

## Royal Mail's Response to Ofcom's consultation on 'Securing the Universal Postal Service: Safeguard cap for large letters and packets'

### Introduction

1. Royal Mail welcomes this opportunity to input into Ofcom's consultation process on the safeguard cap for large letters and packets.
2. Royal Mail remains disappointed that Ofcom took the decision in March 2012 to extend the safeguard cap to Second Class large letters, packets and parcels <2kg. This response therefore provides further analysis to support our contention that this intervention is not required; along with Royal Mail's views on the technical questions raised by Ofcom related to the form and structure of the safeguard cap.
3. The key fact remains: Royal Mail is currently [§<] on Second Class large letters and parcels and more generally this segment of the market is characterised by very low returns for all players.
4. In addition adequate safeguards already exist in this market segment to protect vulnerable groups:
  - i. The universal service obligation already requires that Royal Mail's prices are affordable, fair and reasonable, and geographically uniform;
  - ii. The continued development of competition in this segment of the market already constrains Royal Mail's pricing freedom; and
  - iii. There is no evidence to support concerns on affordability (the majority of customers who use these services send only 4 items per annum).

As such we do not believe that Ofcom has provided clear evidence to support the need for this additional regulatory invention.

5. Given that this segment of the packets market is evolving rapidly both in terms of customer preferences and increasing competition, Royal Mail believes Ofcom should commit to a formal public review of the continuing need for this intervention to conclude no later than March 2014.
6. The remainder of this response is structured as follows:
  - Section 1 provides a short commentary on why Royal Mail believes the safeguard cap for Second Class large letters, packets and parcels <2kg is unnecessary.
  - Section 2 sets out Royal Mail's response to each of the questions raised in Ofcom's consultation document.

## Section 1 – Challenging the need for a safeguard cap

7. The universal service obligation is designed to ensure that a minimum level of service and quality is provided at an affordable price for all users of the service. Under the new regulatory framework, Royal Mail is still subject to significant regulatory oversight in this area, due to its universal service obligation, which ensures that robust safeguards exist for all customers:
  - a. ***Price changes need to be fair and reasonable.*** Royal Mail must ensure it considers the impact of any price change on customers and can demonstrate that these changes are “fair and reasonable” if required to;
  - b. ***Prices must remain affordable.*** It is a requirement of the Postal Services Directive that universal service prices must remain affordable. If Ofcom deem that they are not then they have the power to investigate and take action to remedy this; and
  - c. ***Uniform tariff.*** Royal Mail has to charge the same price nationwide which means that all customers are protected by being able to access affordable products (whether they live in densely populated urban areas or deep rural communities) through the “one price goes anywhere” requirement.
8. Historically both Royal Mail and other operators have made very low returns in the UK parcels market – Royal Mail’s core parcels business [X] Royal Mail has begun the process of unwinding the price distortions created by historic price controls. Other operators have already entered the market e.g. myHermes and Yodel<sup>1</sup>. They too have called for a need for increased prices to underpin the financial sustainability of the sector.
9. As competition in the consumer / micro SME<sup>2</sup> segment of the packet market is increasing there is growing customer awareness of potential alternatives to Royal Mail. Customer preferences regarding their requirements from the delivery experience are also changing rapidly. This means that Royal Mail, and other operators, must continue to invest to refine their product portfolios to ensure they continue to offer what customers want. It is essential that Royal Mail has the pricing flexibility available to continue necessary price rebalancing to ensure its prices more accurately reflect the costs of handling packets and to ensure it can earn a reasonable commercial return on necessary investment.

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<sup>1</sup> Yodel offers a CollectPlus service which provides a network of sites where customers can drop off a parcel for delivery or collect a parcel.

<sup>2</sup> SME – 10 employees or fewer, Ebuyers – must send at least 3 items in six months.

10. The reseller market has also been growing steadily year on year and there are now a large number of resellers including Parcel2Go, Parcel Monkey and MyParcelDelivery operating in the UK, offering further choice for consumers.
11. In light of the fact that this market is evolving rapidly Royal Mail believes that Ofcom should commit to a formal review of the continuing need for the safeguard cap on Second Class large letters and packets, to conclude no later than March 2014. This review should re-consider whether a safeguard cap remains necessary in light of continuing market developments.

### Consultation Questions

#### **Question 3.1: do you agree with our proposals for the structure and form of the safeguard cap? If not please explain why.**

12. If a safeguard cap is to be applied to large letters, packets and parcels < 2kg we believe that it is essential that the cap is structured to provide Royal Mail with maximum pricing flexibility.
13. Royal Mail needs to be able to respond quickly to customer requirements and to enable prices to more accurately reflect the costs of handling different types of packets. We are currently reviewing our packet portfolio to ensure it is fit for purpose in the current market. We require the flexibility to update our product offerings to customers without being constrained by an administrative instrument. Ofcom must ensure there is a quick, efficient and transparent process to re-base the structure (and level) of the cap in the event that Royal Mail introduces new products into this market segment which Ofcom feels must be included within the price control.
14. There should be no subcaps in the pricing formula as this would restrict Royal Mail's ability to innovate in pricing and may create artificial regulatory distortions in our pricing decisions.
15. We welcome Ofcom's proposal to use actual volume rather than forecast volume. The use of forecast volumes would lead to the need to include correction factors in the price cap formula which we believe would lead to an unnecessary increase in the regulatory burden associated with the safeguard cap.
16. However we do not agree with Ofcom's proposal to use October to September actual volume information. Stamp volume figures are calculated based on sampling information from the Mail's Characteristics Survey. The stamp information, alongside all other volume information, is audited to an annual timetable following the end of the financial year. If October to September volume information were to be used a new process would have

to be introduced to review and agree the numbers for use in the cap calculation, introducing additional administrative costs. We believe that a much simpler approach would be to use the audited year end volume figures in the price cap formula. We believe that this would create transparency regarding the volume figures while avoiding the need to incur additional regulatory costs.

**Q 3.2: do you agree with our recommendation of up to 53% for the maximum increase permitted by the cap (in addition to inflation)? If not, please explain why.**

17. Royal Mail believes that the level of the safeguard cap must, as a minimum, be equal to the Second Class letter cap and that the level and continuing need for the cap should be reviewed within two years to ensure it remains necessary.
18. [X] In a market where traditional mail volumes are falling, it is important that Royal Mail is afforded the necessary flexibility to enable it to earn sufficient returns over its whole portfolio to ensure a financially sustainable universal service.
19. Royal Mail's pricing decisions will be based on detailed considerations of both market demand conditions and the need to cover the costs of handling the products. The safeguard cap must be defined in a way which does not restrict Royal Mail's ability to respond to these factors.
20. We have also considered international price comparisons to determine whether our current pricing levels for Second Class stamp large letters, packets and parcels are out of line with other postal operators. It is difficult to undertake direct comparisons as different countries offer different services and product specification may vary. We considered 13 other EU countries<sup>3</sup>, of this group only four offer a second class service.
21. The table below provides a summary of the product offerings, including the major EU countries. The UK is one of the few countries in the EU offering a Second Class packet and parcels service. Many other countries – including the Netherlands and Germany – only offer the equivalent of a First Class service.

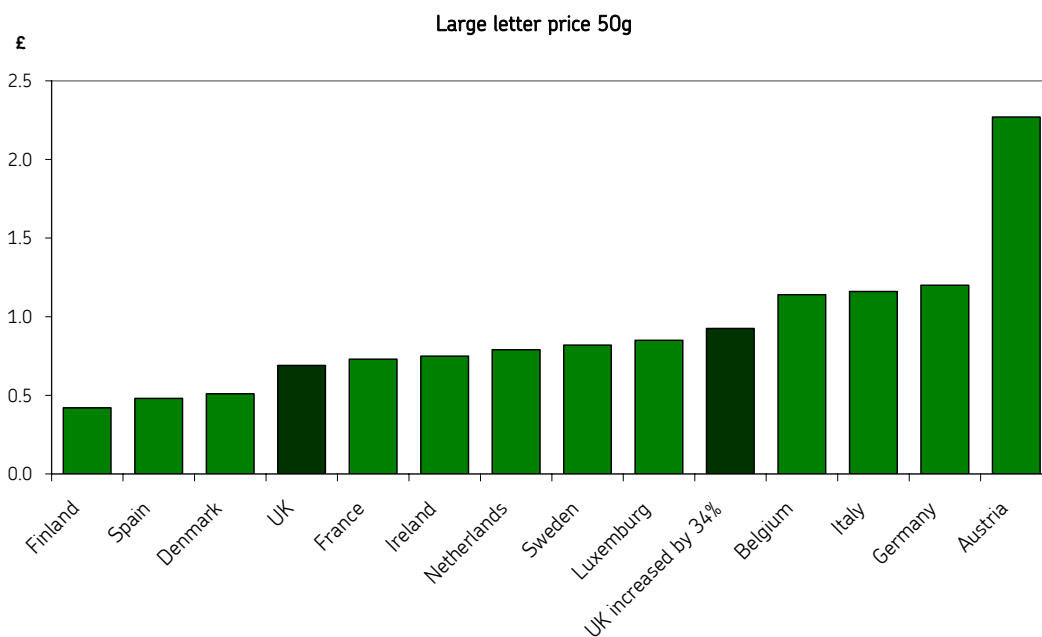
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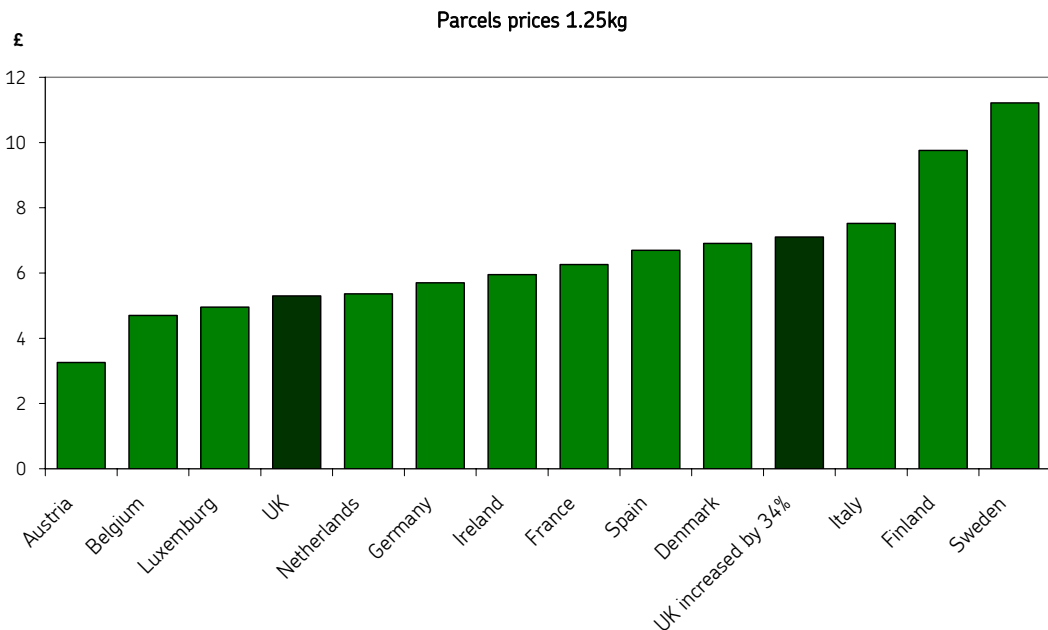
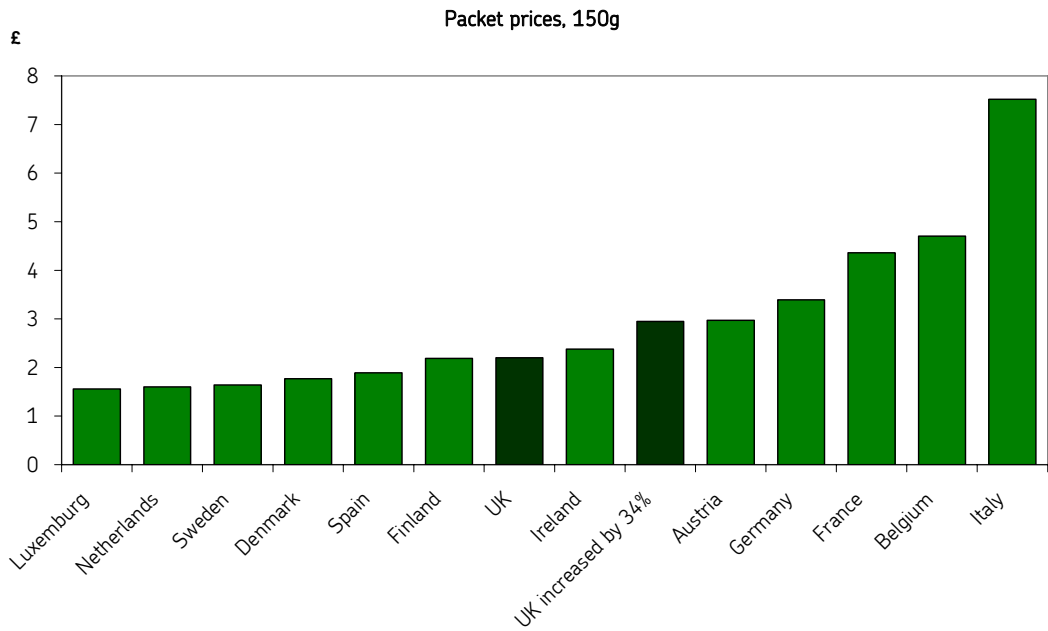
<sup>3</sup> Germany, France, Netherlands, Belgium, Ireland, Luxemburg, Italy, Austria, Denmark, Finland, Sweden, Spain

Country	Products	Class of products offered	Date price guide published
Germany	Letter, Compact Letter, Large Letter, Maxi Letter, Small Packet, Parcel	First Class only	01/01/2012
France	Letter <sup>1</sup> , Mini Max and Parcel	First, Second and Third	01/10/2011
Netherlands	Letter <sup>2</sup> , Parcel	First Class only	01/01/2012
Belgium	Letter, Non-standard Letter, Parcel (4 formats of parcel)	First Class only	01/01/2012
Ireland	Letter, Large Letter, Packet, Parcel	First Class only	01/05/2012
Luxemburg	Letter, Non-standard Letter, Maxi Letter, Parcel	First Class only	01/01/2012
Italy	Small Letter, Medium Letter, Extra Letter, Parcel	First Class only	?
Austria	Standard, Standard Plus, Maxi, Maxi Plus, Large Letter, Parcel	First Class only	01/01/2012
Denmark	Letter <sup>2</sup> , Packet	First and Second	01/01/2012
Finland	Letter, Maxi Letter, Parcel	First and Second	06/01/2012
Sweden	Letter <sup>2</sup> , Parcel	First and Second	01/01/2012
Spain	Letter <sup>2</sup> , Parcel	First Class only	01/01/2012
<b>UK</b>	<b>Letter, Large Letter, Packet, Parcel</b>	<b>First and Second</b>	<b>28/04/2012</b>

1) Letter product in France can only be used when posting an item of correspondence which is defined as written communication on a physical medium, excluding books, catalogs, newspapers, periodicals and merchandise with or without commercial value.  
2) Where Letter covers all products with dimensions: (length+height+depth)≤900mm

22. For illustrative purposes we compared prices at particular weight steps to gain an appreciation for whether Royal Mail's prices are in line with other EU countries. The graphs below show that Royal Mail's prices are at or towards the bottom half of the sample. We have also shown the impact of increasing the 2012/13 prices by a further 34%, in line with the potential pricing freedom in the safeguard cap for 2012/13. This demonstrates that the level of the cap proposed by Ofcom is in line with offerings in other EU countries. This analysis does not take account of potential price increases which other EU countries may be considering.





**Conclusions**

23. Royal Mail believes that the segment of the market to which the price cap will apply is developing rapidly and that price regulation should only occur where the market and other regulatory tools do not provide sufficient protection to consumers. We believe that the emergence of increasing competition in the market with the regulatory requirement that price increases must be fair and reasonable and remain affordable provides sufficient protection for customers. We therefore propose that the safeguard cap should be reviewed within 2 years.

24. Turning to the technical details of the price cap, when introducing a price cap it is essential that the cap is appropriately structured. We have discussed amendments required to the current proposal. In summary we:
- a. Agree there should be one basket for Second Class large letters, packets and parcels <2kg with no subcaps; and
  - b. Agree that actual volumes should be used but they should be based on financial year audited figures.