

# **Annex 17**

## **Royal Mail Service Standards Penalty and Reward Regime**

**A response by Royal Mail**

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# ROYAL MAIL SERVICE STANDARDS PENALTY AND REWARD REGIME

## Introduction

Postcomm proposes that Royal Mail should continue to pay up to 5% of revenue to bulk mail customers under the bulk mail compensation scheme and that the C factor penalty should be increased to cover 5% of revenues for social products.

Although some form of positive incentive was supported by Postwatch and by the findings of the MORI survey, Postcomm proposes that Royal Mail should not receive any reward for exceeding the target levels as this might encourage Royal Mail to “gold plate its services beyond the requirements of its customers”.

Postcomm also proposes that Royal Mail should continue to have to argue for mitigation in payments because of force majeure events, such as severe weather, and that it does not consider that any form of industrial action by Royal Mail or its agents should be taken into consideration.

Finally Postcomm proposes changes to Royal Mail's Licence to reverse the burden of proof on reasonable endeavours, which potentially can apply to any performance falling below the target level, and to give Postcomm control of loss and damage compensation for all Royal Mail products.

Taken as a package, Royal Mail is exposed to some £280m of automatic penalties pa, not including downstream access compensation (at up to 5% of revenues), retail compensation payments for loss and damage (which are unlimited) or fines (which may be up to 10% of turnover). Royal Mail's maximum automatic penalty for quality failure represents 160% or more than one and a half years of its core allowed profit under the proposed regime. This is at odds with all regulatory precedent, where a typical figure is in the range of 10% to 20%.

Postcomm's proposals are punitive and offer no upside for superior performance. Royal Mail does not believe that a regime of this severity is required to incentivise it to maintain good standards of performance. In an increasingly competitive market, in the event of underperformance, unhappy customers are able to move to competitors and do not need a regulator to intervene on their behalf. Under these proposals, which cover an inappropriately wide set of products, Royal Mail would lose both customers, as would be expected in a competitive market, and also face significant penalties. This represents a double jeopardy for the business, which may, in the worst case, threaten the financial viability of Royal Mail. The treatment of force majeure is also of particular concern since the operational efficiency targets Postcomm is considering would require Royal Mail to drive through its transformation without rewarding its people, making substantial quality of service penalties almost inevitable. Royal Mail believes that Postcomm's continued refusal to consider major industrial action as force majeure is irrational in the context of a

performance regime designed to prevent Royal Mail from reducing costs at the expense of quality.

Royal Mail believes quality of service regulation should be limited in scope to only those areas that are not likely to be subject to effective competition and should not be more punitive than in other regulated industries. Therefore Royal Mail believes that the level of automatic exposure for poor performance should be considerably reduced to no more than 15% of core allowed profit, with the emphasis shifted to core USO products and downstream access, and that there should be appropriate incentives for good performance.

## Proposal for Revised Service Standards

Royal Mail proposes in its response to the price control consultation that the present service standards regime be replaced by the set of banded standards shown in table 1.1 below, together with annual national measurement and publication of misdelivery performance. The standards are offered as a package to replace the existing standards.

**Table 1.1 Proposed Standards with Bandings**

Standards	Standard	Excellent at or above	Good between	Needs improvement at or below	Unacceptable below
1C Stamped & Metered	93.0 J+1	94.0 1% above std	92.0-94.0	92.0 1% below std	88.0 5% below std
2C Stamped & Metered	98.5 J+3	99.5 1% above std	97.5-99.5	97.5 1% below std	93.5 5% below std
Standard Parcel	90.0 J+3	91.0 1% above std	89.0-91.0	89.0 1% below std	85.0 5% below std
Special Delivery non-account	99.0 by guaranteed time	100.0 1% above std	98.0-100.0	98.0 1% below std	94.0 5% below std
PCA floor target (1C S&M delivered) to be met by all PCAs except HS, KW, ZE	90 J+1	91 aligned to national	89-91	89 aligned to national	86 aligned to national
USO delivery (rounds completed)	99.5	100.0 0.5% above std	99.0-100.0	99.0 0.5% below std	97.0 2.5% below std
USO collection	To be agreed during 2006/7 for introduction in 2007/08				
Bulk 1 (MS1, PPI1, RS1)	90.5 J+1	91.5 1% above std	89.5-91.5	89.5 1% below std	85.5 5% below std
Bulk 2 (MS2, PPI2, RS2)	97.5 J+3	98.5 1% above std	96.5-98.5	96.5 1% below std	92.5 5% below std
Mailsort 3	97.5 J+7	98.5 1% above std	96.5-98.5	96.5 1% below std	92.5 5% below std

All standards are annual excluding the Christmas period as currently defined and all except the PCA floor standard are national. All E2E standards are measured as percentage items meeting service specification – i.e. all combinations are on the basis of volume. USO delivery is defined as the percentage of delivery rounds fully completed during the year and USO collection is defined as the percentage of daily collections made from boxes and Post Offices® during the year on days when a collection was due (all daily collections made as a proportion of all daily collections due). All standards are to one decimal place except for the PCA floor standard, which is to the nearest percent. All levels for all standards are offered on the basis that the reported results exclude major force majeure events (which includes industrial action). The standard levels also assume that there is no adverse impact on Royal Mail's ability to achieve its targets caused by compliance with future transport legislation, for

example in relation to airport restrictions, or with other legislation. The Bulk 1 standard assumes an underlying performance of 85% J+1 for RS1 and the Bulk 2 standard assumes an underlying performance of 95% J+3 for RS2.

## **Proposal for a Penalty Regime based on these Service Standards**

The primary purpose of any Quality of Service regulation should be to protect the interests of customers. Customers need differing levels of protection depending on whether the product or service is open to free and efficient competition. Royal Mail believes that Quality of Service regulation should be 'light touch' and limited in scope to those areas that are not likely to be subject to effective competition.

In competitive areas, if Royal Mail is not offering its customers a high quality of service in business areas that are subject to effective competition, then it will lose those customers to competitors who can provide that quality level at that price. Customers are able to choose a service provider that meets their own individual quality of service needs. In these business areas competition is the most effective policeman of service quality. Whilst it may be appropriate to retain standards with the possibility of fines and enforcement for such products during the next price control Royal Mail believes it is disproportionate to apply further penalties in the shape of bulk compensation or C factor to these products, particularly where standards and current performance levels are high.

Quality of service regulation is, however, necessary in those business areas where Royal Mail is unlikely to face effective competition – essentially stamped mail. These areas are essentially stamped mail where customers are unlikely to be able to choose a service provider according to the quality of service on offer. Hence the service provider should agree acceptable levels of quality with the regulator and consumer body and these should be funded by the price control. As Royal Mail products use the same networks and performance is highly correlated, the regulation of quality for core products and services will also underpin quality levels for other products.

Where products already have individual compensation in place for failure to meet the specification Royal Mail believes that this provides sufficient incentive to achieve a good standard of performance. Special Delivery Next Day has a refund of fee for failure to meet the guaranteed time and an additional payment for further failure under the retail compensation scheme. Royal Mail therefore believes it is disproportionate to apply additional penalties under the C factor for this product.

In order to meet the requirements above, with a maximum level of exposure equivalent of no more than 15% of core allowed profit (assumed here to be c£400m pa), Royal Mail believes it would be appropriate to cease the bulk compensation scheme and to focus the C factor around the core USO stamped products and the USO collection and delivery standards. Downstream access mail would also receive compensation payments, although on a reduced basis, as volumes for this service are expected to increase substantially during the period of the control. Other products with Licence standards would be regulated on the basis of fines only, using the proposed bandings to report performance and to determine whether fines should be considered.

Royal Mail believes that the regime should reward as well as penalise where appropriate. The Accent/Rand market research study<sup>1</sup> supports a symmetrical reward/penalty regime for all first class products plus second class stamped and standard parcels, and for changes in USO collection and delivery performance. Therefore a symmetric penalty/reward scheme is appropriate for all the proposed C factor components.

Royal Mail also believes that the reward/penalty regime should be related to customer willingness to pay. The Accent/Rand results demonstrate that customers are not interested in price reductions or increases for small changes (at least 1%, more for Mailsort 3) in end to end quality. This supports the application of a 1% leeway before penalties or rewards are applied under the C factor and before downstream access compensation is paid. Royal Mail believes some leeway is also needed for the USO delivery and collection penalty/reward system, to allow for factors such as minor force majeure events and measurement error, but proposes a reduced level of 0.5% for these standards.

Royal Mail has also used the Accent/Rand findings to propose relative payback/reward rates between standards. Those with a higher value of delivered service have a higher payback/reward rate. If performance falls into the penalty or reward banding the penalty or reward is calculated in relation to the standard.

The proposed maximum failure to be considered is derived from the boundary between the proposed service standard “Needs improvement” and “Unacceptable” ranges in table 1.1. Once beyond this boundary no further automatic penalties are incurred but fines and enforcement may be considered. The maxima for national end to end standards are set at 5% below the standard, in line with the current C factor calculations. The postcode area floor maximum is 4% below the standard as this is the equivalent of 5% below the national standard for first class stamped and metered mail. For the USO standards, where performance should be closer to 100%, a lower maximum of 2.5% is proposed as more appropriate.

The proposed maximum reward to be considered reflects the maximum failure as far as is mathematically possible and the proposed reward rate is the same as the proposed payback rate.

Royal Mail’s proposed regime is summarised in table 1.2 below.

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<sup>1</sup> Pricing Quality of Service Accent and Rand Europe July 2005

**Table 1.2 Reward/Penalty Regime by standard**

Standard	Reward at/above	Standard	Penalties at/below	Fines possible below	Notes
1C Stamped & Metered	94.0	<b>93.0</b>	92.0	88.0	Reward & penalty for stamped mail only via C factor
2C Stamped & Metered	99.5	<b>98.5</b>	97.5	93.5	Reward & penalty for stamped mail only via C factor
Standard parcels	91.0	<b>90.0</b>	89.0	85.0	Reward & penalty for stamped parcels only via C factor
Special Delivery non-account	N/A	<b>99.0</b>	N/A	94.0	Individual compensation and fines only
PCA (1C S&M delivered)	91	<b>90</b>	89	86	Reward & penalty via C factor
USO delivery	100.0	<b>99.5</b>	99.0	97.0	Reward & penalty via C factor
USO collection	TBA when measurement in place				Reward & penalty via C factor
Bulk 1 (MS1, PPI1, RS1)	N/A	<b>90.5</b>	N/A	85.5	Fines only
Bulk 2 (MS2, PPI2, RS2)	N/A	<b>97.5</b>	N/A	92.5	Fines only
Mailsort 3	N/A	<b>97.5</b>	N/A	92.5	Fines only

## C Factor

Royal Mail proposes that the C factor penalty should be capped at about 3.75% of revenues for first class stamped mail, second class stamped mail and stamped standard parcels only. The equivalent maximum reward would be about 3% of the same revenues. This is less than the penalty due to the asymmetrical upper range limits for 2C stamped mail and the two USO standards. A proposed mechanism for applying the C factor is set out in table 1.3 below.

**Table 1.3 Details of C factor calculation**

Standards	No. m	C factor weighting $mw_m$	Reward rate per 1% over target $rr_m$	Reward range lower limit $r_m$	Reward range upper limit $R_m$	Penalty rate per 1% under target $pr_m$	Penalty range lower limit $p_m$	Penalty range upper limit $P_m$
1C Stamped	1	70% split by product revenue in year t	1	1%	5%	1	1%	5%
2C Stamped	2		0.7	1%	1.5%	0.7	1%	5%
Standard parcels	3		0.5	1%	5%	0.5	1%	5%
PCA delivered	4	10%	1	1%	4%	1	1%	4%
USO delivery	5	10%	0.5	0.5%	0.5%	0.5	0.5%	2.5%
USO collection <sup>2</sup>	6	10%	0.5	0.5%	0.5%	0.5	0.5%	2.5%

<sup>2</sup> To be confirmed when target levels agreed. Similar regime to delivery assumed.

This can be expressed as a penalty performance fraction  $f_t$  applied to 3.75% of stamped revenues

$$f_t = \sum_{m=1 \text{ to } 6} (1 - pr_m f(tm_{mt} - pm_{mt}) / P_m) mw_m, \text{ where}$$

$tm_{mt}$  is the standard in percentage points in formula year t against each of the quality measures m set out in table 1.2

$pm_{mt}$  is the performance in percentage points in formula year t against each of the quality measures m set out in table 1.2,

$mw_m$  is the weight applicable to measure m as set out in table 1.3

$pr_m$  is the payback rate for measure m as set out in table 1.3

$p_m$  is the penalty range lower limit for measure m as set out in table 1.3

$P_m$  is the penalty range upper limit for measure m as set out in table 1.3, and

$$f(tm_{mt} - pm_{mt}) = \begin{cases} tm_{mt} - pm_{mt} & \text{if } p_m \leq tm_{mt} - pm_{mt} \leq P_m, \\ 0 & \text{if } tm_{mt} - pm_{mt} < p_m \\ P_m & \text{if } tm_{mt} - pm_{mt} > P_m \end{cases}$$

and a reward performance fraction  $g_t$  applied to 3% of stamped revenues:

$$g_t = \sum_{m=1-6} (1 - rr_m g(pm_{mt} - tm_{mt}) / R_m) mw_m, \text{ where}$$

$tm_{mt}$  is as defined above

$pm_{mt}$  is as defined above

$mw_m$  is the weight applicable to measure m as set out in table 1.3

$rr_m$  is the reward rate for measure m as set out in table 1.3

$r_m$  is the reward range lower limit for measure m as set out in table 1.3,

$R_m$  is the reward range upper limit for measure m as set out in table 1.3, and

$$g(pm_{mt} - tm_{mt}) = \begin{cases} pm_{mt} - tm_{mt} & \text{if } r_m \leq pm_{mt} - tm_{mt} \leq R_m, \\ 0 & \text{if } pm_{mt} - tm_{mt} < r_m \\ R_m & \text{if } pm_{mt} - tm_{mt} > R_m \end{cases}$$

Royal Mail notes that the calculations above assume that the products attracting a C factor reward or penalty are in a single tariff basket. If these products were split over more than one tariff basket Royal Mail would expect the associated C factor penalty or reward to be pro-rata'd between the revenues in the relevant baskets.

## Downstream Access

Royal Mail's suggested downstream access compensation regime is set out in tables 1.4 and 1.5 below. Compensation is not paid until performance is at least 1.0% below target and is capped at 1% of revenue when performance has dropped 5% below target. As compensation would be paid under contract rather than as part of the Licence regime Royal Mail would not be subject to fines for this service.

**Table 1.4 Downstream access compensation structure**

	Reward at/above	Contract compensation target	Penalties at/below	Fines possible below	Notes
Downstream access	N/A	95.0 <sup>3</sup>	94.0	N/A	No Licence standard. Compensation via contract

Until dedicated measurement is in place, the compensation target and measurement against this will continue to be based on a proxy as for existing contracts.

**Table 1.5 Downstream access compensation calculations**

	Reward rate per 1% over target	Reward range lower limit	Reward range upper limit	Penalty rate per 1% under target	Penalty range lower limit	Penalty range upper limit
Downstream access	N/A	N/A	N/A	0.2	1%	5%

This can be expressed as

$$PRA = AP * 0.2 * P$$

where

AP is the aggregate postage due to be paid by the customer in the service standard period (less any contractual exclusions), and

- P = 0 if performance meets or is less than 1% below the compensation target  
 = the difference between the compensation target and Royal Mail's performance, calculated to the nearest 0.1%, if Royal Mail's performance is at least 1% and no more than 5% below the compensation target  
 = 5% if performance is over 5% below compensation target

## Enforcement and Fines

The potential impact of fines is far greater than the level of automatic penalties proposed by either Royal Mail or Postcomm. Royal Mail needs a high degree of regulatory certainty during the price control and expects both the levels of performance below which enforcement and fines are considered, and the period for which these are fixed, to be incorporated explicitly into its Licence, so that they cannot be changed without its consent.

Royal Mail believes that the treatment of reasonable endeavours must be proportionate as attainment of the standards is not mechanistic but dependent on many conditions, some of which are within, and some outside, Royal Mail's control. Royal Mail's failure to meet a required standard is a matter over which it is necessary for a regulator to exercise discretion. The use of 'all reasonable endeavours' as currently drafted in Royal Mail's Licence allows Postcomm to take into account any factors that may have affected the service, and

<sup>3</sup> Assumes proper measurement in place, otherwise a proxy will continue to be used.

for Royal Mail to challenge Postcomm if it feels that discretion had not been properly exercised.

Royal Mail therefore proposes that enforcement and fines should not be considered for any standard until performance has fallen below the levels set out in table 1.2, which should be incorporated into its Licence. Any fines and enforcement should be subject to reasonable endeavours on the basis currently set out in Royal Mail's Licence. This will allow Royal Mail an appropriate degree of regulatory certainty during the period of the next price control.

## **Retail Compensation**

Royal Mail's loss and damage compensation schemes for ordinary postal items are among the most generous in the world, with payment of up to £30 (100 times the cost of a first class stamp) for a lost or damaged item. Compensation payments for claims of loss or damage are potentially unlimited, particularly as it is difficult to establish for individual claims whether loss or damage has actually occurred or whether it was caused by Royal Mail. It is therefore important for Royal Mail to have as high a level of certainty as possible over the process and maximum amount of compensation that may be paid for such claims during the period of the next price control. Royal Mail proposes that the current arrangements for retail compensation should continue, with compensation for loss and damage determined under Royal Mail's schemes and contracts.

## **Conclusion**

Royal Mail believes quality of service regulation should be limited in scope to only those areas that are not likely to be subject to effective competition and should not be more punitive than in other regulated industries. Therefore Royal Mail believes that the level of automatic exposure for poor performance should be considerably reduced to no more than 15% of core allowed profit, with the emphasis shifted to core USO products and downstream access, and that there should be appropriate incentives for good performance.

Royal Mail believes that the proposals outlined above to cease bulk compensation, to cap C factor penalties at 3.75% and rewards at 3% of stamped revenue, and to pay compensation of up to 1% of downstream access revenues provide a regime that meets these requirements for an assumed profit in the region of £400m pa.

Royal Mail believes further that enforcement and fines should not be considered for any standard until performance has fallen below the levels set out in the proposals, that any fines and enforcement should be subject to reasonable endeavours on the basis currently set out in Royal Mail's Licence, and that the current arrangements for retail compensation should continue, with compensation for loss and damage determined under Royal Mail's schemes and contracts.