# Financial sustainability of the universal postal service

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# Contents



**Figures and tables**



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# Executive Summary

The issue of financial sustainability is central to the economic regulation of 'essential services'. If financial sustainability is threatened, the regulated company may struggle to attract the necessary investment to maintain and improve the regulated activities, to the detriment of users and society.

The postal sector is no different in this respect. The provision of a privately financed, user-funded universal postal service relies on the provider being financially sustainable. In fact, the unique challenges of the postal sector—a combination of high fixed costs to meet the universal service obligations, declining demand for certain products, and competitive pressures—mean that financial sustainability is an even more critical issue. As a result of the high level of operational gearing, the financial health of the universal service is highly sensitive to movements in the market that affect revenues.

The onus is on Royal Mail, as the universal service provider, to take actions to support its financial performance by investing in its network, operating efficiently and meeting the needs and preferences of postal users.

However, Ofcom's duties require it to have regard to the financial sustainability (and efficiency) of the universal service, including the need for the universal service provider to earn a commercial rate of return on expenditure related to its provision. In light of this duty, it is also reasonable to expect that Ofcom will take steps to support the financial sustainability of the universal service.

We see two ways in which it might do this.

- First, by creating a regulatory environment that provides the universal service provider with the *opportunity* to earn a fair rate of return. It is important to stress that this is not a guarantee of a certain rate of return. Actual financial returns will depend on market dynamics and Royal Mail's own performance. However, the universal service provider should have a reasonable prospect of earning the commercial rate of return, in line with Ofcom's 'fair bet' principle.
- Second, by having a mutually agreed, transparent approach for assessing the financial health of the universal service provider and the likelihood that it will continue to be financially sustainable in the future. To the extent possible, this should provide clarity on when/how Ofcom would expect to take measures to address a financial sustainability concern.

In other regulated sectors, there are well-established processes in place for assessing the future financial sustainability of the regulated business. While the utility regulation model has demonstrably not worked in the postal sector, the general approach applied by companies and economic regulators to assess financial sustainability is of relevance. In particular, there is merit in an approach that allows the company and its regulator to gain assurance that the regulated business is financially sustainable by (i) directly drawing on the indicators and ratios that are relied on by debt and equity investors; and (ii) having an agreed view on when there should be cause for concern.

The benefit of having a predictable, stable and transparent regulatory approach is that it should aid investor confidence and therefore act to encourage investment for better quality services and innovation, which are ultimately to the benefit of users of the universal postal service. Uncertainty over the regulatory approach or a perceived lack of regulatory commitment around

Royal Mail's ability to earn a commercial rate of return have the potential to undermine incentives to invest in the universal service.

We see particular benefits to both parties having a common understanding around how different actions could contribute to, or adversely affect, financial sustainability. Given regulatory interventions taken by Ofcom could alter the expected returns from investment, it is important that there is clarity on how any proposed changes to the regulatory framework would affect the financial sustainability of the universal service.

Since 2012, Ofcom has put in place a regulatory framework intended to provide Royal Mail with the commercial and operational flexibility required to adapt to changing market conditions. Furthermore, Ofcom monitors and comments on elements of Royal Mail's financial performance as part of its annual monitoring process. This includes an indicative rate of return on sales of 5–10% (EBIT margin) for the Reported Business, and a suite of debt metrics.

However, in the context of Ofcom's Review of Postal Regulation, it is relevant to consider the ongoing suitability of the approach to financial sustainability, as currently applied. The profitability of the Reported Business has remained below the 5–10% EBIT margin range for a prolonged period of time. This continued 'profitability gap', and the downwards trend in the EBIT margin, raises the question as to what constitutes a financial sustainability concern and indicates a need for more clarity and transparency on this issue going forward.

Royal Mail is implementing a transformation plan with a view to meeting changing customer needs, transforming its operations and enhancing the long-run profitability of the business. At the same time, there remains a high degree of uncertainty over how the postal sector will evolve in the next few years, particularly in the aftermath of the COVID-19 pandemic. The combination of a sustained period of underperformance against the financeability EBIT margin, the business transformation, and the market uncertainty point to a need for transparency over financial sustainability.

This report presents a potential approach to financial sustainability that we consider would have the advantages of providing enhanced levels of transparency and a more holistic view of financial sustainability, taking account of both debt and equity. This approach is intended to reflect the financial indicators that would be considered by the investor community when assessing the creditworthiness of a postal operator and its attractiveness as an investment proposition. We have sought to define illustrative thresholds for a financially sustainable universal service using market evidence and benchmarks. These are shown in the table below.

For the avoidance of doubt, this table is intended to be illustrative—the exact design of the framework will need to be subject to further discussion and agreement between Ofcom and Royal Mail to ensure it appropriately reflects the objectives of both parties and the specific features of the universal postal service. This includes consideration of the appropriate level at which these metrics can be assessed in practice (e.g. Reported Business, Royal Mail UK or Royal Mail Group).

| Metric | Likely cause for concern (Red) | Below financially sustainable level (Amber) | Financially sustainable level (Green) |
|---|---|---|---|
| **Profitability** | | | |
| EBIT margin | [✂] | [✂] | [✂] |
| **Debt metrics** | | | |
| FFO/net debt (S&P) | [✂] | [✂] | [✂] |
| Debt/EBITDA (S&P) | [✂] | [✂] | [✂] |
| EBITDA/interest (S&P) | [✂] | [✂] | [✂] |
| Liquidity | | [✂] | |
| **Equity metrics** | | | |
| Dividend cover (if input) | [✂] | [✂] | [✂] |
| Dividend yield (if input) | [✂] | [✂] | [✂] |
| Total shareholder returns | [✂] | [✂] | [✂] |

Source: Oxera.

If a cause for concern were to be identified, a framework of this kind would allow Ofcom and Royal Mail to consider enablers and blockers to financial sustainability and the actions that could be taken to return the universal service to a financially sustainable level of performance. Given the lack of a price lever and complexity of regulatory levers in the postal sector, any action would likely require ongoing dialogue and agreement between Royal Mail and Ofcom.

# 1 Introduction

## 1.1 Introduction

Oxera has been commissioned by Royal Mail to support it in relation to Ofcom's Review of Postal Regulation. As part of this review, Ofcom is seeking stakeholder views on whether its current approach to financial sustainability and efficiency of the universal postal service is appropriate and, if not, what changes should be made. This report provides suggestions for a more transparent approach that both Ofcom and Royal Mail can use to understand and analyse the financial health of the universal service, and comments on the benefits and optimal design of such an approach.

## 1.2 Context

### 1.2.1 Ofcom's approach to financial sustainability

Under the Postal Services Act 2011, Ofcom's primary duty is to secure the provision of a universal postal service. Furthermore, the Act states that in exercising this duty, Ofcom 'must have regard to the need for the provision of a universal postal service to be financially sustainable and efficient', which 'includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service'.[1]

To that end, Ofcom monitors a number of financial sustainability measures to help it assess any risks to the sustainability of the universal postal service and to inform its thinking on whether its regulatory framework needs to change.[2]

Specifically, Ofcom monitors the EBIT margin of the Reported Business[3] and considers that a range of 5–10% is 'appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk within the business'.[4] In addition to this, Ofcom considers financial metrics relating to the Relevant Group to 'enhance [its] understanding of the short to medium term sustainability of the postal service'. In particular, as a minimum, Ofcom considers the FFO/Debt, Net Debt/EBITDA and EBITDA/Interest (interest cover) metrics,[5] and the Viability Statement Royal Mail publishes as part of its own financial reporting.[6]

Overall, Ofcom recognises the importance of the universal postal service being financially sustainable and efficient. Its initial view in the Call for Inputs is 'that the approach of the existing regulatory framework towards sustainability and efficiency, and the range of measures we use, are likely to continue to be appropriate for the next review period'. However, Ofcom acknowledges that various stakeholders have had concerns in relation to sustainability and efficiency, and has therefore indicated that it would welcome views on what the framework should entail going forward.[7]

[1] Postal Services Act 2011, Part 3, 29.
[2] Ofcom (2021), 'Review of postal regulation: call for inputs', 11 March, para. 4.4.
[3] Reported Business is an entity defined by Ofcom for regulatory purposes. It contains the Universal Postal Service network and all the products provided through or in relation to that network.
[4] Ofcom (2021), 'Review of postal regulation: call for inputs', 11 March, paras 4.5–4.7.
[5] Net Debt/EBITDA and EBITDA/Interest metrics are based on Royal Mail's covenants on its debt.
[6] Ofcom (2021), 'Review of postal regulation: call for inputs', 11 March, para. 4.7.
[7] Ibid., para. 4.12.

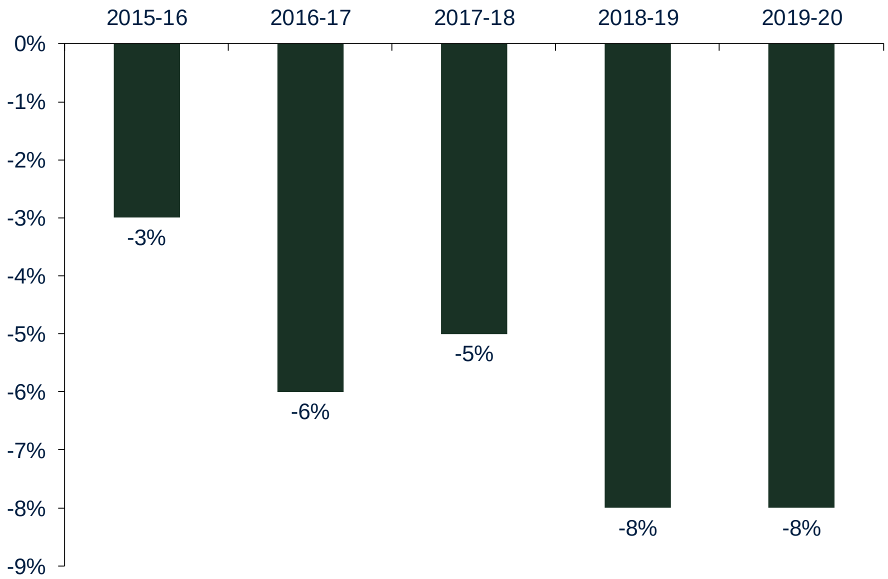
### 1.2.2 Drivers of financial sustainability

The financial sustainability of the universal service is inherently linked to the revenues that Royal Mail is able to earn over its universal service network and the cost base required to maintain and operate this network. In this context, Ofcom has outlined three key revenue and cost drivers that affect the financial sustainability of the Reported Business and the universal postal service. These are:

- the decline in letters;
- growth in parcels;
- cost transformation.[8]

First, overall letter volumes have been in decline since 2005/06, reflecting a continued structural decline in transactional and advertising mail. As a result, revenues from letters (at the total market level) have fallen from £4.7bn in 2015/16 to £4.0bn in 2019/20.

**Figure 1.1 Year-on-year change in addressed letter volumes (excluding elections)**

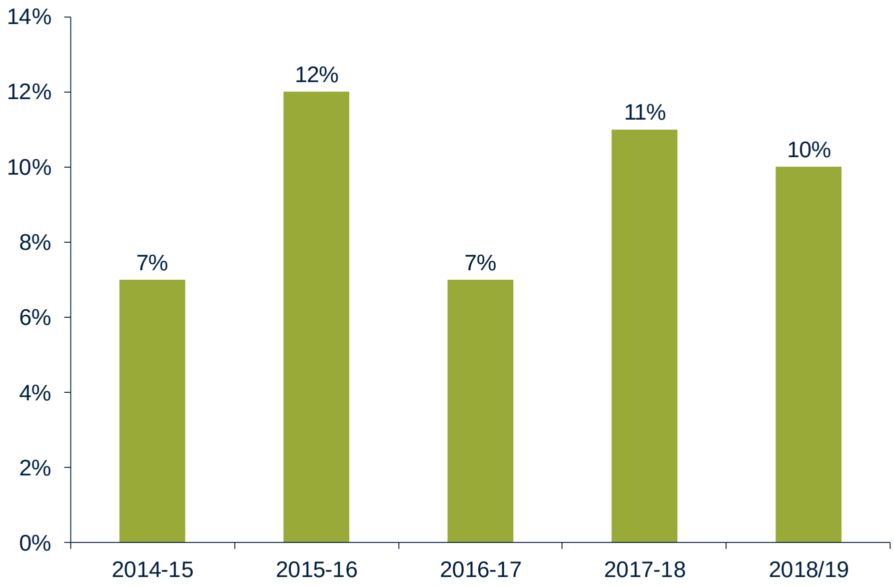



Source: Oxera, based on Ofcom (2020), 'Annual Monitoring Update on Postal Services: Financial Year 2019-20', November.

Second, there has been significant year-on-year growth in parcels volumes at the national level driven by the increase in e-commerce. The overall volumes of parcels grew at a CAGR of 9.6% in the period between 2016–17 and 2019–20, reaching a total of over 2.8 billion items by the end of 2019–20.[9] COVID-19 has accelerated the decline in addressed letters and the increase in parcels volumes in FY2020/21, with Royal Mail reporting that Q3 2020/21 was the busiest quarter for parcels in its history (while addressed letters volumes declined by 14% year on year).[10]

[8] Ofcom (2021), 'Review of postal regulation: call for inputs', 11 March, para. 4.10.
[9] Ofcom 'Annual monitoring update on the postal market' reports from 2017–18 to 2019–20. Operator returns / Ofcom estimates. Volumes for delivery of access parcels included in domestic.
[10] Royal Mail (2021), 'Trading update for the nine months ended December 2020', 11 February.

**Figure 1.2 Year-on-year change in total measured parcel volumes (entire UK market)**




Source: Oxera, based on Ofcom (2020), 'Annual Monitoring Update on Postal Services: Financial Year 2019-20', November.

Third, in terms of costs, there is an important relationship between the efficiency of Royal Mail's operations and its financial performance. Ofcom has expressed disappointment in the level of efficiency savings that Royal Mail has been able to achieve in recent years and has stated that efficiency progress is a cause for concern.[11] It has identified efficiencies as a critical determinant of long-term financial sustainability.[12]

Royal Mail has commercial levers available to it to drive improvements in financial performance—for example, through its pricing strategy, product/service offering, operational practices, efficiency initiatives, and investment decisions. It has acknowledged the issues around generating efficiencies, particularly given the challenging industrial relations environment, and has put in place a plan to transform its operations, invest in services, reduce costs and allow greater flexibility to meet changing user needs.[13] The transformation plan includes a management restructure, investment in services, greater automation of sorting, network redesign (e.g. parcel hubs and dedicated van delivery), and increased use of digital technology and data.[14]

Importantly, Ofcom's interventions also affect financial performance (by design) and therefore changes to its regulatory framework could be positive or negative for the health of the universal service provider. Ofcom's duties indicate that it has a responsibility to ensure that its regulatory framework does not act as an impediment to the sustainability of the universal service and that there is a

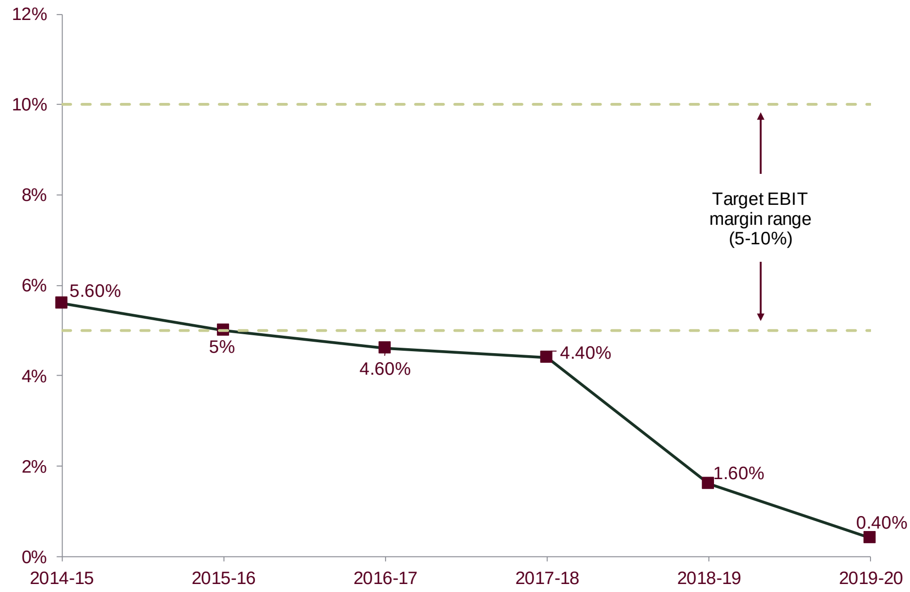
[11] For example, Ofcom concluded in its FY2019/20 annual monitoring report that: 'While Royal Mail has made some improvements, notably an increase in parcel automation from 12% to 33%, efficiency achievements continue to be disappointing. The ambition set out at the start of 2019–20 to transform the business, including making significant productivity improvements, has yet to be realised. We are concerned that many of the enablers of efficiency improvements identified by Royal Mail are behind schedule and have yet to be implemented.' Ofcom (2020), 'Annual Monitoring Update on Postal Services – Financial Year 2019-2020', 26 November, p. 53, para. 6.3.
[12] Ibid., p. 63, para. 6.43.
[13] Royal Mail Group (2020), 'Royal Mail Group Full Year 2019-20 Results and Business Update', 25 June.
[14] Royal Mail Group (2019), 'Turnaround and grow: Our UK transformation plan', 10 July.

reasonable prospect that the universal service provider can earn a commercial rate of return on its expenditure.

### 1.2.3 Recent financial performance

In recent years, the financial performance of the universal service has come under significant challenge. Since Ofcom introduced the 5–10% EBIT margin guideline range in 2012, profitability of the Reported Business has frequently been below the bottom end of the range. The actual EBIT margin earned by the Reported Business (known as the financeability margin) has fallen below 5% in seven years out of nine, including every year since FY2016–17 (as shown in Figure 1.3).

**Figure 1.3 Financeability margin for the Reported Business**

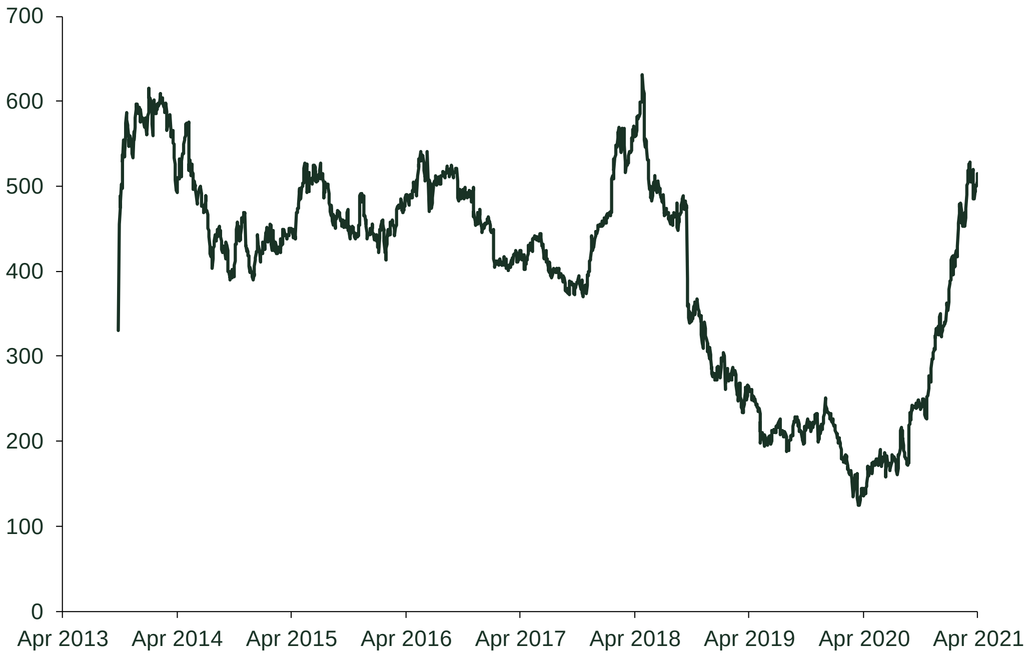



Source: Oxera based on Royal Mail Regulatory Financial Statements.

Given that Royal Mail Group is publicly listed, its share price provides a good indication of how market participants view its financial performance (at group level). Royal Mail Group was privatised in October 2013 at an initial offer price of 330p per share. The share price initially rose sharply before stabilising within the range of 400–500p per share for the majority of the four-year period from April 2014 to early 2018. Following a spike in early 2018, the share price has been highly volatile over the last three years. Between May 2018 and April 2020, the share price fell from a high of 630p to a record low of 124p. However, over the last 12 months, the group has experienced strong share price growth and is currently trading closer to 500p (as of mid-April 2021).

It is important to note, in the context of the above, that the Royal Mail Group share price reflects the performance of both Royal Mail UK and GLS, together with the prospects of the wider group. Movements in the share price are affected both by factors within management's control and factors outside its control.

**Figure 1.4 Royal Mail Group share price (pence)**




Source: Datastream.

Although Royal Mail's profitability has frequently fallen below the target range, Ofcom has to date not concluded that this constitutes a financial sustainability issue nor taken any specific action to address this. In its recent Annual Monitoring Update, Ofcom found that 'even though the Reported Business' EBIT margin decreased from 1.6% to 0.4% in 2019–20 (below the 5–10% range), Royal Mail is likely to be sustainable in the short-term'.[15] Ofcom did, however, note that the downward trend in the Reported Business's EBIT margin in recent years was a concern:[16]

> [U]nless Royal Mail modernises its network and becomes more efficient, there is a risk it will not be able to secure a commercial rate of return for the Reported Business. This could put the financial sustainability of the universal postal service at risk in the longer term.

### 1.2.4 Why consider financial sustainability now?

There are three main reasons to consider the suitability of the current approach to financial sustainability.

- **The prolonged period of underperformance against the financeability margin**—the Reported Business has been below the 5–10% EBIT margin range for a sustained period of time. Given that the Act explicitly refers to the need for the universal service provider to earn a reasonable commercial rate of return on any expenditure incurred in providing the universal service, this continued 'profitability gap' (and the fact EBIT margin has been trending downwards) would appear to be cause for concern.
- **Royal Mail's business transformation**—Royal Mail is seeking to transform its business towards parcels and has put in place a transformation plan including a management restructure, investment in services, greater automation of sorting, network redesign (e.g. parcel hubs and dedicated van

[15] Ofcom (2021), 'Review of postal regulation: call for inputs', 11 March, para. 4.8.
[16] Ibid., para. 4.9.

delivery), and increased use of digital technology and data.[17] Its forward Business Plans will be based on certain assumptions about Royal Mail's ability to achieve that transformation, grow its parcels business and earn a fair return on its investments.

- **COVID-related impacts and recovery**—COVID-19 has had a significant impact on demand for postal services and Royal Mail's operations. While the short-term growth in parcels demand has been positive, there has also been a faster reduction in letters volumes. There remains a high degree of uncertainty over how the postal sector will evolve in the next few years, giving rise to a wide dispersion of potential outcomes.

Against this backdrop, there are considerable benefits to having a mutually agreed approach that allows both parties to assess the financial health of the universal service and understand the sensitivity to key drivers (both within and outside management's control).

## 1.3 Objective and structure of report

This report sets out Oxera's views on what the approach to financial sustainability might entail going forward. In particular, it sets out the design of a financial sustainability framework, which builds on Ofcom's current approach. The intention is that this framework can be used as a diagnostic tool, allowing Ofcom and Royal Mail to identify any potential causes for concern as early as possible and to agree on relevant actions together.

The report is structured as follows.

- Section 2 provides background on how to define and assess financial sustainability.
- Section 3 sets out the design of the financial sustainability framework.
- Section 4 concludes.

[17] Royal Mail Group (2019), 'Turnaround and grow: Our UK transformation plan', 10 July.

# 2 Defining and assessing financial sustainability

Financial sustainability is an important consideration for economic regulators. If financial sustainability is threatened, the regulated company may struggle to attract the necessary investment to maintain and improve the regulated activities. At the extreme, a deterioration in financial performance could lead to interruptions to (or cessation of) services, at high cost to users and society.

The financial sustainability duty requires an assessment at three levels:

- the financial health of the universal service on an ongoing basis;
- the likelihood that the universal service will continue to be financially sustainable in the future;
- how any proposed changes to its regulatory framework or actions would affect the financial sustainability of the universal service.

In this section, we define financial sustainability (section 2.1) and set out how it is typically assessed by economic regulators in the UK (section 2.2), before considering how this might be applied to the postal sector (section 2.3) and the benefits to users (section 2.4).

## 2.1 Defining financial sustainability

Ofcom’s duty explicitly refers to financial sustainability rather than financial viability. There is an important distinction between these two concepts, which has implications for the approach to monitoring and assessing financial sustainability.

- A company can be considered to be **financially viable** if there is a reasonable likelihood that it will be able to fulfill its operating costs and debt obligations as they come due. This is the minimum requirement for a company to continue operating and remain a going concern in the short term.
- A company can be considered to be **financially sustainable** if it is earning a rate of return that it is commensurate with the risks taken by debt and equity investors. This provides appropriate incentives to invest in the longevity and growth of the business.

Consequently, a company may be considered financially viable even if it is earning well below the commercial rate of return. A standard of financial sustainability is therefore a significantly higher threshold than financial viability.

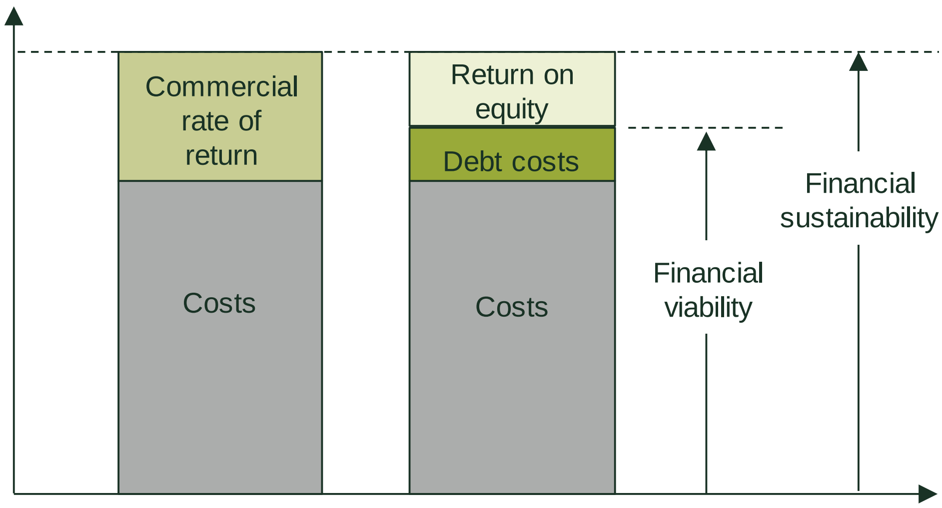
**Table 2.1 Distinction between financial sustainability and viability**

| | Viability | Sustainability |
|---|---|---|
| Time frame | Short-term | Long-term |
| Key question | Can the business meet its financial obligations as they arise over the next few years and will it remain financially viable in downside scenarios? | Can the business generate sufficient cash flows to secure the provision of the USO, attract capital and support investment? |

Source: Oxera.

As shown in Figure 2.1, the key difference between viability and sustainability is the equity return component—namely, that a financially sustainable company needs to be able to earn revenues that allow it to cover its debt costs and provide equity investors with a return on their investment. If equity investors are continually unable to earn a commercial rate of return, or do not see a realistic proposition of doing so in the future, the company will not be able to attract the equity investment that is needed in order to invest in the business. Over time, this will work against the interests of users as there will be insufficient investment in service quality.

**Figure 2.1 Distinction between financial sustainability and viability**




Source: Oxera.

The distinction between sustainability and viability has important implications in terms of the level of financial performance that is consistent with meeting Ofcom’s duty and the information that is relevant to assessing financial sustainability. Some of the information currently considered by Ofcom—such as Royal Mail’s viability statement and ability to meet debt covenants—provides an indication of short-term financial viability rather than long-term sustainability. While these are informative, they do not provide the whole picture. As discussed further in section 3, in order to fully assess financial sustainability, it is also necessary to consider the perspective of equity investors.

## 2.2 Assessing financeability: lessons from other sectors

In the UK, it is common for economic regulators to have a statutory duty to ensure, or have regard to, the ability of the regulated company to finance its functions (see Appendix A1). The general approach applied by other regulators is a useful reference point for how financial sustainability can be defined and assessed. However, the approach to financial sustainability applied in the postal sector will naturally need to reflect the specific characteristics of the universal service.

### General approach applied by economic regulators

In light of their financing duties, economic regulators conduct explicit financeability tests when setting price controls. The purpose of these tests is to assess the capacity of the regulated business to finance its day-to-day operations and capital investments under the terms of the price settlement.

The assessment of financeability is considered to be a critical component of ensuring that a price control is in the public interest given the potentially significant costs to users (and society) if the company experiences financial distress or incentives to make efficient investments are diluted.

There are generally considered to be two legs to financeability:[18]

- allowing an efficient, well-run company to earn a rate of return that is commensurate with the cost of capital;
- providing sufficient revenues to enable an efficient, well-run company to raise finance from capital markets readily and on ‘reasonable’ terms.

To assess whether companies are able to access capital markets on ‘reasonable terms’, regulators tend to consider financeability in terms of the company’s ability to maintain a target credit rating. This rating is based on the credit rating agencies’ assessment of a company’s business fundamentals and cash-flow metrics. The steps typically taken to assess the sufficiency of cash flows are set out below.[19]

1. **Define the notional company, including the assumptions that are made about the financial structure of the business.** The analysis of financeability is typically conducted assuming the financial structure of a notionally efficient company, on the basis that actual financing decisions are the responsibility of company management and any potential inefficiencies in companies’ actual financing decisions should not influence the assessment. This requires assumptions about a certain financing structure, which attempts to approximate what an efficiently financed company would adopt in terms of gearing, debt portfolio, and so on. Moreover, for the purposes of assessing financeability, regulators typically restrict the scope of the notional company to the regulated business activities (such that any non-regulated activities are excluded).
2. **Establish target credit rating.** Regulators (including the UK Competition and Markets Authority) generally accept that a financeable company should be able to secure a ‘comfortable/solid’ investment-grade credit rating.[20] This reflects the fact that borrowing costs tend to be much higher for firms with sub-investment-grade ratings. The definition of a ‘comfortable/solid’ investment-grade rating has been interpreted in different ways and regulators have increasingly relied on companies to provide their own analysis and assurance around the appropriate target rating. However, it has been common practice across companies (and regulators) to target a credit rating two notches above investment grade (i.e. BBB+/Baa1).[21]

[18] See, for example, Ofgem (2010), ‘Regulating Energy Networks for the Future: RPI-X@20: Emerging Thinking – Embedding financeability in a new regulatory framework’, 20 January, para. 3.1.
[19] This is a stylised representation for clarity and simplicity. In practice, there are differences across sectors.
[20] For example, the Civil Aviation Authority’s approach to financeability for H7 involves checking that ‘HAL’s financial position in the base case (i.e. when all costs and revenues match up with the regulatory allowances) is consistent with a ‘reasonable investment grade’ credit rating’. Civil Aviation Authority (2019), ‘Economic regulation of capacity expansion at Heathrow: policy update and consultation’, CAP 1782, March, p. 20, para. 1.28. Similarly, Ofgem has defined financeability as ‘an efficiently managed company geared at the notional level achieving credit metrics that are consistent with a ‘comfortable investment grade’ credit rating (BBB-A range) and exhibiting stable equity metrics.’ Ofgem (2012), ‘RIIO-T1: Initial Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd’, p. 45, para. 5.29.
[21] For example, Ofgem noted that for the RIIO-2 price review all networks assured their business plans on the basis of a target rating of at least BBB+/Baa1. Ofgem (2020), ‘RIIO-2 Draft Determinations—Finance Annex’, 9 July, p. 95, para. 5.6. Similarly for PR19, all water companies assessed notional company financeability in terms of BBB+/Baa1, and this was the basis of Ofwat’s assessment. See Ofwat (2019), ‘PR19 final determinations: Aligning risk and return technical appendix’, December, p. 67.

3. **Identify key debt and equity ratios.** A core part of the analysis of financeability is typically to look at credit ratios used by rating agencies. The rating agencies give more weight to certain ratios in their rating determinations (e.g. interest cover ratios, gearing, FFO/net debt and debt/EBITDA). It is good regulatory practice for regulators to consider the same credit ratio definitions as used by credit rating agencies, given that it is the agencies that ultimately determine creditworthiness within capital markets. Credit ratios provide an indication of debt financeability but not equity financeability—i.e. the extent to which the price control provides an equity return that appropriately remunerates investors given the risk of the investment. Given that companies finance themselves through a combination of debt and equity, this is an important component of meeting the financing duty. It is therefore also relevant to consider the adequacy of the equity return and other equity metrics.
4. **Define minimum thresholds.** Credit ratings agencies provide guidance on minimum thresholds for key ratios. There is typically a degree of flexibility around lower bounds for individual ratios (rather than a ‘hard’ floor), but these guidelines provide a strong indication of what is likely to constitute a financeability concern.
5. **Assess whether the notional company will exceed the minimum thresholds under the price control settlement.**
6. **Conduct sensitivity analysis** using plausible alternative scenarios. In addition to considering whether the company is financeable on the assumption that it meets the base regulatory cost allowances and incentive targets, regulators and companies often ‘stress test’ the settlement against plausible downside scenarios. These downside scenarios might include shocks to income or expenditure, or penalties from regulatory incentive mechanisms. Regulators typically seek to ensure that companies have sufficient financial headroom to (i) absorb downside shocks or (ii) withstand estimation error by the regulator in setting the price control (e.g. an unachievable efficiency target).

The benefit of this approach is that it provides a transparent framework for regulators and companies to gain assurance that the regulated business will be able to finance its activities, by directly drawing on the indicators and ratios that are relied upon by debt and equity investors.

## 2.3 Application to the postal sector

There are a number of important principles that are relevant to the financial sustainability framework in post.

- First, economic regulators consider financial sustainability from the perspective of whether the regulatory framework (and, in other sectors, the price settlement) provides the company with an opportunity to earn a fair rate of return. Specifically, they test—on a forward-looking basis—whether the company’s *expected* rate of return from regulated activities is in line with the cost of capital. As a principle of regulatory practice, they neither provide companies with a guarantee of earning a certain return nor seek to claw back any ‘excess’ returns. This is critical to ensuring that the right incentives are in place for investment and for efficiency. In the telecoms sector, Ofcom has captured this in its ‘fair bet’ principle.[22] Our interpretation of the ‘fair bet’ principle in the postal sector is that it means that:

1. Ofcom would not be expected to intervene if returns fall below the commercial rate of return on a temporary basis (i.e. the target profitability range is not a guarantee).
2. Equally, Ofcom would be expected to provide suitable commitment that Royal Mail will be able to earn a return on the investments that it is making and that it would not intervene to cap Royal Mail’s returns if these lead to a higher return. This is an important consideration as regulatory interventions taken by Ofcom (e.g. changes to access requirements) could have significant implications for the expected returns from investment. Consequently, uncertainty around whether Ofcom might impose such regulations in the future could affect incentives to invest.

- Second, regulatory financeability tests are focused on the regulated activities and do not seek to ensure that any activities outside the scope of the regulated business are financially sustainable. This is relevant to Royal Mail in that the Postal Services Act refers explicitly to the financial sustainability of the universal postal service, and not to other activities that Royal Mail undertakes on a commercial basis that do not use the universal service network (e.g. Parcelforce and GLS).[23]
- Third, there is a relationship between financial sustainability and efficiency. Other regulators have interpreted their duties as meaning that an efficient company should expect to earn a rate of return commensurate with the cost of capital. However, when applying the financeability test, regulators do not test that the company is at the efficiency frontier at all points in time. The Postal Services Act requires Ofcom to ‘have regard to the need for the provision of a universal postal service to be efficient before the end of a reasonable period’. When considering financial sustainability, it is important to consider the reasonable timeline for the company to reach the efficiency frontier, taking account of the legacy position and an achievable rate of efficiency savings.

The general approach outlined in section 2.2 above could be usefully applied to Royal Mail as a means of defining what financial sustainability looks like for the universal service provider and testing Business Plan projections against this to assess the likelihood that the universal service will be financially sustainable.

However, the application of such an approach would need to reflect the important differences between the postal sector and other regulated utilities. From a practical standpoint, the processes in other sectors (e.g. full regulatory

[22] Ofcom has defined the fair bet as follows: ‘An investment is a ‘fair bet’ if, at the time of investment, expected return is equal to the cost of capital. This means that, in order to ensure that an investment is a fair bet, the firm should be allowed to enjoy some of the upside risk when demand turns out to be high (i.e. allow returns higher than the cost of capital) to balance the fact that the firm will earn returns below the cost of capital if demand turns out to be low. This issue is particularly important where there is significant uncertainty around demand (or other factors that affect returns)’. Ofcom (2011), ‘Proposals for WBA charge control’, 20 January, p. 181. This concept has also been adopted by the UK government, which defines the fair bet as ‘one that allows firms making large and risky investments to have confidence that any regulation will reflect a fair return on investment, commensurate to the level of risk incurred at the time of making the investment decision’. Department for Digital, Culture, Media & Sport (2019), ‘Statement of Strategic Priorities for telecommunications, the management of radio spectrum and postal services’, Consultation, 15 February, para. 22.

[23] Ofcom has defined the Reported Business for the purpose of focusing its monitoring on the profitability of the business activities that rely on the universal service network. The services within the Reported Business include all universal service products and other ‘non-USO’ products which use the universal service network (for example, retail bulk mail and access).

assessment and challenge of the business plan) are time and resource intensive, and it would be disproportionate to replicate these detailed exercises within the regulatory model applied in post. Moreover, there are key differences in terms of market dynamics, business models and the regulatory frameworks that are applied in these sectors that need to be captured in the design of the financial sustainability framework.

- **Lack of a price lever.** In other regulated sectors, financeability is primarily a question of whether the price/revenue cap has been set at a sufficiently high level to allow the company to recover its costs and a 'fair' return on capital. The 'solution' to a financeability issue in these cases is generally to increase the price or revenue cap. In the postal sector, however, Ofcom has deemed that price control-based regulation, as was previously applied by Postcomm, was not effective given the characteristics of the market.[24] Royal Mail now has pricing freedom with the exception of a safeguard cap (on the price of second class stamps, representing less than 5% of group revenue), which is intended to ensure vulnerable consumers have access to an affordable, basic universal service.

  Unlike the price caps in other sectors, the level of the safeguard cap is not determined through an analysis of forecast costs plus a rate of return.[25] The move away from price control-based regulation reflected the structural decline in letters volumes and shift in demand away from higher value products.[26] These characteristics, and the consequent regulatory framework, mean that it is more challenging to address financial sustainability issues through price increases and Ofcom has significantly less ability to influence the level of return earned by the universal service provider.

- **Market dynamics.** Unlike other stable regulated markets, the postal sector is evolving at a rapid pace and Royal Mail faces competition in large parts of the market (e.g. in parcels), as well as ongoing structural decline in letter volumes. This creates considerable revenue uncertainty for Royal Mail.

- **Business model.** Royal Mail's operating model and cost structure creates different risks to other regulated companies. First, the nature of the universal service obligations means that Royal Mail is a fixed cost business with high operational gearing. When combined with declining volumes, this has led to upwards pressure on unit costs. Second, Royal Mail is a labour-intensive business with lower capital intensity than regulated networks (e.g. utilities). As a result of the high operational gearing and need to maintain low levels of financial risk, equity is a fundamental part of Royal Mail's capital structure.

These differences are summarised in Table 2.2.

[24] In 2012, Ofcom noted that: 'The lesson from recent experience is that a price control-based approach has demonstrably failed to deliver on the required regulatory objectives specified at the time. In particular, the experience since 2006 is that price controls have: not been effective in ensuring that Royal Mail improved efficiency […] [have] not protected consumers against price rises…[and] resulted in a position where the universal service was approaching a point where it was no longer financially sustainable'. Ofcom (2012), 'Securing the Universal Postal Service: Decision on the new regulatory framework', 27 March, p. 4, para. 1.23.
[25] For example, Ofcom (2019), 'Review of the Second Class Safeguard Caps 2019', 17 January, section 4.
[26] Ibid, p. 1.

**Table 2.2 Differences between post and utilities**

| | Utilities | Post |
|---|---|---|
| **Regulatory framework** | Ex ante price cap | Price cap limited to second class stamp |
| **Demand** | Inelastic | Elastic (for many products) |
| **Volumes** | Stable/increasing | Declining for letters |
| **Capital intensity** | Capital intensive | OPEX intensive (high operational gearing) |
| **Financial gearing** | High (55%+) | Low |
| **Market dynamics** | Stable market | Rapidly evolving market |
| **Competition** | Licensed monopolies with very little competition | Competition in large parts of the market (e.g. parcels) |

Source: Oxera.

A number of observations can be made as a result of these characteristics of the postal sector.

- It is prudent for Royal Mail, as the universal service provider, to maintain low levels of financial risk given the high operational gearing—this should be reflected in the design of any financial sustainability assessment.
- A mechanistic approach to financial sustainability is not feasible given the lack of a regulatory price lever.
- Sensitivity testing is critical and the approach to financial sustainability needs to be flexible and agile to reflect the pace of change in the market.
- A conservative approach may be warranted when designing the regulatory framework and making interventions as it will be challenging to unwind any negative consequences on financial sustainability. In particular, Ofcom should be mindful of the risk that its regulatory interventions impede Royal Mail's ability to respond quickly and effectively to changes in the market.

## 2.4 Benefits of having a more transparent approach

As outlined above, the characteristics of the postal sector and the reliance on commercial freedom (rather than price regulation) mean that Ofcom has less influence over Royal Mail's financial performance than utility regulators do in relation to regulated companies in other sectors. However, there are still benefits to having a transparent approach that seeks to define what constitutes a sustainable level of financial performance, when there might be cause for concern, and allows Ofcom and Royal Mail to assess the likelihood that the universal service will fall within these parameters.

In particular, a more predictable, stable and transparent approach to financial sustainability should aid investor confidence and therefore act to encourage investment for better quality services and innovation, which would ultimately be to the benefit of users of the universal postal service.[27] While it would be neither feasible nor desirable for Ofcom to guarantee a particular level of return, the regulator could have a positive impact on investor confidence

[27] This has been recognised, for example, by the National Infrastructure Commission in its work on modernising UK economic regulation. 'Long-term investors, who bring significant capital and subsequent benefit to the UK market, such as pension funds, value stability and predictability. Investors should receive a fair return on their investments, and be insulated from political cycles by predictable, stable regulation.' National Infrastructure Commission (2019), 'Strategic investment and public confidence', October, p. 14.

through implementing a more transparent approach, which recognises the importance of both debt and equity, and is supportive of investment.

From a regulatory perspective, there may be benefits in having an agreed framework for assuring that the sustainability duty is being met (i.e. that there is no immediate threat to the provision of the universal service). In particular, a more transparent approach to financial sustainability would allow Royal Mail and Ofcom to test different assumptions and understand the impact of different regulatory actions on projected financial performance and would act as an 'early warning' system, potentially allowing for corrective action before a financial sustainability issue were to materialise.

As discussed in section 1.2.4, this is particularly relevant at this point in time given Royal Mail's recent financial challenges, the ongoing business transformation and the high levels of uncertainty created by COVID-19. In this context, a more transparent approach would allow Royal Mail and Ofcom to test the financial resilience of the business if a different set of circumstances materialise (given factors that are outside management control).

Moreover, transparency is a general regulatory principle that is captured in the UK Regulators' Code,[28] the Communications Act 2003 ('regulatory activities should be **transparent**, accountable, proportionate, consistent and targeted only at cases in which action is needed'),[29] and Ofcom's regulatory principles ('Ofcom will strive to ensure that interventions are evidence-based, proportionate, consistent, accountable and **transparent** in both deliberation and outcome').[30]

[28] Department for Business Innovation and Skills (2014), 'Regulators' Code', April, pp. 5–6.
[29] Communications Act 2003, Part 1, Section 3, 3(a).
[30] See: https://www.ofcom.org.uk/about-ofcom/policies-and-guidelines (last accessed 18 May 2021).

# 3 Design of a financial sustainability framework

In this section, we consider the optimal design of the USO financial sustainability framework. The aim is to provide a framework that both Royal Mail and Ofcom can use to understand and analyse the financial health of the universal service.

Critically, this should not be interpreted as a form of 'cap-and-collar mechanism' or a guarantee of a certain level of return. Rather, the intention is that this framework would act as a diagnostic tool for identifying potential causes for concern at an early stage, allowing both parties to discuss, agree on and take relevant actions to ensure the financial sustainability of the business.

The framework aims to inform understanding of Royal Mail's financial sustainability in terms of:

- **Current performance:** how does current financial performance compare to a financially sustainable level?
- **Forward-looking assessment:** is there a reasonable probability that the business plan will deliver a financially sustainable universal service, taking account of downside scenarios?
- **Annual monitoring:** as the business plan is implemented, have Royal Mail's actual financial ratios been in line with the target levels?

Although it is informative to assess current performance and undertake annual monitoring, the primary focus when assessing financial sustainability is forward-looking. The remainder of this section therefore considers the design of a forward-looking framework.

## 3.1 Forward-looking assessment

The forward-looking assessment could be used by both Royal Mail and Ofcom as part of the annual business planning process to understand the key risks and to identify any potential causes for concern as early as possible in order to take any necessary remedial action.

In line with the typical regulatory approach outlined in section 2, we envisage that the key steps in undertaking such an assessment would be as follows.

1. **Royal Mail would generate forward projections for volumes, costs, prices, and profits.** Royal Mail's annual Business Plan document would provide the basis of these projections. However, we understand that Royal Mail's Business Plans typically cover a three-year period. Consequently, Royal Mail may also need to generate longer-term forecasts at set points in time (e.g. to coincide with Ofcom's reviews of the regulatory framework). These longer-term projections would be more high level and 'directional' in nature given the uncertainty around the longer-term outlook, in terms of future market conditions and transformation initiatives.

2. **Calculate key financial ratios under these projections:** Based on the projections from step one, the second step would be to calculate financial ratios that are of relevance to debt and equity investors. We discuss what metrics should be used to measure financial sustainability in Section 3.3.1.

3. **Assess against minimum thresholds:** We discuss the potential thresholds for each of the relevant metrics in Section 3.3.3.

4. **Conduct sensitivity testing under different scenarios.** The final step would be to assess how financial performance changes under different scenarios. These scenarios could be based on assumptions around the different drivers of financial sustainability identified by Ofcom (e.g. decline in letters volumes, growth of parcels volumes, cost transformation) and also different regulatory scenarios.

This can be then used to identify when there is a cause for concern (section 3.3.5) and to agree on what to do if a cause for concern arises (section 3.3.6)

## 3.2 Practical considerations

While this approach builds on practice in other regulated sectors, the processes involved in utility-type regulation are disproportionate in the postal sector. It is not our intention that these processes (e.g. full regulatory assessment and challenge of the business plan) should be directly replicated in Ofcom's oversight of the postal sector. In particular, we do not see the process outlined above as requiring Ofcom to 'sign off' the Business Plan. Rather, we see the steps outlined above as a relatively light overlay to the annual business planning process, using data that would be relied upon by equity investors, lenders and credit ratings agencies to have clarity on whether action is needed. The objective would be to get a joint understanding of what is in the plan and how financial performance could vary if the market moves differently than expected

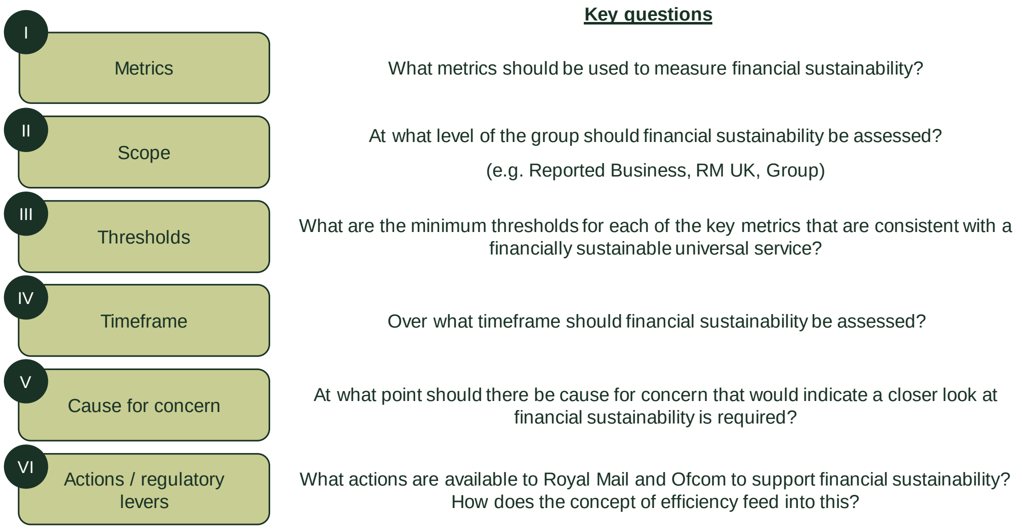
Our working assumption is that the modelling would be undertaken by Royal Mail and shared with Ofcom. We do not consider that this would necessitate additional obligations or formal information disclosures. While it may indicate a higher regulatory burden for Ofcom and Royal Mail, we understand that there is already a relatively detailed level of engagement on the Business Plan each year. The main additional information required under this approach would be the longer-term projections extending beyond the current business planning period. We understand that Royal Mail is assessing the feasibility of such plans.

Moreover, if there is agreement on the financial sustainability framework, it could also be used by Ofcom to inform its decision-making. In particular, if Ofcom were proposing an intervention, it could use the framework to understand the potential impact of its interventions on Royal Mail's financial health.

## 3.3 Key design issues

In the remainder of this section, we discuss the key design issues for the financial sustainability framework. We have identified six questions covering: the choice of metrics, the definition of entity for which the assessment is conducted, the minimum thresholds, the time frame, the point at which intervention would be considered, and the actions that might be taken to address financial sustainability concerns. We consider each of these six questions in turn.

**Figure 3.1 Key questions regarding the design of the financial sustainability framework**




Source: Oxera.

### 3.3.1 What metrics should be used to measure financial sustainability?

In order to be considered financially sustainable, the universal service provider needs to be able to earn a reasonable commercial rate of return and to be able to raise finance from capital markets readily and on ‘reasonable’ terms. This requires Royal Mail to be able to maintain its investment grade credit rating and to provide a reasonable return to equity investors.[31]

We consider that the appropriate metrics for the framework are those that would be relied upon by capital market participants (i.e. equity investors, lenders and credit ratings agencies) when deciding whether to invest in the business. The overall profitability of the business is clearly a relevant indicator, but we also consider that the framework should take account of specific financial metrics considered by debt and equity investors.

**Profitability**

In its March 2012 regulatory statement, Ofcom determined that the appropriate measure of profitability for the universal postal service is return on sales, as measured by the EBIT margin, rather than return on assets or return on capital employed. This reflected the low level of capital intensity and high proportion of labour costs involved in operating Royal Mail’s universal postal service network. Ofcom also noted that the EBIT margin was an appropriate proxy for operating cash generation.[32]

The use of an EBIT margin approach to measure profitability was consulted on extensively at the time and was accepted by respondents, including Royal Mail, as the appropriate approach. This position was reiterated in the 2017 Review of Regulation with Royal Mail and Ofcom both acknowledging the challenges of implementing a return on assets approach given the issues in determining a robust value for the Regulated Asset Base of the Reported

[31] This is consistent with how other regulators have interpreted financial sustainability. For example, in RIIO-1 Ofgem stated that: ‘We define financeability as an efficiently managed company geared at the notional level achieving credit metrics that are consistent with a ‘comfortable investment grade’ credit rating (BBB-A range) and exhibiting stable equity metrics.’ Ofgem (2012), ‘RIIO-T1: Initial Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd’, p. 45, para. 5.29.
[32] Ofcom (2012), op cit., p. 47, para. 5.25.

Business.[33] We consider that the EBIT margin remains the appropriate metric to consider as part of the financial sustainability framework.

**Debt**

A second element of financial sustainability is that the universal service provider should be able to maintain credit ratios that are consistent with an investment grade credit rating.[34] This is consistent with how other UK economic regulators have interpreted their financing duties.[35]

As discussed further in section 3.3.3, it has been common for regulators to target a credit rating for the regulated business that gives ‘comfortable’ headroom over the minimum investment grade level of BBB-. This has generally, but not always, been interpreted as at least BBB+. Allowing two notches above BBB- provides protection in the case of downside shocks, given that the loss of an investment grade rating could have a negative impact on the company’s ability to access finance readily and at a reasonable cost.

Royal Mail’s credit rating is currently set by Standard & Poor’s (S&P). On S&P’s scale, the lowest investment grade credit rating is BBB-. A credit rating of BBB (as currently held by Royal Mail Group) is one ‘notch’ above BBB-, and BBB+ is two ‘notches’ above.

In 2017, Ofcom outlined its intention to assess additional financial health metrics used by lenders and credit rating agencies and therefore expanded its monitoring to include:[36]

- Funds From Operations (FFO)/Net Debt;
- Net Debt/EBITDA;
- EBITDA/interest.

These metrics are all considered by Standard & Poor’s in determining the credit rating of the Royal Mail Group and are also used in Royal Mail’s financial covenants. Given their prominence in S&P’s assessment, we agree with Ofcom that these are relevant ratios to consider in assessing financial sustainability. We note that the S&P methodology for calculating the Net Debt/EBITDA and EBITDA/interest ratios differs from that currently used by Ofcom (which is based on the calculation used for Royal Mail’s covenants). For the purposes of this report, we refer to the level of the metrics under the S&P methodology.

We understand that liquidity is a key internal target for Royal Mail’s finance team and that, in light of COVID-19, the group has been required to comply

[33] Ofcom (2017), ‘Review of the regulation of Royal Mail: statement’, 1 March, paras 3.47 and 3.55.
[34] In other sectors (e.g. water), there are explicit requirements for companies to maintain an investment grade rating within company licences.
[35] For example, the CMA observed in the Bristol Water redetermination that: ‘In assessing financeability, it is good regulatory practice to consider the views of the credit rating agencies, and by implication, the financial ratios they partially base their views on.’ Competition and Markets Authority (2015), ‘Bristol Water plc: A reference under section 12(3)(a) of the Water Industry Act 1991’, 6 October, p. 348, para. 11.24.
[36] This followed advice from CEPA (2015) that it was relevant to consider measures of dynamic gearing given the market’s focus on these metrics. ‘What is clear is that the market is concerned both with profitability as well as the indebtedness of the business: various static and dynamic measures of gearing are used by the credit rating agencies. This could reflect the speed of change that is possible in an industry so dependent on external factors and which has high operational gearing. So, even though profitability in the short-term may be at an acceptable level, the market worries about the exposure that would be generated by significant gearing and how this could hamper a company’s ability to respond to a changing market situation. Given these concerns, if Ofcom is concerned about assessing the overall financial health of Royal Mail there are advantages in adopting a measure of dynamic gearing alongside the ex post profitability measures.’ CEPA (2015), ‘Relevance of Margin Based Approach’, reported prepared for Ofcom, 17 November, p. 24.

with a minimum liquidity level in place of its usual covenants. [✂][37] We therefore include liquidity within the metrics.

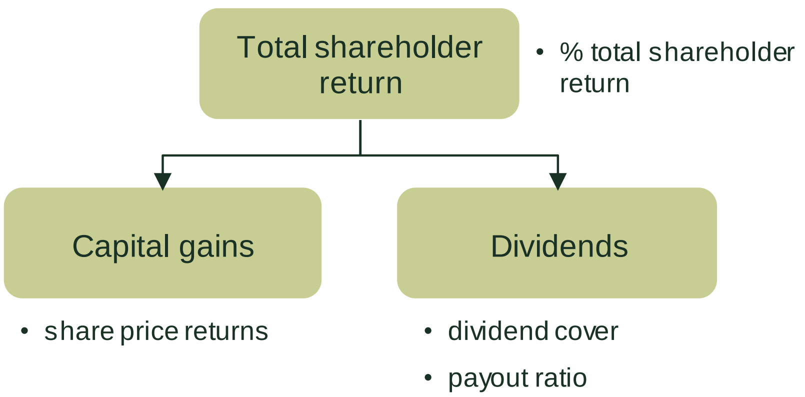
### Equity

Royal Mail's business risk profile and high operational gearing mean that it is prudent for the company to maintain low levels of financial leverage in order to retain an investment grade credit rating. Consequently, equity is a fundamental part of Royal Mail's capital structure, and the ability of the universal service to provide equity holders with a return on their investment is critical to the assessment of financial sustainability. More generally, as discussed in section 2.1, equity returns are a key component of ensuring financial sustainability—if the business is unable to generate adequate returns for equity investors it will become increasingly difficult to attract the equity capital that is required to finance investment and provide a buffer against downside shocks.

This points to broadening the current indicators to take account of equity-related metrics—i.e. metrics that provide an indication of shareholder returns and the ability of the business to pay dividends.[38] This will be driven to a large degree by the ability of the business to generate an EBIT margin that is in line with the commercial level. However, we consider that looking at equity metrics would help to provide additional clarity on the extent to which equity investors see Royal Mail as an investible proposition and, where the EBIT margin falls below the target range, to better understand the impact of this from an equity perspective.

The equity return can be measured through the total shareholder return (TSR), which has two components—capital gains (e.g. share price returns) and dividends (dividend cover and pay-out ratio). Both of these elements are important to understanding returns from the perspective of equity investors. Looking at either of these in isolation will only provide a partial view.

**Figure 3.2 Equity metrics**




Source: Oxera.

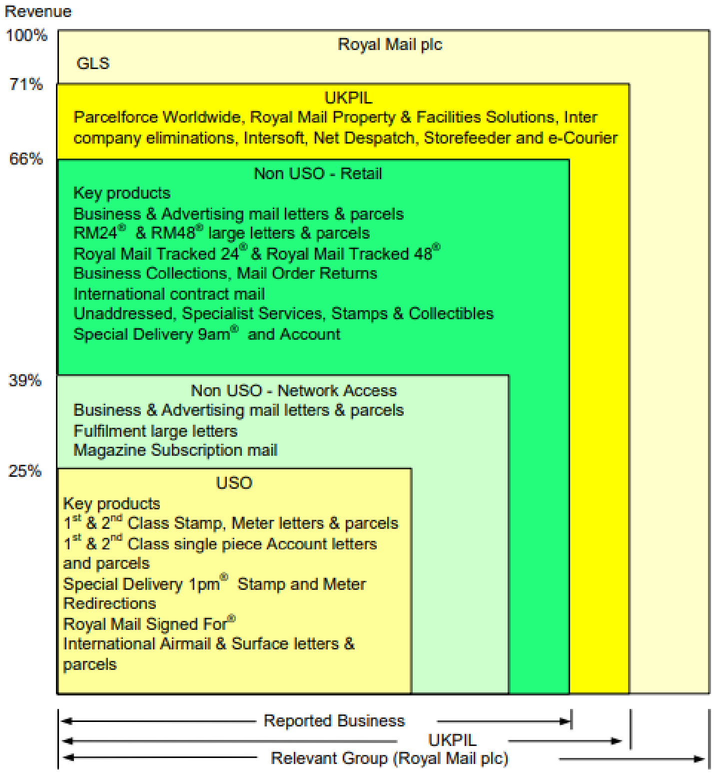
[37] [✂]
[38] This is consistent with regulatory practice in other sectors. For example, Ofgem states that: 'In assessing financeability we will take into consideration both the relevant equity and cash flow metrics for the notional company to ensure that the overall package is financeable for an efficient company.' Ofgem (2010), 'Handbook for implementing the RIIO model', p. 111, para. 12.29.

### 3.3.2 At what level should financial sustainability be assessed?

In designing the financial sustainability framework, it is necessary to define the entity for which financial sustainability should be assessed. Ofcom's duties explicitly refers to the financial sustainability of the universal service, indicating that the assessment of financial sustainability should, at least in theory, be conducted at the level of the universal service network, including all (USO and non-USO) products and services that use that network.

Recognising this, Ofcom introduced the concept of the Reported Business. This is the part of Royal Mail's business that undertakes activities related to the provision of the universal service (e.g. First and Second Class letters and parcels). As shown in Figure 3.3 below, the Reported Business includes some non-USO products and services (e.g. retail bulk mail and access mail), but excludes the activities of Parcelforce and Royal Mail's Property business. It also excludes Royal Mail's international business (GLS). The Reported Business is not a legal entity and does not raise finance itself.

**Figure 3.3 Structure of Royal Mail Group**




Source: Royal Mail (2020), 'Regulatory Financial Statements 2019-20', August, p. 4.

In terms of the appropriate scope of assessment, we maintain the following.

- The framework should consider financial performance using the best proxy for the universal service network.
- In practice, there may be good reasons why it is not possible to assess the Reported Business in isolation—both Ofcom and Royal Mail appear to recognise that there are data limitations.
- To the extent possible, GLS should be excluded from the analysis given it relates to a different national market and therefore does not use the UK

universal service network. As it is currently more profitable than the Reported Business, its inclusion may act to 'hide' a potential financial sustainability issue.

We note that some financial sustainability metrics, such as total shareholder returns, are only available at the Group level. As such, it may be necessary to consider financial sustainability at different levels of the business but in doing so, recognising what could be driving differences in financial sustainability at different levels. We understand that Royal Mail is currently exploring the feasibility and practicality of producing different metrics at Reported Business or Royal Mail UK level rather than at the Royal Mail Group level.

### 3.3.3 What does a financially sustainable Royal Mail look like?

As discussed in section 2, we consider that a key objective of the financial sustainability framework should be to define what a financially sustainable business looks like and, by extension, the parameters beyond which there may be concerns. For each of the key metrics (profitability, debt and equity), we have therefore sought to define relevant thresholds for financial sustainability based on market benchmarks and evidence.

**Profitability**

Since 2012, Ofcom has used an EBIT margin range of 5–10% as an indicative range for the returns that would be consistent with the commercial rate of return for the universal postal service. This range was initially informed by benchmarking undertaken by CEPA on behalf of Postcomm.[39] The CEPA study considered a wide comparator set including companies in the mail and logistics, and transport sectors, as well as companies facing structural change and those with a highly unionised workforce.

This range has been used as a key indicator in assessing medium- to long-term financial sustainability. Ofcom has previously recognised that an EBIT margin consistently below 5% may be an indication that the universal postal service faces financial sustainability issues.[40]

> If the forecast EBIT margin is above 5%, or shows an increasing trend that exceeds 5% over the forecast period, then the indications are that the Reported Business is financially sustainable. **If this is not the case – for example if the forecast EBIT margin stays consistently below 5% or has a decreasing trend taking it below 5% – then there may be indications that the universal postal service faces financial sustainability issues in the long term.** However, concerns about financial sustainability may not arise if, for example, the EBIT margin goes below 5% for a shorter period due to specific circumstances which may be addressed by Royal Mail without affecting its longer-term financial sustainability.

In order to assess whether the 5–10% EBIT margin remains appropriate, we have considered a number of sources of evidence.

First, we have benchmarked Royal Mail's margins against other European postal operators. In particular, we have analysed EBIT margins for the end-to-end mail activities of five European postal operators (see Table 3.1 below).[41]

[39] CEPA (2011), 'Financeability of the Universal Service', October.
[40] Ofcom (2018), 'Annual monitoring update on the postal market: Financial year 2017-18', 27 November, p. 57, para. 6.28.
[41] We note the challenges in identifying like-for-like benchmarks in terms of disaggregated activities. For example, Bpost's mail and retail activities includes revenues and costs from post offices, including banking and financial products. The definitions we have used are in line with FTI (2015), 'Financial Sustainability of the USO', September.

While this represents a considerably narrower comparator set than that analysed by CEPA in October 2011, it is in line with the approach adopted by Ofcom for the 2017 Review of Regulation.[42] We have used a comparator set of five postal operators: Austrian Post, Bpost, Deutsche Post, La Poste and Post NL. Three of these operators (Austrian Post, Deutsche Post and Post NL) were included in Ofcom's comparator set of four companies. Ofcom excluded Bpost from its 2017 analysis on the basis that Bpost did not meet sufficient criteria for inclusion. One of the missing criteria was the requirement to hold an investment grade credit rating, which Bpost did not have at the time. Since it does now hold an A credit rating, we include it in our comparator set. Ofcom also excluded La Poste on the basis that it does not have private capital.

This analysis indicates that two operators (Austrian Post and Bpost) have consistently earned margins above the Ofcom range. Deutsche Post, La Poste and Post NL have typically been within the range. La Poste has generally earned the lowest EBIT margins, which may be the result of its public ownership. The (unweighted) average margin across the comparator group was 9% in 2019, down from 14% in 2014. This is largely driven by the decline in the margin earned by Bpost.

### Table 3.1 European postal operators' EBIT margins

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| Austrian Post (Mail & Branch Network) | 17% | 20% | 18% | 19% | 19% | 17% |
| Bpost (mail and retail) | 26% | 24% | 25% | 22% | 16% | 12% |
| Deutsche Post (Post & Parcel Germany) | 8% | 7% | 8% | 8% | 5% | 8% |
| La Poste (Services-Mail-Parcels) | 4% | 6% | 5% | 5% | 4% | 3% |
| PostNL (mail in NL) | 14% | 12% | 10% | 9% | 7% | 4% |
| **Average** | 14% | 14% | 13% | 13% | 10% | 9% |

Source: Oxera analysis based on company financial statements.

We have also considered credit rating agency guidance on the EBIT margin thresholds that are consistent with specific credit ratings. S&P does not publish specific guidance for postal operators but has indicated in recent decisions that [✂][43]

[✂]

Moody's previously published threshold values for EBIT margins as part of its December 2011 methodology for rating postal operators. This indicated an EBIT margin of 8–12% was in line with a Baa rating and 12–16% was consistent with an A rating. However, the Moody's methodology was retired in October 2016 and, as far as we are aware, it has not published any guidance on thresholds since this time. We therefore consider that limited weight should be placed on this guidance.

[42] Ofcom stated that: 'we have adopted a similar, but more focused approach this time on the basis that the first of these groups (i.e. postal operators) should provide sufficient data for our work in this consultation. This is because we are mainly interested in assessing the impact of any changes in Royal Mail and the postal market since March 2012 on the appropriateness of the 5-10% range'. Ofcom (2016), 'Review of the Regulation of Royal Mail: Annexes 5 to 11', 25 May, p. 54, para. A6.66.
[43] [✂]

**Table 3.2 Moody's threshold values for EBIT margins of postal operators**

| B | Ba | Baa | A | Aa | Aaa |
|---|---|---|---|---|---|
| 0-4% | 4-8% | 8-12% | 12-16% | 16-20% | >20% |

Source: Moody's Global Postal and Express Delivery Methodology, Exhibit 6.

Based on the evidence on the margins earned by European postal operators [✂], there are strong grounds to retain, as a minimum, the 5–10% range that has been utilised by Ofcom since 2012.

**Debt**

In terms of assessing what can be considered to be financially sustainable from a debt perspective, we note two questions.

- What is the appropriate credit rating for a financially sustainable universal provider to target?
- What are the thresholds for financial ratios that are in line with this rating?

At group level, Royal Mail currently holds a BBB rating (negative outlook). [✂] A number of other European postal operators hold higher ratings (e.g. Deutsche Post, La Poste and Swiss Post) than Royal Mail. As a general trend, the operators with higher profitability appear to hold higher credit ratings. However, the credit ratings of postal operators need to be interpreted with caution as, in some instances, the ratings also incorporate several notch upgrades in recognition of government support to the company.

**Table 3.3 Credit ratings of European postal operators**

| | Long-term |
|---|---|
| Austrian Post | No rating |
| Bpost | A (incl. uplift for government support) |
| Deutsche Post | BBB+ |
| La Poste | A (incl. uplift for government support) |
| Poste Italiane | BBB |
| Post NL | BBB |
| Swiss Post | AA+ (incl. uplift for government support) |
| Royal Mail | BBB |

Source: Oxera.

Given the challenges in interpreting postal operators' credit ratings, we consider that a more relevant benchmark is the credit ratings targeted by UK economic regulators for the purposes of conducting financeability assessments.

When considering debt financeability, it is typical for UK economic regulators to target a 'comfortable' investment-grade credit rating. The definition of a 'comfortable/solid' investment-grade rating has been interpreted in different ways. Companies have increasingly been tasked with providing their own analysis and assurance around the appropriate target rating when developing their regulatory business plans. However, this has generally been interpreted as at least BBB+/Baa1 (i.e. two notches above the minimum investment grade threshold), including in the Competition and Markets Authority's recent final decision in the PR19 water redeterminations (see Table 3.4).

### Table 3.4 Credit ratings targeted by UK economic regulators

| | Sector | Target rating |
|---|---|---|
| CMA | Water (PR19 redeterminations) | BBB+/Baa1 |
| CAA | Air traffic control (RP3) | A/A2 |
| Ofwat | Water (PR19) | BBB+/Baa1 |
| Ofgem | Energy (RIIO-T2 / RIIO-GD2) | BBB+/Baa1 |

Source: Oxera based on recent regulatory determinations.

Based on this precedent from other sectors, it would be appropriate for the universal service provider to target financial ratios that are in line with a BBB+ credit rating. It is important to stress that this would not be a requirement for the Royal Mail Group to hold a BBB+ rating but simply that, for the purposes of assessing long run financial sustainability within the regulatory context, the target financial ratios would be line with such a rating. The actual rating of the Group would be dependent on the range of other factors considered by the rating agencies.

[✂][44]

[✂]

44 [✂]

### Table 3.5 S&P credit ratio guidance

| | Core ratios | | Supplementary coverage ratios | |
|---|---|---|---|---|
| | FFO/debt (%) | Debt/EBITDA (x) | FFO/cash interest (x) | EBITDA/interest (x) |
| Minimal | 60+ | Less than 1.5 | More than 13 | More than 15 |
| Modest | 45–60 | 1.5–2 | 9–13 | 10–15 |
| Intermediate | 30–45 | 2-3 | 6-9 | 6-10 |
| Significant | 20–30 | 3-4 | 4-6 | 3-6 |
| Aggressive | 12–20 | 4-5 | 2-4 | 2-3 |
| Highly leveraged | Less than 12 | Greater than 5 | Less than 2 | Less than 2 |

Source: S&P Global Ratings (2013), ‘Corporate methodology’, November 19.

In terms of liquidity, S&P does not provide guidance on the levels that it would expect for different ratings. [✂]

## Equity

On average over time, the equity return for a financially sustainable business should be in line with the cost of equity. The financial sustainability framework should consider the extent to which the TSR is in line with the required return on equity (i.e. cost of equity).

In Table 3.6 below, we combine the most recent determinations by the CMA and Ofcom on the risk-free rate and the equity risk premium with Royal Mail’s equity beta to find the implied cost of equity of c. 8–10%. We consider that this recent regulatory precedent provides a reasonable benchmark for the commercial return on equity over the long run (noting that both Ofcom and the CMA estimate the total equity market return with reference to long run historical averages). This in turn suggests if Royal Mail is financially sustainable, then its equity return (as measured by the total shareholder return) should on average, over time, be between 8–10% as well.

### Table 3.6 Illustrative cost of equity for financial sustainability assessment based on regulatory precedent

| | Ofcom 2021 | CMA 2021 |
|---|---|---|
| Risk-free rate | 0.9% | 0.63% |
| Equity risk premium | 7.9% | 8.31% |
| Royal Mail equity beta (Oxera range based on current market evidence) | 0.90–1.10 | 0.90–1.10 |
| **Cost of equity (nominal, post-tax)** | **8.0–9.6%** | **8.1–9.8%** |

Source: Competition and Markets Authority (2021), ‘Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited Price Determinations: Summary of Final Determinations’, 17 March, Table 7. Ofcom (2021), ‘Promoting investment and competition in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26’, 18 March, Table A20.1.

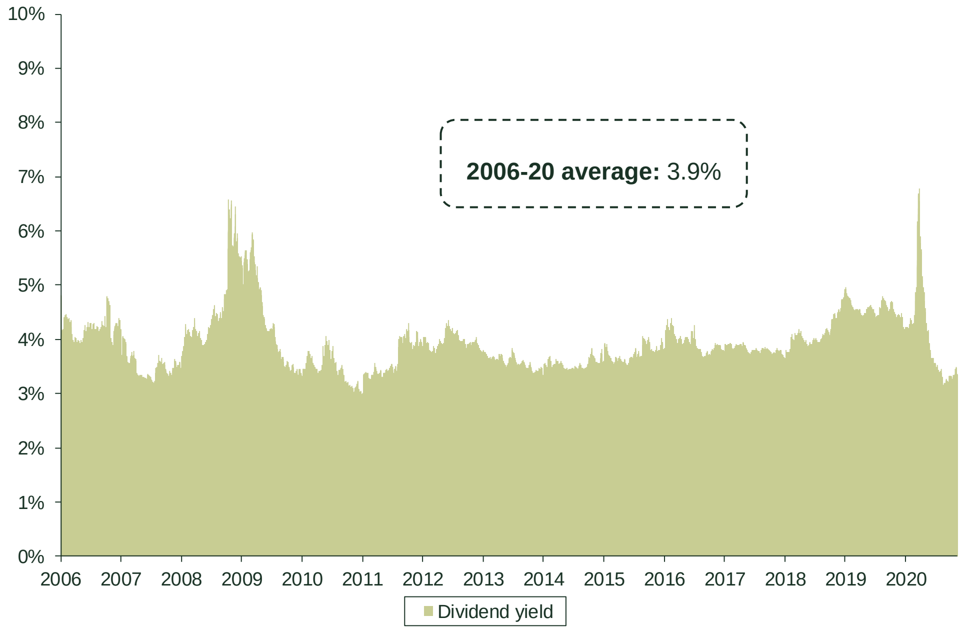
Although the TSR can be usefully monitored, it is difficult to forecast or model as it incorporates movements in the share price, which are determined by market investment decisions. Moreover, the TSR could only be calculated at the Group level—i.e. including both the Royal Mail UK and GLS businesses. Equity financeability can still be taken into account in a forward looking assessment by considering evidence on the company's dividend policy and ability to make dividend payments to equity investors.[45]

There are two alternative approaches that could be used to build equity financeability into the forward-assessment of financial sustainability. (The levels stated below are intended to be illustrative, based on market benchmarks. However, there would need to be further discussion between Royal Mail and Ofcom to determine the appropriate levels and reporting entity.)

- Input a dividend yield assumption into the forward modelling and test whether the projected dividend coverage is in line with market benchmarks. Given the average dividend yield for FTSE 100 companies between 2006 and 2020 was 3.9% (see figure below), it would be appropriate to input a dividend yield assumption of [✂]%.
- Input a dividend cover or payout ratio assumption and test whether the projected dividend yield is in line with market benchmarks. Given the average pay-out ratio for FTSE 100 companies between 2009 and 2019 was 46%,[46] it would be appropriate to input a dividend coverage ratio of [✂].

Regardless of which of these approaches is adopted, the assumption around dividends will alter the projected credit ratios as the implied dividend payments will be netted off cash flows. This means that the modelling will test the business' ability to maintain credit ratios above the defined thresholds while paying dividends consistent with market averages.

**Figure 3.4 Average dividend yield for FTSE 100 companies**




Source: Oxera analysis based on Bloomberg and Datastream data.

[45] Equity investors are concerned with both dividend payments and capital growth, therefore it would be necessary to understand the drivers of a change in dividend policy when drawing conclusions around financial sustainability. For example, a short-term reduction in dividends in order to finance capital growth would not be a cause for concern.
[46] Ofgem (2020), 'RIIO-2 Draft Determinations – Finance Annex', para. 11.42.

### Summary

The table below summarises the illustrative thresholds for each of the financial sustainability metrics discussed above. We have sought to define a three-tiered framework, incorporating:

1. **green**—the target, financially sustainable level in the long run;
2. **amber**—a level that the company could slip into in the short run or temporary basis;
3. **red**—a minimum level, which would likely signal there is cause for concern.

This three-tiered approach reflects the fact that financial sustainability is not a binary ‘pass/fail’ issue and there is typically a degree of flexibility around lower bounds for individual ratios (rather than a ‘hard’ floor). Indeed, credit ratings agencies typically accept short-term variations from their guidance without immediately triggering a ratings downgrade, while profitability and equity returns would be expected to fluctuate from year-to-year such that a single bad year in isolation would not be considered a threat to long-term financial sustainability. As mentioned elsewhere in this report, these thresholds are intended to be illustrative and there would need to be further discussion between Royal Mail and Ofcom to determine the appropriate levels and reporting entity.

**Table 3.7 Summary of illustrative thresholds**

| Metric | Likely cause for concern (Red) | Below financially sustainable level (Amber) | Financially sustainable level (Green) |
|---|---|---|---|
| **Profitability** | | | |
| EBIT margin | [✂] | [✂] | [✂] |
| **Debt metrics** | | | |
| FFO/net debt (S&P) | [✂] | [✂] | [✂] |
| Debt/EBITDA (S&P) | [✂] | [✂] | [✂] |
| EBITDA/interest (S&P) | [✂] | [✂] | [✂] |
| Liquidity | | [✂] | |
| **Equity metrics** | | | |
| Dividend cover (if input) | [✂] | [✂] | [✂] |
| Dividend yield (if input) | [✂] | [✂] | [✂] |
| Total shareholder returns | [✂] | [✂] | [✂] |

Source: Oxera.

### 3.3.4 Over what timeframe should financial sustainability be assessed?

We consider that financial sustainability is a medium- to long-run question. As outlined elsewhere in this report (see section 2.3), Ofcom’s duty to have regard to the financial sustainability of the universal service does not mean that the universal service provider should be guaranteed a certain level of return in any given year. However, over the medium to long run, the universal service provider should have a reasonable prospect of earning the commercial rate of return.

This raises the question of how the medium to long term is defined in a sector such as post. In this context, the following is notable.

- The market is very dynamic and subject to rapid change, as exhibited in the evolution of the letter and parcel markets over the last ten years.
- There are high levels of competition meaning that there is higher risk over future returns relative to regulated utility companies.
- There is significantly less capital investment and over shorter asset lives than in traditional network industries.

Consequently, the reasonable timeframe for achieving financial sustainability would be expected to be short relative to fixed networks (e.g. telecoms, water and energy). For this market, the appropriate definition of 'the medium term' is likely to be in the region of 3–5 years and the 'long term' is 5–10 years.

In order to take a view on medium- to long-run financial sustainability that meets this definition, Royal Mail's typical business planning period (of three years) would need to be extended out to cover a 5–10 year period. This requires the development of longer-term financial projections. In light of the degree of uncertainty over future forecasts, these will necessarily be more high level and 'directional' than the three year forecasts set out in the Business Plan. We understand that Royal Mail does not routinely generate longer-term projections and that it may not be practicable to do so annually. As such, these longer-term projections may only be generated to coincide with regulatory review points or if analysis of the short-term projections indicates a potential concern around financial sustainability.

### 3.3.5 When might there be cause for concern?

A potential weakness of the current approach to financial sustainability is that there is a lack of clarity as to when stakeholders would perceive there to be an issue around financial sustainability and the potential courses of action that the different parties might choose to take in such an instance. The prolonged period of sub-5% profitability has not led to any action from Ofcom despite its previous recognition that 'if the forecast EBIT margin stays consistently below 5% or has a decreasing trend taking it below 5% – then there may be indications that the universal postal service faces financial sustainability issues in the long term'.[47]

While the suggested framework does not seek to mechanistically link regulatory action to specific thresholds, the intention is that it would provide a common understanding of what a financially sustainable universal service looks like and what constitutes a financial sustainability issue. If the financially sustainability metrics were to indicate a cause for concern in a given year, this would not necessarily mean that immediate action is required. This would facilitate discussions around the causes of any financial performance issues and the potential solutions.

We acknowledge that it will not be possible to define a 'pass/fail' test but that Ofcom and Royal Mail will need to consider the likelihood that the universal service will remain financeable and whether this represents an acceptable level of risk to comply with the financing duty. In this context, it would be relevant to consider both the absolute level of metrics and trends over time.

There is likely to be particular cause for concern if:

[47] Ofcom (2018), 'Annual monitoring update on the postal market: Financial year 2017-18', 27 November, p. 57, para. 6.28.

- a significant proportion of metrics fall below the long run financially sustainable ('green') level in a given year;
- the metrics remain below the 'green' level at the end of the business planning period (given that the central case is likely to represent a stretching target);
- any of the debt metrics fall below the 'red' level, as this would imply the BBB rating is at risk;
- the analysis indicated that a regulatory action was likely to lead to a deterioration in the metrics;
- under the downside scenarios, a single metric would be persistently below the 'red' level or the average value of a metric over the business planning period is below this level.

### 3.3.6 What to do if there is a cause for concern?

If a cause for concern has been identified, the framework would allow Ofcom and Royal Mail to consider enablers and blockers to financial sustainability and what actions can be taken to achieve financial sustainability. This should include both levers available to Royal Mail—e.g. additional efficiency measures—as well as potential regulatory measures.[48]

Unlike other regulated industries, where changes to price/revenue caps can directly improve financial sustainability, the relevant action to take in the postal sector is less clear cut (see section 2.3). Any interventions would need to be more pragmatic and flexible, taking into account the drivers of financial sustainability. Any action would likely require ongoing dialogue between Royal Mail and Ofcom.

[48] This was noted by CEPA in its advice to Ofcom in 2011: 'Financeability may therefore require visibility of how the regulatory regime might protect investors under [downside] scenarios. In particular, the Postal Services Act 2011 contains provisions to provide financial support in the event that it is needed, but the way in which such provisions might be used is not at all clear. Clarity on how Ofcom would approach such a situation may be needed to ensure that Ofcom can fulfil its statutory duty to ensure that the USO is financeable.' CEPA (2011), 'Financeability of the universal service', report prepared for Ofcom, October, p. 4.

# 4 Conclusions

Based on the evidence discussed above, we reach the following conclusions.

- There are benefits to having a transparent approach to financial sustainability that seeks to define what constitutes a sustainable level of financial performance, when there might be cause for concern, and allows Ofcom and Royal Mail to assess the likelihood that the universal service will fall within these parameters. In particular, this should aid investor confidence and therefore act to encourage investment in the universal service network, which should ultimately benefit users of USO and non-USO products.
- Ofcom has an established approach to financial sustainability but developments in the market suggest it is relevant to consider whether this approach remains suitable. Analysis of Royal Mail's financial performance since flotation shows that equity investors have not been able to earn a return in line with a commercial return on equity, and the Reported Business financeability margin has consistently been below Ofcom's indicative range (5–10% EBIT margin).
- Given Ofcom's duty in this area, there would be benefits to having greater clarity on how Ofcom sees itself as supporting financial sustainability, the steps it is taking (when considering changes to its regulatory framework, such as the scope of access mandation) to ensure that any proposed changes will not undermine financial sustainability, and when/how Ofcom would seek to intervene to address a financial sustainability issue. We see benefits to both parties having a common understanding around how different actions could contribute to, or adversely affect, financial sustainability.
- The cost structure and business risk profile of delivering postal services mean that equity is critical to the financing of the universal service. To reflect this, the approach to financial sustainability should explicitly test whether equity investment can be obtained and sustained in the long term, and that the universal service business would be able to sustain a comfortable investment-grade from a debt perspective. The current indicators could be broadened to take account of equity-related metrics.
- The lack of regulatory levers to restore the Universal Service to financial sustainability points to a conservative approach, accounting for downside scenarios, when designing the wider regulatory framework and making interventions in the postal sector.
- We have presented a potential financial sustainability framework that we consider would have the advantages of providing transparency and a more holistic view of financial sustainability, taking account of both debt and equity. Our proposals are illustrative, based on initial analysis of market benchmarks. The exact design of the framework—e.g. the thresholds and appropriate entity—will necessarily be subject to further discussion and agreement between Ofcom and Royal Mail to ensure it appropriately reflects the objectives of both parties.

# A1 Comparison of regulatory financing duties

The table below sets out a comparison of different UK regulators' financing duties.

### Table A1.1 Regulatory financing duties

| Regulator | Legislation | Statutory duties | Financing duty |
|---|---|---|---|
| **Ofcom (Post)** | Postal Services Act 2011 | Primary duty to carry out its function in a way that it considers will secure the provision of a universal postal service.<br><br>Must 'have regard to' financial sustainability and efficiency | '[Ofcom] must have regard to the need for the provision of a universal postal service to be financially sustainable.'<br><br>'The need for the provision of a universal postal service to be financially sustainable includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.' |
| **Ofcom (Telecoms)** | Communications Act 2003 | Principal duty 'i) to further the interests of citizens in relation to communications matters; and ii) to further the interests of consumers in relevant markets, where appropriate by promoting competition.'<br><br>Must 'have regard to' several other factors | No explicit financing duty.<br><br>Ofcom must take account of 'the desirability of encouraging investment and innovation in relevant markets' but this is one of many factors it must take account of under the Act |
| **CAA (Air traffic control)** | Transport Act 2000 | Principal duty 'to maintain a high standard of safety in the provision of air traffic services'<br><br>Must 'have regard to' several other factors (including financing), but these are secondary to safety. | CAA 'must exercise its functions in a manner that it considers best calculated […] to secure that licence holders will not find it unduly' difficult to finance activities authorised by their licences' |
| **CAA (Airports)** | Civil Aviation Act 2012 | Principal duty to further the interests of users of air transport services, where appropriate by promoting competition.<br><br>Seven factors that it must 'have regard to' (including financing). | CAA 'must have regard to […] the need to secure that each [licence holder] is able to finance its provision of airport operation services in the area for which the licence is granted' |
| **Ofgem (Energy)** | Gas Act 1986<br><br>Electricity Act 1989 | Principal statutory objective to protect the interests of current and future users, where appropriate by promoting effective competition.<br><br>Three secondary duties (securing reasonable demands are met, financeability, and sustainable development) | Ofgem 'shall have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations [under the Act]' |
| **Ofwat (Water)** | Water Industry Act 1991 | Four primary duties (of which the financing duty is one)<br><br>Five secondary duties | Ofwat has a primary duty 'to secure that [licence holders] are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions' |
| **ORR (Rail)** | Railways Act 1993 | Statutory duties to funders, business and users. No hierarchy of duties | ORR must act in a manner which it considers will not render it unduly difficult for licence holders to finance their activities |

Source: Oxera.

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