



Securing the Universal Postal Service

Safeguard cap for Large Letters and packets

Statement

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Section 1

Summary

- 1.1 On 27 March 2012, we published our decision on the new regulatory framework for the postal market (“the March 2012 statement”).¹ In this document we set out our decision to grant Royal Mail significant pricing freedom to help secure the ongoing provision of the universal postal service. At the heart of our proposals was the imposition of key safeguards, including a safeguard cap to ensure that vulnerable consumers are able to afford a basic universal service.
- 1.2 We decided in the March 2012 statement that the safeguard cap needed to cover all Second Class stamp products up to 2kg. We confirmed the form and level for the cap on the Second Class stamp Letter.² We set this cap at 55p, which represented a 53% increase on the stamp price at the time which was 36p (2011-12 prices). This cap applies for seven years and is subject to indexation at CPI.
- 1.3 We also noted we would consult on the structure, form and level of the safeguard cap for Second Class Large Letters³ and packets up to 2kg. As a result we published a consultation on 27 April 2012 that set out our proposals in this regard for these products (“the April 2012 consultation”).⁴ Designing such a cap is slightly more complex compared to the cap applied to Second Class stamp Letters, as Royal Mail offers Large Letter, packet and Standard Parcel products at a variety of different weights.
- 1.4 We proposed a simple basket approach that would give Royal Mail flexibility to set the structure of individual prices subject to a cap on the maximum overall price increase for users of Second Class stamp Large Letters and packet products up to 2kg.
- 1.5 In considering the level of the cap, we noted that in general consumers buy Large Letter and packet products even less frequently than Letters and have a low weekly spend on these products (when this is averaged across the year). Therefore we proposed that it was appropriate to set the cap at the same price increase as for Letters (53% plus CPI). This would limit the maximum increase over a seven year period to protect consumers from very significant increases in the cost of these products, while giving Royal Mail sufficient flexibility as part of our overall approach to price deregulation.
- 1.6 In this document, we consider responses from stakeholders to our proposals and set out our conclusions. The majority of respondents were concerned about the level of price rises that could occur under our proposals. Consumer Focus and the CWU reiterated their concerns that higher prices could result in these universal services no

¹ Securing the Universal Postal Service – Decision on the new regulatory framework (<http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>).

² “Letters” means any item up to length 240mm, width 165mm, thickness 5mm, and weighing no more than 100g.

³ “Large Letters” means any item larger than a Letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.

⁴ Securing the Universal Postal Service – Safeguard cap for Large Letters and packets (<http://stakeholders.ofcom.org.uk/consultations/postal-service-letters-packets/>).

longer being affordable. However, respondents did not provide any specific evidence that the proposed levels for the safeguard cap were unaffordable.

- 1.7 Royal Mail reiterated its arguments that such a cap on Large Letters and packets was unnecessary. It was also concerned that the cap should be set at a level that enabled it to set prices that respond to market conditions and cover its costs in the growing packets markets. Royal Mail did not in our view demonstrate that the proposed level of the cap would prevent it meeting these objectives.
- 1.8 We have concluded that we will, as proposed, set the level of the safeguard cap at a 53% increase over 2011-12 prices for the seven year duration of the regulatory framework, increasing with CPI inflation.

Section 2

Introduction

- 2.1 This statement sets out our decisions on the form, structure and level of the safeguard cap for Second Class stamp Large Letters and packets. Our decision to extend the safeguard cap to these products was set out in the March 2012 statement on the new regulatory framework. We then consulted in April 2012 on our proposals for the form, structure and level of the safeguard cap and the draft regulatory condition required to implement our proposals. This statement should be read in conjunction with these two documents.
- 2.2 This section describes how the decisions set out in this statement fit in with the wider market context for the postal sector, the legislative framework and the new regulatory framework that we implemented in March 2012. It also sets out the structure of the remainder of the document.

Legal framework

- 2.3 The framework for our assessment of any regulatory safeguards in relation to Royal Mail's pricing of universal postal services is set out in the Postal Services Act 2011 ("the Act") which received Royal Assent on 13 June 2011 and came into force on 1 October 2011.
- 2.4 The framework is set out in Part 3 of the Act and its provisions also give effect to Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008 ("the Directive"), which amends Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services.
- 2.5 This sub-section summarises the key features of the regulatory framework relevant to the decisions set out in this statement.

Duty to secure provision of a universal postal service

- 2.6 Section 29(1) of the Act provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service. Section 29(2) of the Act provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1) of the Act.
- 2.7 Section 29(3) of the Act provides that, in performing our duty under section 29(1), we must have regard to the need for the provision of a universal postal service to be:
- financially sustainable; and
 - efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 2.8 The concept of "financially sustainable" is not exhaustively defined. However, section 29(4) of the Act states that it includes the need for a reasonable commercial rate of return for any universal service provider (USP) on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.

- 2.9 We note in this regard that in a letter dated 15 April 2011 to Ofcom and Postcomm, the Secretary of State set out the government's view that the words "reasonable" and "commercial" in section 29(4) seek simply to ensure clarity that, where Ofcom deems it appropriate, it should take into account private sector international operators in the postal market, their respective levels of efficiency and the different markets they are operating in, as well as regulated commercial companies in other regulated sectors.

General duties

- 2.10 Section 3 of the Communications Act 2003 ("the 2003 Act") provides that it shall be our principal duty, in carrying out our functions, to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
- 2.11 This principal duty applies also to functions carried out by us in relation to postal services. Section 3(6A) of the 2003 Act provides that the duty in section 29(1) of the Act takes priority over our general duties in the 2003 Act in the case of conflict between the two where we are carrying out our functions in relation to postal services.
- 2.12 In performing our general duties, we are also required under section 3(4) of the 2003 Act to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations appear potentially relevant, including:
- the desirability of promoting competition in relevant markets;
 - the desirability of encouraging investment and innovation in relevant markets;
 - the vulnerability of children and of others whose circumstances appear to Ofcom to put them in need of special protection;
 - the needs of persons with disabilities, of the elderly and of those on low incomes;
 - the opinions of consumers in relevant markets and of members of the public generally;
 - the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas; and
 - the extent to which, in the circumstances of the case, the furthering or securing of the matters mentioned in section 3(1) is reasonably practicable.
- 2.13 Section 3(5) of the 2003 Act provides that in performing our duty to further the interests of consumers, we must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.
- 2.14 Pursuant to section 3(3) of the 2003 Act, in performing our general duties, we must have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice.

- 2.15 In this regard, we note Ofcom's general regulatory principles including in particular the following in the present context:
- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
 - seeking the least intrusive regulatory mechanisms to achieve our policy objectives; and
 - consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.
- 2.16 We also note the Secretary of State's letter referred to above, in which he stresses the need for the universal service provider to have commercial flexibility, where appropriate, to react to market dynamics in pricing and product innovation. He also urges Ofcom to reflect that its regulatory decisions retain sufficient flexibility and adjustment mechanisms to allow for rapid change helping to secure the future of the universal postal service, while providing appropriate incentives for Royal Mail to improve its efficiency over time.
- 2.17 Finally, we have an ongoing duty under section 6 of the 2003 Act to keep the carrying out of our functions under review with a view to ensuring that regulation by Ofcom does not involve the imposition of burdens which are unnecessary or the maintenance of burdens which have become unnecessary.
- 2.18 Under the Act, Ofcom can potentially impose different types of condition on different types of postal operator. The price cap that is the subject of the decisions taken in this statement will be implemented as a designated universal service provider (DUSP) condition.

Legal tests

General test for imposing regulatory conditions

- 2.19 Schedule 6 to the Act provides that we may impose a regulatory condition only if we are satisfied that the condition:
- is objectively justifiable;
 - does not discriminate unduly against particular persons or a particular description of persons;
 - is proportionate to what it is intended to achieve; and
 - is transparent in relation to what it is intended to achieve.

Specific tests for imposing DUSP Conditions under section 36 of the Act

- 2.20 A DUSP condition may be imposed on a universal service provider. Royal Mail is the designated universal service provider in the UK (the USP).
- 2.21 A DUSP condition may require the universal service provider to do one or more of the following:

- Provide a universal service or part of a universal service, throughout the UK or in a specified area of the UK, in accordance with the standards set out in the universal postal service order;
 - Provide access points for the purposes of a universal postal service;
 - Provide specified information to postal operators and users about the universal services it is required to provide; and
 - Do anything else that Ofcom considers appropriate for the purposes of or in consequence of any of the above three obligations.
- 2.22 In particular, a DUSP condition may make provision as to tariffs to be used for determining prices in accordance with which a universal postal service, or part of a universal service, is provided (section 36(4) of the Act).
- 2.23 Section 36(5) of the Act provides that, in exercising the power conferred by section 36(4), Ofcom must seek to ensure that the prices are affordable; the prices take account of the costs of providing the service or part of a service; and the prices provide incentives to provide the service or part of a service efficiently.

General impact assessment

- 2.24 The analysis presented in Section 3 represents an impact assessment, as defined in section 7 of the 2003 Act.
- 2.25 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the 2003 Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information, see our guidelines, 'Better policy-making: Ofcom's approach to impact assessment'.
- 2.26 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

Equality impact assessment

- 2.27 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:
- eliminate unlawful discrimination, harassment and victimisation;
 - advance equality of opportunity between different groups; and
 - foster good relations between different groups,

in relation to the following protected characteristics: age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation.

- 2.28 Such equality impact assessments (EIAs) also assist us in making sure that we are meeting our principal duty under section 3 of the 2003 Act discussed above.
- 2.29 We have considered what (if any) impact the decisions in this statement may have on equality. We do not consider the impact of the decisions in this statement to be to the detriment of any group within society. In particular we have addressed in Section 3 below the specific issue of how the safeguards proposed will take into consideration the needs of vulnerable consumers.
- 2.30 We have therefore not carried out separate EIAs in relation to race or gender equality, or equality schemes under the Northern Ireland and Disability Equality Schemes.

Market context

- 2.31 The postal sector is essential to the UK economy and society. In 2011-12, 15 billion items⁵ were delivered to more than 29 million addresses and Royal Mail was responsible for delivering over 99% of these.⁶ Nearly all businesses in the UK use post for activities such as sending and receiving goods and communicating with their customers. Residential consumers receive significantly more mail than they send and the average weekly expenditure on post is low. However, residential consumers continue to place significant value on a functioning and high quality postal service.
- 2.32 The universal service obligation is central to the role that post plays in society. This requires Royal Mail to collect and deliver letters six days a week to all addresses in the UK.⁷ It also requires that universal service prices be affordable and uniform throughout the UK.
- 2.33 However, the postal sector faces some difficult challenges. In recent years there have been significant decreases in mail volumes due in part to electronic substitution, with overall market volumes shrinking by over 25% since 2006. In addition, there have been changes in product mix with many customers switching to lower cost alternatives, further reducing Royal Mail's revenue. Royal Mail has not been able to reduce its costs sufficiently to compensate for the fall in revenue, which has resulted in higher average unit costs. This has resulted in the viability of the universal service being under threat.
- 2.34 Royal Mail's current financial position is not strong. Since overall market volumes started to decline (around 2006), it has accumulated unpredicted and sustained losses. However, due to significant price increases in 2011-12, Royal Mail's financial results have shown some signs of improvement. While it achieved positive cash flow for the first time in four years, according to Royal Mail's annual report and financial statements for 2011-12 its operating margin after modernisation costs was only 0.3%.⁸
- 2.35 Furthermore, it is likely that the universal service will continue to be at risk as the underlying challenges remain. For the foreseeable future market volumes are

⁵ Inland addressed volumes – Royal Mail's 2011-12 annual report and financial statements (http://www.royalmailgroup.com/sites/default/files/Annual_Report_2012.pdf)

⁶ Royal Mail's 2010-11 annual report.

⁷ It is required to deliver packets five days per week.

⁸ Based on an operating profit after modernisation costs of £23 million (before other operating exceptional items).

expected to continue to decline due to electronic substitution. There is also significant uncertainty over the future rate of decline and in particular, the volume impact of price increases. Unless Royal Mail can deliver sufficient efficiency gains to compensate for the reduction in its revenue, it will have to rely on increasing prices. This would be likely to further reduce volumes which will put additional upward pressure on unit costs and prices.

- 2.36 These challenges were set out in the two reports undertaken on behalf of the Government by Richard Hooper.⁹ These argued that the status quo was not tenable and recommended that Royal Mail needed to be opened to private investment; that the pension deficit needed to be moved to the Treasury; and that responsibility for regulating post should be transferred to Ofcom.

New regulatory framework

- 2.37 As noted above Ofcom gained responsibility for regulating the postal industry in October 2011. Shortly after this, on 20 October 2011, we published a consultation document on the future framework for economic regulation (“the October 2011 consultation”).¹⁰ This document set out our view that a price control based approach to regulation would not be likely to provide sufficient efficiency incentives or protect consumers from continued price increases given the current market and the financial context for Royal Mail. We therefore proposed to give Royal Mail more commercial flexibility so that it could respond to the significant challenges facing the business.
- 2.38 However, we also recognised the risks associated with giving Royal Mail pricing freedom. In particular, we were concerned that Royal Mail would improve its profitability through price rises alone and not tackle the considerable efficiency challenge. There was also a related risk that Royal Mail raises prices to such an extent that there could be affordability concerns for vulnerable consumers.
- 2.39 These risks are significant and we therefore considered that commercial freedom could not be provided without ensuring there were key safeguards in place to manage the risk. These safeguards included:
- effective monitoring of performance, including the scope for re-regulation if the incentives to deliver greater efficiency are demonstrably failing;
 - a safeguard cap, intended to ensure that a basic universal service is available and affordable to all; and
 - the discipline of competition and innovation.
- 2.40 We received 72 responses to the October 2011 consultation and after considering all of the evidence (including that provided by respondents), the March 2012 statement set out our decision to move away from a price control based approach and give Royal Mail commercial freedom to set the majority of its prices. Alongside this we

⁹ R, Hooper (2008): Modernise or decline (<http://www.bis.gov.uk/files/file49389.pdf>) and R. Hooper (2010): Saving the Royal Mail’s universal postal service in the digital age (<http://www.bis.gov.uk/assets/biscore/business-sectors/docs/s/10-1143-saving-royal-mail-universal-postal-service>).

¹⁰ Securing the Universal Postal Service (<http://stakeholders.ofcom.org.uk/consultations/securing-the-postal-service/>).

also decided to implement the safeguards proposed in the October 2011 consultation with some changes to the detail of how some of them would be implemented – in particular to the safeguard cap.

- 2.41 The October 2011 consultation set out our detailed proposals for how we would implement these proposals. With respect to the safeguard cap (the subject of this statement) we considered a number of options for the scope of the cap. These were:
- First Class stamps (all weights);
 - Second Class stamps (all weights);
 - Second Class stamps for Letters only; and
 - both First and Second Class stamps (all weights)
- 2.42 We considered that a cap on First Class stamps or both First and Second Class stamps would be likely to directly and indirectly constrain a significant proportion of Royal Mail's revenues and that this did not meet our objective of minimising the effect of the safeguard cap on Royal Mail's pricing freedom. We therefore considered that the safeguard cap should be limited to Second Class stamp products and proposed a range of 45p to 55p for Second Class stamp Letters. We invited evidence on both the affordability of prices within this range as well as of the use of, and reliance on, Royal Mail for Large Letter and packet and parcel products.
- 2.43 While we were provided with some evidence of the impact of price rises on customers, no parties provided us with evidence that indicated that there would be specific affordability issues at any particular level within our proposed range. Given this, and recognising the benefits of giving Royal Mail pricing flexibility in the current circumstances, in the March 2012 statement we set the safeguard cap for Second Class stamp Letters at 55p, increased by CPI for the duration of the regulatory period.
- 2.44 Based on evidence provided by stakeholders and our own survey evidence on the usage of Large Letters and packets, we also concluded in the March 2012 statement that the prices for these formats were likely to be important factors in determining whether there is an affordable basic universal service product available to all consumers.
- 2.45 We therefore decided in the March 2012 statement that it would be appropriate to extend the scope of the safeguard cap to Second Class stamp Large Letters and packets up to 2kg. In determining the appropriate scope of the safeguard cap for packets, we considered various options, but concluded, for reasons further explained in Section 3 below, that the safeguard cap should only be imposed in relation to packets up to 2kg.

April 2012 consultation

- 2.46 The April 2012 consultation set out our proposals in relation to the form, structure and level of the safeguard cap for Second Class stamp Large Letters and packets. Specifically we proposed that:

- A basket should be used to administer the cap on Second Class stamp Large Letters and packets with no additional regulation restricting Royal Mail's commercial pricing (such as sub-caps on individual prices); and
- The level of the basket should be set at up to an increase of 53% relative to 2011-12 prices (an additional 34% on current prices), and then increase by CPI over a seven year period.

- 2.47 We received seven responses to the April 2012 consultation from Royal Mail, Consumer Focus, the Communication Workers Union (CWU) and four individuals or small businesses. We have responded to these concerns in Section 3 below. In addition, Consumer Focus submitted further views to Ofcom after the deadline for responses had passed (and after the publication of the responses to consultation in July 2012). This supplementary response repeated a number of points that it had already made and raised a number of concerns regarding Royal Mail's response, all of which we have addressed in this statement.
- 2.48 In general, respondents supported the imposition of a cap for these products (aside from Royal Mail who considered that Ofcom had not proven there is a need for a cap on these products). However, many respondents were concerned about the level of the cap and whether or not prices would remain affordable. On the other hand, Royal Mail was concerned about the extent of the restriction on its pricing freedom in this growing market. The CWU considered that as packets are the principal growth area in the postal market, the *"regulatory decisions on the pricing of Large Letters and packets have the potential to significantly affect Royal Mail, its customers and the postal sector as a whole."*¹¹
- 2.49 These responses are summarised in detail in relation to the individual areas of concern in Section 3.

Outline of the rest of the document

- 2.50 Section 3 sets out the responses to consultation, our analysis of the additional evidence received and our decision in relation to the key issues consulted on. It also sets out our assessment of the statutory tests for imposing regulatory conditions. The new regulatory condition that relates to the safeguard cap for Second Class stamp Large Letters and packets up to 2kg is contained in Annex 1.

¹¹ CWU submission to Ofcom consultation: Safeguard cap for Large Letters and packets, June 2012 – paragraph 7 (http://stakeholders.ofcom.org.uk/binaries/consultations/postal-service-letters-packets/responses/Communication_Workers_Union.pdf)

Section 3

Safeguard cap – Large Letters and packets up to 2kg

Introduction

- 3.1 This section discusses our decision, set out in the March 2012 statement, to include Second Class stamp Large Letters and packets in the safeguard cap and our April 2012 consultation on the structure, form and level of such a cap. It also summarises the responses received to this consultation and sets out our assessment of the evidence and our decisions in relation to these aspects of the cap. In addition, it sets out our assessment of the statutory tests for imposing such a condition.

Scope of the cap

Summary of March 2012 decision

- 3.2 In the March 2012 statement we set out our decision to extend the safeguard cap for vulnerable consumers to Second Class stamp Large Letters and packets up to 2kg. This decision was on the basis that while Letters make up the significant majority of postal items sent by consumers, Large Letters and packets account for around half of total household postal expenditure. We therefore concluded that the prices for Large Letter and packet formats were likely to be important factors in determining whether there is an affordable basic universal service product available to all consumers. In addition, we took into account evidence that consumers lacked sufficient competitive alternatives for these products. By contrast, we considered that there was no need for a safeguard cap above 2kg as consumers' use of parcels over this level was low and there are a greater number of competitive alternatives to Royal Mail.
- 3.3 We also assessed the impact of the extension to the safeguard cap on Royal Mail's pricing freedom to ensure that it would not compromise the objectives of the new regulatory framework. We concluded that it would not have a material impact on Royal Mail's flexibility as it would still only apply to a small proportion of its revenues and would not materially constrain the prices of other Second Class Large Letter and packet products or comparable First Class products.

Responses to consultation

- 3.4 Royal Mail and the CWU commented on our decision to extend the safeguard cap to Second Class stamp Large Letters and packets. Royal Mail reiterated its position that a safeguard cap was not required and expressed concern about the extent of restriction on its commercial freedom particularly for the fast growing packet segment. It argued that this market segment is characterised by low returns for all operators and that other operators have called for prices to increase to underpin the financial sustainability of the sector. Royal Mail considered Ofcom had not provided clear evidence to support extending the cap. In particular, it argued that adequate safeguards already existed in this market segment that protect vulnerable groups including that:

- The universal service obligation already requires that Royal Mail's prices are affordable, fair and reasonable, and geographically uniform;
 - Competition in the consumer and micro SME section of the market is increasing and there is growing consumer awareness of alternatives to Royal Mail (constraining its pricing freedom); and
 - There is no evidence to support concerns on affordability (it noted that the majority of customers who use these products only send four items per annum).
- 3.5 The CWU supported the extension of the price cap to Second Class stamp Large Letters and packets up to 2kg. However, it stated that, in order to guard against increased prices driving away demand and to ensure affordability for all users, all universal service prices should be price controlled (particularly to protect vulnerable consumers and small businesses). It considered that it is important to put in place appropriate monitoring and control mechanisms for all universal service products to ensure they remain affordable. In addition, the CWU was concerned that excluding packets above 2kg could lead to those without access to competitors (such as rural consumers) having to pay a punitive premium for heavier weight packet and parcel products.
- 3.6 Consumer Focus supported the extension of the safeguard cap. Its research showed that vulnerable low-internet-use consumers have similar price inelasticity for Large Letters and packets and parcels up to 2kg as they do for Letters.

Our assessment

- 3.7 Our decision not to impose a price control on the significant majority of Royal Mail's universal service and access products is a fundamental aspect of the new regulatory framework. We have not reprised the arguments against imposing a more comprehensive price control here but they are set out in detail in the October 2011 consultation and March 2012 statement.
- 3.8 It is important to note that the absence of a price control does not lessen our obligation set out in the Act and the Directive to ensure that universal service prices remain affordable. We consider we can address the risk that further price increases will result in some universal services becoming unaffordable through our work on affordability and the monitoring regime.
- 3.9 As discussed in the April 2012 consultation, we consider that if there are competitive options for universal service customers in much of the country, then, when combined with the uniform pricing requirement for universal services, this should have a positive impact on Royal Mail's pricing for all consumers of these services. Specifically, the constraint of the uniform price obligation should benefit even those for whom these competitive alternatives are not available or practical. Therefore, we consider that not imposing a safeguard cap for packet and parcel products above 2kg will not lead to consumers being disadvantaged on the basis of their location. We therefore disagree with the CWU's concerns about the impact of excluding packets above 2kg from the scope of the safeguard cap.
- 3.10 Royal Mail reiterated many of the arguments that it made in response to the October 2011 consultation on why it did not consider the safeguard cap should be extended to Large Letters and packets. As set out in the March 2012 statement, once traditional price controls have been removed, we consider it is important to have key

safeguards in place. The safeguard cap is one such safeguard and is in our view necessary to protect vulnerable consumers and ensure a basic universal service is available for all, given the lack of alternatives for universal service customers. We also recognised in March that while the Act and the Directive require universal services to be affordable this is a difficult concept to prove (or disprove). This is further discussed in the section on the level of the safeguard cap below.

- 3.11 In addition, the March 2012 statement set out our analysis of the level of competition in the market. This showed that while there are some packet and parcel operators that offer products to consumers and small businesses that are competitively priced relative to Royal Mail, the evidence suggests that awareness and/or use of these competitive options is currently relatively low. Royal Mail did not provide any additional evidence to challenge this view.
- 3.12 However, Royal Mail has raised a new argument about the level of returns for all operators in the UK parcels markets. From Royal Mail's perspective this includes packet and parcel products targeted at consumers and small businesses (such as the universal service products) and bulk mail products for larger businesses that send higher volumes. While we do not have any evidence that other operators have called for price increases in this sector of the market (as asserted by Royal Mail), we have considered the impact of the safeguard cap on the returns that operators are able to obtain in the wider market segment.
- 3.13 While the impact of the safeguard cap will be a function of the level of the cap (which is discussed further below), we considered in the March 2012 statement whether a cap on Second Class stamp Large Letters and packets (up to 2kg) would materially constrain Royal Mail's pricing for other products. Our analysis showed a significant price differential between Royal Mail's stamp products and all other comparable product categories. For example, bulk Large Letters and untracked packets were both priced at a significant discount to the relevant stamp products.¹²
- 3.14 In addition, we considered that bulk tracked products and express products were not direct substitutes for the stamp products and as such they would not be materially (if at all) constrained by any cap on stamps. We therefore concluded that a cap on the stamp products would not constrain, to any material extent, Royal Mail's pricing flexibility on other single piece or bulk Large Letter and packet products. Royal Mail did not challenge this analysis.
- 3.15 Furthermore, these business prices are no longer directly constrained by regulation and Royal Mail now has the commercial freedom to seek to increase prices in this part of the market if it is commercially feasible to do so. In addition, as discussed further below, we have taken into account the low returns for these products in setting the level of the cap.
- 3.16 Therefore, we continue to believe it is appropriate that Second Class stamp Large Letter and packet products (up to 2kg) be included within the safeguard cap.

¹² This analysis was based on 2011-12 prices. We have reviewed this analysis in relation to the 2012 prices and while the discount from Second Class stamp packets to bulk untracked packets has decreased, we remain of the view that a cap of the level proposed will not materially constrain Royal Mail's prices for other Large Letter and packet products.

Structure and form of the cap

Our proposals

3.17 In April 2012 we proposed that:

- The Second Class stamp Large Letter and packet (up to 2kg) products should be included in a basket that is subject to a cap based on the weighted average increase of the basket and that Royal Mail should have commercial freedom to determine the prices of individual products within this basket;
- The overall level of the basket cap should be set at a maximum increase relative to 2011-12 prices for the seven year period of the regulatory framework (consistent with the approach used for determining the level of the cap on Second Class stamp Letters); and
- Consistent with our decision on the form of the safeguard cap for Second Class stamp Letters, the level of the basket cap should be index linked to CPI.

Responses to consultation

3.18 Respondents raised concerns about the proposal to use a basket for all of the relevant Large Letter and packet weight steps and the proposed approach to weighting the basket. Royal Mail was also concerned about the process for including new products within the basket. No respondent commented on the proposal to index the level of the basket to CPI.

Use of a basket

3.19 Consumer Focus and the CWU were concerned about the flexibility within the basket for Royal Mail to change the relative prices of the individual products. Consumer Focus considered that this provided far less certainty on the future prices for individual products (particularly compared to the cap for Letters which is a price point cap). It was particularly concerned that this would result in universal service prices becoming unaffordable for individual customers who have atypical posting profiles and considered this might particularly be an issue for some small businesses.

3.20 The CWU agreed that pricing for some of the products within the basket might not currently be at optimum levels and as a result there might be efficiency advantages in allowing Royal Mail the flexibility to rebalance prices within the basket. However, it was also concerned about Royal Mail implementing targeted price increases that were detrimental to consumers and considered that Ofcom should retain the capacity to monitor the market and protect against this possibility.

3.21 Royal Mail considered there is a growing customer awareness of potential alternatives to Royal Mail and customer preferences and requirements from the delivery experience are also changing rapidly. It therefore argued it is essential that it has pricing flexibility to rebalance its prices so that:

- a) Prices can more accurately reflect the costs of handling packets;

- b) It can “*earn a reasonable rate of commercial return on necessary investment*”;¹³ and
- c) It can respond quickly to its customers’ needs.

Royal Mail therefore agreed with the proposal not to impose any additional constraints on individual pricing within the basket.

- 3.22 In addition, Royal Mail noted that there was a need for a quick, efficient and transparent process to amend the structure and level of the cap if it introduced “*new products into this market segment which Ofcom feels must be included within the price control.*”¹⁴

Data used to weight the basket

- 3.23 Royal Mail agreed with our proposal to use actual rather than forecast volumes as a weighting factor for the prices within the basket. However, it considered that the use of October to September volumes (i.e. the most recent data that would be available when it has historically set prices) would require new processes and additional administration costs to review and agree the volumes used. It noted that stamp volumes, alongside all other volume information, are audited to an annual timetable following the end of the financial year. It therefore recommended using the audited year end volume figures for the price cap formula (April to March of the previous year).
- 3.24 Consumer Focus expressed a concern about the accuracy of Royal Mail’s volume data. It considered that if volumes were not accurate this could reduce the effectiveness of the basket. Consumer Focus believed that Ofcom should provide reassurance (potentially in its annual report or the market update) on how Royal Mail’s pricing decisions were affecting demand, and therefore the volume, for the products within the basket.

Our assessment

Use of a basket

- 3.25 We considered in the April 2012 consultation that a single basket would be sufficient to protect consumers and that no further constraints on individual prices would be required. This proposal would allow Royal Mail to increase prices for some products within the basket by more than others, and indeed that individual price increases could potentially be higher than the total increase allowed across the basket of products under the price cap formula (proposed to be up to 53%).
- 3.26 While we appreciate that this might reduce certainty for customers of future prices for individual products, it is important to balance this against the need to provide sufficient pricing flexibility to Royal Mail so that it can respond quickly to customers’ needs and market changes. We consider that Royal Mail would only have the incentive to change its pricing structure if this would be likely to increase its overall revenues and/or profits for these products. For example, our proposals would allow

¹³ Royal Mail’s Response to Ofcom’s consultation on ‘Securing the Universal Service: Safeguard cap for large letters and packets’, June 2012 – paragraph 9.

¹⁴ Royal Mail’s Response to Ofcom’s consultation on ‘Securing the Universal Service: Safeguard cap for large letters and packets’, June 2012 – paragraph 13.

Royal Mail to further simplify its pricing, as it has recently done for lower weight packets, if that is likely to increase its overall revenue or profits from these products.

- 3.27 In addition, we recognise the risk that individual customers whose sending patterns differ significantly from the average could face greater price rises. However, we consider that the monitoring regime should identify if any universal services become unaffordable over time (see discussion on affordability below) and this would likely lead to a review of the level of the safeguard cap.
- 3.28 Therefore, on balance we do not consider that the potential impact of lower certainty of future prices, or the risk that certain universal services become unaffordable for individual consumers (given the monitoring regime we have in place), is sufficient to outweigh the need to give Royal Mail greater commercial flexibility. This will allow it to better meet the needs of its customers more generally and to increase the use of mail (or at least slow volume decline), which will help support the sustainability of the universal service.
- 3.29 We also note Royal Mail's concern about the need for a simple process to include new products in the basket and rebalance the level to reflect the relative price and volumes of the new service. However, given the basket is limited to a small subset of Royal Mail's universal service products (Second Class stamps only), we consider the scope for such changes is likely to be small. It is therefore not practical or necessary to build a process to include new products in the basket into the condition. If this becomes necessary due to Royal Mail's commercial strategy we would undertake a short review to determine if the scope of the control should be changed.

Data used to weight the basket

- 3.30 Both Consumer Focus and Royal Mail expressed concerns about the transparency and accuracy of the data used to weight prices within the basket. Royal Mail proposed that we should change to using an annual measure of volumes based on its financial year (April to March), as it would be able to use audited volume data to weight the basket.
- 3.31 Since Royal Mail is required to determine and announce its prices prior to the start of the financial year, this will therefore be based on actual data for the year prior to the calculation of the prices, i.e. two years before the prices are implemented. For example, 2013-14 prices which are likely to be announced early in 2013 will be based on actual volume data for the year to March 2012 (as these will be the most recent audited volumes).
- 3.32 We agree that using audited volume data to produce an annual measure of volumes based on Royal Mail's financial year (April to March) would be a practical approach and also consider it would help meet Consumer Focus' concerns around transparency. We have therefore made a change to the formula in the condition to use April to March actual volumes to weight the prices within the basket.

Form of the control

- 3.33 No respondent queried our proposal for a seven year control linked to CPI in all years after 2012-13. We have therefore concluded that this approach remains appropriate.

Our decision

3.34 We have therefore made the following decisions in respect of the structure and form of the safeguard cap for Second Class stamp Large Letters and packets:

- To include the Second Class stamp Large Letter and packet weight steps in a single basket;
- To set the overall level of the basket cap based on a weighted average increase relative to 2011-12 prices for the seven year period of the regulatory framework;
- To calculate the weighted average price of the basket using April to March audited actual volumes for the year prior to the calculation of prices; and
- To increase the level of the cap by CPI each year.

Level of the safeguard cap

Our proposals

3.35 In the April 2012 consultation, we considered that many of the same issues that were taken into account in setting the level of the cap for Second Class stamp Letters were also relevant in determining the level of the safeguard cap for Large Letters and packets (up to 2kg). We proposed that the level of the safeguard cap should be set at up to a 53% increase on 2011-2012 prices¹⁵ for the seven year period of the control as:

- Within such a cap, the proposed prices for Large Letters and packets up to 2kg would be likely to remain affordable for vulnerable consumers;
- This would be likely to offer sufficient pricing flexibility for these products over the period of control not to unduly restrict Royal Mail's pricing freedom; and
- Royal Mail would retain significant pricing flexibility for other Second Class Large Letter and packet and the equivalent First Class stamp products.

Responses to consultation

3.36 Consumer Focus, the CWU and the majority of individual and small business respondents were concerned about the impact of the proposed price increases (particularly with respect to affordability). On the other hand, Royal Mail considered that the level of the safeguard cap must, as a minimum, be equal to the Second Class Letter cap. No respondent put forward another proposal for the potential level of the cap.

Affordability

3.37 Consumer Focus and the CWU were concerned about the products within the basket remaining affordable for vulnerable consumers. Consumer Focus noted that affordability was a complex issue for both residential and small business customers and it was therefore important that the impact of price rises is closely monitored

¹⁵ This equates to a 34% increase on current prices.

(particularly given the significant latitude for increasing individual prices within the basket). It also considered that the indirect impact of postal price increases, due to businesses passing increased postal costs onto consumers, should be considered when determining if the current level of prices are affordable.

- 3.38 However, Consumer Focus noted that without access to Royal Mail's confidential volume data, it was unable to propose a more appropriate lower level for the basket cap and considered that Ofcom should review the data to ensure it is confident that the cap is set at an affordable level.
- 3.39 The CWU considered that Ofcom's methodology for assessing affordability was not sufficiently rigorous, and there was a need to establish the principles on which affordability would be measured. It was concerned that our proposed price increases would risk making the universal services unaffordable for some users and our treatment of affordability could be interpreted as failing to comply with the requirements of European and UK law.

Impact on profitability

- 3.40 Royal Mail considered that to ensure a financially sustainable universal service it needed sufficient flexibility to earn a commercial rate of return over its whole portfolio of products, to respond to market demand conditions and to cover the costs of handling such products. Royal Mail therefore considered that as a minimum the level of the safeguard cap for Second Class stamp Large Letters and packets (up to 2kg) must be equal to the cap put in place for Letters.

Other Issues raised by respondents

- 3.41 Consumer Focus believed that the proposed level of the cap was too high and was concerned that Ofcom's rationale behind its proposal to allow the same level of increase for the Large Letters and packets cap as that used to determine the level of the existing safeguard cap for Second Class stamp Letters was flawed. It considered that as there were significant differences in the external constraints on Royal Mail's pricing behaviour it was not appropriate to allow the same increase as that allowed for Letters. It cited the constraint imposed by higher electronic substitutes for the Letter format and contrasted that with the minimal physical alternatives to Royal Mail's Large Letter and packet products and (as noted by Ofcom) the fact that competing options for the products within the basket were very limited.¹⁶ Consumer Focus therefore believed that the level of the Large Letters and packets cap should be reconsidered by Ofcom.
- 3.42 Consumer Focus was also concerned about the negative impact that a cap of the level proposed would have on Royal Mail's efficiency incentives in the growing packets sector. It noted that Ofcom considered access competition was an important driver for Royal Mail to reduce its cost base and to become more responsive to its customers' demands. Consumer Focus therefore reiterated its view that we should review our decision to remove mandated access for packets as "*they constitute a significant and growing part of the access market*"¹⁷ and there was a hypothetical possibility Royal Mail would effectively foreclose this part of the market to

¹⁶ Consumer Focus agreed with Ofcom's view set out in the March 2012 statement that there is limited consumer awareness of alternative operators for Royal Mail's packet and parcel services.

¹⁷ Consumer Focus response to Ofcom's consultation on the safeguard cap for large letters and packets, June 2012 – page 8.

competition. It urged Ofcom to closely monitor Royal Mail to ensure the basket cap does not reduce its efficiency incentives and asked for clarity on how the requirement to have regard to the universal service becoming efficient was met.

- 3.43 In addition, Consumer Focus asked for clarification on whether or not the proposed 53% increase for the basket would constitute a reasonable commercial rate of return. It noted that it is difficult to justify price increases of the scale proposed without a clear understanding of the efficient cost of providing the products and considered that Ofcom should pursue greater cost transparency.
- 3.44 Royal Mail also looked at international price comparisons to determine whether its current pricing levels for Second Class stamp Large Letters and packets and parcels are out of line with other postal operators. It provided some price comparisons for particular Large Letter and packet weight steps across a wide range of European countries (including many countries that do not offer a Second Class service). These comparisons showed that Royal Mail's Second Class services were currently in the middle to low end of prices and a 34% increase on 2012-13¹⁸ prices tended to put around the upper quartile (given current prices for other European operators). Consumer Focus urged caution in the assessment of the affordability of stamps in comparison to other countries, due to the inherent difficulties of international comparisons.
- 3.45 In general, the individual and small business respondents were unhappy at the proposed level of further price increases, but they did not indicate what level of price increase they considered would be appropriate. One respondent commented that it was inappropriate to set the cap so far in advance and that the level of the cap should be set on an annual basis.

Our assessment

- 3.46 It is important to note that no respondent put forward an alternative proposal for the level of the safeguard cap for Second Class stamp Large Letters and packets up to 2kg. Royal Mail noted that returns for these products overall are low (as discussed in the section on the scope of the cap above) and that it was essential that the level of the cap be set at a minimum of the equivalent increase for the Letters product. It did not propose a different level for the cap or provide any evidence to support a cap at a higher level than that proposed, notwithstanding that it did not support any cap being applied. In addition, while Consumer Focus, the CWU and the majority of individual and small business respondents were concerned about the impact of the proposed price increase (particularly with respect to affordability), they also did not put forward any alternative potential options for the level of the cap.
- 3.47 We have considered the specific issues raised by respondents in the relevant sections below.

Affordability

- 3.48 We acknowledged the difficulties in measuring consumer affordability for a relatively low cost and infrequently used service such as post in the October 2011 consultation and March 2012 statement. However, on the basis of the evidence available

¹⁸ Ofcom proposed up to a 53% average increase in prices across the basket based on 2011-12 prices. Given Royal Mail's 2012 price increases this equates to a further 34% increase on current prices for the period of the regulatory framework (index linked to CPI).

(including the responses to the consultation) we concluded that the safeguard cap would ensure that Second Class stamp Letters would remain affordable over time by setting the cap at 55p plus CPI for seven years. The challenge of assessing affordability for larger formats is even more difficult as consumers use these much less frequently than Letters and prices vary by size and weight. However, given the relatively low spend on Large Letters and packets overall and their infrequent use by consumers, we considered that a similar increase of up to 53% on 2011-12 prices, as allowed for the Letters product, would likely be affordable for vulnerable customers. We therefore proposed to set the level of the cap on the basis of not allowing greater price increases for the larger formats than that allowed for Letters.

- 3.49 While Consumer Focus, the CWU and some individuals raised affordability as a concern, no respondent provided any evidence to show that price rises up to the 53% proposed would result in prices ceasing to be affordable. Therefore, on the basis of the evidence available, we have concluded that prices for Second Class stamps for Large Letters and packets up to 2kg are likely to remain affordable for vulnerable consumers if capped as proposed.
- 3.50 We will continue to monitor and assess affordability in postal services in two ways. First, as described in the March 2012 statement, as part of the monitoring regime, we will review price and non-price changes for universal services over time (including the impact this has on volumes), with particular regard to affordability and the costs of provision. Second, earlier this year we launched a new project which will commission detailed research and analysis to help further understand the role of affordability on consumer behaviour in relation to the use of postal services and to consider how we might assess the affordability of universal postal services on an ongoing basis (including the extent to which we will consider indirect as well as direct postal costs). We intend to publish our findings early next year.
- 3.51 This work will be used to inform our view of the affordability of all universal services, including those within the safeguard cap.

Impact on profitability

- 3.52 As discussed in the section on the scope of the cap, we note Royal Mail's argument that the Second Class Large Letter and packet segment of the market is characterised by low returns for all players. However, as discussed, we do not consider that a cap on Second Class stamp Large Letters and packets up to 2kg will materially constrain Royal Mail's prices for its relevant business mail products. We also consider that the flexibility allowed within the proposed maximum cap of 53% is sufficient to ensure that Royal Mail can earn a reasonable commercial rate of return on Second Class stamp Large Letters and packets. Royal Mail has not suggested that it would need any further pricing flexibility than the maximum level proposed within the consultation.

Other issues raised by respondents

- 3.53 We note Consumer Focus' argument that there are greater constraints on Royal Mail's pricing for Letters in comparison to Large Letters and packets due to electronic substitution. However, this view is not supported by Royal Mail's recent pricing behaviour. For example, while Royal Mail has increased the price of Second Class stamp Letters by 39% in 2012-13, the corresponding Large Letter and packet increase was only 14% overall (although there were significantly higher increases for individual products as it changed its pricing structure for lower weight packets). While

there is greater electronic substitution for Letters, there is no evidence that this immediately translates into Royal Mail's commercial decisions.

- 3.54 We also note the concern expressed by Consumer Focus about the lack of efficiency incentives inherent in the safeguard cap if the level was to be set at 53%, particularly for the growing packets segment. The main justification for putting the safeguard cap in place is to ensure that a basic universal service product is available to all. While efficiency incentives are important to ensure the future provision of the universal service, we considered in the October 2011 consultation and March 2012 statement that Royal Mail has inherent efficiency incentives in any event. Second Class stamp packets account for a small proportion of Royal Mail's Second Class packet products. As the significant majority of the costs of handling packets are common to all these products, the cap is not likely to have a material impact on Royal Mail's overall efficiency incentives.
- 3.55 We also note Consumer Focus' reference to the lack of mandated access for packets and the hypothetical possibility that Royal Mail might effectively foreclose this part of the market to competition. However, as explained more fully in our March statement, we decided not to impose a USP access condition requiring Royal Mail to provide packet access services because we had not received sufficient information to demonstrate that the criteria for imposing such a condition were met. Furthermore, we recognised that Royal Mail currently offers an access packets service, albeit one for which take up is currently low, and were not persuaded of the need to consider mandating access at that stage. However, if Royal Mail were to stop providing an access packet service or if demand for such a service increased, we might need to reconsider the evidence available at the time and whether it was appropriate to impose a USP access condition.
- 3.56 Consumer Focus was also concerned about whether the proposed 53% increase in the level of the cap over the seven year period of the control would constitute a reasonable commercial rate of return on these products. However, as set out in the March 2012 statement, we consider it is important to take into account all the products that use the universal service network when determining whether it is earning a reasonable commercial rate of return. We therefore do not consider that it is appropriate to assess whether a small sub-set of products achieves a commercial rate of return. Royal Mail has recently announced its 2011-12 results which show that it is making a small profit on the universal service network (approximately 0.3%).
- 3.57 We agree with the concerns raised by Consumer Focus about the difficulties in comparing prices between countries. This is particularly true for Large Letter and packet formats as there are significant differences in the way that universal service providers have structured their prices. We only intended to use international comparisons as a check that our proposed level of the cap would not result in prices that are significantly out of line with other international operators. We are confident that this would not be the case for these products overall for the seven year period of the control, if the level of the cap was set at 53%.

Summary of our views

- 3.58 We note the point made by Consumer Focus that no other respondent (apart from Royal Mail) has access to Royal Mail's confidential volume and cost information and that this may have restricted their ability to propose alternative options for the level of the cap. However, the key objective in setting the level of the cap is ensuring that prices remain affordable for vulnerable consumers. We therefore consider that

respondents could have provided alternative proposals for the level of the cap if this was justified by evidence that the proposed level of the basket would be unaffordable.

- 3.59 Given that we do not consider that the level of the cap we proposed will give rise to affordability concerns, we consider it is appropriate to give more weight to our key objective for the regulatory framework to allow Royal Mail greater commercial flexibility so that it can ensure the universal service becomes financially sustainable.
- 3.60 Respondents' concerns about the level of the basket cap highlight how important the monitoring regime, including our research into affordability, will be in mitigating the significant risks associated with the removal of price controls. These risks include universal service products becoming unaffordable and a lack of efficiency improvements, or accelerated volume decline in response to significant price increases, that threaten the financial sustainability of the universal service.

Our decision

- 3.61 After careful consideration of the evidence available, and in particular the responses to the consultation, we have decided to set the level of the basket cap for Large Letters and packets up to 2kg at a 53% increase to the 2011-12 prices. This equates to a potential further 34% increase on current prices over the seven year period of the regulatory framework.

Review of the cap

Our proposal

- 3.62 Consistent with our approach to the review of the safeguard cap for Second Class stamp Letters, we noted that we might review the level of the cap in two to three years' time if there was further evidence on affordability or changes in Royal Mail's costs or the market.

Responses to consultation

- 3.63 Royal Mail considered that Ofcom should commit to a formal public review of the safeguard cap within two years, i.e. to conclude by March 2014. It believed that this was necessary as this segment of the packets market is evolving rapidly, with respect to customer preferences and increasing competition.

Our assessment

- 3.64 We set out in the April 2012 consultation that we might review the level of the cap in two to three years' if there was further evidence on affordability or concerns about Royal Mail's ability to finance the universal service. We did not intend this to be a formal public review of the continuing need for a cap, but if the evidence from the review indicated that changes in the market meant that the rationale for imposing a cap had changed, we would inevitably take this into consideration as part of such a review. We consider that it is not appropriate to be too definitive now about the exact time when such a review should be undertaken as it will be important to have some flexibility to respond to market developments.
- 3.65 In particular, the outputs from the affordability project and the monitoring regime that we are currently undertaking, should identify any concerns with regard to the

affordability of the products within the basket and if it is unduly constraining Royal Mail's pricing flexibility. We therefore consider there is not a need to commit to a formal public review of the cap beyond that indicated by our consultation and in particular that this should be completed in less than two years.

Our decision

3.66 We consider it is neither necessary nor proportionate to commit to a formal public review of the ongoing need for the safeguard cap for Large Letters and packets by April 2014. We will however, continue to monitor the market and Royal Mail's prices to ensure that they remain affordable and the cap is not unduly constraining Royal Mail's ability to finance the universal service. This may result in a review of the level of the cap in two to three years' time.

Summary of our decision

3.67 To summarise, we have decided:

- The safeguard cap on Second Class stamp Large Letters and packets up to 2kg will be in the form of a single basket for all the Large Letter and packet weight steps with no additional constraints on Royal Mail's pricing flexibility;
- The overall level of the basket cap will be based on a weighted average increase relative to 2011-12 prices for the seven year period of the regulatory framework;
- The weighted average price of the basket will be calculated using the April to March audited actual volumes for the year prior to the calculation of prices;
- The overall level of the cap will be increased by CPI each year;
- The level of the basket will be set at a 53% increase on 2011-12 prices (equates to a 34% increase on current prices); and
- We may review the level of the cap in two to three years' time if there is further evidence on affordability or concerns about Royal Mail's ability to finance the universal service.

Assessment of the statutory tests for imposing regulatory conditions

3.68 The key features of the legal framework and the relevant duties applicable to Ofcom's regulation of the postal sector are summarised in Section 2 and set out in more detail in Section 3 of the March 2012 statement.

3.69 In particular, we have a duty under section 29(1) of the Act to secure the provision of a universal postal service. In performing this duty we must have regard to the need for the provision of a universal service to be both:

- financially sustainable; and
- efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.

- 3.70 We have set out above the details of the condition that we have decided to impose on Royal Mail to ensure that a basic universal service is available to all. This condition will implement our decision in the March 2012 statement to extend the safeguard cap to Second Class stamp Large Letters and packets up to 2kg.
- 3.71 This extension to the safeguard cap is being imposed through a DUSP condition which may be imposed on a universal service provider. Royal Mail is the designated universal service provider in the UK. Section 36 of the Act sets out the permitted subject-matter of a DUSP condition, including (under section 35(4)) tariffs to be used for determining prices in accordance with which a universal postal service, or part of a universal service, is provided.
- 3.72 Section 36(5) of the Act provides that, in exercising the power conferred by section 36(4), Ofcom must seek to ensure that the prices are affordable; that the prices take account of the costs of providing the service or part of a service; and that the prices provide incentives to provide the service or part of a service efficiently.
- 3.73 Our reasons for deciding to impose a safeguard cap on Second Class stamp Large Letters and packets up to 2kg, and the analysis of the legal tests in this regard, are set out in our March 2012 statement, and we do not repeat them here. We consider below how our decisions on the level of that cap meet our statutory duties as set out above.
- 3.74 We consider that the level at which we have decided to set the cap, in combination with our other decisions set out in our March 2012 statement to provide more freedom to Royal Mail to set prices generally subject to certain important safeguards (including the safeguard cap on Second Class stamp Letters), takes account of the costs of providing the service and will help to provide incentives to provide the service in an efficient manner.
- 3.75 We also consider that the safeguard price cap is:
- objectively justifiable because it will ensure that an affordable basic universal service is available to all, including vulnerable consumers. Although consumers and vulnerable consumers in particular use these services infrequently, we have estimated that they account for over 50% of total postal expenditure due to their higher prices;
 - not unduly discriminatory because it affects the USP – and there is only one such USP (Royal Mail) in the UK;
 - proportionate because the safeguard cap is being set at a level which takes account of the needs of vulnerable consumers and what is affordable for them, whilst still ensuring that Royal Mail retains sufficient pricing flexibility to make a reasonable commercial rate of return on the services which are the subject of the control; and
 - transparent because it is clear as to the maximum average price that Royal Mail is permitted to charge for the basket of relevant services under the cap.

Annex 1

Statutory Notification: designated USP condition

NOTIFICATION OF A DECISION TO IMPOSE A REGULATORY CONDITION IN ACCORDANCE WITH SECTION 36 OF, AND PARAGRAPH 3 OF SCHEDULE 6 TO, THE POSTAL SERVICES ACT 2011

BACKGROUND

- (A) On 27 April 2012, at Annex 5 to the consultation document entitled 'Securing the Universal Postal Service: Safeguard cap for Large Letters and packets', OFCOM published a notification in accordance with section 53 of, and paragraph 3(3) of Schedule 6 to, the Act setting out their proposals to impose on Royal Mail a designated USP condition pursuant to their powers in section 36 of the Act (the "**First Notification**").
- (B) A copy of the First Notification was sent to the Secretary of State in accordance with Schedule 6 paragraph 5(1)(a) of the Act.
- (C) In the First Notification (and the accompanying consultation document), OFCOM invited representations about any of the proposals set out therein by 11 June 2012.
- (D) By virtue of section 53 of, and paragraph 3(5) of Schedule 6 to, the Act OFCOM may give effect, with or without modifications, to a proposal with respect to which they have published a notification only if they—
 - (i) have considered every representation about the proposal that is made to them within the period specified in the First Notification; and
 - (ii) have had regard to every international obligation of the United Kingdom (if any) which has been notified to them for this purpose by the Secretary of State.
- (E) OFCOM received responses to the First Notification and have considered every such representation made to them in respect of the proposals set out in the First Notification (and the accompanying consultation document); and the Secretary of State has not notified OFCOM of any international obligation of the United Kingdom for this purpose.

DECISION

1. OFCOM hereby impose on Royal Mail, in accordance with section 36 of, and paragraph 3 of Schedule 6 to, the Act and pursuant to powers and duties in section 36 of the Act, a Designated USP condition with effect from 20 July 2012, to make provision for matters set out in that section 36.
2. The Designated USP condition imposed by OFCOM is specified in the Schedule hereto.
3. The effect of, and OFCOM's reasons for making, this decision are set out in the accompanying explanatory statement.

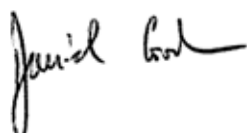
OFCCOM'S DUTIES AND LEGAL TESTS

4. OFCCOM are satisfied that this decision satisfies the general test in paragraph 1 of Schedule 6 to the Act.
5. In making this decision, OFCCOM have considered and acted in accordance with their principal duty in section 29 of the Act and their general duties in section 3 of the Communications Act 2003.

INTERPRETATION

9. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them in this Notification and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Act.
10. In this Notification—
 - (a) “**Act**” means the Postal Services Act 2011 (c.5);
 - (b) “**First Notification**” has the meaning given to it in recital (A) above; and
 - (c) “**Royal Mail**” means Royal Mail Group Ltd, whose registered company number in England and Wales is 04138203.
11. For the purpose of interpreting this Notification—
 - (a) headings and titles shall be disregarded;
 - (b) expressions cognate with those referred to in this Notification shall be construed accordingly;
 - (c) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.
12. The Schedule to this Notification shall form part of this Notification.
13. Unless otherwise is stated in that Schedule, this Notification shall take effect on 20 July 2012.

Signed by **Daniel Gordon**



Competition Policy Director

A person duly authorised by OFCOM under paragraph 18 of the Schedule to the Office of Communications Act 2002

20 July 2012

SCHEDULE 1

**DESIGNATED USP CONDITION 3
SAFEGUARD CAP PRICE CONTROL FOR LARGE LETTERS AND RELEVANT
PACKETS**

3.1. Application, Definitions and Interpretation

DUSP 3.1.1	This designated USP condition (“ DUSP Condition ”) shall apply to the <u>universal service provider</u> .
DUSP 3.1.2	In this DUSP Condition—
	<p>(a) Basket means the services of sending <u>Large Letter</u> and <u>Relevant Packet</u> products by <u>Second Class Post</u> that the <u>universal service provider</u> currently provides;</p> <p>(b) “Consumer Prices Index” or “CPX” means the index of consumer prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office for National Statistics at the time of publication of this Notification) from time to time in respect of all items;</p> <p>(c) “Large Letter” means a letter weighing up to 750 grams that is no more than 25 millimetres thick and up to 353 millimetres in length and up to 250 millimetres in width.</p> <p>(d) “Relevant Packet” means any item greater than a <u>Large Letter</u> in dimensions but weighing no more than 2kg;</p> <p>(e) “Relevant Year” means one of the following periods:</p> <p style="padding-left: 40px;">(1) the period beginning on 1 April 2012 and ending on 31 March 2013 (the “First Relevant Year”);</p> <p style="padding-left: 40px;">(2) the period beginning on 1 April 2013 and ending on 31 March 2014 (the “Second Relevant Year”);</p> <p style="padding-left: 40px;">(3) the period beginning on 1 April 2014 and ending on 31 March 2015 (the “Third Relevant Year”);</p> <p style="padding-left: 40px;">(4) the period beginning on 1 April 2015 and ending on 31 March 2016 (the “Fourth Relevant Year”);</p> <p style="padding-left: 40px;">(5) the period beginning on 1 April 2016 and ending on 31 March 2017 (the “Fifth Relevant Year”);</p> <p style="padding-left: 40px;">(6) the period beginning on 1 April 2017 and ending on 31 March 2018 (the “Sixth Relevant Year”);</p> <p style="padding-left: 40px;">(7) the period beginning on 1 April 2018 and ending on 31 March 2019 (the “Seventh Relevant Year”);</p>

	<p>(f) “Second Class Post” means a service of sending an item by post where the <u>universal service provider</u> aims to deliver the item no later than the third working day after it was posted. For the purposes of this DUSP Condition it does not include services which are not universal services or which include charges in respect of additional registered, insured, tracked or recorded services;</p>
DUSP 3.1.3	<p>For the purpose of interpreting this DUSP Condition—</p> <p>(a) except in so far as the context otherwise requires, words or expressions shall have the meaning assigned to them in DUSP 3.1.2 above and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the <u>Act</u>;</p> <p>(b) headings and titles shall be disregarded;</p> <p>(c) expressions cognate with those referred to in this DUSP Condition shall be construed accordingly; and</p> <p>(d) the Interpretation Act 1978 (c. 30) shall apply as if this DUSP Condition were an Act of Parliament.</p>
3.2 Maximum price to be charged for specified services	
DUSP 3.2.1	<p>This DUSP Condition specifies the maximum prices that the <u>universal service provider</u> shall be permitted to charge for the group of services within the <u>Basket</u> in each <u>Relevant Year</u>.</p>
DUSP 3.2.2	<p>In each <u>Relevant Year</u> t the price of services i in the <u>Basket</u> shall be set such that –</p> $\frac{\sum_i P_{i,t} V_{i,t-2}}{\sum_i V_{i,t-2}} \leq \left(\frac{\sum_i P_{i,0} V_{i,t-2}}{\sum_i V_{i,t-2}} \times X_t \right)$ <p>where –</p> $X_t = (1 + 53\%) \times \frac{CPX_t}{CPX_0}$ <p>$P_{i,t}$ is the maximum price charged for sending a single <u>Large Letter</u> or <u>Relevant Packet</u> by <u>Second Class Post</u> in <u>Relevant Year</u> t; and</p> <p>$V_{i,t-2}$ is the volume of stamped mail delivered by the <u>universal service provider</u> in the twelve months to March in the year $t-2$ for service i as calculated by the <u>universal service provider</u> using a reasonable methodology which has been disclosed to <u>OFCOM</u>.</p>

DUSP 3.2.3	Where the <u>universal service provider</u> makes a material change (other than to a charge) to any product or service which is subject to this Condition or there is a material change in the basis of the <u>Consumer Prices Index</u> , DUSP Conditions 3.2.1 and 3.2.2 shall have effect subject to such reasonable adjustment to take account of the change as <u>OFCOM</u> may direct to be appropriate in the circumstances. For these purposes a material change to any product or service which is subject to this DUSP Condition includes the introduction of a new product or service wholly or substantially in substitution for that existing product or service.
DUSP 3.2.4	The <u>universal service provider</u> shall record, maintain and supply to <u>OFCOM</u> in writing, no later than three months after the end of each <u>Relevant Year</u> , the data necessary for <u>OFCOM</u> to monitor compliance of the <u>universal service provider</u> with the requirements of this Condition.
DUSP 3.2.5	This DUSP Condition shall not apply to such extent as <u>OFCOM</u> may direct.
DUSP 3.2.6	The <u>universal service provider</u> shall comply with any direction <u>OFCOM</u> may make from time to time under this DUSP Condition.

Table of terms defined in the Act

This table is provided for information and does not form a part of this condition. We make no representations as to its accuracy or completeness. Please refer to the Act.

Defined term	Section of the Act
<i>OFCOM</i>	90
<i>universal service provider</i>	65(1) and Schedule 9 paragraph 3(3)