Summary: Ofcom ‘Annual Monitoring Update on the Postal Market, 2016-17’

Today Ofcom published its ‘Annual Monitoring Update on the Postal Market’ for the 2016-17 financial year as part of the organisation’s statutory duty to monitor the universal postal service with regard to financial sustainability and efficiency. The report covers six key areas: Royal Mail’s regulatory compliance; consumer and small business experience of postal services; the letters market; the parcels market; and the financial performance and efficiency of Royal Mail’s reported business.

Regulatory Compliance

Royal Mail’s price rises for 2017-18 complied with Ofcom’s safeguard caps and were broadly consistent with price increases in 2016-17 in nominal terms. However, in real terms prices actually fell for consumers.

Overall, Royal Mail’s quality of service (QoS) performance in 2016-17 improved compared to the prior year. Its performance was the same as, or better than, 2015-16 against seven of the eight QoS measures. However, despite this improvement, it failed to meet its Postcode Area, delivery routes completed, and Special Delivery QoS targets by 2.5%, 0.1% and 0.5% respectively.

The number of complaints Royal Mail received rose 3% from last year. Although lost items remain the most common cause of complaint, the rise is accounted for primarily by complaints regarding damage and unspecified ‘general complaints’.

Consumer and Business Experience of Postal Services

Ofcom research indicates that “the majority of residential consumers are satisfied with postal services overall (86%) and Royal Mail (84%)” and three quarters of residential consumers are satisfied with the value for money of postal services overall. In addition, more than eight in ten SMEs who use Royal Mail (81%) said they were satisfied, however, nearly nine in ten SMEs (87%) using other providers said that they were satisfied with the services they received.

When sending letters, guaranteed delivery, low cost and uniform pricing across the UK were the factors most often rated as important by residential consumers, and guaranteed delivery was most often rated as important by SMEs. Next day delivery was important to a lower percentage of both residential consumers and SMEs. When sending parcels, guaranteed delivery and proof of despatch/delivery were rated as important by the highest proportions of respondents in both cases.
UK Letters Market

In 2016-17 total addressed letters volumes fell by 5%, to 11.7 billion items. This was an increase in the rate of decline against the previous year (4% per annum). Total addressed letters revenue stood at £4.2 billion in 2016-17, a decrease of 5% in real terms on the previous year.

Ofcom reports that the main driver of the fall was “the 11% decline year-on-year in Royal Mail end-to-end letter volumes”, however, access letter volumes were more robust, falling by just 1% to 7.1 billion items. Access mail accounted for 61% of total addressed letters in 2016-17, up from 58% in 2015-16.

UK Parcels Market

Total measured national volumes increased in 2016-17 by 7% to 2.1 billion items and revenue increased by 3% to £8.7 billion, leading to a fall in average unit revenue. This is consistent with the level of competition in the sector. The rate of growth was slower than in 2015-16 when volumes rose by 12% and revenues by 8% year-on-year.

Financial Performance of the Reported Business

The financeability earnings before interest and taxes (EBIT) margin of the Reported Business fell from 5.0% to 4.6%. This is outside of the indicative 5% to 10% range that Ofcom considers representative of a reasonable commercial rate of return for a financially sustainable universal service in the medium to long term.

However, despite this, Ofcom continues to argue that “the universal service is likely to remain financially sustainable in the immediate future. This is because the financial position and financial health metrics of the Relevant Group do not indicate any short to medium-term financial health issues.” It is noted that Royal Mail’s BBB credit rating was recently reaffirmed, and it passed its banking covenant tests in 2016-17.

Additionally, Ofcom says that the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. Continued progress on efficiency is likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.

However, Ofcom states that “there are various downside scenarios which have the potential to impact the financial sustainability of the universal service. These downside risks include the impact of potential industrial action, affordability of the pension scheme, increased competition within the parcels market, and economic and market downturn.”
Efficiency

Total costs for the reported business fell by 0.4% in real terms in 2016-17 (compared with 1.6% in the prior year). This movement is the result of several factors including changes in volumes and efficiency savings. PVEO analysis provides a measure of efficiency improvements by separately identifying Price, Volume, Efficiency and “Other” factors. It indicates an underlying efficiency improvement (excluding transformation costs) of c.2.2% in 2016-17 (against c.1.5% in the prior year).

Royal Mail reduced total gross hours spent by employees in delivery and processing by 1.9% in 2016-17 (slightly less than the reduction in the prior year). However, average people costs per full time equivalent employee (FTE) increased while average revenue per FTE decreased, meaning that people costs increased relative to revenue.

In light of these changes, Ofcom remains of the view that “Royal Mail has the potential to make further efficiency gains in the future, but recognises that the timing and scope for further improvements in performance from the levels achieved in 2016-17 are dependent on the nature of any settlement agreed with its workforce on its future pay and pension arrangements.”