

Hermes UK's response to Ofcom's Review of the Second Class Safeguard Cap Consultation

Hermes UK

Hermes UK delivers over 300 million parcels in the UK annually and is the UK's largest carrier of parcels after Royal Mail. Hermes is based in Morley, West Yorkshire and traces its roots back to 1912 when the Grattan catalogue was founded in Bradford. We are part of the German owned Otto Group.

A British success story, Hermes has grown on average 15% a year since 2013, today turning over £650m annually. Hermes directly employs almost 3,000 staff. A network of around 15,000 self-employed couriers regularly provides services to Hermes, the majority working less than 6 hours per day. This increases to 17-18,000 at peak times.

An integral part of UK e-commerce, Hermes delivers parcels domestically and internationally on behalf of the UK's best-known retailers and brands, including Next, John Lewis and Asos, with a market leading first time delivery rate of 95%. As UK companies focus more on international export post Brexit, Hermes' role will become ever more important, delivering British goods cost-effectively to over 190 countries around the world.

Continued growth in online shopping has been underpinned by Hermes reinvesting in its UK business. In the past three years it has invested £100m in its UK operations – the equivalent to all our profits in this period. Hermes has invested £30m each in 'Super Hubs' in Warrington and Rugby, with both investments creating hundreds of jobs locally. Over the next three years Hermes intends to invest up to £30m in the UK each year to offer even better services to its customers.

General comments

Hermes welcomes the opportunity to respond to this consultation on the Second Class safeguard caps which are due to expire in March 2019. We understand the importance of regulatory price caps to ensure that specific postal services, not widely available in the market, remain affordable, specifically for vulnerable consumers.

Our response focuses on the parcels element of the large letters and parcels cap as Hermes is not active in the letters market.

As Ofcom states in the consultation, Royal Mail has significant share in the parcels market, combined with strong brand awareness giving it a significant degree of pricing power. We would suggest that, in addition to this, Royal Mail's exclusive relationship with the Post Office further cements its strong position, allowing consumers to easily send single piece parcels through its network, something no other parcel operator has due to the exclusivity of this business agreement which runs to 2022.

Extending the safeguard cap to large letters and parcels

Ofcom did not initially include large letters and parcels in the safeguard cap, but took the decision to do so following representation from Consumer Focus (now Citizens Advice). This in itself is a confusing decision given that although Consumer Focus called for the cap to protect vulnerable consumers, its own research showed that vulnerable consumers, especially those with limited or no internet access, were largely insensitive to price increases across all formats (mail and parcels).¹

Conversely, Royal Mail in its submissions to Ofcom in 2012 said it believed that as letters accounted for almost 90% of Second Class stamp volumes it would not be proportionate regulation to extend the cap to other formats. It did not believe that a broader cap would be necessary to meet Ofcom's objectives for the safeguard cap². In particular, Royal Mail was concerned about the extension of the cap to its Standard Parcels product. It noted that on average UK adults only send one Standard Parcel every seven years.

Royal Mail also noted in its submission that consumer choice of which provider to use to send packets and parcels was increasing. It considered this included the use of consolidation websites which enable customers to compare and purchase from different parcel services such as Hermes, City Link, TNT and Collect+. Royal Mail noted that the Parcel2Go website and Collect+ (which uses a network of shops for posting and collection) provide 3-5 day delivery service at comparable prices to its Standard Parcels product.³

Further to this, the Postal Services Act 2011 and the EU Postal Services Directive both require the universal service provider, in this case Royal Mail, to provide parcel services up to 20kg (in the PSA 2011) at an "affordable price".

On this basis, Hermes believes that there is already adequate protection in place for consumers, including vulnerable consumers, and that Ofcom's intervention to extend the cap to cover parcels is unnecessary.

Bundling of large letters and parcels

Not only does there seem to be a poor evidence base for extending the cap to products beyond standard Second Class letters, there does not seem to have been a clear, evidence base behind the decision to bundle together large letters and parcels up to 2kg weight, perhaps other than the fact that Royal Mail delivers both and for the ease of the regulator.

The parcels market is fiercely competitive, even more so now than when this decision was taken in 2012, with margins of around 5%. Companies like Hermes must ensure its prices are competitive with what Royal Mail can offer. This challenging commercial environment is compounded by Royal Mail's 20% VAT advantage on its USO products.

It seems an anomaly to bundle large letters and parcels together under one cap, meaning that the price other postal operators can charge for 0-2kg parcels to remain competitive with Royal Mail, is

¹ https://www.ofcom.org.uk/data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf

² As above Ofcom 2013 statement

³ As above

artificially impacted by the price of letters – a brand of the market many postal operators, including Hermes, are not active in and, as such, have no control over.

If, following consultation, Ofcom decides a safeguard cap should remain, large letters and parcels should be decoupled so that a cap on parcels is not impacted by letters.

Large letters and parcels cap

As Ofcom states in the consultation, the safeguard cap is designed to allow Royal Mail to make a reasonable commercial rate of return on the safeguarded products. Hermes is concerned that Royal Mail's prices are not fully cost reflective as Ofcom acknowledges that Royal Mail is pricing well below the cap and has been for some time due to poor pricing decisions in made in 2013/4 which allowed competitors, such as Hermes, to gain a foothold in the single piece C2X market.

There seems to be an inconsistency between Royal Mail pricing 29% under the current cap and Ofcom's assertion that there is insufficient competition to protect consumers. Hermes would argue that the main reason Royal Mail is pricing significantly under the cap – which it does not do for letters, where prices are increased each year in line with CPI and where it tends to be closer to the roof of the cap – is that it is sufficiently concerned by the level of competition in the parcels market that it keeps its prices as low as possible. Something it is able to do given the additional advantage of the VAT exemption on the suite of products in the universal service.

Ofcom's consultation states that Royal Mail considers its competitors' prices before setting its own prices and it is concerned about the entry and expansion of competitors in the single piece parcels sector⁴ (paragraph 3.62). Table 3.2 in the consultation shows that Hermes's prices for parcels in the 0-1kg weight category via parcel shops are lower than Royal Mail's and are competitive in the 1-2kg weight category.

The fact that Royal Mail is charging well under the cap for parcels and large letters does not suggest that, were the cap to be removed, it would rush to increase prices, leaving consumers without access to affordable services. Indeed, Ofcom recognises in the consultation that concern about reputational damage and political concerns may be contributing factors to Royal Mail's reluctance to increase prices.

Ofcom research 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 (approximately 70p per week). The consultation also points out that as these figures include First Class and other products the figure for Second Class services alone is likely to be lower.

As Ofcom is well aware, competition is the best tool to protect consumers and keep prices affordable. The removal of retail price controls has worked well in the telecoms sector, where competition has delivered competitive prices and innovation for consumers.

The significant amount that Royal Mail is currently pricing under the safeguard cap, coupled with fear of reputational damage and losing more market share in single piece parcels to its competitors would also suggest the cap, for parcels at least, is now redundant and should be removed.

⁴ https://www.ofcom.org.uk/data/assets/pdf_file/0021/116643/Review-Second-Class-Safeguard-Caps-2019.pdf

Ofcom's own consumer research suggests that price responsiveness is relatively low in parcels. Just 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.

The consultation suggests this price insensitivity would not provide a strong constraint on Royal Mail's pricing. However, as already stated Royal Mail already has significant pricing freedom under the safeguard cap yet continues to set prices significantly below this cap.