



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Ofcom's consultation on the safeguard cap for large letters and packets

June 2012

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Contents

About Consumer Focus	2
Executive summary	4
Key issues for Consumer Focus	6
Reconsideration of the level of the cap – Concerns around alternatives for consumers	6
Reconsideration of the level of the cap – Impact on efficiency of large letter and packet products	8
Reconsideration of the level of the cap – Ofcom’s duties under the Postal Services Act 2011	9
Need to monitor affordability for residential consumers and SMEs	9
Need for clear and accurate data on volumes	10
Need for greater cost transparency	11
International comparisons	12

Executive summary

In its decision on the new regulatory framework published in March 2012, Ofcom stated that it would extend the proposed cap on Second Class standard letters to encompass Second Class large letters and packets and parcels up to 2kg, and would consult on the structure and form of this cap.

Ofcom proposes to establish a safeguard cap for Second Class large letters and packets and parcels up to 2kg. This will be in the form of a 'basket' for the capped products with prices within the basket weighted by volume. It is proposed that the overall weighted average of the cap will not exceed a 53 per cent increase on 2011-2012 prices, with an adjustment for CPI each year.

Consumer Focus welcomes the extension of the safeguard cap to Second Class large letters and packets up to 2kg and the additional protections it affords to residential consumers and Small and Medium Enterprises (SMEs). We have consistently emphasised the importance of an affordable, sustainable postal service for all consumers. Our research supporting our response to the Ofcom consultation on the economic framework for regulation clearly showed that consumers, particularly vulnerable low-internet-use consumers, still rely on the mail service.¹

The research also indicated that those consumers with online alternatives were less captive to price increases than those without online alternatives. This suggests that a key factor for vulnerable low-internet-use consumers is not just Royal Mail's prices but also the digital divide, which prevents those without internet access from accessing price comparison sites and other competitive alternatives to Royal Mail. We therefore also support the cap as a way to safeguard significant groups of consumers in the absence of effective competition to Royal Mail.

Recognising Ofcom's objective to provide Royal Mail with pricing flexibility while protecting consumers, we accept the rationale for a weighted average (by volume) basket approach to the products covered by the extension of the cap. However, we believe that the proposed level of the cap on the basket (53 per cent on 2011/12 prices plus the change in CPI each year) is too high as:

- the rationale for level of the cap, which is that it is the same allowed increase as the cap for Second Class standard letters, is flawed as the products are not comparable particularly due to the absence of e-substitution options which act as a constraint on Royal Mail in the standard letters market; there are minimal competing alternatives to Royal Mail for the products in the extended basket
- there could potentially be a negative impact on efficiencies in the growing packets sector which is likely to be the largest segment of the postal market in future

Whilst we have concerns about the level of the cap, without consideration of Royal Mail's confidential volume data, we are unable to propose a more appropriate lower level. We suggest that Ofcom reviews the data to ensure that it is confident that the proposed weighted average of the cap is set at an affordable level.

¹ *Consumer Focus report on potential impacts of stamp price increases on consumers – A supplement to the Consumer Focus response to Ofcom's consultation...* January 2012, <http://bit.ly/yZ6hwi>

Consumer Focus also remains concerned around the impacts on affordability for residential consumers and SMEs particularly given the scope for price increases within the basket. We support Ofcom's intention to continue to monitor price rises, but it is essential that Ofcom does not consider these in isolation but in the context of their impacts and the consumer response to them, so that prices do not present affordability concerns.

We also believe provision of accurate, detailed volume data from Royal Mail for the products within the basket will be important in ongoing monitoring of the new regime particularly as the basket is weighted by volume, so inaccurate volume data could skew the basket total and make the cap less effective.

Key issues for Consumer Focus

Consumer Focus supports the extension of the safeguard cap to large letters, packets and parcels up to 2kg and is pleased that Ofcom has taken steps to provide further protections for consumers against significant price increases.

We welcome Ofcom's decision to extend the safeguard cap, particularly as our own research has shown that vulnerable low-internet-use consumers demonstrate similar price inelasticity for large letters and packets and parcels up to 2kg as they do for standard letters.² The extension will give more certainty to vulnerable consumers that the postal service they rely upon will continue to be available to them at an affordable rate.

We do however have some concerns around the level and form of the cap which we would like Ofcom to consider.

Reconsideration of the level of the cap – Concerns around alternatives for consumers

We fully support the extension of the cap to Second Class large letters and packets up to 2kg, but we believe that Ofcom's decision to base the level of the extended cap on the existing safeguard cap for Second Class standard letters should be reconsidered given the differences between the standard letter product and those in the proposed basket.

In its consultation document, Ofcom has stated that the level of the basket should be set at 53 per cent on 2011-12 prices, plus annual CPI inflation; the rationale is that this is equivalent to the rise allowed under the Second Class standard letter cap.³ We suggest Ofcom reconsiders the level of the weighted average cap for the basket as we do not believe it is appropriate to base the basket cap on the existing cap for standard letters.

We note that Ofcom's main rationale for having a Second Class standard letter cap was that this was the main product used by vulnerable consumers.⁴ Consumer Focus was supportive of the cap for this reason. However, both Ofcom and Royal Mail have noted a number of external factors which also act as an effective constraint on prices; one is e-substitution and the other is alternative operators, both falling under the category of competition to Royal Mail services.

E-substitution

Ofcom notes that e-substitution appears to act as a constraint by stating that 'the variation of price increases within its price rises suggested some constraint as Royal Mail applied relatively smaller price increases to services more at risk from e-substitution.'⁵

Consumer Focus research carried out in relation to Ofcom's October 2011 consultation also suggested that those consumers with online alternatives were less captive to price increases than those without online alternatives.⁶

² *Consumer Focus report on potential impacts of stamp price increases on consumers – A supplement to the Consumer Focus response to Ofcom's consultation...* January 2012, <http://bit.ly/Z6hwi>

³ *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, Ofcom [27 April 2012], p.18. <http://bit.ly/JyG5wB>

⁴ *Securing the Universal Postal Service – Proposals for the future framework for economic regulation*, Ofcom [20 October 2012], p.7. <http://bit.ly/wCZ4OD>

⁵ *Ibid*, p.60. <http://bit.ly/wCZ4OD>

This is not to suggest that the safeguard cap for standard letters is unnecessary as there are e-substitution options available. The cap is vital because vulnerable low-internet-use consumers have no alternatives to Royal Mail if they wish to send written communication. However, the presence of e-substitution acts as a potential additional constraint to Royal Mail's pricing decisions as there is the possibility that significant increases can drive those with online options away from the service. Should an increase in prices mean that more consumers switch away to e-substitution, the safeguard cap provides certainty to vulnerable low-internet-use consumers that they themselves will not be burdened with significant price rises to use the service or disproportionately bear the burden of any such rise.

Alternative operators

As recognised by Ofcom, products within the basket are not subject to much e-substitution,⁷ as the majority of these items are fulfilment traffic such as physical objects, and do not therefore have an equivalent online alternative.

In the absence of e-substitution, another constraint on Royal Mail's pricing decisions is the presence of alternative operators. However, for those products in the basket competitive options are very limited. Ofcom has stated that end-to-end competition for large letters is minimal, and this is also true of the lower packet weight steps; although in this area at least there is some indication that competition is increasing.⁸

While Ofcom has indicated at least two alternative packet operators which have prices comparable to Royal Mail for packets below 2kg (Collect+ and Hermes) it acknowledges that 'awareness and/or use of these competitive options is currently relatively low...'⁹

Consumer Focus agrees with Ofcom's findings that there is limited competition to Royal Mail below 2kg packets and parcels, and limited consumer awareness of those competitive alternatives. We also agree that this is why the extension of the safeguard cap is important; for example, as detailed in our written evidence to the BIS Select Committee, the Collect+ service still does not have a significant coverage of parcel drop-off points, unlike Post Offices.¹⁰ Vulnerable low-internet-use consumers, identified in our research as being a group of consumers more captive to price increases, will also find it even more difficult to access price comparison sites and other alternative operators to Royal Mail.

The level of the safeguard cap for Second Class standard letters is appropriate as there are other potential constraints on Royal Mail's pricing decisions in that market, albeit not strong or certain enough to warrant removal of the cap. However, using the level of the standard letter cap as the basis for the basket is less appropriate given the absence of comparable external factors which will offer additional constraints for the prices of products within it.

We would also point out that as the standard letter safeguard is a price-point cap it offers significant certainty as to the level of future prices for the product. However, the extended cap is on a basket of several products which provides far less certainty regarding the future prices for individual products.

⁶ *Consumer Focus report on potential impacts of stamp price increases on consumers: A supplement to the Consumer Focus response to Ofcom's consultation 'Securing the Universal Postal Service...'* Consumer Focus [January 2012]. <http://bit.ly/yZ6hwi>

⁷ *Securing the Universal Postal Service – Decision on the new regulatory framework*, Ofcom [27 March 2012], p.123. <http://bit.ly/Ja756d>

⁸ *Ibid*, p.125. <http://bit.ly/Ja756d>

⁹ *Ibid*, p.127. <http://bit.ly/Ja756d>

¹⁰ *Stamp Prices – Fifteenth Report of Session 2010–12, Volume II: Oral and written evidence*, Business, Innovation and Skills Committee [1 March 2012], EV29. <http://bit.ly/KuAlny>

It is important to note that we recognise the importance of both the Second Class standard letter cap and the extended safeguard cap because vulnerable low-internet-use consumers and those in deep rural areas have limited alternatives to Royal Mail. The key issue however is whether the cap acts as the sole constraint on Royal Mail's prices going forward. In the case of products in the basket this seems likely until competition has grown sufficiently to offer consumers greater choice for their fulfilment mail, so we believe Ofcom should reconsider the level of the basket on this basis.

Reconsideration of the level of the cap – Impact on efficiency of large letter and packet products

We understand the safeguard cap extension is not intended as a price control, however we consider that setting a cap at 53 per cent + CPI on the basis that it is the same as the Second Class standard letter cap should be reconsidered given the decline in social mail (standard letters) and increase in fulfilment traffic. Limited competition in fulfilment markets at this weight and format reduces the incentives on Royal Mail to continue to make efficiencies in this area. In order to avoid the unintended consequence of removing incentives for efficiency in the only growing sector in the UK market, the level of the basket cap should be reconsidered.

Consumer Focus recognises Ofcom's decision to move away from a traditional price control as expressed in its March decision document,¹¹ and that the safeguard cap is designed to protect consumers and not to act as a price control in so far as it is not 'intended, in and of itself, solely to provide efficiency incentives to Royal Mail.'¹²

We also recognise the challenge of imposing efficiency on a large organisation like Royal Mail with its many difficult historic cost structures, and understand that greater efficiencies are a key objective of Royal Mail's ongoing modernisation programme.

However, efficiencies are vital for the sustainability of the Universal Service, and we are therefore concerned that there could be unintended consequences on Royal Mail's efficiency due to the 53 per cent + CPI cap on the basket, particularly as many of the items in the basket, such as packets, constitute fulfilment traffic, one of the few areas where the UK mail market is growing.¹³

We note that Ofcom considers access competition an important driver for Royal Mail to increase its efficiency and become more responsive to customer demands.¹⁴ We therefore reiterate our concerns previously expressed in our response to Ofcom's *Review of Regulatory Conditions – Postal Regulation*, in relation to removing mandated access for packets as they constitute a significant and growing part of the access market.¹⁵ Given the larger revenues generated by packets due to the price-per-unit being higher than standard letters, in a scenario where there is no mandated access for packets it is hypothetically possible that an incumbent could effectively close off this section of the market to alternative operators in order to maximise its revenues. This could have the effect of removing a key driver for efficiency in what is likely to be a significant market in the near-future. Ofcom needs to be alert to this, albeit hypothetical, possibility.

¹¹ Securing the Universal Postal Service – Decision on the new regulatory framework, Ofcom [27 March 2012], p.5. <http://bit.ly/Ja756d>

¹² Ibid p.119. <http://bit.ly/Ja756d>

¹³ Royal Mail has stated: 'At half year 2011-12, we saw letter volumes decrease by 6 per cent with packets and parcels volumes up by 5 per cent.' *Summary of Royal Mail's response to Ofcom's consultation 'Securing the Universal Postal Service'*, Royal Mail [January 2012], p.1. <http://bit.ly/Kih6Td>

¹⁴ *Securing the Universal Postal Service – Decision on the new regulatory framework*, Ofcom [27 March 2012], p.142. <http://bit.ly/Ja756d>

¹⁵ *Consumer Focus response to Ofcom consultation in relation to Review of Regulatory Conditions: Postal Regulation*, Consumer Focus [January 2012], p.20. <http://bit.ly/LOIDYW>

Whilst we recognise that Royal Mail is attempting to make efficiencies through its modernisation programme we remain concerned that without the threat of competition from either e-substitution or operators Royal Mail could ultimately end up being less focused on delivering efficiencies in its work practices in the future and rely more on price increases to maintain its revenue stream. This could lead to an expensive service for consumers in the short-to-medium term in the one growing sector of the market upon which the universal service may depend.

We urge Ofcom to closely monitor Royal Mail's price increases and the development of competition in the large letters and packets market to ensure that the basket cap does not reduce the incentives on Royal Mail to continue making efficiencies.

Reconsideration of the level of the cap – Ofcom's duties under the Postal Services Act 2011

Under the Postal Services Act 2011, Ofcom is obliged to ensure that in securing the provision of a Universal Postal Service it has regard to the need for the service to be financially sustainable, defined as ensuring a reasonable commercial rate of return for the universal service provider.¹⁶ We would therefore appreciate further clarification from Ofcom as to whether the 53 per cent + CPI cap on the basket constitutes a 'reasonable commercial rate of return,' and how this relates to Ofcom's need to also ensure that the universal postal service remains 'efficient.'

Need to monitor affordability for residential consumers and SMEs

We welcome Ofcom's decision to extend the safeguard cap as it demonstrates that it is open to, and aware of, concerns around potential affordability issues for vulnerable consumers and SMEs. However, continued monitoring is also required to ensure that future product prices do not become unaffordable, particularly given the large amount of latitude for increases within the basket.

We are pleased that Ofcom has taken on board our concerns around affordability for vulnerable consumers and SMEs in its decision to extend the safeguard cap to large letters, packets and parcels up to 2kg. It is however worth noting that affordability for postal services remains a complex issue for both residential consumers and SMEs, so close monitoring of the impact of price rises on consumers is essential.

Direct impact of rises in stamp prices

Royal Mail has consistently argued that there are no affordability issues for residential consumers around stamp prices. It says the percentage of low income household spending on postal products is low compared to that spent on services like energy. Post comprises less than 0.5 per cent, whereas gas, electricity and water each comprise 4 per cent.¹⁷

However, the BIS Select Committee considered this assessment misguided, stressing that affordability should in fact be based on the ability of consumers, particularly vulnerable consumers, to switch spending from other household items to post in periods of peak spending.¹⁸

¹⁶ *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, Ofcom [27 April 2012], p.2-3 <http://bit.ly/JyG5wB>

¹⁷ This data was based on the Office for National Statistics Family Spending Survey. *Level of the safeguard cap for 2nd Class stamps – Annex 1*, Royal Mail [January 2012], p.3. <http://bit.ly/wu8En3>

¹⁸ *Stamp Prices – Fifteenth Report of Session 2010–12, Report, together with formal minutes*, Business, Innovation and Skills Committee [1 March 2012], p.21 <http://bit.ly/Jt8VoL>

Indirect influences of rises in stamp prices

It is also important to recognise the indirect influences of prices on household spending. Postcomm has stated in a previous business affordability study that SMEs may attempt to pass on an increase in costs for postal services to the end consumer.¹⁹

Furthermore, an increase in the price of postal products can also be spread by a business across all its retail product prices. Economic modelling undertaken by Borsenberger, Joram and Martin²⁰ attempted to assess the indirect impact on households due to an increase in the price of bulk mail products. They concluded that businesses that treat postal products as a key input into their business will pass any increases in these costs through by spreading the costs over the final price for their services.²¹ This in turn has an indirect affect on household budgets.

While some businesses will be able to pass on an increase in postal prices to their customers, certain businesses will be unable to do this; for example when the cost of postage exceeds the cost of the product. Whether businesses that have significant use of this product will be able to manage the price increase and remain commercially viable is an issue which will need to be properly monitored.

We note that Ofcom believes that there is little if any chain of substitution between the different weights or formats of products within the basket. Ofcom does not consider this to be an issue as it believes that consumers have sufficiently mixed posting profiles; price increases for one product should be balanced with price decreases for another product.²²

We acknowledge that consumers as a whole will benefit from low prices for some items while having to pay more for other items and that for consumers overall prices will balance out, but we are concerned that not all individual consumers, particularly SMEs, have such diverse posting profiles. As a result, it is likely that not all consumers will see their postal spend balance out over products with the basket and affordability could become an issue for them.

In order to assess whether price rises are causing affordability issues, Consumer Focus will be undertaking further research to see how the new postal prices are impacting consumers, both residential and SME. We will also be undertaking research to investigate the posting profiles of SMEs and how they view the postal service. We will share this research with Ofcom, but suggest that in the meantime it closely monitors the impact of prices and consumer responses to see if they are causing affordability issues for residential consumers and SMEs.

Need for clear and accurate data on volumes

It is important to understand the volumes for different products, and therefore the potential number of consumers affected by the increase of a price for each product in the basket. It would also be useful to see how Royal Mail's pricing decisions are affecting usage, and therefore the volume, of these products.

Ofcom's approach to the safeguard cap extension is a basket, with the cap weighted by the average of the total volumes of each product within the basket. These volumes will be

¹⁹ *The building blocks for a sustainable postal service: Universal Service - Discussion paper on affordability*, Postcomm, [Feb 2011], Page i. <http://bit.ly/Jti2pF>

²⁰ *Affordability of Postal Services Addressed to Households*, Claire Borsenberger, Denis Joram and Lise Martin, in *Multi-modal Competition and the Future of Mail*, Michael Crewe and Paul R. Kleindorfer, eds [2012].

²¹ *Ibid*, p.133.

²² *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, Ofcom [27 April 2012], p.13. <http://bit.ly/JyG5wB>

based on Royal Mail's actual volumes to the 12 months to the September of the year prior to the time it is setting the basket.²³

We consider that Ofcom's decision to weight the basket on actual volumes rather than forecast volumes is appropriate as a forecast-volume approach could result in difficulties due to market uncertainties in the short-term.

However, if the basket is to work as a safeguard then it is vital that Royal Mail provides Ofcom with sufficiently detailed volume information otherwise it will be difficult to tell how much of the allowed increase on the basket is currently being used.

Accurate volume data will also enable Ofcom to assess the affect of growing end-to-end competition to Royal Mail for some of the products within the basket, particularly around how Royal Mail's pricing decisions for the different large letter and packet categories is affecting these volumes year-on-year. As Royal Mail has been given significant pricing freedom for products within the basket, it is necessary to monitor whether Royal Mail is maintaining its share of the fulfilment market or driving these volumes to competitors through price increases.

We note that Royal Mail considers that the volumes for each of its individual products are commercially confidential, and understand the difficulties Ofcom could face in publishing this data. However, we would welcome reassurance from Ofcom that it has obtained clear and accurate volume data from Royal Mail. We would also like to be reassured that Ofcom has sufficient data to monitor how Royal Mail's pricing decisions are affecting usage, and therefore the volume, of products within the basket, and has satisfied itself that there are no knock-on or unintended consequences once they have reviewed the volume profile by product. We feel that such reassurances would fit with Ofcom's intention to publish an annual report to set out how the regulatory framework (and hence, Ofcom) is fulfilling its objective of securing the provision of the universal service.²⁴

Need for greater cost transparency

Cost transparency is vital to ensure that any price rises or consolidation of products within the basket is justified. We do however note Ofcom's opinion that the safeguard cap extension will affect less than 5 per cent of Royal Mail's revenues from stamp sales; the extension will only make a small financial difference for Royal Mail but it could make a significant financial difference to SMEs and residential consumers.

Consumer Focus believes that a sustainable universal service is dependent on Royal Mail continuing to make efficiencies and reduce its costs rather than relying on price increases.

We note Ofcom's statement that the extension of the Second Class safeguard cap to large letters and parcels up to 2kg will only impact another 5 per cent of Royal Mail's revenues from its regulated business (the initial safeguard cap for Second Class standard letters affected 5 per cent).²⁵ This is a small percentage of Royal Mail's income.

Price rises within the basket are justified by Ofcom on the grounds that they are part of Royal Mail's commercial business plan, and are therefore reflective of the cost of providing the product. While we recognise that Royal Mail needs commercial flexibility, such significant price rises for products where consumers have no alternative to Royal Mail are hard to justify without a clear understanding of the cost of providing this service.

²³ *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, Ofcom [27 April 2012]. <http://bit.ly/JyG5wB>

²⁴ *Ibid*, p.6. <http://bit.ly/Ja756d>

²⁵ *Ibid*, p.123. <http://bit.ly/Ja756d>

Given the level of the cap, such price increases must be commercially justifiable and assessed on the basis of whether the increased price for consumers is covering the efficient costs for Royal Mail rather than merely increasing its profit margins at the expense of its captive customers.

With close monitoring of the affordability of postal services for residential consumers and SMEs, we urge Ofcom to continue to pursue greater cost transparency from Royal Mail so that consumers can be confident that potentially burdensome price increases are going towards sustaining the universal service.

International comparisons

Ofcom has attempted to find international benchmarks for the prices of products within the basket and the level of the cap on the basket. Consumer Focus understands that such comparisons are difficult, and therefore urges caution as to any assessments made as to the affordability of stamps in comparison to those in other countries.

In the consultation document, Ofcom has attempted to provide international comparisons for the price of products in the proposed basket, however it has noted that this is difficult and has ultimately only been able to find one product within the basket that can be compared to products in 12 other countries.²⁶

While we appreciate Ofcom's attempts to benchmark Royal Mail's product prices against those offered by other countries, we are not sure how much information can be gained from this exercise. If Ofcom were to publish its methodology it may provide further clarification on this matter, although we recognise that finding international benchmarks for many of Royal Mail's products is difficult.

²⁶ *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, Ofcom [27 April 2012], p.17. <http://bit.ly/JyG5wB>



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