Review of the Second Class Safeguard Caps 2019

Proposed price caps for Second Class standard letters, large letters and parcels up to 2kg

CONSULTATION:
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Closing Date for Responses: 4 October 2018
About this document

This document sets out our proposals for the continued regulation of Royal Mail’s Second Class stamp prices.

In March 2012, we imposed a price cap on Second Class standard letters. The cap was set at 55p for 2012/13, to increase by no more than inflation (CPI) for seven years (the control period). In July 2012, this safeguard was extended to large letters and parcels up to 2kg, and we imposed a cap covering these products, which was also fixed in real terms (at CPI) for the control period. We refer to these prices caps throughout this document as the ‘safeguard caps.’

In 2017, we decided that the approach to regulation we established in 2012 should remain in place until 2022. This included retaining the safeguard caps, which we considered necessary to ensure a basic universal service is available to all at affordable prices; and to ensure that users of postal services, especially vulnerable consumers, are protected from significant price increases. In that statement, we said we would review the level of the safeguard caps during the 2018/19 financial year.

We have sought to provisionally determine the appropriate level at which the safeguard caps should be set. We are seeking the input and views of stakeholders on our proposals by 4 October 2018, and plan to issue a statement in early 2019.
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1. Executive summary

Overview of our key proposals

We have a duty to secure the provision of a universal postal service

1.1 Postal services are essential to the UK economy and remain a very important means of communication for many people. The majority of consumers value postal services. Older people and those without access to the internet are particularly reliant on the postal service to communicate with friends and family.¹

1.2 Ofcom has legal duties to secure an efficient and financially sustainable universal postal service. The universal service currently requires Royal Mail, as its provider, to deliver and collect letters six days a week, and parcels five days a week, at an affordable and uniform price throughout the UK.

1.3 The regulatory framework for postal services has been in place since March 2012. At the time, the universal service network was making a loss and Royal Mail’s future provision of the universal service was under threat. To help sustain the universal service, which benefits postal users, Ofcom granted Royal Mail greater commercial and operational flexibility to meet these challenges.

1.4 At the same time, to ensure that postal services remained affordable for vulnerable consumers, we imposed safeguard caps on Royal Mail’s retail prices for delivering Second Class standard letters, large letters and small and medium parcels up to 2kg (the “Second Class products”).²

1.5 The safeguard caps are designed to ensure a basic universal service is available to all at affordable prices; and to ensure that users of postal services, especially vulnerable consumers, are protected from significant price increases. The caps are also designed to ensure that Royal Mail can earn a reasonable commercial rate of return on the safeguarded products, and to minimise the effect of the caps on Royal Mail’s pricing freedom. This is to avoid the caps having any material effect on the wider financial sustainability of the universal postal service. The safeguard caps are due to expire in March 2019.

1.6 This consultation sets out our proposals for the regulation of the safeguard caps from April 2019, after the current caps expire. The consultation sets out our market analysis, an assessment of the affordability of the Second Class products, as well as of the commercial flexibility currently afforded to Royal Mail under the safeguard caps.

² There is one cap for standard letters and a separate ‘basket’ cap covering large letters and parcels, and both caps increase in line with the Consumer Prices Index (“CPI”) each year.
Royal Mail has a significant share for letters and parcels

1.7 The UK letters market is in structural decline, with total letter volumes falling by around 16%, or 3% per year, since the safeguard caps were introduced in 2012/13. Royal Mail’s stamped letter volumes have fallen even faster, with end-to-end stamped letter volumes declining by around 11% per year on average. Over the same period, revenues from these products have fallen by 7% per year on average.

1.8 Against the backdrop of a declining letters market, our assessment shows that Royal Mail remains a near monopolist in the delivery of letters. In the small and medium parcels sector, Royal Mail has a significant share, which, combined with an extensive access network and strong brand awareness, gives it a significant degree of pricing power.

1.9 We cannot rely on competition alone to protect consumers from significant price increases, and so a safeguard cap continues to be necessary. In addition, we do not consider that there has been a change in competitive conditions that would suggest altering the structure or scope of the safeguard caps.

Retaining a safeguard cap to protect vulnerable customers

1.10 In determining the appropriate level at which the safeguard caps should be set, our duties require us first to ensure the prices of the products falling within the scope of the safeguard caps are affordable. As part of this review, we have therefore carried out research into whether residential consumers and small businesses are likely to consider the safeguarded products to be affordable, both at current prices and at future higher prices. We have particularly focused on the ability of potentially vulnerable consumers to afford the Second Class products.

1.11 In general, consumer spending on post is low. On average, households spent 70p per week on postal services in 2016/17. This data covers all postal services, and is similar in real terms to expenditure in 2012/13 when the caps were introduced.

1.12 In addition, our own research also indicates that the sum of average spending on each of standard letters, larger letters and small and medium parcels (up to 2kg) was around £3.10 in the last month (also approximately 70p per week). As this data also includes First Class mail and other products, actual expenditure on Second Class services will be lower than these estimates.

1.13 Real disposable incomes have increased moderately since 2013, including for people in the lowest income decile. According to Office for National Statistics data, real disposable incomes for people in the lowest income decile have increased by 7.6% since 2013. Disposable incomes for low income retired households have also increased, albeit at a slower rate (1.9% over 2012/13 to 2016/17). However, our consumer research suggests a minority of households can, at times, struggle to pay for postage at current prices. Any

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3 In assessing affordability we have considered each of these groups, which we categorise as potentially vulnerable consumers: (i) over 65; (ii) without internet access; (iii) rural areas; and (iv) in socio-economic group C2DE.
4 Office for National Statistics data.
1.4 Given low levels of spending, measures such as ‘proportion of disposable income’ may not reflect problems of affordability that arise where consumers need to cut back on other essentials, or decline to send post that they consider essential. There is a range of evidence and no single price point emerges as clearly being the limit of affordability, so assessing affordability requires us to exercise our judgment based on a range of indicators. However, determining the appropriate level of the safeguard caps requires us to identify a specific limit.

1.5 In our judgment, the evidence suggests that having a cap 5% in real terms above the current caps would not render the Second Class products unaffordable, either for consumers generally or for a significant majority of those we have identified as potentially vulnerable. However, the potential for adverse effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase should be considered unaffordable.

Any changes to the standard letter cap should ensure Royal Mail has sufficient commercial flexibility to respond to threats to the universal service

1.6 We believe the universal postal service is likely to remain financially sustainable in the immediate future, but it faces a number of potential challenges. Market conditions and shareholder discipline continue to provide efficiency incentives, and the level of the safeguard caps does not prevent Royal Mail from making a reasonable commercial return on the safeguarded products.

1.7 Since the safeguard caps were introduced, Royal Mail has consistently chosen to price its products below them. When the caps were introduced, the maximum permitted price of a Second Class stamp was 55p. Royal Mail chose not to price to the level of the cap, instead pricing a Second Class stamp at 50p. This provided it with pricing ‘headroom’ of approximately 10%. The current level of the cap now stands at 60p and the price of a Second Class stamp is currently 58p. This means that Royal Mail’s headroom under the standard letter cap now stands at less than 5%, despite Royal Mail increasing prices by only 1-2p per year on average since 2013. By contrast, Royal Mail currently has headroom of approximately 29% under the cap for large letters and parcels up to 2kg, which gives it considerable commercial flexibility.

1.8 If the standard letter cap were left unchanged, Royal Mail’s commercial flexibility to increase prices above inflation would be likely to erode within two to three years. Therefore, raising the level of the standard letter cap would allow Royal Mail increased flexibility in the future.

Our provisional conclusions

1.9 In light of the findings of our affordability assessment in particular, we are proposing to raise the level of the Second Class standard letter cap by 5% in real terms, which would...
take the upper limit of the cap from 60p currently to 65p\(^5\) from April 2019, thereafter increasing each year by CPI. This would re-establish the approximate degree of pricing flexibility that Royal Mail was afforded under the standard letter cap in 2012, which would improve Royal Mail’s ability to respond to unforeseen market developments which may threaten the sustainability of the universal service. Raising the level of the standard letter cap should ensure that its impact on Royal Mail’s pricing flexibility is minimised, and that the safeguard caps do not have any wider impact on the financial sustainability of the universal postal service.

1.20 We do not propose to adjust the level of the cap for large letters and parcels up to 2kg, which will continue to increase each year by CPI. This is because Royal Mail already has considerable pricing flexibility of approximately 29% under this cap, so there is no need to increase its level further, despite the results of our affordability assessment.

1.21 We propose to retain the safeguard caps until we consider it necessary to change them. It is likely that we will next review the levels of the safeguard caps in 2022, when we anticipate that the next review of the regulatory framework for postal services will take place.

**Next steps**

1.22 Ofcom invites responses to this consultation, to reach us by no later than 4 October 2018. The period for this consultation is 10 weeks, consistent with Ofcom’s Consultation Guidelines.

1.23 We anticipate issuing a final statement early in 2019.

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2. Introduction and summary of the regulatory framework

Structure of this consultation document

2.1 This consultation concerns the regulation of the safeguard caps currently imposed in relation to Royal Mail’s Second Class standard letters, large letters and small and medium parcels up to 2kg (the “Second Class products”).

2.2 In this section, we summarise Ofcom’s powers and duties relevant for our consideration and assessment of our proposals in this consultation. We then summarise the background to the review and the current regulatory framework for postal services, of which the safeguard caps form a part. The remainder of this document is as follows:

- section 3 sets out our market analysis;
- section 4 sets out our assessment of affordability;
- section 5 sets out our assessment of the commercial flexibility afforded to Royal Mail under the caps; and
- section 6 sets out our proposals.

2.3 Information on how to respond, including our consultation questions, is set out in Annexes 1 to 4. Annex 5 sets out our proposed modifications to the legal conditions which currently impose the safeguard caps on Royal Mail.

Our powers and specific duties relevant to our proposals

2.4 The legal framework relating to the regulation of postal services is set out in the Postal Services Act 2011 (the “PSA 2011”), which transposes the EU Postal Services Directive\(^6\) into UK legislation.

2.5 Pursuant to the EU Postal Services Directive, the UK is required to ensure that prices for each of the services forming part of the universal postal service are affordable, cost-orientated and give incentives for an efficient universal services provision. In the UK, the universal postal service is a set of services described in an order made by Ofcom under section 30 of the PSA 2011 (the “Universal Service Order”) and it includes the Second Class stamp products subject to the safeguard caps.\(^7\)

2.6 In 2012, Ofcom designated Royal Mail as the universal service provider and (among other regulation) imposed upon it designated universal service provider (“DUSP”) conditions


\(^7\) The Postal Services (Universal Postal Service) Order 2012, SI 2012/936, as amended by The Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108. See \url{https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/upso}. 
using our powers under section 36 of the PSA 2011. The DUSP conditions are intended to secure the provision in the UK of those services set out in the Universal Service Order. As such, they form part of Royal Mail’s universal service obligations.

2.7 When setting tariffs, such as the safeguard caps, in relation to the provision of the universal postal service, under section 36(4) of the PSA 2011, Ofcom must seek to ensure that the prices of the relevant universal postal services:

- are affordable;
- take account of the costs of providing the service; and
- provide incentives to provide the service efficiently.

2.8 The proposals set out in this consultation seek to modify the existing DUSP conditions. Before imposing or modifying a regulatory condition, such as the DUSP conditions, we must be satisfied, pursuant to Schedule 6 of the PSA 2011, that the imposition or the modification in question must:

- be objectively justifiable;
- not discriminate unduly against particular persons or a particular description of persons;
- be proportionate to what it is intended to achieve; and
- be transparent in relation to what it is intended to achieve.

2.9 Ofcom is also required to publish a notification prior to imposing or modifying a regulatory condition. We set out the effects of our proposed modifications in section 6, and our notification itself is published at Annex 5.

2.10 Our power to impose a regulatory condition is also subject to the specific duty in section 29(1) of the PSA 2011, which provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service.

2.11 Section 29(3) provides that, in performing its duty under section 29(1), Ofcom must have regard to the need for the provision of a universal postal service to be:

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

2.12 However, section 29 does not require that Ofcom gives more weight to one of those considerations over the other. We must take them both into account in arriving at our judgment as to how we ought to carry out our functions, including when considering imposing or modifying regulatory conditions.

**General duties**

2.13 Ofcom’s principal duty under section 3(1) of the Communications Act 2003 (the “CA 2003”) is to further the interests of citizens and consumers, where appropriate by promoting competition. This duty, in addition to our specific duty under section 29 of the PSA 2011,
also applies when we carry out our functions in relation to post. The CA 2003 also requires that Ofcom must, in performing its principal duty, have regard to various factors as appear to us relevant in the circumstances, such as the needs of persons with disabilities, of the elderly and those on low incomes (vulnerable consumers).

2.14 In performing our principal duty, we must also have regard, in particular, to the interests of consumers in respect of choice, price, quality of service and value for money. We must further have regard, in all cases, to regulatory principles which should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice.

2.15 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom’s general duties in the CA 2003 in the case of conflict between the two, where Ofcom is carrying out its functions in relation to postal services.

**Securing the Universal Postal Service 2012**

2.16 The current regulatory framework for postal services has been in place since March 2012, when we established a new regulatory framework for postal services (the “2012 Statement”). We removed the previous price control regime implemented by Postcomm in order to give Royal Mail greater commercial and operational flexibility, in recognition of the major challenges facing the postal sector at that time.

2.17 In making that decision, we also recognised the risks associated with giving Royal Mail greater pricing freedom. In particular, we were concerned that Royal Mail would seek to improve its profitability through price rises alone and avoid tackling the considerable efficiency challenge. There was also a related risk that Royal Mail raised prices to such an extent that there could be affordability concerns for vulnerable consumers.

2.18 For these reasons, we concluded that, together with moving away from a price control-based approach to regulation, vital safeguards needed to be put in place to ensure that Royal Mail delivered on our regulatory objectives. We therefore put in place the following new regulatory regime in 2012:

- **an ongoing monitoring regime** to track Royal Mail’s performance in respect of the universal service, efficiency levels, pricing and competition;
- **safeguard caps** including a cap on the price of Second Class stamps10 for standard letters, and separately a basket cap for Second Class stamps on large letters and small and medium parcels up to 2kg11; and

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8 CA 2003, section 3(4)(i).
10 Unless otherwise specified, throughout this consultation, references to Second Class stamps are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.
11 The safeguard cap on Second Class stamp standard letters came into effect on 1 April 2012 and is imposed by DUSP Condition 2, as amended on 18 December 2017 (“DUSP 2”). An unofficial consolidated version of DUSP 2 is available via
• access regulation to maintain access competition given the benefits it can bring, such as lower prices for consumers.

2.19 This review is concerned with the safeguard caps only.

Introduction of the safeguard caps

2.20 The safeguard caps, introduced in 2012, seek to ensure a basic universal service is available to all at affordable prices, and to ensure that users of postal services, especially vulnerable consumers, are protected from significant price increases. Both safeguards caps are due to expire on 31 March 2019.12

2.21 We considered that if the safeguard caps ensured that a universal service product was affordable to vulnerable consumers, it would also be affordable to all residential consumers and small and medium businesses (“SMEs”) that were reliant on universal services and Royal Mail to provide their postal services.

2.22 To ensure that the safeguard caps did not undermine the financial sustainability of the universal service, we sought to minimise the impact of the caps on Royal Mail’s wider pricing freedom and considered that Royal Mail should be allowed to make a reasonable commercial rate of return on the safeguarded products.

2.23 We therefore adopted the following policy objectives in determining the appropriate scope, level and duration of the safeguard caps:

• ensure a basic affordable universal service product is available to all;
• protect vulnerable consumers from ongoing price increases;
• allow Royal Mail to make a reasonable commercial rate of return on the safeguarded product; and
• minimise the effect of the safeguard caps on Royal Mail’s pricing freedom so as to avoid a material effect on wider financeability and/or efficiency incentives (together, the “safeguard caps objectives”).

Scope and level of the cap on Second Class standard letters

2.24 In October 2011 we first consulted on whether a safeguard cap should be introduced with respect to First and/or Second Class stamp products.13 On the basis of research and evidence relating to the usage of stamp products, as well as the need to give Royal Mail...
more pricing flexibility to secure the provision of the universal service, we proposed limiting the scope of the safeguard cap to Second Class standard letters only.

2.25 In March 2012 we decided to impose a safeguard cap on Second Class standard letters set at 55p for 2012/13.\(^{14}\) This represented a 53% increase on the stamp price at the time which was 36p (2011/12 prices). The cap was to apply for seven years and is subject to indexation at the Consumer Prices Index (“CPI”). As noted above, that safeguard cap is due to expire on 31 March 2019.

**Addition of a basket cap for large letters and parcels**

2.26 After a consultation in April 2012,\(^{15}\) we decided in July 2012 to extend the scope of the safeguard caps to create an additional, separate basket cap comprising Second Class large letters and small and medium parcels up to 2kg (the “2012 Basket Cap Statement”).\(^{16}\) We set the level of this basket cap to allow for a 53% increase in the overall price of products within the cap (thereafter increasing each year by CPI), in line with the level of price increase allowed for under the standard letter cap. As noted above, this basket cap is also due to expire on 31 March 2019.

2.27 We considered that designing such a cap is slightly more complex compared to the cap applied to Second Class standard letters, as Royal Mail offered large letter, packet and standard parcel products at a variety of different weights. We decided to adopt a simple basket cap that would give Royal Mail flexibility to set the structure of individual prices subject to a cap on the maximum overall price increase for Second Class stamp large letters and packet products up to 2kg.\(^{17}\)

**Royal Mail’s pricing behaviour since 2012**

2.28 Following our change in approach to regulation in 2012, Royal Mail implemented significant price increases (although still below the level of the caps) across its universal service products in 2012 and 2013. Since then, for standard letters and large letters, it has generally implemented smaller annual price increases at or around the Retail Prices Index (“RPI”) – meaning that prices for Second Class letters have increased slightly each year in real terms (when compared to CPI). Figure 2.1 shows the percentage headroom under the safeguard caps from 2012/13 to 2018/19. Figure 2.2 shows the prices of Second Class standard letter and large letter products in nominal terms over the period 2011/12 to 2018/19.

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\(^{14}\) 2012 Statement. See footnote 11 for DUSP 2.


\(^{17}\) We also made some minor amendments to the basket cap on 28 March 2013 and 18 December 2017, respectively.
Source: Second Class safeguard cap compliance submissions as part of Royal Mail Regulatory Financial Reporting Information.

Source: Royal Mail published prices\textsuperscript{18}/Ofcom Annual Monitoring Update analysis.\textsuperscript{19}

\textsuperscript{18} Prices obtained from Royal Mail website, for most recent price list see: https://www.royalmail.com/sites/default/files/Our-prices-2018-effective-26-March-2018.pdf.

\textsuperscript{19} For our most recent Annual Monitoring Updates see: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports.
2.29 For parcels, Royal Mail implemented size-based pricing in 2013 so that parcels were no longer priced solely by weight but also by their dimensions. This involved differentiating between small and medium sized parcels and led to substantial price increases for very lightweight and medium format parcels. By consolidating the weight steps, Royal Mail also reduced the price of some small but heavier weight Second Class stamp parcels in relation to 2011/12 prices. In 2015, Royal Mail introduced a single price for 0-2kg for small and medium Second Class parcels, which effectively reversed some of these price increases, as shown in Figure 2.3. Since 2015, Royal Mail has generally implemented price increases for its Second Class parcels products, broadly in line with RPI.

Figure 2.3: Second Class small and medium parcel <2kg nominal prices, 2011/12 to 2018/19

Source: Royal Mail published prices\(^{21}\)/Ofcom Annual Monitoring Update analysis.\(^{22}\)

2.30 Table 2.1 shows the impact of the price changes implemented since 2012 including how the consolidation of prices for parcels weighing up to 2kg has caused the prices of parcels

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\(^{20}\) In 2013, Royal Mail introduced new parcel products and size-based pricing. To enable comparison between the current Second Class parcel products, we use proxies based on Royal Mail’s most comparable previous parcel products. The line in this chart is dashed where we rely on these proxies.

For small and medium parcels weighing less than 1kg, we use a proxy of Royal Mail’s Second Class packet product, which had a maximum dimension equivalent to a medium parcel. As this product was available at a range of weight steps up to 1kg, we use a weighted average price. Individual component prices in were as follows: April 2011: £1.33 (0-100g), £1.72 (101-250g), £2.61 (251-500g), £2.16 (501-750g) and £3.15 (751-1000g); April 2012: £2.20 (0-750g) and £3.50 (751-1000g). For small and medium parcels weighing 1-2kg, we use of proxy of Royal Mail’s Standard Parcel up to 2kg.

\(^{21}\) Prices obtained from Royal Mail website, for most recent price list see: https://www.royalmail.com/sites/default/files/Our-prices-2018-effective-26-March-2018.pdf.

\(^{22}\) For our most recent Annual Monitoring Updates see: https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/monitoring_reports.
at some weight steps to increase very significantly while others have fallen. For example, medium parcels weighing 0-100g have increased in price by 280%, whereas small parcels weighing 1-2kg have decreased in price by 33%.

### Table 2.1: Second Class stamp parcel prices, 2011/12 to 2018/19

<table>
<thead>
<tr>
<th>Medium Second Class</th>
<th>Medium Second Class</th>
<th>% change to price from 2011/12-2018/19</th>
<th>Small Second Class</th>
<th>Small Second Class</th>
<th>% change to price from 2011/12-2018/19</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-100g</td>
<td>£1.33</td>
<td>280%</td>
<td>£1.33</td>
<td>£2.95</td>
<td>122%</td>
</tr>
<tr>
<td>101-250g</td>
<td>£1.72</td>
<td>194%</td>
<td>£1.72</td>
<td>£2.95</td>
<td>72%</td>
</tr>
<tr>
<td>251-500g</td>
<td>£2.16</td>
<td>134%</td>
<td>£2.16</td>
<td>£2.95</td>
<td>37%</td>
</tr>
<tr>
<td>501-750g</td>
<td>£2.61</td>
<td>93%</td>
<td>£2.61</td>
<td>£2.95</td>
<td>13%</td>
</tr>
<tr>
<td>751-1kg</td>
<td>£3.15</td>
<td>60%</td>
<td>£3.15</td>
<td>£2.95</td>
<td>-6%</td>
</tr>
<tr>
<td>1-2kg</td>
<td>£4.41</td>
<td>15%</td>
<td>£4.41</td>
<td>£2.95</td>
<td>-33%</td>
</tr>
</tbody>
</table>

Source: Ofcom analysis of Royal Mail Second Class stamp parcel prices from 2011 to 2019.

**Review of the Regulation of Royal Mail 2017**

2.31 In June 2015, we initiated a Review of the Regulation of Royal Mail with the objective of ensuring that the regulation of Royal Mail remained appropriate and sufficient to secure the universal postal service (the “2017 Review”). We published a statement on our final decision in March 2017 (the “2017 Statement”).

2.32 In the 2017 Statement, we concluded that it was appropriate to maintain the current regulatory approach for a further five years, until 2022. We considered that the imposition of wholesale or retail price controls and/or efficiency targets on Royal Mail would not be appropriate in order to secure the objectives of the regulatory regime. Rather, we

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concluded that market conditions and the shareholder discipline which Royal Mail is subject to as a privatised company are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation.

2.33 We also concluded that the Second Class safeguard caps should remain in place to ensure vulnerable consumers can access a basic universal service. This was on the basis that Royal Mail continues to be a near monopolist in single piece letters and therefore has the ability to profitably raise prices above the current level of the safeguard caps. In parcels, we noted that Royal Mail’s significant share of the single piece parcel sector, combined with its extensive access network and strong brand awareness, provides it with a significant degree of pricing power. We therefore concluded that we could not rely on competitive constraints to prevent Royal Mail from raising prices.

2.34 Data from our monitoring regime showed that Second Class revenue had increased at a time when First Class revenue had fallen, which we considered may indicate that some customers now favour cheaper Second Class products, perhaps due to price rises and the desire to economise. We considered that this highlights the importance of maintaining the safeguard caps as an affordability measure, in order to ensure that consumers, in particular vulnerable consumers, continue to have access to a universal service at affordable prices.

2.35 We concluded that the safeguard caps should be retained to ensure vulnerable consumers can access a basic universal service. However, we also committed to review the level of the safeguard caps during the course of the 2018/19 financial year, so we could take an informed view based on the most up-to-date market information and any changes to the financial sustainability of the universal service and/or the prices vulnerable consumers can afford prior to the expiry of the safeguard caps in March 2019.

Aim of this review

2.36 As noted above, we committed in the 2017 Review to review the level of the safeguard caps during the course of the 2018/19 financial year.

2.37 This consultation forms part of our review and sets out our proposals for the continued regulation of the Second Class products taking account of up-to-date market information and our latest assessment of the financial sustainability of the universal service and of the prices we consider vulnerable consumers can afford, with a view to securing our safeguard caps objectives.

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26 2017 Statement, paragraphs 3.179 and 4.46.
2.38 In carrying out our analysis for the purposes of this consultation we have relied on several sources, including:

- data from a *Residential Omnibus Survey*\(^{27}\) commissioned by Ofcom in April 2018 relating to consumers’ postal expenditure and sending patterns (“Residential Omnibus Survey”);
- data from Ofcom’s *Business Postal Tracker 2018* relating to January-December 2017\(^{28}\) and April 2018\(^{29}\) on small and medium business’ postal expenditure and sending patterns (“Business Postal Tracker”);
- data from Ofcom’s *Residential Postal Tracker 2018*\(^{30}\) relating to January-December 2017 on usage and affordability (“Residential Postal Tracker”);
- data on household disposable incomes, expenditure on postal services, expenditure on other comparator items and household expenditure from the Office for National Statistics’ (“ONS”) *Living Costs and Food Survey*\(^{31}\);
- data received from Royal Mail in response to an information notice sent on 15 May 2018, pursuant to our information gathering powers under section 55 of the PSA 2011, relating to Royal Mail’s pricing decisions, consumer research, price- and cross-elasticities and costs (“s.55 Notice”); and
- data received from various parcel operators in response to an information notice sent on 13 April 2018, pursuant to our information gathering powers under section 55 of the PSA 2011, relating to volumes and revenues (“s.55 Market Data Notices”).

2.39 We believe the objectives set out at paragraph 2.23, which underpinned our review in 2012, remain appropriate for the purposes of the present review.

2.40 We currently expect to make our decision on these matters following our review of responses received to this consultation in a statement, to be published in early 2019.

**General impact assessment**

2.41 The analysis presented in this consultation represents in its entirety an impact assessment, as defined in section 7 of the CA 2003.

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2.42 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy making. This is reflected in section 7 of the CA 2003, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom’s activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom’s approach to impact assessments, see our guidelines, *Better Policy Making: Ofcom’s approach to Impact Assessment*.32

2.43 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the CA 2003) is secured or furthered by or in relation to what we propose.

**Equality impact assessment**

2.44 In carrying out our functions, including with regard to the safeguard caps under review, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation;
- advance equality of opportunity between different groups; and
- foster good relations between different groups

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

2.45 Such equality impact assessments also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 mentioned above.

2.46 We have therefore considered what (if any) impact the proposals in this consultation may have on equality. Having carried out this assessment, we are satisfied that our proposals are not detrimental to any group defined by the protected characteristics set out in paragraph 2.44 above.

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3. Market analysis

Introduction and summary

3.1 This section assesses the market context and competitive constraints in the segments of the postal market where the safeguard caps apply. We discuss the single piece standard letter, large letter and parcel market segments in turn. We focus on the competitive constraints in each of these market segments, from both the supply and demand side. We also consider interactions between the different products within scope of the caps.  

3.2 We last carried out an assessment of competitive dynamics in the letter and parcel sectors in our 2017 Review referred to in section 2 of this consultation. This assessment drew the following conclusions (which are also relevant to this current review):

- Royal Mail faced limited competitive constraints on its prices for single piece standard letters and large letters; and
- Royal Mail had the ability to significantly increase the prices of single piece parcels, particularly at certain weight steps.

3.3 The 2017 Review concluded in particular that we could not rely on competitive constraints to prevent Royal Mail from raising prices for single piece letters and parcels. We therefore decided that it would be necessary to retain the safeguard caps to ensure vulnerable consumers can continue to access a basic universal service at an affordable price.

3.4 Our analysis set out in this section focuses on assessing the extent to which competitive constraints have changed since we concluded our 2017 Review. In summary, we remain of the view that competitive constraints are insufficient to prevent Royal Mail from raising the prices of the safeguarded products significantly, and that a safeguard cap continues to be necessary. Also, we do not think there has been a change in competitive conditions that would suggest altering the structure or scope of the safeguard caps.

Standard letters

Context

3.5 Within the single piece letters sector, there are two main standard letter products which are available to consumers for domestic services: Royal Mail’s First and Second Class universal letters services. Businesses are likely to have access to a wider range of products

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33 In exercising our powers under section 36 of the PSA 2011 to impose or modify the safeguard caps under the DUSP conditions, we are not required to carry out a market analysis and to assess market power in accordance with the principles of competition law. To conduct this review, we do not consider it necessary to formally define relevant markets or reach findings on the existence of any positions of dominance. We focus instead on an assessment of the extent of competitive constraints in the market segments in question, particularly to inform our understanding of the extent to which market forces might impact on Royal Mail’s ability to set its prices for the products covered by the safeguard caps.

34 Royal Mail specifies that standard letters weigh no more than 100g and have maximum dimensions of: 24cm x 16.5cm x 5mm.
including meter mail (which is also within the scope of the USO, but outside the scope of the safeguard cap) or bulk mail, subject to meeting minimum volume thresholds.

3.6 Customers can pay for universal postal services in three main ways: stamps\textsuperscript{35}, meter and on account. Paying by meter allows customers to access cheaper prices, but is usually only suitable for higher volume users due to the cost of investing in a meter.

3.7 Overall standard letter volumes have been in decline. Royal Mail’s end-to-end standard letter stamp volumes fell by around 11\% per year on average from 2012/13 to 2017/18 (revenues fell by 7\% per year on average). This decline was consistent across First Class and Second Class letters, though higher than the volume and revenue decline across all stamp, meter and account letters (which was around 8\% and 5\% respectively per year on average over the same period).\textsuperscript{36}

3.8 A significant contributor to this declining trend is e-substitution – the replacement of communications previously sent by mail with electronic alternatives. This is a structural change occurring as technology has enabled alternative means of communicating. This process of switching from written to electronic communication would be likely to occur to a large extent independently of pricing and competition in the letters sector. Once any initial set up costs are incurred, the incremental cost of electronic communications is very low. However, we note there may be other barriers to the use of e-substitutes, such as internet literacy, which may constrain the extent they present viable alternatives for some users. Royal Mail has previously argued that significant price increases could lead to a tipping point or step-change in the rate of e-substitution, particularly for larger users. In our 2017 Review, we concluded that there was limited evidence that e-substitution represented a meaningful constraint on Royal Mail’s ability to profitably raise prices, particularly for moderate price increases.

\textbf{Supply-side constraints}

3.9 Royal Mail remains a near-monopolist in Second Class single piece stamped standard letters. It is the only operator offering these end-to-end services on a national scale, although there are a number of smaller scale end-to-end operators delivering in specific geographic areas. We continue to estimate that Royal Mail has a volume share of over 99\% in single piece letters. We estimated in 2016/17 that just 0.1\% of total addressed letters volumes were delivered by end-to-end operators other than Royal Mail.\textsuperscript{37}

3.10 As discussed in our 2017 Review, following Whistl’s exit from end-to-end delivery in 2015, we do not consider that there is likely to be another end-to-end entrant of sufficient scale and scope to provide a significant level of letter delivery competition to Royal Mail in the foreseeable future. As the prospect of significant rival entry has diminished, potential

\textsuperscript{35} As noted in section 2, this includes postage purchased online, though for standard letters this is priced the same as a stamp purchased in person.

\textsuperscript{36} Royal Mail Regulatory Financial Reporting Information.

constraints on Royal Mail are weaker than when the safeguard caps were introduced in 2012, when the prospect of end-to-end entry and expansion was more credible.

3.11 Accordingly, we consider that neither existing competitors nor the threat of future entry are likely to constrain Royal Mail’s pricing for Second Class stamps for standard letters.

Demand-side constraints

3.12 A consumer or business considering sending a Second Class standard letter using a stamp, has, in theory, the following main alternative mail or non-mail options:

- sending the item using a Royal Mail First Class stamp;
- sending the item using a different Royal Mail payment method (for example a meter product) or a competing provider using Royal Mail access products, subject to meeting the necessary volume threshold; and/or
- not sending the item by mail, possibly due to sending it using an alternative electronic form of communication.

Alternative mail products

3.13 Alternative stamp mail products do not provide a direct competitive constraint on Second Class stamps, as Royal Mail is also the only (retail or wholesale) provider of these alternatives. Accordingly, switching between these products does not necessarily affect Royal Mail’s overall profitability, and it is able to set prices across products to maximise overall revenues.

3.14 Interdependencies between products could affect Royal Mail’s pricing decisions and may lead to some degree of indirect competitive constraint, to the extent that other products are constrained by alternatives (that do not involve Royal Mail at retail or wholesale levels) and there are interlinkages between these products and Second Class stamps.

3.15 Royal Mail’s main alternative stamp product to Second Class is its First Class stamp product. This provides a superior service to Second Class (delivery within one working day compared to three working days) and is priced higher to reflect this. This price differential affects switching between the two products, and Royal Mail has chosen to maintain a price differential of around 9p in recent years.

3.16 Alternative payment methods (such as a meter product) are only likely to be a viable option for businesses, given that customers need to send significant volumes of letters for it to be economic to incur the upfront cost of a meter machine. Again, Royal Mail has historically maintained a differential between stamp and meter prices, and the level of this differential affects switching between the products.

3.17 If managing switching between products is desirable to Royal Mail, this may mean it would not implement a standalone price increase for Second Class stamps. However, this would be unlikely to constrain a general increase in prices across products that maintained differentials. This is how Royal Mail has historically implemented price changes, and
evidence from Royal Mail’s internal documents shows that broadly maintaining differentials between products is a consideration when setting prices.38

3.18 Further, these interlinkages would only provide an indirect competitive constraint if some linked products were constrained by other alternatives that do not involve Royal Mail. For higher volume users, Royal Mail’s meter and bulk products may face some competition from operators using access products. If this constrains meter pricing, this may in turn affect the pricing of stamp products to the extent that maintaining differentials between products is important. However, this indirect constraint is not likely to be strong. Only a subset of customers would send sufficient volumes of mail to make them attractive to a competing access provider. In any case, Royal Mail retains the vast majority of revenues from letters delivered via access products.

E-substitution

3.19 Switching to a digital alternative may have upfront costs for some consumers – for example buying a smart phone or putting in place an electronic customer communications platform (such as a business investing in new systems). However, for consumers who already have the means of using an electronic alternative the incremental cost is very low and would be substantially cheaper than using postal services.

3.20 As we concluded in our 2017 Review, e-substitution has led to a decline in single piece standard letter volumes, including Second Class stamps. The structural decline in standard letters means that falling volumes do not necessarily represent responses to price increases. Ongoing volume and revenue decline is not necessarily evidence of constraints on pricing. Once in place electronic alternatives have a substantially lower cost than post at current prices. A further price increase in post would therefore be unlikely to trigger substantial additional switching for those customers that have electronic alternatives in place, as there is already a significant differential between post and electronic alternatives. As 88% of consumers have internet access,39 this is likely to be the case for the majority of consumers.

3.21 For consumers who would need to incur upfront costs before switching to a digital alternative, this may be more likely in response to a significant stamp price increase that might trigger such an investment. This may lead Royal Mail to act conservatively, as it may be uncertain about the level of price increase that might trigger additional e-substitution. Royal Mail’s internal documents on their pricing decisions demonstrate a consideration that larger price increases may have a greater risk of triggering e-substitution.40

3.22 In addition, there may be several factors that affect the likelihood of e-substitution for certain customers or mail types. A lack of e-literacy could be a barrier to some consumers

38 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
40 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
using electronic alternatives, whilst businesses would need to both invest in systems and gain customer consent to switch to communicating electronically. Additionally, it is likely that there will remain a proportion of standard letters for which digital alternatives are not a good alternative. For example, Royal Mail has estimated that e-substitution rates are higher for transactional and advertising mail (≥3% per annum) than for social mail (≥2% per annum\(^1\)), suggesting that e-substitution is more likely for certain letter types.

3.23 Absent very significant price increases, it is not clear that Royal Mail’s prices have a significant impact on the rate of e-substitution. There is limited evidence that e-substitution represents a meaningful constraint on prices. Royal Mail’s price increases have historically been profitable, accounting for structural decline due to ongoing e-substitution.\(^2\) Royal Mail’s internal documents demonstrate that price increases for stamped letters have generally translated into average unit revenue increases.\(^3\) Where it has, for example, considered not increasing meter prices to attempt to slow the rate of e-substitution, it has concluded that the volume retained would be unlikely to compensate for the forgone revenue and has decided to raise prices instead.\(^4\)

**Price sensitivity**

3.24 In this sub-section we consider the available evidence on whether mail consumers are sufficiently sensitive to price increases to make it unprofitable for Royal Mail to increase its Second Class stamp price. Initially we consider responses to consumer surveys, although these tend to overstate the responsiveness to price increases. Then we consider Royal Mail’s own estimates of price sensitivity (the elasticity of demand – the ratio of the percentage change in volume to a percentage change in price).

3.25 Our market research suggests that in general a small minority of consumers are price sensitive in relation to letters. 10% of residential consumers said they would send fewer standard letters and large letters in response to a 10% price increase and a further 2% said they would not send any letters because the price would be unaffordable. 14% said they would send fewer letters, and 3% said they would not send any, in response to a 20% price increase.\(^5\)

3.26 Amongst businesses, 34% said they would send fewer letters in response to a 10% price increase and 1% said they would not send any letters. 51% said they would send fewer letters in response to a 20% price increase, and 3% said they would not send any.\(^6\) This includes a significant proportion who said they would switch to electronic alternatives where they could (29% and 48% respectively). However, only 4% of businesses said they

\(^1\) Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
\(^2\) 2017 Statement, paragraph 3.118.
\(^3\) Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
\(^4\) Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
\(^5\) Residential Omnibus Survey, Q9 and Q10. Question concerned letters, so covers both standard and large letters.
\(^6\) Business Postal Tracker, April 2018, QN7a and QN7b. Question concerned letters, so covers both standard and large letters.
had responded to recent moderate postage price rises by sending less post. Of businesses that had recently decreased their volume of post, only 12% cited cost as the reason. This supports a view that, for businesses, moderate increases are less likely to trigger a significant reduction in volumes, but significant increases may lead them to consider implementing electronic alternatives.

3.27 These survey responses provide mixed evidence on whether a price increase would be unprofitable. We treat, however, this evidence from market research with a degree of caution, given that survey responses to hypothetical questions, such as the ones mentioned above, have a tendency to overstate actual price responsiveness. In addition, our research does not provide an indication of the extent of volume response envisaged by those who would send fewer letters.

3.28 Royal Mail’s own elasticity estimates suggest that social and transactional mail are price inelastic, and transactional mail has a low elasticity for small price changes ([<]). Royal Mail estimate social and transactional mail make up over 95% of Second Class Stamp letter volumes.

3.29 Given potential issues in interpreting answers to hypothetical survey questions, we place greater weight on Royal Mail’s estimates of price elasticity. This evidence suggests that, particularly for residential consumers, few would respond to a significant price increase for a Second Class standard letter by choosing not to send the item. Substantial price increases may increase the likelihood of businesses considering electronic alternatives. Accordingly, we consider that price sensitivity is unlikely to competitively constrain Royal Mail’s prices, particularly for price increases in line with those Royal Mail has implemented in recent years.

Royal Mail’s pricing behaviour

3.30 Our 2012 Statement introduced a safeguard cap for standard letters at 53% above prevailing prices, with subsequent annual increases by CPI. In 2012, Royal Mail implemented significant increases in standard letter prices, though not up to the level of the safeguard cap. Since this increase, Royal Mail has implemented price increases for standard letters of around RPI each year. As RPI has generally been above CPI, this has led to a gradual narrowing of the headroom under the safeguard cap. Royal Mail’s current prices remain 5% below the cap, though it has effectively used most of the headroom granted in 2012.

3.31 As we concluded in our 2017 Review, Royal Mail’s price increases for letters have historically been profitable. Royal Mail’s internal documents indicate that it generally expects that moderate price increases for single piece letters would be revenue enhancing. Though the cap for standard letters is not currently binding, there is little

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47 Business Postal Tracker, April 2018, QN8.
48 Business Postal Tracker, April 2018, QS3a.
49 Royal Mail response dated 6 June 2018 to s.55 Notice, [<].
50 For example, documents prepared for the consideration of 2018/19 price changes suggested that [<<]. Royal Mail response dated 6 June 2018 to s.55 Notice, [<<].
evidence that prices are constrained by competition, or that further price increases would not be profitable.

3.32 Royal Mail appears to have taken a cautious and gradual approach to price increases. This would be consistent with uncertainty about the potential impact of larger price increases, including the potential to trigger a step-change in the rate of e-substitution. As in our 2017 Review, we continue to consider that political pressure, negative publicity and our monitoring regime act as additional constraints on Royal Mail’s pricing of single piece letters to some extent. This is supported by considerations in Royal Mail’s internal documents, which highlight the risk of political intervention or negative publicity as part of a range of factors taken into account when considering stamp price increases.\(^{51}\) This, however, does not mean that Royal Mail would be unable to continue to profitably increase prices, though it may choose to manage uncertainty by implementing changes in a gradual manner.

**Conclusion on competitive constraints on standard letters**

3.33 Royal Mail remains a near-monopolist in the provision of single piece standard letters. Whilst the risk of accelerating e-substitution may cause Royal Mail to be cautious in implementing larger price increases, there is limited evidence that e-substitution represents a meaningful constraint on Royal Mail’s ability to profitably raise prices for single piece letters (particularly with respect to smaller price increases). We therefore remain of the view that Royal Mail faces only limited competitive constraints on its prices for single piece letters.

**Large letters and parcels**

**Large letters**

**Context**

3.34 Products within the large letter\(^{52}\) sector mirror those described above for standard letters – i.e. there are stamp, meter and online variants although the stamp and online variants are priced identically. Meter products are cheaper by comparison. The prices of large letter products also vary by weight step.\(^{53}\) As well as being used to deliver larger paper items, large letters are also used for sending other lightweight, flat items.

3.35 Overall large letter volume trends show a small increase in large letter Second Class stamp volumes and revenues from 2012/13 to 2017/18 – 2% and 4% respectively on average per year. First Class stamp large letter volumes showed a moderate decline (6% in volumes and 4% in revenues on average per year).\(^{54}\) As residential consumers use large letters relatively

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\(^{51}\) Royal Mail response dated 6 June 2018 to s.55 Notice, [X].

\(^{52}\) Royal Mail large letters can weigh no more than 750g and maximum dimensions cannot exceed 35.3cm x 25cm x 2.5cm.

\(^{53}\) These are 0-100g, 101-250g, 251-500g and 501-750g.

\(^{54}\) Royal Mail Regulatory Financial Reporting Information.
infrequently, this trend may be driven by businesses downtrading to Second Class products as the price of both First and Second Class stamps has increased.

3.36 As with single piece standard letters, e-substitution is leading to the decline in some types of large letter volumes, and this is at least somewhat independent of pricing. The increase in Second Class large letters may reflect the use of large letters for fulfilment, and the increase in volume of mail sent for this purpose.

Supply-side constraints

3.37 We consider that supply side constraints for large letters are the same as those for standard letters. Royal Mail remains a near monopolist and the only operator offering these services on a national scale. The prospect of significant rival end-to-end entry has diminished. Accordingly, we consider that neither existing competitors nor the threat of future entry are likely to constrain Royal Mail’s pricing for Second Class stamps for large letters.

Demand-side constraints

3.38 A consumer or business considering sending a Second Class large letter using a stamp, has the following main alternative options:

- send using a different Royal Mail First Class stamp product;
- send using a different Royal Mail payment method (e.g. meter) or a bulk provider, subject to minimum volume thresholds;
- reformat the item so that it can be sent as a standard letter; and/or
- not sending the item by mail, possibly due to sending it using an alternative electronic form of communication.

Alternative mail products

3.39 As discussed above for standard letters, Royal Mail maintains differentials between its Second Class large letter stamp prices and its other large letter products to manage switching between products. As for standard letters, whilst this may constrain standalone price increases in Second Class stamp prices, it would be unlikely to constrain a general increase in prices across products.

Reformatting the item

3.40 Customers sending a large letter-sized item may be able to reformat the item so that it could be sent as a cheaper standard letter. Therefore, standard letter prices may provide some constraint. However, this would only be suitable for some items sent by large letter. Given the current price differentials between these product sets, it is likely that this would have already occurred if it could be done at a low cost, and further moderate widening of the price differential is unlikely to trigger significant additional reformatting. This constraint on large letter pricing is therefore likely to be small.
3.41 In addition, whilst this effect may constrain a standalone increase in price to a limited extent, this would be unlikely to constrain a general increase across standard letters and large letters. Royal Mail’s historic pricing behaviour and internal documents indicate that it takes a coordinated approach to pricing its products to avoid this risk.55

E-substitution and price sensitivity

3.42 As for standard letters, whilst e-substitution may be driving some decline in volumes this is not necessarily a result of price increases. Absent very significant price increases, it is not clear that Royal Mail’s prices have a significant impact on the rate of e-substitution. Market research suggests that many residential customers are not very price sensitive. Royal Mail elasticity estimates are also low.56 This suggests that Royal Mail could implement further price increases without having a significant impact on volumes.

Parcels

Context

3.43 Parcel products vary by weight and size. The safeguard cap applies to Royal Mail’s Second Class stamps for small and medium57 parcels weighing up to 2kg. Within the single piece parcels sector, there are two main Royal Mail products which are available to consumers for domestic services: First and Second Class universal services. Businesses are likely to have access to a wider range of products including meter mail (which is also within the scope of the USO but outside the scope of the safeguard caps) or bulk mail, subject to meeting minimum volume thresholds. Figure 3.1 below summarises these products.

55 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
56 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
57 Maximum dimensions 45cm x 35cm x 16cm and 61cm x 46cm x 46cm respectively.
In line with our 2017 Review, we define single piece parcels as any parcel delivery service which is available for purchase by any member of the public and can be used for sending an individual parcel. We categorise any parcel product that does not fall within the scope of the single piece definition as a bulk parcel product. Bulk products are typically used by businesses to deliver large volumes, and usually include negotiated volume discounts. Such products are not generally available to consumers, given that few consumers are likely to meet the minimum volume requirements which are pre-requisites to access these services, and are therefore outside the scope of this review.

Single piece parcels can be sent from access points or collected from a sender’s premises. We group both these types together in this analysis.

Overall, we estimate that single piece parcel volumes are increasing steadily, at around 2% in 2017/18. We estimate that single piece parcels weighing 2kg or less increased by around 3%.

Royal Mail has the largest share of all parcel volumes and revenues. However, unlike in letters, competitors have a material presence in downstream delivery and provide competing end-to-end services.

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58 This is intended to include products that are sold through parcel reseller websites, such as Parcels2Go, as well as parcels services that are resold to users at a discounted price through marketplace websites, such as eBay. This definition excludes items sold on Amazon Marketplace that are delivered by Amazon Logistics. This is because Amazon Logistics delivery services are only available to those selling products through the Amazon website and are also required to be purchased in combination with other Amazon services (such as warehousing).

59 For example, Post Offices or other retail outlets where consumers can drop off (and collect) parcels.

60 Ofcom calculation using parcel operator responses to s.55 Market Data Notices.

61 Including services offered through Royal Mail Group’s Parcelforce Worldwide arm. Ofcom calculation using parcel operator responses to s.55 Market Data Notices.
3.48 Consumers sending single piece parcels with Royal Mail can either take the item to a Post Office or place it in a pillar box – if the item is small enough and they have applied the correct postage. Royal Mail also offers click and collect services via the Post Office and increasingly via other Royal Mail customer service points such as Delivery Offices. Parcelforce offers a premises collection service as well as allowing customers to drop off parcels via the Post Office.

3.49 Competing operators offer similar products to those within the scope of the safeguard cap, but these may have some differences in delivery timescales, maximum dimensions or other features. For example, most competing providers offer tracking as standard.

**Supply-side constraints**

3.50 Royal Mail retains a very high share of single piece parcels weighing 2kg or below. We estimate this was between 80-90% of both volumes and revenues ([3]>[1]) in 2017/18. Royal Mail also has a high share of single piece parcels as a whole, which we estimate was between 70-80% of volumes and revenues ([3]>[1]) in 2017/18.62 These shares have remained broadly constant over the past two years.

**Figure 3.2: 2017/18 volume shares of single piece domestic parcels <2kg**

[3]>[1]

*Source: Ofcom calculation using parcel operator responses to s.55 Market Data Notices.*

**Figure 3.3: 2017/18 revenue shares of single piece domestic parcels <2kg**

[3]>[1]

*Source: Ofcom calculation using parcel operator responses to s.55 Market Data Notices.*

3.51 Our market research data aligns with these estimates – reported use of Royal Mail for parcels is significantly greater than that of any competitors. In our recent Residential Omnibus Survey, when asked which companies residential consumers had ever used to send a parcel, 89% of those that had sent any small or medium parcels up to 2kg in the past month said they had used Royal Mail. The next most cited competing postal operators were Hermes (37%) and Yodel (25%).63 Of respondents to our Residential Postal Tracker

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62 Ofcom calculation using parcel operator responses to the s.55 Market Data Notices – these shares are higher than reported in our 2017 Statement, as, in the s.55 Market Data Notices some providers have reclassified volumes, previously reported as single piece, as bulk. We lack data to make reliable comparison with earlier years, though we note Royal Mail has generally retained a significant majority of estimated volumes in this segment in previous years (for example, see 2017 Statement, paragraph 3.145).

63 Residential Omnibus Survey, Q14A.
who had sent parcels in the previous month, 92% had used Royal Mail. Hermes, the next most named competitor to Royal Mail, was used by just 16% of respondents.\textsuperscript{64}

3.52 Competing operators have established their own networks of access points, often by partnering with convenience stores and high street retailers to provide a drop-off service. In many cases these networks also provide collection services for e-commerce deliveries. Table 3.1 below summarises the main access point networks available for sending single piece parcels.

### Table 3.1: Access points

<table>
<thead>
<tr>
<th>Parcel operator</th>
<th>Number of access points</th>
<th>Access points locations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Post Office Royal Mail / Parcelforce</td>
<td>11,500</td>
<td>Post Office branches/outlets</td>
</tr>
<tr>
<td>CollectPlus Yodel</td>
<td>7,000</td>
<td>Convenience stores (Paypoint network)</td>
</tr>
<tr>
<td>MyHermes ParcelShop Hermes</td>
<td>4,500</td>
<td>Convenience stores</td>
</tr>
<tr>
<td>UPS Access Point UPS</td>
<td>2,800</td>
<td>Convenience stores</td>
</tr>
<tr>
<td>DPD Pickup DPD</td>
<td>2,500</td>
<td>Halfords, Pharmacy chains, Doddle</td>
</tr>
<tr>
<td>DHL Service Points DHL</td>
<td>1,200</td>
<td>Highstreet/retail park shops</td>
</tr>
<tr>
<td>InPost parcel lockers InPost</td>
<td>1,200</td>
<td>Convenience stores, petrol stations, etc...</td>
</tr>
<tr>
<td>Parcelforce depots Parcelforce</td>
<td>54</td>
<td>Parcelforce depots</td>
</tr>
<tr>
<td>UK Mail (iPost Parcels) UK Mail</td>
<td>50</td>
<td>UK Mail depots</td>
</tr>
</tbody>
</table>

*Source: Parcel operator websites (correct as of July 2018).*

3.53 As noted in our 2017 Review, alternative access point networks have grown in recent years, largely driven by operators wishing to expand their pick up and drop off networks to increase first time delivery success rates. However, these alternative networks tend to have lower coverage in rural areas compared to urban areas, meaning the Post Office (and

\textsuperscript{64} Residential Postal Tracker, QD5.
therefore Royal Mail\textsuperscript{65}) is likely to still be the primary option available to consumers in many rural areas, and these customers may find it difficult to access services from alternative providers. Third party reports provided by Royal Mail show that the Post Office has a smaller share of outlets in more densely populated areas (such as London), and a greater share in less densely populated areas (such as Scotland, Wales and the South West).\textsuperscript{66} However, where competition is present, even where it is largely limited to urban areas, it will tend to constrain Royal Mail’s prices to some extent. Since Royal Mail is obliged to offer a geographically uniform price for products falling within the universal service this has the potential to benefit all consumers.

3.54 In addition, using alternative providers’ services often requires customers to access the internet to pay for postage and generate a label. This is not the case for parcels sent via the Post Office.

3.55 Most alternative providers are focussed on bulk services (for example, delivering online retail orders) or heavier weight single piece parcels. As demonstrated by the volume and revenue shares above, there is currently limited competition for Royal Mail in single piece parcels up to 2kg. Approaches to pricing suggest only a limited number of operators seek to compete with Royal Mail for single piece parcels weighing up to 2kg, though some of the higher priced operators offer an enhanced service to Royal Mail’s Second Class products, such as providing faster delivery or courier pick up.

Table 3.2: Competitor products and pricing

<table>
<thead>
<tr>
<th></th>
<th>0-1kg</th>
<th>1-2kg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Mail Second Class</td>
<td>£2.95 (small);</td>
<td>£2.95 (small);</td>
</tr>
<tr>
<td></td>
<td>£5.05 (medium)</td>
<td>£5.05 (medium)</td>
</tr>
<tr>
<td>Hermes parcel shop drop</td>
<td>£2.79</td>
<td>£3.99</td>
</tr>
<tr>
<td>off (up to equivalent of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royal Mail Medium Parcel</td>
<td></td>
<td></td>
</tr>
<tr>
<td>size)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yodel/Collect+ drop off</td>
<td>£3.99</td>
<td>£3.99</td>
</tr>
<tr>
<td>(up to equivalent of Royal</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mail Medium Parcel size)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK Mail/ipostparcels (depot</td>
<td>£5.09 (small);</td>
<td>£5.09 (small);</td>
</tr>
<tr>
<td>drop off)</td>
<td>£6.29 (medium)</td>
<td>£6.29 (medium)</td>
</tr>
<tr>
<td>APC (courier pick-up)</td>
<td>£13.80</td>
<td>£13.80</td>
</tr>
<tr>
<td>DHL</td>
<td>£16.95-£23.95 (size dependent)</td>
<td>£16.95-£23.95 (size dependent)</td>
</tr>
</tbody>
</table>

\textsuperscript{65} Royal Mail and Post Office have an exclusivity agreement that is due to run until 2022, whereby Post Office is Royal Mail’s exclusive retail outlet.

\textsuperscript{66} Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
### 3.56

Though alternative operators currently have a limited presence in lightweight single piece services, there remains potential for other operators to expand into this area, especially if they have already established access point and delivery networks for bulk fulfilment or click and collect services. However, we have seen limited expansion to date. As highlighted in our 2017 Statement, other carriers saw a rapid increase in single piece volumes between 2013 and 2015\(^{67}\), but since then their rate of growth has slowed, as demonstrated by Royal Mail’s consistently high share of volumes and revenues.

### 3.57

In addition, Royal Mail has an advantage over alternative providers due to its established foot delivery network. This provides it with a cost advantage, particularly for small and lightweight parcels which can fit through a letter box, as these can easily share the letter delivery network (small and lightweight parcels are a sub-set of services in the safeguard cap). In addition, Royal Mail’s universal services are exempt from VAT, whereas competitors’ parcel services are not. [\(<\).]\(^{68}\)

### 3.58

In summary, whilst competing operators are able to offer equivalent services to Royal Mail’s Second Class stamp small and medium parcels, these operators have had limited success to date in terms of gaining a significant share of the services covered by the safeguard cap. They would have to overcome Royal Mail’s cost and VAT advantages in lightweight parcels in order to do so. We consider that, given Royal Mail’s share of the sector, supply-side constraints are unlikely to prevent Royal Mail from raising prices.

**Demand-side constraints**

### 3.59

A consumer or business considering sending a single piece parcel (weighing up to 2kg) with Royal Mail’s Second Class stamp products has, in theory, the following main alternative options:

- sending the item using Royal Mail’s First Class stamp product;
- sending the item using a different Royal Mail payment method (e.g. meter);
- sending the item using a competing parcel operator; and/or
- not sending the item in the mail (potentially due to electronically transferring content instead).

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\(^{67}\) 2017 Statement, paragraph 3.129.

\(^{68}\) [\(<\).]
Alternative parcel products offered by Royal Mail

3.60 Royal Mail maintains differentials between its Second Class parcel stamp prices and its other products to manage switching between products. For parcels, this also includes differentials between weight steps and format sizes. As for letters, whilst this may constrain standalone price increases in individual Second Class stamp prices, it would not constrain a general increase in prices across products.

3.61 Whilst meter products can be used for parcels, in practice users of meter services are primarily senders of letters rather than parcels. Just 2% of Royal Mail’s total Second Class meter volumes were parcels in 2017/18.69 Royal Mail’s internal documents show that it considers that parcels are posted via a meter for convenience, and thus are relatively inelastic, though may still be targeted by competitors.70 Royal Mail’s modelling of switching between products also illustrates that a proportion of stamp volumes would be expected to switch to meter products in response to a moderate price increase, though in our view this proportion is small.71

Send using competing parcel operator

3.62 As discussed above, competing operators account for a relatively small proportion of the single piece parcels sector up to 2kg by both volume and revenue. Whilst many do offer these products, few are price competitive with Royal Mail’s Second Class products. Nevertheless, the threat of consumer switching to competing providers with similar tariffs may constrain Royal Mail’s pricing to some degree. Royal Mail’s internal documents indicate that it considers rivals’ pricing when setting its own prices, and is concerned about the prospect of entry and expansion of competitors in the single piece parcel sector. Royal Mail considers that overcapacity in the market increases the risk of losing volume to competitors.72

3.63 However, Royal Mail has significant brand advantages over its near-competitors in single piece lightweight parcels. Our Residential Omnibus Survey indicates that 95% of respondents were aware of Royal Mail, but just 61% were aware of Hermes.73 There is a similar picture amongst businesses, with 75% naming Royal Mail when asked to think of postal providers, compared to 16% naming Hermes.74 Royal Mail’s own consumer research also shows this advantage in brand strength. Consumers are significantly more aware of Royal Mail, more likely to consider using Royal Mail and more likely to actually use Royal Mail.75

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69 Royal Mail Regulatory Financial Reporting Information.
70 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
71 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
72 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
73 Residential Omnibus Survey, Q13 – prompted. This aligns closely with our Residential Postal Tracker, which shows 96% of consumers are aware of Royal Mail and 71% aware of Hermes.
74 Business Postal Tracker, April 2018, QV3 – unprompted.
75 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
Price sensitivity

3.64 Our consumer research suggests that price responsiveness is relatively low in parcels. 9% of residential consumers indicated they would send fewer parcels in response to a 10% price increase, and 3% indicated they would not send any parcels. Just 10% said they would send fewer, and 4% said they would not send any, in response to a 20% price increase. Among business users, just 3% said they would send fewer parcels in response to a 10% or a 20% price increase.

3.65 As for letters, we treat this evidence from market research with a degree of caution, given that survey responses to hypothetical questions have a tendency to overstate actual price responsiveness. In addition, our research does not provide an indication of the extent of volume response envisaged by those who would send fewer parcels.

3.66 Royal Mail’s own elasticity estimates suggest similar or less price responsiveness at a market level. It estimates that demand for small and medium parcels is relatively inelastic (estimated as $\gamma$).

3.67 This suggests that the risk is low that consumers would respond to a price increase for parcels by choosing not to send the parcel (except perhaps in certain circumstances where digital alternatives are available such as electronically transferring content as opposed to sharing content via a physical CD or DVD transmissible by post). Accordingly, this is not likely to provide a strong constraint on Royal Mail’s pricing.

Pricing behaviour for large letters and parcels

3.68 Our 2012 Basket Cap Statement introduced a basket cap covering large letters and parcels, at 53% above prevailing prices, with subsequent annual increases by CPI. For large letters, Royal Mail’s pricing strategy was in line with its approach to standard letters, introducing significant increases in 2012 and smaller regular increases in subsequent years. Although large letter prices have increased substantially, they have remained below the maximum that would be permitted under the basket safeguard cap.

3.69 Royal Mail made changes to its products to introduce size-based pricing for parcels in 2013. This increase in prices reduced the headroom under the basket cap to 10% in 2014/15. These changes meant that some parcel prices effectively increased by more than 100%. This allowed competitors, particularly Hermes, to gain a foothold in this market segment, which resulted in a decline in single piece parcel volumes for Royal Mail. In response, Royal Mail made some changes to its pricing structure which resulted in reductions to some parcel prices, including the introduction of a flat 0-2kg rate for small and medium parcels. It has since proceeded in a cautious manner raising prices by around 2% per annum in recent years. Royal Mail internal documents state that this has allowed it to slow

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76 Residential Omnibus Survey, Q11 and Q12.
77 Business Postal Tracker, April 2018, QN7c and QN7d.
78 Royal Mail response dated 6 June 2018 to s.55 Notice, $[\gamma]$.
79 Royal Mail response dated 6 June 2018 to s.55 Notice, $[\times]$.
volume decline and return to growth in parcels.\textsuperscript{80} Royal Mail retains significant headroom under the basket safeguard cap which it could use to increase parcel prices significantly.

3.70 This may suggest that competitors could constrain Royal Mail’s parcel pricing to some degree, but there is little evidence that competitor responses have had a significant impact on Royal Mail, except in the case of very significant price increases such as those that affected some shapes and weights when size-based pricing was introduced in 2013. Whilst uncertainty around the prospect of entry and expansion by competitors may lead Royal Mail to take a cautious approach to price increases for parcels, there is little to suggest that moderate increases would be unprofitable.

3.71 This uncertainty around potential market responses to further significant pricing changes, and the risk of unforeseen responses to their pricing strategy may constrain Royal Mail’s pricing decisions and discourage it from making radical changes to pricing. However, it is not clear that this risk would constrain more moderate price increases, particularly given the limited price competition that Royal Mail currently faces.

Conclusion on competitive constraints in large letters and parcels

3.72 In large letters, Royal Mail remains a near-monopolist in the provision of these services. Whilst the risk of accelerating e-substitution may cause Royal Mail to be cautious in implementing significant price increases, there is limited evidence that e-substitution represents a meaningful constraint on Royal Mail’s ability to profitably raise prices for single piece large letters (particularly with respect to smaller price increases). We therefore remain of the view expressed in our 2017 Review that Royal Mail faces only limited competitive constraints on its prices for single piece large letters.

3.73 In parcels, Royal Mail’s strong market position, widespread access point network, VAT exemption and strong brand recognition gives it a significant degree of pricing power for Second Class parcels weighing up to 2kg. This is greater still for small and lightweight items that can fit through a letter box, as Royal Mail has cost advantages for these items. We remain of the view that we cannot rely on competitive constraints to prevent Royal Mail from raising prices for the parcel products subject to the safeguard cap. Whilst Royal Mail is not currently pricing to the cap, it has made use of a significant proportion of the headroom under the cap, and has tended to increase prices roughly in line with RPI in recent years. The risk of unforeseen responses to their pricing strategy may lead Royal Mail to act conservatively.

3.74 Our assessment is that Royal Mail continues to have a significant degree of pricing power in both single piece large letters and small and medium parcels up to 2kg. We consider that, absent regulation, Royal Mail would be able to increase prices materially. However, uncertainty about e-substitution (in letters) or competitor responses (in parcels) may act to limit the scale of price increases implemented at one time.

\textsuperscript{80} Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
Variation in competitive conditions within large letters and parcels

3.75 To inform our proposals on the scope of future regulation, we have considered the extent to which competitive conditions differ between products within the direct scope of the basket cap (Second Class large letters and small and medium parcels up to 2kg).

3.76 Royal Mail faces some competition in small and medium parcels, but virtually no competition in large letters. However, in both instances, Royal Mail remains by far the largest operator with a significant degree of pricing power.

3.77 If competitive conditions differed materially, and the basket cap was currently ‘biting’ on Royal Mail, retaining the products under the same basket cap could distort competition. This is because it would give Royal Mail a strategic incentive to rebalance prices across the basket products to meet the basket cap constraint by setting higher prices in products where it faces a limited threat of competition, and lower prices where it faces greater competition. This could allow it to foreclose competition, whilst maximising revenues within the constraint of the basket cap.

3.78 However, the evidence we have does not suggest sufficient differences in competitive conditions such that a different approach to parcels and large letters would be appropriate. In both sectors, Royal Mail has a very high share, substantial cost and scale advantages, and limited competitive constraints on its pricing. Further, Royal Mail continues to price significantly below the basket cap, suggesting it does not currently have this incentive. We recognise there is potential for some segments to experience a growth in competition, such that it may be appropriate in future to amend the scope of the safeguard caps.

3.79 We have also considered whether interactions between products are sufficiently strong that a control on some products, such as Second Class standard letters, would constrain the prices of other products sufficiently such that these other products can be removed from the cap. There are clear interactions between First and Second Class products and payment types (e.g. stamp or meter) within sectors. Consumers trade off between products based on their requirements and expected volumes. This is demonstrated by Royal Mail’s attempts to broadly maintain consistent differentials and their considerations when setting prices (based on its internal documents).

3.80 However, given current differentials between standard letters and large letters and parcels of different weights, it is unlikely that an increase in a smaller or lighter product would be materially constrained by the risk of switching to a heavier product. Current significant differentials also mean that, if switching to a smaller or lighter product was possible, consumers would likely already have done so. A moderate widening of the differential would be unlikely to prompt significant additional switching. Accordingly, we consider that a cap on both standard letters and large letters and parcels remains necessary.

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81 Royal Mail response dated 6 June 2018 to s.55 Notice, [X].
Conclusion

3.81 Overall, we remain of the view set out in our 2017 Review that competitive constraints are still insufficient to prevent Royal Mail from raising prices for the products under the safeguard caps.

3.82 Royal Mail remains a near-monopolist in standard letters and large letters, with little threat of entry. The risk of triggering a step-change in e-substitution may act to constrain very substantial price increases, but is unlikely to provide protection against smaller increases.

3.83 Though there is more competition in the parcels sector, this is limited for small and lightweight single piece items, where Royal Mail retains a very high share of volumes and revenues. Past competitor responses to very large price increases may lead Royal Mail to act cautiously, but this is unlikely to constrain Royal Mail from implementing moderate price increases.

3.84 We also consider that there is not sufficient evidence of differences in competitive conditions to suggest that a change in the structure or scope of the safeguard caps is necessary.

Question 1. Do you agree with our market analysis? Please state your reasons and provide evidence to support your view.
4. Assessing affordability

Introduction and summary

4.1 As discussed in section 2, when imposing tariffs to be used for determining prices for universal postal services, section 36 of the PSA 2011 requires us to ensure the prices of the relevant services are affordable, take account of the costs of providing the service and provide incentives to provide the service efficiently. Accordingly, the first two of our four safeguard caps objectives mentioned in section 2 are to review the level of the caps to ensure a basic affordable universal service product is available to all, and to protect vulnerable consumers from ongoing price increases. Assessing affordability is therefore a very important component of our assessment.

4.2 This section sets out our assessment of the extent to which consumers, especially potentially vulnerable consumers, are likely to consider the safeguarded products to be affordable both at current prices and at prices above the level of the caps. The next section considers, among other things, the cost of providing the services and the extent to which Royal Mail faces efficiency incentives.

4.3 In summary, there is a range of evidence and no single price point emerges as clearly being the limit of affordability. However, determining the appropriate level of the safeguard caps requires us to identify a specific limit. This requires regulatory judgment, balancing different evidence and the likely effects on different groups of consumers. In our judgment, the evidence suggests that an increase of 5% in real terms above the current level of the caps would not render the Second Class products unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable. The potential for adverse effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase should be considered unaffordable.

Methodology for assessing affordability

4.4 In 2013, we published our report *The Affordability of Universal Postal Services*[^82] (the “2013 Report”) in which we set out our approach to assessing whether universal postal services are affordable. It included our findings with respect to better understanding consumers’ use of and needs for post and how we intended to monitor the affordability of universal postal services on an ongoing basis.

4.5 In the 2013 Report our key guiding principle in assessing the affordability of the universal postal services was to have regard to the consequences for a consumer of either sending post at current prices or choosing not to send post because of current prices, whilst noting

that no one approach can be definitive about whether the price of a good or service may be considered affordable.

4.6 The 2013 Report set out the parameters we applied for determining affordability for each of residential consumers and SMEs. We summarise below our approach in the 2013 Report to assessing the affordability of universal postal services for each group, before turning to our updated assessment of affordability for the purpose of reviewing the safeguards caps.

Residential consumers

4.7 Our approach to assessing affordability in the 2013 Report identified two ways in which postal services might be considered unaffordable for residential consumers, namely where:

- consumers reduce their purchases of postal services due to the price; and/or
- consumers continue to buy postal services, but have to cut back on other essential expenditure.

4.8 In assessing the affordability of universal postal services for residential consumers, we considered that a range of evidence could be relevant, in particular:

- data on consumers’ postal send and spending patterns, broken down by consumer type and over time;
- data comparing expenditure on postal services against expenditure on other ‘comparator’ items and household expenditure from ONS’ Living Costs and Foods Survey, broken down by consumer type and over time; and
- consumer research that we commissioned to explore whether low income and vulnerable consumers face constraints on their ability to send post, and if so, whether they suffer detriment as a result.

4.9 In the 2013 Report, we focused our analysis on certain consumer groups of interest, as follows:

- those with low income;
- those living in rural areas (as they may have a higher reliance on post); and
- other consumers who may be particularly reliant on postal services. For example, those who are aged over 65, or who have a disability, or who have no or limited access to the internet, or recent immigrants to the UK.

4.10 We focused on these groups because we maintained the view that certain consumer groups may be particularly vulnerable with respect to sending post, either because they have a particularly high need to send universal service post products, and/or because they lack the means to do so. We also considered that if the evidence were to suggest that

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84 2013 Report, paragraph 3.23.
85 We note that there is a significant degree of overlap between some of these groups.
86 ‘No internet’ means consumers that have no broadband access at home.
vulnerable consumers in general were able to afford universal postal services, we could be more confident that all consumers on average could afford universal postal services.

**SMEs**

4.11 The 2013 Report set out that universal postal services may be unaffordable for a business if the prices of the postal services jeopardised the commercial viability of a business on an ongoing basis, in ways that a business is unable to avoid. Our approach considered the extent to which the prices of universal postal service products might materially harm a business’ commercial position. We determined that this would be the case where the three following conditions were met:

- universal postal services were a critical input to the business’ commercial proposition;
- there was a lack of good alternatives to universal postal services available to the business; and
- the cost of universal postal services was important for the business’ financial position.

**Our approach to assessing affordability in this review**

4.12 We have decided to maintain the approach to assessing affordability that we adopted in 2013 for the purposes of the present review. This approach is designed to take account of the way in which these consumers use universal postal services, as well as how the affordability of universal postal services has previously been assessed. It also considers stakeholder views. Furthermore, the assessment is informed by approaches to assessing affordability in other sectors, as well as the way in which regulatory authorities in EU Member States have assessed whether universal postal services are affordable. We consider that such an approach remains relevant and appropriate for the purposes of this review.

4.13 We recognise that defining a precise point at which the Second Class products may become unaffordable is challenging. As in 2013, we have considered a range of indicators which inform our overall assessment of affordability. We take our 2013 Report as a starting point, and focus particularly on relevant developments since that assessment which could indicate a change in the level of affordability of postal services, with a particular focus on potentially vulnerable consumers and SMEs likely to encounter affordability issues.

4.14 The 2013 Report considered the affordability of all universal postal services. This review is focused particularly on the affordability of the Second Class products subject to the safeguard caps. Where possible, we have sought to focus our consumer research and data collection on the Second Class products. To the extent that our research relates to the affordability of the universal postal services more broadly, this is indicated in our analysis. We consider that considerations of the affordability of universal services also apply to the affordability of the specific Second Class products subject to the safeguard caps.
4.15 In order to update our assessment, we have collected the following data relating to residential consumers (and in particular those belonging to potentially vulnerable groups):

- data from our Residential Omnibus Survey on consumers’ postal expenditure and sending patterns, broken down by consumer type;
- data from our Residential Postal Tracker on consumers’ postal expenditure and sending patterns affordability; and
- data on household expenditure and disposable incomes from ONS’ Living Costs and Foods Survey, broken down by consumer type and over time.

4.16 For SMEs, we have collected data from our Business Postal Tracker on postal expenditure and sending patterns. Our general approach to assessing affordability for SMEs remains to identify businesses which are potentially (but not necessarily) at risk of finding Second Class postal services unaffordable.

Affordability for residential consumers

Use and expenditure for postal services

4.17 In this sub-section, we discuss the way in which residential customers use Second Class postal services. We look at both expenditure and the number of items sent. We also assess the extent to which this differs between different consumer groups, in particular those who may be more likely to be vulnerable.

4.18 Information on usage of postal services comes from our Residential Postal Tracker, Residential Omnibus Survey and the ONS Living Costs and Food Survey.

4.19 Our Residential Omnibus Survey suggests that on average consumers sent 2.3 letters or small and medium parcels in the past month, around two-thirds of which are standard letters, though a majority say they sent no post in the last month.

4.20 Our Residential Postal Tracker suggests a slight decline in volume of post sent from 2012/13 to 2017, from around 7 to around 6 items of post per month on average. A like-for-like comparison, taking into account a change in methodology in our tracker, suggests

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87 For the purposes of this assessment we categorise consumers in the following groups as potentially vulnerable, consumers: (i) over 65; (ii) without internet access; (iii) rural areas; and (iv) in socio-economic group C2DE (together, potentially vulnerable consumers).
89 Residential Omnibus Survey, Q2 – data from April 2018 fieldwork. As postal use is seasonal this represents a non-peak month rather than an average across the year.
90 In 2012/13, tracker data was collected exclusively using face-to-face interviews. We now collect data using a mix of online and face-to-face surveys which is then weighted to the overall UK population. This like-for-like comparison uses only the data collected via face-to-face interviews. Our Residential Postal Tracker appears to show greater levels of usage in
a greater decline, with an average of 4.9 items sent per month in 2017. 18% of respondents said they had not sent any post in the last month in 2012, compared to 28% in 2017.\textsuperscript{91}

4.21 In general, consumer spending on post is also low. ONS data shows on average households spent 70p per week on postal services in 2016/17.\textsuperscript{92} This data covers all postal services and is similar in real terms to expenditure in 2012/13.

4.22 Our Residential Omnibus Survey aligns with ONS estimates, and indicates that the sum of average spending on each of standard letters, large letters and small and medium parcels (up to 2kg) was around £3.10 in the last month (or approximately 70p per week).\textsuperscript{93} This estimate (and ONS data) also includes First Class mail and other products, so actual expenditure on Second Class services will be lower than these estimates.

4.23 There are significant differences in usage and spending by consumer group, as illustrated in Figures 4.1 and 4.2 below. In relation to those consumer groups which are likely to comprise vulnerable consumers, we observe the following\textsuperscript{94}:

- Consumers aged over 65 and consumers without internet access both send more mail items than average, and a greater proportion of these items are standard letters. As a result of their reliance on cheaper, more basic postal services, total spending for these customer groups is below average.
- Consumers living in rural areas send slightly more mail items, and report slightly higher average spending.
- Consumers in socio economic group C2DE send fewer items than average, and spend less on postal services than average.

4.24 Some of these trends are in line with our 2013 findings, particularly that older consumers tend to send more postal items and lower income consumers tend to send less than average.

\textsuperscript{91} Residential Postal Tracker, QD1.
\textsuperscript{92} Data taken from Living Costs and Food Survey, table 3.2E: ‘Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK.’ https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditureasapercentageoftotalexpenditurebyequivaliseddisposableincomedecilegroupoeccdmodifiedscaleuk32e.
\textsuperscript{93} Residential Omnibus Survey, Q1 – includes those that spent nothing on post.
\textsuperscript{94} Residential Omnibus Survey, Q1 – includes those that spent nothing on post.
Use of postal services is seasonal for many consumers, with a significant increase in average use and spending over the Christmas period. For many consumers, there are peaks in postal spending, which could make issues of affordability more acute at these times. For
example, on average, consumers surveyed in Q1 reported spending £10.50 in the last month, compared to an annual average of £9.30 across 2017.  

4.26 ONS data on household expenditure (as shown in figures 4.3 and 4.4) indicates that expenditure on post for all households and low income households has remained small and largely constant since 2012/13, in both level and share of total expenditure. Spending by consumers aged 65 or over is higher than average and appears to have increased in 2016/17. However it remains a small share of total expenditure.

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95 Residential Postal Tracker, QD1.
96 Data taken from Living Costs and Food Survey, table 3.2E: ‘Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK.’
97 Data taken from Living Costs and Food Survey, table A11: ‘Detailed household expenditure by age of household reference person, UK.’
In general, this evidence indicates that post continues to make up a small share of household expenditure, and that little has changed since 2012/13. There is some indication that some potentially vulnerable consumers may send more items or spend more on postal services than was the case in 2012/13, but overall expenditure by these groups remains broadly in line with 2012/13 levels.

**Disposable income and comparator spending**

In this section, we assess changes in household incomes and expenditure since 2012/13. We also consider trends in expenditure on comparator products. This provides an
indication of the resources available to households and whether spending on post might be constrained.

4.29 Our calculations, from ONS data\(^9\), summarised in table 4.1 suggest that real disposable incomes have increased by 8.9% increase across all households over the period 2012/13 to 2016/17. Real disposable incomes have increased for average retired households at a faster rate than non-retired households. When looking at lower income consumers, who may be more likely to be vulnerable, real disposable incomes have increased by 7.6% for the bottom decile and 9.5% for the bottom quintile. Low income retired households have experienced a slower growth in disposable incomes; 1.9% for the bottom decile and 3.0% for the bottom quintile.

<table>
<thead>
<tr>
<th>Table 4.1: Cumulative growth in real disposable incomes by group, 2012/13 to 2016/17</th>
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<tbody>
<tr>
<td><strong>Bottom decile</strong></td>
</tr>
<tr>
<td>All households</td>
</tr>
<tr>
<td>Non-retired households</td>
</tr>
<tr>
<td>Retired households</td>
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</tbody>
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*Source: Ofcom calculations from ONS Living Costs and Food Survey. We use equivalised household incomes to control for the effect of changes in household size. 2016/17 prices, adjusted using CPI.*

4.30 ONS data\(^9\) also shows that total household expenditure has increased by 2.4% over the same 2012/13 to 2016/17 period, by 2.2% for the bottom income decile and by 2.5% for households where the reference person is aged 65 or over.

4.31 Overall household expenditure and expenditure on comparable communications services (namely, telephone services) has increased by more in absolute terms than spending on post. This holds for both all households and the bottom income decile. This is summarised in Table 4.2 below.

\(^9\) Data taken from *Living Costs and Food Survey*, tables 2, 2a, 3, 3a, 4 and 4a: ‘Effects of taxes and benefits on household income.’  

\(^9\) Data taken from *Living Costs and Food Survey*, table 3.2E: ‘Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK’  
[https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditureasapercentageoftotalexpenditurebyequivaliseddisposableincomedecilegroupoeccdmodifiedscaleuk32e](https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditureasapercentageoftotalexpenditurebyequivaliseddisposableincomedecilegroupoeccdmodifiedscaleuk32e) and table A11: ‘Detailed household expenditure by age of household reference person, UK’  
### Table 4.2: Absolute change in real household expenditure, £/week, 2012/13 to 2016/17

<table>
<thead>
<tr>
<th></th>
<th>All households</th>
<th>Bottom decile</th>
<th>Aged 65 and over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure on post</td>
<td>+0.1</td>
<td>0.0</td>
<td>+0.3</td>
</tr>
<tr>
<td>Expenditure on telephone services</td>
<td>+1.1</td>
<td>+1.1</td>
<td>+1.2</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>+12.9</td>
<td>+5.7</td>
<td>+9.9</td>
</tr>
</tbody>
</table>

Source: Ofcom calculations from ONS Living Costs and Food Survey, 2016/17 prices, adjusted using CPI.

4.32 Taken together, this evidence indicates that households (including potentially vulnerable households) have allocated increased income and expenditure to items other than post. This suggests that spending on postal services was not, and has not become, constrained by income for most households. The increase in household incomes and total expenditure, including for the lowest income decile, since our 2013 Report may suggest that the affordable level of prices for postal services has increased in line with this.

### Market research on affordability

4.33 In this sub-section, we consider consumer research data on the interaction between spending on post and spending on other essentials. We asked residential consumers whether in the last three months\(^{100}\) they had had to reduce their use of postage stamps to afford essentials like food or heating, or whether they had cut back on such essentials to afford stamps.

4.34 Our 2016/17 Residential Postal Tracker data shows 8% reported reducing use of post to afford essentials, and 3% had to cut back on essentials to afford post.\(^{101}\) This proportion does not appear to be significantly greater for potentially vulnerable consumer groups. The equivalent figures for 2012/13 were 3% and 2% respectively\(^{102}\), however we hypothesise this may be due to a change in methodology. Our Residential Postal Tracker data was previously all collected in face-to-face interviews, and now comprises a mix of face-to-face and online data collection. Looking at face-to-face responses only, the equivalent figures are 4% and 2% for 2016/17, suggesting little actual change once the effect of the change in methodology is removed. However, if the new methodology is in fact more accurate, then it may suggest a higher proportion of the population could face affordability issues.

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\(^{100}\) Our Residential Postal Tracker is collected throughout the year, so seasonality is reflected in the results.


4.35 For low income consumers, with annual household income below £11,500, 13% reported reducing use of post to afford essentials, and 8% had to cut back on essentials to afford post in 2017.\(^{103}\) There is little difference between older consumers and the general population. This suggests that for some potentially vulnerable groups, there is an increased risk of affordability issues compared to the general population.

4.36 Our consumer research does not appear to suggest a significant variation in affordability across nations and regions. We note that the Consumer Council of Northern Ireland has carried out research on potentially vulnerable consumers in Northern Ireland.\(^{104}\) This indicates that there may be risks to affordability for some potentially vulnerable consumers if prices increased by more than a small amount. We consider this is broadly in line with our own findings.

4.37 As discussed in section 3, our consumer research suggests that postal consumers are generally not particularly price sensitive and demand tends to be relatively inelastic. This means that price increases would generally result in increased spending on post for consumers, especially in circumstances where the consumer has a particular need to send the postal items and does not have access to alternatives (such as email). For consumers at risk of affordability issues, this may reduce income available for other expenditure.

4.38 Overall, our consumer research suggests that postal services are currently affordable for most. However, a minority may face affordability issues at current prices, and this could increase as a result of a significant price increase.

4.39 It is likely that some of these consumers face circumstances where they would unfortunately have concerns about the prices of the Second Class products, even at much lower prices. This limited set of circumstances 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, reflects very particular circumstances and severe financial hardship. We recognise that an increase in prices could have negative impacts on these consumers, though unfortunately postal services may be unaffordable for some of these consumers even if their prices were reduced significantly.

**Affordability for SMEs**

**Assessment of potential affordability issues**

4.40 In general, we consider that if postal services are affordable for residential consumers, including potentially vulnerable consumers, then they are likely to be affordable for almost all SMEs as well. As in our 2013 Report, our approach to identifying businesses which are

\(^{103}\) Residential Postal Tracker, QF1.

\(^{104}\) The Consumer Council, 2017. *Postal Consumers in Northern Ireland: Experiences and Attitudes of Vulnerable Consumers and Businesses to the Postal Service.*

potentially at risk from affordability issues is to identify businesses that satisfy the three above-mentioned conditions, which we measure using market research data, namely:

- universal postal services are a critical input to the business’ commercial proposition: we measure this condition by reference to businesses that say mail is ‘core’ to their operations;
- the business lacks good alternatives to stamp products: we measure this condition by reference to businesses with reported mail spend of below £100/month, as at this level a meter mail product is unlikely to be significantly cheaper; and
- the cost of post is important for the business’s financial position: we assume this condition is satisfied where postal spending is high relative to turnover; given that condition ii) requires spending to be low, we measure this condition iii) based on businesses with a relatively low annual turnover (of less than £50,000).

4.41 Taken together, we estimate that just 2.5% of UK SMEs would satisfy all three conditions, based on our assessment of responses from our Business Postal Tracker. This equates to around 140,000 SMEs. We estimated this group comprised 2.4% of UK SMEs in 2013. We recognise that there may be some variation within this, for example if post is critical to a greater proportion of SMEs in remote rural areas. However, our evidence does not suggest a significantly greater proportion of SMEs in a given region would be at risk of affordability issues.

4.42 Importantly, this is an estimate of the maximum number of businesses that could be at risk of facing affordability issues. The actual number at risk is likely to be lower still as even for businesses that are dependent on post it is unlikely that the price of Second Class stamp products would be the main determinant of financial viability.

4.43 In 2017, business insolvency rates were around 0.5%, indicating that in general relatively few active businesses have faced financial viability issues.

4.44 Based on this assessment, we consider that Second Class postal services are highly likely to be affordable for almost all SMEs. We have not seen evidence to suggest that SMEs currently face affordability issues, or may be likely to do so in future.

International comparisons

4.45 As part of our analysis we have also considered how Second Class stamp prices in the UK compare to the prices of comparable postal services in other European countries. Although

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105 Business Postal Tracker, January-December 2017, QC2a, QC7 and QV1b.
106 For example, we note Citizens Advice Scotland research that found that one in five (19%) Scottish SMEs described post as core to their business operations (businesses which state they could not function without it) – this figure is higher (29%) for businesses in remote rural areas (Citizens Advice Scotland/Consumer Futures Unit, 2018. Delivering for Business: Scottish SMEs use of Postal Services, paragraph 4.1. https://www.cas.org.uk/system/files/publications/delivering_for_business_-_scottish_smes_use_of_postal_services.pdf).
107 The Insolvency Service, 2018. Estimated Company Insolvency Rate in the United Kingdom, January to December 2017. https://www.gov.uk/government/statistics/estimated-company-insolvency-rate-in-the-united-kingdom-january-to-december-2017. This estimate covers all UK businesses, but as SMEs represent 99.9% of all businesses we consider this is representative of SMEs.
the EU Postal Services Directive requires a degree of harmonisation in postal services across the EU, there remains variation in universal postal services between different European countries, as well as variation in pricing structure and product and delivery specification. For example, many European countries do not offer a Second Class service to consumers, while others (such as France) offer Third Class. In addition, costs vary due to factors such as geography and quality of service standards. However, despite this variation we consider that observing how Royal Mail’s Second Class prices compare to similar services in other countries provides useful context.

4.46 Figure 4.5 shows Second Class stamp prices in 2017 in a number of European countries which offer a Second Class service. Pricing structure varies between the countries included in Figure 4.5. Universal service providers in other comparable countries typically have three sizes of letter products – ‘small,’ ‘standard’ and ‘large’ – whereas Royal Mail has two – ‘standard letters’ (equivalent to other countries’ ‘small’ and ‘standard’ letters) and ‘large letters.’

4.47 At 56p and £1.22, in 2017 Royal Mail’s price for Second Class stamp letters was relatively low in comparison to the other European countries we considered.

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108 A small letter is based on a DL envelope, a standard letter a C5 envelope and a large letter a C4 envelope.
109 We note that Royal Mail announced price increases for 2018/19 which took effect on 26 March 2018. This does not change our assessment of UK stamp prices compared to other countries. For most recent price list see: https://www.royalmail.com/sites/default/files/Our-prices-2018-effective-26-March-2018.pdf.
Figure 4.5: 2017 Second Class stamp prices in selected European countries which offer Second Class services

![Graph of stamp prices in selected European countries](image)

**Source:** WIK/Ofcom analysis.\(^{110}\) Prices as at September 2017. Conversion to GBP calculated by European Commission Currency Converter.\(^{111}\) Small letter: 110mm x 220mm x 5mm, 20g or less. Standard letter: 229mm x 162mm x 5mm, 100g or less. Large letter: 324mm x 224mm x 25mm, 101g or 150g.

**Note delivery specification varies between country (2016):** UK 1C (D+1) 2C (D+3); France 1C (D+1) 2C (D+2); Sweden 1C (D+1) 2C (D+3); Germany 1C (D+1); Netherlands 1C (D+1); Poland 1C (D+1) 2C (D+3); Spain 1C (D+3); Italy 1C (D+1/2/3) 2C (D+4).

### Conclusions on affordability

4.48 As our analysis above shows, it is difficult to measure affordability for post. Given low levels of spending, measures as a share of income may not show affordability issues that arise where price and the need to send essential post requires consumers to cut back on other essentials or not send post that they consider essential. In addition, there are different groups of potentially vulnerable consumers, who have experienced different changes since our last review and may be affected differently by price increases.

4.49 Taking these considerations into account, we recognise that there is a range of evidence and no single price point emerges as clearly being the limit of affordability. However, determining the appropriate level of the safeguard caps requires us to identify a specific

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\(^{110}\) Figure 4.5 comprises countries considered in the WIK/Ofcom analysis which offer services broadly comparable to Royal Mail’s Second Class standard letter and large letter services.

limit. This requires regulatory judgment, balancing different evidence and the likely effects on different groups of consumers.

4.50 In several areas, little has changed since 2013. Postal services still make up a low share of income, and the majority of consumers do not report experiencing affordability issues. However, real disposable incomes have increased moderately since 2013, including for the lowest income decile. This could suggest an increase in affordability. We use the level of increase for the lowest income decile (7.6%) as an upper bound for our consideration of this potential increase in affordability, as the increase in disposable incomes could suggest that these low income consumers could afford an equivalent increase in prices.

4.51 Other evidence may suggest a more cautious approach. Disposable incomes for low income retired households have increased at a slower rate (1.9% over 2012/13 to 2016/17). Another measure of household budgets, total household expenditure has increased more moderately over the same time period (2.2% for the bottom income decile). Postal spending is seasonal, meaning that peaks in postal spending could make issues of affordability more acute at certain times of the year. In addition, our consumer research suggests a minority of households face affordability issues at current prices. A substantial increase in prices could increase the proportion of households at risk of affordability issues with respect to postal services.

4.52 In our judgment, the evidence suggests that an increase of 5% in real terms above the current level of the caps would not render the Second Class products unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable. The potential for adverse effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase should be considered unaffordable.

Question 2. Do you agree with our assessment of affordability of Second Class postal services? Please state your reasons and provide evidence to support your view.
5. Commercial flexibility

Introduction and summary

5.1 We explained in section 2 that, when imposing tariffs on universal postal services, we are required to take account of the costs of providing the universal service and to ensure the level of the tariff provides Royal Mail (i.e. the designated universal service provider) with incentives to provide the service efficiently. In addition, and consistent with the overall regulatory framework for postal services discussed in section 2, we consider it important that the level of the safeguard caps allow Royal Mail to make a reasonable commercial rate of return on the safeguarded products.

5.2 We have also considered whether the level of the safeguard caps implied by our assessment of affordability could overly restrict Royal Mail’s pricing freedom, leading to a material negative effect on Royal Mail’s ability to maintain the financial sustainability or efficiency of the universal postal service.

5.3 In this section 5, we set out our assessment of the costs Royal Mail incurs in providing the safeguarded products and the degree to which the safeguard caps provide commercial flexibility at their current levels and how this has changed over time. We also consider the financial sustainability of the universal postal service and the extent to which Royal Mail continues to face efficiency incentives.

5.4 In summary, we consider that the safeguard caps have afforded Royal Mail sufficient pricing flexibility since their inception to ensure that the safeguarded products make a reasonable rate of return. This is despite some significant cost allocation changes in recent years, which have had some impact on the reported rate of return of the safeguarded products.

5.5 However, while we consider that the headroom of approximately 29% under the basket cap affords Royal Mail considerable commercial flexibility, the available headroom under the standard letter cap has diminished over time and now stands at less than 5%. It is likely that if the standard letter cap were left unchanged Royal Mail’s commercial flexibility to increase prices above inflation would be eroded within 2-3 years.

5.6 Finally, we remain of the view that the universal postal service is likely to remain financially sustainable in the immediate future although it faces a number of credible downside scenarios. We consider that market conditions and shareholder discipline continue to provide efficiency incentives.

Costs of providing the safeguarded products

5.7 In considering the relationship between Royal Mail’s prices for universal services and the costs it incurs in providing these services, we think it is important to take into account the specific features of Royal Mail’s network. As the postal industry is a network business with many costs that are shared between different services, the fully allocated costs of
individual services depend on the scale and type of other services delivered over the same network. This could cause the costs of providing different services to vary significantly. For example, if there was a significantly lower volume of business mail (which makes up the majority of items carried over the network), the average cost of all mail products would increase.

5.8 Therefore in order to ensure that the provision of the universal postal service remains financially sustainable, Royal Mail has incentives to set prices across its different mail products in a manner that maximises overall mail volumes. This, in turn, should help contain costs and prices for all mail users, but it does also mean that the reported accounting margins and profitability across mail services will vary, again possibly significantly.

5.9 As set out in the Annual Monitoring Update on the Postal Market: Financial Year 2016/17 and in Figure 5.1 below, Royal Mail’s Reported Business recorded revenues of £7,182m in 2016/17. £2,923m of this revenue was accounted for by universal services, which equates to approximately 32% of Reported Business revenues. Second Class services accounted for £905m in revenue, including revenue across all payment methods (stamp, meter and account), representing about 13% of revenue. The scope of the safeguard caps applies only to stamp products which accounted for £[>£] in 2016/17, representing approximately [>£]% of Reported Business revenue. Within this, Second Class stamp standard letters in scope of the safeguard cap accounted for £[>£], or approximately [>£]% of revenue, and Second Class stamp large letters and parcels in scope of the safeguard cap accounted for £[>£], or approximately [>£]% of revenue.

Figure 5.1: Reported Business revenues split by product groups, formats and universal service products 2016/17

![Pie chart showing revenue split by product groups](image)

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

*Other mainly consists of unaddressed and international mail.

**Includes special delivery.

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112 The Reported Business is part of Royal Mail’s business responsible for the universal service, which requires Royal Mail to collect and delivery letters and parcels a minimum number of days a week, at an affordable and uniform price to all UK addresses.
5.10 We observe that Royal Mail has made changes to the way that it allocates costs in recent years. This has resulted in variation in the reported rate of return\textsuperscript{113} of some of the safeguarded products. These cost allocation changes make it difficult to assess the extent to which each of the services covered by the safeguard caps makes a reasonable commercial rate of return. As set out in our Annual Plan 2018/19\textsuperscript{114}, we are currently undertaking a review of Royal Mail’s cost allocation, to address any potential inappropriate cross-subsidisation between letters and parcels.

5.11 Nevertheless, data provided by Royal Mail indicates that the costs it incurs in providing the products in scope of the safeguard caps on a Fully Allocated Cost basis in 2016/17 were £\textsuperscript{[>£]}, with the cost of standard letters representing £\textsuperscript{[>£]} and £\textsuperscript{[>£]} attributable to large letters and small and medium parcels.

5.12 This resulted in a reported profit margin of $\textsuperscript{[>[>]}$% for Second Class standard letters and $\textsuperscript{[>[>]}$% for Second Class large letters and small and medium parcels. Taken together, the products covered by each of the safeguard caps made a rate of return of $\textsuperscript{[>]}$% in 2016/17.

5.13 In general, Second Class standard letters are profitable to Royal Mail, while in aggregate the products within the basket cap have earned a significantly lower return and have been loss making in some years.\textsuperscript{115} Taken together however, we observe that the products within the safeguard caps are profitable to Royal Mail, and, in each year, have made a higher rate of return than Royal Mail’s Reported Business overall.

### Pricing headroom under the safeguard caps

5.14 As set out in section 2, Royal Mail increased prices significantly for most of the safeguarded products in 2012/13 after the removal of the previous price control regime. In subsequent years, Royal Mail has chosen to increase the price of standard letters by a relatively constant amount, with annual price increases broadly in line with RPI. For parcels, the introduction of size-based pricing in 2013 led to a very significant increase in the prices of some parcels products, with some products effectively increasing in price by more than 100%. However, subsequent changes to its size-based pricing policy later in 2013 and in 2014 resulted in some of these products reducing in price. Royal Mail has increased prices of products within the basket cap more conservatively since 2015.

5.15 As a consequence of these pricing decisions, Royal Mail currently has significant headroom under the basket cap. As shown in Figure 5.2, it is currently pricing the products within the basket at approximately 29% below the cap. The amount of headroom afforded by the cap is increasing steadily by around 3% year on year due to Royal Mail’s pricing policy for these products in recent years. By contrast, the headroom available under the standard letter safeguard cap has reduced each year since 2013/14 as a result of Royal Mail’s pricing decisions, with the price of a Second Class stamp now just under 5% below the standard

\textsuperscript{113} Royal Mail Regulatory Financial Reporting Information.


\textsuperscript{115} Royal Mail Regulatory Financial Reporting Information.
letter cap (58p against a permitted maximum of 60p). This is despite Royal Mail increasing prices by 1-2p per year on average during that period.

Figure 5.2: Percentage headroom under the safeguard caps, 2012/13 to 2018/19

Source: Second Class safeguard cap compliance submissions as part of Royal Mail Regulatory Financial Reporting Information.

5.16 We sought information from Royal Mail under our formal powers to understand why it has not chosen to make full use of the flexibility afforded to it under the safeguard caps. Royal Mail’s internal documents\textsuperscript{116} reveal that political, reputational and regulatory risks are amongst the factors its considers with respect to above inflation price increases for standard letters. This may partly explain why it has chosen to increase prices of standard letters relatively conservatively since 2013/14, rather than pricing to the level of the cap.

5.17 In respect of parcels, there is evidence from Royal Mail’s internal documents\textsuperscript{117} which suggests it is concerned that overcapacity in the market increases the risk of losing volume to competitors. It is possible that Royal Mail is hesitant to exploit the available headroom under the basket cap given that when it last sought to do this via the introduction of size-based pricing in 2013, it resulted in a significantly greater loss of volume than Royal Mail had anticipated.

5.18 Overall, we consider that the headroom under the basket cap of approximately 29%, with an upward trend, affords Royal Mail considerable commercial flexibility. However, the remaining headroom under the standard letter cap is less than 5% with a downward trend,

\textsuperscript{116} Royal Mail response dated 6 June 2018 to s.55 Notice, [\textless].
\textsuperscript{117} Royal Mail response dated 6 June 2018 to s.55 Notice, [\textless].
despite Royal Mail increasing prices by only 1-2p per year in recent years. If this were left unchanged, and Royal Mail continued to increase prices annually broadly in line with RPI inflation, it is likely that Royal Mail would exhaust the remaining headroom within the next 2-3 years meaning that the cap would have a binding impact on its pricing.

The financial sustainability of the universal postal service

5.19 In our *Annual Monitoring Update on the Postal Market: Financial Year 2016/17* we noted that the 2016/17 financeability EBIT margin for Royal Mail’s Reported Business fell by 0.4 percentage points from 5.0% in the prior year to 4.6%.\textsuperscript{118} This is below the 5% to 10% range that we consider to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.\textsuperscript{119} Figure 5.3 shows the Reported Business Financeability EBIT margin over the period 2012/13 to 2016/17.

Figure 5.3: Reported Business Financeability EBIT margin, 2012/13 to 2016/17

\[
\begin{align*}
\text{EBIT }\% & \quad 6.0\% & \quad 5.0\% & \quad 4.0\% & \quad 3.0\% & \quad 2.0\% & \quad 1.0\% & \quad 0.0\% \\
\text{2012-13}\* & \quad 3.3\% & \quad 3.9\% & \quad 5.6\% & \quad 5.0\% & \quad 4.6\% \\
\text{2014-15} & \quad 5.6\% & \quad 5.0\% & \quad 4.6\% \\
\text{2015-16} & \quad 5.0\% & \quad 4.6\% \\
\text{2016-17} & \quad 4.6\% \\
\end{align*}
\]\n
*Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail.*

*2012/13 EBIT margin is based on 53 weeks.*

5.20 Despite the fall in EBIT margin to 4.6%, in the *Annual Monitoring Update*, we said that we consider that the universal service is likely to remain financially sustainable in the immediate future. Our key reasons were as follows:

\textsuperscript{118} Annual Monitoring Update on the Postal Market: Financial Year 2016/17, paragraph 7.10.

\textsuperscript{119} 2017 Statement, paragraphs 3.54-3.63.
• “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.”

5.21 However, we also recognised that there are various downside scenarios which have the potential to impact the financial sustainability of the universal service. These downside risks included the impact of potential industrial action, affordability of the pension scheme going forward, increased competition for bulk parcels, where Royal Mail competes with other parcel operators for contracts with online retailers, and economic and market downturn.

5.22 Since publishing the 2016/17 Annual Monitoring Update in November 2017, a number of relevant developments have occurred. First, on 1 February 2018 Royal Mail announced that it had reached agreement in principle with the Communication Workers Union (“CWU”) on pensions, pay, a shorter working week, culture and operational changes. The agreement was subsequently ratified by the CWU membership in a ballot. Under the agreement, Royal Mail closed its Defined Benefit pension scheme to accrual on 31 March 2018, and both Royal Mail and the CWU have committed to work towards the introduction of a Collective Defined Contribution (“CDC”) scheme for all employees, subject to necessary legislative changes being enacted. Following this, transitional pension arrangements were put in place from 1 April 2018 until a CDC scheme can be established. Royal Mail confirmed that the ongoing annual cash cost of pensions will continue to be around £400 million as a result of the agreement.

5.23 As a result, the likelihood of two of the downside risks identified in the 2016/17 Annual Monitoring Update materialising in the immediate future appears to us to have reduced. Specifically, the prospect of significant nationwide industrial action now appears less likely to occur in the immediate future than was the case a year ago. In addition, the likelihood of Royal Mail implementing a pension scheme which it cannot afford in the short to medium term appears to have diminished as a result of this agreement.

5.24 Nevertheless, Royal Mail continues to face pressure from competition in the bulk parcels sector, while the rate of volume decline in letters is unpredictable, and a step-change in the rate of e-substitution is possible. In our view, such market conditions continue to incentivise efficiency improvement. We expect Royal Mail’s performance on efficiency to

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120 Annual Monitoring Update on the Postal Market: Financial Year 2016/17, paragraph 77.11.
improve from the levels achieved in recent years now that it has reached a settlement on its future pension plans.

5.25 Taking all of this into account, we remain of the view that the universal postal service is likely to remain sustainable in the immediate future. However, we consider that although some of the downside risks it faced in 2016/17 and 2017/18 appear to have diminished, Royal Mail continues to face a number of credible downside scenarios which may impact its ability to achieve an EBIT margin of between 5-10% for the Reported Business in the immediate future.

5.26 Royal Mail is forecasting an EBIT margin of \( \% \) for the Reported Business for 2018/19.\(^{123}\) \( \% \).\(^{124}\) We also expect Royal Mail to confirm shortly that the EBIT margin for the Reported Business in 2017/18 was around \( \% \).\(^{125}\).

5.27 In addition, despite the conclusion of the pay and pension deals in 2017/18, \( \% \).\(^{126}\)\( \% \).\(^{127}\).

5.28 We believe, however, that Royal Mail is better placed to make efficiency improvements in the coming year compared to recent years. A deterioration in the industrial relations environment while the pension deal was being negotiated limited Royal Mail’s ability to make cost savings during 2017/18. Progress on efficiency is critical to ensuring the sustainability of the universal postal service, particularly given the uncertainty around the rate of letter volume decline. We also continue to believe that market conditions and shareholder discipline provide efficiency incentives to Royal Mail.

**Conclusion**

5.29 Overall, we observe that the current levels of the safeguard caps, including the basket cap, have not prevented Royal Mail from making a reasonable commercial rate of return overall on the safeguarded products. While Royal Mail tends to earn a greater rate of return on standard letters compared to the aggregate rate of return on products within the basket cap, we note that the headroom afforded under the basket cap is such that Royal Mail could increase the prices of these products in order to improve the profitability of these products subject to its elasticity calculations indicating that such price changes would be revenue generating.

5.30 We also observe that while the level of commercial flexibility afforded by the basket cap is significant and growing, the level of flexibility afforded by the standard letter cap has diminished over time and now stands at less than 5%. Should the level of this cap remain unchanged, it is likely that Royal Mail’s commercial flexibility to increase prices above RPI inflation could be eroded within 2-3 years.

5.31 We consider that the universal postal service is likely to remain financially sustainable in the immediate future, although it faces a number of credible downside scenarios. We also consider that Royal Mail retains incentives to improve efficiency, and we expect Royal

\(^{123}\) \( \% \).
\(^{124}\) \( \% \).
\(^{125}\) \( \% \).
Mail’s efficiency performance to improve now that is has reached an agreement on pension reform.

5.32 Taking all of this together, we consider that raising the level of the Second Class standard letter cap could have a beneficial effect of allowing Royal Mail increased flexibility, given the diminishing commercial flexibility under that cap and the fact that the universal postal service faces a number of credible downside scenarios which may impact Royal Mail’s ability to achieve an EBIT margin of between 5-10% for the Reported Business in the immediate future.

Question 3. Do you agree with our analysis of the commercial flexibility afforded to Royal Mail under the safeguard caps? Please state your reasons and provide evidence to support your view.
6. Our proposals

**Our proposed case for the retention of the safeguard caps**

6.1 As set out in section 2, we concluded in our recent 2017 Statement that it was necessary to retain the safeguard caps on the Second Class products, primarily to ensure vulnerable consumers can access a basic universal service at affordable prices. This was on the basis that Royal Mail is a near monopolist in single piece letters and therefore has the ability to profitably raise prices above the current level of the safeguard caps. In parcels, we noted that Royal Mail’s significant share of the single piece parcel sector combined with the extensive Post Office network and strong brand awareness, provides it with a significant degree of pricing power. We therefore concluded that we could not rely on competitive constraints to prevent Royal Mail from raising prices.

6.2 Based on the analysis set out in section 3, we remain of the view that competitive constraints are insufficient to prevent Royal Mail from raising the prices of the safeguarded products significantly, and that a safeguard cap continues to be necessary. In addition, we do not consider there has been a change in competitive conditions that would suggest altering the structure or scope of the safeguard caps. For these reasons, and in light of our affordability assessment set out in section 4, we continue to believe it is necessary and proportionate to impose safeguard caps on Royal Mail’s Second Class stamp products and that the structure and scope of the safeguard caps should remain the same.

**Our proposed levels of the safeguard caps**

6.3 In light of our proposed case for retaining the safeguard caps, we now turn to our proposals for the levels of the respective caps.

6.4 In considering the appropriate level of the safeguard caps, we have been guided in particular by our safeguard caps objectives discussed in section 2, namely to:

- ensure a basic affordable universal service product is available to all;
- protect vulnerable consumers from ongoing price increases;
- allow Royal Mail to make a reasonable commercial rate of return on the safeguarded products; and
- minimise the effect of the safeguard caps on Royal Mail’s pricing freedom so as to avoid a material effect on wider financeability and/or efficiency incentives.

6.5 In summary, we propose the following levels for the safeguard caps:

- **Standard letter safeguard cap**: we propose that this cap should be increased from its current level by 5% in real terms. This would take the upper limit of the standard letter
cap from 60p currently to 65p\textsuperscript{126} from April 2019, thereafter each year on 1 April, increasing by CPI.

- **Basket safeguard cap:** we do not propose to increase the level of the basket cap, and therefore propose to retain the level of that cap at its current level, thereafter each year on 1 April, increasing by CPI, including on 1 April 2019.

6.6 We consider that these proposals are appropriate in meeting our four safeguard caps objectives for the reasons set out below.

6.7 Based on the evidence set out in section 4, our judgment is that an increase of 5% in real terms above the current level of the caps would not render the price of Second Class services unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable. The potential for adverse effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase should be considered unaffordable.

6.8 As shown in section 5, we consider that the significant headroom under the basket safeguard cap ensures that the effect of this cap on Royal Mail’s pricing freedom is minimal and does not prevent it from making a reasonable commercial rate of return. Moreover, given that this cap works on a volume weighted average basis, Royal Mail has the ability to increase the prices of some products within the cap by even more than 29% should it consider it necessary to do so, provided that price increases are such that the overall level of the cap is not breached. This provides an additional degree of pricing flexibility which any narrower caps would not provide. For these reasons, we don’t consider there is a need to change the level of the basket cap, despite the results of our affordability assessment.

6.9 However, in respect of the standard letter safeguard cap, we note that the available headroom has been reducing by around 1-2% per year as a result of Royal Mail’s pricing strategy relative to inflation and now stands at less than 5%. This is despite Royal Mail increasing prices by only 1-2p per year in recent years. In addition, as Royal Mail can only increase the price of a stamp in whole pence increments, the level of commercial flexibility is further constrained by a cap which affords only limited headroom. Our proposed increase in the level of the cap by 5% in real terms would provide additional headroom under this cap, thereby minimising the effect of the cap on Royal Mail’s pricing flexibility and allowing it to continue to make a reasonable commercial rate of return on the safeguarded product, while also ensuring that the price of a standard letter remains affordable and protecting consumers from on-going price increases.

6.10 This would most likely take the upper limit of the cap to 65.2p from April 2019 based on OBS forecast for CPI. This is on the basis that the level of the cap is currently 60.7p. A 5% increase would take the level to 63.7p before inflation, and a further 2.4% increase (representing the OBR forecast rate of inflation for the 12 months ending September 2018) would take the upper limit of the cap to approximately 65.2p. As Royal Mail can only price

\textsuperscript{126} To the nearest whole pence, estimated using Office for Budget Responsibility (“OBR”) inflation forecast, Economic and Fiscal Outlook – March 2018. 
in whole pence increments, this would take the upper limit of the cap to 65p from April 2019.

Our proposed modifications to the DUSP conditions

6.11 Under the PSA 2011, Ofcom is under a duty to publish a notification prior to imposing or modifying a regulatory condition such as the DUSP conditions. In the notification relating to our proposed modifications to the safeguard caps we are required to:

- state that we are proposing to modify the condition specified in the notification;
- set out the effect of the modification(s) (set out in paragraphs 6.13 to 6.25 below);
- give our reasons for making the proposal (this consultation read in its entirety constitutes our reasoning); and
- specify the period within which representations may be made to us about our proposal (the deadline for submitting comments on this consultation is 4 October 2018).

6.12 We publish a notification relating to our proposals for the safeguard caps in Annex 5 of this consultation. Our proposed modifications to DUSP 2 (the standard letters safeguard cap) are specified in Schedule 1, and our proposed modifications to DUSP 3 (the basket safeguard cap) are specified in Schedule 2, to that notification.

Proposed modifications to the standard letter safeguard cap (DUSP 2)

6.13 Currently, the standard letter safeguard cap (DUSP 2) sets the maximum price which Royal Mail (as the designated universal service provider) is permitted to charge for the Second Class standard letter product. For the first year which the cap was in operation (1 April 2012 to 31 March 2013), the maximum price was set at 55p. The cap permits the maximum price to increase by CPI for each subsequent year (from 1 April to 31 March) of the control period, which ends on 31 March 2019. The cap also imposes certain requirements on Royal Mail (as the designated universal service provider) to aid Ofcom’s monitoring of the safeguard cap and ensure compliance.

6.14 We continue to believe that this type of control is appropriate for the Second Class standard letter stamp product. Consumers use significantly more Second Class standard letters than any other Second Class format or price point and consumers tend to have greater awareness of the price of standard letter products compared to large letter and parcel products, reflecting the greater frequency of use of standard letter products. There is therefore benefit in keeping in place a simple cap that allows customers to easily predict future (maximum) prices. We therefore propose to retain DUSP 2 as a standalone cap on Second Class standard letters. This has the benefit of being simple to implement and straightforward for all stakeholders to understand.

6.15 Our proposed main modification to the standard letter safeguard cap is to set a new maximum price in relation to Second Class standard letters. The effect of the modification is to introduce a new, increased maximum price of 63.7p before inflation plus the CPI
amount for the year ending on 30 September 2018. Additionally, and aside from our proposed new definition of ‘Relevant Year’ (see below), we are proposing some minor textual changes as shown in the marked up in Schedule 1 to the notification which can be found in Annex 5.

**Proposed modifications to the basket cap (DUSP 3)**

6.16 The basket cap (DUSP 3) currently imposes on Royal Mail (as the designated universal service provider) a maximum limit on the weighted average increase of the basket of products (large letters and small and medium parcels up to 2kg) falling within the cap by applying the formulae specified in DUSP 3.

6.17 This is on the basis that we consider it appropriate that Royal Mail should have commercial freedom to determine the prices of individual products within this basket, in order to ensure that it has the flexibility to change its products to better suit consumer needs as they evolve, should that be necessary, and to ensure that the impact of the cap on its pricing freedom is minimised subject to prices remaining affordable overall. The maximum price increases by CPI for each year of the control period, until its expiry on 31 March 2019. The cap also imposes certain requirements on Royal Mail (as the designated universal service provider) to aid Ofcom’s monitoring of the safeguard cap and ensure compliance.

6.18 We propose to retain the level of the basket cap at its current level in real terms, with the maximum price limit increasing by CPI for each year that the cap remains in force. We consider that this sets the basket cap on current prices and products in a transparent way. The main effects of our proposed modifications to the basket cap are:

- The formulae used to calculate the basket cap operate by reference to the ‘Base Year’, which is currently defined as meaning the period beginning on 1 April 2011 and ending 31 March 2012. We propose to replace that definition so that it refers to the period beginning on 1 April 2018 and ending on 31 March 2019.
- We have included a list setting out the base year prices for the products caught by the basket cap. We have amended the formulae to specify that the cap is set at 29% above Royal Mail’s 2018/19 weighted average prices as at 26 July 2018 (which is the headroom that Royal Mail currently has under the cap) plus the change in CPI between the base year and the relevant year. We have altered the CPI adjustment term in the formulae, to provide for a change to the level of the cap in line with the change in CPI from 2018/19 to 2019/20.

6.19 Additionally, and aside from our proposed new definition of ‘Relevant Year’ (see below), we are proposing some minor textual changes as shown the marked up in Schedule 2 to the notification.

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127 This CPI amount will only be known after the publication of this consultation. Based on OBR forecasts, we estimate this would lead to a 2.4% increase in the cap, resulting in a cap level of 65.2p from April 2018. We intend to update this condition using the actual value for CPI when finalising the condition for our final statement in early 2019.
Proposed modifications to the definition of ‘Relevant Year’ in each of the safeguard caps (DUSP 2 and DUSP 3)

6.20 In considering our proposed new levels of the respective caps, we have also considered their duration.

6.21 Currently, each of the safeguard caps (DUSP 2 and DUSP 3) define ‘Relevant Year’ as the period running from 1 April to 31 March for the duration of the control period, which commenced on 1 April 2012 and will expire on 31 April 2019.

6.22 We propose not to fix an expiration date for each of the caps set out in DUSP 2 and DUSP 3, and we therefore propose to modify each of the safeguard caps so that neither DUSP condition states a specific date at which the caps will expire. We propose that the new definition of ‘Relevant Year’ for each of DUSP 2 and DUSP 3 should refer to any period of 12 consecutive months beginning on 1 April and ending on 31 March.

6.23 This would mean that the safeguard caps form, structure and level will remain the same (increasing in line with CPI each year) until such time as Ofcom considers it necessary to change them. It is likely that we will next review the levels of the safeguard caps in 2022 when we anticipate that the next review of the regulatory framework for postal services will take place. We consider it unlikely that we would need to intervene to change the level of the caps before 2022, unless material and significant concerns arise concerning the affordability for consumers or Royal Mail’s ability to finance the universal postal service.

Proposed modifications concerning stamped products in each of the safeguard caps (DUSP 2 and 3)

6.24 We propose to modify each of DUSP 2 and DUSP 3 to clarify that we consider that the Second Class products captured by the safeguard caps should comprise traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.

6.25 We consider that this clarificatory modification would reflect a practice already taking place; Second Class standard letter and large letter stamps bought online are currently the same price as the same ‘traditional’ stamp bought over-the-counter at a Post Office, whereas small and medium parcels are currently cheaper to buy online. Moreover, we consider that the safeguard caps should cover both ‘traditional’ postage stamps and the online variant in order to effectively meet our safeguard caps objectives.

Legal tests

6.26 We consider that our proposals (as reflected in our proposed modifications to DUSP 2 and DUSP 3 as set out in Annex 5) satisfy the relevant tests set out in Schedule 6 to the PSA 2011, which must be met where we impose or modify a regulatory condition, namely that they:

- are objectively justifiable;
• do not unduly discriminate against a particular person of a particular description of persons;
• are proportionate; and
• are transparent in relation to what they are intended to achieve.

6.27 We consider that our proposed modifications satisfy these tests. Our reasons are set out in this consultation, and in summary below:

• **Objective justification** – we believe that our proposed modifications are objectively justifiable, because they will ensure that the relevant universal postal services remain affordable, whilst taking account of the costs of providing the service and ensuring that Royal Mail retains appropriate incentives to provide the relevant services efficiently. We also consider that our proposed modifications strike an appropriate balance between our four safeguard caps objectives.

• **Not unduly discriminatory** – we believe that our proposed modifications are not unduly discriminatory because they only affect the universal service provider in the UK (i.e. Royal Mail) reflecting its unique position as the sole universal service provider. We also note that the relevant universal postal services captured by the caps are required to be uniformly priced across the UK. In addition, should Royal Mail decide to offer discounts to the price of Second Class stamps (for example, if it chose to offer Christmas discounts for vulnerable consumers), this would not impact the requirement to charge no more than 65p at all other times and to all other customers.

• **Proportionate** – we believe that our proposed modifications are proportionate because they only impose requirements that we consider are appropriate and necessary to ensure that our safeguard caps objectives (including the requirements set out in section 36(4) of the PSA 2011, as reflected in those objectives) are met, without imposing any undue burden on Royal Mail in its capacity as the designated universal service provider. In particular, we consider that the safeguard caps are being set at levels which take account of affordability for vulnerable consumers, whilst still ensuring that Royal Mail retains sufficient pricing flexibility to make a reasonable commercial rate of return on the Second Class products.

• **Transparent** – we consider that our proposed modifications are transparent because they clearly set out the obligations we propose to impose upon Royal Mail in its capacity as the designated universal service provider, particularly by clearly specifying the maximum prices that Royal Mail is permitted to charge for the relevant services captured under the respective caps.

6.28 In reaching our provisional conclusions, we have also addressed the specific requirements set out in section 36(4) of the PSA 2011 to ensure that, in imposing tariffs on the relevant universal postal services, the prices of these services will be affordable (see section 4). In addition, our provisional conclusion takes account of the costs of providing the universal service, alongside our related policy objective to ensure that Royal Mail is able to make a reasonable commercial rate of return on the safeguarded products (see section 5).
Our assessment has also considered the extent to which the level of the caps may incentivise efficiency improvements. As we set out in our 2012 Statement, the safeguard caps are not intended, in and of themselves, solely to provide efficiency incentives to Royal Mail. However, we are of the opinion that Royal Mail remains incentivised to pursue efficiency improvements given the wider commercial pressures that it faces, and in light of the shareholder discipline to which it is subject to as a privatised company. We believe that Royal Mail would remain incentivised even if it were to choose to immediately make use of all of the additional flexibility afforded under our proposals. We expect Royal Mail’s rate of efficiency improvement to increase in the coming years now that it has settled its pension arrangements.

Finally, in preparing these proposals, we have considered and acted in accordance with our specific duty in section 29 of the PSA 2011 (see section 5 for our assessment of the financial sustainability of the universal postal service) and our general duties in section 3 of the CA 2003. In performing our principal duty under section 3 of the CA 2003, we have had particular regard to those consumers identified as potentially vulnerable and how they may be affected by any decision we may take with respect to the safeguard caps. Taking account the impact of our proposals on each of consumers and Royal Mail, we believe that the interests of citizens and consumers would be secured or furthered by our proposed modifications to the safeguard caps.

Question 4. Do you agree with our proposals relating to the standard letter safeguard cap? Please state your reasons and provide evidence to support your view.

Question 5. Do you agree with our proposals relating to the basket safeguard cap? Please state your reasons and provide evidence to support your view.

Question 6. Do you have any comments on our proposed modifications to the DUSP conditions specified in Annex 5?

Question 7. Please provide any further comments or additional evidence that you believe we should consider in reaching our decision on the Second Class safeguard caps.
A1. Responding to this consultation

How to respond

A1. Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 4 October 2018.

A1.1 You can download a response form from https://www.ofcom.org.uk/consultations-and-statements/category-1/review-second-class-stamp-safeguard-cap. You can return this by email or post to the address provided in the response form.

A1.2 If your response is a large file, or has supporting charts, tables or other data, please email it to postal.regulation@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet (https://www.ofcom.org.uk/consultations-and-statements/consultation-response-coversheet). This email address is for this consultation only, and will not be valid after 5 October 2018.

A1.3 Responses may alternatively be posted to the address below, marked with the title of the consultation:

Lucy Cass
Ofcom
125 Princes Street
Edinburgh
EH2 4AD

A1.4 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:

- Send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files. Or
- Upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.

A1.5 We will publish a transcript of any audio or video responses we receive (unless your response is confidential).

A1.6 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.

A1.7 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.

A1.8 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 4. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom’s proposals would be.
A1.10 If you want to discuss the issues and questions raised in this consultation, please contact Lucy Cass on 0131 226 8109, or by email to Lucy.Cass@ofcom.org.uk.

Confidentiality

A1.11 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents’ views, we usually publish all responses on our website, www.ofcom.org.uk, as soon as we receive them.

A1.12 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don’t have to edit your response.

A1.13 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.14 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom’s intellectual property rights are explained further at https://www.ofcom.org.uk/about-ofcom/website/terms-of-use.

Next steps

A1.15 Following this consultation period, Ofcom plans to publish a statement in early 2019.

A1.16 If you wish, you can register to receive mail updates alerting you to new Ofcom publications; for more details please see https://www.ofcom.org.uk/about-ofcom/latest/email-updates

Ofcom's consultation processes

A1.17 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 2.

A1.18 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.

A1.19 If you would like to discuss these issues, or Ofcom’s consultation processes more generally, please contact Steve Gettings, Ofcom’s consultation champion:
A2. Ofcom’s consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

A2.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

A2.2 We will be clear about whom we are consulting, why, on what questions and for how long.
A2.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.
A2.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.
A2.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom’s Consultation Champion is the main person to contact if you have views on the way we run our consultations.
A2.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

A2.7 We think it is important that everyone who is interested in an issue can see other people’s views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents’ views helped to shape these decisions.
A3. Consultation coversheet

BASIC DETAILS

Consultation title:
To (Ofcom contact):
Name of respondent:
Representing (self or organisation/s):
Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

- Nothing
- Name/contact details/job title
- Whole response
- Organisation
- Part of the response
- If there is no separate annex, which parts? __________________________________________

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name Signed (if hard copy)
A4. Consultation questions

We have included a number of specific consultation questions throughout this document and we would like you to consider these when responding. We have set out these questions below for ease of reference. However, we are not seeking to limit the issues on which respondents may wish to comment and respondents are invited to include representations on any issues which they consider to be relevant.

Question 1. Do you agree with our market analysis? Please state your reasons and provide evidence to support your view.

Question 2. Do you agree with our assessment of affordability of Second Class postal services? Please state your reasons and provide evidence to support your view.

Question 3. Do you agree with our analysis of the commercial flexibility afforded to Royal Mail under the safeguard caps? Please state your reasons and provide evidence to support your view.

Question 4. Do you agree with our proposals relating to the standard letter safeguard cap? Please state your reasons and provide evidence to support your view.

Question 5. Do you agree with our proposals relating to the basket safeguard cap? Please state your reasons and provide evidence to support your view.

Question 6. Do you have any comments on our proposed modifications to the DUSP conditions specified in Annex 5?

Question 7. Please provide any further comments or additional evidence that you believe we should consider in reaching our decision on the Second Class safeguard caps.
A5. Statutory notification: proposed modifications of Designated USP Conditions 2 and 3 (DUSP 2 & DUSP 3)

NOTIFICATION OF PROPOSALS TO MODIFY DESIGNATED USP CONDITIONS 2 AND 3 PURSUANT TO SECTION 36 OF, AND IN ACCORDANCE WITH SECTION 53 OF, AND PARAGRAPH 3(3) OF SCHEDULE 6 TO, THE POSTAL SERVICES ACT 2011

BACKGROUND

(A) On 27 March 2012, following consultation, Ofcom published a statement entitled Securing the Universal Postal Service: Decision on the new regulatory framework setting out various decisions, including the imposition on Royal Mail of designated USP conditions to make provision for matters set out in sections 36 and 37 of the Act, such as Designated USP Condition (the “initial DUSP 2”).

(B) On 20 July 2012, following consultation, Ofcom published a statement entitled Securing the Universal Postal Service: Safeguard cap for Large Letters and packets setting out its decision to impose on Royal Mail another designated USP condition to make provision for matters set out in section 36 of the Act, namely Designated USP Condition 3 (the “initial DUSP 3”).

(C) On 28 March 2013, following consultation, Ofcom published a statement entitled Safeguard cap for Second Class Large Letters and packets: Statement on the proposed modifications to the safeguard cap condition (DUSP Condition 3) setting out its decision to modify the initial DUSP 3 to correct an error in the drafting to ensure that the condition accurately implemented Ofcom’s intended original policy (the “amended DUSP 3”).

(D) On 18 December 2017, following consultation, Ofcom published a statement entitled Regulatory financial reporting for Royal Mail setting out its decisions to modify both DUSP 2.2.4 of the initial DUSP 2 (the “amended DUSP 2”) and DUSP 3.2.4 of the amended DUSP 3 (the “further amended DUSP 3”), to require the data necessary to monitor compliance with the Second Class stamp safeguard caps one month after the implementation of any new prices.

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PROPOSALS

1. Ofcom hereby proposes, in accordance with section 53 of, and paragraph 3(3) of Schedule 6 to, the Act and pursuant to its powers under section 36 of the Act, to modify DUSP 2 and DUSP 3 as set out in paragraph 2 of this Notification in order to make further provision for matters set out in that section 36 and to impose that DUSP 2 and DUSP 3 on the universal service provider, i.e. Royal Mail.

2. The proposed modifications to DUSP 2 and DUSP 3 are—

   (a) specified in Schedule 1 (for DUSP 2) and in Schedule 2 (for DUSP 3) to this Notification, marked up against the existing DUSP 2 and DUSP 3, respectively, to show the changes which Ofcom is proposing to their substance, as highlighted in yellow and in red font for new text and highlighted in yellow and in black font for deleted text (which markings, for the avoidance of doubt, do not form part of the proposed modifications);

   (b) being proposed to come into force with effect on the date of a publication of a notification setting out the modification in accordance with section 53 of, and paragraph 3(1) of Schedule 6 to, the Act.

3. The effect of, and Ofcom’s reasons for making, these proposals are set out in the accompanying consultation document.

OFCOM’S DUTIES AND LEGAL TESTS

4. Ofcom is satisfied that these proposals satisfy the general test in paragraph 1 of Schedule 6 to the Act.

5. In making these proposals, Ofcom has considered and acted in accordance with its principal duty in section 29 of the Act and its general duties in section 3 of the Communications Act 2003.

MAKING REPRESENTATIONS

6. Representations may be made to Ofcom about the proposals set out in this Notification by no later than 4 October 2018.

7. Copies of this Notification and the accompanying consultation document have been sent to the Secretary of State in accordance with paragraph 5(1)(a) of Schedule 6 to the Act.

8. By virtue of paragraph 3(5) of Schedule 6 to the Act, Ofcom may give effect, with or without modifications, to a proposal with respect to which it has published a notification only if Ofcom has—

   (a) considered every representation about the proposal that is made to Ofcom within the period specified in paragraph 6 of this Notification; and

   (b) had regard to every international obligation of the United Kingdom (if any) which has been notified to Ofcom for this purpose by the Secretary of State.

INTERPRETATION
9. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them in this Notification and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Act.

10. In this Notification—

   (a) “Act” means the Postal Services Act 2011 (c.5);

   (b) “DUSP 2” means Designated USP Condition 2 referred to in recital (A) to this Notification as amended by the modification referred to in recital (D);

   (c) “DUSP 3” means Designated USP Condition 3 referred to in recital (B) to this Notification as amended by the modifications referred to in recitals (C) and (D) respectively;

   (d) “Ofcom” means the Office of Communications; and

   (e) “Royal Mail” means Royal Mail Group Ltd, whose registered company number in England and Wales is 04138203.

11. For the purpose of interpreting this Notification—

   (a) headings and titles shall be disregarded;

   (b) expressions cognate with those referred to in this Notification shall be construed accordingly; and

   (c) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

12. Schedules 1 and 2 to this Notification shall form part of this Notification.

Signed by

Marina Gibbs

Competition Policy Director

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

26 July 2018
## SCHEDULE 1

### DESIGNATED USP CONDITION 2

**SAFE GUARD CAP PRICE CONTROL FOR SECOND CLASS STANDARD LETTERS**

### 2.1. Application, Definitions and Interpretation

<table>
<thead>
<tr>
<th>DUSP 2.1.1</th>
<th>This designated USP condition (“DUSP Condition”) shall apply to the universal service provider.</th>
</tr>
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</table>

<table>
<thead>
<tr>
<th>DUSP 2.1.2</th>
<th>In this DUSP Condition—</th>
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<tbody>
<tr>
<td><strong>(a)</strong> “Relevant Year” means one of the following periods:</td>
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<tr>
<td>(1) the period beginning on 1 April 2012 and ending on 31 March 2013 (the “First Relevant Year”);</td>
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<tr>
<td>(2) the period beginning on 1 April 2013 and ending on 31 March 2014 (the “Second Relevant Year”);</td>
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<tr>
<td>(3) the period beginning on 1 April 2014 and ending on 31 March 2015 (the “Third Relevant Year”);</td>
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<tr>
<td>(4) the period beginning on 1 April 2015 and ending on 31 March 2016 (the “Fourth Relevant Year”);</td>
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<tr>
<td>(5) the period beginning on 1 April 2016 and ending on 31 March 2017 (the “Fifth Relevant Year”);</td>
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<tr>
<td>(6) the period beginning on 1 April 2017 and ending on 31 March 2018 (the “Sixth Relevant Year”);</td>
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<tr>
<td>(7) the period beginning on 1 April 2018 and ending on 31 March 2019 (the “Seventh Relevant Year”);</td>
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</table>

**(a)** “First Relevant Year” means the period beginning on 1 April 2019 and ending on 31 March 2020;

**(b)** “Relevant Year” means any period of 12 consecutive months beginning on 1 April and ending on 31 March;

**(b) (c)** “Consumer Prices Index” means the index of consumer prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office for National Statistics at the time of publication of this Notification) from time to time in respect of all items;

**(c)** “Royal Mail” means Royal Mail Group Ltd, whose registered company number in England and Wales is 04138203;

**(d)** “CPI amount” means the amount of the change in the Consumer Prices Index
in the period of twelve months ending on 30th September immediately before the beginning of a Relevant Year, expressed as a percentage (rounded to two decimal places) of that Consumer Prices Index as at the beginning of that first mentioned period;

(e) “Second Class Post” means a service of sending a stamped item by post where the universal service provider aims to deliver the item no later than the third working day after it was posted. For the purposes of this DUSP Condition, it does not include services which are not universal services or which include charges in respect of additional registered, insured, tracked or recorded services;

(f) “Standard Letter” means a letter weighing up to 100 grams that is no more than 5 millimetres thick and up to 240 millimetres in length and up to 165 millimetres in width.

DUSP 2.1.3 For the purpose of interpreting this DUSP Condition—

(a) except in so far as the context otherwise requires, words or expressions shall have the meaning assigned to them in DUSP 2.1.2 above and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Act Postal Services Act 2011;

(b) headings and titles shall be disregarded;

(c) expressions cognate with those referred to in this DUSP Condition shall be construed accordingly; and

(d) the Interpretation Act 1978 (c. 30) shall apply as if this DUSP Condition were an Act of Parliament; and

(e) references in this DUSP Condition to “stamped” postal items (or mail) are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.

2.2 Maximum price to be charged for specified services

DUSP 2.2.1 This DUSP Condition specifies the maximum amount that the universal service provider shall be permitted to charge for the service of sending a single Standard Letter by Second Class Post. In the First Relevant Year, the maximum amount that the universal service provider shall be permitted to charge for sending a single Standard Letter by Second Class Post shall be the amount of 55 pence [see accompanying consultation: Ofcom’s proposal is to insert figure representing 63.7 pence plus the CPI amount for the year ending on 30 September 2018].

DUSP 2.2.2 For each Relevant Year after the First Relevant Year the maximum amount that the universal service provider shall be permitted to charge for sending a single
Standard Letter by Second Class Post shall be the maximum amount that the universal service provider was permitted to charge for that service in the previous Relevant Year increased by the CPI amount.

**DUSP 2.2.3** Where the universal service provider makes a material change (other than to a charge) to any product or service which is subject to this DUSP Condition or there is a material change in the basis of the Consumer Prices Index, DUSP Conditions 2.2.1 and 2.2.2 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For these purposes, a material change to any product or service which is subject to this DUSP Condition includes the introduction of a new product or service wholly or substantially in substitution for that existing product or service.

**DUSP 2.2.4** The universal service provider shall record, maintain and supply to OFCOM in writing, within one month of the coming into effect of any price increase, the data necessary for OFCOM to monitor compliance of the universal service provider with the requirements of this DUSP Condition.

**DUSP 2.2.5** This DUSP Condition shall not apply to such extent as OFCOM may direct.

**DUSP 2.2.6** The universal service provider shall comply with any direction OFCOM may make from time to time under this DUSP Condition.

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**Table of terms defined in the Postal Services Act 2011**

This table is provided for information and does not form a part of this DUSP Condition. We make no representations as to its accuracy or completeness. Please refer to the Postal Services Act 2011.

<table>
<thead>
<tr>
<th>Defined term</th>
<th>Section of the Postal Services Act 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>OFCOM</td>
<td>90</td>
</tr>
<tr>
<td>universal service provider</td>
<td>65(1) and Schedule 9 paragraph 3(3)</td>
</tr>
</tbody>
</table>
### SCHEDULE 2

**DESIGNATED USP CONDITION 3**

**SAFEGUARD CAP PRICE CONTROL FOR SECOND CLASS LARGE LETTERS AND RELEVANT PACKETS**

#### 3.1. Application, Definitions and Interpretation

| DUSP 3.1.1 | This designated USP condition (“DUSP Condition”) shall apply to the universal service provider. |
| DUSP 3.1.2 | In this DUSP Condition— |
| | (a) “Base Year” means the period beginning on 1 April 2018 and ending on 31 March 2019; |
| | (b) “Basket” means the services of sending Large Letter and Relevant Packet products by Second Class Post that the universal service provider currently provides; |
| | (c) “Consumer Prices Index” means the index of consumer prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office for National Statistics at the time of publication of this Notification) from time to time in respect of all items; |
| | (d) “Large Letter” means a letter weighing up to 750 grams that is no more than 25 millimetres thick and up to 353 millimetres in length and up to 250 millimetres in width; |
| | (e) “Relevant Packet” means any item greater than a Large Letter in dimensions but weighing no more than 2kg; |
| | (f) “Relevant Year” means any period of 12 consecutive months beginning on 1 April and ending on 31 March; one of the following periods: |
| | (0) The period beginning on 1 April 2011 and ending on 31 March 2012 (the “Base Year”); |
| | (1) the period beginning on 1 April 2012 and ending on 31 March 2013 (the “First Relevant Year”); |
| | (2) the period beginning on 1 April 2013 and ending on 31 March 2014 (the “Second Relevant Year”); |
| | (3) the period beginning on 1 April 2014 and ending on 31 March 2015 (the “Third Relevant Year”); |
| | (4) the period beginning on 1 April 2015 and ending on 31 March 2016 (the “Fourth Relevant Year”); |
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(5) the period beginning on 1 April 2016 and ending on 31 March 2017 (the “Fifth Relevant Year”);
(6) the period beginning on 1 April 2017 and ending on 31 March 2018 (the “Sixth Relevant Year”);
(7) the period beginning on 1 April 2018 and ending on 31 March 2019 (the “Seventh Relevant Year”);

“Second Class Post” means a service of sending a stamped item by post where the universal service provider aims to deliver the item no later than the third working day after it was posted. For the purposes of this DUSP Condition, it does not include services which are not universal services or which include charges in respect of additional registered, insured, tracked or recorded services.

DUSP 3.1.3 For the purpose of interpreting this DUSP Condition—

(a) except in so far as the context otherwise requires, words or expressions shall have the meaning assigned to them in DUSP 3.1.2 above and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Act Postal Services Act 2011;

(b) headings and titles shall be disregarded;

(c) expressions cognate with those referred to in this DUSP Condition shall be construed accordingly; and

(d) the Interpretation Act 1978 (c. 30) shall apply as if this DUSP Condition were an Act of Parliament; and

(e) references in this DUSP Condition to “stamped” postal items (or mail) are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid including where the postage has been sold online.

3.2 Maximum price to be charged for specified services

DUSP 3.2.1 This DUSP Condition specifies the maximum prices that the universal service provider shall be permitted to charge for the group of services within the Basket in each Relevant Year.

DUSP 3.2.2 In each Relevant Year \( t \) (which is represented as “\( t \)” in the formulas below), the price of services in the Basket shall be set such that—
\[
\frac{\sum_i P_{i,t} V_{i,t-2}}{\sum_i V_{i,t-2}} \leq \left( \frac{\sum_i P_{i,0} V_{i,t-2}}{\sum_i V_{i,t-2}} \times X_t \right)
\]

where—

\[
X_t = (1 + 53.294\%) \times \frac{CPX_t}{CPX_{t-0}}
\]

\(P_{i,t}\) is the maximum price charged for sending a single Large Letter or Relevant Packet by Second Class Post in Relevant Year \(t\);

\(V_{i,t-2}\) is the volume of stamped mail delivered by the universal service provider in the twelve months to March in the year \(t-2\) for service \(i\) (which is represented as \("i"\)) as calculated by the universal service provider using a reasonable methodology which has been disclosed to OFCOM;

\(P_{i,0}\) is the maximum price as listed in the Appendix to this DUSP Condition charged for sending a single Large Letter or Relevant Packet by Second Class Post in the Base Year \(0\) as at 26 July 2018 (which is represented as \("0"\)); and

\(CPX_0\) is the Consumer Prices Index for the month of September immediately before the beginning of a Base Year (rounded to one decimal place), the figure of which is 104.1; and

\(CPX_t\) is the Consumer Prices Index for the month of September immediately before the beginning of a Relevant Year (rounded to one decimal place).

**DUSP 3.2.3**

Where the universal service provider makes a material change (other than to a charge) to any product or service which is subject to this DUSP Condition or there is a material change in the basis of the Consumer Prices Index, DUSP Conditions 3.2.1 and 3.2.2 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For these purposes, a material change to any product or service which is subject to this DUSP Condition includes the introduction of a new product or service wholly or substantially in substitution for that existing product or service listed in the Appendix to this DUSP Condition.

**DUSP 3.2.4**

The universal service provider shall record, maintain and supply to OFCOM in writing, within one month of the coming into effect of any price increase, the data necessary for OFCOM to monitor compliance of the universal service provider with the requirements of this DUSP Condition.
DUSP 3.2.5  This DUSP Condition shall not apply to such extent as OFCOM may direct.

DUSP 3.2.6  The universal service provider shall comply with any direction OFCOM may make from time to time under this DUSP Condition.

Appendix

<table>
<thead>
<tr>
<th>Description of postal item product or service</th>
<th>Maximum price as at 26 July 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Second Class Post, Large Letter, 0-100 grams</td>
<td>0.79 pence</td>
</tr>
<tr>
<td>2. Second Class Post, Large Letter, Second Class Post, 101-250 grams</td>
<td>1.26 pence</td>
</tr>
<tr>
<td>3. Second Class Post, Large Letter, 251-500 grams</td>
<td>1.64 pence</td>
</tr>
<tr>
<td>4. Second Class Post, Large Letter, 501-750 grams</td>
<td>2.22 pence</td>
</tr>
<tr>
<td>5. Second Class Post, Relevant Parcel not exceeding length 45cm x width 35cm x depth 16cm (small parcel), 0-2kg</td>
<td>2.95 pence</td>
</tr>
<tr>
<td>6. Second Class Post, Relevant Parcel not exceeding length 45cm x width 35cm x depth 16cm (small parcel), 0-2kg, (sold online only)</td>
<td>2.85 pence</td>
</tr>
<tr>
<td>7. Second Class Post, Relevant Parcel not exceeding length 61cm x width 46cm x depth 46cm (medium parcel), 0-2kg</td>
<td>5.05 pence</td>
</tr>
<tr>
<td>8. Second Class Post, Relevant Parcel not exceeding length 61cm x width 46cm x depth 46cm (medium parcel), 0-2kg, (sold online only)</td>
<td>4.95 pence</td>
</tr>
</tbody>
</table>

Table of terms defined in the Postal Services Act 2011

This table is provided for information and does not form a part of this DUSP Condition. We make no representations as to its accuracy or completeness. Please refer to the Postal Services Act 2011.

<table>
<thead>
<tr>
<th>Defined term</th>
<th>Section of the Postal Services Act 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>OFCOM</td>
<td>90</td>
</tr>
<tr>
<td>universal service provider</td>
<td>65(1) and Schedule 9 paragraph 3(3)</td>
</tr>
</tbody>
</table>