



Annual monitoring update on
the postal market
Financial year 2012-13

Market update

Publication date: 22 November 2013

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Section 1

Executive Summary

- 1.1 This is our second annual monitoring update on the postal sector and the first covering the period since we introduced the new regulatory framework in our 27 March 2012 statement – *Securing the Universal Postal Service, Decision on the new regulatory framework* ('the March 2012 statement').¹ That decision gave Royal Mail greater pricing freedom² so it could return the universal service to financial sustainability, subject to certain safeguards. One such safeguard was an effective and ongoing monitoring regime to track Royal Mail's performance. As part of this safeguard we committed to publishing an annual report summarising the results of our monitoring programme.
- 1.2 This report covers the four key areas that we set out in the March 2012 statement that our monitoring regime would focus on and sets out the key data and trends for the 2012-13 financial year.³ These are:
- The financial performance of the universal service;
 - Royal Mail's rate of efficiency improvement;
 - Customers and consumers; and
 - Business customers and competition
- 1.3 The metrics in this report are also consistent with those in our first report published in November 2012⁴ (enabling yearly comparisons), although we present some additional data in this document. This includes the findings from our assessment of the affordability of universal services and our market research on the views of residential and business postal service customers.
- 1.4 In summary, with respect to *financial performance*, profit margins for Royal Mail's Reported Business⁵ increased to 2.6%.⁶ This is a significant improvement on the previous year (-0.5%) and closer to the indicative 5% to 10% range we consider is consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term. The main reason for the improved EBIT margin was a 5.8% increase in revenue, largely as a result of increased prices, but also aided by higher parcel volumes;
- 1.5 In terms of *customers and consumers*, most universal service prices rose (in some cases significantly) in 2012, with some prices also increasing in April 2013; but our research indicates these products remain affordable for almost all consumers.

¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf>

² The March 2012 statement removed the majority of price controls on Royal Mail.

³ Although our report also considers the impact of price changes that took effect from April 2013.

⁴ <http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf>

⁵ The part of Royal Mail's business that is responsible for the universal service – this is explained further in Section 2.

⁶ Based on Earnings Before Interest and Tax (EBIT) after transformation exceptional costs as a proportion of sales.

However, First and Second Class stamp letter and large letter prices did not increase in 2013 and the safeguard cap on Second Class stamps will continue to protect vulnerable consumers in the future. While Royal Mail met some quality of service targets including its obligation for Second Class, it failed to meet a number of other targets (including the obligation for 93% of First Class mail to arrive next day). We consider that Royal Mail's requirement to provide universal services to a high standard is an essential part of the regulatory framework. We have told Royal Mail to improve its compliance with its quality of service obligations. We will continue to monitor Royal Mail's progress on quality of service performance closely and will consider investigating and potentially taking enforcement action if it fails to meet quality of service targets in the future.

- 1.6 In relation to *business customers and competition*, while business mail volumes (retail bulk mail and access) continued to decline overall, access volumes increased by 2.1% (0.6% adjusted for working days) and now represent over 47% of total market volumes. There was also a significant increase in end-to-end letter volumes delivered by other operators due to the trial of London delivery operations by TNT Post UK. However, end-to-end competition still only accounts for less than one percent of total market volumes. In March 2013, Ofcom published guidance on its intended approach should end-to-end competition become a potential threat to the provision of the universal service.⁷
- 1.7 With regard to *efficiency*, Royal Mail's physical productivity is gradually improving. As letter volumes are continuing to decline and parcels are increasing it is important to consider the level of effort or "workload" required to process the mail. For example, Royal Mail's workload in 2012-13 (adjusted for working days) only reduced by 0.6% compared to an overall addressed volume decline of 7.3%. In this period Royal Mail reported an improvement in productivity of 1.7% in its mail centres and delivery offices (accounting for changes in volume and product mix). We have also been working to further understand how to assess what would constitute a reasonable rate of efficiency improvement. We will shortly publish two consultancy reports on approaches to measuring the efficiency of postal operators and efficiency programmes in some comparator European countries.
- 1.8 Overall there was a positive but mixed picture in relation to the key metrics that we are monitoring in 2012-13. There have been some signs of progress around financial performance and productivity is increasing, albeit slowly. However, Royal Mail failed to meet some of its quality of service targets.
- 1.9 We note that it has only been a year and a half since we introduced the new regulatory framework, and this report focuses on the first year of that framework. In this time the postal landscape has witnessed further change with the partial privatisation of Royal Mail in October 2013. Therefore, it is important that we continue to monitor the market and Royal Mail's metrics closely. This will allow us to better understand the market trends (including the financial sustainability of the universal service) and help us to assess the effectiveness of the regulatory framework.

⁷ See Ofcom, *End-to-end competition in the postal sector: Final guidance on Ofcom's approach to assessing the impact on the universal postal service*, 27 March 2013
http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf .

Section 2

Introduction

Background

- 2.1 Ofcom gained responsibility for regulation of the postal sector in October 2011. Our primary duty in relation to post is to secure the provision of a universal postal service. In performing this duty we must have regard to the need for the provision of a universal postal service to be:
- Financially sustainable (including the need for a commercial rate of return on the universal service); and
 - Efficient before the end of a reasonable period and remain efficient.
- 2.2 Our approach to regulating the postal sector was set out in the 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.
- 2.3 One of these safeguards was an effective and ongoing monitoring regime to track Royal Mail's performance (for example on quality of service and affordability of universal services, and progress on efficiency), as well as monitoring changes in the postal industry.
- 2.4 As part of this regime, we committed to publishing an annual update which set out key data and trends in the postal sector, focusing on the progress towards securing the provision of the universal service.

Measuring the outcomes of the regulatory regime

- 2.5 We published our first annual monitoring update in November 2012 which covered the 2011-12 financial year – the last year under the previous regulatory framework.⁸ As such, it provided a baseline position for our future monitoring which allowed us to measure whether the new regulatory regime is achieving the desired outcomes.
- 2.6 This second update covers the first full year since the implementation of the new regulatory framework.
- 2.7 The report (like the first) addresses the four key areas that the March 2012 statement noted that our Monitoring regime would initially focus on, namely:
- Section Three – The financial performance of the universal service;
 - Section Four – Royal Mail's rate of efficiency improvement;
 - Section Five – Customers and consumers; and

⁸ Ofcom *Annual Monitoring Update on the Postal Market - Financial year 2011-12* 20 November 2012 <http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf>

- Section Six – Business customers and competition.

The wider monitoring programme

2.8 To recap, our wider monitoring programme includes:

- industry stakeholders providing market specific information, identifying any concerns with how the regime is operating and potential market developments;
- regular internal review of data and indicators for the four key areas set out above (including through our internal governance process);
- (in this report) publishing an annual update which sets out our view of how the regulatory regime is meeting our duty to secure the provision of a universal service; and
- increasing transparency through:
 - external publication by Royal Mail of some annual financial data;
 - publication of prices and changes to non-price terms and conditions by Royal Mail;
 - presenting market developments in the postal sector in Ofcom's annual Communications Market and International Communications Market reports; and
 - publication of additional key postal market data (subject to confidentiality) in this annual market update.

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

2.10 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.

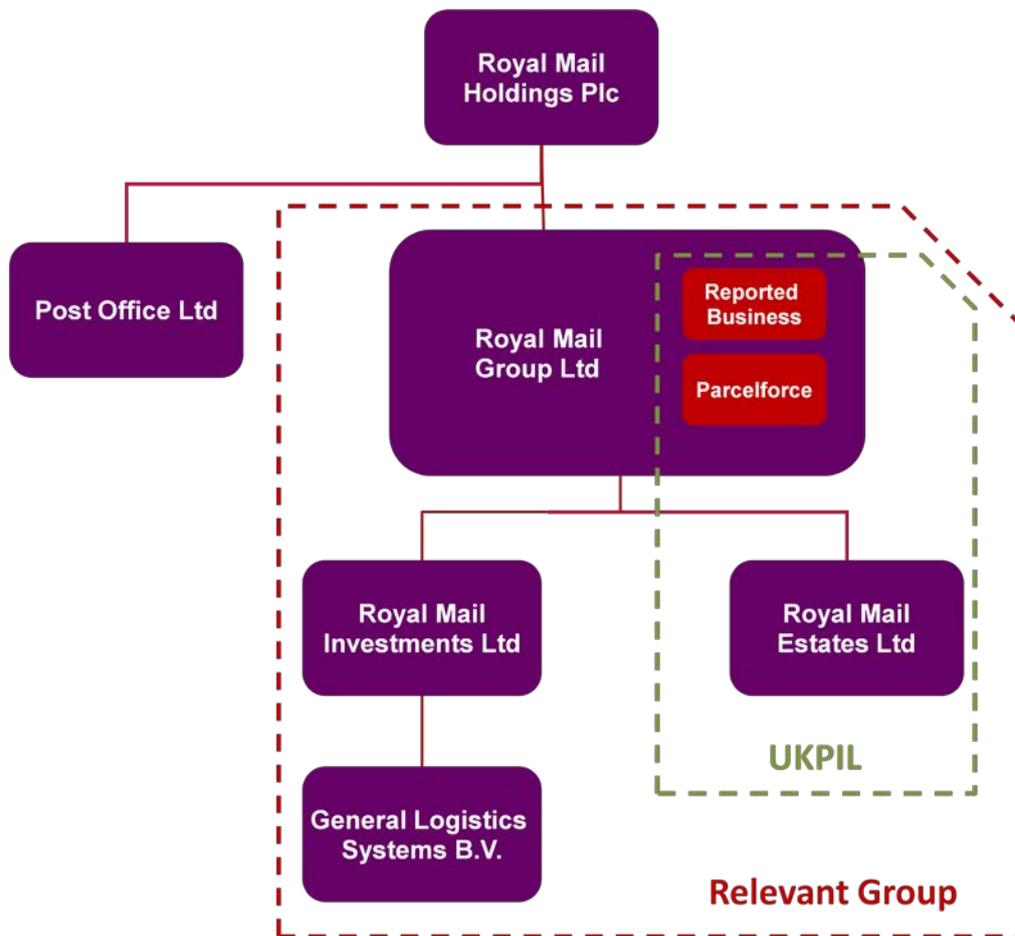
2.11 We note that we have also recently published a consultation on proposed changes to the regulatory financial reporting requirements for our monitoring regime in order to ensure the information we collect and use remains fit for purpose.⁹

⁹ Ofcom *Updating the Regulatory Reporting Framework - Notice of proposed modifications to the USP accounting condition*, 23 October 2013, <http://stakeholders.ofcom.org.uk/consultations/regulatory-reporting-framework/>. The consultation proposes to require new information which we now consider as relevant and important for our monitoring regime; to reduce or remove certain information which is not essential or necessary for our regular monitoring needs; and to change the deadline or frequency of some of the information provided to us, so that the information is available in a more timely and expedient manner for our monitoring purposes.

Royal Mail is the focus of our monitoring regime

- 2.12 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 all 29 million business and household addresses nationwide. As such we designated it as the universal service provider in the March 2012 statement.
- 2.13 However, not all of Royal Mail's business falls within our regulatory remit. The parts that are regulated 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). This, in turn, sits within a wider group of companies – the 'Relevant Group'¹⁰. The structure of Royal Mail Group as at 31 March 2013 is shown in Figure 2.1 below.

Figure 2.1 – Structure of Royal Mail Holdings plc



- 2.14 It should be noted that since this date Royal Mail's organisational structure has changed. As part of the pre-IPO structuring, a new company Royal Mail plc (which is the listed entity) was inserted between Royal Mail Holdings plc and Royal Mail Group Limited. The name of Royal Mail holdings plc was changed to Postal Services

¹⁰ In 2012-13, Royal Mail Estates Ltd was aligned within the UKPIL business unit.

Holdings Company plc and this entity holds the remaining HM Government stake in Royal Mail plc. Post Office Limited (POL) no longer forms part of the Royal Mail group.¹¹

- 2.15 As the designated provider of the universal postal service, Royal Mail is subject to certain minimum requirements, as set out in the Act and the Postal Services (Universal Postal Service) Order 2012.¹² These requirements include undertaking collection and delivery services six days per week;¹³ providing priority (next day) and standard (within three days) delivery services; and minimum quality of service targets. The Reported Business includes all universal services,¹⁴ as well as retail bulk mail¹⁵ and access products which also use the universal service network.¹⁶

Privatisation of Royal Mail

- 2.16 The sale of Government shares in Royal Mail was one of the key intended outcomes of the Postal Services Act 2011 (“the Act”) alongside reforming the regulatory regime and resolving the historical pension deficit. This prospect of privatisation was recognised in the development of the current regulatory regime that was put in place in March 2012. It was clear that regardless of ownership structure, Royal Mail needed greater commercial freedom to return the universal service to financial sustainability and that it was important for us to focus on efficiency, quality of service and affordability while providing regulatory certainty. We did not consider that there would be any need for substantial change to the framework if privatisation did or did not occur.
- 2.17 We therefore do not consider it is necessary to make any changes to the regulatory regime now that the government has sold the majority of its shares and transferred an additional 10 percent of shares in the company to its staff. We continue to consider that the current regulatory framework is fit for purpose and we will continue to monitor market developments and Royal Mail’s performance in relation to the four key areas outlined above.

¹¹ See page 210 of Royal Mail’s share prospectus.

http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf .

¹² <http://www.legislation.gov.uk/ukxi/2012/936/made>

¹³ Five days per week for parcels.

¹⁴ <http://www.royalmailgroup.com/regulation/how-were-regulated/universal-service-obligation>

¹⁵ 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 6.

¹⁶ We are consulting on proposed technical and minor amendments to the Universal Postal Service Order and related regulatory conditions. See Ofcom *Technical and Minor Amendments in Postal Regulation*, 5 September 2013

<http://stakeholders.ofcom.org.uk/binaries/consultations/post/summary/condoc.pdf> . Our proposals are intended to clarify the drafting of the Order and the scope of the regulatory obligations. However, we note that none of the proposed amendments has any practical impact on users, Royal Mail and other postal operators because, if they are implemented as we propose, they would not require any changes to Royal Mail’s current provision of the universal postal service.

Section 3

Royal Mail's financial performance

- 3.1 This Section summarises Royal Mail's financial results and position in the previous five financial years.
- 3.2 We discuss in sequence:
- Changes in overall volumes and revenues for the Reported Business – and then by product groups and formats, to help us understand what is driving overall revenue and volume changes;
 - 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; and
 - Profit margins and cash flow. We need to monitor Royal Mail's progress on these because under the Act, we are required to have regard to the need for the provision of a universal postal service to be financially sustainable. This includes the need for a reasonable commercial rate of return for any universal service provider.
- 3.3 Royal Mail reports its financial statements using whole weeks. This means that for the 2012-13 financial year Royal Mail has reported a 53 week year, which makes comparison difficult with previous years that are usually 52 weeks. Where possible, 2012-13 results have been adjusted for 52 weeks by Royal Mail to enable a like-for-like year-on-year comparison. Where we discuss changes, we are referring to the comparisons to the previous financial year i.e. 2012-13 to 2011-12 (unless otherwise stated).

In 2012-13 total volumes continued to fall but revenues increased

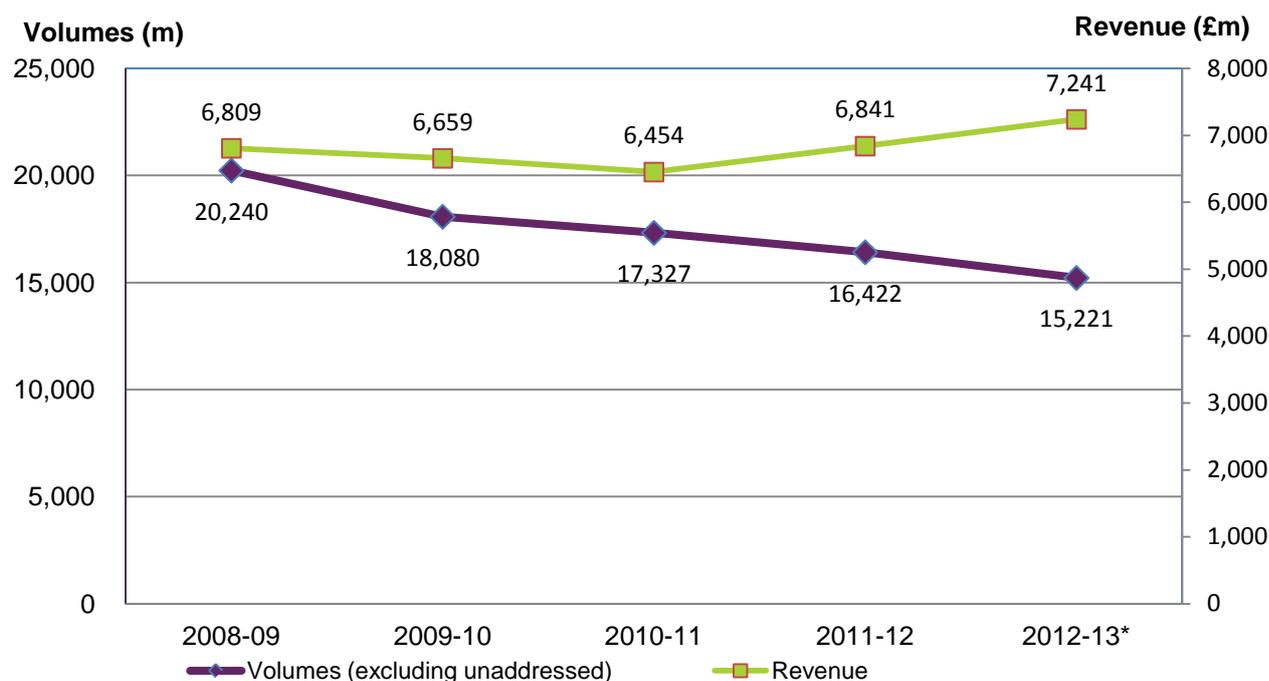
- 3.4 Mail volumes have been falling in the UK since 2005. A recent PwC report on UK mail volumes suggested this is due to a combination of factors. One factor is the impact of e-substitution as electronic forms of communication, such as e-mail, replace mail volumes. Another factor it considered affected volumes was the macroeconomy and it is likely that the recession experienced in the UK over the last few years has reduced or slowed the growth (or increased the rate of decline) of some mail volumes more than would otherwise have been the case.¹⁷ In addition, PwC considered that price rises in mail products (particularly those that were above inflation) were also likely to have impacted the consumption of mail products. It is feasible that all three factors have been influencing the decline in UK mail volumes in

¹⁷ For example, see the PwC report *The outlook for UK mail volumes to 2023* at <http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf> slides 9, 26 and 33. The rate of mail volume declines seem to have been more pronounced since 2008 indicating there has been a macroeconomic impact. In particular, the recession seems to have been a key contributor to the rapid decline of direct mail volumes in recent years (see slide 40).

recent years to some degree although it is inherently difficult to determine their individual effects on the overall decline in any precise way.¹⁸

- 3.5 We note that the total volumes of (addressed and unaddressed) mail for the Reported Business continued to fall in 2012-13, by 5.2% to 18.5bn. The decline was driven by the reduced number of addressed mail items handled by Royal Mail, which was 15.2bn in 2012-13, a fall of 7.3%. This was a steeper decline than in 2011-12 (when volumes fell by 5.2%) and may be partly attributable to last year's price increases across most postal products.
- 3.6 However, total revenue for the Reported Business continued to rise in 2012-13, by 5.8% to £7.2bn. These trends are illustrated in Figure 3.1 which shows total revenues and addressed mail volumes over the previous five years.
- 3.7 As we discuss later in this Section and report, the increase in revenue during the period is mainly attributable to price rises – for stamps, bulk mail, access and other products – as well as the increasing volume of higher revenue parcels being handled by Royal Mail.

Figure 3.1 – Reported Business volumes and revenue



Source: Royal Mail Regulatory Accounts
* adjusted 52 weeks

¹⁸ Mail volumes have been falling in other countries as well, to varying degrees. The PwC report shows that volumes appear to have fallen more sharply in some countries particularly those which have been more focused on digitising mail such as in Denmark (where the Government is seeking to make all government interactions paperless within a few years) and less so in countries like Germany where the public sector has given comparatively low priority to the digitisation of mail and there is a lower acceptance of 'digital signatures'.

Changes in product volumes and the impact on revenue

3.8 We have considered changes in the volumes and revenues of First Class, Second Class, access¹⁹ and retail bulk mail²⁰ products – which are also illustrated in Figures 3.2 and 3.3 on page 11 – in order to gauge their impact on Reported Business volumes and revenue.²¹

3.9 In doing so, we note that there was a change in these product categories last year. Prior to 2012-13, PPI²² mail was included within the ‘First class Stp (Stamp) / Mtr (Meter)²³’ and ‘Second class Stp/Mtr’ product groupings. However, as part of Royal Mail’s changes to its business mail products that took effect in 2012-13, Bulk PPI mail was reclassified to the ‘Bulk mail’ grouping, and a single-piece PPI product was introduced. We have therefore reclassified the ‘First class Stp/Mtr’ and ‘Second class Stp/Mtr’ categories, as ‘First Class single piece’ and ‘Second Class single piece’ respectively.

3.10 We have also provided figures below which adjust historical PPI volumes to reflect the impact of this change in classification. We have done this by by categorising First Class PPI and Second Class PPI (in 2011-12 and preceding years) as bulk mail. It should be noted that the First Class (and Second Class) single piece figures for 2012-13 include stamp, meter and account (the new single piece PPI product).²⁴

3.11 We note that:

- First Class single piece letter and parcel volumes continued to fall in 2012-13, by 13.0%. However their revenues increased by 5.0%, largely due to the price rises that took effect in April 2012;
- The decline in Second Class single piece letter and parcel volumes slowed in 2012-13, falling by 5.2% (compared to 8.7% the previous year). However their revenues increased by 15.5%, again largely due to the price rises that took effect in April 2012.

The fall in Second Class volumes was significantly less than the fall in First Class volumes last year. There may be a variety of reasons for this. Firstly, consumers

¹⁹ Access means allowing other companies to use a postal incumbent’s facilities for the partial provision of a postal service. In the UK this involves Royal Mail accepting mail collected and processed by third parties at its inward mail centres under wholesale contracts. Access mail is therefore the mail which is partially handled by users of these wholesale services.

²⁰ Bulk mail means mail for which the price per postal item is subject to discounts related to (i) the number of postal packets sent; (ii) the positioning or formatting of text on the postal packet; (iii) the requirement to apply markings which facilitate the use of machines to sort postal packets and (iv) pre-sortation into geographical areas for delivery.

²¹ We were not provided with adjusted 52 weeks results for volume and revenue split by product groups (Figures 3.2 and 3.3, respectively). On an aggregate 53 week basis, total volume reduced by 6.3% and total revenue increased by 7.6%.

²² PPI (Printed postage impressions) is an indication on the envelope that the postage has been paid and can be used by customers with an account with Royal Mail. It offers a pre-printed alternative to stamps and franking machines.

²³ Meter is a way of paying postage in advance, and items have a franking impression made by a franking machine licensed by Royal Mail.

²⁴ We note that if we exclude the 2012-13 First Class single-piece PPI product revenues, then First Class stamp and meter revenues fell by 1.7% in 2012-13.

of Second Class products may have been less sensitive to the price increases in 2012 compared to consumers of First Class products. We note that the proportion of business mail in Second Class single piece products is higher than the comparative First Class products (as consumers tend to send more First Class than Second Class mail). It is also possible that some customers may have been choosing cheaper Second Class products either as a result of the price rises and perhaps a greater desire to economise due to wider macroeconomic factors;

- Royal Mail's volumes declined by 15.1% for the category of retail bulk mail (including bulk PPI) and business parcel volumes²⁵. However their revenues increased by 0.8%, partly due to price rises.²⁶

We note the overall bulk mail market is shrinking and that Royal Mail's bulk mail market share has been reducing while other operators have gained a greater proportion of bulk mail business;

- The decline in Royal Mail's retail bulk mail volumes has however contributed to some increase in access volumes which grew by 2.1% in 2012-13 (as access operators generally rely on the downstream part of Royal Mail's network for final delivery). Due to price rises, access revenues increased by 14.3% over the same period; and
- Finally, combined access and retail bulk volumes declined by 4.5%, but revenues grew by 5.9% in 2012-13.

This volume decline was lower than the overall addressed mail volume decline of 7.3% (adjusted for 52 weeks) which would suggest business mail volumes (which include transactional mail) may have been less affected by factors, such as e-substitution, which are contributing to the decline in some other forms of addressed mail. The increase in revenues reflects the price rises, and the growth in the volume of access and business parcels products.

3.12 The price rises over the last five years are discussed further in Section 5.

²⁵ The volume decline is for the combined category as business parcel volumes actually increased.

²⁶ These figures include all Special Delivery items (i.e. they include universal service Special Delivery items as well as contract Special Delivery).

Figure 3.2 – Volumes split by product group - First and Second Class, access, bulk

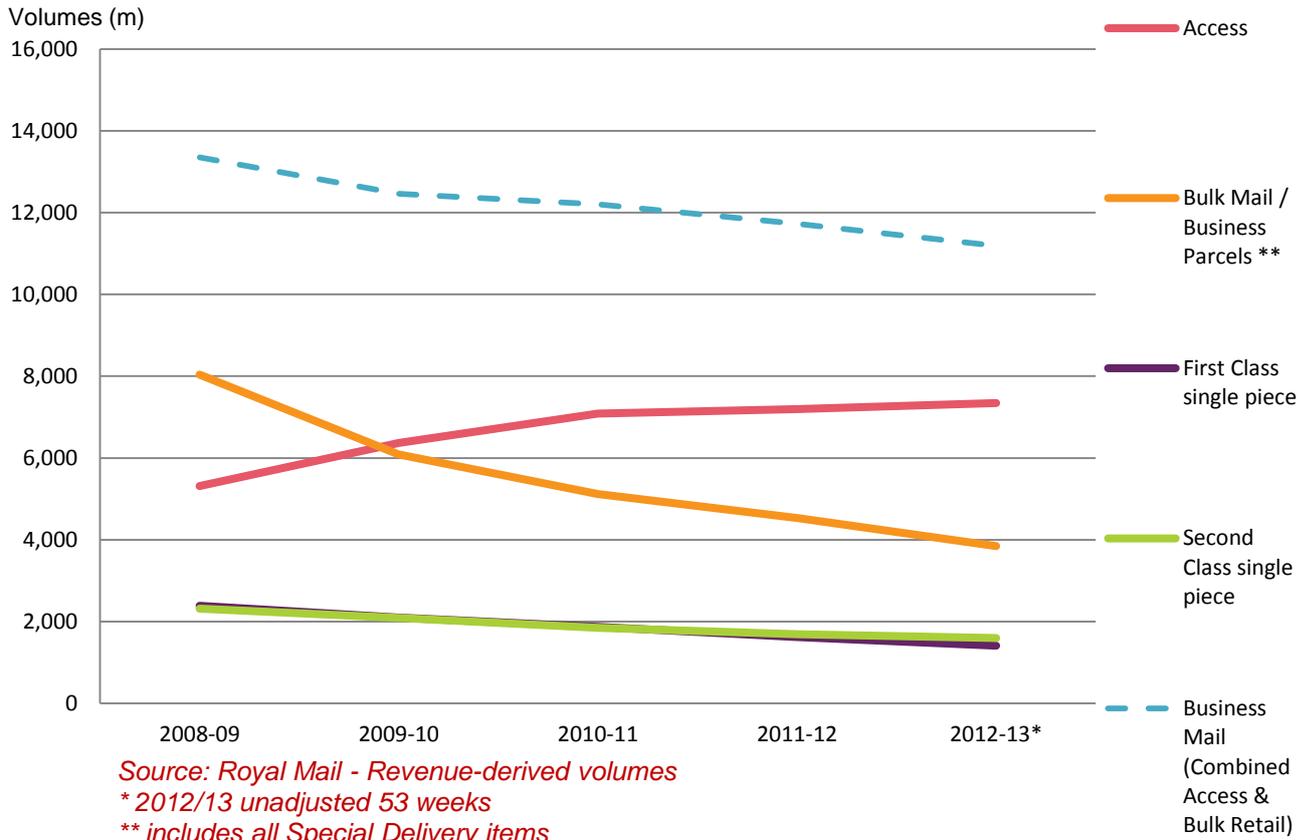
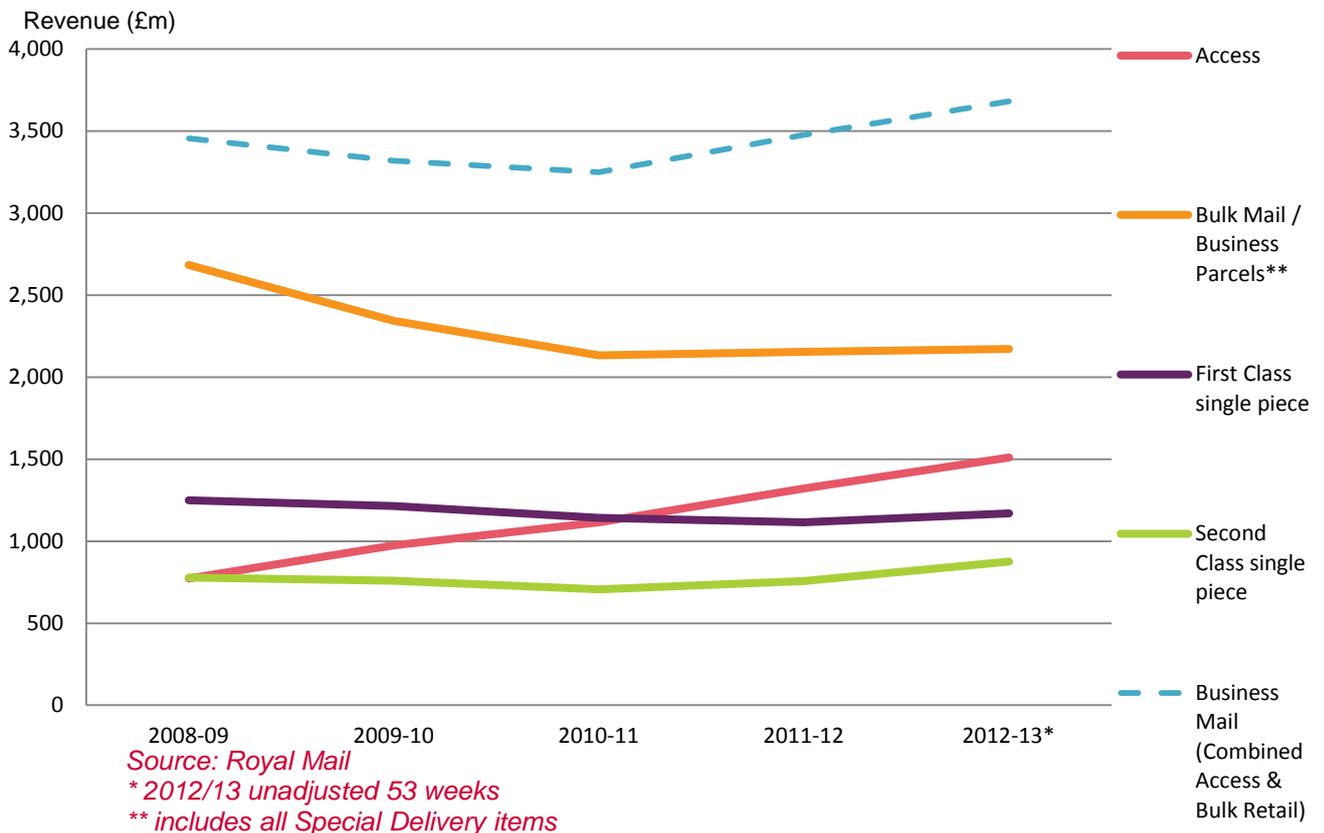


Figure 3.3 – Revenue split by product group - First and Second Class, access, bulk



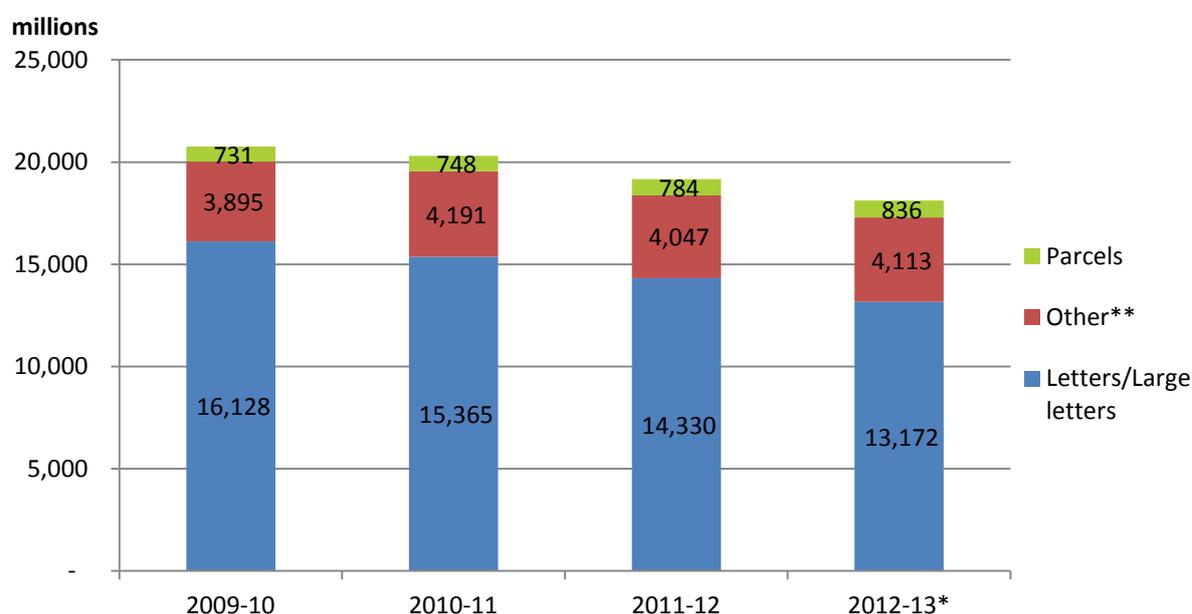
Changes in format volumes and the revenue impact

3.13 We have considered changes in the volumes and revenues of different product formats in order to ascertain if and how they have contributed to the overall decline in Reported Business volumes and the increase in revenues. Figures 3.4 and 3.5 below contrast the trend for Letters/Large Letters (including retail and access), other items (including international and unaddressed mail) and Parcels (both retail and access).²⁷

3.14 We note the trends (on volume decline and revenue increase) for letters and (on volume and revenue growth) for parcels intensified in 2012-13 relative to the previous year. In particular:

- *Letters/Large letters* – volumes reduced by 8.1% (compared to the previous year when they fell by 6.7%); while revenues increased by 2.7% (the previous year they were up by 1.0%) due to the price increases in these products in 2012;
- *Parcels* – volumes increased 6.6% (the previous year they were up by 4.8%). Parcel revenues increased 14.3% (the previous year they rose by 11.7%) driven by both volume growth and price increases; and
- *Other items* – these consist of unaddressed letters and international mail and volumes increased by 1.6% due to growth in unaddressed advertising mail being partly offset by a decline in international mail. Revenues increased by 7.6% due to the growth in unaddressed advertising mail and across the board price rises.

Figure 3.4 – Volumes split by format – Letters/Large Letters, other items and Parcels

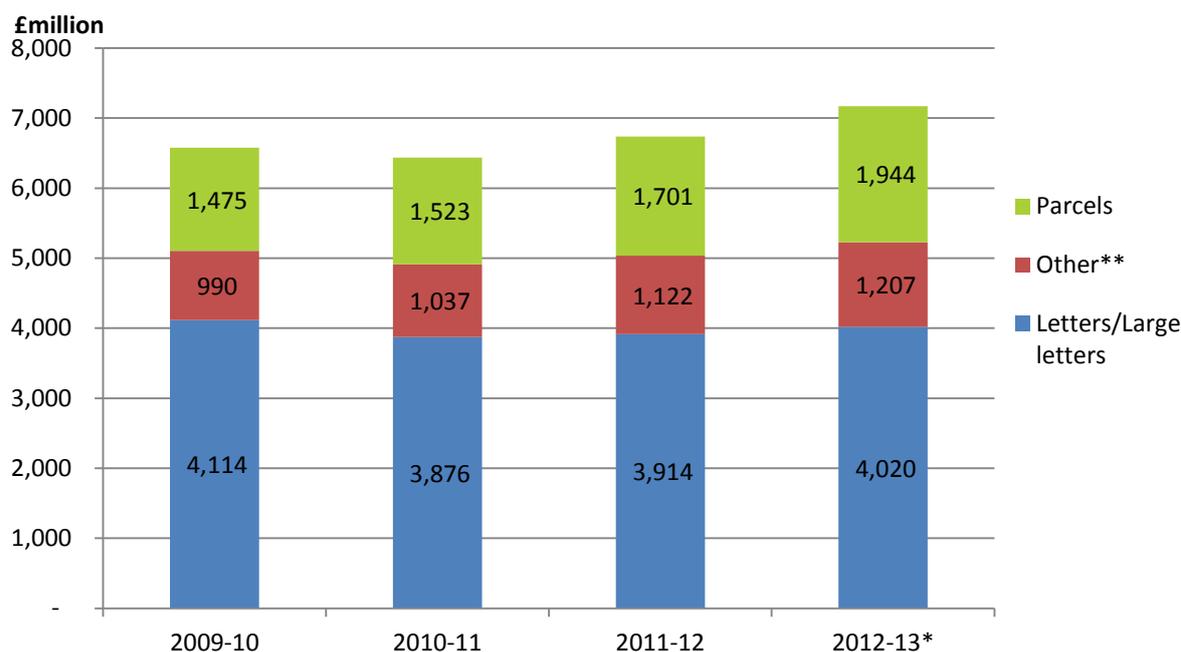


Source: unpublished submission provided to Ofcom. Volumes shown are UKPIL excluding Parcelforce

* adjusted 52 weeks

** Other includes unaddressed and international mail

²⁷ Figures are based on an adjusted 52 week period.

Figure 3.5 – Revenue split by format – Letters/Large Letters, other items and Parcels

Source: unpublished submission provided to Ofcom. Volumes shown are UKPIL excluding Parcelforce

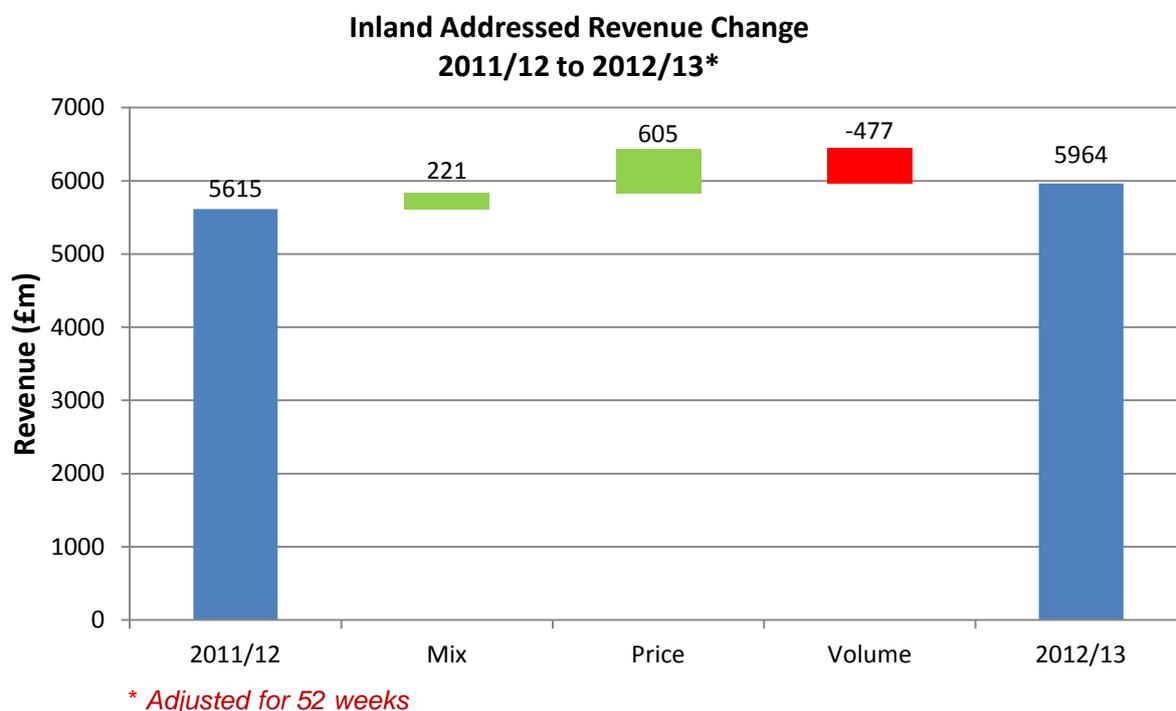
* adjusted 52 weeks

** Other includes unaddressed and international mail

- 3.15 In terms of absolute numbers, year on year parcel revenue grew by £244 million and letters/large letters revenue increased by £106 million (while other grew by £85 million).
- 3.16 We have undertaken some high level analysis to ascertain how much of the overall increase in Reported Business revenues in 2012-13 was due to the growth in parcel volumes and how much was attributable to price rises. Our analysis²⁸ – set out in Figure 3.6 – shows the relative contributions of price increases, overall volume decline and the change in volume mix (i.e. higher proportion of parcels) towards the increase in revenue for inland addressed mail. This analysis suggests that price increases were the main driver of revenue growth in addressed mail (accounting for over 73% of the revenue increase) – and also highlights that the change in mix between letters and parcels would not be sufficient to offset the revenue impact of the overall decline in addressed mail volumes (in the absence of price increases).

²⁸ The analysis looks at the drivers behind the change in addressed mail revenue between 2011-12 and 2012-13. This is calculated with reference to the overall change in revenue for letters and large letters (combined) versus parcels. The calculation is undertaken in three steps: a) to estimate the impact of changes in mix the 2011-12 total volumes and average prices were used alongside the 2012-13 change in mix (i.e. the proportion of letters/large letters compared to packets); b) to estimate the impact of the change in prices, 2012-13 average prices and mix was used alongside the 2011-12 total volumes; and c) to estimate the impact of the volume decline total volume was scaled to reflect 2012-13 total volumes along with the 2012-13 prices and mix.

Figure 3.6 – Contributions of mix, price and volumes to inland addressed revenue change



Universal service and non-universal service volumes and revenues

- 3.17 As set out in Section 1, the Reported Business includes all universal service products, as well as other products which use the universal service network (for example, retail bulk mail and access products).
- 3.18 Figure 3.7 shows the Reported Business volumes, broken down into universal service and non-universal service products. Note these are the same volumes as those shown in previous Figures, only categorised in a different manner.
- 3.19 The volume of universal service products has declined significantly in recent years and in 2012-13 fell by 15.1% (equating to a reduction of 48.1% over the last five years). Some of the decline in the volumes for universal service products is due to the removal of certain products from the scope of the universal service as part of Postcomm's August 2011 review²⁹. Based on the 2012-13 universal service product scope, like-for-like volumes fell by 8.9% in 2012-13 (equating to a reduction of 38.7% over the last five years). The volume of non-universal service products has fallen as well but less so, with a 4.4% reduction in 2012-13 (and 11.4% reduction over the last five years).³⁰ This was mainly due to the growth of access volumes (as shown above and in Figure 6.1) as other operators have taken upstream volume from Royal Mail. It also shows that the decline in bulk business mail volumes has been significantly

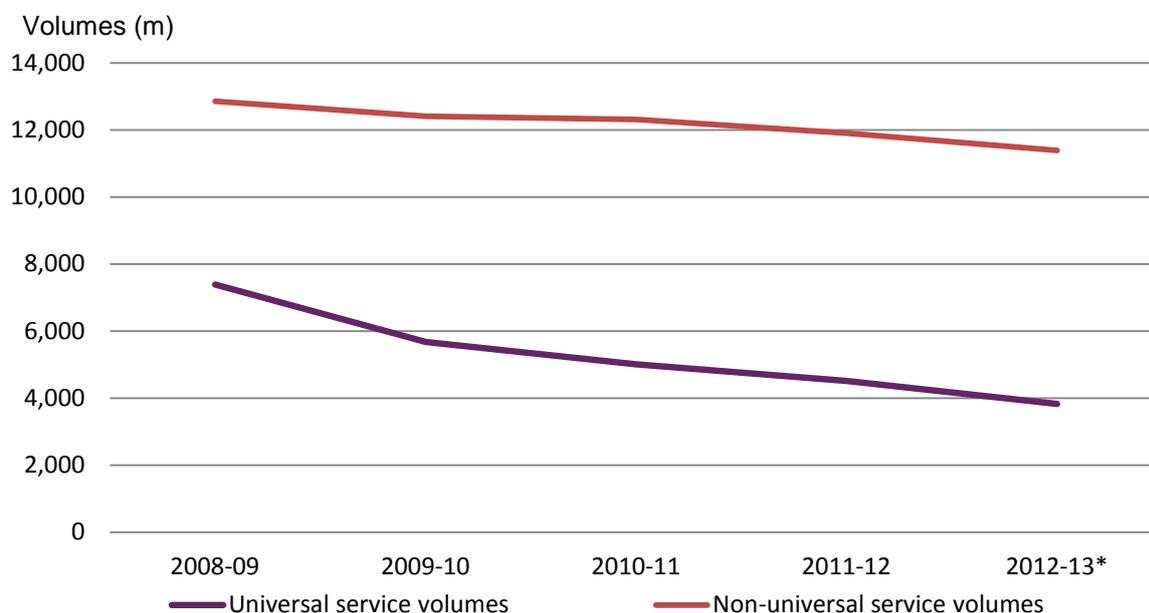
²⁹ See Postcomm *Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document*

<http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf>

³⁰ Based on adjusted 2012-13 52 week period.

slower than universal services predominantly used by consumers and small business.

Figure 3.7 – Volumes split by universal service and non-universal service products



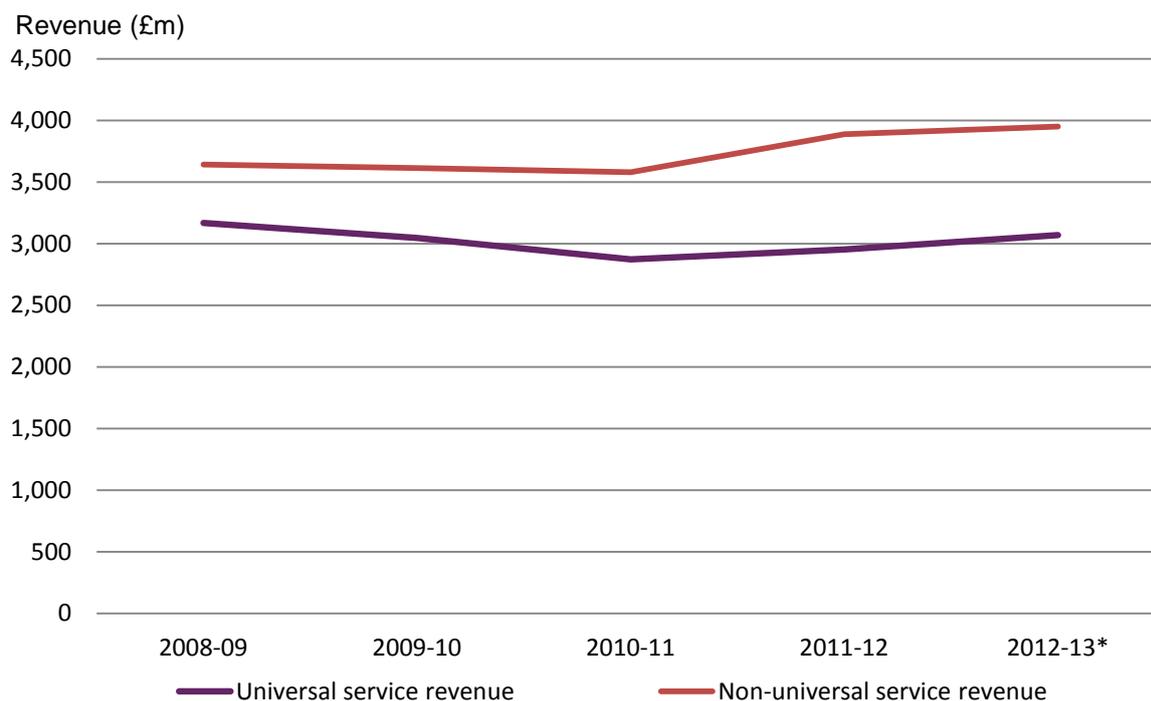
Source: Royal Mail Regulatory Accounts, addressed volumes
* adjusted 52 weeks

- 3.20 Figure 3.8 sets out the corresponding revenue for the Reported Business split between universal and non-universal service products. Despite the volume decline discussed above, revenues from universal service products have increased over the last three years, largely due to price rises.³¹ In 2012-13, revenues rose 4.0% and in nominal terms, are returning towards the revenue levels seen five years ago.³² The significant increase in revenues for non-universal services in 2011-12 was due to the price increases implemented following an application by Royal Mail for an increase in the level of revenue allowed under the previous price control and Postcomm's subsequent consultation.
- 3.21 Non-universal service products contain discounts for presentation, sorting of the mail and/or volume which reduces the cost of processing these items for Royal Mail. They therefore have a lower unit revenue than universal services. This explains why the gap between universal service and non-universal service volumes is much larger than their respective revenues.

³¹ Based on adjusted 52 week 2012-13 period

³² Based on the 2012-13 universal service product scope, like-for-like revenues increased by 7.6% in 2012-13.

Figure 3.8 – Revenue split by universal service and non-universal service products



Source: Royal Mail Regulatory Accounts; addressed revenue
* adjusted 52 weeks

Costs

3.22 In addition to increasing revenues, costs excluding exceptional items for the Reported Business increased in 2012-13 by 3.0% to £6.9 billion. These costs can be broken down into people costs, non-people costs and exceptional costs, the latter of which include transformation costs (amongst other things). The breakdown of costs to these categories is shown in Figure 3.9³³ and we note that:

- Non-people costs – rose slightly to £2.4 billion; an increase of 1.1%, largely due to higher distribution and conveyance costs. Royal Mail noted that the increase in parcel volumes has resulted in higher vehicle fleet and associated fuel and maintenance costs; and
- People costs – increased to £4.4 billion; an increase of 4.1% despite a slightly lower headcount, largely due to a increase in pay for frontline staff of 3.5%,³⁴ increased pension contributions and implementation of requirements in the Agency Workers Directive (as Royal Mail also employ some agency staff).

3.23 Exceptional costs in 2012-13 were £0.2 billion, which represents a reduction of 2.5% compared with 2011-12. The transformation related exceptional costs which

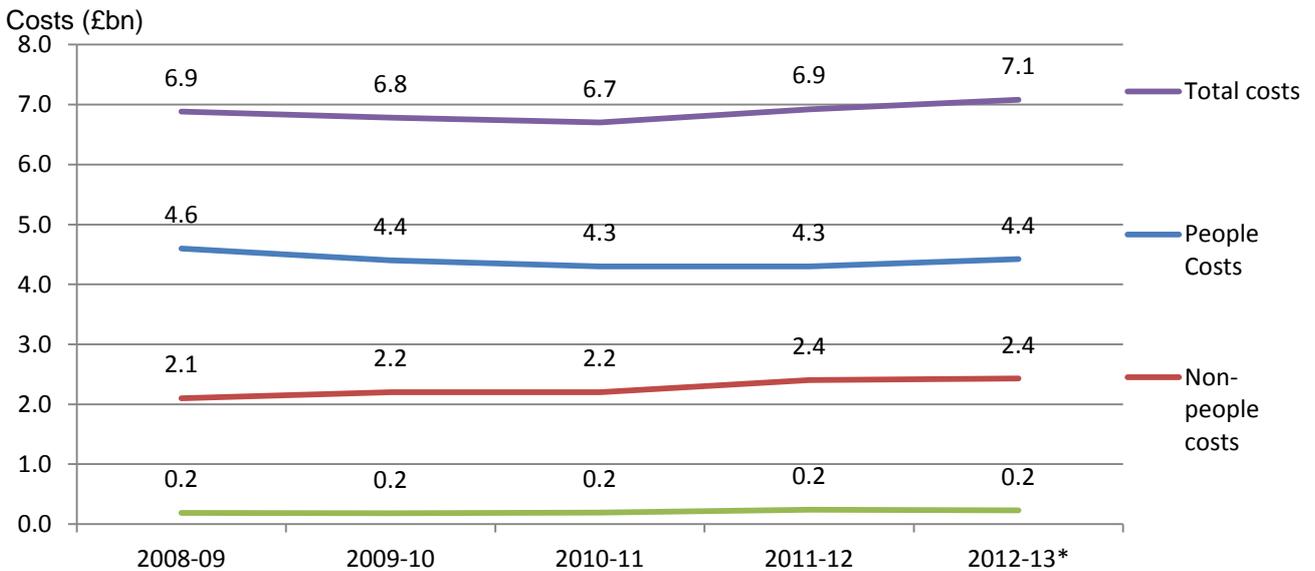
³³ Based on 2012-13 adjusted 52 week period.

³⁴ Agreed as part of the Business Transformation Agreement with the CWU which was signed in 2010.

comprise the largest part of exceptional costs also fell by 9.4%, largely due to lower business transformation payments.³⁵

3.24 In terms of the overall trend, we note that total costs have increased in each of the last two financial years after several years of decline. While the number of parcels handled by Royal Mail is increasing, this is not sufficient by itself to offset the revenue impact of the decline in letter volumes. Therefore as overall volumes are expected to continue to decline slowly, Royal Mail's ability to improve its efficiency levels will be important to help sustain the viability of the universal service.

Figure 3.9 – Reported Business costs



Source: Royal Mail (figures constructed for regulatory purposes and are unaudited)
* adjusted 52 weeks

³⁵ Business transformation payments relate to the Pay and Transformation 2010 Agreement where Royal Mail staff receive up to £1,000 based on specific milestones and specific bonuses with respect to transforming the network.

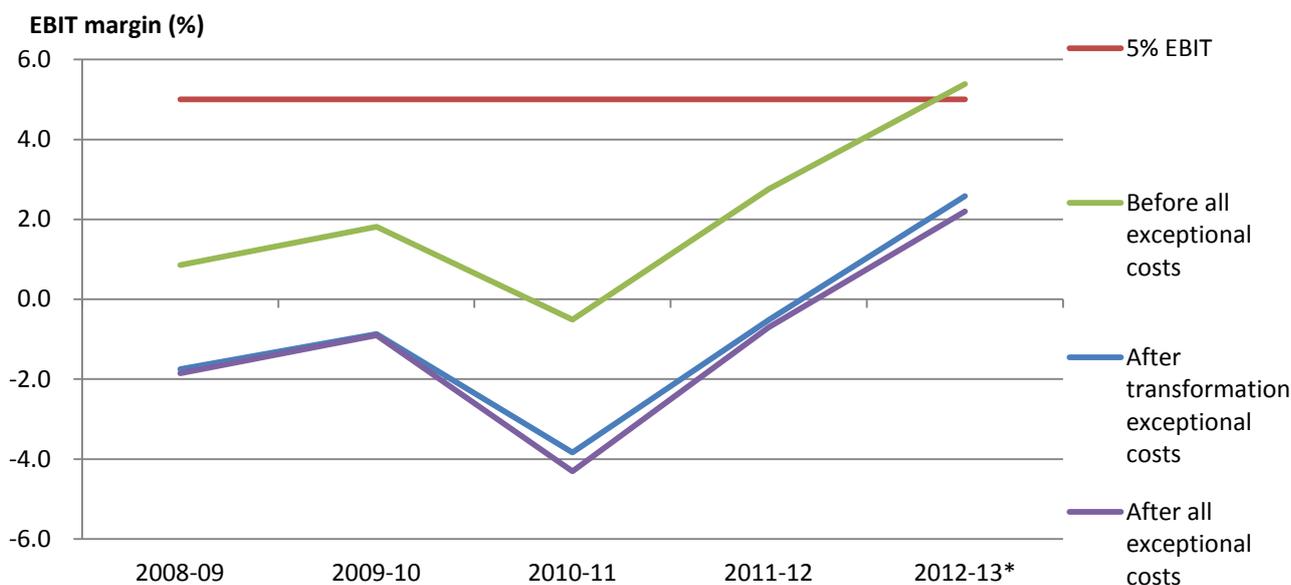
Profit margins have increased

- 3.25 In considering the financial sustainability of the universal postal service, the Act requires that we should 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. In the March 2012 statement we confirmed that an indicative earning before interest and tax ('EBIT') margin range of 5% to 10% was consistent with this need.
- 3.26 We also set out in the March 2012 statement that the EBIT margin would be calculated on a pre-exceptional basis. We noted that we would not expect restructuring or redundancy costs, that are likely to recur year on year, to be included in exceptional items and we would determine the exceptional nature of items on a case by case basis.³⁶
- 3.27 We note that under its regulatory financial reporting requirements, Royal Mail is required to report EBIT before and after all exceptional costs in its annual regulatory accounts.³⁷ Royal Mail has included its restructuring and redundancy costs in exceptional items. However, it also reports a further EBIT margin figure 'after transformation exceptional costs' (which includes the restructuring and redundancy costs related to modernisation).
- 3.28 As the EBIT figure after transformation exceptional costs includes redundancy and restructuring costs, it appears to be more in line with our approach to the EBIT margin – and therefore more useful for assessing the financial sustainability of the universal service.
- 3.29 In order to give a fuller picture, Figure 3.10 shows the EBIT margin of the Reported Business over the last five years:
- a) before all exceptional costs;
 - b) after transformation exceptional costs; and
 - c) after all exceptional costs.

³⁶ Footnote 69 of the March 2012 statement

<http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf> .

³⁷ Our recently published consultation on updating the regulatory reporting framework (see <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/summary/framework.pdf>) includes a proposal that Royal Mail should provide further information about the nature of the exceptional costs. This further information will help us make a decision, on a case by case basis, as to which items are exceptional for the purposes of calculating the EBIT margin, and which are not.

Figure 3.10 – Reported Business EBIT margins

Source: Royal Mail Regulatory Accounts
* adjusted 52 weeks

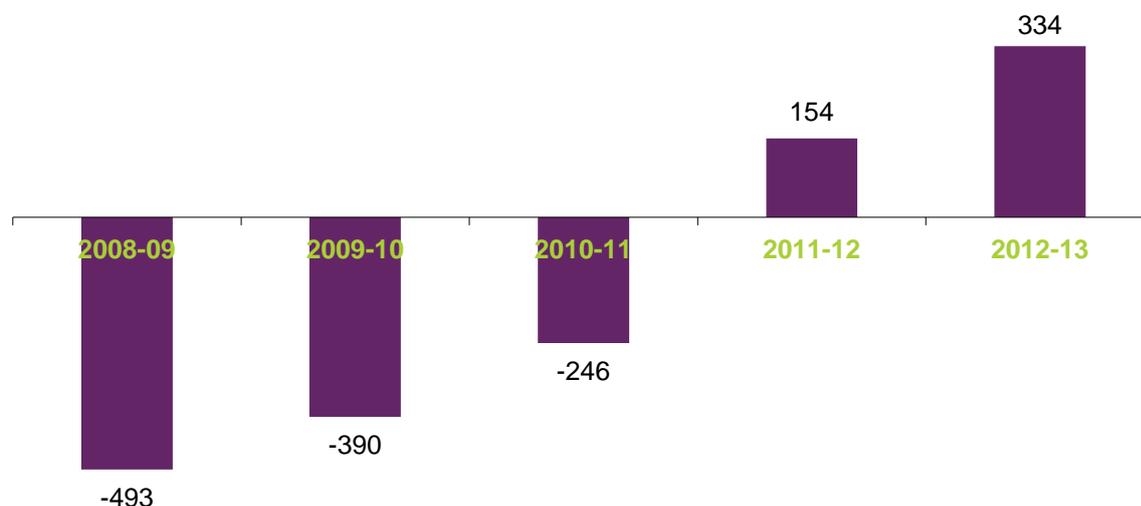
- 3.30 In 2012-13 the EBIT margin became positive (and is also above 2%) on all three EBIT margin lines – the first time this has occurred over the five year period displayed. As discussed above, this improvement in the EBIT margin is largely due to the increase in revenues from price rises.
- 3.31 The EBIT margin (after transformation exceptional costs) was 2.6% in 2012-13, which is 3.1 percentage points higher than the margin for 2011-12 when it was -0.5% and represents an increase of 6.4 percentage points on the 2010-11 EBIT margin (-3.8%). This is a significant improvement and closer to the indicative 5% to 10% range we consider is consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.

Cash Flow continued to improve

- 3.32 Cash flow is also an important component in ensuring the financeability of the universal service. We set out in the March 2012 statement that we considered the EBIT margin was an approximate proxy for operating cash generation, as Royal Mail had projected the operating cash flow and EBIT to be broadly comparable towards the end of its plan.
- 3.33 The cash flow of the Relevant Group has been a concern for a number of years. Free cash flow was negative in 2007-08 and as shown in Figure 3.11 remained so for several years. However, as the Figure also illustrates, it has recently improved, turning positive in 2011-12. Royal Mail Group saw a further improvement in its cash flow in 2012-13 where it reached £334m which represents a 117% increase on the previous year.
- 3.34 The main reasons for this are (1) the increase in its overall trading performance, largely due to higher revenue as a result of the price rises; and (2) the removal of the

pension deficit payment in 2011-12³⁸ (which removed Royal Mail's approximately £300 million per annum pension deficit payments).

Figure 3.11 – 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

Summary of financial performance

3.35 We have reviewed a broad set of financial performance data in this Section. In summary, the key results for the 2012-13 financial year were:

- Profit margins and cash flow improved;
- The main cause for the improvement in profit was an increase in revenue largely as a result of the price rises across most products in April 2012 but the growth in parcels also contributed to the revenue gains;
- Costs for the Reported Business increased by 3.0% in 2012-13 compared to 2011-12. The main reason for this was a 4.1% increase in people costs due to the pay increases (in the last year of the 2010 pay deal), increased pension contributions and implementation of the Agency Workers Directive; and
- Overall addressed letter mail volumes continued to decline. While the number of parcels handled by Royal Mail continued to increase, if we exclude the effect of the price rises this would not be sufficient to offset the revenue impact of the overall decline in addressed mail volumes. This suggests that, absent above inflation price increases, there will need to be a focus on cost reduction in the

³⁸ Following its approval by the European Commission in March 2012 (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:279:0040:0068:EN:PDF>), the UK Government transferred Royal Mail's historic pension deficit assets and liabilities to the Treasury in the first half of 2012. In addition, Royal Mail stated in its prospectus that it also received £124 million in restructuring aid. Royal Mail still needs to provide for the ongoing pension costs accrued for its staff.

future to continue to improve financial performance and return the universal service to a financially sustainable footing.

- 3.36 Indeed, while we noted in our March 2012 statement, that we expected Royal Mail would need to improve the viability of the universal service in the short term through price rises, we also stated that Royal Mail needed to become more efficient to secure the provision of the universal service in the long term alongside ensuring universal service quality targets are met. We therefore discuss efficiency in the next Section and actual quality of service performance within Section 5 on Customers and Consumers.

Section 4

Efficiency

4.1 In this Section we discuss efficiency, covering:

- why it is an important aspect of our monitoring regime;
- the further work we are doing to better understand Royal Mail's efficiency; and
- what Royal Mail itself has been doing to improve its efficiency.

4.2 We then set out in more detail some provisional efficiency metrics which potentially provide useful indicators in considering Royal Mail's efficiency.

Efficiency is an important element of our monitoring regime

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

4.4 Traditionally regulators have used either competition (actual or potential) or price controls to incentivise efficiency in regulated companies. Given Royal Mail's financial position and the fact that the postal market was, on the whole, declining, we considered that Royal Mail had inherent efficiency incentives when we put the regulatory framework in place in March 2012. This was an important factor in our decision not to impose a comprehensive price control despite there being very little competition in parts of the postal pipeline. However, in the March 2012 statement, we noted that we expected Royal Mail to improve its efficiency levels and to sustain such improvements thereafter to avoid relying solely on price increases with the associated risk of exacerbating volume decline. However, we did not set specific efficiency targets.

4.5 To ensure that Royal Mail's inherent efficiency incentives remain and they are sufficient to secure the financial sustainability of the universal service in the longer term, efficiency is one of the key areas we assess as part of the monitoring regime. It is important to understand what Royal Mail's actual rate of efficiency improvement is and form a view of what represents a reasonable rate of efficiency improvement. When the regulatory framework was put in place, our view of what would constitute a reasonable rate of efficiency improvement was based on analysis we had undertaken on Royal Mail's restructuring plan.

4.6 In addition, an understanding of Royal Mail's achieved and planned future rate of efficiency improvement would also be important in any future review of the need for intervention in relation to end-to-end competition, as explained in our March 2013 guidance.³⁹ This set out that we would need to reach a view on the expected financial position of Royal Mail, taking account of expected future efficiency savings. This would include an assessment of Royal Mail's potential commercial response to

³⁹ Ofcom *End-to-End Competition in the Postal Sector*, 27 March 2013
<http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/statement.pdf>

end-to-end competition, including the impact of stronger incentives to improve efficiency. And we would also consider the extent to which any poor financial performance was the result of factors within Royal Mail's control, including an assessment of whether Royal Mail had achieved and was planning to achieve a reasonable rate of efficiency improvement.

We are doing further work to better understand Royal Mail's efficiency

- 4.7 When measuring efficiency it is important to identify changes in costs that are due to other factors such as the impact of volume decline and the changing proportion of packets (mix). We are therefore currently reviewing the metrics used to understand and monitor Royal Mail's level of efficiency improvement. There are a number of different metrics which could be adopted to measure changes in efficiency, each with different strengths and weaknesses. We discuss some of the metrics that Royal Mail and Ofcom have been considering below but note that this is work in progress and we expect to be able to provide updated efficiency metrics in the next annual monitoring update in late 2014.
- 4.8 As set out in our guidance on our approach to end-to-end competition in the postal sector, we have also been undertaking preliminary work to understand how we might assess what constitutes a reasonable rate of efficiency improvement by Royal Mail. As part of this we will shortly be publishing two independent reports that we commissioned as part of our preliminary work:
- The **NERA report** on approaches to measuring the efficiency of postal operators, considers the advantages and disadvantages of different methodologies for assessing Royal Mail's efficiency. This will inform our view of the analysis that should be undertaken in any such future review and how to determine what constitutes a reasonable rate of efficiency improvement; and
 - The **WiK report** sets out the efficiency programmes undertaken by other comparable European postal operators and the savings that they have been able to realise in light of changes in the market environment (e.g. fall in volumes, end-to-end competition).
- 4.9 These reports will be used to inform our view of the analysis that should be undertaken in any future review.

Royal Mail is implementing a modernisation plan aimed at improving its efficiency

- 4.10 Royal Mail has been implementing a large scale modernisation plan (also described by Royal Mail as 'transformation activities'⁴⁰) in recent years. Royal Mail has implemented changes to four key phases of its network – to collection, sortation, logistics and delivery.
- 4.11 This has included greater automation in Royal Mail's letters sorting processes (for instance, increased sequence sorting technology which enables letters to be sorted

⁴⁰ These activities are described in more detail in the Royal Mail plc Prospectus 2013 http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf - for instance, in pages 72-74.

into address order, ready for final delivery by postmen and women), the rationalisation of its mail centres, implementation of new working practices in mail centres and delivery offices and more recently, changes to Royal Mail's delivery operations (such as greater use of trolleys and shared vans for the delivery of parcels and letters by postmen and women).⁴¹

- 4.12 We require Royal Mail to share its business plan with us (at a minimum annually) and this sets out more detail of its plans to reduce costs and improve efficiency. As much of this plan is commercially sensitive, we have not disclosed its details in this report. However, the plan and Royal Mail's progress against its own targets informs our ongoing internal monitoring of Royal Mail's efficiency.
- 4.13 In terms of Royal Mail's ongoing rationalisation of Mail Centres, nine further centres were closed in 2012-13, leaving 48 in operation, compared to 69 operational mail centres in 2007-08. In 2012-13, Royal Mail also modernised around 452 Delivery Offices, bringing the total number modernised to 860 out of the around 1,400 offices. Royal Mail says, that as well as more efficient operations, these changes are expected to bring about improvements in working conditions and safety for Royal Mail's staff.

Provisional indicators of Royal Mail's efficiency improvements

- 4.14 The efficiency of a company can be defined as the extent to which it is able to minimise its costs for producing a given mix and volume of outputs. Efficiency is calculated with reference to the environment in which the company operates, for example the economic conditions and other factors that may impact its costs such as the geography of the area in which it operates.
- 4.15 As noted above, we have undertaken analysis to consider which metrics would best show changes in Royal Mail's productivity and efficiency. This work is ongoing and as such we would emphasise that the efficiency measures shown in the rest of this Section are only a provisional view of metrics that might be used as indicators of Royal Mail's efficiency.

Unit Costs

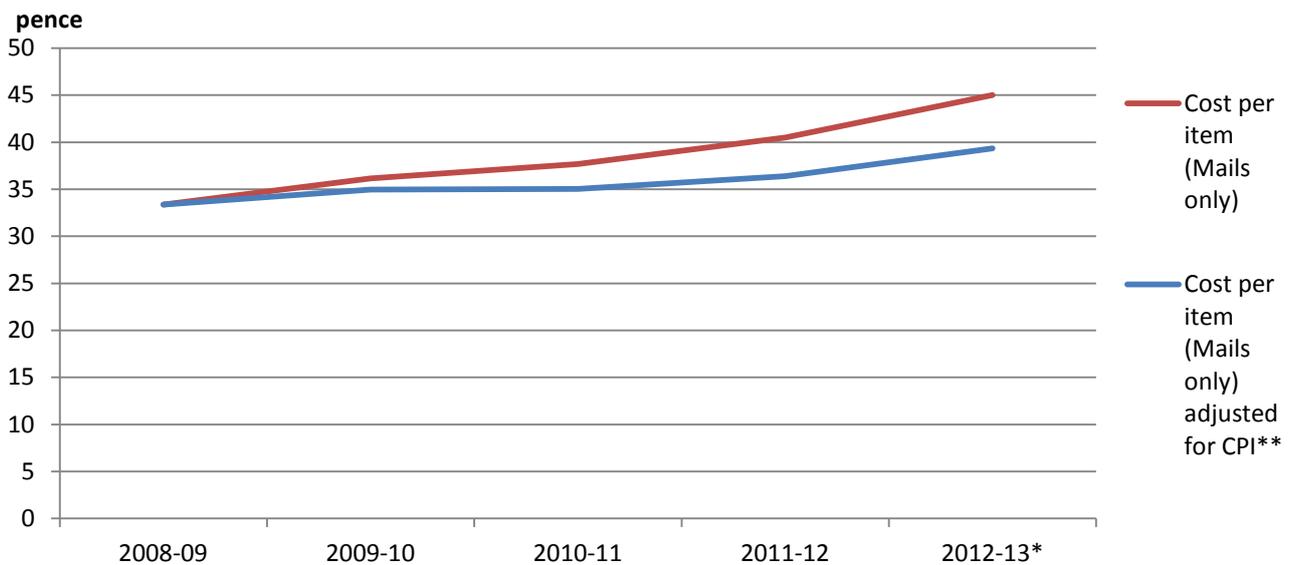
- 4.16 Unit cost analysis is a simple way of assessing efficiency. For this report we have provided the simplest form of unit cost metric – i.e. a straightforward unit cost over time and also an adjusted unit cost taking into account inflation. The unit costs measures we have included are:
- Overall cost per mail item. This metric considers the cost of the Reported Business (as defined earlier in this report) against the total number of posted mail volumes⁴²; and
 - People cost per Full Time Equivalent Employee (FTE).

⁴¹ Mail Centres now make greater use of sorting machines and 'walk sequencing' technology. This has resulted in a reduction in the manual sorting of mail and the time taken to sequence the mail into delivery order.

⁴² The volume measure used is "Total Mails" and includes all posted items, excluding non-mail products such as Address Management Centre, Customer Management, Royal Mail Specialist Services, Stamps & Collectables. Unaddressed mail is excluded.

- 4.17 As shown in Figure 4.1 below, the cost per item has continued to increase in 2012-13 both in nominal terms and when costs have been adjusted for inflation. This suggests, absent any other changes, it is costing more per unit of output. However, in the postal industry this does not necessarily show the improvement in efficiency over time as it does not account for any changes in the proportion of packets and parcels (which have a higher unit cost) and/or the impact on cost of declining letter volumes.
- 4.18 This is important as packets take significantly more time to process and deliver than standard letters as they are currently not automated and, in general, cannot be posted through the letter box. So an increasing proportion of packets and parcels in total mail volume will act to increase workload requirements (if we exclude the impact of volume decline). In addition, in a market with declining volumes such as post, absent any other changes, unit costs would be expected to rise as fixed costs are shared over a reduced number of items.
- 4.19 More sophisticated approaches control for these mix and volume effects and our ongoing work on the efficiency metrics aims to address these issues.

Figure 4.1 – Total Mails cost per item



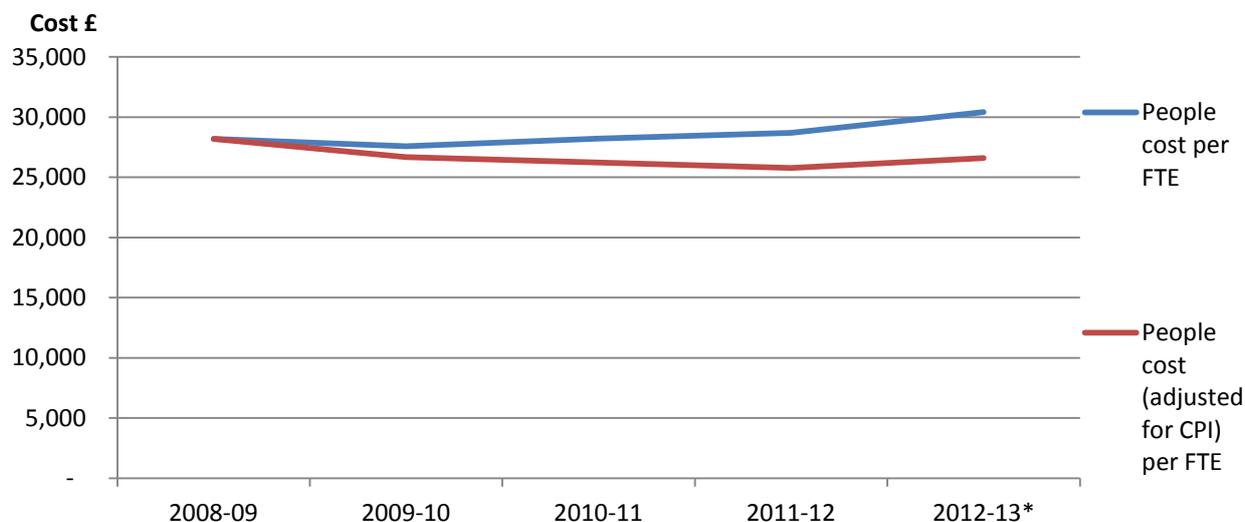
Source: Royal Mail (figures constructed for regulatory purposes and are unaudited)

* adjusted 52 weeks

** March CPI

- 4.20 People costs per employee might provide an indication of a certain type of efficiency or help to explain changes in unit costs. People costs represent a significant proportion of Royal Mail's costs. However, it may not provide a reliable indicator on its own. For example, a company may have a high cost per employee but a low cost per customer dependent on the company's structure. Nevertheless, it might be useful in highlighting a trend. We see in Figure 4.2 that there has been a recent small upward trend in costs per employee but this increase is slight once inflation has been taken into account.

Figure 4.2 – Reported Business people cost per FTE



Source: Royal Mail (figures constructed for regulatory purposes and are unaudited) FTE data (including agency staff) provided by Royal Mail. The 53 week year-end FTE calculation is based on March hour data, therefore does not take into account the peak Christmas season. Based on unaudited 12/13 data, using the full year FTE average results in lower people cost per FTE.

** adjusted 52 weeks*

*** March CPI*

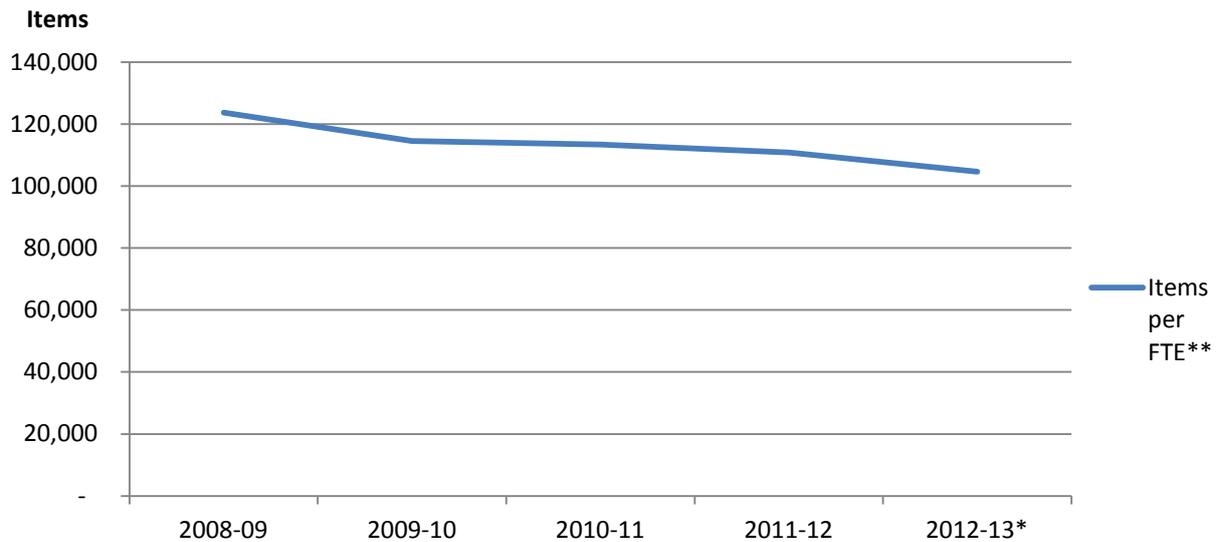
Productivity metrics

4.21 Productivity can be considered to be the efficiency of the operational activity e.g. how many items are worked in a given amount of time or by an employee.

4.22 In this report we consider two productivity metrics:

- Delivered Mail Items per Employee; and
- Royal Mail's own productivity metric defined as items worked (processed / delivered) per unit of time.

4.23 As with the unit cost metrics, consideration needs to be given to how well the measure controls for changes in volume and mix. Figure 4.3 shows a gradual reduction in items delivered per FTE suggesting a decline in productivity. However, as with the unit cost metric above, this does not adjust for changes in mix which may give rise to an reduction in delivered items per employee as the proportion of parcels increases (as they take longer to process). It also does not account for the fixed costs relating to the reducing volume of letters (i.e. postmen being required to deliver six days a week but delivering fewer items).

Figure 4.3 – Reported Business items per FTE

Source: Royal Mail (figures constructed for regulatory purposes and are unaudited) FTE data (including agency staff) provided by Royal Mail. The 53 week year-end FTE calculation is based on March hour data, therefore does not take into account the peak Christmas season. Based on unaudited 12/13 data, using the full year FTE average results in lower items per FTE.

** adjusted 52 weeks*

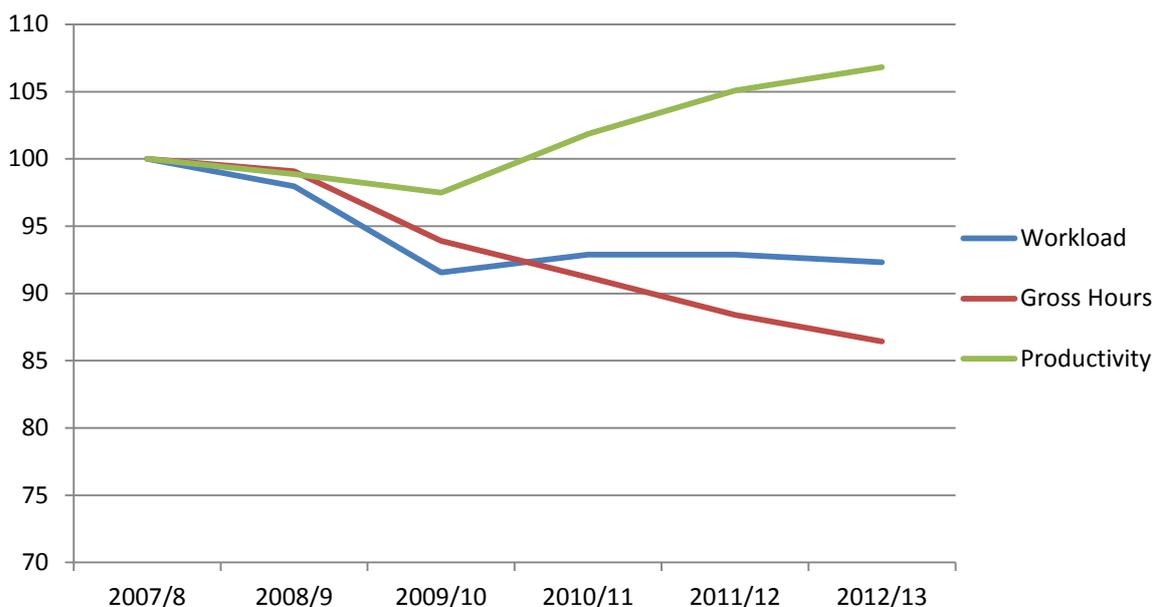
*** Addressed mail only*

- 4.24 Royal Mail has recently adopted a productivity metric which provides a measure of the operational efficiency of its delivery and processing (mail centre) operations. We are continuing to work with Royal Mail to understand the productivity metric's advantages and limitations. We note that the measure calculates the ratio between volumes processed and time taken. Volumes are weighted by the time expected to be taken to process them to give a weighted volume (or "workload") which includes the impact of a change in mix of products and volume decline. This is a key advantage of this metric which suggests that if it accurately accounts for these factors it may provide a meaningful indication of operational efficiency over time.
- 4.25 There are however some limitations to this type of measure. For instance it currently only covers delivery and processing activities and so excludes parts of Royal Mail's pipeline (although delivery and processing people costs account for a significant proportion of Royal Mail's regulated business costs). Furthermore, the measure is a productivity measure not a financial measure, hence whilst it captures the rate of work it does not cover the costs involved in achieving that rate of work i.e. how much people are being paid.
- 4.26 Royal Mail's recent productivity improvement, employing this approach, is shown in Figure 4.4. This shows an improvement in productivity as the time taken to work the items has decreased relative to the change in workload. The metric, unlike the others we have shown, accounts for mix and suggests that if we were to account for mix and volume decline Royal Mail can be seen to be becoming more efficient.
- 4.27 Overall productivity improved last year in mail centres and delivery offices – by 1.7%. Royal Mail has been able to achieve significantly higher productivity improvements in mail centres compared to delivery offices. This is likely to be due to the fact that early on in the modernisation plan Royal Mail focused its efforts on mail centres and also

potentially the difficulty in implementing changes in over 1400 delivery offices (compared to the 48 mail centres).

4.28 Productivity, on this measure, appears to have been improving since 2010-11. If 2007-08 is used as a baseline year, Royal Mail has increased its productivity by around 7% over this five year period. At the same time, workload has decreased by about 8%, although it has been relatively stable over the last three years and gross hours have declined by 14% since the 2007-08 baseline year.

Figure 4.4 – Productivity in Delivery and Processing



Source: Royal Mail figures

Summary of efficiency metrics and rate of improvement

- 4.29 We have worked with Royal Mail to understand the best metrics to measure change in efficiency levels over time. It is likely that we will need to employ a range of metrics to show the changes in Royal Mail’s costs. The productivity metric adopted by Royal Mail shows that it has been able to achieve a small but gradual improvement in productivity since 2010-11. This is complemented by a small decline in workload (which has been steady over the last few years) and a slow but steady decline in gross hours worked.
- 4.30 The outcome of our work on efficiency metrics will be shown in our 2013-14 annual monitoring update. In addition, we will shortly be publishing the two consultancy reports in relation to how we might assess what constitutes a reasonable rate of efficiency improvement and efficiency programmes undertaken by comparable European operators.

Section 5

Customers and consumers

5.1 In this Section we discuss the impact of Royal Mail's pricing and operational decisions on its customers and consumers. As noted in our March 2012 decision, 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 April 2012 and also its April 2013 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.⁴³ Our March 2012 decision set out the quality standards that Royal Mail is required to meet. This was to ensure high levels of universal service performance were maintained for consumers.

5.2 We note that in March 2013 we published the results of our review of users' needs from the universal service – this found that overall the needs of customers were being met by the current universal service and as a result Ofcom did not propose any changes to the universal service.⁴⁴

5.3 This Section also includes relevant findings from our new residential and business consumer surveys on postal services. This covers the period from July 2012 (when the surveys began) to June 2013. We will continue to use these surveys to help us monitor public perceptions about the postal service.

Pricing of universal services

5.4 Until 2012 the significant majority of Royal Mail's retail and wholesale prices were subject to price controls. This meant that while prices generally increased over time, there were regulatory limits on the level of the price rises. In our review of the regulatory framework, completed in March 2012, we removed nearly all of these price controls in order to give Royal Mail greater freedom to respond to changes in the market. In addition, we put a number of safeguards in place, including a cap on the price of Second Class stamps (less than 2kg) to ensure that a basic universal service is available to all for the seven year period of the regulatory framework.

5.5 We considered that it was necessary to give Royal Mail sufficient commercial freedom to enable it to return the universal service to a financially sustainable position. It was expected that there would be some restructuring of prices given the low and negative returns that Royal Mail had been making in recent years on the reported business and the threat that this posed to the financial viability of the universal service. However, we considered that Royal Mail would need to make efficiency improvements to ensure the provision of the universal service in the medium term. In its share prospectus, Royal Mail noted its expectation that any letter

⁴³ We also monitor Quality of Service closely given the risk Royal Mail could degrade quality in order to reduce costs rather than improve efficiency.

⁴⁴ Ofcom, *Review of postal users' needs*, 27 March 2013

<http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf> .

price increases for the next three years (ending in the 2015-16 financial year) would be broadly in line with RPI. It also expected that after the parcel price increases implemented in 2013-14 due to size based pricing, parcel prices would also increase broadly in line with RPI. In addition, as discussed above, the safeguard cap on Second Class stamps will continue to protect consumers and small businesses.

Royal Mail has complied with the safeguard caps

- 5.6 As noted above, the new regulatory framework gave Royal Mail significantly more pricing flexibility subject to certain key safeguards. This included a safeguard cap on Second Class stamp Letters and Second Class stamp Large Letters⁴⁵ and packets up to 2kg. This was to ensure vulnerable consumers could afford a basic universal postal service.⁴⁶
- 5.7 For Second Class standard letters, the cap is 55p in 2012-13 plus the relevant consumer price index ('CPI') inflation rate for the remaining seven year period of the regulatory framework. This means that the level of the cap was 56p in 2013-14. The Large Letter and packets (up to 2kg) cap is a basket which allowed Royal Mail to increase the prices of these products by up to 53%⁴⁷ on average in 2012-13, increasing by CPI for the remainder of the regulatory framework. This reflects the same percentage price increase as the letter cap over 2011-12 prices.
- 5.8 We can confirm that Royal Mail's prices for Second Class stamps complied with the level of these safeguard caps in 2012-13 and its prices so far in 2013-14 are also lower than the level required under these caps.
- 5.9 We set out in the March 2012 statement that we would review the level of the caps if we considered they were unduly impacting 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. We do not consider there is any evidence to suggest pricing flexibility or (as explained later in this Section in paragraphs 5.24 to 5.28) affordability are under threat at this point in time.

Letter and Large Letter stamp prices did not change in 2013 although Meter and parcel prices increased

- 5.10 In this subsection, we discuss the prices which took effect from 2 April 2013 including First and Second Class stamp and meter prices for Letters and Large letters and prices for Parcels. Our analysis is conveyed in nominal terms i.e. excluding any adjustment for inflation.⁴⁸

⁴⁵ "Standard Letters" or "Letters" means any item up to length 240mm, width 165mm, thickness 5mm and weighing no more than 100g. "Large Letters" means any item larger than a Letter and up to length 353mm, width 250mm, thickness 25mm and weighing no more than 750g.

⁴⁶ 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 can be found at: <http://stakeholders.ofcom.org.uk/binaries/consultations/postal-service-letters-packets/statement/statement.pdf>.

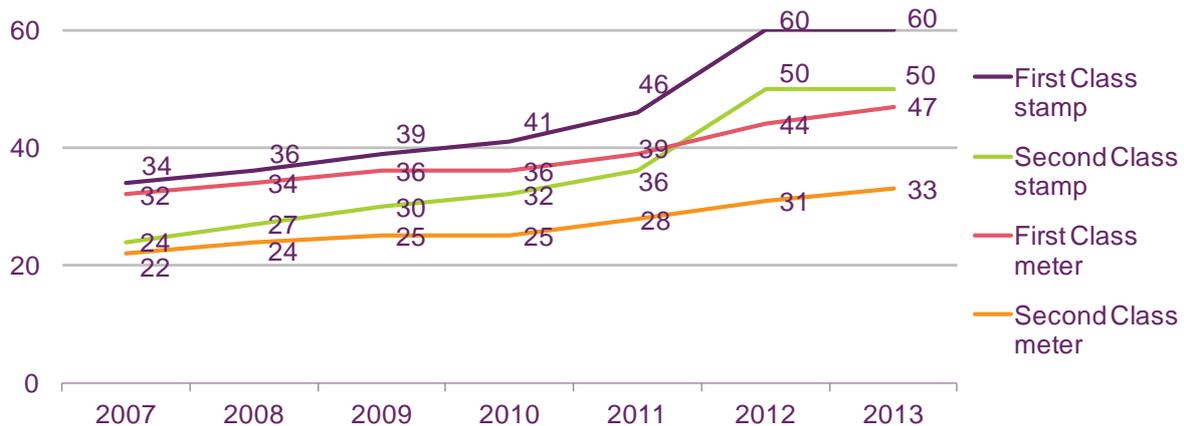
⁴⁷ Over 2011-12 prices.

⁴⁸ Some more detail on April 2013 price increases for universal services is available in paragraphs 2.16 to 2.23 of our report on the *Affordability of universal postal services*, 19 March 2013

Standard letter stamp and meter prices

5.11 In our 2011-12 annual monitoring update, we noted that Royal Mail significantly increased the prices of First and Second Class standard letter stamps in April 2012. As shown in Figure 5.1, Royal Mail did not change the prices of its standard letter stamp products in 2013 (First Class and Second Class were held at 60p and 50p respectively). Royal Mail did, however, increase its meter prices – to 47p for First Class and 33p for Second Class letters – which means the difference between stamp and meter prices has narrowed slightly.

Figure 5.1 – Standard Letter First and Second Class stamp and meter prices



Source: Royal Mail

Large letter stamp and meter prices

5.12 There are several weight steps for Large Letters – 0-100g, 101-250g, 251-500g and 501-750g. Figure 5.2 shows the average price for Large Letters in recent years (across the weight steps and taking account of volumes in each weight step).⁴⁹

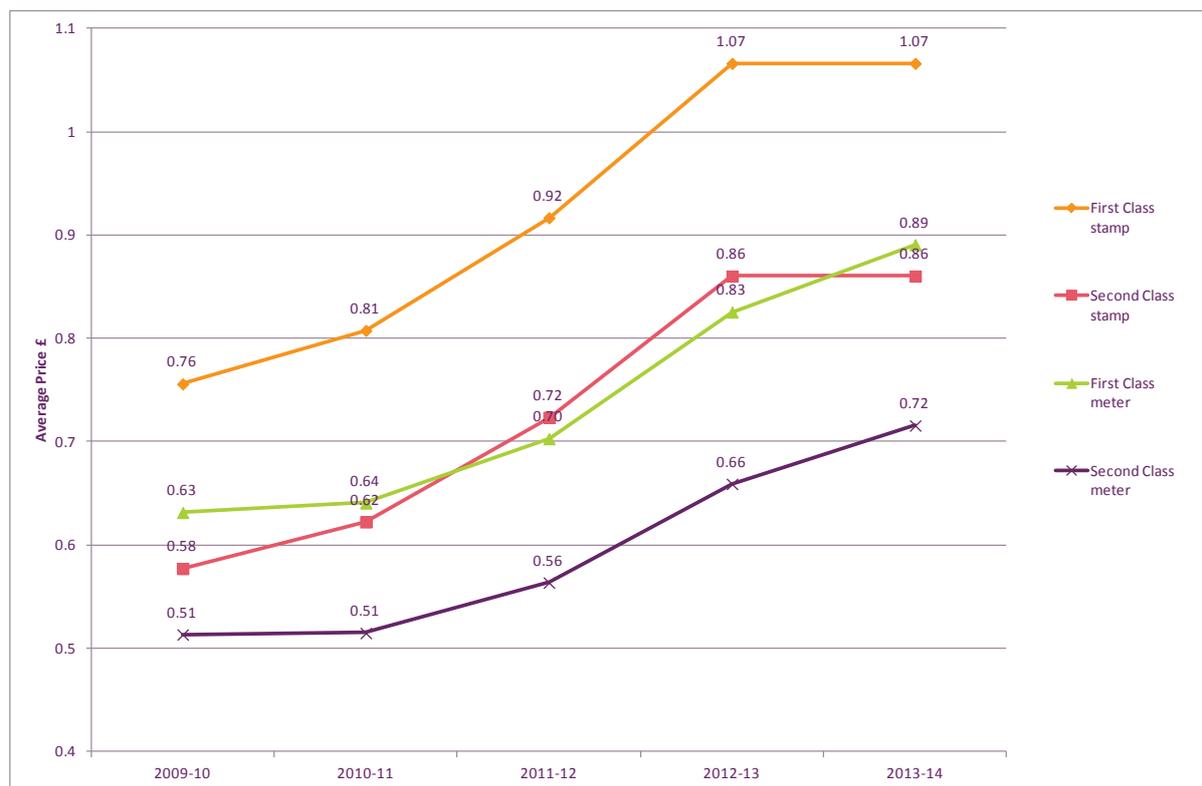
5.13 Prices rose for Large Letters in April 2012. However, stamp prices for Large Letters in all weight steps did not increase in April 2013 although meter prices did rise by an average of 7.2% and 9.1% for First Class and Second Class respectively.⁵⁰

<http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf> . For example, this notes that the prices for 'Royal Mail Signed For' services increased from 95p to £1.10 and that the prices of 'Royal Mail Special Delivery Guaranteed' increased slightly (with the increase dependant on size and weight).

⁴⁹ We note that in 2011-12, the majority of volumes for First and Second Class stamp and meter Large Letters were in the 0-100g and 101-250g weight steps.

⁵⁰ Average increase calculated by Ofcom based on 2011-12 weight step volume distribution.

Figure 5.2 – Average Large Letter First and Second Class stamp and meter prices



Source: Royal Mail. Ofcom calculation based on volume weighted average by weight step

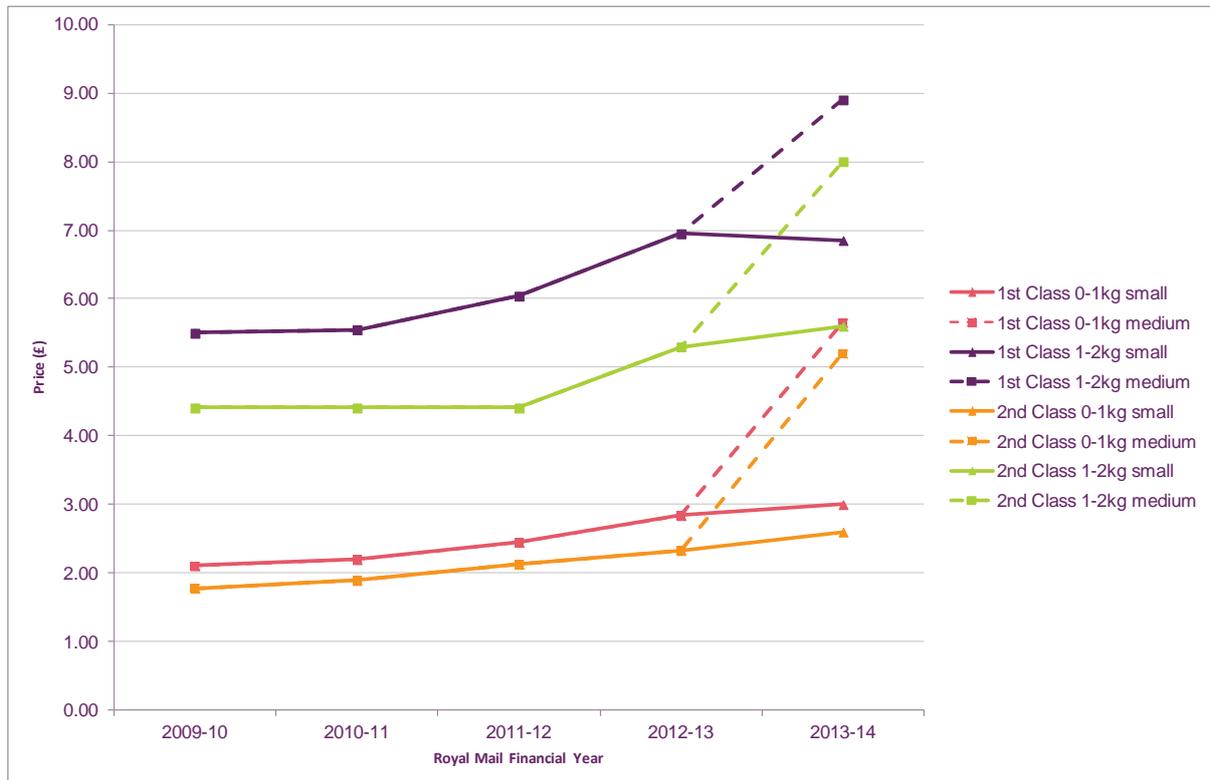
5.14 Our affordability research – discussed later in this Section – showed that residential consumers spend, on average, much less on Large letters (compared to standard letters and parcels).⁵¹

Parcel prices

5.15 As with letters and large letters, parcel prices generally increased until 2013. As an illustration, we have shown the trend in parcel stamp prices between 2009-10 and 2012-13 in Figure 5.3. The weight bands shown are the current weight bands Royal Mail uses. Some of these weight bands have changed over the years. However, as we have data on the volumes sold in each year in the different weight steps set out below, we have been able to show a trend in the weighted average price.

⁵¹ See Figure 3 in <http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf> .

Figure 5.3 – Weighted average price for First and Second class stamp parcels 2009-10 to 2013-14



Source: Royal Mail, Ofcom calculation based on volume weighted average price

5.16 In April 2013 Royal Mail introduced a key change in its parcel formats which affected universal postal service parcel charges – pricing was no longer based solely on weight but on size/dimensions as well as weight. This is because Royal Mail had determined that the cost of delivery is driven more by the size of a parcel than its weight⁵². From 2 April 2013, Royal Mail has offered two new parcel formats for its universal service parcel products, ‘Small Parcel’ and ‘Medium Parcel’⁵³ (and shown in the graph above).

5.17 We note that the Standard Parcel service for non priority items weighing more than 1kg (but less than 20kg) was withdrawn and replaced by an extension of the Second Class parcels product, which previously only went up to 1kg (we have represented this as Second Class from 1-2kg in the figure above). A benefit of this change was that customers are now able to purchase the Royal Mail Signed For service which was previously not available with Standard Parcels.

⁵² For example, while small parcels can be delivered by postmen and women on their standard delivery round, bulkier parcels require a more costly delivery operation as they have to be delivered by van. ‘Large parcels’ – with maximum dimensions of L1.5M and 3m length and girth combined up to 30kg – will be carried by Parcelforce Worldwide as that business can carry larger items more efficiently than Royal Mail.

⁵³ ‘Small parcel’ no bigger than: 45cm length x 35cm width x 8cm depth, no heavier than 2kg
‘Medium parcel’ no bigger than 61cm length x 46cm width x 46cm depth, no heavier than 20kg.
In addition Royal Mail made an exception to allow small cubes⁵³ to be sent as a ‘Small Parcel’ – with maximum dimensions of 16 x 16 x 16cm and no heavier than 2kg.
For more details see: <http://www.royalmail.com/parcels-made-easy> .

- 5.18 Given the recent change to pricing so that it is now based on both weight and size, it is not straightforward to compare 2013 parcel prices against those in previous years. However, as an illustration,⁵⁴ we have shown below in Table 5.1 the year-on-year change in stamp prices for Second Class parcels which meet the small parcel dimensions. We note that the level of the price changes for small parcels in 2013 differs depending on the weight of the product – but that the stamp price increase is greatest for small 0-750g packets which now cost around 18% more.

Table 5.1 - Prices for Second Class stamp Small Parcels

Prices applying prior to 2 April 2013		'Small Parcel' format prices from 2 April 2013		Price change %
Format	Price	Format	Price	
0-750g packet	£2.20	'Small Parcel' 0-1kg	£2.60	+18.2%
751g–1kg packet	£3.50	'Small Parcel' 0-1kg	£2.60	-25.7%
Standard parcel up to 2kg	£5.30	'Small Parcel' 1-2kg	£5.60	+5.6%

- 5.19 Prices for stamp 'Medium Parcels' are between £2.05 and £2.65 above those for 'Small Parcels', for weights up to 2kg (First Class and Second Class). This means that the price of sending an item that is relatively bulky but light in weight has seen a correspondingly larger increase following Royal Mail's April 2013 price changes. For example, a parcel weighing just under 2kg, with dimensions just under 61cm length x 46cm width x 46cm depth, was previously classed as a 'Standard Parcel' and cost £5.30. From April 2013, such a Second Class parcel is classed as a 'Medium Parcel' and costs £8.00, a price increase of 51%.
- 5.20 However, Royal Mail indicated that over 70% of parcel volumes would fall into the 'Small Parcel' weight and size requirements and that this proportion may become higher to the extent that consumers and small businesses choose to pack their items to meet the 'Small Parcel' dimensions.⁵⁵ If this assumption is correct, most consumers will have experienced a maximum price increase of 18% when sending parcels using Second Class stamps.
- 5.21 We note that we received a small number of complaints regarding the new parcel formats (in relation to the dimensions of the 'small parcel'). Moreover, following its own customer feedback, Royal Mail subsequently consulted on replacing the small parcel (exception) cube format with a deeper 'shoebox' format of increased dimensions (35cm x 25cm x 16cm) — and implemented this replacement format from 28 October 2013.⁵⁶ This change will result in a greater number of parcels meeting the small parcel size and weight criteria.
- 5.22 We will continue to monitor both stamp and meter parcel prices and will illustrate in our next annual report if and how these change based on Royal Mail's new 'weight and size' pricing structure.

⁵⁴ More examples of the parcel price changes are given on page 7 of <http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf> .

⁵⁵ See page 7 of Royal Mail's parcels consultation decision (1 March 2013) at

<http://www.royalmailgroup.com/sites/default/files/Decision%20Document%20Final.pdf> .

⁵⁶ See <http://www.royalmailgroup.com/royal-mail-makes-changes-its-small-parcels-range> . For clarity, this amended deeper Small Parcel size will be in addition to the existing wider Small Parcel format measuring up to 45cm x 35cm x 8cm.

- 5.23 In the next subsection, we discuss the work we have undertaken to consider the affordability of universal postal services.

Affordability of universal services

- 5.24 The Postal Services Act 2011 and the EU Postal Services Directive 1997 require universal postal service prices to be affordable. In our March 2012 statement, we committed to an effective and ongoing monitoring regime to track Royal Mail's performance on (amongst other things) the affordability of universal postal services.
- 5.25 We also committed to further consider our approach to assessing whether universal postal services are affordable. In March 2013⁵⁷ we therefore published a report of our findings on the affordability of universal postal services, which included some consumer research we had undertaken.
- 5.26 Our analysis focused on those residential consumers and businesses that we consider are most likely to be at risk of not being able to afford universal postal services. For residential consumers this comprised of consumers on low incomes, and consumers who may be particularly reliant on postal services including, for example, the elderly and disabled, or those who lack internet access. For businesses, this comprised of small and medium businesses for which postal services are a critical input.

Our research indicated that universal services are affordable

- 5.27 In summary, the evidence we collected indicated that universal postal services are affordable for both residential consumers (including low income and other vulnerable consumers) and businesses (including small and medium businesses) at 2012 prices. We also reviewed the price changes that took effect from 2 April 2013 (as announced by Royal Mail in March 2013), and noted that we considered universal postal services would continue to be affordable based on these new prices.
- 5.28 Our research findings indicated that there are some very limited circumstances where a residential consumer could be at risk from not being able to afford universal postal services. These circumstances are where they are in significant financial difficulty or have a very low income, and a frequent need to send post items they consider to be essential. This reflects very particular circumstances and severe financial hardship. It is likely that residential consumers in such circumstances would, unfortunately, have concerns about the prices of universal postal services even at much lower prices. Although we also found that a very small proportion of businesses might potentially be *at risk* of being unable to afford universal postal service prices,⁵⁸ we did not find (nor have we received) any evidence to show that such businesses are *in fact* unable to afford universal postal services or that the commercial viability of businesses would be significantly impacted by 2012 prices or at the prices which took effect from April 2013.

⁵⁷ Ofcom report on the *Affordability of universal postal services*, 19 March 2013
<http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf> .

⁵⁸ These would be specific types of business which have low turnover, low spend on mail, and where mail is 'core' to their business.

Monitoring affordability in the future

- 5.29 We will continue to use our new quantitative consumer survey for residential consumers and businesses – which is discussed later in this Section – to enable us to monitor use of postal services, and to assess the affordability of services in the universal service, value for money and satisfaction with post and postal prices. We would also seek to commission further consumer research to explore consumer views and the experience of affordability if we consider that this is necessary to supplement our ongoing monitoring.

Non-price terms of universal services

- 5.30 In our March 2012 statement, we stated that as part of the monitoring regime, we would also consider the impact of non-price changes for universal services. In addition to the format change to parcels introduced in April 2013 (which changed parcel prices and which we discussed above), the main recent change to the non-price terms of universal services related to compensation policies.
- 5.31 Previously, Royal Mail capped the compensation payable for non Special Delivery items at the postage refund plus £46. This was changed from 2 April 2013 to a new cap of the postage refund plus £20 on basic First and Second Class items and a cap of postage refund plus £50 on items sent using the ‘Royal Mail signed for’ service (which offers proof of delivery, for an additional fee of £1.10).⁵⁹ Compensation for ‘Articles for the blind’ items remain capped at £46. We have asked Royal Mail to analyse the impact of this change in terms of the total sum of compensation paid to customers in the first year following the implementation of the new arrangements. Royal Mail will share the results of this analysis with us.

Quality of Service

The Second Class target was achieved but Royal Mail failed to meet its First Class and Postcode Area targets

- 5.32 The EU Directive requires that universal service providers be subject to quality of service targets. Ofcom takes this issue very seriously as customers have a right to know what quality of service they can expect when they purchase universal service products. Royal Mail is therefore subject to a number of quality of service (QoS) targets. We monitor its performance against these targets and these are discussed in turn below. The figures cited in this subsection (and shown in Figures 5.4 to 5.7) are those from Royal Mail’s QoS reports and are unadjusted i.e. they do not reflect any adjustment to account for force majeure events such as very severe weather.
- 5.33 Regulatory conditions imposed by Ofcom require Royal Mail to deliver 93% of all First Class retail items (single piece stamp, meter and PPI letters and parcels) on the day after collection, and 98.5% of all Second Class⁶⁰ retail items within three days of

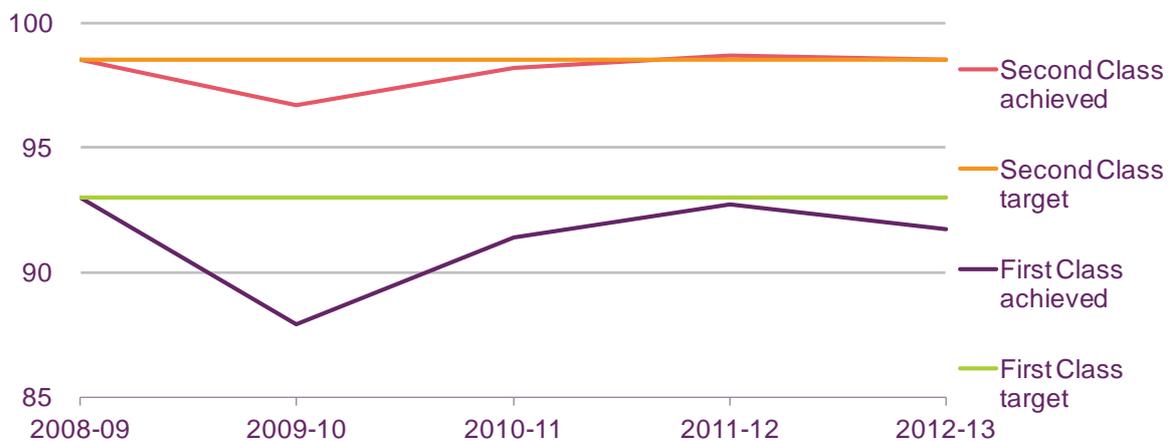
⁵⁹ See <http://www.royalmail.com/termschanges#Royal Mail 1st and 2nd Class products> .

⁶⁰ We note that until 2 April 2013, consumers could send parcels up to 20kg First Class and Second Class parcels up to 1 kg (and a Standard Parcels product existed for consumers for those wishing to send items weighing between 1kg to 20kg, but more cheaply than First Class – Standard Parcels were subject to a lower QoS target – see paragraph 5.40. From 2 April 2013, Royal Mail removed its Standard Parcel service and now offers Second Class parcels up to 20kg, the performance of which

collection. These targets are not set at 100% to allow for any unforeseen circumstances that may arise in the transportation, processing and delivery of mail (for example disruption to ferry sailings due to bad weather or missed connections as a result of delays due to road traffic and accidents). If the targets were set at a higher level then this is likely to increase Royal Mail's costs and therefore potentially universal service prices.

- 5.34 As shown in Figure 5.4 (which also shows historic performance), in 2012-13, Royal Mail missed its First Class target, reaching 91.7%; but met its Second Class target of 98.5%. This means that out of the 1.4 billion First Class single piece items delivered, 117 million items missed the next day delivery target.

Figure 5.4 – Retail First and Second Class: Performance against (items delivered on time) targets



- 5.35 Postcode Areas (PCAs) are the geographic areas into which the UK is divided by Royal Mail for operational purposes.⁶¹ There are 121 in total. Within 118 of these PCAs, Royal Mail is required to deliver 91.5% of all First Class stamp and meter mail the day after collection. This ensures Royal Mail provides a good level of service across the UK – not just in more densely populated areas, but also in less densely populated areas and those where addresses may be harder to reach. 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.

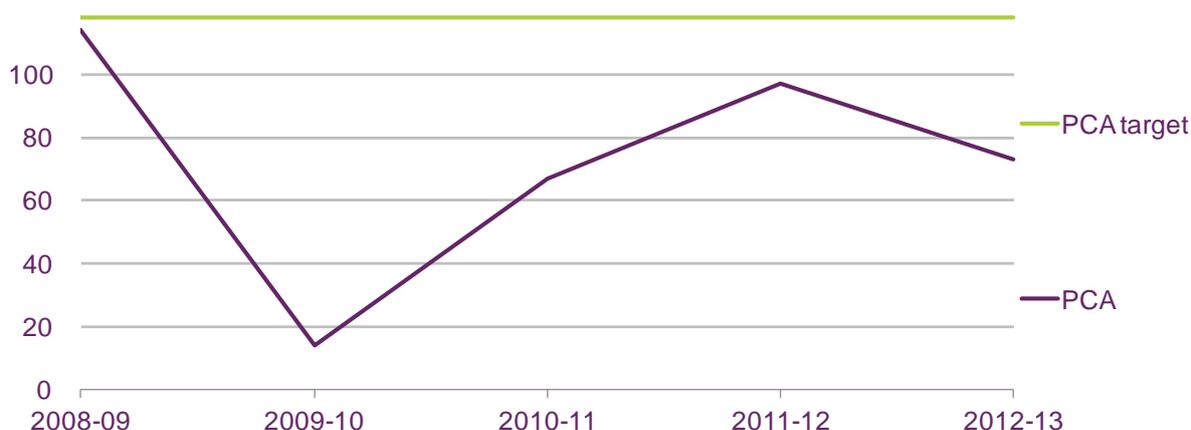
- 5.36 As shown in Figure 5.5, in 2012-13 Royal Mail achieved this 91.5% target in just 73 of its 118 PCAs, which is worse than in 2011-12 when the target was met in 97 PCAs. It should be noted that performance in 2009-10 was very poor due to national industrial action.

will be measured against the Second Class letter quality of service target, which is higher than the previous Standard Parcel target.

⁶¹ The postcode area is the largest geographical unit used by Royal Mail for mail processing purposes, and forms the initial characters of the alphanumeric UK postcode; for example, Cardiff postcodes begin 'CF', Glasgow postcodes 'G', and Leicester postcodes 'LE'.

5.37 We also note that the PCA target was missed in seven PCAs in each year between 2009-10 and 2012-13.

Figure 5.5 – Number of PCAs in which First Class delivery targets were met



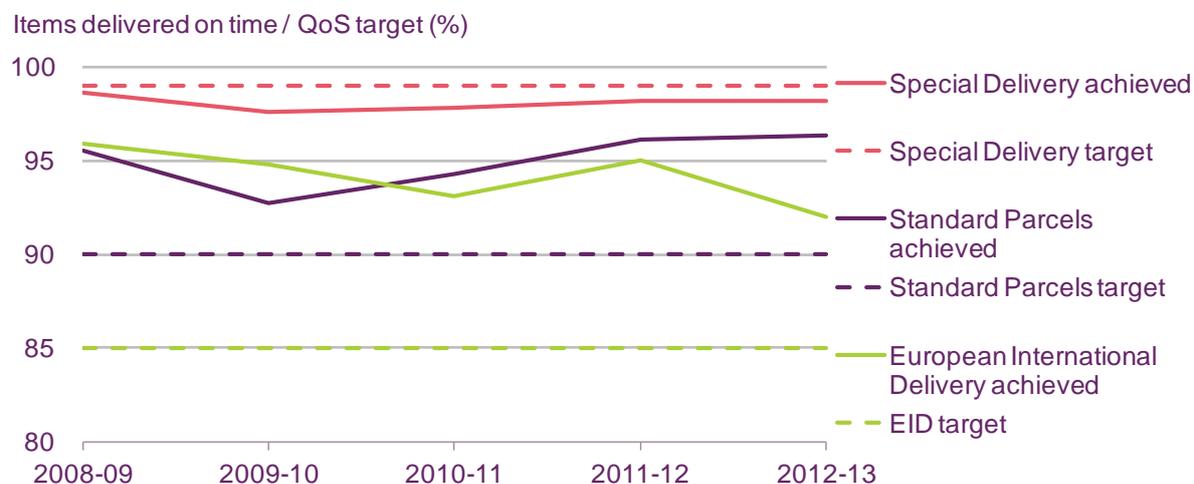
Targets were achieved for standard parcels, European International and items correctly delivered but narrowly missed for Special Delivery and for collection and delivery routes completed

5.38 Also included within the universal service were Standard Parcels, European International Delivery and Special Delivery (Next Day) Services.

5.39 As shown in Figure 5.6 below, for the Special Delivery (Next Day) product 99% of items are required to be delivered on the next delivery day. As with previous years, in 2012-13 Royal Mail narrowly missed the target for Special Delivery items, achieving 98.2% on time delivery.

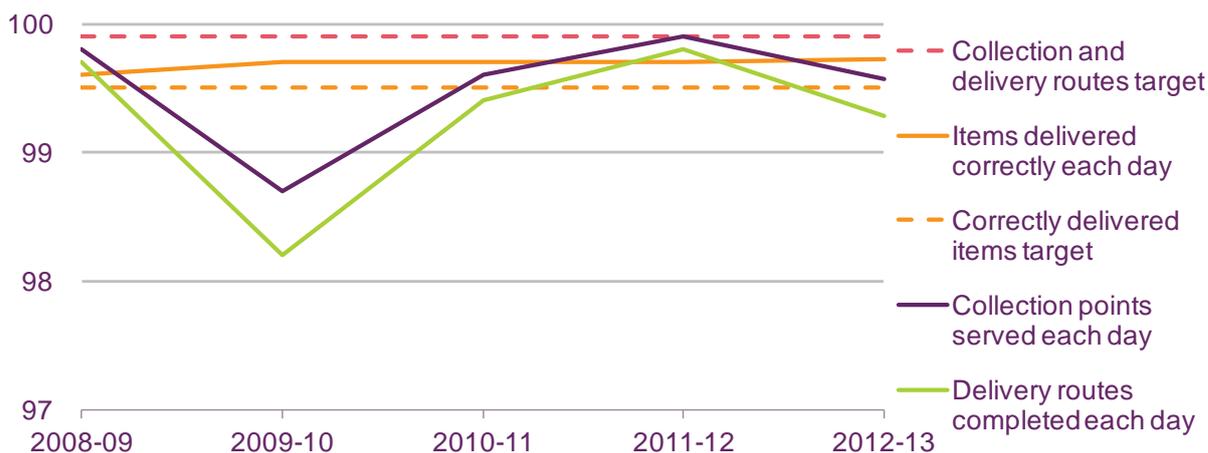
5.40 In addition, at least 90% of Standard Parcels were required to be delivered within five days of posting and 85% of European International items should be delivered three days. Royal Mail clearly exceeded its targets both for Standard Parcels (achieving 96.3%) and for European International items (achieving 92%).

Figure 5.6 – Performance on targets for other universal service products



- 5.41 In addition to the above product-related targets, Royal Mail has a number of service-oriented targets – six days per week it should: collect from 99.9% of its collection points; complete 99.9% of its delivery routes; and deliver 99.5% of items correctly.
- 5.42 As shown in Figure 5.7, in 2012-13 Royal Mail met the target for correctly delivered items but just failed to meet its targets for collection points served and delivery routes completed each day.

Figure 5.7 – Performance against targets for correctly delivered items, collection points served and delivery routes completed



We will continue to monitor Royal Mail's QoS closely

- 5.43 Royal Mail failed to meet the majority of its quality of service targets in 2012-13 – although some of these were narrowly missed. We decided that enforcement action would not be a proportionate response on this occasion and in reaching this decision we had particular regard to the impact on quality of service of Royal Mail's ongoing modernisation programme.
- 5.44 However, we are very concerned about these failures. In particular, we note the poor and highly variable performance of the PCA target and as noted above we have identified persistent annual failures in recent years in certain postcode areas.
- 5.45 Therefore, on receipt of its annual QoS figures in May 2013, we wrote to Royal Mail to underline our expectation that all necessary steps are taken to ensure that it meets all of its QoS targets in future. Royal Mail has since put in place an action plan to improve performance, particularly in the underperforming postcode areas identified, and is reporting progress to Ofcom on a quarterly basis.
- 5.46 We will continue to monitor Royal Mail's QoS closely and if Royal Mail fails to meet its QoS targets in future, we will consider opening a formal investigation. This could result in enforcement action, following the procedures under schedule 7 of the Act, which includes the potential for issuing notifications (for contravention of regulatory requirements) as well as the potential imposition of financial penalties.

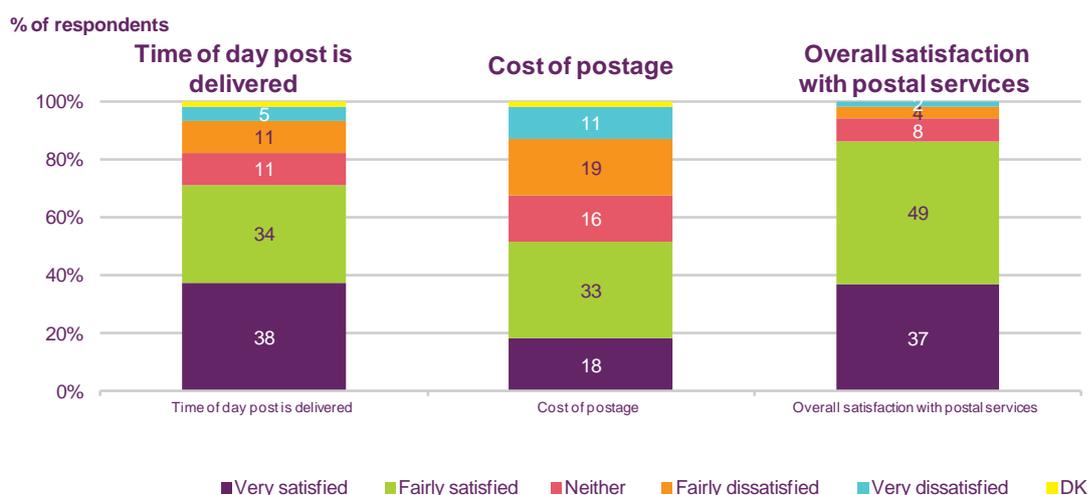
New residential and business customer surveys

- 5.47 In order to support our duty to safeguard the universal postal service in the UK and to our ongoing monitoring regime, we started a programme of market research to ensure we have up to date views of consumers on the postal market.
- 5.48 This includes two separate surveys – one focused on residential consumers, the other on business customers – to track their use of and attitudes to post. The tracker began in July 2012 and so we do not have data for the full (2012-13) financial year. We have nevertheless set out findings for twelve months using data from the second quarter of 2012-13 (July to September 2012) until the first quarter of 2013-14 (April to June 2013). This period will provide a baseline for understanding future trends i.e. in next year’s monitoring report, we will compare this period against data from July 2013 to June 2014.
- 5.49 A full range of data from these surveys is summarised in our Communications Market Report. Below we discuss some of the consumer metrics which we consider are particularly relevant to our monitoring regime.

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

- 5.50 As shown in Figure 5.8, our first year findings from the residential consumer survey show that the majority of residential consumers claim they are satisfied with postal services (this level of satisfaction was relatively stable throughout the year). Around 86% of residential consumers were satisfied overall with postal services and 71% were satisfied with the time of day when post is delivered (although the actual number of respondents who were fairly or very dissatisfied was lower than this would suggest as a number of respondents were “neither”). Satisfaction with cost of postage is not as high, though just over half were satisfied with this aspect of postal services.

Figure 5.8 – Residential consumers’ views on delivery times, cost of postage and overall satisfaction with post

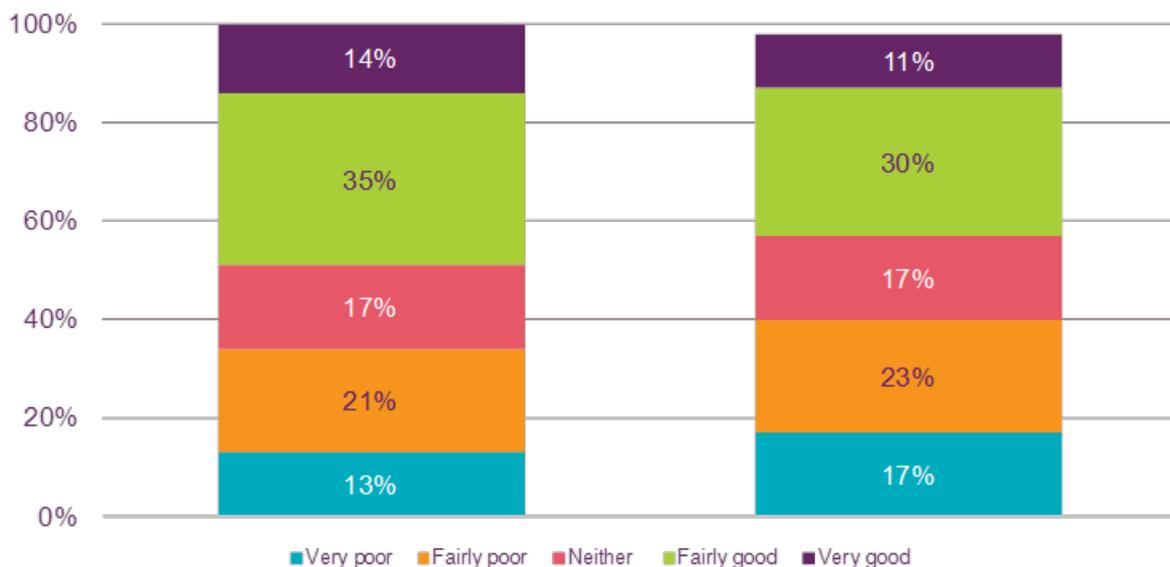


Source: Ofcom Residential Post tracking survey. Base: All respondents.

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

- 5.51 Our survey also considered consumer perceptions on the value for money of postal services. Once informed of the correct price for First and Second Class stamps,⁶² the Figure below shows the extent to which people think they offer good value for money.
- 5.52 We note that across the year more residential consumers considered that First Class stamps offer fairly or very good value for money than Second Class stamps (49% compared to 41%), although the consumers who believed that value for money was fairly or very poor were in the minority. These figures are not as strong as those from a previous Postcomm⁶³ survey (in 2009) in which 82% of adults rated First Class stamps 83% Second Class stamps as good value for money. This may be due to the fact that there have been significant above inflation increases in both First and Second Class stamp prices since 2009.⁶⁴ Nonetheless, the results from our recent survey indicate that the number of respondents who consider that First and Second Class stamps offer very good value for money has slowly improved over the course of the year – i.e. they have increased in each quarterly period following the significant price increases implemented in April 2012.

Figure 5.9 – Perceived Value for Money of First and Second Class Stamps



Source: Ofcom Residential Post tracking survey. Base: All respondents. QF3: It currently costs 60p to send a standard letter First Class within the UK, how would you rate Royal Mail's First Class service in terms of value for money? (Single coded) QF4: It currently costs 50p to send a standard letter Second Class within the UK. How would you rate Royal Mail's Second Class service in terms of value for money? (Single code)

⁶² Only 30% of respondents were aware of the correct price of a First Class stamp (60p) in Q4 2012-13, with 35% indicating an incorrect price and 34% stating they did not know. For Second Class stamps, only 18% of people were able to state the correct price (50p).

⁶³ Postcomm was the previous postal regulator in the UK. Its responsibilities transferred to Ofcom in late 2011. We also note that the phrasing of the value for money questions in the Postcomm survey was different to those in our new survey.

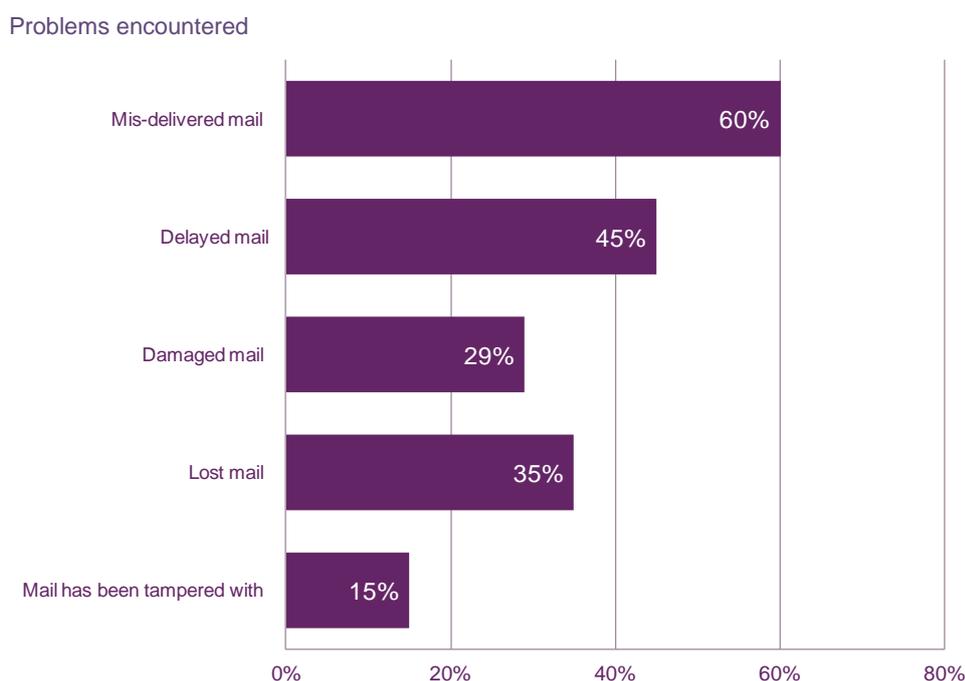
⁶⁴ First Class stamp prices have increased by 53% since 2009 and Second Class by 67%.

Misdelivered or delayed mail is the most common problem experienced by residential consumers

5.53 In addition, our survey asked residential consumers about the types of problems they have experienced with postal services.

5.54 When asked specifically about the service received from Royal Mail about 36% had experienced some problem. When prompted, the main problem experienced with Royal Mail was with misdelivered or delayed mail, as shown in Figure 5.10.

Figure 5.10 – Main postal issues experienced by residential consumers (who have reported problems)



Source: Ofcom Residential Post tracking survey.

Base: All respondents who have reported problems with Royal Mail in the last 12 months (973)

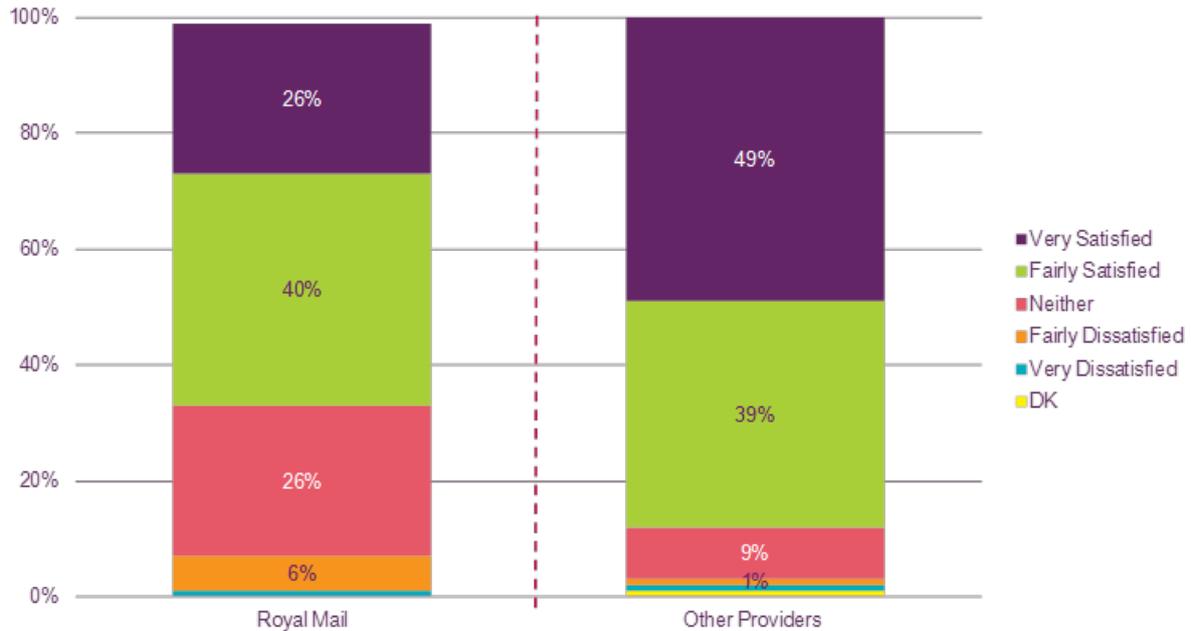
Business satisfaction levels

5.55 As discussed above, we have also been asking business consumers what they think about postal services⁶⁵. Business users are particularly important in the postal market as they account for the significant majority of all sent mail (around 90%). Almost three quarters of businesses surveyed (73%) use Royal Mail as their only postal operator and a quarter (24%) also use another provider in addition to Royal Mail.

⁶⁵ There were more than 250 companies in our sample most of which were SMEs – those with 0-249 employees. The sample included some larger companies but these were not really representative of the large company profile in the general business population.

5.56 Figure 5.11 below shows the satisfaction levels amongst businesses for Royal Mail and other postal operators.⁶⁶ The majority of business consumers are either very or fairly satisfied with postal services although satisfaction rates are better for other postal operators (compared to Royal Mail).

Figure 5.11 – Satisfaction levels amongst businesses for Royal Mail and other postal operators



Source: Ofcom Business Post tracking survey. QRM2/QOP1a: Thinking generally about the service your organisation receives as a whole, on a scale of 1-5 where 1 = very dissatisfied and 5 = very satisfied, how satisfied are you with the overall quality of the service you receive from Royal Mail vs. other provider as a recipient or a sender?

Our consumer surveys will play an increasingly useful role in our future monitoring reports

5.57 The findings from our new surveys give us a baseline against which we can measure future changes in 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 aim to provide more detailed analysis from our ongoing consumer surveys in our future annual monitoring updates.

⁶⁶Our survey also revealed that between a fifth and a quarter of business users experience problems with their mail but our sample size for the type of problems experienced was relatively small and did not allow us to produce meaningful analysis.

Complaints data

- 5.58 Finally, we also note that all regulated postal operators including Royal Mail are required to publish annual complaints data. Additionally, Royal Mail is required to publish quarterly reports showing the amount of compensation paid.⁶⁷
- 5.59 We have observed that since 2008 complaints⁶⁸ to Royal Mail have generally fallen. However, average compensation payments have been increasing over the period, although this is partly due to (1) compensation policies becoming more transparent; (2) a change in Royal Mail's policy so that all first time claims receiving compensation of six First Class stamps and (3) an increasing proportion of intrinsic value items being sent.⁶⁹
- 5.60 For its complaint figures, Royal Mail reports the top ten categories of complaint. In 2012-13, the greatest number of complaints was in relation to lost items, followed by redirection issues. These two categories account for 45% of all complaints.
- 5.61 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.

Summary

- 5.62 The key findings for the first year of the regulatory framework that are particularly relevant to customers and consumers are:
- There were some significant price increases for universal service products in April 2012 (although standard letter stamp prices – which are commonly used by residential customers – and Large Letter stamp prices did not rise again in April 2013). Our research indicates that these prices are affordable. In addition, Royal Mail is complying with the safeguard caps that we have put in place;
 - Royal Mail failed a number of its QoS targets last year and in particular performed poorly on its PCA target. We have set out to Royal Mail the importance we place on meeting the quality of service targets and asked it to provide us with an improvement plan. We will continue to monitor its progress in relation to QoS closely and if QoS targets are not met in future then we will consider investigating and potentially taking enforcement action; and
 - Our market research indicates that the vast majority of residential consumers (and the majority of business customers) are satisfied with their postal services.

⁶⁷

http://www.royalmail.com/sites/default/files/RoyalMail_ConsumerComplaints_and_Compensation_Report_201213.pdf . Please note that Royal Mail reports on two different complaint figures. First it reports the number of complaints relating to regulated postal services. Secondly in relation to the compensation paid this relates to the payments made to all customers (consumer and business) in accordance with product terms and conditions, the regulatory compensation scheme for delay, and any goodwill payments made in respect of customer complaints received.

⁶⁸ Complaint figures referred to here relate to all Royal Mail complaints not just those relating to regulated postal services.

⁶⁹ An increase in parcels sent 'over the counter' by non account small businesses. Also any items using 'Signed For' now attract compensation up to £50.

Our first year of findings will also provide us with a baseline against which we can continue to monitor public perceptions about the postal service.

- 5.63 We will report again on the quality of experience for users of postal services in the Consumer Experience Report which will be published in January 2014.

Section 6

Business customers and competition

- 6.1 As set out in the March 2012 statement, competition in the postal market has a number of potential benefits for customers. This includes providing choice for customers and incentives for Royal Mail to become more efficient and to innovate. However, we also recognised that competition has the potential to threaten the future sustainability of the universal service if it results in a significant acceleration in Royal Mail's volume and revenue decline.
- 6.2 This Section discusses the different types of competition and market trends for the alternative types of mail volumes. We then discuss Royal Mail's price increases for its retail bulk mail and access products, as these are the business customers that are, in general, targeted by other access or end-to-end postal operators. Finally we discuss trends and new developments in both access and end-to-end competition in the UK.

Types of competition

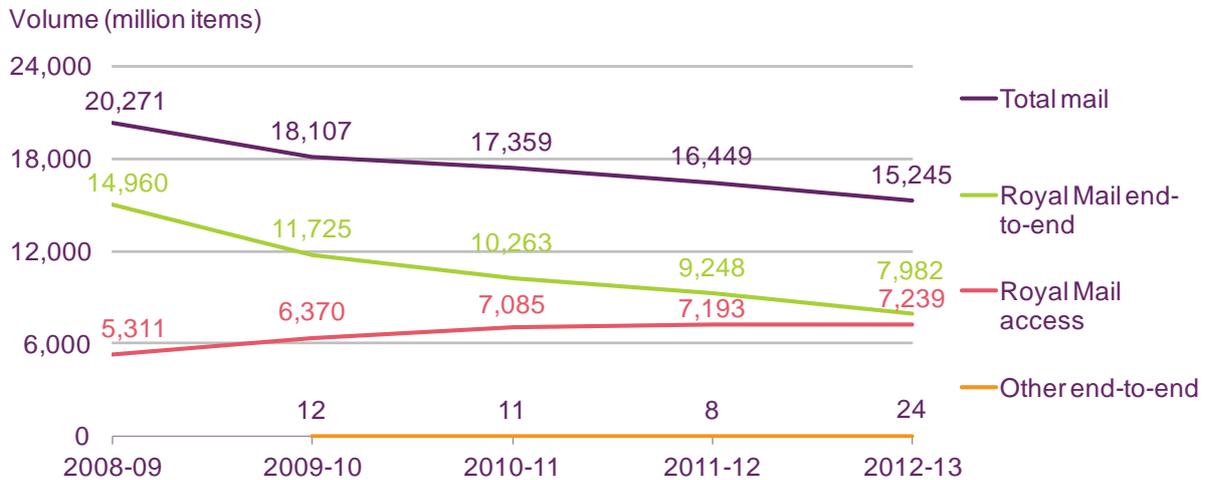
- 6.3 Within the postal sector, there are two main forms of competition: end-to-end and access.
- 6.4 Access competition is where the operator collects mail from the customer, sorts it and then transports it to Royal Mail's Inward Mail Centres, where it is handed over to Royal Mail for delivery. Royal Mail is subject to a regulatory condition to continue to offer access to its Inward Mail Centres for letters and large letters. This enables other operators to offer letter postal services to larger business customers without setting up a delivery network. Access has been the predominant form of competition in the UK since the first access contract was signed in 2004.
- 6.5 End-to-end competition is where an operator other than Royal Mail undertakes the entire process of collecting, sorting and delivering mail to the intended recipients.
- 6.6 Together, the total market comprises three parts: mail collected and delivered by Royal Mail ('Royal Mail end-to-end'); 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').
- 6.7 '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).

Trends in the overall mail market

- 6.8 Figure 6.1 shows the total mail market volumes by type of operator in these terms. Total mail market volumes continued to fall in 2012-13 declining by 7.2% to 15.2 billion items. This represents a 25% decline over the past five years.
- 6.9 Access volumes have continued to increase, but growth slowed again this year, increasing by 0.6% to 7.2bn items. This represents 47% of total market volumes. Royal Mail's end-to-end volumes fell by 13.7% as, in addition to the First and Second

Class volume decline and the slower decline in business mail volumes, it continued to lose upstream bulk mail volumes to competitors, as noted in Section 3.

Figure 6.1– Total mail market volumes by type of operator



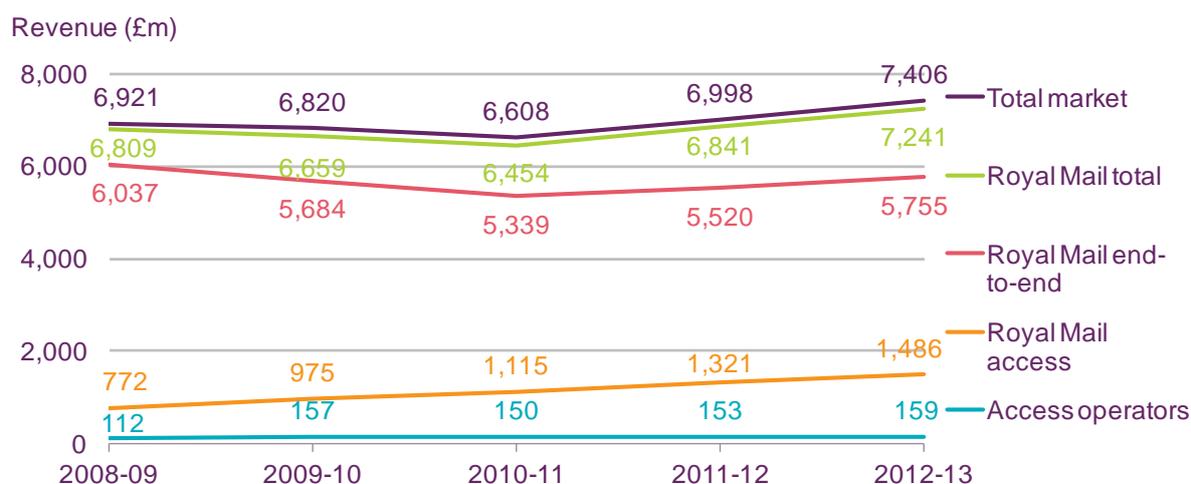
Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, operator returns to Ofcom, Ofcom estimates.⁷⁰

- 6.10 As shown in Figure 6.2, despite the fall in volumes, total mail market revenue grew by 5.8% to £7.4 billion. This is partly due to the increase in prices charged by Royal Mail for its mail products, but also due to the change in the mix of mail, as the continued growth in online retail drives an increase in packets and parcels.⁷¹
- 6.11 Revenue from access operations increased both for Royal Mail and for the access operators. Price rises for these products meant that Royal Mail grew its access revenues by 12.5% to £1.5 billion. Access operators increased their revenues by 3.8% to £159m, despite access volumes only growing by 0.6% over the same period. This is likely to be due to access operators gaining unsorted volumes which have a higher unit price and cost.

⁷⁰ Royal Mail total figures are for the Reported Business. 2012-13 figures are 52 week adjusted. Royal Mail end-to-end refers to Royal Mail total mail volumes excluding access. Other operator end-to-end is included in Total mail from 2008-09 onwards. Prior data is not comparable. Access figures include all access products and do not reconcile to prior year regulatory accounts. Addressed mail only.

⁷¹ Royal Mail stated in its 2012-13 annual report that parcel volumes for UKPIL grew by 5% year on year, while parcel revenue rose by 13%. Source: Royal Mail Group Limited, Annual Report and Financial Statements 2012-13.

Figure 6.2 – Total mail market revenue by type of operator



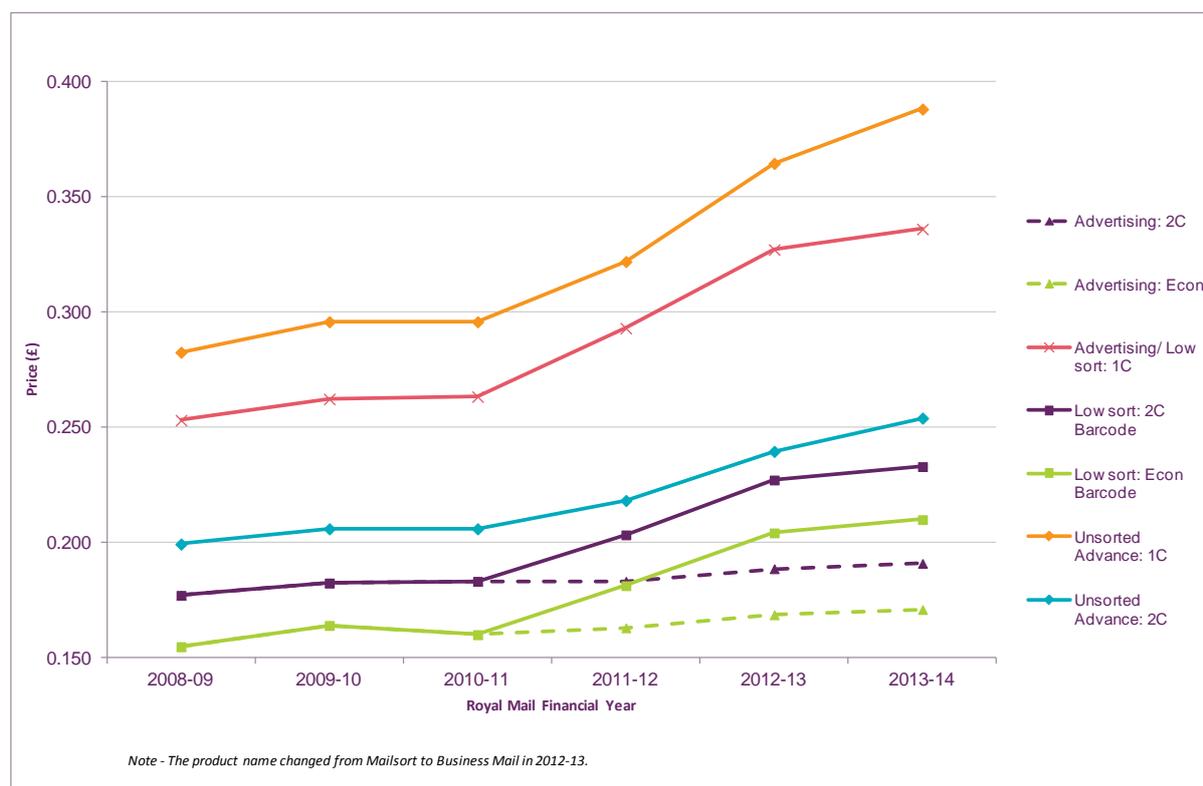
Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, operator returns to Ofcom, Ofcom estimates.⁷²

Price trends for retail bulk mail and access customers

Retail bulk mail prices

- 6.12 Royal Mail and other providers also 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 volume, 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 or the level of sortation.
- 6.13 Royal Mail has also increased the price of these products in recent years. As an illustration, we have shown the trend in prices for several of its main retail bulk mail products in Figure 6.3 below. These show the trend in the maximum discount prices for these pre-sorted mail products in recent years. Royal Mail now offers larger discounts on its retail advertising mail products (introduced in 2010-11) and the difference in price between advertising and transactional mail has increased over time.

⁷² Royal Mail total figures are for the Reported Business. 2012-13 figures are 52 week adjusted. Royal Mail end-to-end refers to Royal Mail total mail revenues except access but including unaddressed. Other operator end-to-end is included in Total mail from 2008-09 onwards. Prior data is not comparable. Access figures include all access products and do not reconcile to prior year regulatory accounts.

Figure 6.3 - Royal Mail Business Mail prices – 2008-09 to 2013-14⁷³

Source: Royal Mail, Ofcom calculation based on maximum discounted prices

Access prices

- 6.14 As noted above in Section 3, Royal Mail's price increases for access to its network have increased its revenues for access products. As set out in Figure 6.4 below, Royal Mail raised its access prices in both April 2012 and April 2013. The overall increase in prices since 2011 (over a two year period) for the Access 1400 and Access 70/120 CBC products was around 20% and 17% respectively. The prices for the advertising mail products increased at a slower rate, around 10% for Access 70/120 CBC – advertising mail and 13% for Access 1400 – advertising mail over the same two year period. These price increases have come on top of a significant increase in access prices (around 15% on average) in May 2011 as a result of Royal Mail's application to Postcomm to increase the level of the price control.⁷⁴
- 6.15 Recent analysis by PricewaterhouseCoopers (PwC) suggested that access volumes are unlikely to be adversely affected by these price increases. The majority of access mail is transactional mail and publications, with one-third made up of advertising mail.⁷⁵ PwC believed that further substitution of transactional mail will be slow, as

⁷³ Low sort Barcode was previously called Mailsort 70 CBC (prior to 2011-12 Mailsort 120 CBC), Economy was previously Mailsort 3 and Unsorted Advance was previously called Cleanmail Advance. Advertising Mail was introduced in 2011-12 and the relevant Mailsort price has been used prior to this date.

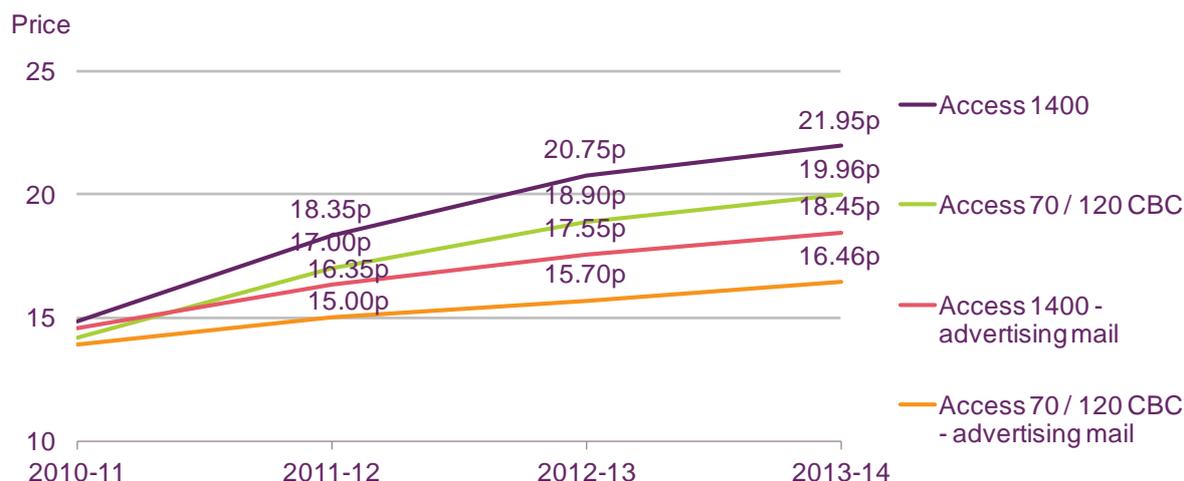
⁷⁴ For example, prices for Access 1400 and Access 70 CBC have increased by 48% and 41% respectively since 2010. Advertising mail has increased at a slower rate with a 27% increase for Access 1400 advertising and a 19% increase for Access 70 CBC advertising over the same period.

⁷⁵ Ofcom, *Communications Market Report 2013*, p.395.

financial institutions have already “captured many of the ‘quick wins”,⁷⁶ suggesting that the majority of access mail volumes that have been affected by the larger price increases are less likely to be substituted as a result of future price increases.

- 6.16 As advertising mail volumes, and advertising expenditure in general, mirror trends in GDP, maintaining a comparatively lower price for advertising mail may help to encourage advertisers to use direct mail. As PwC identified, the lower cost of access mail (compared to Royal Mail’s retail bulk mail products) to senders has been beneficial for overall mail volumes as average price increases have been reduced.

Figure 6.4 – National access prices: 2010-11 to 2013-14

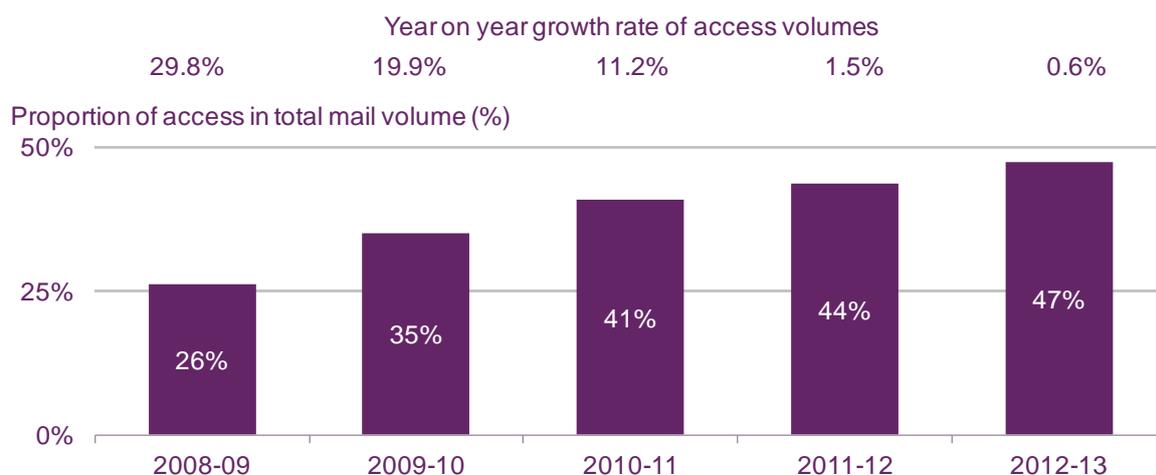


Source: Royal Mail, based on National access prices, weighing 0-100g

Access competition

- 6.17 Access represents a significant portion of the market by volume (47% of all delivered mail), though the proportion of revenue retained by other operators from access is much smaller (£159 million out of a total market revenue of £7.4 billion).
- 6.18 Figure 6.5 shows that access has continued to grow as a proportion of total mail volumes, although growth has slowed significantly in recent years. Access grew from just under 44% of the market by volume in 2011-12, to account for just over 47% of the market by volume in 2012-13.
- 6.19 Although there are a number of operators handling access mail, the bulk of volumes are handled by two companies – TNT Post UK and UK Mail.

⁷⁶ 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>

Figure 6.5 – Growth of access mail

Source: Royal Mail Regulatory Financial Statements, Royal Mail Wholesale, 2012-13 are 52 week adjusted figures

6.20 We also note that Royal Mail is subject to regulation of its activities in relation to ensuring access based competition. One of these regulations is a control on Royal Mail's retail bulk mail prices that seeks to ensure that they are sufficient to cover the cost of the upstream portion of the pipeline (otherwise undertaken by access operators) and are consistent with the charge Royal Mail sets for its wholesale access services. This control ensures that Royal Mail does not unfairly compete with other operators who purchase wholesale access services from Royal Mail in the (D+2) Letter and Large Letter market. We note that we have received quarterly compliance reports from Royal Mail which set out revenue, cost and contract information related to its compliance with this regulation.

End-to-end competition

6.21 There is very 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).

6.22 In 2012-13, alternative operators to Royal Mail delivered 24 million letters entirely through their own networks – which is still less than 0.2% of the addressed letter mail market. However, this does represent a 200% increase compared to 2011-12 and notably, it reverses a previously downward trend, as shown in Figure 6.6.⁷⁷ The large percentage increase in these volumes is due to TNT Post UK which began trialling the delivery of letters in West London in April 2012. It is offering a service that includes scanning on delivery and provision of management information to customers.

6.23 Since TNT Post UK started its trial, it has increased both the size of the area in which it delivers and consequently its volumes. In its press releases, TNT Post UK's parent

⁷⁷ Figure 6.6 shows the volume of addressed letter mail delivered end-to-end by operators other than Royal Mail. It does not include packet and parcel volumes. There is significantly more end-to-end competition in the delivery of packets and parcels and for closed user group services. We plan to collect more information on volumes and revenues in the growing packet and parcel markets from the start of next financial year and will report on this in future annual updates.

company PostNL has stated that its volumes have risen from an average of 345k per week in December 2012 to an average of 600k per week in March 2013.⁷⁸ In this time, TNT Post UK has expanded its operations from West London to Central London and it has since also expanded into South West London.⁷⁹

- 6.24 As discussed above, end-to-end competition has the potential to have a significant impact on the future sustainability of the universal service. Given this we have reviewed TNT Post UK's business plans alongside Royal Mail's restructuring plan to assess the potential impact of this entry on the future provision of the universal service. In this review we took into account that TNT Post UK's market share was expected to be low in the early years of the plan (which would be unlikely to result in a material impact on Royal Mail's financeability) and that there was a degree of uncertainty around TNT Post UK's business plan, Royal Mail's potential commercial response and other key market factors. We therefore published an update in July 2012⁸⁰ setting out that we did not consider it necessary at that point in time to impose any regulatory conditions on end-to-end operators to secure the provision of the universal service but that we would continue to monitor the situation.
- 6.25 In March 2013, Ofcom also published guidance on its approach to assessing the impact of end-to-end competition in the postal sector.⁸¹ This document sets out the process that we intend to use to assess the impact of end-to-end competition on the universal service and discusses the options for regulatory intervention should this be necessary at some point in the future. Given the fact that end-to-end competition only represents around 0.2% of total market volumes and Royal Mail's financial position is improving we continue to consider it is not necessary to impose any additional regulatory conditions on end-to-end operators to secure the ongoing provision of a universal postal service at this point in time.

⁷⁸ Post NL, *Q1 2013 Results: Press release*, 7 May 2013, http://www.postnl.com/Images/20130507-postnl-2013-q1-press-release_tcm216-670692.pdf

In November 2013, Post NL reported that TNT Post UK was delivering an average of 1.2 million items per week. TNT Post UK started delivering in SW London Q1 2013-14.

⁷⁹ TNT Post UK has also recently announced its intentions to start delivery operations in Greater Manchester in November 2013.

⁸⁰ Ofcom, *Update on Ofcom's position on end-to-end competition in the postal sector*, 25 July 2012, <http://stakeholders.ofcom.org.uk/binaries/post/update.pdf>

⁸¹ Ofcom, *End-to-end competition in the postal sector: Final guidance on Ofcom's approach to assessing the impact on the universal postal service*, 27 March 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf

Figure 6.6 – Other operators' end-to-end delivered volumes

Source: Operators' returns, based on former licensed area delivered volumes

6.26 On an equivalent basis end-to-end competition has a significantly higher impact on the universal service as Royal Mail retains 85-90% of the total revenue for access mail. It is therefore important that we continue to monitor the development of end-to-end competition in the postal market.⁸²

Summary of trends in competition

6.27 Access volumes continued to grow in 2012-13, both in terms of actual volume and its proportion of total volumes. More than 47% of total mail volumes are now handled by other postal operators. However, other operators only retain about 2% of total market revenue.

6.28 The decline in business mail volumes was also lower than the overall market reduction.

6.29 End-to-end competition has increased significantly in 2012-13 (200%) but this was from a very low base and only represents around 0.2% of total market volumes. Given this we do not consider that end-to-end competition represents a threat to the future provision of the universal service and do not intend to impose any additional regulatory conditions on end-to-end operators at this point in time.

⁸² As set out in our July 2012 update on Ofcom's position on end-to-end competition in the postal sector. See <http://stakeholders.ofcom.org.uk/binaries/post/update.pdf>.

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 and Annual Budget	Annually
Reported Business income statement, product profitability statements, capital employed statement, and cash flow statement (including accounting separation)	Annually
RM data on compliance with the safeguard cap	Annually
Relevant Group consolidated cash flow projections	Quarterly
Reported Business income statement, and product profitability statements (including accounting separation)	Quarterly
RM Costing Manual (including zonal costing) and Accounting Methodology Manual	Quarterly
Other operators' 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
RM quality of service reporting	Annually/quarterly*
RM Mail integrity reporting	Annually/quarterly
RM changes to latest delivery and collection times	Three months before change
RM request to change terms and conditions for USO products	One month before proposed change
RM request to change prices for USO products	One month before proposed change
RM notification of changes to terms and conditions for non-USO products	One month before change
RM notification of changes to prices for non-USO products	One month before change
RM change to compensation policies	One month before change