making communications work
for everyone

Annual monitoring update on the postal market

Financial year 2016-17

Market update

Publication Date: 23 November 2017

About this document

This report sets out the key data and trends in the postal sector for the 2016-17 financial year. The regulatory framework Ofcom put in place in March 2012, and reviewed in March 2017, fulfils our statutory duty of securing a universal postal service, having regard to financial sustainability and efficiency. An effective and on-going monitoring regime remains one of the key safeguards of the regulatory framework, alongside greater pricing freedom for Royal Mail.

This document, together with an expanded range of interactive data, constitute our sixth annual monitoring update on the postal sector. This report covers six key areas: Royal Mail's regulatory compliance; consumer and small business experience of postal services; the letters market; the parcels market; and the financial performance and efficiency of Royal Mail's Reported Business. The Reported Business is the part of Royal Mail's business responsible for the universal service, which requires Royal Mail to collect and deliver letters and parcels a minimum number of days a week, at an affordable and uniform price to all UK addresses.

Contents

Section

Annex

1. Executive Summary

1.1 This is our sixth annual monitoring update on the postal market.

1.2 This report covers the key areas we said in March 2012 would be the focus of our monitoring regime, augmented by further information on financial health metrics as set out in our March 2017 Review of Royal Mail Regulation (the March 2017 Statement).[1] It also sets out the key data and trends in the postal sector for the 2016-17 financial year.

1.3 The metrics in this update are, unless otherwise stated, consistent with those in our 2015-16 annual monitoring update on the postal market, published in November 2016[2] (enabling year-on-year comparisons). While the majority of the analysis in this report focuses on 2016-17, pricing information focuses on the most recent pricing data available (i.e. 2017-18), which is in line with previous monitoring updates.

1.4 This annual monitoring update comprises both this report and accompanying interactive data available on the Ofcom website.[3] Data presented in the annual monitoring update is available in csv files on the Ofcom website.[4]

Regulatory compliance

1.5 Royal Mail is subject to safeguard caps on the price of Second Class stamps for letters, large letters, and parcels up to 2kg, to ensure that consumers can access an affordable universal postal service. The caps prevent Royal Mail from increasing prices by more than inflation as measured by CPI.[5] Royal Mail's price rises for 2017-18 complied with these safeguard caps. Royal Mail's price increases for its single piece products in 2017-18 were broadly consistent with price increases in 2016-17 in nominal terms. However, prices in real terms actually fell for consumers, as Royal Mail's price increases were less than the rate of inflation.

1.6 Overall, Royal Mail's quality of service (QoS) performance in 2016-17 improved compared to the prior year. Its performance was the same as, or better than, 2015-16 against seven of the eight QoS measures. However, despite this improvement, it failed to meet its Postcode Area (PCA[6]), delivery routes completed, and Special Delivery[7] QoS targets by

[1] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf
[2] Ofcom, *Annual monitoring update on the postal market,* 30 November 2016, https://www.ofcom.org.uk/__data/assets/pdf_file/0029/94961/2015-16-Annual-Report.pdf
[3] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017
[4] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017
[5] Consumer Price Index, or CPI, is a measure of inflation and measures changes in the price level of a basket of consumer goods and services purchased by households.
[6] The PCA target requires Royal Mail to deliver 91.5% of First Class stamped and metered items by the next working day in 118 postcode areas.

relatively small margins. We take Royal Mail's compliance with its QoS obligations very seriously. We will continue to closely monitor its performance and should Royal Mail fail to meet its regulatory obligations in future, it could face financial penalties.

1.7 The number of complaints Royal Mail received rose 3% from last year. Although lost items remain the most common cause of complaint, the rise is accounted for primarily by complaints regarding damage and general complaints, as well as a new category of complaint – denial of receipt. See Section Three for more details.

Consumer and Business Experience of Postal Services

1.8 Our research indicates the majority of residential consumers are satisfied with postal services overall (86%) and Royal Mail (84%), which is broadly similar to figures reported in previous years. Three quarters of residential consumers are satisfied with the value for money of postal services overall. In addition, more than eight in ten SMEs who use Royal Mail (81%) said they were satisfied, while nearly nine in ten SMEs (87%) using other providers said they were satisfied.

1.9 Our research also reveals changes in the way residential consumers and SMEs are using postal services. Most residential consumers reported no change in the frequency of sending post in the last two years. However, the proportion of those saying that they are sending less than two years ago was higher than the proportion reporting that they are sending more, with the exception of tracked post.

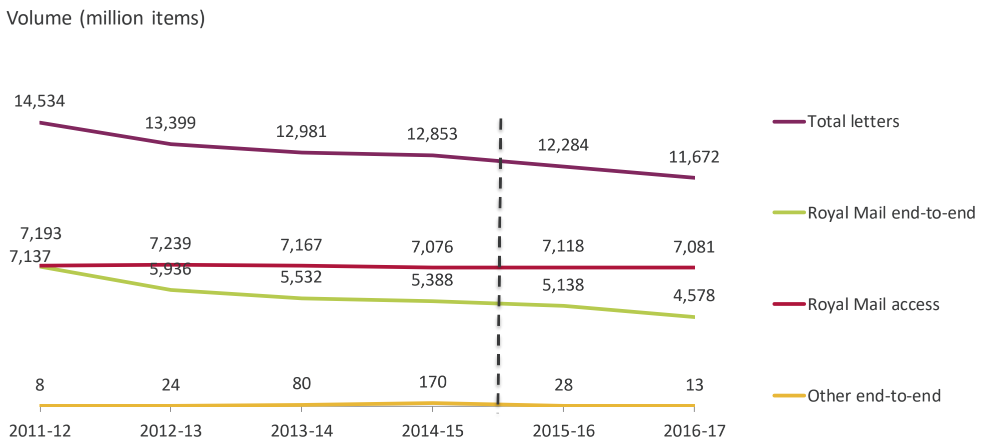
1.10 When sending letters, guaranteed delivery, low cost and uniform pricing across the UK were the factors most often rated as important by residential consumers, and guaranteed delivery was most often rated as important by SMEs. Next day delivery was important to a lower percentage of both residential consumers and SMEs. When sending parcels, guaranteed delivery and proof of despatch/delivery were rated as important by the highest proportions of respondents in both cases. See Section Four.

UK letters market

1.11 In 2016-17 total addressed letters volumes fell by 5%, to 11.7 billion items. This was an increase in the rate of decline in recent years of roughly 4% per annum. Total addressed letters revenue stood at £4.2 billion in 2016-17, a decrease of 5% in real terms on the previous year. See figures 1.1 and 1.2 below, and Section Five.

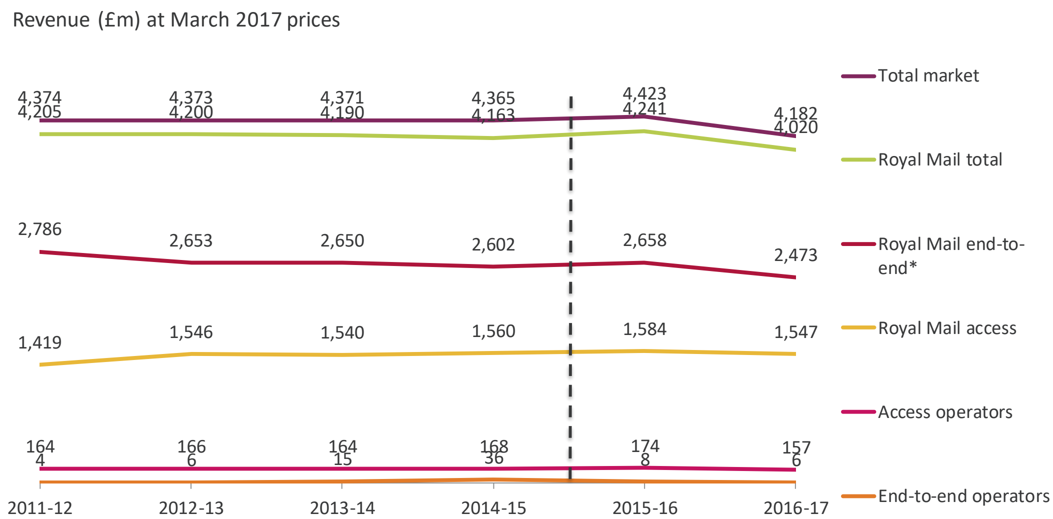
[7] The Special Delivery target requires Royal Mail to deliver 99% of all Special Delivery (Next Day) items by the next delivery day.

Figure 1.1 - Addressed letters volumes by type of operator



Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates. Due to changes in methodology, data prior to 2015-16 are not directly comparable to data after this point. See chapter 5 for full details.

Figure 1.2 - Addressed letters revenue by type of operator



Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates. Data prior to 2015—16 are not comparable with data form 2015-16 onwards due to a change in methodology. See chapter 5 for full details.

Bulk mail services

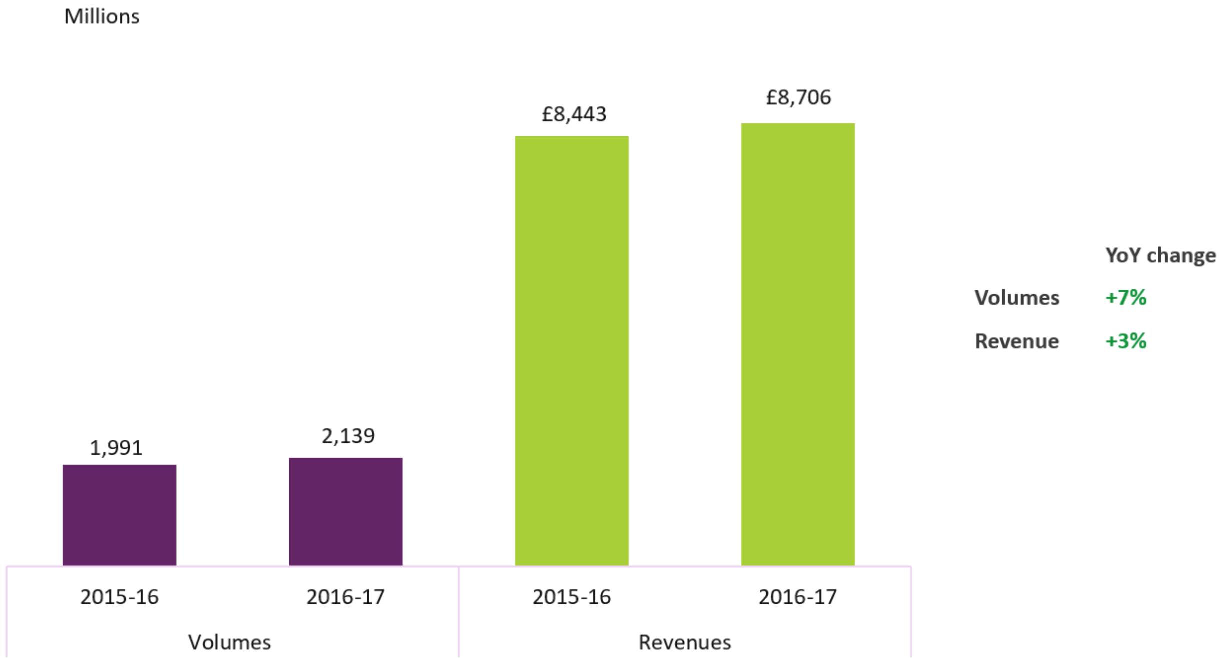
1.12 Access mail (mail injected by other providers into Royal Mail's network for delivery to end customers) accounted for 61% of total addressed letters in 2016-17, up from 58% in 2015-16.

1.13 Royal Mail changed the prices of its retail and access mail products in 2017-18. For retail products, real terms price increases in 2017-18 were smaller on average (0.1%) than the price increases for 2016-17 (1.6%), with a significant price reduction for Unsorted Mailmark second class. For access mail, real terms price increases in 2017-18 were lower than the previous year, with the average price increase across all six products being 0.2%, compared to an average price rise of 1.1% in 2016-17. See Section Five.

The parcels market

1.14 Total measured national volumes increased in 2016-17 by 7% to 2.1 billion items and revenue increased by 3% to £8.7 billion, leading to a fall in average unit revenue. This is consistent with the level of competition in the sector. The rate of growth was slower than in 2015-16. See figure 1.3 below and Section Six.

Figure 1.3 – Total measured national parcels volumes and revenues (including international)



Source: Operator returns to Ofcom (includes access volumes and revenues). Figures adjusted for CPI.

Financial performance of the Reported Business

1.15 The financeability EBIT margin of the Reported Business[8] fell from 5.0% to 4.6%. This is outside of the indicative 5% to 10% range that we consider to be representative of a reasonable commercial rate of return for a financially sustainable universal service in the medium to long term (see Figure 1.4 below).

1.16 Despite this, we consider that the universal service is likely to remain financially sustainable in the immediate future. This is because the financial position and financial health metrics of the Relevant Group do not indicate any short to medium-term financial

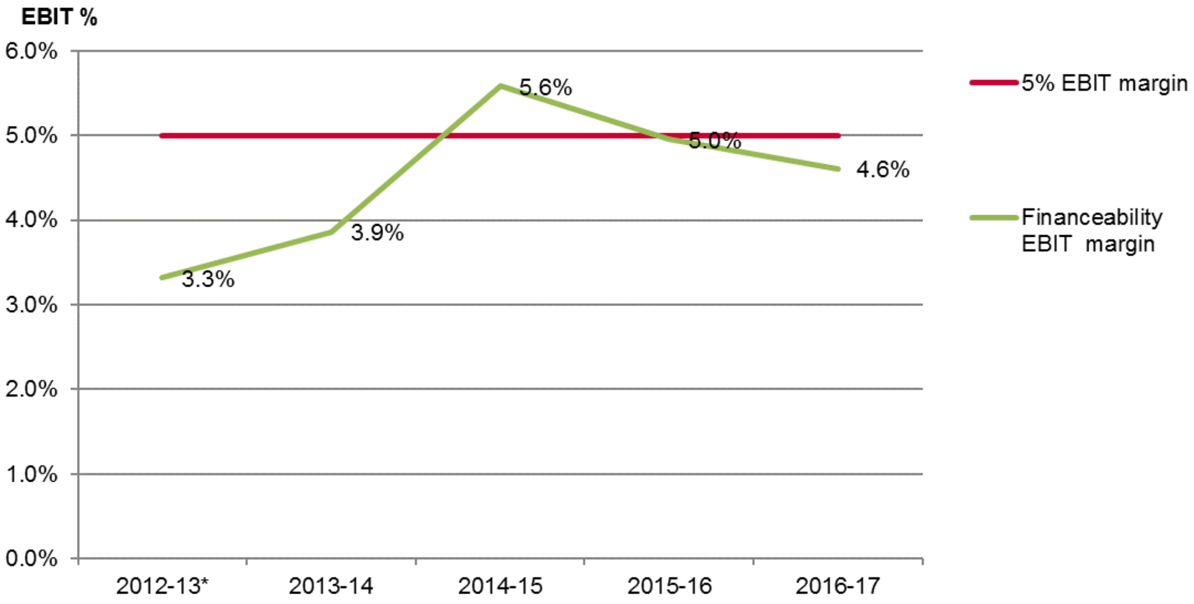
[8] The Reported Business is the part of Royal Mail's business responsible for the universal service.

health issues. In reaching this view, we note that Royal Mail Group's BBB credit rating was recently reaffirmed, and it passed its banking covenant tests in 2016-17.

1.17 In addition, the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. Continued progress on efficiency is likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.

1.18 However, we recognise that there are various downside scenarios which have the potential to impact the financial sustainability of the universal service. These downside risks include the impact of potential industrial action, affordability of the pension scheme, increased competition within the parcels market, and economic and market downturn. We will continue to monitor these developments closely. See Section Seven for more detail.

Figure 1.4 Reported Business Financeability EBIT margin



*Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail. *2012-13 EBIT margin is based on 53 weeks*

Royal Mail's efficiency

1.19 Total costs for the reported business reduced by 0.4% in real terms in 2016-17 (compared with 1.6% in the prior year). However, this movement in costs is due to several factors including changes in volumes as well as efficiency savings. PVEO analysis provides a useful measure of efficiency improvements by separately identifying Price, Volume, Efficiency and "Other" factors. It indicates an underlying efficiency improvement (excluding transformation costs) of c.2.2% in 2016-17 (against c.1.5% in the prior year).

1.20 Royal Mail reduced total gross hours spent by employees in delivery and processing by 1.9% in 2016-17 (slightly less than the reduction in the prior year). However, average people costs per full time equivalent employee (FTE) increased in the year, while the average revenue per FTE decreased, meaning that people costs increased relative to revenue.

1.21 Overall, Royal Mail has made some efficiency improvements in 2016-17 in a challenging environment. We remain of the view that Royal Mail has the potential to make further efficiency gains in the future, but recognise that the timing and scope for further improvements in performance from the levels achieved in 2016-17 are dependent on the nature of any settlement agreed with its workforce on its future pay and pension arrangements.

2. Introduction

Background

2.1 Ofcom has a duty under the Postal Services Act 2011 to secure the provision of a universal postal service, having regard to its financial sustainability and efficiency. The minimum universal service requirements are set by Parliament and require Royal Mail to provide certain postal services at an affordable, uniform price throughout the UK. In light of this duty, our approach to regulating the postal sector was set out in our March 2012 Statement.[9] This included the decision to give Royal Mail greater pricing freedom to enable it to return the universal service to financial sustainability, subject to certain safeguards.

2.2 One of these safeguards was an effective and on-going monitoring regime to track Royal Mail's performance, as well as monitoring changes in the postal market. As part of this regime, we committed to publishing an annual monitoring update which sets out key data and trends in the postal sector, focusing on the progress towards securing the provision of a universal service.

2.3 On 1 March 2017, we published a statement concluding a review of the regulation of Royal Mail.[10] This included our decision to maintain the current regulatory approach for a further five years until 2022. We confirmed that our on-going monitoring of the postal market remains a very important component of our regulatory framework, representing one of the three safeguards on which the framework rests, alongside the Second Class safeguard caps on certain universal service products and mandated access regulation.

2.4 In order to ensure that the regulatory framework continues to work effectively we confirmed our intention to monitor a range of factors including Royal Mail's performance on efficiency, quality of service, the financial performance of the universal service network, and competition in parcels and letters. We also confirmed our intention to monitor Royal Mail's future efficiency performance and to publish our view of Royal Mail's efficiency in our annual monitoring updates.

2.5 In addition, we set out our intention to continue to monitor consumers' experiences in the postal sector. Although we already gather some information in relation to consumer experiences, we said that in future we intended to place greater emphasis on monitoring the evolution of postal consumer needs and preferences as part of our overall monitoring programme, specifically by adding focused questions in our postal trackers. As a result, this year's annual monitoring report contains a new chapter entitled, "Consumer and business experience of postal services" (See Section Four).

---

[9] Ofcom, *Securing the Universal Postal Service,* 27 March 2012, https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf

[10] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

2.6 Transparency around Royal Mail's costs form an important part of the framework established in the March 2012 Statement, as it helps us understand how Royal Mail allocates its costs to activities and products, how and why these allocations change over time and what the impact of these changes are. This analysis is key to informing our work on assessing and monitoring financial sustainability and efficiency, and as such Royal Mail has to fulfil a number of requirements regarding regulatory reporting on costs.[11]

2.7 On 31 March 2017 we consulted on proposals to amend the universal service provider accounting condition (USPAC) and the regulatory accounting guidelines (RAG) to ensure they remain fit for purpose. These proposals relate to accounting separation; cost and efficiency reporting; business planning information; cost data submissions and change control, reporting deadlines; and margin squeeze control. We are currently in the process of considering responses to these proposals and expect to publish a statement in December 2017 and two further consultation documents in the New Year. Any changes made as a result of this review which affect our monitoring programme will be incorporated into future annual monitoring reports.

Measuring the outcomes of the regulatory regime

2.8 This report focuses on the 2016-17 financial year and in particular on:

- Compliance with regulation – Section Three
- Consumer and business experience of postal services – Section Four
- The letters market – Section Five
- The parcels market – Section Six
- The financial performance of the Reported Business – Section Seven
- The efficiency of the Reported Business – Section Eight

2.9 We continue to monitor market developments and Royal Mail's performance in the key areas outlined above.

The wider monitoring programme

2.10 In addition to this annual monitoring update, the aims of which are discussed above, the wider programme includes:

- industry stakeholders providing market specific information, identifying any concerns with how the regime is operating and potential market developments; and

[11] Ofcom, *Review of Regulatory Financial Reporting for Royal Mail: Consultation,* March 2017, https://www.ofcom.org.uk/__data/assets/pdf_file/0038/99785/Consultation-Review-of-Regulatory-Financial-Reporting.pdf

- regular internal review of data and indicators for the key areas set out above (including through our internal governance process).

2.11 Within this report we provide our view of how the regulatory regime is meeting our duty to secure the provision of a universal service. To ensure transparency, we are publishing some Royal Mail data on its financial performance, changes to terms and conditions of its products and highlighting market developments in the past year.

2.12 Royal Mail (along with other postal operators) provides a range of confidential data to us. Although the confidential nature of this data means that we cannot publish it, the data informs our on-going internal monitoring programme, and is used to identify any potential or emerging problems in relation to the provision of the universal service. So that stakeholders are aware of the information we gather, a list of data that we currently gather is listed in Annex 1.

Royal Mail is the focus of our monitoring regime

2.13 The focus of our monitoring is Royal Mail, although we do this within the context of the broader postal services market. This is because Royal Mail is currently the only postal business in the UK which operates a network capable of delivering letters and parcels to over 29 million business and household addresses nationwide. As such, it is the designated universal postal service provider.

2.14 Not all of Royal Mail's business is subject to Ofcom regulation. The parts that are subject to our monitoring regime are known as the 'Reported Business', which sits within a group of business units referred to as Royal Mail UK Parcels, International and Letters (UKPIL).

2.15 The Reported Business includes all universal services,[12] as well as retail bulk mail,[13] access products and parcels which also use the universal service network.[14]

2.16 Although we focus on the financial year 2016-17, in parts we deviate from this time period to include more recent events and price changes, including in analysing residential letter and parcel prices (which are normally increased in April and last for the rest of the financial

---

[12] Royal Mail, *Universal Service Obligation,* http://www.royalmailgroup.com/regulation/how-were-regulated/universal-service-obligation

[13] Retail bulk mail relates to a range of services provided directly to sending customers by Royal Mail that are subject to volume or presentation discounts. This category represents bulk mail collected and delivered by Royal Mail itself, as opposed to bulk mail delivered by Royal Mail under an access agreement. Access is discussed further in Section 4.

[14] In December 2013, we published a Statement implementing technical and minor amendments to the Universal Postal Service Order and related regulatory conditions. See Ofcom, *Technical and Minor Amendments in Postal Regulation*, 10 December 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/post/statement/statement.pdf. None of the amendments have any practical impact on users, Royal Mail and other postal operators as they do not require any changes to Royal Mail's current provision of the universal postal service.

year),[15] business prices (which are normally increased every January) and developments in the parcel market.[16]

Presentation of data in this Annual monitoring update

2.17 Data presented in the annual monitoring update on the postal market is, unless otherwise stated, in real terms.

2.18 Where we discuss absolute or percentage changes, we are referring to comparisons to the previous financial year i.e. 2015-16 to 2016-17 (unless otherwise stated).

2.19 Where we report real terms changes, we have elected to use the Consumer Price Index (CPI) as the basis for our calculations for the same reasons as stated in previous annual monitoring updates on the postal market.[17]

[15] For the purposes of clarity, in this report, we analyse residential prices for letters and parcels from March 2017 onwards.
[16] For all developments, price rises and areas of interest to this report, outside of Royal Mail's financial and efficiency analysis (which is based on the financial year 2016-17 in this report), we include the most recent information available to us. This approach is consistent and remains unchanged with our approach in last year's Annual monitoring report.
[17] Ofcom, *Annual monitoring update on the postal market - Financial year 2014-15*, 27 November 2015, paragraph 2.22, https://www.ofcom.org.uk/__data/assets/pdf_file/0025/56923/annual_monitoring_update_2014-15.pdf

3. Regulatory compliance

3.1 In this section, we discuss Royal Mail's compliance with its regulatory obligations.

3.2 As part of its role of as the designated universal service provider, Royal Mail is subject to a set of minimum requirements and service standards in the provision of universal services. These include performance standards for First and Second Class deliveries, maintaining daily delivery (to all UK addresses) and collection (from all access points[18]) of letters (six days a week) and parcels (five days a week), reporting on the most common causes for complaint and providing services at affordable prices, at a uniform public tariff service to all UK addresses.

3.3 As noted in our March 2012 Statement, we monitor:

a) Prices of universal service products – particularly any impact on vulnerable groups and those that rely on postal services. We discuss Royal Mail's price changes (as well as changes to non-price terms) within this section; and

b) The quality of service achieved by Royal Mail in the provision of universal services.[19] Our March 2012 Statement set out the quality standards that Royal Mail is required to meet. This was to ensure appropriate levels of universal service performance were maintained for consumers.

3.4 This section reports on Royal Mail's compliance with these obligations using data which Royal Mail is required to provide to us in its role as the designated universal service provider.

Pricing of universal services

3.5 In March 2012, Ofcom removed the majority of price controls to give Royal Mail sufficient commercial freedom to enable it to return the universal service to a financially sustainable position. At the same time, we introduced a number of safeguards, including a cap on the price of Second Class stamps (for letters, large letters and parcels less than 2kg),[20] so that vulnerable consumers remain able to access a basic universal service. In March 2017, we concluded that the safeguard caps should be retained as an affordability measure, in order

---

[18] An access point is a point in Royal Mail's network that customers can send letters or parcels from (e.g. a postbox or a Post Office).

[19] We also monitor Quality of Service closely given the risk Royal Mail could degrade quality in order to reduce costs rather than improve efficiency.

[20] The safeguard cap on Second Class stamp letters came into effect on 1 April 2012 and can be found in our March 2012 statement, *Securing the Universal Postal Service*, 27 March 2012, https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf. The safeguard cap on Second Class stamp large letters and packets up to 2kg came into effect on 20 July 2012 and was subsequently modified in our March 2013 statement, *Safeguard cap for Second Class Large Letters and packets*, 28 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/safeguard-cap/statement/statement.pdf

to ensure that consumers (in particular vulnerable consumers) continue to have access to a universal service at affordable prices.[21]

3.6 While the majority of the analysis in this report focuses on 2016-17, the pricing information as detailed below focuses on Royal Mail's most recent pricing announcements (i.e. 2017-18), which is in line with previous monitoring updates.

Royal Mail has complied with the safeguard caps in 2017-18

3.7 For Second Class standard letters, the cap in 2017-18 is 59p. [22]

3.8 The Second Class large letter and parcel (up to 2kg) basket cap allowed Royal Mail to increase the prices of the basket products by up to 56% in 2012-13 (over 2011-12 prices), followed by CPI in each following year for the duration of the 2012 regulatory framework. For 2017-18, this meant Royal Mail could increase prices by an additional 8% from the permitted price rise in 2012-13, or an additional 1.5% from 2016-17, for products within the basket safeguard cap.

3.9 Royal Mail's prices for Second Class stamps complied with these safeguard caps in 2017-18. From 27 March 2017, Second Class letter stamps cost 56p, while the prices of other Second Class products were within the level permitted by the basket safeguard cap.

3.10 The safeguard caps are due to expire in March 2019. We intend to consult on the level of the cap from 2019 to 2022 during the course of the 2018-19 financial year.

The majority of letter and parcel prices fell in real terms in 2017-18

Standard letter stamp and meter prices

3.11 Royal Mail changed its prices in March 2017. For the first time since 2012-13, price rises in 2017-18 fell behind the rate of inflation, though this was only for stamp products. The price of a First Class standard letter stamp rose by 1p to 65p, which represented a real terms decrease as it was below the rate of inflation.[23] However, First Class meter[24] prices rose 4p, from 53p to 57p, which represented a 5.1% real increase, which is the largest year-on-year increase for this product, in real terms, since 2011-12.

---

[21] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, paragraphs 3.178-9, 4.44-6, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

[22] The cap is calculated by reference to the 2012-13 cap of 55p plus the relevant CPI inflation rate each year from 2012-13 to 2018-19.

[23] First Class standard letter stamp prices fell this year (2017-18) compared to the previous year (relative to inflation) by 0.7%, whereas since 2013-14, First Class stamp prices have increased (in real terms) 1.7%, 1.6% and 1.1% respectively compared to the previous year.

[24] Metered mail refers to a method of payment or payment channel for Royal Mail services where customers pre-pay for postage and apply an impression to the envelope, label or wrapper using a franking machine licensed by Royal Mail.

3.12 The price of a Second Class standard letter stamp increased by 1p to 56p, which represented a fall in real terms,[25] whilst Second Class meter prices increased 1p, to 41p, a real terms increase,[26] and significantly below recent year-on-year price rises.[27]

Figure 3.1 – Standard Letter First and Second Class stamp and meter prices for 2017-18

Stamp	65p	1p (1.6% ↑)	56p	1p (1.8% ↑)
Meter	57p	4p (7.5% ↑)	41p	1p (2.5% ↑)

Source: Royal Mail price list. Prices and price rises for 2016-17 to 2017-18 are in nominal terms.

3.13 The differential between stamp and meter prices for Second Class letters remained the same as in 2016-17 (15p), but decreased for First Class (from 11p difference in 2016-17 to 8p difference in 2017-18).

3.14 Page 3 of the interactive data shows historic trends in letter prices.[28]

Large letter stamp and meter prices[29]

3.15 There are four weight steps for Large Letters – 0-100g, 101-250g, 251-500g and 501-750g. Prices fell in real terms for Large Letters across all weight steps, except for First Class meter products, in 2017-18 compared to the previous year.

3.16 The average price for large letter stamps rose 2.2% for First Class and 1.5% for Second Class in nominal terms, but fell relative to inflation (for the first time since 2013-14) by

---

[25] Second Class standard letter stamp prices fell this year (relative to inflation) by 0.5%, whereas since 2013-14, Second Class stamp prices have increased (in real terms) 4.3%, 1.9% and 1.3% respectively compared to the previous year.
[26] Second standard letter meter prices rose 0.2% this year, relative to inflation.
[27] Since 2013-14, Second Class meter price rises, year on year, have been 10.3%, 5.4% and 2.1% respectively. The price rise of 0.2%, for 2017-18, in real terms, is the smallest price rise, year on year, for any of the four aforementioned letter products since 2007-08.
[28] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017
[29] For this year's report, we have changed our methodology to measure the various products and weight categories offered as a large letter service.

0.1% for First Class and 0.7% for Second Class compared to 2016-17 prices. For Second Class large letter stamps, this represented the first fall in price for consumers, in real terms, since Ofcom started monitoring large letter prices in 2010-11. Meter prices in nominal terms increased by 9.5% for First Class, and 3.3% for Second Class. This represents a significant real terms price increase for First Class meter products but a price fall in real terms for Second Class meter products.[30] For Second Class large letter meter prices, this was the first price fall, in real terms, since Ofcom started its analysis from 2010-11.

3.17 Page 3 of the interactive data shows historic trends in large letter prices.[31]

Parcel prices

3.18 Since March 2016, Royal Mail has offered two prices for each parcel product that it provides within the universal service, depending on whether postage is purchased via an online account or at the Post Office. For parcel postage purchased via an online account prices are generally 5-8p cheaper than parcel postage bought at a Post Office. The price differences can be seen in table 3.1 below:

Table 3.1 – 2017-18 Royal Mail parcel prices and products

Parcel product	Post Office price (£)	Royal Mail online account price (£)
First Class 0-1kg small	3.40	3.35
First Class 0-1kg medium	5.70	5.65
First Class 1-2kg small	5.50	5.45
First Class 1-2kg medium	8.95	8.90
Second Class 0-1kg small	2.90	2.82
Second Class 0-1kg medium	5.00	4.92
Second Class 1-2kg small	2.90	2.82
Second Class 1-2kg medium	5.00	4.92

Source: Royal Mail price list, March 2017. Prices are in nominal terms.

3.19 In order to ensure a consistent comparison with prior years, we have used Post Office prices in the interactive data accompanying this report.

3.20 Last year, parcel prices, across both online and Post Office products, rose by an average of 0.6%, on the previous year (2015-16); in real terms, this represented a 0.4% increase. This year, the average price rise for a parcel product was 0.7%. However, when inflation is

[30] First Class large letter meter prices, relative to inflation, rose 6.3% in 2017-18, whereas prices for Second Class large letter meter products relative to inflation fell 0.4%.
[31] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

considered, this represents an average price fall of 1.6% for consumers. While the price of all parcel products rose in nominal terms, each of these price increases was lower than inflation, leading to real terms price decreases ranging from a reduction of 53p (Second Class 0-1kg and 1-2kg small parcels, Post Office) to the biggest real terms price fall of £2.30 (all First Class parcel products, except 0-1kg small parcels). Although last year was the first year Royal Mail introduced differentiated pricing for parcel postage bought online (hence the average price rise for parcel postage bought in the Post Office, when inflation is considered, was 0.7%, and there was no comparison to previous years for online postage), this year enables us to see that prices (compared to last year) fell by more, in real terms, for online parcel postage (1.8%) than for Post Office parcel postage (1.4%).

3.21 Page 4 of the interactive data shows historic trends in parcel prices.[32]

Affordability of universal services

3.22 One of the key safeguards in the current regulatory framework is ensuring that universal postal services are affordable. In March 2013 we published a report[33] which set out that we considered that universal postal services remained affordable for both residential consumers (including low income and other vulnerable consumers) and businesses (including small and medium businesses) at both the 2012 and 2013 prices. Since then, we have been monitoring the affordability of postal services through the responses to questions in our postal tracker surveys and through reviewing Office for National Statistics (ONS) data.

3.23 As noted in Section Four, 59% of residential consumers surveyed were satisfied with the cost of postage.[34] Furthermore the most recent ONS data shows that weekly household expenditure on postal services remains low, and unchanged from last year (0.1% of total expenditure, at 60p per household per week).[35] This is between the price of a first class (65p) and second class (56p) stamp.

3.24 Eight per cent of respondents reported that they had had to reduce their use of postage stamps so that they could afford essentials like food or heating, in the previous three months.[36] There is a difference across socioeconomic groups[37], with a higher proportion of

---

[32] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

[33] Ofcom, *The affordability of universal postal services*, 19 March 2013, http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf

[34] Ofcom residential postal tracker Q3 2016-Q2 2017, QG3_7: "How satisfied are you with the following aspects of Royal Mail's service? Cost of postage"

[35] ONS, *Family Spending in the UK: financial year ending March 2016*, 16 February 2017, Figure 2, https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/bulletins/familyspendingintheuk/financialyearendingmarch2016#how-has-the-digital-era-affected-uk-households-spending-habits

[36] Ofcom residential postal tracker Q3 2016-Q2 2017, QF1_1: "In the last 3 months have you had to… Reduce your use of postage stamps so that you can afford essentials like food or heating?"

[37] For a definition of socioeconomic groups, see Ofcom, *Communications Market Report: United Kingdom*, 3 August 2017, pages 237-238, https://www.ofcom.org.uk/__data/assets/pdf_file/0017/105074/cmr-2017-uk.pdf

those in the DE group (10%) reporting that they had done so compared to those in the AB and C1 groups (both 7%).

3.25 While we consider that universal service products are currently affordable for most residential consumers, we will continue to monitor respondents' views regarding affordability in future. As noted in our review of the affordability of universal postal services in 2013, there are some circumstances where a consumer could be at risk from not being able to afford universal postal services. These circumstances are where a consumer suffers both significant financial difficulty or very low income, and has a frequent need to send post items they consider to be essential. This reflects very particular circumstances and severe financial hardship. It is likely that consumers in such circumstances would unfortunately have concerns about the prices of universal postal services, even at much lower prices.[38]

Non-price terms of universal services

3.26 As part of the monitoring regime we also consider the impact of non-price changes to the terms of universal services, which involve changes to Royal Mail's Postal Schemes.

3.27 Postal Schemes set out the terms and conditions for postal services for consumers and business customers who use Royal Mail's services but who do not hold an individual contract with Royal Mail. Customers who use stamps, online postage, or franking meters to pay for Royal Mail services do so under a Postal Scheme rather than a contractual arrangement. Details of the Postal Schemes are available on Royal Mail's website.[39]

3.28 Before making changes to the Schemes, Royal Mail must consult customers and stakeholders, including Ofcom, and the consumer advocacy bodies, for example, Citizens Advice, providing at least one month's notice in advance of the date on which Royal Mail proposes to implement the change.

3.29 During 2016-17, Royal Mail made several changes to non-price terms:

- Amending the prohibited items list:
    - **To prohibit self-balancing scooters** (i.e. hoverboards), given they often contain batteries over a certain size which Royal Mail does not carry for safety reasons.
    - **To allow carriage of items that include a small amount of human or animal ash**, on the basis that Royal Mail became aware of companies involved in the production of items (e.g. jewellery) that contain small

[38] Ofcom, *The affordability of universal postal services*, March 2013, paragraph 6.3
https://www.ofcom.org.uk/__data/assets/pdf_file/0014/10445/affordability.pdf
[39] Royal Mail, *Postal Service Act 2000,* https://www.royalmail.com/non-contract-terms-and-conditions. The most recent Postal Scheme is dated January 2017, see https://www.royalmail.com/sites/default/files/Royal-Mail-UK-Post-Scheme-January-2017.pdf

amounts of these substances and concluded that items with a small amount of either substance do not pose a risk to health and safety.[40]

- **Clarification regarding Royal Mail's International Tracked products**[41]: this change made it clearer to customers that the product could be priced either by the pricing zones and/or a more granular level by individual country or group of countries.[42]
- **Clarification for franking customers regarding the impact of incorrectly segregating First Class and Second Class mail** (i.e. where First Class items found in Second Class mail, they are delivered as Second Class and the difference in price for the lesser service is not refunded).
- **Introducing delivery confirmation for First and Second Class small and medium parcels within the UK**: this initiative was first launched via Royal Mail's online postage channel, then deployed to Post Office postage (not available for parcels posted directly via a letter box).

Quality of Service

3.30 Royal Mail is subject to annual quality of service (QoS) targets. We monitor its performance against these targets so that we can take prompt and appropriate action if we identify failures, where we consider it is necessary to do so.

3.31 Figure 3.2 summarises Royal Mail's performance in 2016/17 and, for comparison, 2015/16 against the QoS targets we have set.[43] Page 6 of the interactive data shows historic trends for each KPI below.[44]

[40] However, the prohibition of items that contain more than a small amount of human and/or animal ashes remains.
[41] International Tracked is a non-USO service, but Royal Mail conducted a consultation as it is a product within the Post Scheme.
[42] In addition, in September 2017, Royal Mail launched free email notifications on all Royal Mail International Tracked products, alerting customers to when their item has left the UK, arrived in the receiving country, entered and cleared customers and been delivered/attempted to be delivered. See Post and Parcel, *Royal Mail launching tracked email notifications for international parcels*, 19 September 2017, http://postandparcel.info/82430/news/royal-mail-launching-tracked-email-notifications-for-international-parcels/
[43] The figures cited in this subsection are taken from Quality of Service reports submitted by Royal Mail to Ofcom and do not include any adjustments that Royal Mail makes to account for force majeure events, such as very severe weather.
[44] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

Figure 3.2 – Quality of Service Summary[45]

KPI	Target		2015/16 Result	2016/17 Result	Change from prior year
First Class delivery	**93.0%**	Items delivered day after collection	92.5%	93.1%	▲
Second Class delivery	**98.5%**	Items delivered within 3 days of collection	**98.8%**	98.9%	▲
Post Code Area (PCA) Target: First Class single piece mail	**118/121** PCAs	91.5% items delivered day after collection	**104/121**	110/121	▲
PCA Target (with confidence interval)[46]	**118/121 PCAs**	91.5% items delivered day after collection	**113/121**	117/121	▲
Special Delivery	**99.0%**	Items delivered next delivery day	**98.5%**	98.5%	=
European International Delivery	**85.0%**	Items delivered in 3 days	**87.5%**	86.1%	▼
Collection points: 6 days per week	**99.9%**	Collection points served	**99.9%**	99.9%	=
Delivery routes: 6 days per week	**99.9%**	Delivery routes completed	**99.8%**	99.8%	=
Correct delivery: 6 days per week	**99.5%**	Items correctly delivered	**99.7%**	99.8%	▲

Source: Royal Mail Quality of Service Reports, Year End Adjusted 2015-16 and 2016-17

[45] Royal Mail monitors its compliance in relation to quality of service standards using a series of surveys of test mail items, which are carried out by a research agency on its behalf, which are not identifiable to Royal Mail when travelling through its network. The sampling allows Royal Mail to estimate its delivery performance based on a sample of test items, which can then be extrapolated to estimate the performance across all mailing items.

[46] Due to the sampling method outlined in footnote 45, this means each result is subject to a confidence interval that describes the range within which there is a 95% probability of the true result occurring. For the PCA Target, there is a confidence interval of 0.1%, which means there is a 95% probability that the true performance lies in the range 92.4% to 92.6%. Ofcom's position is that if Royal Mail's performance meets a standard within that margin of error, we would not intervene or investigate further as in such circumstances "it could not be ascertained whether Royal Mail had missed the target or not" (Ofcom, *Annual monitoring update on the postal market – Financial year 2014-15*, page 18, paragraph 3.35).

Royal Mail's quality of service performance improved in 2016-17 but it did not meet all of its obligations

3.32 Royal Mail is required to deliver 93.0% of all First Class retail items (single piece stamp, meter and PPI[47] letters and parcels) on the next working day after collection, and 98.5% of all Second Class retail items within three days of collection.[48] Royal Mail exceeded its target for both First Class and Second Class delivery in 2016/17, by 0.1% and 0.4% respectively.

3.33 The postcode area[49] (PCA) target requires Royal Mail to deliver 91.5% of First Class mail the day after collection from a postbox, Post Office or other collection point to 118 of the 121 postcode areas.[50] Although Royal Mail failed to meet its PCA target, its performance significantly improved compared to the previous year. When the confidence error margin is considered, it met the target in 117 of the 121 postcodes.

3.34 The PCA where Royal Mail's performance was below the confidence error margin was Inverness (IV), which only achieved 89.0%. This is a decrease on the prior year, when Inverness achieved 89.8%. Royal Mail has said that Inverness faces particular challenges due to its location and the long distances that vehicles have to travel to get mail to remote locations for delivery. The Inverness PCA is now the subject of an improvement plan, and we will monitor Royal Mail's performance in this PCA closely.

3.35 Royal Mail failed to meet its Special Delivery target, achieving the same result as last year (98.5%). This is the same as its performance in the prior year, and 2014/15.

3.36 Performance against the European International Delivery target fell for the fifth year in a row, falling from 95% in 2011-12 to 86.1% in 2016-17. However, it remained above the required performance level of 85%.

3.37 Royal Mail exceeded its requirement to ensure at least 99.5% of items are correctly delivered, achieving 99.8% which represented an improvement in performance from the prior year. Royal Mail also met its requirement to ensure that at least 99.9% of collection points are served each day.

3.38 Royal Mail narrowly failed to achieve its target to complete at least 99.9% of delivery routes on each working day achieving 99.8%, the same level of performance as in the prior year. Royal Mail has not achieved this target since 2010-11.

---

[47] Printed Postage Impressions, or PPIs, is a pre-printed alternative to a postage stamp or franking to indicate that postage has been (or will be) paid.
[48] These targets are set below 100% to allow for commonly experienced circumstances that may arise in the transportation, processing and delivery of mail, for example, disruption to aircraft flights due to bad weather or missed network connections due to road traffic delays and breakdowns. If the targets were set at a higher level it would be likely to substantially increase Royal Mail's costs and, potentially, universal service prices. The 93% First Class target was originally agreed as achievable by Royal Mail and Postcomm in 2001.
[49] The postcode area is the largest geographical postcode unit and forms the initial characters of the alphanumeric UK postcode.
[50] Three of the PCAs – HS (Hebrides), KW (Kirkwall, Orkney) and ZE (Shetlands) – are excluded from this target, principally because it is not practical logistically to achieve a next day service for 91.5% of First Class mail sent from across the UK to these remote destinations. In addition, these offshore areas are more frequently subject to weather-related disruption of ferry and air services.

3.39 We take Royal Mail's compliance with its QoS obligations very seriously. We will continue to closely monitor its performance and should Royal Mail fail to meet its regulatory obligations in future, it could face financial penalties.

Complaints data

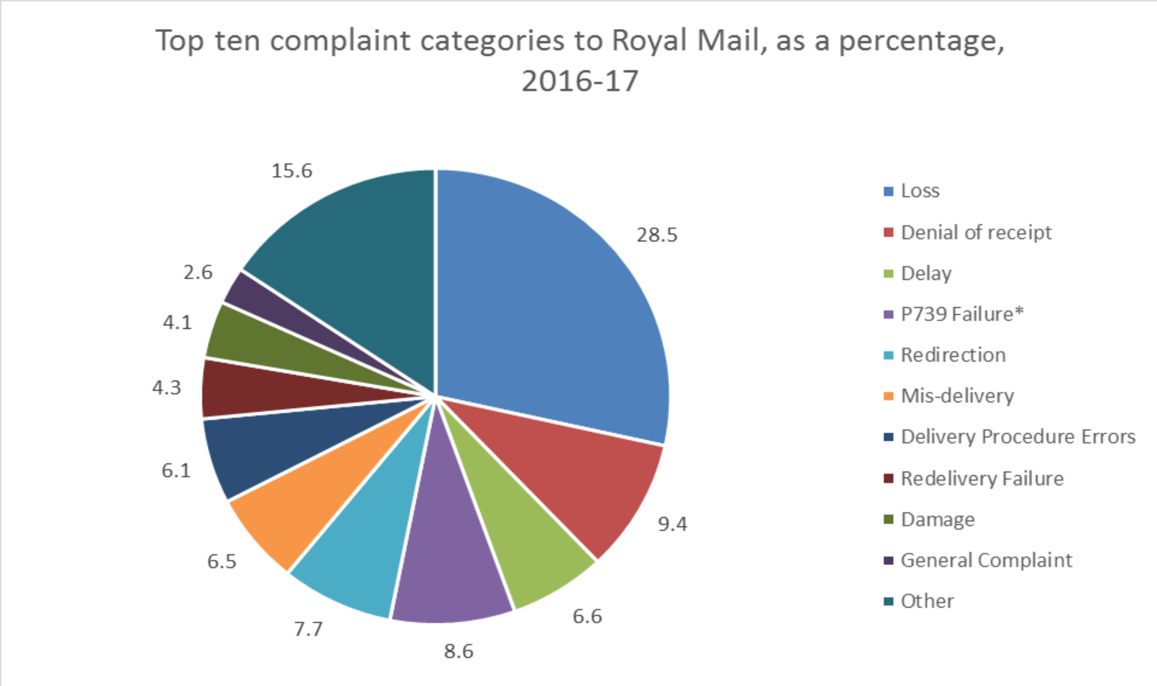
3.40 Ofcom requires Royal Mail, as the universal service provider, to publish an annual report setting out the number of complaints received in each financial year and the amount of compensation paid in relation to those complaints. It is also required to report the top ten categories of complaint.

3.41 Since Postcomm (Ofcom's predecessor as the postal services regulator) introduced this requirement, loss has accounted for the highest proportion of complaints, and this is still the case in 2016-17 (28.5%). However, the proportion of complaints accounted for by loss fell by 3.5 percentage points from last year. Overall complaint volumes[51] rose for the third year in succession, rising 3% from last year. This can be attributed to the continued rises in complaints about damage (9% increase from 2015/16) and general complaint (11% increase), as well as the large number of complaints for a new category, denial of receipt.[52] The first of these is likely to be a result of the rise in parcel volumes. However, complaints about delayed mail fell 32% from last year, most likely as a result of Royal Mail's improved quality of service performance in 2016-17. Complaints about loss (down 8%) and delivery procedure errors (down approximately 8%) also fell notably. The continued fall in the number of addressed mail items, combined with the higher number of complaints, meant the number of complaints per 100,000 mail items rose by approximately 8%, to 7.29.

[51] Overall complaint volumes refer to the top ten categories of complaints that Royal Mail report to us on an annual basis, as they are required to as the Universal Service Provider (as set in Schedule CP 3, Consumer Protection Condition 3: Complaints Handling and Redress, CP 3.3.15, https://www.ofcom.org.uk/__data/assets/pdf_file/0019/105256/cp3.pdf). As such, the composition of complaint categories within the top ten categories may change from year to year, depending on the volume of complaints for each category.

[52] As outlined in footnote 51, a new complaint category in 2016-17 was 'denial of receipt', which received approximately 90,000 complaints this year. As there is no base figure (i.e. 0) for 2015-16, we are unable to calculate a percentage increase for this complaint category; however, this also contributed to the overall volume of complaints rising in 2016-17.

Figure 3.3: Royal Mail's top ten complaint categories, as a percentage, 2016-17



Source: Royal Mail

**A P739 form is issued by a postal worker when a customer is not at home, or is otherwise unable to receive an item of mail at the delivery address.*

3.42 Royal Mail is required to provide compensation on a fair and reasonable basis where a customer experiences loss, delay or damage in relation to certain universal postal services.

3.43 Average compensation paid per complaint rose significantly in 2016-17. Whereas average compensation paid per complaint rose 1% from 2014-15 to 2015-16, it rose 15% from 2015-16 to 2016-17 to £20.77. However, the total number of complaints where compensation was paid fell by 2.5%. Total compensation paid by Royal Mail rose 12.3% from last year, to approximately £7 million, reflecting the rise in average compensation per complaint. We will continue to monitor complaints and compensation data in future.

3.44 We will continue to examine Royal Mail's complaints data on an on-going basis as part of our monitoring programme.

3.45 The interactive data section contains the top ten complained about categories to Royal Mail since 2013/14 in further detail.[53]

[53] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

4. Consumer and business experience of postal services

Introduction

4.1 In this section, we present data from our ongoing market research programme. We run two separate surveys to track use of and attitudes to post, one focused on residential consumers and the other focused on small and medium enterprise (SME) business customers.[54] The data reported here are from the period of Q3 2016 to Q2 2017 reflecting the most up-to-date data we have at the time of publication. Snapshot trend data is provided by comparing Q2 2017 to Q2 2016.

4.2 Further data from these surveys can be found in our Communications Market Report, and data tables are published on our Statistical Release Calendar going back to 2012 when the research programme began.[55] The research was briefly paused in 2015, as a review was carried out to consider what additional data it might be necessary for us to obtain in light of changing consumer and business behaviour. Methodological and questionnaire changes at the start of 2016 for the residential tracker mean that data from prior to this time are not directly comparable.

Residential consumers

4.3 Over eight in ten residential consumers are satisfied with Royal Mail (84%) and postal services overall (86%)[56], with dissatisfaction at 4% and 3% respectively. Three quarters of residential consumers (75%) are satisfied with the value for money of postal services overall, with 8% dissatisfied. The Q2 trend data show that all three of these measures remain broadly similar to last year.

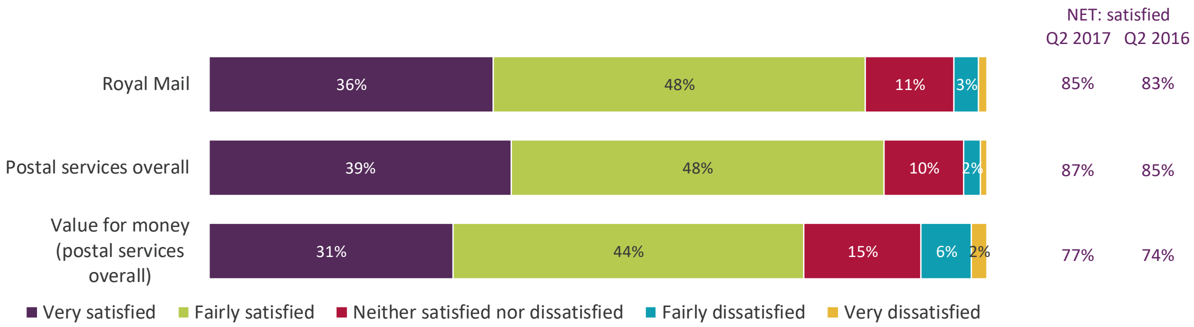
---

[54] Businesses that have under 250 employees.

[55] Ofcom, *Communications Market Report: United Kingdom,* 3 August 2017, pages 219-232, https://www.ofcom.org.uk/__data/assets/pdf_file/0017/105074/cmr-2017-uk.pdf; our Statistical Release Calendars can be found at https://www.ofcom.org.uk/research-and-data/data/statistics

[56] Some of the percentage totals quoted in Section 4 (e.g. the number of residents satisfied with postal services overall) do not appear to exactly match the sum of the corresponding figures in the composite bar charts. This is because all figures quoted in the bar charts are rounded to the nearest whole number, whereas all percentage totals have been calculated using the original unrounded figures and then subsequently rounded to the nearest whole number in order to achieve greater accuracy and avoid rounding error.

Figure 4.1 – Residential consumers' satisfaction with postal services



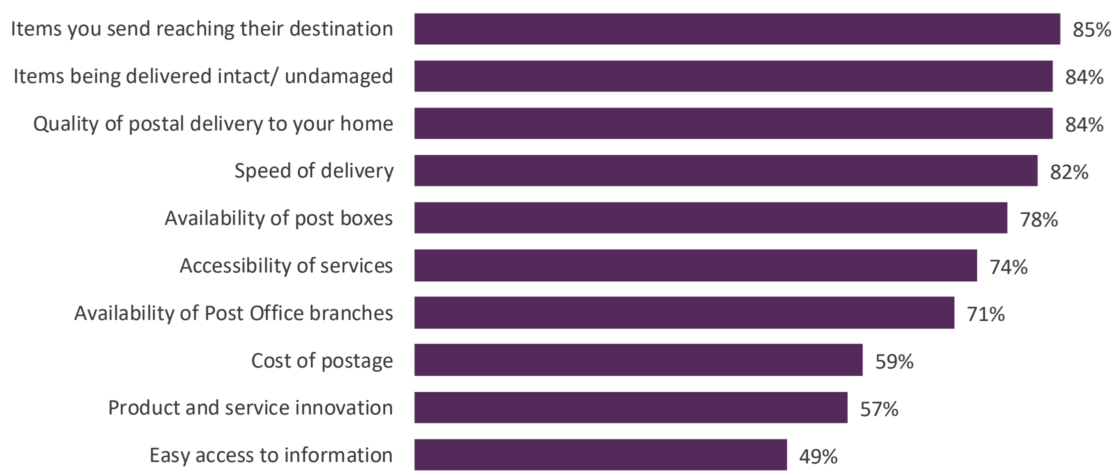
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All respondents (6097)

QG2: How satisfied are you overall with the postal services in terms of delivering value for money for sending mail?; QG5: How would you rate your overall satisfaction with Royal Mail?; QG6: How would you rate your overall satisfaction with postal services? (ALL providers)

4.4 Looking at specific aspects of Royal Mail's service, residential consumers are most satisfied with items sent reaching their destination (85%), items being delivered intact/ undamaged (84%), the quality of postal delivery to the home (84%) and the delivery speed (82%). Satisfaction is lowest with cost of postage (59%), product and service innovation (57%) and easy access to information, for example about complaints procedures (49%).

Figure 4.2 – Residential consumers' satisfaction with specific aspects of Royal Mail's service



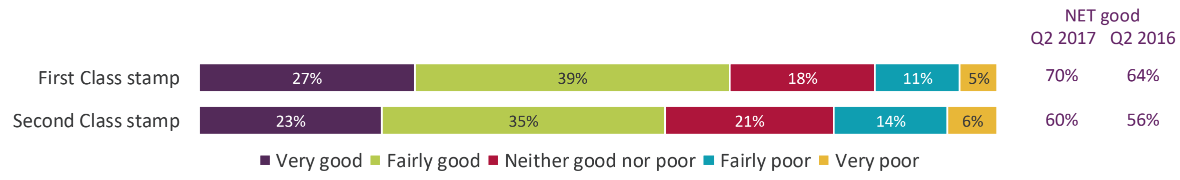
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All adults (6097)

QG3: How satisfied are you with the following aspects of Royal Mail's service? (NET: "very satisfied" and "fairly satisfied")

4.5 Two thirds (66%) of residential consumers think that First Class Stamps represent good value for money, with a lower percentage (58%) thinking that Second Class Stamps are good value. One in five (20%) said that Second Class stamps are poor value, while a lower proportion said this about First Class Stamps (15%). In both cases, there has been a significant increase in value for money perceptions from Q2 2016 to Q2 2017 (70% in Q2 2017 vs. 64% in Q2 2016 for First Class stamps, and 60% in Q2 2017 vs. 56% in Q2 2016 for Second Class stamps).

Figure 4.3 – Residential consumers' perception of value for money of stamps



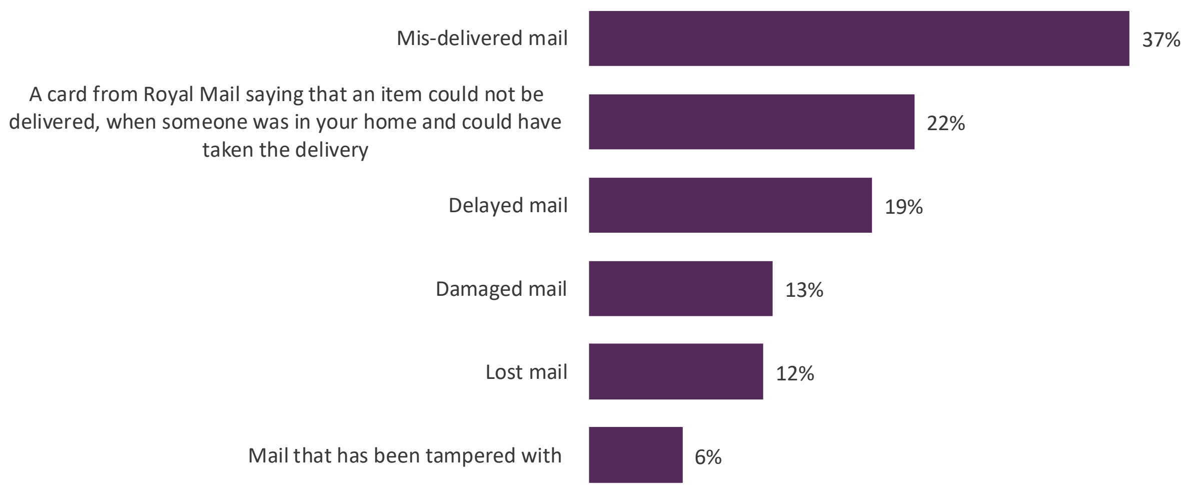
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All respondents (6097)

QF4: A First Class stamp currently costs 64/65p. How would you rate Royal Mail's First Class service in terms of value for money?, QF5: A Second Class stamp currently costs 55/56p. How would you rate Royal Mail's Second Class service in terms of value for money?

4.6 Residential consumers were asked whether they had experienced one or more of a range of problems with Royal Mail's service over the past year. Over a third (37%) experienced problems with mis-delivered mail, while just over one in five (22%) said they had received a card from Royal Mail saying that an item could not be delivered when someone was at home and could have taken delivery. A similar proportion (19%) reported a problem with delayed mail.

Figure 4.4 – Residential consumers' problems with Royal Mail



Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All adults (6097)

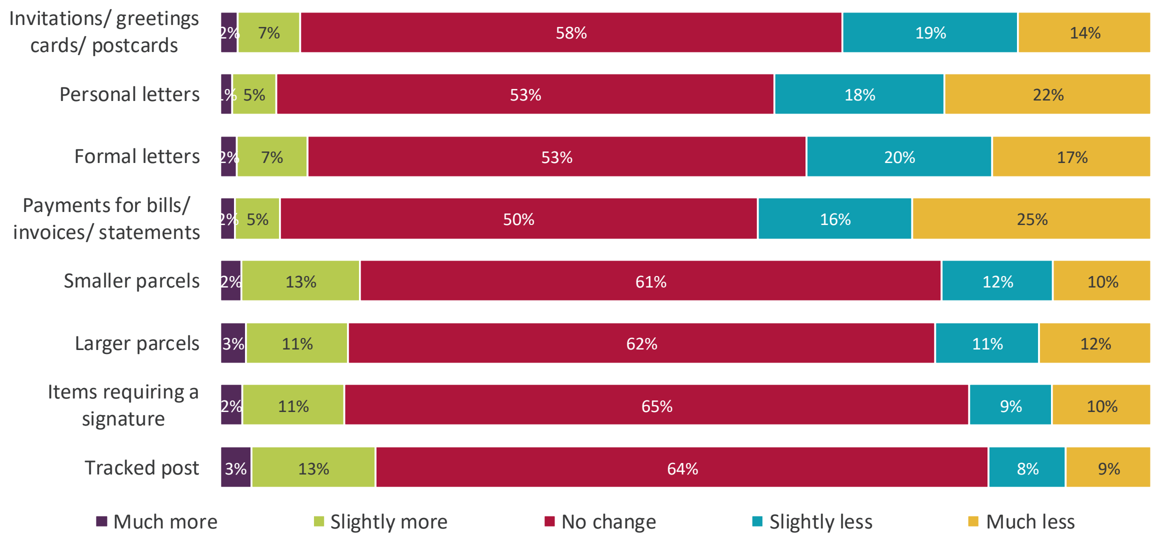
QH1: In the last 12 months, have you experienced problems with Royal Mail's service in terms of...

4.7 For each of the eight types of post asked about, the proportion of residential consumers saying that they are sending less than two years ago was higher than the proportion reporting that they are sending more, with the exception of tracked post.

4.8 Four in ten are said they are sending fewer payments for bills/ invoices/ statements (42%) and personal letters (40%). Around a third said they are sending fewer formal letters (37%) and invitations/ greetings cards/ postcards (33%).

4.9 Less than one in five consumers said they are sending more tracked post (16%) and smaller parcels (15%). Around one in eight are said they are sending more larger parcels and items requiring a signature (both 13%).

Figure 4.5 – Frequency of residential consumers sending different types of post compared to two years ago



Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

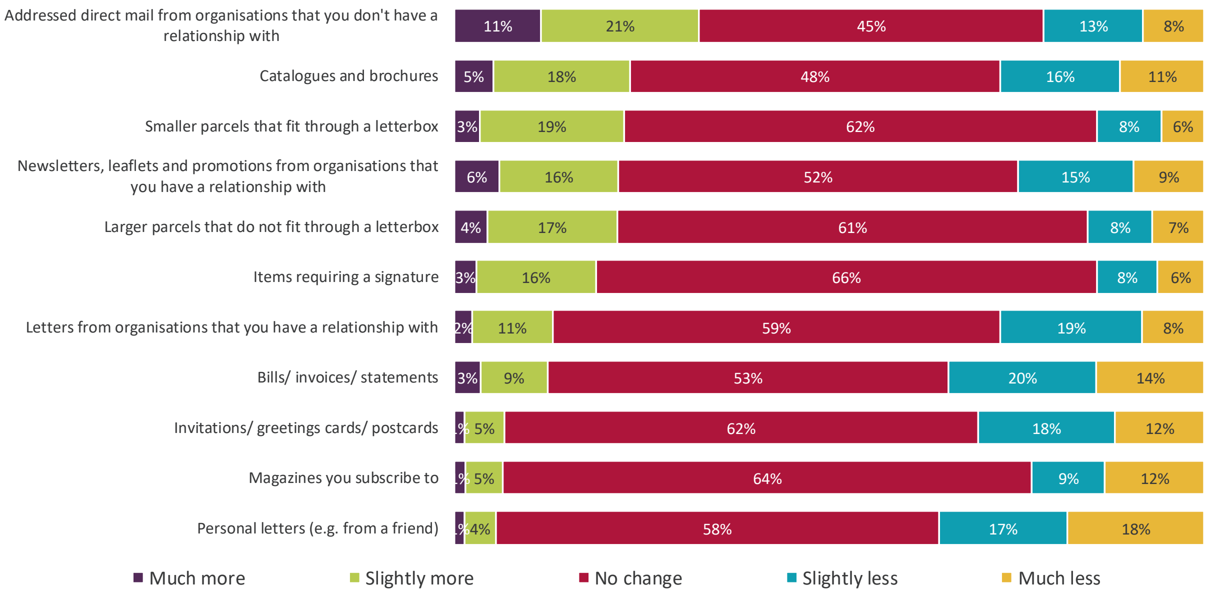
Base: All respondents (excl. Feb, Apr, Jun 2017) (4653)

QD12: Frequency of sending ... compared to two years ago

4.10 Residential consumers were also asked about the levels of different types of post that they are receiving, compared to two years ago. Three in ten or more reported that they are receiving fewer personal letters (35%), bills/ invoices/ statements (34%) and invitations/ greeting cards/ postcards (30%).

4.11 One in five or more are receiving more addressed direct mail from organisations they do not have a relationship with (32%), catalogues and brochures (23%), smaller parcels (22%), newsletters, leaflets and promotions from organisations they have a relationship with and larger parcels (both 21%).

Figure 4.6 – Frequency of residential consumers receiving different types of post compared to two years ago



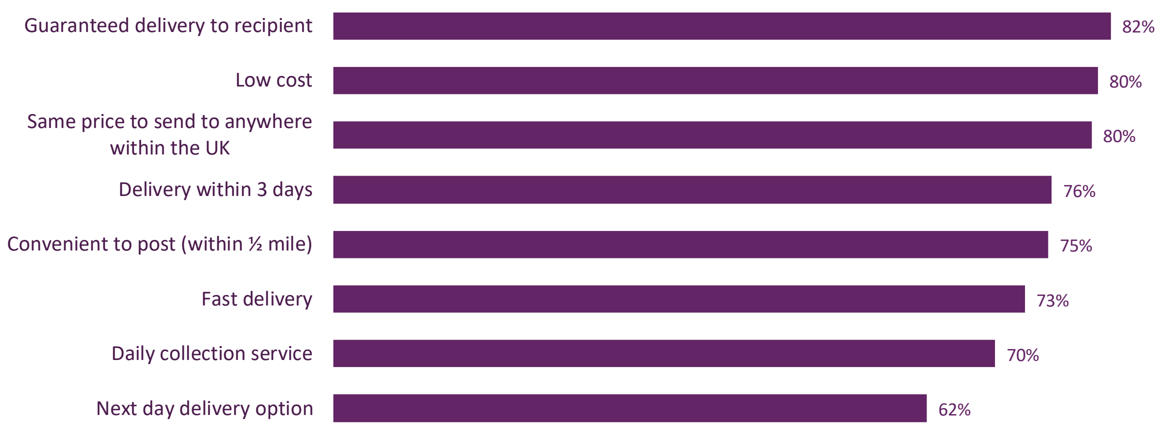
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All respondents (excl. Feb, Apr, Jun 2017) (4653)

QD12: Frequency of receiving ... compared to two years ago

4.12 Residential consumers were asked to rate the importance of several different factors when sending letters. Over four in five (82%) said that guaranteed delivery to recipient was "mandatory" or "great to have", followed by low cost and same price to send anywhere within the UK (both 80%). Fewer than three quarters (73%) gave one of these responses for fast delivery, while the options receiving the lowest proportion of these responses were daily collection service (70%) and next day delivery option (62%).

Figure 4.7 – Factors rated as important for people when sending letters



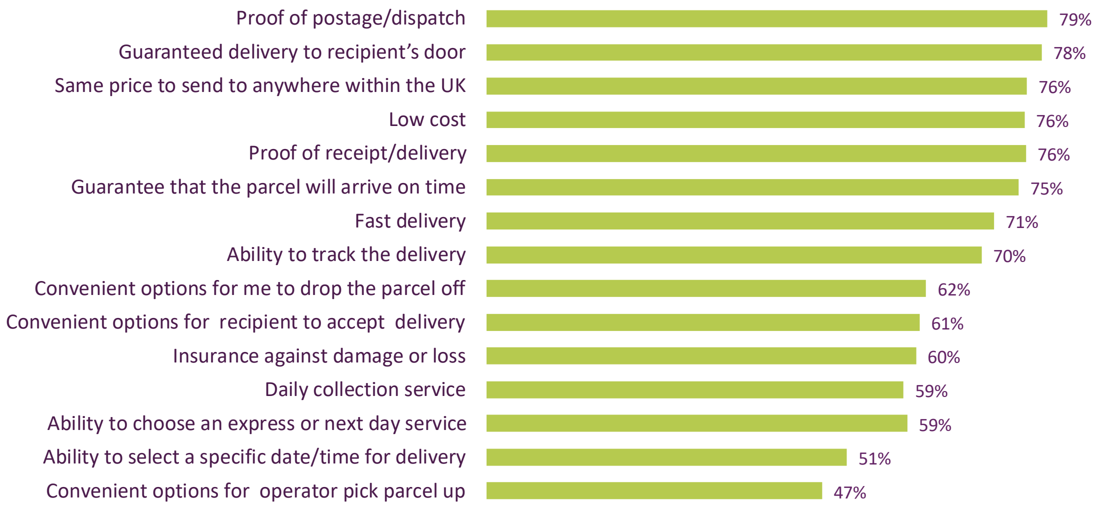
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: All respondents (excl. Feb, Apr, Jun 2017) (4643)

QD10b: List of factors people consider when sending parcels... (NET: "mandatory" and "great to have")

4.13 The same question was asked about sending parcels. Here, a range of factors were rated as "mandatory" or "great to have" by between 75% and 80% of respondents, including proof of postage/ dispatch, guaranteed delivery and low cost. Around seven in ten gave these responses for fast delivery (71%) and the ability to track delivery (70%), while over six in ten did so for convenient options to drop the parcel off (62%) and convenient options for recipient to accept delivery. The options that received the lowest proportion of these responses were ability to select a specific date/ time for delivery (51%) and convenient options for operator to pick parcel up (47%).

Figure 4.8 – Factors rated as important for people when sending parcels



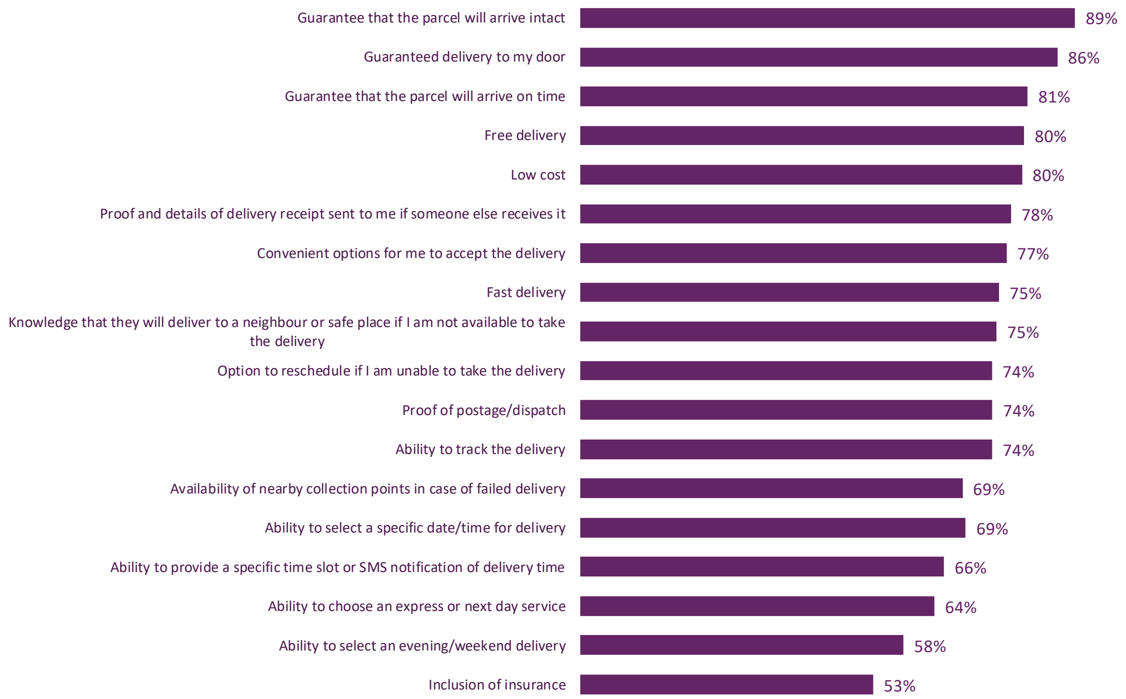
Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

Base: Those who have sent a parcel or tracked item/item requiring signature in the past month (3545)

QD10a: List of factors people consider when sending parcels... (NET: "mandatory" and "great to have")

4.14 Respondents were asked about the importance of several different factors when choosing delivery for letters/ parcels that they will receive. Nearly nine in ten (89%) said that the guarantee that the parcel will arrive intact was "mandatory" or "great to have", followed by guaranteed delivery to my door (86%), guarantee that the parcel will arrive on time (81%), free delivery and low cost (both 80%). The options that received the lowest proportion of these responses were ability to select an evening/ weekend delivery (58%) and inclusion of insurance (53%).

Figure 4.9 – Factors rated as important for people when choosing delivery for letters/ parcels that they will receive



Source: Ofcom Residential Postal Tracker Q3 2016 – Q2 2017

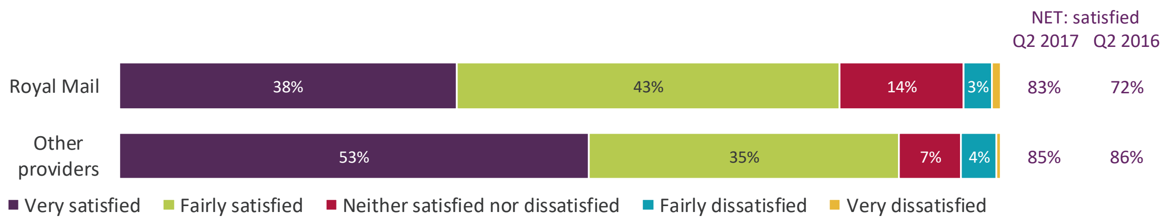
Base: Those who were required to select a postal/delivery option for letters or goods that were delivered to themselves in the previous month (2571)

QE10b: List of factors people consider when choosing delivery for letters/ parcels that they will receive... (NET: “mandatory” and “great to have”)

SME consumers

4.15 When asked about their satisfaction with the service from their postal provider, over eight in ten SMEs who use Royal Mail (81%) said they were satisfied, compared to a higher proportion of those who use other providers (87%). Overall dissatisfaction was 4% for both. Looking at trend data, satisfaction with Royal Mail has increased from 72% in Q2 2016 to 83% in Q2 2017.

Figure 4.10 – SME satisfaction with postal services



Source: Ofcom Business Postal Tracker Q3 2016 – Q2 2017

Base: All respondents who use Royal Mail (1933), All those who use other providers to RM (434)

QRM2: Thinking generally about the service your organisation receives as a whole, how satisfied are you with the overall quality of the services you receive from Royal Mail as a recipient and sender?

QOP1a: … Thinking generally about the service you receive as a whole… how would you rate the quality of the services you receive from [QV4 provider]?

4.16 Looking at specific elements of Royal Mail's service, SMEs are most satisfied with items being delivered intact/ undamaged (87%), delivery consistency/ reliability (77%) and amount of lost mail (74%). Satisfaction is lowest with time of collection (58%) and price of postage (44%).

Figure 4.11 – SME satisfaction with specific elements of Royal Mail's service

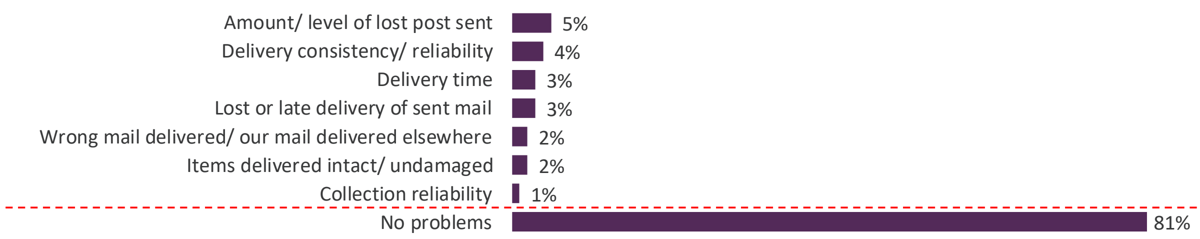
Source: Ofcom Business Postal Tracker Q3 2016 – Q2 2017

Base: All respondents who use Royal Mail (1933)

QRM3: How would you rate the performance of Royal Mail, as a recipient and sender, in the following areas on a five-point scale where 1 is very dissatisfied and 5 is very satisfied?

4.17 SMEs were given a list of possible problems that they might have experienced with Royal Mail, and asked whether they had done so. For each of the problems asked about, one in twenty (5%) or fewer reported that they had experienced it in the past six months. Over four in five (81%) reported that they had not experienced any problems.

Figure 4.12 – SME problems experienced with Royal Mail



Source: Ofcom Business Postal Tracker Q3 2016 – Q2 2017

Base: All respondents who use Royal Mail (1933)

QRM4: Have you experienced any problems with your service from Royal Mail (as a sender or recipient of mail) in the last 6 months?

4.18 SMEs were asked to rate the importance of several different factors when sending letters. Around two thirds (68%) said that guaranteed delivery was "mandatory" or "great to have". Over six in ten gave one of these responses for delivery within three days (62%), convenient to post and low cost (both 61%). The options that received the lowest proportion of these responses were daily collection service (51%) and next day delivery option (50%).

Figure 4.13 – Factors rated as important for SMEs when sending letters

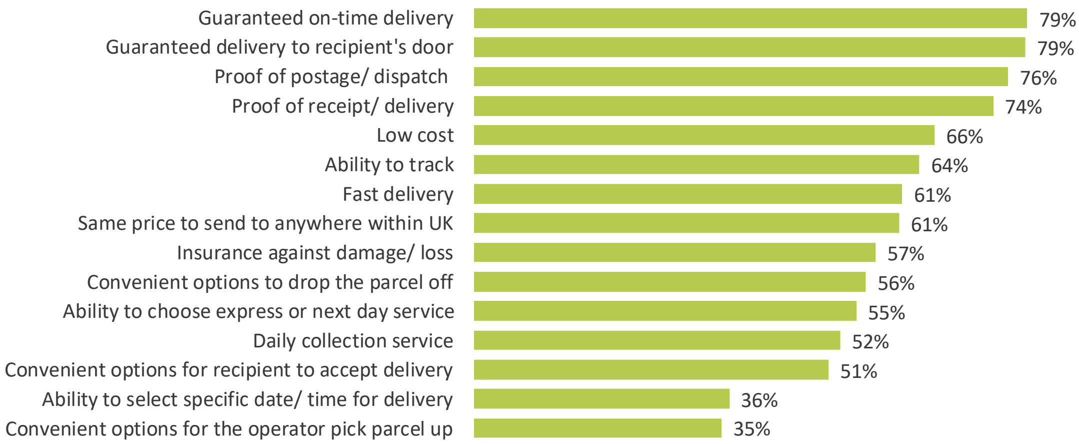
Source: Ofcom Business Postal Tracker Q3 2016 – Q2 2017

Base: All respondents who use Royal Mail to send letters or large letters and selected a service (1644)

QD10b. Below, are a list of factors people tell us they consider when sending letters. For each factor, please tell us how important it is to you in choosing a postal provider or service. (NET: "mandatory" and "great to have")

4.19 SMEs were asked the same question about sending parcels. Eight in ten claimed that guaranteed on-time delivery and guaranteed delivery to recipient's door were "mandatory" or "great to have" (both 79%), followed by proof of postage/ dispatch (76%) and proof of receipt/ delivery (74 %). The options that received the lowest proportion of these responses were ability to select specific date/ time for delivery (36%) and convenient options for the operator to pick the parcel up (35%).

Figure 4.14 – Factors rated as important for SMEs when sending parcels



Source: Ofcom Business Postal Tracker 2016

Base: All using Royal Mail to send parcels and packets (684)

QD10a. Below, are a list of factors people tell us they consider when sending parcels. For each factor, please tell us how important it is to you in choosing a postal provider or service. (NET: "mandatory" and "great to have")

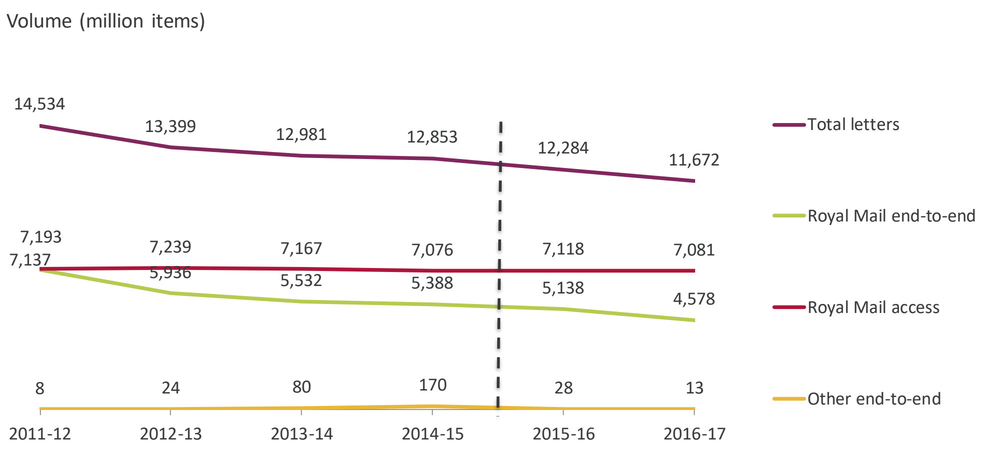
5. The letters market

Introduction

5.1 In this section, we outline and discuss trends and developments in the UK letters sector, including different types of competition within the market. We then discuss the pricing of Royal Mail's retail bulk mail products and its wholesale access products. For interactive data on the UK's letters market, including the data behind the charts in this chapter, please visit our interactive data site.[57] All revenue and pricing data are presented in real terms.

5.2 In 2016-17 total letters volumes fell by 5%, to 11.7 billion items. The key driver of this fall was the 11% year-on-year decline in Royal Mail end-to-end letters volumes to 4.6 billion items. In contrast, access letters volumes (i.e. where a postal operator other than Royal Mail collects mail from a customer, and hands it over to Royal Mail to complete delivery) were more robust and declined 1% year -on- year to 7.1 billion items. This meant access mail's share of total letters volumes grew by 3 percentage points to 61% in 2016-17.

Figure 5.1 - Addressed letters volumes by type of operator



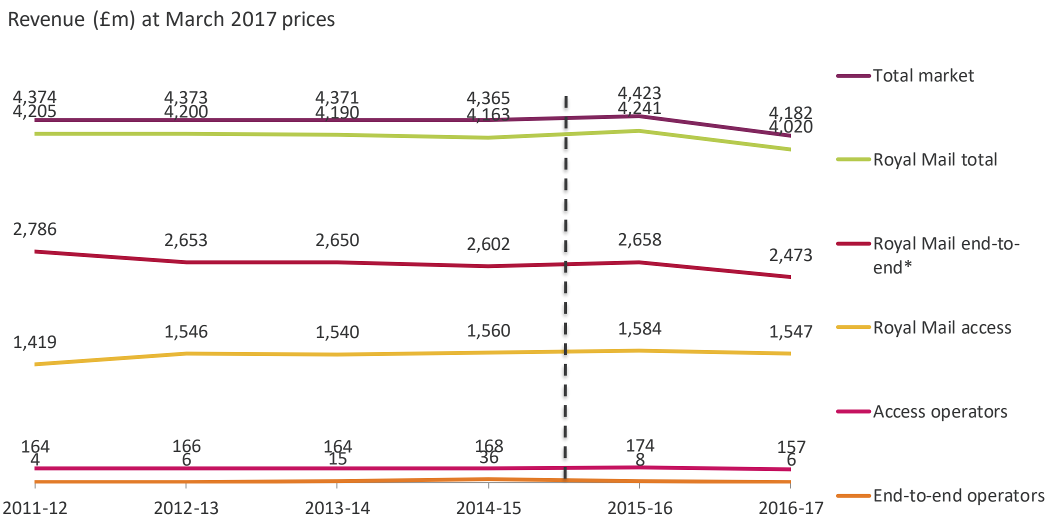
Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates. Royal Mail financial year volume figures are derived from Ofcom calculations based on financial year figures in Royal Mail's Regulatory Statements and unaudited submissions to Ofcom and are therefore not directly comparable with Royal Mail's published accounts. Due to changes in methodology, data prior to 2015-16 are not directly comparable to data after this point. Royal Mail figures relate to the 'Reported Business'.[58] 2015-16 other end to end figure restated following receipt of restated data from operators.

[57] For further information on letter volumes and revenues, see page 8 of the interactive data.
[58] Royal Mail end-to-end is an Ofcom calculation and refers to Royal Mail total letters volumes excepting access. Royal Mail access volumes are as per its Regulatory Financial Statements and include a small number of parcels. The effect of this is that Royal Mail's access volumes are slightly overstated and its end-to-end volumes are slightly understated.

5.3 In its 2016-17 results, Royal Mail cited e-substitution and economic uncertainty as key factors behind falling letters volumes. In particular, Royal Mail noted a reduction in discretionary advertising mail volumes as advertisers delayed or moved expenditure to digital channels.[59]

5.4 Total addressed letters revenue stood at £4.2 billion in 2016-17, a decrease of 5% in real terms on the previous year. While Royal Mail access revenues fell 2% in real terms to £1.5 billion, the decline in Royal Mail's end-to-end letters volumes impacted corresponding revenues, which fell 7% in real terms to £2.5 billion.

Figure 5.2 – Addressed letters revenue by type of operator



Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates.[60] Royal Mail revenue figures are derived from Ofcom calculations based on financial year figures in Royal Mail's Regulatory Statements and unaudited submissions to Ofcom and are therefore not directly comparable with Royal Mail's published accounts. Royal Mail figures relate to the 'Reported Business'. Data prior to 2015—16 are not comparable with data form 2015-16 onwards due to a change in methodology. Figures for 2015-16 for access End-to-end operators have been restated following receipt of more to up to date data. Adjusted for CPI.

Competition in the letters market

5.5 Together, the letters and large letters mail sector consists of three parts:

- mail collected and delivered by Royal Mail (Royal Mail end-to-end) which consists of both bulk and non-bulk mail;

---

[59] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 12, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

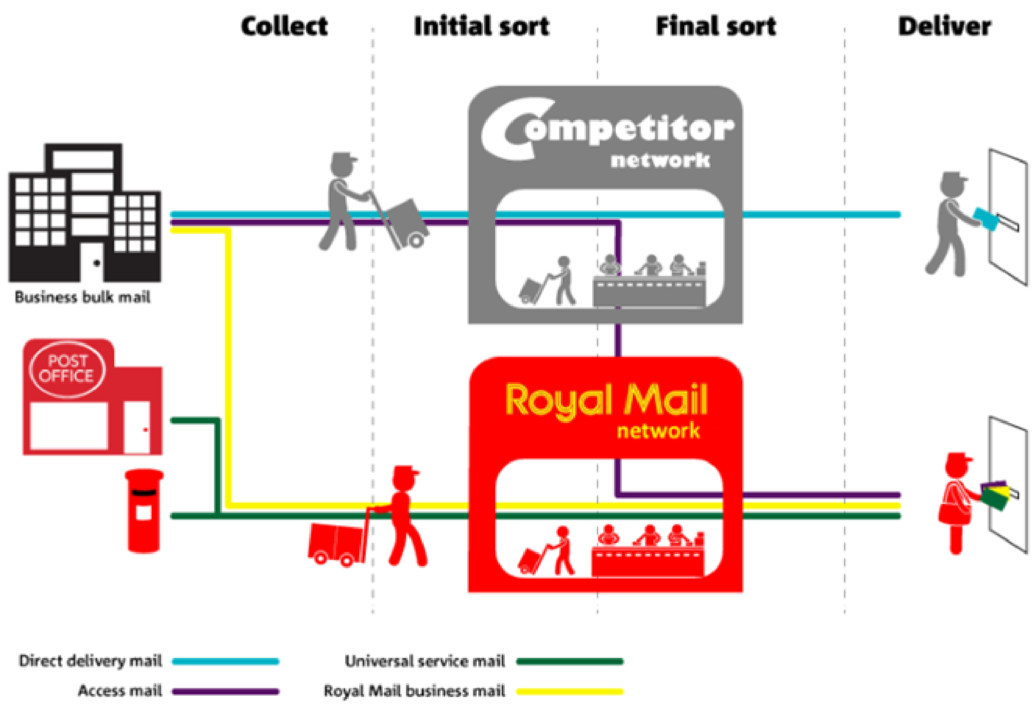
[60] Total Royal Mail letter revenue refers to Royal Mail total access and end to end. Royal Mail end to end revenues are calculated with reference to total letter revenues less access. Royal Mail access revenues are as per its Regulatory Financial Statements and include a small amount of parcels. The effect of this is that Royal Mail's access revenues are slightly overstated and its end-to-end revenues are slightly understated. Revenue retained by access operators includes a small element of access parcels revenues.

- mail collected by other operators and delivered by Royal Mail (Royal Mail access);
- mail collected and delivered by other operators (other operators' end-to-end).

5.6 Therefore, within the postal sector, there are two main forms of letters competition: access and end-to-end.

5.7 Access competition is the predominant form of letters competition in the UK. This is where a postal operator other than Royal Mail collects mail from the customer,[61] sorts it and then transports it to Royal Mail's Inward Mail Centres, where it is handed over to Royal Mail for delivery. Royal Mail is subject to a regulatory condition requiring it to offer access at its Inward Mail Centres to other postal operators and customers for certain letters and large letter services with a routing time of two working days or later. This enables other operators to offer postal services to their customers (normally large businesses) for these formats without setting up a delivery network.

Figure 5.3 - Forms of competition in the UK postal sector



Source: Ofcom

5.8 While the majority of Royal Mail access mail is bulk mail,[62] residential and business consumers who post relatively few letters compared to larger organisations are also able to take advantage of access competition. In July 2017, Whistl and Parcel2Go launched a

[61] Some access mail operators also have direct marketing operations, meaning they also take responsibility for the production of at least some of the volumes they pass to Royal Mail for final delivery.
[62] Bulk mail is a service for consumers (traditionally large businesses) that offer cheaper postage options compared to normal postage options (e.g. stamps, franked or metered postage), providing that the consumer meets a minimum volume of letters to send with the postal operator.

service allowing residential consumers and small businesses to send letters, large letters and parcels via Whistl's access network for final delivery by Royal Mail.[63]

5.9 Royal Mail access revenue is the revenue paid to Royal Mail by other operators for the delivery of access mail; other operators' access revenue is that paid to other operators by customers for the delivery of their mail, minus the portion of that revenue paid to Royal Mail for delivery (i.e. the Royal Mail access revenue).

5.10 Within the access mail market, reported total revenue retained[64] by access operators fell by 10% in real terms to £157 million in 2016-17. The fact that this decline is greater in proportionate terms than the decline in Royal Mail's access revenues suggests that access operators are competing with each other on price when contracts are renewed.

5.11 In 2016-17 we have continued to receive quarterly compliance reports from Royal Mail in relation to its margin squeeze control on its retail prices for D+2 Letter and Large Letter bulk mail. Royal Mail is required to do this under our USP Access Condition.[65] The control seeks to ensure that the upstream element of the revenues of these bulk mail services is sufficient to cover the costs of the relevant upstream activities carried out by Royal Mail to provide the services. This is in place so that it does not compete unfairly with the access operators that purchase wholesale access services from Royal Mail to provide bulk mail services in the market.

5.12 In contrast to access competition, end-to-end competition does not rely on Royal Mail for collection, sortation or delivery of letters to end customers.

5.13 Reflecting Whistl's exit from the end-to-end letters delivery market in early 2015-16, the number of letters delivered by end-to-end operators other than Royal Mail continued to decline, falling 53% year-on-year to 13 million items, representing 0.1% of total addressed letters volumes.

5.14 Although there is no nationwide end-to-end competitor to Royal Mail, there are a number of smaller scale end-to-end operators delivering in specific geographic areas. However, in May 2017 one of these operators, Yellow Jersey, which offered a service in the Coventry area, exited the market. These geographically-focused businesses generally offer lower prices than Royal Mail for letters delivery within the area they serve. They may also offer other value-added services, such as mail collection from business premises for their customers.

[63] Post & Parcel article, 'Parcel2Go announces Letters and Small Parcels service', 12 July 2017, http://postandparcel.info/81118/news/parcel2go-announces-letters-and-small-parcels-service/
[64] i.e. revenues net of the sum paid to Royal Mail for delivery
[65] Ofcom, *USP Access Condition*, https://www.ofcom.org.uk/__data/assets/pdf_file/0022/105259/usp-access-condition.pdf

Price trends for retail bulk mail and access customers

Retail bulk mail prices

5.15 Royal Mail and other operators offer a number of products and services to business customers who send larger volumes of mail, which are not within the universal service. These include letter, large letter and parcel products that are subject to discounts for factors such as the volume of mail sent, the way the mail has been presented (for example, using specific fonts to make it easier for the machine to read the address), applying machine barcodes, the level of sortation (i.e. unsorted, low sort and high sort).

5.16 Royal Mail offer various products for bulk mail, depending on the content of a customer's mailing:

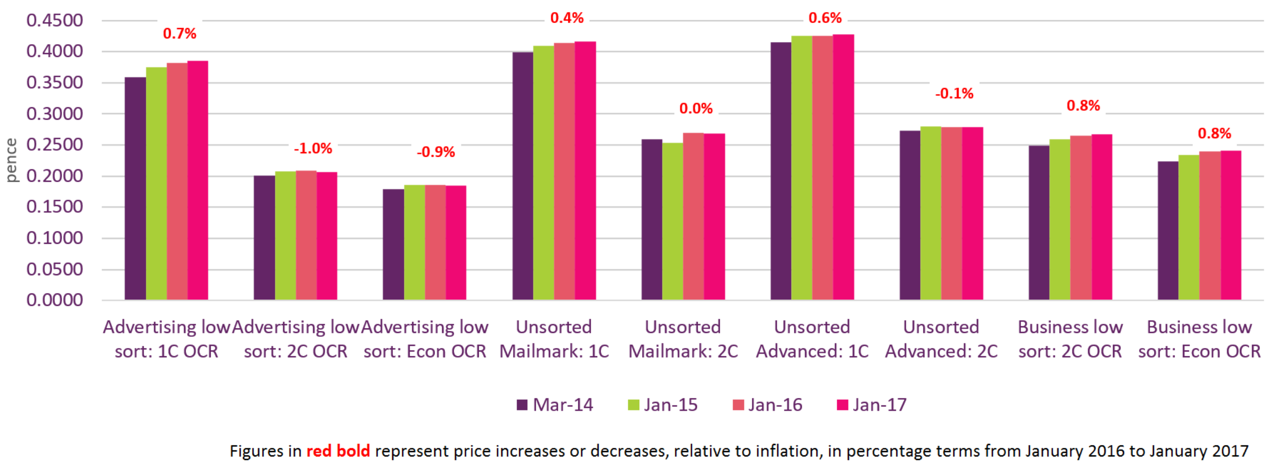
a) Advertising Mail

b) Publishing Mail (e.g. magazine, newsletters)

c) Business Mail (e.g. transitional mail i.e. bank statements, contracts, bills)

5.17 Mailmark is a barcode service introduced by Royal Mail in November 2013, which offers enhanced services as compared to normal barcodes. In order to encourage users to migrate to Mailmark, Royal Mail has offered this product at a discounted rate compared to other barcode products (i.e. Barcode and OCR). There is also a similar Mailmark product offered for access products.

Figure 5.4 - Royal Mail Business Mail and Advertising Mail prices – April 2014 to January 2017[66]



Source: Royal Mail, Ofcom calculation based on maximum discounted prices i.e. 120k+ volume discounts and low sort barcode discount for standard letter sizes. Prices adjusted for CPI.

[66] '1C' and '2C' refer to First Class and Second Class, with a delivery service of D+1 (i.e. the working day after collection) and D+3 respectively. 'Econ' refers to 'Economy', a third classification of service which is cheaper than both First Class and Second Class and offers a delivery service of D+4. OCR, or Optical Character Recognition, is a mail format specification whereby the printed address can be read by Royal Mail's automated sorting machines and a barcode is applied to the envelope.

5.18 Overall, business and advertising mail prices increased in 2017-18. In real terms prices remained broadly flat across these products, increasing at a lower real terms rate than last year.

5.19 Low sort Business Mail products increased by c.3% on average in nominal terms, which represented a real terms price increase as it was above the rate of inflation. Unsorted Mailmark products increased by c.2.5% on average, which was a slight real terms increase. Unsorted Advanced mail prices rose overall by c2.5% in nominal terms, but whilst second class prices stabilised in real terms this year, first class prices rose above the rate of inflation.

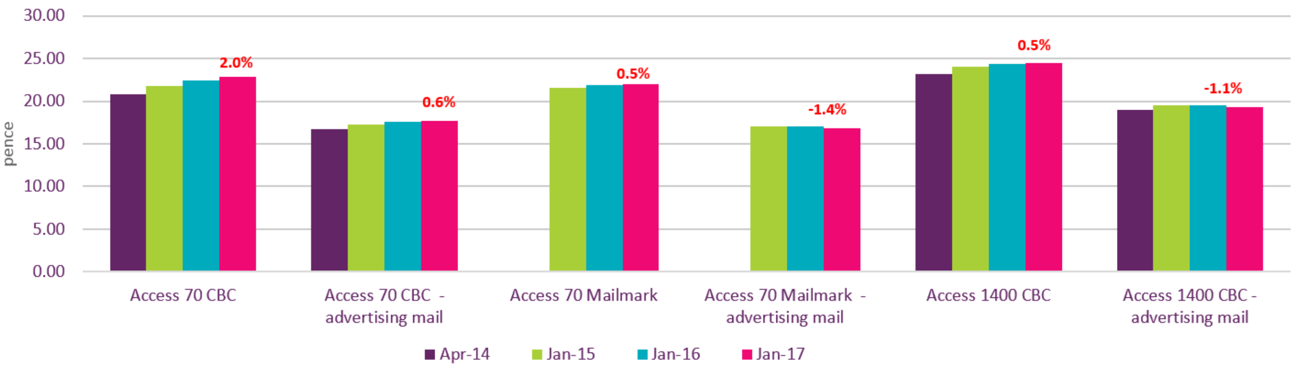
5.20 On average, business and advertising mail price rises were lower for second class or economy products than their first class equivalents, with first class prices increasing in real terms compared to slight real terms decreases for second class products. In line with previous years, Royal Mail offers larger discounts on its advertising mail products than on its products for business mail.

5.21 Page 9 of the interactive data shows historic trends in business and advertising mail prices.[67]

Access prices

5.22 Royal Mail, under regulatory obligation, is obliged to offer access to its postal network to operators for certain letter and large letter services with a routing time of two working days or later. Figure 5.5 sets out the prices that Royal Mail charges access operators for national access products.

Figure 5.5 - Royal Mail national access prices, April 2014 to January 2017[68]



Figures in **red bold** represent price increases or decreases, relative to inflation, in percentage from January 2016 to January 2017

[67] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

[68] The terms 'Access 70' and 'Access 1400' refer to two different levels of mail sorting which must take place before access mail enters Royal Mail's network. CBC stands for 'Customer Barcode', which is a mail format specification which applies to certain access products.

Source: Royal Mail, Ofcom calculation based on National access prices, weighing 0-100g. Prices adjusted for CPI.

5.23 Royal Mail increased its access prices in January 2017. Overall, there was a slight real terms price increase, but this was lower than the prior year real terms increase.

5.24 The most significant real terms price increases, like last year, were in the Access 70 CBC products, though this was lower than the real terms increase for these products in the previous year. Royal Mail has retained a price differential between Mailmark and Access 70 CBC products, as it continues to encourage take up of the Mailmark product.

5.25 In early 2015, Royal Mail introduced a provision to the terms of its contract with access operators that increased its flexibility to offer incentive schemes and promotions in access products to stimulate mail volume growth. These discounts are not included in Figure 5.5.

5.26 The price rise for non-advertising access mail was higher than the prior year, and also represented a real terms price rise although lower than the real terms rise of the previous price change. As with its retail business mail prices, access price increases were lower for advertising mail than transactional mail with overall advertising mail showing a real terms price decrease.

5.27 Page 10 of the interactive data shows historic trends in access mail prices.[69]

[69] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

6. The parcels market

6.1 This section outlines trends in the UK parcels sector for domestic parcels, and inbound and outbound international parcels.[70] We then summarise recent developments in the parcels market. We also set out findings from work undertaken to better understand the causes and effects of parcel surcharging in Northern Ireland and the Highlands and Islands of Scotland.

Collecting information on parcels

6.2 As part of our regular monitoring of the postal sector, we have collected volume and revenue information from parcel operators. This section sets out our analysis of this information. For the purposes of the information presented in this chapter, we have defined a parcel as an addressed postal item that is delivered end-to-end and is:

- larger than a Large Letter (i.e. an item up to length 353mm, width 250mm, thickness 25mm, and weighs no more than 750g);
- weighs no more than 31.5kg; and
- can be lifted by a single average individual without mechanical aids.

6.3 We collected information from all major parcel operators providing UK-wide services. These companies are: The Alternative Parcels Company Limited, Amazon Logistics,[71] DHL International (UK) Limited, DPD Group UK Limited, DX (Group) plc, FedEx UK Limited, Hermes Parcelnet Limited, Royal Mail Group Limited including Parcelforce Worldwide, TNT UK Limited, Tuffnells Parcels Express Limited, UK Mail Limited, UPS Limited and Yodel Delivery Network Limited. We have not collected information from operators who offer only same-day delivery services.

6.4 It is our view that the information we have collected represents the significant majority of UK parcel volumes and revenues carried by national operators. We recognise however, that the range of operators we have collected information from, may differ from other market sizing exercises and may, therefore, not be directly comparable.

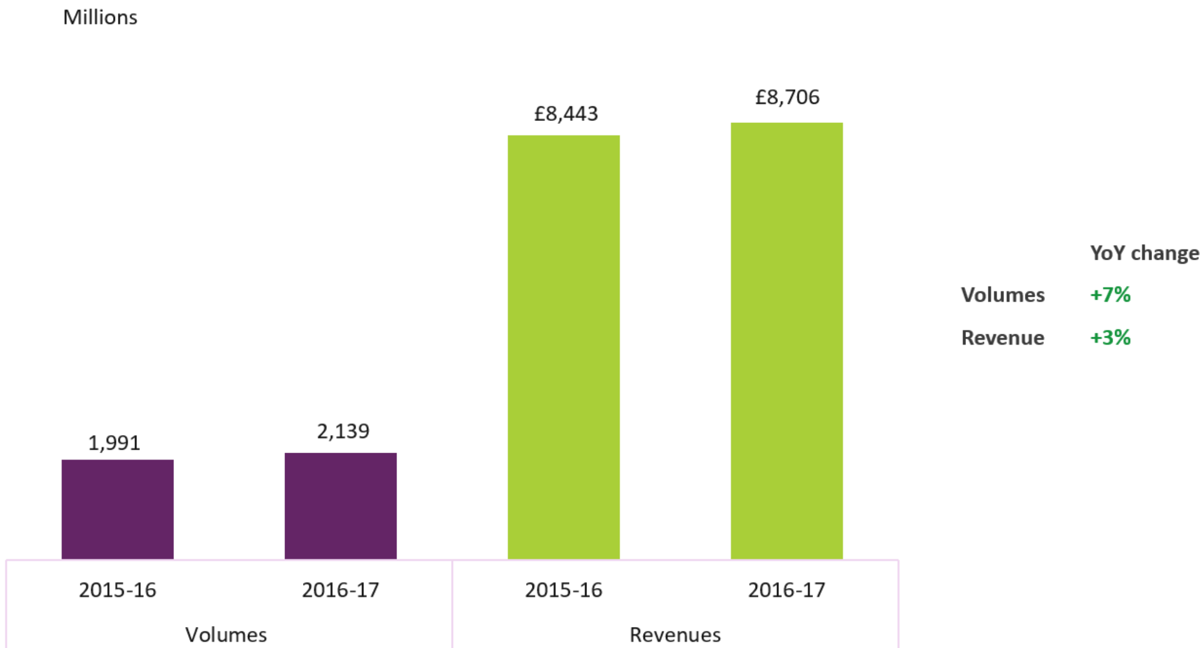
6.5 Where we state proportions of total volumes and revenues below, the figures presented are (unless otherwise stated) shares of the data collected. All revenue and pricing data are presented in real terms.

[70] International data is collected from operators within the United Kingdom. Ofcom is unable to confirm whether data captured in international outbound includes revenue from external shipping or delivery.
[71] Excluding within the hour delivery.

Parcel volumes and revenues

6.6 Total measured national volumes and revenues continued to grow in 2016-17, although the rate of growth slowed compared to the prior year. Total measured national volumes increased in 2016-17 by 7% to 2.1 billion items and revenue increased by 3% to £8.7 billion.[72] This is shown in Figure 6.1 below. This is lower than the rate of volume and revenue growth in 2015-16, when volumes were up 12% and revenues grew 8% year-on-year. One of the key drivers of growth in the parcel market is the expansion of e-commerce. Research by IMRG and Capgemini shows UK online sales exceeded £130 billion in 2016, up 16% compared to 2015. They were propelled by the rise in m-commerce in 2016 as more purchases are completed via smartphones.[73] The average unit revenue year-on-year decreased 4%, from £4.24 to £4.07.

Figure 6.1 –Total measured national parcels volumes and revenues (including international)



Source: Operator returns to Ofcom (includes access volumes and revenues). Figures adjusted for CPI.

6.7 Figure 6.2 and Figure 6.3 show the measured total parcels volumes and revenues on a quarterly basis for both 2015-16 and 2016-17. The market continues to be the busiest during the Christmas (Q3) period for domestic and international parcels.

---

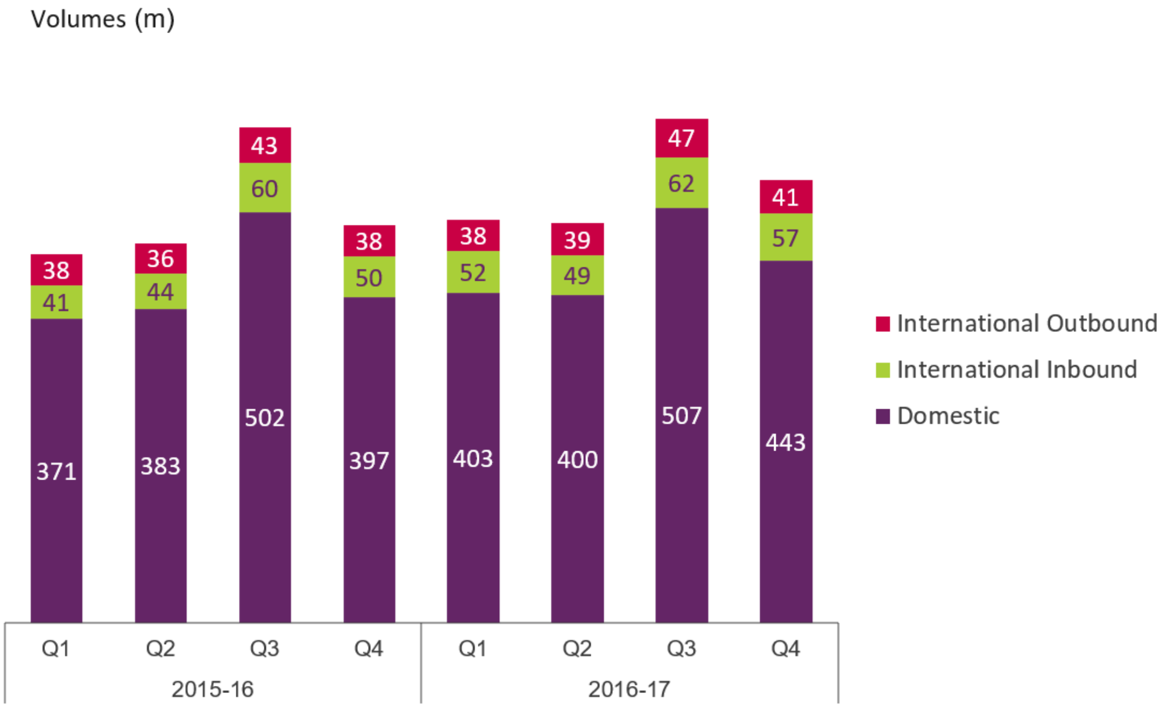
[72] The revenue numbers that we report are based on self-reported figures provided to us by parcel operators and expressed in real terms (adjusted by a CPI factor of 1.0222954). As a result the data may be affected by the company's internal reporting, accounting or transfer pricing.
[73] IMRG, *UK online sales exceed £130 billion in 2016, fueled by sales growth on smartphones,* 17 January 2017, https://www.imrg.org/media-and-comment/press-releases/uk-online-sales-in-2016/

6.8 During this period, the majority of e-commerce revenue was driven by Christmas shopping.[74] Retail events such as Black Friday and Cyber Monday (which occur in November) provide consumers with the chance to buy products at a discounted price, driving up parcel volumes and revenues. According to the ONS, the amount spent online in November 2016 increased (in real terms) by 25% compared with the previous year, and was up by 3% quarter-on-quarter, compared to October 2016.[75]

6.9 Though Q3 was the busiest (with the highest level of volume and revenue recorded in the year), post-Christmas Q4 volumes and revenues noted the largest year-on-year increase in the period covered in this report, up 11% and 5% respectively. This may reflect greater use by consumers of e-retailer returns options in recent years. A report by MetaPack comments on an increasing interest from consumers in easy to use and cheap return options. Retailers appear to be reacting to this by providing return services which take advantage of pick-up points in stores and CollectPlus.[76]

6.10 Despite Q3 being the busiest, the rate of growth was slower than in previous years. Parcel volumes for Q3 in 2016-17 were up 2% over the same period last year, and revenues increased 3%. This is a deceleration from the 11% volume and 9% revenue growth between Q3 2014-15 and Q3 2015-16 (adjusted for CPI).

Figure 6.2 – Quarterly measured volumes for parcels, 2015-16 to 2016-17



---

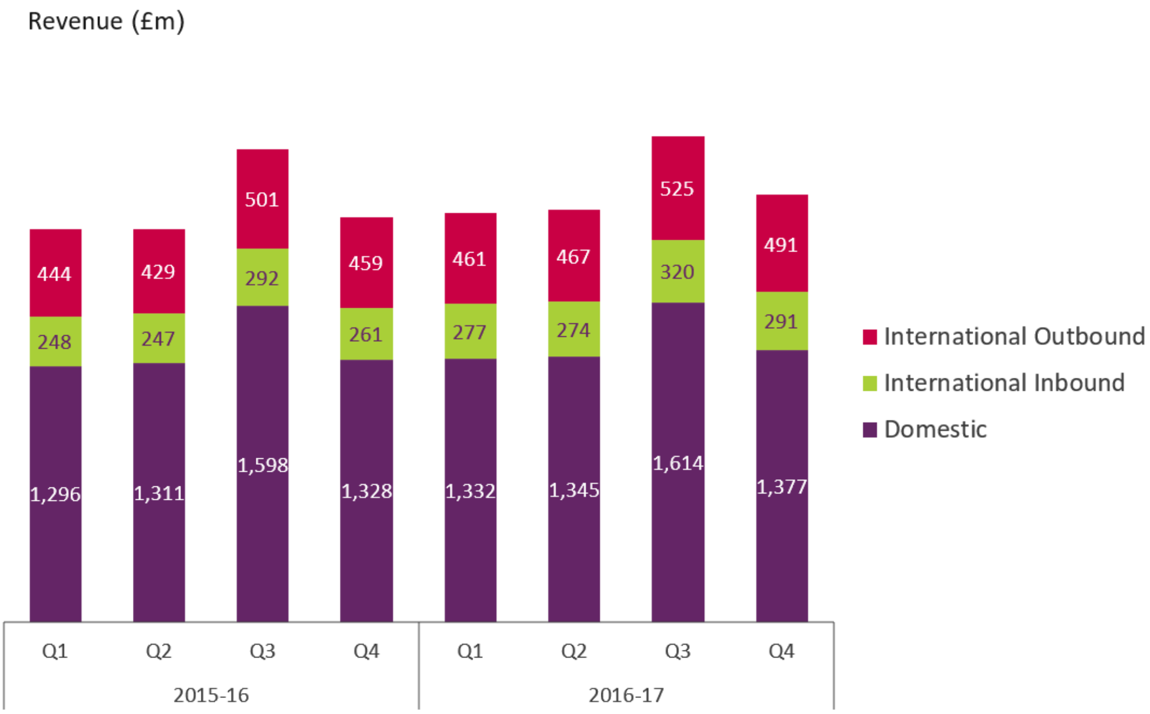
[74] ONS, *Retail sales in Great Britain: Nov 2016*, 15 December 2016, https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/nov2016

[75] Ibid.

[76] MetaPack, *Returns – the New Battle Ground for Retail,* available at http://www.metapack.com/wp-content/uploads/2015/02/Returns-The-new-battleground-for-retail.pdf

Source: Operator returns to Ofcom (includes access volumes).

Figure 6.3 – Quarterly measured revenues for parcels



Source: Operator returns to Ofcom (includes access revenues).

6.11 In 2016-17 measured domestic[77] parcel volumes increased 7% to 1.75 billion items (accounting for 82% of total volumes) and measured domestic revenues increased 1%, to over £5.6bn (accounting for 65% of total revenues, a 1 percentage point decrease from 2015-16). International inbound parcels[78] made up 10% of volumes and 13% of revenues (a 1 percentage point increase from 2015-16), and outbound parcels[79] made up 8% of volumes, and 22% of revenues (up 0.4 percentage points).

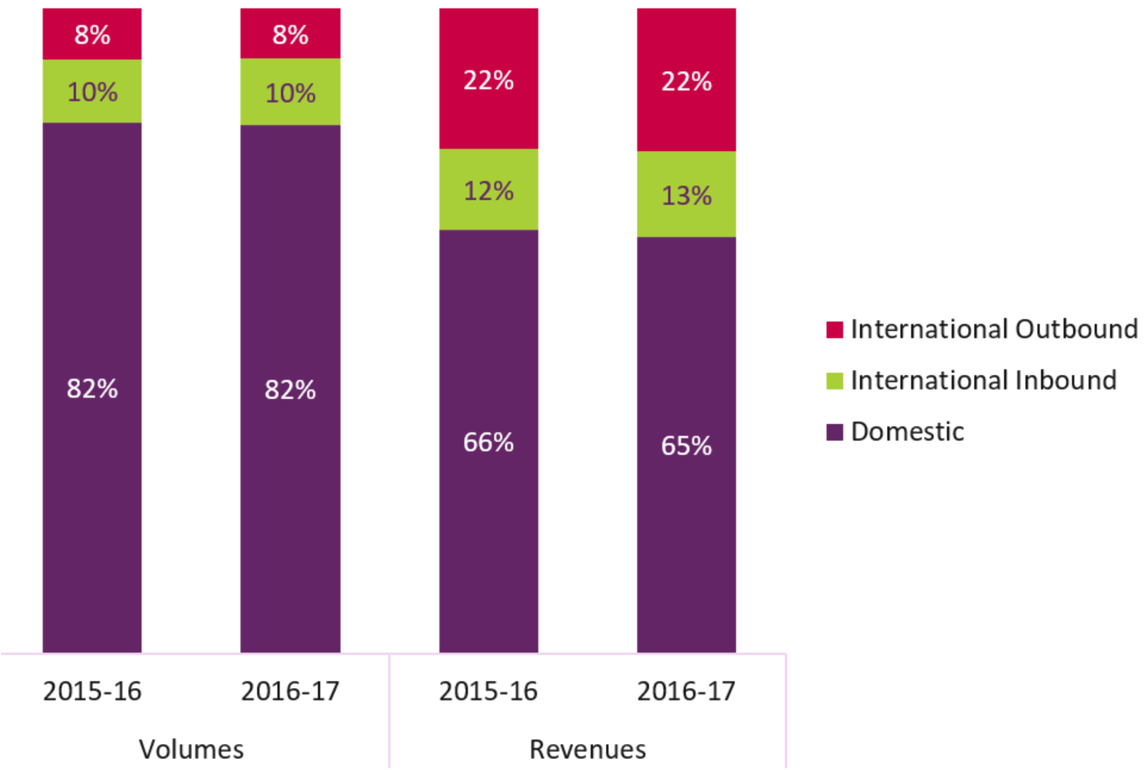
6.12 Figure 6.4 sets out the proportion of measured national volumes and revenues made up by domestic parcels and international inbound and outbound parcels. As illustrated in Figure 6.4, domestic parcels continue to make up the majority of parcel volumes and revenues. Domestic parcels represent a larger proportion of total volumes than of total revenue. This is reflected in the average unit revenues: in 2016-17 the average unit revenue for a domestic parcel was £3.21, whereas the average unit revenues for international inbound and outbound parcels were £5.26 and £11.62 respectively.

[77] Where the parcel is sent and delivered in the UK.
[78] Where the parcel is sent from outside the UK and delivered in the UK.
[79] Where the parcel is sent from within the UK and delivered outside the UK.

6.13 In 2015-16, average unit revenue for a domestic parcel was £3.39. The average unit revenue for a domestic parcel of £3.21 in 2016-17 therefore represents a 5% decrease in last year's figure. This is the second consecutive year of decline in average unit revenue and may reflect, at least in part, growing price competition among parcel operators.[80]

6.14 The average unit revenue for an international outbound parcel decreased in 2016-17 by 1% from £11.77 in 2015-16 to £11.62 in 2016-17. The proportion of total revenue attributed to international outbound parcels is higher than that accounted for by international inbound parcels. This is likely due to other revenues incurred in the process of sending a parcel overseas, such as delivery fees. According to IMRG, cross-border volumes were at the highest point in July 2016,[81] following the UK referendum on exiting the European Union in mid-2016. There was a sharp rise in orders from shoppers in Europe and the US[82] most likely ensuing from the weakening of Sterling against the US Dollar and the Euro.

Figure 6.4 – Volumes and revenue for measured parcels by delivery type (international and domestic)



Source: Operator returns to Ofcom (includes access volumes and revenues). Figures adjusted for CPI.

[80] Post and Parcel, *Tight at the top, and tough at the bottom,* 26 September 2017, http://postandparcel.info/82601/news/tight-at-the-top-and-tough-at-the-bottom/

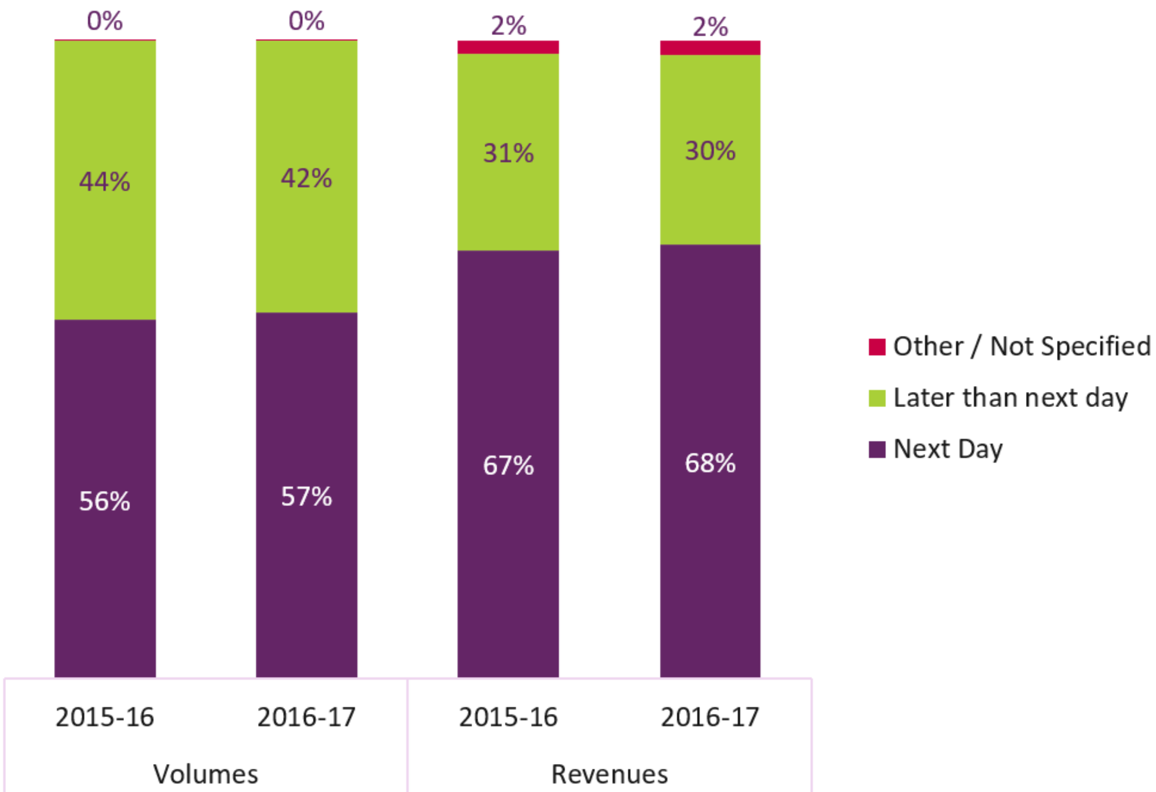
[81] Since the IMRG MetaPack UK Delivery Index began in 2011. The information presented is aggregated from a consistent sample of MetaPack's extensive dataset so all retailers, carriers and other suppliers remain completely anonymous.

[82] IMRG, *Cross-border order volumes at record high following Brexit,* https://www.imrg.org/media-and-comment/press-releases/cross-border-order-volumes-at-record-high-following-brexit/

6.15 As shown in Figure 6.5, of measured domestic volumes, Next Day parcel services were the most commonly used, accounting for 57% of all domestic volumes in 2016-17. Next Day services accounted for a greater proportion of total domestic revenues (68%) than of total domestic volumes (57%). This reflects the premium price often charged for Next Day services.

6.16 Conversely, while services slower than Next Day services accounted for 42% of domestic volumes in 2016-17, these services only accounted for 32% of domestic revenues. This is reflected in average unit revenue, which was £3.82 in 2016-17 for Next Day parcels, but only £2.25 for later than next day. The increase in the proportion of parcels delivered Next Day is likely to be explained by growing consumer expectations about speed of delivery.[83]

Figure 6.5 – Domestic parcel volumes and revenues by speed of delivery: 2016-17[84]



Source: Operator returns to Ofcom

6.17 In summary, overall parcels volume and revenue continued to grow in 2016-17. As e-commerce in the UK boosts the parcels market, volumes and revenues continued to increase, though at a slower rate than in the previous year. The speed at which consumers expect their parcels to arrive is rising, reflecting slight growth in the proportion of parcels delivered next day, which make up the majority of volumes and revenues in the UK's parcel

[83] See paragraph 6.36 for more information on consumer expectations around speed of delivery.
[84] Due to rounding, percentages may not always appear to add up to 100%.

market. More than half of UK adults (55%) said they had used a next day delivery service in February 2017.[85]

6.18 In the following section, we discuss selected recent developments in the parcels sector in more detail.

Developments in the parcels sector

Price promotions in the consumer to anywhere (C2X) market

6.19 In July 2017, Royal Mail announced it was trialling lower prices on some of its single piece parcel products for a limited time.[86] Between July and October 2017, the cost of sending a second-class medium parcel, between 2-5kg, was reduced from £13.75 to £6.29 and the cost of sending Second Class Signed For, medium parcels was £7.29, reduced from £14.75. Both offers were only available to purchase online.

6.20 Over the summer months in 2017, there was also a pricing promotion by Hermes on its myHermes products. Sending a 2.5kg parcel via myHermes was available for £5.49 (previously £6.49) or £4.99 (previously £5.99) if dropped off at a parcel shop during Hermes' own price reduction period. Furthermore, myHermes reduced prices for both its courier and parcel shop services, and across other products (from parcels sub-2kg to up to 15kg parcels).[87]

6.21 Parcel2Go, which acts as a reseller of parcels products (although with different terms and conditions), also dropped its prices for its standard myHermes products for two weeks – such that small parcels below 2kg (and dropped off to parcel shops) cost £1.91, compared to £2.39.[88]

6.22 For a two-week period in September 2017, Ebay, through its Shutl delivery service, offered a significant price discount on its drop off myHermes products. 0-2kg parcels were £2 (previously £2.75 and £3.94), 2-5kg parcels were £4.99 (previously £5.52) and 5-15kg parcels were £6.49 (previously £7.32 and £9.72).

6.23 In November 2017, Amazon announced it was offering free one-year Prime memberships to residents in the ten UK villages which have been the most frequent Amazon customers. The free membership includes unlimited one-day delivery.[89]

---

[85] Ofcom, *Communications Market Report: United Kingdom*, 3 August 2017, Figure 6.7, https://www.ofcom.org.uk/__data/assets/pdf_file/0022/105439/uk-post.pdf
[86] Post and Parcel, *Royal Mail trialing lower price on Second Class medium parcels,* 12 July 2017 http://postandparcel.info/81127/news/royal-mail-trialing-lower-price-on-2nd-class-medium-parcels/
[87] Tamebay, *myHermes slash the cost to send a parcel for the Summer,* https://tamebay.com/2017/07/myhermes-slash-cost-send-parcel-summer.html
[88] Post and Parcel, *Parcel2Go dropping price for myHermes deliveries,* 31 July 2017, http://postandparcel.info/82124/news/parcel2go-dropping-price-for-myhermes-deliveries/
[89] Amazon, Press Release – Amazon gives Prime to every household in 10 rural villages across the UK to celebrate 10th anniversary of the membership programme, 9 November 2017, http://phx.corporate-ir.net/phoenix.zhtml?c=251199&p=irol-newsArticle&ID=2315709

Innovation and investment

6.24 Over the last year, operators continued to invest in their networks to add capacity and enable growth. For example, Hermes and DHL expanded their operations by investing in new hubs and depots. In August 2017, Hermes opened a new £31m distribution hub in the UK in Rugby.[90]

6.25 In the same month, and following its acquisition by Deutsche Post DHL Group in December 2016, UK Mail announced that it would invest more than £21m in three new sites within its UK regional network.

6.26 In October 2017, Amazon confirmed its plans to open a new fulfilment centre in Bolton in 2018, bringing its total number of fulfilment centres to 16 in the UK,[91] and more recently opened a development centre, which will include developing Prime Air (delivering packages by drone).[92]

6.27 In the medium term, analysts predict that the UK parcel market will focus on developing technology in last-mile delivery. In its most recent 2017 report on the parcel shipping market, Pitney Bowes cited new delivery models like crowd shipping, on-demand delivery services, evening and weekend delivery and drones as some of the key future developments in the parcels market.[93] A similar report by McKinsey also foresees last mile delivery by drone.[94]

Mergers and acquisitions

6.28 Since we published the 2015-16 Annual Monitoring report, mergers and acquisitions (M&A) activity in the parcels sector have continued as operators seek opportunities to build scale and diversify their revenues. Here, we discuss some recent M&A activity which has taken place since in the 2016-17 financial year below.

6.29 In 2016-2017, Royal Mail Group's GLS business made acquisitions in selected markets to increase scale in certain geographic territories.[95] In June 2016, its Spanish subsidiary, GLS Spain acquired the Spanish express parcels delivery company ASM Transporte Urgente, to give GLS Spain (which had previously been focused on international parcels) greater scale

---

[90] Post and Parcel, *Hermes opens new Midlands Super Hub,* 18 August 2017, http://postandparcel.info/81860/news/hermes-opens-new-midlands-super-hub-2/

[91] Post and Parcel, *Amazon opening FC in Bolton*, 16 October 2017, http://postandparcel.info/83009/news/amazon-opening-fc-in-bolton/

[92] Post and Parcel, *Amazon opens Cambridge development centre*, 2 November 2017, http://postandparcel.info/83407/news/amazon-opens-cambridge-development-centre/

[93] Post and Parcel, *Pitney Bowes: UK parcel market set for "huge shake-up" in new trends and technologies*, 31 August 2017, http://postandparcel.info/82081/news/pitney-bowes-uk-parcel-market-set-for-huge-shake-up/

[94] https://www.mckinsey.com/industries/travel-transport-and-logistics/our-insights/how-container-shipping-could-reinvent-itself-for-the-digital-age?cid=soc-web

[95] Royal Mail, *GLS – Divisional Update*, 18 May 2017, http://www.royalmailgroup.com/sites/default/files/GLS%20Divisional%20Update.pdf

in the domestic parcels market.[96] In April 2017, it acquired US regional overnight parcels operator Postal Express, following its October 2016 purchase of GSO, another US regional operator.

6.30 Following the acquisition by DHL in December 2016, UK Mail announced it would invest over £21m into three new sites within its network across the UK.[97] Through the acquisition, DHL has gained access to UK Mail's network of more than 50 sites in the UK.

6.31 In December 2016, DPDGroup took full control of e-commerce parcels company, wnDirect. wnDirect is a global e-commerce parcels company which specialises in e-commerce network software. DPD's other acquisition was of a digital mapping company Pie Mapping in October 2016, which aimed to develop and optimise DPD's network through mapping and navigation support.[98] DPD had previously invested in the company though its technology incubator programme.

6.32 First proposed in March 2017 as an opportunity to build scale and generate synergies in its parcels and logistics business, DX Group's proposed £40m acquisition of John Menzies' distribution business was called off in August 2017.[99] [100] Following this announcement, the DX board announced it would continue its business transformation on a stand-alone basis.[101]

Changing consumer expectations

Click and collect services

6.33 Access points allow consumers to pick up or drop off parcels for onward delivery. In February 2017, just over one in ten (12%) said they had ever used access points in parcel shops for the delivery of shopping ordered online.[102]

6.34 Around half (49%) of adults have used click and collect services (i.e. ordering a purchase online but picking it up in store)[103] and recent research has found that click and collect services are expected to account for 35% of all deliveries by 2018,[104] and grow by 64%

---

[96] Royal Mail, *GLS acquires Spanish express parcels delivery company, ASM Transporte Urgente*, 20 June 2016, http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/RMG/12860248.html
[97] UK Mail, *UK Mail invests over £21m (€23m) in regional network to support growth,* 21 August 2017, https://www.ukmail.com/news/2017/08/21/uk-mail-invests-over-21m-(-23m)-in-regional-network-to-support-growth
[98] Post and Parcel, *Pie Mapping planning for growth following DPD acquisition,* 8 March 2017, http://postandparcel.info/78615/news/pie-mapping-planning-for-growth-following-dpd-acquisition/
[99] John Menzies, *Potential combination of DX and John Menzies' Distribution division,* 31 March 2017, http://www.johnmenziesplc.com/media/1804/potential-combination-of-dx-and-john-menzies-distribution-division.pdf
[100] BBC, *John Menzies scraps planned £30m DX Group merger*, 14 August 2017, http://www.bbc.co.uk/news/uk-scotland-scotland-business-40923527
[101] Ibid.
[102] Ofcom, *Communications Market Report: United Kingdom*, 3 August 2017, Figure 6.5, https://www.ofcom.org.uk/__data/assets/pdf_file/0022/105439/uk-post.pdf
[103] Ibid.
[104] Post and Parcel, *Pitney Bowes: UK parcel market set for "huge shake-up" in new trends and technologies*, 31 August 2017, http://postandparcel.info/82081/news/pitney-bowes-uk-parcel-market-set-for-huge-shake-up/

between 2016 and 2021.[105] The main reasons for consumers using click and collect is to avoid delivery charges (55%) and it being more convenient than home delivery (49%).[106]

6.35 The click and collect market has seen several changes recently:

- Pass My Parcel is a company which enables retailers to offer shoppers same-day pickup from a nearby newsagent. As part of a venture with Smith News stores, it provides a 'click and collect' service for sellers such as Amazon, opening networks to deliver to customers within 12-hours after placing an order.[107] Pass my Parcel announced in August 2017 that it has invested in offering faster returns via its network. It partnered with returns provider ReBOUND, to offer customers the choice to fill in their return order details online before dropping the parcel at a local shop for collection.[108]
- Doddle, which was launched as a collection and sending service in June 2014, announced in April 2017 that it would be shutting down most of its physical stores to focus on retail partners for click and collect.[109] The company announced plans to open up to 500 locations to support its click and collect network, targeting locations such as inside Morrisons and Ryman outlets, and plans to have 1,000 locations in the next two years.[110]
- CollectPlus announced in June 2017 that it would work with on-demand delivery service Gett Delivery, to provide return services for unwanted consumer purchases, which can be collected from their homes, or from the nearest CollectPlus store.[111] Though still a limited service, the venture will allow customers in zones 1 and 2 of Central London to use to Gett app to return items to retailers. It will be trialled for six months in Central London, with a plan to expand to other cities across the UK by the end of the year. All parcels are tracked with £50 of insurance included for every parcel.[112]

---

[105] Business Wire, *United Kingdom Click and Collect Report 2016-2021: Market is Forecast to Grow by 64%*, 6 December 2016, http://www.businesswire.com/news/home/20161206006421/en/United-Kingdom-Click-Collect-Report-2016-2021-Market
[106] JDA & Centiro Customer Pulse 2017 – United Kingdom, *Voice of the online UK Shopper,* http://now.jda.com/rs/366-TWM-779/images/JDA_and_Centiro_Customer_Pulse_Report_2017_UK.pdf
[107] Smiths News, *Smiths News launches new Pass My Parcel Delivery service with Amazon.co.uk,* 15 October 2014, https://www.smithsnews.co.uk/media/news/smiths-news-launches-new-pass-my-parcel-delivery-service-with-amazoncouk
[108] Post and Parcel, *Pass My Parcel partners with ReBOUND*, 22 August 2017, http://postandparcel.info/81917/news/pass-my-parcel-partners-with-rebound/
[109] Post and Parcel, *Doddle focusing on retail partners for Click and Collect network*, 25 April 2017, http://postandparcel.info/79603/news/doddle-focusing-on-retailer-partners-for-click-collect-network/
[110] Ibid.
[111] Post and Parcel, *CollectPlus teams up with Gett Delivery for London returns*, 28 June 2017, http://postandparcel.info/80716/news/collectplus-teams-up-with-gett-for-london-returns/
[112] CollectPlus, *CollectPlus offers Londoners hassle-free returns with Gett Delivery,* 27 June 2017, https://www.collectplus.co.uk/press/gett-delivery-collectplus/

- Click and collect for Argos products and Sainsburys clothing brand will expand to 100 Sainsbury's Local branches,[113] whilst Waitrose has launched a self-service check-in for John Lewis' click and collect orders in its stores.[114]

Faster delivery

6.36 Companies are also expanding their delivery offerings in response to growing consumer demand for faster than next day delivery. Although only 14% people say they have used a same day delivery service, when asked, another 53% of people said they would be interested in such a service.[115] Retailers including Amazon,[116] Tesco[117] and Sainsbury's[118] offer same day or faster (within 2 hours or less) delivery of purchases to parts of the UK, whilst one retailer has launched a same-day, one hour delivery service.[119] Recent consumer research across mainland Europe and the US suggests that 54% of consumers want eCommerce sites to offer one-hour delivery in urban areas, whilst 31% of consumer said they would pay a monthly fee to get unlimited next day deliveries.[120]

6.37 Online fashion retailer ASOS announced in October it was launching same-day deliveries in London, at a cost of £12.95 per parcel,[121] through City Sprint, and then announced in November it was expanding the service to Leeds and Manchester, at a reduced price of £9.95, with further availability in other UK cities next year.[122] Wholesaler Parcelhub recently added a next day delivery service by Hermes to its existing offerings for its customers.[123] Recent research has predicted that the B2C parcels segment will grow at a faster rate in the UK, for revenue, than B2B parcels, further suggesting the demand for online shopping shows no signs of abating.[124]

6.38 In the forthcoming retail season over Christmas, one company has stated they expect consumers to demand more varied, flexible delivery options, despite free delivery likely to

---

[113] Sainsbury's, *Interim results for the 28 weeks to 23 September 2017,* 9 November 2017, https://www.about.sainsburys.co.uk/news/latest-news/2017/09-11-2017
[114] Post and Parcel, *Waitrose launches self-service check-in for 'click and collect' orders*, 16 November 2017, http://postandparcel.info/83648/news/waitrose-launches-self-service-check-in-for-click-and-collect-orders/
[115] Ofcom, *Communications Market Report: United Kingdom*, 3 August 2017, Figure 6.7, https://www.ofcom.org.uk/__data/assets/pdf_file/0022/105439/uk-post.pdf
[116] Through its Amazon Prime product. See https://www.amazon.co.uk/gp/prime/
[117] Tesco, *Tesco becomes the first retailer to offer same day grocery delivery nationwide,* 24 July 2017, https://www.tescoplc.com/news/news-releases/2017/tesco-becomes-first-retailer-to-offer-same-day-grocery-delivery-nationwide/
[118] BBC, *Sainsbury's to launch same-day online delivery*, 21 July 2016, http://www.bbc.co.uk/news/business-36855976
[119] Post and Parcel, *Planet Organic launches same day, one-hour London delivery service,* 7 November 2017, http://postandparcel.info/83450/news/planet-organic-launches-same-day-one-hour-london-delivery-service/
[120] Post and Parcel, *Consumers abandon a purchase if they don't like delivery choices,* 14 November 2017, http://postandparcel.info/83586/news/consumers-abandon-a-purchase-if-they-dont-like-the-delivery-choices/
[121] Post and Parcel, *ASOS using On the dot for its same-day delivery service,* 12 October 2017, http://postandparcel.info/82967/news/asos-using-on-the-dot-for-its-same-day-delivery-service/
[122] Post and Parcel, *ASOS Instant comes to Leeds and Manchester,* 21 November 2017, http://postandparcel.info/83673/news/asos-instant-comes-to-leeds-and-manchester/
[123] Post and Parcel, *Parcelhub adds Hermes Next Day delivery option,* 8 November 2017, http://postandparcel.info/83516/news/parcelhub-adds-hermes-next-day-delivery-option/
[124] Post and Parcel, *Pitney Bowes: UK parcel market set for "huge shake-up" in new trends and technologies*, 31 August 2017, http://postandparcel.info/82081/news/pitney-bowes-uk-parcel-market-set-for-huge-shake-up/

remain the main factor for consumers in choosing delivery options. It also stated that consumers this year are expected to have less tolerance for longer or imprecise delivery times, an expectation of try-before-you-buy, delivery to neighbour and in-flight changes (i.e. once the item has been dispatched).[125]

Tracking

6.39 Operators have continued to offer tracking and visibility solutions as a free addition to their current services, as consumers increasingly ask for visibility of their parcels. As such, the market has responded with:

- Royal Mail's introduction of delivery confirmation for small and medium domestic parcels and email notifications for Royal Mail International Tracked products.[126]
- In September 2017, myHermes launched a new (free) Estimated Time of Arrival service enabling online retailers and marketplace sellers to provide their customers with a four-hour time window of expected delivery via email, on the morning of when delivery is due.[127]
- CollectPlus's new service, enabling users to send parcels even if they only have the recipient's email address or mobile phone number and which provides full tracking to both parties, as well as proof of delivery for the sender.[128]

The demand on industry

6.40 In October 2017, Pitney Bowes carried out its annual Global Ecommerce Study, which found that retailers are "racing to keep up with consumer demand" and that the market is being driven by a "more demanding, frequent and global online shopper". Key insights from the report include:[129]

- 47% of online shoppers globally reported frustration with delivery, such as shipping, returns, lost products and miscalculated duties and taxes during the 2016 Christmas and Cyberweek season.
- Shipping costs are one of the top causes of margin erosion for retailers, which, combined with growing consumer expectation, have led to 45% of retailers either implementing or trialling end-to-end shipping capabilities.

---

[125] Post and Parcel, *Peak season trend spotting,* 31 October 2017, http://postandparcel.info/83332/news/peak-season-trend-spotting/

[126] See footnote 42 above.

[127] Post and Parcel, *myHermes launches new ETA solution,* 19 September 2017, http://postandparcel.info/82432/news/myhermes-launches-new-eta-solution/

[128] Post and Parcel, *CollectPlus launches "Sociall Send" service,* 24 October 2017, http://postandparcel.info/83223/news/collectplus-launches-social-send-service/

[129] Pitney Bowes, *The 2017 Global Ecommerce Report,* https://www.pitneybowes.com/content/dam/pitneybowes/us/en/campaign-pages/2017-global-ecommerce-report/global-ecommerce-report-updated.pdf

6.41 Low-cost, fast and accurate shipping has become key to ensuring customers return to a retailer for additional purchases – 50% of retailers cite delivery speed and cost as top operational priorities. More recent research, carried out by MetaPack on the state of eCommerce Delivery, surveyed consumers in mainland Europe and found:[130]

- 54% of consumers say delivery defines who they always shop with.
- 39% never shop again with an online retailer following a negative delivery experience.
- 43% use social media to express their displeasure at a poor delivery experience - amongst 18-26 year olds, this figure rises to 48%.

6.42 Finally, research released earlier this month, which focused on London consumers, found similar influence of delivery providers over consumers purchases, with 89% stating it would influence their decision to purchase from a particular retailer. 67% said Delivery time slots are too vague and 31% said delivery options are not flexible enough. 54% have a minimum expectation that retailers should offer deliveries within an hour. Overall, 96% of those surveyed said providing delivery at an exact time slot determines who they shop with.[131]

Parcel surcharging in Northern Ireland and the Scottish Highlands and Islands

6.43 Ofcom has powers to gather all necessary information from postal operators to carry out comparative overviews of the quality and prices of postal services, with a view to publication and in the interest of users of postal services.

6.44 In our 2016-17 Annual Plan we committed to work with Citizens Advice Scotland (CAS) and the Consumer Council for Northern Ireland (CCNI) in order to better understand the causes and effects of parcels surcharging in Northern Ireland and the Scottish Highlands and Islands, using our information gathering powers to obtain relevant information.

6.45 Accordingly, we sought information from certain postal operators in order to inform our understanding of where and in what circumstances higher delivery prices for parcels may be applied due to the region of the United Kingdom to which the parcel is delivered.[132]

6.46 In our 2015-16 annual monitoring update, we outlined our initial findings from the first phase of this work. This involved a programme of information gathering from parcel operators focused on better understanding the extent and geographic variation of

---

[130] Post and Parcel, *Consumers abandon a purchase if they don't like delivery choices,* 114 November 2017, http://postandparcel.info/83586/news/consumers-abandon-a-purchase-if-they-dont-like-the-delivery-choices/

[131] Post and Parcel, *London shoppers calling out for more flexible delivery options,* 9 November 2017, http://postandparcel.info/83538/news/london-shoppers-calling-out-for-more-flexible-delivery-options/

[132] We do not have any powers to impose price regulation, or other direct remedies, on parcel operators in the bulk retail parcel market (i.e. outside of the scope of the universal postal service). Our work in this area has therefore been focused on obtaining relevant information and publishing a summary of this information (respecting confidentiality) in order to ensure that policy makers have access to relevant information on which to design future policy.

surcharges applied to the delivery of parcels to Northern Ireland and the Highlands and Islands of Scotland.[133]

6.47 The information we gathered showed that the majority of operators from whom we collected data charge higher prices to their bulk parcel customers for delivery services to certain locations in the UK. These locations were predominantly in Northern Ireland and the Scottish Highlands & Islands, but also included other locations such as the Scilly Isles and the Isle of Wight.

6.48 We identified that the key factors contributing to higher delivery charges in these areas were a reliance on third parties for delivery, higher fuel costs and lower drop density (i.e. a smaller number of parcels being delivered in a particular location). Specifically, in relation to Northern Ireland, we also identified that the need to use transport companies to transport goods across water from Great Britain to Northern Ireland also contributed towards higher delivery costs.

6.49 Having gathered this information, we confirmed our intention to undertake further work in this area in 2016-17 by working with parcel operators to understand the extent to which the factors given as causes of parcel surcharging account for the additional charges and to develop our understanding of the value chain, using our information gathering powers. This work has now been completed and we summarise the findings below.

2016-17 Update

6.50 Of the factors which we identified as contributing to parcel surcharging as part of our analysis in 2015-16, we observed a relatively strong correlation between areas of the UK where operators rely on a third party or transport company for some part of the delivery journey, and areas where operators charge their bulk customers a higher price.[134] This suggested that the presence of additional players in the value chain may be a contributory factor in delivery prices being higher. For example, we noted that each operator that uses a third party to deliver to the Scottish Highlands and Islands also charges a higher price for delivery to these areas.

6.51 On this basis, we have undertaken further information gathering over the last year to develop our understanding of the extent to which the costs incurred by parcel operators in the use of third parties for delivery; and the use of transport companies to transport parcels between Great Britain and Northern Ireland, may account for the surcharges applied to retailers.

---

[133] Ofcom, *Annual monitoring update on the postal market,* 30 November 2016, pages 37-42.

[134] We define a third party as 'a separate corporate entity with which a parcel operator has entered a contractual relationship for the delivery of parcels on its behalf in locations in which its own network does not extend, excluding self-employed owner-drivers and downstream access operators'. When we refer to 'transport companies', we mean separate corporate entities with which a parcel operator has entered a contractual relationship specifically for the transportation of parcels by air or ferry from Great Britain to Northern Ireland.

6.52 We asked four of the largest parcel operators providing services in the UK[135] to provide the names of the third parties they use for delivery, the volume of parcels delivered by these third parties and the total amount paid by the parcel operator to each third party for performing this service. This information allowed us to calculate a volume-weighted average cost per parcel incurred by each parcel operator, in relation to each third party delivery company that it contracts with.

6.53 We found that the price paid by operators to third parties varies significantly with the average cost per parcel ranging from £2.32 to £4.56. The price paid by operators varies depending on the third party used and the area of the UK in which the third party operates.

6.54 We also requested information on the volume of parcels each operator delivered between Great Britain and Northern Ireland, and, the amount paid to air and ferry transport companies for the transportation of these parcels from Great Britain to Northern Ireland for onward delivery. This information allowed us to calculate an average cost per parcel each operator incurred in transporting parcels between Great Britain and Northern Ireland.

6.55 On average, operators incur a cost of 66p for transporting a parcel between Great Britain and Northern Ireland. This cost is in addition to the costs operators incur transporting parcels throughout the rest of their network. One operator also told us that processing costs per parcel are higher in Northern Ireland than the rest of the UK, due to the low population density in Northern Ireland. This operator also said that the geography of Northern Ireland brings a higher level of fixed costs to its operation. In particular, it said that due to distances involved in transporting items within Northern Ireland, it has had to establish additional processing depots, despite the relatively small population in Northern Ireland, leading to higher unit costs.

6.56 We compared this data to the confidential data we had previously acquired about the level of surcharging that operators apply to their bulk retail customers by location. This indicates that in most cases, the surcharge applied by the parcel operator is greater than the cost incurred by the operator in relation to third party delivery. It is therefore not clear that costs incurred in reliance on third parties and transport companies fully account for the surcharges applied by parcel operators to their bulk retail customers. However, we note that it is likely that other factors beyond a reliance on third parties and air and ferry transport companies also contribute to additional costs in certain areas.

6.57 In addition, we note that while some retailers apply a surcharge to consumers for delivery to certain locations, other retailers choose to apply a uniform delivery charge for all areas of the UK. Therefore, it is not clear that surcharges applied by parcel operators to online retailers necessarily lead to delivery surcharges to consumers in all cases.

[135] DPD, Hermes, Parcelforce and Yodel. Although Royal Mail is also a large parcel operator, we did not seek further information from Royal Mail on this issue on the basis that it does not vary its retail bulk prices by location within the UK. Parcelforce is a subsidiary of the Royal Mail Group.

6.58 While we anticipate that the information we have gathered to date concludes our current phase of work in this area, we will continue to engage with the Consumer Council for Northern Ireland and Citizens Advice Scotland, and other relevant organisations as necessary, in future as they take forward these findings.

7. The financial performance of the Reported Business

7.1 This section summarises the financial performance of the Reported Business for 2016-17, and where relevant, a five-year trend. We monitor the financial performance of the Reported Business[136] with regards to our duty to ensure the financial sustainability of the universal service as set out in the March 2012 Statement.[137]

7.2 We discuss in sequence:

- profit margins, cash flow, financial health metrics and Royal Mail's most recent Viability Statement;[138]
- changes in overall volumes and revenues for the Reported Business, and then by product groups, formats and universal service products, to help us understand what is driving overall revenue and volume changes of the universal service provider; and
- changes in the costs of the Reported Business, to understand what progress has been made in relation to cost reduction. This information is also an important input when considering the efficiency of the universal postal service, which is discussed further in Section Eight.

7.3 Revenue and cost figures presented in this section are in nominal terms, consistent with Royal Mail's Regulatory Financial Statements.

Reported Business profit margin

7.4 In considering the financial sustainability of the universal postal service, we are required to take into account the need for the universal service provider to be able to earn a reasonable commercial rate of return in connection with its provision of the universal service.[139] In the March 2012 Statement, we said that an earnings before interest and tax (EBIT) margin range of 5-10% was indicative of a reasonable commercial rate of return. In the Review of the Regulation of Royal Mail 2017 statement, we updated our analysis of the EBIT margins of appropriate benchmark companies. The results of our analysis continue to

---

[136] The Reported Business is a part of Royal Mail's UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of Parcelforce International and Royal Mail Estates Ltd.
[137] Ofcom, *Securing the Universal Postal Service,* 27 March 2012, https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf
[138] In the Review of the Regulation of Royal Mail 2017 statement, we committed to monitoring the following short to medium term financial health metrics: Funds from operations/net debt, net debt/EBITDA and EBITDA/interest. While we cannot publish forward looking metrics as these rely on Royal Mail's confidential Business Plan, we can provide historic metrics as an indicator of financial health over the period considered
[139] Section 29(4) of the Postal Services Act 2011.

support our view that the 5-10% EBIT margin is an appropriate range for assessing what is a reasonable commercial rate of return for the Reported Business.[140]

7.5 In undertaking this analysis, we noted that if the forecast EBIT margin is above 5%, or shows an increasing trend that exceeds 5% over the forecast period, then the indications are that the Reported Business is financially sustainable. If this is not the case – for example if the forecast EBIT margin stays consistently below 5% or has a decreasing trend taking it below 5% – then there may be indications that the universal postal service faces financial sustainability issues in the long term. However, concerns about financial sustainability may not arise if, for example, the EBIT margin goes below 5% for a shorter period due to specific circumstances which may be addressed by Royal Mail without affecting its longer-term financial sustainability.[141]

7.6 In the March 2017 Statement, we confirmed our decision to supplement the approach we had previously used for assessing whether the provision of the universal service is financially[142] with consideration of a range of financial health metrics and indicators assessed at the Relevant Group level.

7.7 When we refer to Royal Mail's EBIT margin, our intention is that this refers to a pre-exceptional measure of profitability and that restructuring or redundancy costs, which are likely to recur year-on-year and are referred to as transformation costs by Royal Mail, are not considered to be exceptional items.[143]

7.8 In the 2014 Review of End-to-End Competition Statement, we said it was appropriate to adjust Royal Mail's Reported Business EBIT margin to restate pension costs on a cash basis (i.e. the rate the contributions are actually paid at), rather than the rate calculated using the accounting standards. We considered that this methodology takes account of the true cost of pensions and we refer to this EBIT margin measure as the 'financeability EBIT margin'.[144]

7.9 In the March 2017 statement we confirmed our decision to continue to calculate the financeability EBIT margin metric by deducting transformation costs and restating pension costs on a cash basis.[145] In 2016-17, the accounting pension rate was 28.8% whereas the

[140] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, paragraph 3.60, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

[141] Ofcom, Review of the Regulation of Royal Mail, May 2016, A6.92 https://www.ofcom.org.uk/__data/assets/pdf_file/0030/57954/annexes-5-11.pdf

[142] We refer to Royal Mail PLC and the group of companies it holds collectively as the Relevant Group or Royal Mail Group.

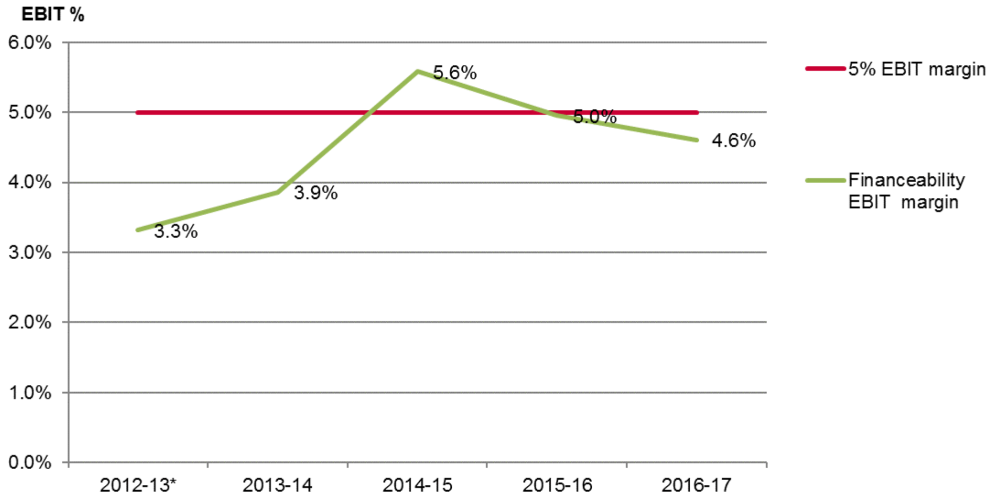
[143] Exceptional costs are considered to be large and uncommon (non-recurring) costs. See Ofcom, *Securing the Universal Postal Service,* 27 March 2012, paragraph 5.41 and footnote 69, https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf

[144] Ofcom, *Review of end-to-end competition in the postal sector*, 2 December 2014, page 15, https://www.ofcom.org.uk/__data/assets/pdf_file/0024/31956/end-to-end.pdf

[145] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, paragraph 3.46, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

cash pension rate was 17.1%.[146] We have reported on the financeability EBIT margin in each of our annual monitoring updates since 2013-14.[147]

Figure 7.1 – Reported Business Financeability EBIT margin



Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail

**2012-13 EBIT margin is based on 53 weeks*

7.10 Figure 7.1 shows that the 2016-17 financeability EBIT margin fell below both the 5% to 10% range,[148] and the prior year margin to 4.6%.

7.11 Despite this, we consider that the universal service is likely to remain financially sustainable in the immediate future. Our key reasons are:[149]

- As we explain below, the financial position and financial health metrics (including credit rating) of the Relevant Group do not indicate any short to medium-term financial health issues; and
- The challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. Continued progress on efficiency is likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.

---

[146] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 27, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf . The accounting and cash pensions rate are likely to continue to move further apart until the end of the current agreement in 2018.

[147] For more explanation of this approach please see earlier Annual monitoring updates, in particular Paragraph 6.6 in the 2014-15 Annual monitoring update on the postal market: https://www.ofcom.org.uk/__data/assets/pdf_file/0025/56923/annual_monitoring_update_2014-15.pdf

[148] The range that we considered in March 2012 and March 2017 to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.

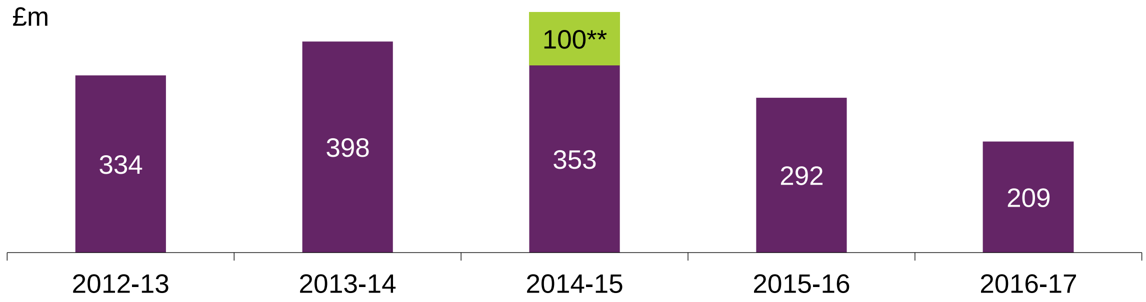
[149] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, paragraph 3.69, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

7.12 However, we recognise that there are various downside scenarios which have the potential to impact the financial sustainability of the universal service. These downside risks include the impact of industrial action, affordability of the pension scheme going forward, increased competition within the parcels market and economic and market downturn.

7.13 The decrease in financeability EBIT margin from 5.0% in 2015-16 to 4.6% in 2016-17 is largely due to a fall in total revenue of 0.5%, with total costs declining slightly year on year by 0.1%. We discuss the scale and nature of cost reductions in Section Eight on efficiency.

Royal Mail Group's cash flow

Figure 7.2 – Relevant Group free cash flow* (£)



Source: Royal Mail Statutory Accounts

** Free cash flow: net cash flow before financing activities (except finance costs paid), less the net cash purchase/sale of financial asset investments, including profit on disposal of properties*

*** Relates to a one-off disposal of a property in the London property portfolio, separately stated in Royal Mail's 2015-16 statutory accounts*

7.14 Cash flow is also an important component in ensuring the financeability of the universal service. In 2016-17 free cash flow of the Relevant Group fell by 28.4% in 2016-17 to c.£0.2bn. The main drivers for this were increased investment in parcel IT systems, parcels automation and the purchase of new PDAs[150] and investment in GLS.[151] Royal Mail Group did not make any significant property disposals in 2016-17, similar to its strategy in the prior year, only contributing £37m to free cash flows.

7.15 Despite cash flow falling, Royal Mail Group still had significant undrawn funding facilities (£1.02bn) as at 26 March 2017. This cash can be drawn upon depending on business needs.[152]

[150] Postal digital assistants.
[151] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 29, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf
[152] Ibid, page 95.

Financial health metrics and the viability statement

7.16 In the March 2017 statement, we committed to monitor a number of additional financial health metrics to help us in our assessment of the short to medium term financial health of the universal service.

7.17 Funds from Operations (FFO) / Debt is one of the key metrics that Standard & Poor's (S&P) credit ratings agency uses in order to assess the credit worthiness of Royal Mail Group. S&P recently provided a BBB credit rating assessment in relation to Royal Mail Group's 10-year €500 million bond.[153] As part of its assessment, S&P reviewed Royal Mail Group's historical and forecast performance against a number of metrics including FFO / Debt. Royal Mail has also informed us that this is a key metric that it monitors.

7.18 S&P's latest credit research affirmed Royal Mail Group's credit rating at BBB as it considered the outlook stable based on Royal Mail Group's FFO / Debt being above 45% (see Figure 7.3) in a difficult operating environment.[154] S&P categorised Royal Mail Group as low risk from a financial risk viewpoint as its FFO / Debt percentage was above 60%.[155]

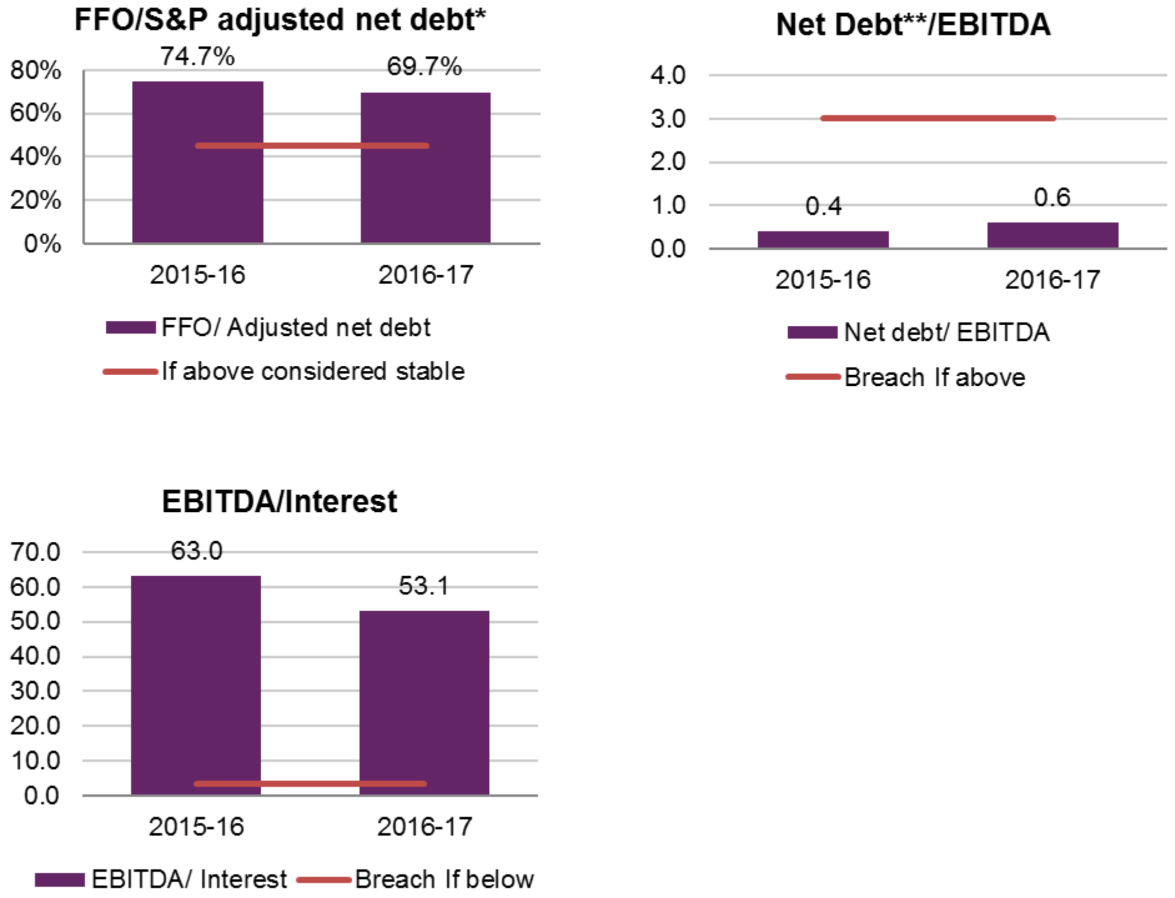
7.19 The Net Debt / EBITDA and EBITDA / Interest (interest cover) metrics are used as financial covenants relating to Royal Mail Group's syndicated credit facility. The Net Debt / EBITDA metric helps assess Royal Mail Groups ability to repay its debts using its operating profits (measured before non-cash elements of depreciation and amortisation). It broadly represents the number of years of annual profit required to repay all of the company's net debt. The interest cover metric is used to assess how easily Royal Mail Group can pay interest on its outstanding debt. Royal Mail Group's banking covenants require Net Debt / EBITDA to remain below 3 and its interest cover to remain above 3.5.

7.20 Royal Mail Group passed its banking covenant tests in 2016-17 (as shown in Figure 7.3 below).

---

[153] S&P Ratings Direct, *Research Update*, 1 August 2017 – Report available for purchase from S&P.
[154] S&P Ratings Direct, *Research Update: Royal Mail Ratings Affirmed at 'BBB/A-2'; Outlook Stable*, 1 August 2017 – Report available for purchase from S&P.
[155] S&P Ratings Direct, *Corporate methodology*, page 35, http://www.maalot.co.il/CriteriaDocs/Paper16.pdf

Figure 7.3 – Financial health metrics



Source: S&P Ratings Direct & Royal Mail Annual Report and Accounts

**S&P make certain adjustments to Royal Mail's reported net debt. S&P ratings methodology can be found on its website*

*** Net debt is adjusted for letters for credit for bank covenant purposes. This differs from S&P's calculation of net debt*

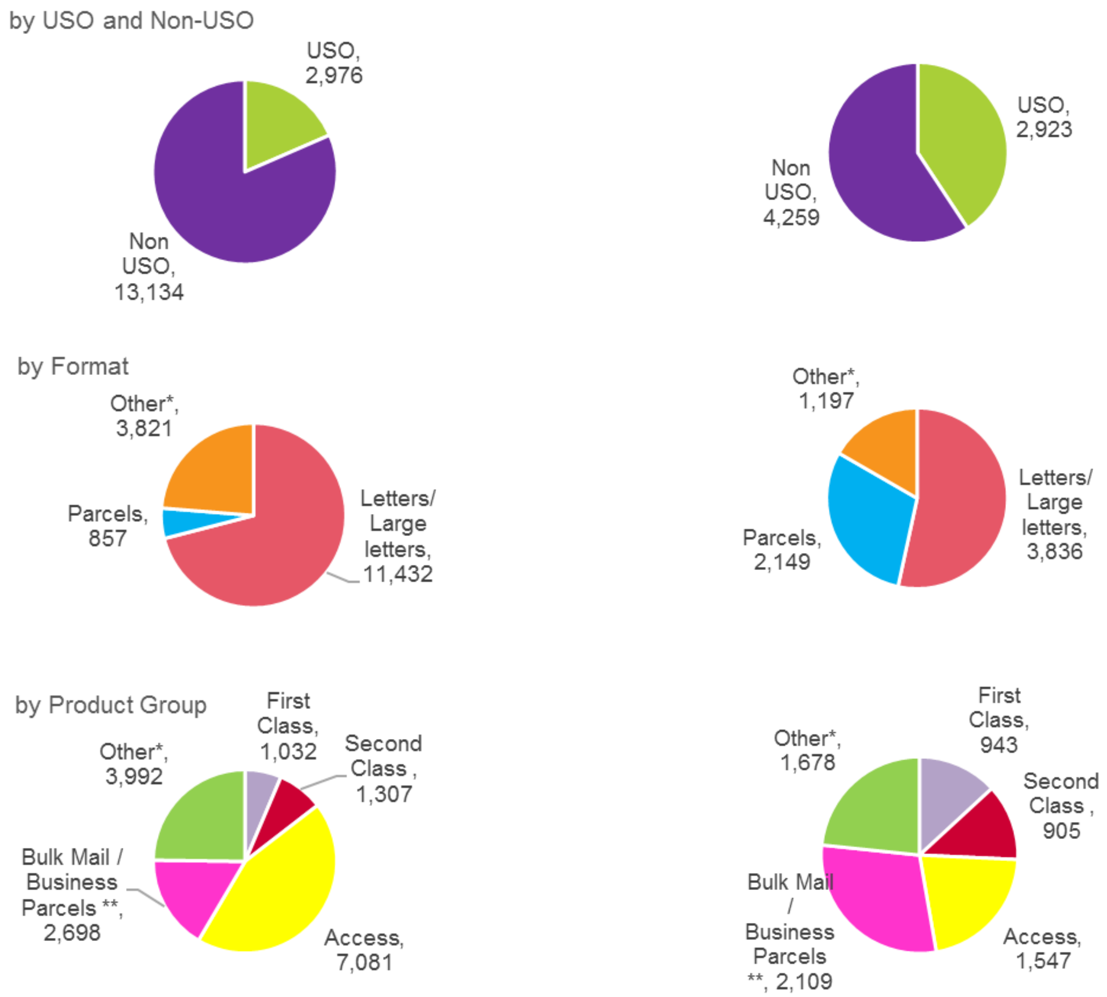
7.21 In addition to the above health metrics, we stated we would also give regard to Royal Mail Group's Viability Statement as published in its Annual Report and Financial Statements. Under the 2014 Corporate Governance Code, directors are required to make a statement that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. In order to do this, they must take into account the company's current position and principal risks.

7.22 In its Annual Report and Financial Statements for the year ended 26 March 2017, Royal Mail Group stated that "based on the results of their analysis, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2020."[156]

Volumes and revenues for the Reported Business fell in 2016-17

Figure 7.4 – Reported Business volumes and revenues split by product groups, formats and universal service products

Volumes (millions): 16,110m (4.1% decrease)   Revenues (£m): £7,182m (0.5% decrease)



Source: Royal Mail Regulatory Financial Statements and unaudited submissions from Royal Mail.

**Other mainly consists of unaddressed and international mail*

*** Includes special delivery*

7.23 Reported Business total volumes (addressed and unaddressed mail) continued to fall in 2016-17, by 4.1% to 16.1bn (the decline of which has accelerated from 3.4% in 2015-16).

---

[156] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 41, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

7.24 Total revenue fell by 0.5% to £7.2bn, as price increases were not sufficient to offset the effect of volume decline. This is the third consecutive year in which overall revenue has fallen, following the period from 2010-11 to 2013-14 when total revenue grew year on year despite volume decline. See Section Five for more information on prices.

7.25 We discuss below revenues and volumes for each of the splits in Figure 7.4 above (i.e. by product groups, formats and universal service products).

7.26 Letter and parcel price trends are available as part of the interactive data published on the Ofcom website.[157]

Universal service and non-universal service volumes and revenues

7.27 As set out in Section Three, the services within the Reported Business include all universal service products and other products which use the universal service network (for example, retail bulk mail and access products).

7.28 The volumes of both universal service (USO) and non-universal service (non-USO) products (including unaddressed mail) continue to decline. In 2016-17, they declined by 6.8% and 3.5% respectively. This follows the historic trend, where USO items have been declining at a faster rate than non-USO items. Non-USO volumes mainly consist of access, bulk and unaddressed products. The decline in non-USO volumes was primarily driven by a decline in retail bulk mail volumes, while access and unaddressed products declined more slowly. Royal Mail has stated that overall business uncertainty had an impact on letter volumes in 2016-17, with advertising and business letters particularly affected.[158]

7.29 Revenues from USO and non-USO products declined by 1.5% and 0.5% respectively in 2016-17, compared to 3.7% decline and a 0.2% increase in 2015-16, as price increases were not sufficient to offset volume decline especially for USO products.

Changes in Reported Business volumes and revenue by product group

7.30 The analysis below focuses on year-on-year trends. Page 9 of the interactive data provides longer historic trends.[159]

First Class revenues and volumes

7.31 First Class single piece letter and parcel volumes fell by 9.5% in 2016-17. This was partly driven by the continuing structural decline in letter volumes, though it is also likely that this was partly the result of switching to Second Class. This decline was higher than in the previous year (7.0% decline in 2015-16).

---

[157] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

[158] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 9, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

[159] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

7.32 First Class single piece letter and parcel revenues fell by 4.9%, compared to a 5.4% decrease in 2015-16. The decrease in revenue was partly attributable to continuing lower relative price increases in 2016-17 compared to prior year, which were not sufficient to offset the structural decline in letter volumes.

Second Class revenues and volumes

7.33 Second Class single piece letter and parcel volumes continued to decline in 2016-17, falling by 5.4% (compared to 6.0% in the previous year). However, revenues increased very slightly in 2016-17 by 0.1% compared to a 2.8% decrease in the prior year. This followed price rises in 2016-17 for Second Class stamps and Second Class meter mail. See Section Five for more details.

7.34 For the fifth year in a row, Second Class volumes continued to decline at a slower rate than First Class volumes. The gap between the relative rate of decline of both products increased in 2016-17. This may be a result of consumers of First Class products switching to Second Class products.

Bulk revenues and volumes

7.35 For retail bulk mail (including PPI[160]) and business parcels, volumes declined by 11.3% and revenues decreased by 1.9%.[161]

7.36 Reported Business access volumes decreased by 0.5% to 7.1bn items, with declining business advertising volumes likely to be a factor contributing to the decrease. However, the price rises in 2016-17 led access revenues to remain in line with previous year revenue at £1.5bn. Access and end-to-end competition is discussed in Section Five.

7.37 Combined access and retail bulk mail volumes declined by 3.8% and revenues decreased by 1.1% in 2016-17. The decline in volumes and revenues was significantly more than that of the prior year volume decline of 1.9% and a revenue increase of 0.3%. The decline in access and retail bulk revenues continues to make up a significant portion of the decline in overall addressed mail (letters and parcels) volumes of 4.2% in 2016-17. It is likely that increased business uncertainty has contributed to lower business advertising spend while some businesses have moved from post and other traditional media to digital media advertising which is often seen as “lower cost media” and quicker to market.

Changes in Reported Business volumes and revenue by format

7.38 Below we consider the year-on-year variances in letters and large letters volumes and revenues (including retail and access), other items (including unaddressed and

[160] Printed postage impressions. These can be used instead of stamps or franking machines and printed directly onto labels or envelopes.
[161] These figures include all Special Delivery items (i.e. they include universal service Special Delivery items as well as contract Special Delivery).

international mail) and parcels (both retail and access).[162] Page 10 of the interactive data shows longer-term historic trends.[163]

7.39 Combined letter/large letter volumes reduced by 5.0% in 2016-17 compared to 3.4% in the prior year. As volume decline accelerated, letter/large letter revenues decreased by 3.4% compared to 2.0% in 2015-16. As discussed above, business uncertainty and long term structural decline are likely to account for declining letter and large letter volume and revenues.

7.40 Reported Business parcel volumes increased by 4.3% in 2016-17 compared to 0.6% in 2015-16, while Reported Business parcel revenues grew by 4.4% in 2016-17 compared to 0.3% in 2015-16. Royal Mail stated the growth was driven by new contract wins in account parcels.[164]

7.41 Other volumes (which mainly consist of unaddressed letters[165] and international mail) decreased by 3.1% (compared to a 4% decrease in the previous year). The decrease was largely accounted for by a decrease in unaddressed volumes from the prior year due to a loss in key customers, bringing it more in line with the long term decrease in volumes. International mail volumes declined from prior year most likely due to increased competition as a result of cross-border trade driven by e-retail.[166]

7.42 Other revenues increased by 0.4%, compared to a 2.7% decrease in the previous year. Although unaddressed letter volumes declined significantly, these generate a small proportion of revenue. The average unit revenue for both international letters and parcels increased in the financial year, driven by improvement initiatives in UK delivery service with China Post, hence the small increase in other revenues.[167]

7.43 We have undertaken some high-level analysis to ascertain how much of the overall decrease in total Reported Business revenue in 2016-17 was due to mix and how much was attributable to price rises.

---

[162] Figures are from unaudited and unpublished submissions provided to Ofcom. Parcel volumes are based on Royal Mail's definition of parcels and include some fulfilment letters and large letters and are therefore not directly comparable to the parcel market volumes collected by Ofcom and reported in Section 6. Ofcom's definition of what constitutes a parcel is set out in paragraph 6.2.

[163] Interactive data can be accessed here: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports/interactive-data-2016-2017

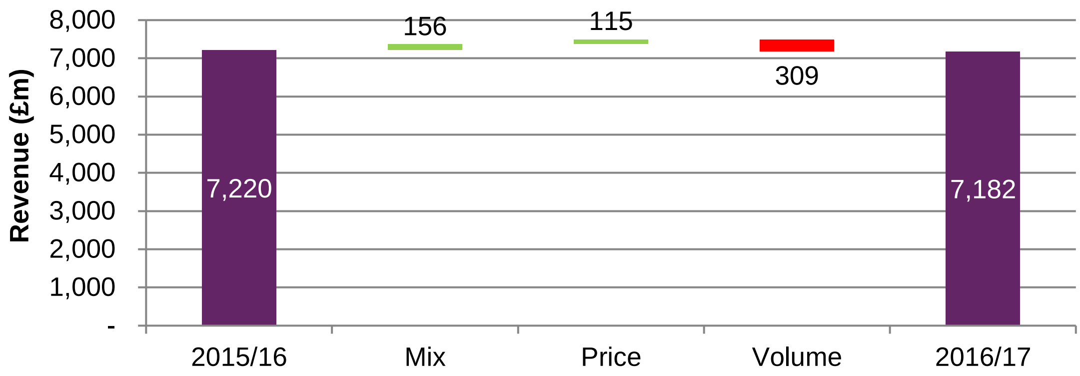
[164] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 21, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

[165] Addressed mail is mail which is either addressed to a specific individual or to a generic recipient (for example, "to the occupier"). All other mail is categorised as unaddressed mail.

[166] Royal Mail Plc, Annual Report and Financial Statements 2016-17, page 2, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

[167] Royal Mail Plc, Annual Report and Financial Statements 2016-17, pages 21-22, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

Figure 7.5 – Contributions of mix, price and volumes to total revenue change



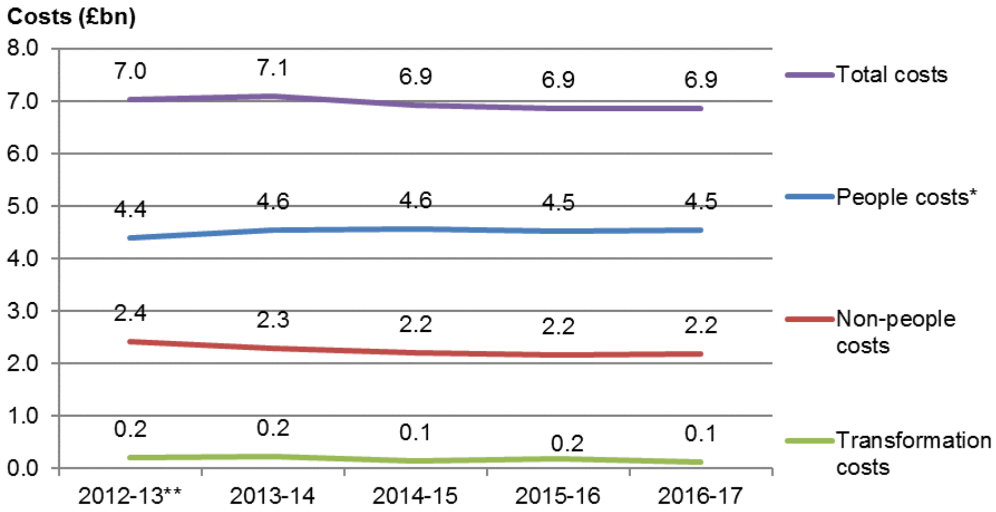
Source: Ofcom analysis

7.44 Our analysis[168] – set out in Figure 7.5 – shows the relative contributions of price increases, overall volume decline and the change in volume mix towards the decrease in total revenue. As with the prior year, this analysis suggests that price increases were not able to offset volume decline in total revenue. Overall, while changes in mix (i.e. an increase in the proportion of mail accounted for by higher average unit revenue products such as parcels) and price increases had some positive impact on total revenue, this was not sufficient to offset the negative impact on revenue from volume decline. This resulted in an overall year on year revenue decline.

[168] The analysis looks at the drivers behind the change in total revenue between 2015-16 and 2016-17. This is calculated with reference to the overall change in revenue for letters/large letters (combined), parcels and other. The calculation is undertaken in three steps: a) to estimate the impact of changes in mix, the 2015-16 total volumes and average prices were used alongside the 2016-17 change in mix (i.e. the proportion of letters/large letters compared to parcels and other); b) to estimate the impact of the change in prices, 2016-17 average prices and mix were used alongside the 2015-16 total volumes; and c) to estimate the impact of the volume decline, total volume was scaled to reflect 2016-17 total volumes along with the 2016-17 prices and mix.

Reported Business costs

Figure 7.6 – Reported Business costs



Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail

** Adjusted for cash pensions charge*

*** Adjusted unaudited 52 weeks*

7.45 Costs, including transformation costs for the Reported Business, fell by 0.1% in 2016-17 to £6.85bn. These costs can be broken down into people costs, non-people costs and transformation costs. The breakdown of costs by these categories is shown in Figure 7.6 and we note that:

- People costs[169] – increased by 0.6% to £4.54bn. Increased salaries as a result of the 1.6% pay rise and increased national insurance costs were partially offset by a reduction in gross hours.
- Non-people costs – increased by 0.8% to £2.18bn, partially due to weakening of Sterling resulting in higher terminal dues[170] and rise in depreciation costs (due to a reassessment of assets useful lives). This increase was partially offset by Royal Mail's cost avoidance activities.
- Transformation costs – decreased by 28.6% to £0.13bn in 2016-17, due mainly to lower voluntary redundancy costs compared to 2015-16. In addition, Royal Mail has told us that, as part of its cost avoidance programme, it has moved some employees from full-time contracts to part-time contracts, which does not involve any transformation costs.

[169] Adjusted to reflect the cash cost of the defined benefit pension scheme rather than the accounting charge.
[170] A payment that the destination postal operator is entitled to collect from the dispatching postal operator for the costs incurred to handle the mail from the dispatching postal operator in the destination country

Summary of financial performance

7.46 We have reviewed a broad set of financial performance data in this section. In summary, the key trends for the 2016-17 financial year were:

- The financeability EBIT margin decreased from 5.0% to 4.6% in 2016-17, due to a reduction in revenue and a slight increase in people and non-people costs, offset by lower transformation costs.
- Although lower than 2015-16, free cash flow continued to be positive in 2016-17 (£0.3bn). Royal Mail still has access to a further (c. £1.02bn) of funds from its undrawn banking facilities.
- Reported Business letter volumes continued to decline, and the rate of decline accelerated from prior year. Parcel volumes and revenues grew year on year, largely driven by new contract wins in account parcels.
- Reported Business revenues continued to decline as structural decline in letters was not offset by increasing parcels revenue.
- Reported Business costs decreased by 0.1% year-on-year due to a slight increase in both people and non-people costs offset by decreased transformation costs. Cost reductions are covered in more detail in Section Eight.

8. Efficiency of the Reported Business

8.1 In this section, we discuss efficiency covering:

- Why it is an important aspect of our monitoring regime;
- Our estimate of Royal Mail's efficiency performance in 2016-17;
- Royal Mail's views on its efficiency; and
- What Royal Mail has been doing to improve its efficiency.

Efficiency is an important aspect of our monitoring regime

8.2 In discharging our duties in relation to post, the PSA 2011 requires us to have regard to the need for the provision of a universal service to be financially sustainable and for it to become efficient within a reasonable period and then remain efficient at all subsequent times.

8.3 In the March 2017 Statement, we concluded that the imposition of price controls or efficiency targets on parts of Royal Mail's business was not necessary. In reaching our conclusion we considered Royal Mail's efficiency performance; the incentives on Royal Mail to make further efficiency improvements in future; and our ability to intervene in such circumstances as Royal Mail failing to make sufficient progress on improving its efficiency. We also took into account the challenges Royal Mail faces in the short term, including the need to reach agreement on pay and pension deals, which may affect its ability to make efficiency improvements in the short term. We highlighted the importance of our monitoring regime in providing a safeguard. Hence, efficiency is one of the key areas we assess as part of the monitoring regime.

Indicators of Royal Mail's efficiency performance

8.4 In the March 2017 Statement, we set out the metrics and framework we proposed to adopt to monitor Royal Mail's efficiency performance.[171] We proposed to use a variety of metrics and adopt Royal Mail's 2015 Business Plan, on which a lot of our analysis was based, as a reference point to review performance.

8.5 Here we report on our high-level indicators of efficiency; the overall change in real costs, the change in cost excluding the impact of inflation, volume, and one-off costs (PVEO[172] analysis), frontline gross hours in delivery and processing and the ratio of revenue to FTE (Full-Time Equivalent) versus cost to FTE.

[171] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, paragraph 3.90, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

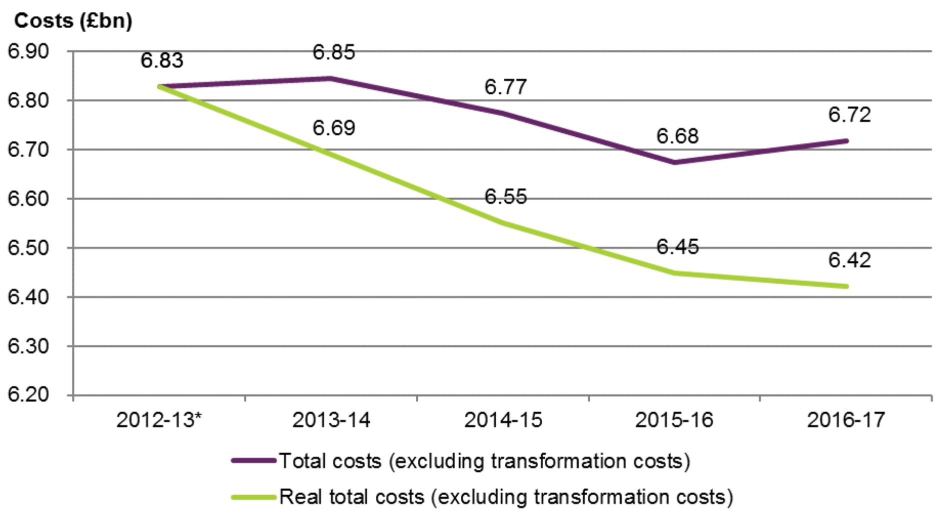
[172] "PVEO" analysis identifies cost movements due to inflation, volume, efficiency and other (one-off activities). Efficiency is calculated as the residual item once other the other three categories of cost movements have been accounted for.

Real cost reduction[173]

8.6 Real cost reduction shows how Royal Mail has reduced people and non-people costs through implementation of its cost avoidance programme and other initiatives. This provides a high-level view as cost changes due to volume and one-off costs are not adjusted for in this metric of efficiency.

8.7 Figure 8.1 shows at an aggregate level, real total costs (excluding transformation costs) fell by 0.4% in 2016-17, which was less than the fall in the prior two financial years of 1.6% and 2.1% in 2015-16 and 2014-15 respectively.

Figure 8.1 – Total real and nominal costs excluding transformation costs



Source: Regulatory financial statements and Ofcom analysis

**52-week period*

Price, Volume, Efficiency and Other Analysis

8.8 PVEO analysis provides a measure of efficiency by disaggregating movements in total costs[174] in terms of price (i.e. inflation) changes, volume effects, efficiencies achieved and other one-off costs.

8.9 Our analysis assumes an inflation index of CPI across all costs. Cost movements due to volume are accounted for on a subset of the total cost base. These correspond to the frontline costs of delivery and processing, payments to Post Office Limited (POL) and international terminal dues. The remainder of cost movements, once one-off items have been accounted for, are assumed to relate to efficiency.

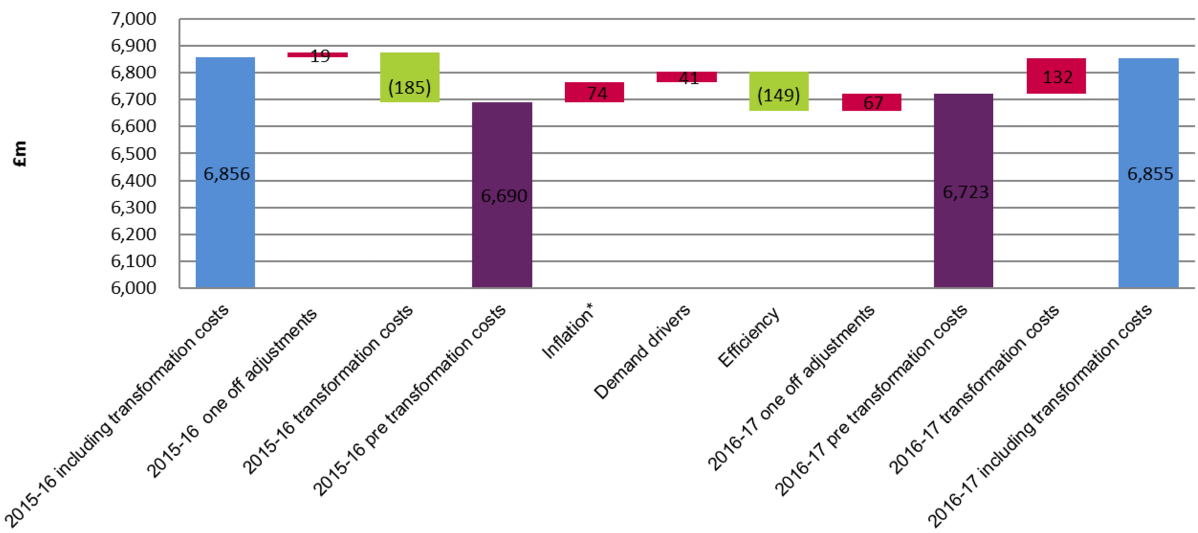
[173] Total costs have been adjusted by CPI based on 2012-13 values.
[174] Reported Business people, non-people (including depreciation) adjusted for cash pension rate excluding transformation costs.

8.10 Our PVEO analysis (Figure 8.2) between 2015-16 and 2016-17 suggests that efficiency achieved in 2016-17 was 2.2%, which was more than that achieved in 2015-16 (1.5%) and less than that achieved in 2014-15 (2.6%).

8.11 The difference in trend between the PVEO view of efficiency and that of overall real costs is largely explained by the one-off costs relating to an increase in Royal Mail's employer National Insurance contributions for employees participating in the Royal Mail Pension Plan of £65 million in the year and an increase in terminal dues by £37 million, reflecting the weaker value of Sterling.[175] These one-off costs increased the costs in 2016-17 but are not adjusted for in the real cost view.

8.12 In 2016-17, Royal Mail spent £53m less (in real terms) on transformation costs than in 2015-16. See Section Seven for discussion on transformation costs.

Figure 8.2 – PVEO bridge 2015-16 to 2016-17



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)

**ONS 12-month trailing average CPI figures (April to March)*

Frontline gross hours (delivery and processing)

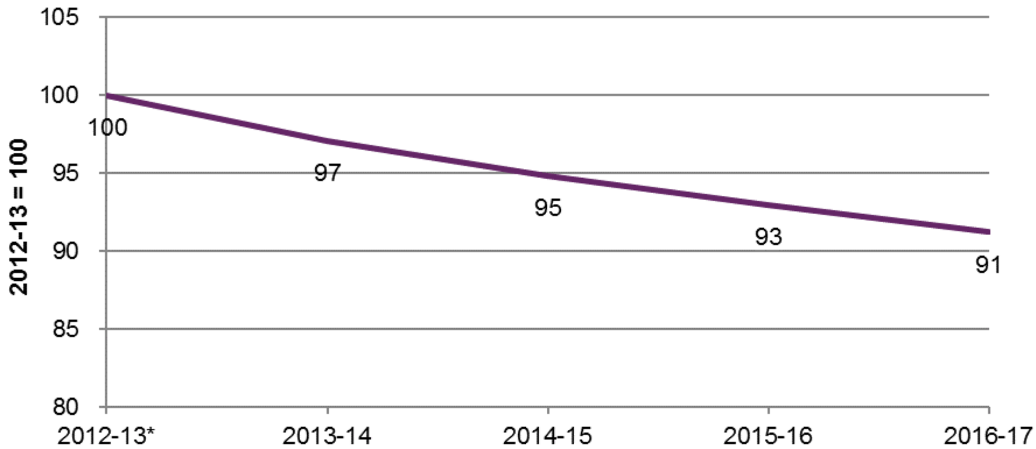
8.13 We analysed the hours paid for by Royal Mail for the key cost areas of its frontline staff, including frontline delivery and frontline processing hours. These are referred to as 'gross hours' and include both worked hours and paid absences such as sickness and leave. The gross hours metric captures year on year changes in hours worked as a result of volume changes as well as efficiency both of or which are relevant to our analysis. We consider the metric of gross hours to be relevant to the consideration of Royal Mail's efficiency.

[175] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 22, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf

8.14 We report on gross hours reduction independently of Royal Mail's own productivity metric. Figure 8.3 shows that Royal Mail achieved a total gross hours' reduction in delivery and processing of 1.9% in 2016-17, slightly down from the prior year reduction of 2.0% and 2.3% in 2014-15.

8.15 Royal Mail now includes hours related to regional distribution centres (RDCs) in its total hours' calculation. To present data on a consistent basis, we have excluded these hours from the calculation. If we were to include them in 2016-17, total hours have still decreased by 1.9% as RDC hours represent a small percentage of total hours and therefore do not influence the calculation significantly.

Figure 8.3 – Gross hours' reduction indexed from 2012-13 to 2016-17



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)

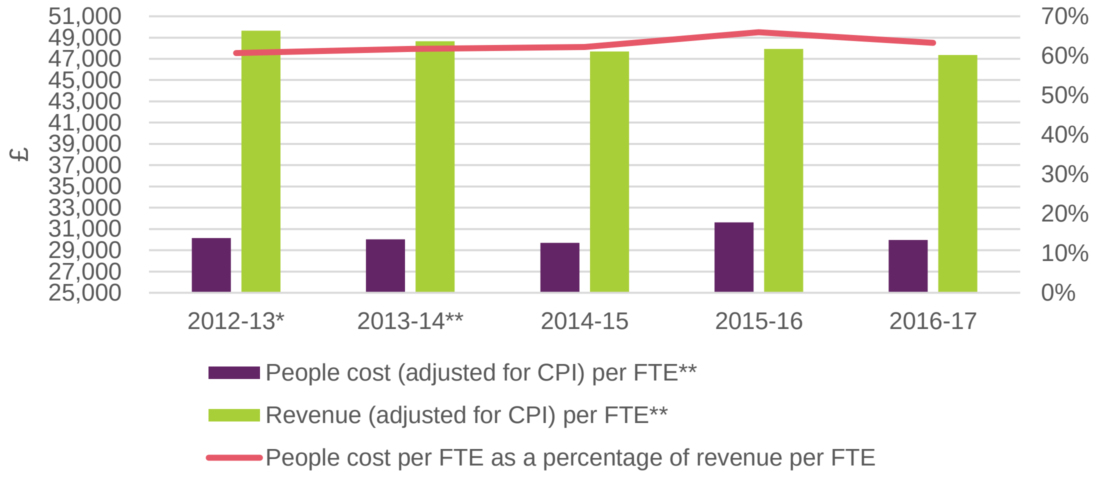
**52-week period*

Revenue and people cost per FTE

8.16 Comparing revenue per FTE and people cost per FTE also provides an indication of efficiency. For example, if revenue per FTE increases at a greater rate than people cost per FTE, it may suggest that each FTE is generating greater revenues than their relative expense. However, there may be other contributory factors, such as price changes, which could influence revenue per FTE, thereby lessening the direct relationship with people cost per FTE.

8.17 People costs represent a significant proportion of Royal Mail's costs. However, it may not provide a reliable indicator of efficiency performance on its own as a company may have high cost per employee but low cost per customer dependent on the company's operations. Nevertheless, it is useful in highlighting a trend.

Figure 8.4 – Reported Business real people cost and real revenue per FTE



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)

FTE data (including agency staff) provided by Royal Mail.

** 53-week data used in calculation*

*** 2013-14 Restated onto 39 hour working week to bring in line with 2014-15*

8.18 We see in Figure 8.4 that people costs per FTE decreased from 2012-13 to 2014-15 before increasing in 2015-16, followed by a further decrease in 2016-17. Revenue per FTE shows a similar trend.

Royal Mail's own statements on efficiency

8.19 Royal Mail has stated publicly that it has achieved its cost reduction targets for the past three consecutive years and its cost avoidance programme is on track, with £225 million of costs avoided in 2016-17.[176]

8.20 In Royal Mail's May 2017 presentation to the market on its UK Core Network,[177] Royal Mail stated it had achieved the following in relation to its cost reduction initiatives:

- all collection routes have been re-planned;
- low volume boxes are now collected on delivery;
- mail centre closure programme has been completed with 38 mail centres remaining at the end of 2016-17;
- introduction of c.1,000 double deck trailers;

[176] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 10, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf
[177] Royal Mail Plc, *UK Core Network Divisional Update*, 18 May 2017, http://www.royalmailgroup.com/sites/default/files/UK%20Core%20Network%20Divisional%20Update_0.pdf

- new delivery methods have been completed and delivery routes reduced to c.60,000 routes; and
- rolled out doorstep scanning, with new Postal Digital Assistants on all routes.

8.21 Royal Mail adopts its own efficiency metric, in its Annual Report and Financial Statements, the method for which differs slightly to Ofcom's methodology and it has stated in its Annual Report and Financial Statements that UKPIL collections, processing and delivery productivity improved by 2.7%,[178] which was at the higher end of its target range of 2.0% to 3.0% improvement per annum.[179] Royal Mail has made certain changes to the way it calculates its efficiency since the 2015 Business Plan was produced. We note that if productivity were to be calculated on the same basis as that set out in the 2015 business plan it would result in a lower number.

Summary of efficiency metrics and rate of improvement

8.22 In summary, the key efficiency trends for the 2016-17 financial year were:

- Total real cost reduction for the Reported Business was 0.4% against 1.6% in the prior year.
- The PVEO analysis indicates an underlying efficiency (excluding transformation costs) of c.2.2% against c.1.5% in the prior year. Efficiency estimated through PVEO analysis also accounts for cost movements due to volumes and one offs.
- Royal Mail reduced total gross hours in delivery and processing by 1.9% in 2016-17, slightly less than the reduction in the prior year.
- People cost per FTE as a percentage of revenue per FTE ratio has decreased from c.66% in 2015-16 to c.63% in 2016-17 reflecting that people cost incurred have increased in comparison to the decline in revenue. See Section Seven for detailed revenue and people costs analysis.
- Royal Mail indicated in its Annual Report and Financial Statements that it has achieved its cost reduction targets for three consecutive years and its cost avoidance programme is on track.[180]

8.23 We continue to believe that the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency. Further progress on efficiency is likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service.[181]

---

[178] Productivity can be considered to be the efficiency of the operational activity, for example, how many items are worked in a given amount of time or by an employee.
[179] Royal Mail Plc, *Annual Report and Financial Statements 2016-17*, page 10, https://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202016-17_0.pdf
[180] Ibid.
[181] Ofcom, *Review of the Regulation of Royal Mail*, 1 March 2017, Annex A3.69, https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf

8.24 Royal Mail has made some efficiency improvements in 2016-17 in a challenging environment. We remain of the view that Royal Mail has the potential to make further efficiency gains in the future, but recognise that the timing and scope for further improvements in performance from the levels achieved in 2016-17 are dependent on the nature of any settlement agreed with its workforce on its future pay and pension arrangements.

A1. Current information collected as part of the monitoring programme

Information for financial monitoring	Frequency
Relevant Group consolidated income statement, balance sheet and cash flow statement	Annually
Royal Mail Strategic Business Plan	Annually
Reported Business income statement, product profitability statements, capital employed statement and cash flow statement (including accounting separation)	Annually
Royal Mail data on compliance with the safeguard cap	Annually
Relevant Group consolidated cash flow projections	Quarterly
Reported Business income statement, product profitability statements, capital employed statement and cash flow statement (including accounting separation)	Quarterly
Royal Mail Costing Manual (including zonal costing) and Accounting Methodology Manual	Quarterly
Other Operators' letters volume and revenue data split by product	Quarterly
Other Operators' parcels volume and revenue data split by product	Annually
Reported Business revenues and volumes report	Monthly
Relevant Group monthly management and KPI performance pack	Monthly

Information for monitoring impact on customers and consumers	Frequency
Royal Mail Quality of Service Reporting	Reported quarterly against annual targets
Royal Mail integrity reporting	Reported quarterly against annual targets
Royal Mail changes to latest delivery and collection times	Three months before change
Royal Mail request to change terms and conditions for USO products	One month before proposed change
Royal Mail request to change prices for USO products	One month before change

Royal Mail notification of changes to terms and conditions for USO products	One month before change
Royal Mail notification of changes to prices for non-USO products	One month before change
Royal Mail changes to compensation policies	One month before change