HOUSE OF COMMONS

Business, Innovation and Skills Committee

Oral evidence: Competition in the Postal Services sector and the Universal Service obligation

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Wednesday 10 December 2014

Ordered by the House of Commons to be published on 10 December 2014.

Witnesses including written evidence where submitted:

At 9.30am:

- Alan Halfacre, Chairman, Mail Users Association
- Adam Scorer, Director of Consumer Futures, Citizens Advice

At 10.30am:

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

Watch the meeting

Members present: Mr Adrian Bailey (Chair), Mr William Bain, Paul Blomfield, Katy Clark, Mike Crockart, Caroline Dinenage, Rebecca Harris, Ann McKechin, Mr Robin Walker, Nadhim Zahawi

Questions 108-205

Witnesses: **Alan Halfacre**, Chairman, Mail Users Association, and **Adam Scorer**, Director of Consumer Futures, Citizens Advice, gave evidence.

Q108 Chair: Good morning and thank you for agreeing to help us with our inquiry this morning. We need to crack on. Just for voice transcription purposes, could you introduce yourselves?

Adam Scorer: I am Adam Scorer, the director of Consumer Futures at Citizens Advice.

Alan Halfacre: Good morning. I am Alan Halfacre, chairman of the Mail Users Association.

Q109 Chair: Some questions will be person-specific; others will be to both of you. If, by any chance, one speaker has said everything that the other would have said, do not feel obliged to answer—although you do represent different perspectives, so that might be less likely in comparison with some of the panels that we have.

This is to you both: can you just summarise your users' views on the universal service obligation and their experience of competition within the sector? We will start with you, Adam.

Adam Scorer: We represent domestic service users of the postal and mail markets and some SME interests, and what we always find is that consumers highly value the USO. They value its level of equity—the single price across the nation. People are aware that it is an explicit cross-subsidy. They are very keen that it protects those who are at the end of the logistical line and those who are most vulnerable to it. There is general support for the USO in principle. There is a high level of engagement with Royal Mail's postmen and postwomen, not just in their day-to-day job, but because of the other things they do around the community such as tapping on doors to make sure people are okay. There is a huge value in that, especially in rural communities.

Our research suggests that there is some wavering around the value of first and second class, and some valuing around the level of service delivery. People have had stuff lost in the post or some issues of service failure from Royal Mail and some competitors.

What we also find is that when you ask a different question—"Does the USO meet your needs? What are your postal needs? How are they changing?"—you get a range of different responses that reflect the fact that many people, although not everybody, are thoroughly engaged in digital e-substitution and have less of a need for written mail and much more of a focus on reliability and speed of parcel delivery, but fundamentally there is this feeling that the principle of the USO is incredibly important. It has social value across the fabric of the nation. People think it should stay, but there is this question about how it reflects their needs.

In the level of end-to-end competition, obviously it is limited. There is selected entry in certain parts of the country. What we have seen—rather than consumers telling us, this is what we see—are some material benefits of competition so far in terms of service innovation: handheld devices, more tracking, more reliability of delivery and some downward pressure on costs.

Q110 Chair: Thank you. Alan, your users may have a slightly different perspective.

Alan Halfacre: It is a different perspective in that broadly my users do not use the universal service as a product. Nevertheless, everything that they do is happening in parallel with the universal service and we are concerned that it is maintained and appropriate to what is needed, as Adam has just pointed out, but that one cannot exist without the other. The-revenue earning capability of the non-USO products is the one thing that maintains the viability of Royal Mail.

As far as end-to-end competition and the USO are concerned, the current end-to-end competition is in bulk mail to the end user, not letter to letter. They are not collecting it from post boxes. You are not seeing two post boxes or multiple post boxes on the street. They are looking only at the bulk mail business and its application to end-to-end delivery.

Q111 Chair: You implied that the finances of the universal service obligation were in part dependent on the other categories of market there. Do you not think that competition at that particular end could affect the universal service obligation, or does it not affect your members at all?
Alan Halfacre: If it impacted on the USO, clearly it would be for the regulator and Parliament to understand what to do about that. It seems unlikely. There are other far more important influences on the future of mail than just competition between the USO and the support of the USO and bulk mail—the super users. It is much more to do with cost, efficiency, performance and things like that.

Q112 Chair: Do the people or organisations you represent—the so-called super users—benefit in any way from the Royal Mail's universal service obligation, or does their bulk mail tend to go to areas that would otherwise be served if it were abolished?
Alan Halfacre: They benefit in one sense, in that having to deliver to every household six days a week is an opportunity for the bulk mail to be delivered as rapidly as possible. However, frankly, if that six-day, every-household delivery did not exist, it would have no material impact on the bulk users. The mail would still have to be delivered, and one of the issues that is perhaps more relevant is the transit time, rather than that it must be delivered the following day.

Q113 Chair: Yes, that is right, so they are less dependent on, if you like, short delivery times.
Alan Halfacre: There are mechanisms for short delivery, be they the modern stuff—the "e"—but there are also products that will get you things delivered the following day and they are not necessarily USO products. They are not necessarily cheap either—I make that point—but that is neither here nor there.

Q114 Chair: Adam, you seemed to be indicating you wanted to come in there.
Adam Scorer: I was just reflecting on the point about reliability over speed. As I said, consumers hugely value the USO and its key characteristics. One of our concerns is to understand how the USO can keep fit for purpose. The world is changing; people's behaviours change. There is a really important group of people who value the characteristics of the USO as it is currently conceived, but we need to understand the shift, especially in the letters aspect, between reliability over speed. What do consumers actually need? What are their needs and how are they expressed in the USO going forward?

Q115 Chair: Just to conclude my questions, where do you think the USO will be in five years' time?
Adam Scorer: I hope it is a long process to figure out whether it is appropriate or not. Ten years is probably a better horizon.

Chair: I was about to say "or 10 years".

Adam Scorer: I would be really surprised if it has the same characteristics in 10 years' time, because the world would need to have stopped spinning on its axis for that to happen, in some ways. The important principles for me and for Ofcom—you will have the regulator later on—when it goes about reviewing the USO and its financial stability is whether it is meeting consumer needs, especially for those consumers who are at the end of the line or are most vulnerable, and how those needs are going to change. It is not the desires or the challenges of the incumbent or of new entrants or competitors, but how consumer needs and their changes are going to help to construct the argument about whether to keep the USO as currently characterised. The core elements are six days a week—I could imagine that coming down—and first and second-class delivery. All those different components are going to need to be understood through that general rubric of what consumers need and how we can afford to resource it. I would be surprised, though, if it retains exactly its current shape.

Q116 Chair: If I can summarise, and I do not want to put words into your mouth, basically you think it will change, but that that change will be driven by consumer needs.
Adam Scorer: I think it must be delivered by consumer needs. I do not want it driven by other considerations.

Q117 Chair: Yes, okay. Alan, you have said in your written evidence that there should be some sort of assessment of whether the universal service obligation should be fit for purpose in the future in a changing market.
Alan Halfacre: As you well know, Ofcom has planned a review in 2015 and we absolutely support that. The USO is defined by European directive and by the Postal Services Act, so change is in your area, not ours, but regarding what that change should be, there has to be some really joined up, co-joint analysis. We are very clear. If you ask a citizen what they want, they will always tell you they want at least what they have now, if not more, but you have to do the co-joint—you have to give them the alternatives: this and that at this price; this performance, etc. We are clear that probably the first class should come out of the USO, but whether we finish up with a 1.5 class as opposed to a second-class mail is for debate and analysis.

Q118 Chair: Why do you think the first class should come out of it?
Alan Halfacre: The cost to Royal Mail is enormous. Having to make sure that mail is picked up, sorted, trucked and delivered the following day is very expensive. If they can deliver it the day after that, the logistics of managing mail are much more cost-effective. I believe, therefore, okay they will lose some revenue, because it will not be first class, but

they will be able to be much more efficient, and it will be one of those things that could potentially impact on whether we need six-day-a-week delivery, for instance. Do we need it?

Q119 Chair: What they could do is keep, if you like, the second class, which would conform to the economies that you are referring to, but charge a premium for first class, which would potentially cover the extra cost involved.
Alan Halfacre: I am not saying you do not continue to have first-class mail, but the price might be very different and it being a universal service obligation—in other words, it has to be done to every household every day—may be a problem. We get back to this transit time. If you need to get something to an individual the following day, there are mechanisms. They are expensive for physical items, but are they the only way the citizen can communicate? We come down to, "I want to send my birthday card." Well, try to remember to do it the day before rather than the last day. You have been getting round to it for a long time, but, no, you have to do it two days before instead of one day before. You have seen the press have picked up this year, for the first time in the front pages, "Do not send your Christmas cards first class because they are only going to go on a second class service". Well, okay, that is a very narrow and specific example, but nevertheless if you had that concept in your mind every day of the year, you would look at first and second class in a different way. It is not a social stigma to put a second class stamp on a letter.

Chair: Probably most MPs could only afford to send them second class anyway.

Q120 Caroline Dinenage: Could you tell us about initiatives at a European level, please, particularly within the European Regulators Group for Postal Services, on what consumers need and want from a universal service?
Adam Scorer: I will go with that. It is not so much about initiatives. The point is that the process that all mature European postal delivery industries are going through is exactly the same one that we are doing, which is to understand what the needs of their consumers are, whether the mature systems are fit for purpose and whether there needs to be a change in the minimum standards of the USO as required by nations. The same conversations are happening across member states and across the European Commission. I cannot tell you exactly about what the initiatives in individual member states are. However, I think they are replicating the sorts of conversations we are having here and the sort of review that the regulator needs to have—and it is kicking that off next year, which is right—about whether there is this fundamental match between the characteristics of the USO, what consumers need now, especially those in greatest vulnerability, how that might change and what the financial implications of any of those changes will be. Is it a net cost or a net benefit to the universal service provider? If it is a net cost, what do you do to address those issues? The dialogue that is happening across the European member states is a common one, therefore.

Alan Halfacre: Have you seen the Post Europe note that came out in November?

Caroline Dinenage: No.

Alan Halfacre: There was a note that came out in November that was supported by 30 of the 31 members, and the bottom line was that declining letter mail volumes and changing communication behaviour means that the universal service must be reviewed. It was suggesting that while there should be a base level through an EU directive, it should be as flexible as possible to allow each country to determine its own particular version of the universal service. Out of the 31, the one that did not subscribe to the note that came out was Royal Mail. I can make that reference available.

Q121 Caroline Dinenage: Yes, that is really helpful. Thank you very much. Adam, can you describe the findings from your 2012 report *Sense and sustainability* and whether you think that users' views have changed since that report?
Adam Scorer: What we tried to do in that report back in 2012, and the digital environment has moved on apace even from then, was to try to understand not so much how you use the USO, as currently provided, and what you think about it—you get some positive responses when you ask those sets of questions—but to try and do that deeper piece of work that says, "What are your needs? How have your communication habits changed over a number of years? How might that be reflected in the level of service that you require?" We got some really interesting results: first, the strong welcome and support for the principles of the USO, its explicit cross-subsidy, and the criticality of meeting the needs of users at the end of the line in rural and remote communities, and of vulnerable consumers. We also got this sense of, "In the way I am using mail now, what would the tipping point be? Where is the point at which I would still get what I need from the universal service even if the frequency of delivery was different?"

You get these common tropes, which are different in different groups, because consumers are not a homogeneous bunch, but you have this, "What we really value is the price structure." It is a common price across the country. It is, "What we really value is the person walking up the lane—the role of the postal workers and delivery staff." However, there is an emerging tolerance—I do not think it is strong enough to say this is how the USO should change—of, "If it was five days a week, would I be hugely disadvantaged? Not really. Is speed more important than reliability? Well, not really. Reliability is what I need. What is the difference in my need for letters, because I do not initiate many letters anymore? Between letters markets and parcels, I am much more demanding in the parcels area, and that is about convenience, about tracking, about drop off, about collection—a whole range of things." However, it is important always to remember that with different cohorts, younger, digital natives, and people using different ways of using communications, there is this common trope that we see the social value—the social good—of the USO in reaching out to all communities and all consumer vulnerabilities. We accept the cross-subsidy entailed in meeting that, but within it my behaviours are changing. I like the USO, but if I was to design something that was to reflect my needs, it might be a very different beast.

Chair: I should explain that we do not normally meet on a Wednesday morning. As a result, Members will have other obligations factored into their diaries, so there may be some to-ing and fro-ing. Please do not think that is a reflection on the quality of your answers. It is just the nature of MPs' diaries.

Q122 Mr Walker: I apologise, but I will have to disappear shortly after asking my questions. You mentioned earlier, Adam, the material benefits, I think you said, of competition that mail users have seen. Could you expand on that? I would be interested in Alan's views as well as to what those material benefits are for consumers and also for the super users.

Adam Scorer: I do not speak for the super users. We should say it is not a mature competitive market, especially in the letters area, and obviously in end-to-end, it is just in certain areas. The material benefits that we have seen are some of the behaviours of entrants, which is just the level of tracking, the drop off and collection, the carrying of the handheld—much more convenience—which has led to a responsive innovation from Royal Mail. My level of expectation as a consumer of delivered letters and parcels has gone up, and we have seen Royal Mail respond to it. We have seen a little restraint on price increase on products, which has been quite good. We have seen Royal Mail, for instance, get much better about how it describes its products and the products it brings to market. I do not want to overstate this, but we are starting to see signs of that in the way in which products are designed, products are brought to market, and the ways in which consumers are kept informed about the traffic of their letters and parcels have increased.

One of the issues that we have at Citizens Advice is that the level of complaint made by consumers is poor, and that is perverse, because we do not want consumers to have cause for complaint. However, I worry that the current redress system does not enable us to see the pressure points—the failure of service—sufficiently. That is something Ofcom needs to look at, quite clearly, but there are signs in which competition, either through choice of product, choice of supplier but also through Royal Mail upping its game and responding to the market, has been beneficial to the extent that we have had it.

Alan Halfacre: The marketplace would be very different now for mail if competition did not exist. It started back in 2004, as you know, with the liberalisation of the access regime. The access regime has been fundamental in maintaining the volumes of mail in the system. Without it, there is no doubt that migration to e-substitution would have been much quicker. It has offered competitive services and put a brake on prices. As you well understand, I am sure, the price for wholesale mail—for buying it in bulk—is very different from the headline price that you see on a stamp. Nevertheless, it is cost-reflective, just, for the service that is provided.

A slight diversion: do remember that the universal service for Royal Mail makes a much bigger margin in its P&L than the access services—the competitive services that it is providing at the moment. That competition has provided some certainty on price, which is important for super users. It has improved quality of performance enormously. Prior to that, there was no way seriously to encourage Royal Mail to improve its quality of service. It has reacted, because of the way access works, by improving the quality of the delivery time on the second-class service—bringing it forward. I will not say "galvanised"—that is too strong—but it has encouraged Royal Mail to be competitive in providing a more value-for-money service.

Q123 Mr Walker: In terms of competition, the area that has seen the most competition already is parcels, and you mentioned earlier that consumers are becoming more demanding for parcels. Do you think that is partly a result of competition?

Adam Scorer: I think it is. If you take the trialling of Sunday deliveries and of delivery offices opening on Sunday, clearly it is the consequence of not just competition between parcel deliverers, but the competition that falls out of e-commerce—out of the way in which consumers behave in markets, the need to fulfil a massively greater amount of traffic than before and the opportunities that gives for new entrants. It is much easier for a new entrant to come in and design a service in such a way that takes advantage of new technology, identifies certain areas, and has particular contracts with large e-retailers than it is for a logistical operation like Royal Mail to turn itself around in order to respond. Royal Mail has really tried hard, given the hard constraints it has, to respond to the market. It cannot be as dynamic as those deft new entrants, but what they have done—tracking, delivery, drop-off points, text conversations with people about when they are coming—clearly has led to a focus from Royal Mail, with its new commercial status and its new drive for better commercial rates of return, to respond, especially in that parcels market.

Q124 Mr Walker: It is quite striking that in a very fragmented market it is still, far and away, the market leader in that space. Do you think that is a position that they will be able to maintain?

Adam Scorer: Royal Mail is the dominant incumbent and has huge efficiencies of scale. It has a massively trusted brand. It has so much going for it. The extent to which it will maintain that level of dominance or market power will depend on how it is able to deliver products to consumers and e-tailers that will enable it to win in what will become a very competitive market. It can do it. It may take it a bit longer to change its logistical systems in order to deliver it, but how it responds to that competitive threat is its fundamental test in the parcels market. It is not real hot breath on its neck at the moment, but it should become so. The extent to which it delivers value to consumers and to the people from whom consumers are buying products and services will be the test of the market share it is able to retain.

Q125 Mr Walker: Alan, to what extent are your members using the Whistl service—the end-to-end service?

Alan Halfacre: Almost all my members, one way or another, who are sending out bulk mail will be using Whistl's service. On the specific point you made about the end-to-end service, if they currently meet the national geographic profile and can do that by, nevertheless, moving their mail from London, Manchester and Liverpool into the end-to-end service, they will use it, because it is more attractive. It is providing a service that, from the point of view of every penny counts, is quite material.

Q126 Mr Walker: The interesting conundrum and what we have picked up in the evidence of previous sessions is the extent to which end-to-end competition will affect, in the long run, Royal Mail's ability to compete and the USO, which is why we are here in

the first place. At our previous oral evidence session we had Moya Greene talking about the economies of scale of a universal service being primarily at the delivery level and saying that cherry-picking of urban routes unwinds these economies of scale and creates diseconomies of scale. What is your view on so-called cherry-picking?
Alan Halfacre: "She would say that, wouldn't she?" would be my first point. It is not cherry-picking—it is as simple as that—in that if you send mail to rurals, urbans, suburbans and London, the four zones, you are charged different rates. You are charged different rates, in theory, on a cost basis, so it costs more to send to rurals, but the premium you pay to send stuff to rurals, as a bulk user, is higher. There is no cherry-picking per se, in that it may be easier to do it in the high densities, but you are not disadvantaging Royal Mail save for the one simple aspect that it is losing revenue, yes, and that will therefore have an impact on the total, long run, incremental cost of every piece of mail. However, this is not the key criterion. It is such a small piece, currently, of its total revenue. It is so small you just cannot see it. There are much more material impacts on long-run costs—basically, the declining volume of mail. That is having much more of an impact than mail going to somebody else, and it will continue to for some considerable time, I suspect.

Q127 Mr Walker: Absolutely. I raised the point in a previous evidence session that there is a concern that given it has the USO and the need to deliver the mail, what Royal Mail cannot do is remove capacity from its system to the extent that, if the competition suddenly disappeared, it was not able to deliver. I suppose that is where your consumer customers might be particularly concerned.
Adam Scorer: I think so. I have looked at the transcript from the previous session. There is a very strong line of argument, from Royal Mail and from the staff side, that there are potential unintended consequences of competition for the financing of the USO and of Royal Mail, in particular. The information we get has a big black pen written through it with lots of redacted information and it is difficult to see. Personally, I can see no real immediate and material evidence of a direct threat at the moment, but a lot of information is redacted—I do not see that. I do understand the line of argument from Royal Mail that there is a potential, and maybe a high potential, for detriment to its ability to deliver big logistical information because of end-to-end competition. I do not see the evidence of material threat. That is for Ofcom to do.

I am less precious about the word "cherry-picking". Clearly, there is selective entry into urban areas and you can call that cherry-picking. It is market segmentation—whatever you want to call it. I just observe that a lot of it is in London, which is the highest or second highest—I am not sure—cost to serve because of the perverse effect of density with verticality, which is people going upstairs and that sort of stuff, so I am not sure about that. I am pleased that Ofcom has brought forward its consultation on access pricing because of course one of the critical things is how end-to-end competition and the undoubted effects of that are balanced out by a cost-reflective and appropriate access pricing regime. I do not see the urgency, the immediacy and the materiality of Royal Mail's argument that Ofcom needs to bring forward its review and do it, but I do think there is a line of argument that there is a potential unintended consequence of competition, which Ofcom needs to be alive to and needs to be well into for a review in 2015.

As an organisation, we have a role for postal consumers and energy consumers, and we are really attuned to the lessons we learned about regulators taking overenthusiastic, almost ideological, positions on introducing the benefits of competition into essential markets, particularly on the removal of price controls on prepayment meters, which is a different issue. I do not see that same blind zeal to drive competition in Ofcom. I see an instrument; it is a means to an end. Let’s understand how much of a means to an end it is and the extent to which consumers benefit, and what the impact is, critically, on Royal Mail. Is it a net cost? Is it a net benefit? If it is a net cost, what do we do about it? That is what I want Ofcom to look at.

Q128 Paul Blomfield: I wonder if I can pursue Robin’s line of questioning, particularly in relation to bulk mail and parcels. You have both talked about the efficiencies that competition has driven Royal Mail towards in response to other market entrants. How do you think that it could develop that further? What further efficiencies do you think there are for Royal Mail in meeting the increasing competition that it is facing in bulk mail and parcels?

Adam Scorer: I find it very difficult to answer that and am hesitant about even trying. It is a huge operation. We know where their major cost centres lie. For me, it is up to Royal Mail to see where its efficiencies are. It is up to Ofcom to see whether it is driving an efficient service, where it can make it. I suppose I am more interested to see where product innovation and service delivery innovation comes out of competition. It would be churlish and a little snide of me to try to pretend that I know how Moya Greene can find the efficiencies across such a large logistical operation, so I am afraid I cannot answer that question.

Paul Blomfield: Okay, that is fine.

Alan Halfacre: I would not demur from that perspective. It is very difficult, but one wants to see Royal Mail being proactive and not reactive—not just chasing the tails of new competitors, or even existing competitors who are in their market space. I do not quite see it yet from our members’ perspective, but it has become a parcels company that carries letters, in that it now takes more revenue from parcels than it does from letters. However, it is not so long ago that that was not the case and it did not see parcels as something that was going to impact it in a material way. I believe that the train has left the station as regards trying to regulate parcels. That would be a retrograde step from the point of view of where we are. Parcels has been an open market for years. If you have the ability to carry a parcel and deliver it, you can do so, and it would seem unwise to try to restrict that marketplace.

Where can it go on efficiency? It is up to Moya to run a successful business. It has not done a lot of investment previously in parcel management, and I do not just mean handheld, but sortation and the like. Historically, there has not been a lot of investment there. Would that have an impact? I am sure it is bound to, but it is above my pay grade from the point of view of trying to work those things out from Moya's point of view, so that is not particularly helpful—I am sorry.

Q129 Paul Blomfield: No, it is helpful in its way, so I am grateful for both your answers.

In its written evidence to us, Ofcom said that the number of parcel operators in the UK was far higher than in comparable countries. Would you confirm that, and what impact do you think that has?

Adam Scorer: I think that is true. The evidence that we see suggests it is true. I would probably be a little less sanguine about the benefit of unfettered competition in the parcels market. We see huge amounts of variability in standards of service: people meeting consumer expectations; the value if you are in a remote community as opposed to an urban community. It is a dynamic market; it is accelerating. There are lots of entrants. All those usual tests of whether it is an effective competitive market are probably there. As always, we come back to saying, "But what is the outcome for consumers?" and it is variable. I would like Ofcom to see what the regulatory burden would be like and what the incremental costs and benefits are of looking at the parcels market—maybe not in formal regulatory terms, but to see whether we cannot force a better set of standards to be applied to that market.

Maybe the question is less for consumers, who see a whole range of different collection options, delivery options and tracking options, and more for the e-tailers who are driving this market. That is the channel through which it is coming, and there is a nexus there between the e-tailer, the delivery and the amount of information and clarity that comes to consumers about what they can expect for what price and what they can do if it goes wrong. That is my test of whether that market is effectively competitive for consumers and whether there are areas of action that a regulator or another initiative may want to take to drive levels up. It is difficult to maintain high levels of standards across a market when you have huge numbers of competitors, some very small, but it still has an impact on the quality of service that consumers receive.

Q130 Paul Blomfield: Would you agree, Alan, that there is a potential for Ofcom to look at the regulatory options in relation to parcels?

Alan Halfacre: I suppose, as a headline, I would not see it as necessary. It depends, on one sense, what the conclusion is. Over-regulation is something we have been trying to avoid.

Q131 Paul Blomfield: Under-regulation in other areas has caused us some difficulties, has it not?

Alan Halfacre: Yes. In the E to X space, there is only one supplier, and that is Royal Mail. The consumer really only has one way of sending parcels. Others exist, but broadly there is only one way: they use Royal Mail through the Post Office. That is not likely to materially change. The click-and-collect services and the returns services are growing, but to send a parcel without a returns service is quite difficult for most citizens and, as I say, not likely to change. Royal Mail has the opportunity of benefiting from that and developing that service. As to the other way round, with mainly B to E—the e-tailer-type services—most of the e-tailers are canny enough to work out that they want a sharp price, but expect a good service, and the market will organise itself, in that poor performers will not get the business and will disappear.

Q132 Paul Blomfield: When we had a session with Royal Mail and Whistl exploring this area, Whistl's challenge to Moya, sitting alongside them, was essentially—I do not want to unfairly paraphrase it—"You have to cut your labour costs." That led us into a robust exchange with Whistl about its use of zero-hours contracts, its pay rates and so on. Is there not a danger that the competition and the challenge is going to lead to a race to the bottom in employee conditions, and that that, in itself, will lead to poorer customer service? What would your view be of the potential impact on the USO?

Adam Scorer: Royal Mail has the need to deliver the universal service as currently characterised as a big logistical operation. Regarding its ability to drive what you might call traditional efficiencies out of the cost base, it is doing lots of it, and the evidence it gave to the Committee shows it is doing that, but it is constrained by the need to deliver the universal service as currently implemented. It would have a detrimental impact on consumers if the development of competition in the market had the effect that all delivery providers started to cut costs and to have less reliability of delivery and a low quality of service because of an underinvestment in what is a critical part of any postal, logistical operation—its staff.

I have no material evidence or information about the cost base of Royal Mail—I would not be able to do this even if I had—to see if there are efficiency savings that could be driven out of the labour cost base. I do not think we got the whole picture in the evidence session, but I was interested to see the answer from Whistl about what the basis of its remuneration package for its labour force was. I hope you get some further information about that because that will be really interesting. A race to the bottom in those aspects—we have seen it in lots of other markets on the customer service side—inevitably leads to a lower level of service, higher degrees of complaint and a lack of trust and confidence in engaging in those markets. I could see clear detriment, if that was done as a necessary, kneejerk, fast response to the growth of competition. I just cannot see that growth in competition, at the moment, being such an immediate material threat to Royal Mail's position, and that is why we need Ofcom to hold the middle, to get the information from the incumbent and from challengers, and to understand the economics and costs of delivering the USO.

Alan Halfacre: I do not recollect the union that supports Whistl complaining particularly at your session. It appeared to be happy to take the members. Is that just a diversion?

Paul Blomfield: We were more interested in the exchange with Whistl and Royal Mail themselves, I think. Thank you.

Q133 Chair: Can I just put a question to you? There has been a lot of emphasis put on competition driving efficiencies in Royal Mail. I do not know what assessment has

been done—this may well be commercially confidential information that Ofcom has—on how efficient its rivals are. Equally, is there not an argument that by placing a more consistent regulatory regime on all the rivals, that could drive efficiency in the rival competition as well as Royal Mail? Have you any comments about that?
Adam Scorer: Only that the focus of regulation clearly is on the USO and the universal service provider, and that is the frame of Ofcom's purview. We are preparing our own understanding of what the economic consequences of greater end-to-end competition will be for consumers. I would expect Ofcom, as I said before, to look at a number of simple things: the benefits for consumers' needs and the extent to which competition is delivering benefits to consumers through innovation or through efficiencies, and also the extent to which that has an impact on the financial ability of Royal Mail to deliver the USO—is it a net cost or a net benefit? If it sees it as a net cost and that the presence of competition is not balanced out by the access pricing regime—if it is a net cost on Royal Mail that is unacceptable for a private company to bear—it has to think about what it can do, and it has a range of options. Some are not in its purview: state aid; thinking about tendering out parts of it. It could also look at, if this was a likely scenario, what the short-term regulatory interventions would be across the market. Should it bring forward regulatory obligations upon other providers? However, that needs to follow from its proper consideration about the impact of current levels of competition on Royal Mail's ability to finance and deliver the USO. I am answering in a complicated way.

Q134 Chair: No—that is a comprehensive summary of the issues that are confronting it. Alan, do you have anything to add?
Alan Halfacre: I have nothing more to add to that. That is a good summary, as you say, of where we are.

Q135 Ann McKechin: I want to turn to Ofcom's latest annual monitoring report, which came out last week. I want to know your views on that update and whether you agree with its response to the Royal Mail submission in June about the USO.
Adam Scorer: As I said before, there is lots of redacted big black pen that goes through the base information, which makes me hesitant about being able to give a balanced view about the impact of competition. From what Ofcom has said, I have to say that that probably reflects our reading of the market situation. It seems reasonable. In these situations, with a dominant incumbent and non-regulated other providers, there is a huge responsibility on Ofcom to hold the middle, to understand and to bring forward the information and ensure that what it does reflects the needs of consumers. In short, what Ofcom came out with we probably expected. Its response to Royal Mail in terms of accelerating the USO review I can probably buy as well.

Q136 Ann McKechin: Perhaps I can probe you a bit further. It is a statement of where the market is right now, but as you have both alluded to this morning, this is a market that is changing very rapidly. To what extent do you think that Ofcom is giving due weight to considering what the strategic position should be of the USO over, say, the next two, three or five years?

Adam Scorer: My expectation of Ofcom is that in 2015 it should be well down the road of reviewing the USO, its implications for Royal Mail as the USP and for the delivery of benefits to consumers, and, as I have said before, whether there is either a net cost now, or there is likely to be if the trajectory goes that way. My only observation, which I have said a few times now, is I do not think it should be answering an exam question from either an incumbent, or a competitor or a new entrant. That is not its job. It is to hold the middle and understand it, but given the nature of this market, it only regulates one firm. There is a huge responsibility on the regulator to do that, to be transparent about it and to make sure that the response to the position of Royal Mail is clear, open and one that can be seen to embrace the dynamic of the market, as well as the snapshot of where we are at the moment.

Ann McKechin: That is very useful.

Alan Halfacre: We must make sure that Ofcom's remit is not changed, in that it should not be restricted in what it can do, but it must not be diluted in the powers that it currently has. It needs robustly to examine that marketplace to ensure that it can come back to you with good advice on any change that is needed. The short term is certainly not in danger; it is the medium-long term, and that medium-long term depends on your view about structural change in volumes and the performance of the various parties involved. An open market is very important so long as you can maintain the requirements of a reasonable universal service obligation.

Q137 Mr Bain: Ofcom issued a further document last week in terms of a Royal Mail access pricing review consultation that it has launched. The document contains a proposal to, apparently, restrict the flexibility of Royal Mail when it comes to the zonal pricing issue. The review makes some particular requirements about seeking a uniform rate of return across a zone. What are your views on what the consultation might involve in terms of changes in the postal services industry?

Alan Halfacre: Zonal pricing needs to be cost-reflective. It should not be just used as a marketing tool to attack the marketplace. For instance, end to end in London, currently there is a proposal on the table that would finish up with London being cheaper than it is now by some significant amount and adding that cost into the rurals. You end up with a 2:1 variance in the access price between delivering in London and delivering in a rural. That is only a proposal at the moment. Well, as you will recall, the plans for 2014 were frozen because of the objection, so they did not go through, which is where this comes from. While, in 2008, 2009, 2010, a London weighting was 14% over the national average, it is now going to be, on this current plan, minus 25% on the national average. So, for being the admitted most expensive zone, it wants to charge 25% less than the national average. That needs management from the regulator. It cannot do that just to attack the marketplace. It has to be cost-reflective and historically, although they have said it would be, it clearly is not.

Adam Scorer: I would not want to pretend I can go into the details about the implications for the postal industry of the consultation on the access review. I would want to come out of that consultation something that I do not think we have at the moment, but would be incredibly valuable in this discussion and in the ongoing review, because I do not think it should be periodic, about whether the USO is fit for purpose and fundable. That is that we have a clear, transparent and cost-based pricing mechanism across the industry, so we are able to understand that there is proper competition where it is appropriate and that there is benefit for consumers—that Royal Mail does not protect its incumbent position in unfair ways. I just do not think at the moment that we have that level of clarity and transparency about price discovery for different bits of the market that enables us—or you—to be able to come to a clear position that says we are able to understand the balance between end-to-end competition, the extent to which that is a threat to Royal Mail, the extent to which a proper zonal access pricing regime balances that and enables Royal Mail to recover the necessary costs and margins it needs to be able to deliver a service, and for me, to be able to say that this market—to the extent it is quite a strange one in the relationship between entrants and competitors—is one that delivers value to consumers. So, I have a lot I want out of it without really, at the moment, being able to tell you how I expect it to change the mechanics of the industry.

Q138 Mr Bain: What was your overall impression about the impact of the document published in terms of competition, which surprised some and disappointed many others? Has Ofcom got it right, or does it need to revisit this certainly within the next 12 months?

Adam Scorer: As I said before, the position it came to is one that I recognise. It is one that seems, to me, to reflect the dynamics and the evidence that we have been able to see about the impact on the market. However, as a bit of a snapshot, we need within the next calendar year—and this is planned—for Ofcom to be well down the road to understanding and responding to the concerns of this Committee, incumbents and competitors that we need to do more to understand the current shape of the USO and the current ability of Royal Mail to deliver it, given the pressures of end-to-end competition in parts of the market and where that might go. At the moment, I am reasonably content with the position that Ofcom has taken, given the evidence that we have seen. However—you will be putting this, I am sure, to Ofcom in just a few minutes—we want to see a commitment that in the next year it is starting a process that enables it to answer the whole range of questions about: consumer needs; financial stability and viability; the potential impact of end-to-end access competition; what the regulator may need to do to ensure that the USO, as it is currently characterised, is deliverable; and how the implications of any changes to the USO, which may come in the fullness of time, may impact on the structure of cost recovery in the market, the nature of regulation of a range of players and all those sorts of issues. I would agree that we would expect the regulator to respond to the issues that are alive at the moment and to have a proper, robust process that goes forward, but that does not start from answering an exam question from either an incumbent or a competitor, but takes a rounded, Copernican view, with the consumer slap bang in the middle rather than the USP deliverer or the value of competition in and of itself.

Q139 Mr Bain: Alan, did Ofcom get it right last week?

Alan Halfacre: I think it got it more right than wrong, yes, absolutely. It tackled the issues and gave a view that, to me, sounded reasonable from our user perspective. There is change needed to the USO, but then my members do not use the USO product. It is just the impact on the total Royal Mail that is the important thing. Certainty is the importance for big users: knowing where the market is going from the point of view of the supplier in performance and price. Next year, the plan is equivalent to a 6% increase in price for wholesale mail. That is a very big increase in costs for the users. It will drive them to substitution or other methods of communicating with their customers, and it is an open market. It is up to Royal Mail, if that is what it wants to do, but it is putting itself and the USO in jeopardy if it just continues to ramp up prices in the sort of business environment that we have at the moment.

Q140 Chair: Just before we move on, I want to play devil's advocate a bit. Royal Mail is now privatised. It is now having to compete in an open market with rivals. Royal Mail, because of the current regulatory regime, has to have a cost level that its rivals do not have. The area of competition is in bulk delivery. What is wrong with Royal Mail competing with its rivals in the most profitable areas and lowering its prices for that bulk delivery in order to compete with those rivals so that the bulk deliverers get the benefit of competition there, but putting up its price in the zones where its rivals do not have the infrastructure and do not want to take the cost burden that Royal Mail bears? So, for the bulk deliverers, the one is, if you like, compensated by the other, but Royal Mail is at least given the ability to cross-subsidise and offset some of the higher costs that are placed upon it by the regulatory regime. Could I have your response to that?

Alan Halfacre: That will encourage bulk mailers to not send mail to consumers in the expensive places if they do not need to.

Q141 Chair: Can I just also respond to that? Somewhere in its recommendations Ofcom said that Royal Mail could reduce its access delivery in some areas, which is, if you like, a modified form of what you have just said. It does seem to me very strange that we are told that competition benefits service delivery, yet one way of offsetting the effects of competition is to reduce service delivery. That seems totally contradictory. You may want to comment on that or amplify what you said before.

Alan Halfacre: Currently, in broad terms, Royal Mail handles its bulk mail as though it was USO product. If it has it in the depot, it delivers it. Does it need to? No, but there are logistical reasons why it is useful to do that. If the van is going half empty, you might as well fill it up with what you have. If you do not have the space to carry it, you only deliver it three times a week. All those logistical problems would immediately rear their head. Currently, although you are not buying a USO product, it is being treated as a USO product: delivery every day, six days a week—just get rid of it. Would it make any material difference to the marketplace in bulk mail if Royal Mail said, "We will only deliver your product three days a week"? Probably not, because those who felt they needed quicker transit time or a specific drop point would buy the product that was associated with that. The hint that Ofcom gave is a perfectly valid one. It could be done without material impact on the bulk mail user.

Adam Scorer: I hesitate to comment on business models that firms should do from the consumer's interest. I would not know what the income on the revenue stream for

Royal Mail would be. My anxiety would be one that Alan referred to before. One is the impact on volumes and the ability to maintain the volumes going through the market to support the USO, but it comes down to what impact that would have on folk at the end of the line. People at the end of the logistical line already get a poor level of service on parcels or a more expensive and variable level of service on parcel deliveries, and I would be loth for that to be replicated—especially for bulk mailing from energy firms, mobile firms and banks with proper information—for anything that would lessen the quality or equity of delivery of those services to consumers in more remote, higher-cost-to-serve areas.

Chair: I would like to pursue this further, but I am conscious that we are running out of time and I have one more question that I want Rebecca to ask.

Q142 Rebecca Harris: My question goes back to Ofcom, which you have largely answered, particularly Adam, in your very full answers to previous questions. However, this is a final opportunity for you to sum up or to add anything to what you think Ofcom should be doing to protect the universal service obligation and consumers that has not been covered already.

Alan Halfacre: It needs to be able to persuade you that we have the right universal service, because that will impact on its cost to perform, and there is an argument, which needs proper research in expressing, as to whether the universal service is right today. Ofcom needs the encouragement to be able to get on with that, and its current time frame is, as you know, the next calendar year, and that does not seem to be unreasonable for the amount of time it will take to do the job properly, come up with an answer and make the proposals to Parliament for change, if it is necessary, in an Act. Over and above that, I do not think we should be diluting its powers, but I cannot see that it is necessary in the open regime that we move to. We changed completely in the last Act in the way post is looked at. It is: you can do whatever you like, a permissive regime, so long as you do these very specific things. That is very different from the regime we were in prior to that, and that needs to be encouraged and Ofcom needs to be encouraged to ensure that that is the line it takes and that there is no diminution in its power. However, there is no further need, as far as I can see, for additional powers. It has the powers it needs to manage this industry.

Adam Scorer: I will add a few things to what I have said already. Like many markets, if you have a situation where there is a fundamental disagreement between incumbent and competitors and market and regulators over the core datasets we are talking about—what the volumes, costs, revenues and threats are—you get a lack of confidence and trust from consumers, especially in markets where a lot of people will not know that they are competitive, or not think that they should not be competitive. Therefore, it is really important that through the next review process Ofcom is able to find some common datasets around which we can have a civilised conversation about what the threats to the delivery of the USO are and what they might be going forward. If you do not have that, the bottom falls out of trust and confidence in markets, and we cannot afford to have that in this particular market.

There are other things that Ofcom should have within its purview. I would really push hard for it to have a look at whether affordable consumer tracked products should come into the USO—into the regulatory frame—because of their growth in importance and use as people think about how they are protected in regulatory frames. People are going to think about those sorts of products, not just the delivery of letters. As I have said before, I would hope that we do not just fixate or have a fetish about the level and the benefits or risks of competition, but look at other big consumer drivers and issues, like the standard of complaint handling or the awareness of where to go when something goes wrong. As the market gets more complicated, you have many more people in there. It is more important that consumers are aware of their simple journey to get redress, so we must not lose sight of the fact that there are some fundamental issues about consumer benefit and welfare that need to be considered, as well as the financial stability of the delivery of the USO as currently constituted.

Chair: Thank you very much. We have run out of time. I think there probably are some more questions and we may well write to you seeking further information on this. Equally, of course, if you feel that, in retrospect, you would have preferred either to modify or to give further information about any of the questions we did ask you, we would be very happy to receive that as supplementary evidence. Thank you. That is very helpful indeed, both of you.

Examination of Witnesses

Witnesses: **Ed Richards**, Chief Executive Officer, Ofcom, and **Chris Rowsell**, Competition Policy Director, Ofcom, gave evidence.

Q143 Chair: Good morning and welcome. Thank you for agreeing to help us with our inquiry. We know who you are, but please introduce yourselves for voice transcription purposes.

Ed Richards: My name is Ed Richards. I am the chief exec of Ofcom.

Chris Rowsell: I am Chris Rowsell and I am a policy director in Ofcom's competition group, looking after postal regulation.

Q144 Chair: I am slightly paraphrasing, but in your report you said there was no immediate threat to the universal service obligation. What data did you monitor to come to that conclusion?

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

Q145 Chair: Can you tell us what elements of the business and the market you examined to come to the conclusion that you arrived at?
Ed Richards: We look at all elements of the business.

Q146 Chair: Yes, but could you just outline them?
Ed Richards: Letters. The universal service products are the principal focus, so we look at all of those, but clearly we cannot look at that alone. We need to look at the overall postal services market, because there are many products that are not part of the USO but are important in the economics of the USO, because they are carried over the same network. The only way of answering the question without going through every single element of data is to say that, in essence, when we make that judgment we are looking at the overall postal services market, the developments in that market, all the products in that, and their relationship with the USO and its sustainability.

Q147 Chair: I would not dispute anything you have said, but I am trying to drill down and find out exactly what those elements were. Chris, it may be more your area. I do not mind who answers as long as I get an answer. Did you look at labour costs, factors for growth or decline in different markets, and the cost of competitors and their market penetration?
Ed Richards: Yes, all those things.

Q148 Chair: Well, why could you not say so?
Ed Richards: Well, because all those are elements of the overall postal service.

Q149 Chair: Yes and I was asking what were the elements. That is the point I am trying to get at.
Ed Richards: Let us build it up. When we look at the postal services market, we are looking at a range of products that are part of that. We are looking at the revenues associated with those products. We are looking at the costs associated with those products and we are looking at the profitability associated with those products. However, the critical thing is that you need to look at it in aggregate, because the core test in that area is whether the USO is financially sustainable, so we are looking at that principal question.

Do we look at the costs associated with a product? Yes. Do we look at likely changes to volumes? Yes, we do. Do we look at the implications for revenues associated with that? Yes, absolutely we do. Do we track all that back together to ask ourselves the core question of whether the USO is financially sustainable? Yes, that is exactly what we do. We looked at that in terms of the facts today and projections into the future. Clearly, there is more uncertainty about the future than there is the present, but we looked at that very carefully and, as I think you are aware, we looked at that on the basis of a great deal of confidential information that was given to us both by Royal Mail, which asked for it to be made confidential and remain confidential, and by Whistl, which asked for that information to be confidential as well.

Q150 Chair: Yes, I understand that there are areas of confidential information and I would not expect you, in a public session like this, to spell them out. Did you assess: first of all, the cost of the universal service obligation; secondly, the potential cost to Royal Mail of the impact of competition in these selected markets; and, thirdly, the ability of Royal Mail to offset the costs of the impact through an efficiency delivery mechanism?
Ed Richards: Yes, we looked at each one of those elements in considerable detail. As I have said, to some extent the valuation we made there is dependent upon projections, but we looked at each of those in very considerable detail—far more detail than we originally expected to. That was the result of the fact that we received such a considerable submission from Royal Mail, in particular, but then considerable submissions from others, and we found ourselves reviewing the issue in very considerable detail. That is why, having taken it through our board on multiple occasions and having reviewed it over a number of months, we found ourselves in a position to take a view, at that point in time, about what our judgment was on the financial sustainability of the USO. We looked at each of those issues in very considerable detail, yes.

Q151 Katy Clark: I just wanted to ask to what extent you looked at projections because this is a very quickly changing situation. You will be aware of the very aggressive strategies to try to take work away from Royal Mail in the most profitable areas, so to what extent did you look at how this is likely to impact on the years as we go forward?
Ed Richards: That is precisely what we looked at. That is absolutely precisely what we looked at, and we contrasted and were able to contrast the data from one company with the data from another company. Obviously, we were the only ones who had access to both sets of data and could make sure that it made sense. We tested that ourselves against our own set of assumptions and we examined it in relation to for example, as the Chairman suggested a moment ago, different responses and different alternative developments. So that was exactly what we did, yes.

Q152 Chair: You say that you have done all these forward projections. You have obviously come to the conclusion that the potential financial impact of competition could be countered by an efficiency drive with Royal Mail, and we will go into the elements of efficiency a little later on, but could you just elaborate? We might come to a situation where the market share of rivals is such that it will obviously affect the bottom line of Royal Mail even after it has implemented all reasonable efficiencies but is increasingly unable to compete because of the higher cost bases imposed upon it by the universal service obligation. What measures would you contemplate taking in order to protect this in the event of this happening?
Ed Richards: May I just say something about the first half of the question and then return to the second half? Efficiency is an important dimension of this, of course, but it is not the

only dimension. We were not exclusively looking at whether Royal Mail had an efficiency plan or potential responses to improve efficiency that would ensure that the USO was sustainable. That is an important part of the mix; of course it is an important part of the mix. I do not think anybody would want a situation where we did not have an eye on whether the USO was being delivered efficiently or not, but there are other factors. In particular, for example, there is what is going on in the parcels market, and that is one of the reasons why we have highlighted that we will undertake further work in the parcels market to make sure we understand the impact of those developments for the core USO and its financial sustainability. It is a broader range of issues, and efficiency is one, but the revenue side and the parcels market, for example, is another important dimension of it.

In terms of the measures that we could look at in relation to the USO should it become a question of sustainability, the kinds of things we can look at are the general service conditions, where we could introduce obligations on competitors in order to change that balance. That is one option. The second option is the universal service compensation fund. Just as an important caveat to that, we are not able to introduce that ourselves unless directed to by the Secretary of State prior to 2016. I believe that is in the Act. The fund is a very important idea, as is the previous example. The fund would compensate Royal Mail in such a circumstance and it would be capable of being levied on any operator whose business was capable of being carried over the USO network. It is quite broadly drawn and very important in the context of, for example, what we see as developments in the parcels market where, as you know, there is a lot more competition. There is diversity of supply, much of which involves post parcels that could, indeed, be carried over the USO network, so if and when we reach that point, that is the territory that we would certainly be looking at.

Can I just emphasise one other point? I did mention earlier that we have made a judgment "at a point in time". Those are very precise words. We clearly retain the ability to review that judgment at any point in time. There is no set date and there is no specific obligation on us as to when we could reopen that, and it is important for me to emphasise that we take our principal duty in this area, which Parliament set us, extremely seriously, and we are very mindful of the need to make sure that the USO is financially sustainable as well as being efficient. Therefore, we will keep a very close eye on it in the coming months and years.

Q153 Chair: We will come back to the timing issue, but there is just one quick question that I wanted to ask. You mentioned, in response to measures that could be taken, a change in the general service conditions of other operators. What sort of conditions could those be? Can you just give me an example?

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

Q154 Chair: I have another very quick one. I think I know the answer, but it would be useful to have your opinion very briefly. Why is the London zone more expensive than the others? Is it because of the verticality, as described by a previous witness, of many of the addresses, or are there other reasons?
Ed Richards: There are two reasons, as we understand it, but you need to ask Royal Mail fundamentally. The first reason is to do with density, flats and all those sorts of issues. The second is that there is a very different cost of labour in London; there is a very significant London weighting. Do we know what it is?

Chris Rowsell: Just doing a confidentiality check. Over 20%.

Chair: You can provide us with written evidence on that.
Ed Richards: It is a very substantial enhancement for London weighting and clearly that has a very significant impact on the underlying cost structure, so London, as we may return to, turns out to be a high-cost area rather than a low-cost area.

Chair: Okay. I do not want to labour the point. If you could send us any details, it would be helpful.

Q155 Caroline Dinenage: Moya Greene told us that the total cost of the universal service is £7.2 billion. Why does it cost so much?
Ed Richards: I am not sure it does cost £7.2 billion. It depends how you look at it and Moya's approach is, I think, the cost of the entire network for a year. We have taken a different approach to it. That is the cost of the whole network, but of what goes over that network of that £7.2 billion, only 20% is USO defined—80% of what is carried over the network is not. When one then asks what costs should be associated with which area, the numbers are quite different. For example, in the Royal Mail's own regulatory financial statements, which it has to submit to us, the allocation from the USO, or the cost of the USO, is not £7.2 billion but £2.7 billion. They are very different numbers. Those are its numbers that it has returned to us in its regulatory financial statements, and that is driven by the fact that the network is also providing all sorts of other services or carrying all sorts of other post that is not universal service post. What it does—this is its approach, but one which we accept—is then to look at how the activities are undertaken and how one therefore allocates the cost to certain activities that are USO activities and certain other activities that are not USO activities. Those numbers are not ours; they are Royal Mail's regulatory financial statements, and there is obviously a very big difference between £7.2 billion and £2.7 billion.

Q156 Caroline Dinenage: With those figures in mind, does your evidence show that the Royal Mail makes a profit from the universal service products?
Ed Richards: It does, and Royal Mail itself reports a profit on the USO. It is important to be very clear about this. The audited 2013-14 regulatory financial statement from Royal Mail to us—so audited externally—reports an operating profit of £484 million on universal service mail after transformation costs, which are one-off costs. If you omit transformation costs, the operating profit on the universal service was £556 million, so half a billion pounds of profit on the universal service in the audited regulatory accounts

for 2013-14. With that in mind, that is one of the important facts, I think, that probably helps you to understand why we made the decision that we did at this point in time.

Q157 Caroline Dinenage: The Ofcom response to Royal Mail's submission of June 2014 is full of redacted sections. While we appreciate, obviously, the need for confidentiality, how can we be assured of the veracity of your conclusions if we cannot see the evidence on which you are basing them? What kind of assurances can you give us?
Ed Richards: I agree this is a conundrum and a little bit tricky. On the other hand, Royal Mail—and, indeed, Whistl—is free to decide that it can make that information available to Parliament and the Committee whenever it wishes. It is not us that has chosen to make that confidential; it is the companies. For our part, once a company—this is true of all companies we work with, not just in post, but in all the other sectors for which we are responsible—has said that information is commercially confidential and we must treat it as such, we are under a legal obligation to honour that. We would be acting illegally if we did not maintain that commercial confidentiality, so that is difficult. It is worth going on to say, however, a couple of things. First, if, in due course, our decision is appealed, which it may well be, access to that confidential information would extend to the court, and we would be very happy for that to be the case. There is a check on our judgment through the courts, and the courts would have access to precisely the same confidential information.

The second point to make about it generally is that, because we are dealing with private companies of this kind that do have commercially confidential information, that is one of the reasons why Parliament creates independent regulators: so that there is a third party that is entrusted by the companies to have access to that confidential information that can be trusted and legally obliged to treat it confidentially, but then can exercise a judgment in the public interest. That is at the heart of why Parliament created the system of independent regulation, of which this is quite a good example.

Q158 Rebecca Harris: Your monitoring report stated last week that the majority of consumers or the majority of the British public, however you look at it, are satisfied with their postal services and that the prices remain affordable to almost all customers. Can you just give the Committee a bit more of an explanation of how you arrived at that conclusion, firstly?
Chris Rowsell: Yes. We carry out considerable research into consumer affordability. We did a major piece of work, which we published last year, and we keep this up to date in tracking research. We did a series of focus groups looking at only consumers who were on very low incomes. We did a separate piece on SMEs, because there is a separate shaped question there, but, if we are focusing on residential consumers, we looked, essentially, at people who were in the lowest couple of deciles—the lowest 20% of income in the UK—and we asked them. We asked them in quantitative surveys whether they felt postal services were affordable and whether they felt there were things they could not send, and we did focus groups to dig into that a bit more as well. When we were thinking about what is essential, we included both things that are legally essential, where you have

to file a return or something or send a letter to the local council, and things like birthday and Christmas cards and presents. They are an essential part of using the service.

There were two areas we found where there may be consumers who could not afford to pay for everything that they needed. Consumers on very low incomes with a desire to send international parcels may not be able to afford that and, particularly, some sets of immigrant communities working in low-income jobs and wanting to send parcels home to their families, for example. The other was groups of people on very small or no incomes who needed to engage with the authorities in a formal way in writing. That particularly related to immigration cases and so forth—people applying for citizenship.

Q159 Rebecca Harris: Did you look at these groups to see if they were also digitally excluded as well?
Chris Rowsell: We did not do that in the same exercise, but we have a companion piece of work looking at the same issue in telecoms.

Ed Richards: We have looked at the issue of digital exclusion pretty carefully elsewhere. I am not sure we have done a precise mapping across. Digital exclusion is not quite as easily predicted as you might think, so while it does skew towards lower-income groups, it also skews quite heavily to older-age groups, some of whom are not poor. There is a big age effect and there is a low-income effect. I will go slightly out on a limb here. We can check this, but I doubt there is much of an ethnicity skew in digital exclusion. There is a low-income element of it and there is an age element of it, but I think ethnic communities in the UK are among the more digitally engaged, generally speaking.

Q160 Rebecca Harris: I was thinking about those people who maybe find it difficult to afford the postal service and have no other alternative, but you did not find that.
Chris Rowsell: These are scenarios in which people need a postal service. There is not a digital way of sending a parcel to another country, so it is very specifically about the postal services, and then again it was about those people needing to send forms back to the Government, for example, on paper.

Ed Richards: These are things that cannot be done by e-mail; that is the key.

Q161 Rebecca Harris: What you produced last week was a snapshot in time. What steps could you take if you found that opinions were changing on this—that people were finding themselves either unsatisfied or unhappy with the price and unable to afford it?
Ed Richards: We would look at this. This raises a much bigger question, which is how we and, indeed, the industry respond to changing patterns of demand, and this is one of the critical questions of the next few years. The postal service was, in some ways, very stable for decades, and now it faces a huge amount of change through technology, changing consumer habits and all sorts of different things. The reality of that is that we and others—this will include Parliament in due course—are going to have to look at how we

specify the universal service, what is in it, what pricing arrangements there are and how we make sure that that is kept up to date with the specific kind of problem that we have just been talking about, but also the much more general question of how the whole population is changing its habits and its needs in relation to postal services in the future. We already know there has been very radical change in that respect in relation to both letters and parcels even in the last decade—change that we have not seen in postal services since their inception. This will be a critical issue for us, and we have means through which we can consult and engage on that, but in due course it will come back to Parliament to look at as well.

Q162 Ann McKechin: I want to come to zonal access costs. In your paper last week—I am going to quote this because it is a pretty complex phrase—you said: "Our objective is to design a remedy that enables Royal Mail to reflect differences in its zonal costs in its zonal charges and does not constrain Royal Mail in determining its absolute return, but at the same time removes the potential for Royal Mail to set charges in a way that can undermine beneficial entry into delivery." Is it possible to find a third way that does not constrain it, but does not undermine beneficial entry or, if I can put it this way, is there bound to be a solution that will, to some extent, not manage to achieve both of those?
Ed Richards: It is possible, but what we are trying to do genuinely is to strike the balance that we have articulated there. The reason why we are trying to strike that balance is because there are two important sides to this equation. One side is that we want to design an approach that does permit and ensure that there is enough freedom for Royal Mail to make a commercial rate of return. We should be very clear about that. We want Royal Mail to be healthy and profitable. We should be very clear about that. We want the USO to be commercially sustainable, and we want that to happen on the basis of a healthy, efficient and profitable Royal Mail. On the other side, as I know you have heard from other contributors to the Committee, it is important, where we can, to create some space for the stimulation and the discipline of competition when that is consistent with the underlying sustainability of the USO.

Let me just elaborate on that by taking the detailed conditions that we have proposed. Just to give you one by way of illustration, what we have said on zonal pricing is that Royal Mail has the freedom to set its margin as it chooses. However, what we have said to ensure that that is consistent with a fair approach for the market overall is that that should be consistent from zone to zone, and that the prices should be reflective of the costs in the zones. That seems, to us, to be a reasonable and fair basis. In other words, where Royal Mail has higher costs, it is able to charge a higher price, but it is not able simply to select a price that suits its ability to inhibit, or to risk inhibiting, competition when that competition can offer something useful for consumers and the market. We are trying to strike a balance—I accept that—and at the moment our judgment is that that can work and should work but, as I mentioned earlier, that is something that we will keep under review.

Q163 Ann McKechin: Could you give us some idea of the rate of return that you think Royal Mail would achieve? Would it be within the parameters that other mail delivery companies with USO obligations in the EU are achieving?

Ed Richards: We have said an indicative EBIT margin of 5% to 10%. The emphasis there is on “indicative”. There is no scientific number that one can arrive at. It is the right to earn that range; it is not a guarantee. We cannot give a private company a guaranteed rate of return. The market, to a degree, needs to determine that, and it needs to determine that for itself through its own actions, but we have said that that is the indicative range within which we believe a commercial rate of return is operating. That is something we will probably return to. We set that indicative range before privatisation or around privatisation.

Chris Rowsell: It was in March 2012.

Ed Richards: Okay. These numbers can change through time, as you have suggested. You look at them in comparison with what other companies operating commercially in the sector elsewhere in the world are earning, so that is something that we will look back on, but the indicative range is there to help everybody.

Q164 Ann McKechin: Entry into delivery is starting, at the moment, at a slow pace, but it could speed up very rapidly, and we know that Whistl has ambitious plans for expansion. We have also heard from Amazon, which is changing the types of model in the way of its delivery. How can the USO be provided at the lowest possible cost, which you say it is your responsibility as the regulator to try to achieve, while ensuring that the business is making sufficient profit for long-term stability? To what extent does a business of this nature need to have—perhaps you could argue—a larger than average reserve to allow it to cope with such rapid changes that are taking place in the market?

Ed Richards: There is a fine line between us doing Royal Mail’s job for it and asking Royal Mail to manage and determine its own destiny. Most good regulatory practice involves regulators setting frameworks that allow companies to determine their own destiny, so I would be very cautious about going too far down the road of us dictating this level of reserve or that level of reserve, or any other specific variable. Primarily, we have to say to the companies we regulate—this is true of all other areas as well—“The principal job is for you to get on with it.” Within that, we set a framework in which we are conscious and mindful of the need for it to be sustainable in the long term.

The heart of your question is: are there going to be dramatic changes that could change the economics and the situation in the market? That is possible, but that is why we have said we will look at this again and we will keep monitoring. However, I am bound to make it absolutely clear to the Committee that we looked at this in great depth over the last few months because of the submissions we were given by the parties and particularly Royal Mail. We looked at it in terms of the best possible information that we have at this point in time—facts and projections—and we took that view.

Q165 Ann McKechin: You have made a lot about it being at a point in time, but should there be a greater precautionary approach, given the fact that you, as well as many other people in this market, are finding it very difficult to predict where we may be three or five years down the line? Should there be a greater emphasis on a precautionary approach?

Ed Richards: We have thought very carefully about the level of risk that we think we should take, given our duties. We have thought very carefully about what one might call the precautionary principle, and our board is comfortable with the position that we have taken today. However, as I have said, we will re-look at that in due course.

Q166 Mr Bain: In our previous session, Ms Greene said we need a forward-looking regulatory approach that looks at the hazards of cherry-picking. Can you explain why you do not consider that competitors being able to enter the market on a selective geographic basis represents unfair competition?
Ed Richards: Yes, I can. Let us start with the phrase “cherry-picking”, which is essentially the heart of your question. Cherry-picking is one of those slightly emotive phrases that I have come across over the years in many different circumstances. It was used frequently in other regulated industries in the past—particularly but not only, in telecoms. What is usually meant by cherry-picking is when you have a uniform price and a company goes into a low-cost area and cherry-picks the margin that is available in those circumstances. When we examine what is happening in the market at the moment, it turns out to be quite a lot more complicated, and I do not necessarily think it is very helpful to think about it as cherry-picking.

Let us take the example that was raised by the Chairman earlier. It turns out that one of the principal places—arguably the principal place—that the new entrant has brought services into the market is London. London does not adhere to the traditional view of what cherry-picking is. It is not a low-cost area where they have come in to take the margin between the average price and the low cost; it is a high-cost area. In some ways, it is the precise opposite of what people have historically regarded as cherry-picking. The second thing is that what we have said in our approach is that Royal Mail is able to price access according to costs in different zones. That allows it to be able to set prices higher where costs are higher and, indeed, lower where costs are lower, which gives a significant degree of flexibility to respond to the traditional notion of what cherry-picking is. The situation is, in fact, much more complicated, and it is not entirely consistent with what economists regard as standard cherry-picking.

Q167 Mr Bain: London is a particular case because of high housing costs and the London premium that is paid on wages, of course. There are other parts of the country where there has been selective entry by Whistl and other companies in which those factors are not quite as pronounced. Can you explain why they are operating in Manchester but not in some of the rural counties around Greater Manchester?
Ed Richards: I cannot explain that. I should not explain that. That is a matter for them. You will have to ask them.

Q168 Mr Bain: Do you ask them that?
Ed Richards: We discussed the issues with them and they discussed them with us confidentially, but I am not in a position to tell you why they opened in Manchester rather than Shrewsbury or anywhere else. I would highlight one other point, though, to illustrate

the complications on this and why it is not as simple as often presented. Let's take the example of London again, which is a high-cost area and yet they are there. One of the things that happened in relation to the cherry-picking argument is that Royal Mail set out some prices to deal with that and it priced in a very low way in London to address the competition. The consequence of that was that prices had to go up elsewhere, so prices went up in rural areas, particularly Scotland. What we have heard from a number of operators operating in Scotland is that they are very concerned about that response, because it excludes them from the market. It has raised costs to them and what they say to us is that in Scotland they are able to offer a high-value-added service in addition to Royal Mail, but the consequence of that reaction to cherry-picking is that they will no longer be able to do so or their business would be placed at risk. I make that example to illustrate the fact that there are often two sides to this coin. In our experience so far, to think about this as very conventional cherry-picking of the old kind that we all grew up to understand does not turn out to give you a very insightful understanding of what is going on and the freedoms that are available to respond to different kinds of entry, and the consequences for different geographies and different communities.

That said—where the picture is far more complicated than often presented—let me sit back and take the overview of the question. It returns us fundamentally to the question that was at heart of the previous question as well: could this entry lead to questions about the financial sustainability of the USO and the nature of competition? My answer to that is yes, it could, and, in due course, there may well be scope or the need for us to respond to that using the kinds of terms that I described to the Chairman at the start—the service conditions or, indeed, the compensation fund post-2016 in our case. That is quite possible, so we may find ourselves evaluating the information in six months, a year, two years or three years and saying to ourselves, "The nature of that challenge and the advantage that the entrant has, for example, by not having to deliver six days a week has meant that there are developments in the market that we need to take account of and, to ensure that we deliver our primary duty in relation to the USO, make a response to." The door is open on that; it will remain open. We have not closed that door and we will never close that door. We have taken a view at this point in time and we will look at it again in the future, I have no doubt.

Q169 Mr Bain: On the precise tools that you have available to you, you have mentioned a couple of them, which are to introduce potentially more requirements on participants in the market in terms of their obligations on delivery. One of the other aspects is also to broaden the extent of the geographical landmass of the UK that such operators cover as well. Again, I would put to you some of the original pitches that Whistl and other companies made was that by this stage they would be covering Glasgow, Edinburgh and other parts of the UK. They have not done so. They have delayed their plans. They have almost focused on the areas that they have prioritised. Is there not a strong case for you to be looking proactively at putting some geographical percentages on the amount of the UK that such operators should cover?

Ed Richards: The direct answer to that is not at the moment, and the reason for that lies in precisely the observation that you have just made. What your observation about what they said they would do and what they have done, and the absence of the roll-out in those areas, reveals is that the impact of Whistl is not as great as people originally expected. It has not rolled out in those areas and, therefore, it has not taken revenue away from Royal Mail in those areas. That is part of the reason why we have made the judgment that we have made. Had it rolled out in those areas and had a huge impact on the market in those areas, it is possible we would be making a different judgment, and that is what we will look at in the future. At the moment, we do not think we need to do that, but as I have said, that could easily change. We are comfortable with the judgment we have made at this point in time, but we will look at it again in the future, and those kinds of things are the kinds of things that, should there be a risk, we would of course look at.

Q170 Chair: Could I just raise a couple of points? The first is that you are saying the zonal pricing should be based, if you like, on the costs of delivery in that particular area. That does not really deal with the potential for another operator to operate in, say, London, which is a higher-cost area, but do it at a reduced level purely and simply as a marketing device to capture Royal Mail's market. If Royal Mail was unable to compete by lowering its price because of the criteria that you have set that should determine the price, you are, by virtue of your regulation, effectively pricing it out of that market. It is not fair competition. Would you give flexibility to Royal Mail in that circumstance?
Ed Richards: I am not going to say to the Committee that all things as between the operators are equal, because patently they are not, so I am not going to advance that argument. As I said in answer to Ms McKechin earlier, we are trying to strike a balance. I am not going to advance an argument that says the new entrant has exactly the same obligations as Royal Mail. That is patently not true. We are about striking a balance, because we think there are some benefits that can be brought from that.

Having said that, there are significant freedoms available to Royal Mail to respond. Some of those are all the conventional management responses that everybody running a company thinks about when they face competition. Anyone running a company has to deal with those sorts of things, and you do not want me to list the various tools and levers available to an executive team and a board when they respond to competition; everybody knows what they are. Equally, though, let me give you an example of a freedom it has in response to this kind of entrant. What Whistl has done is focused on certain areas, but it has also focused on bulk mail, which is very low margin and not part of the USO. A crucial point is that it is not part of the USO, so it is available to Royal Mail to offer its own bulk mail service that does not match USO obligations to compete directly with Whistl. That is a significant freedom.

Q171 Chair: Yes, but coming back to a point I made to the previous panel, what you are talking about are the virtues of competition. In this context, the great virtue of competition is you could get a reduced service. Would the consumer not think that was slightly odd?
Ed Richards: I do not think that is right.

Q172 Chair: Well, surely, if you are getting a six-day delivery now and it is reduced to three days, that is a reduction in service.
Ed Richards: No, it is not, Chairman, because we are talking about business users, who are perfectly happy with a three-day service.

Q173 Chair: Yes, I understand what you are saying, in effect—that business users do not need the six-day service—but it is still a reduction in service. I would also be interested to know if you have evidence to demonstrate that business users would be happy with that reduction in service.
Ed Richards: Business users determine the service they want. They go to the suppliers.

Q174 Chair: On that basis, when they are delivering six days, surely that is what they want.
Ed Richards: No, because when they go to Whistl, for example, or others, they say, "We are content with a three-day-a-week service," which is precisely why Whistl has offered a three-day service. If business users wanted a six-day service for their bulk mail, Whistl would have to offer it, so there is a big difference.

Q175 Chair: The counter to that is that those who go to Royal Mail want a six-day service and as a result of competing with Whistl they may not get it.
Ed Richards: The six-day service is part of the USO, so they will get it while the USO is financially sustainable, which we have an obligation to ensure.

Q176 Chair: I thought you just said that it was not part of the USO.
Ed Richards: The six-day letters service is part of the USO.

Q177 Chair: I am talking about the bulk delivery service.
Ed Richards: No, that is not part of the USO.

Q178 Chair: I understand that, but they still get a reduced service.
Ed Richards: They choose to have that, though, because it is a commercially determined service. It is not dictated by the regulator. That is a commercially determined service.

Q179 Chair: What I am trying to get to is, yes, you could argue that those who take Whistl on a reduced service are making a choice. If those who currently use Royal Mail find that their service is reduced to three days as opposed to six, that is a service dictated not necessarily by their preferences, and it arises as a result of this competition.
Ed Richards: That will not happen while the USO is in place, because the USO requires six days a week.

Q180 Chair: Sorry, but it does not apply to bulk delivery.
Ed Richards: Bulk mail users could elect to have six days a week if they wished to, but they would rather have a lower price and accept three days a week. That is a matter for them.

Q181 Chair: What I think you are saying is they could elect to pay more.
Ed Richards: They can pay more or less. They can choose.

Q182 Chair: That is still a change in service.
Ed Richards: No, I do not think so. The users who wish to continue to use the Royal Mail service can continue to use the service.

Q183 Chair: Chris, you seem to want to come in on this. I do not think we are going to agree on this, but it may be that you can shed some sort of light on it.
Chris Rowsell: Quite often what the business users are after is speed of delivery, and so D plus three is the typical second class service, and you can deliver to the customer sending a D-plus-three service while delivering every other day of the week, because some people get their mail on the second day and some on the third day, and it rotates depending on when the mail was put into the system. What Whistl will be offering its customers is a D-plus-three service, a three days after posting service, which arrives alternately, so some people in some streets will get it on the second day, some on the third day, but it is all arriving within the same quality standard rather than six days a week. In some other countries what we have seen is universal service providers flexing their workload on different days. For example, in Denmark and the Netherlands, they have essentially busy days where they deliver a lot of mail, including the bulk mail, and then quiet days where they are delivering the first class mail. The consumers are still getting deliveries six days a week, but they are using their resources flexibly to reduce costs overall to support the universal service while still delivering the same quality of service to their bulk mail customers and to their residential customers.

Q184 Chair: It would appear on the basis of what you have said that, even if the bulk deliverers were not too bothered about the timing, there would be a reduction in the flexibility that Royal Mail would have arising from this.
Chris Rowsell: No, I do not think so.

Q185 Chair: You just said that they use this flexibility. Because they have to deliver those anyway, there would still be a reduction in flexibility, or they would have to operate the other elements of the universal service obligation at a higher price with lower capacity.

Chris Rowsell: In the Netherlands and Denmark, the way it works is three days a week the postie walks around the streets very quickly delivering the far smaller amount of first class mail and consumer mail. On the other days of the week, they have a shorter route that takes a longer period of time, and you have more posties on the street that day as opposed to on the light delivery days. That is how they have found a way of maximising the return.

Q186 Chair: This is obviously a very specialised area, so I would be grateful if you could put that all in writing so that we can examine it in detail and, if necessary, test it with Royal Mail, because there is something that does not quite fit to me.

Ed Richards: The fundamental point for us remains that business users can determine their needs in the way that normal commercial arrangements are determined, and we need to make sure that developments in that area are consistent with the USO and the six-days-a-week delivery. At the moment, our view is that that is the case, and that is the most fundamental point. If, in due course, those developments in the business market, the bulk mail market, have an impact on the underlying sustainability of the USO, as I have said throughout the meeting, we will then look at it—and they might.

Q187 Chair: This is the whole thrust of Royal Mail's argument here.

Ed Richards: They might, but in our judgment they are not at the moment. We are very nervous about over-dictating in any kind of market. It is a very dangerous area. You have to leave companies, to a degree, the ability to make their own decisions and their own judgments. We set a framework and we look at the overall delivery of the critical objectives that Parliament set.

Chair: We understand that. The argument is that, in effect, Royal Mail has to respond to a framework that puts it at a disadvantage.

Q188 Nadhim Zahawi: I am pleased to hear you say that you are keeping an open mind on every bit of the competition, and you are right to be nervous about over-intervention. Are you also then nervous, just picking up on William Bain's point, that part of the reason perhaps for the competition not going further so quickly is the tipping point? That is, they are concentrating on bits where, once it tips, which is one of the arguments we have heard as well, it is very hard to take back. How are you monitoring that? That could be detrimental where you cannot do anything about it because it is then too late.

Ed Richards: The idea of the risk of tipping points is a serious one. It is not what we have seen so far. Certainly we have not seen an extreme form of it so far. You see significant mail change, but we have not seen incredibly dramatic tipping points so far, but we are mindful of the risk. That is why we need to keep monitoring it on a very careful and frequent basis, and it is why we need to be alert to what we would do in such circumstances—and I think we are. I am certain we are. It is something we have thought about quite carefully and we will continue to do so.

This is an opportunity to make one other point clear to the Committee: Whistl is under an obligation to provide us, in advance, with its plans for roll-out, so we do have visibility of the plans and the implications well in advance, which allows us to begin to condition our thinking prior to the facts.

Q189 Chair: How far in advance?
Chris Rowsell: We collect their business plan that is signed off by the board on a periodic basis, and that goes out several years to sort of 2018-19. We have been looking at that. The notification condition that requires it to send it to us on a quarterly basis, I think, looks six or nine months in advance, but I will go back and check that.

Q190 Nadhim Zahawi: It can amend that, though. There is no obligation on it.
Ed Richards: We do get its business plans, and they are board business plans, so it is relatively safe. They are not going to have 12-month business plans. That is very helpful and it allows us to have visibility of those kinds of risks. The two things that we then bring together are the experience in a market they have entered, so what we know from the facts about whether it tips or not, and then you can associate that with the roll-out plans and bring the two together. It is a serious point, and it is something that we need to keep looking at.

Q191 Nadhim Zahawi: That is good to hear. At our previous oral evidence session, Dave Ward from the CWU told us that "if the regulator is using labour standards to compare efficiency, we say that is completely and fundamentally wrong. We say it is outside their remit". What is your response to that?
Ed Richards: I do not know exactly what he means by labour standards. Let me put it this way. Are we taking a view on labour costs and wages? No, we are not taking a view on that. That is outside our remit, and if anybody wishes to do anything about that from a regulatory or legal perspective, it cannot be us because it is nowhere near our powers. In other countries that sort of thing has been looked at, but it is certainly not part of our powers or remit. We take a general view of efficiency which involves, as we know, lots of different things: working practices, automation, flexibility—all sorts of different things. So the direct answer to that is no.

Q192 Rebecca Harris: Could I push a bit further on that? Dave Ward was very clear. He said that "what Ofcom is really saying is that postal workers' pay and conditions need to be cut in the name of efficiency. In criticising Royal Mail's efficiency, Ofcom is preparing the ground for postal workers' terms and conditions and pay to be dragged down to the level of its competitors". He went further and said it was time to take you to judicial review for this, so how do you react to that?
Ed Richards: The allegation or the prospect of judicial review?

Rebecca Harris: Both.

Ed Richards: I am very relaxed about the prospect of judicial review. CWU, like everybody else, is very welcome to take us to court if it wishes to; that is its right. I am perfectly happy if it does not happen, but I am perfectly happy if it does happen. I have no particular view on that. We find ourselves in court on these sorts of issues all the time, so this would be nothing abnormal for us.

On the first issue, we absolutely do not have that view. We are taking a view on efficiency overall, as Parliament requires us to do. This is terribly important. We have talked a lot today about the risks to the USO.

Q193 Chair: That is your priority consideration.
Ed Richards: It is.

Q194 Chair: Yes. So it is perfectly legitimate to do that.
Ed Richards: It is.

Q195 Chair: I want to move on, but can I just get something quite categorically? When you are talking about efficiency, you are not talking about wages and the working conditions of employees. You are talking about investment and possible changes in working practices.
Ed Richards: We are talking about everything that contributes to the productivity and efficiency of an organisation—everything. Our approach is to look at efficiency, which has many determinants, and to compare it with other standards and performances elsewhere.

Q196 Chair: Are wages and conditions part of that?
Ed Richards: The cost of labour is inevitably one of the inputs among many. In some cases you have higher labour costs and higher productivity because it is associated with more efficient working practices or, indeed, capital investment. These things are very complicated, and I would resist the notion of distilling this down to a single input, when anybody who has run any kind of organisation knows full well that these things have many different factors and the outcome is determined by all of them rather than one. I do not think it is right to try to isolate a single factor.

Chair: Could you again send us a written brief on what criteria you judge efficiency on? I am conscious of time and it is PMQs at noon.

Q197 Mike Crockart: I will keep it short, Chair. When we were talking about the universal service obligation and its sustainability, I wanted to enquire about the relationship you see between profitability and sustainability of the USO and the parcels sector. You seem to have identified Royal Mail's performance in the parcels sector as a threat to the USO, but also earlier in your evidence you seemed to hint that perhaps better cross-use of the facilities used for the universal service obligation for parcels delivery would be a way to help to support the USO. Are we talking about cross-subsidy really between Royal Mail's parcels service and Royal Mail's letters service?
Ed Richards: And the USO, for sure. We are absolutely talking about that. We are not in the business of criticising or commenting on Royal Mail's performance, other than making

factual observations about it. That is an important first point. The team there have done a very good job over the last few years, so let's make sure we are clear about that. However, what does matter to us is that if you look at the parcels market, what you discover is very intense competition—really very intense competition—with a lot of different supply and very tough times for everybody in the market. Now, to the extent that that parcels business is being carried over the Royal Mail network and is, therefore, making a contribution to the costs of that network, and that revenue disappears because it has been taken by somebody else, even though those parcels are not part of the USO, we need to take care about that, because that is affecting or could affect the underlying sustainability of the USO. We have chosen, because of our primary duty to secure the USO, to make sure we understand what is going on there and how it is likely to develop. That is the context of it; it is not a criticism of Royal Mail.

Q198 Mike Crockart: That is not the same as a direct cross-subsidy of some income from parcels being used to maintain the sustainability of the USO.
Ed Richards: No. It is about the contribution that is made from a certain product revenue stream, which is, in this case, parcels that are outside the USO, which help to contribute to the overall cost of the network, and that helps the cost of the network.

Q199 Mike Crockart: Okay, but given that you have said it is an intensely competitive sector, is the end result of what you are suggesting not then likely to be that Royal Mail would separate out its parcels service, charge it separately for carrying it over the USO, and enable the parcel service then to compete on a much freer basis with the rest of the parcels sector?
Ed Richards: Outside the USO, its parcels business is free to compete and does compete, and it is not for me to hope one thing or another, but it has had a challenging set of circumstances in the last year or so with parcels. It may well be that it competes more effectively in the future and recovers some of that business. I do not know; we will have to wait and see, but it is an important component of how you finance the overall network. The way Royal Mail chooses to do it, and it makes a lot of sense, is that it has the underlying network in place for the USO, but wherever it can put business in addition to that on the network, it helps the underlying sustainability. You can call that a cross-subsidy if you want. You can call it a contribution to the costs of the network. I do not think it really matters. The fact is that if more business is carried on the network, it helps the underlying sustainability of the network. So, where we see an area where there is significant change, of which parcels is the most obvious, we need to make sure we have a weather eye on that just to understand what is going on, to understand what the economic implications are of that in the medium term, and to ensure that we meet our duty in the round.

Q200 Katy Clark: I wish to make a declaration and make reference to my entries in the Register of Members' Interests. I want to ask specifically about labour costs. It is not in the public interest for companies to be using devices such as zero-hour contracts or, indeed, low pay, because, as a society, we simply have to deal with that in another way and the Government, for example, have to pay an awful lot more in benefits to people who are on low pay. Is that something, as a Government regulator, you take into account in any way?

Ed Richards: We are conscious and aware of those sorts of issues, but labour costs, and employment law and the regulation of the price of labour—the minimum wage and all those sorts of things—are clearly not part of our remit. We cannot deal with that. We are very much a creature of statute. We do what the statute tells us to do, and it is very clear that that is not part of our duties. Fundamentally, it is a matter for the Government and Parliament, so the direct answer to you is that we cannot look at that. We are obviously mindful of the general issue—of course we are—and aware of the general point that you are making, but it absolutely is outside our remit.

Chair: I am going to close the session at about 11.50 am to enable Members to get into PMQs. We have four more questions. If you could make them as concise as possible, I would be grateful.

Q201 Rebecca Harris: In our previous session, Moya Greene said very clearly, "We do need a more forward-looking regulatory framework, one that is more encompassing, looks at quality of service across the whole industry, not just Royal Mail, that looks at labour standards across the whole industry, not just Royal Mail, and that looks at how much latitude Royal Mail needs to be given." What is your direct response to Moya's statement to us?

Ed Richards: We have a forward-looking framework. It depends what your time horizon for forward-looking is, but from our perspective, as I hope I have made clear, we are looking at projections. We are looking at assessments of how things will develop in the coming years so, from our perspective, we are certainly taking a forward-looking view. There is no question about that, and our determination to review the position in the future, should that be necessary, is, I think, an example of how we are forward looking.

As you look further forward than that, you are into broader territory. We can do only what Parliament tells us to do and we can act only within UK law and European law, so if there are broader issues that are raised for the longer term on a more forward-looking basis, that will, ultimately, be a matter for you.

I am sorry, I missed the second half of the quotation.

Q202 Rebecca Harris: The phrase "one that…looks at quality of service across the whole industry, not just Royal Mail, that looks at labour standards across the whole industry, not just Royal Mail". What is your response to that?

Ed Richards: I have made some comments about labour standards, so I will not repeat those in the interests of time. Quality of service is something that we look at, and we will, I am sure, have a further discussion with Royal Mail about whether there are issues to do with quality of service or mail integrity—all those kinds of things—that we need to look at on a forward-looking basis. We would be very happy to do that.

Q203 Rebecca Harris: What is really important is your opinion on the "not just Royal Mail".
Ed Richards: That is one of the questions, obviously, but we are able to have a look at that on a forward-looking basis and we are very happy to have that conversation. I am not in a position today, obviously, to give you an answer as to whether we will or will not change anything of that kind. We have to look at it properly.

Chris Rowsell: One slight clarification: Royal Mail has no regulatory quality of service standards on bulk mail. It is on exactly the same footing as, say, for example, Whistl, and Royal Mail's parcel wing, Parcelforce, is on the same footing as UPS, etc. When Royal Mail delivers parcels outside the universal service over its own network, yet again the quality of service standards are dictated by its customers—the senders of that mail—not by us.

Q204 Nadhim Zahawi: Very briefly, two very quick questions. Do Ofcom's duties need to be reformed now that Royal Mail is a private company? The second one is, Ed, you are leaving your post at the end of the month. What advice do you have for your successor in terms of securing the provision of the universal postal service?
Ed Richards: Whether our duties need to be changed needs some considerable deliberation. There is no doubt that we are in slightly uncertain territory, which is why you have all heard from me the commitment we have to monitoring and evaluation. I have to tell you that that is wholly exceptional. There is no other market that we look at and that we are responsible for that has this level of attention, in this detail, with this frequency. None at all. That is the internal Ofcom position on this. We are in some uncertainty and we do not know for sure how things will unfold, and that was why I kept emphasising earlier that we had made a judgment at a point in time. I do not know what the judgments will be in future and, in relation to the question, I do not know for sure yet that we have precisely the right duties. They feel all right for now, but that does need to be kept under review.

In terms of what I would say to my successor, and I am assuming you mean in relation to postal services, I would start from something that perhaps is not said as often as it should be and that we have not dwelt on today. The fact is that Royal Mail is in a stronger financial position today than it has been at any point in last 10 years. It is important to start with that. We are in a better position. Its economics are better. Moya and her team and the staff of Royal Mail have taken the organisation to a better and more robust position than at any point in the last decade and they deserve a lot of credit for that. I would start with that.

I would then underline the need for us to be mindful and very alert to the changes and developments in the market, more so than in some other sectors because of these uncertainties, and for us to then be working really effectively with everybody involved in the sector. I am not going to say that this area is an absolutely unique case, but it does need particular attention and focus over the next few years because of the uncertainties. It is an unusual case. In some of the other areas we work, the story has been just of growth and growth and more growth. This is an unusual and difficult case, because you have obviously a decline of our propensity to send letters, but you also, on the other hand, have the revolution of e-commerce and the delivery of parcels, so it is a complicated beast with a very subtle balancing act, and I would say to my successor that they need to concentrate very carefully on it.

Q205 Chair: We have a few seconds left and I wanted to ask you a very specialised question. We will be publishing written evidence submitted by this person on the website, but in anticipation of that I would like your comments. We have received evidence from a Mr Jerry Cox, who is the sole inhabitant of Boreray Island off the Western Isles—no doubt he is enjoying splendid weather at the moment. He describes the difficulties he has had on a regular basis in connection with parcels. As the regulator, what would you say to reassure him of the future service?

Chris Rowsell: There are a number of features. It sounds as though he almost certainly is one of the 2,000 or so delivery exceptions where Royal Mail is allowed special rules on not doing six days a week. I would assume he is; they quite often map on to the islands. Supply from other delivery companies I can imagine being more difficult. I suppose I would refer the Committee to the work that Citizens Advice and Citizens Advice Scotland have been doing with BIS in the UK generally, but also with the Scottish Government on parcel delivery to remote localities. It tends to be issues more dictated by the online retailer in the way they want to contract with their parcel operators rather than the parcel operators' willingness themselves to deliver at a standard rate. It is complicated, and I know the Scottish Government and UK Government have been looking at this issue very closely, and he is the sole inhabitant of an island.

Chair: Okay. Your reaction reminded me of a session I attended at a school last week when I was asked what the easiest part of my job was, and I had to say delegating difficult questions to my staff.