

Royal Mail

Response to Ofcom's call for input on the future of the universal postal service, 24 January 2024

Royal Mail Submission

2 April 2024

Confidential information which has been redacted is indicated by: [X]



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Foreword

The need for urgent change of the postal Universal Service

Foreword by Gus O'Donnell

Chairman of Frontier Economics

We all know that the one price goes anywhere postal Universal Service has delivered many benefits for our society, by ensuring that all towns, cities and nations can get affordable access to postal services, no matter where they live or work. This has not only delivered the social benefits of keeping the people of the United Kingdom connected, it has supported economic growth in regions which might otherwise not have had access to an affordable letter and parcel service. Even today, none of Royal Mail's competitors provide the same coverage for all products at the same price to all areas.

But we also all know that there have been massive changes in the way people communicate, with technology improving drastically the ability to transfer information and documents instantaneously across the whole country and indeed the whole world. Inevitably, people post many fewer letters, so that Royal Mail's volumes of letters have fallen by roughly two-thirds in the past 20 years. This has entirely changed the economics of the postal service. The nature of the obligations on Royal Mail need to change to reflect this. The present regulatory model is simply unsustainable as Ofcom itself recognises. Compared with other countries, the UK has been dangerously slow to reform, and unless very rapid action is taken there is a serious risk that the Universal Service will collapse.

The growth in ecommerce has enabled Royal Mail to partially support its letter delivery with higher parcel volumes. But, operating in a highly competitive parcels market means that Royal Mail cannot deliver sufficient profit from parcels to make up for the cost of the Universal Service, which Ofcom has estimated at up to £675m p.a. despite letter price rises. Royal Mail's margins have been below the level deemed necessary by Ofcom to ensure its longer-term financial sustainability and investment for more than 7 years. Even the temporary surge in demand for parcel and test kit deliveries during the Covid lockdowns did not return Royal Mail to that range, and the company has been running losses in 2022/23 and its current financial year.

The fundamental problem in simple terms is that letters must be delivered on each of six days Monday to Saturday, but the volume has fallen by two-thirds and continues to fall. This means posties have to walk more than three times as far to deliver a letter than they did before, with a proportionate increase in the delivery costs per letter. To tackle this problem, either letter prices will have to rise substantially more than they otherwise would to recover the costs (leading to a vicious circle of unsustainability), or Government will have to fund the shortfall.

The need for reform is therefore urgent and Ofcom and the Government must act before it is too late. For there is also general agreement that a one price goes anywhere service is worth preserving on both social and economic grounds, but that it cannot survive without rapid change.

Ofcom has proposed options for consideration, some of which could reduce the financial burden of the Universal Service significantly. One obvious option, much discussed, has been a reduction in the number of delivery days from six to five or three. After reviewing the economics of this and other options, Frontier Economics has come to the view that a different option would better meet the needs of customers and the social and economic purpose of the Universal Service, whilst reducing the cost of its provision.

This option is to maintain the six day delivery requirement for First Class letters, whilst moving to deliveries every other working day (Monday to Friday) for all non-First Class letters. However, to achieve this Universal Service option, certain other changes would be needed in regulatory obligations which are detailed in the submission. This provides the platform for Royal Mail to transform its provision of the Universal Service.

Experience from other countries shows that reform will require careful planning, consistent execution and flexible implementation. My own experience of change in large people-centric organisations makes me greatly aware of the challenge. Neither Ofcom nor the Government should under-estimate the difficulty and should be careful not to handicap Royal Mail on its reform journey as it responds to the effects of revolutionary changes in the communications market.

It is critical for Ofcom, the Government and all stakeholders to agree on reform of the USO as a matter of urgency and to make sure that sufficient change is possible to give Royal Mail the best chance of succeeding in this acutely difficult task.

A handwritten signature in black ink, reading "Lord O'Donnell". The signature is written in a cursive style with a large initial 'L' and 'O'.

Lord O'Donnell

April 2024

Executive summary

The universal service obligation for post (the “USO”) the legal requirement for Royal Mail to deliver to the United Kingdom’s 32 million addresses six days a week – as currently structured is now unsustainable. Whilst it remains a vital part of life in the UK, a means of communication used and relied on by millions of people and businesses, and an important part of how society connects in every corner of the country, urgent modernisation is required.

Royal Mail is committed to deliver the one price goes anywhere USO and it is a privilege to be part of the fabric of daily life in the UK. However, the minimum requirements of the USO have remained largely unchanged for over 20 years since the UK adopted the EU Postal Services Directive. As with any service, the USO must adapt and evolve to meet the needs of those that use it. It cannot stand still in the face of changing customer behaviours and hope to survive simply because of its long and proud history. Ofcom’s conclusion in its call for input on ‘The future of the universal postal service’ is therefore right that *“the universal service needs to change to better align with the needs of consumers and to ensure it can continue to be affordable and sustainable in the future”*.

We have talked to a wide range of customers and businesses across the UK. They recognise that change to the USO must come, and our proposals for reform protect those aspects of the USO that they told us matter most to them.

1 Falling letter volumes and unsustainable losses

The way in which people communicate has changed, causing a material decline in the use of letters that is set to continue. The USO requires Royal Mail to deliver First Class, Second Class, Retail and Access customer letters six days a week to 32 million addresses in the UK. But there is no longer a letter for every address, every day. From 20 billion letters a year posted at their peak in 2004/05, seven billion letters were sent last year, and addresses now receive just four letters a week; during the same period the number of addresses has increased by over four million.

Whilst the number of parcels that Royal Mail delivers has increased, this is in a highly competitive delivery market where Royal Mail chooses to offer industry leading terms and conditions to our employees. Demand for parcels has not increased fast enough to offset the financial impact of the structural decline in letters.

Whilst consumers are demanding more and more from parcel services and sending fewer letters, the USO in its current form means Royal Mail must maintain a high fixed cost network to deliver the USO and bulk letters six days a week to every address, without the revenue to sustain it. In practice, this means our posties are delivering fewer letters to more and more addresses, with the cost of delivering each letter ever-increasing. This fact has been recognised by Ofcom where it calculates that providing the current USO to the UK has a **net cost to Royal Mail of £325m to £675m every year** – or put another way, Royal Mail is spending around **£1m - £2m per day** to provide the USO to the UK.

We absolutely agree with Ofcom’s conclusions that *“the consequences of misalignment between the obligations and users’ reasonable needs are significant. We estimate that the USO imposes a considerable net cost on Royal Mail”* and that *“we consider that the net cost we have calculated may represent an unfair financial burden on Royal Mail”* such that it *“raises serious questions as to whether it is a cost Royal Mail should or even can be expected to continue to meet.”* **This must be urgently addressed.**

This is the **very real and urgent financial sustainability challenge** that Royal Mail faces. Royal Mail posted losses of £419 million in financial year 2022/23 and losses in the first six months of the 2023/24 financial year of £319 million. Whilst Ofcom’s own guidance outlines that Royal Mail should have the ability to earn sustainable profit margins of 5-10% per year, the average profit margin achieved over the last five years is less than 1%. A profit margin of 5% or above has been achieved only twice since

privatisation more than 10 years ago (in 2014/15 and 2015/16) notwithstanding our continuing efforts to transform.

Royal Mail is doing as much as it can to transform itself to:

- **meet changing customer needs** with new products and services. In letters we have introduced Mailmark (lower prices and increased visibility of performance for customers through embedded data in barcodes) and a new economy (D+5) service for our Access and Retail customers. Barcoded stamps make each stamp unique and reduces fraud). In parcels we have improved convenience for customers by launching Parcel Collect from customers' doorsteps, expanded Sunday parcel deliveries, and are introducing more options for customers to deliver and drop-off parcels outside the home, including a new partnership with Collect+ and the roll out of 3,000 parcel lockers;
- **improve efficiency** through prioritising investment on delivering new services and adapting our estate to provide the services that customers want. We have reduced our mail centre estate from 69 to 37 and invested in 36 parcel sorting machines. We are improving quality of service by focusing on our people and driving network efficiency. We are reducing our reliance on agency staff, recruiting more permanent colleagues on new terms and conditions to drive sustainable growth and we are also shaping our future network to reflect the changing market to deliver further efficiencies;
- **invest in our future sustainability** with increased parcel automation, including two new state-of-the-art parcel super hubs in the North West of England and Midlands, which can process up to 90,000 parcels an hour. We also have the UK's largest fleet of final mile electric vans, helping to make us the UK's greenest delivery company based on competitors' reported emissions; and
- **Modernise our industrial relations** following 18 days of industrial action in 2022, we signed an agreement with the Communication Workers Union that includes:
 - seasonal hours for delivery staff to manage efficiently the peaks and troughs of mail in our business across the year;
 - a new absence policy to tackle high absence rates and frontline performance management; and
 - later start times for our delivery staff to improve our environmental footprint, deliver cost efficiency and improve quality of service by reducing our reliance on flights.

These have all been vital changes to adapt, evolve and reset into a more customer focussed and efficient business. We are doing everything we can to transform and ensure we can continue to deliver the USO for many years to come, but we cannot do this entirely on our own. **We also need Ofcom and Government to take action urgently.**

2 Our proposal – the future USO

The only way to maintain the USO is to modernise the USO. The reforms we ask for are intended to address the significant net cost of providing the USO to the UK, and to realign the USO to meet reasonable users' needs. They would allow for a more efficient and modernised USO that gives customers products and services that they want, and greater confidence in a UK-wide universal price and a parcels service for the digital age.

We have listened to customers

We have **invested significant time in understanding what our customers want** from a modern USO. This includes extensive research with over 3,000 consumers, 500 SMEs and 48 large businesses, as

well as meetings with over 100 organisations over recent months, including consumers, businesses, public services (including NHS bodies) and groups representing a wide range of consumers (including in rural communities, on low incomes, older people and those with disabilities) across the UK.

Our proposal is designed to meet the needs of customers today and into the future by protecting what customers told us matters most to them in the USO and creating a platform for growth.

As part of our proposal, **we would protect what customers value with no changes** to:

- The **one price goes anywhere** service to all parts of the UK;
- The **choice of First and Second Class letters**. In our research, 81% of consumers and 83% of SMEs emphasised the importance of having a choice between a First and Second Class service;
- **First Class letters delivered daily, six days a week** (Monday to Saturday) to the same timescales. In our research, industries like publishing and greeting cards explained the importance of next day and Saturday deliveries; and
- **USO parcel services** which we are required to deliver Monday to Friday, but which we also deliver on Saturdays. On commercial parcels we will continue to deliver Monday to Saturday and increasingly on Sundays.

Vital changes to deliver our future financial sustainability

As we have set out, the USO in its current form is unsustainable. Our proposal includes the following changes which **are critical to unlocking a new delivery model and ensuring a more efficient, financially sustainable USO**:

- **all non-First Class letters would be delivered to every address every other weekday** (Monday to Friday). 92-93% of consumers in our research said non-First Class letter deliveries twice a week meet their needs: our proposal exceeds this; and
- **aligning the delivery speed of Access Standard letters with Second Class**, so it arrives within three weekdays instead of two.

As a result of these changes, we would be able to deliver a more efficient, reliable and financially sustainable service as our posties would be delivering letters to around seven out of ten addresses compared to around four out of ten today.

Expand and modernise the USO

Listening to what customers have told us is important, we also call on Ofcom to **expand and modernise** the USO for the digital age by introducing the following new features:

- **Greater reliability**
 - We recognise that we must **increase reliability** in the USO – our customers have told us that loud and clear. Our research, and Ofcom’s analysis, shows that speed and reliability are both parts of what customers value in quality of service – and more customers value reliability than value speed. Our quality of service regime has not been comprehensively reviewed for 18 years, during which time the market has changed profoundly. We propose rebalancing speed and reliability, to give customers further confidence in the service they would receive by **introducing new, additional reliability targets in First Class and Second Class** USO products alongside revised, realistic speed targets (recognising that high speed targets drive high fixed cost in a

declining market, and that no country of a comparable size has First Class or Second Class USO speed targets as high as the UK).

- **Greater choice**
 - **tracking on USO parcels** to reflect strong customer preferences, and the principle that it is only the USO that offers one price goes anywhere to everyone in the UK. Other countries have allowed tracking in the USO to protect their USOs; and
 - a new, additional “**end of day**” **Special Delivery** product that would be priced lower than the 1pm guaranteed Special Delivery product.

Working with the NHS

We value the part we play in helping the NHS to communicate with patients. In conversations with a number of NHS representatives and advocates, it was evident that letters would continue to be an important part of their communications for years to come. It also became obvious that many parts of the NHS use postal services in different ways. We are committed to working in partnership with the NHS, in all parts of the UK, to ensure that vital NHS letters are delivered in a timely manner. We would continue to offer choice to the NHS on price, and speed of services, to meet their needs. In addition to continuing to offer a First Class delivery six days a week, we would explore options with the NHS that may provide greater reliability for time sensitive medical letters.

Our people

We would continue to offer industry leading terms and conditions and our proposals create a more sustainable business for more secure jobs. Our proposals would also mean that our posties would get more Saturdays off work and create a wider range of jobs including traditional walking delivery roles with mainly letters and van-based roles with mainly parcels.

Over a period of around 18-24 months from the date of regulatory change, the total number of delivery routes is expected to reduce by c. 7,000-9,000. Whilst this may mean fewer delivery roles in Royal Mail, we expect to be able to manage the vast majority of changes through natural turnover with no compulsory redundancies. Based on current estimates, we expect voluntary redundancies to be minimal (c. 1,000 based on current modelling).

The sustainability impact of our proposal on Royal Mail

Our proposal, if implemented, would reduce the run-rate net cost of the USO to Royal Mail up to £300m per year, although this is dependent on the time taken for reform and the rate of letter decline. It would allow the business to continue to invest in modernising and transforming to provide products and services that customers want. Our proposals would also mean we can continue to operate our unique “feet on the street” delivery model, significantly contributing to keeping our emissions low, consistent with our Steps to Zero strategy.

Our prices would continue to rise across our products alongside any reform, reflecting a structurally declining market and the increasing cost burden of delivering letters, however reform of the USO would mean that prices do not rise as sharply as they would absent reform.

The scale of change

Whilst we are confident that these changes can be deployed successfully, as similar changes have been deployed internationally for other Postal Operators. Nonetheless, they represent a major change in our operation. It would likely take around 18-24 months from the point of regulatory change to fully implement across the entire network, making **the urgency of regulatory change all the more imperative**. With complexity of this scale and constantly evolving letters and parcels markets, these

changes of course come with risk through transformation costs, the value of benefits changing over time and execution.

3 Change is within Ofcom's current powers

Our proposal for USO reform can be achieved with modest regulatory change and does not require legislative changes: it requires changes to Ofcom's Postal Service Order, its Access conditions and its Designated Universal Service Provider conditions.

4 Future-proofing the USO

Whilst the USO needs urgent modernisation now, and this submission sets out those reforms that are necessary and within Ofcom's gift today, there is also a need to future-proof the USO with **three important regulatory and legislative changes** that should follow in the future and allow the USO to adapt and evolve swiftly as customer preferences continue to change in a structurally declining market. This would help to avoid the unacceptable position of the last four years where necessary reforms to adapt to quickly changing markets are not the political priorities of the day:

- Firstly, there will come a time when, even if the USO is reformed, there is still a financial burden to Royal Mail of providing the USO. **Royal Mail believes the UK needs a mechanism whereby Ofcom carries out a regular net cost calculation** (akin to those carried out in France and Belgium) at least every two years so there is transparency of the true costs of the USO to Royal Mail, allowing for a fair debate about how those costs are rightly met;
- Secondly, given the continuing structural decline in letters, the USO would need to adapt and evolve more quickly than is provided for by the current legislative framework. **Ofcom should be granted the flexibility to change the minimum requirements of the USO via regulatory change** (rather than legislative, as is currently the case); and
- Thirdly, in a declining letters market, if there is a time in the future where further reform is no longer sufficient to meet a net cost that Ofcom may identify, **it may fall on Government to contribute to those costs**, as is the case in several European countries. Ofcom has stated that *"it would be open to the Government to decide to meet some or all of the financial burden via public subsidy"*. The contribution fund in the Postal Services Act 2011, which requires contributions from postal operators or users, is recognised by Ofcom to be unworkable and must be reformed.

5 The urgent need for reform now

Changing customer needs, the structural decline in letters, and the consequential financial sustainability challenge of the USO, is not a problem unique to the UK or to Royal Mail. The need to reform the USO to tackle these issues has been recognised and acted upon by postal regulators and governments across the world for years; but the UK has stood still and done nothing. Royal Mail has been calling for reform of the USO for over four years. During that time, the business has suffered heavy losses as we have tried to modernise and transform to meet today's customer needs.

Ofcom has now recognised that reform is necessary, and that the financial cost of the USO to Royal Mail each year is significant, but **we have serious concerns that the urgency of the situation is not properly recognised**. We call on Ofcom to act faster than its Call for Input envisages (where it says it will *"provide an update in the summer"* of 2024). Instead, Ofcom must reach a swift decision on USO reform and move to consult and introduce new regulations by April 2025 at the latest – accounting for the possibility of a General Election late in 2024 which cannot be an impediment to USO reform. Royal Mail is materially loss making and simply cannot continue to meet the significant costs of a USO that far exceeds the needs of customers.

The now recognised significant net cost of the USO to Royal Mail (£325m-£675m) has been borne since at least 2021/22 and during this time the business has incurred (and continues to incur) heavy losses. Whilst the process of regulatory reform is ongoing, and during any period of implementing change, **we call for Government to consider a temporary contribution to address the net cost of the USO.** The case for a temporary contribution is even more imperative if **Ofcom delay urgently needed regulatory reform** until after a General Election. A failure to urgently reform, as Ofcom acknowledges, could lead to *“consumers paying higher prices than necessary for USO products”*.

6 Conclusion

The USO remains an important part of life in the UK. It is valued by customers and is a key means of communication still used and relied on by millions of people and businesses. The USO generates significant UK-wide socio-economic benefits, and it is hugely important for social cohesion and economic growth by improving access to markets for SMEs, particularly in rural/remote areas. However, **in its current form, the USO carries a significant net cost to Royal Mail that is simply unsustainable: it must be reformed, and it must be reformed quickly.**

The immediate changes we propose in our submission can be implemented with relatively limited regulatory change that is within Ofcom’s gift. We also propose several other legal and regulatory changes that help future-proof the USO.

Our proposal for USO reform is built on meeting the needs of customers, protecting what they value and creating a more reliable and financially sustainable service that continues to connect all parts of the country.

1 Introduction

Key messages:

- We welcome the opportunity to respond to Ofcom’s Call for Input in relation to the future of the USO. The need for reform is urgent.
- In developing our proposal for reform, we have focussed on ensuring that it is:
 1. Good for customers and growth;
 2. Financially sustainable and addresses the significant net cost of the USO to Royal Mail; and
 3. Good for our people.

Overview

- 1.1 Royal Mail is proud to deliver the one price goes anywhere USO and it is a privilege to be part of the fabric of daily life in the UK. However, the minimum requirements of the USO have remained largely unchanged for over 20 years¹ and, as with any service, it must adapt and evolve to meet the needs of those that use it. It cannot stand still in the face of changing customer behaviours and hope to survive simply because of its long and proud history. We therefore welcome Ofcom’s Call for Input of 24 January 2024 (CFI) in relation to the future of the USO.
- 1.2 We agree with Ofcom’s conclusions that *“the consequences of misalignment between the obligations and users’ reasonable needs are significant. We estimate that the USO imposes a considerable net cost on Royal Mail”*² and that *“we consider that the net cost we have calculated may represent an unfair financial burden on Royal Mail”*³ such that it *“raises serious questions as to whether it is a cost Royal Mail should or even can be expected to continue to meet.”*⁴ This must be urgently addressed, particularly given the very real and urgent financial sustainability challenge that Royal Mail faces.
- 1.3 This document sets out our assessment of the need for urgent USO reform, and our proposal for its future shape to align with customer needs and address the significant net cost burden of providing the service to the UK.
- 1.4 The reforms we propose will create a more customer focussed, modernised, reliable and financially sustainable USO, giving greater confidence in a UK-wide universal service that can operate effectively in the digital age.

Reform criteria

- 1.5 In developing our proposal, we have focussed on ensuring the reform is:
 - Good for our customers and growth;
 - Financially sustainable and addresses the significant net cost of the USO to Royal Mail; and
 - Good for our people.

¹ EU Postal Services Directive 97/67/EC, amended by Directive 2002/39/EC and Directive 2008/6/EC, implemented in the UK by the Postal Services Acts 2000 and 2011

² Ofcom, The Future of the Universal Postal Service Call for Input 24 Jan 2024 paragraph 10.3.

³ Ibid, paragraph 8.47.

⁴ Ibid, paragraph 10.3.

- 1.6 These are largely in line with the principles that Ofcom identified in its CFI.
- 1.7 However, Ofcom sets out that the USO is a “*safety net to provide a good quality, basic postal service to those whose needs might not be met by the wider competitive market.*”⁵ We disagree. The widespread use of the USO generates significant UK-wide socio-economic benefits, and it is hugely important for social cohesion and economic growth by improving access to markets for SMEs, particularly in rural/remote areas, and enabling other sectors to add further value to the economy. A modern, reliable, efficient and sustainable USO that is attuned to evolving customer needs will deliver greater economic and social value than one that is stuck in the past.

Reforms must be good for our customers

- 1.8 Given the high fixed costs we face, there are strong incentives to maximise the volume of letters in our network and to provide consumers and businesses with products and services that they have told us they want. We have developed our proposal to take account of the following characteristics that our customers have told us are important:
- **Universality** – we remain committed to the one price goes anywhere service to all parts of the UK;
 - **Reliability** – a dependable service where mail is delivered on time;
 - **Choice** - offering customers the choice between different service features allows them to select the products that best meet their needs at prices they are willing to pay. Limiting choice potentially leads either to over-specification of products and services and higher prices, or to the needs of some customers not being met (or both); and
 - **Affordability** – we recognise affordability as a fundamental aspect of the USO.

Reforms must be sustainable

- 1.9 In order to be able to meet our customer needs, we have to ensure that our proposal is sustainable in the following ways:
- **Financial sustainability** – the significant net cost burden of providing the USO to the UK as it stands today must be addressed and Royal Mail must be able to earn a financially sustainable rate of return in order to invest in modernising and transforming to provide products and services that customers want, and to provide a reliable service;
 - **Urgency** - given the significant net cost burden of providing the USO to the UK and the financial position of the company, the need for change is urgent. Therefore, any solution needs to be implemented within a short timeframe, particularly given the time taken to make changes in our operations given the scale of our business;
 - **Flexibility and future proofing** - customer needs will continue to evolve in a structurally declining market. Any proposal needs to ensure that there is sufficient flexibility built into it to allow for further change in the future; and
 - **Environmental sustainability** - we want to continue to operate our unique “feet on the street” delivery model, significantly contributing to keeping our emissions low, consistent with our Steps to Zero strategy.

Reforms must be good for our people

- 1.10 We have carefully considered the impact on our people in the following ways:

⁵ Ibid, paragraph 9.38.

- We want to continue to offer employees industry leading terms and conditions and secure jobs;
- We want to reduce the need for weekend working and be able to offer variety and choice where possible; and
- We want to be able to manage the change as sensitively as possible, minimising the need for voluntary redundancies and we expect to avoid the need for compulsory redundancies.

2 Customer behaviour, changing market dynamics and the urgent need for reform

Key messages:

- The structural decline in letters, driven by changing customer needs and behaviours over the last 20 years will continue despite all we have done to innovate and retain letter volume. Furthermore, parcels market is highly competitive and growing revenues have been insufficient to offset the structural decline in letters.
- The USO drives our delivery footprint, but it has remained largely unchanged for the last 20 years, creating unsustainably high fixed costs.
- As a result of changes in how customers use letters, and despite everything we have done (and continue to do) to improve our financial position. Royal Mail has faced financial sustainability challenges over a number of years and became heavily loss making in 2022/23, remaining so at HY 2023/24. This is an unsustainable position for a publicly listed company.
- Ofcom has found that *“The evidence indicates an increasing risk of the current obligations becoming unsustainable both financially and operationally.”*⁶ In fact, the current obligations are already financially and operationally unsustainable. Other postal regulators have adapted their postal regimes to reflect these fundamental letter market shifts whereas the UK remains stuck in the past.
- We need Ofcom and Government to take urgent action, to enable us to address the significant fixed costs in our delivery operation. Royal Mail on a standalone basis would have a sub-investment grade credit rating. Reform is much more urgent than Ofcom identifies in its CFI.

The structural decline in letters over the last 20 years will continue despite all we have done to innovate and retain letter volume

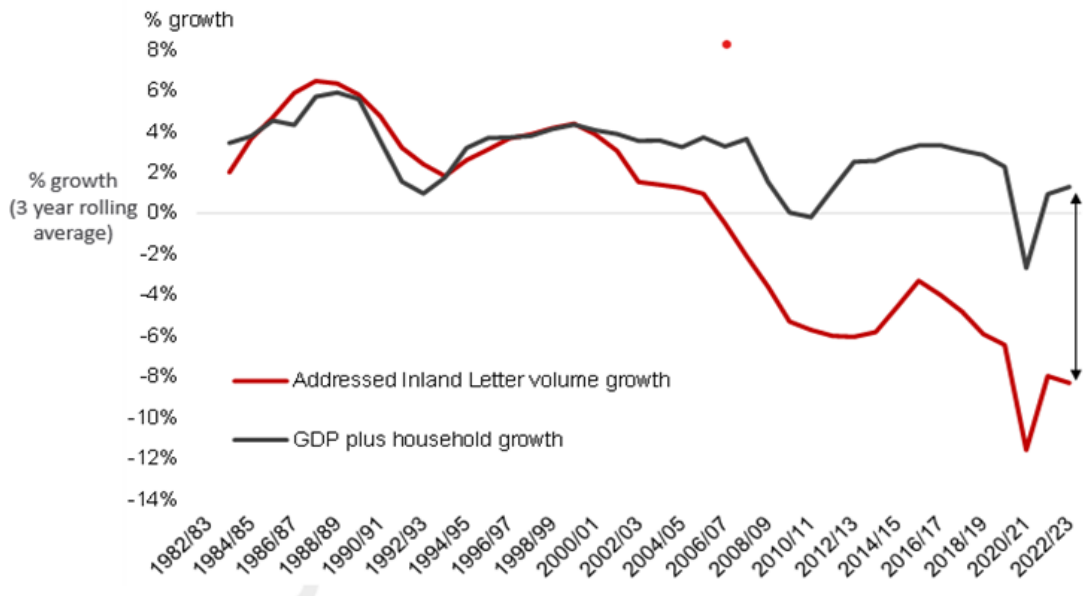
2.1 Customer behaviour has changed and continues to change in the UK and around the world as the trend towards digitalisation causes a reduction in the demand for letters.⁷ People are also sending and receiving more parcels. As Ofcom states *“letter volumes halved between 2011/12 and 2022/23, from around 14 billion items to 7 billion ... In contrast, parcel volumes have increased considerably over the last decade (with 3.6 billion items sent in 2022/23) as online shopping has become mainstream”*.⁸ This rate of structural decline in letters is expected to continue.

⁶ CFI, Overview: In Summary.

⁷ UK Government, 2022. UK Digital Strategy, section 3.
<https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1089103/UK_Digital_Strategy_web_accessible.pdf>

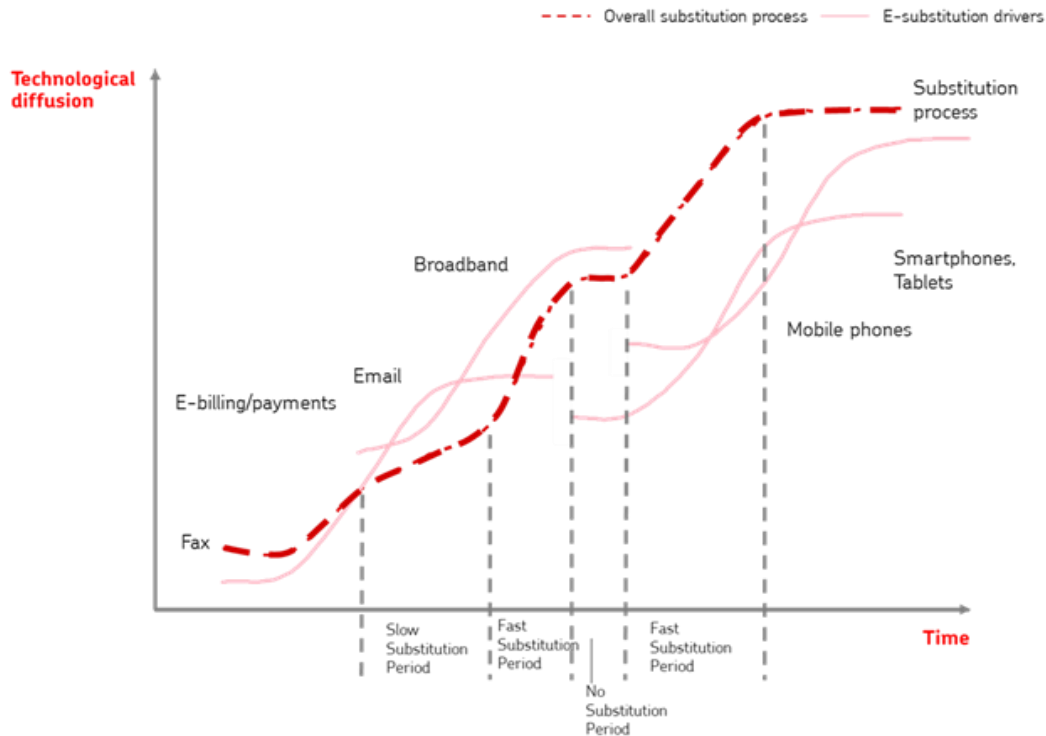
⁸ CFI, Overview: In Summary.

Figure 2.1: Decline in domestic letter volumes: % change since peak year to 2022



2.2 Technological developments (including originally fax, then email, broadband, mobile phones, smartphones, etc.) have led to an increased digitalisation of communication and a move away from letter communication (a trend known as e-substitution). Figure 2.1 shows that letter volumes no longer follow the economy (GDP) and instead have grown more slowly since 2000/01, and then have fallen in absolute numbers since 2004/05. E-substitution has driven a wedge between letter volume growth (decline) and GDP. Whilst GDP has remained an important driver of volumes, the relationship has become more complex. New technologies mature and their usage evolves over time. As Figure 2.2 below demonstrates, the evolution of new technologies is an ongoing dynamic process driven by individual technologies overlapping. As an “old technology” starts to plateau, a new one emerges.

Figure 2.2: E-substitution is a dynamic and evolving process



2.3 E-substitution shows no sign of diminishing. We do not know when the next technological advancement will be. It acts as a constraint on our ability to increase prices. We have to consider carefully our approach to pricing. Price increases risk customers switching away permanently, primarily to digital alternatives, ultimately damaging profitability in the long run and increasing the risk of creating a financial sustainability issue for the USO.

Keeping letters relevant – innovation

2.4 We have a track record of introducing innovations to meet customer needs, ensuring letters stays relevant and keeping as many letters in the postal network as possible. We invest in a centre of excellence for letters, MarketReach⁹, which provides mail users with insights, evidence, tools, inspiration and training to be able to maximise their returns from investing in letters. This mirrors best practice in other media channels.

2.5 We use product development to meet the evolving needs of key customer segments and the wider market. For example, we introduced an Economy product in Access and Retail to give bulk mailers a choice of delivery speed and cost. We also seek to make letters as easy to use as possible for customers, for example by simplifying our product portfolio. See Annex 1 for further detail.

2.6 Despite these numerous initiatives and engagement with the industry, it has not been possible to arrest the structural letter decline.

The parcels market is highly competitive and growing revenues have been insufficient to offset the structural decline in letters

2.7 The UK has a very competitive and dynamic parcels market and competition occurs across the full spectrum of products. This includes economy B2C services (where Evri and Yodel are key

⁹ <https://www.marketreach.co.uk/unleash-the-magic-of-mail>.

players alongside Royal Mail, and where Amazon Logistics is disrupting the market); as well as the consumer to anywhere (C2X)¹⁰ market for consumer parcels, where historically Royal Mail has been strong but now faces effective competition, for example, from Evri, DHL, Yodel and DPD, who are offering a range of services across different parcel formats and with varying speeds and features such as tracking facilities and proof of delivery.

- 2.8 Indeed, as the sector has become more competitive, customers' expectations have increased. All carriers – including Royal Mail – have invested and innovated in order to develop features that customers want.
- 2.9 In parcels, to meet growing demand, we have improved convenience for customers by launching Parcel Collect (customers can have their parcels collected from their doorstep by their posties), expanding Sunday parcel deliveries. We are introducing more options for customers to deliver and drop-off parcels outside the home, including a new partnership with Collect+ (to enable customers to drop off parcels at one of the 5,000 Collect+ stores), and most recently, a partnership with Quadient to provide a planned 3,000 lockers for dropping off (and in due course also collecting) parcels.
- 2.10 We have invested in our future sustainability with increased parcel automation, including two new state-of-the-art parcel super hubs in the North West of England and Midlands which can process up to 90,000 parcels an hour. We also have the UK's largest fleet of final mile electric vans, which helps to make Royal Mail the UK's greenest delivery company based on competitors' reported emissions.
- 2.11 However, at the same time, across the parcel sector, Ofcom's own data indicates that prices have declined in real terms. As Ofcom stated in its 2023 Annual Monitoring Report: *"Real-term average unit revenue per measured parcel fell by 10% year-on-year from £3.91 to £3.52. Average unit revenues will be impacted by any change in product mix but, overall, this data suggests parcel prices have gone up by less than inflation"*.¹¹ This is despite a significant shift to higher-value next-day and tracked products. This indicates strong pricing pressures driven by competition.
- 2.12 This level of competition will continue. Barriers to expansion for the 13 carriers operating national networks are low, particularly as they are not required to provide universal coverage. There has been significant expansion as carriers look to offer a more complete range of products and profitable opportunities by leveraging their existing networks to move into other segments, for example, all major carriers are now expanding from the B2C segment into C2X.¹² Many operators also have flexible employment models, which implies that capacity – particularly in delivery – can be scaled up or down to accommodate demand relatively quickly and easily.
- 2.13 Whilst the number of parcels that Royal Mail delivers has increased, this is in a highly competitive parcels market. Demand for parcels cannot increase fast enough to offset the financial impact of the structural decline in letters.
- 2.14 Figure 2.3 compares the changes in Royal Mail revenue since 2014/15¹³. Total revenues in 2019/20 (pre-Covid and before industrial action), revenue was c£40m lower (black line). This was because the additional revenue from parcels (dashed green line) was lower than letter revenue decline (dotted red line).

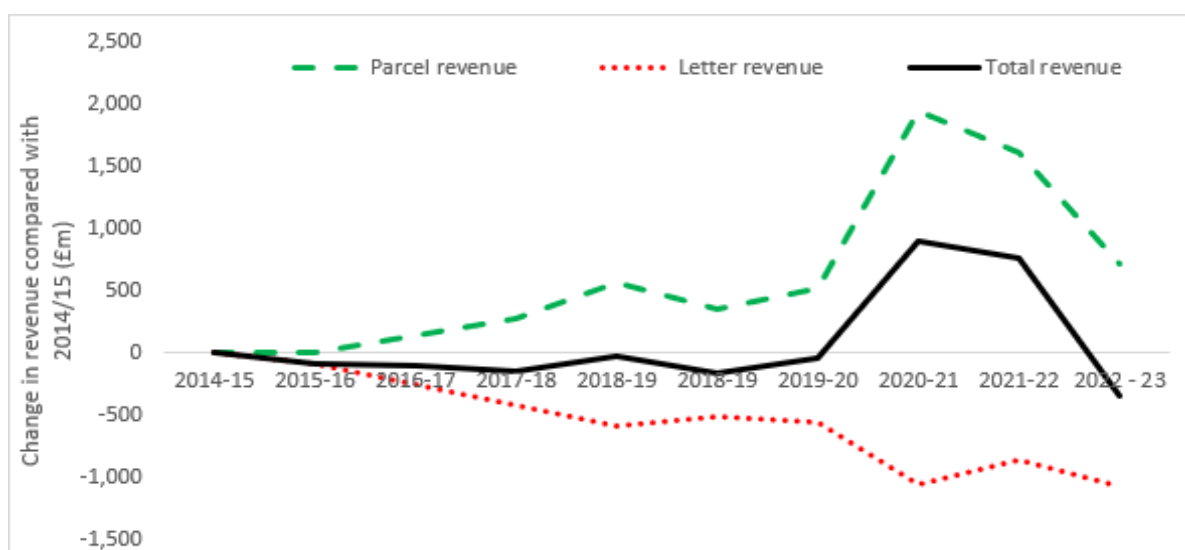
¹⁰ "Consumer to Anywhere" (i.e. consumer-to-business and consumer to consumer).

¹¹ Ofcom, Annual Post Monitoring Report 2023, page 8.

¹² For example, Yodel, which was initially active in B2C services, relaunched its C2X proposition in 2022.

¹³ We have chosen this year as it was the first year the Reported Business made a commercial rate of return.

Figure 2.3: Change in Royal Mail revenue in £m since 2014/15

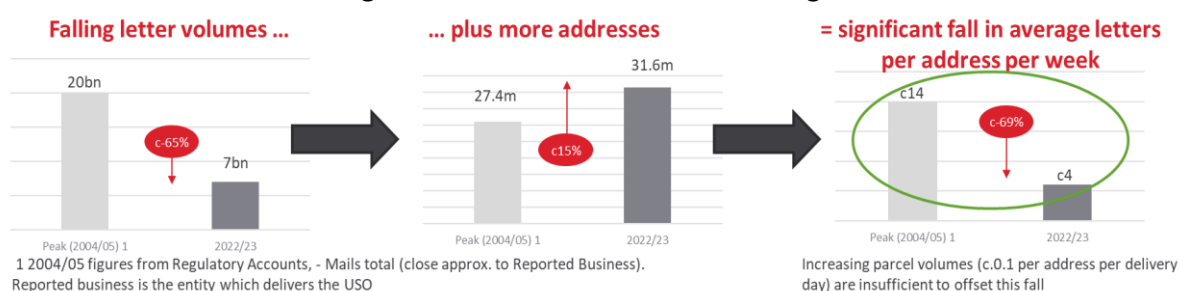


2.15 If we review the results for 2022/23 (recognising this will have been impacted by one-off factors such as industrial action), the position is starker. Since 2014/15, revenue has fallen by £350m as letter revenue has fallen by more than parcel revenue growth.

The USO drives the delivery footprint but has remained largely unchanged for the last 20 years, creating unsustainably high fixed costs in delivery

2.16 At the peak of the letters market, an address received 14 letters a week. Now, they receive four. This is a c. 70% reduction. During the same period, the number of addresses to which we have to deliver has increased by 15% to nearly 32 million. The number of parcels that we deliver each year is increasing, but volumes are not increasing fast enough to offset the structural decline in letters. However, the unchanged USO requires us to maintain the same structure as was necessary when letter volumes were 20bn per annum 20 years ago.

Figure 2.4 Customers needs have changed



2.17 Our network is set up to meet the stringent standards of the USO – one price goes anywhere in the UK, delivering letters six days a week. Maintaining an infrastructure that was established to meet our USO requirements - the ability to walk down every street in the UK six days a week to deliver and collect letters, five days for parcels - drives significant fixed cost. Our operation consists of c. 1,200 delivery offices, 37 mail centres, four parcel hubs and two parcel super hubs.

2.18 The USO drives the delivery footprint. The delivery pipeline, in place to meet our six day a week USO obligation, accounts for around 50% of Royal Mail’s total cost. But with falling letter volumes, our posties currently walk past more addresses than they deliver to. As volumes fall,

we cannot reduce costs in delivery in line with volume reduction as we still need to walk the streets of the UK every day.

- 2.19 In order to remove fixed costs in delivery, to become more efficient, we need changes in our regulatory requirements to unlock a new delivery model.

Ofcom recognises that the current USO letters specification goes beyond that required to meet reasonable users' needs

- 2.20 The CFI states: "...our [Ofcom's] assessment is that the current USO letters specification goes beyond that required to meet reasonable users' needs"¹⁴, that "the consequences of misalignment between the obligations and users' reasonable needs are significant. We estimate that the USO imposes a considerable net cost on Royal Mail"¹⁵ and "one of our motivations for considering changes to the specification of the USO is to prevent any excess costs being passed on to consumers".¹⁶

As a result of these market dynamics, Royal Mail has faced financial sustainability challenges for a number of years and in 2022/23 became heavily loss making

- 2.21 Ofcom uses an EBIT margin for the Reported Business¹⁷ in the range of 5-10% as a first order indicator of whether Royal Mail is earning a commercial rate of return on the provision of the USO¹⁸. Ofcom has stated that: "We consider that margins consistently below 5% could indicate that the universal service faces sustainability challenges."¹⁹ The Reported Business has not made a financially sustainable margin since 2015/16, as shown in Figure 2.5 below, [redacted].²⁰

¹⁴ Ibid, paragraph 9.86.

¹⁵ Ibid, paragraph 10.3.

¹⁶ Ibid, paragraph 9.85.

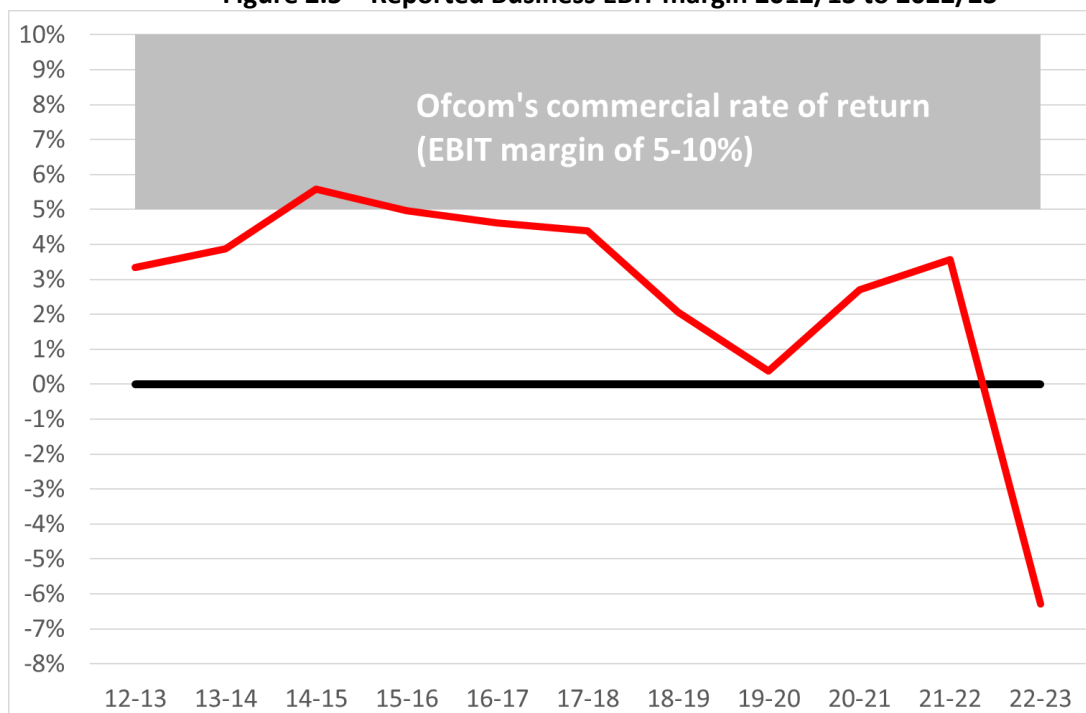
¹⁷ Ofcom has defined a regulatory reporting entity called the Reported Business. It contains the products and services, network and operations that provide the universal service.

¹⁸ Ibid, paragraph 2.12.

¹⁹ Ibid, paragraph 2.12.

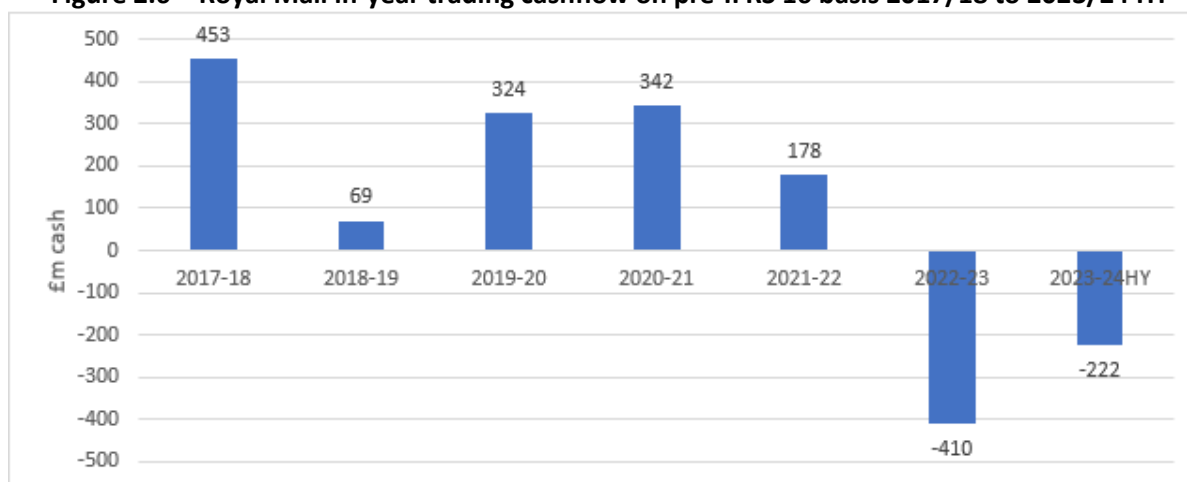
²⁰ [redacted]

Figure 2.5 – Reported Business EBIT margin 2012/13 to 2022/23



- 2.22 As the chart above shows, only twice in the ten years since privatisation has the Reported Business achieved profit margins that Ofcom has itself defined as sustainable. Whilst Ofcom’s own guidance outlines that Royal Mail should have the ability to earn sustainable profit margins as a business of 5-10% per year, the average profit margin achieved over the last five years is less than 1%.
- 2.23 We have faced financial sustainability issues for a number of years since 2014/15. Temporary respite came with the surge in parcel volumes in 2020/21 and 2021/22 during the Covid years. However, in 2022/23 Royal Mail faced an impossible combination of events. Sharply declining revenues, driven by post-Covid unwind and an acute cost of living crisis that rapidly drove down consumer spending (both external factors that were outside Royal Mail’s control) created an urgent and unavoidable need for structural network, delivery and ways of working which ultimately led to 18 days of industrial action.
- 2.24 Royal Mail’s financial situation in 2022/23 became very serious and the outlook remains deeply concerning. Royal Mail lost £419m in 2022/23 and £319m in 2023/24 HY. [X].
- 2.25 As Ofcom has set out elsewhere, the Reported Business EBIT margin is a long-term measure of financial sustainability. Cashflow is a short-term measure of financial viability. The figure below shows the in-year trading cash flow for Royal Mail over the last six years. It shows a marked reduction in cash flow from 2022/23.

Figure 2.6 – Royal Mail in-year trading cashflow on pre-IFRS 16 basis 2017/18 to 2023/24 HY



Ongoing losses are not sustainable for a publicly listed company

- 2.26 Financial sustainability is more than achieving a target margin (or in our case, not making the target). It is being able to do so durably and reliably, thereby enabling the raising of capital to invest in innovation and growth. Royal Mail was privatised to enable access to private sector capital and to bring in market discipline. When Royal Mail cannot earn a commercial rate of return, it becomes unattractive for private sector capital, reducing our ability to raise funds to invest and transform.
- 2.27 Royal Mail’s financial position has affected the Group’s credit rating. The uncertain outlook for Royal Mail is reflected in IDS plc’s BBB credit rating being on a negative watch.²¹ Although IDS plc has a BBB credit rating, this is due to GLS. If we were to source a separate credit rating for Royal Mail, we estimate that it could be sub-investment grade (‘junk’) status.²² When Ofcom is considering USO reform, it should give due consideration as to whether the USO can attract sufficient capital to finance the delivery of the USO. Hence, if Royal Mail’s financials are not consistent with an investment grade rating, then there would be significantly increased financing costs for the USO that Ofcom should not ignore. Again, this re-enforces the urgent need for USO reform.
- 2.28 The ability for IDS plc to access the capital markets has become more difficult due to Royal Mail’s financial position and our concern is that without the ability to earn a reasonable return, capital markets may not be prepared to provide further funding at reasonable financing cost. In the last two years, from April 2022, the share price has broadly been between £2 and £3 (below flotation price) and IDS plc has not paid a dividend since September 2022.
- 2.29 Accordingly, the ability for IDS plc to access the capital markets has become more difficult and more expensive due to Royal Mail’s financial position. This reduces our ability to respond to changing customer demand, particularly where regulations act as a blocker to unlocking efficiency improvements – for instance, we need the Access Condition to move from D+2 to D+3 in order to unlock the new delivery model.

²¹ S&P Global Ratings, IDS plc, 15 August 2023 - The negative outlook reflects that S&P could downgrade Royal Mail in the next 12-24 months if it appears that adjusted FFO to debt will remain below 45% on a sustained basis.

²² Royal Mail estimate based on internal analysis.

We are doing everything we can to improve our financial position

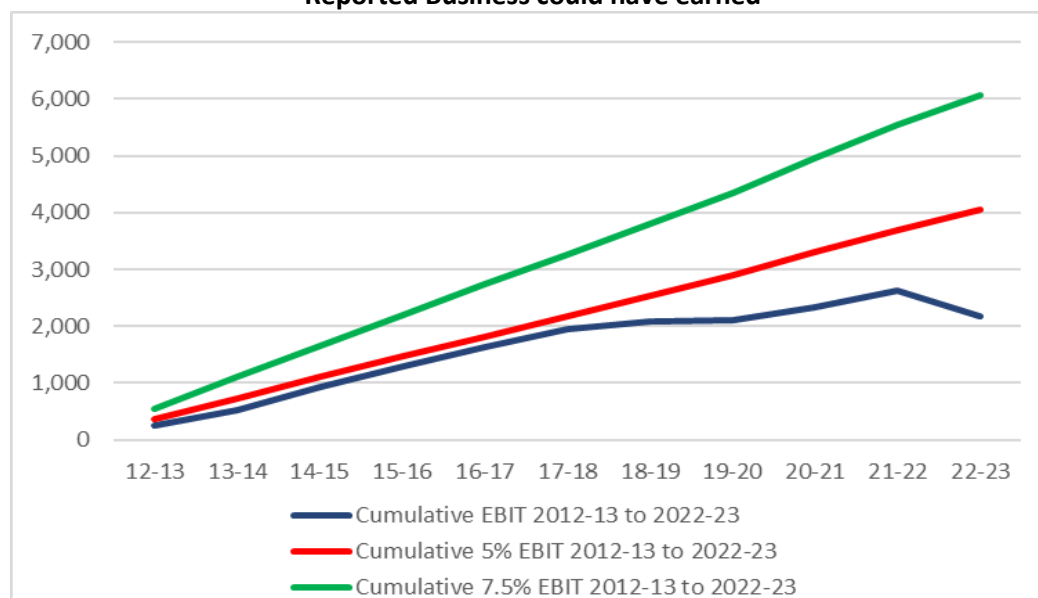
2.30 Royal Mail is a privatised company facing competition in letters and parcels. We have every incentive to improve our efficiency, invest in the future of our business and compete through offering high quality, fairly priced products to our customers. We have set out our actions to improve our financial performance in Chapter 3.

USO reform is urgent –“The evidence indicates an increasing risk of the current obligations becoming unsustainable both financially and operationally.”²³

2.31 Since 2020, we have called for USO reform due to changing customer needs and the very significant cost of providing the USO. Ofcom has now found that there is a considerable and unfair financial burden in providing the USO. It has estimated that Royal Mail incurred a net cost of £325m - £675m (in 2021/22) as a consequence of being the USO provider which equates to a cost of £1m - £2m per day. It is manifestly unfair that a publicly listed company should bear this material cost the benefits of the USO accrue to all UK consumers and businesses and the UK more widely, rather than the investors in Royal Mail. We discuss the net cost further in Chapter 3.

2.32 The chart below shows the cumulative Reported Business EBIT (blue line) for 2012/13 to 2022/23 compared to an indicative EBIT if the Reported Business had earned a 5% EBIT margin (red line) and a 7.5% margin (green line). Between 2012/13 and 2017/18, our EBIT margin tracked relatively closely to the bottom of Ofcom’s indicative 5-10% margin range. Since 2018/19, the EBIT earned has materially deviated from the 5% minimum. Had we earned the minimum profit required by Ofcom to ensure a sustainable USO over this period, we would have earned c. £4bn. Had we earned a 7.5% (mid-point of Ofcom’s commercial rate of return) EBIT margin, we would have earned c. £6bn. We actually earned c. £2bn.

Figure 2.7 – Cumulative Reported Business EBIT 2012/13 to 2022/23 compared to what the Reported Business could have earned



²³ CFI, Overview: In Summary.

Other postal regulators have adapted to fundamental letter market shifts but the UK remains stuck in the past

- 2.33 The UK is not alone in the challenges we face. We face a significant risk of hitting a ‘tipping point’ in structural decline of letter volumes similar to that which other European postal operators have experienced. UK letter volume decline has, to date, been around the mid-point of international comparisons. But other countries have shown significantly larger increases and show that dramatic reductions in volume can happen quickly. For example, letter volume in Denmark has declined 87% since 2001.²⁴
- 2.34 Royal Mail appointed Frontier Economics as a specialist economic consultancy to review the key trends driving USO change. They found that falling letter volumes per capita were an important driver. Early movers for USO change, such as Denmark, tended to be those who had lower per capita letter volumes. Countries with similar per capita letter volumes, such as France and Germany, have or are considering changes to the USO now. The UK’s per capita addressed letter volumes is below the level at which several other countries have made changes to their USO. We are one of the few comparable countries that has not reformed the USO in response to significant structural letter decline. For more information on international benchmarking see Chapter 9.
- 2.35 Frontier Economics also found that financial sustainability was a key driver of USO reform in other countries. Other factors also mattered. The chart below shows that for 11 countries where there has been change, financial sustainability was relevant in each of them. Further, in most circumstances, other reasons such as consumer needs also played a role in the need for change.

Figure 2.8 Financial sustainability is the key driver of change --but other factors also matter²⁵

Country	Financial sustainability	Consumer needs	Change in government policy	Improve competition	Environment impact	Reduce need for subsidy
Belgium	✓	✓				
Canada	✓					
Denmark	✓		✓			
Finland	✓	✓		✓		
France	✓				✓	
Germany	✓				✓	
Italy	✓					
Netherlands	✓	✓				
New Zealand	✓	✓				✓
Norway	✓	✓			✓	✓
Sweden	✓				✓	✓

Source: Frontier Economics review of company and regulator documents

- 2.36 It is clear from international experience that the UK is stuck in the past. The UK USO is no longer fit for purpose. We need USO reform to better meet customer needs and address significant financial sustainability concerns; and we need reform urgently.

²⁴ Economics & Business Forecasting calculations using domestic addressed volume data from IPC (November 2023) and reports by operators and regulators

²⁵ See Annex 9 for the Frontier Economics’ report “USO benchmarking review findings”.

The CFI does not reflect the urgent need for reform

2.37 This chapter has set out:

- Letters are in significant permanent structural decline despite the innovations we have brought to market;
- Parcel volumes have grown but historically not quickly enough to offset letter decline;
- The USO drives a high fixed cost network particularly in delivery and has not been changed in over 20 years;
- These market dynamics have resulted in financial sustainability concerns over a number of years, culminating in significant losses in 2022/23 and 2023/24 HY; and
- Ofcom has recognised that the USO, in its current form, may no longer be sustainable.

2.38 Urgent change is needed to reform the USO to meet customer needs and to put it on a sound financial footing. Swift changes to the regulatory conditions are within Ofcom's gift. We ask that:

- Ofcom consults on proposed changes to the regulations by summer/autumn 2024; and
- Ofcom concludes the consultation before Christmas 2024 and issues its decision in early 2025 to take effect from 1 April 2025.

3 Significant cost of being the USO provider

Key messages:

- We agree with Ofcom that “*providing the USO imposes a significant net cost on Royal Mail*”²⁶ and that it is “*likely to be unfair*”²⁷ that Royal Mail’s shareholders bear this cost. The scale of the net cost, coupled with the underlying financial performance of Royal Mail, demonstrates the urgency for USO reform.
- The significant net cost negatively affects consumers through: higher prices than they otherwise would be; constraining our ability to invest to transform and innovate; constraining our ability to meet Quality of Service (QoS) levels; and threatening the financial sustainability of the USO.
- USO reform must provide for a financially sustainable USO. If the regulatory reforms we set out in this submission are not granted, and there remains a significant net cost after reform then other options must be considered.
- Given the significant net cost burden of the USO to Royal Mail (£325m-£675m), which has been borne by Royal Mail since at least 2021/22, whilst the process of regulatory reform is ongoing and during any period of implementing change, we call for Government to consider making a temporary contribution to address the net cost of the USO. The case for a temporary contribution is even more imperative **if Ofcom delay urgently needed regulatory reform** until after a General Election.
- To strengthen the regulatory framework, we ask Ofcom to review the costing methodology in the regulatory accounts. This provides an opportunity to ensure the regulatory accounts reflect the true cost of providing the USO. This will provide enhanced transparency to all stakeholders.

We agree with Ofcom that “*providing the USO imposes a significant net cost on Royal Mail*”²⁸

- 3.1 Ofcom has estimated the net cost burden of USO provision is in the range of £325m to £675m in 2021/22.²⁹ Ofcom’s estimate, coupled with Royal Mail’s recent losses, demonstrates the urgency for USO reform to secure the financial sustainability of the USO.
- 3.2 Ofcom’s calculation of the net cost of the USO is welcome. Having transparency of Ofcom’s view of the net cost of provision is helpful to frame Ofcom’s national debate on the USO. All stakeholders have the opportunity of reviewing and understanding the sizeable burden that Royal Mail is bearing today. In Annex 2, we set out detailed comments on Ofcom’s methodology and approach.

We agree that “*as a starting point, imposing that financial burden on Royal Mail is likely to be unfair*”³⁰

- 3.3 The USO delivers significant benefits to UK consumers and businesses, with affordable and uniform prices supporting economic and social activity throughout the UK, particularly promoting economic growth in regions that might otherwise not have had access to a Universal Service.

²⁶ CFI, paragraph 8.42.

²⁷ Ibid, paragraph 8.38.

²⁸ Ibid, paragraph 8.42.

²⁹ Ibid, paragraph 8.27

³⁰ Ibid, paragraph 8.38

3.4 In view of the significant benefits that accrue to the whole of society from the USO we agree with Ofcom it is unfair that a publicly listed company should bear the full burden of the material net cost of providing the USO. The UK postal USO was designed over 20 years ago, it has not kept up with customer needs and is firmly stuck in the past.

3.5 Ofcom set out the factors which it considers in relation to fairness which included:

- **Is the net cost burden transitory?** No. We have been calling publicly for reform since 2020 in recognition that the USO needs to be modernised. Without USO reform, we will continue to need to provide a six-days a week delivery service for all letters even though customers are no longer using all our letter services to the same extent. The burden of provision remains;
- **Is the net cost burden material?** Yes. Ofcom has estimated the range as £325m to £675m in 2021/22.³¹ This is clearly material. Ofcom has stated *“we note that our initial estimate of the current financial burden set out in this chapter is significant. We also consider that this financial burden is likely to increase in the future, mainly due to the continued decline in letter volumes”*.³² Ofcom’s range of net cost saving is 4% to 9% of Royal Mail’s 2022/23 costs.³³ A cost saving in the middle of this range would have addressed our loss for 2022/23.³⁴ We agree with Ofcom that, in the context of Royal Mail’s finances, this is significant; and
- We note that Ofcom’s calculation of the net cost does not include intangible benefits. These are likely to be de minimis as Ofcom has set out *“we do not expect that including the impact of any intangible benefits in the net cost would significantly change the range we have calculated, given its size, nor would it change the key findings we have set out in this document.”*³⁵

3.6 We are not aware of any arguments – bar the points Ofcom has raised above - as to why a material non-transitory net cost incurred to meet recognised wider social and economic objectives should be borne by a single publicly listed company. We concur with Ofcom that *“we have not identified any reasons why a net burden of the order we have estimated is likely to be fair.”*³⁶

The impact of the significant net cost will negatively affect consumers

3.7 In its CFI, Ofcom has set out how a significant net cost could affect consumers. This is through:

- **Higher prices** – Ofcom has stated *“If the obligation to deliver universal services is beyond a level that is needed by users (as suggested in chapter 5), then it is likely that the net costs of that obligation (or at least part of them) would have to be recovered from users via excess pricing. In other words, it could lead to consumers paying higher prices than necessary for USO products.”*³⁷ We agree. Our prices are informed by our costs. A reduced ability to invest, innovate and achieve efficiencies will lead to higher costs which have likely led to higher prices than if the USO imposed no unfair burden. We carefully consider our price changes, taking account of inflation and the sensitivity of customers’ demand to prices and the risk of hitting tipping points in customer behaviour. Given the demand characteristics we face in both letters and parcels we cannot simply price our way to financial sustainability;

³¹ Ibid, paragraph 8.27.

³² Ibid, paragraph 8.40.

³³ Royal Mail’s operating costs (including transition costs) were £7,830m for 2022/23

³⁴ Royal Mail lost £419m in 2022/23.

³⁵ Ofcom, CFI, A7.93.

³⁶ Ibid, paragraph 8.41.

³⁷ Ibid, paragraph 8.45

- **Less capital investment so less innovation** – Ofcom stated that *“this net cost limits Royal Mail’s capacity to invest and restructure its network to respond to customer needs (such as reliability in letter delivery and more service options in parcels), and its capacity to innovate and remain competitive (which is ultimately detrimental to consumers).”*³⁸ We agree that Royal Mail’s financial difficulties have inevitably resulted in tight capital management. As set out in Royal Mail’s 2023/24 HY results, Royal Mail needed to be stabilised in the short term. We had to take difficult choices on investment reprioritisation; and
- **Operational issues** – Ofcom *“recognise that the extent and the net cost of the obligation could contribute to the challenges in meeting QoS levels.”*³⁹ We agree. A cash-constrained company does not have a limitless ability to invest in quality while at the same time there is an unrelenting focus on driving efficiency.

3.8 Ofcom has also explained that there is a significant impact on Royal Mail. It stated that *“clearly the financial burden of the USO makes a material contribution to those challenges”*⁴⁰ Royal Mail faces in relation to financial sustainability.

3.9 However, we disagree with Ofcom’s statement that *“Royal Mail has struggled to meet its obligation to deliver its USO services efficiently as it has regularly failed to meet its efficiency targets over the years since privatisation”*.⁴¹ It does not give due credit for the significant steps in efficiency that Royal Mail has taken since privatisation. For example, in 2016 Ofcom recognised our *“progress on efficiency in recent years”*.⁴² We explain below what we have done to improve our financial position.

We have delivered on efficiency and continue to have ambitious efficiency targets

3.10 Royal Mail is a privatised company facing competition in letters and parcels. We have all the incentives we need to improve our efficiency, invest in the future of our business, and compete through offering high quality fairly priced products to our customers. As Ofcom has stated *“we consider that market conditions and shareholder pressures provide Royal Mail with incentives to make efficiency gains in order to maximise profits (and ultimately shareholder returns)”*.⁴³ Royal Mail has taken a range of actions to improve its financial performance as set out below.

³⁸ CFI, paragraph 8.45.

³⁹ Ibid, paragraph 8.47.

⁴⁰ Ofcom, CFI, 8.43

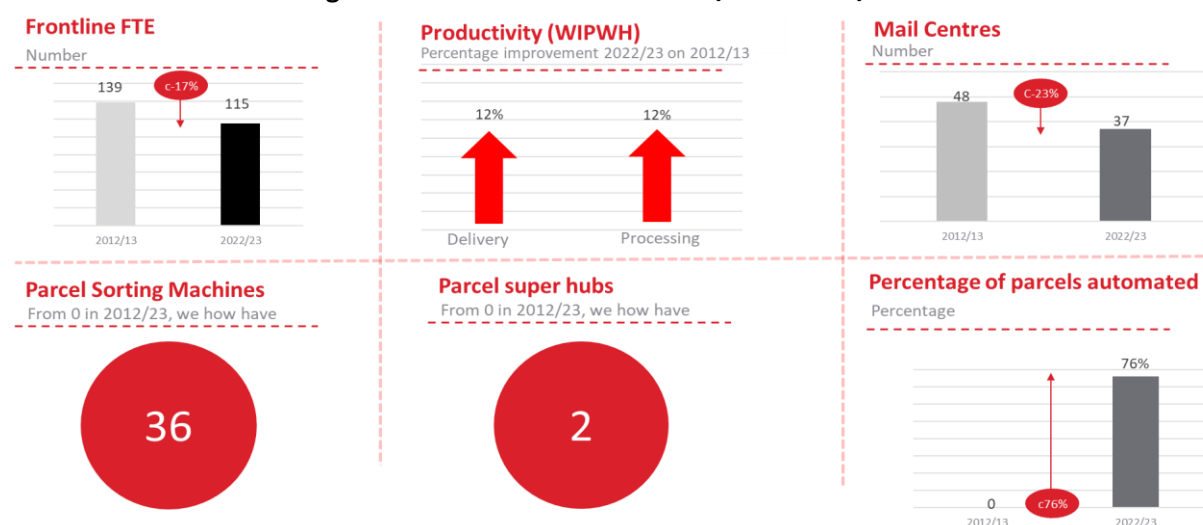
⁴¹ Ibid, paragraph 8.43

⁴² Ofcom, Review of the Regulation of Royal Mail, 25 May 2016, paragraph 4.71

⁴³ Ofcom, 2022 Review of Postal Regulation, 18 July 2022, paragraph 4.38.

Transformation since privatisation

Figure 3.1 – innovation from 2012/13 to 2022/23⁴⁴



- 3.11 See Chapter 2 and Annex 1 for a summary of the actions we have taken to keep letters relevant for our customers. For example, investing in the Delivery to Specification programme, has enabled Royal Mail to launch our Access Economy product with cheaper pricing for the benefit of our Access customers.
- 3.12 Clearly, the pace at which we can invest in further customer innovation and efficiency is constrained by our cashflow, which of course is constrained by the current USO and the significant net cost burden of being the USO provider.

The need for an innovative solution to replace an unaffordable Defined Benefit Pension Scheme

- 3.13 In March 2018, we closed our Defined Benefit Pension Scheme to career average accrual. This was difficult for our staff but necessary for the financial sustainability of the business. This initiative required innovative thinking, finding consensus on a solution with our unions and our people, and significant investment in both the development and implementation set up costs of a new scheme.
- 3.14 There was detailed discussion with our unions on the need for this change plus recognition that there needed to be a new pension scheme. In conjunction with our Unions, a new innovative pension proposal (Collective Defined Contribution, or CDC) was developed, it provides members with an income in retirement, and it gives Royal Mail stable and predictable pension costs.
- 3.15 This required pension legislative change which we have been working hard to achieve. Government introduced the primary legislation in 2021 and further secondary legislation has followed since, most recently in early 2024.
- 3.16 Closing to career average accrual avoided additional cash costs of £800m p.a. from April 2018⁴⁵, equivalent to a 10% efficiency (using Ofcom's 'price, volume, efficiency and other' – PVEO approach). But Ofcom's efficiency metric did not recognise this significant and difficult change. Ofcom's approach to measuring efficiency significantly underestimated the efficiency benefit from this approach and indeed the benefit to financial sustainability and underlying cashflow.

⁴⁴ Weighted Items Per Work Hour (WIPWH)

⁴⁵ Royal Mail, 2017-18 Annual Results. The Royal Mail Defined Benefit Pension scheme was closed to future accrual "to avoid expected increase in cash contributions to around £1.2 billion per annum" and "It is anticipated that the ongoing annual cash cost of pensions to the Company will continue to be around £400 million." This is therefore a net avoided cost of £0.8bn.

Activities since 2022/23

3.17 As set out in Chapter 2, we had to progress an overdue radical, structural transformation agenda to address our difficult financial position. Following 18 days of industrial action in 2022, we signed an agreement with the CWU that included:

- seasonal hours for delivery staff to manage efficiently the peaks and troughs of mail in our business efficiently across the year;
- a new absence policy to tackle high absence rates and frontline performance management; and
- later start times for our delivery staff to improve our environmental footprint, deliver cost efficiency and improve quality of service by reducing our reliance on flights.

3.18 In addition, we progressed with:

- the introduction of new starter terms and conditions for c. 9,000 employees⁴⁶ who are now on more modern, sustainable terms and conditions; and
- the imminent introduction of a new and comprehensive frontline performance management mechanism for the first time in Royal Mail's history to drive quality and performance for customers.

3.19 But due to our difficult financial position, we had to take short-term actions in 2023/24 to address Royal Mail's cash position. We are doing what we can to stabilise Royal Mail after performance had suffered due to industrial action and customer losses. At the half-year 2023/24, we announced the following short-term actions:

- new cash management approach with tighter financial controls, strategic sourcing, and capital investment reductions. We had to take difficult choices on investment reprioritisation;
- reductions to non-core costs; and
- targeted price increases to offset inflation and costs of USO.

Ofcom (with Government support) need to take urgent action to help us address the significant fixed costs in our delivery operation

3.20 We have taken difficult decisions to enable us to transform and become more efficient. We have made measured pricing increases where we can, and we are transforming our business through significant operational change.

3.21 However, our 'self-help' activities are insufficient to address the financial challenges that Royal Mail faces. To unlock further significant efficiency saving, we need USO reform as we cannot reduce the significant fixed cost in delivery without regulatory change. Around 50% of our cost is in delivery. These costs are largely fixed and exist to meet the requirements of today's six days a week USO letter delivery service. We need Ofcom to urgently make the regulatory changes set out in this submission to create the platform for us to transform our delivery network.

⁴⁶ As at October 2023

There is now a clear public policy issue on how to respond to the significant unfair burden on Royal Mail – price increases, USO reform, compensation for the net cost or a combination of all three

- 3.22 In this document, we have set out our proposals for USO reform and why our customer-driven solution is right for customers and Royal Mail. Our preference is for USO reform – our proposal addresses the significant net cost burden at the lower end of Ofcom’s range. With appropriate and proportionate changes to the USO, it would be possible to make a significant improvement to the finances of the universal service.
- 3.23 Government (or Ofcom) may decide that the current USO is appropriate or put in place a reformed USO that continues to be an unfair burden for Royal Mail. If this occurs, then, as a publicly listed company, we need to be compensated for a level of provision that drives a material cost into our business.
- 3.24 We believe Ofcom prefers USO reform over Government funding as it has assessed that the current USO is over-specified for consumers and SMEs. But Ofcom recognises that this is a decision for Government. *“While subsidy does present a potential way of maintaining the current USO specification, our assessment is that the current USO letters specification goes beyond that required to meet reasonable users’ needs. Therefore, adapting the USO specification is likely to be preferable to using subsidy to maintain the existing levels of service and products, although this would ultimately be a decision for government.”*⁴⁷

Other countries where there has been a significant net cost have had USO reform, price increases or funding, or a combination of all three.

- 3.25 Frontier Economics found that a number of comparator countries have made, or are making material changes to their USO: including speed, frequency, quality of service, and/or delivery point. Of those that have not changed, Frontier Economics noted that several have stated that the net cost of the USO is totally financed by state funds. See chart below.

Figure 3.2 International experience of USO reform⁴⁸

- The below 18 countries have all made changes to their USO specification in the last 10 years.
- Of those countries that have not changed, the majority are Central Eastern European countries.
- Several of those have stated that the net cost of the USO is totally financed from State funds.*

Country***	Delivery frequency	Delivery speed	QoS	Delivery point****
Austria			X	
Belgium	X	X	X	
Canada				X
Czech Republic	X			
Denmark	X	X		
Finland	X	X	X	
France		X		
Germany**	X		X	
Greece			X	
Italy	X		X	
Latvia			X	
Netherlands	X			X
New Zealand	X	X		
Norway	X	X	X	
Romania			X	
Slovakia			X	
Slovenia			X	
Sweden	X	X		

Source: ERGP, Report on the Future needs of the USO, 2023

Note: * For example, Bulgaria, Estonia, Croatia, Hungary, Lithuania (source: ERGP report); ** Germany is currently consulting on changes *** Countries in the sample that are not listed here had no material change in USO scope; **** Delivery point changes relate to increased use of public mailboxes in certain areas.

⁴⁷ CFI, paragraph 9.86.

⁴⁸ See Annex 9 for the Frontier Economics’ report “USO benchmarking review findings”.

If there is no appropriate reform to the USO, then Government must step in and contribute to the cost of delivering the USO

- 3.26 If there is not sufficient reform to the USO, then it must be because Government (and consumers and SMEs) want the USO to remain in its current form or be modified in a way that would continue to constitute an unfair burden for Royal Mail. In such a case, it must be that Government considers that the wider social and economic benefits of the reformed USO outweigh its costs. It therefore follows that Government and/or customers should pay for the net cost of the USO. Customers are not doing so – there is only a third of the letter volume now that there was in 2004/05. In which case, it is the role of the Government to step in.
- 3.27 Ofcom’s estimate of the net cost burden of the USO was between £325m - £675m in 2021-22. This is a significant and unfair burden for a publicly limited company that has made considerable losses in 2022-23 and at HY 2023-24.
- 3.28 Ofcom has stated that *“While subsidy does present a potential way of maintaining the current USO specification, our assessment is that the current USO letters specification goes beyond that required to meet reasonable users’ needs. Therefore, adapting the USO specification is likely to be preferable to using subsidy to maintain the existing levels of service and products, although this would ultimately be a decision for government.”*⁴⁹
- 3.29 Should Ofcom conclude changes as part of this process, that are not sufficient to remove the financial burden on Royal Mail, then Government must step in and fund the cost of the over provision of the USO. We cannot let an unfunded USO burden continue.

If there is no sufficient reform to the USO and no commitment from the Government to fund the USO, then Royal Mail will need to take more radical action

- 3.30 Royal Mail is incurring material losses while, at the same time, bearing the significant and unfair net cost of being the USO provider. We will need to consider what further actions (above and beyond our 2023 business plan) are necessary to secure the finances of Royal Mail and protect the interests of our shareholders. Without reform to the USO, the greater the risk to the financial sustainability and the greater the risk that more significant action will need to be taken to secure the provision of a financially sustainable USO.
- 3.31 Actions to stabilise Royal Mail could include further and significant price increases. We carefully consider our prices, and we seek to keep prices to a level that delivers good value for money for our customers whilst allowing us to make a reasonable return. This is hard in the face of increasing cost pressures, declining letter volumes and lack of USO reform. It is inevitable that with declining letter volumes and a fixed cost network, the reality is letter prices need to rise each year. Pushing our prices too high risks a ‘spiral of doom’ where:
- Royal Mail increases prices to address profitability concerns;
 - prices increases are at a level that trigger a ‘tipping point’ in customer behaviour – we do not know precisely where this lies;
 - customers significantly reduce volumes leading to, lowering revenues;
 - Royal Mail removes variable cost, but fixed cost remains exacerbating further our challenging financial position; and
 - attempting to restore our margins through further price increases to address profitability concerns takes us back to the start.

⁴⁹ Ibid.

- 3.32 The current cost burden of the USO places severe constraints on Royal Mail's ability to invest in the environment and to deliver greener products and services to consumers, such as increased zero emission final mile deliveries and related infrastructure, and investment in new low carbon building and transport technologies.
- 3.33 Inevitably, if we cannot make a commercial rate of return due to the sizeable net cost burden of being the USO provider, even after price rises, then the long term future of the UK postal USO in its current form is at risk.

We call for Government to make a temporary contribution

- 3.34 In addition to the need to consider the longer-term financial sustainability of the USO, Ofcom's assessment indicates that Royal Mail has incurred a substantial financial cost for the delivery of the USO. Even based on the lower end of Ofcom's estimate of £325m p.a. net USO cost, Royal Mail's funding of the cost of the USO since 2021/2022 will be close to £1bn by the end of this financial year. This is during a period when the cumulative net losses of Royal Mail exceeded £300m.⁵⁰
- 3.35 We have been calling for USO reform for the last four years. However, we have serious concerns that the urgency of the situation is not properly recognised. In the Executive Summary and Chapter 2, we have asked Ofcom to act faster than its CFI states "*provide an update in the summer*"⁵¹ of 2024. We need new regulations to be in place by April 2025 at the latest. Thereafter it would take around 18-24 months to fully implement the new delivery model over our UK-wide footprint. But, in the meantime, Royal Mail will continue to incur the significant costs of a disproportionate USO that exceeds the needs of customers. This is manifestly unfair.
- 3.36 Royal Mail has already made a substantial contribution to the funding of the USO. Given the now recognised significant net cost burden of providing the USO, whilst the process of regulatory reform is ongoing and during any period of implementing change, Government must consider a temporary contribution. The need for a temporary contribution becomes even more critical if Ofcom chooses not to proceed with the relatively straightforward regulatory change set out in this submission because of a General Election this year. This is simply 'kicking the can down the road' again.

We ask Ofcom to review the costing methodology in the regulatory accounts to ensure they reflect the true cost of providing the USO

- 3.37 Ofcom dictates the costing methodology to be used in the regulatory accounts. Ofcom acknowledges that the current methodology "*is not appropriate for net cost considerations*".⁵² We agree with Ofcom. In fact, we have considered this point sufficiently important to highlight it in the introduction to the regulatory accounts – setting out that the regulatory accounts do not reflect the true cost of the USO. Given the size and burden of the net cost and the losses Royal Mail faces, it is more important to use the regulatory accounts to assess the net cost rather than for monitoring purposes.

⁵⁰ Royal Mail adjusted operating profit/loss from 2021/22 to half-year 2023/24, source: IDS plc financial results.

⁵¹ CFI, paragraph 9.93

⁵² Ibid, paragraph A7.29

4 Our proposed reforms put customers first

Key messages:

- We commissioned detailed independent customer research to understand what our customers want from our letter services. There is still a strong desire to use post despite the structural decline in letter volumes. Geographic universality and the “one price goes anywhere” remain very important.
- Reliability is paramount for all our customers.
- Affordability for all is considered important.
- Our customers want choice and the option of a priority (First Class) service when they need it.
- User needs would be met with less frequent non-priority letter delivery. Whilst large businesses do want frequent deliveries, they also want to know that their mail will be delivered on time.
- Tracking on parcels is becoming even more important for our customers.

Building a modern and sustainable USO by putting customers first

- 4.1 Royal Mail is committed to creating a modern and sustainable postal service that meets the changing needs of our customers. Throughout the process of exploring reform options, we extensively consulted with customers including consumers, SMEs and large businesses.

Figure 4.1: Approach to research

Consumers and SMEs

During August and September 2023, Royal Mail commissioned Illuminas to independently conduct over 3,000 interviews with consumers and 500 interviews with SMEs. The main objectives of the research were to understand current usage of the USO, how demand for Royal Mail’s services is likely to change over the coming years and how customers will be affected by potential changes to the USO, with a particular focus on delivery speeds and the frequency of letter deliveries.

The residential interviews covered all key UK socio-demographics including those living with a disability, those aged 65 or over, people on low incomes and those living in rural areas. Business interviews were conducted with a broadly representative sample of the UK SME business base.

The research followed a similar structure and methodology to the User Needs Research programme we conducted in August and September 2019 and enables us to compare behaviour, preferences and intent over the past four years.

Large business customers

To gain insight into the needs of large businesses, we commissioned B2B International to conduct qualitative research with 48 large businesses between September and November 2023. Our aim was to investigate how and why large business customers currently perceive and integrate our services into their own customer and marketing communications, as well as the benefits they derive from using mail. The insights gathered from this research enabled us to gain a sector and segment specific understanding of how changes to the USO will affect their end consumers, as well as how they are likely to respond.

Key findings

- 4.2 Geographic universality and the “one price goes anywhere” element of the USO remain very important with 82% of consumers and 87% of SMEs stating that ‘same price for same speed of delivery anywhere in the UK’ is very or fairly important.
- 4.3 ‘Affordability for all’ is considered important by 95% (up 2% since 2019) of consumers and 96% of SMEs. Reliability is paramount also for large businesses that depend on our delivery services to meet their customer needs.
- 4.4 There is a clear preference for maintaining a choice of service, with 82% of consumers and 83% of SMEs highlighting its importance. Our customer research shows residential customers, SMEs and large businesses all express a strong preference for retaining a priority (First Class) service.
- 4.5 Delivery of non-priority letters reduced to two days a week would meet the needs of the vast majority of consumers (92%) and SMEs (93%) if the First Class service were retained at six days a week. Large businesses were also willing to accept small changes to delivery frequency, particularly within marketing communications, where their mail is typically not urgent or expected. However, they emphasised the importance of having an option to send urgent mail and reliability on deliveries completed on time.
- 4.6 Tracking on parcels is becoming even more important. The appeal of tracking and need to track the end-to-end process has grown significantly since 2019. For residential customers this increased to 84% (from 63%). For businesses it is up by c. 20% in each category across First Class and Second Class letters and parcels since 2019.
- 4.7 We explore these themes in more detail in the rest of this chapter. Further detail on our customer research is in Annex 8.

Universal pricing: one price, any destination in the UK

- 4.8 The geographic universality feature of the USO ensures that basic communication services are accessible to individuals regardless of their location, whether in urban or rural areas. This commitment aims to reduce the digital divide, ensuring that everyone has equal access to connectivity and participation in society, regardless of where they live.
- 4.9 82% of consumers emphasise the significance of having uniform pricing for delivery services across all regions of the UK. We recognise the findings of Ofcom's research, which highlights how uniform pricing contributes to simplicity and ease of use for consumers, identifying it as a fundamental component of the USO. Aligning with Ofcom's 2020 study, its most recent research shows that two thirds (66%) value the universal pricing of Royal Mail services.⁵³
- 4.10 Likewise, 87% of SMEs appreciate the universal pricing aspect of the USO. The significance of universality has notably risen among SMEs, up from 76% in 2019.
- 4.11 We therefore remain committed to providing a USO with the one price goes anywhere principle.

Reliability matters

- 4.12 Our own customer research, especially among large businesses, underlined that speed of delivery is of lesser importance compared to reliability. Customers prioritise reliability (delivery specifications) over speed (quick delivery), emphasising why quality of service remains a primary focus for our company. Discussions with our large business customers across different sectors including publishers, medical, utility, and finance highlighted the critical nature of Royal

⁵³ CFI, paragraph 5.8.

Mail providing a dependable service, as any shortcomings can directly impact their operations and the service they extend to their customers.

- 4.13 We recognise that quality has not been where it needs to be and we have outlined our plans to improve performance.⁵⁴ However, there needs to be a reset on the regulated quality of service targets, rebalancing speed and reliability, to give customers further confidence in the service they would receive (see Chapter 6).

Affordability matters

- 4.14 95% of consumers and 96% of SMEs emphasised the importance of affordability for all. Our research is consistent with Ofcom's findings that 91% value an affordable USO.⁵⁵ This highlights the importance of maintaining accessible prices for our customers.
- 4.15 Chapter 8 provides further detail on affordability.

Customers value having choice

- 4.16 With consumers sending letters less frequently and a decrease in the urgency of their correspondence, slower mail services typically align with their mailing needs. However, there are occasions when a faster service is necessary, highlighting the value of having a First Class option available when required. This is consistent with Ofcom's research.⁵⁶
- 4.17 81% of consumers emphasise the importance of having a choice between a First and Second Class service, while 83% of SMEs underscore the significance of offering a choice between First and Second Class delivery—an important increase from 65% in 2019.
- 4.18 Our consumer and SME research demonstrates that the elimination of the First Class service markedly decreases the percentage of both consumers and SMEs whose needs are met. SMEs, in particular, find a single-tier service unattractive as it does not offer them sufficient choice and flexibility to meet their needs effectively. Large businesses also highlighted the critical need for a faster delivery service being available to them. They also highlighted that reliable and timely deliveries are integral to the success of many of their business models.

Rethinking letter delivery frequency for customer needs today and in the future

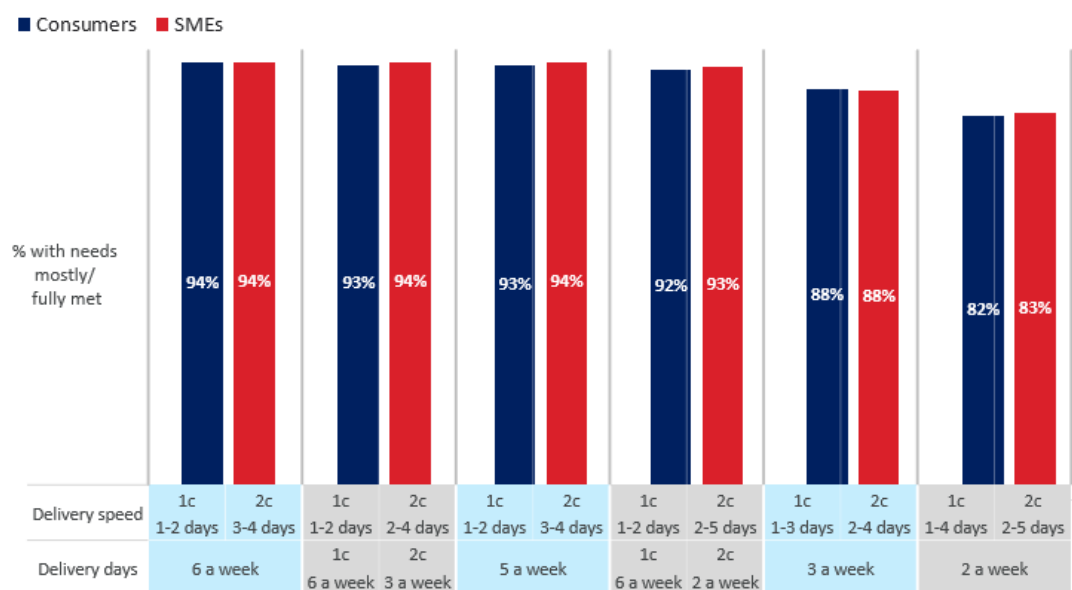
- 4.19 Our research findings, which are similar to Ofcom's findings, indicate that the vast majority of consumers are willing to accept fewer letter delivery days per week (see figure below). Customers are sending fewer urgent letters.

⁵⁴ IDS Half Year Results 23-24 (2023) internationaldistributionsservices.com/media/12139/ids-plc-hy-2023-24-results-rns-16-11-23.pdf

⁵⁵ CFI, paragraph 5.19.

⁵⁶ CFI, paragraph 5.17.

Figure 4.2: Simulation of consumer and SME needs met by USO with different letter delivery days and speeds



Consumer survey respondents (n = 3150). SME survey respondents (n = 500)

- 4.20 As can be seen from the figure above, reducing letter delivery days from six to five days a week would have almost no impact on the proportion of consumer and SME needs that would be met by the USO. The USO would fully or mostly meet the needs of 93% of people, compared with 94% with the current six days-a-week letter delivery. Further reducing delivery days to two days-a-week would result in the USO services still meeting the needs of over four-fifths of consumers and SMEs.
- 4.21 Reducing Second Class letter delivery frequency to three days a week, provided the option of a First Class service is unchanged, would have a minimal reduction (1%), shown in the second pair of bars in figure above in the proportion of consumers whose needs are met. Similarly, there would be no impact on SMEs.
- 4.22 Further reducing Second Class letter delivery frequency to two days a week, with the current First Class service unchanged, would meet the needs of 92% of consumers and 93% of SMEs, shown in the fourth pair of bars above. Given that the current USO was found to meet the needs of 94% of both consumers and SMEs, the change to delivery frequency would again have minimal impact on both consumers and SMEs.
- 4.23 As Ofcom’s research also found, receiving letters every two to three days would be acceptable for the majority of respondents, including the groups it defines as “vulnerable”.⁵⁷ Our consumer research shows that the proposed reform meets the needs of 92% of individuals aged 65 and above, as well as those residing in rural areas and those without internet access. Moreover, it satisfies the needs of 91% of individuals with lower incomes and 90% of those with disabilities.
- 4.24 Our large business research highlighted the possibility of exploring a less frequent delivery service, such as a two or three-day delivery option, if prices were significantly lower for both First and Second Class services. Businesses could opt for this option for non-time-sensitive mail, provided they are confident with the associated delivery timeframes. However, our research found that relying solely on this service is unlikely to be sufficient, as there are occasions when large businesses and organisations need to send urgent mail as well – particularly in the case of medical, utilities and financial services correspondence.

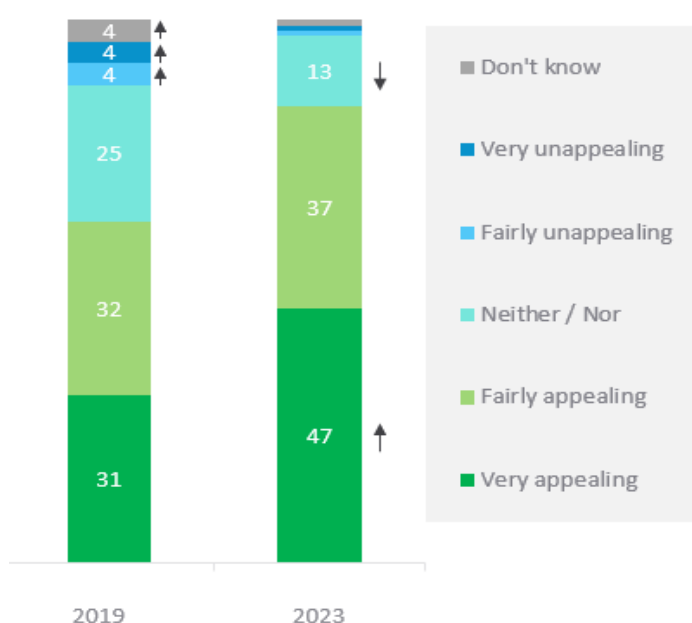
⁵⁷ CFI, paragraph 5.33.

- 4.25 Since 2020, the importance of Saturday deliveries for letters has decreased to 58%.⁵⁸ Furthermore, Ofcom’s research suggests that users are generally satisfied with not receiving mail on weekends, as they typically do not engage with it during that time.⁵⁹
- 4.26 While most businesses do not deem Saturday delivery essential, a smaller segment depends on it and considers it crucial for their operations. In particular, the publishing industry relies heavily on Saturday deliveries, with publishers often scheduling magazines and newspapers to arrive as weekend reading. Hence, we are committed to maintaining the option to send letters using the six-day-a-week First Class service which will include Saturday delivery.

Customers increasingly want tracking as a core feature

- 4.27 The appeal of tracking for parcels and large letters has grown significantly since 2019, among both consumer and SMEs.

Figure 4.3: Appeal or tracking: consumers and SMEs⁶⁰



- 4.28 As figure 4.3 shows, the proportion of consumers, finding it very or fairly appealing has increased from 63% in 2019 to 84% in 2023[1]. For business customers the trend is similar. Tracking has become more important than it was in 2019, across large letters and parcels, as well as First and Second Class. Tracking is especially important for parcels. It is especially important for businesses to be able to track First Class parcels, and 87% would like to be able to do this, up from 67% in 2019. For Second Class parcels the comparative figures are 75% today and 59% in 2019.

- 4.29 In terms of large letters, again it is more important for SMEs to have the ability to track First Class post (73%) than Second Class (61%). In 2019 tracking was considered important for First Class large letters by 46% and for Second Class large letters by just 36% so both are significant increases over four years.

⁵⁸ Yonder, 2023. Consumer Survey Research on Post, slide 9.

⁵⁹ CFI, paragraph 9.22.

⁶⁰ Source: O3a. How appealing is it to have the option of tracking large letters or parcels that you send First or Second Class in the UK with Royal Mail? Base: All Residential respondents 2019 (n = 2027) 2023 (n = 3150).

4.30 According to Ofcom's research, certain vulnerable consumers, such as those who are deaf or have hearing loss, consider tracking and Signed For options crucial to avoid missing parcels.⁶¹ Moreover, frequent users noted that their expectations of Royal Mail have risen alongside the evolving competition. Consumers feel that Royal Mail must use technology more effectively, including enhancing tracking options and providing flexible delivery slots, to maintain its competitiveness.⁶² See Chapter 7 for further details on tracking on USO parcels.

Conclusion

4.31 As set out in the next chapter, we have used the key findings from our extensive engagement with all customer groups to develop a proposal that aligns with their needs and requirements while also supporting the financial sustainability of the USO.

⁶¹ Jigsaw, 2023. Understanding the needs of postal service users: A report of findings from qualitative research, with a focus on potentially vulnerable groups, slide 24.

⁶² Ibid, slide 54.

5 Our proposal

Key messages:

- We have structured our proposal to: (1) meet customer needs; (2) address the financial sustainability challenges of Royal Mail; and (3) be good for our people.
- Our reform proposal protects what customers continue to value: it maintains the one price goes anywhere service to all parts of the UK; the choice of First Class USO letters delivered to the same timescales, six days a week; and parcel services delivered six (or increasingly seven) days a week.
- To reflect changing customer needs, we propose to enhance and modernise the USO with new regulated reliability QoS targets, and by including tracking for parcels in the USO and introducing a new Special Delivery Guaranteed End of Day product.
- Our proposal addresses the financial sustainability concerns and net cost burden by introducing a more efficient delivery model. We would deliver all non-First Class letters to every address every other weekday; and we would align the speed of Access Standard letters with Second Class.
- Our reform proposal reduces the net cost burden of the USO by up to £300 million per year, would allow us to continue to operate our unique ‘feet on the street’ model, and continue to offer secure jobs with industry leading terms and conditions.
- Our proposal is similar in many ways to the options identified by Ofcom – but we believe our proposal better meets the customer needs of today.

5.1 In this chapter we set out how our proposal meets the three main assessment criteria that we identified in Chapter 1:

- Good for customers and growth;
- Financially sustainable and addresses the significant net cost of the USO to Royal Mail; and
- Good for our people.

5.2 In developing our proposals, we worked with Frontier Economics to assess a range of options for USO reform. Further detail on our approach is set out in Annex 3.

Overview of our proposal

We would protect what customers continue to value

5.3 As part of our proposal there would be no changes to:

- The **one price goes anywhere** service to all parts of the UK;
- The **choice of First and Second Class letters**. In our research, 81% of consumers and 83% of SMEs emphasised the importance of having a choice between a First and Second Class service;
- **First Class letters delivered daily, six days a week** (Monday to Saturday) to the same timescales. The use of First Class mail for important time-critical services such as certain

NHS communications, Government mailings, greeting cards and time-sensitive magazines and publications; and

- **USO parcel services** which we are required to deliver Monday to Friday, but which we also deliver on Saturdays and on Sundays. We will continue to deliver commercial parcels Monday to Saturday and increasingly on Sundays.

We would enhance and modernise the USO

5.4 Our proposal involves the following changes that enhance reliability, customer choice and financial sustainability:

- Rebalancing speed and reliability QoS targets by adding new, regulated “tail of the mail” targets⁶³ and revised realistic speed targets:
 - First Class D+1 90% and D+2 96%; and
 - Second Class D+3 95% and D+5 99%.
- **all non-First Class letters would be delivered to every address every other weekday** (Monday to Friday). 92-93% of consumers in our research said non-First Class letter deliveries twice a week meet their needs: our proposal exceeds this;
- **aligning the delivery speed of Access Standard letters⁶⁴ with Second Class**, so it arrives within three weekdays instead of two; and
- Adding parcel enhancements, including tracking on USO parcels, to reflect strong customer preferences and a new Special Delivery End of Day (SDG EOD) service.

Our proposal meets what customers have told us they need

5.5 We have talked to a large number of customers and businesses across the UK.⁶⁵ They recognise that change to the USO must come, and our proposal for reform protects those aspects of the USO that they told us matter most to them⁶⁶. This is summarised in the table below.

Key feature:	Our proposal	Our research shows	Ofcom’s research shows
Universality	The 'One price goes anywhere' of the USO would be retained.	'One price goes anywhere' is considered important by 82% of consumers and 87% of SMEs.	Response to uniform pricing was largely positive. It remains an essential feature of the USO service. ⁶⁷ There continues to be majority agreement (66%) with the idea of universal pricing. ⁶⁸

⁶³ Further detail on QoS can be found in Chapter 6.

⁶⁴ Access Standard represents a very large proportion of all addressed letter volumes. In 2022-23 Access D+2 and later represented c70% of total addressed letter volumes. Access Standard alone represented c. 55% of addressed letter volumes. Royal Mail 2022-23 Regulatory Statements.

⁶⁵ Both Royal Mail and Ofcom separately conducted research into customer needs – please see Chapter 4 for further details.

⁶⁶ We are also not proposing any changes on the services for the blind that we are currently offer (and are required by the PSA 2011).

⁶⁷ [Understanding the needs of postal service users \(ofcom.org.uk\), slide 46.](https://www.ofcom.gov.uk/consult/condocs/post/understanding-the-needs-of-postal-service-users/understanding-the-needs-of-postal-service-users/)

⁶⁸ [Consumer survey research on post \(ofcom.org.uk\), slide 3.](https://www.ofcom.gov.uk/consult/condocs/post/consumer-survey-research-on-post/consumer-survey-research-on-post/)

Key feature:	Our proposal	Our research shows	Ofcom's research shows
Reliability	We would continue to offer a high standard of service whilst also placing greater emphasis on managing the tail of the mail so that letters that do not achieve the quality targets are recovered and delivered quickly.	Reliability is more important than speed, subject to a next day option being available for occasional use. Reliability is particularly vital for our large business customers that depend on our delivery services to meet their customer needs.	Residential users and SMEs value certainty and reliability over speed and are generally open to a reduction in delivery days for letters. ⁶⁹ Reliability ranked as important by 88% of consumers. ⁷⁰
Providing our customers with a choice between a First and Second Class service	The First and Second Class service for both letters and parcels would be retained.	There is a clear preference for maintaining a two-tier service, with 82% of consumers and 87% of SMEs highlighting the importance of maintaining a choice of service.	<i>"We note, however, that there is evidence of some consumer need for a D+1 service to be available on the occasions where users need to convey urgent items. Therefore, even if more mail was sent using a D+3 service, there would still be the need for an affordable D+1 service to enable the next day delivery of the occasional urgent letter".⁷¹</i>
Changes to delivery frequency	First Class delivery for letters remains a six day service, whilst Second Class is delivered two to three times a week (Monday – Friday). There would be no change to parcel delivery.	The current USO service meets the needs of 94% of consumers and SMEs. A reduction in non-First Class letter delivery frequency to two days a week, with the current First Class service is unchanged, would meet the needs of 92% of consumers and 93% of SMEs.	Most consumers were willing to accept fewer delivery days a week as they rarely needed to receive letters urgently. Ofcom's research found that a reduction to four or five delivery days would meet the needs of most users. A further reduction to receiving letters every two to three days would be acceptable for the majority of respondents, including most vulnerable groups. ⁷²

5.6 More detailed information on the impact per customer group is set out in Annex 4.

Time critical NHS mail

5.7 Letters remain a vital channel for the NHS to communicate with patients, especially those patients who are digitally excluded, and will continue to be an important part of NHS

⁶⁹ [Understanding the needs of postal service users \(ofcom.org.uk\), slide 49.](https://www.ofcom.gov.uk/consult/condocs/post/understanding-the-needs-of-postal-service-users/understanding-the-needs-of-postal-service-users.pdf)

⁷⁰ [Consumer survey research on post \(ofcom.org.uk\), slide 11.](https://www.ofcom.gov.uk/consult/condocs/post/consumer-survey-research-on-post/consumer-survey-research-on-post.pdf)

⁷¹ CFI, paragraph 9.52

⁷² [Understanding the needs of postal service users \(ofcom.org.uk\), slide 49.](https://www.ofcom.gov.uk/consult/condocs/post/understanding-the-needs-of-postal-service-users/understanding-the-needs-of-postal-service-users.pdf)

communications for years to come. We are committed to working in partnership with the NHS, in all parts of the UK, to ensure that vital NHS letters are delivered in a timely manner.

- 5.8 We recognise that the NHS is made up of many different parts, each with varied requirements. We would continue to offer the NHS a choice in service levels and pricing, to suit the differing priorities of each part of the organisation. In addition to existing services, including our First Class services such as unsorted, sorted and hybrid products, we are committed to exploring options that could help us to provide greater reliability for time sensitive letters such as appointments and test results.

Our proposal delivers significant sustainability benefits reducing the net cost of the USO by up to £300m each year, when fully deployed

- 5.9 Our proposal is forecast to reduce the run-rate net cost of the USO to Royal Mail by up to £300m (although this is dependent on the time taken for reform to be implemented and the rate of letter decline).⁷³ The net cost saving is driven by a reduction in number of total daily routes. This is enabled by delivering non-First Class letters less often (see below).
- 5.10 We expect implementation would take around 18-24 months from the date of regulatory change with the net number of delivery routes to reduce by c. 7,000-9,000 (more parcel routes, fewer traditional walking routes). This in turn lowers the significant fixed costs in delivery.

A financially sustainable company is good for our customers

- 5.11 A financially sustainable company is better positioned to meet customer needs effectively, providing a reliable and valuable service, maintaining long-term relationships leading to a more positive and fulfilling customer experience.
- 5.12 The financial improvement from USO reform would allow Royal Mail to continue to invest in modernising, offering a more reliable and efficient delivery model while transforming to provide products and services that customers want. Financial sustainability would allow us to innovate, to expand and grow, and to deliver faster on our environmental, social and governance commitments.

It supports our 'feet on the street' network, contributing to keeping our emissions low, consistent with our Steps to Zero strategy

- 5.13 Royal Mail is the only operator in the UK to use a 'feet on the street' network and this is made possible only because of the high call rate of letters and parcels. As letter volumes have declined, the call rate has dropped significantly and would continue to do so to a point that walking routes would no longer be viable. The consolidation of letter deliveries to fewer days would increase the call rate and help ensure that walking routes are still viable. Just over half of Royal Mail deliveries are wholly or partially made on foot, which keeps our emissions per letter and parcel far lower than other delivery companies who report on this measure and largely deliver by van.

⁷³ This is the benefit of our proposed changes to delivery frequency. It does not include the net benefit from the removal of the Second Class Safeguard Cap and other changes set out in Chapters 7 and 8.

Our people

5.14 We believe our reform proposal would have a positive impact on the role of a postie:

- **Job security** - a more sustainable business means we would continue to be able to offer industry-leading terms and conditions to our employees. Over a period of around 18-24 months from the point of regulatory change the total number of delivery routes is expected to reduce by c. 7,000-9,000. Whilst this may mean fewer delivery roles in Royal Mail, we expect to be able to manage the vast majority of changes through natural turnover and no compulsory redundancies. Based on current estimates, we expect voluntary redundancies to be minimal (c. 1,000 may be required based on current modelling);
- **Fewer Saturdays** - removing non-First Class mail from Saturday delivery would reduce the frequency of Saturday working. Saturday deliveries would be limited to First Class letters and all parcels; and
- **Variety of roles** - our proposals would also create a wider range of jobs. For example:
 - Walking delivery roles involving delivering mainly letters. These delivery routes would continue to be predominantly undertaken on foot and are less reliant on the need to hop in and out of vans. By delivering non-First Class letters every other day, posties would visit more addresses and when they do, they would have more items for their customers. Where the address density is lower, these routes would be operated using an appropriate vehicle as they are now (e.g. in more rural areas). We believe our posties would continue to know their routes and their customers well. These routes are also expected to cover 15-20% less total distance.
 - Van-based roles delivering mainly parcels with First Class letters. This role would generally be vehicle-based delivery and would concentrate on delivering parcels from a van in addition to First Class letters due for delivery. These would be 'hop in/hop out' roles, which may appeal to posties more confident with technology-driven customer interactions and offer potential for those possibly less comfortable with foot-based roles.

How our proposal works in practice

5.15 Our proposal would lead to a more efficient delivery model alongside greater reliability for customers through the new regulatory reliability targets outlined above. Parcels and collections operate with the same frequency as now, so there is no change to these services.

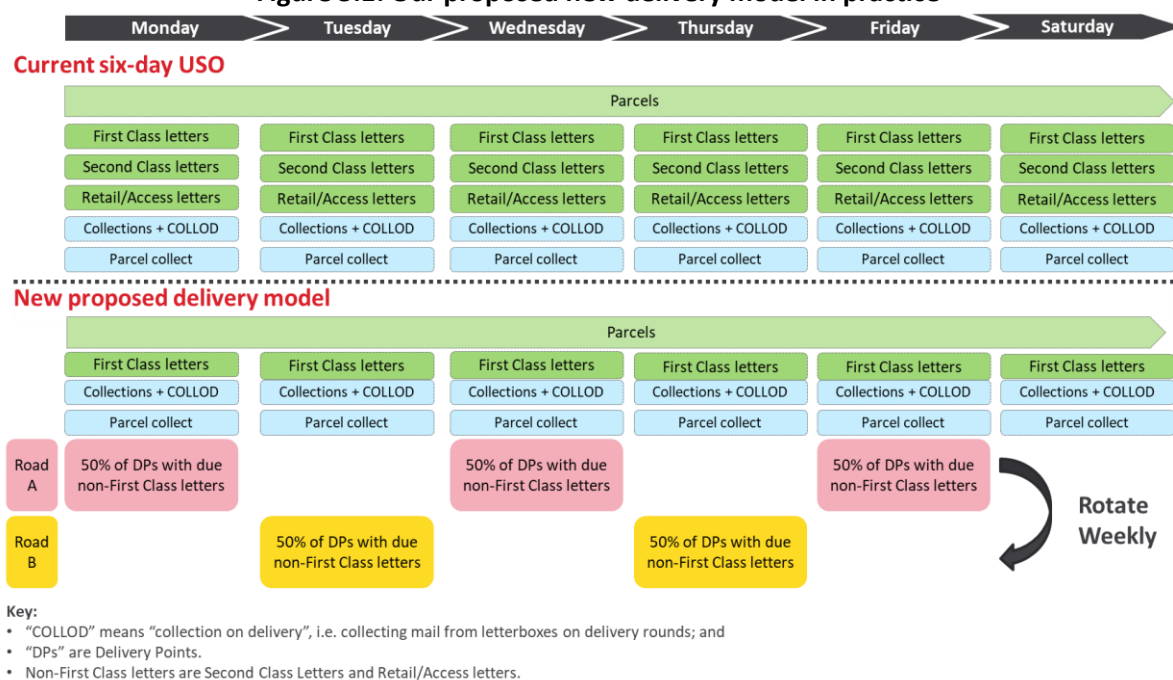
5.16 Our letter deliveries would work as follows:

- **all non-First Class letters would be delivered to every address every other weekday⁷⁴** (Monday to Friday) in line with its service specification to customers. The difference from today is that non-First Class letters would be sent to the delivery office only on the days when the address is due a non-First Class delivery (every other weekday) rather than every day; and
- **First Class letters would continue to be delivered daily, six days a week** (Monday to Saturday). They would be delivered either with the non-First Class mail (if there is a non-First Class letter delivery to an address that day), or on a van route with parcels (if there is no scheduled non-First Class letter delivery that day).

We summarise this model in Figure 5.1 below.

⁷⁴ The delivery speed of Access Standard letters will be aligned with Second Class, so it arrives in up to three days instead of two.

Figure 5.1: Our proposed new delivery model in practice



5.17 The diagram shows:

- **For Road A customers**, on Monday, Wednesday and Friday, non-First Class mail (Second Class, Retail, Access etc.) is delivered alongside First Class mail. On Tuesday, Thursday and Saturday, First Class mail is delivered with parcels by van;
- **Road B customers** have a different cadence. Non-First Class mail would be delivered alongside First Class mail on Tuesdays and Thursdays. On Monday, Wednesday, Friday and Saturday, First Class mail is delivered with parcels by van; and
- As there is an odd number of non-First Class service days in a five day pattern, in the next week (not shown in the diagram), the delivery frequency rotates so that on Road A, non-First Class mail is delivered Tuesday and Thursday, and on Road B non-First Class mail is delivered on Monday, Wednesday and Thursday. Non-First Class mail is delivered to every address, every other service day, and First Class letters are delivered to Road A and Road B every day.

Why the change to the handling of non-First Class letters?

5.18 By changing how non-First Class letters are handled in our operation, we can put in place a more efficient delivery network. We currently deliver letters to every address six days a week. The current call rate in delivery⁷⁵ is c. 43%, so on average households receive mail around every other day. This means we currently cover the whole delivery route every day. However, on average we deliver to less than every other address.

5.19 Consolidating two days' worth of non-First Class mail to deliveries every other weekday generates significant cost-efficiencies. This increases the proportion of addresses to which we deliver on each walk by combining the non-First Class mail from two days, which also increases average letters per delivery point. We increase the average number of addresses we deliver mail to c. 68% of the walk, therefore having a higher call rate for 50% of delivery points receiving

⁷⁵ The call rate is number of times a Royal Mail postie will deliver to a delivery point (address) as they go on their round. A call rate of 100% would indicate that every household gets a letter every day. A call rate of 50% indicates that on average households get a letter every other day.

non-First Class mail today. This increases the efficiency of the delivery route by sharing the costs of conducting the route amongst more items.

5.20 In covering the whole delivery route every day, Royal Mail is required by the current USO to maintain a high fixed cost base. Reforming the USO to move to delivering non-First Class letters Monday to Friday enables us to better reflect the services that customers want and to realign our delivery costs.

5.21 Figure 5.2 below shows an illustrative example of this: a postal route today may cover 550 addresses and due to the volume of mail the postie would deliver mail to c. 250 of those addresses. In the future, there may be 460 addresses, which can be serviced in the same outdoor duty span, and a postie would deliver mail to c. 315 of those addresses. This improves our call rate from 43% to 68% leading to a more efficient operation as there are more calls on the route and more items per call. More addresses called at, with more items delivered per hour, reduces the unit cost helping to keep our prices affordable for customers. On First Class letter service and parcel routes, a postie would have c. 1,000 addresses on a route and deliver to c. 200 of those addresses. This means fewer routes are needed to cover this half of address points than if they were taking one day's worth of non-First Class letters as well.

Figure 5.2: Example delivery route



How we would move to the new operating model

5.22 This would be a complex change to our operation. We would need to change how we handle mail in the mail centres so that machinable non-First Class letters are either passed straight for

delivery, or intercepted and deferred to enable them to be delivered within their service specification window based on the address (and its alternate day delivery calendar) and the service selected. Manual letters (including large letters) would be sorted to route and deferred within the delivery office. Changes would need to be made to a number of our supporting systems including our mail sequencing software to reflect the alternate day calendar. We would need to deploy structural revisions in each of our delivery offices to implement the new way of delivering letters and parcels.

- 5.23 We have experience of managing significant change to our business. National revisions have been implemented before. We have also implemented changes to our network window requiring changes to all parts of our operation. Nevertheless, implementing our proposed solution is not without implementation risk that we would seek to minimise.
- 5.24 We estimate that full implementation would take around 18-24 months from the date that the amended regulations are in place.

Why our proposal best meets the needs of customers, financial sustainability and our people

- 5.25 Both Ofcom and Royal Mail have considered a range of different USO reform options. As set out in this chapter our proposed solution is good for customers; is financially sustainable and addresses the significant net cost of the USO to Royal Mail; and is good for our people. See Annex 5 for a further assessment of Ofcom's USO reform options.

6 Quality of Service

Key messages:

- We recognise the reliability of our service has not been good enough and we are working hard to restore it. But Ofcom's USO quality of service (QoS) regime, which has not been looked at since 2006, must be refreshed to rebalance reliability and speed to meet customer needs, and be financially sustainable.
- Reliability is more important for customers than speed. Customers want certainty that mail will arrive when it is due.
- However, Ofcom's USO QoS targets over-emphasise speed, which drives high fixed costs by requiring us to carry an excessive resource cushion to absorb volatility, negatively affecting financial sustainability.
- We agree with Ofcom that "*Obligations which exceed the reasonable needs of users mean that people could pay higher prices for USO products than necessary.*"⁷⁶ and "*...could also contribute to the challenges in meeting QoS requirements.*"⁷⁷ However, we disagree with Ofcom that the "*financial ... impact of reducing QoS targets would be minimal.*"⁷⁸
- Our proposal rebalances reliability and speed by introducing new "*tail of the mail*" reliability targets and realistic speed targets.

Reliability is more important for customers than speed

- 6.1 We recognise, and Ofcom's research shows, that customers value reliability highly (indeed more than delivery speed). Ofcom's CFI states that "*Reliability... provides certainty to users that items will arrive when promised and is achieved via QoS targets for certain products and services which are set in regulatory conditions.*"⁷⁹
- 6.2 We also recognise that our QoS is not where it should be and we are focused on making progress. However, we face significant challenges and Ofcom's current targets are neither achievable nor in keeping with comparable countries. The QoS targets Royal Mail is required to meet are some of the most stringent in the world and this is recognised by Ofcom: "*we set tough delivery targets for Royal Mail.*"⁸⁰
- 6.3 QoS targets are an important part of the regulatory regime as they are a means of giving customers certainty about the reliability of service they will receive. It is important that these targets are not arbitrary but are carefully designed to support customers and give them confidence in the postal products they are choosing. However, targets set too high drive high fixed costs into business. This is a particular concern in a loss-making business that is managing the material structural decline in letters.
- 6.4 We disagree with Ofcom that "*...the financial...impact of reducing QoS targets would be minimal.*"⁸¹ Ofcom estimates that "*Royal Mail could achieve relatively modest savings of £75-125m per year in 2018/19 terms, based on a scenario in which Royal Mail was only required to*

⁷⁶ CFI, Paragraph 10.5.

⁷⁷ Ibid, Page 54.

⁷⁸ Ibid, Paragraph 9.79.

⁷⁹ Ibid, Paragraph 4.17b.

⁸⁰ Ian Strawhorne, Radio 4, 13 November 2023.

⁸¹ CFI, Paragraph 9.79.

*deliver 80% (rather than 93%) of its First Class mail.*⁸² In the context of a loss making business spending £1m to £2m every day to provide the USO, such savings are in no way “modest”.

- 6.5 The current QoS regime has not been comprehensively reviewed since 2006, during which time the postal sector has changed profoundly. Market dynamics have changed, but our targets have not and do not reflect the new reality. Ofcom’s QoS targets are now impossible to meet at a reasonable level of cost, given our ever-increasing costs and greater operational challenges - primarily a network established for letters (and QoS targets set accordingly) that is now delivering more parcels. As letter volumes continue to decline, the cost burden to retain high QoS increases. High QoS targets require high levels of resource, which becomes more difficult to fund when letter volumes are in continuing structural decline.
- 6.6 Reflecting this structurally declining letter market and the ever-increasing costs of delivering fewer letters (which cannot always be offset just by raising prices) we are offering new regulated reliability targets and revised speed targets that meet customer needs.

Ofcom’s current targets are unachievable and require review

- 6.7 Ofcom’s QoS targets are set out in DUSP condition 1.⁸³ There are eleven QoS targets, seven domestic and four international. The domestic targets (combined letter and parcels) are subject to external monitoring and audit by third parties appointed by either Royal Mail or Ofcom. They cover performance against expected speed of delivery, collection activities, delivery route completions, as well as performance across UK postcode areas.
- 6.8 The targets (including the 7% and 2.5% tolerances on First Class and Second Class respectively) were set by Postcomm in 2006, before the structural decline in letters took hold. They were adopted by Ofcom when it took over regulation of post.⁸⁴ They were originally based on internal stretch targets used by Royal Mail management but were never tested from a regulatory perspective. Some targets are disproportionately ambitious and, despite strong management focus, have never been achieved. Moreover, there was a degree of tolerance under the Postcomm regime. The current pass / fail zero tolerance approach adopted by Ofcom requires a set of targets that are proportionate and achievable.
- 6.9 We have achieved our First Class target three times and our Second Class target seven times since 2012. The highest we have achieved on First Class was 93.2% in 2013.⁸⁵ Ofcom’s targets were clearly already too high to be achievable at a reasonable level of cost.
- 6.10 However, the current QoS challenges are not equal across all letters products. For example, the Access Economy products which we introduced in 2021, and negotiated realistic quality of service targets, we are meeting these targets. This service now represents half of the Access letter volumes in the UK and has consistently met its targets since its launch.
- 6.11 It is becoming increasingly difficult to balance efficiency improvements and forecast workload, as the resource cushion has been reduced. As efficiency improves, we are increasingly exposed to demand volatility whilst operating with a traditional “fixed” labour model. High volatility across both letters and parcels makes it very difficult to forecast the required workload. As a rule of thumb, each 1% variation in workload equates to a need for [X] Full Time Employee (FTE) at target levels of productivity.

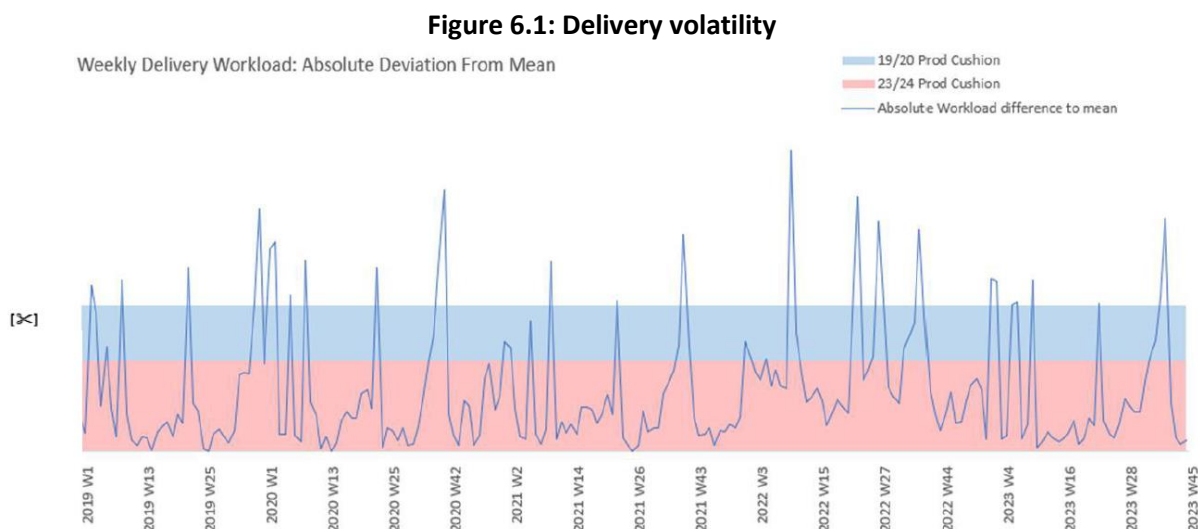
⁸² Ibid, Paragraph 9.77.

⁸³ Designated USP Condition 1.

⁸⁴https://webarchive.nationalarchives.gov.uk/ukgwa/20111129111144/http://www.psc.gov.uk/universal/what_are_we_doing_to_protect_the_universal_service_

⁸⁵ [Decision finding Royal Mail contravened its Quality of Service performance targets in 2022/23 and imposing a financial penalty \(ofcom.org.uk\)](#). Note these are unadjusted for matters beyond our reasonable control.

6.12 For example, in 2023/24 weeks 44-47, letter volumes declined between [X]% and [X]% year on year and parcel volumes increased between [X]% and [X]%. This translates to a [X] – [X]% decline in contribution to total workload from letters offset by an increase in contribution to total workload of [X]% - [X]% from parcels growth. In week 47, for instance, we would require an additional [X] FTE to meet the requirements of unforeseen workload variation.



6.13 The above figure shows weekly national volatility levels, but the impact increases appreciably at daily delivery office level, where an individual delivery office will experience average daily forecast variability of [X]-[X]%. In practice, this makes it much more difficult to resource to demand, given it is not possible to have an accurate forecast to demand at individual delivery office level on a weekly basis. As we have sought to increase efficiency in delivery offices this has inevitably reduced the number of staff and reduced the resource cushion. For example, as at 20 March 2024, at national level we are showing 0% variance to forecast, but the region Wales is [X]% above forecast, the delivery area of West Wales is [X]% above forecast, and some individual delivery offices are between [X]% and [X]% above forecast.

6.14 We also need constantly to respond to substantial changes in workload. For example, between 2021/22 and 2022/23, we experienced a c. [X]% decline in workload. This level of reduction was unlike anything the operation has previously had to respond to. This resulted in the need to remove a significant number of FTEs at pace given the financial challenges we were facing. We have also historically relied on performance in Q1 and Q2 being better than the QoS target, in order to compensate for performance in Q3 (which is traditionally impacted by factors including cyber week and adverse weather).

6.15 A further challenge in meeting QoS targets is our continuing high levels of sick absence and difficult recruitment environment. Sick absence remains above 2019/20 levels (like other organisations) and impact available resource, exacerbating the stress on the resourcing cushion. Our initiatives to reduce sick absence are starting to yield results and whilst sick absence is falling, it remains above the national average. Despite introducing incentives, recruitment is challenging in certain hotspots, where it is proving difficult to hire and retain delivery employees.

Our proposal for First Class and non-First Class USO QoS targets

- 6.16 Customers have said they value reliability more than speed,⁸⁶ but Ofcom's QoS regime emphasises speed, which drives high fixed costs into a structurally declining letters market. Over-specified speed targets drive significant costs into delivery but lead to only marginal incremental improvements in QoS. This flies in the face of addressing the significant net cost burden of the USO to Royal Mail and achieving a sustainable balance going forward.
- 6.17 Looking internationally, we believe that Royal Mail is held to much higher standards than other postal operators.⁸⁷ When France still operated a First Class service, its QoS target was 85% for D+1, and Germany and Italy set theirs at 80%. No country of a comparable size to the UK has a D+1 target as high as 93%, whilst our Second Class target of 98.5% for D+3, we understand is the highest in the world.
- 6.18 Across the world regulators hold postal operators to account on reliability by using additional "tail of the mail" targets, often accompanied slightly lower speed targets. We observe that 12 countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Norway, Portugal, Spain, Sweden) have additional reliability targets for their First and/or non-First Class mail products, with nearly all having lower speed targets. The UK is one of only four comparator countries we have looked at that does not have a tail of the mail target.⁸⁸
- 6.19 Reflecting a structurally declining letters market, the increasing costs of delivering fewer letters, and that we believe we are an international outlier on regulated QoS targets, we therefore ask for a rebalanced, more sustainable Ofcom QoS target regime that meets our customer needs of reliability and speed by introducing:
- new regulated reliability targets (i.e. tail of mail); and
 - realistic speed targets.
- 6.20 The new regulated reliability targets would provide customers with increased confidence in our ability to provide a service that meets their expectations, receiving the service they paid for.
- 6.21 On **First Class**: we propose a new reliability target of 96% on D+2 and a realistic speed target of 90% on D+1. Our customer insight suggests that customers would be willing to accept a small reduction in the speed target provided we can offer greater levels of reliability. International benchmarking shows that at 90%, the UK would continue to have high and challenging First Class targets.⁸⁹
- 6.22 On **Second Class**: we propose a new reliability target of 99% on D+5 and a realistic speed target of 95% on D+3. Under our proposal for delivery model reform, non-First Class services would have fewer delivery opportunities each week. If a non-First Class letter is not delivered on its due date, it would be two days before the next opportunity to deliver it. A revised Second Class QoS target is therefore critical in order to unlock the new delivery model. Our proposal aligns with other countries who have deployed similar non-First Class delivery models (for example, France operates a similar model with 95% at D+3).

⁸⁶ "The quality of service regime helps to ensure that users benefit from certainty that an item will reliably arrive on the date promised. We know that users value these aspects of the universal service above speed of delivery." CFI page 91.

⁸⁷ Ofcom notes "Royal Mail's QoS targets are arguably more stretching than its European counterparts." Ibid, paragraph 9.69.

⁸⁸ <https://www.cullen-international.com/postal.html>

⁸⁹ No country of a comparable size to the UK has a D+1 target as high as 93%. In Belgium and the Netherlands, the QoS target is 95%. In Australia, they have retained a 94% QoS target for D+1 services within the same city only. Ireland (94%) and Portugal (95%) are other notable countries with a high D+1 QoS. Both are materially smaller than the UK.

Figure 6.2: Proposed new reliability and revised speed targets

Product	D+1	D+2	D+3	D+4	D+5	D+6
First Class USO	90%	96%	-	-	-	-
Second Class USO	-	-	95%	-	99%	-

6.23 We disagree with Ofcom that “...lowering QoS targets is [not] an attractive option” or would reduce our “...incentives to maintain a high-quality service”.⁹⁰ However, we agree with Ofcom that a “...lower target [of 80%] ... would allow greater flexibility across the network, with collections, processing and logistics activities better able to adapt to any fluctuations in the volume of First Class mail, thereby reducing costs and helping to improve efficiency.”⁹¹ We are proposing a target of 90% for First Class, but the reasoning put forward by Ofcom as regards reducing costs still stands true. Our proposed new reliability targets are also consistent with Ofcom’s research, “...that there is greater user support for a higher QoS standard over a longer time period than a quicker, but less reliable, service”.⁹²

Our proposal for changes to our other domestic QoS targets

Remove Postcode Area (PCA) target

6.24 Local area-based targets are not necessary to ensure Royal Mail maintains quality and we do not need local regulatory targets to ensure we are focused on maintaining the highest possible geographic QoS for all parts of the country. All managers are already heavily focused on QoS in their own areas. Moreover, the new reliability targets and rebalanced 90% First Class and 95% Second Class national targets would drive performance across the UK.

6.25 No other European postal operator is subject to such granular targets. Given the commercial incentives on Royal Mail to keep standards high, it is ‘gold plated’ regulation. To meet these targets, we must maintain an overly high level of service across the whole of the UK.

6.26 From a commercial perspective, Royal Mail must already ensure high QoS in all local areas of the UK. This is what our customers expect and demand. The ongoing structural decline of letter volumes means it is more important than ever that our letter customers get a consistently high service throughout the whole of the UK. The successful delivery of national mail in one area of the country is dependent on the successful functioning of the network in another. For example, mail being delivered in London relies on the collection and transportation of mail from all areas of the UK. Royal Mail’s network structure means a national target is sufficient to ensure a high-quality service across the UK.

6.27 If Ofcom deems it is important to maintain the PCA target, it should be reduced to 86%, so that it is statistically aligned with a 90% national First Class target. With such granular regulation, unprecedented in Europe, we also need a degree of tolerance built in to reflect the significantly negative impact that localised events can have on delivery performance within individual PCAs. It would be proportionate to allow for up to six out of the 118 PCAs to not meet the target in any given year. This would make the target realistic.

⁹⁰ Ibid, paragraph 9.79.

⁹¹ Ibid, paragraph 9.70.

⁹² Ibid, paragraph 9.74.

Revised methodology for calculating delivery USO target

6.28 We propose updating the methodology underpinning the Delivery Route performance target to provide a more accurate assessment of the impact of part-route failures. Royal Mail is fully committed to delivering to 32 million addresses six-days-a-week across the country. Under Ofcom's QoS framework, we are required to complete 99.9% of delivery routes every day. The methodology underpinning this target should be changed to measure percentage of delivery points (not routes) completed daily.⁹³ This would more closely reflect the true service our customers are receiving. It would also bring the calculation into line with the equivalent collection USO calculation. In addition, when the target was introduced, we did not have the technical ability to record individual delivery points visited, which we now have.

Extend the Christmas Exemption to include Cyber week⁹⁴

6.29 To reflect the profound changes in the postal market, we propose moving the start date of the Christmas Exemption forward to the Friday following the fourth Thursday in November ('Black Friday'⁹⁵) to include Cyber Week.

6.30 Retailer promotions in Cyber Week have extended the Christmas period. Many major retailers now start Christmas promotions earlier and have extended the time period for promotions. Cyber Week, at the end of November, now marks the start of Christmas for retailers. As a result, Royal Mail parcel volumes in Cyber Week are comparable to those seen in December. The Christmas Exception is there to avoid the need for Royal Mail to inject disproportionate cost into our operations, but Cyber Week generates precisely the same issues. It is simply not efficient to resource to this level for the additional period. In addition, late night and last minute shopping, together with increased average parcel sizes, has made it increasingly difficult to forecast volumes and therefore workload during Cyber Week accurately, making resourcing to workload a significant challenge. This has become a notable drag on performance, reducing QoS by c0.4% in 2023/24.

6.31 If Ofcom does not update the regulations to reflect this fundamental change, Royal Mail is forced to over-achieve on QoS for the rest of the year to meet the First Class target. This would increase our costs in the first half of the year, which would challenge our efficiency improvements. There is a limit to how much we can increase our network on a temporary basis. A regulation setting the need to over-achieve a target at considerable cost is not proportionate.

6.32 Ofcom have previously acknowledged the challenges Cyber Week places on our network but decided not to include it as a mitigating circumstance outside Royal Mail's control (MBORC) in its 2023/24 investigation. Rather than treating Cyber Week as MBORC, we urge Ofcom to simply extend the Christmas Exemption to include Cyber Week. No other regulatory options to deal with the emergence of Cyber Week provide the same level of regulatory certainty or simplicity as an extension. We note that we have successfully negotiated a six week Christmas exemption period with our Access customers.

⁹³ Delivery point is an individual residential or business address. A delivery route represents the collective total residential and/or business addresses a member of staff would visit on his or her walk.

⁹⁴ Cyber Week describes the period running from Black Friday into early December.

⁹⁵ In practice, the Christmas period for retailers can begin much earlier, but Black Friday is a helpful market-driven marker.

7 USO enhancements - tracking on parcels and new Special Delivery Guaranteed End of Day service

Key messages:

- Parcel tracking is a hygiene factor that customers increasingly want and need and that is offered by competitors as a standard service.
- Surcharging by other parcel operators means that the market does not provide a fair solution that addresses the needs of customers in rural and remote areas of the UK.
- If parcel tracking is not in the USO, USO parcels are left to compete with one hand tied behind their back in the digital age.
- It is vital that Ofcom includes parcel tracking in the USO so that all consumers and SMEs have access to an affordable, one price goes anywhere, fully tracked parcel service. There is no evidence to suggest this would materially undermine competition in the market.
- Adding a new Special Delivery Guaranteed End of Day (SDG EOD) product to the USO would provide customers with greater choice and allow the USO to evolve to meet the changing needs of modern consumers.

Parcel tracking is a hygiene factor offered by competitors as a standard service

7.1 While technology has led to unprecedented growth in e-commerce and parcel volumes, it has also led to the ability to offer new services, including the option of tracking on parcels. As a result, consumer expectations are increasing; tracking is now seen as a hygiene factor and is offered as standard by all other parcel operators. However, Royal Mail is currently the only operator in the UK to offer this service on a universal basis with geographically uniform pricing.

Customer research shows this is what customers want

7.2 Our consumer and SME research shows that tracking is the most important factor when choosing a parcel operator. The proportion of consumers, finding it very or fairly appealing has increased from 63% in 2019 to 84% in 2023⁹⁶, demonstrating an increasing demand for the feature amongst customers sending First and Second Class fulfilment large letters and parcels (i.e. those sending items to fulfil orders).

7.3 For business customers, the trend has been comparable. The importance of tracking has risen from 46% to 73% for First Class large letters and 67% to 87% for First Class parcels over the same period. It is vital that the USO evolves alongside changing consumer behaviours. Without this change, the USO runs the risk of failing to fulfil its primary purpose of meeting user needs. Under Ofcom's rules we are not able to provide a tracked parcel product in the USO. This risks consumer in some areas of the country not being able to access a tracked parcel product at a universal, uniform price.

7.4 Customer demand for tracking is also driven by sales on some of the largest UK online marketplaces (including eBay and Etsy). Marketplace sales constitute an important driver of C2X growth. They have expanded the routes to market for smaller businesses and spurred growth of online transactions for second-hand objects. Recommerce sites such as Vinted and Depop further fuel this growth. The increase in marketplace selling is particularly strong among young users. In Q1 2020/21, 36% of 16-34 year-olds reported having sold an item on an online marketplace in the last month, compared with 26% in Q1 2014/15. In Q1 2020/21, 74% of 16-

⁹⁶ Source: O3a. How appealing is it to have the option of tracking large letters or parcels that you send First or Second Class in the UK with Royal Mail? Base: All Residential respondents 2019 (n = 2027) 2023 (n = 3150).

24-year-olds reported ever having sold an item on an online marketplace, compared with 58% in Q1 2014/15. This, in turn, has driven demand for parcels services. Marketplace platforms increasingly require their sellers to use full tracked services when fulfilling sales over their platforms.

7.5 Including parcel tracking in the USO would offer our customers several benefits:

- it provides customers with end-to-end visibility of the parcel journey including proof of delivery. Our research shows that 70% of customers in 2023 require tracking to show an item has been delivered when sending mail, and 32% of business customers cite proof of delivery as the main reason why they require tracking;
- making tracking data easily accessible to customers immediately reduces the number of queries to our Customer Experience team as customers can get updates on their item's movements at each processing point in our network;
- it allows customers to feel in control of their post and can support an efficient resolution of any complaints by making it easier to identify where in the pipeline an item is;
- it can prevent disingenuous claims made to our Customer Experience team as bad actors may be less likely to rely on false information where clear updates are provided throughout an item's journey through our network. This would allow our teams to direct resources to genuine claims and provide a higher quality overall customer experience, as aligned with Ofcom's aims; and
- it provides greater control and transparency on progress of an item through the network, including allowing for inflight delivery options and delivery preferences. Our inflight delivery options include leave with a neighbour, safe place or deliver on another day. When receiving mail, 52% of customers require tracking for the day before an item is due. Tracking facilities allow customers to customise their experience and plan their deliveries around their schedules – not the other way around. This is particularly valuable for vulnerable and disabled customers and their carers.

7.6 A modern, 21st century USO requires tracking to remain relevant and sustainable. Without this feature we are consigning the parcels USO to history by insisting it remains an analogue product in the digital age.

7.7 Tracking has been included in the USO for nearly 10 years in Italy, with light tracking added in 2015; in Greece, which welcomed tracking and electronic stamps in 2021; and in France a new 'Turquoise' tracked letter service was introduced in 2023.⁹⁷ Ofcom must make changes now to improve the overall customer experience and the sustainability of the USO.

The market does not provide a fair solution that addresses the needs of customers in rural and remote areas of the UK - other parcel operators surcharge

7.8 Competitors surcharge for deliveries and collections to rural areas and fail to provide a next day service. For example, Evri charge an additional location charge of £2.75 for deliveries to non-urban areas.⁹⁸ Additionally, Yodel add an additional six working days to deliveries in some rural areas and provide limited weekend deliveries in other non-urban parts of the UK.⁹⁹

⁹⁷ See Annex 9 for the Frontier Economics' report "USO benchmarking review findings".

⁹⁸ Evri, "Location Charge Postcodes" <<https://www.evri.com/location-charge-postcodes>>

⁹⁹ Yodel, "Remote Areas and Transit Times" <<https://www.yodel.co.uk/remote-areas-and-transit-times>>

- 7.9 A comparison of the services offered by Royal Mail and some of its key competitors (Evri, Yodel and DPD) shows that Royal Mail is the only player whose C2X products are available across all of the UK, at a uniform charge, and with no limitations in terms of extra delivery times.

Figure 7.1: summary of geographic provision by parcel operators

	Royal Mail	Evri	Yodel	DPD
Coverage of the UK territory	All postcodes in the UK	All postcodes in the UK (with exceptions)	All postcodes in the UK	All postcodes in the UK
Extra-charges for remote areas	No extra charges	Surcharges for remote areas (£2.75)	No extra charges	Surcharges for remote areas
Extra delivery times for remote areas	No additional transit days	No additional transit days	Additional transit days for remote areas	Additional transit days for remote areas

- 7.10 Ofcom correctly recognises the need to stay digitally connected and the impact this has on the needs of postal users.¹⁰⁰ This is amplified in rural and remote areas where broad geographical variations in broadband coverage exist.¹⁰¹ Subsequently, there is a greater need for reliable, transparent, and efficient postal services. Since 2016, consumers have been asking for tracking in order to “*meet their needs for ease and convenience*”, particularly in areas with less broadband coverage.¹⁰² Royal Mail want communities in rural and remote parts of the UK to access the same service features as those in urban areas as part of the USO; therefore, we see tracking as essential to the USO.
- 7.11 We have recognised the need for a tracked parcel service for customers. In 2018 we launched a non-account tracked parcel service and demand has been growing. Currently it is one price goes anywhere and does not include a surcharge as our competitors do. This however may need to be a future consideration to remain competitive.

There is no evidence that suggests that if Royal Mail were to offer tracking on USO services, it would drive out or materially undermine competition

- 7.12 As part of the 2022 Regulatory Review, we commissioned Oxera to undertake an independent analysis of C2X services and how tracking in the USO would affect competitive dynamics.¹⁰³ Oxera found that competition in the C2X segment was strong and was likely to remain so. C2X services have been built off the back of a competitive and growing B2X segment that has led to the development of a number of expansive Pick Up and Drop Off (PUDO) and logistics networks. This existing infrastructure reduces barriers to entry and expansion and has allowed other operators to serve C2X customers at low marginal cost. This means that competition in this sector can be considered sustainable, even in the event that Royal Mail is allowed to enhance its USO parcels product offering through the inclusion of tracking.

¹⁰⁰ CFI, Page 13.

¹⁰¹ Ofcom, 2023. Connected Nations UK 2023, page. 22.

<https://www.ofcom.org.uk/_data/assets/pdf_file/0022/273721/connected-nations-2023-uk.pdf>

¹⁰² Citizens Advice, “The future of the consumer needs for postal services” (2016)

<<https://www.citizensadvice.org.uk/Global/CitizensAdvice/essential%20services%20publications/Post/Citizens%20Advice%20-%20The%20future%20of%20consumer%20needs%20for%20postal%20services%20090816.pdf>>

¹⁰³ UK consumer parcels: Assessment of tracking in the Universal Service, Oxera – 3 March 2022

- 7.13 There was no material impact on competitors when we introduced Delivery Confirmation on USO parcel services in 2017, and indeed competition has only grown since then. More recently, the launch of our own non USO consumer tracked offering has not resulted in any detriment to competition.
- 7.14 Reflecting the overwhelming evidence that consumers want a tracked parcel service, we ask Ofcom to include parcel tracking in the USO. This would allow all consumers to benefit from parcel tracking at a uniform price regardless of where they live in the UK.

SDG EOD needs to adapt to the changing needs of the modern consumer

- 7.15 Special Delivery Guaranteed (SDG) 1pm is an essential part of the Royal Mail's USO service. The service is used by 83% of businesses and 61% of consumers and it is highly valued for its guarantee of timeliness, security, and reliability.¹⁰⁴ The current USO obligations place an economic burden on Royal Mail in the context of a highly competitive market for time-guaranteed express services. Having only the SDG 1pm USO model creates both operational challenges as well as inconvenience to some customer groups, for whom a 1pm delivery time may not be the ideal proposition. Change is required to achieve an optimum USO offering for all customer segments.

Guaranteed next day delivery

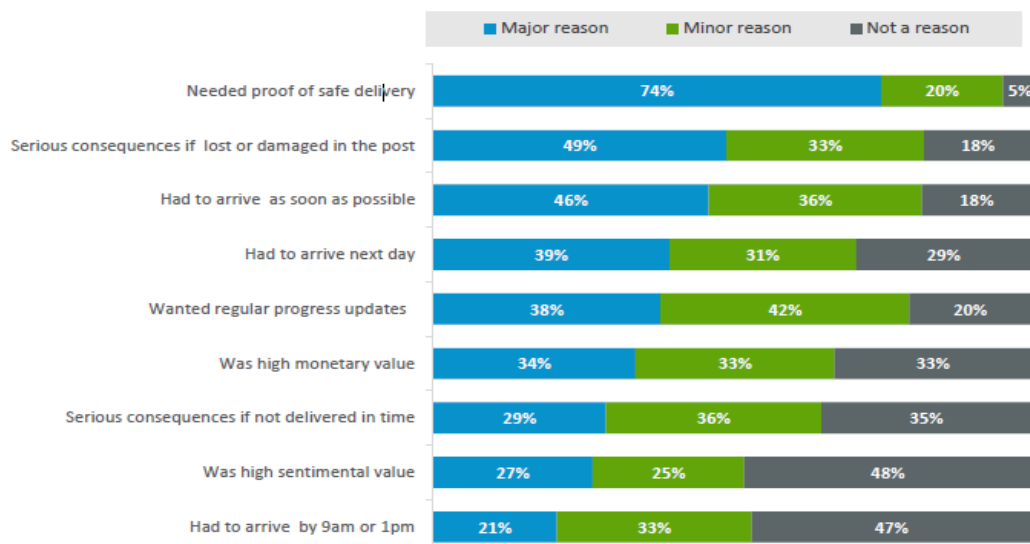
- 7.16 The main reasons customers rely on the SDG product are the need for proof of safe delivery, consequences if lost or damaged in transit, and the need for the item to arrive the next day. This view is shared amongst both consumers and business customers, wanting one or more of these features. Timed delivery is seen as an "unnecessary" feature amongst some customer groups.¹⁰⁵ The inflexibility around delivery times means that some recipients who are often not at home at 1pm due to work, school, university, or other reasons are forced to collect items from their local delivery office or attempt to reschedule a redelivery. This is reflected in the research showing consumers cite delivery by 9am (non USO product) or 1pm (USO product) the next day as the least important reason for choosing SDG products.¹⁰⁶

¹⁰⁴ Royal Mail, SDG Variant Research, March 2020 – Quantitative: 3,000 online panel interviews with consumers, 700 online panel interviews with SMEs, 150 panel interviews with businesses with 250+ employees. Qualitative: four focus groups and four in-depth interviews with marketplace sellers.

¹⁰⁵ Royal Mail, SDG Variant Research, March 2020 – Quantitative: 3,000 online panel interviews with consumers, 700 online panel interviews with SMEs, 150 panel interviews with businesses with 250+ employees. Qualitative: four focus groups and four in-depth interviews with marketplace sellers.

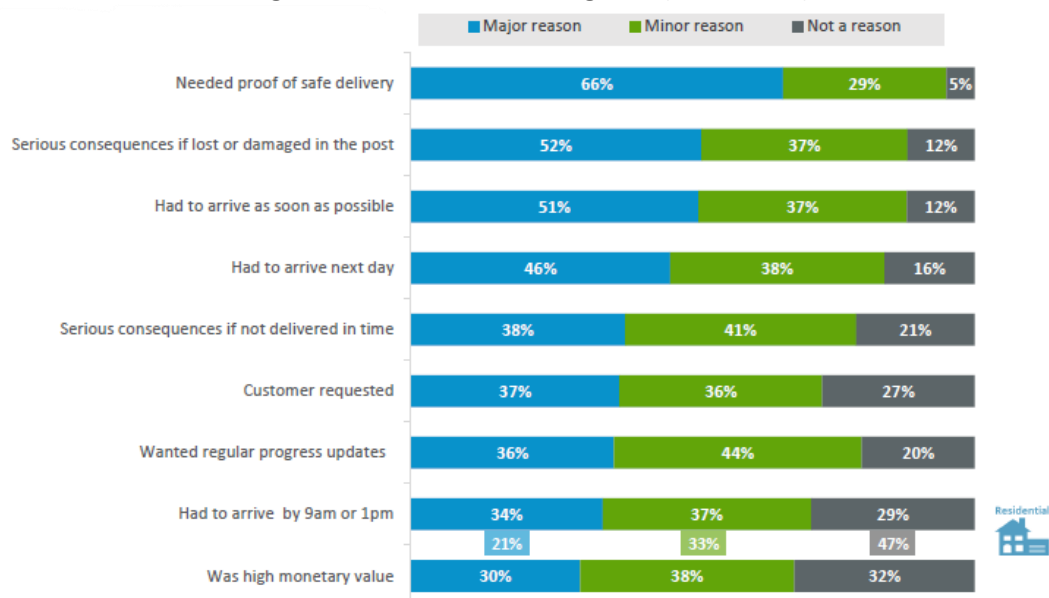
¹⁰⁶ Royal Mail, SDG Variant Research, March 2020 – Quantitative: 3,000 online panel interviews with consumers, 700 online panel interviews with SMEs, 150 panel interviews with businesses with 250+ employees. Qualitative: four focus groups and four in-depth interviews with marketplace sellers.

Figure 7.2: Reasons for using SDG (consumers)



7.17 Business customers are more likely to rely on the 1pm deadline of the SDG 1pm product as it is commonly used to send documents and small parcels.¹⁰⁷ Although only 21% of consumers require timed delivery, 34% of business customers rely on the timed aspect of our time-guaranteed services.¹⁰⁸ To deliver on Ofcom’s aim of achieving a better overall customer experience, change must take place. Our vision for a modern USO includes an SDG product which accommodates the needs of both consumers and business customers.

Figure 7.3: Reasons for using SDG (businesses)



The introduction of SDG EOD will allow a more efficient delivery network

7.18 In order to meet the 1pm deadline of SDG 1pm product, our posties are often required to adjust their walks to mitigate and remove deviations. This drives inefficiency that ripples through the

¹⁰⁷ Royal Mail, SDG Variant Research, March 2020 – Quantitative: 3,000 online panel interviews with consumers, 700 online panel interviews with SMEs, 150 panel interviews with businesses with 250+ employees. Qualitative: four focus groups and four in-depth interviews with marketplace sellers.

¹⁰⁸ Ibid.

operation and impacts overall QoS. To improve Royal Mail's financial sustainability and protect the USO service, regulatory change is needed.

- 7.19 We believe the most effective way to address customer demands while maintaining a reliable, secure, timely and accessible service is to introduce an additional SDG EOD product. Customers can customise the delivery to suit their personal needs, for example, by taking advantage of our Inflight Delivery Options or Delivery Preferences on days when they are not at home, thereby also improving first-time delivery. An SDG EOD USO product would provide Royal Mail with greater operational flexibility and drive efficiency. This would provide customers with greater choice, and they would be able to pick the service that better meets their needs. We have already recognised the demand for this service and launched an SDG EOD service to customers in February 2024. We would like this service to be available nationally under the USO to our consumers too.

8 Second Class safeguard cap and affordability

Key messages:

- The affordability of USO services remains an important feature for consumers. We always carefully consider the prices of our products - we want to maintain as many letters and parcels as possible in our network.
- Ofcom's research shows that stamp prices in the UK are affordable and we have some of the lowest stamp prices in Europe. Average household spend on post is just 70p per week, or 0.1% of weekly expenditure - this is less than the price of a packet of crisps.
- There are no affordability issues in post for the vast majority of users. Whilst prices will continue to rise across our products alongside any reform, reflecting a structurally declining letters market and the greater cost burden and environmental impact of First Class, reform of the USO would mean that prices do not rise as sharply as they would absent reform.
- Ofcom recently announced the continuation of the Second Class safeguard cap on stamp letters and large letters for a further three years. We do not believe there is any justification for continuing price caps on Second Class stamp letters or large letters.
- Royal Mail has already invested significant time and resources in exploring an approach to address the affordability concerns of the small proportion of consumers who genuinely find postal services to be unaffordable. We would welcome input from Ofcom.

Customer research supports the view that there is no issue with affordability in post

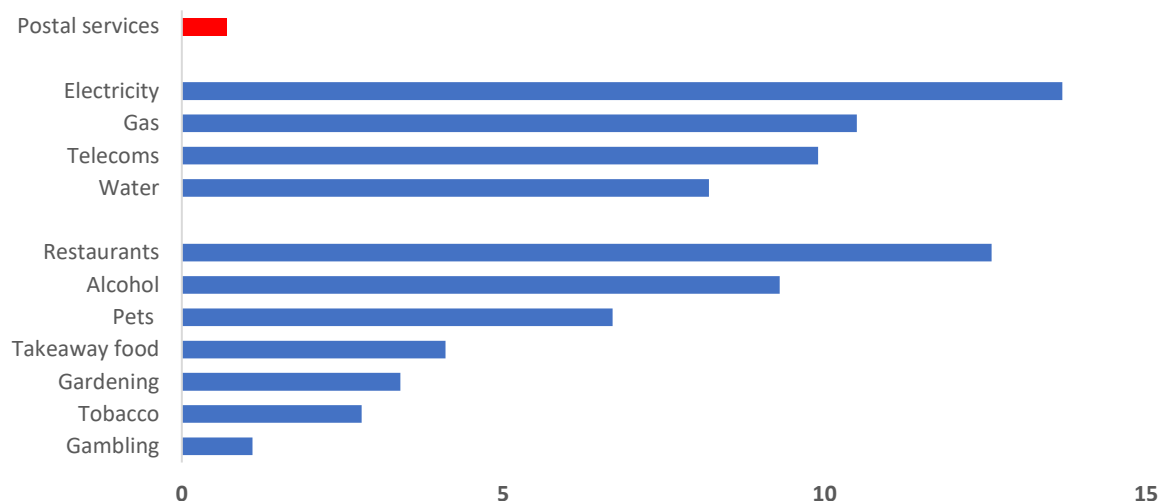
- 8.1 Ofcom assesses the affordability of postal services *"by considering whether current postal prices cause consumers significant detriment."*¹⁰⁹ However, we do not consider there is any issue with affordability in post. Whilst there may be a small minority of consumers with concerns around affordability, the safeguard cap is a crude tool to protect them.
- 8.2 Consumer spending on post is low, both in absolute terms and relative to spend on other goods and services. According to the Office for National Statistics (ONS),¹¹⁰ the average household spend on post is 70p per week, or just 0.1% of weekly expenditure.¹¹¹ By comparison, weekly spending on other vital services and many discretionary activities is substantially higher.

¹⁰⁹ This was the same test it used in its 2013 review of postal affordability and its 2018-19 safeguard caps review. [Review of Second Class safeguard caps 2024 \(ofcom.org.uk\)](https://www.ofcom.gov.uk/consult/condocs/secondclass/secondclass2024/secondclass2024.pdf)

¹¹⁰ ONS, Family spending in the UK: April 2021 to March 2022, May 2023.

¹¹¹ Including parcels.

Figure 8.1: Average household weekly spend (£)



8.3 The ONS data shows that weekly expenditure on postal services of those in the lowest income decile stands at just 50p. This accounts for 0.2% of their weekly expenditure. Even within the bottom decile of income, the average spend on post is less than the price of a packet of crisps. For that price it is possible to send a letter from the Scilly Isles (off the South-West coast of England) to the Shetland Islands (off the North coast of Scotland), over 1,000 km away. Ofcom’s research shows that consumers are not raising concerns about the price of stamps.

8.4 Ofcom acknowledges that the application of affordability tests is challenging due to declining letter volumes and recent increases in the cost of living, suggesting that traditional indicators may not be reliable. Its research finds that whilst the proportion of consumers reporting affordability issues has increased significantly, this is likely driven by broader economic pressures rather than postal prices alone.

8.5 Independent affordability research undertaken for Ofcom by the research firm Jigsaw, which was published in June 2023,¹¹² identified that:

- “[n]one of the participants mentioned the price of stamps as having a major impact on them”; and
- “[p]articipants’ personal circumstances seemed to have a greater impact on perceptions of postal affordability than the price of a stamp”.

8.6 Ofcom has stated in its consultation on the Second Class Safeguard Cap that “concerns about affordability appeared to relate to general economic conditions rather than relating specifically to post.”¹¹³ Whilst consumers are conscious of a cost-of-living crisis, the impact of this squeeze on incomes on affordability of postal services is negligible to consumers, such that it was not mentioned on a single occasion during the research.

Prices are below the European average

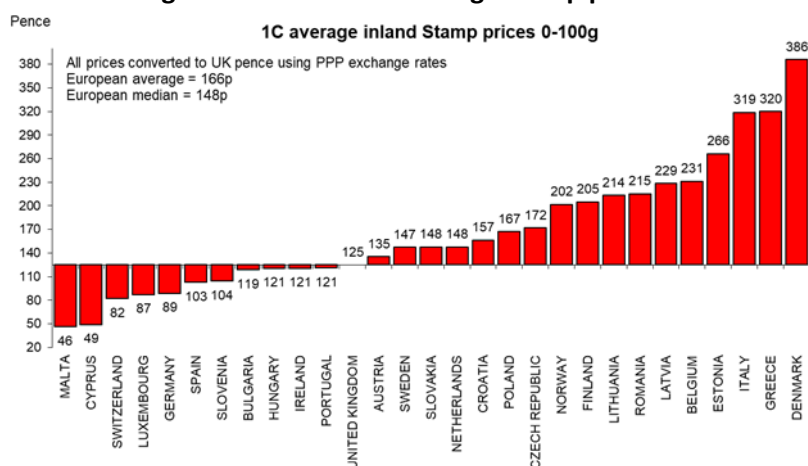
8.7 Comparing our prices to those across Europe, Royal Mail stamp letter prices are on average (across First Class and Second Class and all weight bands) below those in Europe; 102p versus an average of 150p and median of 130p.

8.8 As the figure below shows, Royal Mail’s First Class stamp letter price of 125p is below the European 0-100g average of 166p and median of 148p (even with a rise to 135p in April 2024).

¹¹² Jigsaw, Residential Postal Affordability Research, June 2023.

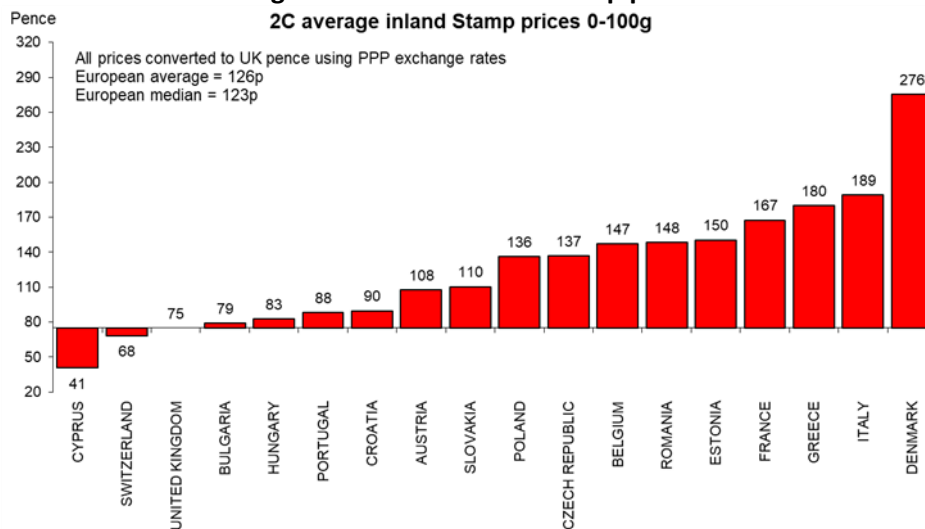
¹¹³ Second Class Cap Consultation Paragraph 2.46.

Figure 8.2: First Class average stamp prices¹¹⁴



8.9 It is also clear that the price of our Second Class stamp is significantly below the European average. As of January 2024, the European average Second Class stamp letter price was £1.26, with a median of £1.23, compared to 75p in the UK. Even with the increase to 85p in April 2024, the Second Class stamp price is still significantly cheaper. Royal Mail has long maintained a prudent pricing policy on letters to avoid “tipping points” whereby price increases push customers away from post entirely.

Figure 8.3: Second Class stamp prices



8.10 Even with the USO reforms set out in this submission, the price of sending letters would continue to rise over time reflecting a structurally declining market but a largely fixed cost network. However, prices would rise less than they would otherwise need to without USO reform, and we would continue to have regard to affordability, as we always have.

Consumers overestimate stamp prices

8.11 Ofcom regularly tracks the views of consumers through its Residential Postal Tracker. Ofcom’s data shows the majority of consumers think that a Second Class stamp offers value for money.¹¹⁵ This is despite the majority of consumers overestimating the price of a Second Class

¹¹⁴ Source: Royal Mail calculations using data from RM Mail Characteristics Survey; various European postal operator websites; World Bank; and Oxford Economics

¹¹⁵ Ofcom, Residential Postal Tracker Q3 2021 – Q2 2022, September 2022.

stamp. Consumers, on average, think that the price of a Second Class stamp is £1.06, which is 25% higher than the actual price of 85p.¹¹⁶

Royal Mail faces incentives to ensure affordability

8.12 Even in the absence of a formal price control, Royal Mail would face continued incentive to ensure affordability for a number of reasons, including:

- competition from digital forms of communication; and
- the need to maintain volumes of mail in the network to benefit from economies of scale.

Second Class stamp prices

8.13 We have set out clearly in this chapter that there are no affordability issues for the vast majority of consumers. However, Ofcom’s decision to maintain the Second Class safeguard cap has the potential to significantly constrain our commercial flexibility and impacts our financial sustainability.

Figure 8.4: The “pricing ladder”

Royal Mail sets prices for its services to reflect the different characteristics of those services and the channels through which they are purchased. This means that we use a “pricing ladder” where prices of services are set in relative terms, with differences in prices reflecting the relative convenience of different products and services. Price differentials are key levers to ensuring we drive efficiency in our operation. For example, through our automation strategy, Mailmark products are cheaper than their manual equivalents. Mailmark products are also better from a customer perspective as they provide more information at a cheaper price, as well as being better for Royal Mail as they are operationally more efficient and benefit from a unique identifier.

This means that the price of letters sold via other channels are, in practical terms, controlled by stamp prices. Letters and large letters are sold via channels other than just stamps. For most account customers, the customer sorts the mail and / or uses a Mailmark barcode. This means the prices for these must be set lower than stamps to reflect the additional costs that customers face to meet the extra requirements.

The pricing ladder includes the following products with prices that are related to Second Class stamp prices (and are therefore indirectly controlled by the Second Class safeguard cap): Meters and USO Account (both USO); Business Mail Unsorted; Business Mail Low Sort Mailmark. The ladder goes all the way down to our lowest prices in wholesale (Access).

8.14 The pricing ladder means that a binding cap on Second Class letters and large letters will limit the price increases we can put on our other letters services including wholesale (Access) products. This significantly constrains our commercial flexibility and could have a significant impact on our finances. For further details please refer to our response to Ofcom’s Second Class cap consultation.

8.15 Due to market conditions, recent Business Mail prices have increased by RPI +5% on average, i.e. increasing the absolute price gap between services. If we want to maintain the current price gap between services, a cap on Second Class stamps means we cannot increase other prices by

¹¹⁶ 2c stamp price as at 2 April 2024.

more than the CPI allowed by the cap. Ofcom’s proposal would therefore have a negative impact on revenue. For further details please see our response to Ofcom’s Second Class cap consultation.

- 8.16 We have consistently increased the differential between manual products and the Mailmark equivalents to encourage customers to move to the more efficient products; we need to be able to continue to do this in the future. The figure below sets out the current prices of the different products and channels that are related to Second Class stamp pricing.

Figure 8.5: Current prices related to Second Class stamp pricing

Channel / Product	Letter Price	Notes
Second Class stamp	75.0p	Service available to consumers and businesses via Post Office Ltd; online, and other outlets.
Second Class meter	69.0p	Meter customers spend c. £40 per month on a meter machine and Royal Mail also saves on stamp commission costs. This is the minimum price difference we need from stamps to make the channel viable.
Second Class USO Account	67.0p	Account customers need to spend a minimum of £5k a year to set up an account.
Second Class Business Mail Manual Unsorted	65.0p	VAT payable version of USO Account and attracts Volume Related Discounts , as all Business Mail products do.
Second Class Business Mail Mailmark Unsorted	51.2p	Mailmark is more efficient for Royal Mail to process and gives more information to the customer. Min 250 items per posting.
Economy Business Mail Mailmark Sorted	45.9p	The lowest priced retail product with sortation required by the customer and a longer delivery spec. Min 4k items.
Economy Access 70 Business Mail Mailmark	40.1p	There is a minimum price gap between Retail and Wholesale products to pass Regulatory and Competition Law tests.

Note: Prices as at 1 March 2024.

Next steps

- 8.17 Ofcom considers that *“it is in respect of the needs of vulnerable groups that questions of affordability are most acute.”*¹¹⁷ It states that it considers *“that there are three main groups with protected characteristics who are more likely to struggle to afford postal services: older people (those aged 55+); people in ethnic minority groups; and people with disabilities.”*¹¹⁸

¹¹⁷ [Review of Second Class safeguard caps 2024 \(ofcom.org.uk\)](https://www.ofcom.gov.uk/consult/condocs/secondclass/secondclass24/secondclass24.pdf), paragraph 3.15.

¹¹⁸ [Review of Second Class safeguard caps 2024 \(ofcom.org.uk\)](https://www.ofcom.gov.uk/consult/condocs/secondclass/secondclass24/secondclass24.pdf), paragraph 2.68.

- 8.18 Ofcom has stated its wish to work with Royal Mail to consider alternatives to the safeguard cap which might offer a more targeted approach. Ofcom notes the practical issues to consider, *“including the mechanism of the scheme (i.e. how eligible consumers would access the discount), eligibility criteria, and how the scheme would be promoted”* and that it *“requires a clear set of options from Royal Mail”*.¹¹⁹
- 8.19 We will look to work with Ofcom to understand the feasibility of a scheme targeted at those consumers who genuinely face affordability constraints with respect to post, and will engage with Ofcom to understand what might meet Ofcom’s expectations.

¹¹⁹ [Ibid.](#), paragraph 2.50.

9 International benchmarking

Key messages:

- The digital age has transformed how mail services are used, and the UK is seeing trends similar to those seen internationally. Reliance on letters as a form of communication has declined and the growth in ecommerce has led to an increase in parcel deliveries around the world.
- Our proposal for USO reform is designed to meet the needs of the UK. But there are things we can learn from abroad. Comparator countries have already made changes to their USO, or are making changes now in response to falling letter volumes and challenges to financial sustainability. The pace of USO reform is increasing as countries adapt to changing customer needs. The UK risks being left in the past if it does not urgently reform its USO.
- Countries have reformed their USO in ways which meet their own customer needs, without any acceleration in the structural decline in letter volumes. There is a range of options (including delivery frequency, speed, QoS targets, subsidy) often used in combination.
- While the unique circumstances of the UK mean we need to find our own solutions, our proposal aligns well with the approach used in comparator countries.

The digital age has transformed how mail services are used globally

9.1 The Universal Postal Union (UPU), a part of the United Nations, is the international body that ensures that letters as a means of communication remains vital across the world. It recognises the global postal system as a “*critical element in the global ecosystem*” in connecting people, businesses, and governments, playing a vital role in a country’s economic infrastructure and social inclusion.¹²⁰

9.2 Post has long been a vital communication tool. But, as we have entered the digital age, e-communication has increasingly reduced the reliance on letters as a means of communication. At the same time, the growth of e-commerce means that postal services are now vital in connecting online retailers with their customers. Whilst the “*declining trend of letter-post volumes is undeniable*”, *domestic parcel traffic is the only segment showing growth in the postal sector. It is estimated that global parcel revenues could outstrip letter revenues by 2025, representing “transformative shifts in consumer behaviour ushered in by the digital age”*.¹²¹

UK trends in customer use of mail reflect those seen around the world

9.3 The change in global customer use of postal services is a trend that can also be seen in the UK. As we have set out in Chapter 2, the needs of Royal Mail’s customers have fundamentally changed. There is a long-term trend in declining letter volumes in the UK. From a peak of 20 billion letters sent in 2004/05, this has now fallen to seven billion in 2022/23, and is predicted to continue to fall to around four billion letters within five years. Ofcom acknowledges this, stating in its CFI that structural letter decline is likely to continue. Although declining, letters are expected to continue to play a vital role in the UK.¹²² The solution for the UK needs to be tailored to the unique circumstances in the UK. However, countries around the world are grappling with the same challenges and there are lessons to be learnt from abroad.

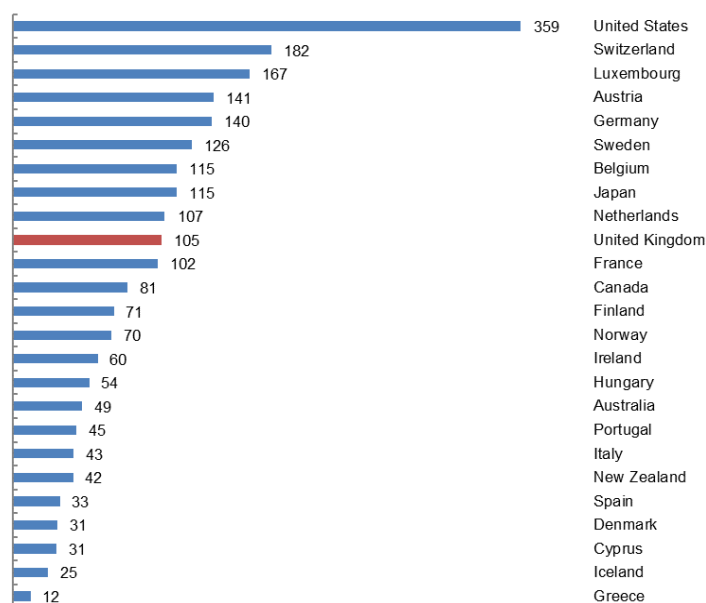
¹²⁰ UPU, State of the Postal Sector report, 2023.

¹²¹ UPU, State of the Postal Sector report, 2023.

¹²² CFI, paragraph 3.3.

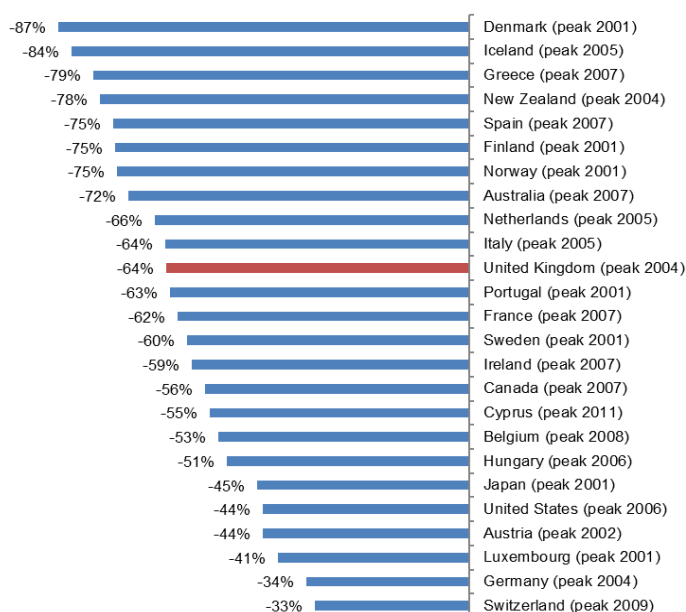
9.4 As shown in the figure below, domestic letter volumes vary by country. Each country is unique, with factors such as real incomes, prices, geography, government legislation and cultural differences driving these differences. The UK per capita volumes are in line with those in other developed countries.¹²³

Figure 9.1 Domestic letter volumes per capita, 2022



9.5 The UK also reflects international trends in letter volume decline. We have analysed when letter volumes reached their peak in individual countries and calculated how much letter volumes have declined. The peak for domestic volumes seems to have occurred around the mid-2000s for most countries. The percentage of letter volume decline from peak in the UK is comparable to that seen in similar countries (see figure below).¹²⁴

Figure 9.2 – percentage letter volume decline form peak



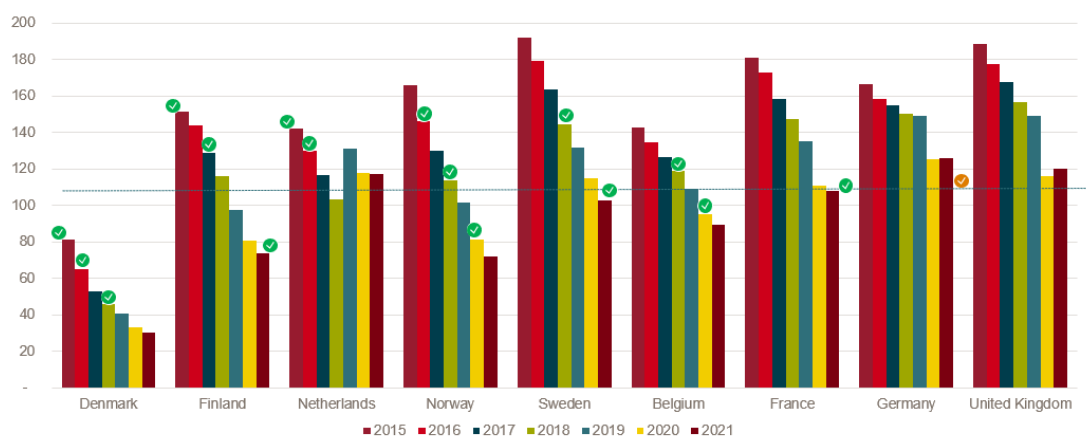
¹²³ Royal Mail Economics & Business Forecasting calculations using domestic addressed volume data from IPC (November 2023) and reports by operators. 2021 volume per capita is used for Hungary as 2022 data was unavailable. We note that individual countries may define mail items differently.

¹²⁴ Ibid.

We spent time understanding how other countries have adapted

- 9.6 In 2023, Royal Mail commissioned Frontier Economics to benchmark a range of international comparator countries to understand how those countries had adapted to changes in the market.¹²⁵ Frontier Economics looked at the characteristics of the postal sector in these countries, including the legislative and regulatory regimes in those countries to produce a list of comparator countries.
- 9.7 A significant number have already made, or are currently making, changes to their USO. The majority of countries where no changes have been made to their USO are in central eastern Europe. The countries considered to be most similar to the UK in the benchmarking, based on social and economic characteristics and the current state of their national postal sector, have all made, or are currently in the process of making, changes to their USO. This demonstrates that a positive change is possible to maintain a sustainable USO.¹²⁶
- 9.8 Financial sustainability was found to be the most commonly stated reason for USO reform. Meeting consumer needs, reducing environmental impact of deliveries, reducing the need for subsidy, changes in government policy and improving competition are the other drivers for change. In a number of countries where no USO change has taken place (Bulgaria, Estonia, Croatia, Hungary, Lithuania) the entire financial burden of their USO is borne by the state.¹²⁷
- 9.9 The decline in letter volumes is a key driver of USO change. Part of the analysis undertaken by Frontier Economics was to look at the tipping point in letter volumes which were the catalyst for USO change in comparator countries. Frontier Economics found that early adopters of USO reform tended to be those with a lower number of letters per person. For example, Belgium, Denmark, Finland and the Netherlands started with a lower per capita volume of letters per person, and all made changes to their USO at least five years ago – and indeed more than 10 years ago in some cases.¹²⁸

Figure 9.3 Addressed letter items per capita delivered by Universal Service Providers¹²⁹



Source: Company accounts, PostNL European Postal Markets overview
 Note: 🟢 🟠 = year in which USO change was made or considered. Tick to the left or right of the bars shows that change was made before or after the years shown.
 Dashed line is the UK's 2022/23 items per capita. In Netherlands, PostNL acquired a competitor in 2019 which resulted in increased in volumes.

¹²⁵ See Annex 9 for the Frontier Economics' report "USO benchmarking review findings".

¹²⁶ Ibid.

¹²⁷ Ibid.

¹²⁸ Ibid.

¹²⁹ Ibid.

- 9.10 Several countries were observed to have had similar letter volumes to those in the UK in 2015 including France, Germany, Norway, and Sweden. Both Norway and Sweden have now made multiple changes to their USO, choosing to do so whilst their volumes were higher per capita than those in the UK now. In 2022/23, Royal Mail delivered approximately 105 items per capita. This is already below the level at which many other countries made USO changes.¹³⁰
- 9.11 The Frontier Economics benchmarking report makes it clear that many countries, including those most similar to the UK, are modernising and adapting to the new realities of the digital age. It states *“Most comparator countries made material changes including delivery speed, delivery frequency, quality of service, or delivery point. Other USPs (UK, Germany, France) had previously sought to retain volumes of letters, but decline is now reaching the point to act.”*¹³¹

The pace of regulatory change in the postal sector is increasing

- 9.12 Since Frontier Economics completed its report in November 2023, there have been further changes in postal regulation internationally:
- In November 2023, Portugal proposed to reduce the number of QoS targets from 24 down to eight;¹³²
 - In December 2023, The European Regulators Group for Postal Services (ERGP) called for an investigation into solutions that balance service levels and the costs of providing the USO;¹³³
 - In December 2023, Australia announced they would be moving to a new delivery model, reducing the number of delivery days per address per week for non-First Class letters, citing the need for financial sustainability and to focus on parcel delivery;¹³⁴
 - In December 2023, the German Government adopted a new draft Postal Act, which was sent to parliament for discussion. This includes changing the requirement for a D+1 service in the USO to a D+3 service, and amendments to QoS targets;¹³⁵
 - In December 2023, the European Commission approved the plans for France to compensate La Poste €500-520m annually for the cost of its USO;¹³⁶
 - In January 2024, Denmark abolished its USO almost entirely, with some small elements still protected;¹³⁷
 - In January 2024, the Czech Government consulted on significant changes to its postal act, allowing for changes to delivery frequency, consumer protections, wholesale access and USO funding;¹³⁸
 - In February 2024, the Polish Government announced that Poczta Polska would be receiving c. €161m for 2021-22 in state aid for providing the USO in Poland;¹³⁹

¹³⁰ Ibid.

¹³¹ Ibid.

¹³² https://www.anacom.pt/streaming/ProjetoProposta_versaoPublica.pdf?contentId=1758603&field=ATTACHED_FILE

¹³³ ERGP, Report on the effects of the modernisation / adaptation of the Universal Service, 2023

¹³⁴ [Australia Post modernisation media statement | Australia Post Newsroom \(auspost.com.au\)](https://www.auspost.com.au/newsroom/australia-post-modernisation-media-statement)

¹³⁵ German Federal Ministry for Economic Affairs and Climate Action, Revision of the Postal Act, 2023

¹³⁶ https://ec.europa.eu/commission/presscorner/detail/en/ip_23_6334

¹³⁷ [Vedtagelsen af ny postlov medfører justeringer hos PostNord | PostNord](https://www.postnord.com/ny-postlov-medforer-justeringer-hos-PostNord)

¹³⁸ <https://www.cullen-international.com/news.html>

¹³⁹ <https://kep-meldungen.de/>

- In February 2024, CNMC, the Spanish postal regulator, suggested modifying the accounting methodology used to calculate the USO net cost in Spain;¹⁴⁰ and
- In February 2024, PostNL announced that it would be engaging with the Dutch Government to move standard delivery times from D+1 to D+2, and then ultimately D+3.¹⁴¹

Countries have reformed their USO in ways which meet their own needs

9.13 Each country has had to respond to changes in the postal sector in a way that is right for their unique circumstances. There is not a one-size-fits-all solution, and no two solutions are exactly the same. Frontier Economics found the most common change to USO in the benchmarked countries has been to amend QoS targets (11 countries) and to change the required frequency of deliveries (10 countries). A change to the delivery speed to certain products was another common change to USO services. By making these changes, two popular delivery models have emerged: (1) a five day letter delivery model; and (2) fewer delivery days per address each week for non-First Class mail. These models can be utilised to reduce the costs faced by a postal operator, most notably in transport and delivery.¹⁴²

Fewer delivery days for non-First Class letters

9.14 The option to reduce the number of delivery days per week for delivery of non-First Class letters gives the universal service provider (USP) an opportunity to reduce delivery days for non-First Class mail whilst maintaining a network for more urgent mail. It is seen as the best way to reducing the financial burden of the USO. This model can be made possible by a change to delivery speed, delivery frequency, QoS changes, or a combination of all three.

Five day delivery

9.15 Moving from a six day to a five day delivery model is a relatively simple operational change and does not require a major redesign of the operational network. Savings can be realised relatively swiftly but are more limited in scope. It has been successfully deployed by removing Saturday deliveries in Denmark and Norway, removing Tuesday deliveries in Finland, and by removing Monday deliveries in the Netherlands.¹⁴³

Changing QoS targets

9.16 Changing QoS targets has been used in a range of ways by different countries to support wider changes to USO and allowing for operational reforms. There is no single change that is appropriate for every country.

- **When geographic variations are introduced, QoS targets can be aligned.** In Italy in 2015, delivery speed was reduced to allow the D+1 product to be delivered in D+2 (rural) or D+3 (deep rural).¹⁴⁴ The 80% QoS target was retained across the three groups, allowing for alternate day deliveries in the more rural municipalities.¹⁴⁵
- **When delivery speeds are reduced, QoS targets can be increased.** In Sweden in 2018, a move from a D+1 service to a D+2 service resulted in a change to the QoS target from 85%

¹⁴⁰ [STP/DTSP/052/23 - REVISIÓN DE PRECIOS DE LOS SERVICIOS POSTALES PRESTADOS BAJO RÉGIMEN DE OBLIGACIONES DE SERVICIO PÚBLICO PARA EL AÑO 2024 | CNMC](#)

¹⁴¹ PostNL, PostNL reports Q4 & FY 2023 results, 2024.

¹⁴² See Annex 9 for the Frontier Economics' report "USO benchmarking review findings".

¹⁴³ Denmark, Norway, and Finland have subsequently reduced frequency further as mail volumes have declined.

¹⁴⁴ D+2 where either the delivery or access point are served on alternate days and D+3 where the delivery and access points are both served on alternate days.

¹⁴⁵ IPC, Postal Regulatory Database country directory, 2023.

to 95%. This is also believed to be an option being considered in Germany. Whilst the delivery speed is reduced, reliability (i.e. certainty about delivery) can be increased.¹⁴⁶

- **When delivery speeds are reduced, QoS targets can be decreased.** For example, in Finland in 2017, a move from D+2 to D+4 was accompanied by a move from 95% to 50%. This allowed Finland to make significant operational savings in moving to a three day delivery model.¹⁴⁷
- **When new delivery speeds are introduced, new targets can be introduced.** In Norway in 2018, a new D+2 service was introduced with an 85% QoS target. This was in line with the D+1 service it replaced.¹⁴⁸

Changing delivery speed

9.17 Reducing the delivery speed of the main universal service product allows for operational restructuring and increased efficiency, especially in creating a more efficient logistics network, and a more efficient delivery model. Norway and Sweden moved from a D+1 to a D+2 service (D+3 is now being considered in Sweden),¹⁴⁹ France has moved from D+1 to D+3 (for physical letters), New Zealand moved from D+2 to D+3, and Germany is currently considering moving from D+1 to D+3.

Geographical variations

9.18 Introducing geographical variations in USO service provision gives the USO provider an opportunity to make operational savings whilst delivering to certain parts of the country. In Italy, Poste Italiane was allowed to introduce alternate day deliveries for up to 25% of the population, and is based on the size of conurbations, the population density, and the number of business users. The move to alternate day deliveries in some of the country allowed Poste Italiane to reduce the “particularly onerous” burden of their USO.¹⁵⁰

Subsidies

9.19 Changes to the USO to allow for operational efficiencies are not the only option that has been explored internationally. Where the net cost of the USO cannot be met by the USP, a number of countries have introduced additional funding to cover the financial burden of providing the USO:

- **France.** The French Government has authorised an annual subsidy of €500m – €520m for providing the USO from 2021 to 2025, dependent upon certain QoS targets being achieved;¹⁵¹
- **Italy.** Poste Italiane receives an annual subsidy of up to €262m from 2020 to 2024 for providing the USO;¹⁵²
- **New Zealand.** The New Zealand Post contract allows for funding of up to NZD130m to be drawn down as the profitability of the USO declines. This funding was expected to be exhausted by the end of 2023,¹⁵³

¹⁴⁶ See Annex 9 for the Frontier Economics’ report “USO benchmarking review findings”.

¹⁴⁷ ERGP, Report on the effects of the modernisation / adaptation of the Universal Service, 2023.

¹⁴⁸ See Annex 9 for the Frontier Economics’ report “USO benchmarking review findings”.

¹⁴⁹ ERGP, Report on the effects of the modernisation / adaptation of the Universal Service, 2023.

¹⁵⁰ Ibid.

¹⁵¹ https://ec.europa.eu/commission/presscorner/detail/en/ip_23_6334

¹⁵² https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2276

¹⁵³ <https://www.nzpost.co.nz/about-us/media-centre/media-release/nz-post-welcomes-its-shareholders-confidence-in-its-future>

- **Norway.** In 2003, the Norwegian Government proposed to allocate approximately NOK 1,260.6 million for government purchases of unprofitable postal services;¹⁵⁴
- **Spain.** In Spain, Correos received €1.28bn in total between 2011 and 2020. In 2021, a new methodology for calculating the net cost of the USO was proposed;¹⁵⁵
- **Sweden.** A new model of compensation is currently being considered by the Swedish Government;¹⁵⁶ and
- **Belgium.** In Belgium, Bpost is required to undertake a yearly USO net cost calculation, which is then verified by the regulator. In the case of a claim, a process is set out for USO change, or financial compensation to be paid.¹⁵⁷

A closer look at France and Germany

- When looking at a broad range of factors such as demographics, size, geography, population density, socio-economic development, postal market development (including high levels of competition in the parcels market), ecommerce penetration and the regulatory environment, France and Germany are considered to be good comparators for the UK postal sector. France has already made significant changes to its USO, and Germany is in the process of doing so.

France

- Geographically, France is approximately twice the size of the UK, with a lower population density.¹⁵⁸ La Poste has been working with its government and regulator for a number of years. In 2011, La Poste updated its USO, introducing a new D+2 product which gave consumers an additional option when sending letters.¹⁵⁹ In 2021, the French Government introduced an annual subsidy of €500m – €520m dependent upon QoS. In 2023, France removed its traditional D+1 product (instead offering a D+1 e-letter) and changed its D+2 letter product to D+3. Whilst delivery still takes place on a Saturday, it is restricted to a small number of priority products, including its e-letter product. This allows for a significant reduction in the cost of providing the USO in France.¹⁶⁰

Germany

- The geography of Germany is more comparable to the UK. By landmass, it is c. 50% larger than the UK with a slightly lower population density than the UK.¹⁶¹ It currently delivers USO letters six days per week against a D+1 target of 80%. This is considered to be the ‘worst of both worlds’ target. It requires a next day service which has a negative impact on the cost of providing the USO service whilst a target of 80% is not meaningful for consumers. Deutsche Post has worked with its government to reform postal legislation and is now in the process of working with its regulator to agree how this can be reflected in its regulation. In January 2023, the German Government announced a “*fundamental modernisation of the regulatory framework for postal services... in an increasingly digital society*”.¹⁶² The German proposal is to remove the D+1 letter product from the USO, instead replacing this with a D+3 letter product, and increasing the QoS target from 80% to 95%. This change would allow for significant operational saving and give customers more certainty around reliability.¹⁶³

¹⁵⁴ CFI, page 98.

¹⁵⁵ [https://www.boe.es/eli/es/res/2021/06/15/\(3\)](https://www.boe.es/eli/es/res/2021/06/15/(3))

¹⁵⁶ [Posttjänst för hela slanten. Finansieringsmodeller för framtidens samhällsomfattande posttjänst. SOU 2023:4 \(regeringen.se\)](https://www.posttjanst.se/for-hela-slanten)

¹⁵⁷ Bpost, Strategy update & capital allocation, 2020

¹⁵⁸ United Nations, Department of Economic and Social Affairs, Population Division, 2022

¹⁵⁹ ERGP, Report on the effects of the modernisation / adaptation of the Universal Service, 2023

¹⁶⁰ <https://www.lapostegroupe.com/fr/actualite/la-poste-modernise-sa-gamme-courrier>

¹⁶¹ United Nations, Department of Economic and Social Affairs, Population Division, 2022

¹⁶² German Federal Ministry for Economic Affairs and Climate Action, Revision of the Postal Act, 2023

¹⁶³ ERGP, Report on the effects of the modernisation / adaptation of the Universal Service, 2023

- 9.20 It is important that any change to the USO reflects the needs of users. In its CFI, Ofcom considered how the posting habits of customers were impacted by USO changes in other countries. Whilst some consumers in those countries raised concerns, Ofcom’s analysis of posting volumes showed *“no indication that changes to USO specifications had significantly affected volumes... indicating neutral attitudes to changes.”*¹⁶⁴Our proposal shares many similarities with comparator countries.
- 9.21 Our solution for reform is designed to meet the needs of our customers and to support a financially sustainable USO. Whilst there is no one-size-fits-all solution for USO reform, it is reassuring to understand that our proposed solution is in line with the kinds of changes made in other countries.
- 9.22 Reducing the number of delivery days per week for delivery of non-First Class letters is seen as the best route to reduce the cost of the USO, while continuing to meet customer needs. It is now the standard delivery method in Belgium, Finland, France, Italy, New Zealand, Norway and Sweden and is being considered by Germany. Consolidating non-First Class mail to deliver every other weekday allows for an increased efficiency in delivering both First Class and Second Class letters (see Chapter 5 for more details) and enables us to retain a First Class letter service. Retaining a First Class product is in line with countries such as Belgium and the Netherlands. When compared to Germany and France, the UK has a higher population density, meaning that it is more efficient to deliver a D+1 letter product. As set out in Chapter 4, UK consumers and SMEs are keen to retain a choice between a First Class and a Second Class letter product.¹⁶⁵
- 9.23 Figure 9.4 below shows in more detail how the key elements of our proposal benchmark against other countries.

¹⁶⁴ CFI, paragraph 7.8.

¹⁶⁵ United Nations, Department of Economic and Social Affairs, Population Division, 2022.

Figure 9.4 – comparison of our proposal with other countries

Our proposed option	International peers
We will continue to offer First Class letters six days a week – customers still value First Class	<ul style="list-style-type: none"> • There is no ‘one size fits all’ approach across global posts • Where First Class is withdrawn, this is primarily due to high costs (geography/population density), low demand (loss making product) or Government policy (digitalisation). • Some countries have withdrawn First Class USO completely (e.g. Denmark, Norway, Sweden, Germany (considering)) • Others have limited First Class - France only has e-letters (and are removing this due to low demand) and Australia only has D+1 within the same city. • Others (e.g. Belgium and Netherlands) have retained First Class to date.
Less frequent delivery for non-First Class letters Monday – Friday. First Class letters delivered six days	<ul style="list-style-type: none"> • Many countries have used less delivery days and/ or less frequent non-priority delivery days to reduce costs • Belgium (five days, reduced non-priority deliveries), Australia (five days, reduced non-priority deliveries), France (six days, reduced non-priority deliveries), Italy (five days, reduced non-priority deliveries, rural differences), Norway (alternate day delivery), Germany (alternate delivery being considered over six days) • Sometimes reductions are made in steps (e.g. Norway and Denmark) • France, UK, Germany and Malta are the only countries in Europe required to delivered six days per week
Maintain geographic uniformity and uniform price	<ul style="list-style-type: none"> • Consistent across most European countries • Exceptions are Italy and Australia due to significant regional variations in population density
Quality of service - reliability and refreshed speed targets on First and Second Class USO products	<ul style="list-style-type: none"> • No country of a comparable size to the UK has a D+1 target as high as 93%. • Only materially smaller countries have retained high First Class targets (e.g. Austria (95%), Belgium (95%), the Czech Republic (92%), Ireland (94%), the Netherlands (95%) and Portugal (94.5%) all have targets in excess of 90%. The largest of these, Portugal, is approximately one third the size of the UK. • Targets in other larger countries such as France (prior to reforming its USO, 85%), Poland (82%), Germany (currently 80%) and Italy (80%) are much lower than the current 93% in the UK. • International D+3 targets are much lower than our current 98.5% target (Belgium (95%), France (95%), Australia (94%), Spain (93%), Norway (85%), Sweden (85%)) • Reliability targets are widespread e.g. Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Norway, Portugal, Spain and Sweden
Financial – contribution required if no USO reform. Ofcom has recognised this. The compensation mechanism in PSA 2011 does not work.	<ul style="list-style-type: none"> • State ownership makes a subsidy more likely. The following countries have a subsidy (New Zealand (100% state owned), Spain (100%), Norway (100%), Sweden (100%) and Denmark (100%), France (34%), Italy (29%)) • USO reform has been used to avoid the need for subsidy completely (Australia, Belgium). • Belgium (does not have subsidy), Norway and New Zealand regularly review the financial burden of the USO and the level of subsidy required

Conclusion

9.24 Postal services remain important. However, changes in how post is used in the digital world have led to structural decline in letter volumes whilst domestic parcels continue to grow. Postal operators around the world are working to adapt to these changes and ensure their postal USO is financially sustainable. The UK has failed to respond to the change in market conditions. Mail volumes per capita in the UK are much lower than the threshold for action in other countries and the UK is behind the times when it comes to reforming its USO.¹⁶⁶ As Ofcom pointed out in its CFI: *“The UK remains one of a small group of countries in which the USP is required to deliver letters 6 days a week and offer a mainstream high-volume next day (i.e. First Class) letters product.”*¹⁶⁷

9.25 There is no one solution to USO reform that meets the specific needs of every country. However, many countries have already acted and successfully reformed their USO. There is robust evidence that Royal Mail’s proposals for USO reform are in line with adaptations we have seen in other countries whilst still reflecting the specific needs of UK customers. Reducing the number of delivery days per week for delivery of non-First Class letters is becoming a standard approach to supporting a financially sustainable USO. Retaining a six day per week First Class delivery service means the USO would still meet the needs of UK consumers. Adjusting the QoS targets and introducing new reliability targets means that consumers can benefit from increased certainty about reliability as they already do in many other countries.

¹⁶⁶ See Annex 9 for the Frontier Economics’ report “USO benchmarking review findings”.

¹⁶⁷ CFI, page 46.

10 Future proofing the USO

Key messages:

- Our reform proposal for unlocking a new delivery model is designed to address the net cost challenges of providing the USO. However, structural letter decline will inevitably continue, and so at some point in the future further change is likely to be required.
- The current legislative and regulatory framework for change is not fit for purpose. To get to this stage of Ofcom even starting the CFI process has taken far too long.
- We are therefore calling for a new framework, to identify and address any financial sustainability issues driven by continuing changes in customer demands, in order to future proof the USO. This comprises:
 1. Ofcom carrying out a regular (at least every two years) effective net cost assessment to provide an early warning system and potential solutions to address USO financial sustainability issues. This would allow transparency of the true costs of the USO to Royal Mail, allowing for a fair and open debate about how those costs are rightly met;
 2. Ofcom to be given the power unilaterally to make changes to the minimum number of delivery days, if required, rather than having to obtain Government and Parliamentary approval; and
 3. A revised contribution fund mechanism to support any net cost in providing the USO, to replace the existing mechanism which Ofcom has itself recognised as not being fit for purpose.

There is a clear need to future proof the USO

- 10.1 We have set out in this submission the reasons why the USO needs urgent modernisation now, and our proposal for how that modernisation can be achieved. Our proposal is simple and achievable within a short timeframe. It does not require legislative change.
- 10.2 However, there is also a clear need to future proof the USO. The letters market will continue to see structural decline over the coming years and decades. Accordingly, whilst the change we are asking for now would address the current net cost we are facing in providing the USO, it is unlikely to be sufficient in the longer term.
- 10.3 However, the last four years have demonstrated that, under the current regulatory framework, change is extremely slow and reliant on political “buy in”, which may not be forthcoming, particularly when there are always other, more politically appealing, priorities. We have been calling on Government and Ofcom to examine this issue now for four years. However, engagement has been slow and sporadic.
- 10.4 Moreover, additional hurdles have been placed in the way. For example, under Section 34 PSA 2011, the Secretary of State can table an amendment to the minimum requirements following Ofcom carrying out a User Needs Review demonstrating that customers’ needs would be met by a reduced minimum delivery requirement. However, in late 2022, Government refused to engage at all on this question until Ofcom had carried out a review establishing that we were facing a cliff edge regarding financial viability, even though this is clearly not required by statute.
- 10.5 We are therefore calling for a new framework, with **three important legislative and regulatory changes** that should be made in the future (following the immediate changes we are calling for in our core proposal), which would allow the USO to adapt and evolve swiftly as customer

preferences continue to change in a structurally declining letter market. We set out further details on each of these below.

Regular net cost assessment

- 10.6 For the reasons set out in this submission, we welcome Ofcom’s review and its recognition that there is a net cost burden in providing the USO as currently specified. We agree with these conclusions. However, this is just a snapshot of the position in 2021/22. We consider that it is important to have regular, up-to-date, information on whether there is a net cost in providing USO services. This would provide an independent “early warning system”, which lets all stakeholders know when action may need to be taken.
- 10.7 Royal Mail therefore calls for the introduction of a requirement on Ofcom to carry out an effective regular net cost calculation every two years. This would provide visibility and transparency about the true costs of the USO to the USP, allowing for a fair and open debate about how those costs are rightly met and allowing for action to be taken to address the burden in a timely manner.
- 10.8 There are requirements on regulators in other jurisdictions to carry out regular net cost assessments. For example, Belgium, Spain, Italy and Norway.
- 10.9 We recognise that there is already a mechanism in the PSA 2011 for Ofcom to carry out a net cost assessment in the context of assessing whether a fund should be created for seeking contributions from postal operators or users. However, there is currently no requirement on Ofcom to carry out this assessment on a regular basis.
- 10.10 Alongside calling for a new provision to be introduced to the PSA 2011 to conduct an effective net cost assessment, we ask that Ofcom conducts a regular assessment in any event in the interim period.

Ofcom should have power to change minimum delivery requirements

- 10.11 We are also calling for a change in the PSA 2011 to give Ofcom the power to change the minimum delivery and collection requirements, rather than having to obtain Government and Parliamentary approval. We believe that the cause of the current uncertainty around reform derives from how the regulatory regime is currently structured in the UK under the PSA 2011.
- 10.12 In particular, there is a regulatory gap caused by the current dichotomy of control over the current regulatory framework (and therefore reform of it) between Ofcom and Government/Parliament. Ofcom has control over certain types of change (e.g. characteristics of the services to be offered, delivery speeds, and access points), whereas Government/Parliament has control over other types of change (such as minimum number of delivery days and collection days).
- 10.13 Whilst in theory this might seem a workable arrangement, with Government/Parliament retaining control over what it sees the most important aspect of the USO, in practice, the changes envisaged are often a complex combination of both areas (e.g. delivery speeds and delivery days), and so neither Ofcom nor Government can decide alone on an overall solution and hence move quickly to implement a remedy. We believe it is also deeply unhelpful that key decisions around ensuring financial sustainability become “politicised” and linked to electoral cycles.
- 10.14 We therefore call for control over the minimum requirements concerning delivery and collection days, currently set out in the PSA 2011, to be provided to Ofcom so that any changes necessary in the future to reflect changing user needs can be implemented more quickly and

efficiently through regulatory change by a specialist economic regulator that is closer to market dynamics.

Revised contribution fund mechanism

10.15 Where it is established that there is a net cost burden of providing the USO, and where it is not possible to address this through price increases alone, there are essentially three ways of addressing the unfair burden of the USP having to bear that net cost:

- the USO is reformed, so it no longer results in a net cost burden; or
- the USP is given financial support from Government in order to help meet that net cost burden of providing the USO; or
- a combination of both USO reform and financial contributions.

10.16 Ofcom recognises in the CFI that the current mechanism for a contribution fund under the PSA 2011 is not workable in practice. Contributions from postal users or other postal operators would simply not work.

10.17 That does not mean, however, that financial contributions for meeting the net cost of the USO should be ruled out entirely. As Ofcom states in its CFI, it may fall on Government to contribute to those costs, as is the case in a number of European countries. Ofcom has stated that *“it would be open to the Government to decide to meet some or all of the financial burden via public subsidy”*.¹⁶⁸

10.18 There are several countries where recent USO reform has included the provision of some form of Government funding, either on its own, or coupled with USO reform. See Chapter 9 for further details.

10.19 Whilst it is open to Government to provide Royal Mail with a financial contribution to address the net cost burden of providing the USO outside of the PSA 2011 framework, it would clearly be more appropriate and simpler if this mechanism were enshrined in the postal statutory framework. We therefore call on Government, with Ofcom’s assistance, to review and update the contribution fund mechanism in the PSA 2011, to ensure that it is fit for purpose, and allows Government to provide financial support if ever required in the future.

¹⁶⁸ CFI, paragraph 8.7.

11 Legal and regulatory framework for change

Key messages:

- Our reform proposal for unlocking a new delivery model would continue to meet the minimum requirement in Section 31 of the PSA 2011 of providing letter deliveries six days a week. It does not require Government or Parliamentary approval.
- All that is required is for Ofcom to update its 2020 User Needs Review and carry out a consultation exercise on the changes required to the regulatory conditions. Ofcom should be able to quickly refresh its User Needs assessment given its continuous Postal Tracker research, the research it has carried out in advance of publishing its CFI, and the recent UK wide stakeholder events.
- Our proposals on QoS, tracking on parcels, a new SDG EOD product and removal of the Second Class price cap can also be made by Ofcom alone making changes to its DUSP conditions.

Figure 11.1 - Legal instruments to be updated to implement Royal Mail's proposals

Proposals	Designated USP Conditions	USP Access Condition	Postal Services Order 2012	Postal Services Act 2011
• New delivery model (six day First Class; five day non-First Class)	✓	✓	✓	✗
• Rebalanced Quality of Service targets	✓	✗	✗	✗
• Tracking on USO parcels	✓	✗	✗	✗
• "End of day" SD product	✓	✗	✗	✗
• Removal of Second Class Price Cap	✓	✗	✗	✗
• Net cost assessment	✗	✗	✗	✓
• Ofcom power re delivery days	✗	✗	✗	✓
• Revised contribution fund	✗	✗	✗	✓

Our reform proposals

Unlocking a new delivery model and rebalanced QoS targets

The PSA 2011 minimum requirements would not need to be changed

- 11.1 The PSA 2011 minimum requirements are set out in Section 31 of the PSA 2011. Requirement 1 is for "at least one delivery of letters every Monday to Saturday ... to the home or premises of every individual or other person in the UK".
- 11.2 No further details are provided in the PSA 2011 regarding which products/services need to be delivered to meet the minimum requirement for letters. Therefore, the requirement for Saturday letter delivery would be met by the continued delivery of First Class letters, and so would the other minimum requirements – for example, the service would be provided at a tariff which is affordable and uniform across the UK (Requirement 3).

- 11.3 For the reasons set out in Chapter 5 above, our First Class letter service under our reform proposal would meet these requirements. In particular, it would continue to be sold at an affordable and uniform tariff across the UK. Please see Chapter 5 for further details on the proposal.
- 11.4 Ofcom recognises that the options it considers in the CFI involving changes to delivery speeds (rather than a change to the number of delivery days), which is effectively what our proposal is, does not require legislative change. For instance, at paragraph 9.93 of the CFI, Ofcom states that *“Some of the options for change require legislative change, others could be made through changes to our regulations”*.

Changes to Ofcom’s Order and regulatory conditions

- 11.5 A change to non-First Class letter delivery frequency would require changes to the Ofcom Postal Services Order (**“the Order”**) and will require changes to certain regulatory conditions. See paragraphs 11.10 to 11.12 below for details of the key changes that would be required.
- 11.6 At a high level, the changes would remove the requirement for the delivery of certain letter products/services on a Saturday in the Order, the DUSP Condition 3 and the Access Condition.
- 11.7 Such changes can be made by Ofcom, following the procedures set out in the PSA 2011. Ofcom can modify the Order under Section 30, paras 1 to 3, having carried out a User Needs Review. In this case, however, Ofcom could simply update the detailed review it conducted in 2020, by refreshing its research in that review. In particular, the broad conclusion that Ofcom reaches, namely that users’ needs would still be met with a five day letter service, is likely to hold true, and so it would seem logical that users’ needs would still be met under our proposal, of having a six day a week First Class letter service, and a five day a week non-First Class letter service.
- 11.8 In addition, Ofcom have undertaken a number of other research activities, including its Residential Postal Tracker (a continuous tracking study that measures opinion, usage and attitudes to postal services among UK adults), the research it carried in advance of publishing its CFI and its recent stakeholder events could all be used to inform its User Needs assessment. Further, we have carried out an extensive consumer research exercise which demonstrates that our proposal meets customer needs (see Chapter 4 and 5, and Annex 8).
- 11.9 The relevant regulatory conditions can be amended under the procedures set out in Schedule 6 of the PSA 2011. This requires Ofcom to carry out a consultation exercise, whereby it publishes a notification stating that it is proposing to modify certain conditions, sets out the effect of the modification, provides reasons and specifies the period (of at least one month) within which representations may be made to Ofcom about the proposal.

Changes required to the Order

11.10 The changes required to the Order are as follows:

- Schedule 1, Paragraph 2 and Paragraph 3, which set out the key requirements for standard First Class and non-First Class services respectively, should make clear that these First Class services are required to be delivered only Monday to Saturday, and non-First Class services delivered only Monday to Friday; and
- change the definition of "working days" for non-First Class letters (and large letters) to exclude Saturdays as well as Sundays and public holidays.

Changes required to the Ofcom DUSP Condition

11.11 The changes required to the Ofcom DUSP Condition are as follows:

- add a sub-paragraph to the descriptions of the standard non-First Class services at paragraphs 1.6.1(a) and 1.6.1(b) to make it clear that these services are to be delivered on Monday to Friday only;
- change the definition of “working days” for non-First Class services to exclude Saturdays as well as Sundays and public holidays; and
- adjustments required to the performance targets for letter services as specified in Chapter 6.

Changes Required to the Ofcom USP Access Condition

11.12 The changes required to the Ofcom USP Access Condition are as follows:

- amend the definition of "working day" to "any day which is not a Saturday, Sunday or a public holiday"; and
- standard letter (and large letter) service changed from D+2 to D+3.

Allowing tracking on USO parcels

11.13 For the reasons set out in Chapter 7 above, we are calling for Ofcom to remove the outdated and inappropriate prohibition on providing tracking on USO parcel services. It would be easy for Ofcom to introduce this change unilaterally by removing the relevant wording in the DUSP Condition. In particular, the following bullets could simply be deleted from paragraphs 1.6.1(a) and 1.6.1(b) of the DUSP Condition:

“(e) do not include provision of a tracking facility.”

11.14 This change could be made following a public consultation regarding changes to the DUSP Condition, which could be conducted at the same time as Ofcom is consulting on changes for the other core proposals set out above.

A new Special Delivery “End of Day” product

11.15 Again, for the reasons set out in Chapter 7 above, we are calling for Ofcom to allow us to offer a new USO Special Delivery product to allow for delivery before end of day. Again, we consider it would be easy for Ofcom to introduce this change unilaterally by updating the relevant wording in the DUSP Condition to allow for the product.

11.16 As above, this change could be made following a public consultation regarding changes to the DUSP Condition, which could be conducted at the same time as Ofcom is consulting on changes for the other proposals set out above. We are asking for Ofcom to make these changes now.

Removal of the Second Class price cap

11.17 For the reasons set out in Chapter 8 above, we are calling for Ofcom to remove the blunt Second Class price cap on letters and large letters that came into force on 1 April 2024. It should be removed at the earliest opportunity given the net cost outlined in Ofcom’s CFI. Ofcom, following a consultation, can remove the DUSP Condition 2, which sets out the price cap, in its entirety.

Review of the PSA 2011

11.18 In addition, as set out in Chapter 10, we are calling on Government to start work on updating the PSA 2011 more generally to address a number of clear shortcomings in the current statutory framework. This may include updating the PSA 2011 as follows:

- introduce a requirement on Ofcom to conduct a regular (at least every two years) net cost assessment;
- give Ofcom the ability to make changes to the Section 31 PSA 2011 USO minimum requirement concerning the number of delivery and/or collection days; and
- update the Section 46 mechanism for a contribution fund.

11.19 Government can make proposals to Parliament to introduce these amendments.

Government contribution to the current net cost of the USO

11.20 Finally, as explained in Chapter 3 above, we are calling for the Government to provide us with a temporary contribution in relation to the current net cost of providing the USO that we incur and would continue to face pending the introduction of USO reform.

11.21 The Government can provide funding to compensate Royal Mail for the net cost of providing the USO under its existing discretionary statutory powers. Government departments can also provide funding to industry under a range of general broad statutes which give relevant Government departments significant discretion in this regard. For example, the Enterprise Act 2002 provides at section 274(a) that: *“the Secretary of State may give financial assistance to any person for the purpose of assisting activities which the Secretary of State considers are of benefit to consumers”*. In addition, the Government has relied several times (including relatively recently) on broad powers under the Industrial Development Act 1982.

12 Concluding remarks

- 12.1 We want to continue to offer a market-funded USO. However, we are facing significant risks: structural decline in letters that historically has not been offset by the growth in a highly competitive parcels market, and an over-specified USO that drives high fixed cost into the business and creates a high USO net cost burden to Royal Mail. Despite Royal Mail's strides in innovation, efficiency and transformation, we are left in an unsustainable financial position of heavy losses. The USO and the high net cost burden must be reformed, and be reformed urgently.
- 12.2 We have listened carefully to our customers. Letters and the USO are still important means of communications but customer needs have rapidly changed. Urgent reform of the USO is vital not just to ensure its (and Royal Mail's) financial sustainability, but to ensure a modern, reliable and vibrant USO that meets customers' needs and can survive in the digital age.
- 12.3 We have proposed a reformed USO that is driven by, and better meets, customer needs, and addresses the net cost burden on Royal Mail. It would be a more modern, reliable and efficient letter service and it can be achieved with relatively limited regulatory changes.
- 12.4 However, if Ofcom does not take the opportunity to reform the USO now then the financial sustainability of Royal Mail and the USO will get worse. Every year that regulatory reform is delayed, the benefits of the proposed change are reduced and greater USO reform will be inevitable. We are confident that we can deliver the reform proposals operationally. But the scale of change in our operation is significant, comes with risk, and will take around 18-24 months from the point of regulatory change to full deploy and realise the benefits. There is no time to waste.
- 12.5 We call on Ofcom to ensure that new regulations are in place by April 2025 to allow Royal Mail to begin to act. We have set out in Annex 6 a timeline that we believe is achievable to enact the necessary urgent regulatory changes, recognising that time is of the essence.
- 12.6 The now recognised significant net cost of the USO to Royal Mail (£325m-£675m) has been borne since at least 2021/22 and during this time the business has incurred (and continues to incur) heavy losses. In effect, Royal Mail is spending around **£1m - £2m per day** to provide the over-specified USO to the UK. Whilst the process of regulatory reform is ongoing, and during any period of implementing change, **we call for Government to consider a temporary contribution to address the net cost of the USO**. The case for a temporary contribution is even more imperative **if Ofcom delays urgently needed regulatory reform** until after a General Election. As Ofcom has stated, "*we have not identified any reasons why a net burden of the order we have estimated is likely to be fair*".¹⁶⁹
- 12.7 Finally, it has become very clear over the past few years that the regulatory and legal framework in place to govern the USO is not fit for purpose to handle a rapidly changing market and the structural decline in letters. It is too easily affected by a lack of political or regulatory interest and an unwillingness to act. We have set out in our submission a number of important changes to help future proof the postal system and allow for swifter action to protect the viability of the USO in the UK. These future proofing proposals are in addition to the key USO reform proposals set out in our submission, and we envisage would take a longer period of time to implement.

END

¹⁶⁹ CFI, Para 8.41.