Royal Mail plc

Response to Ofcom's July 2015 Discussion paper:

Review of the regulation of Royal Mail

18th September 2015

Public version

Confidential information which has been redacted from this document is indicated by: [✂]

Executive Summary

Approach to this submission

Ofcom announced a fundamental review of the regulation of Royal Mail on 16 June 2015. The purpose of this review is *"to ensure that regulation remains appropriate and sufficient to secure the universal postal service".* Ofcom has asked six questions. In this submission, Royal Mail responds to each question in turn in a separate chapter, together with an executive summary, supplemented by five appendices. Each chapter is structured with a summary box at the outset, which sets out the key arguments made in that chapter, and the principal points of evidence. Each chapter finishes with a conclusions box which summarises the key messages from that chapter.

We are the proud provider of the universal postal service in the UK. Royal Mail has made great strides in efficiency and innovation since 2012. But we operate within a fragile ecosystem. Intense competition and ongoing structural decline make the postal sector very challenging.

I. **Royal Mail is the proud provider of the universal postal service.** We offer a six days a week service to more than 29mn addresses in the UK. The Universal Service Obligation (USO) underpins a vibrant and growing e-commerce industry. We are committed to the government's overarching policy objective - delivering a high quality USO to the market without government subsidy. While the scope of the USO is outside Ofcom's review, we believe the current scope provides the best means of optimising the revenue available to fund the universal service. We do not wish to see any reduction in the current scope.

II. **The pace of change and innovation at Royal Mail has accelerated since the new regulatory framework was put in place in 2012.** Royal Mail is well on the way to implementing one of the UK's biggest transformation programmes. Our recent rate of efficiency improvement has outperformed that of the UK economy[1]. [✂] We are investing heavily in customer initiatives, IT, change programmes, etc. as part of our ongoing transformation. Royal Mail's customer favourability ratings – see later in this document – have increased following the embedding of a whole range of programmes centred on customer convenience and price. In short, Royal Mail has seized the commercial freedom provided by deregulation and the discipline of being a publicly listed company and used them for the benefit of customers and the USO.

III. **We operate within a fragile ecosystem with limited room for manoeuvre.** Royal Mail faces a unique set of circumstances which need to be recognised by the regulatory framework. These circumstances were present in 2012 when Ofcom deregulated. They remain very much in place today. The work that FTI Consulting has done identifies the features that make Royal Mail unique and concludes a "one size fits all" regulatory approach is inappropriate:

- Addressed letter volumes are falling. Many other regulated industries are stable or growing. BT, for example, has a number of large and growing businesses. In short, Royal Mail faces asymmetric risks to its profitability.
- We have robust estimates on ongoing volume decline. But there is potential volatility not seen in other regulated industries due to possible acceleration of decline from increased e-substitution – 'tipping points' and fluctuations in volumes in the short term. This leads to greater uncertainty and risk.
- Royal Mail is much more labour intensive than other regulated industries. 61% of Royal Mail Group's operating expenditure is accounted for by staff cost, compared to 27% of, for example, BT's. This complicates judgments on the right pace of change for the organisation given the pressing need to sustain revenues.

[1] For the Reported Business, efficiency based on PVEO analysis, using RPI deflator. Further discussion of PVEO methodology is contained in the FTI Consulting annex – efficiency metrics. UK productivity measured as total factor productivity.

IV. **Significant regulatory risk remains a feature of the postal sector.** There has been a history of regulatory failure which Ofcom has previously acknowledged. Richard Hooper's review pointed out that Royal Mail is *"not like other utilities"*. As he said, *"the delivery of the universal service in the postal sector is under much greater threat than in other sectors"*. In a sector like post, with a high level of common and fixed costs and structural decline, the wrong kind of regulation can have serious consequences. Volume forecasting errors by Postcomm, for example, led to the re-opening of Royal Mail's 2006 price control. The Postcomm regulatory regime also chose to favour the development of access competition. By 2007-08, access volumes (4.1bn items) were 60% more than the regulator had originally forecast. Royal Mail was by then also facing serious financial difficulties. These risk factors have only increased in the last five years.

V. **A regulatory blueprint for post and the challenging dynamics of the parcels market.** Regulatory intervention needs to be clearly grounded in the realities of the postal sector. Any return to wholesale and retail price caps or introduction of efficiency targets is therefore inappropriate and retrograde. As FTI Consulting has pointed out, the risks of "getting it wrong" are asymmetric. For example, if price controls are set "too low" then the USO might become financially unsustainable. This is also the judgement that Ofcom itself reached in 2012. Since Ofcom came to that judgement, the parcels market has become more challenging, with clear implications for the USO. We estimate there is spare capacity of about 20%, [✂] These factors, alongside growing disintermediation, mean there is significant downward pressure on parcel prices. This is one major reason for the decline in Reported Business revenue, in real terms, in 2013-14 and 2014-15.

VI. **We need a regulatory framework for the 21st Century.** In this document, we answer the six questions posed by Ofcom. We also provide five appendices, four produced by our consultants, covering a range of key issues. Our main points are:

- The 2012 regulatory settlement was a significant step forward. But its full potential has never been realised. We want to work with Ofcom to make this happen for the benefit of the USO and the people it serves.
- The analysis which drove the major regulatory changes in 2012 is as relevant now as it was just three years ago. Our concerns with direct delivery competition was about the impact on revenue: there are more than enough spurs to efficiency, e.g., ongoing structural decline in letters, increasing competition in parcels and the discipline of being a listed company.
- There is indeed a pressing need to review the effectiveness of the framework. But not for the reasons - absence of direct delivery and alleged pricing/non-pricing behaviours - cited by Ofcom. Errors of both commission (e.g., inappropriate regulation) and omission (e.g., not fleshing out the regulatory framework) on the regulator's part can have a profound impact on the USO.
- We have exercised our commercial freedom – pricing and non-pricing - in a fair, reasonable, and proportionate manner. We strongly refute Ofcom's provisional view to the contrary.
- The provision of the USO is funded through the market. If the revenue pools to fund it are removed or reduced because of inappropriate regulatory decisions, a subsidy would most likely be required. Ofcom has very few public policy tools available to rectify the situation.
- The regulatory review provides Ofcom with a major opportunity to flesh out in a meaningful and positive way the 2012 regulatory framework. We believe the key elements here should focus on:
  - » A forward looking framework for parcels:
    - The removal of remaining burdensome regulation.
    - A level playing field for the USO.
    - Tracking for all USO parcels.

- » A future-facing financial sustainability framework for the USO:
  - Maintaining the focus on EBIT margins.
  - A recognition by Ofcom that the 5%-10% range is at the low end of the spectrum compared to other European postal players, other FTSE 100 companies and the thresholds set by credit rating agencies.
  - A recognition by Ofcom of the importance of Royal Mail maintaining access to capital markets (at low cost). This requires us to adopt capital structures, dividend and investment policies to ensure access to capital at reasonable costs.

We are transforming our business. We are delivering for our customers and our people.

VII. Since the regulatory settlement in 2012, we have made **major progress in driving efficiency**. We have changed every aspect of the working day of c. 100,000 delivery colleagues. We have revised the composition and deployment of 59,000 walks. We now sequence over 82% of our letters in delivery route order. In processing, we have also made major changes, including closing down 22 mail centres and opening 2 new modern mail centres. We have cut overheads by significantly reducing the number of managers. The benefits of our focus on efficiency are clear. Since 2010-11, we have avoided approximately [✂]of costs a year based on a [✂] investment. We held down underlying costs in UKPIL last year. We expect them to be flat or better in 2015-16.

VIII. **The pace of innovation has quickened** very considerably. Since 2012 we have delivered more than 30 projects to innovate for our customers. They include Local Collect, Sunday parcel deliveries, Delivery to Neighbour, growth incentives – such as Mailmark, easy parcel shipping tools and development of digital apps. We are delivering high quality service, e.g., 93% on first class mail. Business customer satisfaction has improved from 70 in 2011-12 to 76 in 2014-15. Underpinning this innovation is our unique position as the UK's **most trusted and preferred delivery company**. 83% of online shoppers say they trust Royal Mail, compared to 56% for the nearest competitor[2].

IX. Our transformation programme is now entering a new phase, and the main elements of the programme have been shared with Ofcom. **We are embedding a cost-conscious culture** right across our business. We have over 70 material initiatives in hand designed to reduce costs, optimise our networks, and streamline our processes. They include: parcels tracking, collections on delivery, more delivery revisions, a focus on high impact units and management structures. Our business plan by design is very stretching. Delivering it will be challenging. Its success will require close cooperation with our partners, including the unions, and the continual exercise of management judgement.

The 2012 Regulatory Framework was a significant step forward. But unfinished business remains. The USO requires major revenue pools and a future-facing financeability framework to sustain it, including the right EBIT margin regime.

X. **Despite the progress made by the 2012 regulatory framework** in granting Royal Mail greater commercial and operational flexibility, the **freedoms were incomplete**. In general, we cannot change USO prices, products, or customer processes without notification and/or consultation periods. This slow and burdensome regulation prevents Royal Mail from moving quickly, especially in the fast paced parcels sector. Innovative promotions on USO services are not possible. We cannot offer full tracking of standard parcels within the USO so cannot respond to customer demand and keep our USO products relevant. At present, a loophole means that the Mails Integrity Code of Practice only applies to 'Regulated Operators': i.e., operators regulated under the old Postcomm regime. Moreover, since the Code only covers items below 350g costing less than £1 to post, it excludes almost all parcels.

[2] Independent research conducted by Hall & Partners asking a nationally representative sample of 1,539 UK consumers

XI. **The regulatory focus needs to shift now to focus on the revenue pools** to pay for the high fixed cost universal service. Research we have shared with Ofcom shows that Royal Mail relies on revenues from non–USO commercial activities, particularly parcels, to fund the USO. If Ofcom intervention were to reduce Royal Mail's ability to compete in these markets, the sustainability of the USO could be challenged. If the **financial sustainability of the USO were to come under threat**, there is little which Ofcom could do to return the business to profitability. Ofcom cannot award Royal Mail additional revenues or reduce its cost base. Hence we believe that Ofcom needs to be especially vigilant at this stage. Regulatory changes which damage the sustainability of the USO may have major consequences.

XII. **Ofcom is looking at whether the EBIT margin approach remains valid. Research commissioned from FTI Consulting by Royal Mail suggests that EBIT margin is the right approach for considering the financial sustainability of the USO.** Further, it demonstrates the current 5%-10% range is at the lower end of the spectrum. The main FTI Consulting findings are:

- The weighted average EBIT margin earned by FTSE 100 and FTSE 250 companies from 2007-14 ranges from 10%-12%.
- No industry sector earned an average margin of less than 8% between 2007-14.
- The average EBIT margins earned by Royal Mail's relevant European peers in the same period were 10% on a weighted basis and 16% on an unweighted basis.

This evidence supports our view that, as part of its review, Ofcom needs to assess how Royal Mail can move up the 5%-10% range to sustain the UK's high fixed cost USO.

Royal Mail has exercised the greater pricing freedom it was given in 2012 in a fair and responsible manner. Royal Mail refutes Ofcom's provisional view that it has discouraged entry and expansion into bulk mail delivery[3], through price or non-pricing behaviour.

XIII. **The substantial price increases in April 2011 and April 2012 – which Ofcom has acknowledged were necessary – returned Royal Mail to profitability.** This was after a sustained period when the company was balance sheet insolvent and reporting significant negative cash flows. Since then, as FTI Consulting has found, the overall price rises have been broadly in-line with RPI, this is despite the revenue impact of falling volumes. FTI Consulting found a number of likely explanations for this price restraint:

- Royal Mail's pricing is constrained by the fact that customers could switch away permanently, primarily to digital alternatives. As Hooper said, *"if something is digitable, postal operators should act on the basis that it will sooner or later be digitised"*.
- Key factors like ongoing structural decline and the allure of digital alternatives are actively taken into account by Royal Mail executives when making pricing decisions. A stark example of the structural constraint on Royal Mail is transactional mail, a key revenue stream for the Reported Business. This letter category, which accounts for [✂] of total addressed mail volume, has declined by [✂] since 2011-12 to 2014-15. Prices have only increased by c. 0.9% on average above RPI p.a. since April 2012. This reflects Royal Mail's prudent approach to pricing.

XIV. **Royal Mail's record on pricing speaks for itself. Since the essential recalibration to bring Royal Mail to profitability, the company has consistently priced at or around RPI.** FTI Consulting found that:

- After the re-calibration of letter prices in April 2011 and April 2012 and parcel prices in April 2013, overall price increases returned to a level comparable to those observed in 2010 under the old regulatory regime.

[3] Ofcom "Review of the Regulation of Royal Mail" Issues Statement, July 2015

- UKPIL revenues have actually fallen in real terms. The price increases were more than offset by continuing volume decline. This indicates the existence of significant constraints on Royal Mail's pricing.
- Price decreases (in real terms) are as much a feature of Royal Mail's strategy as price increases:
  - » For advertising mail, price increases were substantially lower than for other letter products. This reflects intense competition from access operators and other forms of advertising. On average advertising mail prices have increased by c. 0.6% p.a.below RPI since April 2012.
  - » For parcels, after the price increases in April 2013, prices reduced in real terms by an average of c. 1% p.a..
  - » For consumer parcels, following the structural change in prices in April 2013, prices have increased by c. 1.8% p.a. below RPI.

XV. **Royal Mail has worked with access operators to ensure sending and receiving customers enjoy a great service. Price increases have been fair and reasonable. So too have non-pricing behaviours. Royal Mail strongly refutes Ofcom's provisional view to the contrary.** The access market has developed rapidly since its introduction in 2004. It is now by far the biggest postal access market in the EU. Access operators now handle about 70% of all addressed letters posted by large businesses. FTI Consulting found that:

- After the necessary price increases in April 2011 and April 2012, the average increase in access prices since April 2012 has been c. 0.3% p.a. above RPI.
- The average price increases for this period were also very similar to that of 2005-06 to 2009-10-2010 when a restrictive price control regime under Postcomm was in place.

XVI. **Royal Mail did not engage in non-pricing behaviour intended to prejudice any of its access customers.** We have valid operational and commercial rationales for our actions. We have acted within set guidelines. Our relationship with access customers is a supervised one. Any proposals on changes can be challenged by our access customers. In theory, any proposed change can be referred to Ofcom for review. In practice, we have successfully made a series of changes to the access contract. These changes followed consultation or disclosure with our access customers. Outside the strict terms of the access contract, we collaborate daily with our customers addressing the many operational issues that may arise. Complaints are resolved quickly and to the satisfaction of our customers and Royal Mail. We refute each individual complaint set out in paragraph 3.15 of Ofcom's 'Review of the regulation of Royal Mail'.

To conclude, the USO needs an appropriate and settled regulatory regime as Ofcom originally promised.

XVII. **The sustainability of the USO rests on market funding**. The more Ofcom intervenes to control, restrain, and regulate Royal Mail's delivery of the USO, the more responsibility Ofcom takes on for whether the USO can continue to be sustained without Government subsidy. The right way forward now is for Ofcom to recognise the competitive intensity of the industry. Ofcom should:

- Put in place an **appropriate and supportive** regulatory framework as soon as possible.
- Provide **additional guidance** on the commercial flexibility provided in 2012.
- Ensure **regulatory certainty**. Ofcom promised regulatory certainty for seven years, the need for a stable regulatory framework remains.
- Give a clear signal on how it will manage its regulatory intervention and oversight to
  - » Continue the provision of a **high quality USO.**

- Ensure the USO provider is making adequate **progress on efficiency.**
- But, as a matter of priority, ensure the **USO is financially stable.**

XVIII. The USO, the people it serves, our people, investors and other market participants require the **certainty of a settled regulatory framework** for post.

Chapter 1: Do you agree with our view that there is a need to consider the effectiveness of the existing regulatory structure?

Royal Mail agrees there is a need to consider the effectiveness of the existing regulatory framework. But not for the reasons set out by Ofcom. The ecosystem within which Royal Mail operates remains fragile. The regulatory framework must reflect the unique and challenging circumstances of post. These circumstances were present in 2012 when Ofcom deregulated and remain very much in place today. The 2012 regulatory settlement was a significant step forward. But its full potential has never been realised. We set out in Chapters 3, 5 and 6 the specific changes Ofcom should make in order to do this.

Royal Mail disagrees with Ofcom's reasons for undertaking a fundamental review:

- The **absence of direct delivery letter competition does not diminish market incentives** to drive efficiencies. Competitive pressure and structural decline already strongly incentivise Royal Mail to deliver efficiencies. Ofcom has not provided evidence to demonstrate that direct delivery would act as a spur to efficiency in Royal Mail. Our latest business plan has a stretching trajectory of improvements. We have detailed plans to reduce costs, which we have shared with Ofcom. Regulatory targets are not required. They would be counter-productive. See Chapter 4.
- **Royal Mail's overall pricing and non-pricing behaviour is significantly constrained.**
  - Royal Mail's **pricing in parcels and consumer letters has been consistently fair, reasonable, and cost oriented**. Historic price changes were an essential recalibration to bring Royal Mail to profitability. Our services remain affordable and offer excellent value for money. Since recalibration, the overall price rises have been broadly in-line with RPI.[1] Pricing levels for 2nd class letter stamps still remain well below the price cap set by Ofcom. See Chapter 2.
  - Royal Mail's prices for access and contract letters have been fair, reasonable and cost oriented. Pricing proposals have been cost-oriented and, compliant with competition law. **Royal Mail has not engaged in non-pricing behaviours intended to prejudice any of its access customers.** There is no evidence to justify a return to wholesale or retail price caps. See Chapter 2.
- **Royal Mail's finances have improved since 2012. But the USO remains fragile.** The financial position of the USO as demonstrated by the Reported Business has improved. The Reported Business moved from an EBIT margin of (0.6%) in 2011/12 to an EBIT margin of 3.9% in 2014/15.[2]
  - 2014-15 was the first year under Ofcom's regulatory framework where the Reported Business earned an EBIT margin within the range of the 5-10% guidance. However, this was due to a refinement in the definition of EBIT, to Sustainability EBIT, by Ofcom in December 2014
  - Benchmarking analysis undertaken by FTI Consulting of other postal operators, FTSE 100 companies and credit rating agencies' views suggests a reasonable range for margins of 5% to 16%. Therefore, we consider a future EBIT margin range of 5% to 10% to be conservative. See Chapter 6.

In Royal Mail's view, there are other pressing reasons why a review is needed to realise the full potential of the 2012 framework:

- **Royal Mail faces a unique set of circumstances that mean a "one size fits all" regulatory approach is inappropriate.** We operate in a fragile ecosystem with limited room to manoeuvre. Royal Mail is proud to provide a market-funded, high quality USO. However, we have high fixed costs.

[1] Average price increases across the domestic product portfolio have been broadly in line with RPI since the recalibration in letters prices in April 2011 and April 2012 and in parcel prices in April 2013

[2] We believe that in 2014-15 the Reported Business achieved EBIT margins (based on the cash cost of pensions) at the lower end of the 5-10% identified by Ofcom as a reasonable commercial rate of return. Royal Mail Regulatory Financial Statements, 2014-15, Page 5

In an environment of declining volumes, volatile markets, and the need to work together with the unions to drive change, the challenges highlighted by Ofcom in 2012 remain. The analysis that drove the major regulatory changes in 2012 is as relevant now as it was just three years ago.

- **Significant regulatory risk remains a feature of the postal sector.** There has been a history of regulatory failure, which Ofcom has previously acknowledged. The more Ofcom intervenes to control, restrain, and regulate Royal Mail's delivery of the USO, the more responsibility Ofcom takes on for whether the USO can continue to be sustained without government subsidy. Royal Mail needs the current commercial freedoms, along with further deregulation in parcels, in order to sustain the USO.
- **The market has moved on significantly since 2012.** The postal sector is changing rapidly. Regulatory interventions need to be clearly grounded in the realities of today's postal sector. Royal Mail is innovating at pace. But competition has intensified, especially in parcels. Addressed letter volumes have continued to decline. Customer needs have changed. These factors, alongside growing disintermediation, mean there is significant downward pressure on parcel prices. This is one major reason for the decline in Reported Business revenue, in real terms, in 2013-14 and 2014-15. See Chapter 2.
- **The regulatory framework should be flexible enough to provide consumers with a modern, 21st century Universal Service.** The UK needs a modern high quality parcels and letters USO to continue to grow the e-commerce industry and to ensure customers enjoy a high quality delivery experience. We believe Ofcom should change aspects of the current regulatory framework to enable this. See Chapter 5.
- **As Royal Mail transforms, it needs both USO and non-USO revenue pools to sustain the USO.** As we have discussed with Ofcom, a high-quality USO has high fixed costs. The regulatory focus needs to recognise this and shift to focus on the revenues, from both USO and non-USO products, needed to fund the USO. Ofcom needs to put in place a clearly defined financial sustainability framework for the USO. Ofcom's framework should allow Royal Mail to maintain an investment grade rating and to provide an adequate return to debt and equity investors. See Chapter 6.
- **The postal industry needs regulatory certainty.** This was promised by Ofcom. The USO, the people it serves, our people investors in Royal Mail, and other market participants require an appropriate and settled regulatory framework for post. Ofcom should:
  - Put in place an appropriate and supportive regulatory framework as soon as possible.
  - Provide additional guidance on the commercial flexibility provided in 2012.
  - Ensure regulatory certainty. Ofcom promised regulatory certainty for seven years. The need for a stable regulatory framework remains
  - Give a clear signal on how it will calibrate its regulatory intervention and over sight to
    - Continue the provision of a high quality USO
    - Ensure the USO provider is making adequate progress on efficiency
    - But, as a matter of priority, ensure the USO is financially stable

Royal Mail disagrees with Ofcom's reasons for undertaking a fundamental review.

1.1 There is indeed **a pressing need to review** the effectiveness of the regulatory framework. But not for the reasons – absence of direct delivery competition and alleged price/non-pricing behaviours – cited by Ofcom. Errors of both commission (e.g., inappropriate regulation), and omission (e.g., not fleshing out the regulatory framework), on the regulator's part can have a profound impact on the USO.

The absence of direct delivery letter competition does not diminish market incentives. Royal Mail is already strongly incentivised to deliver efficiencies.

1.2 Ofcom states that, due to the withdrawal of Whistl from end-to-end services, it is "*concerned that Royal Mail may have weakened incentives to deliver efficiency improvements and an increased ability to charge excessive prices*". However, it provides no evidence in support of this. As we have consistently said, direct delivery letter competition only reduces revenues. **Direct delivery letter competition provides no additional spur to efficiency**. Instead, it is a threat to USO revenues and financial sustainability. This is because many costs are fixed due to the USO. The relationship between volumes and costs is not linear. Whilst some cost reduction is possible as a response to volume decline, Royal Mail postmen and women must still walk the same streets, just delivering fewer items as they go. Therefore, reducing volumes has a direct negative impact on Royal Mail's revenues, but only allows a marginal reduction in cost or hours. As a result, efficiency decreases.

1.3 Efficiency improvements and pricing **behaviours are modulated much more effectively by existing significant upstream competition**, by e-substitution and by the fiercely competitive parcels market, than by selective end-to-end competition in letters. Whistl's exit has no impact on these incentives. As explained further in Chapter 4, Royal Mail must be as low cost as possible to stem letters decline and have a cost competitive proposition in parcels. Shareholder pressure applies a further spur to efficiency, as demonstrated by academic research.[3] The absence of direct delivery letter competition does not diminish these incentives.

1.4 Independent research shows we are transforming our operations broadly **in line with comparable European Posts**. This is despite the fact that major European Posts such as Deutsche Post, PostNL and Austrian Post have been privatised for significantly longer periods. For example, Deutsche Post has been privatised for over 20 years. Privatisation provided these companies with better access to capital and shareholder discipline, enabling them to fundamentally restructure their networks earlier than Royal Mail and drive profitable growth. Royal Mail's integrated parcels and letters network is the optimally efficient delivery model for the UK. While Royal Mail periodically evaluates alternative models, not all competitor models are appropriate.

1.5 As we set out in Chapter 4, Royal Mail has already **made major progress in efficiency**. Royal Mail's recent rate of efficiency improvement has outperformed that of the UK economy.[4] This includes delivering substantial reductions in operational headcount of [✂], reductions in management costs of [✂] in real terms, and reductions in overhead costs of [✂] in real terms since 2010-11. [✂]. Productivity is up c.9% since 2010-11. We have done all this whilst maintaining high levels of service. This is a business working hard to continuously improve.

1.6 Royal Mail is determined to **deliver even greater efficiency**. We know where our gaps are. We have a clear plan to address them. Our latest business plan has a stretching trajectory of improvements. We have detailed plans to reduce costs, including in delivery, network, and fleet. We are investing in automation and IT to reduce processing costs. We are further improving customer service. We regularly look at external best practice benchmarks to go further. Our forecasted efficiency gains are broadly in line with targets set by other regulators.

1.7 Driving efficiency at such scale, with the fixed costs of the USO, is **very challenging**. Royal Mail faces a unique set of characteristics which impact on our ability to remove cost at pace. There is not a one for one relationship between volume decline and cost reduction. Costs do not come out automatically with volume declines: we have to take action to remove costs. Throughout the modernisation programme, Royal Mail has sought and delivered exceptionally high quality of service. We will continue to do so but this requires

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[3] Please refer to Appendix 3 of the *FTI Consulting Efficiency Metrics for Royal Mail report*

[4] For the Reported Business, efficiency based on PVEO analysis, using RPI deflator. Further discussion of PVEO methodology is contained in the FTI Consulting annex – efficiency metrics. UK productivity measured as total factor productivity.

change to be absorbed by our staff. Based on recent rates of improvement, we judge that 2-3% productivity improvement p.a. over the business plan period is stretching. Nevertheless we aim to achieve it.

1.8 We have deliberately chosen a collaborative approach with our union and staff to enable accelerated change. Post is a people business; **we employ c. 143,000 people**. To drive productivity improvements, we seek to create the right incentives for our people to do things differently. The pace of change is constrained by the time it takes to build a new culture and to reduce staff headcount without industrial disruption. The alternative is costly. Strikes cost Deutsche Post €100mn in the second quarter of 2015 alone.

1.9 Given the strong, existing, market-based incentives that Royal Mail faces to drive efficiency, it is **not necessary to impose any further regulation**. There are strong arguments against efficiency targets. They are difficult to set, and may be unachievable if based on assumptions that are invalid. Ofcom rejected price controls (incorporating efficiency targets) in 2012 as being too static and not dynamic for the market place. Potential disruptions to the business are greater now than in 2012, when Ofcom stated that, *"the recent experience of postal regulation, however, has demonstrated all the weaknesses of price controls with none of the benefits. In a highly uncertain market, price controls have removed the flexibility that would allow Royal Mail to adjust to changes in demand, while at the same time Royal Mail has been unable to improve efficiency, either at the rate expected by the regulator when the price control was set, or at the rate set by its own internal targets at the time."*[5]

1.10 As discussed by FTI Consulting (see Appendix: 'Efficiency metrics for Royal Mail'), **an explicit "efficiency target" would be likely to distort incentives,** particularly around dynamic efficiency. Efficiency targets are built into price controls, but if a firm fails to meet these it is not explicitly penalised, but instead will have higher costs than anticipated. The regulated firm then suffers through lower profits. Were an explicit efficiency target to be put in place with penalties or rewards around this target then management may become overly focussed on meeting that target. The incentive would be to meet the efficiency target as defined in regulation, rather than to necessarily make Royal Mail more efficient. Also, because the efficiency target would be fixed in advance, Royal Mail would be unable to respond to market conditions in improving efficiency. Royal Mail might focus on efficiency measures that were designed to meet the short-term target, rather than on efficiency measures that might deliver advantages in the medium to long term.

1.11 It is not appropriate to set a price control in this market due to the potentially high levels of volume volatility, revenue uncertainty and high fixed cost nature of the USO. In setting a price control, the regulator needs to make a revenue forecast. It is highly likely that the actual revenue will be significantly different from the forecast. In a declining market, this significantly increases the risk to the revenue pool due to the price control. That is because the regulator will need to re-open the price cap to enable the company to remain financially sustainable. However, **regulatory process often means there is neither a timely review nor resolution of the issue**, as demonstrated by the previous postal price control. Ofcom has itself recognised the risk associated with forecasting uncertainty. It stated in March 2012 "*A price control is unlikely to be effective in the current context, given the level of uncertainty within the postal market, and the very high sensitivity of Royal Mail's profitability to changes in the assumptions used in setting a price control"*

1.12 The issue is compounded in two ways both of which are relevant to a network business like Royal Mail. Firstly, the shortfall generated by the price control mean less revenue overall is available to fund the high fixed costs of the universal service. Secondly, we have a significant level of common costs allocated across the various products. If individual product revenue growth is different from the forecast, this leads to a material reallocation of common costs between products resulting ex post in the necessity to adjust the LRAIC attributable to the relevant products. This in turn leads to a high degree of pricing uncertainty. This problem persists because of an **absence of general guidance** to date on the degree of pricing freedom that the regulator believes should be accorded to Royal Mail to support the USO. For example, it is not clear when undertaking pricing tenders what cost information Royal Mail should use when setting the tender

[5] Securing the Universal Postal Service. Proposals for the future framework for economic regulation, October 2011

price. The forecast product cost at the beginning of a tender process may allow us to offer one price that before the end of the tender process may no longer be allowed as unit cost forecasts may have moved. This is because under the cost allocation model the relevant costs assigned to this product could have changed therefore putting the price offered at risk.

Royal Mail's overall pricing and non-pricing behaviour is significantly constrained.

1.13 As explained further in Chapter 2, Royal Mail's **pricing and non-pricing behaviour is significantly constrained** by the decline in addressed letter volumes, competition from other media, intensive upstream access and parcels competition.

1.14 **Royal Mail's letter prices are significantly constrained by declining addressed letter volumes.** Royal Mail sets prices in a manner which takes into account the threat from increasing the long term rate of e-substitution (currently [✂] per year) to avoid triggering a 'tipping point'. Royal Mail's pricing in consumer letters has been consistently fair and reasonable. **Our services remain affordable and offer excellent value for money.** The only material letter stamp price rises were in April 2011 and April 2012. Pricing levels for 2nd class letter stamps still remain well below the price cap set by Ofcom.

1.15 **Intense parcels competition significantly constrains Royal Mail's prices.** The parcels market is challenging. It is changing at a rapid pace with intense levels of competition, greater disintermediation, and disruptive business models. Royal Mail prices have been fair with overall price decreases in some segments. We have also invested in many product and process innovations. Royal Mail has made concerted efforts to deliver better value for money to its parcel customers, e.g., price decreases and price promotions, and broadened eligibility for value-added services, e.g., tracked account parcel services and account discounts.

1.16 Royal Mail's record on pricing speaks for itself. Since the essential recalibration to bring Royal Mail to profitability, the company has **consistently priced at or around RPI**. FTI Consulting found that:

- After the re-calibration of letter prices in April 2011 and April 2012 and parcel prices in April 2013, overall price increases returned to a level comparable to those observed in 2010 under the old regulatory regime.
- UK revenues have actually fallen in real terms. The price increases were more than offset by continuing volume decline. This indicates the existence of significant constraints on Royal Mail's pricing.
- Price decreases (in real terms) are as much a feature of Royal Mail's strategy as price increases:
  - » For advertising mail, price increases were substantially lower than for other letter products. This reflects intense competition from access operators and other forms of advertising. On average advertising mail prices have increased by c. 0.6%p.a. below RPI since April 2012.
  - » For parcels, after the price increases in April 2013, prices, reduced in real terms by an average of c. 1% p.a. a year.
  - » For consumer parcels, following the structural change in prices in April 2013, prices have increased by c. 1.8% p.a. below RPI.

1.17 **The UK has the most developed access market in Europe.** The access market has developed rapidly since its introduction in 2004. It is now by far the biggest access market in the EU. Access operators now handle about 70% of all addressed letters posted by large businesses. Royal Mail has worked with access operators to ensure sending and receiving customers enjoy a great service. Royal Mail's prices for access and contract letters have been fair, reasonable and cost-oriented. Our pricing proposals have been cost-oriented and compliant with competition law. Royal Mail has not engaged in non-pricing behaviours intended to prejudice any of its access customers. Quality of service is high and terms & conditions of access are clearly balanced. Other non-pricing behaviours (e.g., use of bags and trays) are driven by operational considerations and comply with competition law and the relevant regulatory rules.

1.18 **Price increases have been fair and reasonable**. Royal Mail strongly refutes Ofcom's provisional view to the contrary**.** FTI Consulting found that:

- After the necessary price increases in April 2012 and the average increase in access prices since April 2011 has been c. 0.3% p.a. above RPI.
- The average price increases for this period were also very similar to that of 2005-06 to 2009-10 when a restrictive price control regime under Postcomm was in place.

1.19 Any return to wholesale and retail **price caps would be inappropriate** and retrograde. The risks of "getting it wrong" are asymmetric. For example, if price caps are set "too low" then the USO might become unsustainable. This is the judgement Ofcom itself reached in 2012. Since then the sector has become more challenging.

Royal Mail's finances have improved since 2012, but the USO remains fragile.

1.20 **Royal Mail has worked hard to improve its finances.** Ofcom includes in its reasons for a fundamental review that "*Royal Mail is in a stronger position financially than when we last reviewed the postal framework in 2011-12*". Royal Mail has made great strides in efficiency and innovation since 2012. We have reduced costs as quickly as we can, given the constraints. As we discuss in detail in Chapter 4, we have exercised our commercial freedoms in a fair, reasonable, and proportionate way. We discuss this in detail in Chapters 2 and 3.

1.21 **Our efforts have yielded results. 2014-15 was the first year under Ofcom's regulatory framework where the Reported Business earned an EBIT margin within the range of the 5-10% guidance.** However, this was due to a refinement in the definition of EBIT, to financeability EBIT, by Ofcom in December 2014. Without this refinement, Royal Mail's reported business margin remains below the 5-10% range based on the original basis set by Ofcom in 2012. Between 2012/13 and 2014/15, revenues have decreased in real terms.

1.22 **We reaffirm that the EBIT metric and range for sustainability of 5-10% should be the minimum target margin for the Reported Business.** Ofcom has previously stated that a 5-10% EBIT margin is appropriate for Royal Mail's Reported Business. This range was based on analysis it commissioned in 2011. The analysis, undertaken by Ofcom, which drove the major regulatory changes in 2012 is as relevant now as it was just three years ago. Royal Mail is not making excessive profits.

1.23 Royal Mail believes that, based on the significant **challenges** it faces in the market, an EBIT margin of **5-10% is the minimum necessary for future financial sustainability of the USO**. Benchmarking analysis undertaken by FTI Consulting of other postal operators, FTSE 100 companies and credit rating agencies' views suggests a reasonable range for margins is 5% to 16%. Therefore, we consider an Ofcom defined margin range of 5- 10% to be conservative. Ofcom's framework should allow Royal Mail to maintain an investment grade rating and to provide an adequate return to equity investors such that it is able to raise funds at reasonable rates. In Chapter 6, we set out in more detail a future facing financeability framework to sustain the USO.

1.24 **The USO therefore remains fragile**. Royal Mail must earn a commercial rate of return that allows it sufficient headroom to mitigate the unique set of risks it faces:

- Possible acceleration in the ongoing structural decline in addressed letter volume;
- High fixed costs of the USO in relation to delivery, quality of service and peak volumes;
- Increased competition in parcels;
- High labour-intensity and a heavily unionised workforce; and
- Uncertainty with regard to the regulatory environment.

1.25 Royal Mail has **limited "levers" to reduce costs in the short run**, so our EBIT margin is highly sensitive to revenue risk. Without sufficient headroom, the challenges outlined above may mean that lower than expected revenue would cause the EBIT margin to fall below investor expectations and even become negative. Regulatory intervention will not address these risks. Ofcom must ensure it does not impose restrictions that could accelerate the impact of these risks and prevent Royal Mail from being able to transform.

In Royal Mail's view there are other pressing reasons why a review is needed in order to flesh out in a meaningful and positive way the 2012 framework.

Royal Mail faces a unique set of circumstances which need to be recognised by the regulatory framework.

1.26 Royal Mail is facing a **unique set of operating conditions**:

- Addressed letter volumes are falling. Many other regulated industries are stable or growing. In short, Royal Mail faces asymmetric risks to its profitability.
- We have robust estimates on ongoing volume decline. But there is potential volatility not seen in other regulated industries due to possible acceleration of decline from increased e-substitution, 'tipping points' and fluctuations in volumes in the short-term. This leads to greater uncertainty and risk.
- A combined network is used to fulfil USO and non-USO services: the Royal Mail downstream network (Inward Mail Centre ('IMCs'), local distribution Delivery Offices ('DOs') and delivery staff) deliver USO mail, access bulk mail, retail bulk mail, and parcels – all within a single shared network. The single network must be sustainable – and hence profitable.
- Royal Mail is much more labour-intensive than other regulated industries. 61% of Royal Mail Group's operating expenditure is accounted for by pay compared to 27% of, for example, BT's. This complicates judgements on the right pace of change for the organisation, given the pressing need to sustain revenues.
- An efficiency challenge which is fundamental to remaining competitive and sustainable but which is also complex and challenging to achieve in a highly unionised environment dealing with declining volume environment.

1.27 As FTI Consulting discusses in its 'Regulatory Interventions' Appendix, the **standard regulatory toolkit cannot be applied on a "one size fits all" basis** and the standard economic theory around the application of controls and their incentive properties needs to be considered in the light of the particular challenge that Royal Mail, and the postal industry, is facing. The standard regulation mentioned by Ofcom, and informed by other regulated industries operating in stable environments, was recognised in 2008, 2010 and 2012 as being inapplicable. Our comparison of Royal Mail's current market environment suggests that it is still inapplicable in 2015.

Significant regulatory risk remains a feature of the postal sector.

1.28 There has been a **history of regulatory failure**, which Ofcom has previously acknowledged. Richard Hooper's review pointed out that Royal Mail is *"not like other utilities"*. As he said, *"the delivery of the universal service in the postal sector is under much greater threat than in other sectors"*. In a sector like post, with a high level of common and fixed costs and structural decline, the wrong kind of regulation can have serious consequences. Volume forecasting errors by Postcomm, for example, led to the re-opening of Royal Mail's 2006 price control. The Postcomm regulatory regime also chose to favour the development of access competition. By 2007-08, access volumes (4.1bn items) were 60% more than the regulator had originally forecast. Royal Mail was by then also facing serious financial difficulties.

1.29 Regulatory intervention needs to be clearly grounded in the realities of the postal sector. Any return to more restrictive wholesale and retail charge **controls or efficiency targets is therefore inappropriate and**

retrograde. As FTI Consulting has pointed out, **the risks of "getting it wrong" are asymmetric**. For example, if price controls are set "too low" then the USO might become unsustainable. This is also the judgement that Ofcom itself reached in 2012. Since Ofcom came to that judgement, the parcels market has become more challenging, with clear implications for the USO. We estimate there is spare capacity of about 20%, [✂], These factors, alongside growing disintermediation, mean there is significant downward pressure on parcel prices. This is one major reason for the decline in revenue in real terms in 2013-14 and 2014-15.

1.30 The more Ofcom intervenes to control, restrain and regulate Royal Mail's delivery of the USO, the more responsibility Ofcom takes on for whether the USO can continue to be financially sustained without government subsidy. In the event that Royal Mail were to encounter financial difficulty, there is very little regulatory intervention could do to solve the problem. This means that **Ofcom needs to be extremely careful** about taking steps ex ante which reduce Royal Mail's revenues or add to our cost base. Royal Mail needs the current commercial freedoms, along with further deregulation in parcels in order to sustain the USO.

The market has moved on significantly since 2012. The postal sector is changing rapidly. Regulatory interventions need to be clearly grounded in the realities of today's postal sector.

The pace of change and innovation at Royal Mail has accelerated since the new regulatory framework was put in place in 2012.

1.31 Royal Mail is well on the way to implementing one of the UK's biggest transformation programmes. As discussed in chapter 4, our recent rate of **efficiency improvement has outperformed that of the UK economy**. We have fewer management layers relative to 75% of benchmarked organisations, [✂] We are investing heavily in customer initiatives, IT, change programmes etc., as part of our ongoing transformation. Royal Mail's customer favourability ratings – see later in this document – have increased following the embedding of a whole range of programmes centred on convenience and price. In short, Royal Mail has seized the commercial freedom provided by deregulation and the discipline of being a publicly listed company and used them for the benefit of the USO.

1.32 Since the regulatory settlement in 2012, we have made major progress in driving efficiency. We have changed every aspect of the working day of c. 100,000 delivery colleagues. We have revised the composition and deployment of 59,000 walks. We sequence over 82% of our letters in delivery route order. In processing, we have also made major changes, including closing down 22 mail centres and opening two new modern mail centres. We have cut overheads by significantly reducing the number of managers. The benefits of our focus on efficiency are clear. Since 2010-11, we have avoided approximately [✂] of costs a year based on a [✂] investment. We held down underlying costs in UKPIL last year. We expect them to be flat or better in 2015-16.

1.33 **The pace of innovation has quickened very considerably**. We have delivered more than 30 product and service innovations for our customers. They include Local Collect, Sunday parcel deliveries, Delivery to Neighbour, growth incentives such as Mailmark, easy parcel shipping tools and development of digital apps. We are delivering high quality service, e.g., circa 93% on first class mail. Business customer satisfaction has improved from 70 in 2009-10 to 76 in 2014-15. Underpinning this innovation is our unique position as the UK's most trusted and preferred delivery company. 83% of online shoppers say they trust Royal Mail, compared to 56% for the nearest competitor.

1.34 Our transformation programme is now entering a new phase, and **the main elements of the programme have been shared with Ofcom.** We are embedding a cost-conscious culture right across our business. We have over 70 material initiatives in hand designed to reduce costs, optimise our networks, and streamline our processes. They include: parcels tracking, collections on delivery, more delivery revisions, a focus on high impact units and management structures. Our business plan by design is very stretching. Delivering it will be challenging. Its success will require close cooperation with our partners, including the unions, and the continual exercise of the management judgement referred to earlier.

Royal Mail faces intense competition in letters and parcels.

1.35 As outlined in Chapter 3, **aggressive e-substitution** and growth in mobile usage are driving an estimated [✂] per year decline in addressed letter volumes over the medium term. Almost a quarter of consumers claimed to have sent no items of mail in the past month. Spend on UK direct mail as a proportion of total advertising spend has fallen year on year since 2010. Access accounts for c.50% of all addressed letters (c.7bn items per year), and 70% of the addressed letters sent by large businesses. Price competition is fierce. Access customers compete with one another, and with Royal Mail, for customers' mailings. The largest contracts are won or lost over fractions of a penny per item. **Competition in the access market is working effectively.**

1.36 Royal Mail faces an **increasingly competitive market in parcels**. Royal Mail estimates that there is c.20% overcapacity in the parcels market at present. [✂]. The consequent overcapacity is depressing parcel prices and leading to significant competitive pressure. It is particularly acute in the consumer and SME markets, segments key to Royal Mail. These trends are likely to continue. Indeed, they may accelerate as new technology enables further disintermediation. The impact on Royal Mail of this increased competition is downward pricing pressure and parcels revenue growth not fully compensating for the decline in letters revenue.

The regulatory framework should be flexible enough to provide consumers with a modern, 21st century Universal Service.

1.37 As Article 5 of the Postal Services Directive says, the Universal Service should ***"evolve in response to the technical, economic and social environment and to the needs of users"***. Royal Mail believes that customers should be able to access a USO service as good as that from non-USO operators on crucial product and service features.

1.38 An up to date **USO is vital for e-commerce**. E-commerce rests on two services: broadband and post. Whilst extensive investment is still needed to develop a truly universal network for broadband, the UK already has a highly specified postal USO. It enables businesses selling goods online to operate just as effectively from a village in rural North Wales as a business in the centre of London. Without the Universal Service, it is likely that the market would not deliver affordable and accessible parcel drop-off and delivery services throughout the whole of the UK. Only the USO provides a high quality uniformly priced next day service right across the UK.

1.39 As we outline in Chapter 5, to protect consumers' interests, the regulatory framework should follow three principles:

- **Provide consumers with a modern, 21st century universal service enabling e-commerce to grow, thereby empowering customers.** The UK needs a modern, high quality parcels and letters USO to continue to grow the e-commerce industry and to ensure customers enjoy a high quality delivery experience. USO consumers should have access to the same services as non-USO customers. As Article 5 of the Postal Services Directive says, the Universal Service should "evolve in response to the technical, economic, and social environment and to the needs of users".
- **Encourage and enable the Universal Service Provider to innovate rapidly to meet evolving consumer needs.** This requires minimising the burden of bureaucracy. Even a change that is clearly beneficial to customers currently requires a consultation process. For example, reducing the number of weight steps for USO parcels took c.12 months.
- **Provide consistent standards to make delivery a better experience for consumers, especially in parcels.** 40% of consumers see delivery concerns as a barrier to them shopping more online. All operators should be held to the same basic standards to protect customers. For example, the Mails

Integrity Code of Practice does not apply to most parcel operators. We believe it should. Consumers need a service they can rely on, whichever operator they choose.

1.40 We believe Ofcom should amend the current regulatory framework in line with these regulatory principles. It should:

- **Provide a flexible framework to create a service fit for the 21st century.** Examples include:
  - » Permitting tracked standard parcels in the USO;
  - » Enabling Royal Mail to offer modest volume discounts on USO products; and
  - » Systematically including all major operators in Ofcom's monitoring.
- **Remove unnecessary regulation** that limits Royal Mail's ability to innovate and compete fairly. For example, reducing the length and volume of regulatory notification and consultation periods and streamlining burdensome regulatory reporting requirements.
- **Provide certainty and clarity for consumers** by applying the same consumer protection requirements to all operators. This guarantees consumers a consistent service, which drives confidence.

As Royal Mail transforms it needs both USO and non-USO revenue pools to sustain the USO.

1.41 Royal Mail is the proud provider of the universal postal service in the UK. Royal Mail has the network to ensure it can offer a next-day service at 93% quality six days a week to more than 29mn addresses. This **high quality universal service best serves customer needs**. Royal Mail provides this in a competitive marketplace, without the need for a government subsidy.

1.42 A high quality universal service has **high fixed costs**. As we have reported to Ofcom previously, the true cost of the universal service accounts for [✂] of the Reported Business' cost base, while corresponding volumes account for [✂] this is the cost of maintaining a network capable of delivering the universal service at current volumes. This large and complex network also places constraints on the achievable rate of change.

1.43 The calculated standalone cost of the USO is [✂]. Set against USO-related revenues of [✂], this implies a shortfall of [✂]. **Revenues from commercial activities are therefore required in order to maintain overall profitability**. Funding the USO requires Royal Mail to be successful in the markets in which it operates. This makes it imperative that Royal Mail is able to compete fairly and effectively for these revenue pools, alongside maintaining our revenues from USO products. If Royal Mail fails to compete effectively in these commercial markets, or is prevented from doing so (e.g., by regulatory intervention), the financial sustainability of the USO could be undermined.

1.44 The USO remains fragile. If Royal Mail's revenues were to suffer significantly such that the USO could not be sustained commercially, the burden of the USO could potentially fall on the taxpayer through a subsidy or other means. Given the success of the market funding model to date, this **would represent a major regulatory failure** on the part of Ofcom.

The postal industry needs regulatory certainty.

1.45 **Ofcom promised regulatory certainty**. It said in 2012 that the framework would "last for seven years". This fundamental review comes just three years after Ofcom concluded that Royal Mail needed commercial flexibility to secure the USO. Ofcom stated at the time that the risk of regulatory failure was high. The risks facing Royal Mail are as significant as they were when Ofcom made this assessment. The right way forward now is for Ofcom to recognise the competitive intensity of the industry and put in place an appropriate and supportive regulatory framework as soon as possible.

1.46 Any regulatory intervention must be clearly grounded in and reflective of the realities of the postal sector. The 2012 Framework recognised that **the postal market is different to other regulated markets**, and that price controls do not work for post. Ofcom concluded that the risk of regulatory failure was high. It described how the Postcomm regime, of price and non-pricing regulation, had failed. Ofcom itself said that price controls and efficiency targets had not worked and were not appropriate for the postal industry. For Ofcom to be considering re-introducing price caps two or three years later, when circumstances are even more dynamic and competitive than they were in 2012, is surprising and increases the existing regulatory uncertainty.

1.47 **The sustainability of the USO rests on market funding.** The more Ofcom intervenes to control, restrain, and regulate Royal Mail's delivery of the USO, the more responsibility Ofcom takes on for whether USO can continue to be sustained without government subsidy. The right way forward now is for Ofcom to recognise the competitive intensity of the industry. Ofcom should:

- Put in place an **appropriate and supportive** regulatory framework as soon as possible.
- Provide **additional guidance** on the commercial flexibility provided in 2012.
- Ensure **regulatory certainty.** Ofcom promised regulatory certainty for seven years, the need for a stable regulatory framework remains.
- Give a clear signal on how it will Manage its regulatory intervention and oversight to
  - » Continue the provision of a high quality USO
  - » Ensure the USO provider is making adequate progress on efficiency
  - » But, as a matter of priority, ensure the USO is financially stable

1.48 The USO, the people it serves, our people, investors and other market participants in Royal Mail require the certainty of a settled regulatory framework for post.

Royal Mail believes there are three critical points in regards to the regulatory model.

1.49 **The 2012 Framework was a step in the right direction. However, its underlying intention has not been fully realised**. The commercial freedoms, along with significant cost savings made by Royal Mail, allowed UKPIL to move from loss making (£120mn[6] operating loss) in 2010-11, to modest profitability (£341mn[7] operating profit) in 2014-15. Increased commercial flexibility benefited customers. It enabled Royal Mail to secure the USO in the near term. Nevertheless, the USO is still fragile.

1.50 We believe that **there are certain critical points with regards to the regulatory model** that Ofcom should seek to address now:

- Preserve the commercial and operational freedoms embodied in the 2012 Framework.
  - » We should not return to efficiency targets and price caps. These drove the business into balance sheet insolvency under Postcomm, and were recognised as a failure by Ofcom in 2012.
- Realise the full potential of the 2012 Framework. Key elements include:
  - » A future-facing financial sustainability framework for the USO, with a recommitment to EBIT margins as a measure of financial sustainability
  - » Promised guidance on access pricing.
- Act to deregulate further, in line with current government guidelines. Key elements include:
  - » A forward looking framework for parcels. For example, including tracking in the USO
  - » Removal of unnecessary red tape that limits Royal Mail's ability to innovate and compete fairly.

6 After modernisation costs.
7 After modernisation costs.

1.51 In Chapter 3, we discuss Access regulation and the **guidance** we consider Ofcom should provide. In Chapter 5, we discuss the specific ways we consider Ofcom should **change the current framework** and so further support the sustainability of the USO. In Chapter 6, we discuss a **future-facing financial sustainability framework** for the USO.

Conclusion

There is a need to consider the effectiveness of the existing regulatory framework, but not for the reasons set out by Ofcom. The 2012 regulatory settlement was a significant step forward. But its full potential has never been realised.

Royal Mail disagrees with Ofcom's reasons for undertaking a fundamental review:

- The **absence of direct delivery letter competition does not diminish market incentives** to drive efficiencies. Regulatory targets are not required. They would be counter-productive.
- **Royal Mail's pricing in parcels and consumer letters has been consistently fair, reasonable, and cost oriented.**
- **Royal Mail's prices for access and contract letters have been fair, reasonable and cost oriented.** There is no evidence to justify a return to more restrictive wholesale or retail price controls.
- **Royal Mail's finances have improved since 2012. But the USO remains fragile.**
  - » 2014-15 was the first year under Ofcom's regulatory framework where the Reported Business earned an EBIT margin within the range of the 5-10% Ofcom guide.
  - » Benchmarking analysis of other postal operators and FTSE 100 companies suggests a reasonable range for margins of 5% to 16%.

There are other pressing reasons why a review is needed:

- **Royal Mail faces a unique set of circumstances that mean a "one size fits all" regulatory approach is inappropriate.** We operate in a fragile ecosystem with limited room to manoeuvre. The analysis that drove the major regulatory changes in 2012 is as relevant now as it was 3 years ago.
- **Significant regulatory risk remains a feature of the postal sector**. There has been a history of regulatory failure. Royal Mail needs the current commercial freedoms, along with further deregulation in parcels in order to sustain the USO.
- **The market has moved on significantly since 2012**. **The postal sector is changing rapidly. Regulatory interventions need to be clearly grounded in the realities of today's postal sector**.
- **As Royal Mail transforms, it needs both USO and non-USO revenue pools to sustain the USO.** The regulatory focus needs to shift to focus on the revenues needed to fund the USO. Ofcom needs to put in place a clearly defined sustainability framework for the USO.
- **The postal industry needs regulatory certainty. Ofcom should act to:**
  - » Put in place an appropriate and supportive regulatory framework as soon as possible.
  - » Provide additional guidance on the commercial flexibility provided in 2012.
  - » Ensure regulatory certainty. Ofcom promised regulatory certainty for seven years, the need for a stable regulatory framework remains:
  - » Give a clear signal on how it will calibrate its regulatory intervention and over sight to
    - Continue the provision of a high quality USO
    - Ensure the USO provider is making adequate progress on efficiency
    - But, as a matter of priority, ensure the USO is financially stable

Chapter 2: To what extent do you consider Royal Mail's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as e-substitution?

Royal Mail's overall pricing and non-pricing behaviour is significantly constrained by the decline in addressed letter volumes, competition from other industries, parcels competition and intensive upstream access competition. After the re-calibration in letters prices in April 2011 and April 2012 and in parcel prices in April 2013, Royal Mail has been able to keep the average price increases across its inland mail broadly in line with RPI. In fact, increases have returned to levels comparable to those observed in 2010 under the previous regulatory regime.

(a) Letters

- **Royal Mail's letter prices are significantly constrained by declining addressed letter volumes.** Management judgement and the commercial flexibilities granted in 2012 are essential. Royal Mail sets prices in a manner that takes into account the threat from increasing the long term rate of e-substitution (currently [✂] per year) to avoid triggering a 'tipping point'.
- **Royal Mail's pricing in consumer letters has been consistently fair and reasonable. Historic price changes were an essential re-calibration to bring Royal Mail to profitability. Our services remain affordable. They offer excellent value for money.** The only material letter stamp price rises were in 2010-11 and 2011-12. Subsequent price rises have been below RPI on average. Pricing levels for 2nd class letter stamps still remain well below the price cap set by Ofcom.
- **The UK has the most developed access market in Europe.** Royal Mail's prices for access and contract letters have been fair, reasonable and cost-oriented. Its pricing proposals have been cost-oriented and compliant with competition law.
- **Royal Mail has not engaged in non-pricing behaviour intended to prejudice any of its access customers.** Non-pricing behaviours, e.g., use of bags and trays, are driven by operational considerations and comply with competition law and the relevant regulatory rules. Quality of service is high and terms and conditions of access are clearly balanced.

(b) Parcels

- **Intense parcels competition significantly constrains Royal Mail's prices. Royal Mail's prices have been fair with overall price decreases in some segments.** The parcels market is challenging. It is changing at a rapid pace with intense levels of competition, greater disintermediation and disruptive business models.
- **We are providing value for money for our parcels customers. We are investing in many product and process innovations.** Royal Mail has made concerted efforts to ever increase the value for money for its parcel customers, e.g., price decreases and price promotions, and broadened eligibility for value-added services, e.g., tracked account parcel services and account discounts.

Ofcom has concerns about the potential for excessive pricing by Royal Mail. These concerns are misplaced. Royal Mail has adopted a measured approach and has not shown high levels of profitability. UKPIL revenues fell from 2013-14 to 2014-15 in real terms. Parcel revenue did not grow as originally expected so as to compensate for ongoing decline in letters revenue. 2014-15 was the first year where the Reported Business earned an EBIT margin within the Ofcom indicated 5-10% range. This was only due to a refinement of the definition of EBIT by Ofcom. Without this refinement (using the original basis set by Ofcom in 2012)[1], the EBIT margin remains below the 5-10% range and is lower than that observed by other European postal operators.

[1] Ofcom set out in its 'Annual monitoring update on the postal market Financial year 2013-14' (published Dec 2014) that the 5-10 per cent indicative EBIT range was defined as the cash pension rate adjusted EBIT margin after transformation costs (financeability EBIT margin) http://stakeholders.ofcom.org.uk/binaries/post/monitoring-report-13-14/annual-monitoring-update-postal-2013-14.pdf-.

Our Approach to the chapter:

This chapter will show that Royal Mail's pricing and non-pricing behaviour is constrained in letters and parcels. We will provide evidence for the constraints placed on us by the market. We will detail Royal Mail's view that our pricing and non-pricing behaviours have been fair. We will describe this for (a) letters (consumer and access) in the first section of the chapter, and for (b) parcels in the second. (a) and (b) are included to signpost across all headings and subheadings in the chapter.

(a) LETTERS

(a) Royal Mail's letter prices are significantly constrained by declining addressed letter volumes.

2.1. Royal Mail has not abused the increased pricing freedom provided by Ofcom in the 2012 regulatory framework. FTI Consulting's analysis shows that Royal Mail's addressed inland mail prices since April 2012 have increased by c.1.2% p.a. above RPI. That is a rate comparable to those observed in 2010 under the old regulatory regime. Across all addressed inland letters and large letters the increase was c.0.7% p.a. above RPI. This average increase is based on headline prices. It does not reflect promotions or discounts offered to customers such as discounts for first time users, incentives for growth or bespoke contracts. For example, in 2014-15 Royal Mail offered discounts to promote growth to c.50 customers covering c.95mn items, and discounts to first time users to c.230 customers covering c.30mn items.

2.2. USO products and services remain affordable. When benchmarked against other EU posts for stamp prices, **Royal Mail remains below the European average for both 1C and 2C addressed inland letter stamps.**

2.3. After the price increases in April 2011 and April 2012, the average increase for access letters prices was c.0.3% p.a. above RPI. These **price increases have been similar to the overall changes in 2006-10 when they were restricted by the price control regime in place prior to 2012 under Postcomm.**

2.4. Since 2011-12, revenues have remained broadly flat in nominal terms for the Reported Business. [2] There was an increase in 2013-14 compared to the previous year. This was followed by a moderate decrease in nominal revenues in 2014-15. **Between 2012-13 and 2014-15, revenues decreased in real terms as inflation over the period has averaged c.2.9% on an RPI basis.** This was due to a decline in letter volumes and intense parcels competition.

(a) The UK is experiencing ongoing and rapid levels of decline in letter volumes. This is driven by e-substitution and growth in mobile, SMS and online advertising.

2.5. We estimate that the UK, similar to many other European countries, continues to experience **rapid levels of decline in addressed letter volumes of between 4% and 6% per annum** in the medium term, excluding elections[3]. Ofcom, in its Communications Markets Report 2015, acknowledges this rapid decline. It states that between 2010 and 2014, total letter volumes declined by 18.5%. In 2014, there were 2.9bn fewer addressed letter items than in 2010.

2.6. This trend is likely to continue. The proportion of adults using the internet on a daily basis has increased from c.35% in 2006 to 76% in 2014[4]. **E-substitution** and alternative modes of communication such as **social media and online advertising continue to rise.** Royal Mail's estimate for e-substitution in 2014-15 is around [✂] for total addressed inland letters. This is made up of [✂] for advertising mail, [✂] for business mail and [✂] for publishing mail. Further information on Royal Mail's e-substitution assumptions and projections can be found in the *Mail Volumes Trend* report provided to Ofcom.

[2] This is the entity defined by Ofcom as responsible for delivering the universal service.
[3] http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.
[4] More detail can be found in the Competitive Constraints Appendix.

2.7. In the case of business mail, which accounts for [✂] of Royal Mail's addressed inland letter volume, market research by Accent-RAND Europe suggests that, on average, **58% of business customers' communications will be electronic within the foreseeable future**.

2.8. Ofcom's own analysis (2015 Communications Market Report) indicates that almost eight in ten (77%) **16-34 year olds who are sending less post than 2 years ago claim to have replaced post with email.** This age group is also more likely to be using a range of alternative electronic communication methods as a replacement for post. Almost half (47%) use SMS. More than a third use voice calls on mobile phones (37%) or social networking (37%), and 16% are using instant messaging[5].

(a) The threat of increasing e-substitution and the 'tipping point' in price rises which could accelerate the move to mass digitisation – alongside the ongoing structural decline in letter volumes – constrains Royal Mail's pricing behaviour.

2.9. Royal Mail management exercises commercial judgement in setting prices in letters. This judgement is used to maintain a large base of letter volumes well into the future to sustain the Universal Service. Royal Mail also considers factors outside the scope of measured price elasticities. For example, Royal Mail management has considered other media channels an important constraint. Management has explicitly considered price changes in other media sectors, such as television. A Pricing Strategy Board paper make reference to:

- *'Information received over the past 3 months suggests that other media are holding or limiting price increases to below 2%, with price reductions expected in television[6].*

2.10. Estimated average elasticities for all letter segments are low. [7] In practice, Royal Mail's pricing decisions do **not reflect measured price elasticities.** Pricing decisions are made based on expected future changes in the market. They include the introduction of new products or alternatives. In setting prices for advertising mail, Royal Mail takes into account price movements in other advertising media such as TV and newspapers.

2.11. Royal Mail believes that **high letter prices carry an asymmetric risk of triggering mass digitisation.** Research commissioned by Royal Mail[8] highlights the potential risk of a steeper decline, or potentially 'tipping point' type effects. This is particularly the case if large customers decided to adopt more aggressive e-substitution strategies in the face of higher price increases. The risk would increase considerably if large mailers took coordinated action or if they followed one another to significantly reduce their letter communications. In Denmark, mail volumes declined by 50% in six years, partly due to the expansion of the 'e-boks' electronic document system. **A number of European countries have experienced significant declines in volume over the last decade:** Denmark (65%), Netherlands (50%) and Italy (44%)[9]. Volume lost to e-substitution is likely to be irreversible.

2.12. Research commissioned by Royal Mail[10] concluded that **estimated price elasticities would be significantly higher – around double – in response to large price increases.** This is **due to an increase in e-substitution. Business mail, accounts for** [✂] **of all Royal Mail's addressed inland letters, is most prone to e-substitution.** This trend will continue. It will likely accelerate in the future. Government departments are facing pressures to reduce costs, potentially prompting a move to digitisation. The Driver and Vehicle Licensing Agency (DVLA) has already digitised significantly in the past year, ceasing to issue paper tax discs. **A combination of these factors can drive letter volumes down significantly. These factors place significant pricing pressure on Royal Mail.**

2.13. In summary, **Royal Mail pricing decisions on letters are significantly constrained by (a) the competitive pressures driven by the internet and (b) the potential 'tipping point' effect of price rises** leading to mass digitisation. Large price rises are not a rational strategy in a declining market. This is

[5] Ofcom Communications Market Report, 2015, Section 6.3.1.
[6] Pricing Strategy Board (13) 17 paragraph 4.
[7] 2015 Mail Volume Trends Report.
[8] Accent and RAND Europe, "Letter mail e-substitution and prospective trends; customer stated intention analysis" Report, December 2011.
[9] Annual reports.
[10] Royal Mail, Mail Volume Trends Report, 2015.

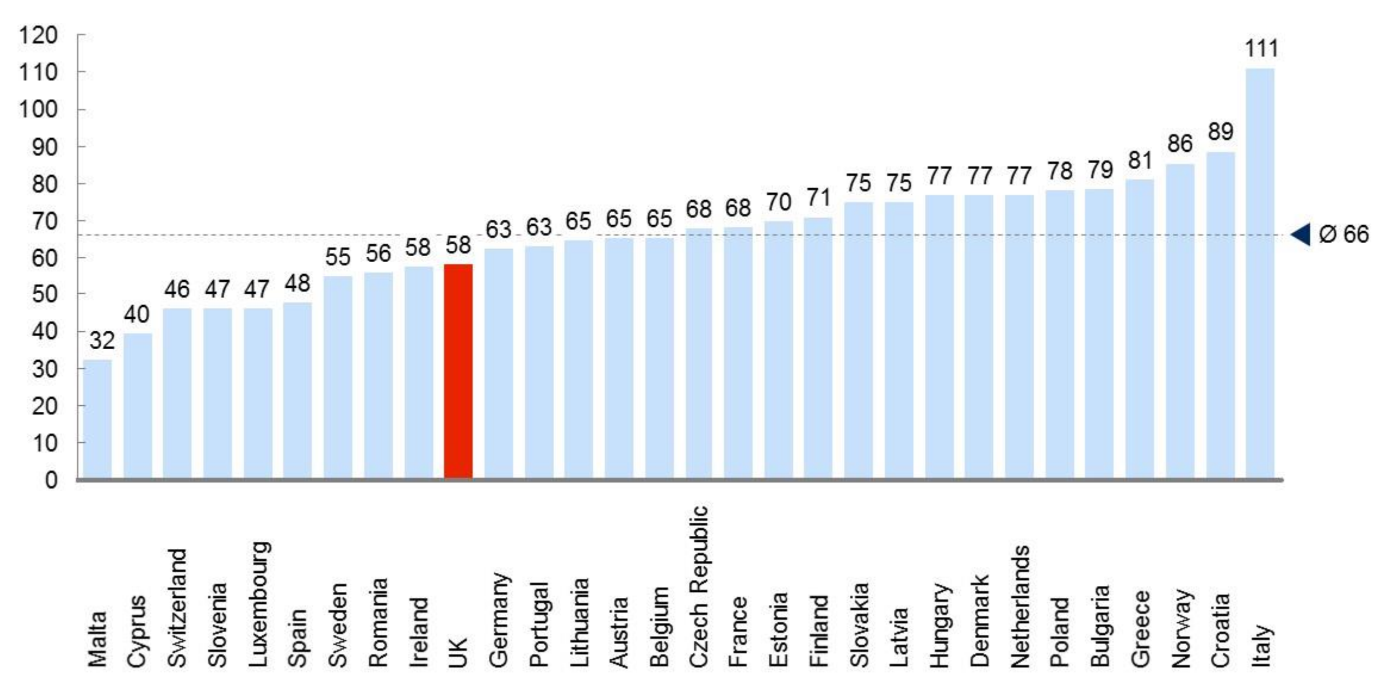
particularly the case as the substitution away from letters is likely to be irreversible, even if prices are subsequently reduced[11]. This is confirmed by FTI Consulting's analysis of Royal Mail's price changes in the Competitive Constraints Appendix. **Royal Mail has not abused the commercial freedom granted by Ofcom in 2012.** The average annual real price increase for overall letters, including large letters, between April 2012 and April 2015 was c.0.7%.

(a) Royal Mail's pricing in consumer letters has been consistently fair and reasonable. Historic price changes were an essential re-calibration to bring Royal Mail to profitability. Our services are affordable. They offer excellent value for money.

2.14. For retail consumers, **material letter price rises occurred in April 2011 and April 2012.** They were an essential re-calibration needed to return Royal Mail to profitability. Ofcom clearly realised these price rises were needed to return the USO to financial sustainability. It set the 2nd class stamp price cap at the very top of the 45p-55p range set out in its regulatory framework consultation.[12] Since then, the average stamp price increase has been below RPI. Royal Mail's pricing levels for 2nd class letter stamps still remain below the initial base year of this price cap at 54p in 2015-16. The current cap is set at c.58p in 2014-15 prices.

2.15. USO products and services remain affordable. When benchmarked against other EU posts for stamp prices, **Royal Mail remains below the European average for both 1C and 2C addressed inland letter stamps** (Exhibit 1). After April 2012 prices of first and second class stamp letters were increased at below RPI on average to assist the return of Royal Mail to profitability[13].

Exhibit 1: 1C-2C average inland letter prices for 0-100g[14] ***(UK pence, converted at PPP)***



[11] The Competitive Constraints Appendix illustrates this with a theoretical model
[12] http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf and http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf
[13] See Competitive Constraints Appendix
[14] Only the UK, Switzerland and Ireland operate 0-100g pricing. All other counties operate different USO letter pricing structures. Comparisons are based on the 51-100g price point where a 0-100g price point does not exist. Stamp prices based on information published on operators websites. Average prices calculated using UK volume weights. Royal Mail analysis

(a) Royal Mail has introduced multiple innovations on product and pricing in consumer letters. Royal Mail has also significantly improved customer service.

2.16. **Competitive constraints have also affected Royal Mail's non-pricing behaviour**. This increases the incentive to innovate and provide better service to customers.

2.17. Customer focus is one of Royal Mail's key strategic imperatives. **Since 2012, consumer complaints to Royal Mail have fallen by 15%. Customer Satisfaction has improved** from 70[15] in 2011-12 to 76[16] in 2014-15. This results from a number of initiatives implemented across our letters and parcels businesses. They include adopting a 'root cause' approach to complaints and reducing call response times. Delivering innovation enables Royal Mail to continue to respond to customer needs and to remain competitive. Significant investment in IT since 2012 is being realised in a number of innovations. This includes the launch of Mailmark, our major innovation in letters.

2.18. Compared with other entities within Ofcom's remit, postal services account for a small percentage of complaints. The level of telecoms complaints over the last two years have generally fluctuated between 6,000 and 7,000 per month. This compares to around 25 per month relating to postal services. According to the 2014 Consumer Action monitor survey, **only 1% of consumer complaints related to post**, 11% to energy and 15% to telecoms. Compared with other utilities, in 2014 Royal Mail received 27% of the number of the complaints received by British Gas and 34% of those received by EDF[17]. It is however important to use caution when comparing Royal Mail results with companies in other industries[18].

(a) The UK has the most developed access letters market in Europe.

2.19. The UK has **the most developed access letters market in Europe.** Access accounts for c.50% of all addressed letters (c.7bn items per year), and c. 70% of the addressed letters sent by large businesses. **Price competition is fierce.** Access customers compete with one another, and with Royal Mail, for customers' mailings. The largest contracts are won or lost over fractions of a penny per item. Competition in the access market is working effectively.

2.20. Royal Mail's share of addressed letters sent by large businesses has fallen by around [✂] since 2007. [✂]

Exhibit 2 [✂]

[✂]

(a) Royal Mail's prices for access and contract letters have been fair, reasonable and cost oriented.

2.21. Ofcom asserts that Royal Mail has proposed "changes to contract terms and pricing which could act to discourage end-to-end competitive entry and expansion". Royal Mail rejects this assertion. **Price changes proposed and charged by Royal Mail for access to its network have consistently been fair and reasonable.** After the price increases in April 2011 and April 2012, the average annual increase in access was c. 0.3% p.a. in real terms. This is in line with the average price changes experienced during the previous price control period under Postcomm.

2.22. Ofcom expressed concerns with Royal Mail's 2013-14 proposals. In its Access Pricing Review, Ofcom also contended that the proposals demonstrated Royal Mail's ability to discriminate between different types of operators. Royal Mail strongly opposes this contention. **Our access pricing proposals have been:**

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[15] A Customer Satisfaction questionnaire completed by business customers via the telephone. Results are calculated by assigning each of the 7 points of the satisfaction scale a value ranging from 100 for the highest scale point (Extremely Satisfied) to 0 for the lowest scale point (Extremely Dissatisfied). The average score from all customer responses was then calculated

[16] 2011-12 survey based on email and telephone survey, whereas subsequent years were 100% telephone based

[17] Statistics from Royal Mail's annual reports, http://www.britishgas.co.uk/help-and-advice/contactus-personal-details/complaints/gas-electricity.html and https://www.ofgem.gov.uk/about-us/how-we-work/working-consumers/supplier-performance-consumer-complaints

[18] Ofcom: The Consumer Experience of 2014 Research report - 28 January 2015 http://stakeholders.ofcom.org.uk/binaries/research/consumer-experience/tce-14/TCE14_research_report.pdf

- cost-oriented;
- compliant with competition law; and
- not capable of putting an efficient end-to-end competitor at a competitive disadvantage.

Royal Mail took steps to bring the proposals to the attention of Ofcom prior to their announcement. Royal Mail developed the proposals to help secure the sustainability of the universal service, against the backdrop of a continuing decline in letter volumes. The proposals also respond to Ofcom's comments in its March 2013 guidance document that Royal Mail should use its pricing flexibility to respond to end-to-end competition.

2.23. Ofcom expressed concerns with proposals consulted on by Royal Mail in October 2012. These proposals meant that, among other things, access customers that met certain national profile commitments and committed certain volumes would benefit from lower access charges than would apply in "pay as you go". These proposals were never introduced. It was recognised that the industry would require more time to implement them due to their complexity. **Royal Mail also strongly opposes the assertion that mere consultations or announcements of prices could lead to market uncertainty.** The fact that Royal Mail announced new prices is common to all commercial operations. We do not accept that normal announcements of price changes can, of themselves, create uncertainty in a market. Royal Mail is committed to being open and transparent in its activities. We consulted with the industry and presented options for our proposals in 2012. The alternative would be for Royal Mail to not consult on our proposals, which would go against our commitment to being a collaborative industry player.

2.24. Ofcom suggests that Royal Mail has introduced significant year-on-year changes to its frameworks leading to uncertainty for access customers. Royal Mail refutes this assertion. Royal Mail has merely used the commercial freedoms granted to us to react to market forces. Ofcom indicated that it first expected Royal Mail to use the commercial flexibility granted in 2012 to address the threat of end-to-end competition. Ofcom stated that it would wait to observe the effect of that response prior to taking any further action. **Although Ofcom indicated that guidance was required and would be provided on how Royal Mail's access terms and conditions were fair and reasonable, this was never provided. Therefore, to the extent that there was any uncertainty in the market, it was as a result of Ofcom's actions, not Royal Mail's.** In March 2013, Ofcom undertook to provide further guidance on access pricing. At the same time, it encouraged Royal Mail to respond commercially to "mitigate the direct impact of increased competition"[19]. The promised guidance on access pricing never materialised. Less than three years later, Ofcom is now considering new restrictive regulations, including further price controls, on access pricing.

(a) Royal Mail has structured pricing for the access market to encourage migration to innovative and cost-efficient products and processes.

2.25. Royal Mail has set **access prices to encourage migration into newer, more automated products and away from less efficient legacy products.** This involves setting access prices that provide the right incentives for customers to invest in, and migrate to, new technologies and processes.

- Royal Mail has structured pricing for access customers and bulk letter customers in a manner that **incentivises migration to Mailmark.** Mailmark is more cost efficient for both Royal Mail and our customers due to lower prices compared to other products and improved visibility of their mailing.
- Using pricing as an incentive to **encourage customers to migrate from provision of mail in bags to trays** as trays are more cost efficient. In the case of both Mailmark and trays prices, differentials have increased over time to give customers and mail producers time to migrate. Customers were consulted

[19] Ofcom Direct Delivery Guidance, March 2013

on the move to Mailmark[20], with an investment fund made available to mail producers to support their Mailmark investment[21].

To date, the migration of bulk mail customers to Mailmark and the conversion rate from bags to trays has been higher in access services than in Royal Mail's bulk retail business.

(a) Royal Mail has not engaged in non-pricing behaviour intended to prejudice any of its access customers.

(a) Non-pricing behaviour has been driven by operational considerations, and complies with competition law and the relevant regulatory rules.

2.26. **Ofcom outlines several issues raised by stakeholders in relation to Royal Mail's non-pricing behaviour.** We strongly assert that any such behaviour was in accordance with policies and practices that were known to, and understood by, our customers. These were consistent with competition law and the regulatory framework. We deal with each individual complaint (set out in paragraph 3.15 of the Fundamental Regulatory Review) below:

[20] Details can be found at http://www.royalmail.com/sites/default/files/Royal-Mail-Mailmark-Migration-Consultation-27th-July-2015.pdf
[21] Further details can be found at http://www.royalmail.com/mailmark

Ofcom concern	Royal Mail response
i. Concerns about Royal Mail's rules for the use of its bags and trays loaned to access customers.	• **A reliable and sustainable supply of bags and trays is critical to our customers.** They are supplied at no cost. • **In November 2014, there was a serious shortage of trays** for two weeks. This caused regrettable difficulties for both Royal Mail's retail and wholesale customers. • This was caused by two things. **Firstly, unforeseen demand. Secondly, it appears some customers had more trays than they required.** It also appears trays were used outside of our network by at least one operator for purposes outside our rules. • **The problem was fixed.** We purchased new trays and put measures in place. There has been no shortage of tray supplies since November 2014. • **We are developing a new way of providing and repatriating trays within access.** This has been developed specifically with UK Mail over the last 4-5 months and has been welcomed by Whistl and Secured Mail.
ii. Some access customers have said that, to enable them to compete more effectively, Royal Mail should be obliged to provide access to a broader range of products than those specified in the current USPA conditions. This includes products such as first class delivery or access at other points in Royal Mail's network.	• **Royal Mail's access arrangements already provide access to a broader range of products** well beyond those specified in the USPA conditions. Examples of these include: » C9 Premium Agreement (facilitating equivalent first class service) » International Extraction Agreement » Wholesale Parcels Contract » Bespoke Parcels Contract
iii. Concerns about the frequency and extent to which Royal Mail should be permitted to make unilateral changes to its access contracts.	• **Royal Mail's ability to make unilateral changes to the access contracts is substantially constrained** by the various contractual notice periods and the need for consultation where changes are material. • **We have made very few changes to our non-pricing conditions since the introduction of the contracts.** These have proved uncontentious. • In January 2015, **Royal Mail consulted on a proposal to remove the limit on the number of price changes made over the course of a year.** The rationale for the proposal was to allow us to alter prices by service at potentially different times of the year. • **After feedback** on this consultation, it was decided to only lift the restriction on price decreases while retaining the limit on price increases – an **approach that was welcomed by access customers.**
iv. Differences in the terms and conditions between contract or	• It is very difficult to comment on this point as, in the absence of an example, **we are not sure of the specific**

product types do not appear consistent with the difference in the nature of those contract/products and may inappropriately disadvantage companies competing with Royal Mail.	**allegation.** • Where we have differences in terms and conditions between different contracts or products, **we believe those differences are a reflection of the different obligations and specifications in question.** • Royal Mail believes it has **never inappropriately disadvantaged companies competing with us.**

(a) The quality of service provided to access customers and contract letter customers has been excellent.

2.27. The quality of service provided by Royal Mail to access customers has improved. The target has been achieved in the past two years. In 2014–15, **our access quality of service was 95.6%, against a contractual target of 95%. Overall complaints have fallen by 18%[22] since 2012.**

2.28. **Since 2012, we have realised significant innovation in letters**, for example in the delivery of the MarketReach Research programme. MarketReach demonstrates the value of mail in a digital world as a way to drive volumes. This, in addition to driving research, uses specialist media consultants to help customers maximise the ROI on marketing campaigns. Another example is Mailmark. This is a new franking mark for business letters. Mailmark provides transparency of knowing where mail is in the network, when it is due to arrive and enables performance tracking at an item level, using an online analytics dashboard.

2.29. Royal Mail has invested in product and process innovations in response to feedback from access customers and contract letter customers.

- Segmentation by format: Introduced in 2012 following a request by Whistl and UK Mail to **improve their sortation and networking efficiencies.** This allowed our access customers to become more competitive when tendering for carriage only contracts.
- Acceptance By Vehicle: Introduced in July 2013 following a request by Whistl and UK Mail to improve the turnaround time of their vehicles within their allocated access unloading slot at a mail centre. The **change improved vehicle utilisation for carriers and docket accuracy for Royal Mail.**
- Changes to 24 hour forecast requirements: In January 2015, we changed the time for final confirmed copy of the 24 hour forecast from 10am to 4pm the day before handover. This was a result of working with customers over 18 months.

2.30. **Royal Mail fosters positive and collaborative relationships with access customers.** We go above and beyond our contractual obligations to serve them. Royal Mail responds in a prompt and timely manner to requests from access customers.

- Royal Mail has allowed late acceptance of mail from access customers in an overwhelming majority of cases (c.99%). Royal Mail has also accepted c.99% of requests for changes to the access slot allocated to an operator[23]. Recent feedback from one of our customers states, "*I would like to thank everyone in DSACC and the mail centres for all the help and assistance we have been given today. I feel you have all gone the extra mile to ensure we got the mail in today.*"
- Royal Mail has an effective complaints handling process. The majority of complaints are resolved within 10 days. There is no contractual or indeed published target for Royal Mail to deal with and close customer complaints or enquiries. We aim to acknowledge all complaints and enquiries within two working days and conclude them within 10 working days. Where complaints take longer, it is due to the nature of the complaint involving longer lead times of analysis and investigation.

2.31. Since 2004, Royal Mail has made changes to its access contracts to reflect changing customer needs. **Many of those changes have been made in response to access customers' requests.** In 2013, we developed

[22] Royal Mail consumer complaints reports, 2012-13 to 2014-15
[23] Royal Mail Network Access data

a "bespoke" parcel contract based on discussions with operators about their parcels business. In 2015, we introduced the regional price plan (zones). This was following the request of a regional operator and subsequent stakeholder consultation. As far as Royal Mail is aware, there have been no complaints to Ofcom about changes to the access contracts other than for the 2014 price proposals which were suspended, never implemented and have since been withdrawn.

(b) PARCELS

(b) Intense parcels competition significantly constrains Royal Mail's prices. Royal Mail's prices have been fair with overall price decreases in some segments. This has meant that UKPIL revenues have decreased in real terms.

2.32. **Royal Mail has not abused the increased pricing freedom provided by Ofcom** in the 2012 regulatory framework. FTI Consulting's analysis shows that addressed inland mail prices since April 2012 on average have increased by c.1.2% p.a. above RPI[24]. That is a rate comparable to those observed in 2010 under the old regulatory regime. UKPIL revenues fell from 2013-14 to 2014-15 in real terms. Parcel revenue did not grow as originally expected so as to compensate for ongoing decline in letters revenue.

2.33. **Overall, there is downward price pressure across all segments.** After the price rises in April 2013, Royal Mail's average parcel prices have fallen by an average of 1% p.a. in real terms. For consumer parcel prices, the average annual price increase was c.1.8% p.a. below RPI[25]. This is due to intense competition and low barriers to entry. **We estimate that Amazon has reduced the addressable market growth rate available to Royal Mail** to c.1-2% annually in the short term[26, 27].

2.34. Since 2012, revenues have remained broadly constant in nominal terms for Royal Mail's Reported Business. There was an increase in 2013-14 compared to the previous year, followed by a moderate decrease in nominal revenues in 2014-15. **Between 2012-13 and 2014-15, revenues for the Reported Business have increased by 1.2% and inflation over the period has averaged c.2.9% on an RPI basis. This means revenues have decreased in real terms.** This is due to a decline in letter volumes and intense parcels competition. This is dealt with in more detail in Chapter 3 of this response.

(b) The parcels market is changing at a rapid pace. There are ever-increasing levels of competition. This is due to low barriers to switching, greater disintermediation and disruptive business models.

2.35. Royal Mail faces **strong competition in the parcels market. The level of competition is increasing.** Royal Mail Group considers it has a combined domestic market share, including fulfilment Large Letters, of 52% by volume and 38% by revenue. Market volume is growing at an estimated c.4% per annum (excluding the impact of Amazon Logistics)[28]. We believe there are low barriers to entry or exit in the UK parcels market. There are no observable constraints on growth as a result of Royal Mail activity: DPD is growing fast at the express, higher weight end of the market, and at the lower cost, typically lighter weight deferred end of the market. Hermes is also growing quickly with prices often lower than Royal Mail's.

2.36. While mandated access in the letters market has seen c.50% of the market move to access operators, in parcels, competitors already have almost half the market. **This market is working well for operators and consumers.** Access operators can and do already inject parcels into other end-to-end carrier networks such as Hermes where small parcels are already fully tracked. Such arrangements are on an individually-agreed, commercially-priced basis.

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[24] More details can be found in the Competitive Constraints Appendix
[25] More details can be found in the Competitive Constraints Appendix
[26] Royal Mail estimates based on historic growth trends (Triangle Management Services/ RMG Fulfilment market measure, December 2014), and forecast data (Verdict UK E-retail Survey 2015)
[27] This will be dependent on the speed and extent of rollout of Amazon's own delivery network
[28] Triangle/Royal Mail estimates based on latest competitor financial accounts and Royal Mail financial year end revenue/volume. Domestic market only (excludes all Import/Export), Including Large Letters

2.37. The market is **highly fragmented.** Compared with many other European markets, the UK parcels market is less concentrated. There are 16 major national carriers. Almost all are growing and actively looking to increase market share. Carriers are also working together to rival Royal Mail's reach and compete in segments where they previously had low market share. Royal Mail **faces competition from established global integrators** (UPS, FedEx, TNT and DHL), traditional regional and domestic carriers (DPD, Yodel and Hermes) **and disruptive business models** (Amazon Logistics and resellers such as ParcelMonkey).

2.38. **Amazon has introduced its own logistics and delivery capability.** It already delivers as many items as some of the largest national carriers. This has effectively removed a substantial volume of parcels from the addressable market. We estimate that it has halved the addressable market growth rate available to Royal Mail to c.1-2% annually in the short term. However, this will be dependent on the speed and extent of rollout of Amazon's own delivery network.

2.39. **Disintermediation is disrupting carriers' relationships with shippers**, particularly amongst marketplaces. While information on the scale of marketplaces within the wider e-retail market is not publicly available, we estimate that of the [✂]. As the largest UK marketplace, eBay is disintermediating carriers by developing its own network of access points for drop-off and pick-up services through partnerships with Argos and Sainsbury's. If eBay's drop-off solution is successful, it is likely to get cheaper bulk rates, significantly reducing carriers' Average Unit Revenues. This is an alternative to Post Offices or other parcel shop networks.

2.40. The **speed with which new business models have emerged has accelerated.** There has been a very rapid expansion of parcel shop networks. They are targeting SMEs and offering collection and returns services to consumers. The combined high street presence of competitors is now larger than the Post Office network of c.11,500 branches. Online resellers have also continued to grow. They offer price comparisons and virtual distribution solutions, allowing consumers to select a carrier based on lowest cost to serve. There has also been an **equally swift growth in the ability** (and consumer take up) of booking a delivery to a retailer's own store (Click and Collect) **to pick-up in store at the consumer's convenience.**

2.41. **Technology is enabling new entrants to insert themselves into the value chain further intensifying competition.** For example, carrier management systems, such as Metapack, integrate senders with carriers. They enable senders to switch carriers quickly and easily.

(b) Capacity investments have maintained high levels of spare capacity in the market. This has put downward pressure on prices.

2.42. A series of capacity investments made by a range of carriers has been completed. Royal Mail estimates that this will have increased carrier sorting capacity by over [✂] parcels per annum from July 2011 to December 2015. As a result of this investment and Amazon Logistics removing a substantial volume of items from the addressable market, Royal Mail believes that **there is c.20% spare capacity in the parcel market** (see Exhibit 3) and that this is currently growing. This could increase as Amazon Logistics continues to expand.

2.43. The combined effect of Amazon Logistics and overcapacity has put very **significant downward pressure on prices. Carriers are seeking to fill their networks.** They are also targeting parcels outside their traditional spaces. For example, DPD has invested heavily in improving its consumer deliveries. It has increased DPD's proportion of B2C traffic from less than [✂]. Yodel, Hermes and UPS have built extensive networks of parcel shops to target consumer and small business sent traffic.

Exhibit 3 [✂]

[✂]

(b) We are providing value for money for our parcels customers. We are investing in many product and process innovations.

2.44. Royal Mail has made **concerted efforts to deliver better value for money to its parcel customers.** We offer the cheapest consumer next day 0-1kg parcel in the market. Recent pricing across all segments (including single piece and bulk prices) included price decreases (e.g., flatlining 0-2kg second class small parcels)[29]. In March 2015, we also introduced an International Large Letter format to reduce the price of letterboxable export parcels. We also **changed the account thresholds for SMEs which led to overall price reductions** for them.

2.45. Our **parcels services are good value for money with Royal Mail investing in a number of product and process improvements and innovations** in this sector, such as our First Time Delivery Programme and our Returns Portal. We are also undertaking a major transformation programme in our parcels business, including rolling out of acceptance and delivery scanning on standard parcels, which will launch in spring 2016. Investment in technology for frontline staff and barcoding the majority of our parcels will provide the capability to track the majority of parcels delivered through our network every year across the UK.

2.46. There have been **initiatives to improve both the ease of shipping parcels** (such as easier to use shipping solutions and Later Acceptance Times) **and ease of collection** (such as 'Local Collect', offering a 'click and collect' service into 10,500 Post Office branches to all business customers including 20,000 SMEs). Another example of major investment are the 'Customer and You' improvements to delivery offices. These include a trial of Sunday opening at selected locations, investing in new enquiry office IT systems and training 3,000 staff to make parcel collection quicker with more payment options. We have also launched a multi-channel e-commerce solution. Royal Mail has also made a number of investments to expand our offering to e-retailers. Since the start of 2015, we have acquired or bought a stake in Storefeeder (e-commerce management tools), Mallzee (personal shopping app) and Market Engine (online shop fronts and web integration). Through these strategic investments, we are supporting the growth of small and medium-sized enterprises.

Conclusion

(a) Letters

- **Royal Mail's letter prices are significantly constrained** by declining addressed letter volumes
- Royal Mail's **pricing in consumer letters has been consistently fair, reasonable and cost oriented**
- The UK has the most developed access market in Europe. **Royal Mail's prices for access and contract letters have been fair**, reasonable and cost oriented
- **Royal Mail has not engaged in non-pricing behaviour intended to prejudice any of its access customers**

(b) Parcels

- Intense parcels **competition significantly constrains Royal Mail's prices**
- Royal Mail **prices have been fair with overall price decreases in some segments.** We have also invested in many product and process innovations

Ofcom has concerns about the potential for excessive pricing by Royal Mail. These concerns are misplaced. Royal Mail has adopted a measured approach and has not shown high levels of profitability.

[29] 2C small parcels (1-2kg) reduced from £5.60 in March 2014 to £3.80 and then subsequently to £2.80 as part of a promotion which has been extended to March 2016. In March 2014, 1c parcels were reduced from £6.85 to £5.45. In March 2015, we also reduced 2c Medium parcel 0-1kg from £5.20 to £4.89.

Chapter 3: To what extent do the competitive constraints faced by Royal Mail vary by different types of mail, e.g. for letter services, between advertising mail, transactional mail, and publishing mail; and for parcel services, between single-piece and bulk parcels?

All segments of mail face high competitive constraints. Future evolution is uncertain. This, together with the existing regulatory framework, has been more than sufficient to constrain Royal Mail's pricing behaviour. Price rises have been fair and reasonable. These conclusions apply to all segments despite some variations in competitive intensity. Royal Mail's overall UKPIL revenues fell in 2014-15 in real terms, underlining the competitive nature of the market. There is no need for increased regulation on Royal Mail. **Inappropriate regulations could damage revenues, undermining the financial sustainability of the USO.** We believe there is room for deregulation of some key activities. These are set out in Chapter 5.

(a) Letters

- **Letters are declining in all the three segments, driven by e-substitution. There is a high degree of uncertainty about the rate of e-substitution; this decline could accelerate.** A number of countries are experiencing significantly higher volume declines than the UK.
- **Whilst Royal Mail's historical average elasticities are low for all letters segments, Royal Mail has acted on the basis that it is constrained in price setting.** Given such strong volume declines, small real price increases are expected to protect revenues. Despite this, FTI Consulting's model shows that it is rational for Royal Mail to price more competitively to protect the future size of the market.
  - **Transactional mail has declined by [✂] since 2011-12. Large customers are switching to digital alternatives. High price rises could trigger a "tipping point".** The government and other large customers may decide to switch to online communications at any moment. This constrains Royal Mail's price rises. They averaged c.0.9% p.a. over RPI.[1]
  - **Advertising mail spend faces major competitive constraints. It is competing aggressively with other media channels for advertising budget.** Price rises are therefore below that of other products-on average c.0.6% p.a. below RPI.[2]
  - **Publishing mail has declined sharply. Online and mobile reading substitutes for print and new delivery methods are further reducing volume.** Price rises have been constrained. They have not exceeded on average c.1.2% p.a. above RPI.[3]

(b) Parcels

- **The parcels market is even more competitive than the letters market.** The competitive trends in parcels have accelerated since 2012. The outlook for the competitive landscape is highly uncertain: (i) Competitors already account for approximately half the market by volume and are growing. (ii) Expansion by competitors in the market has meant that traditional B2B players have moved into B2C, generating even more competition in this fast growing segment. (iii) We estimate that spare capacity is at c.20%, with no real prospect of this declining in the short-term. (iv) Amazon Logistics' entry has halved the growth in the addressable market for Royal Mail.
- **The impact on Royal Mail of this increased competition is downward price pressure with parcels revenue growth failing to compensate for the decline in letters revenue.** Royal Mail's parcel prices have fallen by an average of c.1% p.a. in real terms since April 13. This intense competition has prevented parcel growth from fully offsetting letters decline, causing a decline in Royal Mail's UKPIL revenues from 2013-14 to 2014-15 in real terms. Parcels are an ever growing proportion of non-USO revenues. Non-

1 For business mail, from April 2012. See Competitive Constraints Appendix
2 From April 2012. See Competitive Constraints Appendix
3 From April 2012. See Competitive Constraints Appendix

USO revenues are required to sustain the USO. **Declining growth in parcel revenues could jeopardise the sustainability of the USO.**

- As Ofcom has recognised, **these factors create a high level of uncertainty around Royal Mail's parcel volumes and revenues:**
  - » **Single piece parcels are now facing strong and ever growing competition, which has intensified since 2012.** This is driven by the rapid rise of parcelshops, and online resellers and consolidators. **There is growing disintermediation.** Marketplaces (e.g. eBay) are developing alternative services and channels for this segment.
  - » **Bulk parcels sent by the largest retailers face significant competition from other carriers, and alternative delivery models**, e.g. Click and Collect. Royal Mail starts from a position of low share in the segment. Royal Mail estimate that we have [✂] of volume from the top 100 UK parcel shippers excluding Amazon. Contractual commitments, high switching costs, and price competition significantly limit Royal Mail's ability to gain market share.

(a) LETTERS

Letters are declining in all markets, driven by e-substitution. There is a high degree of uncertainty about the rate of e-substitution; this decline could accelerate.

3.1. **E-substitution is driving structural decline in letters.** This was acknowledged when the 2012 regulatory regime was put in place. As the Hooper report said[4]: *"if something is digitable, postal operators should act on the basis that it will sooner or later be digitised."*

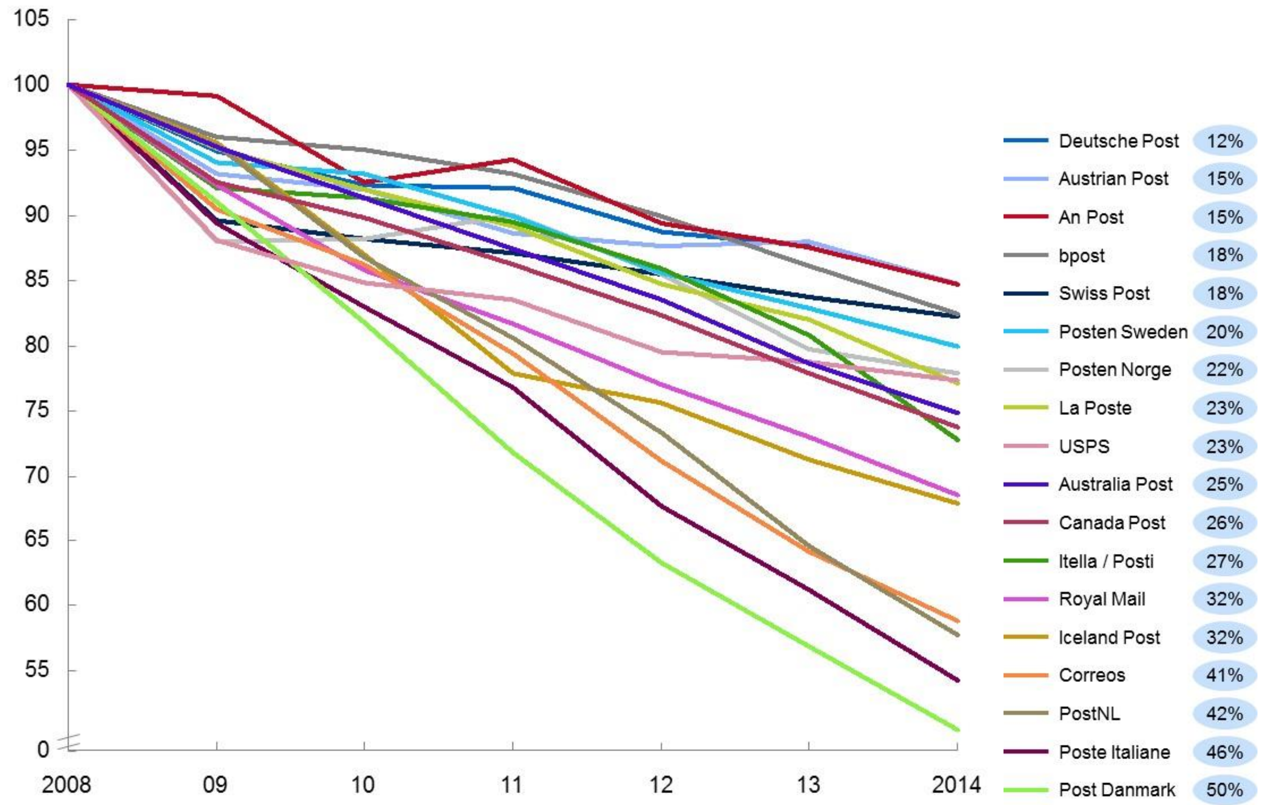
3.2. Over 84% of households in the UK now have internet access.[5] This **enables the move towards e-substitution**. ONS data on internet usage shows that such initiatives by firms and the government hold the potential to influence a large number of customers. The share of adults who use the internet daily increased from 35% to 76% between 2006 and 2014.

3.3. Examples from other countries show **drastic reductions in mail from large customers can happen quickly.**

- Exhibit 1 below shows total mail volumes for 15 Western European countries, USA, Canada and Australia declining across the board.
- As seen in Exhibit 1, Denmark had the largest volume decline of the countries included. Total mail volumes dropped by about 50% in the space of six years. This was partly driven by the expansion of 'e-boks', a system for securely sending and receiving transactional mail. As of August 2015, around 70% of the general population and 22,000 firms and public-sector senders were using this service.[6] The government has made digital correspondence between the state and citizens mandatory through the e-boks system, further driving the decline. While this may not be replicable in the UK, it demonstrates that rapid changes are possible.

[4] Hooper (2010), Saving the Royal Mail's universal postal service in the digital age.
[5] ONS: Statistical Bulletin, Internet Access- Households and Individuals, 2014.
[6] http://www.e-boks.dk/ (Accessed 13 August, 2015)

Exhibit 1: Letter volumes across countries, index from base 100 in 2008, overall declines shown[7]



Whilst Royal Mail's historical average elasticities are low for all letters segments, Royal Mail has acted on the basis that it is constrained in price setting.

3.4. **Royal Mail has not raised prices materially beyond inflation since April 2012, despite falling volumes and average low price elasticities[8].** There was a period of re-calibration of letter prices in April 2011 and April 2012. After this period, FTI Consulting's analysis shows that Royal Mail's overall prices for addressed inland letters have increased by c.0.7% above RPI p.a.[9]. That is a level of increase comparable to those observed in 2010 under the old regulatory regime. As explained in Chapter 2, Royal Mail's prices remain below the European average for both 1C and 2C addressed inland letter stamps.

3.5. FTI Consulting found **two likely explanations for this price restraint:**

- Royal Mail is actively complying with the 2012 framework
- Royal Mail's pricing is constrained by the fact that customers could switch away permanently, primarily to digital alternatives.

3.6. **Management judgment has been exercised to account for the likelihood of a "tipping point".** For example, a Pricing Strategy Board meeting in November 2013 argued that "larger price increases might trigger accelerated e-substitution"[10]. As illustrated by the modelling from FTI Consulting, the ongoing decline in the letters market means that **Royal Mail will rationally price more competitively**, as it takes into account the impact that current prices have on the size of the market in the future[11].

[7] More detail can be found in Competitive Constraints Appendix. Sources used are Annual Repots where available, where not available, PostNL European Markets report, UPU, SPACE model, and press sources used
[8] More detail can be found in Competitive Constraints Appendix
[9] More detail can be found in Competitive Constraints Appendix
[10] Pricing Steering Board Paper (13) 79 aX
[11] More detail can be found in Competitive Constraints Appendix

3.7. **Traditional calculations of elasticities do not take into account the effect of irreversible e-substitution.** Once a customer has accepted to receive council tax bills and banks statements only in digital form, there is little reason to believe that they would want to switch back to paper communications. Similarly, the bank or local authority would have little reason to start offering this again. As new technologies mature and their usages evolve over time, econometric estimates using historical data are unlikely to reflect future long-term substitution trends.

3.8. In a market with structural decline causing falling volumes, price increases are necessary to maintain margins. To maintain margins successfully, these price increases should cover inflation, and the increase in unit costs which arise from inflexible high costs. **Since April 2012, Royal Mail has increased addressed inland mail prices by on average 1.2% above RPI p.a. in order to protect the USO[12]. This does not constitute excessive pricing.**

Transactional mail has declined by [✂] since 2011-12. Large customers are switching to digital alternatives. High price rises could trigger a "tipping point".

3.9. **Mail volumes for transactional mail are declining as a result of e-substitution.** Transactional mail, has declined by [✂] since 2007-08, and by [✂] since 2011-12. Royal Mail's upstream transactional mail market share was [✂] in 2014-15 (compared to [✂] in 2010-11).

3.10. Examples from different industries show how they have used this increase in internet usage to e-substitute:

- **Evidence from banks indicates a strong push to online and e-statements.** Customers now expect online statements and some banks such as TSB are offering higher interest rates to customers who go paperless. Other banks in the UK are introducing other measures such as offering default quarterly instead of monthly paper statements, or forcing customers to actively opt-in for paper statements.
- **Utility companies are encouraging paperless billing.** E.ON and Southern Electric now offer a £5-6 discount for each product (gas/electricity) and Virgin Media and TalkTalk offer discounts on phone bills.
- **UK government drive to digitize (e.g., Government Digital Strategy).** Government departments are encouraging online communication through differential pricing (ordering copies from the Land Registry), later submission dates (tax self-assessment) etc. DVLA has removed paper counterpart driving licences and car tax discs. According to recent proposed legislation, local authorities would no longer be legally required - unless specifically requested - to send certain documents related to council tax bills by post[13].

3.11. Despite an average price elasticity of [✂] in business mail, prices have only increased by c. 0.9% on average above RPI p.a. since April 2012[14,15]. Access prices have risen by c. 0.4-1.4% over RPI p.a. on average for key business mail over the same period. This shows that **management have acted based on more than the current price elasticity.** A Pricing Strategy Board paper[16] shows that management acted on the need to show restraint with price rises, recognising that:

- *"Larger price increases might trigger accelerated e-substitution especially amongst banks and utilities. Customers are asking for greater price certainty. Otherwise they might fear [the] worst based [on] our recent track record of increasing prices".*

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12 See Competitive Constraints Appendix
13 50 ways to save – Examples of sensible savings in local government, Department for Communities and Local Government, December 2012.
14 Royal Mail does not have a separate price for transactional mail items. Transactional mail items are sent using the Business Mail product. Customers are also able to use Business Mail for other type of business correspondence
15 See Competitive Constraints Appendix
16 Pricing Strategy Board (13)79aX

Advertising mail spend faces higher competitive constraints. It is competing aggressively with other media channels for advertising budget.

3.12. **The advertising market is growing. But advertising mail volume is shrinking.** As Ofcom highlights in its 2015 Communications Market Report, Direct Mail has decreased as a proportion of total advertising spend every year since 2010[17].

- Advertising mail volumes have declined by [✂] since 2011-12. Over the same period, spend on other forms of advertising (internet/ media) has been increasing[18].
- Advertising mail now makes up only c. 13.9% of the overall advertising market in revenue terms[19].
- Royal Mail's upstream advertising mail market share was [✂] in 2014-15 (down from [✂] in 2011-12).

3.13. Despite an average price elasticity of [✂] in advertising mail, on average prices have increased by c. 0.6% pa below RPI since April 2012. **This shows the management have again acted based on more than the elasticity.** A Pricing Steering Board paper shows that management considered Royal Mail's advertising mail prices to be constrained by other media channels:[20]

- *"Information received over the past 3 months suggests that other media are holding or limiting price increases to below 2%, with price reductions expected in television".*

3.14. **Increased internet penetration means that online advertising can now be considered an even stronger constraint on advertising mail than before.** In 2011, Ofcom considered whether online advertising might act as a constraint on TV advertising. Ofcom's main argument on product characteristics was that online did not yet have the same population reach as TV. Comparing online and advertising mail in the same way, this argument would be less applicable today because online usage is now much more developed[21].

3.15. **For the largest advertising contracts, media buyers strongly influence the choice of media.** Media buyers calculate the Return on Investment (ROI) of different media when deciding on a campaign showing substitutability between different media. Internal Royal Mail pricing strategy documents make clear reference to competing media channels. Royal Mail's **pricing decisions are made based on a review of price changes in the wider advertising market.**

Table 1: Year on year growth in advertising spend by media in real terms.

Items	Internet	Direct mail	TV	Radio	Out of Home	Print Media	Total Spend
2011-12	11.3%	(2.4%)	(4.8%)	1.3%	(3.6%)	(13.0%)	7.4%
2012-13	11.2%	(3.0%)	(2.9%)	(2.8%)	5.4%	(13.6%)	5.8%
2013-14	10.8%	(7.0%)	0.3%	(3.6%)	(1.3%)	(10.9%)	6.2%
2014-15	12.4%	0.2%	4.9%	9.3%	3.5%	(9.0%)	8.9%

Note: Real terms prices in 2014-15 terms using the RPI index.

Sources: Advertising Association/ Warc, ONS Consumer Price Inflation monthly report.

[17] The Communications Market Report, Ofcom, 6 Aug 2015.
[18] See Competitive Constraints Appendix.
[19] See Competitive Constraints Appendix.
[20] Pricing Strategy Board (13) 17.
[21] Although made in the context of a comparison with TV advertising, not direct mail.

Publishing mail has declined sharply. Online and mobile reading substitutes for print and new delivery methods are further reducing volume.

3.16. **Publishing Mail declined sharply** by c. [✂] since 2007-08. This decline is a result of:

- The growth in online reading substituting for reading publications in physical form. The increase in importance of online/mobile devices has been a key driver of this. Internet-based magazine subscriptions have developed onto new platforms such as eReaders and Tablet PCs. This makes electronic subscriptions more portable and closer substitutes to their printed counterparts.
- Alternative options gaining strength such as internet, delivery with online grocery shopping, newsstands, retailer delivered subscriptions etc.

3.17. Despite a price elasticity of [✂] in publishing mail, prices have only increased by c. 1.2% over RPI on average since April 2012. This shows that management have acted based on more than elasticity.

(b) PARCELS

The parcels market is even more competitive.

3.18. **There are 16 major national independent carriers** (including Royal Mail Group) **in the UK market[22]. There are also access-style models.** The market is operating effectively with competition based on price, service and innovation. The largest customers e.g., Next with Hermes, directly inject volumes into carriers' depots. Large customers inject traffic directly into the central hubs of many, if not all, national carriers. Royal Mail is already mandated by the USO to carry Access Large Letters used for goods such as DVDs. For parcels of all sizes, Hermes offer direct injection services for DPD and Whistl.

3.19. **Competitors account for approximately half the market volume. Their volume share has grown since the IPO.** It is estimated that in 2013 Royal Mail Group (Royal Mail and Parcelforce Worldwide combined) had a parcels market share of 38% by revenue and 52% by volume (including large letters used for fulfilment)[23]. Royal Mail is not constraining competitor growth at either end of the market. Hermes (lowest priced) and DPD (premium B2C) both grew revenues by 20%+ in their last full trading year[24].

3.20. **Spare capacity stands at an estimated c.20%[25].** There has been rapid expansion of carriers' capacity since 2013. Amazon have built their own delivery network – Amazon Logistics - since 2012, which is reducing the size of the addressable market. They delivered an estimated [✂] parcels in 2014 and are still growing very rapidly. [✂] Royal Mail estimates that Amazon Logistics will reduce the annual rate of growth in the UK addressable market to 1-2% p.a. in the short-term[26].

3.21. The short-term marginal cost of using spare capacity is very low. Therefore, **carriers are generally incentivised to reduce prices in an attempt to utilise their spare capacity.** Carriers have also diversified away from their traditional segments of the market. DPD have targeted B2C parcels increasing their proportion from under a third in 2009 to over half their volume today[27]. Hermes have targeted consumer and small business sent parcels.

3.22. **Barriers to entry to the parcels market are low. New entrants to the market have grown quickly.**

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[22] Triangle Management Services/RMG estimates based on latest competitor financial accounts and Royal Mail financial year end revenue/volume. Domestic market only; includes Large Letters.
[23] Triangle Management Services/RMG estimates based on latest competitor financial accounts and Royal Mail financial year end revenue/volume. Domestic market only; includes Large Letters.
[24] Based on latest filing at Companies House (DPD for year ending 29/12/13, Hermes for year ending 28/02/14) and Euromonitor International.
[25] RMG analysis.
[26] Royal Mail's 2014-15 Half Year results.
[27] ONS Retail Sales Statistical Monthly Bulletins, January 2011-January 2015, Triangle/ Royal Mail estimates.

- HDNL (since rebranded Yodel) was originally established as the logistics division of Shop Direct Group, which provided significant volume and gave it scale. It demerged in 2008 and is now a standalone parcels company.
- Another example is APC Overnight (Alternative Parcel Company) which has grown [✂]

The impact on Royal Mail of this increased competition is downward price pressure and parcels revenue growth failing to compensate for the decline in letters revenue. Declining parcel revenues could jeopardise the sustainability of the USO.

3.23. **Overall, there is downward price pressure across all segments.** After the price increases in April 2013, Royal Mail's parcel prices have fallen by an average of 1% p.a.[28] in real terms.

3.24. For consumer parcels, after the price increase of April 2013, Royal Mail's price increases were c.1.8%[29] below RPI. This is due to **intense competition, and low barriers to entry as well as the impact of overcapacity generally in the market.** Royal Mail has considered this competition when setting prices as evidenced in a Pricing Strategy Board paper:

- [✂]
- [✂]

3.25. Parcels revenues have not grown as fast as expected at the time of privatisation**.** UKPIL revenues were broadly flat, they were, in nominal terms, £7,787mn in 2013-14 and £7,757mn in 2014-15, with letters revenues declining by 1%, and parcels revenues increasing by 1%[30].

3.26. Royal Mail is competing to grow its non-USO revenues in order to protect the financial sustainability of the USO. Parcels are a significant and growing segment of the non-USO revenues. **This decline in parcel revenue growth risks the sustainability of the USO.**

These factors create a high level of uncertainty around Royal Mail's parcel volumes and revenues.

3.27. The **significant speed and scale of change is driving uncertainty in the parcels market.** This was recognised by Ofcom in its 2014 end-to-end review. The regulator noted that **"the effect of competition in parcels …" is "in part, at least, exogenous" to Royal Mail.** Ofcom further noted that **"relatively small changes in parcel volumes … could significantly affect Royal Mail's future EBIT margins".** The rate of expansion of Amazon's own logistics and delivery capability and the speed of capacity addition by competitors was not expected a few years ago. The **entire value chain has been disrupted.** One example is through carrier management systems (e.g., Metapack). Carriers are also innovating rapidly, for example DPD, Parcelforce Worldwide and UK Mail have developed predicted delivery slots.

3.28. **Royal Mail has identified significant risks in the parcels market going forward.**

- Further disintermediation by retailers and marketplaces, e.g. successful trial of eBay's Click and Drop service in Argos and Sainsbury's.
- New disruptive business models continue to emerge, e.g. a potential rapid expansion of same day B2C model.
- New entrants to market, e.g. Deutsche Post DHL possibly targeting UK as they aggressively build a B2C parcel network across Europe.

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28 See Competitive Constraints Appendix
29 See Competitive Constraints Appendix.
30 RMG Annual Report and Financial Statements 2014-15.

3.29. **Inappropriate regulation in the parcels market would create further uncertainty** about Royal Mail's profitability in parcels. This **instability would harm the sustainability of the USO.**

Single piece parcels are now facing strong and ever growing competition, which has intensified since 2012. There is growing disintermediation in the market.

3.30. **The market offering has changed considerably since 2012.** Historically, the Post Office was one of the only places to post a parcel. Consumers and small businesses now have multiple posting options:

- myHermes and Collect+ have built parcelshop networks of over 10,000 branches between them, covering the whole country. DHL, DPD and UPS have a further 7,000 branches[31].
- In total, competitor branches now outnumber POL (11,500 branches). In many cases, these competitor shops have longer opening hours (open 50% more hours on average)[32].
- There has also been a rise of online resellers and consolidators (e.g., Parcelmonkey, Parcel2Go). These enable customers to easily and quickly compare price and service options. The majority of Royal Mail's competitors are displayed on these reseller sites. Many offer exclusive discounts, e.g., myHermes provide a discounted price on Parcel2Go that is not available in their parcelshops.
- Carrier's online channels allow an alternative option for posting a parcel for IT-enabled customers. For example, Yodel and myHermes allow customers to print a shipping label at home, and arrange a collection, without needing to visit a parcelshop.

3.31. **There is growing disintermediation in the market, creating further uncertainty.** A large proportion of the demand is generated by marketplaces (e.g., Amazon and eBay), and they are now trying to increase control in shipping.

- Amazon's 'Fulfilment By Amazon (FBA)' is expanding rapidly. Marketplace sellers use Amazon for warehousing, pick and pack, and delivery of their items. This takes volume from all other carriers, but in particular Royal Mail.
- eBay is disintermediating carriers by developing its own network of access points for drop-off and pick-up services through partnerships with Argos and Sainsbury's. If this drop-off solution is successful, eBay is likely to get cheaper bulk rates, significantly reducing carriers' AURs.

Royal Mail has been working to improve parcels offering to single-piece and bulk customers, by:

- **Working with our retail partner the Post Office (POL) to improve the customer experience** in branch and extend opening hours. To date, over 4,000 branches have extended opening hours[33].
- **Re-engineering our online postage journey** with the introduction of Click and Drop that allows easy purchase and printing of postage labels.
- **Introducing seasonal pricing promotions** for consumer parcels.
- **Improving commercial terms and pricing for SMEs**, and lowering the spend requirements for accounts.
- **Re-negotiating contracts for the majority of large parcel senders** that more accurately reflect their needs.

[31] RMG Analysis (Apex European Parcel Shops & Locker Networks; Triangle Alternative Delivery Market; Verdict Collection Point Strategies; press releases CEP Research, Post & Parcel).
[32] RMG Analysis (Apex European Parcel Shops & Locker Networks; Triangle Alternative Delivery Market; Verdict Collection Point Strategies; press releases CEP Research, Post & Parcel).
[33] 3,000 are open seven days a week, and over 1,000 branches have been transformed in the last 18 months. See Post Office Annual Report 2014-15 for more details.

Bulk parcels sent by the largest retailers face significant competition from other carriers and alternative delivery models.

3.32. **The largest retailers send significant volumes of parcels within the UK.** In 2012, it is estimated that the top 100 UK retailers sent over 500mn parcels[34]. Their volumes are growing rapidly. Their volumes are also increasingly distributed through alternative solutions such as Click and Collect. For retailers with their own physical shops, this has become a significant channel. For example, over half of John Lewis's e-retail sales are now Click and Collect[35].

3.33. **Royal Mail is significantly under-represented in the top 100 parcel shippers.** Excluding Amazon, Royal Mail only carried an estimated [✂]. Many of the largest customers ship the majority of their traffic with a competitor and Royal Mail has a low share of wallet with these shippers. For example, Debenhams ship the vast majority of their home delivery items with Hermes.

3.34. **The largest shippers can have significant barriers to changing carrier.** Many have invested significant money in developing their IT with existing carriers. Some are located close to their principal carrier's operation. However, they also have substantial price setting power as carriers need their largest shippers' volumes to maintain capacity utilisation. Therefore, these carriers will do all they can to retain their largest shippers' volumes. **These factors taken together significantly limit Royal Mail's ability to gain market share.**

Conclusion

All segments of mail face high competitive constraints. Future evolution is uncertain. This, together with the existing regulatory framework, has been **more than sufficient to constrain Royal Mail's pricing behaviour.** There is no need for increased regulation on Royal Mail. **Inappropriate regulations could damage revenues, undermining the financial sustainability of the USO.** We believe there is room for deregulation of some key activities. These are set out in Chapter 5.

(a) Letters

- **Letters are declining in all three segments, driven by e-substitution.** There is a high degree of uncertainty about the rate of e-substitution; the decline could accelerate.
- Whilst Royal Mail's historical average elasticities are low for all letters segments, **Royal Mail has acted on the basis that it is constrained in price setting.**

(b) Parcels

- **The parcels market is even more competitive than the letters market.** The competitive trends in parcels have accelerated since 2012.

The impact on Royal Mail of this increased competition is downward pricing pressure and parcels revenue growth failing to compensate for the decline in letters revenue. **Lower parcel revenue growth than expected could undermine the sustainability of the USO.**

[34] Euromonitor International, November 2013 Customer Report.
[35] Internet Retailing, March 13, 2015, John Lewis Partnership Annual Report 2015.

Chapter 4: Do you consider that Royal Mail faces appropriate incentives to deliver efficiency improvements?

Yes, Royal Mail faces strong and growing market-based incentives to deliver efficiency improvements. The absence of direct delivery letter competition does not diminish these incentives. Royal Mail has made major progress in efficiency, despite the challenges of driving change at such scale. Working in partnership with our staff and unions, we are determined to do more. Additional regulation is not needed to spur efficiency.

Competitive pressure already strongly incentivises Royal Mail to deliver efficiencies. Royal Mail must be as low cost as possible to stem letters decline and have a cost competitive proposition in parcels. **Shareholder pressure applies a further spur** to efficiency, as demonstrated by academic research[1]. Together, both provide ample spurs to efficiency.

- **The absence of direct delivery letter competition does not diminish these incentives.** The market incentives described above are already driving Royal Mail to reduce costs at pace. There is a limited amount of cost that can be removed. Ofcom has not provided evidence to demonstrate that direct delivery competition would act as a spur to efficiency in Royal Mail. Therefore direct delivery letter competition only reduces revenues.
- **Royal Mail has already made major progress in efficiency.** Royal Mail's recent rate of efficiency improvement has outperformed that of the UK economy[2]. This includes delivering substantial reductions in operational headcount of [✂], reductions in management costs of [✂] in real terms, and reductions in overhead costs [✂] in real terms since 2010-11. [✂]. Productivity is up c.9%[3] since 2010-11. We have done all this whilst maintaining high levels of service. This is a business working hard to continuously improve.
- **Royal Mail is determined to deliver even greater efficiency. We know where our gaps are. We have a clear plan to address them.** Our latest business plan has a stretching trajectory of improvements. We have detailed plans to reduce costs, including in delivery, network, and fleet. We are investing in automation and IT to reduce processing costs. We are further improving customer service. We regularly look at external best practice benchmarks to go further. Our forecasted efficiency gains are broadly in line with targets set by other regulators.
- **Driving efficiency at such scale, with the fixed costs of the USO, is very challenging. Royal Mail faces a unique set of characteristics which impact on our ability to remove cost at pace.** There is not a one for one relationship between volume decline and cost reduction. Costs do not come out automatically with volume declines: we have to take action to remove costs. Throughout the modernisation programme, Royal Mail has sought and delivered exceptionally high quality of service. We will continue to do so but this requires change to be absorbed by our staff. Based on recent rates of improvement, we judge that 2-3% productivity improvement p.a. over the business plan period is stretching. Nevertheless we aim to achieve it.
- **We have deliberately chosen a collaborative approach with our union and staff to enable accelerated change**. Post is a people business: we employ c.143,000 people[4]. To drive productivity improvements, we seek to create the right incentives for our people to do things differently. The pace of change is constrained by the time it takes to build a new culture and to reduce staff headcount

[1] Further information provided in *FTI Consulting Efficiency Metrics for Royal Mail report.*
[2] For the Reported Business, efficiency based on PVEO analysis, using RPI deflator. Further discussion of PVEO methodology is contained in the annex of the *FTI Consulting Efficiency Metrics for Royal Mail* report. UK productivity measured as total factor productivity (TFP)
[3] Productivity = % change in Weighted items per Gross Hour, for delivery and processing, 2014-15
[4] UK PIL, As at March 2015

without industrial disruption. The alternative is costly. Strikes cost Deutsche Post €100mn in the second quarter of 2015 alone.

- **Independent research[5] shows Royal Mail is transforming its operations broadly in line with comparable European Posts.** This is despite the fact that major European Posts such as Deutsche Post, PostNL and Austrian Post have been privatised for significant periods. For example, Deutsche Post has been privatised for over 20 years. Privatisation provided these companies with better access to capital and shareholder discipline enabling them to fundamentally restructure their networks earlier than Royal Mail and drive profitable growth. Royal Mail's integrated parcels and letters network is the optimally efficient delivery model for the UK. While Royal Mail periodically evaluates alternative models, not all competitor models are appropriate.

- **Given the strong, existing, market-based incentives that Royal Mail faces to drive efficiency, it is not necessary to impose any further regulation.** There are strong arguments against efficiency targets. They are difficult to set, and may be unachievable if based on assumptions which do not hold. Ofcom rejected price controls (incorporating efficiency targets) in 2012 as being too static and not dynamic for the market place. Potential disruptions to the business are probably greater now than in 2012.

Royal Mail faces strong and growing market-based incentives to deliver efficiency improvements.

4.1. Competitive pressure already strongly incentivises Royal Mail to deliver efficiency. As outlined in Chapter 3, Royal Mail **faces intense competition in letters and parcels.** Aggressive e-substitution and growth in mobile usage mean we continue to expect that UK addressed letter market volumes, excluding elections, will decline by 4-6% per annum in the medium term. Almost a quarter of consumers claimed to have sent no items of mail in the past month[6]. Spend on UK direct mail as a proportion of total advertising spend has fallen year on year since 2010[7]. As previously discussed, maintaining revenue through price increases risks reaching a tipping point on volumes. Therefore we have to be as efficient on costs as possible.

4.2. Royal Mail faces an **increasingly competitive market in parcels.** Royal Mail estimates that there is c.20% overcapacity in the parcels market at present. [✂]. The consequent overcapacity is depressing parcel prices. It is leading to significant competitive pressure, particularly in the consumer and SME markets, segments key to Royal Mail. These trends are likely to continue. They may accelerate as new technology enables further disintermediation.

Shareholder pressure applies a further spur to efficiency.

4.3. **Royal Mail was privatised in 2013 and is now a publicly listed company.** This acts as a strong, constant spur to efficiency, quite apart from any action by Ofcom. The effects of public listing on efficiency are well established. One study analysed 118 firms privatised from 1961-95 in 29 countries[8]. It showed that privatised firms can exhibit efficiency gains due to greater scrutiny by investors in larger and more sophisticated capital markets.

4.4. This efficiency argument was **central to the UK government's decision** to privatise Royal Mail. As the then Secretary of State for Business, Innovation and Skills said during the Bill's passage through

[5] The consumer impact of competition in the UK postal market - A study prepared for Whistl, Copenhagen Economics, November 2014
[6] Communications Market Report, Ofcom, 6 August 2015, Page 3
[7] Communications Market Report, Ofcom, 6 August 2015
[8] D'Souza, Megginson, and Nash, 2001

Parliament, "*Private sector capital will bring with it private sector disciplines, which will allow the company to modernise faster to keep pace with the changes in the market*"[9].

4.5. **Equity analyst reports demonstrate the power of shareholder pressure.** Recent reports stress the need to cut costs and automate. Current analyst consensus expectation for underlying UKPIL operating costs in 2015-16 is a c.1% reduction, with a range of flat to down c.2%. This is in the context of Royal Mail's stated guidance for 2015-16 underlying UKPIL operating costs to be "flat or better" than 2014-15. The failure to deliver against public promises would have very real share price and reputational implications. For example, Royal Mail's share price fell 16% in July 2014 largely due to the announcement that our parcels revenues would be lower than expectations. Therefore Royal Mail faces the same – if not more - pressure to increase efficiency as any other publicly listed company.

The absence of direct delivery letter competition does not diminish these incentives.

Whistl's exit from the direct delivery market does not fundamentally change the efficiency incentives.

4.6. Market incentives are already driving Royal Mail to reduce costs at pace. Ofcom asserts that direct delivery will act as a spur to efficiency but does not provide evidence to support its position. Direct delivery competition provides no additional spur to efficiency. Instead, it is a threat to USO revenues and financial sustainability. This is because **many costs are fixed due to the USO.** The relationship between volumes and costs is not linear. Whilst some cost reduction is possible as a response to volume decline, Royal Mail postmen and women must still walk the same streets, just delivering fewer items as they go. Therefore, reducing volumes has a direct negative impact on Royal Mail's revenues, but only allows a marginal reduction in cost or hours. As a result, efficiency decreases.

4.7. This is demonstrated by recent econometric work, carried out by FTI Consulting to look at the rate of efficiency improvement in delivery offices impacted by direct delivery competition. This preliminary analysis suggests that direct delivery competition did not drive greater rates of efficiency improvement. In fact, it indicates that the rate of efficiency improvement in areas that were subject to competition were slower than in those that were not.

4.8. We operate a **single network for the delivery of both letters and parcels.** Since one system processes both letters and parcels, fierce competition in parcels requires Royal Mail to improve efficiency across its entire cost base. Letters therefore benefit from the efficiency effects of parcel competition. Independent research, commissioned specifically for this response, shows that Royal Mail's current model of **joint delivery is the optimally efficient model** for the universal service provider in the UK.

Royal Mail has already made major progress in efficiency.

Royal Mail is executing one of the largest transformation programmes in the UK.

4.9. Royal Mail has delivered a step change in efficiency in the Reported Business. The Reported Business, which is the regulated entity that Ofcom has defined as delivering the Universal Service, has improved efficiency by 4.5%[10] in 2014-15. This is a significant improvement on prior years. Underlying **costs have fallen** in UKPIL – they were down 1% in 2014-15. We expect them to be flat or better in 2015-16.

4.10. We are **transforming all the main elements of our operation** – delivery, processing, logistics, overheads. In doing so, we have significantly reduced the number of people in the Operation – [✂] since 2010-11. We have done this while delivery points have been growing by just under 1% per annum. We do not take account of the increasing number of delivery points in our productivity measure.

[9] Postal Services *Bill Second Reading*, 27 October 2010
[10] Using Price, Volume, Efficiency, Other approach, RPI inflation as deflator. For further discussion of PVEO methodology is contained in the *FTI Consulting's Efficiency Metrics for Royal Mail report*.

4.11. A key element of our reforms is to **modernise delivery.** We are taking post "off the shoulder", and shifting to the more efficient 'park and loop' model of delivery. As part of this change we have deployed c.14,000 shared vans, c.33,500 new trolleys, c.40,500 PDAs and redesigned c.59,000 walks from 2010-11 to 2014-15.

4.12. Another major component of modernisation has been to **automate our processes and update machinery.** We have invested in 31 new generation intelligent Letter Sorting Machines since 2010-11. We have upgraded or refurbished 329 machines since 2010-11. We have increased letter sequence sort rates from 34% in 2010-11 to 82% by end of 2014-15. We have simplified our processes in mail centres to allow us to introduce sequencing, and eliminate an inward sorting pass altogether.

4.13. We have also made great strides to improve the **efficiency of our transport and logistics** operations. We have adopted a variety of methods to get more out of our investment in fleet. We have restructured our vehicle service centres to improve vehicle utilisation, achieving 97% availability. Better management has allowed us to remove 3,000 vehicles. Core network reviews since 2010 have reduced the overall number of miles from c.162,000 per day in 2010-11 to c.144,000 per day in 2014-15.

4.14. **We have rationalised our estate.** We have closed 22 mail centres since 2010-11 and opened two new modern mail centres[11] out of a starting total of 59[12] and modernised more than 1,200 delivery offices. Royal Mail is the only post in Europe to tackle this issue at scale. Since 2010-11, we have avoided [✂] of cost p.a. on [✂] investment.

4.15. These changes have allowed us to **reduce manpower.** Headcount in operations is down [✂] since 2010-11. These reductions have been difficult and painful for all concerned. Throughout, we have striven to treat colleagues fairly and with dignity. **We have continuously streamlined our overhead and management** costs to match the leaner frontline. In 2010, we centralised support functions, we removed around [✂] staff with a net present value saving of c.£464mn and recurring benefits of c.£120mn per annum. In spring 2012, we removed 2 layers of operational management entirely. [✂]. In 2014-15, we removed 13% of managerial heads, (c.1,500 staff), saving c.£80mn per annum from 2015-16.

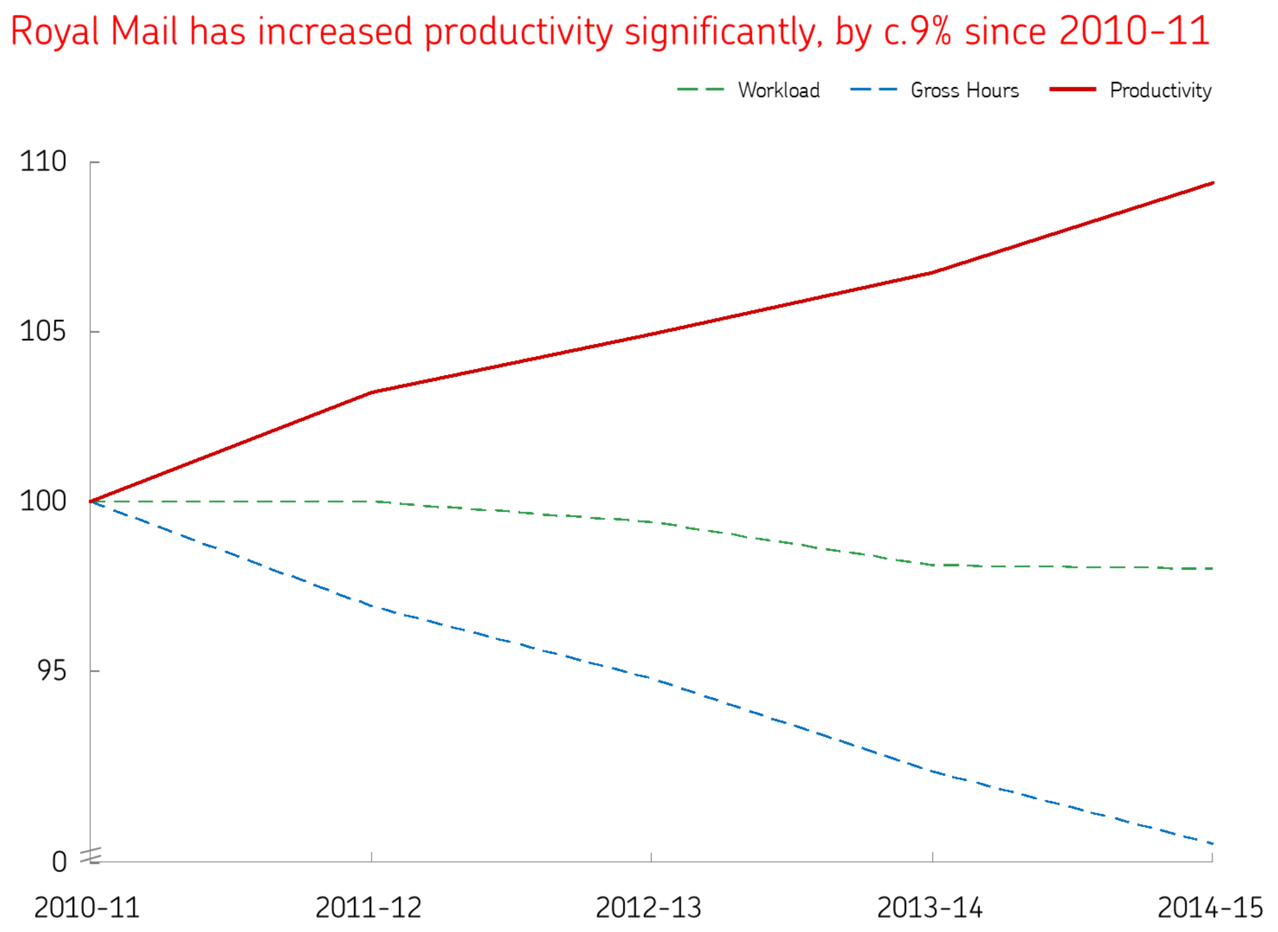
4.16. We have **implemented major pension reforms.** The Royal Mail Pension Plan was closed to new employees on 31 March 2008. They were offered a defined contribution plan instead, and the basis of future pension accrual was changed from final salary to career average. At the same time, Royal Mail agreed that the normal retirement age for existing Defined Benefit plan members would increase from 60 to 65 for benefits accrued from April 2010. From 1 April 2014, we linked future Royal Mail Pension Plan pensionable pay increases to RPI rather than actual pay increases. This enabled company contributions to be maintained at 17.1% of pensionable pay rather than the [✂] that would have been otherwise required.

As a result of our ongoing transformation, labour productivity and cost efficiency is up. We have done this whilst continuing to innovate and maintain our high quality of service to our customers.

4.17. Royal Mail's **productivity[13] in processing and delivery has improved by 9%** from 2010-11. This has been primarily driven by a 10% reduction in hours; investment in the new mail centre estate; the implementation of automated processes; and new integrated methods of parcel and letter delivery. This progress continues. In 2014-15, we achieved 2.5% improvement in productivity, which was within our stated target range of 2-3% per annum.

[11] By end of 2014-15
[12] By end of 2010-11
[13] Productivity = percentage change in weighted items per gross hour

Exhibit 1: Royal Mail productivity record



4.18. **Royal Mail's efficiency[14] performance has also outstripped the UK economy** productivity (using total factor productivity (TFP)) over the period 2011-12 to 2013-14.

Exhibit 2 [✂]

[✂]

4.19. In 2011-12 we achieved strong productivity[15] growth in delivery and processing of 3.2%, as well as a pay award of 1.4% compared to an RPI of 3.5%, which drove efficiency progression of [✂] over the period 2011-12 and 2012-13, we were negotiating the next pay deal, and undertaking significant modernisation resulting in high transformation costs. In addition, a focus of the organisation prior to 2013-14 was on achieving a successful privatisation. Following privatisation, the challenges of the market, including shareholder pressure, have demanded a strong focus on cost efficiency, demonstrated by our 2014-15 performance. **In 2014-15, we improved efficiency by** [✂] which was partially enabled by improving trades union relationships and strong cost control, as well as ongoing return on transformation investments.

4.20. **Royal Mail achieved this whilst continuing to innovate and significantly improve the customer experience.** We have implemented more than 30 projects to innovate for our customers since 2012: 5

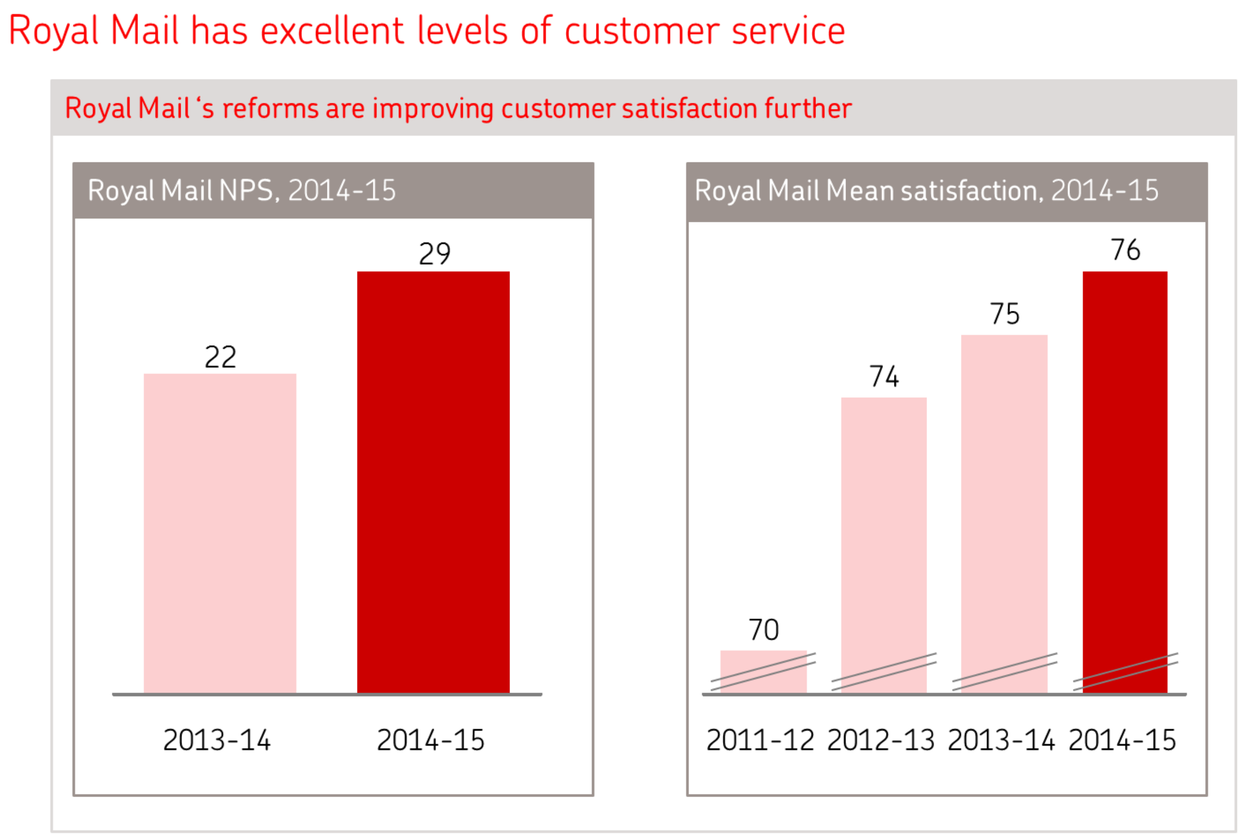
[14] For Reported Business, using PVEO approach utilising RPI deflator. Further discussion of PVEO methodology is contained in the annex of *Efficiency Metrics for Royal Mail* report

[15] Productivity = percentage change in weighted items per gross hour

of the 14 key measures on our corporate balanced scorecard are around customer focus. Bonuses for all managers are directly linked to these measures, with very limited exceptions. We have adopted a root cause approach to dealing with consumer complaints, which has led to a 24% improvement in loss, 16% improvement in redirections, and a 16% reduction in misdelivery over the period 2012-13 to 2014-15.

4.21. As a result, mean Business **Customer Satisfaction has improved** from 70[16] in 2011-12 to 76[17] in 2014-15. Business complaints have fallen 33% since 2012, from c.156,000 to c.104,000. Our net promoter score[18] is the highest in the industry. In 2015, Royal Mail ranked in the top 15 'Superbrands' in the UK on the basis of quality, reliability, and distinction. We are the UK's most trusted and preferred delivery company[19].

Exhibit 2: Royal Mail's customer service scores



Source: Royal Mail's Business Customer CSI survey – run by Ipsos:Mori (2013-14 & 2014-15)

Royal Mail is determined to deliver even greater efficiency. We know where our gaps are. We have a clear plan to address them.

[✂]

4.22. [✂]

4.23. [✂]

[16] A Customer Satisfaction questionnaire completed by business customers via the telephone. Results are calculated by assigning each of the 7 points of the satisfaction scale a value ranging from 100 for the highest scale point (Extremely Satisfied) to 0 for the lowest scale point (Extremely Dissatisfied). The average score from all customer responses was then calculated

[17] 2011-12 survey based on email and telephone survey, whereas subsequent years were 100% telephone based

[18] Net Promoter Score (NPS) is a measure of how likely customers are to recommend a brand. It is the net position of promoters less detractors.

[19] Research conducted by Ipsos MORI, consumer CSI tracker, measuring 12 delivery companies

4.24. [✂]

4.25. **Our business plan is developed to reflect commercial pressures** and the competitive landscape that we operate in. We do not have the same philosophy in business planning as occurs in many regulated sectors. The absence of price control removes the incentive to inflate cost projections and understate profits. Instead we set challenging targets which are reflective of market expectations.

Royal Mail understands where efficiency gaps remain, and has a clear plan to target them.

4.26. There are **five elements** to our efficiency strategy:

- Reducing dispersion in Delivery Offices;
- Reducing variability in Mail Centre performance;
- Reducing costs in logistics;
- Introducing new ways of working; and
- Reducing management and overhead costs.

4.27. This **plan is very ambitious**. It includes:

- [✂] material operations initiatives to drive efficiency, [✂]
- At the frontline, savings will be underpinned by new initiatives, such as moving to collections on delivery, delivery revisions, and a number of logistics initiatives including national road and air network reviews, along with focus on fuel, maintenance, and fleet costs.

4.28. We aim to **increase automation, introducing new ways of working, and to pay fairly**. We will increase the utilisation of the flexibility allowed in the national agreement and narrow the gap between what is permitted and what is used.

4.29. In delivery offices, we are **improving the performance in underperforming offices** by undertaking further revision activity. We are standardising the resourcing to workload approach across all offices, upgrading planning tools and systems, and further indoor method improvements. We are moving to a delivery round collection model for c.43,000 post boxes that receive fewer than 50 items a day.

4.30. We are **improving automation and processes** in mail centres. Royal Mail is:

- Standardising the methodology for efficient movement of containers within the mail centres;
- Consulting on closing two further mail centres in Ipswich and Portsmouth;
- Enhancing address read rates to enable more large letters to be processed by sorting machines;
- Improving local distribution by adopting better route planning, vehicle utilisation, better driver behaviour;
- Improving our production control system to provide better traffic and workload forecasts; and
- Deploying new "tug and trailer" equipment to move mail more efficiently between work areas.

Royal Mail is reducing its logistics and labour costs and has embedded a culture of continuous improvement.

4.31. [✂]

4.32. [✂]

4.33. **Productivity is a key dimension of our management remuneration**. Royal Mail incentivises and tracks all frontline managers on improving productivity. This includes their relative, as well as absolute, performance. At the corporate level, productivity is one of 14 elements of our corporate balanced scorecard, upon which we base executive remuneration. These processes create a lasting impetus to greater efficiency. Management reviews performance on a weekly basis, underpinned by monthly and quarterly performance meetings based on a common balanced scorecard. Under-performing units have additional performance management focus. [✂]

Driving efficiency at such scale, with the fixed costs of the USO, is very challenging. Royal Mail has a unique set of characteristics, which impact on our ability to remove cost at pace.

Many of Royal Mail's costs are fixed by the nature of the USO.

4.34. Royal Mail faces challenges on the revenue side: significant structural decline in addressed letter volume and increased competition in certain areas such as parcels. These are compounded by challenges on the cost side, too. High fixed costs of the USO in relation to quality and peak volumes; high labour-intensity with challenging labour relations; and uncertainty with regard to the regulatory environment. Taken together, these create a very **challenging environment in which to drive efficiency.** Specifically:

- As FTI Consulting noted[20], it is more difficult to make efficiency gains when volumes are falling and there are high fixed costs. In this circumstance, unit costs will increase as volume declines. Cost reduction in the face of declining volumes would typically take the form of reduction in terms of labour hours, which may require costly redundancy programmes. Furthermore, the measures undertaken to re-optimise the network require time and there is a lag effect between falling volumes and costs. Therefore the rate of efficiency progression is slower, compared to a growing volume business.
- The nature of Royal Mail's business and its network means that the relationship between volumes and costs is not linear. This is demonstrated by the high level of fixed and common costs. For instance, Royal Mail estimates that [✂] of its workload in processing and delivery is represented by fixed costs. These represent, for example, the fixed costs of walking down the street to access all the delivery addresses. Whilst on delivery, the post men and women have to pass by the delivery points on the route whether or not the delivery point has mail. There is the same amount of work in delivering mail to an address whether there is one or several items[21]. Royal Mail can only reduce costs when there are no items for the address. Finally, the number of delivery points is increasing at just under 1% per annum leading to further increase in fixed costs.
- As the provider of last resort, Royal Mail is subject to **more volatility than other operators.** Competitors can optimise their operations to match their average volume. They can offload any peaks for both letters and parcels into Royal Mail's network. They often do so with little notice. While volatility is not large at an aggregate level, it can have an important impact at the local delivery office level.

4.35. Cost reduction in response to declining volumes takes time: it needs to be absorbed and needs to be achieved while maintaining our high quality of service to customers.

Royal Mail is a people-driven business. Change is not simply a matter of upgrading machinery.

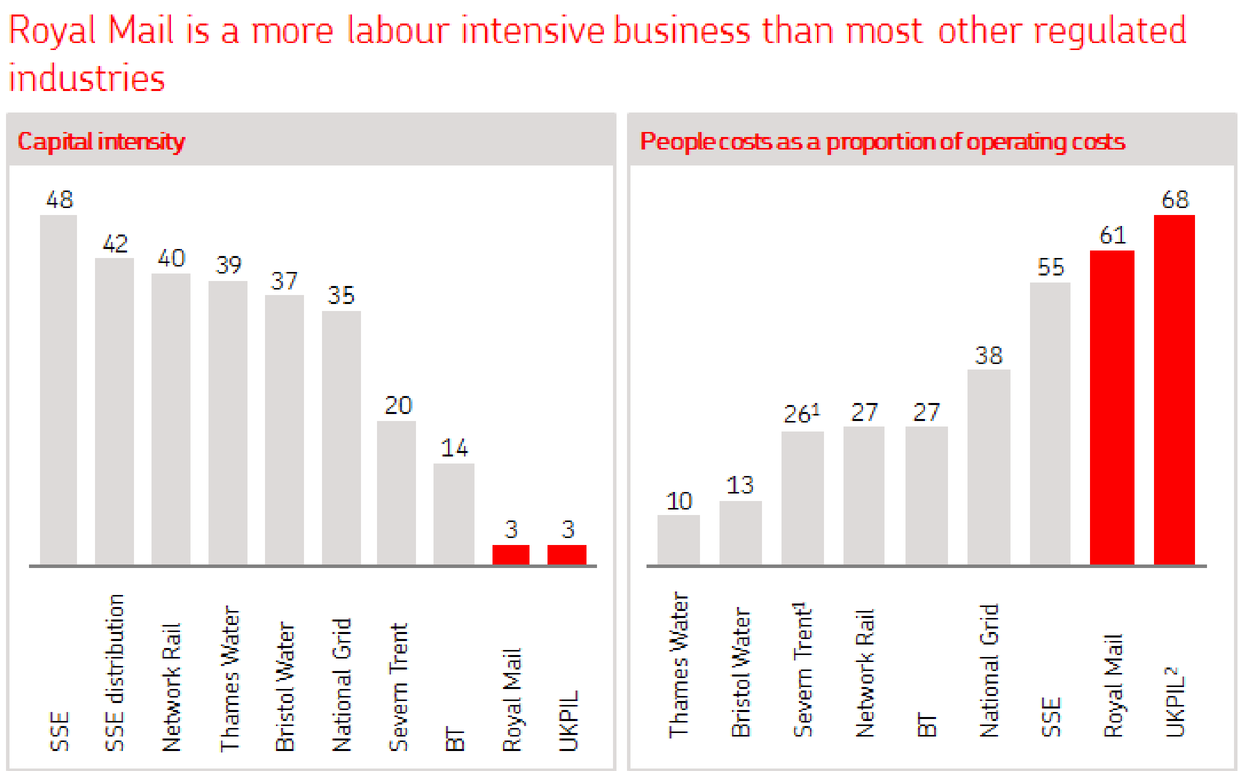
4.36. **Post is a people business.** 68% of Royal Mail UKPIL's costs are staff costs. Change is not simply a matter of upgrading capital. It is limited by the time it takes to build new mind-sets and behaviours. In modernising and transforming our business, we are requiring our staff to do things differently. Royal

[20] FTI Consulting's *Efficiency Metrics for Royal Mail Report* annex
[21] Excluding attendance calls

Mail operates at huge scale. We are one of the UK's largest employers, with c.143,000 people[22]. On average, one in every 200 people working in the UK works for Royal Mail.

4.37. Unlike most regulated industries, the **majority of Royal Mail's cost is not capital or investments, but people costs.** The chart below demonstrates that Royal Mail, in comparison to other UK utilities, has a higher proportion of labour costs.

Exhibit 3: Comparisons of labour intensity across regulated sectors.



1 Includes pension contributions, salary costs and social security costs. It was not possible to remove share payments to staff
2 UKPIL is the letter and parcel business of Royal Mail in the UK. All costs are pre transformation costs
Source: 2015 Annual reports of individual companies

4.38. Post is a major industrial process, involving many tasks that have to be done to exacting to standards, millions of times over. These processes have been designed to operate in a certain way. If they have to be re-designed, it takes time to implement the change throughout an organisation of this size. Therefore there is a **limit to the pace of change any organisation can digest.** The cost of this network is highly inelastic to a reduction in volumes particularly in the short term.

Royal Mail operates in declining markets. This makes the pursuit of efficiency gains particularly challenging.

4.39. **Royal Mail operates in a different environment** to many, if not all, other entities overseen by the UK's economic regulators. As the 2010 revision to the Hooper report recognised, Royal Mail is *"not like other utilities [because]… the delivery of the universal service in the postal sector is under much greater threat than in … telecommunications, electricity, gas and water…, in contrast to these other sectors, delivery volumes… are in sharp decline"*[23]. Therefore, unlike many other regulated industries, Royal Mail operates in a structurally declining letter market.

[22] UKPIL 2014-15
[23] *Saving the Royal Mail's universal postal service in the digital age* – Hooper 2010, Page 27

Exhibit 4: Market conditions for Royal Mail versus other regulated industries.

Differences between Royal Mail and other regulated industries

Sector/ entity	Present in both upstream & downstream	Change in volumes	Level of competition
Royal Mail (letters)	Yes	⬇	While Royal Mail is the only E2E operator, there are significant competition constraints such as e-substitution and other advertising media
Royal Mail (parcels)	Yes	⬆	Significant and increasing levels of competition
Network Rail	No	⬆	N/A
Water	Yes	➡	Largely still geographic monopolies with recent increase in the retail market.
Electricity	No	➡	Geographical monopoly for distribution and national monopoly for transmission
Gas	No	⬇	Geographical monopoly for distribution and national monopoly for transmission
Telecomms	Yes	⬆ & ⬇	Retail competition. Still limited wholesale competiton

Sources: Royal Mail: data provided by Royal Mail, includes all volumes excluding parcels; Network Rail: 2015 Annual report page 72. Volumes used are passenger km, passenger numbers x distance travelled per passenger; Thames Water: 2015 Annual report page 155. Volumes are distribution input, which includes leakages; Severn Trent: 2015 Reported financial statements page 128. Volumes are distribution input, which includes leakages; National Grid: Gas - 2013/2014/2015 annual reports. Volumes are TWh of gas distribute. Electricity - "Although demand for electricity is generally increasing around the world, in the UK it is expected to remain broadly flat over the next five to ten years"; SSE: 2015 Annual report. Volumes are therms of gas delivered to households and kWh of electricity delivered to households; Telecoms: Depends on product, some are increasing while others are decreasing. Business Connectivity Market Review – May 2015.

We have deliberately chosen a collaborative approach with our union and staff to enable accelerated change.

Delivering change in such a heavily unionised business is not straightforward.

4.40. **Royal Mail is heavily unionised.** c.80% of frontline staff belong to the Communication Workers Union or other unions. Therefore there is the risk of industrial action if modernisation is mishandled. **The cost of industrial action is particularly high in post.** Mail is a 'just in time' industry. It is not possible to stockpile to meet demand. Moreover, Royal Mail may not be able to win back customers lost during strikes. Post is not like travel on London Underground. Tube passengers have little option but to resume using the tube when the strike is over. By contrast, Royal Mail's customers have many alternatives.

4.41. History shows that **conflict can cause serious, lasting damage**, as we and other operators have found. For example, in its financial report on the second quarter of 2012, PostNL announced that it had to put its modernisation plans on hold due to significant quality of service issues[24]. In August 2015, Deutsche Post announced that postal strikes had cost €100mn in the second quarter alone. It said, *"as a result of the strike, the post unit saw revenue and volume declines, as well as additional costs for measures to minimise the impact on customers"*[25].

[24] Quality issues and reorganisation delays affect PostNL's Q2, http://postaltechnologyinternational.com/news.php?NewsID=41868
[25] Deutsche Post DHL Group: Further important steps taken in line with Strategy 2020, published 6th August 2015, http://www.dhl.com/en/press/releases/releases_2015/group/dpdhl_group_takes_important_steps_in_line_with_strategy_2020.html

4.42. Royal Mail has made a deliberate strategic decision to take a **collaborative approach with our unions.** This has fostered much more constructive levels of cooperation with change initiatives. We have stretching productivity targets in place in 2015-16. In the second year of the deal, as the new working patterns bedded in, the rate of **productivity improvement rose,** from +1.7% in 2013-14 to +2.5% in 2014-15. We have secured Communication Workers' Union **support for innovations** and increasing the number of staff leaving the business.

For the reasons given above, we judge that, overall, a 2-3% productivity improvement per annum[26] is a stretching pace of change.

4.43. We judge that **2-3% per annum improvement in productivity, over the business plan period, is the right rate** to balance the need to drive efficiency with the need to continue serving our customers without disruption. This is a trajectory we are achieving now and have plans to continue driving into the future.

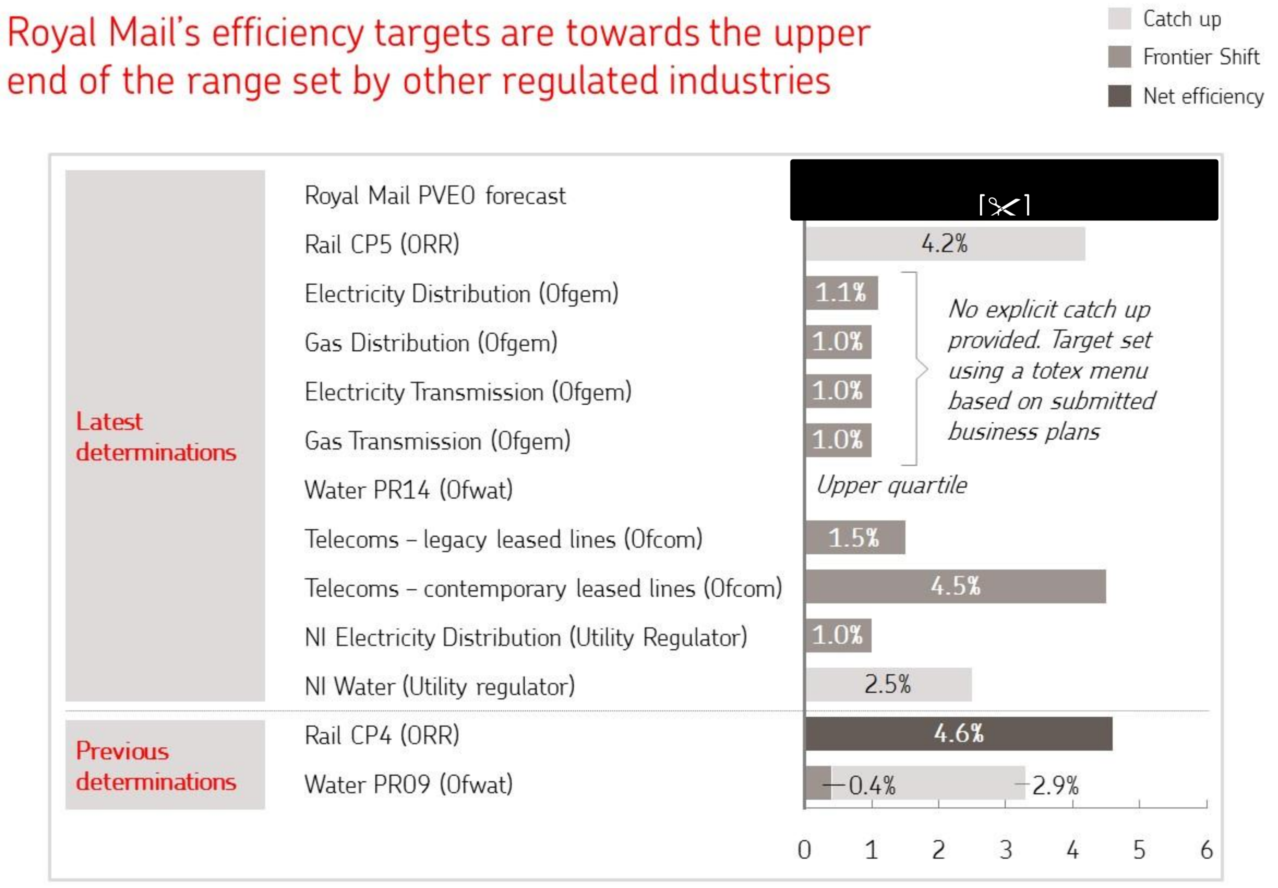
4.44. [✂]

Exhibit 6 [✂]

[✂]

4.45. [✂]

Exhibit 7



26 Over the Business Plan period

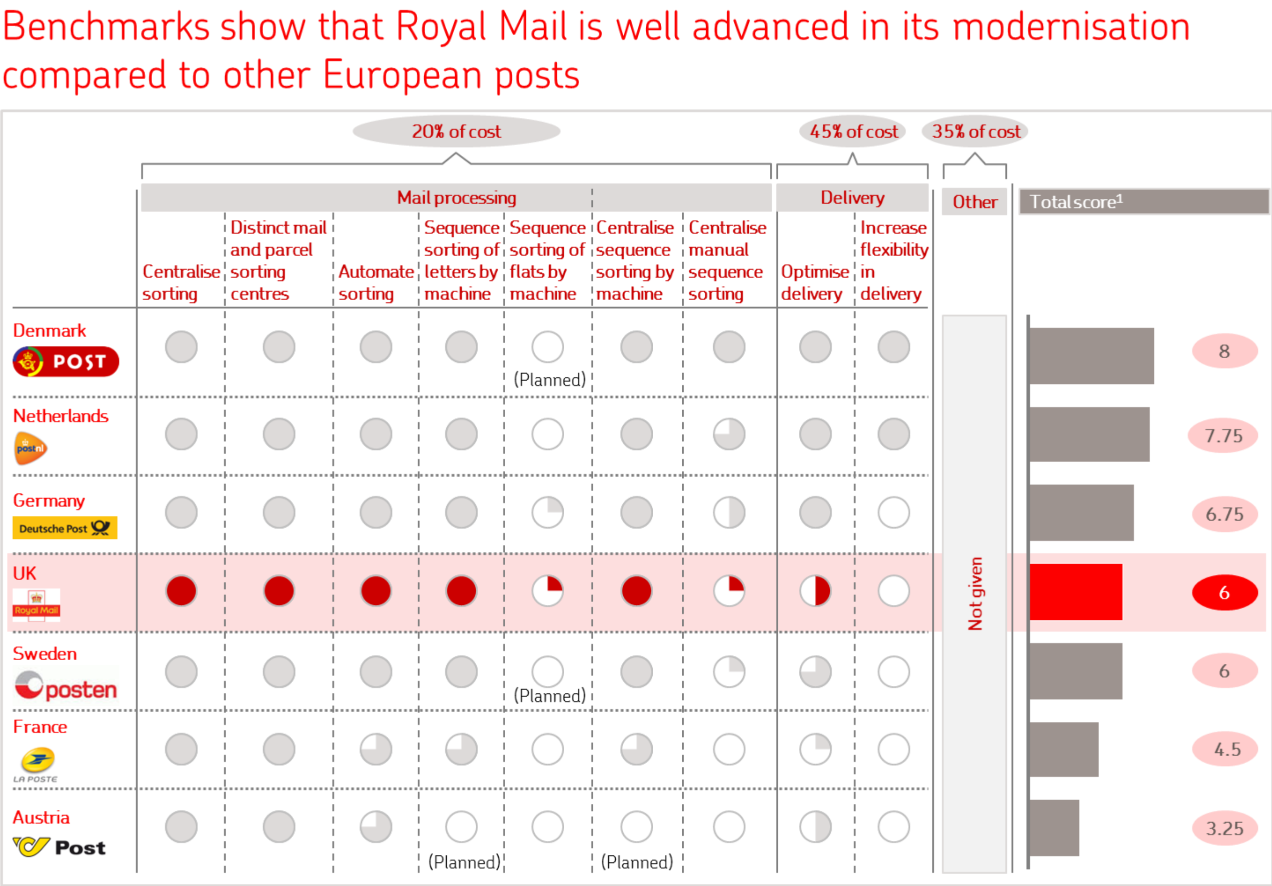
4.46. Royal Mail understands that Ofcom is currently undertaking an econometrics based efficiency analysis and believes that this should also confirm that Royal Mail is making significant efficiency gains.

Independent research shows Royal Mail is reforming its operations broadly in line with comparable European Posts.

Royal Mail is comparable in most areas, except delivery.

4.47. Independent research by Copenhagen Economics[27] demonstrates that **Royal Mail is broadly comparable** to Germany and Sweden, and ahead of many other European Posts such as France, in adopting modern processes.

Exhibit 8: Comparison of European postal modernisation



1 Summed from red circles. Possible total of 9
Source: Adapted and reformatted from Copenhagen Economics, based on WIK Consult (2013b), Section 3.4 and Table 3.4, at p. 32. Share of costs by activity based on WIK Consult (2013a), Table 3-5, p.197

4.48. Copenhagen Economics has identified delivery as an area in which Royal Mail has not modernised in the same manner as other European Posts. Royal Mail has adopted a different strategy in delivery – joint delivery of letters and parcels in urban areas. Independent research, commissioned specifically for this response, shows that Royal Mail's current model of **joint delivery is the optimally efficient model** for the universal service provider in the UK.

4.49. **Under the best case scenario, separating letters and parcels delivery would result in a net operational cost increase**. This reflects the need to separate non-letterboxable parcels from letters

[27] *The consumer impact of competition in the UK postal market* - A study prepared for Whistl, Copenhagen Economics, November 2014, accessed at http://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/3/273/0/The%20consumer%20impact%20of%20competition%20in%20the%20UK%20postal%20market.pdf

and letterboxables parcels in urban routes, and place them in a separate van dedicated network. We will provide further analysis on this topic to Ofcom shortly.

4.50. Parcels automation as adopted in some European posts is **not efficient for the UK volume mix**. UK players that have overinvested in automation are now struggling. For example, UK Mail issued a profit warning after a move to a new fully-automated parcel processing facility. UK Mail said that the mix of parcels had proved "incompatible" with its brand new automated sorting equipment[28]. Some continental posts which are trialling different labour models, such as self-employed workforces, are finding them not to be risk free. For example, in summer 2015, PostNL equalised costs between independent parcel deliverers and PostNL employees[29], after many strikes. Royal Mail believes it has the right balance for long term efficiency.

Given the strong, existing, market-based incentives, Royal Mail is on course to achieve major efficiency gains without the need for regulatory targets.

Efficiency targets are hard to devise and can have unintended consequences.

4.51. **Efficiency targets in isolation are not part of the standard regulatory toolkit.** Regulators do not routinely set standalone efficiency targets. Such targets are not consistent with incentive based regulation. Where they are set, they are within broader price control, which, for the reasons set out in FTI Consulting's report on regulatory interventions, are not suitable for application to Royal Mail.

4.52. **It is difficult to measure efficiency.** As discussed in FTI Consulting's *Efficiency Metrics for Royal Mail* report, there is no one single definition of efficiency or a single metric that can be used to calculate it. Efficiency may be thought of as allocative, productive, or dynamic. Metrics may focus on changes to costs, inputs, volumes or a combination of these, usually controlling for variables outside the company's control. Different metrics produce different results. No single number tells the whole story. An accurate understanding depends on taking a basket of metrics, not a single target figure.

4.53. If appropriately defined, Ofcom's PVEO[30] metric can provide useful insight into Royal Mail's historical and forecast efficiency levels. However, **Royal Mail already uses a modified version of Ofcom's proposed methodology** in business planning.

4.54. However, it is not fit for purpose for setting an efficiency target. The rapid pace of change in post would mean it is likely to be based on **invalid assumptions** and render a fixed efficiency target outmoded. For example, there could be new entrants, changes in the macroeconomic environment, or a change in the rate of e-substitution. The exact change is impossible to predict but would likely impact an efficiency metric.

4.55. Use of a short-term target may appear to get around some of the issues of forecasting longer term efficiency targets in a volatile environment. However, **short term targets would drive focus from dynamic to static efficiency** – focussing on year on year efficiency to meet the target, rather than on cost transformation programmes that realise efficiencies over the longer term and which may require initial outlay before the benefits are realised.

4.56. If an annual target were in place, with penalties or rewards, Royal Mail would inevitably focus on achieving this target. **Looking at a single year does not incentivise efficiency**. In the extreme, management may hold back efficiencies in one year in order to meet the following year's target.

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28 UK Mail warns on profits after influx of oversized parcels overwhelms new hub, published 7th August 2015. http://www.telegraph.co.uk/finance/newsbysector/supportservices/11789061/UK-Mail-slashes-profit-guidance-amid-operational-challenges.html

29 PostNL makes an offer to all independent parcel deliverers, published 13th July 2015 http://www.postnl.nl/en/about-postnl/press-news/press-releases/2015/july/postnl-makes-an-offer-to-all-independent-parcel-deliverers.html

30 Using Price, Volume, Efficiency, Other (PVEO) approach, RPI inflation as deflator. Further discussion of PVEO is provided in FTI Consulting's *Efficiency Metrics for Royal Mail* report

Comparisons to other regulated industries are tenuous. FTI Consulting has not found any example of regulators using pure efficiency targets; although there are of course examples of efficiency targets being embedded within price and revenue controls. However as previously explained, comparisons with other regulated sectors are not appropriate.

Conclusion

Royal Mail is making major progress without efficiency targets.

- For the reasons given above, **Royal Mail does not require targets** imposed by the regulator to drive efficiency. Royal Mail has a track record of making major progress on efficiency. Our business plan already contains stretching efficiency targets. It is not clear how additional regulatory intervention would help.
- Royal Mail has a clear understanding of the drivers of efficiency. Royal Mail's own efficiency targets built into the business plan **are in line with those observed in other industries**, on a PVEO basis.

Chapter 5: Do you consider that there are any areas of existing controls on Royal Mail activity where there is the potential for deregulation?

Yes, we believe there are pressing reasons for deregulation in a number of key areas. Elsewhere in this document, we identify areas where the existing 2012 Framework needs to be fleshed out: Chapter 2 discusses the need for guidance on access pricing; Chapter 6 discusses the requirement for a future-facing financial sustainability framework for the USO. This chapter sets out where further deregulation beyond the 2012 Framework is required, and why.

- **E-commerce and the crucial role of delivery is changing rapidly in the UK.** E-commerce is maturing. Customer expectations are naturally much higher now. E-commerce, disintermediation, and new entrants are creating a rapidly evolving environment for consumers and operators alike. In this climate, it is easy for regulation to fall out of step with consumer expectations.
- To protect consumers' interests, **the regulatory framework should follow three principles:**
  - » Principle 1; Provide consumers with **a modern, 21st century universal service enabling e-commerce to grow, thereby empowering customers.** The UK needs a modern, high quality parcels and letters USO to continue to grow the e-commerce industry and to ensure customers enjoy a high quality delivery experience. USO customers should have access to the same services as non-USO customers. As Article 5 of the Postal Services Directive says, the Universal Service should "evolve in response to the technical, economic and social environment and to the needs of users".
  - » Principle 2: Encourage and **enable the Universal Service Provider to innovate** rapidly and adapt to meet evolving consumer needs. This requires minimising the burden of bureaucracy. Even a change that is clearly beneficial to customers currently requires a consultation process. For example, reducing the number of weight steps for USO parcels took c.12 months.
  - » Principle 3: Provide **consistent standards to make delivery a better experience for consumers,** especially in parcels. 40% of consumers say that delivery concerns are seen as a barrier to them shopping more online[1]. All operators should be held to the same basic standards to protect customers. For example, the Mail Integrity Code of Practice does not apply to most parcel operators. We believe it should. Consumers need a service they can rely on, whichever operator they choose.
- **Royal Mail has identified three specific areas of deregulation or regulatory change.** In line with these principles, we have identified areas of deregulatory and regulatory change Ofcom should address. Ofcom should:
  - a) **Provide a flexible framework to create a service fit for the 21st century.** Examples include:
    - Permitting tracked standard parcels in the USO;
    - Enabling Royal Mail to offer modest volume discounts on USO products; and
    - Systematically including all relevant major operators used by consumers and SMEs in Ofcom's monitoring and regulatory reviews.
  - b) **Remove unnecessary regulation** that limits Royal Mail's ability to innovate and compete fairly. For example, reducing the length and volume of regulatory **notification and consultation** periods and **streamlining burdensome reporting** requirements.
  - c) **Provide certainty and clarity for consumers** by applying the same **consumer protection requirements to all operators**. This guarantees consumers a consistent service, which drives confidence.

[1] IMRG Consumer Home Delivery Review 2015

E-commerce and the crucial role of delivery is changing rapidly in the UK.

E-commerce is maturing and customer expectations are naturally much higher now.

5.1. E-commerce, disintermediation, and new entrants are creating a **rapidly evolving environment** for consumers and operators alike. New technology and options are driving new behaviours and expectations amongst consumers. In this environment, it is easy for regulators and providers to fall out of step with consumer expectations. For example, some product features that were once not in the USO because they were specialist or expensive are **now a common, and should therefore be part of the USO**.

5.2. Consumer options and preferences – particularly around parcels - have changed significantly in the three years since the original 2012 Framework: see Chapters 2 and 3. As a result, there are a number of areas where **Ofcom needs to change the 2012 Framework**. This is to ensure that the regulatory framework is appropriate for the modern market.

The regulatory framework should follow three principles.

Principle 1: a modern, 21st century universal service enabling e-commerce to grow thereby empowering customers.

5.3. The regulatory framework should provide consumers with a modern, 21st century Universal Service. As Article 5 of the Postal Services Directive says, the Universal Service should "evolve in response to the technical, economic and social environment and to the needs of users". Royal Mail believes that **customers should be able to access a USO service** as good as that from non-USO operators on crucial product and service features.

5.4. **An up to date USO is vital for e-commerce.** E-commerce rests on two services: broadband and post. Whilst extensive investment is still needed to develop a truly universal network for broadband, the UK already has a highly specified postal USO. It enables businesses selling goods online to operate just as effectively from a village in rural North Wales as a business in the centre of London. Without the Universal Service, it is likely that the market would not deliver affordable and accessible parcel drop-off and delivery services throughout the whole of the UK. Only the USO provides a high quality uniformly priced next day service right across the UK.

- **The UK was one of the early adopters of e-commerce**. Penetration rates are high. Internet shopping has developed very substantially in recent years.
  - » The UK has the highest share of online retailing in the world[2] - and a one third share of the entire European e-commerce market[3].
  - » The UK's B2C e-commerce turnover increased by 14.7% in 2014 reaching €127bn – this is considerably higher than our nearest European rivals Germany (€71bn) and France (€57bn)[4].
  - » The UK is also the global leader in terms of consumer spend on the internet – UK consumers spend close to £2,000 per head online every year[5].

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[2] UKTI, 'Online retailing in numbers', downloaded 20 August 2015. https://www.gov.uk/government/publications/beyond-e-commerce-to-everywhere-commerce/beyond-e-commerce-to-everywhere-commerce
[3] Enders Analysis and Ernst & Young, 'Digital UK 2015', February 2015: http://www.digital-uk.london/~/media/Files/D/Digital-UK/pdf/digital-uk-2015.pdf
[4] Ecommerce Europe, European B2C e-commerce report 2014, 17 June 2015: http://www.ecommerce-europe.eu/press/2015/european-e-commerce-turnover-grew-by-14.3-to-reach-423.8bn-in-2014
[5] Enders Analysis and Ernst & Young, 'Digital UK 2015', February 2015: http://www.digital-uk.london/~/media/Files/D/Digital-UK/pdf/digital-uk-2015.pdf

5.5. **To get to the next stage of e-commerce adoption,** e-commerce needs an infrastructure to connect all businesses, large and small, and all consumers, wherever they may be. No matter where someone lives in the UK, the USO should have product features that are now commonplace in the market. Almost 90% of Scottish businesses report that they encounter an additional surcharge for delivery due to their geographic location. Many providers will not serve Northern Ireland – 33% of online retailers apply some form of delivery exclusion to Northern Ireland postcodes[6]. Royal Mail, on the other hand carries post for the same price to every part of the UK. Royal Mail does not surcharge on its USO services for deliveries to more remote areas. The UK requires a modern high quality parcels and letters USO to meet consumer needs.

Principle 2: Enable the Universal Service Provider to innovate.

5.6. The regulatory framework should encourage and enable the USO provider to innovate rapidly and **adapt to meet evolving consumer needs**. As set out in Chapters 2 and 3, the parcels **market in the UK is changing rapidly**. For example:

- Rivals to the USO now have more retail outlets combined than the Post Office.
- Another example is the rise of Click and Collect, which many retailers are now actively promoting with their customers.

5.7. However, Royal Mail is hamstrung by excessive consultation requirements which make it hard to respond to customer needs. Even a small change, which clearly benefits customers, like reducing the number of weight steps for USO parcels took c.12 months. Royal Mail needs to be **as nimble as its rivals** if it is to serve consumers well and remain competitive. This requires minimising the burden of bureaucracy. In addition, Ofcom should future-proof all regulation to ensure regulation is flexible enough to accommodate further changes that may arise.

Principle 3: Consistent standards to make delivery a better experience for consumers.

5.8. The framework should provide the clarity, simplicity, and consistency that consumers require to have confidence in operators. There is evidence that driving further growth in **e-commerce depends on consumers' confidence** that their goods will be delivered on time, safely and securely. Today, some consumers receive a poor service. 40% of consumers say that delivery concerns are seen as a barrier to them shopping more online[7]. A recent survey by Which?[8] found 26% have experienced problems with delivery in the past 12 months. The main problems were late delivery (17%), delivery failure (3%), and damaged items (2%). In a rapidly evolving marketplace, with a multiplicity of options, consumers need a service they can rely on, whichever operator they choose.

5.9. Today, there is no one common standard across all parcels operators. To safeguard consumers' confidence in operators, Ofcom should put in place a framework that requires **all operators to abide by the same basic standards.**

Royal Mail has identified three specific areas of deregulation or regulatory change to match these three principles.

(a) Provide a flexible framework to create a service fit for the 21st century

5.10. The first objective for deregulation is to create a USO flexible enough to adapt to the new challenges and be fit for the 21st century. Royal Mail suggests three specific sub-components to deliver this aim: permitting

[6] Either refusing to deliver, adding a surcharge, or requiring longer delivery times. The Consumer Council for Northern Ireland.
[7] IMRG Consumer Home Delivery Review, 2015
[8] Which? magazine, November 2014

tracked standard parcels in the USO; enabling Royal Mail to offer modest volume discounts on USO products; and systematically including all relevant major operators used by consumers and SMEs in its monitoring and regulatory reviews.

5.11. **Permit tracked standard parcels in the USO.**

- Online **tracking of parcels is now commonplace**.
  - » Some form of visibility is now a common expectation of deliveries for 85% of consumers[9].
  - » Amongst heavy online shoppers – predictors of future e-commerce trends - 69% said that 'Tracking of Item' was the most important attribute of their delivery service[10].
  - » 60% of online shoppers now say that they would track every item if it were possible[11].
- Tracking can now be considered a common part of parcel services. However, at present, tracked standard parcels are not permitted within the USO.[12] Including tracked standard parcels in the USO is likely to **accelerate the growth of e-commerce.** Increasing online retail depends on consumers having confidence that what they buy will be delivered: 77% of online shoppers say that tracking deliveries would improve their confidence in making online purchases[12].
- Tracked standard parcels in the USO would also be a valuable **boost to SMEs**. In June 2014, 42% of SMEs – c.2.2mn businesses were 'taking orders for goods online'[13]. Large retailers routinely offer tracking on their items. Many SMEs are sole traders using online market places like eBay. In contrast to large retailers, they do not have access to a tracked product: tracking is not permitted within the USO for standard parcels and SMEs are too small to access account products.
- Permitting tracking of standard parcels as USO products will also make an important **contribution to the financial sustainability of the USO overall.** Royal Mail's strategy is to transition from being a letters business that delivers parcels to a parcels business that also delivers letters. As such, keeping our USO parcels offer relevant and up to date with consumer preferences is essential.

5.12. Enable Royal Mail to offer modest **volume discounts** on USO products.

- At present, **Royal Mail is unable to offer volume discounts** to members of the public.
  - » Ofcom defines a Single Piece service as a service for sending an individual postal packet, "whose price per postal packet is not subject to any discounts related to … the number of postal packets sent"[14].
  - » This prescriptive wording prevents Royal Mail from providing any sort of volume-related discounts. This includes even very small scale examples such as offering loyalty cards to customers posting several Christmas parcels.
  - » This definition means that innovative promotions on USO services are not possible. Our competitors have no such restriction. They can and do offer volume discounts. For instance, Yodel offers an increasing discount for every additional parcel posted[15].

5.13. Systematically **include all relevant major operators used by consumers and SMEs in its market monitoring** and regulatory reviews.

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[9] IMRG, Consumer Home Delivery Review, 2015
[10] Consumer CSi Results, Q4 2014-15
[11] Delivery Matters UK Focus, May 2015
[12] It is required for Special Delivery items
[13] Ofcom Communications Market Report 2015, p.357
[14] Designated Universal Service Provider Condition 1, DUSP 1.1.2(ee)
[15] Yodel multi parcel discount at https://www.yodeldirect.co.uk/content/multi-parcel-pricing

- There is an emerging pattern of an **absence of full cooperation** by some other operators with requests for information from Ofcom.
- Ofcom therefore sometimes has to rely **on imperfect proxy methods**, such as household surveys. For example, in August 2015 Ofcom announced that it would not be taking forward a full review of complaints handling. Part of Ofcom's rationale was the low number of respondents to its Residential Postal Tracker. Ofcom said it was "unable to reach any firm conclusions based on the data gathered".
- **Other statutory bodies have found the same**. During one investigation, Citizens Advice stated that "the POSTRS website lists 11 members of the redress scheme … We issued a total of nine information requests and received six responses". The report goes on to say that even those six were incomplete.
- This inevitably means that Ofcom is making decisions about the whole market with information from only a fraction of the market. Royal Mail believes that **all relevant major providers should cooperate** with the regulator to create the best possible market. Ofcom should be able to collect the same information from all providers to enable it to build a complete picture of the whole market.

(b) Remove unnecessary regulation

5.14. Ofcom should **reduce the length and volume of regulatory consultation** periods.

- **Lengthy consultation periods** reduce Royal Mail's ability to bring to market swiftly changes that benefit the consumer. In general, we cannot change services or customer processes without consultation periods - even for beneficial changes.
  - » We have to give three months' notification for changes to collection and delivery times. We currently cannot change USO prices, products, or customer processes without one month's notification to Ofcom.
  - » In addition, we take time to discuss changes with Ofcom and other stakeholders.
- The combined effect of these regulations is that the **minimum time to effect change is 3 months**. It is often considerably longer. For example, the move to Collection on Delivery took c. 6 months to agree. This was despite the fact that Ofcom and the consumer bodies were supportive of the change. In a market-driven system, change periods of this length are overly constraining.
- **Consultation delays customers from accessing beneficial changes.** When Royal Mail wanted to do two price promotions last Christmas, it had to notify the regulator[16]. A reduction in the number of days before which a customer could claim compensation took three months to agree, even though the change is clearly beneficial for consumers.
- **Our competitors do not face these constraints.** Notification periods allow competitors to follow Royal Mail's lead in innovation but implement ahead of us. In March 2014, myHermes dropped their prices to 2p below Royal Mail, five days before Royal Mail's new prices came into effect. We do not need regulatory requirements to act fairly.

5.15. Streamline **burdensome reporting** requirements.

- **Royal Mail is subject to a significant reporting burden.** We are required to provide over 170 financial and non-financial reports to Ofcom every year. This equates to an average of three reports per week. They are not required by Royal Mail management to run the business. Royal Mail would welcome the opportunity to discuss streamlining the volume of material with Ofcom, or aligning it more closely with

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[16] For the duration of the promotion, 2nd Class Small Parcels of 0-2kg were priced as 0-1kg parcels. This created a single price for 2nd Class Small Parcels up to 2kg, meaning that consumers sending 1-2kg 2nd Class parcels were charged less.

Royal Mail's internal reporting formats. There is further ad hoc reporting as Ofcom may require. Many of these reports are produced solely for Ofcom's use.

5.16. Further **examples of how Ofcom's current regulations constrain** Royal Mail are given in the table at the end of this chapter.

(c) Provide certainty and clarity for consumers

5.17. To improve clarity and simplicity for consumers, Ofcom should **apply the same minimum set of consumer protections to all items** posted - letters and parcels - to ensure all consumers receive a consistent service in which they can have confidence.

- In Ofcom's recent 'Call for Input' on complaints handling, Royal Mail made the case for a **single Consumer Protection Condition. In other words, a condition** flexible enough to apply to all mail operators, both letters and parcels[17]. This single set should cover all the key aspects needed to give customers confidence:
  - » How complaints are handled
  - » How disputes are resolved
  - » How mail is handled to keep it safe and secure, etc.
- Other **stakeholders agree**. Citizens Advice, Citizens Advice Scotland, and the Consumer Council for Northern Ireland also made the case for the Consumer Protection Conditions to be "enhanced and brought closer in line"[18]. In 2012, Ofcom committed to a wider review of some of these issues, on complaints handling in particular. However, in August 2015, Ofcom announced that it had no plans to change the current requirements[19]. We ask Ofcom to reconsider, or clearly state a rationale for inaction.

5.18. This single set of protections should **cover all relevant operators**.

- At present, there are **a variety of different standards** and conditions for different operators and different types of items. Many regulations apply only to 'Regulated Operators', e.g. Mail Integrity regulations on letters.
  - » "Unregulated operators" do not abide by these rules. Parcels are treated in a different manner to letters. For example, the Mail Integrity Code of Practice only applies to items below 350g which cost less than £1 to post, and which are delivered by a 'Regulated Operator'. As a result, it does not apply to some operators or to most parcels.
- Ofcom should **update the definition** of a 'Regulated Operator' to reflect market realities, and in particular to cover parcels operators, which are such an important part of the contemporary landscape.

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[17] Royal Mail response to Ofcom Call for Input on Complaints Handling, April 2015: http://stakeholders.ofcom.org.uk/binaries/post/review-complaint-handling-redress/Royal_Mail_Group.pdf

[18] Citizens Advice, Citizens Advice Scotland and Consumer Council for Northern Ireland joint response to Ofcom call for input in complaints handling, April 2015: http://stakeholders.ofcom.org.uk/binaries/post/review-complaint-handling-redress/Citizens_Advice_Citizens_Advice_Scotland_Consumer_Council_NI.pdf

[19] Royal Mail Group response to Ofcom call for input in complaints handling, April 2015: http://stakeholders.ofcom.org.uk/binaries/post/review-complaint-handling-redress/Royal_Mail_Group.pdf

Conclusion

- The context to deregulation is that **the postal market is changing rapidly**.
- To protect consumers' interests, **the regulatory framework should follow three principles**. The regulatory framework should:
  - » Provide consumers with a modern, 21st century universal service enabling e-commerce to grow, thereby empowering customers.
  - » Enable the Universal Service Provider to innovate rapidly to meet evolving consumer needs.
  - » Provide consistent standards to make delivery a better experience for consumers, especially in parcels.
- **Royal Mail has identified three specific areas of deregulation and regulatory changes** to match these principles. Ofcom should:
  - » Provide a flexible framework to create a service fit for the 21st century, permitting tracked standard parcels in the USO, and enabling Royal Mail to offer modest volume discounts on USO products.
  - » Remove unnecessary regulation by reducing the length and volume of regulatory notification and consultation periods, and streamlining burdensome reporting requirements.
  - » Provide certainty and clarity for consumers by applying the same consumer protection requirements to all operators.

Examples of how Ofcom's current regulations constrain Royal Mail

Topic	Regulation	Implication
USO	One month consultation period for any changes to USO products that means there needs to be a change to the Postal Schemes One month notification to Ofcom and the Consumer Advocacy bodies, and publication, of changes to products and pricing	• c. 3 month delay, including for minor changes and beneficial changes e.g. reduction in time period for claims; changes to small parcel sizes. In the last year, we have consulted on four changes, all of which were beneficial for customers • Competitors can beat us to market with our own ideas e.g. price changes; size changes etc.
	Three month notification and publication for changes to collection and delivery times	• Straightforward regulatory process but still a protracted process to affect the change e.g. collection on delivery took six months
	No volume related pricing discounts	• We cannot offer any innovative pricing options to make USO products more attractive e.g. "get one free" loyalty cards
	No tracking through the network (other than Special Delivery 1pm)	• It is increasingly difficult to compete in the SME parcels space without tracking as an option
Access regulation	10 week notification and publication	• Prior agreement is required from operators before we change standard T&Cs. We then must give 10 weeks notification and publication before those changes come into effect
	Margin squeeze	• Increases in access prices mean we have to increase retail prices in order to maintain the differential
Reporting	Reporting	• Some financial reporting is undertaken only for Ofcom e.g. Reported Business split and quarterly regulatory financial statements. Estimated an additional 1.5 FTE due to this requirement

Chapter 6: Do you have any further comments or views (supported by evidence where available) on the issues identified in this discussion paper?

Yes. Ofcom needs to confirm (a) the existing financial sustainability framework, reconfirming as a minimum a 5-10% EBIT margin on the Reported Business. In making its decisions, Ofcom needs to take into account the need for Royal Mail to maintain investment grade and make reasonable returns for equity investors. Ofcom should also (b) avoid unnecessary regulatory intervention and demonstrate how any new interventions are consistent with its duties and the principles of better regulation.

(a) the financial sustainability of Royal Mail and the Universal Service

- **Financial sustainability is based on Royal Mail being able to earn a reasonable commercial rate of return[1].** In its March 2012 Statement, Ofcom proposed that: (i) an EBIT margin range of 5% to 10% would represent an appropriate commercial rate of return; and (ii) that this return should be applied to the Reported Business. We have only in 2014-15 achieved a margin at the lower end of Ofcom's range[2]. Updated analysis shows that the comparator set used by Ofcom continues to suggest that this represents an appropriate EBIT margin range.

- **Royal Mail must earn a commercial rate of return that allows it sufficient headroom to mitigate the unique set of characteristics it faces:**
  - » possible acceleration in the ongoing structural decline in addressed letter volume;
  - » high fixed costs of the USO in relation to delivery, quality of service and peak volumes;
  - » increased competition in parcels;
  - » high labour-intensity and a heavily unionised workforce; and
  - » uncertainty with regard to the regulatory environment.

  Royal Mail has limited "levers" to reduce its costs in the short run, so its EBIT margin is highly sensitive to revenue risk. Without sufficient headroom, the challenges outlined above may mean that lower than expected revenue could cause our EBIT margin to fall below investor expectations and even become negative. Regulatory intervention will not address these risks. Ofcom must ensure it does not impose restrictions that could accelerate the impact of these risks and prevent Royal Mail from being able to transform.

- **Royal Mail believes that, based on the significant challenges it faces in the market, an EBIT margin of 5% to 10% is the minimum necessary for future financial sustainability in the long term.** Benchmarking analysis undertaken by FTI Consulting of other postal operators, FTSE 100 companies and credit ranging agencies views suggests a reasonable range for margins of 5% to 16%. Therefore, we consider an Ofcom defined margin range of 5% to 10% to be conservative.

- **Ofcom's framework should allow Royal Mail to maintain an investment grade rating and to provide an adequate return to equity investors such that we are able to raise funds at reasonable rates.** It is fundamental to the USO's financial sustainability that Royal Mail maintains access to capital markets:
  - » Royal Mail has adopted a conservative capital structure commensurate with its business risk profile;
  - » this capital structure enables Royal Mail to achieve a low cost of debt; and

[1] Postal Services Act 2011, 29(4).

[2] Based on cash pension rate adjusted EBIT margin after transformation costs (financeability EBIT margin). Royal Mail Regulatory Financial Statements 2014-15, p5.

  » imposing regulatory interventions that constrain the margin achievable to unsustainably low levels could mean that Royal Mail is unable to access capital markets when required, threatening the sustainability of the USO.

- **In the event that Royal Mail were to encounter financial difficulty, there is very little that regulatory intervention could do to solve the problem. In circumstances of financial difficulties it would not be possible for Ofcom to increase revenue or reduce cost. There is an asymmetric regulatory risk, therefore Ofcom must take extreme care before imposing further regulations, particularly given Ofcom's primary duty to financial sustainability.** This means that Ofcom needs to be extremely careful about taking steps ex ante which reduce Royal Mail's revenues or add to the cost base.

(b) Conditions for Ofcom to impose any further regulation.

- Given the fragility of the Universal Service, and its statutory duty to avoid imposing unnecessary regulation, **Ofcom should have a presumption against further regulatory intervention**. If, however, Ofcom proposes new or amended regulatory conditions, it should do so only after having carefully considered the legal requirements of the PSA 2011, the principles of better regulation including proportionality, and having undertaken a robust impact analysis.

(a) The financial sustainability of Royal Mail and the Universal Service

Financial sustainability is based on Royal Mail being able to earn a reasonable commercial rate of return.

6.1. **Ofcom has a duty under the PSA 2011 to secure the provision of the Universal Service[3].** This means allowing the provider to earn a reasonable commercial rate of return[4]. Ofcom set out in its March 2012 Statement that an EBIT margin range of 5% to 10% would represent an appropriate commercial rate of return and that this return should be achieved at the Reported Business level (entity which provides the USO). In 2010-11 Royal Mail was earning a margin of -4% on the Reported Business[5].

6.2. Royal Mail considers that range, set out in the March 2012 Statement, represents a reasonable starting point for assessing the financial sustainability of the USO. Updated analysis of the comparators used by Ofcom suggests the EBIT margin range of 5% to 10% set out in its March 2012 statement remains a minimum appropriate level[6]. The risks to Royal Mail's margins remain at least as significant as in March 2012 meaning **a minimum of a 5% to 10% EBIT margin range** for the Reported Business is still required.

6.3. Changes in the market and Royal Mail's capital structure since 2012 mean that Ofcom should now take extreme care before imposing further regulatory interventions or proposing changes to the financial sustainability framework. The postal market developments and changes in Royal Mail's ownership and funding structure mean that that **an investment grade credit rating and a reasonable return for equity investors** should be pre-requisites for financial sustainability. This has been the approach adopted by Royal Mail since privatisation.

6.4. Royal Mail's current business plan is contingent on the existing regulatory framework established in 2012. In particular, it assumes that Royal Mail would have the flexibility to earn a commercial rate of return. Making significant **changes to this regulatory framework would create uncertainty** for debt and equity investors. **Royal Mail should be afforded the commercial flexibility** to target levels for its commercial rate of return and other key financial ratios that it requires to maintain an investment grade credit rating and meet the objectives of equity investors.

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[3] Postal Services Act 2011, 29(1).
[4] Postal Services Act 2011, 29(4).
[5] Ofcom's 2013/14 Annual Monitoring Report on the Postal Market
[6] FTI Consulting response to the Fundamental Regulatory Review, Financial Sustainability of the USO, paragraphs 4.5 to 4.8

Royal Mail must earn a commercial rate of return that allows it sufficient headroom to mitigate the unique set of risks it faces.

6.5. The **unique combination of challenges** faced by Royal Mail include:

- The USO means the business has **high fixed costs** relating to delivery, quality of service and peak volumes. These costs (see below) are difficult to remove while volumes are declining.
- The extent of **competition in the parcels market** means that Royal Mail has not achieved the level of parcel revenue it originally expected in order to mitigate the financial impact of volume decline in the addressed letters market.
- **Volume decline** coupled with the existence of fixed costs leads to increasing unit costs. It is easier to adjust the cost base when volumes are increasing than when volumes are declining. As volumes decline, Royal Mail actively works to remove the surplus capacity from the business where possible. This may mean, for example, reducing staff hours, the number of staff, and/or redesigning routes. This takes time to implement, especially in a heavily unionised industry such as post. An acceleration of this volume decline poses a significant risk for future financial sustainability of the USO.
- Royal Mail's cost base is largely labour related. This workforce is heavily unionised. **Industrial action risk is high** compared to other sectors. Industrial action would itself have a significant impact on Royal Mail's financial sustainability.

6.6. **Royal Mail faces a number of significant business risks.** There is substantial uncertainty around the nature and magnitude of the impact these risks may have on financial performance. Many of these risks are asymmetric. This combination of challenges means Royal Mail faces a plausible downside scenario in which revenues fall and unit costs increase, resulting in lower profitability. Royal Mail has limited "levers" to reduce its costs in the short run, which means that its EBIT margin is highly sensitive to a realisation of revenue risks.

6.7. Without sufficient headroom, the combination of these challenges may therefore mean that lower than expected revenue **would cause the Reported Business EBIT margin to fall** below the commercial rate of return and even become negative.

Royal Mail believes that, based on the substantial challenges it faces in the market, an EBIT margin of 5% to 10% is the minimum necessary for future financial sustainability in the long term.

6.8. Ofcom has previously stated that **a 5% to 10% EBIT margin is appropriate** for Royal Mail's Reported Business[7]. This range was based on analysis it commissioned in 2011. We consider this represents the minimum margin for the Reported Business. This is based on analysis undertaken by FTI Consulting (see the Financial Sustainability of the USO Appendix). In summary:

- benchmark postal operators earn average EBIT margin range of 10% to 16%;
- FTSE 100 and FTSE 250 firms suggests a range of 8% to 23%;
- analysis by Oxera suggests that even businesses with zero accounting assets would be expected to earn a margin of 5%. This is below the minimum for the reasonable level of margin for Royal Mail which has positive net assets; and
- Moody's considers that a postal operator should achieve a margin in the range 8% to 12% in order to receive an investment grade credit rating.[8]

[7] Ofcom (March 2012), Securing the Universal Postal Service, 5.47
[8] Moody's, Global Postal and Express Delivery Methodology, Exhibit 6.

Ofcom's framework should allow Royal Mail to maintain an investment grade rating and to provide an adequate return to equity investors such that it is able to raise funds when required.

6.9. **Royal Mail requires access to both equity and debt capital markets.** We therefore need to generate sufficient sustainable cash flow to provide returns to all of our capital providers. To access debt capital markets at reasonable cost, it is necessary to achieve an investment grade credit rating.

6.10. Non-investment grade firms typically have considerably greater costs associated with raising funds in the capital markets. They have to pay higher rates of interest to reflect the higher risk of default. Royal Mail's peers such as Deutsche Post and PostNL have investment grade ratings. Therefore, investors would expect a postal services business of Royal Mail's scale to be investment grade. The metrics defined by Royal Mail's lenders in its debt covenants are also very similar to those monitored by credit ratings agencies. **An investment grade credit rating is widely recognised as being central to financial sustainability** by investors, banks and other economic regulators.

6.11. To maintain our financial sustainability, a high fixed cost, lower margin business such as **Royal Mail needs access to equity capital at reasonable cost.** We must therefore generate sustainable dividend returns to shareholders. At the time of the IPO, Royal Mail indicated that it would pursue a progressive dividend policy in regard to the normalised earnings progression of the Group. Without access to either debt or equity capital markets, Royal Mail may be unable to raise the substantial funds required to invest in transforming the business. We could ultimately be left in a position where we would be unable to fulfil the USO. It is essential that we are able to achieve levels of profitability that allow us to generate sufficient returns for both our debt and equity providers and to maintain financial metrics consistent with an investment grade rating.

In the event that Royal Mail where to encounter financial difficulty there is very little which regulatory intervention could do to solve the problem.

6.12. In the 2012 regulatory settlement, **Ofcom rightly acknowledged the existence and material nature of the significant risks** discussed above:

> "*…we recognised that when the individual sources of uncertainty combine, Royal Mail faces significant risks to both its revenue and cost outlook. Our sensitivity analysis demonstrated that deviations from Royal Mail's plan could have major implications for the financeability of the universal service, and the scope of uncertainty for Royal Mail extends beyond risks which it can manage efficiently itself*"[9].

6.13. The combination of these risks may cause a serious threat to the future financial sustainability of the USO to arise quickly. Therefore any restriction on the headroom in the margins that the Reported Business is able to earn, or other constraints on the business, may have unintended consequences. They could accelerate the impact of risks to financial performance and prevent Royal Mail from being able to transform its business when needed. **Ofcom needs to be extremely careful about taking steps ex ante** which reduce Royal Mail's revenues or add to Royal Mail's cost base.

6.14. Given the limited regulatory levers available to Ofcom to quickly and decisively respond to the impact of these risks, Royal Mail proposes that it instead provides Ofcom with details of the key financial sustainability metrics that it is required to monitor for internal management purposes. From 2016, Royal Mail will be required by the revised UK Corporate Governance Code to explain in its Annual Report how it will be able to continue in operation and meet its liabilities. This is referred to as a "viability statement" and considers the business and its risks over a period greater than twelve months. Royal Mail proposes that the content of the viability statement would form an appropriate basis for constructive engagement and discussion with Ofcom

[9] Ofcom (2012), Securing the Universal Postal Service, paragraph 5.9, page 44

on financial sustainability. We consider **periodic discussion is more appropriate than ex ante regulation** which, as discussed above, may affect Royal Mail's financial sustainability.

6.15. Although the content of the viability statement has not yet been determined, we would anticipate that it would consider how Royal Mail's **forecast performance would affect the key ratios** considered by its credit rating agency and the required covenants of Royal Mail's banks. Given that Royal Mail will be preparing and reporting this information, it would not be appropriate for further additional reporting to be required from a regulatory perspective.

(b) Conditions for further regulatory intervention

Ofcom should have a presumption against further regulatory intervention.

6.16. The unique combination of potential downside risks faced by Royal Mail and the high fixed costs of the USO, mean that **it is essential that the regulatory framework continues to allow sufficient commercial flexibility**. Otherwise, the financial sustainability of the USO will be put at significant risk. The USO is fragile. Ofcom is under a statutory duty not to impose unnecessarily burdensome regulation on Royal Mail. Section 6(1) of the Communications Act 2003 ('CA 2003') requires Ofcom to "*keep the carrying out of their functions under review with a view to securing that regulation by Ofcom does not involve the imposition of burdens which are unnecessary; or the maintenance of burdens which have become unnecessary.*" Ofcom's Regulatory Principles state that Ofcom will operate with a bias against intervention,[10] and Ofcom's Guidance states *"[t]his means that a high hurdle must be overcome before we regulate"*[11].

6.17. Better regulation requires that ***"[t]he option of not intervening … should always be seriously considered.*** *Sometimes the fact that a market is working imperfectly is used to justify taking action. But no market ever works perfectly, while the effects of … regulation and its unintended consequences, may be worse than the effects of the imperfect market"*[12].

6.18. The efficiency targets and price caps imposed by Postcomm drove the business into cash insolvency. They were recognised as a failure by Ofcom in 2012[13]. The failures of the Postcomm era, during which Royal Mail faced onerous and inflexible regulation, mean Ofcom should be particularly careful about imposing additional regulation on Royal Mail. Therefore, **Ofcom's starting position in carrying out its review should be a presumption against further regulation** being imposed on Royal Mail.

Ofcom must consider the legal requirements of the PSA 2011 and the principles of better regulation.

6.19. Should Ofcom propose introducing additional regulation, **it must have regard to its obligations under the PSA 2011.** They include the detailed legal requirements for imposing different types of regulatory conditions set out in Part 3 of the PSA 2011. In particular, Ofcom must not impose (a) any regulatory conditions under the PSA 2011 unless it is satisfied that such conditions are objectively justified, (b) not unduly discriminatory, (c) proportionate to their aims and (d) transparent as to what they are intended to achieve[14].

6.20. **Ofcom must also take into account the overarching principles of better regulation** including proportionality, accountability, consistency, transparency and the need for regulation to be targeted to remain relevant and address only the problem identified[15]. For example:

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10 http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/
11 Ofcom, *Better Policy Making - Ofcom's approach to Impact Assessment*, July 2005 ("Ofcom's Guidance"), para. 1.1.
12 Better Regulation Task Force, *Principles of better regulation*, 1997.
13 Ofcom, 2012, Securing the Universal Postal Service, paragraph 1.23.
14 Postal Services Act (2011), Schedule 6, paragraph 1, page 83.
15 Better Regulation Task Force (1997), Principles of better regulation, page 6. Ofcom's own Regulatory Principles incorporate these values: "*Ofcom will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome.*" (http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/)

- The complexity of regulation can undermine its effectiveness. This was a key fault of the Postcomm regime[16]. The principle of transparency requires that any regulation should be simple and user-friendly.
- The need for a carefully targeted regulatory framework is particularly important given that the postal market is currently subject to significant and rapid change. An important reason for the failure of the Postcomm regime was its inability to predict or respond to such rapid change[17].

Ofcom must undertake a robust Impact Assessment.

6.21. In our response to Ofcom's Access Pricing Review consultation,[18] we raised concerns that Ofcom had proposed very intrusive, untested regulatory intervention in a fragile declining market without compelling evidence and without carrying out a proper impact assessment. Such **an impact assessment would be all the more important** should Ofcom propose further regulatory interventions as a result of the Fundamental Regulatory Review.

6.22. **Ofcom has a statutory duty under section 7 CA 2003 to carry out an Impact Assessment** in relation to proposals which are "important". However, Ofcom's Guidance states that this will be regarded as a minimum requirement and it expects to carry out Impact Assessments in relation to the "great majority" of its policy decisions[19]. Ofcom's Guidance makes clear that, in carrying out an Impact Assessment, Ofcom has a duty to consider a wide range of options, including alternatives to formal regulation[20]. In particular, Ofcom states that:

- the option of no new intervention should be the benchmark or base case against which other options will be judged;
- other options should normally include the option of removing existing regulation;
- it will often be useful to consider an option to 'wait and see', such that no action would be taken immediately, with monitoring and review to take place at a later time on the basis of further evidence[21].

6.23. As an integral part of its Impact Assessment, Ofcom must identify and, where possible, quantify the costs and benefits that would flow from each option, and the associated risks, including any unintended consequences[22]. Ofcom must therefore quantify or assess the likely impact of the proposals on Royal Mail's profitability and assess the impact of Royal Mail's efficiency. In particular, given its primary duty in this regard, **Ofcom must quantify the impact on the USO.** Ofcom must also identify any impact on competition[23]. This is particularly important given the need for Royal Mail to be able to compete effectively in order sustain the USO.

Conclusion

- Ofcom should confirm that the commercial rate of return, as a minimum is 5-10% EBIT margin for the Reported Business
- Royal Mail should be provided the commercial flexibility to maintain investment grade credit rating and make reasonable returns for equity investors
- Ofcom should avoid introducing unnecessary regulatory interventions

[16] Securing the Postal Service, paragraphs 1.19 and 6.67, pp. 3 and 62.
[17] Securing the Universal Postal Service, paragraphs 1.19 and 1.23, pp. 3 and 4.
[18] Response to Ofcom's December 2014 Consultation: 'Royal Mail Access Pricing Review: Proposed amendments to the regulatory framework'", Royal Mail plc, 24 February 2015
[19] Ofcom's Guidance, para. 4.5.
[20] Ofcom's Guidance, para. 1.3.
[21] Ofcom's Guidance, paras. 5.13, 5.14 and 5.16.
[22] Ofcom's Guidance, para. 2.1, see also paras. 5.31-33.
[23] Ofcom's Guidance, para. 5.22-23.