Annual monitoring update on the postal market

Financial year 2015-16

Market update

Publication date: 30 November 2016

About this document

This report sets out the key data and trends in the postal sector for the 2015-16 financial year. An effective and on-going monitoring regime is one of the key safeguards of the regulatory framework that Ofcom put in place in the postal sector in March 2012, alongside greater pricing freedom for Royal Mail. We also committed to publishing an annual report summarising the results of our monitoring programme. In May 2016, we published a consultation on the findings of our Review of Royal Mail Regulation, in which we explain that we continue to consider this an important element of our postal regulatory framework. This document and accompanying interactive charts constitute our fifth annual monitoring update on the postal sector.

This report covers five key areas: Royal Mail's pricing and quality of service for residential and small business consumers; the letters market; the parcels market; the financial performance of Royal Mail's Reported Business (i.e. the part of Royal Mail's business responsible for the universal service); and efficiency of Royal Mail's Reported Business.

We have updated the format of this report, making this document shorter and publishing accompanying interactive data tables presenting data trends in Royal Mail pricing (stamp, business and access), Royal Mail quality of service, letter market volumes and revenues by type of operator and Royal Mail volumes and revenues (USO/non USO, product group and format). We have also included additional financial health metrics and altered the metrics we monitor for efficiency by way of implementing the findings of our Review of Royal Mail Regulation.

Contents

Section 1

Executive Summary

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

1.2 This update covers the key areas set out in the March 2012 Statement as the focus of our monitoring regime, augmented by further information on financial health metrics as set out in our May 2016 consultation on the findings of our Review of Royal Mail Regulation (the 2016 Review consultation).[1] It also sets out the key data and trends for the 2015-16 financial year.

1.3 The metrics in this update are, unless otherwise stated, consistent with those in our 2014-15 Annual monitoring update on the postal market published in November 2015[2] (enabling year-on-year comparisons).

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

Residential and small business consumers

1.5 Our research indicates the majority of consumers are satisfied with postal services (85%) and that prices remain affordable. The safeguard cap on Second Class stamps remains in place to protect vulnerable consumers. Prices in 2016-17 continue to increase across most products albeit at a slower rate than the previous year. See Section 3.

1.6 Royal Mail's 2015-16 quality of service (QoS) performance was lower than in the prior year on six of the eight measures. It failed to meet its First Class, Postcode Area (PCA), delivery routes completed and Special Delivery QoS targets. We take Royal Mail's QoS performance seriously (as one of the three key safeguards within the regulatory framework) so we opened an investigation regarding the failure to meet the First Class and PCA targets. On 20 October 2016, we concluded that although Royal Mail had contravened Designated Universal Service Provider condition 1.9.1 by failing to meet minimum QoS standards, we would not impose a financial penalty on this occasion. Royal Mail missed the relevant standards by relatively small margins and had taken steps to address the breach. However, we expect Royal Mail to ensure it meets QoS requirements going forward. If it breaches

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[1] *Review of the Regulation of Royal Mail,* 25 May 2016 http://stakeholders.ofcom.org.uk/consultations/royal-mail-review2016/. We provide more background on the potential impact of the 2016 Review consultation findings on our postal monitoring work in Section 2: Introduction.

[2] Ofcom *Annual monitoring update on the postal market - Financial year 2014-15*, 27 November 2015 http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.

[3] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data),* 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

[4] https://www.ofcom.org.uk/postal-services/monitoring_reports

the condition again, we may consider the imposition of a significant financial penalty on Royal Mail.[5] See Section 3.

UK letters market

1.7 Between 2011-12 and 2014-15 total addressed letters volumes declined by 11.9% to 12.6bn items (c.4% per annum). Although not directly comparable, volumes continued to fall in 2015-16.

1.8 The letter market had volumes of 12.3bn and revenues of £4.3bn in 2015-16. See Section 4.

Bulk mail services

1.9 Access letters volumes and revenues increased due to the withdrawal of Whistl from the end-to-end market (as Whistl end-to-end volumes returned to Royal Mail Access) and price rises. Access accounted for 58% of the letters market in 2015-16.

1.10 Royal Mail's prices for retail bulk mail and access increased in 2016-17, generally by less than the increases in 2015-16. See Section 4.

Parcels

1.11 Measured national parcel volumes increased in 2015-16 by 12%. While revenues also increased, they increased at a slower rate (8%) than volumes, which is consistent with the level of competition in the sector.[6] See Section 5.

Financial performance of the Reported Business

1.12 In summary, the financeability EBIT[7] margin of the Reported Business[8] fell from 5.6% to 5.0% but was still within the indicative 5% to 10% range that we considered in March 2012 and the 2016 Review consultation to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term (see Figure 1.1 below). The main reason for the fall in margin was due to a fall in letter revenue and increase in transformation costs partially offset by lower people and non-people costs. See Section 6 for more detail.

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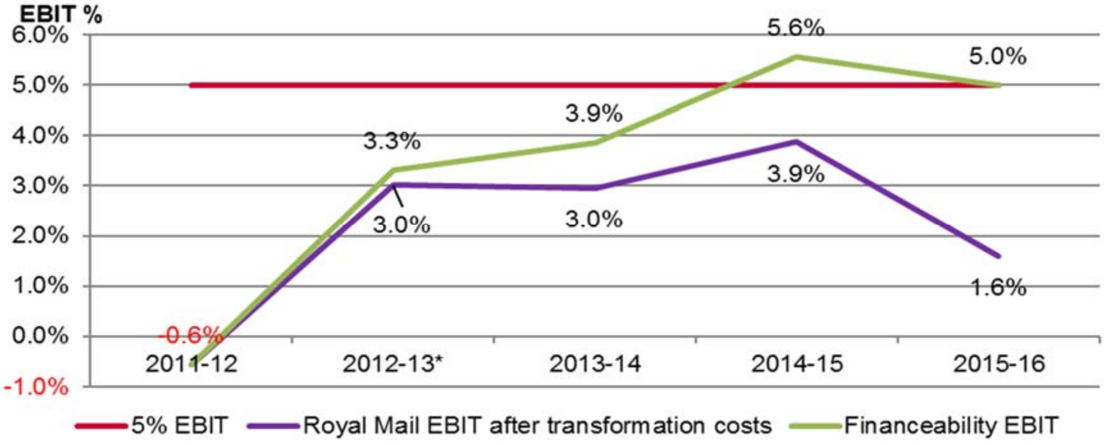
[5] https://www.ofcom.org.uk/__data/assets/pdf_file/0028/92746/161020-non-confidential-decision-v3.pdf.

[6] These are volumes and revenues relating to parcels weighing up to 31.5kg carried by postal operators with a UK-wide network. See Section 5 for a full definition of parcels and list of operators.

[7] Financeability EBIT margin is EBIT after transformation costs adjusted for pension costs on a cash basis. This measure was introduced in the 2013-14 Annual monitoring update. It is the financeability EBIT margin that we measure against the indicative 5-10% range which we considered in March 2012 was consistent with a commercial rate of return, and therefore use to assess the financial sustainability of the universal service.

[8] The part of Royal Mail's business that is responsible for the universal service. This is explained further in Section 2.

Figure 1.1 – Reported Business EBIT margin



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

Royal Mail's efficiency

1.13 Price, volume, efficiency and other (PVEO) analysis provides a measure of the impact of efficiency gains on costs. In 2015-16, the PVEO analysis indicates that Royal Mail reduced real costs by c.1.5% due to efficiency improvements (largely related to a real decrease in people costs). The rate of efficiency improvement decreased from the prior year (c.2.6% real decrease in costs). At the same time, Royal Mail reduced total gross hours by 2.0% in 2015-16, which was less than the reduction in the prior year (2.3%). See Section 7.

Section 2

Introduction

Background

2.1 Our approach to regulating the postal sector was set out in our March 2012 Statement. This included the decision to give Royal Mail greater pricing freedom to enable it to return the universal service to financial sustainability, subject to certain safeguards.

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

2.3 On 25 May 2016, we published the 2016 Review consultation which sought views on the findings of our Review of the Regulation of Royal Mail and on proposals for the future framework. It included our assessment of Royal Mail's efficiency, analysis of its position within the letter and parcel sectors, and consideration of the company's potential ability to set wholesale prices in a way that might harm competition. The proposals for the future framework focused on five main areas:

- Maintaining a regulatory approach that recognises the structural decline in letters and an increasingly competitive parcels market, and extending the regulatory framework for a further five years;
- Supporting competition and innovation in the parcels sector;
- Tightening rules on access competition;
- Focusing mail integrity regulation on appropriate areas and securing good consumer outcomes; and
- Ensuring all regulatory conditions remain appropriate and fit-for-purpose.

2.4 We set out that we intend, subject to consultation responses, to continue the current regulatory framework with the three key safeguards of: monitoring, affordability and competition.

2.5 In respect of the monitoring regime, we said that we would continue to operate an effective and on-going monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels and pricing and competition, as it represents one of the three safeguards on which the framework rests.

2.6 The regime will remain broadly unchanged. With regards to efficiency, however, we will update the metrics based on those outlined in the 2016 Review consultation and we intend to work with Royal Mail to get better insight into its performance against its efficiency initiatives.

2.7 We also intend to continue to monitor consumers' experiences in the postal sector. In our 2013 Review of Users' Needs, we said it is important for Ofcom to continue to understand the needs of users of postal services and how these needs may change in the future.[9] Although we already gather some information in relation to user needs, we intend in future to place greater emphasis on monitoring the evolution of postal user needs and preferences as part of our overall monitoring programme, specifically by adding focused questions in our postal trackers.

2.8 In addition, we have committed to reviewing the regulatory reporting framework under which Royal Mail operates. Based on the revised objectives of the regulatory framework, we will consult on changes to the regulatory reporting framework in early 2017. Where changes are proposed to the regulatory reporting framework, we will incorporate these into future postal market updates.

2.9 Where changes to the monitoring regime have been proposed (as summarised above), and we consider them consequential and complementary to the existing monitoring regime, we have reflected them in this report. We plan to issue a statement before the end of 2016-17.

Measuring the outcomes of the regulatory regime

2.10 This report focuses on the 2015-16 financial year and in particular on:

- Residential and small business consumers – Section Three;
- The letters market – Section Four;
- The parcels market – Section Five;
- The financial performance of the Reported Business – Section Six; and
- Efficiency of the Reported Business – Section Seven.

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

The wider monitoring programme

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

- industry stakeholders providing market specific information, identifying any concerns with how the regime is operating and potential market developments; and
- regular internal review of data and indicators for the key areas set out above (including through our internal governance process).

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

[9] See Ofcom's 2013 *Review of postal users' needs*, 27 March 2013, paragraph 1.4, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf.

2.14 Royal Mail (along with other postal operators) provides a range of confidential data to us. Although the confidential nature of this data means that we cannot publish it, the data nonetheless informs our on-going internal monitoring programme, and is used to identify any potential or emerging problems in relation to the provision of the universal service.

2.15 So that stakeholders are aware of the information that we gather, a list of data that we currently collect, some of which is not published for confidentiality reasons, is listed in Annex 1 to this report.

Royal Mail is the focus of our monitoring regime

2.16 The focus of our monitoring is Royal Mail. It is currently the only postal business in the UK which operates a network capable of delivering letters and parcels to over 29 million business and household addresses nationwide.[10] As such, it is the designated provider of the universal postal service (universal service provider).

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

2.18 The Reported Business includes all universal services,[11] as well as retail bulk mail,[12] access products and parcels which also use the universal service network.[13]

2.19 Following the sale of the Government's remaining shares on 13 October 2015, Royal Mail Group Plc became fully privatised.

Presentation of data in this Annual monitoring update

2.20 Data presented in the Annual monitoring update on the postal market is, unless otherwise stated, in nominal terms.

2.21 Where we discuss absolute or percentage movements, we are referring to the comparisons to the previous financial year i.e. 2014-15 to 2015-16 (unless otherwise stated).

2.22 We have again elected to use the Consumer Price Index (CPI) as the basis for calculating real movements in Royal Mail's costs for the same reasons as stated in previous annual monitoring updates on the postal market.[14]

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[10] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 2 http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202015-16_0.pdf.

[11] http://www.royalmailgroup.com/regulation/how-were-regulated/universal-service-obligation.

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

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

Section 3

Residential and small business consumers

3.1 In this Section we discuss the impact of Royal Mail's pricing and operational decisions on those customers primarily using the universal service products, usually residential and small business consumers. As noted in our March 2012 Statement, we are monitoring:

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

- The quality of service achieved by Royal Mail in the provision of universal services.[15] Our March 2012 Statement set out the quality standards that Royal Mail is required to meet. This was to ensure appropriate levels of universal service performance were maintained for consumers.

3.2 This Section also includes relevant findings from our residential and business consumer surveys on postal services, which were introduced in July 2012. These surveys help us monitor public perceptions about the postal market.

3.3 This report focuses on comparisons with last year's data. Detailed trends in pricing are available as interactive data on our website.[16]

Pricing of universal services

3.4 Ofcom's principal duty in relation to post under the Postal Services Act (PSA) 2011 is to secure the provision of the universal postal service. In March 2012, Ofcom removed the majority of price controls to give Royal Mail sufficient commercial freedom to enable it to return the universal service to a financially sustainable position. At the same time, we introduced a number of safeguards, including a cap on the price of Second Class stamps (for letters and parcels less than 2kg),[17] so that vulnerable consumers remain able to access a basic universal service.

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[14] Ofcom *Annual monitoring update on the postal market - Financial year 2014-15*, 27 November 2015, paragraph 2.22, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.
[15] We also monitor Quality of Service closely given the risk Royal Mail could degrade quality in order to reduce costs rather than improve efficiency.
[16] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data
[17] The safeguard cap on Second Class stamp letters came into effect on 1 April 2012 and can be found at: http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex7.pdf. The safeguard cap on Second Class stamp large letters and packets up to 2kg came into effect on 20 July 2012 and was subsequently modified in our March 2013 statement: *Safeguard cap for Second Class Large Letters and packets,* 28 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/safeguard-cap/statement/statement.pdf.

3.5 While the majority of the analysis in this report focuses on 2015-16 (in line with previous monitoring updates), the pricing information as detailed below focuses on Royal Mail's most recent pricing announcements (2016-17).

Royal Mail has complied with the safeguard caps

3.6 For Second Class standard letters, the cap in 2016-17 was 58p.[18] The large letter and parcel (up to 2kg) basket cap allowed Royal Mail to increase the prices of the basket products by up to 56% over 2011-12 prices in 2012-13, followed by CPI in each following year for the duration of the 2012 regulatory framework.

3.7 Royal Mail's prices for Second Class stamps complied with these safeguard caps in 2016-17. From 29 March 2016, Second Class letter stamps cost 55p.

3.8 In our March 2012 Statement, we said that we would review the level of the caps if we considered that they were unduly affecting Royal Mail's pricing flexibility and therefore its ability to return the universal service to a sustainable footing, or if we had evidence to suggest the prices were no longer affordable. As noted above, we are currently reviewing the regulation of Royal Mail[19] and we anticipate issuing a final statement before the end of the 2016-17 financial year.

All letter and parcel prices increased in 2016-17[20]

Standard letter stamp and meter prices

3.9 Royal Mail changed some of its prices from 29 March 2016. As shown in Figure 3.1, First Class standard letter stamps and meter prices increased by approximately 2% to 64p and 53p respectively.

3.10 Second Class standard letter stamps increased by approximately 2% to 55p, whilst Second Class meter prices increased by approximately 3% to 40p. These increases were greater than CPI, but broadly consistent with RPI.[21]

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[18] The cap is calculated by reference to the 2012-13 cap of 55p plus the relevant CPI inflation rate for the remaining seven-year period of the regulatory framework.
[19] Ofcom, *Review of the Regulation of Royal Mail*, 25 May 2016, paragraph 4.98, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-review/summary/Review-of-Royal-Mail-Regulation.pdf.
[20] Our analysis is conveyed in nominal terms, i.e. excluding any adjustment for inflation.
[21] The change in CPI, comparing March 2016 against March 2015 showed an increase of 0.5%. RPI increased by 1.6% over the same period.

Figure 3.1 – Standard Letter First and Second Class stamp and meter prices for 2016-17

Stamp	64p	1p (1.6% ↑)	55p	1p (1.9% ↑)
Meter	53p	1p (1.9% ↑)	40p	1p (2.6% ↑)

Source: Royal Mail price list

3.11 When Royal Mail was granted pricing freedom (subject to the safeguard cap), it initially increased the price of First Class and Second Class stamps by 30.4% and 38.9% respectively. However, since March 2013, prices for First Class and Second Class stamps have increased by 6.7% and 10% respectively, while CPI increased by 5% over the same period.

3.12 The differential between stamp and meter prices for First Class and Second Class letters remained the same as in 2015-16 (11p and 15p respectively).

3.13 Page 3 of the interactive data shows historic trends in letter prices.[22]

Large letter stamp and meter prices

3.14 There are four weight steps for Large Letters – 0-100g, 101-250g, 251-500g and 501-750g. Prices rose for Large Letters across all weight steps in 2016-17 compared to the previous year.

3.15 The average price for large letter stamps increased by 1.1% for First Class and 1.3% for Second Class. Meter prices increased by 5.1% and 5.6% for First and Second Class respectively.

3.16 Page 3 of the interactive data shows historic trends in large letter prices.[23]

Parcel prices

3.17 Following a slight fall in prices last year, all parcel prices increased in 2016-17 by c. 1-2%. The biggest price increase was a 1.8% increase in prices for 0-1kg and 1-2kg Second Class small parcels.

3.18 Page 4 of the interactive data shows historic trends in parcel prices.[24]

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[22] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

[23] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

Affordability of universal services

3.19 As noted above, one of the key safeguards inherent in the current regulatory framework is ensuring that universal postal services are affordable. In March 2013 we published a report[25] which set out that we considered that universal postal services remained affordable for both residential consumers (including low income and other vulnerable consumers) and businesses (including small and medium businesses) at both the 2012 and 2013 prices. Since then, we have been monitoring the affordability of postal services through the responses to questions in our postal tracker surveys and through reviewing ONS data.

3.20 As noted further in this Section, 56% of residential consumers surveyed are satisfied with the cost of postage, and the most recent ONS data shows that weekly household expenditure on postal services remains low (0.1% of total expenditure (60p)).[26] This continues to be a little less than the cost of a First Class letter stamp (64p).

3.21 However, we observe a difference in the extent to which respondents from different socioeconomic groups reported reducing their use of postage stamps in order to afford essentials like food or heating. 11% percent of respondents from the C2DE socioeconomic group said that they had had to reduce spend on postage stamps to afford other essentials. This is higher than the percentage of those in the ABC1 group (6%) and retired people (4%).[27,28] While we consider that universal service products are currently affordable, we will continue to monitor respondents' views regarding affordability in future.

Non-price terms of universal services

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

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

3.24 Before making changes to the Schemes, Royal Mail has to consult customers and stakeholders, including Ofcom, and the consumer advocacy bodies, for example,

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[24] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

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

[26] ONS Family Spending 2015 Edition, Table 3.2, published 8 December 2015.

[27] Ofcom *The Consumer Experience of 2014,* 28 January 2015 includes a definition of socioeconomic groups on page 236. https://www.ofcom.org.uk/__data/assets/pdf_file/0019/63523/tce14_research_report.pdf.

[28] Residential Q1-Q2 2016 questions for Royal Mail Annual Monitoring Report, https://www.ofcom.org.uk/__data/assets/pdf_file/0032/94937/Residential-Q1-Q2-2016-questions-for-Royal-Mail-Annual-Monitoring-Report.pdf.

Citizens Advice, providing at least one month's notice in advance of the date on which Royal Mail proposes to implement the change.

3.25 During 2015-16, Royal Mail made the following changes to non-price terms both of which were positive for consumers:

- Claims Policy – Royal Mail shortened the length of time before a claim for the loss of an item can be made from 15 working days to 10 working days for a standard item. For Special Delivery Guaranteed the time period was reduced from 10 working days to 5 working days. Royal Mail also made changes to allow customers to submit evidence to support a claim in digital format;

- Alternative dispute resolution – Royal Mail updated the Postal schemes to set out the name and web address of the Postal Redress Service (POSTRS). It also included within the Postal Schemes details of its complaints handling process. These changes made it clearer for customers how they can raise a complaint and how they can appeal a decision if they remain unhappy at the conclusion of Royal Mail's internal process.

Quality of Service

3.26 Royal Mail is subject to a number of annual quality of service (QoS) targets. We monitor its performance against these targets closely so that we can take prompt and appropriate action if we identify failures.

3.27 Figure 3.2 summarises Royal Mail's performance against our QoS targets.[29] Page 5 of the interactive data shows historic trends for each KPI below.[30]

[29] The figures cited in this subsection are taken from Quality of Service reports submitted by Royal Mail to Ofcom and do not include any adjustments that Royal Mail makes to account for force majeure events, such as very severe weather.
[30] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

Figure 3.2 – Quality of Service Targets Summary

KPI	Target		2014/15 Result	2015/16 Result	Change
First Class delivery	**93.0%**	Items delivered day after collection	93.0%	**92.5%**	▼
Second Class delivery	**98.5%**	Items delivered within 3 days of collection	98.9%	**98.8%**	▼
Post Code Area (PCA) Target: First Class single piece mail	**118/121** PCAs	91.5% items delivered day after collection	109/121	**104/121**	▼
PCA Target (with confidence interval)	**118/121 PCAs**	91.5% items delivered day after collection	118/121	**113/121**	▼
Special Delivery	**99.0%**	Items delivered next delivery day	98.7%	**98.5%**	▼
European International Delivery	**85.0%**	Items delivered in 3 days	89.4%	**87.5%**	▼
Collection points: 6 days per week	**99.9%**	Collection points served	99.9%	**99.9%**	=
Delivery routes: 6 days per week	**99.9%**	Delivery routes completed	99.8%	**99.8%**	=
Correct delivery: 6 days per week	**99.5%**	Items correctly delivered	99.8%	**99.7%**	▼

Royal Mail failed to meet its First Class national target and its PCA target but exceeded its Second Class national target

3.28 Royal Mail is required to deliver 93.0% of all First Class retail items (single piece stamp, meter and PPI letters and parcels) on the next working day after collection, and 98.5% of all Second Class retail items within three days of collection.[31]

3.29 As you can see from Figure 3.2, in 2015-16 Royal Mail exceeded its Second Class target by 0.3%, but failed to meet its First Class target by 0.5%, delivering 92.5% of all First Class retail items on the next working day after collection.

3.30 Royal Mail also failed to meet its Post Code Area (PCA) target. It is required to deliver 91.5% of all First Class single piece mail the day after collection to 118 of the

[31] These targets are set below 100% to allow for commonly experienced circumstances that may arise in the transportation, processing and delivery of mail, for example, disruption to aircraft flights due to bad weather or missed network connections due to road traffic delays and breakdowns. If the targets were set at a higher level it would be likely to substantially increase Royal Mail's costs and, potentially, universal service prices. The 93% first class target was originally agreed as achievable by Royal Mail and Postcomm in 2001.

121 PCAs,[32] but only achieved this in 104 PCAs. Of the 14 PCAs in which Royal Mail failed to meet the 91.5% target, 9 were within the margin of error for the independent survey measurement process used to calculate performance. However, even setting aside these PCAs, Royal Mail still missed the 118 PCA target by 5.

3.31 We take quality of service very seriously and opened an investigation into Royal Mail's failure to meet its quality of service targets.

3.32 On 20 October 2016, we concluded that although Royal Mail had contravened Designated Universal Service Provider condition 1.9.1 by failing to meet the minimum quality of service standards, we would not impose a financial penalty on this occasion. Royal Mail missed the relevant standards by relatively small margins and had taken steps to address the breach. However, we expect Royal Mail to ensure it meets quality of service requirements going forward. If it breaches the condition again, we may consider the imposition of a significant financial penalty on Royal Mail.[33]

Royal Mail achieved its targets for European International Delivery, collection points served daily and items correctly delivered, but narrowly missed for Special Delivery and for delivery routes completed daily

3.33 Performance against the European International Delivery and items correctly delivered targets fell slightly from last year, but Royal Mail still exceeded both targets. It also met its target of serving 99.9% of collection points six days per week.

3.34 For the Special Delivery (Next Day by 1pm) product, 99.0% of items are required to be delivered on the next delivery day. As with previous years, in 2015-16 Royal Mail narrowly missed the target for Special Delivery items, achieving 98.5%.

3.35 Royal Mail also failed to meet its target for delivery routes completed each day. It completed 99.8% of delivery routes, six days per week; 0.1 percentage points lower than the 99.9% target.

3.36 We will continue to monitor quality of service closely during 2016-17.

Overall quality of service performance has dropped from the prior year

3.37 Despite meeting the majority of its quality of service targets, overall quality of service performance has fallen in 2015-16 even in categories where Royal Mail has met the target. We will continue to monitor all quality of service targets closely. In this context we are planning to launch a review of the quality of service regulations to ensure they remain appropriate for consumers' needs.

Complaints data

3.38 All regulated postal operators including Royal Mail are required to publish annual complaints data. Additionally, Royal Mail is required to publish quarterly reports

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[32] Three of the PCAs – HS (Hebrides), KW (Kirkwall, Orkney) and ZE (Shetlands) – are excluded from this target, principally because it is not practical logistically to achieve a next day service for 91.5% of First Class mail sent from across the UK to these remote destinations. In addition, these offshore areas are more frequently subject to weather-related disruption of ferry and air services.

[33] https://www.ofcom.org.uk/__data/assets/pdf_file/0028/92746/161020-non-confidential-decision-v3.pdf

showing the amount of compensation paid in relation to complaints about most universal services.[34]

Figure 3.3 – Royal Mail reported complaints summary for 2015-16

Category of complaint	Number of complaints	Percentage of total complaints
Loss	294,441	32%
Delay	91,913	10%
P739 Failure[35]	78,711	9%
Redirection	75,547	8%
Mis-delivery	63,994	7%
Delivery Procedure Errors[36]	62,232	7%
Redelivery Failure	40,441	4%
Damage	35,135	4%
General Complaint	22,280	2%
Part Loss	20,464	2%
Other	135,096	15%
Total	**920,254**	**100%**

Source: Royal Mail

3.39 Royal Mail is required to report the top ten categories of complaint. Since Postcomm introduced this requirement, loss has accounted for the highest number of complaints, and this is still the case in 2015-16. 32% of complaints related to lost items. This is 22 percentage points higher than the next highest category.

3.40 The number of complaints received by Royal Mail increased for the first time in four years. Complaints per 100,000 items delivered increased by 12.2% to 6.77 complaints. This was primarily led by increases in total complaints related to loss (10.7%) and delay (33.1% increase). This could be due to a number of factors including Royal Mail's reduced First Class quality of service performance in 2015-16 and the changes it has made to make claiming for lost items easier (discussed above at para 3.25). In addition, the average value of items posted via Royal Mail has increased. This is likely to have generated more complaints given that the higher the value of the item affected, the more likely the sender is to complain. The overall trend for the last five years is still a decline of 22.2%.[37]

3.41 There was a general increase across most of the other cost categories with P739 failure (decrease of 4.3%) and redirection (decrease of 5.8%) the only categories which saw a decrease in complaints.

[34] See Consumer Protection Condition 4.3, and also: http://www.royalmail.com/sites/default/files/Annual_Consumer_Complaints_and_Compensation_Scheme_Report_2015-2016_0.pdf
[35] Where the postman/woman fails to leave a a P739 ('while you were out') card or fills it out incorrectly.
[36] Where the postman/woman leaves a card while a customer is in, however the postman/woman does not have the item in question. This also covers instances where customers go to the delivery office to collect an item but the item is not there.
[37] Complaint figures referred to relate to all Royal Mail complaints not just those relating to regulated postal services.
[38] Where the postman/woman fails to leave a a P739 ('while you were out') card or fills it out incorrectly.

3.42 The average compensation per complaint also increased by 1% in 2015-16. However, over the last five years, the average compensation has decreased by 8.6%. The main reason for this fall was that in 2012-13 Royal Mail reduced the maximum compensation available for standard universal service items from 100 times the cost of a First Class stamp (£60 in 2012-13) to £20. This encouraged senders posting higher value items to use the 'Signed For' service with a compensation cap of £50 and a lower probability of loss. The substitution effect and lowering of the maximum compensation had the combined effect of decreasing average compensation per complaint.

3.43 We will continue to examine any complaints data that we receive. This, along with our consumer survey findings, will help to highlight whether there is degradation and/or any areas of concern in postal services used by residential and small business customers.

Residential and business consumer surveys

3.44 As part of our ongoing monitoring regime, we run a market research programme to ensure we have up-to-date views of consumers on the postal market. The research began in July 2012.

3.45 We run two separate surveys to track use of and attitudes to post, one focused on residential consumers[39] and the other focused on small and medium enterprise (SME) business customers.[40]

3.46 In order to ensure that the data we produce remained fit for purpose, Ofcom carried out a review of both the postal tracking surveys between July and September 2015. As such, there is no data available for this period.

3.47 In addition, due to a change in the residential tracker survey methodology and questionnaire in January 2016, it would not be appropriate to combine the data from October to December 2015 with the 2016 data. As such, historic data from the residential postal tracking survey is no longer directly comparable. Data included in this report for the residential tracking survey covers the first half of the 2016 calendar year.

3.48 The business postal tracking survey covers April to June 2015 and October 2015 to March 2016.

3.49 A broader range of data from these surveys is summarised in our Communications Market Report, and detailed survey results are published alongside it.[41] Data summarised in the Communications Market Report is not comparable with data in this report. Below we discuss some of the consumer metrics which we consider to be particularly relevant to our monitoring regime.

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[39] Residential Q1-Q2 2016 questions for Royal Mail Annual Monitoring Report, https://www.ofcom.org.uk/__data/assets/pdf_file/0032/94937/Residential-Q1-Q2-2016-questions-for-Royal-Mail-Annual-Monitoring-Report.pdf.

[40] Business Q2 2015-Q1 2016 questions for Royal Mail Annual Monitoring Report, https://www.ofcom.org.uk/__data/assets/pdf_file/0031/94936/Business-Q2-2015-Q1-2016-questions-for-Royal-Mail-Annual-Monitoring-Report.pdf.

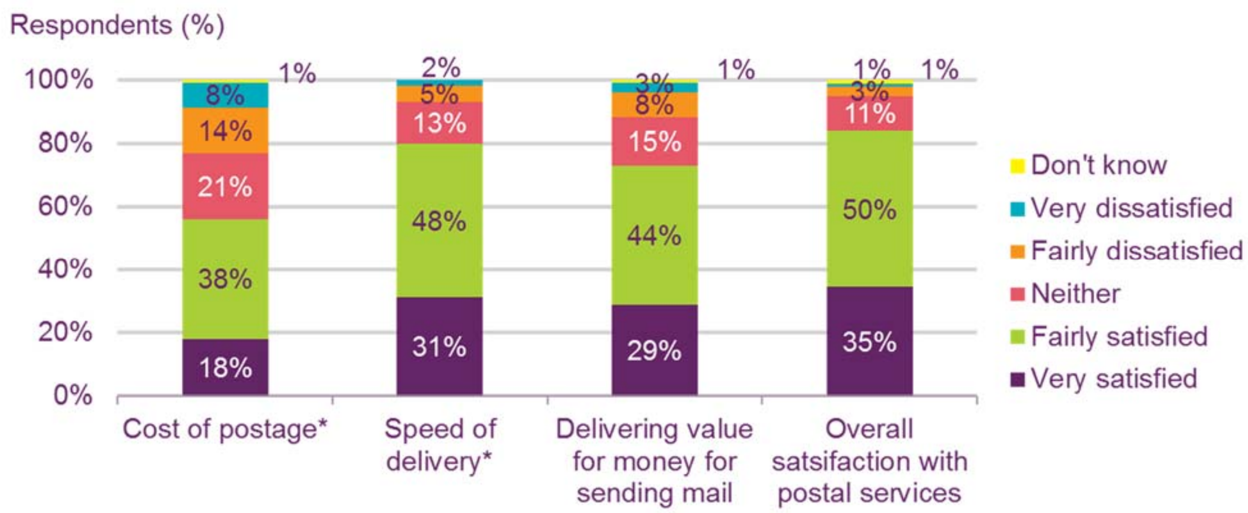
[41] Ofcom, *The Communications Market Report 2016,* 4 August 2016, http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr16/.

3.50 The variation between sample results and the true values (the findings that would have been obtained if everyone had been interviewed) can be predicted from the sample sizes on which the results are based and on the number of times that a particular answer is given. The confidence with which we can make this prediction is 95%; that is, chances are 95 in 100 that the true values will fall within a specified range. Where movements are not statistically significant we have noted them below.

Our findings suggest the majority of consumers are satisfied with postal services

3.51 Residential consumer satisfaction results showed that the majority of consumers are satisfied with various aspects of postal services.

Figure 3.4 – Residential consumers' satisfaction with aspects of postal services



Source: Ofcom Residential Postal Tracker 2016
Base: all respondents (n=3249)
QG3_7: How satisfied are you with the following aspects of Royal Mail's service? Cost of postage; QG2: How satisfied are you overall with the postal services in terms of delivering value for money for sending mail?; 'QG6: How would you rate your overall satisfaction with postal services? (ALL providers); 'QG3_4: How satisfied are you with the following aspects of Royal Mail's service? Speed of delivery.
** Indicates metric measured against Royal Mail's service only*

3.52 As shown in Figure 3.4, a large majority of residential consumers said that they were satisfied with postal services overall, with 85% of respondents stating they were either 'very satisfied' or 'fairly satisfied' with overall postal services from all providers. A majority of residential consumers (73%) also report satisfaction with the 'value for money for sending mail' by stating they were either 'very satisfied' or 'fairly satisfied'.

3.53 On specific metrics relating only to Royal Mail's service, the majority of residential consumers are also satisfied. Figure 3.4 shows nearly eight in ten residential consumers (79%) stating that they were 'very satisfied' or 'fairly satisfied' with the speed of delivery. A majority of residential consumers (56%) also state that they are either 'very satisfied' or 'fairly satisfied' with the 'cost of postage'.

Perceptions of value for money are better for First Class stamps compared to Second Class stamps

3.54 As shown in Figure 3.5, a majority of residential consumers' state that they believe both First and Second Class stamps are either 'very good' or 'fairly good' value for money. More than a quarter of residential consumers (26%) believe that First Class stamps are 'very good' value for money, slightly more than those who thought that Second Class stamps were 'very good' value for money (22%).

Figure 3.5 – Residential consumers' perception of value for money of First and Second Class stamps

Source: Ofcom Residential Postal Tracker 2016
Base: all respondents (n=3249)
QF4: A 1st class stamp currently costs 63p. How would you rate Royal Mail's 1st class service in terms of value for money?; QF5: A 2nd class stamp currently costs 54p. How would you rate Royal Mail's 2nd class service in terms of value for money?

Mis-delivered mail continues to be the most commonly experienced problem with Royal Mail in the last twelve months

3.55 Our survey asked residential consumers about the types of problems they have experienced with Royal Mail services. This is separate from the complaint statistics reported by Royal Mail (see paragraph 3.38 above).

Figure 3.6 – Problems reported by all surveyed residential consumers in relation to Royal Mail*

Source: Ofcom Residential Postal Tracker 2016
Base: all respondents (n=3249)
QH1_1 to QH1_6: In the last 12 months, have you experienced problems with Royal Mail's service in terms of... Lost mail/ damaged mail/ delayed mail/ mis-delivered mail/ mail that has been tampered with/ A card from Royal Mail saying that an item could not be delivered, when someone was in your home and could have taken the delivery
**Categories are not mututally exclusive therefore sum adds up to greater than 100%*

3.56 When asked specifically about the service received from Royal Mail, the most commonly reported problem among respondents to the survey who were residential consumers was 'mis-delivered mail'. More than two in five residential consumers (43%) selected this response. 26% of residential consumers reported that they had experienced 'a card from Royal Mail saying an item could not be delivered, when someone was in your home and could have taken the delivery' or 'delayed mail' (23%).

3.57 Our residential consumer tracking survey also asks those who have used a provider other than Royal Mail if they experienced problems. This information will be published on our website as part of the annual residential tracker data tables in Q1 2017.

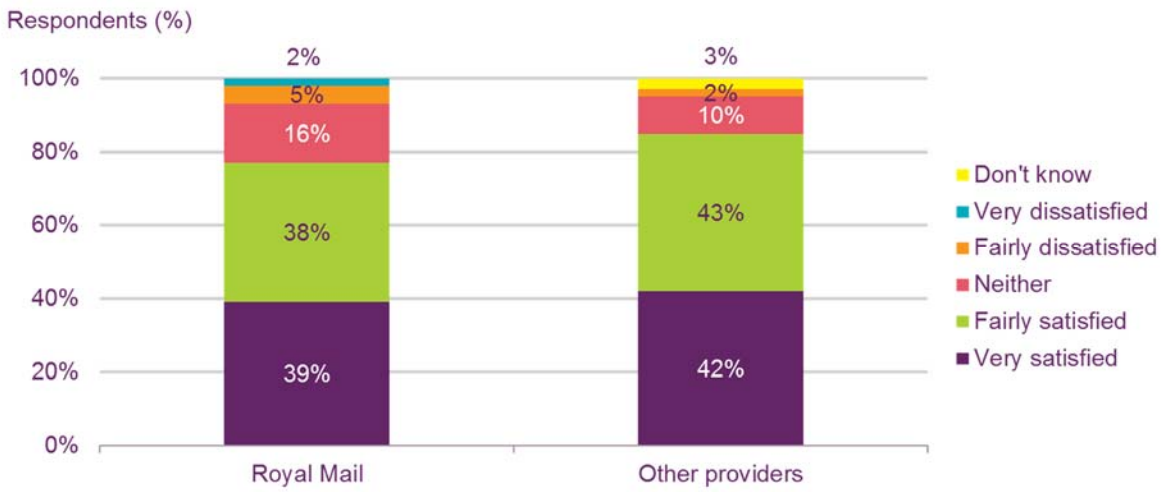
SME Business satisfaction levels

3.58 As discussed in paragraph 3.45, we also conduct a tracking survey among SME decision makers about postal services.[42]

3.59 Figure 3.7 shows that satisfaction levels with Royal Mail and other postal operators are high amongst SMEs. Satisfaction rates are higher for other postal operators with 85% of SME survey respondents being satisfied with services from other operators, compared to 77% with Royal Mail.

[42] 1,297 SMEs were sampled as part of our Business Postal Tracker.

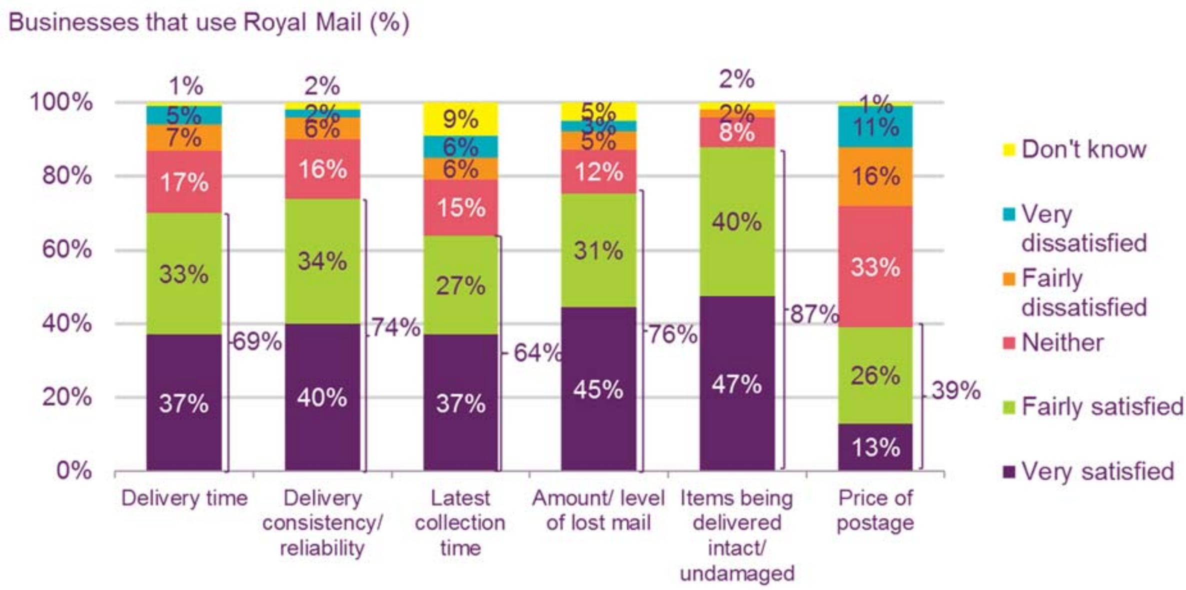
Figure 3.7 – Satisfaction levels amongst businesses for Royal Mail and other postal operators



Source: Ofcom Business Postal Tracker. Base: Royal Mail (1,276), Other Providers (230) April 14 to March 15 QRM2. Thinking generally about the service your organisation receives as a whole, how satisfied are you with the overall quality of the services you receive from Royal Mail as a recipient and sender? QOP1a. ALL PROVIDERS OTHER THAN RM. Thinking generally about the service you receive as a whole as a sender and recipient of mail, how would you rate the quality of the services you receive from [QV5C]

3.60 As shown in Figure 3.8, there was high levels of satisfaction with all aspects of Royal Mail except for 'price of postage', which was the only aspect where less than 50% of businesses said they were either 'fairly satisfied' or 'very satisfied'.

Figure 3.8 – Businesses' satisfaction with aspects of Royal Mail



Source: Ofcom Business Postal Tracker. Base: All those who use Royal Mail (1,276) April 14 to March 15 QRM3. How would you rate the performance of Royal Mail, as a recipient and sender, in the following areas?

The majority of businesses did not report any problems with Royal Mail

3.61 The majority of businesses did not report that they had experienced any problems with Royal Mail. The most common problem with Royal Mail reported by businesses was the amount/level of lost post sent (6%).

Figure 3.9 – Businesses reported problems with Royal Mail

Source: Ofcom Business Postal Tracker. Base: All those who use Royal Mail (1,276) April 14 to March 15 QRM4. Have you experienced any problems with your service from Royal Mail (as a sender or recipient of post) in the last 6 months?

3.62 60% of sampled SMEs also stated they had switched mail to other communication methods within the last 12 months. Half (52%) of respondents who switched stated the reason for switching was because other communications methods were quicker, while 37% said they did so for cost saving reasons. At the same time, when businesses were asked whether in the past 12 months the volume of mail their organisation sends had changed, the majority (69%) said that it had stayed the same, while nearly a quarter (23%) said it had decreased and 7% said it had increased.

We will continue to monitor views on the postal sector through our consumer surveys

3.63 Our business and residential surveys provide us with a useful measurement of the consumer experience of postal services – for example, in terms of general satisfaction with the service, satisfaction with the cost of postage, value for money and the problems encountered. We will continue to provide analysis from both the residential and business surveys in our future annual monitoring updates.

3.64 In order to better monitor consumers' experiences in the postal sector, specifically with regards to monitoring the evolution of postal user needs and preferences, we are planning on adding additional questions to our postal trackers.

Summary

3.65 The key findings relevant to customers and consumers are below:

- First and Second Class stamps are perceived as being good value for money. Royal Mail is complying with the Second Class safeguard price cap we have put in place.
- Our market research indicates that the vast majority of residential consumers and the majority of business customers are satisfied with their postal services, though 77% of Royal Mail's SME customers say they are satisfied compared to 85% of other operators' SME customers.
- Royal Mail failed to meet the First Class and PCA quality of service targets for 2015-16, and performance across most quality of service measures was worse than the prior year. Royal Mail met its Second Class targets for 2015-16.
- Complaints data published by Royal Mail showed the number of complaints received by Royal Mail increased for the first time in four years. Complaints per 100,000 items delivered increased by 12.2% to 6.77 complaints. The overall trend for the last five years is still a decline of 22.2%.

Section 4

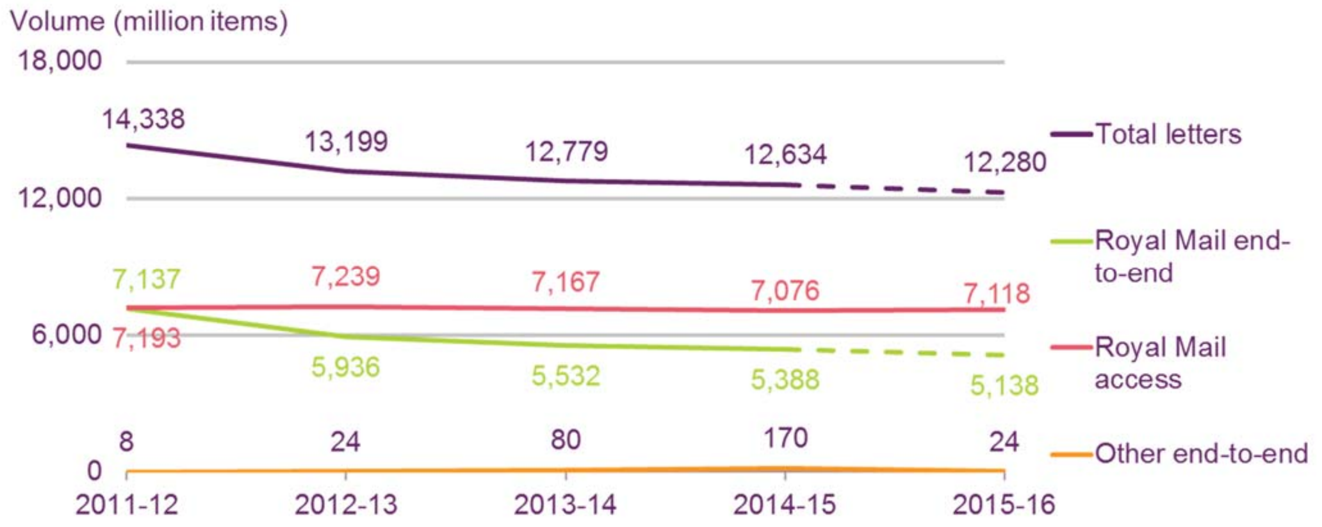
The letters market

4.1 This Section outlines trends in the UK letters sector and discusses the different types of competition and market trends for alternative types of mail volumes. We then discuss Royal Mail's price increases for its retail bulk mail products and the price changes for access products effective from January 2015 to January 2016. We then discuss trends and new developments in both access and end-to-end competition in the UK.

4.2 Interactive data on historical trends is available on the Ofcom website for letters market revenues and volumes by type of operator, bulk and access letters pricing.[43]

4.3 For 2015-16 we have changed the basis on which we categorise certain letter formats as part of our analysis of the total letters market. This means that data presented for 2011-12 to 2014-15 is not comparable to that presented in 2015-16. We therefore do not comment on year on year trends from 2014-15 to 2015-16.

Figure 4.1 – Total addressed letters volume by type of operator



Source: Royal Mail Regulatory Financial Statements, operator returns to Ofcom, Ofcom estimates.[44]

4.4 Figure 4.1 shows that between 2011-12 and 2014-15 total addressed letters volumes declined by 11.9% to 12.6bn items (c.4% per annum). Although not directly comparable, volumes continued to fall in 2015-16.

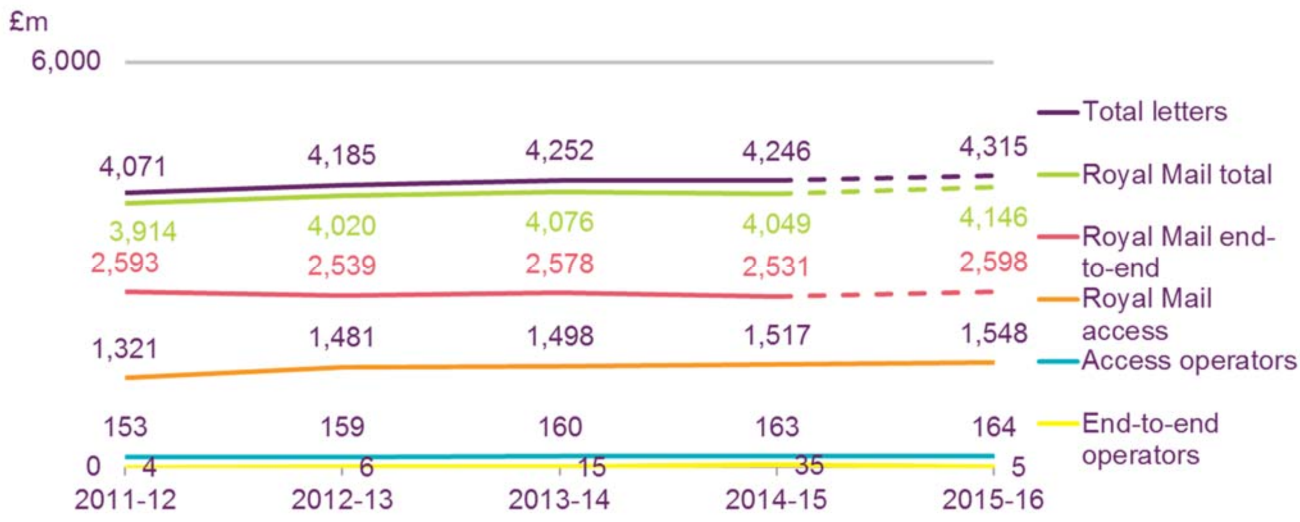
4.5 In a 2013 PwC report commissioned by Royal Mail on UK mail volumes, PwC stated the key factors influencing volume decline from 2005 were e-substitution, low GDP growth and price rises.[45]

[43] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

[44] Royal Mail end-to-end is an Ofcom calculation and refers to Royal Mail total letters volumes excepting access. Royal Mail access volumes are as per its Regulatory Financial Statements and include a small amount of parcels. The effect of this is that Royal Mail's access volumes are slightly overstated and its end-to-end volumes are slightly understated.

4.6 Royal Mail recognises the main drivers of volume decline in 2015-16 as continued e-subsititution and the growth in mobile and online advertising.[46]

Figure 4.2 – Total letters revenue by type of operator



Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, operator returns to Ofcom, Ofcom estimates.[47]

4.7 Figure 4.2 shows that total addressed letters revenues increased by 4.3% between 2011-12 and 2014-15 mainly due to Royal Mail access revenues increasing. Royal Mail end-to-end revenues decreased by 2.4% across the same period. The letters market had volumes of 12.3bn and revenues of £4.3bn in 2015-16.

4.8 Page 6 of the interactive data shows historic trends in letters volumes and revenues.[48]

Types of competition

4.9 Within the postal sector, there are two main forms of bulk letters competition: access and end-to-end.

4.10 Access competition is where a postal operator other than Royal Mail collects mail from the customer, sorts it and then transports it to Royal Mail's Inward Mail Centres, where it is handed over to Royal Mail for delivery. Royal Mail is subject to a regulatory condition requiring it to offer access at its Inward Mail Centres to other

[45] PWC Strategy & Economics, *The outlook for UK mail volumes to 2023,* 15 July 2013, http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf.
[46] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 12.
[47] Total Royal Mail letter revenue refers to Royal Mail total access and end-to-end. Royal Mail end-to-end revenues are calculated with reference to total letter revenues less access. Royal Mail access revenues are as per its Regulatory Financial Statements and include a small amount of parcels. The effect of this is that Royal Mail's access revenues are slightly overstated and its end-to-end revenues are slightly understated.
[48] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

postal operators and customers for letters and large letters. This enables other operators to offer postal services to larger business customers for these formats without setting up a delivery network. Access has been the predominant form of letters competition in the UK since the first access contract was signed in 2004.

4.11 End-to-end competition is where a postal operator other than Royal Mail undertakes the entire process of collecting, sorting and delivering mail to the intended recipients. There is little end-to-end competition in the UK letters market, unlike some other European countries where end-to-end competition is the main form of competition. Whistl's withdrawal from the end-to-end letters sector in May 2015 means that the 1.3% share of end-to-end letter volume accounted for by providers other than Royal Mail in 2014-15 fell to 0.2% in 2015-16.

Bulk letters competition

4.12 Together, the total letters and large letters mail sector consists of three parts: mail collected and delivered by Royal Mail (Royal Mail end-to-end) which consists of both bulk and non-bulk mail; mail collected by other operators and delivered by Royal Mail (Royal Mail access); and mail collected and delivered by other operators (other operators' end-to-end).

4.13 Figure 4.1 shows access volumes increased slightly in 2015-16, growing by 0.6% or 42 million items. This reverses the trend of declining access volumes of the previous two years, as Whistl's former end-to-end customers have reverted to using access providers (including Whistl). However, the absolute growth in access mail is less than absolute decline in end-to-end from operators other than Royal Mail. This shows that some bulk senders have reduced the amount of letter mail that they are sending.

4.14 As access volumes have grown and total letter volumes have declined, the proportion of access in total letters volumes has increased. Access accounted for approximately 58% of total letters market volume in 2015-16.

4.15 The number of letters delivered by other end-to-end operators fell by 86%. This is due to the withdrawal of Whistl from the end-to-end letter delivery market in Q2 2015-16. There are still a number of smaller scale end-to-end operators delivering in specific geographic areas. Some of these operators have seen growth in their volumes year-on-year, including Velopost (delivering in Bristol, Bath and Edinburgh) and Yellow Jersey Delivery (delivering in Coventry).

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

4.17 Figure 4.2 shows revenue from access operations increased for both Royal Mail and access operators. The increases are likely due to the slight increase in access volumes and January 2015 price rises. Royal Mail's access revenues increased by 2.2% to £1.5bn and access operators' revenues increased by 0.8% to £164m (c.4% of addressed letter revenues).

4.18 Page 6 of the interactive data shows historic trends in letters volumes and revenues.[49]

4.19 Royal Mail is subject to a margin squeeze control on its retail prices for D+2 Letter and Large Letter bulk mail. The control seeks to ensure that the upstream element of the revenues of these bulk mail services is sufficient to cover the costs of the relevant upstream activities carried out by Royal Mail to provide the services. The objective of the control is to ensure Royal Mail does not compete unfairly with the access operators that purchase wholesale access services from Royal Mail to provide bulk mail services in the market. We note that in accordance with the requirements in our USP Access Condition, we have received quarterly compliance reports from Royal Mail which set out details of the prices, volumes, revenues, costs and the contract information needed to demonstrate compliance with the control.

Price trends for retail bulk mail and access customers

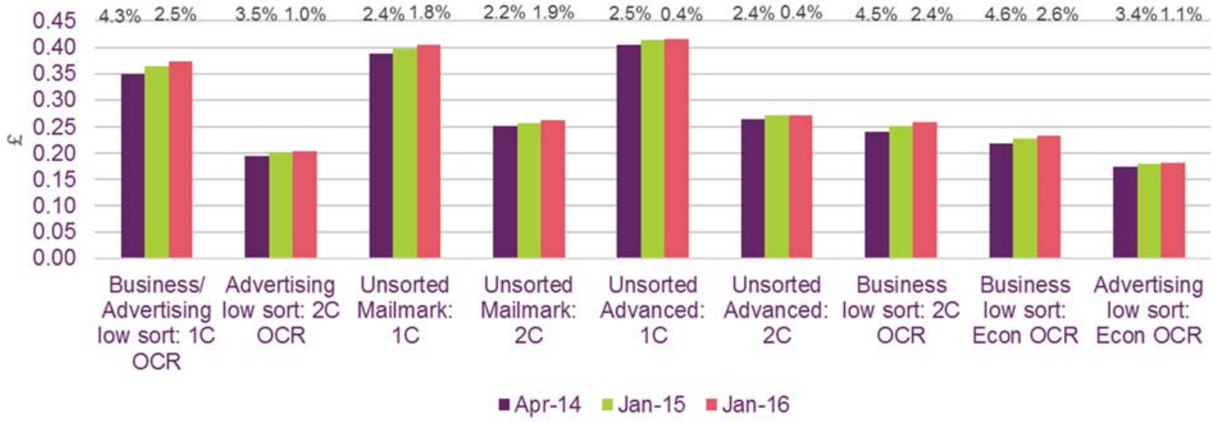
Retail bulk mail prices

4.20 Royal Mail and other operators offer a number of products and services to business customers who send larger volumes of mail, which are not within the universal service. These include letter, large letter and parcel products that are subject to discounts for factors such as the volume of mail sent, the way the mail has been presented (for example, using fonts to make it easier for the machine to read the address), applying machine barcodes, the level of sortation, and/or the purchase of any other conveyance of the same or any other postal packet.

4.21 Royal Mail introduced Mailmark services in November 2013. Royal Mail markets Mailmark as a new barcode option which offers enhanced services as compared to normal barcodes. In order to migrate users to Mailmark it has been offered at a discount to other barcode products. There is also a similar Mailmark product offered for access products.

[49] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

Figure 4.3 – Royal Mail Business Mail prices – April 2014 to July 2016*



Source: Royal Mail, Ofcom calculation based on maximum discounted prices i.e. 120k+ volume discounts and low sort barcode discount
**percentages above relate to year on year percentage change in prices.*

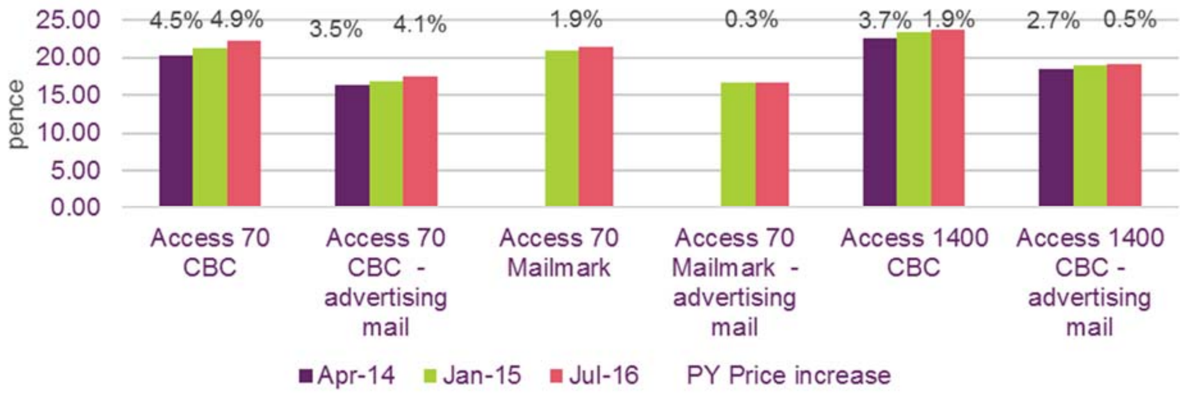
4.22 Figure 4.3 shows prices increased further in 2016-17. Low sort Business Mail products increased by c.2.5% on average whereas unsorted Business Mail increased by significantly less. In line with previous years, Royal Mail offers larger discounts on its retail advertising mail products than on its transactional products (c.22% discount).

4.23 Price increases in 2016-17 were less than the prior period price increases.

4.24 Page 7 of the interactive data shows historic trends in business mail prices.[50]

Access prices

Figure 4.4 – National access prices: April 2014 to July 2016



Source: Royal Mail, based on National access prices, weighing 0-100g

4.25 Royal Mail has increased its access prices each year since 2010, and in particular in 2011 and 2012 (when the overall price increases for some services were around 20%). As with its retail business mail prices, the access price increases have been lower for advertising mail compared to transactional mail.

4.26 In early 2015, Royal Mail introduced a provision to the terms of its contract with access operators that increased its flexibility to offer incentive schemes and

[50] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

promotions in Access products in order to stimulate mail volume growth. These discounts are not included in Figure 4.4.

4.27 Royal Mail increased its access prices again in July 2016. The main bulk of the increases came in Access 70 CBC. Due to a change in pricing Royal Mail now offers Mailmark at a c.4% discount to the CBC equivalent. This has increased from the 1% discount it offered in January 2015. Royal Mail hopes this will increase the switching between the CBC product to the Mailmark equivalent.

4.28 Price increases in 2016-17 were generally less than the 2015-16 price increases.

4.29 Page 8 of the interactive data shows historic trends in access mail prices.[51]

Summary of trends in letters

4.30 The key findings relevant to the letters market are:

- The letters market had volumes of 12.3bn and revenues of £4.3bn in 2015-16.
- Access letters volumes and revenues increased due to the withdrawal of Whistl from the end-to-end market (as Whistl end-to-end volumes returned to Royal Mail Access) and price rises. Access accounted for 58% of the total letters market. Although access operators handle 58% of letter volumes they only retain about 4% of total addressed letter mail revenue.
- End-to-end letters competition decreased significantly due to the withdrawal of Whistl from end-to-end operations.
- Bulk mail and access price increases in 2016-17 were generally less than the 2015-16 price increases.

[51] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

Section 5

The parcels market

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

Collecting information on parcels

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

5.2.1 larger than a Large Letter (i.e. an item up to length 353mm, width 250mm, thickness 25mm, and weighs no more than 750g);

5.2.2 weighs no more than 31.5kg; and

5.2.3 can be lifted by a single average individual without mechanical aids.

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

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

5.5 In our previous monitoring update, we noted that we had not collected information from DHL, who had sought judicial review of our information request. We also noted that we had not collected information from Amazon about its Amazon Logistics services. We have now collected information from these operators.[52]

5.6 To enable comparable year-on-year trend analysis from 2014-15 to 2015-16, and taking into account the addition of two operators to the data set, we have restated some data that we presented in 2014-15. We have also restated some information from 2014-15 where more reliable data has been made available over the course of the last year. This means that we have a more complete and consistent dataset, and

[52] The information provided by Amazon includes parcels sent by Amazon Logistics to Amazon's own customers, as well as parcels sent by Amazon Logistics on behalf of Marketplace sellers on Amazon's platform.

also preserves the confidentiality of the data by preventing each of the organisations not included in the previous analysis to determine the volumes and revenues of the other. It also means that it is not possible to directly compare the volume and revenue reported for 2014-15 in last year's report with that reported in this report. Figures given in this report for 2014-15 represent our restated figures taking into account new data.

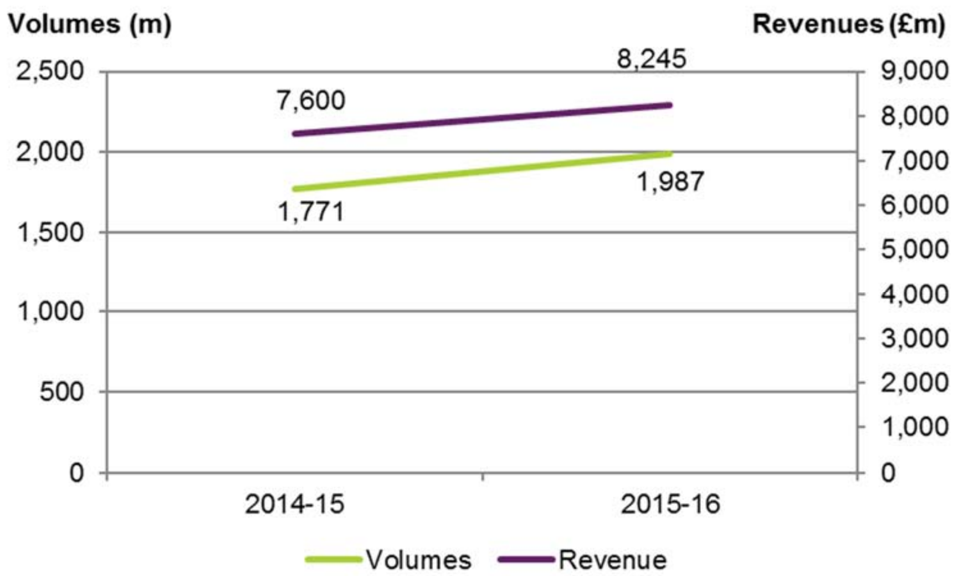
5.7 Where we state proportions of total volumes and revenues below, the figures presented are (unless otherwise stated) shares of the data collected.

Parcel volumes and revenues

5.8 Total measured national volumes and revenues continued to grow in 2015-16. Total measured national volumes increased in 2015-16 by 12% to 2bn items and revenue increased by 8% to £8.2bn. [53] This is shown in Figure 5.1 below.

5.9 The rate of growth is faster than in previous years. It is broadly in line with the rate of volume growth reported by the Interactive Media in Retail Group (IMRG), which reported a 15.7% increase in online retail parcel volumes for the 2015 calendar year as a whole.[54] This was against a forecast growth rate of 13% at the beginning of the year. The continued increase in the popularity of online shopping appears to largely account for the continued market growth.

Figure 5.1 –Total measured national parcels volumes and revenues (including international)



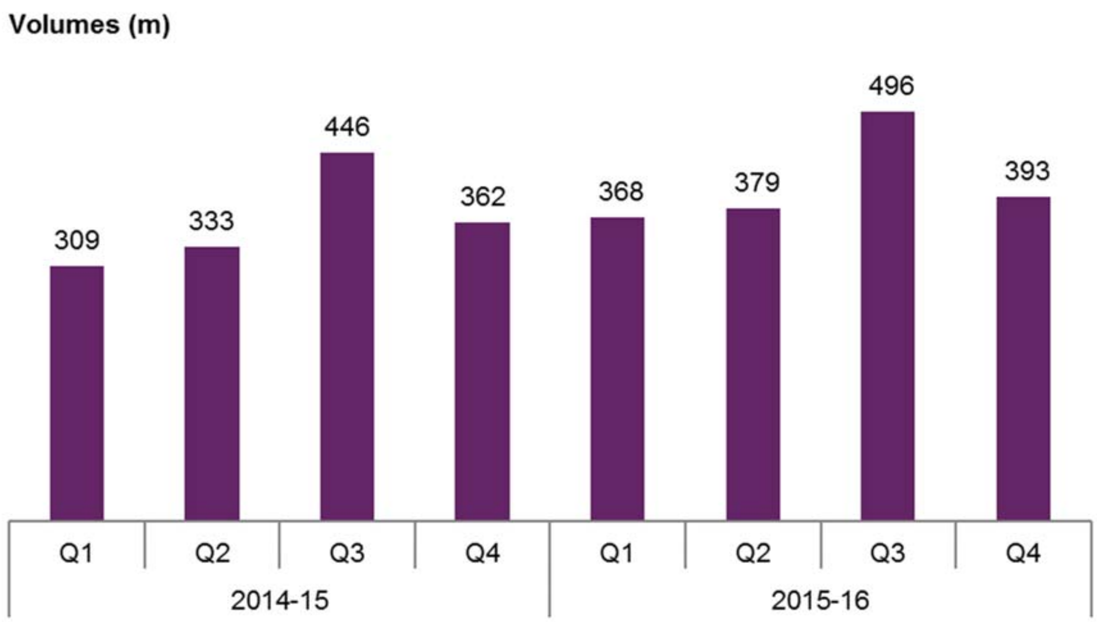
Source: Operator returns to Ofcom

[53] The revenue numbers that we report are based on self reported figures provided to us by parcel operators. As a result, the revenue assigned to particular parcel products may be subject to judgement calls made by individual operators for the purposes of their company's internal reporting, accounting or transfer pricing.
[54] IMRG, *Online retail parcel volumes exceed forecast in 2015,* https://www.imrg.org/media-and-comment/press-releases/online-retail-parcel-volumes-exceed-forecast-in-2015/

5.10 Figure 5.2 and Figure 5.3 show the measured domestic volumes and revenues on a quarterly basis for both 2014-15 and 2015-16. As expected, quarter three is the busiest quarter with additional volume in the run up to and over the Christmas period. The greatest percentage increase by quarter for volumes was in quarter one, where volumes increased by 19% from 2014-15 to 2015-16. The year-on-year percentage volume change in other quarters was around the annual average of 13% in quarters two and three, and below the annual average in quarter four. In terms of revenue, the greatest year-on-year percentage increase was also in quarter one (16%). The year-on-year percentage change in revenue was near the annual average of 11% in quarters two and three, and below the annual average in quarter four.

5.11 Within quarter three, we understand that the rate of increase during November was higher in 2015-16 than in previous years. IMRG observed that shoppers brought much of their Christmas spending forward in 2015-16 in response to many retailers extending their Black Friday discount periods and moving them forward.[55] This resulted in a steeper increase in sales in November before flattening slightly into December, unlike in previous years where many shoppers have tended to wait until December before making online purchases. This is consistent with the findings from our investigation of Royal Mail's compliance with quality of service requirements for First Class postal services in 2015-16.[56]

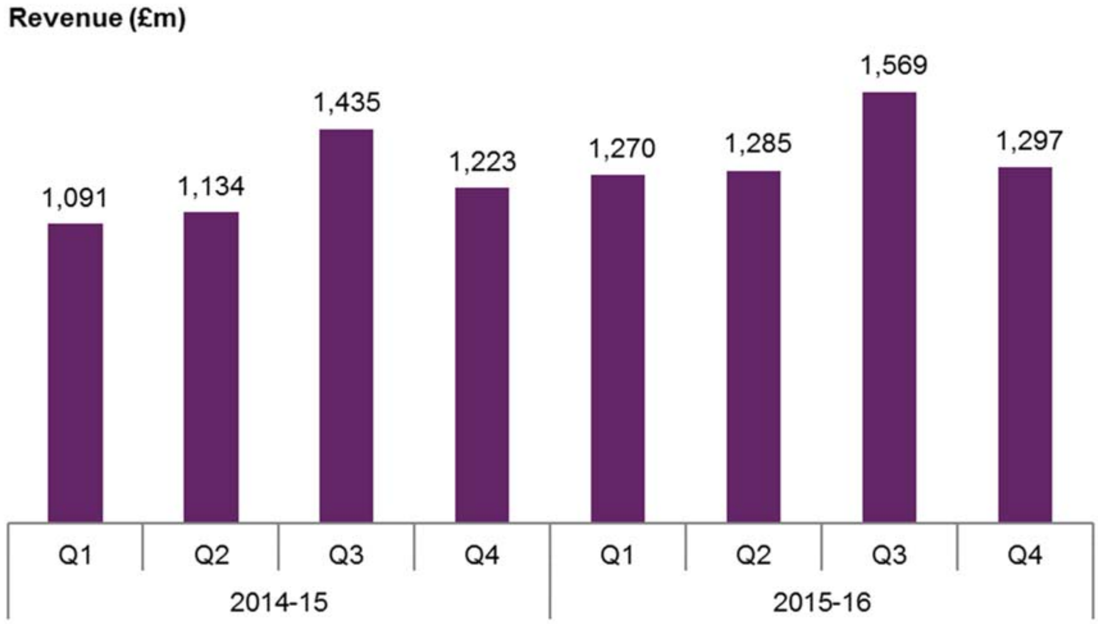
Figure 5.2 – Quarterly measured volumes for domestic parcels



Source: Operator returns to Ofcom (does include access volumes)

[55] IMRG, *Online retail parcel volumes exceed forecast in 2015,* https://www.imrg.org/media-and-comment/press-releases/online-retail-parcel-volumes-exceed-forecast-in-2015/
[56] https://www.ofcom.org.uk/__data/assets/pdf_file/0028/92746/161020-non-confidential-decision-v3.pdf

Figure 5.3 – Quarterly measured revenues for domestic parcels



Source: Operator returns to Ofcom (does include access revenues)

5.12 In 2015-16 measured domestic[57] parcel volumes increased 13% to 1.6bn items (82% of total volumes) and measured domestic revenues increased 11%, to almost £5.4bn (65% of total revenues). International inbound parcels[58] made up 10% of measured volumes and 13% of measured revenues, and outbound parcels[59] made up 8% of volumes, and 22% of revenues.

5.13 Figure 5.4 sets out the proportion of measured national volumes and revenues made up by domestic parcels and international inbound and outbound parcels. As can be seen from Figure 5.4, domestic parcels make up the majority of volumes and revenues. Domestic parcels represent a larger proportion of total volumes than of total revenue. This is reflected in the average unit revenues: In 2015-16 the average unit revenue for a domestic parcel was £3.31, whereas the average unit revenue for international inbound and outbound parcels were £5.26 and £11.50 respectively.

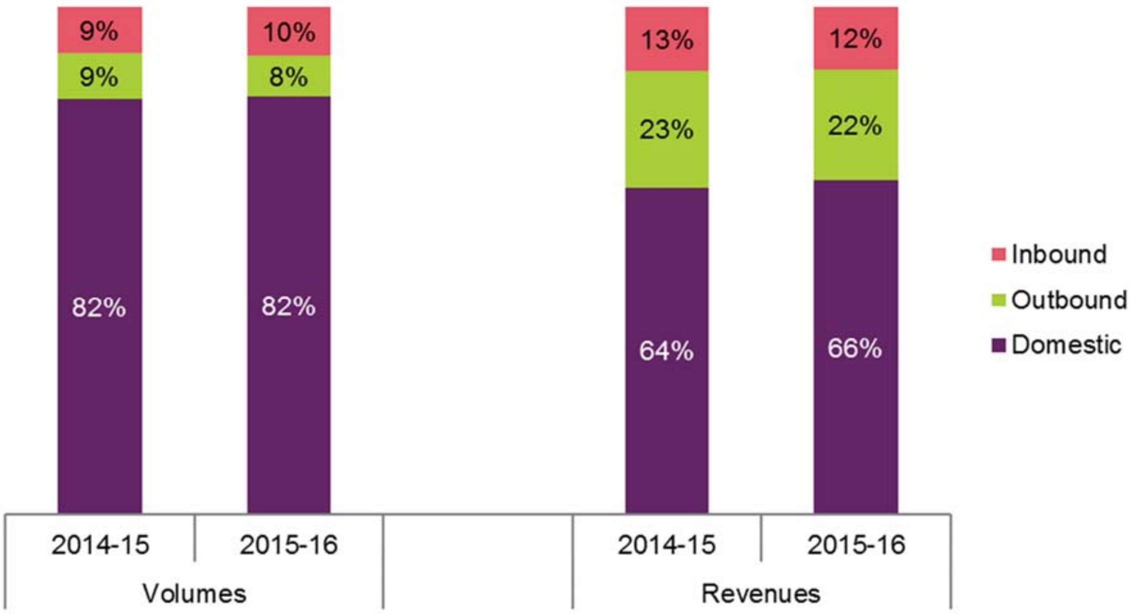
5.14 In 2014-15, average unit revenue for a domestic parcel was £3.37.[60] The average unit revenue for a domestic parcel in 2015-16 of £3.31 therefore represents a 2% decrease in last year's figure. This is likely to be explained by the continued growth of competition among parcels operators, especially in the B2C sector, with operators competing with one another on price to win contracts from e-retailers. It is also likely to be explained by competition driving a more efficient allocation of costs among parcel operators, leading to lower unit prices.

5.15 In 2014-15, average unit revenue for an international inbound parcel was £5.86. The average unit revenue for an international inbound parcel in 2015-16 was £5.26,

[57] Where the parcel is both sent and delivered in the UK.
[58] Where the parcel is sent from outside the UK and delivered in the UK.
[59] Where the parcel is sent from within the UK and delivered outside the UK.
[60] Following a review of the 2014-15 data, we have restated average unit revenue for domestic and international parcels.

representing a 10% decrease on last year's figure. The average unit revenue for an international outbound parcel has increased by 3% from last year. Average unit revenue increased from £11.12 in 2014-15 to £11.50 in 2015-16. The proportion of total revenue accounted for by international outbound parcels is higher than that accounted for by international inbound parcels.

Figure 5.4 – Volumes and revenue for measured parcels by delivery type (international and domestic)

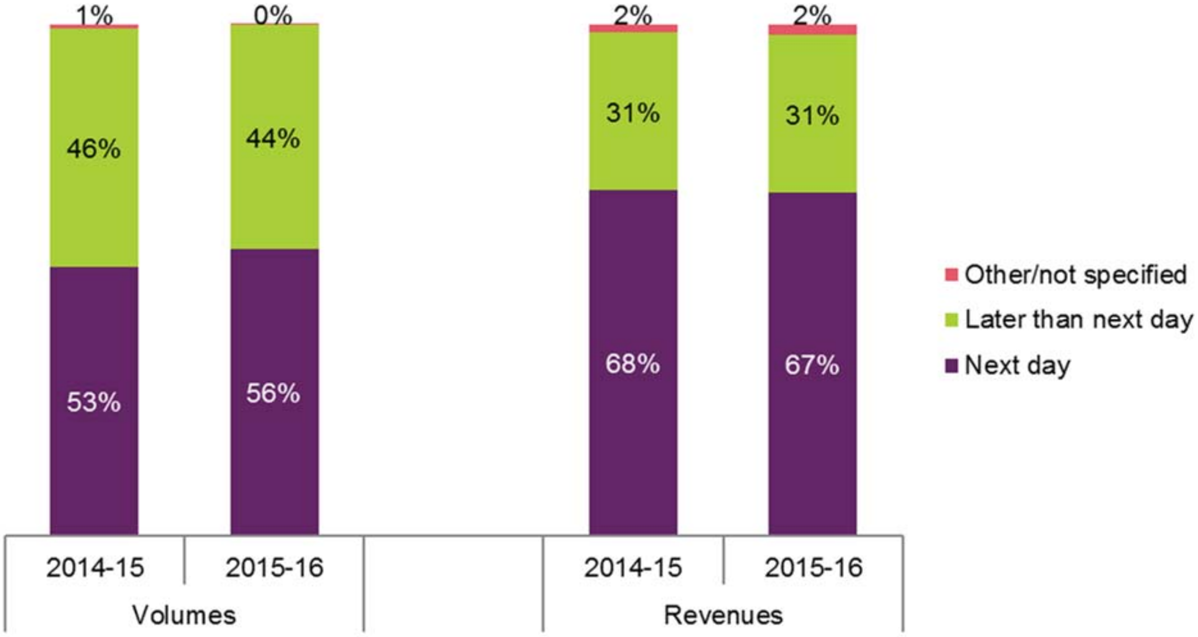


Source: Operator returns to Ofcom

5.16 As shown in Figure 5.5, of measured domestic volumes, Next Day parcel services were the most commonly used, accounting for 56% of all domestic volumes in 2015-16, up from 53% in 2014-15. Next Day services accounted for a greater proportion of total domestic revenues (67%) than of total domestic volumes (56%). This reflects the fact that a premium price is usually charged for Next Day services.

5.17 Conversely, while services slower than Next Day accounted for 44% of domestic volumes in 2015-16, these services only accounted for 31% of domestic revenues. Again this is reflected in average unit revenue, which was £3.91 in 2015-16 for Next Day parcels, but only £2.30 for later than next day. The increase in the proportion of parcels delivered Next Day is likely to be explained by growing consumer expectations about speed of delivery.

Figure 5.5 – Domestic parcel volumes and revenues by speed of delivery: 2015-16[61]



Source: Operator returns to Ofcom

5.18 In summary, overall parcels volume and revenue continued to grow in 2015-16, while average unit revenue fell for domestic and international inbound parcels. The continued growth in the popularity of online shopping appears to account for the continued increase in volume and revenue, while competition is driving down unit prices. The speed at which consumers expect their parcels to arrive is also driving an increase in the proportion of parcels delivered Next Day. In the following section, we discuss developments in the parcels sector in more detail.

Developments in the parcels sector

Changes in market dynamics

5.19 One of the most significant developments in the parcels sector in recent years is Amazon's decision to bring some of its own deliveries in-house, given its large and growing scale.[62] Amazon is not the only company to have brought at least some of its deliveries in-house. For instance, Argos launched its own same-day delivery service in October 2015. Davy Research has stated that in-housing by retailers (particularly by Amazon) risks parcel carriers being left with parcels that are less economically viable.[63] Such developments are changing the market dynamics of the parcels sector.

5.20 Despite the trend of in-housing, a number of operators (e.g. UK Mail, DPD, Parcelforce, Yodel, Hermes and TNT) are expanding their operations by investing in

[61] Due to rounding, percentages may not always appear to add up to 100%.
[62] For instance, Enders Analysis stated that Amazon has a 25% share of UK e-commerce (Enders Analysis, *OTT home entertainment in the UK,* April 2016, http://www.endersanalysis.com/content/publication/ott-home-entertainment-uk), and the Financial Times estimated that, in 2014, Amazon had a 3% share of the UK parcels sector (*Royal Mail blames Amazon network for fall in profits*, 19 November 2014, http://www.ft.com/cms/s/0/56f049f4-6fc0-11e4-90af-00144feabdc0.html#axzz48ohgAp5Q).
[63] Davy Research, *UK parcels market: return to sender*, 17 April 2015, page 34.

new hubs and depots, which has given operators additional capacity.[64] Growth in online retail has also meant that a number of operators (e.g. DPD) that were traditionally focused on delivery of parcels from one business to another (B2B) have expanded their operations to deliver to consumers (B2C).[65]

5.21 There have been a number of acquisitions in the last year. In September, Deutsche Post DHL made a formal offer to acquire UK Mail Group Plc.[66] The acquisition means that UK Mail will become part of the DHL European operation. In addition, Royal Mail has acquired E-courier (a same-day delivery company), NetDespatch (a parcel data management and labelling platform) and Intersoft (a provider of delivery management software for international parcel shipments).[67]

5.22 In October 2016, it was reported that the delivery market in the UK is diverging with B2C and B2B showing very different dynamics.[68] The 2016 edition of the 'UK Domestic Express Parcels Distribution Survey' published by Triangle Management Services finds that B2C shippers tend to switch between carriers frequently, whilst B2B shippers tend to stay with their main domestic parcels carrier for longer. Triangle note that this is creating a divergent market with different dynamics.

5.23 Key insights from Triangle's 2016 report include:

- In the B2B segment, the number of shippers using their main carrier for less than two years is 18% which has fallen to a five-year low. To combat this, there is evidence of increased marketing activities from the carriers.
- In the B2C segment there has been increased churn to levels last seen in 2012, specifically an 8% increase in businesses who have recently stopped using a carrier and an increase to 22% of carriers with less than two years' service.
- The B2C survey shows that improved service levels, marketing and pricing changes are driving shippers to review their choice of delivery partner.

Click and Collect

5.24 A number of stakeholders have noted the growth in click and collect,[69] and have predicted that click and collect will become a more prominent feature of the parcels sector. Barclays estimates that click and collect volumes will grow to 35% of total physical deliveries (up from 26%).[70] Royal Mail suggests that in-store click and collect currently tends to replace purchases that would otherwise have been made on the high street, rather than replacing delivery traffic.[71] However, if (as predicted) click

[64] Royal Mail estimates that sorting capacity has increased by 300m parcels – Royal Mail's response to the July 2015 Discussion Document, *Appendix: Parcels market developments,* paragraph 1.23.
[65] See for instance Davy Research, *Transport Logistics – UK parcels market: return to sender*, 17 April 2015, Figure 9: Evolution of the UK parcel sector, page 8.
[66] https://www.ukmail.com/news/news-article/2016/09/28/deutsche-post-dhl-makes-formal-offer-to-acquire-uk-mail-group-plc
[67] http://www.royalmailgroup.com/financial-and-media-media-centre/finance-media-press-releases
[68] http://postandparcel.info/76227/news/triangle-surveys-show-a-diverging-delivery-market-in-the-uk-with-b2c-and-b2b-showing-very-different-dynamics/
[69] Where items ordered online are delivered to a retail store or intermediary location such as a parcel shop or parcel locker instead of to recipients' homes.
[70] Barclays-Conlumino, *The Last Mile: Exploring the online purchasing and delivery journey*, page 6.
[71] Royal Mail, *Annual Report and Financial Statements 2014-15*, 29 May 2015, page 12.

and collect continues to develop, this may result in final mile delivery increasingly being bypassed.

5.25 Parcel operators have also begun to offer click and collect options to third-party retailers. Examples of such services include Doddle,[72] Asda[73] and Royal Mail, which has re-launched its click and collect offering (Local Collect).[74]

Access Points

5.26 There has been significant entry and expansion in alternatives to the Post Office in recent years, where consumers can drop-off parcels for onward delivery.[75] Notable examples of such services include CollectPlus which launched in 2011,[76] myHermes parcel shops which launched in 2012,[77] UPS Access Point which launched in 2013,[78] and DPD Pickup which launched in 2015.[79]

5.27 Over the course of the last year, alternatives to the Post Office have continued to expand. In June it was reported that 10 Doddle stores in London, Manchester, Birmingham, Brighton, Norwich and Glasgow would become part of the myHermes Parcelshop network offering customers additional pick up locations, as well as drop-off points for online shopping returns and myHermes parcel shipping. Doddle's remaining locations are expected to be added to the network by the end of 2016.[80]

5.28 In addition, in October it was reported that DPD's PickUp service would be extended to 200 Sainsbury's stores from where customers would be able to pick up their DPD parcels.[81] In November, it was reported that Matalan stores would also host DPD's

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[72] Doddle was launched as a collection and sending service in June 2014 and currently plans to expand the number of retail outlets from 43 to 250 by the end of 2017 – *Network Rail launches £24m parcel shop roll-out for UK stations,* 19 June 2014, http://postandparcel.info/61584/news/companies/network-rail-launches-24m-parcel-shop-roll-out-for-uk-stations/.

[73] Asda launched its ToYou service in November 2015, which allows customers to collect and return orders placed with third parties at one of Asda's 614 retail stores – *Asda's game changing parcel innovation*, 11 November 2015, http://your.asda.com/press-centre/asda-s-game-changing-parcel-innovation.

[74] See Royal Mail website, http://www.royalmail.com/business/services/sending/efficiency/local-collect.

[75] When using these alternatives to the Post Office consumers typically have to pre-purchase postage online and print this out. As for the Post Office, consumers can purchase postage in Post Offices, although Royal Mail introduced a cheaper price in 2016 for parcels under 2kg where postage is purchased online.

[76] See CollectPlus, *CollectPlus launches parcel sending service from network of 3,500 local stores as a convenient alternative to the Post Office,* 4 February 2011, https://www.collectplus.co.uk/news/collect-launches-parcel-sending-service-from-network-of-3500-local-shops-as-a-convenient-alternative-to-the-post-office.

[77] See https://www.myhermes.co.uk/help/about.html.

[78] See Post&Parcel, *UPS launches parcel shop access network in the UK,* 7 February 2013, http://postandparcel.info/53731/news/companies/ups-launches-parcel-shop-network-in-uk-ups-access-point/.

[79] See DPD, *DPD announces Stoke HQ for new bespoke parcel shop network*, 20 January 2015, http://www.dpd.co.uk/content/about_dpd/press_centre/news.jsp.

[80] http://tamebay.com/2016/06/myhermes-extends-parcelshop-network-with-doddle.html.

[81] http://postandparcel.info/75788/news/dpd-poised-to-reap-benefits-of-sainsburys-connection/

PickUp service.[82] The users of DPD's PickUp service can already collect parcels from Halfords, Doddle and the Rowlands and Numark Pharmacy chains.

5.29 Consumers can also use services like InPost's locker service (where consumers purchase postage online, and deposit a parcel in a parcel locker). eBay has also reached agreements with Argos to develop its own drop-off network[83] – in other words, eBay sellers can drop-off parcels at Argos branches for onward delivery (and eBay buyers can pick up orders that have been delivered to Argos branches).

5.30 Royal Mail has also worked on developing its offering, working with Post Office branches to extend opening hours (including by moving some Post Office branches to its Post Office Local model, whereby Post Office services are offered over a non-Post Office retail counter).

5.31 Research by Apex Insight suggests the growth in alternative access points and network expansion is continuing across Europe. [84] Apex Insight note that many of the leading European parcel carriers, in particular those with a focus on consumer deliveries, are now involved in building up their own access point networks. According to Apex Insight, the most extensive network is that of Otto, which owns the Hermes and MondialRelay networks, followed by DPD, DHL and UPS. There are also independent players, of which the largest – since the acquisition of Kiala by UPS – is InPost. Other relatively new players in the market include Swipbox, Kariboo and Pass My Parcel.

5.32 Apex Insight expect growth in demand for parcel shops and lockers to continue to be driven primarily by the growth of internet retail. In particular, Apex Insight expects the growth of click and collect type models which allow consumers to select a parcel shop or locker as an alternative to delivery to the home to be faster than that of overall internet retail sales.

Services

5.33 Alongside other operators investing in expanding and improving their parcels services, Royal Mail has said that it is investing in its parcels business to improve efficiency and foster innovation through technology.[85] This includes investing in the capability to barcode more parcels to enable tracking[86] and extending acceptance times for certain products.[87]

5.34 This investment has enabled Royal Mail to offer new services. For example, in May this year it was reported that Royal Mail would offer free online confirmation of

[82] http://postandparcel.info/76635/news/matalan-teams-up-with-dpd/
[83] See eBay press release, *eBay and Argos sign wider multi-year partnership to offer nationwide fulfilment services to buyers and sellers*, 15 October 2015, http://ebay-mediacentre.co.uk/pressrelease/ebay-argos-sign-wider-multi-year-partnership-offer-nationwide-fulfilment-services.
[84] Apex Insight, *European Parcel Shops & Locker Networks Market Insight Report 2016,* July 2016, https://www.apex-insight.com/product/european-parcel-shops-locker-networks-market-insight-report-2016.
[85] Royal Mail's response to the July 2015 Discussion Document – *Parcels appendix: Royal Mail innovation and improvements*.
[86] Royal Mail, *Annual Report and Financial Statements 2014-15*, 29 May 2015, page 12.
[87] See for example *Royal Mail extends acceptance times for Royal Mail Tracked 48 to midnight,* 19 May 2015, http://www.royalmailgroup.com/royal-mail-extends-acceptance-times-royal-mail-tracked-48%C2%AE-midnight.

delivery for barcoded parcels.[88] Other operators also continue to invest in new services. In November 2016 it was reported that Hermes would open an Innovation Lab in Leeds which will focus on developing new delivery solutions.[89]

5.35 We have also observed that some parcel operators are promoting 'same-day'[90] delivery services, particularly in urban areas. The increased availability of such services is likely to be in response to growing consumer demand for items to be delivered quickly.

Parcel Surcharging in Northern Ireland and the Scottish Highlands and Islands

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

5.37 Both CAS and the CCNI have previously published reports about the issue of parcel surcharging. In reports published in 2012 and 2015, the CAS found that the problem of high delivery surcharges continues to impact the Scottish Highlands and Islands more than other rural areas of the UK.[91]

5.38 In a separate report entitled 'The Online Parcel Premium' published in June 2015, the CCNI found that only 50% of online retailers offer the same delivery price to Northern Ireland as to the rest of the UK and that consumers in Northern Ireland face more exclusion and less delivery and collection options when ordering online.[92]

5.39 These reports focus on the effect of parcel surcharging on consumers. In order to supplement the work already undertaken by these organisations, we have collected information from some of the largest national parcel operators in the UK to better understand the causes of parcel surcharging. In particular, we sought to better understand the extent of geographical variation in the prices charged by parcel operators, and terms and conditions offered, and the factors that contribute to such variation for both bulk and single piece parcel services.

5.40 The operators from which we requested information were:

- DPD
- Hermes
- Royal Mail
- Parceforce

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[88] http://postandparcel.info/72988/news/royal-mail-to-offer-free-delivery-confirmation-on-barcoded-standard-parcels/
[89] http://postandparcel.info/76637/news/hermes-launches-innovation-lab/
[90] Ofcom does not gather volume and revenue information from operators who solely provide same-day services.
[91] http://www.cas.org.uk/publications/postcode-penalty-distance-travelled
[92] http://www.consumercouncil.org.uk/filestore/documents/Online_Parcel_Premium_%28FINAL%29.pdf

- YODEL

Bulk Parcels

Service exclusions or restrictions by location, and reliance on third parties

5.41 All five operators from whom we sought information confirmed that they deliver bulk parcels to all addresses in the UK[93] and none impose any specific product delivery restrictions based on location.

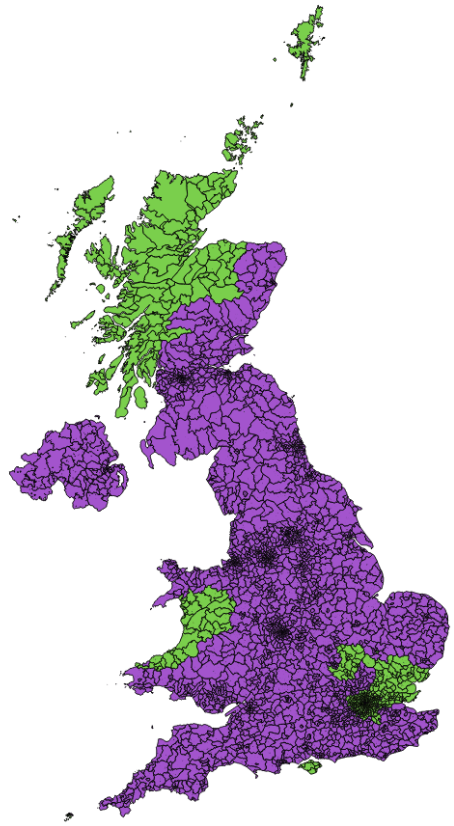
5.42 Four of the five operators rely on third parties to deliver parcels on their behalf in certain locations in the UK.[94] These four operators all use third parties to deliver and collect in the Scottish Highlands and Islands. Third parties are also used by some operators to deliver to remote parts of Wales, areas of London, Essex, Bedfordshire, the Isle of Wight and the Scilly Isles. None of the operators use third parties in Northern Ireland.

5.43 The map below shows those areas of the UK where at least one operator told us that it uses a third party for delivery.

Figure 5.6: Areas of the UK where at least one operator relies on a third party

Green – At least one of the operators that we asked relies on third parties to deliver to these areas.

Purple – None of the operators that we asked rely on third parties to deliver to these areas.



[93] There are some exceptions due to accessibility limitations.
[94] Royal Mail does not rely on third parties on a normal operational day.

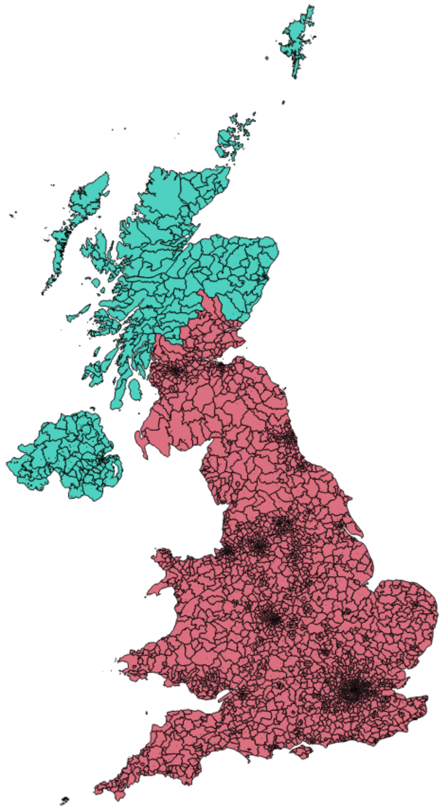
Price variation by location

5.44 The majority of operators from whom we collected data charge higher prices to their bulk parcel customers for delivery services to certain locations in the UK. Bulk parcel customers tend to be large businesses, and some medium sized businesses, who use parcel operators to fulfil delivery of items purchased online by consumers.

Figure 5.7: Areas of the UK where at least one operator charges a higher price for delivery of a bulk parcel

Blue – At least one of the operators that we asked charges a higher price for delivery of a bulk parcel.

Pink – None of the operators that we asked charge a higher price for delivery of a bulk parcel.



5.45 There is some correlation between areas where operators rely on a third party for delivery, and areas where operators charge their bulk customers a higher price. This suggests that the presence of an additional player in the value chain may cause delivery prices to be higher. For example, each operator that uses a third party to deliver to the Scottish Highlands and Islands also charges a higher price for delivery to these areas.

5.46 However, it is also clear that bulk customers shipping items to some locations in the UK where no third party is used pay a higher price regardless of this. This is the case for deliveries to Northern Ireland. Conversely some bulk customers shipping to locations where a third party is used are not subject to a higher price. Examples of such locations include parts of Wales and parts of southern England. This indicates that there might be other factors beyond the use of a third party carrier that could cause price variation in certain locations.

5.47 We asked parcel operators to provide the criteria on which they determine pricing variation by location. All operators told us that the contracts they agree with bulk senders tend to be negotiated on an individual basis, and that prices and terms and conditions are reflective of the prevailing competitive conditions. They said that there is considerable buyer power in the e-retail delivery market, which puts downward pressure on the prices that operators charge their bulk customers. However, some criteria provided by operators appears applicable on a geographic basis, which may explain the higher costs.

5.48 Operators told us that 'drop density' is a relevant factor in determining price variation by region. Drop density refers to the number of parcels being delivered to the same location. A smaller number of parcels means that the costs incurred in their delivery have to be spread over a smaller number of units and the operator cannot benefit from economies of scale. Therefore, the costs for delivery to locations where there is a lower drop density are likely to be higher. This could be a cause of parcel surcharging in more sparsely populated areas of the UK such as the Scottish Highlands and Islands.

5.49 Further, operators told us that they incur additional costs in transporting goods over water, such as the additional cost of ferry or aircraft transportation that parcels transported within the mainland UK do not incur. This could explain why it is that all areas of Northern Ireland are often subject to parcel surcharging, rather than just rural or remote areas as is the case in Scotland.

5.50 Finally, the distance to the delivery location from the operator's nearest hub can also impact the costs incurred in delivery. Each operator has a network of hubs in which they sort and distribute parcels across the UK. The longer the distance from the network hub, the higher the costs to the operator are likely to be. Operators tend to have hubs in or near to areas where the population density is higher, and therefore more remote locations are likely to incur higher costs as they are further from the operator's hub. This could also be a cause of parcel surcharging in remote areas of the UK such as the Scottish Highlands and Islands.

Extended delivery times

5.51 Aside from higher prices, consumers receiving goods in Northern Ireland, the Scottish Highlands and Islands and other islands off the UK are also likely to experience longer delivery times compared to consumers in other parts of the UK. The longest delays typically apply to deliveries and collections in the Scottish Highlands and Islands where consumers can experience additional delivery times of up to seven days. Most operators can fulfil delivery of a parcel to Northern Ireland within 48 hours.

Conclusion

5.52 The data we have gathered demonstrates that prices charged by parcel operators to bulk customers do vary by location in most cases. It also offers some explanation of the causes of the surcharges. However, we do not know the extent to which these surcharges are passed on to consumers. It is possible that the higher costs do not always translate to higher prices for the consumer because some retailers may choose to absorb the additional delivery costs. Therefore, while we now have a better understanding of the causes of parcel surcharges the effect of the surcharges is less clear. It is also not clear whether the causes given by parcel operators necessarily justify the level of the surcharges in all cases.

Single Piece Parcels

5.53 Royal Mail is required to provide a service to all of the UK at a universal price. We therefore did not seek information about geographically variable pricing from Royal Mail in relation to its single piece parcel products.

5.54 Of the remaining four operators that we questioned, DPD and Parcelforce confirmed that they provide single piece parcel services at a uniform price across the UK. However, both operators state that delivery times vary depending on location in the UK.

5.55 YODEL and Hermes confirmed that they do vary their single piece prices by location with Northern Ireland and the Scottish Highlands and Islands being subject to increased prices as well as extended delivery times. However, we note that CollectPus (a joint venture between Yodel and PayPoint) offers a uniform price for single piece parcel services across the UK.

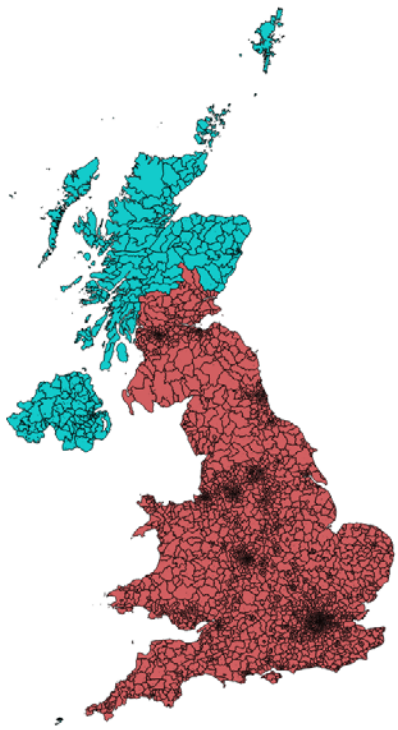
5.56 Operators who vary their single piece prices by location said that they do so because the cost of servicing certain areas is significantly higher than the rest of the UK. Factors that contribute to higher costs include, but are not limited to:

- High distance from despatch point to delivery, causing higher incremental fuel costs;
- Use of more than one driver to comply with driving hours regulations;
- Ferry costs;
- Local labour costs;
- Imbalance of parcel flows leading to underutilisation of spare capacity (e.g. empty trailer legs);
- Drop density; and
- Delivery stem mileages.

Figure 5.8: Areas of the UK where at least one operator charges a higher price for delivery of a single piece parcel

Blue – At least one of the operators that we asked charges a higher price for delivery of a single piece parcel.

Pink – None of the operators that we asked charge a higher price for delivery of a single piece parcel.



Conclusion

5.57 Some operators vary their single piece parcel prices based on location and justify this based on the increased costs associated with delivery. However, other operators do not change the price charged based on location. This could be because operators that charge a uniform price spread the additional cost of delivering to remote areas across all parcels. All of the operators that we asked stated that some rural and remote locations are subject to additional delivery times.

Further work

5.58 While the information presented in this section furthers our understanding of the causes of parcel surcharging to some extent, we intend to explore this issue further over the coming year.

5.59 In particular, we intend to work with parcel operators to understand the extent to which the factors given as causes of parcel surcharging account for the additional charges. This will further our understanding of the causes of parcel surcharging.

5.60 We also intend to develop our understanding of the value chain for parcel delivery and collection, including online retailers and whether the costs associated with delivering to certain locations are absorbed by online retailers so that they are able to offer a uniform price of delivery, or whether they are passed on to the consumer. This will further our understanding of the effects of parcel surcharging.

Cross-Border Parcel Services

5.61 On 25 May 2016, the European Commission (The Commission) adopted a proposal for a Regulation on cross-border parcel delivery services, as part of a package of measures intended to allow consumers and companies to buy and sell products and services online more easily across the EU.

5.62 The Commission has said that consumers and small businesses complain that problems with parcel delivery, in particular high delivery charges for cross-border services, prevent them from selling or buying more across the EU. The Commission has adopted this proposal with the aim of increasing price transparency and regulatory oversight of cross-border parcel delivery services so that individual consumers and small e-retailers can benefit from more affordable deliveries and convenient return options, including to and from peripheral regions of the EU.

5.63 The Commission states that the Regulation will give national postal regulators the data they need to monitor cross-border markets and check the affordability of prices. It also argues that the Regulation will encourage competition by requiring transparent and non-discriminatory third-party access to certain cross-border parcel delivery services and infrastructure. The Commission intends to publish the public list prices of universal service providers to increase peer competition and tariff transparency. [95]

5.64 Ofcom is providing advice and technical assistance to the UK Government as part of the standard process for the development of European legislation. The Regulation is likely to be adopted by the European Parliament around mid-2017 and is expected to come into force from April 2018.

Summary of parcels

5.65 The key findings relevant to parcels were that measured national parcel volumes increased in 2015-16 by 12%. Measured national revenues also increased although at a slower rate than volumes (8%). As was the case in 2014-15, growth in volumes outstripped growth in revenue, which reflects the continued development of competition in the sector.

[95] https://ec.europa.eu/growth/sectors/postal-services/parcel-delivery_en

Section 6

The financial performance of the Reported Business

6.1 As with previous years, this Section summarises the financial performance of the Reported Business (unless otherwise stated) for 2015-16, and where relevant, a five-year trend. We monitor financial performance of the Reported Business with regards to our duty to ensure the financial sustainability of the universal service as set out in the March 2012 Statement.[96]

6.2 We discuss in sequence:

- profit margins, cash flow and financial health metrics;[97]
- changes in overall volumes and revenues for the Reported Business – and then by product groups, formats and universal service products, to help us understand what is driving overall revenue and volume changes of the universal service provider; and
- changes in the costs of the Reported Business – to understand what progress has been made in relation to cost reduction. This information is also an important input when considering the efficiency of the universal postal service, which is discussed further in Section 7.

Reported Business profit margin

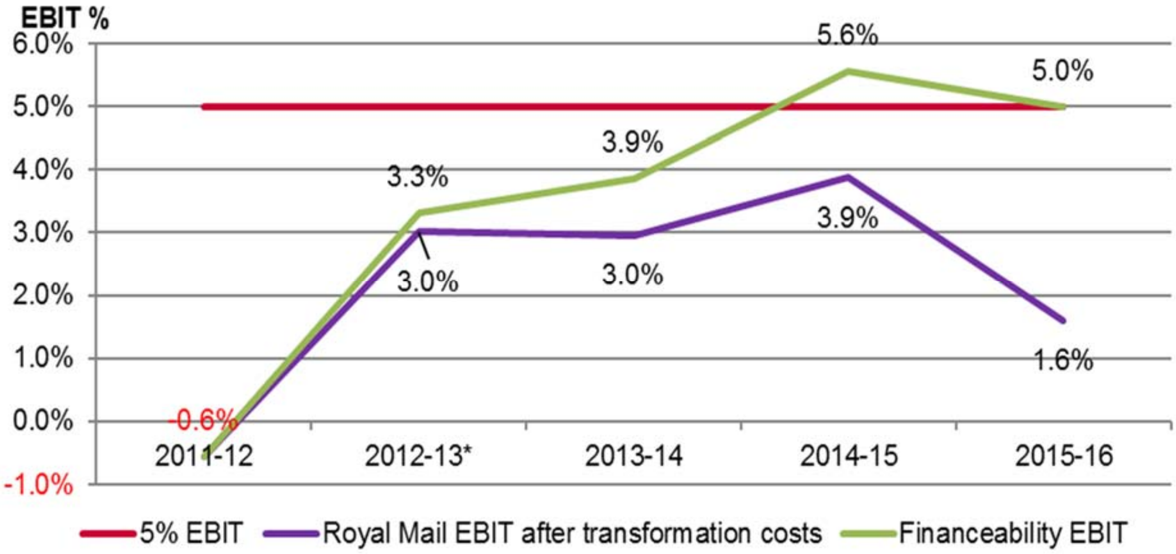
6.3 In considering the financial sustainability of the universal postal service, we are required to take into account the need for the universal service provider to be able to earn a reasonable commercial rate of return in connection with its provision of the universal service.[98] In the March 2012 Statement, we considered that an earnings before interest and tax (EBIT) margin range of 5-10% was indicative of a commercial rate of return. In the 2016 Review consultation we have proposed to keep both EBIT and the 5-10% range as our main indicator of financial sustainability.

6.4 In the 2014 Review of End-to-end Competition Statement, we considered it was appropriate to adjust Royal Mail's reported EBIT margin to restate pension costs on a cash basis (i.e. at the rate the contributions are actually paid), rather than the rate calculated using the accounting standards. In 2015-16, the accounting pension rate was 29.8% whereas the cash pension rate was 17.1%.[99][100] We considered that this methodology takes account of the true cost of pensions and we refer to this EBIT

[96] http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf.
[97] In the 2016 Review consultation, we committed to monitoring the following short to medium term financial health metrics: Funds from operations/net debt, net debt/EBITDA and EBITDA/interest. While we cannot publish forward looking metrics as these rely on Royal Mail's confidential Business Plan, we can provide historic metrics as an indicator of current health.
[98] Section 29(4) of the Postal Services Act 2011.
[99] Royal Mail Plc Annual Report and Accounts 2015-16, page 99.
[100] The accounting and cash pensions rate are likely to continue to move further apart until the end of the current agreement in 2018.

margin measure as the 'financeability EBIT'. We have reported on financeability EBIT since our 2013-14 Annual monitoring update.[101]

Figure 6.1 – Reported Business EBIT margin



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

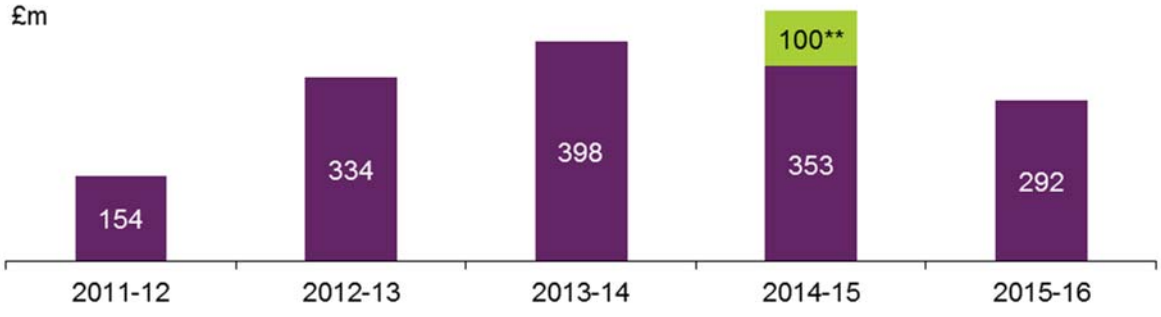
6.5 Figure 6.1 shows that although the financeability EBIT continued to be within the 5% to 10% range,[102] it fell from the prior year. Royal Mail's Reported EBIT for the Reported Business after transformation costs (based on an accounting pension rate) fell further as the accounting pension rate continued to increase in 2015-16 (from 23.6% to 29.8%).

6.6 The decrease in financeability EBIT margin from 5.6% in 2014-15 to 5.0% in 2015-16 is largely due to the fall in letters revenue which was not completely offset by decreases in people and non-people costs. We discuss the scale and nature of cost reductions in Section 7 on efficiency.

[101] For more explanation of this approach please see earlier Annual monitoring updates, in particular Paragraph 6.6 in the 2014-15 Annual monitoring update on the postal market.
[102] The range that we considered in March 2012 and May 2016 to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.

Royal Mail Group's cash flow

Figure 6.2 – Relevant Group free cash flow* (£)



Source: Royal Mail Statutory Accounts
** Free cash flow: net cash flow before financing activities (except finance costs paid), less the net cash purchase/sale of financial asset investments, including profit on disposal of properties*
*** Relates to a one-off disposal of a property in the London property portfolio, separately stated in Royal Mail's 2014-15 statutory accounts*

6.7 Cash flow is also an important component in ensuring the financeability of the universal service. In year 2015-2016 free cash flow of the Relevant Group[103] fell by 17.3% in 2015-16 to c.£0.3bn. The main drivers for this were increased investment in parcel IT systems, parcels automation and the purchase of new PDAs[104] and investment in GLS (c.£50m) and costs relating to the London Property Portfolio (£23m).[105, 106] Royal Mail did not make any significant property disposals in 2015-16.

6.8 Despite cash flow falling, Royal Mail still had significant undrawn funding facilities (£1.05bn) as at 27 March 2016. This cash can be drawn upon depending on business needs.[107]

Financial health metrics and the viability statement

6.9 As part of the 2016 Review consultation we committed to monitor a number of additional financial health metrics to help us in our assessment of the short to medium term financial health of the USO.

6.10 Funds from Operations (FFO) / Debt is one of the key metrics that Standard & Poor's (S&P) credit ratings agency uses in order to assess the credit worthiness of Royal Mail. This is particularly relevant as S&P provided a BBB credit rating in relation to Royal Mail's 10-year €500 million bond.[108] In order to provide this rating, S&P reviewed Royal Mail's historical and forecast performance against a number of metrics including FFO / Debt. Royal Mail has also informed us that this is a key metric they monitor.

[103] The Relevant Group comprises the Companies owned by Royal Mail Plc (Royal Mail Group Limited, Royal Mail Estates Limited, Royal Mail Investments Limited, General Logistics Systems B.V and Romec Limited).
[104] Postal digital assistants.
[105] These costs largely relate to remediation work, reprovisioning costs and professional fees at the Nine Elms and Mount Pleasant sites.
[106] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 27.
[107] ibid, page 95.
[108] Cash flow from operations before changes in working capital and changes in other short-term and long-term operating assets and liabilities.

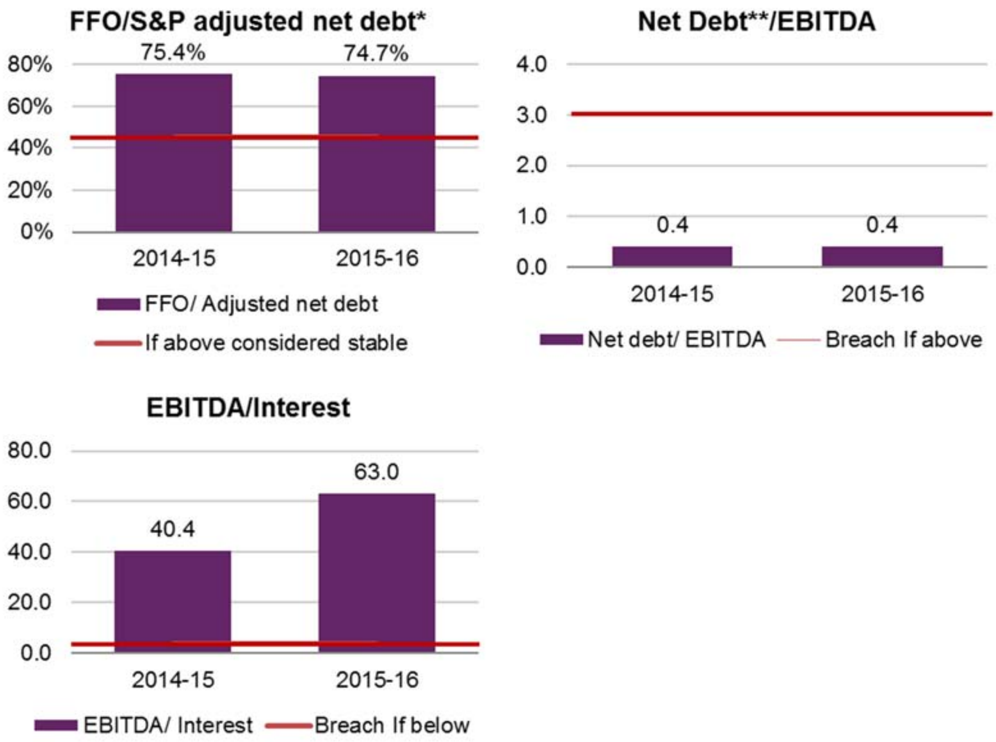
6.11 S&P's latest credit research affirmed Royal Mail's credit rating as it considered the outlook stable based on Royal Mail's FFO / Debt being above 45% in a difficult operating environment.[109] Royal Mail would be categorised as low risk from a financial risk viewpoint as its FFO / Debt percentage is above 60%.[110]

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

6.13 Royal Mail passed its banking covenant tests in 2015-16 (as shown below).

6.14 As part of our internal monitoring we also assess forecast performance against the above metrics using Royal Mail's most recent Business Plan.

Figure 6.3 – Financial health metrics



Source: S&P Ratings Direct & Royal Mail Annual Report and Accounts
**S&P make certain adjustments to Royal Mail's reported net debt. S&P ratings methodology can be found on its website*
*** Net debt is adjusted for letters for credit for bank covenant purposes. This differs from S&P's calculation of net debt*

[109] S&P Ratings Direct, Research Update: Royal Mail Ratings Affirmed at 'BBB/A-2'; Outlook Stable, 24 July 2016 – Report available for purchase from S&P.
[110] S&P Ratings Direct – Corporate methodology, page 35, http://www.maalot.co.il/CriteriaDocs/Paper16.pdf.

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

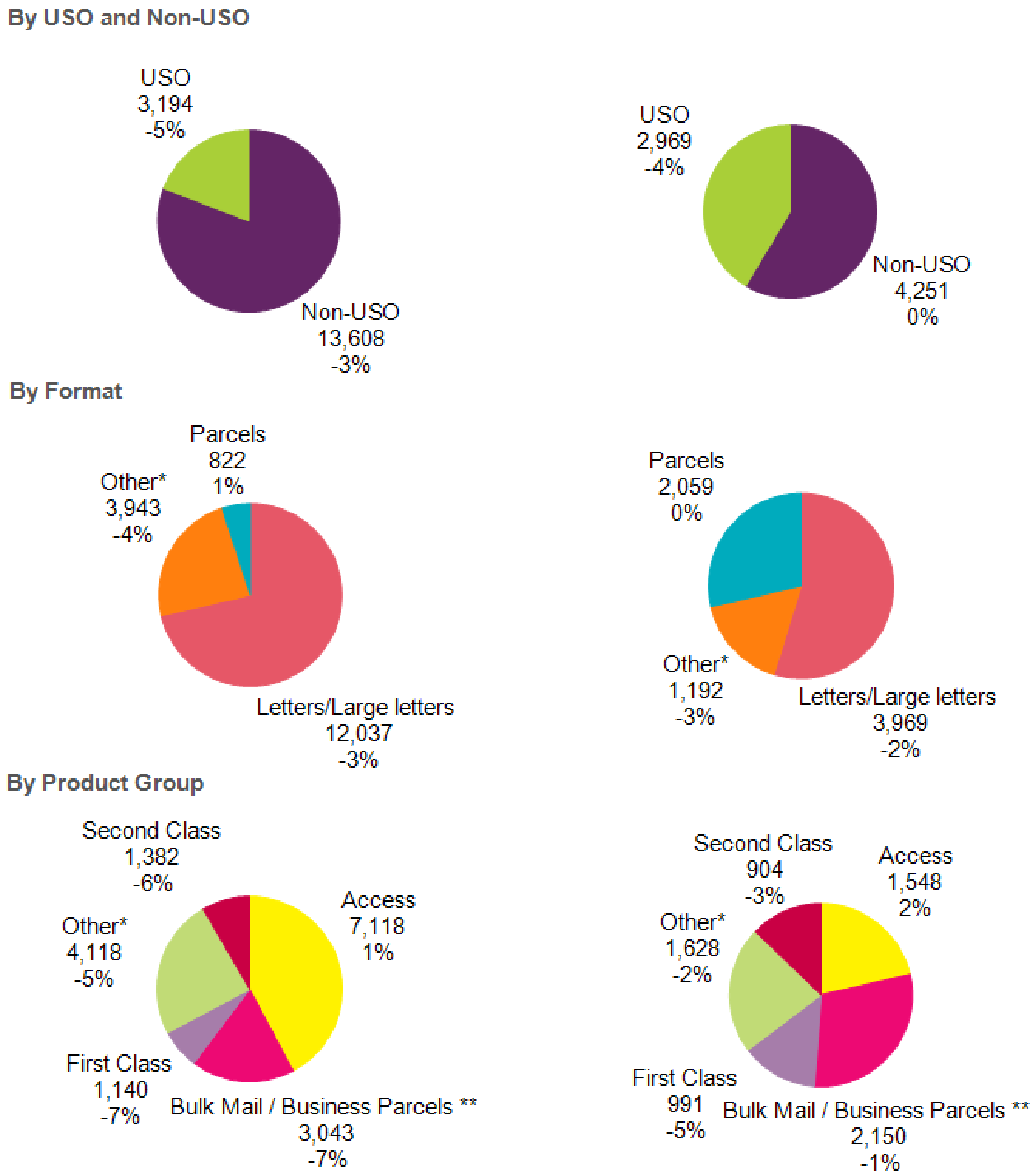
6.16 In its Annual Report and Financial Statements for the year ended 27 March 2016, Royal Mail stated that "based on the results of their analysis, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2019."[111]

[111] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 26.

Volumes and revenues for the Reported Business fell in 2015-16

Figure 6.4 – Reported Business volumes and revenues split by product groups, formats and universal service products[112]

Volumes (millions): 16,802m (3.4% decrease) ***Revenues (£m): £7,220m (1.5% decrease)***



Source: Royal Mail Regulatory Financial Statements and unaudited submissions from Royal Mail.
**Other is a balancing number to reconcile figures to the regulatory financial statements. It mainly consists of unaddressed and international mail*
*** Includes special delivery*

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[112] This analysis replaces analysis that has previously been presented in the Annual monitoring update on the postal market. Other volumes/revenue are now a balancing figure which reconciles other volumes/revenues back to the regulatory financial statements. In previous reports, USO/non-USO volumes and revenues did not reconcile to volumes and revenues by product group and format. We have therefore restated prior year data to reflect this new methodology. This data is available alongside this report on the Ofcom website.

6.17 Reported Business total volumes (addressed and unaddressed mail) continued to fall in 2015-16, by 3.4% to 16.8bn.

6.18 Total revenue fell again, by 1.5% to £7.2bn. Royal Mail was not able to offset the effect of volume decline in letters by raising prices as it had prior to 2014-15. The level of price rises has fallen from previous years. See Section 3 for more information on prices.

6.19 We discuss below revenues and volumes for each of the splits in Figure 6.4 above (i.e. by product groups, formats and universal service products).

6.20 Letter and parcel price trends are available as part of the interactive data published on the Ofcom website.[113]

Universal service and non-universal service volumes and revenues

6.21 As set out in Section 2, the services within the Reported Business include all universal service products and other products which use the universal service network (for example, retail bulk mail and access products).

6.22 The volumes of both universal service (USO) and non-universal service (non-USO) products (including unaddressed) continue to decline. In 2015-16, they declined by 5.0% and 3.0% respectively. This follows the historic trend, where USO items have been declining at a faster rate than non-USO items. Non-USO volumes mainly consist of access, bulk and unaddressed products. The decline in Royal Mail bulk and unaddressed was partially offset by an increase in access volumes (see below).

6.23 Following the prior year trend (of a 2.0% fall), in 2015-16 revenues from USO products declined by 3.7% as the price rises (which were not significant in 2015-16) did not offset the volume decline. Despite declines in non-USO volumes, due to increased parcel and access volumes, Royal Mail was able to maintain non-USO revenues (increase of 0.2%).

Changes in Reported Business volumes and revenue by product group

6.24 The analysis below focuses on year-on-year trends. Page 9 of the interactive data provides longer historic trends.[114]

First Class revenues and volumes

6.25 First Class single piece letter and parcel volumes fell by 7.0% in 2015-16. This was partly driven by the continuing structural decline in letter volumes and switching to Second Class. This decline was broadly in line with the previous year (7.2% decline in 2014-15).

6.26 First Class single piece letter and parcel revenues fell by 5.4%, compared to an 8.4% decrease in 2014-15. The decrease in revenue was partly attributable to continuing lower levels of price increases not offsetting the structural decline in letter volumes.

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[113] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

[114] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

Second Class revenues and volumes

6.27 The decline in Second Class single piece letter and parcel volumes accelerated in 2015-16, falling by 6.0% (compared to 3.0% in the previous year). Revenues also fell in 2015-16 by 2.8% (compared to a 1.6% increase in the previous year). The reason for the fall is that the 2015-16 price rises for stamp (1.9%) and meter (5.4%) did not match the decline in volumes. This was against significant price rises in 2014-15 for stamp (6.0%) and meter (12.1%).

6.28 For the fourth year in a row, the fall in Second Class volumes continued to be less than the fall in First Class volumes, however the gap between the two decreased significantly in 2015-16. It may be that consumers of Second Class products (who are mainly business customers) have decreased their reliance on Second Class mail, in line with the trend we have seen in First Class single piece volumes.

Bulk revenues and volumes

6.29 For the retail bulk mail (including PPI[115]) and business parcels, volumes declined by 7.3% and revenues decreased by 0.9%.[116]

6.30 Reported Business access volumes increased by 0.6% to 7.1bn items. The main reason for the overall increase was that Royal Mail saw access volumes return from Whistl as it ceased its end-to-end operations in May 2016. This, coupled with price rises, led access revenues to increase by 2.0% to £1.5bn over the same period. Access and end-to-end competition is discussed in Section 4.

6.31 Combined access and retail bulk volumes declined by 1.9% and revenues increased by 0.3% in 2015-16. This volume decline was less than the overall addressed mail (letters and parcels) volume decline of 2.7%. In the prior year the decline was in line with the faster overall decline. However, the current year numbers have been affected by the one-off additional Whistl volumes. It is still not clear the degree to which business mail volumes (which include transactional mail) are affected by the same factors (such as e-substitution) as other addressed mail. We will continue to monitor the overall decline in business mail volumes to see if the long term trend continues. The 0.3% increase in revenue was driven by price rises in access mail and Whistl volumes returning. See Section 3 for more information on access pricing.

Changes in Reported Business volumes and revenue by format

6.32 Below we consider the year-on-year variances in Letters/Large Letters (including retail and access), Other items (including unaddressed and international mail) and

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

Parcels (both retail and access).[117] Page 10 of the interactive data shows longer-term historic trends.[118]

6.33 Letters/Large Letters volumes reduced by 3.4%, which was a faster decline than the prior year decline of 1.9%. Due to the accelerated volume decline, Letters/Large Letters revenues decreased by 2.0% (in the previous year they decreased by 0.7%). When Royal Mail was given pricing freedom as part of the revised regulatory framework, it increased prices significantly in 2011-12 and 2012-13. However, since then, price increases have been smaller and as such revenues continue to fall as the volume decline has not been offset by increased prices. The presence of access competition is also relevant to Royal Mail's pricing decisions given the proportion of its volumes and revenues accounted for by access and retail bulk mail products. For further information on pricing refer to Section 3.

6.34 Royal Mail states that Reported Business parcel volumes increased by 0.6% in 2015-16. This is a reversal from the trend as reported in the prior year. Volumes had been falling since 2013-14. It should be noted that the overall parcel market has grown at a faster rate (as noted earlier in the previous Section) suggesting the Reported Business parcel share declined further in 2015-16.[119] The market remains competitive and Amazon's roll out of its own network continues to impact Royal Mail. Amazon is one of Royal Mail's single biggest customers, accounting for 5% of UKPIL parcel revenues.[120]

6.35 Due to the reported increase in volumes, parcel revenues grew in 2015-16 (increase of 0.3%). This was against the prior year where they dropped for the first time since the introduction of the revised regulatory framework. Royal Mail stated the growth was driven by new contract wins in account parcels. This growth replaced declines in consumer/SME parcels and traffic lost to Amazon.[121]

6.36 Other volumes (which mainly consist of unaddressed letters and international mail) decreased by 4.0% (compared to a 1.2% decrease in the previous year). The decrease was due to a large decrease in unaddressed volumes from the prior year, bringing it more in line with the long term decrease in volumes. The rate of decline in international volumes (parcels and letters) fell mainly as a result of an increase in import parcels (mainly from China).

6.37 Other revenues fell by 2.7%, compared to a 1.5% increase in the previous year. This reversal was due to volume decreases in both international and unaddressed mail. The volume growth in import parcels did not translate into overall higher international revenues, as import parcels from China tend to have a lower AUR than export parcels which have declined.

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[117] Figures are from unaudited and unpublished submissions provided to Ofcom. Parcel volumes are based on Royal Mail's definition of parcels and include some fulfilment letters and large letters and are therefore not directly comparable to the parcel market volumes collected by Ofcom and reported in Section 5. Ofcom's definition of what constitutes a parcel is set out in paragraph 5.2.

[118] Ofcom *Annual monitoring update on the postal market – Financial year 2015-16 (Interactive Data)*, 30 November 2016 https://www.ofcom.org.uk/postal-services/monitoring_reports/amr-2015-16-interactive-data

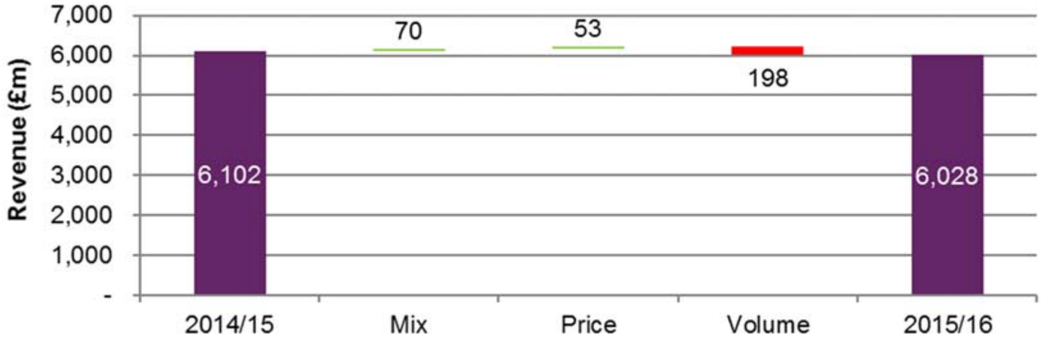
[119] National volumes (as outlined in Section 5) are prepared on a different basis and are not directly comparable with Royal Mail's reported volumes.

[120] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 8.

[121] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 22.

6.38 We have undertaken some high level analysis to ascertain how much of the overall increase in total Reported Business revenue in 2015-16 was due to mix and how much was attributable to price rises.

Figure 6.5 – Contributions of mix, price and volumes to inland addressed revenue change

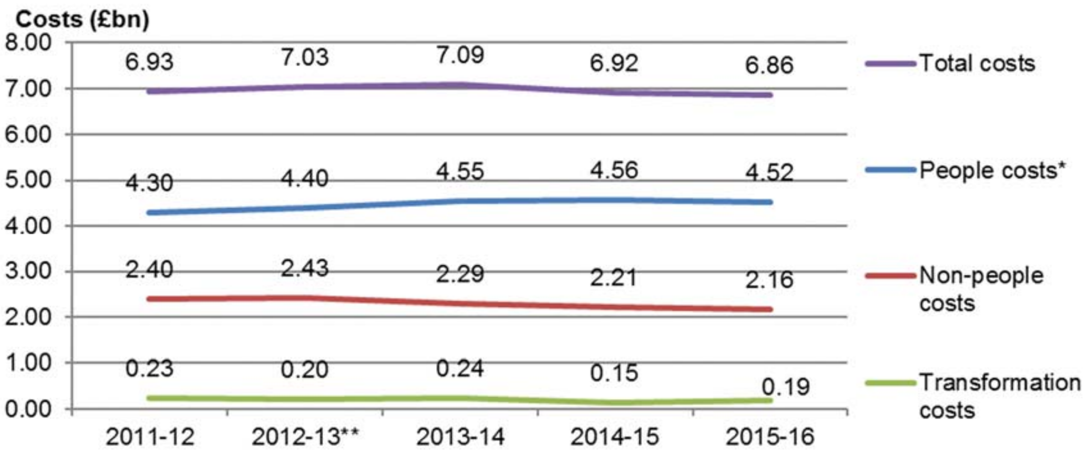


Source: Ofcom analysis

6.39 Our analysis[122] – set out in Figure 6.5 – shows the relative contributions of price increases, overall volume decline and the change in volume mix (i.e. higher proportion of parcels) towards the decrease in revenue for inland addressed mail. As with the prior year, this analysis suggests that price increases were not able to offset volume decline in addressed mail.

Reported Business costs

Figure 6.6 – Reported Business costs



Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail
** Adjusted for cash pensions charge*
*** Adjusted unaudited 52 weeks*

[122] The analysis looks at the drivers behind the change in addressed mail revenue between 2014-15 and 2015-16. This is calculated with reference to the overall change in revenue for letters/large letters (combined) versus parcels. The calculation is undertaken in three steps: a) to estimate the impact of changes in mix, the 2014-15 total volumes and average prices were used alongside the 2015-16 change in mix (i.e. the proportion of letters/large letters compared to parcels); b) to estimate the impact of the change in prices, 2015-16 average prices and mix were used alongside the 2014-15 total volumes; and c) to estimate the impact of the volume decline, total volume was scaled to reflect 2015-16 total volumes along with the 2015-16 prices and mix.

6.40 Costs, including transformation costs for the Reported Business, fell by 0.9% in 2015-16 to £6.86bn. These costs can be broken down into people costs, non-people costs and transformation costs. The breakdown of costs to these categories is shown in Figure 6.6 and we note that:

- People costs[123] – decreased by 1.0% to £4.52bn. A reduction in gross hours and flow through savings from the management reorganisation (£40m) offset increased salaries as a result of the 2.8% pay deal.[124]
- Non-people costs – fell by 2.4% to £2.16bn, partially due to volumes declining which affected export terminal due payments & payments to POL, improved fleet management and rationalisation of UK air routes leading to a reduction in fuel costs.
- Transformation costs – increased by 27.6% to £0.19bn in 2015-16, mainly due to increased voluntary redundancy (VR) payments. Royal Mail stated the increased VR payments supported the net headcount reduction of 3,500 employees in UKPIL[125] (which is primarily comprised of employees in the Reported Business).

Summary of financial performance

6.41 We have reviewed a broad set of financial performance data in this Section. In summary, the key trends for the 2015-16 financial year were:

- The financeability EBIT margin decreased from 5.6% to 5.0% in 2015-16, due to a reduction in revenue and increase in transformation costs, partially offset by lower people costs and non-people costs. Royal Mail's financeability EBIT is still within the 5-10% range we identified as consistent with a reasonable commercial rate of return for a financially sustainable universal service.
- Although lower than 2014-15, free cash flow continued to be positive in 2015-16 (£0.3bn). Royal Mail still has access to a further (c. £1bn) of funds from its undrawn banking facilities.
- Reported Business letter volumes continued to decline, albeit at a lower rate than previous years due to the improvement in UK economic conditions and the return of access volumes from Whistl. Parcel volumes increased marginally, however Royal Mail's share of supply continued to fall as the UK parcels sector grew. See Section 5.
- Reported Business revenues continue to decline due to the parcel revenue increases not offsetting the structural decline in letters.
- Reported Business costs reduced by 0.9% year-on-year. Although both people and non-people costs decreased transformation costs increased. This was significantly less than the fall in the prior year (2.4%). Royal Mail reduced non-people costs significantly in the prior year in response to declining revenues. They were not able to replicate this in the current year. Cost reductions are covered in more detail in Section 7.

[123] Adjusted to reflect the cash cost of the defined benefit pension scheme rather than the accounting charge.
[124] Agreed with the CWU in December 2013.
[125] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 23.

Section 7

Efficiency of the Reported Business

7.1 In this Section we discuss efficiency, covering:

- Why it is an important aspect of our monitoring regime;
- How we have updated our monitoring regime to reflect the findings of the 2016 Review consultation; and
- What Royal Mail has been doing to improve its efficiency.

7.2 We then estimate Royal Mail's efficiency for 2015-16 using metrics which were outlined in the 2016 Review consultation. This represents a change from those metrics used in the 2014-15 Annual monitoring update. The changes are discussed below.

Efficiency is still an important element of our monitoring regime

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

7.4 In the March 2012 Statement, we noted that we expected Royal Mail to improve its efficiency levels and to sustain such improvements thereafter. This was to avoid Royal Mail relying solely on price increases with the associated risk of exacerbating volume decline. However, we did not set specific efficiency targets.

7.5 In the 2016 Review consultation, we stated that we intend to continue to publish our view of the efficiency of Royal Mail within the Annual monitoring update for the same reasons as above, which will include the conclusions and outputs of our PVEO[126] analysis of the Reported Business costs, changes in hours and the comparator trends of revenue and costs per full time equivalent (FTE).[127] We stated that although Royal Mail's proposed initiatives and levels of cost reduction appeared reasonable,[128] we considered them to be at the lower end of a reasonable range for improvement.[129]

7.6 Therefore, efficiency is still one of the key areas we assess as part of the monitoring regime. This is discussed in this Section.

We have updated our monitoring regime to incorporate metrics as defined in the 2016 Review consultation

7.7 In the 2016 Review consultation, we outlined a number of key metrics for monitoring Royal Mail's efficiency going forward. We have adopted these metrics in the 2015-16

[126] Price, volume, efficiency and other (PVEO) analysis provides a measure of the impact of efficiency gains on costs.
[127] A5.201 Ofcom Annex to 2016 Review consultation.
[128] Based on the 2015 Business Plan.
[129] A5.205 Ofcom Annex to 2016 Review consultation.

Annual monitoring update. This has resulted in a number of changes from the 2014-15 Annual monitoring update.

Productivity

7.8 In the 2016 Review consultation we stated that there may be limitations to our future use of Royal Mail's productivity metric. Royal Mail has recently changed the scope of the calculation; expanding it to include additional products and parts of its business. In addition, Royal Mail recently changed some of the assumptions underpinning the calculations. These changes mean that there are limitations to using Royal Mail's measure to provide a meaningful trend. Therefore, while we propose to continue monitoring Royal Mail's productivity metric because it is a basis by which Royal Mail monitors its own performance, we do not propose to use it as an indicator of trend in Royal Mail's efficiency.

Frontline gross hours

7.9 We believe the monitoring of frontline gross hours provides us with a useful indicator of Royal Mail's efficiency in its operations. Previously we noted gross hours reduction movements alongside the analysis on productivity. However, we now propose to solely publish frontline gross hours reduction (delivery and processing) within this report and to monitor the data disaggregated by pipeline (e.g. delivery, processing) internally.

Real cost per unit workload or real unit operating expenditure (RUOE)

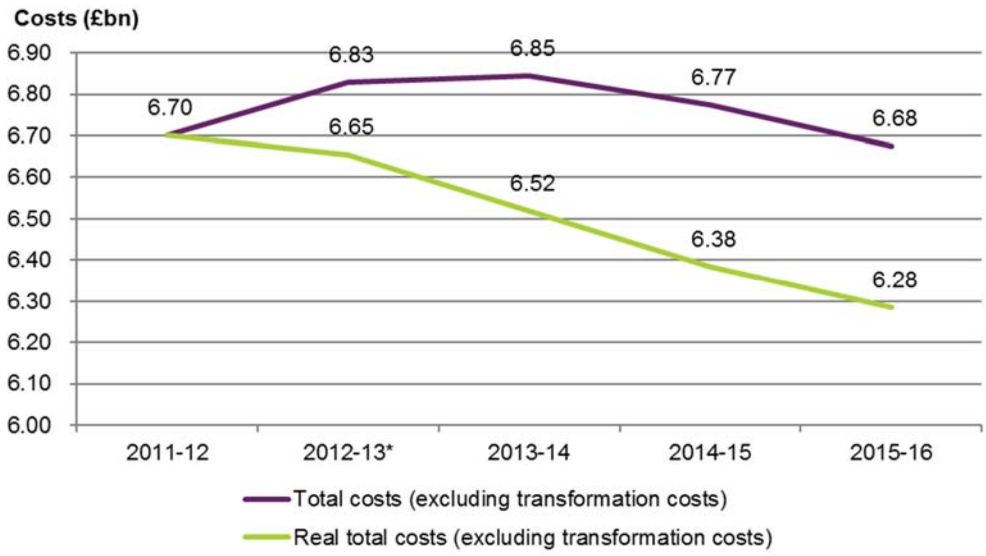
7.10 Changes in the level of cost per unit of output can provide a useful indicator of efficiency. To provide a meaningful trend, adjustments are typically made for changes in volume and inflation. In the 2016 Review consultation we identified limitations to our approach adopted in the 2013-14 and 2014-15 Annual monitoring update of calculating RUOE using Royal Mail's workload metric.[130] We compared it to our approach in calculating efficiency through PVEO analysis and concluded that the latter provided a better measure as it more closely aligned the volume movements to the relevant costs. In this report we therefore no longer report RUOE.

[130] Workload was used as the measure of volumes because it was viewed to control for mix and volume decline.

Indicators of Royal Mail's efficiency performance

Real cost reduction[131]

Figure 7.1 – Total real and nominal costs excluding transformation costs



Source: Regulatory financial statements and Ofcom analysis
**52 week period*

7.11 Figure 7.1 shows at an aggregate level, real total costs (excluding transformation costs) fell by 1.6% in 2015-16, which was less than the fall in the prior year of 2.1%.

Price, Volume, Efficiency and Other Analysis

7.12 We have disaggregated movements in total costs[132] between 2014-15 and 2015-16 in terms of price (i.e. inflation) changes, volume effects, efficiencies achieved and other one-off costs.

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

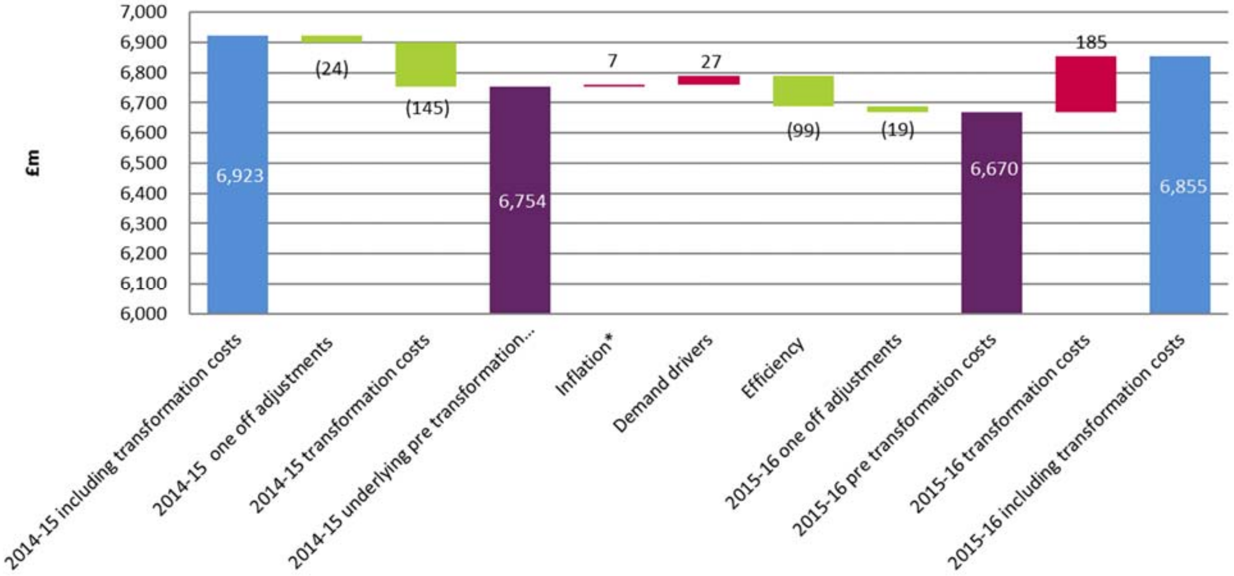
7.14 Following the 2014-15 update, Royal Mail has adjusted its planning values[133] to reflect the latest view of its operations i.e. they now reflect new delivery methods implemented. As the effect of restating workload is not material to the PVEO analysis, we have not restated prior year comparatives.

7.15 Our PVEO analysis (Figure 7.2) suggests that efficiency achieved in 2015-16 excluding transformation costs was 1.5%, which was less than that achieved in 2014-15 (2.6%).

[131] Total costs have been adjusted by CPI based on 2011-12 values.
[132] Reported Business people, non-people (including depreciation) adjusted for cash pension rate.
[133] The theoretical time taken to process products.

7.16 In 2015-16, Royal Mail spent £40m (in real terms) more on transformation costs than 2014-15. The increase in transformation costs in 2015-16 has been driven by an escalation in Royal Mail's voluntary redundancy programme. If we were to calculate efficiency on total costs, including transformation costs, this step change in cost incurred in achieving efficiencies would impact the efficiency calculation, implying a 2015-16 figure of c.0.9% which is significantly less than 2014-15 (c.3.9%).

Figure 7.2 – PVEO bridge 2014-15 to 2015-16



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)
**ONS 12-month trailing average CPI figures (April to March)*

Royal Mail's own statements on efficiency

7.17 Royal Mail has stated publically that it intends to avoid cumulative costs of c.£500m over the three financial years to 2017-18.[134] 2015-16 was the first year this programme was implemented and in its Annual Report and Financial Statements for 2015-16, Royal Mail states that it is on course to achieve these savings.[135]

7.18 In Royal Mail's June 2016 presentation to the market on its UK Operations,[136] Royal Mail stated it is working on a number of initiatives to reduce costs including:

- adding a further 8,000 pillar boxes to collection on delivery (where the postman or woman empties the pillar box on their delivery round, rather than providing a separate collection by van);
- automating parcels processing where economically viable;
- improving fleet management;
- reviewing air network requirements;

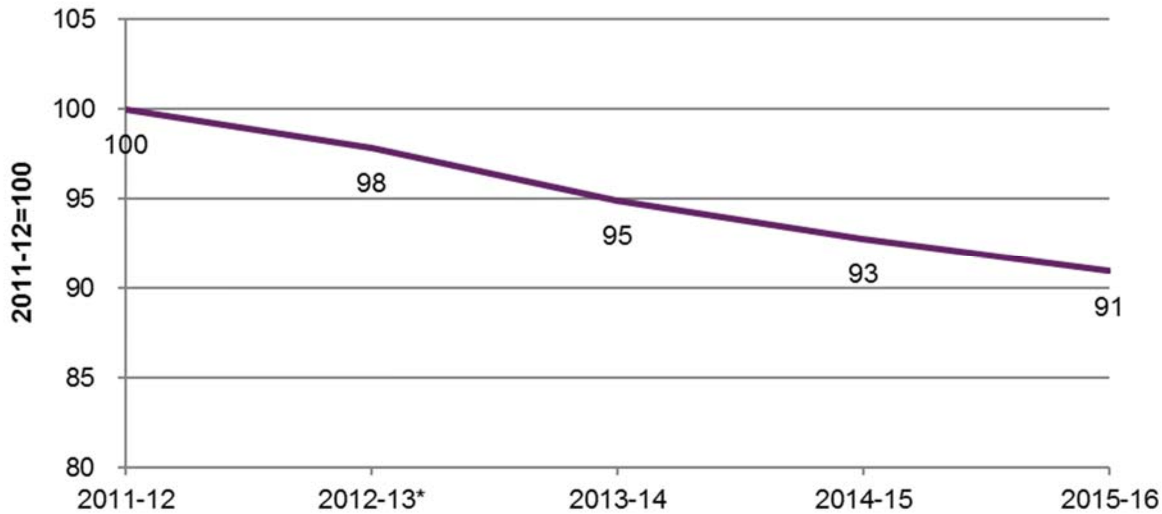
[134] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 11.
[135] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 11.
[136] Royal Mail Group Tour of UK Operations, 28 June 2016, http://www.royalmailgroup.com/sites/default/files/Tour%20of%20UK%20Operations%20-%20Sue%20Whalley_0.pdf.

- expanding doorstep collections (where parcels are collected from customers at their doorstep when other items are delivered);
- optimising its workforce across pipelines in line with changing workload; and
- rolling out doorstep scanning, with new Postal Digital Assistants which will allow improved parcel tracking and allow Royal Mail to identify future efficiency opportunities.

7.19 Royal Mail also stated in its Annual Report and Financial Statements that UKPIL collections, processing and delivery productivity improved by 2.4%, which was within its target range of 2.0%-3.0% improvement per annum.[137] We believe due to change in methodology adopted by Royal Mail in the current year, this is not directly comparable with the productivity figure published by Royal Mail in 2014-15.

Frontline gross hours (delivery and processing)

Figure 7.3 – Gross hours reduction indexed from 2011-12 to 2015-16



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

7.20 As outlined above, we will report on gross hours reduction independently of Royal Mail's own productivity metric. Figure 7.3 shows that Royal Mail achieved a total gross hours reduction of 2.0% in 2015-16, slightly down from the prior year reduction of 2.3%.

7.21 Royal Mail now includes hours related to regional distribution centres in its total hours calculation. To present data on a consistent basis, we have excluded these hours from the calculation. If we were to include them in 2014-15 and 2015-16, total hours still decreased by 2.0% as RDC hours represent less than 2% of total hours and therefore do not influence the calculation significantly.

Revenue and people cost per FTE

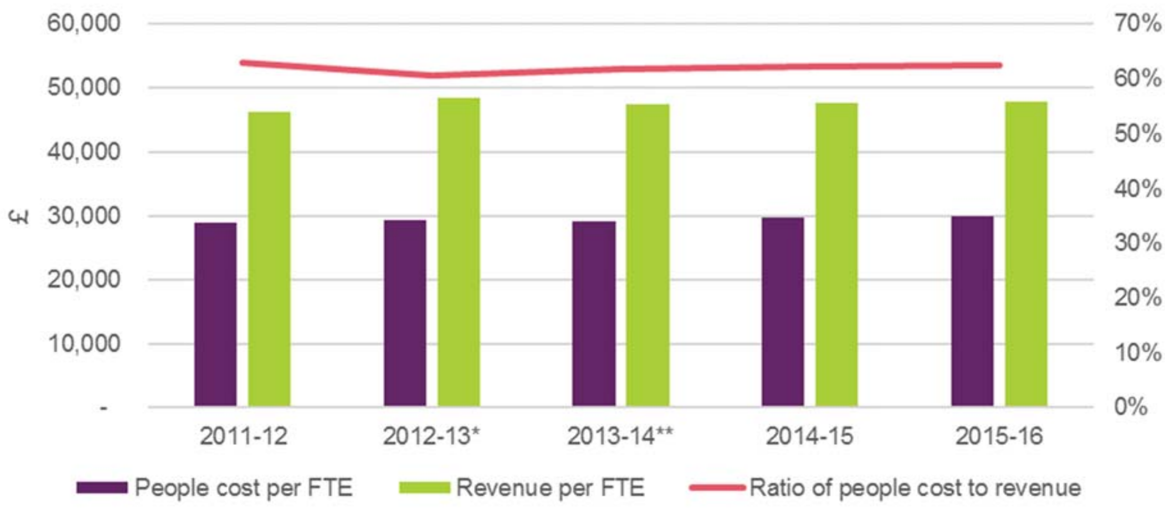
7.22 Comparing revenue per FTE and people cost per FTE also provides an indication of efficiency. For example, if revenue per FTE increases at a greater rate than people

[137] Royal Mail Plc Annual Report and Financial Statements 2015-16, page 4.

cost per FTE, it may suggest that each FTE is generating greater revenues than their relative expense. However, there may be other contributory factors, such as price changes, which could influence revenue per FTE, thereby lessening the direct relationship with people cost per FTE.

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

Figure 7.4 – Reported Business real people cost and real revenue per FTE



Source: Royal Mail Reported Business (figures constructed for regulatory purposes and are unaudited)
FTE data (including agency staff) provided by Royal Mail.
** 53-week data used in calculation*
*** 2013-14 Restated onto 39 hour working week to bring in line with 2014-15*

7.24 We see in Figure 7.4 that real people costs and revenue per FTE have increased on a real basis over the five year period from 2011-12[138] to 2015-16 (with the exception of 2013-14). However, the ratio between the two has stayed similar over this same period.

Future monitoring of Royal Mail's efficiency

7.25 In the 2016 Review consultation we explained that we had commissioned Deloitte to undertake econometric benchmarking analysis of Royal Mail's delivery offices and mail centres.[139] The results of this analysis can be found in Annex 5 of the 2016 Review consultation.

7.26 We also commissioned WIK-Consult (WIK) to undertake a review of the projected costs and initiatives within Royal Mail's 2015 Business Plan relevant to the universal service, to compare its modernisation plans with the plans of comparable postal operators. As part of our internal monitoring we intend to work with Royal Mail to better understand the effectiveness of its initiatives, including identification of metrics, in addition to hours, which may give greater insight into the progress on key initiatives. Insight at this level will be an important component of our internal

[138] Inflation based on ONS 12-month average CPI figures (April to March).
[139] Paragraph 4.53.

monitoring regime. However, as it will be confidential we will not include it in our published Annual monitoring update.

Summary of efficiency metrics and rate of improvement

7.27 In the 2016 Review consultation we outlined the financial and non-financial metrics by which we would monitor Royal Mail's efficiency, as detailed in this Section. In summary, the key efficiency trends for the 2015-16 financial year were:

- The PVEO analysis indicates an underlying efficiency improvement (excluding transformation costs) of c.1.5% against c.2.6% in the prior year. At the same time, Royal Mail reduced total gross hours by 2.0% in 2015-16 which was less than the reduction in the prior year (2.3%).

- Revenue and cost per FTE analysis shows that Royal Mail maintained a ratio of c.62% between average cost per FTE and revenue per FTE.

- Royal Mail indicated in its Annual Report and Financial Statements that it is on track to deliver £500m in cost efficiencies over the three-year period to 2017-18. We will continue to work with Royal Mail to track the success of its initiatives as outlined in the 2015 Business Plan.

Annex 1

Current information collected as part of the monitoring programme

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

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