT UK Ltd ([USO 51](#))

In the year to March 2014, Whistl received 1,627 complaints about their delivery services, which represents one complaint for every 49,000 letters delivered.¹¹² Royal Mail handled 14.3 billion items of mail in 2013–14, and received 735,637 consumer complaints,¹¹³ which represents one complaint for every 19,439 items of mail delivered.

75. We are opposed to a ‘race to the bottom’ of postal sector employees’ wages, terms and conditions, and such a race should not be an inevitable result of greater competition in the sector. Indeed, Royal Mail’s negotiations with the CWU have resulted in pay increases and job security. Our evidence suggests that, while Royal Mail’s criticism of its rivals’ treatment of their staff is not wholly proven, there are certainly examples of where the wages, terms and conditions offered by other companies in the sector fall short of the standards offered by Royal Mail, including what appears to have been a disproportionate use of zero-hours contracts by Whistl.

76. If standards of pay in the postal sector, as in other sectors, fall short, then the taxpayer is left to pick up the difference, because in-work state benefits will cost more. Furthermore, it is unacceptable that delivery of the Universal Service Obligation should require downward pressure on the terms and conditions of staff delivering that service. We recommend that Ofcom investigates the impact on customers and the service provided to customers of any downward pressure on terms and conditions of postal sector staff. We further recommend that the Government considers extending Ofcom’s remit to include consideration of labour costs, conditions and standards in the postal sector.

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112 Whistl ([USO 49](#))

113 Royal Mail ([USO 52](#))

5 Ofcom and the regulatory framework

The postal services market has started to look much more like a private sector market. But in common with many other sectors that have followed the same path, regulatory intervention has been needed to ensure that wider social objectives continue to remain at the heart of the market. [The Social Market Foundation]¹¹⁴

77. The Postal Services Act 2011 clearly sets out what Ofcom must have regard to:

The need for the provision of a universal postal service to be financially sustainable, and 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.¹¹⁵

Ofcom's primary duty is to secure the Universal Postal Service, but this requirement sits alongside Ofcom's duty to ensure that the postal service is fully open to competition.¹¹⁶ Ofcom is therefore striking a balance between protecting the USO (ensuring it is delivered as efficiently as possible) and protecting consumers and taxpayers. Ed Richards told the Committee about the work that Ofcom undertakes, to ensure that the Universal Service is not at risk:

We monitor the whole market very carefully pretty much all the time. We look at it in different forms on a monthly, quarterly and annual basis. We looked specifically in relation to that judgment, which is important to emphasise is a judgment at a point in time, at a situation in the market today: what the facts are and what the empirical data tell us about the position today. Then we overlaid on that information that we received from Royal Mail and Whistl—and from other parties, but particularly those two parties—in terms of their expectations and projections about how the market would develop, particularly in light of different business plans and assumptions.¹¹⁷

78. In 2012, Ofcom published the new regulatory framework for postal services, and the methods by which they would protect the Universal Service, including the following:

- **Quality of Service**—Royal Mail will be required to provide the universal service to the specified standard and we will regularly monitor service quality to ensure that this is the case;
- **Efficiency**—we expect Royal Mail to improve efficiency levels and to sustain such improvement thereafter. While there are many ways to measure efficiency, our focus will be on the level of costs. It would not be in keeping with our regulatory objectives if Royal Mail were to return to a

114 The Social Market Foundation ([USO 19](#)) para 20

115 Postal Services Act 2011, Section 29, para 3

116 In accordance with Directive 2008/6/EC of the European Parliament and of the Council, 20 February 2008

117 Q144

position of sustained profitability, but had done so solely as a result of price rises, and not cost reduction. Conversely, a situation where Royal Mail is able to demonstrate a healthy level of profitability that has been driven by cost savings or business improvements would be consistent with our regulatory objectives, and would not warrant our intervention.

- **Affordability**–If prices rise to a point that they give rise to affordability issues, particularly for vulnerable consumers, then there would be a need to re-intervene.¹¹⁸

79. We asked Ofcom to provide supplementary evidence on the amount of work on postal services it had carried out in the past year. They responded with the following information:

For 2014, Ofcom’s work on regulating postal services took 16 FTE (full time equivalent/person years) or 28,365 hours. This includes the hours worked on these projects by policy, strategy, economics, finance, investigations and legal staff, but not communications, secretariat, operations and senior executives. The equivalent figure for 2013 was 12 FTE, and [that] year included the completion of two major projects, i.e. the review of users’ needs and our guidance on end-to-end competition.

Nearly three-quarters of the 16 FTEs related directly to either Royal Mail’s proposals for access pricing (i.e. the Competition Act investigation and the review of access pricing) or work carried out in response to Royal Mail’s submission on end-to-end competition (our monitoring programme and work on efficiency). If we look at the six month period from June 2014 (when Royal Mail made its submission on end-to-end competition) to November 2014 (when we completed the review, i.e. published on 2 December) we had 20 FTE/month on postal regulation. Both of these were significantly above what Ofcom had budgeted for the year.¹¹⁹

80. We also asked for supplementary evidence from Ofcom about details of the postal sector companies that are monitored (under Section 55 and Schedule 8 of the Postal Services Act 2011). Ofcom monitor Whistl, in relation to the Notification Condition and their future business plans. They also monitor 41 other postal operators: “We collect this information quarterly using our formal powers under section 55 of the Postal Services Act 2011”.¹²⁰

81. However, the remit of Ofcom did not satisfy a number of our witnesses. Moya Greene, from Royal Mail, argued that Ofcom needed to have a wider remit which not only incorporated all companies in the sector but which also could consider “how much latitude Royal Mail needs to be given”.¹²¹ The CWU went further and called for a judicial review of Ofcom, claiming that it failed to fulfil its primary statutory duty to protect the Universal Service Obligation. It went on to argue that Ofcom was ‘part of the problem not the

118 Ofcom, [Securing the Universal Postal Service: Decision on the new regulatory framework](#), 27 March 2012

119 Ofcom ([USO 58](#))

120 Ofcom ([USO 57](#)), where the full list of postal sector companies that Ofcom monitors can be found

121 Q58

solution' for not undertaking a full review of the postal sector, but focusing only on Royal Mail's efficiency.¹²²

82. The Rural Services Network were also critical of the Regulator:

Ofcom have a legal duty to protect the Universal Service and the power to review the situation, but despite consistent warnings from interest groups and elected representatives, have refused to conduct a review until the last possible moment allowed under legislation, at the end of 2015.¹²³

83. By contrast, Adam Scorer, from Citizens Advice, believed that Ofcom should approach its regulation of the USO in the following way:

We would expect the regulator to respond to the issues that are alive at the moment and to have a proper, robust process that goes forward, but that does not start from answering an exam question from either an incumbent or a competitor, but takes a rounded, Copernican view, with the consumer slap bang in the middle rather than the USP deliverer or the value of competition in and of itself.¹²⁴

84. *We recognise that Ofcom has a difficult role in ensuring that the provision of a Universal Service is both financially sustainable and efficient. The sector is changing quickly, and Royal Mail has now moved from the public to the private sector. As competition increases, the statutory remit of Ofcom may need to change. Ofcom has to recognise its over-riding obligation to ensure the protection of the Universal Service Obligation and, if necessary, there should be changes in the regulatory framework to enable it to do so.*

85. *We recommend that Ofcom provides our successor Committee with quarterly updates on the state of the Universal Service, and highlights any potential middle-term effects on the Universal Service, and any action that it is proposing to take.*

122 CWU website, 2 December 2014

123 The Rural Services Network ([USO 05](#)) executive summary

124 Q138

6 Conclusion

86. The postal sector is working within a constantly changing market, with declining volumes of letters, and a burgeoning of internet shopping, with the accompanying sharp increase in parcel volume. Royal Mail claims that Whistl's end-to-end competition is putting the Universal Service at risk, while Whistl claims that Royal Mail has an unfair advantage by its VAT exemption for access services. Neither claim has been proven, but they are illustrative of the current competitive climate in which these private companies are working. As Nick Wells, the CEO of Whistl, told us, "If you want competition, this is not a stroll in the park".¹²⁵

87. While we would not want to stifle competition, we are adamant that the principle of the Universal Service should be upheld. We are not persuaded that the Universal Service is a burden for Royal Mail, but is an obligation that brings revenue and status to the organisation. Ofcom must continue to monitor and must be able to respond quickly if the Universal Service is under threat.

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Conclusions and recommendations

Cost of the Universal Service to Royal Mail, region by region

1. Given the fundamental importance of the USO, we were concerned to note that Royal Mail were unable to provide a regional breakdown of the cost of the Universal Service Obligation (USO). In addition, given the responsibility of Ofcom to protect the USO, we were surprised to learn that there is no consensus between Royal Mail and Ofcom over what constitutes the cost, revenues and profits of the USO. We recommend that both Royal Mail and Ofcom should, as a matter of urgency, agree a set of financial metrics against which the costs should be measured. If necessary, this should be carried out by the National Audit Office (NAO) or a mutually-agreed body of experts. (Paragraph 22)
2. We recommend that Royal Mail—the Designated Universal Service Provider—using these figures, provides a geographical analysis of where the Universal Service is profitable and where it is not. Such detailed analysis and financial monitoring of the Universal Service would provide the evidence to assess the long-term sustainability of the Universal Service. This breakdown of costs should be included in Royal Mail's Audited Regulatory Accounts. If Royal Mail declines to provide these figures, we recommend that the Government should consider extending the remit of Ofcom, to enable Ofcom to enforce this requirement. (Paragraph 23)

Universal Service Compensation Fund

3. Cherry picking is a phrase often used in postal services to describe the easy, most profitable sections of mail services taken by Royal Mail's competitors. Cherry picking is available to Royal Mail competitors but, at the moment, affects only a very small percentage of Royal Mail's total business. This could change quickly, given the ambitions of some of Royal Mail's rivals in the market. Both Royal Mail and Ofcom need an evidence base upon which to gauge the potential threats to the sustainability of the USO in the event of a higher level of market penetration by other providers. We note the decision by Ofcom that, currently, the level of the threat does not justify intervention. We also note that Ofcom is mandated to monitor the situation. (Paragraph 39)
4. Ofcom has the power to impose a General Universal Service Obligation on postal operators other than the Universal Service Designated Provider (Royal Mail), in order to protect the Universal Service. We have yet to be convinced that Ofcom *could* impose the General Universal Service Obligation within the predicted six to eight months. We recommend that Ofcom publish a more detailed timeline for its implementation and an assessment that the timescale is fast enough to avoid a failure in the Universal Service, even in the short term. (Paragraph 40)
5. The alternative regulatory condition—the Universal Service Compensation Fund—involves a lengthy delay in implementation. To avoid such a delay, we recommend that the Secretary of State directs Ofcom to review the net cost of the Universal Service, in accordance with the Postal Services Act 2011. (Paragraph 41)

Views of the Universal Service—should it change?

6. There has already been an extensive debate about the requirements of the Universal Service Obligation. The Committee strongly believes that it would be inappropriate to change the current requirements of the Universal Service Obligation. (Paragraph 45)

Price to customers

7. We note that Royal Mail has again increased its prices this year. Royal Mail should not increase prices in an attempt either to increase its own profit levels or to protect the Universal Service Obligation, without continuing to increase the efficiency of its operations, thereby reducing its costs and enabling it to improve its standards of service. (Paragraph 49)

UK Bulk Mail

8. The evidence that we received suggest that Royal Mail still has to match the technical innovations introduced by many of its competitors. These innovations more clearly match the expectations of consumers, as well as contributing to the efficiency of competing postal operators. (Paragraph 63)

Royal Mail's price structure for national average prices and zonal prices

9. We support Ofcom's consultation on the level of zonal pricing set by Royal Mail. Any recommendations arising from that consultation must balance the need for Royal Mail to retain the freedom to set its prices, dependent on the cost of delivering in that area, with the benefits of retaining an open market and increasing competition. Royal Mail are free to set zonal pricing, but it should be based on actual costs of delivering to those zones, and not as a device to deter, or even stifle, competition. There is a fine balancing act to be set. Ofcom must set out the timetable for this consultation, and when a decision will be made. (Paragraph 68)

Labour costs

10. We are opposed to a 'race to the bottom' of postal sector employees' wages, terms and conditions, and such a race should not be an inevitable result of greater competition in the sector. Indeed, Royal Mail's negotiations with the CWU have resulted in pay increases and job security. Our evidence suggests that, while Royal Mail's criticism of its rivals' treatment of their staff is not wholly proven, there are certainly examples of where the wages, terms and conditions offered by other companies in the sector fall short of the standards offered by Royal Mail, including what appears to have been a disproportionate use of zero-hours contracts by Whistl. (Paragraph 75)
11. If standards of pay in the postal sector, as in other sectors, fall short, then the taxpayer is left to pick up the difference, because in-work state benefits will cost more. Furthermore, it is unacceptable that delivery of the Universal Service Obligation should require downward pressure on the terms and conditions of staff delivering that service. We recommend that Ofcom investigates the impact on

customers and the service provided to customers of any downward pressure on terms and conditions of postal sector staff. We further recommend that the Government considers extending Ofcom's remit to include consideration of labour costs, conditions and standards in the postal sector. (Paragraph 76)

Ofcom and the regulatory framework

12. We recognise that Ofcom has a difficult role in ensuring that the provision of a Universal Service is both financially sustainable and efficient. The sector is changing quickly, and Royal Mail has now moved from the public to the private sector. As competition increases, the statutory remit of Ofcom may need to change. Ofcom has to recognise its over-riding obligation to ensure the protection of the Universal Service Obligation and, if necessary, there should be changes in the regulatory framework to enable it to do so. (Paragraph 84)
13. We recommend that Ofcom provides our successor Committee with quarterly updates on the state of the Universal Service, and highlights any potential middle-term effects on the Universal Service, and any action that it is proposing to take. (Paragraph 85)

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Formal Minutes

Tuesday 3 March 2015

Members present:

Mr Adrian Bailey, in the Chair

Paul Blomfield
Katy Clark
Mike Crockart

Caroline Dinenage
Ann McKechin
Robin Walker

Draft Report (*Competition in the postal services sector and the Universal Service Obligation*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 87 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Ninth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 4 March at 9.00 am]

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Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the Committee's inquiry page at www.parliament.uk/bis.

Wednesday 26 November 2014

Question number

Moya Greene, Chief Executive Officer, Royal Mail, **Nick Wells**, Chief Executive Officer, Whistl, **Guy Buswell**, Chief Executive Officer, UK Mail, and **Daniel Vines**, Director of Sales and Customer Services, TNT UK

[Q1-65](#)

Roy Peticucci, Vice President, EU Operations, Amazon

[Q66-87](#)

Billy Hayes, General Secretary, CWU, **Dave Ward**, Deputy General Secretary, Postal, CWU, **John Park**, Assistant General Secretary, Community, and **Les Baylis**, Special Project Officer, Logistics and Distribution, Community

[Q88-107](#)

Wednesday 10 December 2014

Alan Halfacre, Chairman, Mail Users Association, and **Adam Score**, Director of Consumer Futures, Citizens Advice

[Q108-142](#)

Ed Richards, Chief Executive Officer, Ofcom, and **Chris Rowsell**, Competition Policy Director, Ofcom

[Q143-205](#)

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Published written evidence

The following written evidence was received and can be viewed on the Committee's inquiry web page at www.parliament.uk/bis. INQ numbers are generated by the evidence processing system and so may not be complete.

- 1 Amazon ([USO0043](#))
- 2 BBC TV Licensing ([USO0016](#))
- 3 Campaign for the Protection of Rural Wales (CPRW) ([USO0002](#))
- 4 Care & Repair Cymru ([USO0021](#))
- 5 Citizens Advice ([USO0020](#))
- 6 Civil Service Pensioners' Alliance ([USO0010](#))
- 7 Communication Workers Union ([USO0018](#))
- 8 Community ([USO0048](#))
- 9 Consumer Council for Northern Ireland ([USO0028](#))
- 10 Cornwall Chamber of Commerce and Industry ([USO0041](#))
- 11 Council of the Isles of Scilly ([USO0042](#))
- 12 Countryside Alliance ([USO0007](#))
- 13 CWU ([USO0055](#))
- 14 ESRC Centre for Competition Policy ([USO0025](#))
- 15 Farmers' Union of Wales ([USO0033](#))
- 16 Federation of Small Businesses ([USO0012](#))
- 17 Institute of Directors, Wales ([USO0009](#))
- 18 Jerry Cox ([USO0044](#))
- 19 Joost Vantomme ([USO0045](#))
- 20 Mail Competition Forum (MCF) ([USO0001](#))
- 21 Mail Users' Association ([USO0023](#))
- 22 National Federation of Occupational Pensioners (NFOP) ([USO0011](#))
- 23 National Federation of SubPostmasters (NFSP) ([USO0026](#))
- 24 NI Chamber of Commerce and Industry ([USO0036](#))
- 25 Ofcom ([USO0029](#))
- 26 Ofcom ([USO0054](#))
- 27 Ofcom ([USO0057](#))
- 28 Ofcom ([USO0058](#))
- 29 Ofcom ([USO0059](#))
- 30 Post Office Ltd ([USO0039](#))
- 31 Richard Hooper ([USO0006](#))
- 32 Royal Mail ([USO0052](#))
- 33 Royal Mail ([USO0053](#))
- 34 Royal Mail ([USO0056](#))
- 35 Royal Mail Group ([USO0037](#))
- 36 Royal National Institute of Blind People (RNIB) ([USO0003](#))
- 37 Scottish Chambers of Commerce ([USO0032](#))
- 38 Scottish Council for Development and Industry ([USO0022](#))
- 39 Social Market Foundation ([USO0019](#))

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- 43 The Rural Services Network ([USO0005](#))
- 44 TNT ([USO0051](#))
- 45 UK Mail ([USO0050](#))
- 46 UK Mail ([USO0027](#))
- 47 UK Mail ([USO0047](#))
- 48 Unite The Union CMA ([USO0017](#))
- 49 Welsh Local Government Association (Rural Forum) ([USO0024](#))
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List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the Committee's website at www.parliament.uk/bis.

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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First Report	Royal Mail Privatisation	HC 539-I/II
Second Report/First Joint Report	Scrutiny of the Government's UK Strategic Export Controls Annual Report 2012, the Government's Quarterly Reports from October 2012 to September 2013, and the Government's policies on arms exports and international arms control issues	HC 186
Third Report	Student Loans	HC 558 (HC 777)
Fourth Report	The Implications for Scottish Independence on Business; Higher Education and Research; and Postal Services	HC 504
Fifth Report	Adult Literacy and Numeracy	HC 557 (Cm 8982)
Sixth Report	The Extractive Industries	HC 188(939)
Seventh Report	Business-University Collaboration	HC 249
Eighth Report	Government Support for Business	HC 770
Ninth Report	Competition in the postal services sector and the Universal Service Obligation	HC 769

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First Report	Women in the Workplace	HC 342-I/II/III(Cm 8701)
Second Report/First Joint Report	Scrutiny of Arms Exports and Arms Control (2013): Scrutiny of the Government's UK Strategic Export Controls Annual Report 2011 published in July 2012, the Government's Quarterly Reports from October 2011 to September 2012, and the Government's policies on arms exports and international arms control issues	HC 205
Third Report	The Kay Review of UK Equity Markets and Long-term Decision Making	HC 603(HC 762)
Fourth Report	Consultation on a Statutory Code for Pub Companies	HC 314
Fifth Report	Open Access	HC 99-I/II(HC 833)
Sixth Report	Draft Consumer Rights Bill	HC 697-I/II/III
Seventh Report	Payday Loans	HC 789

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First Report	The Hargreaves Review of Intellectual Property: Where Next?	HC 367-I/II(HC 579)
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Second Report/First Joint Report	Scrutiny of Arms Export Controls (2012): UK Strategic Export Controls Annual Report 2010, Quarterly Reports for 2010 and January to September 2011, the Government's review of arms exports to the Middle East and North Africa, and wider arms control issues	HC 419
Third Report	Post Office Network Transformation	HC 84(HC 678)
Fourth Report	Overseas Students and Net Migration	HC 425(Cm 8557)
Fifth Report	Apprenticeships	HC-I/II/III(HC 899)
Sixth Report	The Insolvency Service	HC 675 (HC 1115)
Seventh Report	Too Little, Too Late: Committee's observations on the Government Response to the Report on Overseas Students and Net Migration	HC 1015(Cm 8622)
Eighth Report	Pre-appointment hearing of the Government's preferred candidate for the post of Groceries Code Adjudicator	HC 1011
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First Report	The New Local Enterprise Partnerships: An Initial Assessment	HC 434 (HC 809)
Second Report	Sheffield Forgemasters	HC 484 (HC 843)
Third Report	Government Assistance to Industry	HC 561
Fourth Report / First Joint Report	Scrutiny of Arms Export Controls (2011): UK Strategic Export Controls Annual Report 2009, Quarterly Reports for 2010, licensing policy and review of export control legislation	HC 686
Fifth Report	Government Assistance to Industry: Government Response to the Committee's Third Report of Session 2010–11	HC 1038
Sixth Report	Is Kraft working for Cadbury?	HC 871
Seventh Report	Rebalancing the Economy: Trade and Investment	HC 735 (HC 1545)
Eighth Report	Trade and Investment: China	HC 1421 (HC 1568)
Ninth Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code	HC 1224-I
Tenth Report	Pub Companies	HC 1369-I/II (Cm 8222)
Eleventh Report	Time to bring on the referee? The Government's proposed Adjudicator for the Groceries Code: Government Response to the Committee's Ninth Report of Session 2010-12	HC 1546
Twelfth Report	Government reform of Higher Education	HC 885-I/II/III (HC 286)
Thirteenth Report	Pre-Appointment Hearing: Appointment of Director of the Office for Fair Access	HC 1811
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Fifteenth Report	Stamp Prices	HC 1841-I/II

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