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APRIL 2024

**CITIPOST MAIL**

# Citipost Response to OFCOM consultation on the USO

1. Please accept this as our response to your document entitled *The Future of the Universal Postal Service* issued on 24 January 2024. This response is broader than the ten specific questions that you posed in your document as we believe the current situation raises wider issues than those you have raised in your questions.

## The Central Problem

2. We accept that the letters market in the UK has slowly changed over time. Letter volumes have halved over the past 10 years, and while parcel volumes have grown over a similar period, they have fallen back since the pandemic. However, the market has not changed overnight – letters have been in slow constant decline for almost 20 years. Royal Mail's current difficult financial position is not exclusively because of the decline in letters volumes; indeed it could be argued that it is not even principally because of the decline in letters volumes.

3. The immediate crisis in Royal Mail's financial situation is due to the fall in Parcels volumes since the pandemic, together with the fall in international business (as a result of or compounded by Covid, Brexit and Royal Mail software failures). As we have noted, the decline in letters volumes has been relatively predictable.

4. A large contributor to the current issues stem from Royal Mail's inability over the past 10 years to realise efficiencies in its network and flex that network to meet the new reality. We would not be confident that if the USO was reduced further to create the opportunity for additional efficiency savings that Royal Mail would be able to achieve such savings and not resort to further above-inflation price rises.

5. Ofcom has chosen to exclude Royal Mail USO parcels from this review. We feel this is a mistake, as parcels contribute to the current problems faced. The USO delivery network is a common network for letters, packets and parcels and for it to be efficient and sustainable it must be configured to meet the demands of letters, packets and parcels. Royal Mail's failure to become more efficient is in no small part a result of Royal Mail being unable to flex its network to accommodate the mix changes between formats it has seen over recent years. Ofcom should accordingly review the need to make changes in the USO across letters, packets and parcels, as it is the totality of the universal service which needs to be safeguarded.

6. Parcels may well be more important than ever before, but as Royal Mail constantly remind us, the UK has a very competitive parcels market, so it is an open question as to whether or not the UK needs a Parcels USO as extensive as the one currently in place. As Ofcom's working assumption is that a USO is inherently a burden, presumably Royal Mail would be better off if the scope of the current parcels USO was also reduced? At the moment, USO parcels enjoy a VAT exemption that puts other parcels companies at a 20% disadvantage.

7. Most consumers of postal services are not students of postal services regulation. They do not make fine distinctions between their NHS letter, their Council Tax demand, a letter from their bank, their magazine subscription or a birthday card. However, as we know, only the birthday card is likely to be delivered through a USO service. Letter volumes have halved over past 10 years – but USO only accounts for less than 17% of reported business, though some 30% of revenue (in other words Royal Mail prices its USO services as premium products).

8. Of the 17% of letters that are within the USO, the majority of these will be sent by businesses using a USO account, postage meters or stamps. The proportion of stamped mail posted by consumers is very small indeed.

9. The postal network is a common network for USO and non-USO letters alike and any decision made must be to the benefit of all mail. Access services account for approximately over 70% of all letters and their continued existence is crucial in ensuring the revenue and volume is there to make a USO network viable. It is very important that OFCOM considers all letter services holistically and finds a way to sustain the interests of all posting customers to help nourish the USO.

10. Any solution put forward to the current difficulties in the market must be directed to solving the current problems. We would suggest that there are three problems that Ofcom needs to address, all of which require a solution:

- i. Royal Mail's financial position (recognising that letter declines are only part of the problem).
- ii. Royal Mail's failure to reach quality of service standards for many years.
- iii. Royal Mail's addiction to frequent above-inflation tariff rises, which not only penalise customers, but also exacerbates volume loss from the market.

11. USO reform needs to go some way to mitigating the root causes of Royal Mail's financial distress, removing the incentives for never-ending above-inflation price rises while safeguarding a USO which meets the needs of society, both in scope and quality.

12. Ofcom has put forward solutions which in essence degrade both the USO letters service and the Access letters services, in order to give Royal Mail scope to reduce its costs (presumably by cutting jobs in delivery). Royal Mail has had almost 20 years to plan for the gradual rate of letters decline that we have seen, but has proved to be incapable of reducing its costs in delivery to meet this challenge. We do not believe that simply providing Royal Mail with the potential for more cost savings now will make any material difference unless there are appropriate incentives in place to change established behaviours.

13. In many ways the two alternatives put forward by Ofcom (reducing service standards or reducing the number of days delivery) are two sides of the same coin. Ofcom has said that the upper end of the potential cost saving is 650m pa., though we note that there is a large range in Ofcom's estimates, presumably reflecting Ofcom's own uncertainty as to whether Royal Mail is capable of removing costs.

## Finding A Way Forward

14. When considering the issue of USO reform, we believe that it is important to consider the issue in a logical order. Although the complex statutory legal regime around the postal USO is (for historical reasons) expressed in terms of delivery frequency, this should not be the issue considered first. Delivery frequency is a consequence of the service offering, so it is the desired service offering that should be considered first.

15. We believe that the five key questions are:

**(i) What should be the USO end-to-end service specification requirement? E.g. next day, 2-day, 3-day etc?**

16. If Ofcom concludes that there should be a next-day service within the USO then it is mandating at the very least a 5-day a week delivery network (or more frequently if weekends are included). Similarly, although the majority of letters which are Access provide a D+2/3 service to the posting customer, the downstream requirement for Royal Mail is a D+1 service, which will require the same delivery network as a conventional 1st class next day letter.

17. It is possible that Ofcom could conclude that although there is a need for a next day letters service, the price could be dramatically increased, so as to encourage more users to downgrade their service to a slower option. Royal Mail have already announced that the price for a 1st class letter will rise to £1.35 next month. Before this price was increased further it would be helpful if Ofcom could publish the current profit/loss margin on a 1st class stamped letter, as it would be clearly wrong to dramatically increase the price of a service provided by a super-dominant supplier if it was already providing a fair and reasonable margin.

**(ii) Do you require USO services to be delivered on a Saturday?**

18. Should a first-class letter posted on a Friday be delivered on the Saturday or the following Monday? Of course, there is nothing to stop Royal Mail from delivering on a Saturday even if the USO does not require it (which is currently the position with regard to parcels) or for charging a premium for Saturday delivery (as is the case for Special Delivery). It could be argued that the USO requirement for a 1st class service is not a burden for Royal Mail, as it can already charge what it wishes and thus make it economical to deliver on Saturday (or any other day of the week) should it choose to do so.

**(iii) What quality of service should then be required and how would it be enforced?**

19. Ofcom's current regime of quality of service enforcement is not fit for purpose. Ofcom currently considers quality of service a year in arrears and the inevitable investigation process can add another 9 months. Therefore, Ofcom is always considering events in the distant past rather than doing something about quality of service failures when they are actually happening. That may have been sufficient in a world where Royal Mail was largely delivering its quality targets, but that has not been the case for several years. It is very important that quality of service targets are not degraded and that Ofcom puts in place incentives to ensure they are reached.

**(iv) What (if any) price controls should be in place to deter excessive pricing?**

20. On average Royal Mail is charging 50% more for its USO letters services, than it is for its non-USO services. For many years Royal Mail has been maximising letters revenue by increasing the prices for most letters substantially and in excess of inflation. This helps explain, at least in part, the continued steady decline in letters volumes. First-class stamp prices have risen more than three times the rate of inflation over the past 10 years. In 2013 a 1st class stamp was 60p. If it had risen in line with inflation, it would now be 80p, yet Royal Mail is charging £1.25 and has announced a price rise from April 2024 to £1.35. Bulk business mail price rises are of a similar order. There needs to be a sensible mechanism to prevent Royal Mail from putting through substantial and frequent inflation-busting price rises in lieu of realising efficiencies in their network. This is even more important if the USO requirement is to be reduced further.

**(v) Given Access is approximately over 70% of UK letters volumes, what changes are required to the Access regime to support the USO?**

21. If changes are made to the USO to enable Royal Mail to have more scope to reduce the costs of delivery, it is inevitable that some changes may be needed to the Access regime to facilitate those changes. For example, if Saturday deliveries are taken out of the USO, then it may be necessary for Saturday deliveries to be taken out of the standard Access contracts as well. However, if a first class USO service is retained, then it may not be necessary to go further and degrade Access services down to a D+2 service.

22. The principal fears of bulk posting customers who use Access services is that the service will be degraded, quality will not be achieved, and above-inflation price rises will continue. If, as a consequence of USO reform Access services are degraded, it is all the more important that in return that customers receive the quality of service they are paying for and that the relentless above-inflation rises in prices is brought to an end.

23. Given the importance of Access customers in posting the letters volumes needed to sustain the USO, we would urge Ofcom to carry out detailed research into the attitudes and intentions of Access posting customers and to take the results of such research into account in making any recommendations.

24. If the status quo is no longer an option, Citipost Mail has the following observations on potential solutions. Any decision to downgrade the services enjoyed by customers (be they USO or Access), should be accompanied by measures designed to alleviate the fears of customers, namely:

- i. That quality of service will not be met;
- ii. That above-inflation price rises will persist;
- iii. That Royal Mail will not take advantage of the opportunities offered, so the company will be back asking for additional measures in the near future.

25. Citipost Mail submits that going forward the ability of Royal Mail to increase prices should be linked to meeting quality of service standards. That would provide Royal Mail with appropriate incentives to meet quality while protecting customers from exploitative price-gouging. Such safeguards should cover both the USO and Access parts of the business. This would relieve Ofcom of the need to instigate quality of service reviews in arrears.

26. Should Ofcom conclude that Access services should be downgraded to a D+2 service, there should be consideration as to what can be done to assist customers to adapt and what can be offered to them which would in some way compensate for the change.

27. For example, given Royal Mail now has extremely good data as a result of the adoption of Mailmark across all letters services, if Access is changed to a D+2 service, Royal Mail should be required to provide data to customers as to the likely aggregate delivery date of their mailings. This would allow for campaigns to be planned better and call-centre resource aligned to the slower service.

28. The form of price control which Ofcom has in place to prevent Royal Mail imposing a margin squeeze on Access operators is no longer effective. There is now so little volume in the standard Royal Mail bulk mail product, that Royal Mail now effectively has a free hand in how it prices Access. Ofcom needs to review the operation of USPA 6 to see if it is still fit for purpose or whether the margin squeeze test should be extended to all Royal Mail's account letter products.

## Questions

**Ofcom asked the following specific questions in the Call for Inputs:**

*1: Do you agree that we have identified the correct aims, supporting principles and features of the USO? Do you consider that these should continue to be respected as far as possible when assessing potential changes to the USO?*

Yes.

*2: Do you agree with our assessment of the direction of change in postal needs of residential (including vulnerable) users and SMEs? Are there other factors relevant to their future demand which we have not considered?*

The reason for having a universal service in the first place is to ensure the provision of affordable services to those that need them, that the free market may not otherwise provide. It is important to clearly distinguish between the needs of consumers as senders (of USO letters) and receivers (of all letters – both USO and non-USO) separately. There is ample evidence that as senders of USO mail, there would not be a significant problem in reducing the delivery frequency of mail sent. However, the needs of consumers as receivers of mail are quite different, as their needs are for the totality of all mail they receive (non-USO and USO). Consumers may not send urgent mail, but they do consider some of the mail they receive to be urgent – and in the main it is the non-USO mail which is the most urgent. As Ofcom has noted, 63% of all consumers say it is important to receive letters 6 days a week.

*3: Do you agree with our assessment of the bulk mail market? Are there other factors relevant to its future evolution which we have not considered?*

Citipost Mail believes that the issue which goes to the heart of whether the USO is fulfilling its purpose is less around the costs of sending a USO letter and more about whether vulnerable users are able to receive paper letters at all. Thus, any changes to the USO need to support the likelihood of senders continuing to send letters to those that need them. If Ofcom imposes changes which deter the sending of bulk letters, it will frustrate the requirements of vulnerable users, whether there continues to be a first-class service or a 3, 5 or 6 day a week service – because the letters will not be sent. The way to degrade the future sending of letters is allow the current situation of poor quality of service and frequent excessive price rises to continue.

*4: Are there specific events/changes that could trigger a significant change in demand for large mail users, including public services?*

It is possible that rate of decline in bulk mail would have already bottomed out if it were not for the excessive price shocks that Royal Mail has put in the market in recent years. Price rises that are unpredictable, frequent and excessive combined with very poor quality of service are undoubtedly leading to additional volume loss. Royal Mail is actively making its own position worse. If the quality of service of Access mail is degraded by a further day, then mail will become even less attractive to bulk posters.

*5: Do you agree with our proposed approach to estimating the financial burden of the USO?*

While the methodology Ofcom has adopted is logical, the wide variation given for the potential additional profit Royal Mail could achieve from cost savings means that the exercise is of little value. It is even perfectly possible that a removal of the USO could result in Royal Mail being less profitable than it is with it. Given the breadth of services that Royal Mail would logically choose to offer in the absence of a USO, Citipost Mail's view is that it is entirely possible that the USO is neither a benefit nor a burden (i.e. that the cost and opportunity are roughly in balance). Should the value of the Royal Mail branding be included in the calculation, the USO is unarguably a benefit.

**6: Do you agree with our considerations regarding the unfairness of the financial burden of the USO?**

No. The burden which Royal Mail struggles to carry is that imposed by its own manpower model and the difficulty it has in any attempt to reduce headcount in delivery and improve efficiency. It is this, not the USO, which has brought about its failure. As we have suggested, without any changes to the USO, Royal Mail could choose to dramatically reduce the volume of first-class mail through pricing and could, with requisite notice, alter the delivery service specification for Access mail. However, over the past 15 years it has continually failed to change its delivery model to reflect the new reality of the mix of traffic it now receives. The likelihood of such change ever happening is not dependant on any definition of the USO, it is dependant on Royal Mail's ability to manage its own business.

**7: Do you agree with our considerations regarding the impact of the financial burden of the USO?**

No. See answer to 5 above.

**8: Do you agree with our analysis of the different options available to change the USO and the impact of those changes on residential (including vulnerable) users, SMEs and bulk mail users? If not, please explain why and set out any option(s) which we have not considered.**

More consideration should be given to a traditional RPI-X price control formula to give Royal Mail real incentives to become more efficient and thus solve its own problems. The management of the company has proved unable to realise efficiencies in the presence of the easy temptation to just increase prices instead. Therefore, in the absence of regulatory regime that requires efficiency gains, we believe that it is unlikely that any of the proposed changes to the USO that are being considered by Ofcom will result in a material change to Royal Mail's financial position or the sustainability of the USO.

Another option, which Ofcom notes has been used in other markets is a state subsidy for the USO. Ofcom should not back away from this option just because it may not prove popular with the government of the day. In the absence of a step change in the ability of Royal Mail to return to profitability, there may be no other alternative.

**9: Which option(s) do you consider would be most appropriate to address the challenges we have identified, while also ensuring that users' needs are adequately met?**

If Royal Mail is to be given further potential scope to become more efficient through a reduction in the level of the USO, it is far more likely to be effective if Ofcom links efficiency targets and quality targets to the ability to further raise prices.

For example, achievement of quality of service targets for a service in a given year should be a condition precedent for the ability to raise prices for that service in the following year.

If quality targets are met and a price rise is permitted, there should be a limit to the extent of any such rise so as to encourage Royal Mail to make the most of the new opportunity it has been granted (i.e. a RPI or even a RPI-X price cap).

The best solution to this issue for the future of Royal Mail and the USO, is any solution that is actually capable of achieving the efficiencies that Ofcom is predicting for Royal Mail. Ofcom must make it easier for the company to become more efficient by giving it the hard economic targets it needs, without which it may just continue to under-perform and disappoint.

If Ofcom concludes that bulk mail Access services should be degraded by a further day to align to a reduced USO, it is important that bulk mail products are not further destabilised by an open-ended review of the Access regime that could further undermine confidence in bulk mail. Changes to Access should be kept to a minimum unless they are changes which actively encourage customers to keep posting.

**10: Do you have any other views about how the USO should evolve to meet users' needs?**

Given the very predictable decline in letters volume and increase in parcels volume, it is perhaps not the USO that needs to evolve to meet the mix of the traffic Royal Mail now carries, it is up to Royal Mail itself to evolve.

*Get in touch*  
to find out how we can help.

**CITIPOST MAIL**

Citipost Mail • Unit 3 • Swanwick Court • Swanwick  
Alfreton • Derbyshire • DE55 7AS • United Kingdom

[citipostmail@citipost.co.uk](mailto:citipostmail@citipost.co.uk) • +44 (0)203 2600 240

[www.citipostmail.co.uk](http://www.citipostmail.co.uk)