



Royal Mail response to Ofcom's consultation "Revising the Penalty Guidelines"

2nd October 2015

Executive Summary

Royal Mail welcomes the opportunity to comment on Ofcom's consultation on draft changes to its penalty guidelines. Royal Mail understands that the purpose of the proposed changes is to ensure that a stronger deterrent effect is created to reduce similar or identical breaches of regulations being systematically repeated by regulated companies.¹ In particular, the changes specifically target the telecoms industry where there has been a history of repeat regulatory contraventions. It is these contraventions Ofcom states that it is seeking to prevent through the proposed changes in the penalty guidelines.²

As such, Royal Mail considers that the changes proposed in the draft penalty guidelines are not appropriate for, or relevant to, the postal sector. The draft guidelines do not take into account that there are a far lower number of complaints, and no evidence of repeat problem behaviour, in the postal sector.

Royal Mail accepts, of course, that there should be penalties for companies that breach the regulations. However, we have the following specific areas of concern:

1. **Royal Mail does not agree that fines need to be increased in the postal sector.** Royal Mail fundamentally disagrees with the concept that fines need to be increased in the postal sector. Royal Mail notes that Ofcom's draft penalty guidelines do not discuss problems associated with the level of fines in the postal sector. Ofcom's "one-size fits all" approach to penalties for all regulated companies in the communications sector as set out in the consultation is therefore not appropriate or proportionate, as it does not take into account the particularities of the postal sector;
2. **Larger fines based primarily on turnover will have a disproportionate impact in the postal sector.** Royal Mail is concerned that if fines are increasingly based largely on turnover, this could have unintended consequences in the postal sector due to the high turnover, yet low margins of the Universal Service Provider (USP); and
3. In light of the above, Royal Mail is concerned that **the higher fines proposed in the draft penalty guidelines could, as currently drafted, have the effect of undermining the financial sustainability of the Universal Service Obligation (USO).** In turn, this would go against Ofcom's primary statutory duty when regulating postal services to secure the provision of a universal postal service.³

We have addressed each of the above concerns in turn in our response below.

¹ See paragraph 1.2

² See paragraphs 1.7 to 1.10

³ Postal Services Act 2011 Section 29(1)

1. Royal Mail does not agree that fines need to be increased in the postal sector

It is clear from Ofcom's consultation that the changes proposed in the draft guidelines refer to a certain type of repetitive behaviour in the telecoms sector that adversely affects consumers (e.g. silent and abandoned calls). Ofcom is concerned that this behaviour has not abated despite the actions it has taken to date. The number of consumer complaints about telecoms companies remains high.⁴ The purpose of the proposed changes to the penalty guidelines is, therefore, to act as a deterrent to companies in the telecoms sector from repeating such offences in the future.

However, the draft guidelines do not take into account that there are a far lower number of complaints and no evidence of repeat problem behaviour (whether impacting consumers or otherwise) in the postal sector. For that reason, we do not consider that the proposed changes are appropriate for the postal sector.

The number of complaints in the postal sector is comparatively low and Ofcom has set out no evidence of significant consumer detriment

Compared with other entities within Ofcom's remit, postal services account for a small percentage of complaints. In its latest Consumer Experience report⁵ Ofcom highlights that complaints about telecoms continue "to dominate complaints received by Ofcom". The level of telecoms complaints to Ofcom between September 2013 and October 2014 fluctuated between 6,000 and 7,000 per month. This compares to around 25 per month relating to postal services. In addition, complaints received by Ofcom about all postal operators continue to fall each year.⁶

Given that Ofcom is able to differentiate the broadcasting industry in its consultation, we hope that Ofcom would be able to make a differentiation for the postal industry. Failure to make a sufficient distinction between the different industries and Ofcom's decision to apply a "one-size fits all" regime to determining penalty amounts is inherently flawed and will lead to disproportionate and unjustified outcomes.

The penalties for contraventions of regulatory requirements in the postal sector are already extensive, and well established

The Postal Services Act 2011 already sets out that Ofcom can set a maximum fine level of 10% of turnover of postal services businesses for breaches of regulatory conditions⁷. Ofcom can impose penalties on Royal Mail for, amongst others:

- not complying with Quality of Service requirements
- not reporting financial information correctly or on time
- not complying with consumer protection requirements (e.g. complaints handling).

Royal Mail is therefore already subject to potentially high fines of up to 10% of turnover of its postal services business. This is set out in legislation⁸. However, for the reasons set out above, Royal

⁴ See paragraphs 1.4 and 1.8

⁵ Ofcom, The Consumer Experience of 2014: Research Report, 28 January 2015, p.12

⁶ Ofcom, Statement on Ofcom's review of complaint handling and redress in the postal market, 28 August 2015

⁷ Postal Services Act, Schedule 7, part 7 (2)

⁸ *ibid*

Mail disagrees that Ofcom should be using its guidelines to make explicit the link between the objective of deterrence and the size and turnover of the regulated body subject to the penalty. Royal Mail does not believe there is any evidence that a greater deterrent effect is required to ensure compliance with the regulations in the postal sector.

The proposed changes to the penalty guidelines are not appropriate or necessary for the postal sector and Ofcom has not demonstrated otherwise.

2. Larger fines based primarily on turnover will have a disproportionate impact in the postal sector

Ofcom has stated in its consultation that it intends to make an explicit link between the objective of deterrence and the size and turnover of the regulated body subject to the penalty. Ofcom states that the larger the regulated body, the greater the penalty needs to be.⁹ We are concerned this could have unintended consequences in the postal sector.

Royal Mail does not agree that using turnover as the starting point for calculating fines is appropriate. We consider that it is too blunt an instrument for calculating penalty amounts. In particular, the effect of imposing large fines based on Royal Mail's turnover will have a disproportionately large impact on Royal Mail as compared to telecoms companies, which are the focus of Ofcom's proposed changes. Although Royal Mail has a relatively high turnover, its profit margins are comparatively low. For example, Royal Mail Group PLC's reported operating profit margin after transformation costs for 2015 was c.5%, compared to 20.9% for BT.

It is clear from Table 1 below that, if Ofcom does decide to implement higher fines based primarily on turnover, this would be disproportionately punitive on Royal Mail compared to other companies under Ofcom's remit who, like BT, have considerably higher operating margins.

Table 1: Examples of operating margins for companies in sectors regulated by Ofcom¹⁰

Company	Operating Margin, rounded to one decimal point
ITV PLC	25.1%
BT PLC	20.9%
Sky PLC	9.7%
Vodafone PLC	6.3%
Royal Mail Group PLC	5.0%

⁹ See paragraph 1.21

¹⁰ Analysis of the latest Annual Report and Accounts published by each company.

Further, as Table 2 shows, Royal Mail also has much lower average EBIT margins than companies in other regulated sectors (such as energy and utilities):

Table 2: Average EBIT margins earned in FTSE 100 across different sectors, 2007 - 2014¹¹

Sector	Average EBIT margins earned in FTSE 100 across different sectors, 2007 - 2014
Materials	19%
Consumer Staples	13%
Energy	8%
Industrials	8%
Consumer Discretionary	11%
Utilities	11%
Other	23%
<i>Weighted average</i>	<i>12%</i>

Ofcom's proposed changes to the penalty guidelines could ultimately put the financial sustainability of the USO at risk should it implement a fine calculated according to Royal Mail's turnover, without also taking into account (i) the specific circumstances of the postal sector and (ii) Ofcom's regulatory duties in respect of post (see below).

On a wider level, disproportionately high fines on Royal Mail could also have an indirect impact on wider UK economy, including subcontractors. Royal Mail makes a very significant contribution to the UK economy. Research carried out by the Centre for Economics and Business Research Ltd (CEBR) found that our impact totals £11.1 billion in terms of value added to the economy, which equates to about 0.69% of UK GDP.¹² This includes our contribution through employment, procurement and taxation. We made the 6th largest contribution to the UK economy of all UK corporations.

CEBR found that, in addition to the c.143,000 people employed by Royal Mail's UK business (UKPIL), a further 120,000 full-time equivalent jobs are indirectly supported by Royal Mail UKPIL in the wider economy.¹³ In the UK, Royal Mail also contributes around £2.5 billion annually procuring goods and services.

¹¹ FTI analysis of data available on Bloomberg.

¹² CEBR, The Contribution of Royal Mail to the UK Economy: A study on the economic contribution of Royal Mail's UK Parcels, International and Letters business unit to the UK, May 2015

¹³ Ibid

Royal Mail's business has a wide and significant impact on the UK economy. This includes the direct business and consumer benefits of providing a six-day-a-week postal service to more than 29 million UK addresses, as well as the wider positive impact that Royal Mail has on the UK economy through employment, procurement and taxation. As a result, imposing higher fines on the USP would have wider ramifications than may be the case in other regulated sectors.

3. Higher fines could undermine the financial sustainability of the USO

Under the Postal Services Act 2011, Ofcom has a primary duty when regulating postal services to secure the provision of the universal postal service and to ensure its financial sustainability. Although Ofcom considers its primary duty under the Communications Act 2003 in the consultation document¹⁴, it does not refer to its primary duty under the Postal Services Act 2011.

We consider it particularly important for Ofcom to consider the particularities of the postal sector, and the financial sustainability of the USO, when setting fines in the postal sector.

The dynamics of the postal market (declining letters and increasing competition in parcels) mean that the finances of the USO are fragile. A high quality USO has high fixed costs. Imposing higher fines by using turnover as the starting point for calculating appropriate levels for fines has the potential to affect our ability to provide the USO.

Royal Mail therefore faces a unique set of circumstances that mean that a "one-size fits all" approach to penalty guidelines is not appropriate or proportionate. The impact on the postal industry, and the USP, should be considered in the penalty guidelines.

Recommendations

1. Ofcom should not make explicit any link between the objective of deterrence and the size and turnover of the regulated body subject to the penalty in its penalty guidelines. This approach would have a disproportionate impact in the postal sector and there is no evidence that a greater deterrent is required in the postal sector.
2. In the alternative, as a minimum, Ofcom should ensure its penalty guidelines have regard to the specifics of the sector concerned and, in the case of the postal sector, the ability of the USP to deliver the USO and Ofcom's primary statutory duty under the Postal Services Act 2011. In this case, Royal Mail therefore recommends that an additional clause be included in the penalty guidelines after paragraph 18 which makes explicit that Ofcom will also consider the impact of a fine on the finances of the USP and its ability to deliver regulated or mandated services. We have set out suggested wording below:

"In setting the amount of any penalty, Ofcom will have regard to its statutory obligations and, in particular, to the impact of any penalty on a regulated company's ability to deliver regulated or mandated services on a sustainable basis".

¹⁴ Paragraph 1.28