House of Commons
Business, Innovation and Skills Committee

Competition in the postal services sector and the Universal Service Obligation: Responses to the Committee's Ninth Report of Session 2014–15

First Special Report of Session 2015–16

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Business, Innovation and Skills Committee

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First Special Report

The Committee published its Ninth Report of Session 2014–15, Competition in the Postal Services Sector and the Universal Service Obligation, on 12 March 2015. The Government’s Response was received on 21 July 2015 and is appended to this Report at Appendix 1. The Ofcom Response was received on 23 June 2015 and is appended to this Report at Appendix 2.

Appendix 1: Government Response

Introduction

In September 2014, the Business, Innovation and Skills Committee (“the Committee”) announced that it would be conducting an inquiry into Competition in the UK postal sector and the Universal Service Obligation. The Committee prepared its report after carrying out several oral evidence sessions and receiving written evidence during September 2014 and February 2015. The report, ‘Competition in the postal services sector and the Universal Service Obligation’, was published on 12 March 2015.

The Government has now considered the Report and this paper sets out its response.

Context

The Postal Services Act 2011 was enacted in June 2011. The overarching objective of the postal reforms was to secure the universal postal service—the one price goes anywhere, 6-days-a-week service—throughout the United Kingdom. Among other things, in accordance with the key recommendations made by Richard Hooper in his independent reviews of the postal sector, the Act provided for the transfer of regulatory powers from Postcomm to Ofcom as an independent regulator with the primary statutory duty to secure the provision of the Universal Service in the UK.

The Government agrees with the Committee’s views about the value of the Universal Service to businesses and communities up and down the country, and the concerns expressed in its Report. We have sought to address those where we can and to propose appropriate ongoing monitoring.

In June 2014, Royal Mail made a regulatory submission to Ofcom setting out its concerns over the potential impact of end-to-end competition on its ability to deliver a sustainable Universal Service and called for early intervention to address the threat from ‘cherry picking’, which it argued undermined its rural cross-subsidy.

In December 2014, having reviewed Royal Mail’s evidence and wider market analysis, Ofcom concluded that end-to-end competition was not threatening the financial sustainability of the Universal Service. As part of a wider review, Ofcom announced it would look at other key factors that could impact on the financial sustainability of the Universal Service—Royal Mail’s performance in parcels and its efficiency and
productivity—as these factors could potentially significantly outweigh the current and likely future effects of end-to-end competition in bulk mail on Royal Mail’s ability to provide the Universal Service.

Since the publication of the Committee’s report, Whistl, the second largest postal operator in the UK, has announced its withdrawal from the direct delivery letters market. Following that decision, which has resulted in Royal Mail no longer being subject to national competition, Ofcom announced, in June, that it would conduct a ‘fundamental’ review of the postal regulatory framework to ensure that regulation remains appropriate and sufficient to secure the universal postal service.

**Government response to the Select Committee’s recommendations and conclusions**

**Recommendation 1: Financial metrics**

*That both Royal Mail and Ofcom should, as a matter of urgency, agree a set of financial metrics against which the costs should be measured. If necessary, this should be carried out by the National Audit Office (NAO) or a mutually-agreed body of experts.* (Paragraph 22) and:

*That Royal Mail using these figures, provides a geographical analysis of where the Universal Service is profitable and where it is not. Such detailed analysis and financial monitoring of the Universal Service would provide the evidence to assess the long-term sustainability of the Universal Service. This breakdown of costs should be included in Royal Mail’s Audited Regulatory Accounts. If Royal Mail declines to provide these figures, we recommend that the Government should consider extending the remit of Ofcom, to enable Ofcom to enforce this requirement.* (Paragraph 23)

**The Government response:**

The Government agrees with the Committee that Royal Mail and Ofcom should establish a common understanding on a set of financial metrics against which the costs of providing the Universal Service can be measured and that this should be achieved as soon as practicable. We will explore with Ofcom and Royal Mail ways to achieve the recommendation.

As a private business, it will be an operational decision for Royal Mail’s management to collect and set out any breakdown of geographical costs and how it might share such commercially sensitive information.

Royal Mail considers its network is designed and run to serve the whole of the UK as efficiently as possible while maximising economies of scale. The company has said that it does not calculate cost by geographic region as much of the network cost is comprised of national overheads which cannot be meaningfully broken down into regional costs. The company does maintain a zonal costing model which assesses the variation in cost of delivering mail in 4 zones (London, Urban, Suburban and Rural), as required by Ofcom’s information requirements.
On the point about extending Ofcom’s remit in relation to this data, the Postal Services Act 2011 gives Ofcom significant powers to require information from postal operators, providing the information is necessary in support of its statutory duty to secure the Universal Service. As the independent regulator, it is therefore a matter for Ofcom to assess and determine what information it requires from postal operators to enable it to meet its statutory duties. Ofcom must ensure that any request for information from postal operators is proportionate to the use to which the information is to be put in the carrying out of its functions.

**Recommendation 2: Timelines for interventions**

*That Ofcom publish a more detailed timeline for its implementation and assessment that the timescale is fast enough to avoid a failure in the Universal Service, even in the short term.* (Paragraph 40)

**The Government response:**

The Government recognises the Committee’s concern over the effectiveness and timeliness of regulatory interventions to protect the Universal Service. We agree it is important to have a clear understanding of the time required for effective interventions to protect the Universal Service to be put in place. We will therefore explore with Ofcom a way to address the recommendation.

Ofcom receives advance warning of competitors’ plans through the notification process it has in place and its ongoing monitoring regime provides regular access to detailed information on Royal Mail’s operational and financial performance. Ofcom keeps market developments under close review to ensure that if there is a need to consider the case for intervention, it is identified and acted on in good time.

**Recommendation 3: Secretary of State Direction**

*The alternative regulatory condition—the Universal Service Compensation Fund—involves a lengthy delay in implementation. To avoid such a delay, we recommend that the Secretary of State directs Ofcom to review the net cost of the Universal Service, in accordance with the Postal Services Act 2011.* (Paragraph 41)

**The Government response:**

We fully appreciate the Committee’s concern over the length of time it may take to introduce a Universal Service Compensation Fund, should it be considered appropriate or necessary, or any of the other measures arising from a review of the net cost of the Universal Service (for example, a review of minimum requirements or a procurement option).

However, at this time, the Government is not aware of any current market evidence that would require the Secretary of State to direct Ofcom to carry out a review of the net cost of the Universal Service Obligation.
We recognise that faced with a letters market in structural decline Royal Mail’s financial position could quickly change as a result of external impacts, which is why we fully agree with the Committee that it is vital for Ofcom to continue to closely monitor the company’s performance and the impact of wider market forces on its operations.

We will continue to monitor the situation and should circumstances change and warrant the need to initiate a review, we will liaise with Ofcom to ensure that appropriate action is taken in good time to address any immediate and longer term risk to the financial sustainability of the Universal Service. If the Government does not initiate a review in the interim, after October 2016, Ofcom can, if necessary, carry out a review of the net cost of the USO without direction from the Secretary of State.

Recommendation 4: Price increases

Royal Mail should not increase prices in an attempt either to increase its own profit levels or to protect the Universal Service Obligation, without continuing to increase the efficiency of its operations, thereby reducing its costs and enabling it to improve its standards of service. (Paragraph 49)

The Government response:

The Government fully agrees with the Committee’s recommendation.

Ofcom has a statutory duty to ensure that the prices of the Universal Service remain affordable, which is carefully monitored. If prices were to increase to a point that they gave rise to affordability issues, particularly for vulnerable consumers, Ofcom has acknowledged that there would be a need to intervene.

Stamp prices in the UK have been low relative to many other European countries, which allowed Royal Mail scope for the recent increases in postal prices.

Under its regulatory framework, Ofcom gave Royal Mail significant pricing freedom to enable the company to return the Universal Service to financial sustainability. This commercial freedom was subject to certain safeguards, such as a price cap on second class post to maintain the affordability of the Universal Service and its ongoing monitoring regime to track Royal Mail’s performance and efficiency improvements.

As part of a broader review of factors impacting on the Universal Service, Ofcom is carrying out further analysis of what might represent a reasonable rate of efficiency improvement by Royal Mail. This is important, given the role that efficiency can play in Royal Mail’s ability to continue to provide a financially sustainable Universal Service.

Recommendation 5: Employment standards in the postal sector

That Ofcom investigates the impact on customers and the service provided to customers of any downward pressure on terms and conditions of postal sector staff. We further recommend that the Government considers extending Ofcom’s remit to include consideration of labour costs, conditions and standards in the postal sector.
The Government response:

The Government acknowledges the Committee’s concerns, and particularly in relation to zero-hours contracts. However, at the current time, it does not consider it appropriate to extend Ofcom’s regulatory powers to include monitoring the employment conditions and standards within the postal sector.

The specific terms and conditions of employment are matters for employers and employees to agree within the framework of employment legislation set by Government. Employment legislation and regulations apply to all economic sectors—to employees and employers within those sectors—of the UK, equally and equitably.

On zero-hours contracts, market evidence shows that they do have a place in today’s labour market; supporting workplace flexibility, making it easier to hire new staff and providing pathways to employment for young people. Employees on zero-hours contracts should not be exposed to unfair exploitation by employers. The Small Business, Enterprise and Employment Act 2015, enacted in March 2015, effectively bans exclusivity arrangements in zero-hours contracts.

During the Committee’s inquiry, concerns were raised specifically about the use of zero-hours contracts by Whistl, Royal Mail’s biggest competitor. Community, the union representing employees at Whistl, has since confirmed that it has reached an agreement with Whistl’s management removing the use of zero-hour contracts by the company.

Recommendation 6: More regulatory powers

Recognises that Ofcom has a difficult role in ensuring that the provision of a Universal Service is both financially sustainable and efficient. The sector is changing quickly, and Royal Mail has now moved from the public to the private sector. As competition increases, the statutory remit of Ofcom may need to change. Ofcom has to recognise its over-riding obligation to ensure the protection of the Universal Service Obligation and, if necessary, there should be changes in the regulatory framework to enable it to do so. (Paragraph 84)

The Government response:

The Government agrees with the Committee’s view of Ofcom’s challenge in maintaining a sustainable and efficient Universal Service. Ofcom has been given a primary statutory duty to secure the Universal Service in the United Kingdom—that is Ofcom’s priority in relation to the postal sector. If there was evidence that the regulatory framework was failing to achieve its principal objective, or if Ofcom raised concerns over its ability to act to fulfill its duties, the Government would review the powers and tools available to the regulator.

The transfer of Royal Mail to the private sector will have no impact on its role as the designated Universal Service Provider for the UK. It will continue to be required by Ofcom’s regulatory conditions to deliver the Universal Service in accordance with the minimum requirements set by Parliament and the quality standards set by the regulator.
Since the publication of the Committee’s Report, Royal Mail’s main competitor, Whistl, suspended its end-to-end delivery operations around the UK and later announced that it would not be resuming this operation, leaving Royal Mail without any national competition for direct delivery of letters. Competition does however remain strong in other areas of the market, such as ‘access mail’ and parcels.

In response, Ofcom has announced it will conduct a fundamental review of the sector to, amongst other things, assess the impact of Whistl’s decision on the dynamics of the postal market.

**Recommendation 7: Regular reporting to the Committee**

*That Ofcom provides our successor Committee with quarterly updates on the state of the Universal Service, and highlights any potential middle-term effects on the Universal Service, and any action that it is proposing to take. (Paragraph 85)*

**The Government response:**

We share the Committee’s ongoing interest in the health of the Universal Service and will explore with Ofcom ways to ensure that the Committee receives timely updates on its operation and any proposed regulatory action.

**Conclusions**

1. *That it would be inappropriate to change the current requirements of the Universal Service Obligation. (Paragraph 45)*

2. *Supports Ofcom’s consultation on the level of zonal pricing set by Royal Mail. Any recommendations arising from that consultation must balance the need for Royal Mail to retain the freedom to set its prices, dependent on the cost of delivering in that area, with the benefits of retaining an open market and increasing competition. Royal Mail is free to set*
zonal pricing, but it should be based on actual costs of delivering to those zones, and not as a
device to deter, or even stifle, competition. There is a fine balancing act to be set. Ofcom must
set out the timetable for this consultation and when a decision will be made. (Paragraph 68)

**The Government response:**

We welcome the Committee’s acknowledgement of the importance of Ofcom’s review of
the access pricing regime. It is for Ofcom, as the independent regulator for postal services,
to ensure that access to Royal Mail’s network allows Royal Mail to compete with other
operators in the postal market while ensuring that it receives a fair return from the use of
its network operations.

Ofcom’s ‘fundamental review’ of the postal sector announced in June 2015 will incorporate
its ongoing work to assess Royal Mail’s efficiency, its performance in the parcels market
and the company’s potential ability to set wholesale prices in a way that might harm
competition. In addition, the review will address the implications of Whistl’s withdrawal,
which represents a significant change in the direct delivery market.

3. The evidence that we received suggest that Royal Mail still has to match the technical
innovations introduced by many of its competitors. These innovations more clearly match the
expectations of consumers, as well as contributing to the efficiency of competing postal
operators. (Paragraph 63)

**The Government response:**

We agree with the Committee that Royal Mail must continue to innovate and modernise
its operations in order to meet market challenges and to be able to fully exploit market
opportunities.

The Government acknowledges that in recent years Royal Mail’s management and postal
workers have been working closely together to introduce new practices and modern
technologies that have helped improve efficiency within the business while maintaining the
company’s high standards of service.

We believe that the privatisation of the company in October 2013 has ensured that Royal
Mail now has ongoing access to the much needed capital for modernisation, allowing the
business to quickly respond to the changing needs of postal users. On 11 June 2015, the
Government sold half of the 30% stake it had retained in Royal Mail, raising a further £750
million. The Government is proposing to sell its remaining stake in the course of this
Parliament.

**General correction:**

Chapter 2: ‘Definition of the Universal Postal Service’ - Paragraph 8

The Postal Services Act 2011 does not ‘name’ Royal Mail as the Universal Service Provider
but allows for the designation of a Universal Service Provider by Ofcom who have
subsequently issued a formal designation (PSA2011 S35).
Section 31 of the Postal Services Act 2011 sets out the ‘minimum requirements’ of the Universal Service. These minimum requirements do not include the bulleted points set out under paragraph 8 of the Committee’s Report.

Schedule 12 (Minor and Consequential Amendments) of the Postal Services Act 2011 omits sections of the Postal Services Act 2000 which had set out restrictions and requirements of a licence for those providing postal services. This has enabled Ofcom to introduce a regulatory system based upon general authorisation, allowing for businesses to set up postal operations without the need of a licence provided that their operations comply with the general regulations set by Ofcom.

21 July 2015
Appendix 2: Response from Ofcom

Ofcom welcomes the balanced and considered report from the Committee on this important and complex issue.

Since the publication of the Committee’s report Whistl has announced (on 10 June) that it has permanently closed its end-to-end delivery network. On 16 June Ofcom announced a fundamental review of the regulation of Royal Mail. This review will ensure regulation remains appropriate and sufficient given the recent withdrawal by Whistl from the ‘direct delivery’ letters market, where Royal Mail is now no longer subject to national competition.

Cost of the universal service to Royal Mail, region by region

Recommendation 1: Given the fundamental importance of the USO, we were concerned to note that Royal Mail were unable to provide a regional breakdown of the cost of the Universal Service Obligation. In addition, given the responsibility of Ofcom to protect the USO, we were surprised to learn that there is no consensus between Royal Mail and Ofcom over what constitutes cost, revenues and profits of the USO. We recommend that both Royal Mail and Ofcom, as a matter of urgency, agree a set of financial metrics against which the costs should be measured. If necessary, this should be carried out by the National Audit Office or a mutually agreed body of experts.

Ofcom response:

As Royal Mail noted in its supplementary written evidence both the figure of £7.2 billion quoted by Royal Mail and the figure £2.7 billion quoted by Ofcom are taken from Royal Mail 2013/14 audited regulatory financial statements. Both Ofcom and Royal Mail recognise these figures, understand how they are produced and agree what they represent. The former represents the total operating and transformation costs of running the network (including the cost of all 14,537 million addressed items delivered across the network), whereas the latter is the costs associated with the 3,534 million universal service items delivered across the network.

Royal Mail believes that the cost of the network is driven by the universal service obligation to deliver six-days per week to every address in the UK. Ofcom’s view is that non-universal service products make up 57% of the revenues and 76% of the addressed volumes of this network and therefore it would be inappropriate to allocate all costs to universal service products. It is unlikely that Royal Mail’s network would be set up in the same way with the same costs if it were only handling universal service products. In addition, as noted in Ofcom’s oral evidence to the committee, Royal Mail’s universal service obligations to collect and deliver mail six days per week do not apply to its non-universal service bulk mail products. Royal Mail could therefore, if it chose to do so, deliver bulk mail on fewer days per week as is the case in Denmark and the Netherlands.

Recommendation 2: We recommend that Royal Mail—the Designated Universal Service Provider—using these figures, provides a geographical analysis of where the Universal Service
is profitable and where it is not. Such detailed analysis and financial monitoring of the Universal Service would provide the evidence to assess the long-term sustainability of the Universal Service. This breakdown of costs should be included in Royal Mail’s Audited Regulatory Accounts. If Royal Mail declines to provide these figures, we recommend that the Government should consider extending the remit of Ofcom, to enable Ofcom to enforce this requirement.

**Ofcom response:**

Ofcom requires Royal Mail to produce a Zonal Costing Model which is intended to show how its costs differ by different types of geographic area.

With regard to a regional breakdown of Royal Mail’s costs we note that Royal Mail’s business is not structured on a regional basis and involves the collection of mail from one part of the UK and its delivery to others. The costs of serving an urban terraced street are likely to be very similar in dense urban centres throughout the UK; while the costs of serving rural villages are likely to be similarly very similar regardless of region. The zonal costing model groups areas with similar delivery characteristics wherever they are in the UK. This approach provides a greater understanding of the underlying costs of the universal postal service than a presentation of the costs on the basis of political/administrative areas of the UK.

We also have statutory powers to require further information from Royal Mail should that prove necessary. Moreover, the Postal Services Act 2011 imposes strict limits on Ofcom’s ability to share/disclose such information—see further the response to Recommendation 13 below.

**Universal Service Compensation Fund**

*Recommendation 4: Ofcom has the power to impose a General Universal Service Obligation on postal operators other than the Universal Service Designated Provider (Royal Mail), in order to protect the Universal Service. We have yet to be convinced that Ofcom could impose the General Universal Service Obligation within the predicted six to eight months. We recommend that Ofcom publish a more detailed timeline for its implementation and an assessment that the timescale is fast enough to avoid a failure in the Universal Service, even in the short term.*

**Ofcom response:**

Given Whistl’s recent closure of its letters delivery operations, the potential need to intervene using General Universal Service Conditions is highly unlikely.

However, Ofcom could carry out the necessary market analysis, gather evidence and impose new regulatory conditions within the six to nine months’ timeframe we suggested to the Committee in both our written and oral evidence if necessary. We collect significant amounts of information from both Royal Mail and other postal operators on a quarterly
basis under our monitoring regime, precisely so we will be able to identify any problems early and have the evidence to take the necessary action quickly.

A good example of similar work conducted within this timeframe is the consideration and analysis of the submission from Royal Mail in the summer of 2014 supporting its view that competition in the postal sector posed a threat to the universal service.

We received the initial document from Royal Mail in June 2014 and requested further information from Royal Mail and other postal operators which we received in July 2014. We then assessed the evidence gathered from the operators and published a statement on 2 December 2014 in which we set out our conclusions, based on the evidence we had seen, that end-to-end competition in the postal sector did not pose a threat to the universal service at the current time. If we had concluded there was a problem and that we needed to impose regulatory conditions, we could at this time have proposed conditions. Depending in part on the urgency of the need for intervention, these conditions could have been subject to only one month’s consultation.

In this instance, and based on the time it took us to consider Royal Mail’s submission, additional evidence and publish a statement, we would have been in a position to impose new regulatory conditions to secure the provision of the universal service within 7-8 months.

**Royal Mail’s price structure for national average prices and zonal process**

*Recommendation 9: We support Ofcom’s consultation on the level of zonal pricing set by Royal Mail. Any recommendations arising from that consultation must balance the need for Royal Mail to retain the freedom to set its prices, dependent on the cost of delivering in that area, with the benefits of retaining an open market and increasing competition. Royal Mail is free to set zonal pricing, but it should be based on actual costs of delivering to those zones, and not as a device to deter, or even stifle, competition. There is a fine balancing act to be set. Ofcom must set out the timetable for this consultation, and when a decision will be made.*

**Ofcom response:**

On 30 April LDC announced that it would not be proceeding with the proposed investment in Whistl’s end-to-end network rollout. On 11 May, Whistl announced that following LDC’s decision it was suspending its end-to-end operations while it carried out an extensive review of the viability and potential for the rollout of an end-to-end delivery network in the UK. On 10 June, PostNL and Whistl announced the closure of Whistl’s end-to-end services.

While we welcome the Committee’s support for our work looking at zonal access prices, given the closure of Whistl’s end-to-end operation we will need to revise the work we have been doing in this area and reassess to reflect the recent market changes.
On 16 June we announced a fundamental review of the regulation of Royal Mail. This review will ensure regulation remains appropriate and sufficient given the recent withdrawal by Whistl from the ‘direct delivery’ letters market, where Royal Mail is now no longer subject to national competition. The new review will incorporate our existing work, announced in December, to assess Royal Mail’s efficiency; review its performance in the parcels market; and address the company’s potential ability to set wholesale prices in a way that might harm competition. In addition, the review will address the significant recent changes in the direct delivery market.

### Labour Costs

**Recommendation 11:** If standards of pay in the postal sector, as in other sectors, fall short, then the taxpayer is left to pick up the difference, because in-work state benefits will cost more.

Furthermore, it is unacceptable that delivery of the Universal Service Obligation should require downward pressure on the terms and conditions of staff delivering that service. We recommend that Ofcom investigates the impact on customers and the service provided to customers of any downward pressure on terms and conditions of postal sector staff. We further recommend that the Government considers extending Ofcom’s remit to include consideration of labour costs, conditions and standards in the postal sector.

### Ofcom response:

Ofcom measures the quality of service of and customer satisfaction with the universal postal service in a number of ways. We monitor Royal Mail’s performance against its quality of service obligations quarterly. As shown in Figures 5.4 and 5.5 of Ofcom’s annual monitoring report Royal Mail’s service performance has improved so that in 2013-14 Royal Mail exceeded both its First and Second Class targets. Royal Mail recently published its regulatory quality of service report for 2014-15 which shows that it met both its First and Second Class targets.1

In addition, we carry out residential and business consumer surveys on a regular basis. In 2013/14 88% of residential consumers reported they were either “very satisfied” or “fairly satisfied” overall with postal services. We also monitor complaints data and in our annual monitoring report noted that complaints have declined since 2008.

### Ofcom and the regulatory framework

**Recommendation 12:** We recognise that Ofcom has a difficult role in ensuring that the provision of a Universal Service is both financially sustainable and efficient. The sector is changing quickly, and Royal Mail has now moved from the public to the private sector. As competition increases, the statutory remit of Ofcom may need to change. Ofcom has to recognise its over-riding obligation to ensure the protection of the Universal Service

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Obligation and, if necessary, there should be changes in the regulatory framework to enable it to do so.

**Ofcom response:**

We welcome the Committee’s recognition that the dual role Ofcom has in ensuring the provision of the universal service is both sustainable and efficient to be a difficult one. Our duty, as set out in the Postal Services Act 2011, is to secure the provision of a universal postal service. This means that securing the universal service is at the heart of all our work on postal regulation.

As Ed Richards told the Committee during our oral evidence session on 10 December 2014: “Whether our duties need to be changed needs some considerable deliberation. There is no doubt that we are in slightly uncertain territory, which is why you have all heard from me the commitment we have to monitoring and evaluation. I have to tell you that that is wholly exceptional. There is no other market that we look at and that we are responsible for that has this level of attention, in this detail, with this frequency. None at all.”

Ofcom believes we currently have the right set of duties to regulate the postal services sector, but this needs to be kept under review as the sector changes.

**Recommendation 13:** We recommend that Ofcom provides our successor Committee with quarterly updates on the state of the Universal Service, and highlights any potential middle-term effects on the Universal Service, and any action that it is proposing to take.

**Ofcom response:**

Ofcom is happy to discuss with the new Committee the introduction of regular updates on developments and changes in the sector and Ofcom’s regulatory plans. However, without the consent of the stakeholders concerned, we are prohibited by provisions in the Postal Services Act 2011 from disclosing/sharing any information provided to us by stakeholders, unless that information is already in the public domain or one of a very limited number of exceptions applies. Breach of these provisions by Ofcom is a criminal offence. We do not consider that any of those exceptions as currently drafted would be likely to permit us to share such information with the Committee.

23 June 2015