Review of the Regulation of Royal Mail

Annexes 5 to 11

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Consultation

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Contents

Annex 5

Efficiency

Introduction

A5.1 In this annex, we outline the efficiency savings, relevant to the universal service, proposed by Royal Mail in its 2015 Business Plan[1] and consider whether they represent a reasonable rate of improvement over the period of the plan. We also consider the incentives that Royal Mail has to improve its efficiency.

A5.2 Based on the analysis below, we consider that Royal Mail's proposed efficiency initiatives and levels of cost reduction are reasonable. However we believe them to be at the lower end of a reasonable range for improvement. While its future plans demonstrate greater ambition than recent historic achievements, our analysis indicates that there remains potential for Royal Mail to make greater efficiency gains than those forecast in its 2015 Business Plan.

A5.3 This annex is structured as follows:

- first we set out the background to our efficiency review;
- then we set out the responses we received from stakeholders in response to the July 2015 Discussion Document in relation to Royal Mail's efficiency
- we then set out our view on issues raised by stakeholders' on the incentives for efficiency for Royal Mail and the potential outcomes of driving for a more efficient universal service.

A5.4 Stakeholders' comments also relate to the definition of efficiency and the use of efficiency targets. These issues are addressed in the remainder of the annex through the description of our assessment, findings and conclusion. We:

- set out the framework for our efficiency assessment including:
    - the definition of efficiency for the purpose of this review;
    - the methodology adopted to understand Royal Mail's efficiency, including the scope of our assessment, the sources of evidence used, and our approach;
- outline our assessment of cost movements due to inflation and volume and how these are used in reaching our findings;
- detail the findings of our high-level and granular assessments of Royal Mail's efficiency, outlining the metrics we have considered and the factors which may affect Royal Mail's potential to achieve its efficiency potential; and
- conclude our assessment on Royal Mail's efficiency plans including our proposed approach to target setting and the metrics we propose to adopt in our monitoring regime going forward.

[1] The 2015 Business Plan [✂].

Background

A5.5 The PSA 2011 requires Ofcom to "carry out their functions in relation to postal services in a way that they consider will secure the provision of a universal postal service". In doing so it requires Ofcom to "have regard to the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all times".

A5.6 In the 2014 End-to-End Statement, we provided our view on Royal Mail's scope for efficiency improvements.[2] We said that it was "not yet clear to us whether Royal Mail's achieved levels and proposed targets for efficiency improvement represent a reasonable rate of improvement, or whether it would be possible and/or necessary for Royal Mail to aim for more ambitious cost savings than those reflected in its current forecasts."[3]

A5.7 We further noted that "given the importance of improving efficiency with respect to Royal Mail's ability to provide a financially sustainable universal service, we are intending to undertake further analysis on what might represent a reasonable rate of efficiency improvement as part of our wider review of factors that affect the future financial sustainability of the universal service."[4] It is in this context that we have carried out the analysis set out in this annex.

July 2015 Discussion Document responses[5]

A5.8 In response to the July 2015 Discussion Document, stakeholders commented on efficiency. Stakeholders suggested that it was necessary to define efficiency, set targets and make Royal Mail's targets transparent. Targets were discussed both in terms of efficiency metric(s) and as part of a charge control. A summary of responses relating to efficiency is set out below.

Defining efficiency

A5.9 The Direct Marketing Association (DMA) considered that central to an assessment of Royal Mail's efficiency is a clear definition of what Ofcom understands efficiency to be. It argued that it is "difficult to answer this question when 'efficiency' is not defined".[6]

A5.10 TechUK, responding on behalf of meter manufacturers, said that until Ofcom published the efficiency improvements it requires from Royal Mail and how they are measured it would have difficulty in answering a question on efficiency.[7]

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[2] See the 2014 End-to-end Statement, http://stakeholders.ofcom.org.uk/binaries/post/end-to-end-statement/end-to-end.pdf.
[3] See the 2014 End-to-end Statement, paragraph 3.78.
[4] See the 2014 End-to-end Statement, paragraph 3.79.
[5] All the non-confidential versions of the responses to the July 2015 Discussion Document are available on our website at: http://stakeholders.ofcom.org.uk/consultations/royal-mail-regulation-review/?showResponses=true.
[6] Page 2 of DMA's response to the July 2015 Discussion Document.
[7] Page 3 of TechUK's response to the July 2015 Discussion Document.

Using metrics to set an efficiency target

A5.11 RBS said that efficiency targets are not sufficiently transparent for stakeholders to be able to make an informed assessment of how well Royal Mail is performing against these targets. It argued that Royal Mail should be required to publish its performance against efficiency targets in order to drive customer and shareholder pressure.[8]

A5.12 The Mail Competition Forum (MCF), a forum for postal operators, said that any regulatory regime designed to drive efficiency needs to be as simple as possible to ensure clear and unambiguous reporting and measurement. This will enable customers and the industry to see if efficiency is genuinely improving.[9]

A5.13 Royal Mail argued that it does not require targets imposed by the regulator to drive efficiency. It said its track record showed major progress on efficiency, its business plan contained stretching targets, and it was "not clear how additional regulatory intervention would help".[10] Royal Mail said that if appropriately defined, Ofcom's PVEO[11] metric can provide useful insight into Royal Mail's historical and forecast efficiency levels. Royal Mail said that it already uses a modified version of Ofcom's proposed methodology in business planning. However, Royal Mail argued that although this measure is useful for providing insights into future efficiency, the rapid pace of change in post means that it is not fit for purpose for setting an efficiency target.[12]

A5.14 Royal Mail said that use of a short-term target may appear to get around some of the issues of forecasting longer term efficiency targets in a volatile environment. However, short term targets would drive focus from dynamic to static efficiency - focussing on year on year efficiency to meet the target, rather than on cost transformation programmes that realise efficiencies over the longer term and which may require initial outlay before the benefits are realised.[13]

A5.15 Royal Mail argued that if an annual target were in place, with penalties or rewards, Royal Mail would inevitably focus on achieving this target. It said that "looking at a single year does not incentivise efficiency".[14]

A5.16 The CWU stated that in considering Royal Mail's efficiency, Ofcom must look at the organisation as a whole, and not just the frontline workforce. Specifically, CWU argued that there is a limit to how much each postal worker can do and was concerned that Ofcom's focus on headline targets did not recognise this.[15]

[8] See RBS's response to the July 2015 Discussion Document, page 6.
[9] See MCF's response to the July 2015 Discussion Document, page 9.
[10] See Royal Mail's response to the July 2015 Discussion Document, page 54.
[11] PVEO is a method of calculating efficiency by identifying cost movements between years due to "price" or inflation, "volume", "efficiency" and "other" or one-off costs. Efficiency is calculated as the residual item once other cost movements have been taken into effect. This is discussed in more detail from paragraph A5.47 onwards below.
[12] See Royal Mail's response to the July 2015 Discussion Document, page 53.
[13] See Royal Mail's response to the July 2015 Discussion Document, page 53.
[14] See Royal Mail's response to the July 2015 Discussion Document, paragraph 4.56.
[15] See CWU's response to the July 2015 Discussion Document, page 18.

Using price or revenue caps to set a target

A5.17 UK Mail and Secured Mail believed it is now necessary for Ofcom to set a regulatory target for Royal Mail efficiency improvement, either through real price increase constraints or other regulatory targets e.g. allowed revenue control.[16]

A5.18 CFH Docmail (CFH), a postal operator, said that while RPI based measures i.e. a price cap are commonplace in seeking to drive real-terms efficiency improvements; they are most often used in asset-intensive utilities. As such, they may be less effective in the postal market which is more labour-intensive. Given the high proportion of people costs, CFH recommended “a measure (perhaps in addition to an RPI price cap measure) which focuses more on the efficiency of the entire business by calculating the total cost per post(wo)man hour”. CFH suggested this would provide an incentive to maintain a “baseline” level of post(wo)man hours, and hence to maintain the level of service quality, rather than to achieve efficiency savings by reducing the number of hours worked, at the expense of quality.[17]

A5.19 Citizens Advice believed that Royal Mail has stronger commercial incentives to use price rises to increase profits rather than to use riskier cost efficiency measures. In light of this, Citizens Advice said that it appears counter-intuitive not to apply to Royal Mail the same types of regulatory controls and disciplines which are typically applied to providers of utility services with significant market power.[18]

A5.20 Royal Mail argued that “regulatory intervention needs to be clearly grounded in the realities of the postal sector. Any return to wholesale and retail price caps or introduction of efficiency targets is therefore inappropriate and retrograde”.[19]

A5.21 CWU believed that previous efficiency targets imposed by Postcomm were shown to be unachievable, and was concerned that Ofcom is considering this approach again. CWU believed such a move would be unnecessary and that attempting to accelerate efficiency beyond the current incentives, which are already significant, may ultimately threaten service levels.[20]

Incentives

A5.22 In the July 2015 Discussion Document, we asked whether Royal Mail faces appropriate incentives to deliver efficiency improvements.[21]

A5.23 Royal Mail and unions representing postal workers, Unite and CWU, stated that Royal Mail faced sufficient incentives to improve its efficiency. Other postal operators, and a direct mailing company, said that the incentives on Royal Mail to improve its efficiency were insufficient. We outline the principle arguments behind each of these views below.

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[16] See page 9 of UK Mail and page 3 of Secured Mail’s responses to the July 2015 Discussion Document.
[17] See CFH’s response to the July 2015 Discussion Document, page 7.
[18] See Citizens Advice’s response to the July 2015 Discussion Document, page 11.
[19] See Royal Mail’s response to the July 2015 Discussion Document, page 2.
[20] See CWU’s response to the July 2015 Discussion Document, page 18.
[21] See Question 4 of the July 2015 Discussion Document, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

Arguments supporting the view that Royal Mail has sufficient efficiency incentives

A5.24 Royal Mail said that the efficiency gains it has made so far provided proof that it faced sufficient incentives to improve its efficiency and that these incentives and associated cost savings would continue in the future.[22]

A5.25 Unite suggested that "one of the main drivers of efficiency is the requirements and challenges set by shareholders" and that "this is not only institutional shareholders but also smaller investors who are keen to see efficiency measures".[23]

A5.26 CWU argued that Royal Mail is facing continuous volume decline in the letters market primarily driven by e-substitution, which incentivises Royal Mail to "continually improve its operational efficiency".[24] CWU also said that privatisation and ongoing pressure to deliver a return to shareholders combined with increasing competition provides sufficient incentive for Royal Mail to improve its efficiency. [25]

Arguments against the view that Royal Mail has sufficient efficiency incentives

A5.27 [✂] and UK Mail said that the current regulatory framework does not provide any incentives for Royal Mail to make efficiency improvements, [✂] argued that Royal Mail would not make efficiency improvements while it still had "the ability to improve profitability by increasing prices" or "reducing its costs by moving them to other parts of the supply chain".[26]

A5.28 CFH, Whistl and [✂] argued that although pressure from shareholders did exist, it was limited. These stakeholders argued that to the extent that this pressure exists, it is aimed towards profitability rather than efficiency and Royal Mail prefers to increase profitability through price rises than efficiency improvements.[27]

A5.29 Whistl said that regulation through price caps is the only remaining option to increase downstream efficiency, while upstream efficiency can be improved by widening upstream competition.[28]

A5.30 Secured Mail said that the most effective efficiency incentive is direct competition, but following the withdrawal of Whistl from the end-to-end market this incentive has been removed.[29] Whistl and MUA also said that greater competition in the end-to-end market would act as an efficiency incentive on Royal Mail.[30]

A5.31 CFH said that "once the practice of increasing prices to offset volume decline is no longer possible then there may be increased pressure from shareholders", however, it said that this is unlikely to be the case in the short term.[31]

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[22] See Royal Mail's response to the July 2015 Discussion Document, page 41.
[23] See Unite's response to the July 2015 Discussion Document, page 4.
[24] See CWU's response to the July 2015 Discussion Document, page 8.
[25] See CWU's response to the July 2015 Discussion Document, page 14.
[26] See page 3 of 'Name Withheld 5' [✂] and pages 8-9 of UK Mail's responses to the July 2015 Discussion Document.
[27] See the July 2015 Discussion Document responses: CFH, page 4; Whistl, page 16; and 'Name Withheld 5' [✂], page 3.
[28] See Whistl's response to the July 2015 Discussion Document, page 16.
[29] Secured Mail's response to the July 2015 Discussion Document, page 7.
[30] See page 4 of Whistl and page 2 of MUA's responses to the July 2015 Discussion Document.
[31] See CFH's response to the July 2015 Discussion Document, page 7.

A5.32 Chris Williams, representing a direct mailing company argued that "without competition, it is doubtful whether Royal Mail would have achieved the efficiencies made so far. The removal of any effective alternative end-to-end competition means it is likely that efficiencies are less likely to be made going forward"'.[32]

Outcomes

A5.33 Stakeholders also shared their views on desirable or projected outcomes from an increased focus on Royal Mail's efficiency.

A5.34 MCF said that efficiency improvements should lead to benefits for consumers and a slowing in the structural decline of mail volumes.[33]

A5.35 The Consumer Council suggested that improving the efficiency of Royal Mail will play an important part in ensuring that the universal service remains sustainable while also protecting consumers from price rises.[34]

A5.36 DMA said that reduced or frozen prices would be a desirable outcome of any efficiency improvements.[35]

A5.37 CWU highlighted the importance of considering the impact that any work around efficiency might have on labour conditions within Royal Mail. CWU argued that "a move to drive efficiency savings will lead to a downgrading of pay and the terms and conditions of its workforce" and this "would compromise the high quality of service that Royal Mail delivers as the universal service provider."[36]

A5.38 Royal Mail said that it is "heavily unionised" which can make modernisation difficult due to the risk of industrial action.[37] Royal Mail highlighted that this was true of other postal operators such as PostNL which put its modernisation plans on hold due to significant quality of service issues.[38] Royal Mail said that it has to meet high quality of service standards,[39] meaning that cost reduction in response to volume decline can take time.[40] Royal Mail also highlighted that it "has sought and delivered exceptionally high quality of service" throughout its modernisation programme.[41]

Ofcom's view on points raised by stakeholders

A5.39 We consider some of the specific points raised by stakeholders including incentives for efficiency, and the potential outcomes of driving for efficiency below. We then set out the framework for our assessment.

[32] See Chris Williams' response to the July 2015 Discussion Document, page 2.
[33] See MCF's response to the July 2015 Discussion Document, page 9.
[34] Seethe Consumer Council's response to the July 2015 Discussion Document, page 10.
[35] See DMA's response to the July 2015 Discussion Document, page 2.
[36] See CWU's response to the July 2015 Discussion Document, page 6.
[37] See Royal Mail's response to the July 2015 Discussion Document, paragraph 4.40.
[38] See Royal Mail's response to the July 2015 Discussion Document, paragraph 4.41.
[39] See Royal Mail's response to the July 2015 Discussion Document, paragraph 6.10.
[40] See Royal Mail's response to the July 2015 Discussion Document, paragraph 4.35.
[41] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.7.

Incentives for efficiency

A5.40 In general, privately owned firms are likely to have greater efficiency incentives than those in the public sector, due to stronger budget constraints and a greater focus on delivering profits for shareholders or other owners.

A5.41 It is possible that, in delivering profits to shareholders, Royal Mail may focus more on increasing prices (especially where it faces limited competition), although there are limits to this. In addition, shareholders may not be willing to ignore potential profits which could be delivered from reducing costs.

A5.42 However, this depends on the degree of scrutiny applied by shareholders, and the information available to them to apply that scrutiny. We consider that our monitoring regime, which includes examining Royal Mail's efficiency, provides a useful complement to this market scrutiny. We set out in paragraphs A5.197 to A5.204 our future intentions as to how we will monitor Royal Mail's efficiency in future.

A5.43 We agree that competition would generally be expected to provide greater efficiency incentives. However, we have not yet seen what effect, if any, the withdrawal of end-to-end competition has had on Royal Mail's plans to deliver efficiency. We also note that there remains a degree of competition from access operators and parcel operators over at least some parts of the value chain.

Outcomes of driving for efficiency

A5.44 We agree with stakeholders that improved efficiency should deliver benefits to consumers. It would improve the sustainability of the universal service, and also reduce the need to increase prices to secure this sustainability.

A5.45 We acknowledge that there can in some circumstances be a trade-off between efficiency and quality. However, Royal Mail is subject to a number of quality service targets in the DUSP Conditions. Our assessment has considered the efficiency initiatives Royal Mail itself has put forward in its 2015 Business Plan and Royal Mail has not suggested that such efficiencies would inhibit its ability to meet the quality of service targets in the DUSP conditions. We do not consider that our conclusions on Royal Mail's efficiency and what we might expect it to achieve conflict with its ability to meet its quality of service targets.

Framework for our assessment

A5.46 In this sub-section we set out the framework that we have used in order to carry out our assessment of Royal Mail's efficiency. We set out:

- our definition of efficiency;
- the scope of what is and is not included in the assessment;
- a description of the sources of evidence we have used in carrying out our assessment; and
- our approach to the efficiency assessment.

Definition of efficiency

A5.47 We agree with those stakeholders who highlighted that it is important to set out what we mean by efficiency when considered in relation to our duty to have regard to the need for the provision of the universal service to be efficient.

A5.48 For the purposes of this assessment, we define efficiency as the extent to which output is produced at minimum costs.[42]

A5.49 Generally economists distinguish between three types of efficiency:

- productive efficiency – ensuring there is no inefficiency or waste in production so that services are provided as cheaply as possible;
- allocative efficiency – ensuring that the right combinations of goods and services are produced given the tastes and preferences of consumers, i.e. prices are aligned to marginal or incremental costs; and
- dynamic efficiency – improvements which occur over time as investment and innovation, for example arising from increased competition, result in the development of new goods and services, and technological advances that make the production of current and future goods and services less costly.

A5.50 While we are seeking to incentivise all types of efficiency, our focus is on Royal Mail's productive efficiency, in particular its ability to reduce costs so as to remain financially viable while providing the universal service.

Scope of our efficiency assessment

A5.51 Having defined what we mean by efficiency, we now outline the scope of our assessment. In particular we outline the part of Royal Mail's business that we consider to be relevant to the provision of the universal service, and therefore relevant to our efficiency assessment. We then discuss which costs are relevant to our assessment and how we have considered them. Finally we provide a high level view of our approach to assessing efficiency, including our consideration of overall real cost movements as well as those absent volume effects.

A5.52 Our efficiency review is based on the costs of the Reported Business. The Reported Business is the part of Royal Mail's business that undertakes activities for the purpose of, or in connection with, the provision of universal service products (such as First and Second Class letters and parcels and, Special Delivery products) and non-universal service products (such as retail bulk mail, access mail and unaddressed mail).[43] The Reported Business is part of Royal Mail's UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of Parcelforce international and Royal Mail Estates Ltd. (refer also to paragraph A6.6 below for a description of the Reported Business and our reasoning behind the adoption of this cost base).

[42] This also corresponds to the approach outline in NERA's 2013 report on "Approaches to Measuring the Efficiency of Postal Operators: Final Report for Ofcom", published August 2013, http://stakeholders.ofcom.org.uk/post/report-postal-efficiency/.

[43] The full definition of the Reported Business is as set out in USPAC 1.1.2(w). The Reported Business is part of Royal Mail's UK Parcels, International and Letters (UKPIL) business unit but excludes the activities and products of Parcelforce International and Royal Mail Estates Ltd.

A5.53 We consider the operating and capital costs of the Reported Business to be relevant to our assessment. In the absence of capital costs for the Reported Business, we use depreciation as a proxy. Hence our assessment is based on the total operating costs (including depreciation) of the Reported Business.

A5.54 We consider pension costs on a cash basis as this is reflective of the actual costs incurred by Royal Mail. This is consistent with our approach for assessing financial sustainability which is discussed in more detail in Annex 6.

A5.55 Our assessment focuses first on the efficiencies achieved and secondly on the costs incurred in achieving them (i.e. transformation costs). We adopt this approach, due to the difficulties in aligning transformation costs with the benefits accrued.[44]

A5.56 Royal Mail is facing volume decline as letters are substituted by electronic alternatives, and growth in parcels is not expected to be sufficient to offset this decline.[45] This poses a challenge for the provision of the universal service as, absent any changes in efficiency, it might be expected to lead to an increase in unit costs due to the fixed costs involved in providing the universal service and hence the potential reduction in economies of scale.

A5.57 In making our efficiency assessment, we seek to remove this effect so that our assessment takes out those cost movements due to volume which cannot be controlled by management. We consider cost movements due to volume in paragraphs A5.81 to A5.90 where we discuss the challenges faced by Royal Mail, the impact of recent operational changes on the flexibility of the universal service and how we account for cost volume movements in our metrics.

A5.58 We also seek to remove the exogenous input price pressures faced by Royal Mail from our assessment. We discuss our approach to capturing cost movements due to inflation in paragraphs A5.71 to A5.80.

A5.59 In summary, the scope of our assessment is Royal Mail's Reported Business. We consider the operating costs (including depreciation) to be the relevant cost base and we take into account transformation costs separately. In order to make our assessment we need to consider the impact volume movements and input price inflation have on costs. We outline how we consider and quantify these impacts in paragraphs A5.71 to A5.80 and A5.81 to A5.90 for inflation and volume respectively.

Sources of evidence

A5.60 Our analysis was informed by consideration of data both internal (Royal Mail specific data) and external (benchmarking data, analyst views) to Royal Mail and utilised a number of methods as recommended by NERA.[46] These included:

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[44] The issue of alignment of transformation costs was also highlighted by FTI. See FTI "*Efficiency Metrics for Royal Mail*" dated September 2015, paragraph 3.20.

[45] PWC, *The outlook for UK mail volumes to 2023*, 15 July 2013, http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf.

[46] See "Approaches to Measuring the Efficiency of Postal Operators: Final Report for Ofcom", published August 2013, http://stakeholders.ofcom.org.uk/binaries/post/postal-efficiency/nera.pdf .

- **Internal review of Royal Mail's Business Plan** – We reviewed Royal Mail's 2015 Business Plan, looking at how its forecast costs (and expected cost savings) compare to its own historic performance. We used various methodologies to adjust for factors which may influence costs, such as inflationary pressures and changes in volumes.

- **Marginality Review** – We asked Analysys Mason to identify the level to which Royal Mail's costs vary, in the short term, with volume across the different parts of Royal Mail's business.

- **Econometric Analysis** – We asked Deloitte to undertake econometric benchmarking analysis of Royal Mail's delivery offices and mail centres. This analysis used statistical techniques to look at how efficiency varies across different delivery offices and mail centres, as well as how performance has evolved over time.

- **Third Party Review of Business Plan** – We asked WIK-Consult (WIK) to undertake a review of the projected costs and initiatives within Royal Mail's 2015 Business Plan relevant to the universal service and to compare its modernisation plans with the plans of comparable postal operators.

- **Other** – We also considered other evidence including Royal Mail's public statements on efficiency and the views of analysts.

A5.61 Our assessment considered different metrics (e.g. hours; costs split by inflation, volume and efficiency; pay levels) to measure the different types of efficiency. For example, efficiency savings may take the form of productivity savings (e.g. a reduction in the number of hours employed for the same level of output) or monetary savings (e.g. reductions in prices paid for inputs).

A5.62 Analysis was conducted both on a rate of change basis (considering historical data versus forecast data) and a comparator basis (considering Royal Mail versus its European peers and versus other UK firms in the same economic sector).

A5.63 This approach of considering many metrics and sources of evidence aligns with that discussed by FTI Consulting (FTI) in its submission for Royal Mail. FTI stated "there is no single metric for assessing efficiency, rather a number of metrics are usually considered." [47]

Our approach

A5.64 The efficiency improvements proposed in Royal Mail's 2015 Business Plan were reviewed against the sources of evidence outlined above to review whether they represented a reasonable rate of improvement.

A5.65 Royal Mail's business plan provides revenue, volume and cost projections for the Reported Business.[48] Costs are forecast with reference to the underlying drivers of inflation (input price), volume movements and efficiency, as well as taking account

[47] FTI public report "*Efficiency Metrics for Royal Mail*" dated September 2015, paragraph 1.4.
[48] Under USPAC 1.3.9(b), Royal Mail is required to provide Ofcom with a Strategic Business Plan each year. See USP Accounting Condition: http://stakeholders.ofcom.org.uk/binaries/post120713/USP_accounting_condition.pdf.

of one-off costs. It also details the efficiency initiatives proposed by Royal Mail and the expected costs incurred in achieving the efficiencies.

A5.66 In order to focus on the efficiency initiatives of Royal Mail, we have aimed to separate out the changes in costs forecasted from inflation drivers and volume movements.

- **Inflation.** We identified the input price inflation faced by Royal Mail. This is the inflationary pressure outside of Royal Mail's control and therefore we needed to account for this separately when considering cost movements.

- **Volume.** We considered the short term level of cost savings that could be expected by Royal Mail due to a change in volumes. This included analysis conducted by Analysys Mason and PLCWW[49] on our behalf. The flexibility of Royal Mail, i.e. the level of savings Royal Mail is able to make as volumes decline was considered relevant to our efficiency assessment. We considered it relevant to consider efficiency metrics which adjusted for volume and those that did not.

A5.67 Having considered these two drivers of costs separately, we then conducted a high-level review of the overall planned cost savings in Royal Mail's 2015 Business Plan. Our analysis included quantification of the elements below.

- **Total Reported Business Costs –** We conducted a high level review of the total costs of the Reported Business. We compared historic data to that forecast, accounting for inflation. Volume impacts were not adjusted for in this analysis.

- **PVEO analysis of Reported Business Costs –** We reviewed the forecast cost movements of the Reported Business split by inflation (input price), volume and efficiency and other (one-off) for the different cost categories within the plan (e.g. delivery frontline, vehicle fleet and fuel). We compared the forecast to that achieved historically, considering both PVEO analysis conducted by FTI on behalf of Royal Mail and PVEO analysis submitted by Royal Mail as part of its business plan.

- **Analyst Commentary on Royal Mail's Efficiency –** We considered the views expressed by analysts on Royal Mail's efficiency

- **Royal Mail's Public Statements on Efficiency –** We also took into account Royal Mail's public statements on its cost reductions.

A5.68 We also conducted a more granular review on key cost areas of the Reported Business. This included separate consideration of the factors contributing to the efficiency of people costs i.e. pay and hours. People costs form the majority of the Reported Business's costs.[50] In particular we reviewed:

- **Frontline Pay Rates –** Pay rates were benchmarked against other UK firms in similar occupations and industries using ONS data;

[49] Postal and Logistics Consulting Worldwide.
[50] See Royal Mail's regulatory financial statement, 2014-15, page 9, http://www.royalmailgroup.com/sites/default/files/Regulatory%20financial%20statements%202014-15%20-%2011.12.15_0.pdf.

- **Delivery and Processing Frontline Hours –** The total hours recorded by Royal Mail for Frontline Delivery and Frontline Processing were reviewed individually and in aggregate against past performance. Frontline Delivery hours represent the time taken in the preparation (sequence sorting) and delivery of mail to recipients i.e. it includes both indoor and outdoor activities. Frontline Processing hours are those incurred in the sortation of mail for onward despatch to either an Inward Mail Centre (outward processing) or to a delivery office (inward processing). Royal Mail also records time taken in the distribution of mail from mail centres and in collections against the categories of Frontline Delivery and Frontline Processing;

- **Delivery Office Hours and Costs –** Deloitte was commissioned to conduct an econometric analysis of delivery office data;

- **Mail Centre Hours and Costs –** Deloitte was commissioned to conduct an econometric analysis of mail centre data; and

- **Initiatives –** Initiatives relevant to the delivery and processing parts of the supply chain were reviewed against European peers. This work was undertaken by WIK and included an overall review as well as this more granular assessment.

A5.69 The detailed evidence above was considered together to formulate a view on the efficiency within delivery and processing.

A5.70 In order to formulate an overall view of Royal Mail's efficiency, we also considered other assessments, including Royal Mail's own estimates of productivity. We also considered WIK's overall view of the initiatives across the business in comparison to those of its peers across Europe.

Accounting for cost drivers other than efficiency

Inflation

A5.71 We reviewed the price pressure faced by Royal Mail. This is the inflationary pressure on costs outside of the control of Royal Mail. Our assessment of cost movements needed to account for this separately from movements due to volume or efficiency.

A5.72 Specifically, we sought an index (or indices) that:

- was reflective of the inflationary pressures on Royal Mail's costs; and

- was available on a consistent forecast and historic basis.

A5.73 In a report for Royal Mail, FTI argued that "it is more appropriate to use specific input price inflation where possible as opposed to using a generic index, and using RPI as the generic index in absence of a specific input price inflation"[51] is appropriate.

A5.74 We considered using specific input price inflation measures (for example, for fuel or property costs). However, in many cases suitable indices for the most significant

[51] Efficiency Metrics for Royal Mail: FTI Consulting response to the Fundamental Regulatory Review, September 2015, paragraph 4.16.

cost lines in Royal Mail's business were not available on a consistent forecast and historic basis. We note that, in Deloitte's econometric analysis of staff costs in delivery offices and mail centres, nominal staff costs are deflated by average weekly pay within the Transport and Storage sector, as this is the industrial group into which the Office of National Statistics (ONS) defines postal workers. However, this index is only available historically.

A5.75 We have therefore used a general inflation index.

A5.76 The operating costs of the Reported Business can be split into people and non-people costs. People costs form the majority of the Reported Business's costs.[52]

A5.77 There are two main general inflation indices; the Consumer Price Index (CPI) or the Retail Price Index (RPI).

A5.78 We adopt CPI as our inflation index and use this throughout our analysis for both people and non-people costs. Our choice is primarily because of a tendency for the RPI to over-state inflation in a way that is not true of the CPI. This is a result of differences in the way the indices are constructed. As a result RPI is no longer classified as a national statistic.

A5.79 In reviewing the cost movements within the 2015 Business Plan we adopt Royal Mail's estimate of CPI, which is [✂] than that currently forecast (by the OBR). We do this so that our estimates of real cost movements, using CPI as a deflator, align with those of Royal Mail. In generating its 2015 Business Plan, Royal Mail includes CPI forecasts of [✂].[53]

A5.80 In summary, we use CPI as the basis for calculating real movements in Royal Mail's costs and adopt this approach throughout our analysis.

Volume

A5.81 In addition to inflation, cost movements are also driven by changes in mail volume. In formulating our view of future efficiency savings and future cost movements we need to have regard to the effect of volume on costs. We briefly discussed in paragraph A5.56 the challenges faced by Royal Mail due to volume decline.

A5.82 Within its business plan, Royal Mail accounts for the short term variation of costs due to volume, which it refers to as marginality. This is the change which can be realised without making structural changes.[54]

A5.83 We asked Analysys Mason to consider the marginality of the Reported Business. This report will be published shortly.

A5.84 Their review was based on the 2014 Business Plan, which contained marginality assumptions which did not reflect the introduction of new delivery methods. Hence

[52] Based on figures from 2014-15. See Royal Mail's Regulatory Financial Statements 2014-15, page 10, http://www.royalmailgroup.com/sites/default/files/Regulatory%20financial%20statements%202014-15%20-%2011.12.15_0.pdf.

[53] Royal Mail Presentation, Business Plan, March 2015.

[54] Royal Mail suggests that "some cost reduction is possible as a response to volume decline". See Royal Mail's response to the July 2015 Discussion Document, paragraphs 1.2 and 4.6.

Analysys Mason both reviewed the marginalities within the 2014 Plan and updated the assumptions to account for recent changes in Royal Mail's operations.

A5.85 Analysys Mason found that the new delivery methods had reduced the marginality of delivery. [55, 56] This was due to "higher marginality methods such as unsupported foot delivery and cycle delivery have been replaced with lower marginality van supported, foot and lightweight trolley delivery".[57]

A5.86 Royal Mail also updated its view of marginality from its 2014 Business Plan in the 2015 Plan. This also sought to update the values to reflect the latest operational methods.

A5.87 Royal Mail estimated that, in frontline delivery and processing, the level of marginality has reduced from [✂] to [✂], largely due to the deployment of new delivery methods.[58] These were introduced with the ambition of achieving greater capacity to absorb the growth in parcels, improve safety and reduce outdoor delivery costs by the introduction of longer flexible routes.[59, 60]

A5.88 In summary, both Royal Mail and Analysys Mason estimate that recent changes to operational practices have served to reduce the marginality of delivery. This means that the delivery operation is now less flexible, i.e. costs are less responsive to changes in volume. If parcels continue to grow this should mean that Royal Mail is better able to absorb the growth without incurring further costs. However, if volumes decline, Royal Mail might be less able to take costs out of this part of its business in response. We observe that while recent labour agreements have helped facilitate the completion of Royal Mail's transformation program, these agreements also included some measures which limit Royal Mail's ability to increase its workforce flexibility. This is discussed in more detail in paragraph A5.128.

A5.89 In comparison, from the work conducted by WIK, across Europe other postal operators have sought to increase their ability to match resources to workload through operating flexibility in working time and/or introducing mail flow control.[61]

A5.90 In conclusion, we believe that Royal Mail's ability to respond in the short term to changes in volume is relevant to considering the efficiency of the universal service. The importance of flexibility was also highlighted by Royal Mail in its 2013-14 Annual Report where it stated "we need to be more flexible and efficient to meet the needs of our customers".[62] We consider that recent changes have reduced this

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[55] See Analysys Mason report "Review of Royal Mail's short-run marginality" (to be published at a later date).
[56] Royal Mail new delivery methods involve the use of trolleys to deliver mail, replacing bags and bicycles. It also involves the increased use of vans. See, for example, Royal Mail's website: http://www.royalmail.com/personal/help-and-support/how-are-you-changing-my-deliveries.
[57] Analysys Mason report "Review of Short Run Marginality" (to be published at a later date).
[58] Royal Mail Presentation [✂]; [✂] of [✂] decrease in cost variability has been driven by deployment of delivery methods.
[59] Royal Mail Prospectus, page 71, http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf
[60] Royal Mail Website http://www.royalmail.com/personal/help-and-support/how-are-you-changing-my-deliveries.
[61] See for example pages 55 to 57 of WIK report.
[62] See Royal Mail's Annual Report 2013, page 2 http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202013-14_DDA_0.pdf.

flexibility which may make it more difficult to remove costs in response to short term fluctuations in volume.

Methodology for accounting for cost changes due to volume in our metrics

A5.91 We considered both efficiency metrics which adjusted for volume and those that did not.

A5.92 This dual approach has, in part, been adopted in acknowledgement of the difficulties in separating cost movement by volume. However, it also allows us to consider the extent to which Royal Mail is able to respond in the short term to changes to its underlying structure (referred to as marginality). We consider this ability to respond in the short term to be relevant to the sustainability of the universal service but to be a challenge given the market context of declining volumes.

A5.93 Metrics which did not adjust for volume included combined frontline delivery and processing hours (refer to A5.134), and total Reported Business real cost movements (A5.105).

A5.94 Metrics which adjusted for volume included our econometric work (see paragraphs A5.164 and A5.184), our PVEO analysis (refer to A5.107 for explanation), and Royal Mail's productivity metric. We also calculated frontline hours which adjusted for the volume impact (see paragraphs to A5.145 for delivery and A5.175 for processing).

A5.95 Below, we outline the methodology adopted by Royal Mail to account for cost changes due to volume in its 2015 Business Plan. We then outline our approach to accounting for cost changes due to volume and the reasons underpinning it.

A5.96 Royal Mail accounts for the change in costs due to volume, or marginality, in different parts of its business in different ways. For its frontline costs (where available), marginality is calculated by reference to changes in weighted volumes or "workload".

A5.97 Workload is a measure derived by Royal Mail based on the theoretical time involved in meeting demand. The time required to meet a given operational volume is estimated using a combination of industrial engineering studies, and assumptions on distances and quantities. The calculation also involves the classification of time into fixed or variable dependent on the activity undertaken. Volumes are weighted by the variable time required (or "planning values") and the total is then added to the fixed time to produce an overall weighted time. This "standard time" estimate has a constant factor applied to it to translate it to Royal Mail's "workload" measure.[63]

A5.98 Royal Mail calculates workload only for those frontline pipeline[64] areas where it has internally agreed the underpinning industrial engineering studies and assumptions. For the 2014 Business Plan, Royal Mail applied marginality calculations corresponding to changes in workload to the pipeline areas of delivery frontline, and

[63] See also FTI "Efficiency Metrics for Royal Mail", (public version), paragraph 4.60.
[64] Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item.

processing frontline. For each of these pipeline areas, Royal Mail calculated pipeline specific workload estimates. The percentage change in workload was assumed to be equal to the percentage change in costs due to changes in volume within each area.[65]

A5.99 As described in A5.86 Royal Mail updated its view of marginality for the 2015 Business Plan and this included an update to the assumptions underpinning the workload calculations and an extension of the workload calculations to include Regional Distribution Centres (RDCs).

A5.100 Other areas of cost volume variability identified by Royal Mail in its 2014 Business Plan (in addition to frontline processing and delivery) are conveyance charges e.g. international terminal dues and payments to Post Office Limited.[66] In its 2015 Business Plan, Royal Mail also identified cost variability due to volume changes in the additional areas of [✂].[67]

A5.101 In our analysis we adjust for volume for the cost categories of frontline delivery and processing, POL and terminal dues. Our methodology to account for costs changes due to volume for each cost category is as below:

- **Frontline Delivery** – we assume changes in cost due to volume equate to changes in workload. We adopt Royal Mail's estimates of delivery workload from its 2015 Business Plan. An alternative approach would have been to adopt Analysys Mason's estimates from its marginality review. However this would not lead to a materially different outcome, and there is a benefit to aligning input assumptions with those of Royal Mail (to avoid discussions being diverted away from efficiency onto issues of calculation methodologies).

- **Frontline Processing** – as with delivery we adopt workload movements as the mechanism for calculating cost movement due to volume and we adopt Royal Mail's estimates of processing workload from its 2015 Business Plan.

- **POL** – after inflation has been accounted for, the residual cost movements are assumed to relate to volume. Costs in this area relate to conveyance charges and as such are assumed to be volume driven.

- **Terminal Dues** – after inflation has been accounted for, the residual cost movements are assumed to relate to volume. Costs in this area relate to conveyance charges and are assumed to be volume driven.

- **Other Areas** – we make no assumption on cost movements due to volume in any other area. This is due to the expected materiality.

A5.102 The derivation of cost movements due to volume involves assumptions and judgement.[68] This applies not only within the workload estimates but also in their

[65] The calculation of workload and its application by Royal Mail is also described in FTI's report FTI Public Report "Efficiency Metrics for Royal Mail", paragraph 4.61, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail_FTI_report_on_efficiency_Metrics.pdf.
[66] [✂].
[67] Royal Mail Business Plan 2015 Submission, [✂].
[68] The difficulty in estimating cost movements due to volume was also highlighted by FTI in their report for Royal Mail. FTI report "*Efficiency Metrics for Royal Mail*" paragraph 4.64.

application. Further judgement is also required in the quantification of cost movements in other areas.

A5.103 We have adopted Royal Mail's assumptions in part (on workload for frontline processing and delivery). In other areas we have adopted a high-level approach. We apply our assumptions consistently to both the business plan and the data set we are reviewing it against. Further, Analysys Mason's review provides us with some reassurance that the marginalities adopted are reasonable. Hence we believe our assessment and methodology for accounting for marginality to be reasonable for the purposes of this review.

High-level efficiency review

A5.104 As the first stage of our assessment of Royal Mail's efficiency, we carried out a high level review of Royal Mail's 2015 Business Plan, as set out below. This high-level review assessed at a total level the operating costs of the Reported Business.[69] In particular, it included:

- analysis of real cost movements;
- Price, Volume, Efficiency, Other (PVEO) analysis;
- analysts' views on issues around Royal Mail's efficiency; and
- Royal Mail's public statements on efficiency.

Total Reported Business Costs

A5.105 The operating costs[70] of the Reported Business reduced in real terms by 1.4% per annum over the past three years (2011-12 to 2014-15).[71] This compares to a forecast real reduction of [✂] per annum from 2015-16 to the end of the Business Plan period (2017-18).

A5.106 Royal Mail is therefore expecting to achieve greater real cost reductions than it has historically achieved.

Price, Volume, Efficiency, Other (PVEO) analysis

A5.107 We also wanted to better understand the causes of the costs movements. To do this we sought to segment the cost movements into those due to inflation, volume and efficiency and other (one-off changes). This type of analysis is referred to as PVEO analysis. Our approach to estimating inflation and volume was outlined in paragraphs A5.5.71 to A5.90 above.

A5.108 Our PVEO analysis of Royal Mail's 2015 Business Plan suggests that the Reported Business is expecting to achieve average annual efficiencies of around [✂] per annum across the Business Plan period. This is an increase on our estimation of what they have achieved on average over the past three years i.e. [✂]. In our

[69] As outlined in section A5.59 these included depreciation, pension costs on a cash accounting basis and excluding transformation costs.
[70] Including depreciation but excluding transformation costs.
[71] See Royal Mail's Regulatory Financial Statements from 2011-12 to 2014-15, available at: http://www.royalmailgroup.com/about-us/regulation/regulatory-financial-statements.

annual monitoring report we reported efficiencies of 0.7% in 2013-14 and 2.6% in 2014-15 respectively.[72]

A5.109 PVEO analyses were also conducted by FTI on behalf of Royal Mail.[73] We summarise the results of the PVEO analyses in the table below.

Figure A5.1: Summary of PVEO Analyses

Average Annual Change in Costs	2011-12 to 2014-15 (Ofcom)	2010-11 to 2014-15 (FTI)[74, 75]	2015-16 to 2017-18 (Ofcom)	2015-16 to 2017-18 (FTI)[76, 77]
Price	[✂]	[✂]	[✂]	[✂]
Volume	[✂]	[✂]	[✂]	[✂]
Efficiency	[✂]	[✂]	[✂]	[✂]
Other	[✂]	[✂][78]	[✂]	[✂][79]

A5.110 As previously outlined, the movements in cost due to volume are projected to be low.

A5.111 The variation between our estimates for Royal Mail's expected efficiencies over the next three financial years, and those estimated by FTI (as commissioned by Royal Mail) for the same period, highlight the sensitivity of the outcome of the analysis to the underlying assumptions adopted. The divergence is largely due to FTI adopting RPI as a general inflation index. However, we note that the outputs show similar trends i.e. an increase in efficiency and small cost movements due to volume.

A5.112 Drawing on the results of the various sources of PVEO analysis we observe an increase in the forecast efficiency suggesting that Royal Mail has become more ambitious in its efficiency programmes. Cost movements due to volume are small.

Analyst and external commentary on Royal Mail's efficiency

A5.113 In addition to conducting our own analysis on the high level costs, we have also noted the opinion of analysts in relation to Royal Mail's efficiency. Given that Royal Mail is now a privatised firm, we expect that the increased scrutiny from analysts, investors and shareholders will be a driver for efficiency at Royal Mail.

[72] Ofcom, Annual Monitoring update on the postal market, Financial Year 2014-15.
[73] FTI Report September 2015 "Efficiency Metrics for Royal Mail". Non-confidential version available at: http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail_FTI_report_on_efficiency_Metrics.pdf.
[74] FTI Report, September 2015 "Efficiency Metrics for Royal Mail", Tables 4.3 and 4.7 of confidential version of report.
[75] The 'underlying' cost base includes transformation costs.
[76] FTI Report, September 2015 "Efficiency Metrics for Royal Mail", Tables 4.4 and 4.7 of confidential version of report.
[77] As above, the underlying cost base includes transformation costs.
[78] FTI has adjusted the underlying cost base data to take into account any 'other' costs that would affect the PVEO analysis, therefore not specifically calculating 'Other' in the PVEO analysis.
[79] As above, FTI has adjusted the underlying cost base data to take into account any 'other' costs that would affect the PVEO analysis, therefore not specifically calculating 'Other' in the PVEO analysis.

A5.114 The potential for Royal Mail to do more on efficiency was highlighted by Rob Byde, an analyst at Cantor Fitzgerald who stated "what Royal Mail needs to do is avoid industrial action but also push through significant automation of parcels and letters sorting, lift productivity and ensure they retain as much workforce flexibility as possible".[80]

A5.115 We note that a number of analysts have also highlighted the potential for Royal Mail to achieve further efficiency gains, while recognising the difficulties involved in reducing costs, particularly in light of ongoing pay discussions and ahead of pension negotiations[81] These included Jefferies who said that it was "relatively cautious" ahead of what it believed would be "relatively difficult labour negotiations, likely involving pension reform discussions". However Jefferies suggested that, given the complexities, "there might be a short-term pay deal for 2016, followed by ongoing discussions for the later years".[82] Barclays suggested that "the outlook for 2017 will be very dependent on the outcome of current pay negotiations".[83]

A5.116 We note analysts' views that there is the potential for further efficiencies but that Royal Mail's future financial outlook is dependent on the outcome of the pay and pension negotiations.

Royal Mail's Public Statements on Efficiency

A5.117 Royal Mail has made some public statements as to its future plans for efficiency. While these statements relate to UKPIL, we consider them to be relevant to the consideration of the future efficiency of the universal service. (The Reported Business accounts for 95% of costs of UKPIL.)[84]

A5.118 Royal Mail has publically stated its intention to avoid costs at a higher rate than that achieved in recent years. For instance, in Royal Mail's half year results for 2015-16, Royal Mail stated "We have avoided around £200 million of costs over the last three years and have over 70 scoped and resourced projects across UKPIL targeted to avoid around £500 million of additional annualised costs by 2017-18".[85]

Granular review of key cost areas

A5.119 In addition to the high-level review of overall costs above, we carried out a more granular review of the key cost areas in the Reported Business.

A5.120 Specifically we looked at people costs, which form the majority (68%) of the Reported Business cost base.[86] The factors contributing to people costs can be split into two: i) the hours of employment that Royal Mail pays for; and ii) the pay levels applied to those hours (including pay rate, pension costs, National Insurance, overtime, and the costs of agency staff).

[80] Financial Times, 26 April 2016.
[81] See Investec *Royal Mail: Analysing the CWU – A Full-Time Job*, 5 April 2016.
[82] See Jefferies *Royal Mail: Expensive Union Proposals*, 31 March 2016.
[83] See Barclays *European Transportation – Logistics by numbers into Q1*, 14 April 2016, page 1.
[84] 2014-15: Royal Mail, Business Plan Board Presentation, Business Cost Matrix 2014-15.
[85] Royal Mail Half Year Results Announcement 2015-16 19th November 2015 http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Financial%20Report%20for%20the%20half%20year%20ended%2027%20September%202015.pdf.
[86] This refers to FY ending 2014-15. See Royal Mail's regulatory financial statement, 2014-15, page 9, http://www.royalmailgroup.com/sites/default/files/Regulatory%20financial%20statements%202014-15%20-%2011.12.15_0.pdf.

A5.121 In the granular review we have therefore considered these factors by:

- conducting a benchmarking exercise of frontline pay rates using data produced by the Office for National Statistics (ONS);
- reviewing the potential for savings in frontline hours by considering processing and delivery in aggregate. Including Royal Mail's productivity metric which looks at the combined efficiency of these areas;[87] and
- looking individually at frontline delivery and frontline processing to identify the potential for efficiencies. In particular, we considered each of these items for both parts of Royal Mail's pipeline:
  - o historic hours and cost reductions;
  - o the pay rate (as captured above);
  - o econometric analysis of operational units (delivery offices for frontline delivery and mail centres for frontline processing); and
  - o international benchmarks of the efficiency initiatives Royal Mail is implementing or plans to implement as part of its 2015 Business Plan.

Frontline Pay Rates[88]

A5.122 Royal Mail's people costs include the costs of basic pay, overtime, bonus, National Insurance, pension (we considered pension costs on a cash accounting basis) and agency staff. The breakdown of people costs for 2014-15 is shown in the chart below.[89]

Figure A5.2: Breakdown of People Costs in Reported Business

[✂]

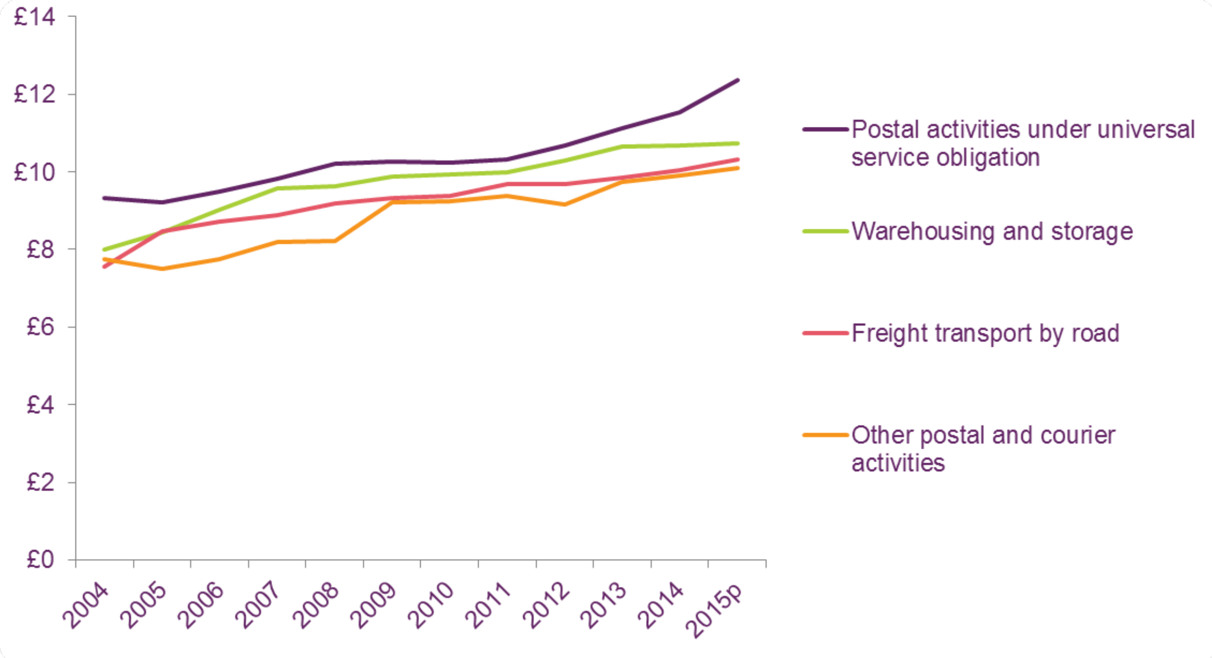
A5.123 We have assessed how Royal Mail's pay (both the absolute level and the rate of change) compares to pay in comparable occupations and industries. We have based our analysis on the ONS Annual Survey on Hours and Earnings (ASHE). This survey examines the level, distribution and make-up of earnings and hours worked for UK employees in all industries and occupations in the UK.[90]

[87] Note Royal Mail has continued to develop its productivity metric. We consider the metric with regard to the frontline areas of processing and delivery consistent with the definition in Royal Mail's prospectus and that in our 2014-15 Annual Monitoring Report.
[88] This analysis focuses on hourly earnings excluding overtime. There are many aspects to employee pay, but we have focused on 'base' pay to ensure we are comparing consistent measures across groups.
[89] [✂].
[90] The Annual Survey on Hours and Efficiency is available at the following link: http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/annualsurveyofhoursandearnings/2015provisionalresults#earnings-by-occupation. ASHE is based on a 1% sample of employee jobs taken from HM Revenue and Customs (HMRC) Pay As You Earn (PAYE) records, with information on earnings and hours obtained from employers. ASHE does not cover the self-employed nor does it cover employees not paid during the reference period.

A5.124 The survey categorises different occupations based on their activities. These categories are referred to as Standard Industrial Classifications (SIC). This classifies businesses and other statistical units by the type of economic activity in which they are engaged. Data relevant to Royal Mail's Reported Business is classified as "postal activities under universal service obligation". This is contained within the "postal and courier activities" category within the industrial major group (SIC 2007) of "Transportation and Storage.

A5.125 Average pay for USO postal and courier activities is higher than other transport and storage occupations, which we consider are comparable (such as freight transport by road, warehousing and storage, and other postal and courier activities). This is shown in the chart below.

Figure A5.3: Median Hourly Earnings (excluding overtime) for postal activities and occupations based upon SIC, 2004 to 2015[91]



A5.126 Looking at the recent trends, USO postal and courier activities have seen a sharper increase than those other job roles between 2012 and 2015 (16%, compared to an increase of between 4% and 10% for other comparable job roles).

A5.127 It should be noted that Royal Mail's previous pay agreement with the CWU, which came into effect in 2013-14 and expired at the end of 2015-16, was negotiated in the context of Royal Mail preparing for privatisation. This agreement included a 3% pay increase for eligible employees in 2013-14, a further 3% pay increase in 2014-15 and a 2.8% pay increase in 2015-16.[92] These pay increases have been greater than the rate of increase in CPI over the same period.

A5.128 In addition, the pay agreement limited Royal Mail's ability to increase the proportion of employees who work part-time hours; included provision for staff to be employed

[91] We have obtained median hourly earnings (excluding overtime) between 2004 and 2015 from ONS ASHE data. ONS Data for 2015 are provisional.
[92] CWU, Agenda for Growth, Stability and Long Term Success, http://www.cwu.org/assets/cwu/legacy-assets/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf.

on permanent contracts except in exceptional circumstances; and included an objective for Royal Mail to achieve all future change without recourse to compulsory redundancy.[93]

A5.129 At that time, Royal Mail faced a unique set of circumstances around employee engagement and the need to avoid disruption to its business. The analysis above focuses on basic pay rates (wages).

A5.130 In summary, we consider that the forecast pay increases in Royal Mail's 2015 plan are reasonable. [✂].

Frontline Hours (Delivery and Processing) and Productivity

A5.131 We analysed the hours paid for by Royal Mail for the key cost areas of its frontline staff. These include frontline delivery and frontline processing hours (as defined in paragraph A5.68). These are referred to as 'gross hours' and include both worked hours and paid absences such as sickness and leave.

A5.132 We consider the metric of gross hours to be relevant to the consideration of Royal Mail's efficiency. This includes both hours' decreases due to volume and those due to efficiency both of which we consider relevant to our assessment.

A5.133 The table below summarises the average annual changes in aggregate.

Figure A5.4: Frontline Hours Reductions

CAGR (%)	2011-12 to 2014-15	2015-16 to 2017-18
Total Hours	-2.5%	[✂]

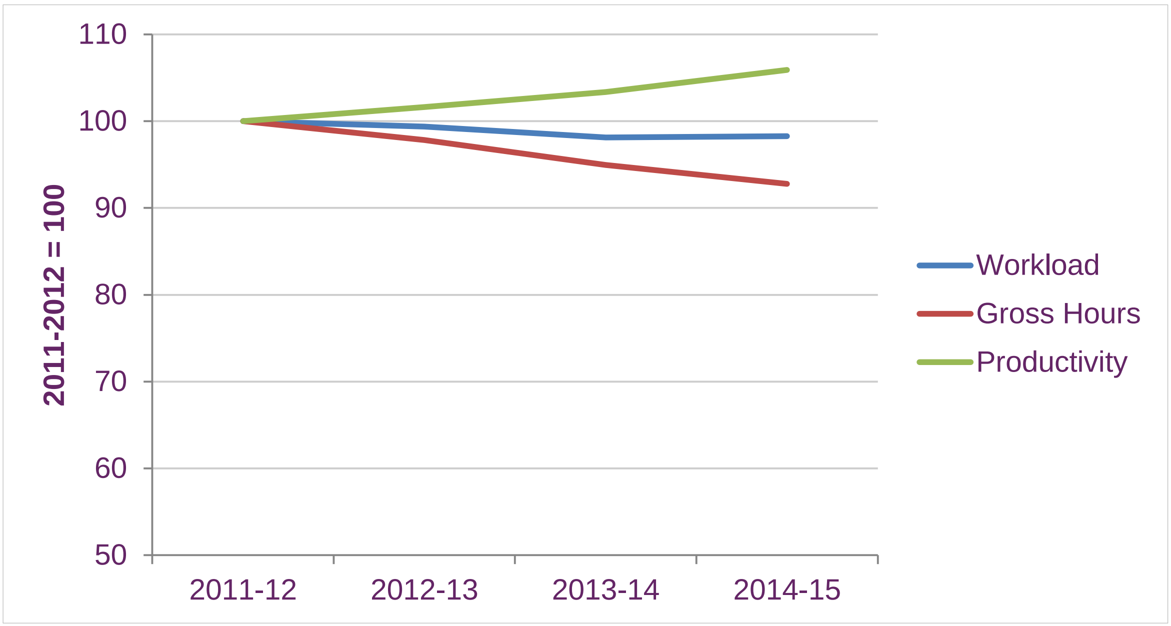
A5.134 Royal Mail reduced its frontline hours by an average of 2.5% per annum in the three years to 2014-15, [94] and its plans are for [✂] over the next three years. These reductions reflect both reductions in volume and increases in efficiency.

A5.135 We note that Royal Mail has reported a reduction in gross hours of 2.0% in 2015-16.[95] This is lower than the average annual hours' reduction achieved over the three years to 2014-15. [✂].

A5.136 The chart below presents both recent hours' reductions and Royal Mail's efficiency measure of productivity.

[93] See the Agenda for Growth, Stability and Long Term Success, paragraph 2.7, http://www.cwu.org/assets/cwu/legacy-assets/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf.
[94] See Ofcom's See Ofcom's Annual monitoring update on the postal market 2014-15, Figure 7.3, http://stakeholders.ofcom.org.uk/post/monitoring_reports/.
[95] See Royal Mail's Full Year Results presentation for 2015-16, Slide 19: http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20Full%20Year%202015-16%20Results%20presentation.pdf.

Figure A5.5: Royal Mail's Productivity Metric[96]



A5.137 Productivity, as shown in this chart, is the metric used by Royal Mail and is the ratio of its workload metric to gross hours i.e. the ratio of weighted operational volumes to hours (refer to paragraphs A5.97 and A5.98 above for an explanation of workload).

A5.138 Royal Mail's workload metric (and hence its productivity metric) contains assumptions which are based on judgement (e.g. the specification of activities into fixed and variable, the estimation of operational volumes). We believe it is important, in terms of understanding an overall trend in productivity to use a consistent set of assumptions to drive the weights for each year. This would mean that the weights would reflect operational practices at a given year, rather than being updated each year. Hence, the productivity metric would represent changes in efficiency due to both operational structure and people efficiencies. Further this would avoid the metric being influenced by changes in assumptions.

A5.139 In particular, as described in section A5.86, the weights applied to operational volumes have recently been updated by Royal Mail. Hence the historical estimate of productivity, of 1.9%[97] is based on different weights to the forecast estimate of [✂] which reflects the latest operational practices.

A5.140 For the purposes of our review, we consider Royal Mail's productivity metric to be relevant. We observe that the forecast trend is based on different weightings and assumptions to the historic trend. However as each are based on a constant base position and each reflect different operational structures; we believe each to be appropriate.

[96] See Ofcom's See Ofcom's Annual monitoring update on the postal market 2014-15, Figure 7.3, http://stakeholders.ofcom.org.uk/post/monitoring_reports/.
[97] CAGR in productivity from 2011-12 to 2014-15. Ofcom's Annual Monitoring Report 2014-15, Figure 7.3.

A5.141 In addition we consider that Royal Mail's use of this metric to measure efficiency means that it is relevant to our consideration. Specifically it enables us to understand Royal Mail's own view. Royal Mail has publically stated that it is targeting productivity improvements of 2-3% per annum over the medium term.[98]

A5.142 However, there may be limitations to the usefulness of this metric for our purposes in the future. The insight it provides on trends will be compromised if the weightings and assumptions are revised year on year, absent a restating of history. This updating of assumptions is likely to be required for operational purposes but could potentially cause difficulty in interpreting the data. Further we note there are some limitations in the derivation of the metric within the 2015 Business Plan; e.g.it does not include all frontline pipelines areas. There are also some inconsistencies in the data used, for example collections hours are included but collections workload is excluded.

A5.143 In summary, indicators of efficiency related to hours worked include gross hours and Royal Mail's productivity metric. Royal Mail is projecting greater efficiencies in its future productivity metric than its past performance over the last three years. [✂]. There may be limitations in our ability to use the productivity metric in the future to monitor Royal Mail's efficiency as our ability to do so relies on the metric being based on a consistent set of weights and assumptions to enable meaningful trends to be inferred.

Delivery Office Hours and Costs

Delivery Office Hours and Costs

A5.144 The frontline costs of delivery, as defined in Royal Mail's 2015 Business Plan [✂]. This equates to [✂] of the costs of the Reported Business.[99] This also includes some frontline costs of collections.

A5.145 Frontline delivery hours and cost projections from the 2015 Business Plan were compared with historical savings. The results are shown in the table below.

Figure A5.6: Frontline Delivery Hours and Costs

CAGR (%)	2011-12 to 2014-15	2015-16 to 2017-18
Total Frontline Hours	[✂]	[✂]
Frontline Hours excluding marginality	[✂]	[✂]
Frontline Real Costs	[✂]	[✂]
PVEO Analysis		
Price	[✂]	[✂]
Volume	[✂]	[✂]
Efficiency	[✂]	[✂]
Other	[✂]	[✂]

[98] Royal Mail, Direct Delivery Submission (Non-Confidential Version), 20 June 2014, page iv, http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission%20Final%20Version%20for%20Publication.pdf .
[99] Based on 2014-15 figures (actual).

A5.146 [✂].

A5.147 [✂].

A5.148 While the comparison of hours and costs with history provides a useful benchmark, we considered other methods, such as econometric analysis, also relevant to inform our judgement of whether the future efficiencies proposed by Royal Mail for the Reported Business represent a reasonable rate of improvement.

Delivery Office Econometric Analysis

A5.149 We commissioned Deloitte to conduct an econometric study to assess the relative efficiency of delivery offices. This is discussed in detail in the Deloitte report.[100]

A5.150 In brief, Deloitte used statistical methods to compare the performance of delivery offices on a like-for-like basis (i.e. taking into account external factors which might influence performance such as geography).

A5.151 Underlying Deloitte's analysis is an assumption that, at each point in time, there is a minimum cost at which any given operating unit can process and deliver any given volume of mail.[101] In the statistical model, this minimum cost profile is determined by the costs of Royal Mail's currently most-efficient operating units. We refer to the set of minimum costs, across all volume levels, as the "**efficient frontier**". The econometric analysis seeks to identify the efficient frontier. The difference between the *actual cost* incurred by a delivery office and the minimum cost is the "**catch up gap**".

A5.152 Over time, improvements in technology and processes create opportunities for greater efficiency, leading to a downward shift in the efficient frontier, called the "**frontier shift**", which Deloitte has also estimated.

A5.153 The econometric analysis identified that Royal Mail has recently improved its efficiency in gross hours. It estimates that average operational efficiency for delivery offices has improved on average by 1.9% per annum since 2010-11 (5.8% overall).

A5.154 However, despite these improvements, the econometric results show that there is a divergence of performance across delivery offices, as shown in the chart below. This shows a spread of relative efficiency (after controlling for external factors) of around 40%. (The most efficient delivery offices are shown on the right with an efficiency of 1.)

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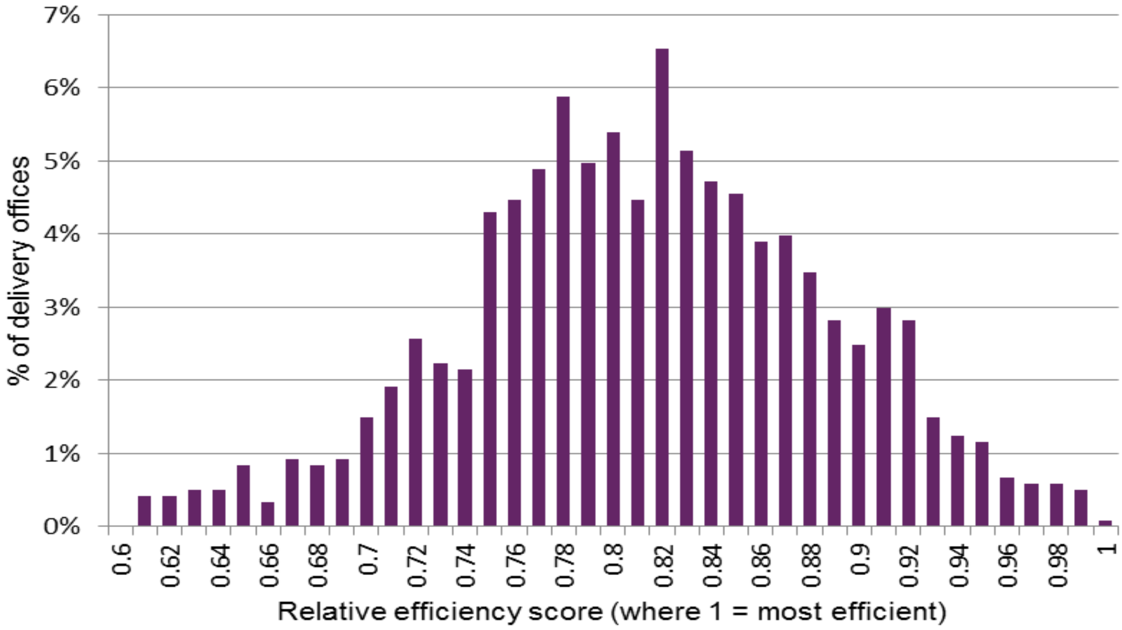
[100] Deloitte report, *Econometric benchmarking in the UK postal sector: Final report*, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-review/annexes/benchmarking-report.pdf.

[101] The analysis can be conducted using different measures of monetary cost (e.g. operating cost, total cost) or the resources used to produce the output (e.g. labour). Deloitte's analysis has been undertaken using both people cost and hours. However, in interpreting the results and incorporating them into our analysis, we focus largely on the results from the hours models, as these abstract from the inflationary pressures facing Royal Mail, which we assess separately. We consider it is more appropriate to assess the degree to which resources could be saved by Royal Mail by improving efficiency, rather than focusing on how it converts those resource savings into cost savings, which will require management judgement.

Figure 5.7: Relative Efficiencies of Delivery Offices



A5.155 Deloitte concluded that Royal Mail could achieve greater efficiencies by increasing the performance of some of its delivery offices to the level of efficiency currently achieved by better performing units, i.e. through catch up efficiency, and also by a continuation of the year on year improvements across delivery offices i.e. frontier shift.

A5.156 It is never possible to completely remove all error from econometric results. Therefore, rather than using the absolute efficient frontier estimated (based on the most efficient unit), it is more common to use a benchmark based on the upper decile or upper quartile. In the present case this means that we consider the most efficient delivery offices (the top 10% (decile) or the top 25% (quartile), and define the catch up gap of other delivery offices in comparison to the bottom of this most-efficient group.[102]

A5.157 There are arguments for using either the upper quartile or the upper decile as the benchmark against which to judge the efficiency of the Delivery Office network.

- The analysis benefits from a rich dataset, producing results which appear robust across different model specifications, which suggests using the upper decile may be reasonable.

- Against this, there are a number of factors which would suggest using a more conservative benchmark (i.e. the upper quartile). In particular, we highlight the following points:

[102] The upper quartile approach means the efficiency savings would be reasonable even if the efficiency frontier were 25% lower than Deloitte's estimates, whereas the upper decile approach means the efficiency savings would only be reasonable if the efficiency frontier was within 10% of Deloitte's estimates.

- There is a degree of overlap between catch up and frontier shift. The results for total possible efficiency may therefore include a degree of double-counting, which cannot be precisely quantified.
- While the model produces an estimate of the catch up gap, it cannot give a view as to how quickly this gap can be closed. This is therefore based on judgment.
- The speed with which modernisation initiatives translate into efficiency improvements has been assumed to be up to two years. If the 'true' time taken for efficiencies to be achieved differs from this, the remaining frontier shift achievable from completing modernisation may also differ.

A5.158 In incorporating the results of the econometric modelling into our overall assessment, we therefore consider both the upper quartile and upper decile as relevant benchmarks.

A5.159 If the relevant benchmark for estimating the catch-up opportunity is assumed to be represented by the upper decile or quartile of the efficient score distribution, the average[103] catch-up gaps (based on the gross hours model) are 5.0% and 9.8% to the upper quartile and decile respectively.[104] This means the average delivery office is between 5% and 10% less efficient than it could be at this point in time.

A5.160 To estimate frontier shift, estimated improvements in efficiency over the sample period (which period likely reflect benefits yielded from the implementation of Royal Mail's modernisation programme)[105] were used to extrapolate estimates of further scope for efficiencies from the full effect of modernisation feeding through to delivery office performance.[106] Deloitte estimated that 78% of the impact of modernisation had been realised at the end of the 2014-15 financial year. The remaining 22% impact of modernisation is expected to be fully realised within the next three years, which equates to a 1.6% frontier shift in total.[107]

A5.161 Taking into account both the potential for catch-up and the frontier shift which is estimated to be achievable from realising the benefits of Royal Mail's modernisation programme, the most conservative estimates presented by Deloitte suggest that Royal Mail could achieve total efficiency savings in delivery offices of 4.3% to 6.6% (with the upper quartile as the benchmark), which it is assumed could be realised over five years. If the upper decile is considered to be the appropriate benchmark, the efficiency savings achievable are estimated to be 6.3% to 11.5%.[108]

[103] This average includes delivery offices in the top decile / quartile.
[104] Deloitte report, pages 28-29. This is the result from the baseline model. The catch-up estimates found by the baseline specification remain largely robust to various sensitivities performed, although these sensitivities produced a range of results as reflected in the range presented for overall efficiency estimates below.
[105] Royal Mail's modernisation programme relates to the activities it has undertaken since 2008 to adapt its processes to serve the changing postal market more effectively. As part of this programme it has introduced automated walk sequencing, deployment of new delivery methods including trolleys and vans, improved office layouts and equipment for manual preparation, and extended delivery spans.
[106] Further details on the modernisation programme, Royal Mail's progress in delivering this and how we have used this to estimate frontier shift, is set out in Deloitte report – pages27-29 and 38-40.
[107] As above, this is based on the base line model estimate for historical frontier shift.
[108] Deloitte report, page 33.

A5.162 It should also be borne in mind that the analysis undertaken is purely an internal benchmarking approach, with the frontier reflecting Royal Mail's own best practice. The results do not reflect changes Royal Mail has not undertaken – either those it plans to adopt but has yet to start (such as new initiatives set out in its 2015 Business Plan), or those which other operators have chosen to pursue but which Royal Mail has not. Therefore, there may well be scope for efficiency gains beyond those captured by the results of this benchmarking exercise. Such potential efficiency gains have been assessed through the other sources of evidence analysed, such as the WIK report.

A5.163 The econometric analysis provides us with a way to quantify expected future delivery office efficiencies based on existing performance. Translating the analysis into an efficiency estimate requires an element of judgement, in particular to assess the speed of catch up and the 'efficient' level.

A5.164 In summary the potential future efficiencies in delivery offices range from 4.3% to 11.5% over five years. Taking into account the profile of efficiency gains set out in Table 6 in the Deloitte report which differ by year, the implied average annual hour efficiencies over the next three years is between 1% and 2.5%. These can be compared to the forecast hours reductions due to efficiency within the 2015 Business Plan. As shown in Figure A5.6 above, Royal Mail forecasts overall hours reductions in frontline delivery (i.e. delivery offices) to be [✂]. Removing forecast hours reductions due to volume to obtain the hours efficiency implies a figure of [✂].

Initiative Review and Comparison with International Benchmarks (WIK)

A5.165 We commissioned WIK to carry out a benchmarking exercise against a selection of six international postal operators[109] in order to compare their operations and efficiency initiatives with Royal Mail's.

A5.166 We believe it is useful to carry out international benchmarking to identify initiatives that have been implemented by other postal operators. WIK identified postal operators which it considered to be comparable to Royal Mail taking into account criteria including social, economic and geographic conditions.[110] We recognise that it is for postal operators to select and implement specific initiatives as they consider necessary.

A5.167 In recent years Royal Mail has introduced initiatives focusing on delivery. For example, it has invested in walk sequencing technology, investing in 574 machines[111] with the result that 82% of letters are now automatically sequenced to the delivery point.[112] It has introduced new delivery methods such as greater use of high capacity trolleys and shared vans for the delivery of parcels and letters by

[109] La Poste (France), Deutsche Post (Germany), USPS (USA), PostNL (Netherlands), PostNord Sweden and PostNord Denmark.
[110] Including, but not limited to, letter volume decline, threat of e-substitution, universal service requirements for European operators, and a business where the largest cost is staff cost. See Table 3-1 of the WIK report http://stakeholders.ofcom.org.uk/binaries/post/postal-efficiency/wik.pdf.
[111] See Royal Mail Prospectus, 2013, page 73, http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf.
[112] See Royal Mail, Annual Report and Financial Statements 2014-15, page 10, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.

postmen and women,[113] and has revised the composition and deployment of 59,000 walks.[114] Further they have completed “delivery office revisions” whereby the layout of delivery offices have been reviewed and updated to allow for more efficient operation.[115]

A5.168 We note that Royal Mail stated that it has “over 70 material initiatives” designed to reduce costs, optimise its networks, and streamline its processes; including “parcels tracking, collections on delivery, more delivery revisions, a focus on high impact units and management structures.”[116]

A5.169 In relation to delivery initiatives,[117] WIK’s view is that Royal Mail is not targeting enough cost savings in its frontline delivery operations, particularly given the importance of this section of its business,[118] and that the initiatives it has chosen for the 2015 Business Plan period are not as ambitious in scope as its international peers (see paragraph A5.171 below).

A5.170 WIK commented that Royal Mail could be more ambitious in reducing gross hours in the delivery side of its operations, adding that Royal Mail frontline employees spend less time proportionately on outdoor delivery (known as the delivery span[119]) than its international peers (Royal Mail’s delivery span is around 60% compared to 80% or above at the benchmarked international operators). Having a larger delivery span is beneficial because each employee can deliver more mail items on his/her route, which can also be a longer route (particularly when combined with a high proportion of sequenced mail), reducing the number of gross hours needed in delivery.

A5.171 WIK identified a number of initiatives not currently deployed by Royal Mail which have been put in place by one or more of the benchmarked international operators. These are set out below:

- Royal Mail’s “major challenge is to transform the benefits from increased automation into more efficiency in delivery”.[120] For example, a greater proportion of automated sequenced letters could allow Royal Mail to increase the delivery span of its staff, meaning it could move to fewer but longer delivery rounds and so reduce the hours required in delivery.

- In addition to the above, WIK considered that Royal Mail could consider separating the tasks of indoor and outdoor delivery and assigning them to separate employees (as opposed to having the same colleague sorting and then delivering mail). While this would be a big change to the current working practices of Royal Mail’s postmen/postwomen, in WIK’s view this would help Royal Mail to

[113] Royal Mail Prospectus, 2013, page 73.
[114] See Royal Mail’s response to the July 2015 Discussion Document, paragraph 1.32.
[115] Royal Mail Prospectus, 2013, page 73.
[116] See Royal Mail’s response to the July 2015 Discussion Document, paragraph 1.34.
[117] Royal Mail’s major delivery-focused initiatives in the 2015 Business Plan include Collections on Delivery, [✂].
[118] See WIK report, page 92.
[119] Delivery span means the proportion of daily worktime a full-time postman/postwoman is busy with delivery of mail (outdoor delivery).
[120] See WIK report, page 87.

maximise the working time of its employees by having fewer but longer delivery runs and all-day processing.[121]

- WIK considered that Royal Mail could move to a more innovative delivery model such as peak/off peak delivery days (PostNord Denmark, PostNL and Deutsche Post for example have mail flow control that allows them to concentrate mail volume on certain days).[122] While Royal Mail would still be required to provide a six-day service under the current Universal Postal Service Order and DUSP 1, it could incentivise postal users to use slower mail services (i.e. D+2 and later).

- WIK considered that Royal Mail could increase the centralisation of mail preparation by moving more of its letter sequencing machines into mail centres or mail processing units (MPUs), and using delivery offices as “pick-up points” instead (as done by PostNL).[123] Again, this would help Royal Mail maximise the value of the hours worked by its delivery staff.

- Finally, WIK considers that, while the agreements currently in place between Royal Mail and the respective unions “significantly limit Royal Mail’s ability to increase flexibility in its postal operations and its potential for additional cost savings”, Royal Mail could consider options to increase flexibility in working time, while still maintaining a full-time workforce.[124] For example, flex time schedules, flexible route re-designs at the local level, and outsourcing options are just some of the options used by international operators.[125] Furthermore, these flexible hour arrangements combined with peak/off-peak days could allow Royal Mail to better respond to mail volume variations.

Summary of Ofcom’s findings on efficiency in frontline delivery

A5.172 The findings of our review of the 2015 Business Plan relating to delivery frontline are summarised in the table below:

Comparator	2015 Business Plan
Historic Hours	• [✂]. • [✂].
Pay Rate	• [✂]. • [✂].
Historic Costs	• [✂]. • [✂].
Econometric	• [✂]. • The econometrics data does not take into account potential new initiatives.
Peer Benchmarking	• Efficiency initiatives beyond those currently deployed by Royal

121 See WIK report, pages 38.
122 See WIK report, pages 57 to 58.
123 See WIK report, pages 104 to 105.
124 See WIK report, pages 100 to 101.
125 See WIK report, page 101.

Mail have been adopted by its international peers.

- Further there are options available to Royal Mail to increase its flexibility and so be better able to respond to variation in volumes.

A5.173 [✂].

Processing Hours & Costs

Processing Hours and Costs

A5.174 The frontline costs of processing, as defined in Royal Mail's 2015 Business Plan, include a proportion of the frontline costs of collections as well as mail centre processing and regional logistics costs. In total these account for [✂] of the costs of the Reported Business.[126] As with delivery costs, these are largely driven by the pay rate (discussed above) and gross hours.

A5.175 Processing hours and cost projections from the 2015 Business Plan were compared with historical savings. The results are shown in the table below.

Figure A5.8: Frontline Processing Hours and Costs

CAGR (%)	2011-12 to 2014-15	2015-16 to 2017-18
Total Frontline Hours	[✂]	[✂]
Frontline hours excluding marginality	[✂]	[✂]
Frontline Real Costs	[✂]	[✂]
PVEO Analysis		
Price	[✂]	[✂]
Volume	[✂]	[✂]
Efficiency	[✂]	[✂]
Other	[✂]	[✂]

A5.176 [✂]. Consolidation of mail centres has resulted in the reduction from 69 centres in 2007/8 to 39 by 2014-15. Across the same time period hours have reduced by [✂], or, more recently, [✂] across the last three years.

A5.177 In the 2015 Business Plan, an additional two mail centres are assumed to be closed by 2016-17.[127] [✂].[128]

A5.178 [✂].

Frontline Mail Centre Econometric Analysis

A5.179 Deloitte also used econometric techniques to assess the efficiency of mail centre processing.

[126] Based on 2014-15 actual data.
[127] Royal Mail's Half Year 2015-16 Results, 19 November 2015, page 7.
[128] [✂].

A5.180 The econometric results showed that Royal Mail has improved its efficiency in gross hours. Reductions, which equated to approximately 2.9% per annum[129], were higher than those found in the delivery econometric work.

A5.181 In addition to the caveats set out at paragraph A5.156, we note the following points relating to the mail centre analysis in particular:

- There has been a significant degree of structural change which presents challenges to benchmarking analysis. We have focused on a shorter time period for the analysis to mitigate this, but as a result have a smaller time series and therefore a smaller sample.

- In addition, there are fewer mail centres than delivery offices, meaning we also have less cross-sectional data. Econometrics generally works better with larger samples, and so these factors induce a greater degree of uncertainty within the results compared to the delivery office analysis.

- Due to data availability, the mail centre analysis also uses proxies for mail centre geography in place of more direct variables such as the proportion of area covered that can be classed as rural.

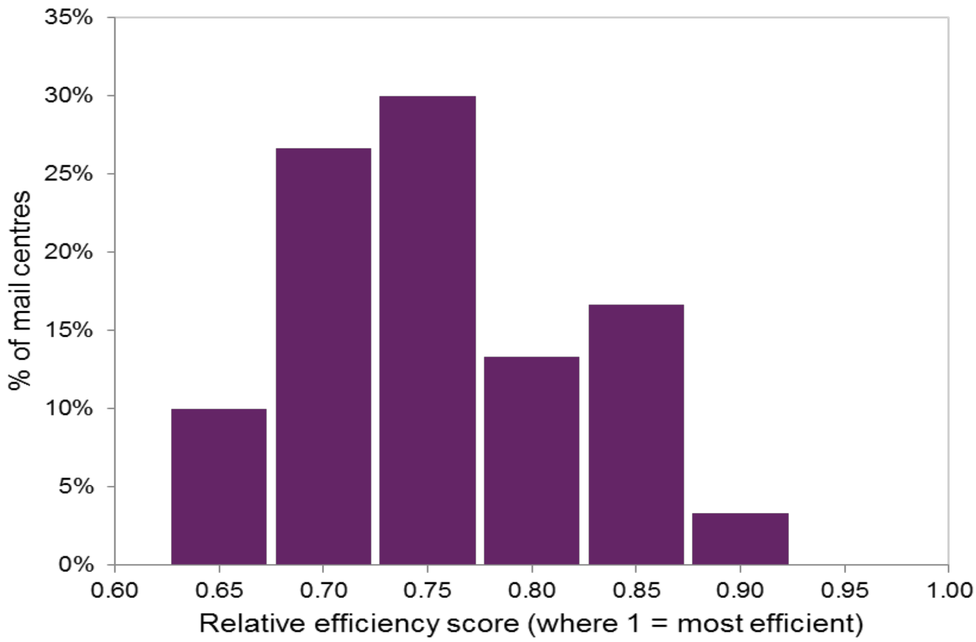
- Deloitte notes that the mail centre results found differ, to some extent, from prior hypotheses: differences in the level of efficiency were expected to be lower between mail centres given that modernisation started and completed earlier than delivery offices and that a larger part of their operations are automated. The relatively large catch-up estimates might reflect estimation error stemming from the small estimation sample and the structural changes that took place in the mail centre network. On the other hand, the estimates remain relatively robust to the additional specifications that were run.[130]

A5.182 The results showed variation in the relative efficiency across mail centres as illustrated in the diagram below.

[129] Deloitte report, page 4 – the estimated average operational efficiency of Royal Mail's Mail Centre network in terms of gross hours has improved by 8.8% over the last three years, approximately 2.9 per annum.

[130] Deloitte report, page 37.

Figure A5.9: Relative Efficiency of Royal Mail's mail centres



A5.183 Given the greater uncertainty in the results of the mail centre econometric analysis, we do not attach as much weight to the precise outputs of the model as we do for delivery offices. However, we consider the general order of magnitude of potential efficiency savings is sufficiently robust to indicate that there remains potential for Royal Mail to improve the efficiency of its mail centres, particularly by reducing the catch up gap between mail centres.[131] The results do not reflect changes Royal Mail has not undertaken – either those it plans to adopt but has yet to start (such as new initiatives set out in its 2015 Business Plan), or those which other operators have chosen to pursue but which Royal Mail has not. Therefore, it is credible that there is scope for efficiency gains beyond those captured by these results.

A5.184 In summary, due to data limitations we do not quantitatively compare the results of the econometric analysis with the projections in Royal Mail's plan. However we observe that the econometric analysis indicates that there remains potential for Royal Mail to improve the efficiency of its mail centre estate, in particular by reducing the variation in performance between mail centres.

Initiative Review and Comparison with International Benchmarks (WIK)

A5.185 As with frontline delivery, WIK considered both Royal Mail's on-going initiatives and those proposed in its 2015 Business Plan relating to frontline processing with those of Royal Mail's international peers.

A5.186 WIK recognised that Royal Mail has undertaken a large transformation process, notably in the rationalisation of its mail centre estate (a process which is still

[131] Deloitte report, page 33 gives a summary of the MC analysis and results. This is expanded upon in pages 35 to 41.

ongoing with two further mail centres set to close).[132] However, in relation to Royal Mail's plans over the 2015 Business Plan period, WIK also identified areas where Royal Mail could be more ambitious. In particular, WIK identified the following.

5.186.1 While Royal Mail has increased its automation levels to around 82% of letters,[133] it has not yet maximised the automation potential of its current machines to achieve similar levels of sequenced letters (some of its international peers have achieved over 90% letters as sequenced).[134] [✄].

5.186.2 Royal Mail said in May 2015 that it intends to introduce parcel sorters into around 20 of its busiest mail centres.[135] WIK considered that while this initiative will somewhat improve the efficiency of parcel processing at Royal Mail, the chosen parcel sorters are [✄][136].[137]

A5.187 WIK suggested some areas for improvements in future [✄].

5.187.1 In the short-term, WIK suggested that Royal Mail could reconsider the way it deals with the bundling of unaddressed items. While the combining of the two sets of items always occurs at some point, Royal Mail could consider where in the chain is more efficient for its business. Currently Royal Mail employees bundle the unaddressed items with their sequenced items at the frame. WIK noted that international operators tend to keep them separate up until the delivery point. WIK also noted that, if items were kept in their separate bundles up to the delivery point, this would mean that automated sequencing of addressed items could take place (as it does in Denmark and Sweden)[138] which may be a further source of efficiency.

5.187.2 Longer term, WIK suggested that Royal Mail could consider moving to a more centralised processing structure by moving its sequencing machines from its delivery offices to its mail centres or MPUs. Machines could then be more efficiently used over longer periods for different tasks, and the specialised maintenance and operating staff could be concentrated to fewer locations.[139]

Summary of Ofcom's findings on efficiency in frontline processing

A5.188 The findings of our review of the 2015 Business Plan relating to frontline processing are summarised in the table below.

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[132] See Royal Mail's Half Year 2015-16 Results, 19 November 2015, page 7, http://www.royalmailgroup.com/sites/default/files/H1%202015-16%20Results%20Presentation%20-%20FINAL%20[WEBSITE]_0.pdf.

[133] See Royal Mail's Annual Report and Financial Statements 2014-15, page 10 http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.

[134] See WIK report page 102.

[135] See Royal Mail, Full Year 2014-15 Results Presentation, 21 May 2015 (http://www.royalmailgroup.com/sites/default/files/FY%202014-15%20Results%20Presentation.pdf).

[136] Datalogic will be providing Royal Mail's parcel sorters. See http://www.datalogic.com/eng/media-center/news/datalogic-selected-by-royal-mail-to-implement-new-parcel-sorting-systems-in-uk-mail-centres-nd-4093.html.

[137] See WIK report pages 16-17.

[138] See WIK report page 103.

[139] See WIK report page 104.

Figure A5.10: Summary of findings in frontline processing

Comparator	2015 Business Plan
Historic Hours	• [✂]. • [✂].
Pay Rate	• [✂]. • [✂].
Historic Costs	• [✂]. • [✂].
Econometric	• The econometrics data indicated that there is potential to improve the efficiency of mail centres. This analysis does not take into account potential new initiatives that could be undertaken.
Peer Benchmarking	• Additional areas for efficiency beyond those currently deployed by Royal Mail have been adopted by its international peers.

A5.189 [✂].

Transformation Costs

A5.190 Royal Mail began its transformation program in 2008, implementing a range of initiatives and programmes to streamline its operating and staff costs. Historically (2012-13 to 2014-15), the Reported Business incurred about £[✂] in transformation costs[140] and is forecast to spend £[✂] from 2015-16 to 2017-18.

A5.191 As stated earlier, when undertaking our efficiency assessment of Royal Mail's Reported Business, we exclude transformation costs from our historic and forecast analysis. In doing so we estimate Royal Mail's cost savings related to its day-to-day expenditure in running its business. Therefore, including transformation costs would distort our assessment of efficiency in Royal Mail's business operations (i.e. day-to-day activities) as such costs are sunk and do not represent Royal Mail's true operating cost base. Furthermore, it is difficult to align benefits accrued from expenditure on transformation projects due to the spill over of cost savings from Royal Mail's transformation projects across multiple years (i.e. flow-through savings). However, it is important to understand how Royal Mail achieves cost savings as a result of its transformation programme.

A5.192 We do not consider Royal Mail's transformation costs in detail; our main objective is to understand what cost savings are achieved by Royal Mail and how it plans on streamlining its current cost base. We will, however, continue to monitor the cost incurred in implementing efficiency savings as part of our overall view of Royal Mail's efficiency programme.

[140] See Royal Mail's Regulatory Financial Statements, 2012-13 to 2014-15, available at: http://www.royalmailgroup.com/about-us/regulation/regulatory-financial-statements.

Other considerations affecting Royal Mail's efficiency potential

A5.193 Despite the potential for further efficiency improvement, we consider there are a number of factors that might limit Royal Mail's ability to realise significant efficiency gains in the short term.

A5.194 Royal Mail's current labour agreement expired in March 2016 and it is currently in negotiations with its staff over a new labour agreement. [✂].

A5.195 In addition, as discussed earlier in this section, when Royal Mail's existing pension agreement expires it is possible that it could face significantly greater pension costs. We note that the CWU has indicated it will resist "any attempt by [Royal Mail] to close the defined benefit pension scheme" and that it will seek to "secure a better pension settlement for those in the current defined contribution scheme."[141] While we would not expect Royal Mail to agree to a future level of contribution that would be unaffordable, we recognise that the outcome of its pension reform may have some bearing on its ability to agree additional efficiency initiatives.

A5.196 If Royal Mail is to successfully implement some of the cost saving initiatives adopted by its international peers but not included in its 2015 Business Plan, it is likely that it will need a greater degree of workforce flexibility. WIK identified that while Royal Mail has recently improved its relationship with its unions, some other international postal operators have been more successful at managing the relationships with their employees and unions and, at the same time, agreeing higher levels of efficiency and cost flexibility. We recognise that for Royal Mail to reduce costs it will need to move forward on a number of fronts simultaneously which may be challenging while maintaining stable industrial relations.

Monitoring Efficiency

A5.197 An important part of our regulatory regime is our monitoring of Royal Mail's performance, including the efficiency of the Reported Business.

A5.198 We currently require Royal Mail to provide monthly volume and revenue reports, operational volume reports and monthly management information packs which provides detail on costs, efficiency initiatives and Royal Mail's own efficiency estimates. We use this information to inform our management and board of Royal Mail's progress on efficiency as well as producing a non-confidential Annual Monitoring Report which is published on our website.[142]

A5.199 We have used a series of metrics in this report to inform our view of Royal Mail's efficiency. These include consideration of the total real costs of the Reported Business as well as the movements separated out using PVEO analysis. We also looked at a more granular level at total hours for frontline delivery and frontline processing and pay rates. We also considered Royal Mail's initiatives.

A5.200 We intend to continue to use these metrics for our own ongoing internal review. We also intend to work with Royal Mail to better understand the effectiveness of its initiatives including the identification of metrics, in addition to hours, which may give

[141] See CWU website, *CWU 'drive for 35'*, 24 March 2016, http://www.cwu.org/media/news/2016/march/24/cwu-drive-for-35/.
[142] Ofcom, Annual Monitoring Report http://stakeholders.ofcom.org.uk/post/monitoring_reports/monitoring-report-14-15/.

greater insight into the progress on key initiatives. We expect that insight at this level will be confidential and so will not form part of our annual monitoring report but will be an important component of our internal review.

A5.201 We intend to continue to publish our PVEO analysis of the Reported Business costs in our Annual Monitoring Report. We also intend to publish the annual changes in hours of frontline staff, costs per FTE (Full Time Equivalent i.e. the number of employees calculated relative to an employee working on a full time basis) and revenue per FTE. We will continue to consider further metrics which might provide the market with insight on an ongoing basis. We will consider the ongoing use of Royal Mail's productivity metric, dependent on our ability to apply it to provide a consistent trend.

A5.202 In 2013-14 and 2014-15 we included a metric of real unit costs (or RUOE) in the Annual Monitoring Report. RUOE was calculated as real operating costs divided by Royal Mail's workload metric. Workload was adopted as a measure of volume because it provided a volume measure which was viewed to control for mix and volume decline. If RUOE is calculated without controlling for these effects, it could be concluded that unit costs have increased due to inefficiency when in reality it could have been driven by either a decline in volumes or a change to a more costly mix of products.

A5.203 There are limitations to adopting workload to calculate RUOE; it is based on a subset of volumes specific to operations in delivery and processing only. Hence it does not provide a volume measure which is reflective of either the overall cost base or of overall revenue generation. In comparison, PVEO applies workload to costs that are more closely aligned to the volumetric and hence we consider this to be more cost reflective. We do not intend to continue to use RUOE as defined above in our monitoring report.

A5.204 We will continue to conduct monitoring of Royal Mail's efficiencies and intend to work with Royal Mail to get better insight into the effectiveness of its initiatives to understand how they have been translated into real cost savings. We further intend to continue to publish our view of the efficiency of Royal Mail within the Annual Monitoring Report, which will include in that our conclusions and outputs of our PVEO analysis of the Reported Business costs, changes in hours and the comparator trends of revenue and costs per FTE.

Conclusion

A5.205 Royal Mail's proposed efficiency initiatives and levels of cost reduction appear to be reasonable. However we consider them to be at the lower end of a reasonable range for improvement. While its future plans demonstrate greater ambition than recent historic achievements, our analysis indicates that there remains potential for Royal Mail to make greater efficiency gains than those forecast in its 2015 Business Plan.

A5.206 Royal Mail has recently been engaged in a transformation programme which has resulted in a significant reduction in its number of mail centres and the modernisation of its delivery offices. In addition, greater automation has also been introduced.

A5.207 We reviewed forecast efficiencies versus recent historical achievement using a series of different metrics. We observed that the forecasts reductions are greater than history across a combination of metrics. [✂]. This suggested that Royal Mail's plans are more challenging than recent achievements.

A5.208 We also compared Royal Mail's own performance across its delivery offices and mail centres. From the econometric analysis of these areas we found that there is scope for further efficiencies. This analysis is based on their current operations and does not include the potential for new initiatives. [✂].

A5.209 WIK's review of the 2015 Business Plan and its initiatives against Royal Mail's international peers shows that there are more initiatives that could be undertaken to achieve further efficiency improvements. Further Royal Mail's peers have sought to increase flexibility in working practices.

A5.210 We considered Royal Mail's own statements and those of analysts which also highlighted the potential for greater efficiencies.

A5.211 We used our judgement to conclude, based on all this evidence, that Royal Mail's 2015 Business Plan includes efficiency projections which are reasonable but that there is the potential for greater efficiencies. In reaching our conclusions we also took into account the challenges faced by Royal Mail. These include responding to a declining letters market, the difficulties in predicting volumes, the importance of stable industrial relations, and the requirement to renegotiate a pay deal and pension agreement.

A5.212 We observed the importance of flexibility, in particular due to the unpredictability of volume movements both in letters and parcels.

A5.213 Stakeholders proposed various measures to incentivise efficiency including charge controls and setting a target using a metric. Given that we consider Royal Mail's planned efficiencies to be reasonable, we do not propose to introduce new measures to incentivise efficiency. We discuss this, including our proposed approach to charge controls, in detail in Section 4 of this consultation.

A5.214 However, we propose to continue to require Royal Mail to provide information relating to its efficiency and to monitor Royal Mail's performance. We consider the levels of efficiency set out in Royal Mail's 2015 plan to be at the lower end of a reasonable range and will monitor its performance against this benchmark. We propose to continue to use a broad suite of metrics and information to inform our view of Royal Mail's efficiency and will continue to publish the results of our analysis in our Annual Monitoring Report.

Annex 6

Financial Sustainability

Introduction

A6.1 Our primary duty under the PSA 2011 is to carry out our functions in relation to postal services in a way that we consider will secure the provision of the universal postal service. In performing that duty, we must have regard to the need for the provision of the universal postal service to be financially sustainable and efficient, including the need for a reasonable commercial rate of return for any universal postal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.

A6.2 In light of our primary duty, we must have an understanding of Royal Mail's historical and forecast financial results and position to allow us to assess the financial sustainability of the provision of the universal postal service. Consideration of the commercial rate of return is a key part of our assessment of the financial sustainability of the provision of the universal service.

A6.3 In this annex, we review whether the approach we have adopted since the March 2012 Statement to assessing the financial sustainability of the universal postal service remains appropriate. We explain why we consider that this approach remains broadly appropriate, and why we intend to supplement it with the inclusion of a review of further financial health metrics that will ensure that our approach to that assessment remains as effective as possible.

Background

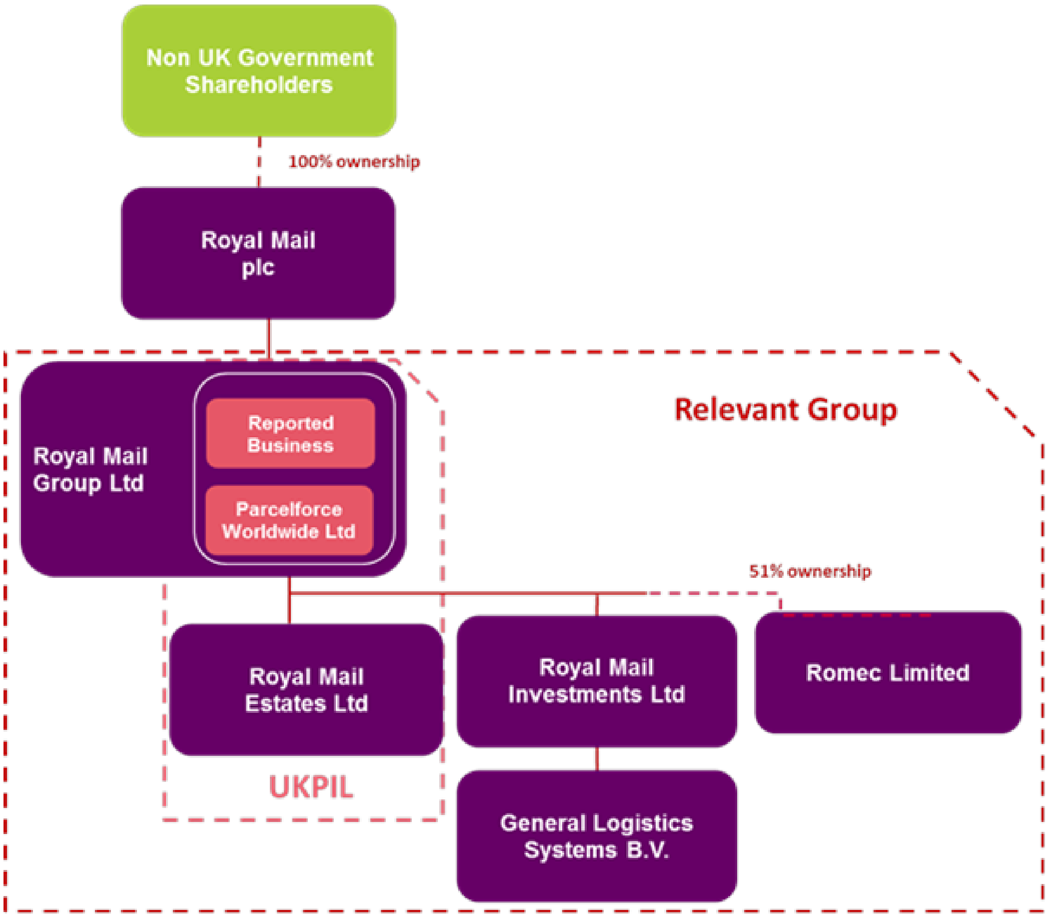
A6.4 We need to be able to assess the financial sustainability of the provision of the universal postal service:

- on an ongoing basis, as part of our monitoring regime;
- if we need to assess the impact of any changes we may propose to the regulatory framework on the financial sustainability of the universal postal service; and
- if we need to assess the impact of changes in the competitive environment on the financial sustainability of the universal postal service.

A6.5 In March 2012, we decided that the activities undertaken for the purpose of, or in connection with, the provision of the universal postal service define the appropriate boundaries of the business relevant to our duty in relation to financial sustainability. As a result, we decided that our financial sustainability assessment would involve considering both the Reported Business and the Relevant Group.

A6.6 The Reported Business is the regulatory entity which contains the universal postal service network and all the products provided through or in relation to that network.[143] Royal Mail PLC holds a group of companies, including Royal Mail Group Limited (Royal Mail). The Reported Business is contained within Royal Mail as part of the UKPIL business unit.[144] We refer to Royal Mail PLC and the group of companies it holds collectively as the Relevant Group.[145] The figure below shows the Royal Mail company structure.

Figure A6.1: Royal Mail company structure



[143] As per the USP Accounting Condition: "Reported Business" means the part of Royal Mail's business that undertakes activities for the purpose of, or in connection with, the provision of USO and non-USO (including, but not limited to, non-Mails), the fully allocated costs of which are derived by the National Costing Methodology and Zonal Costing Methodology as described in the Costing Manual. For the avoidance of doubt, those activities shall be treated to include all the activities, products and/or services which fall within the scope of the Costing Manual from time to time. The reference to fully allocated costs is a reference to a costing methodology in which all costs are allocated to the outputs of the business." http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex1.pdf, Paragraph 1.1.2(w).

[144] UKPIL is a business unit - not a legal entity - within Royal Mail, which comprises the Reported Business, Parcelforce Worldwide, and Royal Mail Estates Limited.

[145] The 2014-15 revenues for the Reported Business and the Relevant Group were £7.327m and £9,328m respectively, http://www.royalmailgroup.com/sites/default/files/Regulatory%20financial%20statements%202014-15%20-%2011.12.15_0.pdf.

A6.7 In our March 2012 Statement,[146] we concluded that an indicative Earnings Before Interest and Tax (EBIT) margin (as a percentage of total revenues) for the Reported Business in the range of 5-10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return "commensurate with the level of risk within the business". We explained that, to calculate the EBIT margin, we include recurring restructuring and redundancy costs[147] (included under the heading of 'Transformation costs' in Royal Mail's annual reports).

A6.8 In our 2014 End-to-end Statement, we explained that we also considered it appropriate to adjust the EBIT margin to restate pension costs on a cash basis (i.e. at the rate the contributions are actually paid which currently stands at 17.1%), rather than the rate which is based on the accounting standards because the cash rate gives a better view of the true cost of pensions.[148] We refer to our particular measure of EBIT margin, which we use for our financial sustainability assessments, as the 'financeability EBIT margin'.

A6.9 In addition to monitoring the EBIT margin, we also decided in March 2012 to consider financial metrics and data relating to the Relevant Group. These metrics and data included a consolidated income statement, balance sheet, and cash flow statement, as well as cash flow projections (all of which we require Royal Mail to provide under the Universal Service Provider's Accounting Condition (USPAC)).

A6.10 Our reason for considering financial performance and position at the level of the Relevant Group was that this is the level at which the company manages its cash and makes investment decisions. Shareholders, investors and analysts also consider Royal Mail's financial health at this level.

A6.11 Our March 2012 Statement set out our decision to use the EBIT margin rather than a measure based on return on assets (ROA), which is often used by regulators in assessing returns.[149] This decision was based on the following reasons:

- The EBIT margin is more relevant than ROA, because (i) Royal Mail's universal postal service network is labour-intensive, i.e. it is largely based on people; and (ii) its operating costs are significantly higher than the value of its assets.
- The EBIT margin was an appropriate proxy for operating cash generation, as the operating cash flow and EBIT became broadly comparable in the most recent Royal Mail business plan submitted.

A6.12 In our March 2012 Statement we also concluded that evidence from a review of returns of a range of comparator companies, and the views of financial market

[146] See http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf, paragraph 5.47.
[147] 'Securing the Universal Postal Service, Decision on the new regulatory framework', 27 March 2012, page 50, footnote 69, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf.
[148] Ofcom's 2014 End-to-end Statement, 'Review of end-to-end competition in the postal sector', 2 December 2014, pages 14-15, http://stakeholders.ofcom.org.uk/binaries/post/end-to-end-statement/end-to-end.pdf.
[149] The EBIT margin approach is a variant of return on sales (ROS) which equates the rate of return to some measure of profit divided by total sales. The ROA metric is calculated by dividing earnings by asset base, presented in percentage terms. To the extent that the asset base is equivalent to the capital employed in the business (equity and debt), the ROA would also be a metric for the return on capital employed (ROCE).

stakeholders, indicated that a 5% to 10% EBIT margin would be consistent with a reasonable commercial rate of return.

A6.13 Since the March 2012 Statement, Royal Mail has been privatised and its position in the parcels market has been affected by intensified competition. In light of these and other changes explained in Section 2, we stated in our July 2015 Discussion Document that we would review whether our current approach to the assessment of financial sustainability continues to most effectively fulfil our duty to have regard to the financial sustainability of the universal postal service.

July 2015 Discussion Document responses

A6.14 Royal Mail was the only stakeholder that directly addressed our review of our approach to assessing the financial sustainability of the universal postal service.[150] FTI Consulting was commissioned by Royal Mail to provide advice on how the financial sustainability of the universal service provider, Royal Mail, should be considered as part of the Royal Mail response.[151] We outline the main arguments put forward below:

- Making significant changes to Ofcom's present financial sustainability framework, e.g. to a ROA approach, could create uncertainty for debt and equity investors and could hinder Royal Mail's ability to ensure access to capital at reasonable cost, which would consequently adversely affect its ability to maintain the financial sustainability of the universal service network.

- Ofcom's approach of using the EBIT margin metric is appropriate and should be retained, but we should also monitor EBIT margin at Relevant Group level and not solely at the level of the Reported Business.

- The current approach should be 'refined' by complementing it with the adoption of additional financial metrics which are generally used by lenders, credit rating agencies and other regulators to assess financial risk (e.g. Debt/EBITDA), and those metrics that Royal Mail monitors to assess whether it is providing 'sufficient' return to equity investors (e.g. Dividend Cover).

- Royal Mail is in the process of developing a 'Viability Statement' which will be included in its Annual Report, the content of which would form an appropriate basis for discussion with Ofcom on financial sustainability. This 'Viability Statement' will consider the business and its risks over a future period of at least twelve months, and it is anticipated that it may include the financial metrics used to assess financial risk referred to above.

- While the EBIT margin provides an important measure of financial performance and therefore financial sustainability, Royal Mail's ability to achieve an investment grade credit rating and a reasonable rate of return for equity investors should be pre-requisites for assessment of financial sustainability.

[150] See Royal Mail's response to the July 2015 Discussion Document, Chapter 6, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail.pdf.

[151] 'Financial Sustainability of the USO, FTI Consulting response to the Fundamental Regulatory Review', FTI Consulting, September 2015: http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail_FTI_report_on_financial_sustainability_of_the_USO.pdf.

- Royal Mail stated that the 5-10% EBIT margin range is at the lower end of the appropriate range, and proposed that the range should be moved up.

A6.15 In the remainder of this annex, we consider whether EBIT margin continues to be the most appropriate metric for assessing the commercial rate of return, and whether the 5-10% range remains an appropriate range for EBIT margin as a reasonable commercial rate of return. We also consider whether there are further data and metrics we should consider in light of the further financial information that has been available since the privatisation of Royal Mail.

The metric for commercial rate of return

A6.16 To assist us in our consideration of the most appropriate metric for assessing the commercial rate of return, we commissioned CEPA,[152] an economic consultancy, to consider both the relative merits of alternative measures of commercial rate of return, and what other metrics, if any, could be used to identify threats to a company like Royal Mail's short to medium-term financial sustainability. We have published CEPA's report.[153]

A6.17 CEPA's findings can be summarised as:

- There are advantages to a ROS approach (such as the EBIT margin) for our assessment of a reasonable commercial rate of return of the universal postal service. It is simple, easily identifiable and objectively measurable – which is not necessarily the case if Ofcom were to adopt an asset-based measure.

- On the basis of developments since March 2012, there is relatively little that might undermine the case for continuing to use an ROS metric as part of a monitoring regime. Other regulators also draw on ROS measures as part of both monitoring regimes and price controls in the regulation of asset-light business such as Royal Mail's.

- Ofcom's focus to date has been on the EBIT margin approach, owing to several concerns that were raised about the application of an ROA approach for a postal company. Most of these concerns could, in the future, at least be partly addressed. The information required to determine an ROA benchmark for Royal Mail is now broadly available but challenges remain.

- Two significant challenges that remain in Ofcom's use of a ROA approach for its assessment of the financial sustainability of the universal postal service are – i) valuing intangible assets, and ii) disaggregating the value of the assets and allocating them across the different areas of the business, where only part of the business (the universal postal service) is the subject of the assessment.

- Having more than one metric that captures different aspects of the commercial rate of return and which are accepted by the market as complements, would seem to be appropriate. This would argue for Ofcom to consider both the EBIT margin (ROS) and ROA. However, the viability and usefulness of adopting a ROA, and at what level it could be applied, would be dependent on whether a credible mechanism could be found to solve the challenges of asset valuation and allocation.

[152] Cambridge Economic Policy Associates Ltd.
[153] 'Relevance of Margin Based Approach' Cambridge Economic Policy Associates, November 2015.

Our assessment

A6.18 When considering the most appropriate metric for assessing the commercial rate of return, we have had regard to the principles of consistency, objectivity, practicability, proportionality and best regulatory practice. As explained above, we must have regard to the need for a universal postal service provider to earn a commercial rate of return, and the Reported Business is the regulatory entity we currently use to inform our assessment in this regard; the metric we adopt should therefore be appropriate to be applied to the Reported Business. We recognise that any benefits that could be gained by changing our current approach should be weighed against the benefits to the postal market of maintaining a consistent approach, and avoiding the imposition of unnecessary regulatory burdens on the universal service provider.

A6.19 Below we consider the case for using Return on Assets; then we consider the case for using a measure based on EBIT.

Return on Assets

A6.20 As set out above, CEPA suggested that we should consider using a ROA approach as a complementary approach to EBIT margin, providing further work on the definition of assets shows the results are sufficiently robust.

A6.21 The ROA approach has been used by most economic regulators in the UK for assessing profitability, and it has been the most commonly adopted methodology adopted by European postal regulators. It has a strong theoretical underpinning and is well understood by regulated companies and investors.

A6.22 However, there is precedent for regulatory bodies viewing a ROA approach as less appropriate for the regulation of asset-light businesses such as the Reported Business. Examples of the use by UK regulatory bodies of a ROS approach include:

- Ofwat's decision to include an allowance for returns based on a retail net profit margin in its 2015-20 retail price controls for household water. Ofwat justified this approach with reference to the asset-light nature of retail water supply, noting that "*retail activities and services are unlikely to require significant capital investment*".[154] It also used EBIT margin as the basis for its calculations.

- The decision of the Northern Ireland Authority for Utility Regulation (NIAUR) to adopt a ROS approach in its 2014 Power NI energy supply price control. This was consistent with its previous decisions, which had been justified on the basis that a supply business is not asset-focused.

A6.23 As noted above, a majority of European postal regulators that use a rate of return approach adopt a ROA metric with the consensus being that the ROA has a stronger theoretical foundation. However, it is recognised by the European Regulators Group for Postal Services (ERGP), an organisation that comprises National Regulatory Authorities (NRAs) from EU countries, that there are two key

[154] 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', Ofwat, 2013.

drawbacks to its applicability to postal regulation.[155] The first of these is the labour-intensive and asset-light nature of postal service operators, and the second is that many are not listed on stock exchanges, which makes it difficult to accurately estimate an appropriate WACC to apply.

A6.24 We also note that some of the NRAs that use a ROA approach are currently in the process of reviewing their approach or have recently changed approach. For example, BNetza, the German regulator, has recently moved to use an EBIT margin approach for its next price control.

A6.25 The use of a ROA approach requires valuing the Regulatory Asset Base (RAB) and calculating a Weighted Average Cost of Capital (WACC) as the benchmark for the return. Share price information is often used to inform the WACC,[156] and a market capitalisation valuation can facilitate the valuation of a RAB. Neither of these key components were available at March 2012, because Royal Mail's shares were held by the Government. Since the March 2012 Statement Royal Mail has been privatised and this information is now available. However, as explained below, our work on the potential methods of valuing the RAB suggest there are several difficulties in developing a robust RAB for the Reported Business.

A6.26 One of the challenges of the ROA approach is the fact that the market data that would help inform the valuation of the RAB and the WACC is related to Royal Mail PLC, i.e. the company that is listed on the London Stock Exchange. Market data specific to the Reported Business is not available.

A6.1 The application of the ROA approach to the Reported Business would therefore require (i) the development of a standalone RAB for the Reported Business distinct from the capital base of Royal Mail PLC; and (ii) an assessment of the WACC applicable to the Reported Business. These two tasks involve challenges as we discuss further below.

Calculating the RAB

A6.27 There remain challenges in robustly estimating a RAB due to the 'asset-light' nature of the Reported Business. In contrast to the majority of regulated infrastructure companies which are reliant on physical assets (including network assets such as wires, duct, pipes or track), Royal Mail and the Reported Business are people-intensive businesses that employ a modest amount of physical capital in relation to their total costs and revenues.

A6.28 The two principal difficulties involved in establishing a RAB for the Reported Business are i) estimating a robust valuation of the assets of the Relevant Group and ii) allocating a proportion of these to the Reported Business.

A6.29 Reasons why it is difficult to derive a robust valuation of the assets include:

- Using a standard accounting balance sheet approach to determine the value of the assets of the Relevant Group is likely to underestimate the true 'capital' base which Royal Mail has invested in and on which it earns its returns. Our top-level

[155] 'ERGP report on specific issues related to cost allocation', ERGP, November 2013, http://ec.europa.eu/growth/sectors/postal-services/ergp/index_en.htm.
[156] For example, share price returns are typically used to estimate the equity beta in order to calculate the cost of equity.

estimates have shown that the net asset value of the business using the accounting valuation falls significantly below an estimate of its enterprise value.[157] We have also estimated a value for the tangible assets of the business under the replacement cost methodology, an approach that values assets based on their ‘current cost’.[158] This value also falls significantly beneath the market capitalisation values.

- As above, a comparison between the book value of Royal Mail PLC and the enterprise value strongly suggests that there could be a significant amount of ‘intangible’ economic asset value that is not recognised under the accounting criteria for recognition of assets. In a company such as Royal Mail, the type of intangible assets in which investment has been made but has not been recognised in the statutory accounts could include, for example, the investment in staff training on developing improved delivery and processing operations, or the investment in developing the brand value of the business. A range of techniques could be used to form a value for these ‘intangible’ assets but there is judgement inherent in each approach that would need to be carefully considered when considering the efficacy of each.

- A RAB based on the enterprise value of Royal Mail PLC might capture the value of the intangible assets of the business. However, the value ascribed by investors in the share price reflects their view of the future returns the business will make, and doesn’t represent the capital base from which those returns are generated.

- A discounted cash flow approach using Royal Mail’s business plan projections also has the potential to provide a valuation that includes a capitalisation of the intangible assets of the business, but there are key features of the approach that could limit its effectiveness. For example, the assumptions that would need to be decided under this approach would include the growth assumptions for the cash flows and the most appropriate cash flows to project forward.

A6.30 It would also be necessary to apportion a value to the Reported Business. Some of the valuation methodologies discussed would require a method of apportionment to the assets or asset classes of the Relevant Group before an allocation to the Reported Business is made. In addition to this, while some of the assets and liabilities are likely to be easily identified as solely used or driven by the Reported Business, a proportion of the Relevant Group assets and borrowing facilities will be utilised by more than one of its business units which would necessitate a meaningful framework for apportionment across the business units to be decided on.

Calculating the WACC

A6.31 A ROA approach would also require an estimate of the WACC for the Reported Business. Deriving a WACC for Royal Mail plc has arguably become easier since its

[157] Market capitalisation plus debt.

[158] Current cost is the lower of the current replacement cost or the recoverable amount. The replacement cost is derived from either the asset’s gross replacement cost i.e. the current purchase price of an identical asset or the cost of a modern equivalent asset with the same service potential. The recoverable amount is the higher of the net realisable value. i.e. likely value if sold at arms’ length or the economic value i.e. the net present value (NPV) of future cash flows from the asset.

privatisation in 2013 because of the availability of market data.[159] However, the Royal Mail PLC WACC would represent the return required by investors to invest in the Relevant Group as a whole, while we would be interested in the WACC for the Reported Business. We would therefore need to assess the extent to which Royal Mail PLC's WACC was applicable to the Reported Business. This assessment would need to consider whether i) the systematic risk of the Reported Business was likely to be higher or lower than that faced by the Relevant Group and ii) if so, whether evidence was available that could measure that difference in risk in order to estimate costs of equity and debt specific to the Reported Business.[160]

EBIT Margin

A6.32 The EBIT margin is a widely used measure of profitability and is used by companies, investors, analysts and other stakeholders as a measure for comparing performance across companies and company performance across time.

A6.33 In our October 2011 consultation, we proposed the adoption of EBIT margin as the appropriate measure of the commercial rate of return. Most stakeholders who responded on the issue supported our proposal.

A6.34 We adopted the EBIT margin approach in March 2012 and it has shown itself to be an effective metric for assessing the commercial rate of return and financial sustainability of the Reported Business. Our application of the EBIT margin approach since March 2012 has indicated no evidence to warrant concern about the fitness for purpose of the EBIT margin approach.

A6.35 Royal Mail said, in its response to the July 2015 Discussion Document, that the use of EBIT margin as a measure of the commercial rate of return should be retained as it continues to represent the most appropriate measure of the reasonable commercial rate of return for the asset-light Reported Business.[161]

A6.36 We agree with Royal Mail that we should not make 'unnecessary' regulatory changes and note its concern of the risk that a significant change to our approach could increase uncertainty and perceived business risk, and could lead to higher financing costs.

A6.37 EBIT margin can be easily identified for the Reported Business because we require Royal Mail to prepare regulatory accounts for the Reported Business. The setting of the EBIT margin benchmark requires us to select appropriate comparators and business units of the comparators that have characteristics that appropriately reflect those of the Reported Business. While there is some judgement in how you decide on appropriate comparators, it is practicable because most universal postal service providers prepare detailed annual reports that include business segmentation

[159] For example share price returns could be used to inform the equity beta when calculating the cost of equity and the rate of interest on Royal Mail's listed debt could be used to inform the cost of debt.
[160] We would also need to consider the proportion of the economic value of the Relevant Group is represented by the Reported Business if we wanted to adopt a disaggregation approach to the WACC similar to that which we use for BT.
[161] See Chapter 6 of Royal Mail's response to the July 2015 Discussion Document: http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail.pdf and 'Financial Sustainability of the USO, FTI Consulting response to the Fundamental Regulatory Review', FTI Consulting, September 2015: http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail_FTI_report_on_financial_sustainability_of_the_USO.pdf.

disclosures. However, as we outline above, a ROA approach would also require judgement when determining the appropriate RAB and WACC.

A6.38 We have considered Royal Mail's submission that we should also monitor the EBIT margin of the Relevant Group in addition to that of the Reported Business. Applying an EBIT margin assessment to the Relevant Group would reflect the performance of the Reported Business but also include GLS, Parcelforce and other activities that do not use the universal postal service network. As the Relevant Group's financial solvency will directly impact on its ability to fund the operation of the universal postal service we recognise that we should review its financial position, but we consider that there are other metrics than EBIT margin (which we discuss below at paragraphs A6.56) that better assess the Relevant Group's financial sustainability.

A6.39 Our experience to date in applying the EBIT margin metric suggests that this is a practicable metric for assessing the commercial rate of return for the Reported Business that requires a proportionate amount of resource from Royal Mail and Ofcom as part of our monitoring. Royal Mail has provided regulatory accounts for the Reported Business since 2012 which include its revenue and profit and EBIT margin.

Our intention for the commercial rate of return metric

A6.40 The key obstacle to the adoption of an ROA approach is the practicability issues we would encounter in determining a robust value for the RAB of the Reported Business. Using an undervalued RAB, based on the book values, would lead us to overestimate the rate of return the Reported Business achieves, and potentially underestimate the financial sustainability issues it may face.

A6.41 We adopted the EBIT margin approach in March 2012 and it has shown itself to be an effective metric for assessing the commercial rate of return and financial sustainability of the Reported Business. Consistent with our analysis based on this approach, the Reported Business and Royal Mail have been financially sustainable since our decision and therefore there has been no evidence to warrant concern about its fitness for purpose.

A6.42 In light of the above, we consider that the EBIT margin of the Reported Business continues to be the appropriate metric to use to assess the commercial rate of return of the universal postal service provider for the purposes of assessing financial sustainability over the medium to long-term.[162] We next discuss how we intend to supplement that metric with a consideration of some financial health metrics for the Relevant Group.

Assessing short to medium term financial sustainability

A6.43 Under the USP Accounting Condition,[163] Royal Mail provides us with quarterly cash flow projections for the Relevant Group, which cover each of the next six financial

[162] When considering Royal Mail's financial sustainability over the longer-term and, in particular, the financeability EBIT margin, we would ordinarily expect to carry out our assessment over a period of at least three years. Depending on the circumstances however, we may consider a longer time period to be appropriate. For example, in our 2014 End-to-End Statement, we considered a five-year timeframe.

[163] See http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex1.pdf, paragraph 1.3.1(d).

quarters. These projections provide us with a short to medium term view of the financial position of Royal Mail and its ability to service its debt and meet its cash requirements. We require these projections at the level of the Relevant Group and not the Reported Business because, as we explained before, this is the level at which the company manages its cash, borrows and invests. Also, since privatisation investors and analysts consider Royal Mail's financial performance and health at this level.

A6.44 As explained above, since the privatisation of Royal Mail, information has been accumulating on Royal Mail's share price, and a great deal of investor analysis and scrutiny has been carried out on Royal Mail's financial results and position.

A6.45 In addition, debt forms a significant part of Royal Mail's capital structure which is not funded or guaranteed by the government. Royal Mail's securing of a credit facility with a syndicate of lenders following the privatisation, and the issuance of a 10-year bond[164] also mean that greater scrutiny of Royal Mail's financial results and position is taking place by lenders and investors.

A6.46 As a result, it is appropriate to consider whether there are any further metrics or indicators which would enable us to obtain a fuller picture of Royal Mail's financial strength and resilience.

A6.47 We have considered the potential sequence of events that might lead to financial health issues given its capital structure. We have considered what indicators and metrics would assist us in identifying threats to its short to medium-term financial sustainability, noting that the financeability EBIT margin metric discussed above should enable us to obtain an understanding of the Reported Business' medium to longer-term financial sustainability.

A6.48 In response to our July 2015 Discussion Document,[165] Royal Mail stated that Ofcom should assess whether the Relevant Group is providing adequate return to its shareholders.[166] We do not consider that reviewing the metrics that Royal Mail uses to assess whether it is providing adequate return to its shareholders will better inform us of whether the universal postal service is financially sustainable in the short to medium term. Instead, as Royal Mail's ability to fund the operation of the universal postal service is likely to be directly impacted by a failure to meet its cash requirements, we consider that those metrics which gauge the ability of the company to generate cash to meet its financial obligations should be key to our assessment.

A6.49 We asked CEPA to advise us in their report on any further financial health metrics which we should now use to assess short to medium term financial sustainability in light of the new financial information provided in the market. CEPA recommended[167] that in assessing the overall financial health of Royal Mail there are advantages in

[164] In July 2014, Royal Mail issued €500 million 2.375% Senior Fixed Rate Notes due July 2024 with a fixed annual interest coupon of 2.375%. See Royal Mail 2014-15 Annual Report, page 27, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.
[165] See Royal Mail's response to Ofcom's July 2015 Discussion paper, 18 September 2015, pages 4, 12, 67-70.
[166] See Royal Mail's response to Ofcom's July 2015 Discussion paper, 18 September 2015, pages 4, 12, 67-70.
[167] Relevance of Margin Based Approach' Cambridge Economic Policy Associates, November 2015.

adopting a measure of dynamic gearing alongside the EBIT margin measure. We discuss examples of these measures in the following section.

A6.50 In response to our July 2015 Discussion Document,[168] Royal Mail stated that Ofcom should refine its approach to assessment of financial sustainability by complementing it with the adoption of additional financial metrics which are generally used by lenders, credit rating agencies and other regulators to assess financial risk (e.g. Debt/EBITDA). We agree with Royal Mail in this regard and discuss some of these metrics in the following sections.

A6.51 In response to our July 2015 Discussion Document,[169] Royal Mail also stated that it was in the process of developing a 'Viability Statement' which would be reported in its Annual Report, the content of which would form an appropriate basis for discussion with Ofcom on financial sustainability. This 'Viability Statement' would consider the business and its risks over a future period of at least twelve months, and it was anticipated that it may consider the financial health metrics used to assess financial risk referred to above.

A6.52 The Viability Statement and a statement of Principal risks have since been included in the Royal Mail PLC's Financial report for the full year ended 27 March 2016, dated Thursday 19 May 2016. The Viability Statement states that "Based on the results of their analysis, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period to March 2019."[170]

A6.53 Having carried out an initial review of the above-mentioned Viability Statement and the statement of Principal risks, we consider that these statements provide important information about the financial sustainability of the Relevant Group. And while these statements do not specifically refer to the financial sustainability of the provision of the universal service or the Reported Business, they are highly relevant to these considerations and the ability of the Relevant Group to continue to provide the universal service.

A6.54 We therefore intend to consider in our assessment of the financial sustainability of the universal service, the Viability Statement and any related statement of risks that Royal Mail publishes.

Supplementary metrics for monitoring the financial health of the universal postal service

A6.55 Based on the above considerations, and the advice given to us by CEPA[171], we intend to use supplementary financial health metrics relating to the Relevant Group which are widely used by lenders, credit rating agencies and analysts in order to assess the ability of businesses to generate sufficient cash to meet their financial obligations. The following financial health metrics are widely used for this purpose,

[168] See Royal Mail's response to Ofcom's July 2015 Discussion paper, 18 September 2015, pages 4, 12, 67-70.
[169] See Royal Mail's response to Ofcom's July 2015 Discussion paper, 18 September 2015, pages 4, 12, 67-70.
[170] See Royal Mail PLC, Financial report for the full year ended 27 March 2016, Thursday 19 May 2016, page 26, http://www.royalmailgroup.com/sites/default/files/Financial%20report%20for%20the%20full%20year%20ended%2027%20March%202016.PDF.
[171] Relevance of Margin Based Approach' Cambridge Economic Policy Associates, November 2015.

and we therefore intend to use these (as a minimum and among other metrics we may find appropriate) when assessing the financial health of the universal postal service in the short to medium-term:

- Funds From Operations (FFO) / Net Debt;[172]
- Net Debt / Earnings before Interest, Tax, Depreciation, and Amortisation (EBITDA); and
- EBITDA / Interest (also known as Interest cover).

A6.56 Standard & Poor's credit rating agency has provided the credit rating in relation to Royal Mail's 10-year €500 million bond. FFO / Net debt is one of the key metrics that Standard & Poor's uses. Royal Mail has also informed us that this is a key metric they monitor.

A6.57 The Net Debt / EBITDA and EBITDA / Interest (interest cover) metrics are used as financial covenants relating to Royal Mail's syndicated credit facility. The Net Debt / EBITDA metric helps assess Royal Mail PLC's ability to repay its debts using its operating profits (measured before non-cash elements of depreciation and amortisation). It broadly represents the number of years of annual profit required to repay all of its debt. The interest cover metric is used to assess how easily Royal Mail PLC can pay interest on its outstanding debt.

A6.58 When considering the financial health metrics, we intend to assess these against the Relevant Group and not the Reported Business. The reason is that Royal Mail PLC, the ultimate parent company of the Relevant Group, and not the Reported Business, is the entity which is listed, borrows in the market, and holds the bank accounts and other funds. For the purposes of short to medium term financeability (which are both closely related to the businesses' cash needs and cash resources), we consider that the Relevant Group is the most relevant entity to monitor.

Assessing short to medium-term financial sustainability

A6.59 We intend to supplement the cash flow projections of the Relevant Group that we currently use when assessing the short to medium-term financial sustainability, with a consideration of a range of financial health metrics that assist in the assessment of the Relevant Groups' ability to meet its financial obligations. In this regard, we would expect to consider, as a minimum and among other metrics we may find appropriate, the FFO/Net Debt, Net Debt / EBITDA and EBITDA / Interest (interest cover) metrics although we may consider other metrics for short to medium-term financial sustainability if we consider this is appropriate.

Financeability EBIT margin range

A6.60 In our March 2012 Statement, we concluded that an indicative EBIT margin of 5-10% for the Reported Business is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk within the business.

[172] Net Debt is a measure of a company's liabilities at a certain point in time which nets off the company's cash and other liquid assets against its debts. FFO is a measure of the net cash flows generated by a company's operations in a financial period, typically one year.

A6.61 Since the March 2012 Statement, there have been various developments in the postal market (e.g. intensifying competition in parcels, and continued decline in letters). We are now considering whether the benchmark of 5-10% continues to be fit for purpose.

A6.62 Based on our work, which we will explain below, we consider that the 5-10% range remains an appropriate benchmark for a reasonable commercial rate of return for considerations of medium to long-term financial sustainability.

A6.63 Our work on the EBIT margin benchmark has been from the financial sustainability viewpoint. We recognise that the top end of our indicative EBIT margin range may be relevant to an assessment of potentially excessive returns. However, we expect that in order to carry out such an assessment, we may need to consider further ways of benchmarking the EBIT margin, and perhaps revisit other metrics such as ROA.

Our approach to benchmarking

A6.64 For the purpose of identifying an appropriate EBIT margin range for the Reported Business, we have considered:

- comparators' EBIT margin – What are the EBIT margins of the appropriate comparator companies (i.e. the sort of companies that Royal Mail is reasonably expected to aim at emulating.)

- the relationship between EBIT margin and financial health metrics – What are the minimum levels of EBIT margin that are consistent with a satisfactory score on financial health metrics? This approach is informative about the lower end of the benchmark as the financial health metrics are concerned with short to medium-term financial health.

A6.65 We have also considered stakeholders' responses to our discussion paper on matters related to the 5-10% financeability EBIT range. Only Royal Mail has specifically addressed this issue. We discuss Royal Mail's response below, where appropriate.

Comparators' EBIT margin

A6.66 In its October 2011 report for Postcomm entitled 'Financeability of the Universal Service',[173] CEPA considered four groups of comparators: mail and logistics, transport companies using a network, companies facing structural change (e.g. directories and travel agencies), and companies with a highly unionised workforce. This informed our March 2012 Statement. We have adopted a similar, but more focused approach this time on the basis that the first of these groups (i.e. postal operators) should provide sufficient data for our work in this consultation. This is because we are mainly interested in assessing the impact of any changes in Royal Mail and the postal market since March 2012 on the appropriateness of the 5-10% range.

A6.67 We have selected the most appropriate postal operators to use as comparators by applying the following criteria:

[173] See http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/financeability.pdf.

i) Fully or partly privatised;

ii) Holding an investment grade credit rating;[174]

iii) Facing competition;[175]

iv) Medium or high perception of efficiency;[176]

v) Being subject to the Postal Services Directive; and

vi) Having universal postal service obligations.

A6.68 These criteria are designed to reflect broadly:

- the type and level of risks Royal Mail, and in particular the Reported Business, faces (criteria i, iii, v, and vi); and
- the characteristics we would expect Royal Mail and the Reported Business to emulate (criteria ii, and iv) to ensure it is financially sustainable.

A6.69 Ideally we would expect comparators to meet all of the criteria but to do so would restrict the number of benchmark comparators to too few to provide a robust range. We have decided that to be an appropriate comparator for the purposes of our analysis, a company must meet criterion (i), and four criteria out of the remaining five criteria. By applying these criteria, we have selected PostNL, Deutsche Post, Austrian Post, and CTT Correios.

A6.70 In response to our July 2015 Discussion Document,[177] Royal Mail suggested that we also use Singapore Post, Malta Post, and bpost as appropriate comparators in identifying an EBIT margin range. We do not agree with Royal Mail on the choice of Singapore Post, Malta Post, and bpost as appropriate comparators. As shown in the following table, these companies do not meet our criteria in some important respects and therefore would not be appropriate comparators to use.

[174] On Standard & Poor's and Fitch's scale, the lowest investment grade credit rating is "BBB-"; for Moody's the equivalent grade is "Baa3".
[175] For these purposes we have relied on the 'ERGP Report on End-to-end Competition and Access in European Postal Markets', June 2014, and whether a country has more than 5% access and/or end-to-end by volume (pages 3-4).
[176] For a view on the efficiency perceptions, we have relied on research provided to Ofcom by WIK Consult in April 2015.
[177] Response to Ofcom's July 2015 Discussion Document, 18 September 2015, pages 4, 12, 67-70.

Figure A6.2: Benchmark comparators assessed against criteria

	Primary criterion	At least 4 secondary criteria should be met				
Company	Private capital	Universal service operator	Subject to EU Postal Directive	Investment grade credit rating	Competition – either Access or End to End	Perception of efficiency (high or medium)
Post NL	√	√	√	√	√	√
Deutsche Post	√	√	√	√	√	√
Austrian Post	√	√	√	√	X	√
CTT Correios	√	√	√	√	X	√
bpost	√	√	√	X	X	√
Singapore Post	√	√	X	√	X	unknown
Malta Post	√	√	√	X	X	unknown

A6.71 In each of the companies considered, we have endeavoured to isolate the business segment(s) which are comparable to the Reported Business. This means that, in many cases, we have not taken the overall EBIT margin of the company if it included services such as banking and other communication services.

A6.72 We have also endeavoured to calculate the EBIT margin of the appropriate comparators in a manner that is consistent with our definition of the financeability EBIT margin for the Reported Business (using the published data available in the annual reports). For example, we consider that the financeability EBIT margin must be calculated after including recurring transformation costs, but before profit or loss on disposal of fixed assets.

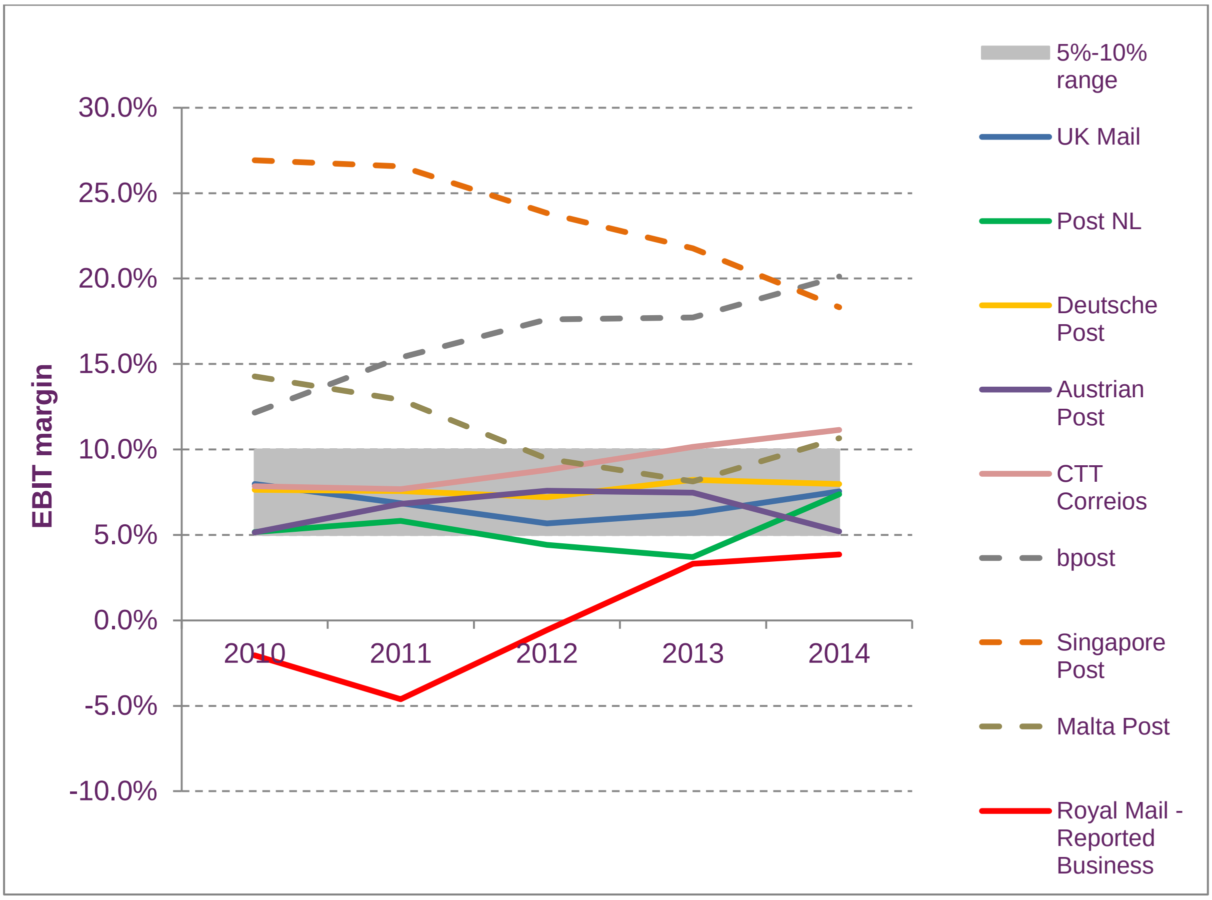
A6.73 With respect to pension costs, our approach has been to make an adjustment from underlying accounting costs to underlying cash costs, but we have excluded one-off charges.[178] This is consistent with how we calculate the financeability EBIT margin for the Reported Business.[179]

A6.74 The graph below includes the EBIT margins of those companies which we consider to be appropriate comparators (PostNL, Deutsche Post, Austrian Post, and CTT Correios). We have included, for comparison, Singapore Post, Malta Post, and bpost, as well as UK Mail (because it is a listed UK company and a competitor of Royal Mail), and Royal Mail's Reported Business.

[178] We have made pension cost adjustments to the EBIT margins of the appropriate comparators, where applicable. We have not made pension cost adjustments to other European operators we have considered (i.e. La Poste, PostNord Denmark, PostNord Sweden, Swiss Post, Posti, Correos, and Malta Post).

[179] See the 2014 End-to-end Statement, pages 14 and 15 http://stakeholders.ofcom.org.uk/binaries/post/end-to-end-statement/end-to-end.pdf.

Figure A6.3: Comparators' EBIT margin %



A6.75 The unweighted and weighted average[180] EBIT margin among the appropriate comparators (Post NL, Deutsche Post, Austrian Post, and CTT Correios) is 7.1% and 7.2% respectively (across all companies and years), with 80% of the EBIT margin observations falling into the 5-10% range. UK Mail's EBIT margin fell within the range in each of the five years considered.

A6.76 If we include in our analysis the other European universal postal service providers which we have considered (including bpost and Malta Post),[181] the unweighted and weighted average EBIT margin would be 6.2% and 5.8% respectively, with more than half of the EBIT margin observations falling into the 5-10% range.

A6.77 In response to our July 2015 Discussion Document,[182] Royal Mail stated that the 5-10% range is at the lower end of the appropriate range, and proposed that the range should be moved up.

180 The weighted average EBIT margin is calculated by using revenues as weights. However, we consider the unweighted average to be more appropriate for our analysis, because having higher revenues does not mean the company is a better benchmark.
181 These other European universal service providers do not meet our criteria and are therefore not considered as appropriate comparators. They are La Poste, PostNord Denmark, PostNord Sweden, Swiss Post, Posti, Correos, Post Italiane, and Malta Post.
182 Response to Ofcom's July 2015 Discussion paper, 18 September 2015, pages 4, 12, and 67-70.

A6.78 Royal Mail stated that the average EBIT margins earned by its relevant European peers in the 2010-2014 period were 10% on a weighted basis and 16% on an unweighted basis. As we explained above, Royal Mail's higher estimates are based mainly on the inclusion of certain comparators, such as bpost, Malta Post and Singapore Post, which we do not consider as appropriate comparators.[183]

A6.79 Royal Mail also stated that the weighted average EBIT margin earned by FTSE 100 and FTSE 250 companies from 2007-14 ranges from 10%-12%, and that no industry sector earned an average margin of less than 8% between 2007-14.

A6.80 We do not consider many of the FTSE 100 and 250 companies to be relevant to the question of the reasonable commercial rate of return for the Reported Business. The FTSE 100 and 250 include various sectors with a wide range of risks and returns which could be significantly different from the postal sector and in particular from the provider of a universal postal service.

A6.81 Royal Mail's consultants, FTI Consulting,[184] considered the above approaches to deriving the EBIT margin range, as well as the margins targeted by credit ratings agencies and the margins earned in other regulated business. FTI concluded that a reasonable range lies between 5% and 17%.

A6.82 FTI stated that Moody's published methodology for the postal sector suggests that an investment grade rating requires an EBIT margin between 8% and 12%. We consider the investment grade credit rating as a relevant indicator of financial sustainability, and as we explain above, we apply it as one of the criteria in selecting good comparators. However, the EBIT margin is only one of a suite of metrics credit rating agencies consider in their decision on the appropriate rating. This is true of Standard & Poor's as well, which is the only agency that has graded Royal Mail, and it has given Royal Mail an investment grade credit rating of BBB. [✂].

A6.83 Finally, we do not consider other non-postal regulated businesses as appropriate comparators, because the differences in price elasticity, volume trends, USO, labour and asset intensiveness, and cost variability significantly limit their relevance to Royal Mail and in particular the Reported Business.

A6.84 In light of the above, we consider that 5-10% continues to be a reasonable range for the commercial rate of return of the Reported Business.

Relationship between the EBIT margin and financial health metrics

A6.85 As explained above, we intend to monitor a range of financial health metrics (including, but not limited to, FFO / Net debt, Net debt / EBITDA, and EBITDA / Interest) for the Relevant Group.

A6.86 FFO / Net debt is one of the key metrics used by Standard & Poor's who have been providing the credit rating for Royal Mail's 10-year €500 million bond. We understand from our discussions with Royal Mail that there would be a risk of Royal

[183] The other reason for these high estimates is that FTI - and it seems Royal Mail also – don't take the EBIT margin of the correct business segment (e.g. in Austria Post and Singapore Post) that is comparable to the Reported Business. They exclude parcels segments while the Reported Business carries a considerable amount of Royal Mail's parcels.
[184] Financial Sustainability of the USO, FTI Consulting response to the Fundamental Regulatory Review, September 2015, pages 22-30.

Mail's credit rating being downgraded if this metric fell below [✂]. Net debt / EBITDA, and EBITDA / Interest are covenants attached to Royal Mail's £1.05bn credit facility. These covenants would be breached if their value fell below 3 and 3.5 respectively.

A6.87 We have analysed the EBIT margins of the Reported Business associated with scenarios in which the above metrics are breached. We have considered actual results in 2014-15 and forecast results from 2015-16 to 2017-18 (based on Royal Mail's 2015 Business Plan). We have investigated scenarios where there is a revenue loss in the Reported Business accompanied by a cost reduction in line with overall marginality. The EBIT margins associated with these scenarios are all below 5%.

A6.88 Our analysis of those scenarios, in which there is a risk of Royal Mail's credit rating being downgraded, suggest the EBIT margins could be as high as [✂] in those scenarios. Royal Mail's current credit rating is BBB. The rating immediately below that is BBB-, and any rating below that is not investment grade. The loss of investment grade status would make raising finance considerably more costly for Royal Mail which could in turn adversely affect the Reported Business' financial performance, if all else remains unchanged. This indicates that the lower threshold of our EBIT margin benchmark should not be considerably lower than [✂].

A6.89 We consider that our analysis of the relationship between the EBIT margin and the financial health metrics further supports our view that the 5-10% range remains a reasonable range for the commercial rate of return of the Reported Business.

A6.90 Our results also show that the FFO/Net Debt metric is a tighter constraint, as it could be breached at higher levels of EBIT than Net debt / EBITDA, and EBITDA / Interest. This suggests that FFO/Net Debt may be a more instructive financial health metric. Royal Mail has also informed us that this is a key metric they monitor.

Our approach to assessing financial sustainability

A6.91 As noted above, whenever we carry out our functions in relation to postal services, we must have regard to the need for the provision of a universal postal service to be financially sustainable. We cannot fetter our discretion as to the issues and factors to which we would have regard when assessing this matter. Any such assessment would be undertaken on a case-by-case basis. However, we would expect a typical financial sustainability assessment to be structured as follows:

- We would consider the medium to long-term financial performance of the Reported Business. We will consider the recent actual EBIT margins achieved, as well as the forecast EBIT margins over an appropriate period. We would normally use Royal Mail's business plan as the starting point for forecasting the EBIT margin and make appropriate adjustments, if necessary.

- We would apply the financial health metrics, such as FFO / Net Debt, to the recent actual results and forecast results of the Relevant Group over an appropriate period in order to assess the Relevant Group's short to medium-term financial sustainability.

- We would consider the cash flow forecasts of the Relevant Group. Under the USP Accounting Condition,[185] Royal Mail provides us confidentially with quarterly cash flow projections for the Relevant Group, which cover each of the next six financial quarters.

A6.92 The conclusions of our assessment will depend on the results of the analyses carried out and the particular circumstances and facts prevailing at that time. However, the following are some general themes:

- If the forecast EBIT margin is above 5%, or shows an increasing trend that exceeds 5% over the forecast period, then the indications are that the Reported Business is financially sustainable. If this is not the case – for example if the forecast EBIT margin stays consistently below 5% or has a decreasing trend taking it below 5% – then there may be indications that the universal postal service faces financial sustainability issues in the long term. However, concerns about financial sustainability may not arise if, for example, the EBIT margin goes below 5% for a shorter period due to specific circumstances which may be addressed by Royal Mail without affecting its longer-term financial sustainability.

- If the actual and the forecast financial health metrics for the Relevant Group deteriorate, to the point that they fall below a healthy level, then the Relevant Group's ability to continue to finance the universal postal service in the short to medium-term may be uncertain.

- If the actual and the forecast financial health metrics for the Relevant Group deteriorate, to the point that they fall below a healthy level, then the Relevant Group's ability to continue to finance the universal postal service in the short to medium-term may be uncertain.

- If the cash flow projections of the Relevant Group show that the Relevant Group cannot meet its cash requirements over the next six quarters, then the Relevant Group may be facing immediate issues in financing the universal postal service.

- It is possible that there may be financial sustainability issues with the Reported Business, while the Relevant Group remains financeable; or the Relevant Group faces financial sustainability problems while the Reported Business remains financially sustainable. The latter would indicate that the cause of the Relevant Group's problems do not lie with the Reported Business or the universal postal service, although this may nevertheless affect Royal Mail's ability to continue to provide the universal postal service.

A6.93 It is possible that there may be financial sustainability issues with the Reported Business, while the Relevant Group remains financeable; or the Relevant Group faces financial sustainability problems while the Reported Business remains financially sustainable. The latter would indicate that the cause of the Relevant Group's problems do not lie with the Reported Business or the universal postal service, although this may nevertheless affect Royal Mail's ability to continue to provide the universal postal service.

[185] See http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex1.pdf, paragraph 1.3.1(d).

Annex 7

Letters market analysis

Introduction and summary

A7.1 Our analysis of the letters sector is summarised in paragraphs 4.82-4.90 of the main document. This annex sets out our analysis in more detail. We have considered how the competitive dynamics in the letters sector have changed in recent years, and whether the constraints on Royal Mail's behaviour have changed in a way that might warrant modifications to the regulatory framework.[186]

A7.2 The letters sector includes a large number of products used by different types of customers to meet a diverse range of needs. To better understand potential differences in the competitive constraints Royal Mail may face in providing different letter products we consider:

a) Single piece and bulk mail services – single piece letters are defined as those where the price per item is not discounted on the basis of volume, format, pre-sortation or ability to be sorted by a machine. Bulk mail users receive discounts based on these factors and bulk mail accounts for the large majority of Royal Mail's delivered letter volumes. Bulk mail products are not included in the universal service but single piece services are.

b) End-to-end delivery and access competition – Royal Mail is currently the only significant end-to-end letter delivery provider, however, it is required to provide access to its delivery network to other postal operators.

A7.3 In this annex we discuss the single piece and bulk mail segments of the letters sector separately. Traditionally bulk mail was sent by large customers with high volumes of pre-sorted mail. However, it is worth noting that the boundary has moved somewhat over recent years as Royal Mail has offered discounts for lower volumes of unsorted mail and access operators have targeted high volume single piece customers and effectively converted them to bulk customers by aggregating their mail with other customers and sorting it.

A7.4 Overall letter volumes have been in decline since 2005-06. Since 2010-11 total letter volumes (i.e. single piece and bulk) have declined by 18%[187] (5% per annum on average). Royal Mail expects this trend of declining letter volumes to continue in the medium term.[188] Despite falling volumes, over the same period total letter revenues have increased slightly – due to price increases by Royal Mail.[189]

A7.5 Figure A7.1 below summarises Royal Mail's volumes for key letters segments.

[186] See Ofcom's July 2015 Discussion Document, paragraph 4.10.
[187] See Ofcom's Annual monitoring update on the postal market 2014-15, page 31, http://stakeholders.ofcom.org.uk/post/monitoring_reports/.
[188] Royal Mail Annual Report 2014-15, page 7, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.
[189] See Ofcom's Annual monitoring update on the postal market 2014-15, page 31.

Figure A7.1: Single piece and bulk letters volumes in 2014-15

	Volumes	
	2014-15 letter volumes	% of total reported addressed volumes[190]
Single piece	c.2.5bn[191]	c.18%
Bulk mail (total)	c.10bn	c.71%
Of which*: *Royal Mail retail	*c.2.9bn*[192]	*c.21%*
Access	*c.7.1bn*[193]	*c.50%*

Source: Royal Mail, Ofcom calculations

A7.6 As can be seen from Figure A7.1 above, letters still make up the overwhelming majority of Royal Mail's volumes. However, given the higher unit revenues associated with parcels and international mail, letters only make up 55% of the total Reported Business mail revenues.[194]

A7.7 Single piece letter volumes have been declining at a higher rate than the overall letter volume decline, largely due to e-substitution, and they now only make up about 20% of total letter volumes. Royal Mail retains a near-monopoly and faces few competitive constraints.[195] However, since the significant price increases in 2012, Royal Mail has been relatively conservative with price rises on average slightly above RPI each year. We consider that its price rises may have been limited by other factors such as political pressure, negative publicity and our monitoring regime.

A7.8 For bulk letters, Royal Mail faces competition from access operators in upstream activities i.e. collection, sorting and trunking. However, these activities only represent around 10-15% of the value chain, and there is very little competition in the remainder of the letter delivery process.[196] Royal Mail delivers practically all bulk mail letters and retains the vast majority of overall bulk mail revenues. As discussed at A7.56 to A7.57, Whistl exited the end-to-end bulk mail delivery market in June

[190] Reported Business total mail volumes (excluding unaddressed) as disclosed in Figure 6.3 of the Annual monitoring update of the postal market 2014-15.
[191] Single piece letter and parcel volumes were c.2.7bn in 2014-15 (Figure 6.4 of the Annual monitoring update of the postal market 2014-15). Applying the percentage proportion of letters to parcels for 2014-15 (as disclosed in Figure 6.6 of the Annual monitoring update of the postal market 2014-15) equates to single piece letter volumes of c.2.5bn in 2014-15.
[192] Based on Royal Mail end-to-end volumes (see Figure 4.2 of the Annual monitoring update of the postal market 2014-15) less single piece volumes calculated above.
[193] See Figure 4.2 of the Annual monitoring update of the postal market 2014-15. Note this figure includes a small amount of parcels.
[194] Reported Business total mail revenues as disclosed in Figure 6.3 of the Annual monitoring update of the postal market 2014-15.
[195] Some other operators offer end-to-end single piece and/or bulk mail services in limited geographic areas, for example, Citipost Ltd, CMS, Velopost, Yellow Jersey Delivery and City Cycle Couriers.
[196] See Ofcom's Access Pricing Consultation, paragraph 3.12 http://stakeholders.ofcom.org.uk/binaries/consultations/rm-access-pricing/summary/Royal_Mail_Access_Pricing_Review.pdf, and Annual monitoring update of the postal market 2014-15, Figure 4.3.

2015. At this point in time we consider any significant entry in end-to-end letter delivery to be highly unlikely. We discuss the impact that this change in market conditions should have on the regulatory framework in Section 4.

A7.9 As with single piece letters, the market is in decline, albeit at a slower rate, and following large price increases in 2011 and 2012 Royal Mail's overall annual price increases have been broadly in line with RPI. Overall we consider that Royal Mail faces limited competitive constraints. Although, as discussed at paragraphs A7.79 to A7.102 we recognise that pricing constraints may vary by application. In particular, we recognise that the pricing constraint on advertising mail may be stronger due to the greater ease of switching between advertising media.

A7.10 In this annex and Annex 8 we present price and revenue numbers in nominal terms. In some cases we have used information from Royal Mail's response to the Discussion Document which compares price changes with the retail price index (RPI) measure of inflation, to provide an indication of how mail prices have changed relative to the overall level of prices. We note that the consumer price index (CPI) is the official measure of inflation in the UK and this tends to be lower than RPI. Using RPI rather than CPI would tend to understate the real terms (i.e. adjusted for inflation) price increase.

Single piece letters

Overview

A7.11 Royal Mail does not publish single piece letter and large letter volumes and revenues separately from its parcel volumes. However, we can look at the change in single piece volumes overall as a close proxy to single piece letters as letters make up 94% of total letter and parcel volumes (excluding international and unaddressed).[197] Figure A7.2 below summarises the key features of single piece letters.

[197] See Figure 6.6 of the Annual monitoring update of the postal market 2014-15.

Figure A7.2: Key features of the single piece letters market 2010-11 to 2014-15

Volume trend	Retail price trend	Revenue trend	Royal Mail share of volumes	Outlook
Royal Mail's single piece volumes have been in decline since 2005-6 Single piece volumes down 27% since 2010-11 (7% p.a. on average) Decline slower since 2012-13 (4.4% p.a. on average)[198]	Stamps – significant increase over 2010-12. Smaller increases subsequently Meter and PPI – more gradual price increase but significantly higher than RPI	Single piece revenues increased 7% since 2010-11 (1.8% p.a. on average) Revenue increase slower since 2012-13 (average 0.8% p.a.)[199]	Royal Mail near monopoly (>99%)	Likely continued decline in volumes due to e-substitution Royal Mail likely to retain near monopoly

Royal Mail's single piece services

A7.12 Royal Mail offers a number of single piece products in the letter and large letters sector with different specifications and characteristics.[200] The main single piece products are:

- First Class – a standard next day delivery service, with a performance target of 93% of items delivered within one day of posting (D+1);
- Second Class – a standard deferred delivery service, with a performance target of 98.5% of items delivered within three days of posting (D+3);
- Special Delivery Next Day – a tracked and guaranteed service. It has two variants: guaranteed delivery by 9am next day (which is not a universal service product) and guaranteed delivery by 1pm next day (which is a universal service product);
- Signed-for services can be bought as either First Class or Second Class delivery, and provide proof of delivery.

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[198] Includes single piece parcel volumes – see Figure 6.4 of the Annual monitoring update of the postal market 2014-15.
[199] Includes single piece parcel revenues – see Figure 6.5 of the Annual monitoring update of the postal market 2014-15.
[200] Royal Mail offers letter and large letter products dependent on the size and weight of the item, see http://www.royalmail.com/personal/help-and-support/Tell-me-about-size-and-weight-formats. Consistent with the definitions used by Royal Mail, we define a letter as having a maximum weight of 100g and dimensions which do not exceed: length 24cm, width 16.5cm, thickness 5mm. A large letter has a maximum weight of 750g and dimensions which do not exceed: length 35.3cm, width 25cm, thickness 25mm.

A7.13 There are three main ways in which customers can pay for single piece letter services:

- Using stamps, bought from a Post Office or stamp re-seller (or print postage in the Post Office) or using Royal Mail's online postage services. These are the only options realistically open to residential consumers. However, our market research has found that 88% of small businesses used stamps as their main method of sending mail;[201]

- Using a franking machine to send meter mail. These are used largely by businesses who are regular senders of mail (but at lower volumes than needed to use Royal Mail or access operators' bulk mail services) and offer greater convenience (particularly if buying a range of different products) and lower prices. To access a franking machine for meter mail, customers need to purchase or rent a machine from a list of Royal Mail approved providers. These machines can be hired for a monthly charge or bought.[202] While our market research shows that franking is used only by 10% of all small businesses as their standard way of sending mail, 43% of these businesses that send between 100 and 500 items a month use a franking machine;[203] or

- Using an Account payment option with printed postage impressions (PPI) where an identifier is printed directly on to the envelope. Royal Mail then invoices account customers for the aggregate number of mail items offering payment terms of up to 30 days and allows customers to access discounts off the stamp price without hiring or purchasing a franking machine.

Overall volume and revenue trends

A7.14 Royal Mail is the only operator offering single piece services on a national scale. There are a number of other operators offering limited end-to-end single piece services in restricted geographical areas[204] but they handle much lower volumes than Royal Mail. Royal Mail therefore delivers the overwhelming majority of single piece letter and large letter volumes (we have estimated this to be over 99%).[205] In addition, at this point in time, the emergence of a national end-to-end entrant for single piece services in the foreseeable future appears unlikely.

[201] Ofcom Business tracker, 2014-15, page 433, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2015May/Business_postal_tracker_Year_3_Data_Tables.pdf.

[202] In 2013, Ofcom calculated that given the price difference between stamps and franking the cost of renting or purchasing a franking machine would be offset if a customer spent about £80 or sent about 120 letters per month, see paragraph 5.14, *The affordability of universal postal services*, available at http://stakeholders.ofcom.org.uk/binaries/post/affordability.pdf.

[203] Ofcom Business tracker, 2014-15, page 433, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2015May/Business_postal_tracker_Year_3_Data_Tables.pdf.

[204] Some local end-to-end operators will accept letters outside of their area of operation but will feed these letters into the Royal Mail network for delivery (using access or Royal Mail's retail services).

[205] End-to-end competition only accounted for the delivery of 1.3% of letters in 2014-15 (see paragraph 4.29 of Ofcom's Annual monitoring update 2014-15). Following the exit of Whistl we expect that the volume of mail delivered by other operators has significantly reduced.

A7.15 In 2014-15, Royal Mail delivered around 2.5 billion single piece letter items and received approximately £1.3 billion[206] in revenue for these services. Single piece letters therefore represent c.18% of the Reported Business total addressed volumes and total reported revenues.[207]

A7.16 Single piece volumes have been declining since 2005-6. As set out in Figure A7.2 above, Royal Mail's single piece volumes (including parcels) have fallen by around 27% since 2010-11 which is higher than the overall rate of letter decline for the same period (18%).[208] The rate of decline has slowed between 2012-13 and 2014-15 to c.4.4% per annum but this is still higher than the corresponding decline in total letter volumes (c.2.1% per annum).[209] Against this there has been an increase of 7% in revenues between 2010-11 and 2014-15 due to the price increases Royal Mail has implemented for these products. [✂].

Pricing trends

A7.17 As discussed in paragraphs 2.24 to 2.31 we removed all of the traditional price controls on Royal Mail in March 2012 to give it sufficient commercial freedom to return the universal service to financial sustainability. One of the safeguards we put in place to ensure that a basic universal service was available to all, was a safeguard cap on its Second Class stamp services up to 2kg. This was implemented in the form of a cap on the letter price and a basket cap on the relevant large letter and parcel products. The level of the cap and basket were set at a 53% increase on the 2011-12 prices as we considered this would not generate any affordability issues and given the importance of not unduly constraining Royal Mail's pricing freedom.[210] The cap on Second Class stamp letters is 58p 2016-17 and the corresponding increase for the basket cap is now 62% (over 2011-12 prices).

A7.18 Figures A7.3 and A7.4 below show the prices for Royal Mail's single piece letter and large letter products between 2010-11 and 2016-17. For large letters, we have produced a weighted average of all the relevant weight steps.

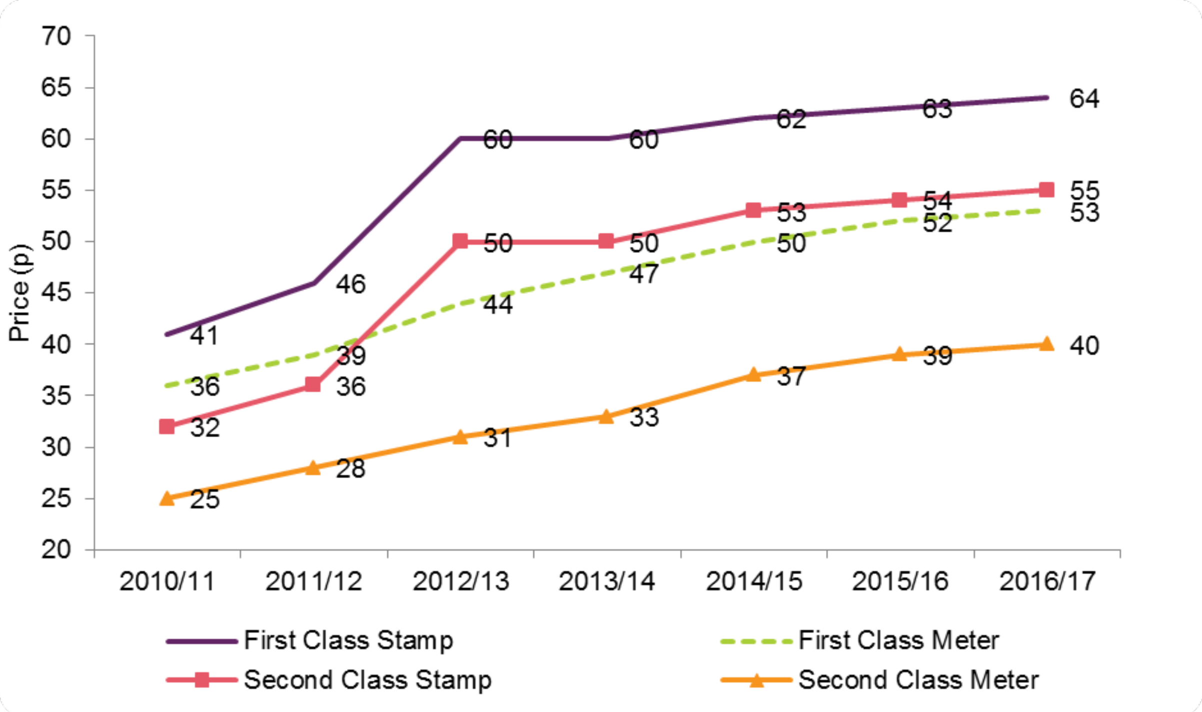
A7.19 As shown in the figures below, First and Second Class stamp letter prices rose significantly in 2012-13. First and Second Class stamp letter prices rose by 14p to 60p and 50p respectively. Royal Mail then froze these stamp letter prices in 2013-14 before instituting small price increases roughly in line with RPI in subsequent years. Letter prices are now 56% and 72% higher than 2010-11 for First and Second Class respectively. Meter price increases for both First and Second Class letters have been more gradual but prices have still risen by 47% and 60% since 2010-11 for First and Second Class respectively. In addition, the differential between stamp and meter prices has grown so that it now represents a discount of 17% for First Class and 27% for Second Class off the related stamp prices.

A7.20 Royal Mail has maintained a consistent absolute differential between its First Class and Second Class letter stamp prices since 2010-11. The current differential is 9p.

[206] Single piece letter and parcel revenues were £2.0bn in 2014-15 (Figure 6.5 of the Annual monitoring update of the postal market 2014-15). Applying the percentage proportion of letter to parcel revenue for 2014-15 (as disclosed in Figure 6.7 of the Annual monitoring update of the postal market 2014-15) we have estimated single piece letter revenues to be c.£1.3bn.
[207] See Figure 6.3 of the Annual monitoring update of the postal market 2014-15.
[208] See Figure 4.1 of the Annual monitoring update of the postal market 2014-15.
[209] Ibid.
[210] Ofcom, *Securing the Universal Postal Service*, paragraphs 1.19 to 1.27 and 1.36 to 1.44.

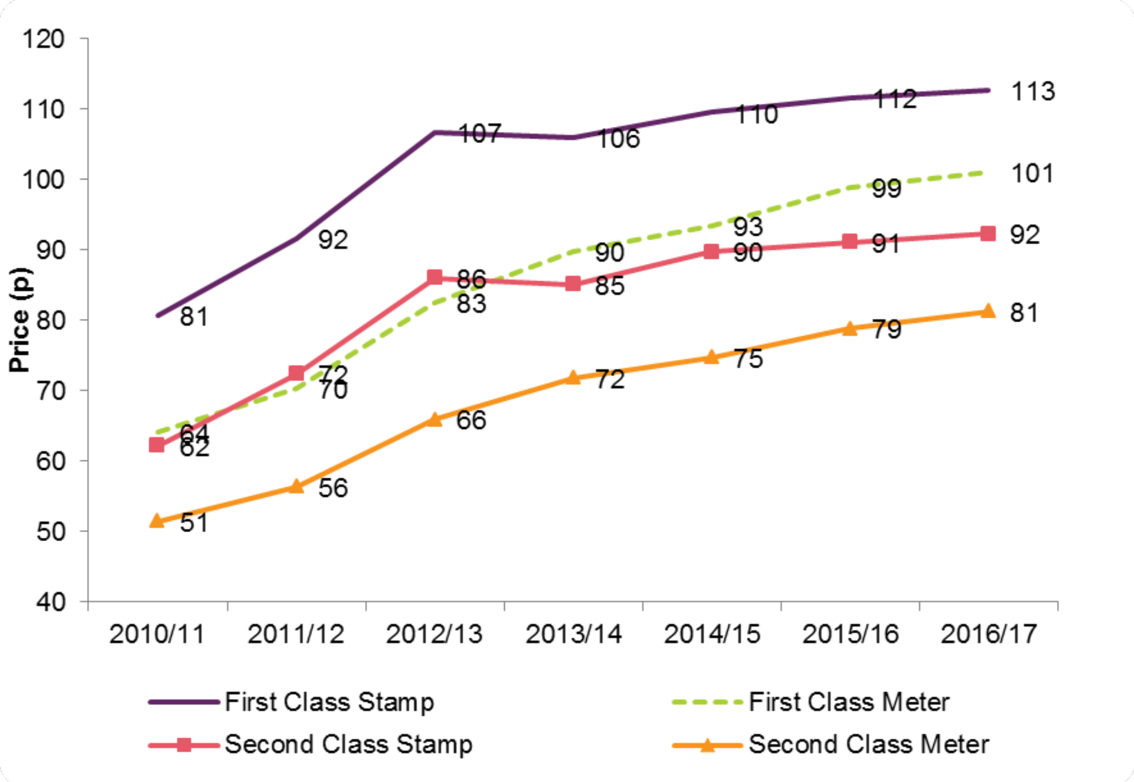
A7.21 For large letters, the stamp price increases have followed a similar pattern to letters, albeit at a lower percentage increase since 2010-11 (40% and 48% increase for First and Second Class stamps respectively). However, in contrast to letters the price increases for meter large letter services have been higher than for stamps.

Figure A7.3: Royal Mail First and Second Class letter prices



Source: Royal Mail public price lists.

Figure A7.4: Royal Mail First and Second Class large letter prices



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

Constraints on single piece letter prices

A7.22 In assessing the constraints on Royal Mail's single piece letter and large letter prices we first consider the impact of e-substitution and then Royal Mail's ability to increase prices.

E-substitution

A7.23 At the beginning of this century letter mail volumes had been growing at roughly the same rate as the economy. More recently, due to the growth of electronic communication methods such as email and text messaging some letter volumes have been switching to electronic alternatives. For example, Richard Hooper noted "the decline in letter volumes worldwide is predominantly structural in nature, caused by email and mobile data substitution."[211]

A7.24 Royal Mail has commissioned a number of reports which indicate that e-substitution is a threat to letter volumes. One report by [✂] in September 2013 considered that the decline in letters is "principally the result of the introduction of alternative communication methods (e.g. email, texts) allowing faster and cheaper communication".[212] FTI Consulting's report for Royal Mail[213] argued that Royal

[211] Richard Cooper, *Saving the Royal Mail's universal postal service in the digital age: An Update of the 2008 Independent Review of the Postal Services Sector*, 2010, page 8, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31808/10-1143-saving-royal-mail-universal-postal-service.pdf.
[212] [✂].

Mail's letter and large letter pricing was "constrained by the risk that customers will switch away permanently" to digital products.[214] The report referenced the September 2010 update to the 2008 Hooper report noted that "if something is digitisable, postal operators should act on the basis that it will sooner or later be digitised".[215]

A7.25 Royal Mail therefore submitted that e-substitution is a significant constraint on its single piece letter prices and argued that it has been pricing on this basis.[216] CWU agreed with this position and considered e-substitution was a threat to the future financial sustainability of the universal service.[217] The Consumer Council also recognised that e-substitution has affected mail volumes for consumers.[218]

A7.26 Ofcom has two postal services trackers to measure consumer and small business usage and attitudes of post over time. In relation to consumers this research found that:

- email is the most common replacement for post with 77% of those aged 16-34 stating they had reduced the amount of post they send in favour of email; [219]
- text messaging, mobile phone calls and social networking sites and apps are also among the most popular options;[220] and
- in each age group, excluding 55 and above, the majority of respondents indicated they preferred to send email rather than letters. For the 55 and above age group, the figure was 35%.[221]

A7.27 In relation to small businesses:[222]

- In 2014-15, 63% of businesses had moved some of their physical mail to other communication methods.
- The most commonly cited reason for doing so was speed, with 46% of those that had moved mail to other methods saying that they had done so because it was quicker, followed by the cost savings businesses could make due to e-substitution which 41% said was the reason. One quarter (24%) had switched mail to another method to take account of customer preferences.

[213] FTI Consulting report entitled '*Competitive constraints on pricing faced by Royal Mail'* submitted in response to the July 2015 Discussion Document.
[214] FTI Consulting report entitled '*Competitive constraints on pricing faced by Royal Mail'* submitted in response to the July 2015 Discussion Document, paragraph 2.6.
[215] See Hooper (2010) '*Saving the Royal Mail's universal postal service in the digital age: an update of the 2008 Independent Review of the postal services sector',* page 19.
[216] See Royal Mail's response to the July 2015 Discussion Document, pages 21 to 23.
[217] See CWU's response to the July 2015 Discussion Document, paragraph 30.
[218] See The Consumer Council's response to our July 2015 Discussion Document, page 7.
[219] See Ofcom's 2015 Communications Market Report, page 397, http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr15/CMR_UK_2015.pdf .
[220] Ofcom's 2015 Communications Market Report, page 401.
[221] Ofcom's 2015 Communications Market Report, page 407.
[222] Ofcom's Business Postal Tracker, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2015May/Business_postal_tracker_Year_3_Data_Tables.pdf.

- Of those that hadn't switched any post to other methods in the past 12 months, the most likely response was that all physical mail that could be moved had already been moved to other methods, with 29% saying this.

- 13% of businesses expected their use of mail to decrease over the following 12 months, with the decline driven by email (49%), new digital communications (23%) and postal costs (21%).

A7.28 However, there is also evidence that postal services will remain important to consumers. Ofcom's 2015 Communications Market Report reported that 77% of adults continued to send post monthly, with invitations, greetings cards and postcards being the most commonly sent items.[223] This report also highlighted that 57% of adults claim to be reliant on post as a form of communication. [224]

A7.29 Although some remaining single piece volumes are likely to be substitutable with digital alternatives, it appears that consumers will still continue to send mail. In a report for Royal Mail, PwC considered that social mail volumes (i.e. personal letters and greeting cards) are not expected to decline rapidly in the long term as many of the customers for whom digital alternatives are preferable have already switched.[225] PwC noted that the mix of social mail will continue to move towards being a majority of greetings cards.[226] This is supported by Ofcom's 2013 research into affordability which found that during December, residential consumers spend two to three times as much on postage as they do at other times of the year.[227]

A7.30 Other research that Royal Mail has commissioned recognised that social mail has some advantages over emails and texts. Its research published in December 2015 indicated that 75% of people would prefer a card over an electronic message.[228]

Our view

A7.31 E-substitution has led to a decline in single piece letter volumes. The greater volume decline seen in single piece letters would suggest that the mail sent by single piece customers (i.e. consumers and businesses who send low volumes of mail) has been more susceptible to e-substitution. In addition, once these volumes have shifted to digital alternatives, they are unlikely to switch back, particularly in response to Royal Mail price changes. We consider this decline in single piece letter volumes due to e-substitution is likely to persist, but at a slower rate as customers for whom digital services are an alternative are likely to have already switched. There will remain a rump of letters for which digital alternatives are not a good option (e.g. greeting cards).

[223] 2015 Communications Market Report, pages 398 and 400.
[224] For the age group 16-34, reported mail usage increased in the preceding two years to the survey. See Ofcom's 2015 Communications Market Report, pages 401 and 408.
[225] See PwC's '*Outlook for UK mail volumes to 2023'* dated 15 July 2013, page 44, http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf.
[226] See PwC's '*Outlook for UK mail volumes to 2023'* dated 15 July 2013, page 45.
[227] Ofcom, *The affordability of universal postal services*, paragraph A2.23
[228] See Royal Mail press release, *Traditional Christmas cards remain more popular than e-cards reveals Royal Mail research*, 8 December 2015, http://www.royalmailgroup.com/traditional-christmas-cards-remain-more-popular-e-cards-reveals-royal-mail-research.

Ability to increase prices

A7.32 Significant price increases for single piece services in 2011-12 and 2012-13 may have contributed to higher rates of volume decline. Overall single piece letter and large letter volumes declined by 10.9% in 2011-12 and 10.6% in 2012-13.[229] However, the rate of decline across the different products and payment methods differed.

A7.33 Total First Class single piece volumes fell by 14% in 2012-13[230] following significant price increases, in the same year Second Class single piece volumes declined at a slower rate (7.5%). First Class stamp letter volume decline [✂] following the 30% price increase. On the other hand, Second Class stamp volume decline [✂] despite the fact prices increased by nearly 40%. This suggests that some customers may have switched to using Second Class rather than First Class in response to the significant price increases. We observe a similar impact for First and Second Class meter letters.

A7.34 However, while the decreases in volume were substantial, we note that:

- Some of the decrease is likely to have been a continuation of the long-term decline in volumes due to e-substitution, and would likely have occurred even absent a price increase;
- These volume decreases should be seen in the context of somewhat larger increases in price – for example a 30% price increase for First Class stamps and a 39% increase for Second Class stamps.

A7.35 Since 2012-13 Royal Mail has increased stamp prices broadly in line with RPI and its Second Class stamp letter price remains 3p below the cap.[231] This does not necessarily suggest that it could not profitably raise prices. Instead, it may be that there are other factors at play which may constrain it from doing so. These may include political and public pressure not to increase the price of stamp products and the fact that Ofcom was closely monitoring its prices.[232]

A6.2 In the 2014-15 Annual monitoring update we noted that the fall in Second Class volumes continued to be less than the fall in First Class volumes, and that Second Class revenue continued to increase while First Class revenue fell. We noted that consumers of Second Class products may be less price-sensitive, and some customers may have been choosing cheaper Second Class products, perhaps as a result of price rises and potentially a desire to economise.[233] This indicates that First Class price increases may be constrained to some extent due to down-trading to Second Class.

A7.36 This view is supported by Royal Mail's pricing behaviour. It has largely kept the absolute price differential between First and Second Class stamps at the same level (but this has resulted in the proportional difference between the classes reducing). This is in the context of no regulatory controls on Royal Mail's pricing for First Class

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[229] Includes single piece parcel volumes – see Figure 6.4 of the Annual monitoring update of the postal market 2014-15.
[230] Ibid.
[231] See Royal Mail's response to the July 2015 Discussion Document, sections XIII-XV.
[232] [✂].
[233] See the Annual monitoring update of the postal market 2014-15, paragraph 6.23.

stamps. It does therefore appear that the level of First Class stamp prices is constrained by Second Class, particularly as it appears some customers have downtraded to Second Class in response to First Class price increases.[234]

A7.37 In addition, it is likely that the threat of competition from access operators has influenced Royal Mail's pricing for the meter and PPI payment methods. Prior to the mid-2000s, Royal Mail did not offer a discount for meter and PPI single piece payment methods. Since then the differential has grown significantly over time – from 2p in 2007 for both classes to 11p and 15p for First and Second Class respectively now. We note that the differential is higher in both absolute terms and proportion of stamp prices for Second Class where Royal Mail is subject to some upstream competition from access operators.[235]

Our view

A7.38 Overall we consider that Royal Mail faces limited competitive constraints on its prices:

- Royal Mail increased single piece prices significantly in 2012 and while the volume decline was higher in this year, it was still significantly less than the overall price increases. While stamp price increases have been relatively limited since 2012 (broadly in line with RPI), and Royal Mail is currently not pricing up to the level of the cap, the significant 2012 and to a lesser extent 2011 price increases have been maintained. In addition, we consider there are likely to be some other factors such as political pressure, negative publicity and our monitoring regime which have so far limited Royal Mail's incentive to implement significant further price increases.

- While consumers can (and do) switch to electronic alternatives it is not clear that, absent very significant price increases (such as those seen in 2012), Royal Mail's prices have a significant impact on the rate of e-substitution. Consumers cite the speed of and personal preference for electronic alternatives rather than Royal Mail's price changes. We note in particular the very significant differential in prices between post and email, text etc. once the initial investment has been made (for example in IT platforms for some businesses and smartphones for consumers).

- There is very little competition for single piece letter delivery and the end-to-end letter delivery competitors that are operating in this sector currently do so in limited geographic areas.

A7.39 However, we consider that the level of constraint may vary between classes and payment methods and that some of Royal Mail's prices may constrain others. In particular, while we consider there are limited constraints on Royal Mail's stamp prices, it appears that Second Class has had a lower volume impact from proportionally greater price increases when compared with First Class. In addition, meter and PPI price increases have been lower than stamps potentially due to the fact that some higher volume single piece customers can switch to access operators.

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[234] [✂].
[235] [✂].

A7.40 We do not consider that the constraints on Royal Mail's ability to raise prices for single piece letters and large letters have significantly lessened compared to 2012.

Bulk mail letters

Overview

A7.41 A significant difference for compared to single piece mail is that other operators are active in the upstream parts of the supply chain for bulk mail. This has been enabled by the requirement for Royal Mail to provide access to its delivery network i.e. upstream operators collect, sort and transport mail and hand it over to Royal Mail for delivery at the Inward Mail Centre (for which they pay Royal Mail). Royal Mail also offers retail bulk mail services to customers where it carries out both the upstream and downstream activities. Royal Mail provides the overwhelming majority (i.e. >99%) of downstream delivery services for bulk mail letters.

A7.42 The access price represents on average 85-90% of the total retail price of D+2 bulk mail letters (which makes up the overwhelming majority of bulk mail volumes) and Royal Mail's pricing therefore has a very significant impact on the overall prices charged by access operators and its own retail business. We have therefore analysed Royal Mail's access prices given the impact these have on overall bulk mail prices. In addition, when considering overall volume trends we have looked at combined bulk mail and access volumes as this gives a better picture of overall trends for bulk mail letters.

A7.43 As with single piece letters discussed above, Royal Mail does not publish bulk mail letter volumes and revenues separately. We have therefore analysed, where appropriate, total bulk mail volumes including parcels to give an indication of how the market trends have changed over time. Figure A7.5 below summarises the key features of bulk mail letters.

Figure A7.5: Key features of bulk mail letters[236]

Volume trend	Access price trend	Revenue trend	Royal Mail share of volumes	Outlook
Overall bulk mail access and retail volumes have been declining – 15.1% reduction from 2010-11 to 2014-15 (3.8% p.a. on average)[237] Bulk mail letter volumes, down [✂] from 2011-12 to 2014-15 and [✂] from 2012-13 to 2014-15.	Significant price increases over 2011 and 2012 c.33%-40% for business mail and c.13-20% for advertising mail Subsequent price increases have been around RPI. Transactional access price increases were greater than advertising access prices	Overall bulk mail access and retail revenues increased by 13.5% from 2010-11 to 2014-15[238] Bulk mail letter revenues declined by [✂] from 2011-12 to 2014-15 and [✂] between 2012-13 and 2014-15.	Royal Mail has a relatively low share of retail volumes 29% (upstream collection and sortation) activity Royal Mail has a >99% monopoly for downstream parts of the value chain (delivery)	Volumes likely to continue to slowly decline (particularly for transactional mail), some uncertainty around the future rate of decline Significant levels of access competition likely to continue Likely to be very limited end-to-end competition

Bulk mail applications

A7.44 Royal Mail has in recent years re-branded its retail bulk mail letter and large letter products around the different applications e.g. transactional (business) mail, advertising (marketing) mail and publishing mail. These are replicated to an extent in its access products with separate transactional (business) and advertising mail products. It is not clear the extent that customers use the retail or access bulk mail products that correspond to the type of mail they are sending. However, it is likely that most advertisers will use the advertising mail access and retail products as they are priced lower than business or publishing mail. While there is not a publishing access mail product, this does not mean publishing mail is not sent using other access products). [✂].

Volume and revenue trends

A7.45 In 2014-15, the bulk mail letter and large letter sector comprised c.10 billion items (approximately an 80% volume share of total letters)[239] and [✂] in revenues. Access operators account for a large majority of upstream (collection and sorting)

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[236] Non confidential bulk market trends include Access Parcels and Business Parcels as reported in Figures 4.3 and 4.4 of the Annual monitoring update of the postal market 2014-15.
[237] Includes bulk parcel volumes – see Figure 6.4 of the Annual monitoring update of the postal market 2014-15.
[238] Includes bulk parcel revenues – see Figure 6.5 of the Annual monitoring update of the postal market 2014-15.
[239] See Figure 7.1 above

volumes (7.1bn items went through access operators in 2014-15).[240] However, Royal Mail accounts for the vast majority of overall revenues given that there is more value (and cost) in the downstream delivery parts of the pipeline (as noted above upstream activities represent only around 10-15% of the value chain). Our analysis shows that in this segment overall bulk mail letter volumes and revenues have fallen by [✂] and [✂] respectively between 2012-13 and 2014-15.

A7.46 Although there are a number of operators handling access mail, the bulk of volumes are handled by two companies – Whistl and UK Mail. Whistl's former parent company Post NL has stated in its 2014 annual report that Whistl has a 56% share of downstream access volumes in the UK. UK Mail stated last year that it carries almost 3 billion items through downstream access each year. [241]

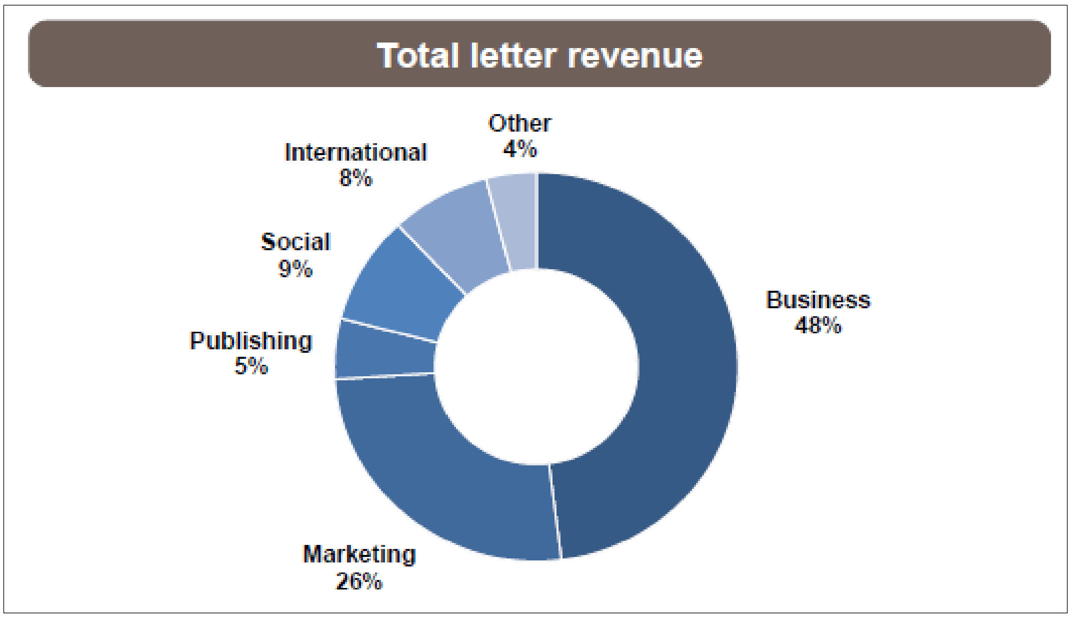
A7.47 Overall bulk mail volumes have declined by 15.1% between 2010-11 and 2014-15.[242] This equates to an average annual decline of 3.8% which is lower than the overall letter volume decline of 18% over the same time period.[243] [✂].

A7.48 The total proportion of bulk mail letters and large letters handled by access operators was 71% in 2014-15 (see Figure A7.1 above) and it has been increasing since 2010-11,[244] while [✂].

A7.49 Figure A7.6 below shows how Royal Mail reports its UKPIL letter revenue split between the three main bulk mail applications. In the chart, business maps to transactional mail and marketing maps to advertising mail. This shows that total bulk mail (i.e. including business, marketing and publishing) makes up 79% of Royal Mail's revenues, with business (transactional) mail accounting for the largest share.

[240] See Ofcom's Annual monitoring update on the postal market, 2014-15, Figure 4.2. Note this figure includes a small amount of parcels.
[241] See Ofcom's Annual monitoring update on the postal market, 2014-15, paragraph 4.26.
[242] See Ofcom's Annual monitoring update on the postal market, 2014-15, Figure 6.4.
[243] See Ofcom's Annual monitoring update on the postal market, 2014-15, Figure 6.1.
[244] See Ofcom's Annual monitoring update on the postal market, 2014-15, Figure 4.6.

Figure A7.6: Royal Mail letter revenues split by applications



Notes: Other includes Royal Mail 24 and 48 and response services and may include some single piece volumes.
Source: Taken from Royal Mail's May 2015 Annual Results presentation.[245]

Pricing trends

A7.50 Royal Mail introduced significant price increases for its bulk mail retail and wholesale products in 2011-12 and 2012-13. Following an application to Postcomm to increase the level of the price control, Royal Mail increased its access prices significantly. For example, as shown in Figure A7.7 below, business mail low and high sort access product prices increased by more than 20%. Price increases for marketing products were more modest, with increases in the high and low sort advertising access products of 8-12%. This was followed by further significant access price increases in April 2012 where business mail access prices increased by between 11% and 13% but advertising product price rises were kept to single digits.

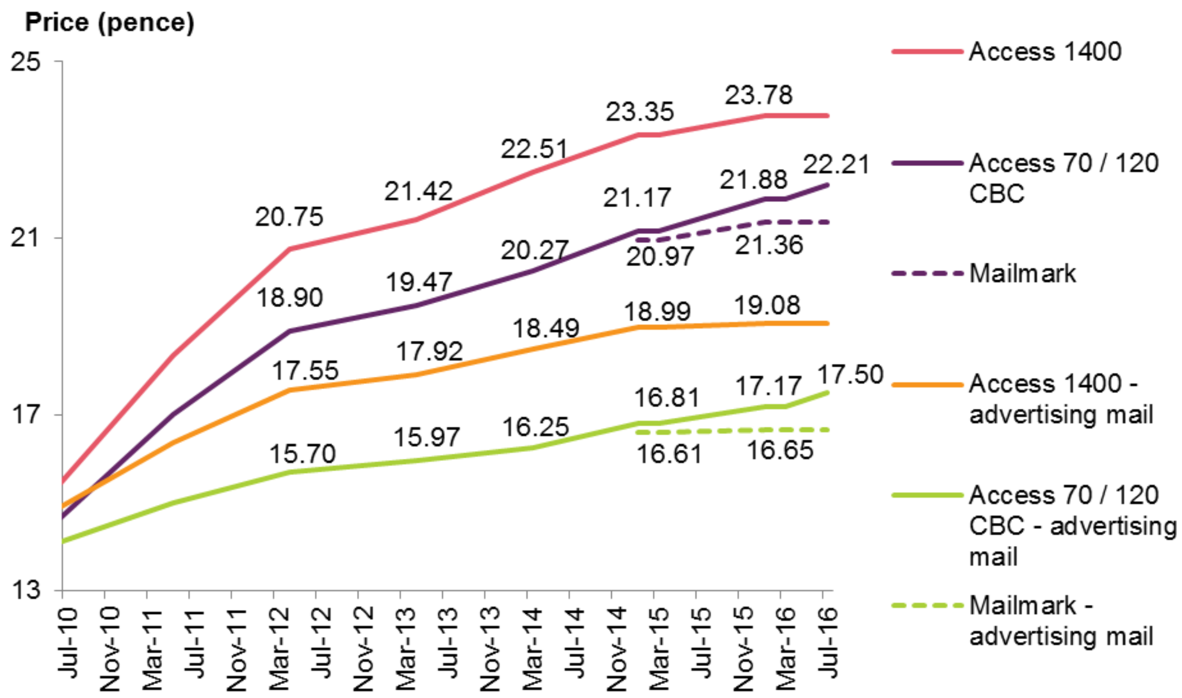
A7.51 Access price increases since 2012 have been more modest. Advertising product prices increased by around RPI on average. However, transactional prices have continued to increase at a rate higher than RPI, albeit at a slower pace than the previous two years.

A7.52 In March 2014 Royal Mail launched its Mailmark option for machine-readable mail with an expectation that more than 70% of machine-readable bulk mail would migrate to Mailmark by the end of 2016.[246] Royal Mail expects Mailmark to replace the CBC and it is therefore committed to the withdrawal of the CBC, which it

[245] See Royal Mail's 'Full Year 2014-15 Results' presentation, page 8, http://www.royalmailgroup.com/sites/default/files/FY%202014-15%20Results%20Presentation.pdf.
[246] See Royal Mail's consultation on Mailmark Migration published on 29 May 2015, https://www.royalmailwholesale.com/mint-project/uploads/238555311.pdf.

currently proposes to do in January 2018.[247] To encourage migration, in January 2015 Royal Mail introduced a 1% price differential between Mailmark and Access 70 CBC Letters products which was increased to 2.5% in January 2016 and will be further increased to 4% in July 2016.

Figure A7.7: Royal Mail access bulk mail letter prices, 2010-11 to 2016-17



Source: Royal Mail, based on National access prices, weighing 0-100g April 2014 prices restated to reflect NPP1 prices

Constraints on bulk mail letters

A7.53 In this sub-section we consider constraints from:

- end-to-end competition;
- access competition; and
- e-substitution.

A7.54 Under each of the above headings we consider information provided by Royal Mail (and reports it commissioned from consultants) and other stakeholders, and we present our views. We then set out our view on Royal Mail's ability to increase prices and summarise other information that has informed our analysis.

<u>End-to-end competition</u>

A7.55 As discussed in 2.34, Whistl started delivering end-to-end letter mail from April 2012. It said publicly that it intended to roll out delivery services to around 40% of

[247] See Royal Mail's decision on Mailmark Migration, 4 December 2015, https://www.royalmailwholesale.com/mint-project/uploads/956216844.pdf.

UK premises.[248] Whistl's expansion plans were put on hold in April 2014 following Royal Mail's notification of its 2014 access prices and it subsequently decided to withdraw its end-to-end delivery services in June 2015. Prior to its withdrawal from delivery operations, Whistl was delivering to around 7% of UK addresses.[249]

A7.56 Therefore from April 2012 until June 2015 Royal Mail faced some actual end-to-end competition from Whistl including the threat of expansion (to the extent its plans had been publicly stated by Whistl). Following Whistl's closure of its end-to-end delivery operations in June 2015 there is no significant end-to-end competitor to Royal Mail in this sector currently. Furthermore, at this point in time we consider any significant entry in end-to-end letter delivery to be highly unlikely given that Whistl – the largest access operator, backed by an incumbent postal operator with experience of entering new markets (PostNL) – was unable to succeed as an entrant.

Information provided by Royal Mail

A7.57 There is some evidence that the threat of end-to-end expansion may have constrained Royal Mail's retail pricing. For example, Royal Mail put a significant submission to Ofcom on the potential impact of end-to-end competition on the universal service in June 2014.[250] [✂].[251] [✂].[252]

Information provided by other stakeholders

A7.58 [✂] considered that, following Whistl's withdrawal from the end-to-end delivery sector, other operators have a 'minimal effect' on Royal Mail.[253] Similarly, DX argued that following Whistl's withdrawal from end-to-end letter delivery, Royal Mail faces no direct constraint on price.[254] The Consumer Council said "with the withdrawal of Whistl's end-to-end delivery in the UK it is difficult to foresee consumers here benefitting from this type of competition in the future. Consequently, we do not see this having any significant influence on Royal Mail's behaviour."[255]

Our view

A7.59 It is possible that end-to-end competition and in particular the threat implied by Whistl's publicly stated expansion plans constrained Royal Mail's wholesale bulk mail letter pricing prior to June 2015. However, at this point in time we consider any significant entry in end-to-end letter delivery to be highly unlikely and this constraint is likely to have diminished.

Access competition

A7.60 A number of alternative operators provide upstream services in conjunction with an access agreement with Royal Mail for delivery. As noted in paragraph A7.44, these

[248] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013.
[249] Ofcom, *Review of end-to-end competition in the postal sector*, paragraph 2.18.
[250] Royal Mail, *Direct Delivery: A threat to the Universal Postal Service Regulatory Submission to Ofcom,* http://www.royalmailgroup.com/direct-delivery-competition-regulatory-submission.
[251] [✂].
[252] [✂].
[253] See 'Name Withheld 5' [✂]'s response to our July 2015 Discussion Document, page 2.
[254] See DX's response to the July 2015 Discussion Document, page 4.
[255] See The Consumer Council response to the July 2015 Discussion Document, page 6.

operators now handle over 70% of all bulk mail letter and large letter volumes and this proportion has been slowly increasing (in recent years this has been due to access volumes having slower decline than overall bulk mail volumes).[256]

Information from Royal Mail

A7.61 In response to the July 2015 Discussion Document, Royal Mail stated that it competes in the most developed access sector in Europe and that "intensive upstream access" constrains its activity.[257]

Information from other stakeholders

A7.62 In response to the July 2015 Discussion Document, other stakeholders presented varied opinions on the constraints access mail provides on Royal Mail. Some stakeholders considered that Royal Mail is constrained by access operators. For example:

- TechUK argued that other postal operators' activity constrains Royal Mail's pricing and non-pricing activity and that Royal Mail needs further commercial freedom to react to other operators and innovate.[258]

- CWU considered that competition in the access sector is the already most developed in Europe and provides incentives for Royal Mail to reduce prices.[259]

A7.63 The Consumer Council said that access competition "benefits business consumers".[260]

A7.64 However, the majority of respondents indicated that Royal Mail faces either limited or no constraint from access operators:

- Stakeholders, including GI Solutions and Secured Mail, said Royal Mail was unconstrained because it retains a significant portion of the revenues from access mail.[261]

- RBS did not believe that access operators and Royal Mail are competitors and that it will use access operators when it has sufficient volume and Royal Mail otherwise.[262]

- MCF said that constraints are only effective where Royal Mail perceives there is a threat of customers' switching from retail to access.[263]

- Whistl argued it would appear that Royal Mail's pricing and non-pricing behaviour is not constrained by other postal operators.[264]

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[256] See Ofcom's Annual monitoring update on the postal market, 2014-15, Figure 6.4.
[257] See Royal Mail's response to the July 2015 Discussion Document, page 20.
[258] See TechUK's response to the July 2015 Discussion Document, page 2.
[259] See CWU's response to the July 2015 Discussion Document, page 7.
[260] See The Consumer Council's response to our July 2015 Discussion Document, page 7.
[261] See GI Solution's response to our July 2015 Discussion Document, page 2. Also see Secured Mail's response to our July 2015 Discussion Document, paragraphs 3.8-3.10.
[262] See RBS's response to our July 2015 Discussion Document, paragraph 3.5.
[263] See MCF's response to the July 2015 Discussion Document, page 2.
[264] See Whistl's response to the July 2015 Discussion Document, page 11.

- UK Mail believed competition from other postal operators and additional factors constrain RM's pricing and non-pricing behaviour to only a small extent overall.[265]
- Unite told us that it believes that Royal Mail is not constrained by other operators but the desire to meet high quality of service targets.[266]

Our view

A7.65 As noted above, access operators' share of the bulk mail market has grown over time. It seems likely that access competition has led to innovation and higher customer service standards for bulk mailers. In addition, it has also led to lower prices for the upstream services. However, the portion of the value chain accounted for by upstream activities is relatively small (10-15% of revenues) and Royal Mail sets the prices access operators must pay for delivery. Therefore access operators are only able to exert constraint over a relatively small part of overall retail price. In addition, we consider that the majority of constraint access operators provide upstream present in 2012.

E-substitution

Information provided by Royal Mail

A7.66 In response to our July 2015 Discussion Document, Royal Mail argued that e-substitution is one of the factors that contributes to a "fragile ecosystem with limited room for manoeuvre" within the letters market.[267] It said that addressed letter volumes are subject to "possible acceleration of decline from increased e-substitution, 'tipping points' and fluctuations in volumes" which contribute to a "unique set of circumstances" in the letters sector.[268]

A7.67 Royal Mail considered that it would remain subject to significant constraint through the threat of digitisation. It argued that UK addressed letter volumes are subject to "rapid levels of decline...of between 4% and 6% per annum" and that this trend is "likely to continue".[269] It highlighted research that it had commissioned which showed that large price increases could increase price elasticities "due to an increase in e-substitution".[270]

A7.68 Royal Mail pointed out that it has contributed to or launched a number of initiatives designed to promote the advantages of business and advertising mail over digital alternatives, including the Keep Me Posted and the Mailmen campaigns.[271] These appear to indicate that Royal Mail is aware of the threat of e-substitution and considers this when defining and advertising its bulk letters products.

A7.69 The FTI Consulting report commissioned by Royal Mail further argued that potential acceleration in e-substitution could constrain Royal Mail's pricing. The report outlined the likelihood that transactional mail senders would migrate to digital alternatives as a cost-saving measure and further noted that the 'digital by default'

[265] See UK Mail's response to the July 2015 Discussion Document, page 4.
[266] See Unite's response to our July 2015 Discussion Document, page 2.
[267] See Royal Mail's response to our July 2015 Discussion Document, paragraph III.
[268] See Royal Mail's response to our July 2015 Discussion Document, paragraph 1.26.
[269] See of Royal Mail's response to our July 2015 Discussion Document, paragraphs 2.5 to 2.8.
[270] See Royal Mail's response to our July 2015 Discussion Document, paragraph 2.12.
[271] See http://www.mailmen.co.uk/ and http://www.keepmeposteduk.com/.

strategy published by the Coalition Government in March 2012 would encourage e-substitution. On advertising mail, it considered that direct mail, print media and online display advertising share similar features in that all are generally static displays or image and/or text that are viewed one or more times in the home. Therefore it considered that many features of direct marketing mail can be replicated by other channels.[272]

A7.70 E-substitution was also addressed in the report produced by PwC for Royal Mail which stated that e-substitution is likely to continue into the future but at a reducing annual rate. PwC noted that:

- volumes for government and business to business services may still see some significant change;[273]
- advertising mail volumes will decline but at a slower rate as the internet advertising market matures; [274] and
- in relation to publishing mail, many newsletters went online as technology developed, but magazines have traditionally been more resilient to e-substitution.[275]

Information provided by other stakeholders

A7.71 In response to our July 2015 Discussion Document, other stakeholders have presented varied opinions on the extent to which e-substitution constrains Royal Mail and the wider postal industry as a whole.

A7.72 Some stakeholders indicated that e-substitution impacts on every operator in the postal industry and not just Royal Mail. TechUK indicated that it considers e-substitution a constraint on the postal sector overall.[276] This view was shared by UK Mail.[277]

A7.73 The CWU believed e-substitution is “a significant threat” to Royal Mail’s future revenue from the letters market and has forced Royal Mail to exercise restraint in price rises and to improve its efficiency.[278] The BBC Licence Fee Unit noted that e-substitution has been the main cause of decline in overall mail volumes but that it is now a “diminishing constraint” on transactional mail.[279]

A7.74 Citizens Advice indicated that modest price increases since 2012-13 for stamp and meter prices could “provide evidence that Royal Mail considers that it cannot raise prices further without triggering steep volume losses due to electronic substitution”.[280]

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[272] See the FTI report entitled ‘*Competitive constraints on pricing faced by Royal Mail*’, paragraphs 4.8-4.9.
[273] See PwC’s *Outlook for UK mail volumes to 2023* report, pages 37 and 38.
[274] See PwC’s *Outlook for UK mail volumes to 2023* report, pages 40 and 41.
[275] See PwC’s *Outlook for UK mail volumes to 2023* report, page 43.
[276] See TechUK’s response to our July 2015 Discussion Document, page 3.
[277] See UK Mail Group’s response to our July 2015 Discussion Document, paragraph 3.12.
[278] See the CWU’s response to our July 2015 Discussion Document, paragraph 30.
[279] See the BBC Licence Fee Unit’s response to our July 2015 Discussion Document, page 3.
[280] See the Citizens Advice Service’s response to our July 2015 Discussion Document, page 8.

A7.75 The MUA noted that its members had mixed views on e-substitution, with some members believing that it constrained Royal Mail in practice to a small extent.[281]

A7.76 Some stakeholders considered that e-substitution was more of a constraint for some applications of mail over others.

- The DMA told us that e-substitution is potentially a constraint on Royal Mail for transactional mail but this does not seem to be reflected in Royal Mail's actual behaviour as prices have increased over recent years (and at a greater rate than advertising mail).[282] The MCF told us that the effect of e-substitution for transactional mail "is significant and permanent" and has been worsened by Royal Mail's pricing behaviour since 2011-12.[283]

- [✂] said that advertising mail is the application subject to the greatest level of constraint from digital media.[284] Secured Mail and UK Mail suggested that Royal Mail's decision to launch a separate advertising mail product indicates that it is aware of the constraint from e-substitution in relation to marketing mail but not transactional mail.[285]

- Some stakeholders, including UK Mail and Secured Mail, said that Royal Mail is constrained by e-substitution for products within the publishing mail application albeit to a smaller extent.[286] However, UK Mail believed that e-substitution was a lesser constraint on publishing mail (compared to advertising mail) because digital products in the publishing industry tend to act as a supplementary product to print or that digital products are more substitutable with 'off the shelf' magazines purchased in person (as opposed to delivered subscriptions).[287]

- The Professional Publishers Association (PPA) said that advertisers are keen to still use print as a main channel of advertising which may restrict any acceleration in e-substitution due to price increases.[288]

- RBS indicated that it believes that only some of Royal Mail's products are constrained.[289]

A7.77 Some stakeholders considered that Royal Mail's behaviour does not indicate that it is constrained by e-substitution.

- Whistl believed that Royal Mail has not been constrained by the risk of e-substitution. In particular, it told us that Royal Mail's assumptions that demand for transactional mail is less elastic than other applications could be damaging to the industry as it could lead to acceleration in substitution rates.[290] Similarly some stakeholders including members of the MCF, Chris Williams and an access

[281] See the MUA response to our July 2015 Discussion Document, paragraph 3.4.
[282] See the Direct Marketing Association's response to our July 2015 Discussion Document, page 1.
[283] See the MCF's response to our July 2015 Discussion Document, page 3.
[284] See 'Name Withheld 5' [✂]'s response to our July 2015 Discussion Document, page 2.
[285] See Secured Mail's response and paragraph 3.13 of UK Mail's response to our July 2015 Discussion Document, paragraph 3.13.
[286] See UK Mail Group's response to our July 2015 Discussion Document, paragraph 3.35; see Secured Mail's response to our July 2015 Discussion Document, paragraph 3.25.
[287] See UK Mail Group's response to our July 2015 Discussion Document, paragraph 3.35.
[288] File note of meeting between PPA and Ofcom, 19 January 2016.
[289] See RBS's response to our July 2015 Discussion Document, paragraphs 3.1 to 3.8.
[290] See Whistl's response to our July 2015 Discussion Document, page 11.

operator [✂] told us that Royal Mail's pricing behaviour has accelerated mail substitution in transaction mail.[291]

- DX argued that it did not consider that e-substitution is an effective constraint and that Royal Mail is setting prices that will "hasten the development of alternative media and their eventual adoption".[292]
- The MCF said that its members noted "little if any evidence" of Royal Mail's non-pricing behaviour being constrained by e-substitution.[293]

Our view

A7.78 We recognise that any price increase for bulk mail carries the risk of accelerating e-substitution, and the impact of this is greater if this switch is permanent (as it likely to be the case for transactional mailers). However, despite the significant access price increases in the bulk mail letters market in 2011 and 2012, volumes only fell by on average c.4.8% per annum for 2011-12 and 2012-13. [✂].

A7.79 It may therefore be more difficult for users of transactional mail to initially switch to using other forms of media, particularly in comparison to advertisers (as evidenced by Royal Mail's pricing strategy to have lower rates of increase for advertising access mail). For example, it may be necessary to develop IT platforms and/or incentivise customers to switch to receiving transactional services via electronic platforms such as email or online.[294]

A7.80 Overall the fact that Royal Mail increased the prices of transactional mail significantly in 2011 and 2012, and price rises have been higher for transactional mail than advertising mail suggests that the threat of increasing e-substitution for transactional services has had a limited impact on Royal Mail's pricing behaviour.

A7.81 On the other hand advertising mail may be less prone to permanent digital switching. The choice of which medium advertisers use for their campaigns is a key part of the overall strategy and is often dependent on a number of factors such as the type of campaign, the target market, return on investment and how this compares across the different mediums.[295] Advertisers may use a multi-strategy approach, for example using direct mail as a follow up to a TV or other mass marketing campaign and as such it is less likely to be subject to ongoing e-substitution. In addition, if advertisers switch to another medium for one campaign, they may well decide to use direct mail for the next one (depending on the specifics

[291] See the MCF's response to our July 2015 Discussion Document, section 2.3; see r C Williams' response to our July 2015 Discussion Document, page 2; and see 'Name Withheld 4' [✂]'s response to our July 2015 Discussion Document, page 2.
[292] See DX's response to our July 2015 Discussion Document, page 4.
[293] See the MCF's response to our July 2015 Discussion Document, sections 2.3 and 2.4.
[294] PwC's '*Outlook for UK mail volumes to 2023'* pages 36 to 38 discusses some of the inhibitors to e-substitution for transactions mail e.g. consumer preferences for paper statements/paper communications, regulation (e.g. the requirement for a 'wet' signature) and limited online access for some customer groups.
[295] For example, http://www.venturechoice.com/articles/choose_adv_medium.htm discusses the impact of different advertising media.

of the campaign and expected ROI).[296] Royal Mail's promotional materials highlight the unique benefits of direct mail.[297]

A7.82 For publishing mail, while there has been some reduction in mail volumes, e-substitution has been less severe than expected. UK Mail noted that users of digital products tended to be 'off the shelf' customers who traditionally bought the magazine from newsagents etc. rather than having it delivered, or those customers who take the digital version as a supplement to the physical magazine.[298]

A7.83 It is therefore not clear that e-substitution has a significant and enduring impact on Royal Mail's ability to increase its bulk mail prices. E-substitution rates vary across the different applications of mail with transactional and, to an extent, publishing mail being impacted by a one-way technological shift. Advertising mail is likely more susceptible to price increases and the relationship between the cost of sending mail and the cost of using other advertising medium.

<u>Ability to increase prices</u>

A7.84 In its response to the July 2015 Discussion Document, Royal Mail presented estimates of price elasticities for its bulk mail services. It considered that that price elasticities are low for all the bulk mail applications.[299] However, it argued that its pricing decisions do not reflect its measured price elasticities, but take into account wider factors including expected future changes in the market. Royal Mail also argued that its estimated price elasticities would be considerably higher in response to large price increases, due to an increase in e-substitution.[300]

A7.85 In practice Royal Mail has increased nominal access bulk mail prices since 2012, although the rate of increase has differed between transactional and advertising services. For transactional access services price increases have, on average, been greater than RPI since 2012. For advertising access mail average price increases have been around RPI for the same period, which may reflect greater pricing constraint due to the greater ease of switching between media and link to return on investment.

A7.86 However, it is also important to consider Royal Mail's access pricing behaviour since 2012 in the context of the previous two years of significant price increases for all access prices, albeit lower increases for advertising products.

A7.87 The low estimated price elasticities provided by Royal Mail may mean that it has some scope to profitably increase prices. While we recognise there is a threat of accelerated e-substitution if Royal Mail were to make some additional significant price increases, it is not clear that the 2011 and 2012 access price increases have resulted in a significant increase in e-substitution. It is possible, however, that given the time some transactional mailers need to develop their online platforms we have not yet seen the full impact from these 2011 and 2012 access price increases.

[296] For example, the DMA noted that, "Advertising mail is subject to the highest level of competitive constraint due to number of alternative media choices available to an advertiser and the fact that it is very easy to switch budget between media." See DMA response to the July 2015 Discussion Document, page 2.
[297] See, for example, http://www.mailmen.co.uk/why-mail.
[298] See UK Mail's response to the July 2015 Discussion Document, paragraph 3.35.
[299] The price elasticity of demand provides information about a supplier's ability to profitably raise prices. Low price elasticities (also called inelastic) indicate an ability to profitably increase prices.
[300] See Royal Mail's response to our July 2015 Discussion Document, paragraphs 2.9 to 2.13.

A7.88 In the rest of this sub-section we set out the information we have considered in reaching our view. For each bulk mail application we look at:

- information provided by Royal Mail including the impact of 2012 price increases on volumes and its elasticity estimates; and
- other stakeholder comments.

Transactional Mail

A7.89 In response to the July 2015 Discussion Document, Royal Mail argued that it has acted with restraint in increasing prices for transactional mail as “larger price increases might trigger accelerated e-substitution” despite its low price elasticity. It noted that it had increased prices for its transactional retail mail products by c.0.9% on average above RPI per annum since April 2012.[301]

A7.90 [✂]:

- [✂].[302]
- [✂].

Advertising Mail

A7.91 In response to the July 2015 Discussion Document, Royal Mail said that it has acted with restraint when increasing prices for advertising mail because of its belief that other media constrain its activity.[303] It said that it has increased prices for its retail advertising mail products at c.0.6% below RPI per annum since April 2012.[304]

A7.92 [✂]:

- [✂][305] [✂].[306]
- [✂].[307] [✂].[308]

A7.93 Other stakeholders including UK Mail and the DMA told us that advertising mail is likely to be the application with the highest level of constraint as the allocation of budget in an advertising portfolio can be more discretionary.[309] For example, the DMA said that, “Advertising mail is subject to the highest level of competitive constraint due to number of alternative media choices available to an advertiser and the fact that it is very easy to switch budget between media. Small changes in cost can have an almost immediate impact on volumes – both up and down.”[310]

[301] See Royal Mail’s response to our July 2015 Discussion Document, paragraph 3.11.
[302] [✂].
[303] See Royal Mail’s response to our July 2015 Discussion Document, paragraph 3.13.
[304] See Royal Mail’s response to our July 2015 Discussion Document, paragraph 3.13.
[305] [✂].
[306] [✂].
[307] [✂].
[308] [✂].
[309] See UK Mail Group’s response to our July 2015 Discussion Document, paragraph 3.34; see the DMA’s response to our July 2015 Discussion Document, page 2.
[310] See the DMA’s response to our July 2015 Discussion Document, page 2.

- The CWU considered that the advertising industry is a challenging one for Royal Mail to continue to grow its letter revenue.[311]

- One access operator [✂] noted that Royal Mail offers special promotions, offers and lower prices relative to other products in recognition of the level of competition for different advertising medium.[312]

- RBS noted that for direct or marketing mail, return on investment is critical. As mail is a powerful medium for advertisers to reach their customers (as Royal Mail's Mailmen campaign demonstrated) it is likely that advertisers will continue to use it. However, the more expensive marketing becomes generally, the more limited spend on mail becomes.[313]

Publishing Mail

A7.94 In response to the July 2015 Discussion Document, Royal Mail indicated that its management had considered factors beyond elasticities when increasing prices. It noted that prices for its retail publishing mail products have increased by c. 1.2% over RPI on average since April 2012.[314]

A7.95 [✂]:

- [✂].[315]

- [✂].

- [✂].[316]

A7.96 Some stakeholders have told us that postage costs are important in the publishing sector.

- PPA believed that postage price changes have affected subscription rates and audience retention in magazines. It said that as subscriptions tend to be annual, price stability and certainty are crucial for publishers.[317]

- The PPA also considered postage can constitute a significant proportion of the unit cost of magazines.[318]

- MCF argued that a lack of choice and competition in publishing mail risks publishers insourcing their delivery and removing volumes from Royal Mail's network.[319]

- Whistl considered that Royal Mail's profile pricing for publishing mail was not available to access operators and that access competition could help to slow e-substitution and/or insourcing.[320]

311 See the CWU's response to our July 2015 Discussion Document, paragraphs 39 and 40.
312 See 'Name Withheld 5' [✂]'s response to our July 2015 Discussion Document, page 2.
313 See RBS's response to our July 2015 Discussion Document, paragraph 4.2.
314 See Royal Mail's response to our July 2015 Discussion Document, paragraph 3.17.
315 [✂].
316 [✂].
317 File note of meeting between PPA and Ofcom, 19 January 2016.
318 Document submitted by PPA to Ofcom, 27 January 2016.
319 See the MCF's response to our July 2015 Discussion Document, page 8.

A7.97 [✂] believed that Royal Mail was not constrained significantly in this application by anything other than e-substitution.[321]

A7.98 The PPA told us that the decline in publishing mail volumes was likely a result of general structural economic issues affecting the industry since 2008. These included strategic decisions by publishers; price increases in mailing and their subsequent impact on subscription rates and audience retention; and digitalisation.[322]

A7.99 However, the PPA told us that decline has been slower in some specialist markets, such as hobby magazines, that serve a niche audience. Magazines on behalf of chartered institutes and membership associations were identified as a growth market for publishers.[323]

Our view

A7.100 In summary:

- Royal Mail provides the overwhelming majority of bulk letter mail delivery and, at this point in time, we consider any significant entry in end-to-end letter delivery to be highly unlikely. Access competition provides some constraints but only on a limited part of the value chain;

- Royal Mail introduced significant price increases for its bulk mail retail and wholesale products in 2011-12 and 2012-13. The threat of a large increase in e-substitution may constrain Royal Mail from increasing prices substantially above current levels; and

- Pricing constraints may vary by application. Price increases for access advertising mail have been smaller than for transactional mail, suggesting that Royal Mail considers advertising mail has a higher elasticity than other mail applications.

A7.101 Overall we consider that Royal Mail faces limited competitive constraints in relation to bulk mail letter and large letters. In commercial terms we consider Royal Mail is likely to be able to unilaterally and profitably raise prices for transactional mail, that there are limited competitive constraints on its pricing behaviour in publishing mail, and that while there may be greater constraints in relation to advertising mail, it is not clear that Royal Mail is effectively constrained.

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[320] See Whistl's response to our July 2015 Discussion Document, page 15.
[321] See 'Name Withheld 5' [✂]'s response to our July 2015 Discussion Document, page 3.
[322] File note of meeting between PPA and Ofcom, 19 January 2016.
[323] File note of meeting between PPA and Ofcom, 19 January 2016.

Annex 8

Parcels market analysis

Introduction

A8.1 In this annex, we set out our analysis of the parcels sector. We have considered how the sector has developed in the past few years, in order to assess whether there have been changes in the level of pricing constraints that Royal Mail faces, and, therefore, whether additional regulation may be required or whether existing regulation on Royal Mail in parcels should be modified or potentially removed.

A8.2 In the analysis below, we provide:

- an overview of the parcels sector;
- our assessment of how we consider pricing constraints on Royal Mail may have changed in single piece parcels; and
- our assessment of how we consider pricing constraints on Royal Mail may have changed in small/lightweight bulk parcels.

A8.3 Our analysis suggests that the parcels sector has become more competitive since 2010, but this does not apply equally to all segments. In single piece parcels, competition has begun to emerge but Royal Mail still has a strong position. In lightweight bulk parcels, Royal Mail continues to have a high share of volumes and revenues overall, but there is evidence competition is emerging for bulk parcels weighing between 1-2kg (consistent with Postcomm's 2010 findings[324]). These findings are broadly consistent with the views expressed by a number of stakeholders, namely that there is more competition in the parcels sector than the letters sector, but that certain segments of the parcels sector (small/lightweight and single piece parcels) are less competitive

A8.4 Figure A8.1 sets out Royal Mail's share of volumes and revenues for the segments we have focussed on (single piece parcels and bulk parcels under 2kg).[325] This shows that Royal Mail's position is stronger in these segments than in the sector overall; its share of all parcels in 2014-15 was [✂] of volumes and [✂] of revenues.

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[324] See Postcomm's *Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets – Decision document*, November 2010, http://webarchive.nationalarchives.gov.uk/20111027102050/http:/www.psc.gov.uk/documents/1158.pdf. (Note: to access this link, please copy and paste the web address into your browser).

[325] Based on the information we collected from operators, we were not able to split 0-2kg bulk parcels into 0-1kg and 1-2kg. Our understanding of shares of supply between 0-1kg and 1-2kg has therefore been informed by information that we have collected from other sources (see paragraphs A8.49-A8.50).

Figure A8.1 – Royal Mail's share of volumes and revenues across single piece parcels and bulk parcels under 2kg in 2014-15

Segment	Volumes (domestic only)			Revenues (domestic only)		
	2014-15 volumes (% change on 2013-14)	% of total volumes	Royal Mail's share of volumes	2014-15 revenues (% change on 2013-14)	% of total revenues	Royal Mail's share of revenues
Single piece (total)	350m (0%)	24%-27%[326]	60%-80%	£1.2bn (0%)	25%-31%	60%-80%
Bulk <2kg	500m (-1%)	34%-45%	60%-80%	£1.1bn (+3%)	22%-34%	60%-80%

Source: operator responses to question 3 of the section 55 notice dated 28 May 2015, and Royal Mail's response to questions 1-3 of the 2nd Review of Royal Mail regulation section 55 notice dated 10 November 2015

A8.5 While Royal Mail has a strong position in single piece parcels and bulk parcels under 2kg, our analysis shows that Royal Mail's share of volumes and revenues has either decreased or remained flat between 2013-14 and 2014-15.

Background

Postcomm's 2010 review and our approach in this review

A8.6 Postcomm analysed the parcels sector in 2010.[327] It divided the sector into a number of segments and found that express[328] and deferred[329] heavy (>2kg) parcels sent by businesses were competitive. However, it found Royal Mail to have market power for:

- single piece parcels;[330] and
- lightweight (less than 2kg) bulk parcels.[331]

[326] We have been unable to categorise all information provided according to whether it refers to single piece or bulk parcels. For this reason, we have provided a range for the percentage of total volumes and revenues that single piece and bulk parcels under 2kg represent.

[327] See Postcomm's *Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets – Decision document*, November 2010, http://webarchive.nationalarchives.gov.uk/20111027102050/http:/www.psc.gov.uk/documents/1158.pdf. (Note: to access this link, please copy and paste the web address into your browser).

[328] Postcomm defined express as time guaranteed, either same day or next day – Postcomm's *Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets – Decision document*, November 2010, paragraph 3.4.

[329] Postcomm defined deferred as non-time guaranteed, both next day and later than next day – Postcomm's *Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets – Decision document*, November 2010, *Appendix A: Glossary*.

[330] Postcomm distinguished between parcels sent from access points (Y2X) and single piece parcels collected from a consumer's premises (C2X). Nevertheless, it concluded that C2X and Y2X were, at the time, part of the same market, and that Royal Mail therefore had market power in the supply of Y2X/C2X services (see paragraph A8.23 for details).

[331] Specifically, Postcomm found Royal Mail to have market power for deferred B2X parcels (i.e. parcels sent from businesses to anyone) weighing less than 2kg.

A8.7 We have not seen any evidence that would challenge Postcomm's finding that express and deferred heavy parcels sent by businesses are competitive. We have, therefore, focused on lightweight bulk parcels and single piece parcels.

A8.8 Until 2015 we had not collected information about the parcels sector. However, in order to better understand the sector, during 2015 we began collecting information from a number of parcel carriers,[332] and we intend to continue collecting information on the parcels sector. For the purposes of our information gathering, we have defined a parcel as an addressed postal item that is delivered end-to-end and is:

- larger than a large letter (a large letter is an item up to length 353mm, width 250mm, thickness 25mm, and weighs no more than 750g);
- weighs no more than 31.5kg; and
- can be lifted by a single average individual without mechanical aids.[333]

A8.9 For the purposes of our assessment, we consider a bulk parcel to be one where a volume related discount could be applied (even if it is not for a specific parcel consignment), or where the price is determined by a negotiated contract. We have considered single piece parcels to be those where the price paid per parcel does not vary according to the volume of parcels being sent (consistent with the definition used for single piece products in the universal service). These are items sent by consumers and small businesses sending insufficient volumes to qualify for bulk contracts.

A8.10 For single piece parcels, we have grouped parcels sent from access points (e.g. the Post Office) and those collected from a sender's premises into a single category. Our analysis of single piece parcels covers all weights of parcel, though we consider that Royal Mail faces greater competition in heavier parcels.

A8.11 Our analysis is based both on the volume and revenue information we have collected from parcel carriers, as well as from other sources of information (both publically available, and that we have collected through our information gathering powers). The details of the volume and revenue information we have collected may be different from other sources of information.[334] However, the general trends we have observed from the volume and revenue information we collected is broadly consistent with the trends found in other sources of information.

Regulation of parcels

A8.12 There are currently two main areas of regulation that apply to parcels:

[332] These operators are: Royal Mail and Parcelforce (which are part of Royal Mail Group Limited), DHL, DPD (including Interlink), DX, FedEx, Hermes, TNT, Tuffnells, UK Mail, Yodel, and UPS. Apex Insight has estimated that the operators listed above represent 95% of total sector revenues (with 4% of the remaining made up by City Link, which has subsequently gone into administration) - Apex Insight, *UK Parcels, Market Insight Report 2014*, September 2014, page 39.

[333] This is the same definition used for the purposes of the 2014-15 annual monitoring update on the postal market. However, some of the information may differ in this annex as we have subsequently received updated information.

[334] For instance, we understand that the definition of a parcel we have used is different from that used when Royal Mail reports its parcel volumes based on work done by Triangle Management Services (see for instance Royal Mail, *Full year 2014-15 results*, 21 May 2015, slide 4 - http://www.royalmailgroup.com/sites/default/files/FY%202014-15%20Results%20Presentation.pdf).

- the universal service obligation; and
- the safeguard cap on Second Class stamped parcels products weighing less than 2kg (see Section 4 for more details).

A8.13 DUSP Condition 1 requires Royal Mail – as the designated universal service provider – to provide at least one delivery and collection of single piece parcels every Monday to Friday. These services must be provided at affordable and geographically uniform prices. For parcels up to 20kg, Royal Mail must provide both a next day (First Class) and D+3 (Second Class) service; and it must also provide registered and insured services for parcels up to 10kg.

A8.14 DUSP Condition 3 puts a safeguard cap price control on Royal Mail's Second Class stamp large letter and parcels up to 2 kg. Insofar as it relates to parcels, DUSP Conditions 1 and 3, the universal service obligations and the safeguard cap apply only to Royal Mail's single piece parcels and with respect to the cap this only applies to Second Class stamp single piece parcels. All postal operators – including single piece and bulk parcel operators – are required by Consumer Protection Condition 3 to have transparent and simple complaints handling procedures.

Overview of the parcels sector[335]

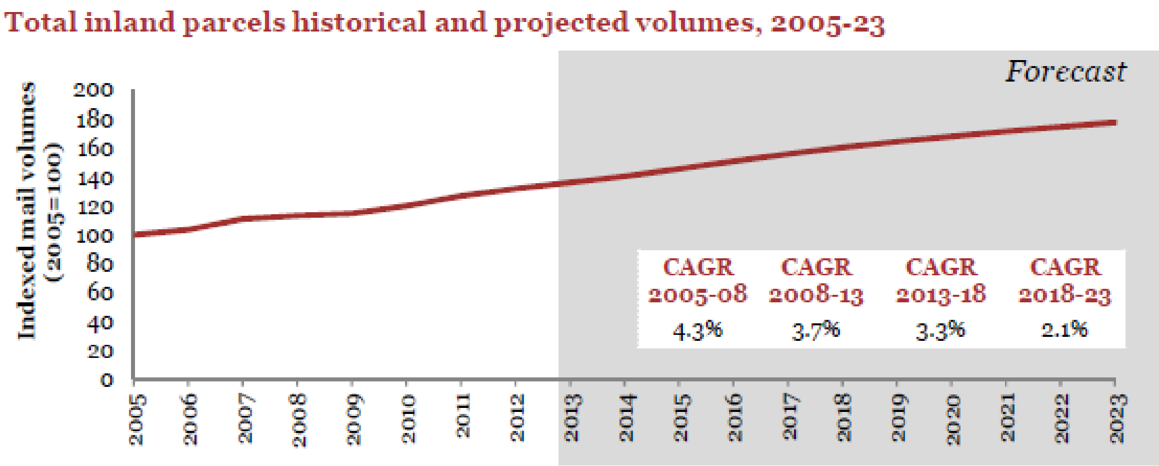
A8.15 PwC has estimated that the parcels sector has grown since 2005, and it predicts that the sector will continue to grow to 2023 (albeit at a slower rate over the later years of its projection – see Figure A8.2].[336] Other sources also predict that the sector will continue to grow.[337]

[335] This overview considers all parcels (as defined in paragraphs A8.8-A8.11), including both bulk and single piece parcels, and tracked and untracked parcels.

[336] See PwC, *Outlook for UK mail volumes to 2023,* 15 July 2013, page 10, http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf.

[337] For example, Royal Mail estimates that the parcels sector will grow at approximately 4% per annum over the medium terms (*Annual Report and Financial Statements 2014-15*, page 12, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf), and Barclays estimated that physical deliveries in the UK will increased by over 40% between 2013 and 2018 (Barclays-Conlumino *The Last Mile: Exploring the online purchasing and delivery journey*, page 6, https://www.home.barclays/content/dam/barclayspublic/docs/BarclaysNews/2014/September/the-last-mile-report.pdf). [✂].

Figure A8.2 – PwC estimate of inland parcel volumes



Source: PwC, *Outlook for UK mail volumes to 2023*, 15 July 2013, page 10.

A8.16 Growth in online retail is helping to drive growth in parcel volumes: Barclays estimates that products ordered online will grow by 28.8% between 2013-2018;[338] figures from the Office for National Statistics show that online retail is accounting for an increasing proportion of total retail sales (11.2% of total retail sales were made online in 2014, compared to 10.4% in the previous year);[339] and in the 2014 calendar year, the Interactive Media in Retail Group (IMRG) estimated the value of e-commerce sales in the UK at £104bn, an increase of 14% in 2014 and more than double the value in 2009.[340] Within online retail, clothing and shoes appear to be the main areas of growth.[341]

A8.17 The growth of online retail has also led to a number of operators (e.g. DPD) that were traditionally focused on delivery of parcels from one business to another (B2B) having expanded their operations to deliver to consumers,[342] alongside expansion from operators already delivering B2C parcels (e.g. Hermes and Yodel).

[338] Barclays-Conlumino, *The Last Mile: Exploring the online purchasing and delivery journey*, page 4 - https://www.home.barclays/content/dam/barclayspublic/docs/BarclaysNews/2014/September/the-last-mile-report.pdf. Note that not all increase in sales will necessarily result in increased parcel volumes (e.g. online sales may be of items that are fulfilled electronically, such as music downloads).

[339] Office for National Statistics, *Overview of Internet retail sales in 2014*, 23 January 2015, http://www.ons.gov.uk/ons/rel/rsi/retail-sales/december-2014/sty-overview-of-internet-retail-sales-in-2014.html.

[340] See Capgemini press release, *UK online sales exceed £100 billion in 2014*, 14 January 2015, https://www.uk.capgemini.com/news/uk-news/uk-online-sales-exceed-ps100-billion-in-2014.

[341] For instance, Barclays puts clothing and footwear growth at nearly 50% between 2013 and 2018 - *The Last Mile: Exploring the online purchasing and delivery journey*, page 3; Royal Mail estimates that volumes of clothing and footwear items will grow [✂] (from [✂] items in 2014 to [✂] in 2019), and will account for [✂] of home deliveries - Royal Mail's response to the July 2015 Discussion Document, Appendix: Parcels market developments, paragraph 1.11.

[342] See for instance Davy Research, *Transport Logistics – UK parcels market: return to sender*, 17 April 2015, Figure 9: Evolution of the UK parcel sector, page 8.

Operators and market shares

A8.18 A wide range of firms deliver parcels in the UK, and we have collected volume and revenue data for the largest firms (Figure A8.3).[343] Based on the information we have collected, Royal Mail, including Parcelforce, has the largest share of revenues (and volume) by a substantial margin, with three other firms having a share above 10% (based on total revenues of those firms from which we received data). Royal Mail's own estimate is that Royal Mail Group Limited has a 52% share of domestic parcel volumes, and a 38% share of domestic parcel revenues.[344]

Figure A8.3 – volume and revenue shares by operator for all parcels, 2014-15

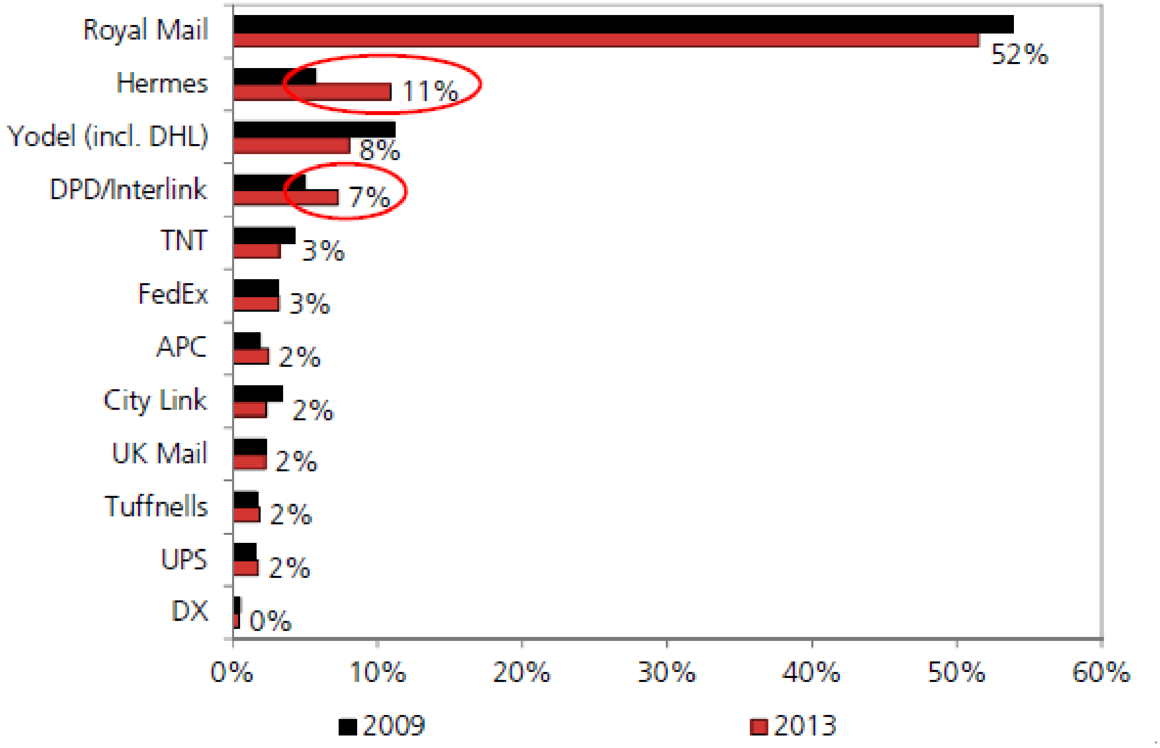
Operator	Volumes	Revenues
APC	[✂]	[✂]
DPD	[✂]	[✂]
DX	[✂]	[✂]
FedEx	[✂]	[✂]
Hermes	[✂]	[✂]
Parcelforce	[✂]	[✂]
Royal Mail (incl. Access)	[✂]	[✂]
TNT	[✂]	[✂]
Tuffnells	[✂]	[✂]
UK Mail	[✂]	[✂]
UPS	[✂]	[✂]
Yodel	[✂]	[✂]

Source: operator responses to Q3 of Ofcom's information request under s.55 PSA 2011 (issued 28 May 2015), and Royal Mail's response to Qs1-3 of Ofcom's information request under s.55 PSA 2011 (issued 10 November 2015).

A8.19 Estimates of market shares from analysts suggest that Royal Mail lost market share (by volume) between 2009 and 2013. For instance, Figure A8.4 below shows Davy's estimate of market share, which suggests that Hermes' share increased by around 75% between 2009 and 2013, whereas Royal Mail's decreased by around 5%. [✂].

[343] This is set out in more detail in Ofcom's *Annual monitoring update on the postal market – financial year 2014-15,* paragraph 5.4. The information we collected (as set out in Figure A8.3) does not include volume and revenue information from DHL as DHL sought judicial review of our information request and did not respond.
[344] Royal Mail plc, *Full Year 2014-15 Annual Results*, 21 May 2015, slide 4.

Figure A8.4 – Estimate of market shares (by volume) for domestic parcels in 2009 and 2013



Source: Davy Research, *Transport Logistics – UK parcels market: return to sender*, 17 April 2015, page 5

July 2015 Discussion Document responses

A8.20 UK Mail,[345] Secured Mail,[346] and Royal Mail[347] argued that the parcels sector is more competitive than for letters. The CWU,[348] MUA,[349] TechUK,[350] First Post,[351] and GI Solutions all considered the parcels sector to be competitive.[352] For instance, GI Solutions suggested that, in parcels, Royal Mail struggles to be competitive in both price and service, and that Royal Mail is having to respond to competitive pressures;[353] the CWU argued that that Royal Mail faces significant (and increasing) competition in an already over-capacity domestic parcels market, particularly in business to consumer parcels;[354] and TechUK pointed to growth in the range of carriers offering local collection points for single piece parcels.[355] DX suggested that Royal Mail's retail prices for parcels were indicative of

[345] UK Mail's response the July 2015 Discussion Document, paragraph 3.37.
[346] Secured Mail's response to the July 2015 Discussion Document, paragraph 3.27.
[347] Royal Mail's response to the July 2015 Discussion Document, page 32.
[348] The CWU's response to the July 2015 Discussion Document, paragraph 42.
[349] The MUA's response to the July 2015 Discussion Document, paragraph S4.2. Note that not all the MUA's members considered all segments of the parcels sector to be competitive, with some suggesting that Royal Mail retains a strong position in single piece and lightweight parcels (see paragraph 3.2 for details).
[350] TechUK's response to the July 2015 Discussion Document, response to Q3.
[351] First Post's response to the July 2015 Discussion Document, response to Q3.
[352] GI Solutions' response to the July 2015 Discussion Document, response to Q3.
[353] GI Solutions' response to the July 2015 Discussion Document, response to Q3.
[354] CWU's response to the July 2015 Discussion Document, paragraphs 42 and 44.
[355] TechUK's response to the July 2015 Discussion Document, response to Q3.

competition.[356] Royal Mail suggested that intense competition in parcels has created downward pricing pressure, that it faces considerable competition in bulk parcels, and that it is now facing strong and growing competition in single piece parcels.[357]

A8.21 However, a number of stakeholders suggested that competition does not exist uniformly across all segments of the parcels sector. In particular, a number of stakeholders considered that there are fewer constraints for single piece than bulk, and for lower weights/size of parcel.

A8.22 The MCF,[358] UK Mail,[359] [✂][360], and Secured Mail[361] argued that there are limited constraints for smaller and/or lighter (under 1.5-2kg) parcels and for single piece parcels. The DMA argued that there are limited constraints on Royal Mail for single piece parcels at lower weight and price levels, but that there is strong competition in bulk parcels.[362] Whistl argued that there is not competition for parcels under 1.5kg (for tracked parcels) or 2kg (for untracked parcels).[363] Hermes expressed concern that Royal Mail could allocate costs from areas where it does not face competition in order to fund “uncommercial” prices in areas where it does face competition.[364] Citizens Advice suggested that Royal Mail’s pricing in lightweight single piece parcels reflects its market power, but that it expects competitive constraints on Royal Mail to increase.[365] In FTI’s report for Royal Mail on competitive constraints, FTI stated that Royal Mail has a cost advantage for “letterboxable” parcels, but that it faces competition in other segments (even in segments where Royal Mail has traditionally had a large share).[366]

Single piece parcels

A8.23 Postcomm’s analysis distinguished between parcels sent by consumers which are collected from the sender’s premises (known as C2X parcels), and parcels sent by consumers or businesses from an access point (known as Y2X parcels).[367] Nevertheless, it concluded that C2X and Y2X were, at the time, part of the same market,[368] and that Royal Mail had market power in the supply of Y2X/C2X services.[369]

A8.24 Our analysis suggests that Royal Mail currently maintains a strong position in single piece parcels, although it has a much weaker position for heavier single piece

[356] DX’s response to the July 2015 Discussion Document, response to Q3.
[357] Royal Mail’s response to the July 2015 Discussion Document, pages 32-33.
[358] The MCF’s response to the July 2015 Discussion Document, response to Q3.
[359] UK Mail’s response the July 2015 Discussion Document, paragraph 3.37.
[360] ‘Name Withheld 5’ [✂]’s response to the July 2015 Discussion Document, response to Q3.
[361] Secured Mail’s response to the July 2015 Discussion Document, paragraphs 3.24 and 3.27.
[362] The DMA’s response to the July 2015 Discussion Document, response to Q3.
[363] Whistl’s response to the July 2015 Discussion Document, page 15.
[364] Hermes’ response to the July 2015 Discussion Document, page 1.
[365] Citizens Advice’s response to the July 2015 Discussion Document, response to Q3.
[366] Royal Mail’s response to the July 2015 Discussion Document – FTI Consulting, *Competitive Constraints Facing Royal Mail*, paragraphs 2.18 and 8.16.
[367] Postcomm, *Laying the foundations for a sustainable postal service – Annex 1: Analysis of markets*, November 2010, Figure 2.
[368] Postcomm, *Laying the foundations for a sustainable postal service – Annex 1: Analysis of markets*, November 2010, Table 3.
[369] Postcomm, *Laying the foundations for a sustainable postal service – Annex 1: Analysis of markets*, November 2010, paragraph 5.7

parcels – Royal Mail's prices are typically higher than competitors for weights over 2kg and Royal Mail's share for single piece parcels over 2kg in 2014-15 was [✂] of volumes and [✂] of revenues.

Developments in single piece parcels

A8.25 If a consumer sends a parcel with Royal Mail, they can either take it to a Post Office, or (if it is small enough and they have applied the correct postage) put it in a pillar box. Royal Mail also offers a click and collect service via the Post Office, which means that consumers can (if a retailer offers this option) opt to have a parcel delivered to a Post Office for the consumer to pick up. There are around 11,500 Post Offices.

A8.26 In recent years, there has been significant entry and expansion in alternatives to the Post Offices, where consumers can drop off parcels for onward delivery.[370] For instance, CollectPlus was launched in 2011,[371] myHermes parcel shops were launched in 2012,[372] UPS Access Point was launched in 2013,[373] and DPD Pickup was launched in 2015.[374] Consumers therefore now have more options for where to drop off a parcel.[375] It is possible that this growth has been largely driven by operators wanting to offer an e-retail returns service, or a click and collect service (i.e. somewhere for consumers to pick up parcels from, rather than places to send them from). Nevertheless, this has led to consumers having more options for places to send parcels from (although Royal Mail remains by far the largest single network). A number of the operators offering alternatives to the Post Office also offer to collect parcels from the sender's premises (what Postcomm called C2X) – Royal Mail does not offer this service (although Parcelforce does).

A8.27 These alternatives to the Post Office continue to expand. For instance, Doddle plans to expand to 250 stores by the end of 2017.[376] Royal Mail has also worked on developing its offering, for instance re-launching its click and collect offering (Local Collect),[377] and working with Post Office branches to extend opening hours (including by moving some Post Office branches to its Post Office Local model, whereby Post Office services are offered over a non-Post Office retail counter). This suggests that Royal Mail sees it necessary to respond to the offerings of competitors.

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[370] When using these alternatives to the Post Office consumers typically have to pre-purchase postage online and print this out. As for the Post Office, consumers can purchase postage in Post Offices, although Royal Mail introduced a cheaper price in 2016 for parcels under 2kg where postage is purchased online.
[371] See CollectPlus, *CollectPlus launches parcel sending service from network of 3,500 local stores as a convenient alternative to the Post Office,* 4 February 2011, https://www.collectplus.co.uk/news/collect-launches-parcel-sending-service-from-network-of-3500-local-shops-as-a-convenient-alternative-to-the-post-office.
[372] See https://www.myhermes.co.uk/help/about.html.
[373] See Post&Parcel, *UPS launches parcel shop access network in the UK,* 7 February 2013, http://postandparcel.info/53731/news/companies/ups-launches-parcel-shop-network-in-uk-ups-access-point/.
[374] See DPD, *DPD announces Stoke HQ for new bespoke parcel shop network*, 20 January 2015, http://www.dpd.co.uk/content/about_dpd/press_centre/news.jsp.
[375] A number of these parcel carriers also offer to collect parcels from the sender's premises (what Postcomm called C2X) – Royal Mail does not offer this service (although Parcelforce does).
[376] See Doddle press release, *Doddle opens 35th store in 35 weeks at Paddington station*, 2 June 2015, https://www.doddle.com/press/doddle-opens-35th-store-in-35-weeks-at-paddington-station.
[377] See Royal Mail website, http://www.royalmail.com/business/services/sending/efficiency/local-collect.

A8.28 Figure A8.5 below sets out a range of parcel access points, where consumers can take parcels for onward delivery.

A8.29 Alongside these alternatives to the Post Office for sending parcels, consumers can also use services like InPost's locker service (where consumers purchase postage online, and deposit a parcel in a parcel locker). eBay has also reached agreements with Argos to develop its own drop-off network[378] – in other words, eBay sellers can drop-off parcels at Argos branches for onward delivery (and eBay buyers can pick up orders that have been delivered to Argos branches).

A8.30 It is possible that these alternative access points or collection services will be seen as a substitute to sending parcels using Royal Mail/the Post Office, subject to awareness of these alternatives among consumers, pricing, and availability. We consider these factors in more detail below.

Figure A8.5 – Parcel access points for sending parcels

Drop-off points	Parcel operator	Number of access points	Where access points located
Post Office	Royal Mail Parcelforce	11,500	Post Office branches and outlets
CollectPlus	Yodel	5,800	Convenience stores, supermarkets, and petrol stations that are part of the Paypoint network
MyHermes ParcelShop	Hermes	4,500	Convenience stores
UPS Access Point	UPS	2,800	Convenience stores and petrol stations
DPD Pickup	DPD	2,500	Halfords, Rowlands Pharmacy, Numark Pharmacy, and Doddle
DHL Service Points	DHL	1,200	Rymans, Staples, WH Smith, Access Self Storage, Homebase, and Safestore, as well as a number of independent stores
InPost parcel lockers	InPost	1,100	Convenience stores, petrol stations, retail parks, train stations
eBay / Argos [379]	UK Mail	840	Argos high street stores for eBay items
Parcelforce depots[380]	Parcelforce	54	Parcelforce depots
UK Mail (iPostParcels)	UK Mail	50	UK Mail depots

[378] See eBay press release, *eBay and Argos sign wider multi-year partnership to offer nationwide fulfilment services to buyers and sellers*, 15 October 2015, http://ebay-mediacentre.co.uk/pressrelease/ebay-argos-sign-wider-multi-year-partnership-offer-nationwide-fulfilment-services.
[379] Unlike the other services listed in this table, consumers can only use Argos for sending a parcel if they are posting something they have sold on eBay (and can only use it for collecting an item purchased through eBay, or from Argos itself).
[380] Consumers sending parcels with Parcelforce can also drop parcels off at the Post Office.

Doddle parcel shop	Doddle	44 (plans to expand to 250 by end of 2017)	Train stations

Source: operator websites and www.postandparcel.info. Correct as of April 2016.

Awareness and usage of alternatives to Royal Mail in single piece parcels

A8.31 Based on the information we have collected, Royal Mail's share of single piece parcel volumes is 60-80% ([✂]).[381] This means that Royal Mail remains the main operator for sending single piece parcels, which is consistent with our Postal Tracker results: in 2015, 90% of consumers who had sent a parcel in the last month said they had sent a parcel with Royal Mail (and 80% said they had only used Royal Mail to send a parcel in the past month). Reported use of other parcel carriers was low (18% said they used a company other than Royal Mail in the past month), and fragmented (8% of consumers said that they used Hermes, 4% that they used Parcelforce, 4% that they used CollectPlus or Yodel, 2% that they used DHL, 1% that they used DPD, and 1% that they used FedEx).[382]

A8.32 However, while usage of alternatives to Royal Mail appears to be comparatively low, competitors have seen their volumes increase quite rapidly (albeit from a low base, and in the context of relatively recent entry into single piece parcels). For instance, based on the information we collected, Hermes' domestic myHermes single piece parcel volumes doubled ([✂]) between 2013-14 and 2014-15,[383] and Yodel increased its domestic volumes from [✂] over the same period. This gave Hermes and Yodel a [✂] share of domestic single piece parcel volumes in 2014-15, respectively.[384] By way of comparison, Royal Mail's domestic single piece volumes declined by [✂] between 2013-14 and 2014-15 ([✂]) and its share of volumes also declined, from [✂] in 2013-14 to [✂] in 2014-15. As noted in paragraphs 5.27, Royal Mail changed its single piece pricing structure in April 2013 to differentiate between small and medium parcels under 2kg. Royal Mail has said that the introduction of size-based pricing contributed to greater than expected volume decline in consumer parcels.[385]

A8.33 This suggests that the market share of alternatives to Royal Mail, while currently low, is growing. This is consistent with there being greater awareness of

[381] While this is a significant share, in 2014-15, single piece parcels represented only 24%-27% of the volumes and 25%-31% of the revenues we have collected from operators – as noted previously, we could not categorise all the information we collected according to whether it was single piece or bulk, which is why we have provided a range.
[382] Ofcom Residential Postal Tracker, 2015, QC23: *Which of these companies did you use to send parcels in the last month?*, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2016Feb-Apr/Residential_Postal_Tracker_2015_data_tables_tbp.pdf. Although not directly comparable on the basis that the time periods do not match), in both Q3 2014-Q2 2015 and Q3 2013-Q2 2014 79% said that they had only used Royal Mail in the past month for sending parcels.
[383] Hermes has told us that its volume growth for this category of parcel slowed during 2015-16 as a result of changes Royal Mail made to its prices for single piece parcels under 2kg.
[384] Operator responses to question 3 of the section 55 notice dated 28 May 2015, and Royal Mail's response to questions 1-3 of the 2nd Review of Royal Mail regulation section 55 notice dated 10 November 2015.
[385] Royal Mail, *Annual Report and Financial Statements,* 2013-14, page 9, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202013-14_DDA_0.pdf.

alternatives. For example, research carried out for Royal Mail by [✂] found that awareness has increased considerably.[386]

Geographic coverage of access

A8.34 Using information collected from Royal Mail, we have assessed the geographic distribution of certain operators' parcel shops and lockers.[387] This is set out in Figure A8.6 below.

Figure A8.6 – Geographic distribution of parcel shops

Operator	% Urban (67% of population)	% Semi-urban (19% of population)	% Rural (12% of population)	% Remote rural (2% of population)
Post Office	52%	31%	10%	6%
CollectPlus	82%	15%	2%	1%
Hermes	81%	16%	3%	0%
UPS	85%	13%	2%	0%
InPost	96%	3%	1%	-
Amazon	95%	4%	2%	-
Doddle	95%	5%	-	-

Source: Ofcom analysis of information collected by [✂] on behalf of Royal Mail – UK Alternative Delivery Market Insight Study, *October 2014*

A8.35 Figure A8.6 above clearly shows that while 67% of the UK population live in urban areas, around 80% to 95% of parcel shops (other than Post Office) are in urban areas.[388] Alternative operators have a low coverage of rural areas and the Post Office is likely to be the primary option available to customers in many rural areas.

A8.36 The more limited availability of alternatives is a drawback for semi-urban and rural consumers. However, competition, even where it is largely limited to urban areas, will tend to constrain Royal Mail's prices, and since Royal Mail is obliged to offer a geographically uniform price this has the potential to benefit all consumers.[389]

Single piece prices

A8.37 We have compared prices across providers to see if there is evidence that alternative access points provide a pricing constraint on Royal Mail. Such price comparison can be complicated; prices vary according to the weight and/or size of parcel (not to mention the range of options available, such as different speeds of delivery), and different operators offer different weight and size options. However, a range of online resellers have emerged, and these enable consumers to compare

[386] [✂].

[387] Parcel lockers are secure, unmanned storage spaces where parcels can be sent from and/or picked up from. Typically a customer will be provided with a code that enables them to access a specific locker space.

[388] Hermes has claimed that 70% of the UK population is within one mile of a myHermes parcel shop. See Hermes news release, Everton put their shirt on myHermes, https://www.myhermes.co.uk/help/news/everton-put-their-shirt-on-myhermes.html.

[389] We recognise, however, that there may be benefits to consumers beyond just price. For instance, these alternatives may be open for longer than Post Offices, which is something that Royal Mail noted in its response to the July 2015 Discussion Document (*Appendix: Parcels market developments*, paragraph 1.26).

prices (according to parameters like weight and/or dimensions) for the parcel that they wish to send.

A8.38 Our analysis, set out in Figures A8.7 and A8.8 below, [390] suggests that, for parcels over 2kg, a number of alternative providers have lower prices than Royal Mail for a broadly comparable service.[391] For parcels under 2kg, a limited number of operators offer prices that consumers may see as competitive with Royal Mail's (although competitor product offerings may include enhanced services such as tracking). This is consistent with our conclusion in the March 2012 Statement that consumers have more choice of alternatives to Royal Mail for parcels above 2kg than for parcels under 2kg.[392]

Figure A8.7 – Next day single piece parcel prices (where the parcel is taken by the consumer to an access point)

	Royal Mail small parcel[393] First Class	Royal Mail medium parcel[394] First Class	Parcelforce	Doddle	DPD	DHL	UPS
>1kg	£3.35	£5.70	£12.89-£15.29	£8.49	£7.19	£15.95	£5.94-£7.79
1-2kg	£5.50	£8.95	£12.89-£15.29	£8.49	£7.19	£15.95	£5.94-£7.79
2-5kg	N/A	£15.85	£13.88-£16.28	£8.49	£7.19	£15.95-£16.95	£5.94-£7.79
5-10kg	N/A	£21.90	£17.30-£19.70	£8.49	£7.19	£16.95-£19.95	£5.94-£7.79

Notes:

Royal Mail: for First and Second Class small and medium parcels up to 2kg, Royal Mail charges a cheaper price for parcels that are paid for online. For First Class parcels up to 2kg, parcels are 5p cheaper if postage is paid online.

Parcelforce: Parcelforce offers a depot-to-depot service (where the sender drops the parcel off at a depot, and the recipient collects from a depot) for a cheaper price. The higher price represents the cost of sending the parcel form a Post Office.

DHL: DHL's cheapest service is £7.95, but for dimensions considerably smaller than Royal Mail's small parcel. DHL's price points also do not fit into our 2-5kg and 5-10kg splits, which is why a range is provided.

UPS: UPS offers a service for £5.94 where the parcel is sent from a UPS Access Point to another UPS Access Point.

Source: operator websites (or www.parcels2go.com for DPD and UPS). Correct as of April 2016.

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[390] A number of the operators included in the tables also offer a collect from the premise service (where the operator picks up a parcel from the sender's premise), but prices for these services are not included in the table.
[391] Indeed, for parcels over 2kg, it is cheaper to send a parcel with Parcelforce than with Royal Mail.
[392] Ofcom, March 2012 Statement, paragraphs 8.132-8.134
[393] Royal Mail's small parcel has maximum dimensions of 45cm x 35cm x 8cm.
[394] Royal Mail's medium parcel has maximum dimensions of 61cm x 46cm x 46cm.

Figure A8.8 – Later than next day single piece parcel prices (where the parcel is taken by the consumer to an access point)

	Royal Mail small parcel Second Class	Royal Mail medium parcel Second Class	Parcel-force	Collect+ (Yodel)	iPostParcels (UK Mail)	InPost	myHermes
>1kg	£2.85	£4.95	£4.80-£10.10	£4.99	£2.39-£4.79	£3.59	£2.70
1-2kg	£2.85	£4.95	£4.80-£10.10	£4.99	£2.39-£4.79	£3.59	£3.78
2-5kg	N/A	£13.75	£5.80-£11.70	£6.29	£5.69-£7.38	£3.59-£5.10	£5.79
5-10kg	N/A	£20.25	£9.22-£15.12	£8.39	£6.89-£8.39	£5.10	£7.49

Notes:

Royal Mail: for First and Second Class small and medium parcels up to 2kg, Royal Mail charges a cheaper price for parcels that are paid for online. For Second Class small parcels up to 2kg, parcels are 5p cheaper if postage is paid online or 6p cheaper for a medium parcel.

Parcelforce: Parcelforce offers a depot-to-depot service (where the sender drops the parcel off at a depot, and the recipient collects from a depot) for a cheaper price. The higher price represents the cost of sending the parcel form a Post Office.

UK Mail offers a depot-to-depot service (where the sender drops the parcel off at a depot, and the recipient collects from a depot) for £2.39. For £4.79, you can drop a parcel off at a depot for delivery to the home.

InPost: InPost's price points do not fit into our 2-5kg split, which is why a range is provided.

Source: operator websites. Correct as of April 2016.

Summary of findings on single piece parcels

A8.39 Competition has begun to emerge in single piece parcels, particularly for parcels over 2kg. However, Royal Mail continues to have a very large share of single piece parcels, and (as we noted in paragraph 4.93 to 4.94) appears likely to retain a strong position in single piece parcels, particularly due to its unrivalled delivery network.

Small/lightweight bulk parcels

A8.40 Our analysis suggests that, while there are indications that competition in bulk parcels has increased, Royal Mail still has a high market share in small/lightweight bulk parcels.

Background

A8.41 Postcomm found that Royal Mail had market power in deferred (i.e. D+2 or slower) bulk parcels weighing less than 2kg, but suggested that competition was emerging, at least for high volume parcels between 1-2kg.[395]

A8.42 For the purposes of our assessment, we consider a bulk parcel to be one where a volume related discount could be applied (even if it is not for a specific parcel consignment), or where the price is determined by a negotiated contract. Bulk parcels will be sent by large retailers (e.g. high street stores and online retailers), and businesses where sending parcels is a core feature of their operation (e.g. for transporting parts, or fulfilling online orders); smaller businesses are more likely to use single piece parcels (unless they specialise in e-commerce).

A8.43 Before considering Royal Mail's position in small/lightweight bulk parcels, we first provide an overview across all weights for context.

Developments in bulk parcels

A8.44 As noted in paragraph A8.16 above there has been considerable growth in e-commerce, which has helped drive growth in the parcels sector. Based on the information we collected from retailers, we estimate that bulk parcel volumes have increased by 6% between 2013-14 and 2014-15.

A8.45 There are some potential constraints on the growth of the parcels sector, including:

- in-housing by large retailers;
- e-substitution; and
- click and collect.

A8.46 In 2012, Amazon launched Amazon Logistics and began to bring some of its own final mile deliveries in-house.[396] Given the size of Amazon's operations,[397] this is a significant development. Royal Mail estimates that Amazon Logistics has grown rapidly, from [✂] to [✂].[398] Royal Mail has said that the impact of Amazon delivering an increasing number of parcels using its own delivery network will reduce the annual rate of growth in its addressable market to around 1-2% in the

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[395] Postcomm, *Laying the foundations for a sustainable postal service – Annex 1: Analysis of markets*, November 2010, paragraphs 5.2-5.3.

[396] We consider it likely that Amazon will bring further volumes in-house. Arguably, Royal Mail (or other carriers) could compete for this traffic by making it preferable for Amazon to deliver via an independent carrier than over its own network. However, we think it is likely that Amazon's incentive is likely to be in part about having control of the supply chain, which may limit the ability of parcel carriers to win contracts for this traffic. Amazon has also begun to deliver parcels on behalf of its marketplace sellers, which is in direct competition with Royal Mail and other parcel carriers.

[397] For instance, Enders Analysis stated that Amazon has a 25% share of UK e-commerce (Enders Analysis, *OTT home entertainment in the UK,* April 2016, http://www.endersanalysis.com/content/publication/ott-home-entertainment-uk), and the Financial Times estimated that, in 2014, Amazon had a 3% share of the UK parcels sector (*Royal Mail blames Amazon network for fall in profits*, 19 November 2014, http://www.ft.com/cms/s/0/56f049f4-6fc0-11e4-90af-00144feabdc0.html#axzz48ohgAp5Q). [✂].

[398] Royal Mail's response to the July 2015 Discussion Document – *Appendix: Parcels market developments*, page 1 and paragraph 1.21.

short term (compared to 4% growth in total).[399] [✂][400] Amazon is not the only company to have brought at least some of its deliveries in-house. For instance, Argos launched its own same-day delivery service in October 2015. Davy Research has stated that in-housing by retailers (particularly by Amazon) risks parcel carriers being left with parcels that are less economically viable.[401]

A8.47 E-substitution of content (primarily of CDs, DVDs, and books) may also constrain the growth of the parcels sector. Royal Mail estimates that letterboxable CDs, DVDs, and books will reduce from [✂] of all home deliveries in 2014 to [✂] of all home deliveries 2019.[402] [✂].[403]

A8.48 A number of stakeholders [✂] have noted the growth in click and collect,[404] and have predicted that click and collect will become a more prominent a feature of the parcels sector. Barclays estimates that click and collect volumes will grow to 35% of total physical deliveries (up from 26%).[405] Royal Mail suggests that in-store click and collect currently tends to still replace purchases that would otherwise have been made on the high street, rather than replacing delivery traffic.[406] However, if (as predicted) click and collect continues to develop, this may result in final mile delivery increasingly being by-passed.

A8.49 However, these potential constraints have thus far not prevented growth in the parcels sector. Growth in the sector has led to a number of parcel carriers expanding their operations. A number of operators (e.g. UK Mail, DPD, Parcelforce, Yodel, and Hermes) have invested in new hubs and depots,[407] which gives operators additional capacity.[408] Growth in online retail has also meant that a number of operators (e.g. DPD) that were traditionally focused on delivery of parcels from one business to another (B2B) having expanded their operations to deliver to consumers.[409] Parcel operators have also begun to offer click and collect options to third-party retailers. Examples of such services include Doddle,[410] Asda[411] and Royal Mail.

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[399] Royal Mail, *Annual Report and Financial Statements 2014-15,* 29 May 2015, page 8.
[400] [✂].
[401] Davy Research, *UK parcels market: return to sender*, 17 April 2015, page 34.
[402] Royal Mail's response to the July 2015 Discussion Document, *Appendix: Parcels market developments*, page 1 and paragraph 1.11.
[403] [✂].
[404] Where items ordered online are delivered to a retail store or intermediary location such as a parcel shop or parcel locker instead of to recipients' homes.
[405] Barclays-Conlumino, *The Last Mile: Exploring the online purchasing and delivery journey*, page 6.
[406] Royal Mail, *Annual Report and Financial Statements 2014-15*, 29 May 2015, page 12.
[407] Ofcom, *Communications Market Report 2015*, 6 August 2015, page 382.
[408] Royal Mail estimates that sorting capacity has increased by 300m parcels [✂] – Royal Mail's response to the July 2015 Discussion Document, *Appendix: Parcels market developments,* paragraph 1.23.
[409] See for instance Davy Research, *Transport Logistics – UK parcels market: return to sender*, 17 April 2015, Figure 9: Evolution of the UK parcel sector, page 8.
[410] Doddle was launched as a collection and sending service in June 2014 and currently plans to expand the number of retail outlets from 43 to 250 by the end of 2017 – *Network Rail launches £24m parcel shop roll-out for UK stations,* 19 June 2014, http://postandparcel.info/61584/news/companies/network-rail-launches-24m-parcel-shop-roll-out-for-uk-stations/.
[411] Asda launched its ToYou service in November 2015, which allows customers to collect and return orders placed with third parties at one of Asda's 614 retail stores – *Asda's game changing parcel*

A8.50 Alongside other operators investing in expanding and improving their parcels services, Royal Mail has said that it is investing in its parcels business to improve efficiency and foster innovation through technology.[412] This includes:

- Investing in the capability to barcode more parcels to enable tracking.[413] Royal Mail currently does not have the capability to offer tracking in the same way as competitors, especially given that competitors like DPD are now able to offer 15 minute delivery slots and options for making changes while a parcel is out for delivery (such as nominating an alternative delivery day if the recipient will be unavailable to receive the parcel).

- Extending acceptance times for certain products.[414]

- Working with the Post Office to extend opening hours, and relaunching its click and collect service (Local Collect).[415]

A8.51 Because of its letter delivery business and its universal service requirements, Royal Mail has the capacity to deliver on foot to every UK household daily. To use this network for parcel delivery, Royal Mail has invested in high-capacity trolleys, and introduced a park and loop system.[416] These enable it to deliver small/lightweight parcels using its foot delivery network. It has therefore configured its network around being able to deliver small/lightweight parcels alongside letters.

Royal Mail's share of volumes and revenues in small/lightweight bulk parcels

A8.52 In 2014-15, based on the volume and revenue information we collected from operators (see Figure A8.3 above), we estimate that bulk parcels under 2kg comprised 22%-34% of all the parcel volumes we collected information on, and 34%-45% of all parcel revenues that we collected information on.[417] Based on the information we collected, Royal Mail remains the largest operator in bulk parcels (not just for bulk parcels under 2kg), with a [✂] share of volumes and [✂] share of revenues.[418]

A8.53 In particular, Royal Mail continues to have a large share of small/lightweight bulk parcel volumes. From the information we have collected, Royal Mail's share of bulk parcels with a weight limit of 2kg is between 60%-80% for both volumes and revenues ([✂] of volumes and [✂] of revenues) – its share of volumes [✂] from 2013-14, and its share of revenues [✂]. FTI Consulting also stated that Royal Mail has traditionally held a large share of items under 2kg (including items that do not fit

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innovation, 11 November 2015, http://your.asda.com/press-centre/asda-s-game-changing-parcel-innovation.

[412] Royal Mail's response to the July 2015 Discussion Document – *Parcels appendix: Royal Mail innovation and improvements*.

[413] Royal Mail, *Annual Report and Financial Statements 2014-15*, 29 May 2015, page 12.

[414] See for example *Royal Mail extends acceptance times for Royal Mail Tracked 48 to midnight,* 19 May 2015, http://www.royalmailgroup.com/royal-mail-extends-acceptance-times-royal-mail-tracked-48%C2%AE-midnight.

[415] Royal Mail's response to the July 2015 Discussion Document, *Appendix: Royal Mail innovation and improvements*, paragraphs 1.13 and 1.15.

[416] Royal Mail's response to the July 2015 Discussion Document, *Appendix: Royal Mail innovations and improvements,* paragraph 1.11.

[417] We have provided ranges here because we were unable to categorise some of the information we collected into either single piece or bulk.

[418] This represents a [✂] on its share in 2013-14.

through a letter box), but suggested that its position for such items is being challenged.[419]

A8.54 Other sources of information suggest that Royal Mail has a particularly high share of bulk parcels below 1kg. [✂][420] Royal Mail's own internal estimates suggest that it has a large share for bulk parcels below 1kg ([✂]), but much lower for parcels above 1kg [✂].[421]

Royal Mail's position in small/lightweight bulk parcels

A8.55 The evidence of new entrants and expansion of existing operators indicate increasing competition in bulk parcels. Certainly, Royal Mail considers that it faces a "very competitive and dynamic parcels market", and that increased competition in the parcels sector has led to downward pricing pressure.[422] Its investment in its parcels business suggests that it sees it necessary to respond to competitors.

A8.56 However, as a number of stakeholders have argued (see paragraphs A8.20 to A8.22), Royal Mail retains a strong position in small/lightweight bulk parcels, largely as a result of its delivery network.

A8.57 As noted above, Royal Mail's foot delivery network enables it to deliver small/lightweight parcels alongside its existing letter delivery requirements. We consider that this is likely to confer a cost advantage for Royal Mail, as the incremental cost of delivering parcels over its foot network is relatively low (particularly for items that fit through a letterbox). As part of its response to the July 2015 Discussion Document, Royal Mail provided a report prepared on its behalf by FTI Consulting (FTI). In this report, FTI argued that Royal Mail's delivery network gives it a cost advantage for items that fit through a letterbox.[423]

A8.58 [✂],[424] [✂].

A8.59 [✂][425] [✂][426] [✂].

Figure A8.9 – Total unit cost per item (for customers sending 75,000 items per year) for Royal Mail and Hermes in 2011-12 (£)[427]

[✂]

Notes: [✂]

Source: [✂]

[419] Royal Mail's response to the July 2015 Discussion Document – FTI, *Competitive constraints on pricing faced by Royal Mail,* paragraph 8.16.
[420] [✂].
[421] Royal Mail's response dated 11 September to Q2 of Ofcom's information request under s.55 PSA 2011 (issued 24 July 2015) [✂].
[422] Royal Mail's response to the July 2015 Discussion Document, *Appendix: Parcels market developments,* pages 1-2.
[423] Royal Mail's response to the July 2015 Discussion Document – FTI, *Competitive constraints on pricing faced by Royal Mail,* paragraph 2.18. As noted by FTI Consulting in paragraph 8.21, Royal Mail considers the size of parcel to be more relevant to costs than weight (see paragraph 8.21).
[424] [✂].
[425] [✂].
[426] [✂].
[427] [✂].

A8.60 [✂].

A8.61 That Royal Mail's network configuration gives it an advantage for small/lightweight bulk parcels is consistent with [✂]'s finding that "competition among parcel delivery companies increases as the weight and size of the parcel increases" and that [✂].[428]

A8.62 Royal Mail's strong position in small/lightweight bulk is reflected in its share of volumes for bulk parcels under 2kg (and, in particular, for parcels under 1kg).

A8.63 [✂].[429] [✂].[430] [✂]. We note that, for its prices taking effect in March 2016, it raised RM24 and RM48 prices by 1.6% on average for 2016.[431]

Summary of findings on small/lightweight bulk parcels

A8.64 Royal Mail has advantages in small/lightweight bulk parcels due to its foot network, and, based on the information we collected, has a large share of volumes (although the information we collected suggests that its share of small/lightweight bulk parcels volumes has decreased since 2013-14). We consider that pricing constraints on Royal Mail's bulk parcels weighing less than 1kg have not increased considerably since 2012. The picture is less clear for parcels weighing between 1-2kg, which is consistent with Postcomm's view in 2010 that there was evidence of competition developing between 1-2kg.

[428] [✂].
[429] Royal Mail's response dated 11 September 2015 to Q2 of Ofcom's information request under s.55 PSA 2011 (issued 24 July 2015) [✂].
[430] Royal Mail's response dated 11 September 2015 to Q2 of Ofcom's information request under s.55 PSA 2011 (issued 24 July 2015) [✂].
[431] See Royal Mail's website, http://www.royalmail.com/prices2016.

Annex 9

List of respondents to July 2015 Discussion Document

A9.1 We published a Discussion Document on 17 July 2015 setting out our thoughts on the scope of the Review of Royal Mail and inviting input from stakeholders. This document can be found here: http://stakeholders.ofcom.org.uk/consultations/royal-mail-regulation-review/.

A9.2 39 stakeholders provided written responses to the Discussion Document:

- Aices;
- BBC;
- CFH;
- Citizens Advice;
- Consumer Council;
- Consumer Panel;
- COSLA;
- Cruise, Mr M;
- CWU;
- D Marshall;
- DMA;
- DX;
- First Post;
- FSB;
- GI Solutions;
- Hermes;
- L Griffiths;
- MCF;
- MUA;
- NFSP;

- Post Office;
- RBS;
- RNIB;
- Royal Mail;
- Secured Mail;
- TechUk;
- The Countryside Alliance;
- The Postal Group;
- UK Mail;
- Unite;
- URBN UK;
- Whistl;
- Williams, Mr C;
- “Name Withheld 1” [✂];
- “Name Withheld 2” [✂];
- “Name Withheld 3” [✂];
- “Name Withheld 4” [✂];
- “Name Withheld 5” [✂]; and
- [✂].

A9.3 We have published the non-confidential versions of the responses from all the stakeholders listed above. These can be found on our website: http://stakeholders.ofcom.org.uk/consultations/royal-mail-regulation-review/?showResponses=true&pageNum=1#responses.

Annex 10

Glossary and defined terms

A10.1 This glossary is a non-exhaustive list of defined terms and acronyms used throughout this consultation. It is designed to help readers understand the terms and acronyms we have used in order to help them understand the document and our proposals with greater clarity and transparency.

Term	Definition
2013 Codes of Practice CFI	Ofcom’s Call for Inputs dated 28 February 2013 entitled *Review: Mail Integrity and Postal Common Operational Procedures - Call for inputs*.
2013 End-to-end Guidance	Ofcom’s Guidance dated 27 March 2013 entitled *End-to-end competition in the postal sector – Final guidance on Ofcom’s approach to assessing the impact on the universal postal service*.
2013 End-to-end Statement	Ofcom’s Statement dated 27 March 2013 entitled *End-to-end competition in the postal sector – Ofcom’s assessment of the responses to the draft guidance on end-to-end competition*.
2013 Review of Users’ Needs	Ofcom’s Review dated 27 March 2013 entitled *Review of postal users’ needs - An assessment of the reasonable needs of users in relation to the market for the provision of postal services in the United Kingdom*
2014 Access Pricing Consultation	Ofcom’s Consultation dated 2 December 2014 entitled *Royal Mail Access Pricing Review - Proposed amendments to the regulatory framework*
2014 End-to-end Statement	Ofcom’s statement dated 2 December 2014 entitled *Review of end-to-end competition in the postal sector*.
2015 Business Plan	The strategic business plan submitted by Royal Mail to Ofcom between April and May 2015. Royal Mail is required to submit a strategic business plan each financial year under USPAC 1.3.9(b).
Access	Allowing other companies operating in the postal market, or other users of postal services, to use Royal Mail’s facilities for the partial provision of a postal service. Access to Royal Mail’s postal facilities could in principle be at any point in the pipeline, though in our regulations we require access at the Inward Mail Centre.
Access Letters Contract	A standard form bi-lateral contract which enables access customers to procure products from Royal Mail using one of four price plans

ACOD	Advisory Committee on Older and Disabled People
ASHE	Annual Survey on Hours and Earnings. This is undertaken by the Office of National Statistics.
B2B	Business to Business
B2C	Business to Consumer
B2X	Business to Anywhere
Consumer Advocacy Bodies (CABs)	This refers to the three consumer bodies - Citizens Advice, Citizens Advice Scotland and General Consumer Council Northern Ireland
C2X	Consumer to Anywhere
CA 2003	The Communications Act 2003
CCP	Communications Consumer Panel
CFH	CFH Docmail
CFI	Call for Inputs
Catch up gap	Efficiency savings associated with an operating unit becoming as efficient as the most efficient comparable unit. Captures the relative efficiency of operating units at a specific point in time.
CEPA	Cambridge Economic Policy Associates
CMR	Communication Markets Report. An annual research report published by Ofcom.
Competition Act	The Competition Act 1998.
COSLA	Convention of Scottish Local Authorities
Costing Manual	The document containing Royal Mail's detailed description of the National Costing Methodology and the Zonal Costing Methodology and identifying all sources of data, and all supporting empirical data used for assumptions, used in these Methodologies. Part of the Costing Manual is published.
CP condition	Consumer Protection condition. A condition which Ofcom may impose under section 51 of the PSA 2011 on every postal operator or postal operators of a specified description relating to consumer protection matters.
CPI	Consumer Price Index

CWU	Communications Workers Union
D+2	A postal service that aims to deliver two working days after collection, also known as a day C service.
D+2 Access	Access to Royal Mail's postal network at the IMC for the purposes of providing D+2 and later than D+2 Letters and Large Letters services.
Document Exchange	A system involving at least three members for the exchange of letters between members of the system
DMA	Direct Marketing Association
Downstream	The activities of sortation in the Inward Mail Centre and delivery of mail items from the Inward Mail Centre to the final destination.
Downstream access	Access to Royal Mail's postal network at the point of entry to an Inward Mail Centre or at any point in the postal chain after that.
DUSP Condition	Designated Universal Service Provider condition. A condition Ofcom may impose on the designated universal service provider under section 36 of the PSA 2011.
EBIT	Earnings Before Interest and Tax.
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation.
Efficient frontier	The minimum cost or resource that is required to process and deliver different volumes of mail (all other factors being equal)
End-to-end operators	Operators other than Royal Mail that provide a postal service from collection to delivery without using Royal Mail's postal network (usually only in some parts of the country).
EIA	Equality impact assessment
ERGP	European Regulators Group for Post
Essential Condition 1	A condition Ofcom may impose under section 49 of the PSA 2011 on every postal operator or every postal operator of a specified description specified in the condition containing such obligations as Ofcom considers necessary for the purposes of safeguarding confidentiality in connection with the sending, conveyance and delivery of letters, safeguarding security where dangerous goods are transported, safeguarding the confidentiality of information conveyed, guarding against the theft or loss of or damage to postal packets and securing the delivery of postal packets to the intended addressee.
FAC	Fully Allocated Costs. An accounting approach under which all the costs of the firm are distributed between its various services. The fully allocated cost of a product may therefore

	include some common costs that are not directly attributable to the service.
Financeability EBIT	EBIT of the Reported Business used for assessing financeability of the universal service.
FFO	Funds from Operations
Frontier shift	Downward shift in the efficient frontier over time resulting from improvements in technology and processes. Captures time-variation in efficiency.
FTE	Full-time Equivalent
FTI	FTI Consulting
Inward Mail Centre (IMC)	The part of a Royal Mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre's catchment area) of mail received from the upstream part of Royal Mail's network, or from other postal operators etc., to the final addresses take place.
IRR	Internal Rate of Return
January 2014 notifications	On 10 January 2014, Royal Mail announced increases to Access prices, as well as changes to its contracts with its Access customers.
July 2015 Discussion Document	Ofcom's discussion paper dated 17 July 2015 entitled *Review of the regulation of Royal Mail.*
Large Letter	A large letter is any item larger than a Letter and up to 353mm in length, 250mm in width and 25mm in thickness, with a maximum weight of 750g.
Letter	A Letter is any item up to 240mm in length, 165mm in width and 5mm in thickness, weighing no more than 100g.
Mailmark	Mailmark is a barcode system used by Royal Mail. This makes letters and large letters machine-readable, which allows for the tracking of items within the Royal Mail network.
March 2012 Statement	Ofcom's Statement dated 27 March 2012 entitled *Securing the Universal Postal Service – Decision on the new regulatory framework.*
MC	Mail centre
MCF	Mail Competition Forum
MICOP	Mail Integrity Code of Practice
MPU	Mail Processing Unit
MUA	Mail Users Association

National Geographic Posting Profile (NGPP)	The national geographic mix of a customer’s mail items. Under the national access contracts a geographically uniform price is charged to access customers, as long as their mailings meet the geographic profile specified by Royal Mail.
NIAUR	Northern Ireland Authority For Utility Regulation
NERA	NERA Economic Consulting
NPV	Net Present Value
NRA	National Regulatory Authority
OBR	Office for Budget Responsibility
Outward Mail Centre (OMC)	The part of a Royal Mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre’s catchment area) of mail received from the upstream part of Royal Mail’s network, or from other postal operators etc., to the final addresses take place. The upstream part of Royal Mail’s network consists of the processes related to collection and distribution of mail.
October 2011 Consultation	Ofcom’s Consultation dated 20 October 2011 entitled *Securing the Universal Postal Service - Proposals for the future framework for economic regulation.*
ONS	Office of National Statistics
PCOP	Postal Common Operational Procedures
PCOP Agreement	Postal Common Operational Procedures Agreement is a default agreement for postal operators to ensure that they follow the PCOP Code and CP 2. The PCOP Agreement itself is not part of the regulatory conditions, however, CP2 provides for a process that Ofcom must follow when modifying the PCOP Agreement if it receives a proposal for change from a signatory to the Agreement.
PCOP Code	Postal Common Operational Procedures Code, which can be found at Annex 1 of CP 2. The PCOP Code sets out a code of practice for the repatriation of mail which has entered the network of one postal operator but which was intended for another.
PCA	Postcode Area
Pipeline	Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item.
PLCWW	Postal and Logistics Consulting Worldwide
POL	Post Office Limited

Postal infrastructure	Both physical infrastructure (such as letter boxes) and infrastructure in non-physical form (such as information relating to postcodes or addresses or arrangements made with others for the provision of any service).
Postal operator	Defined in section 27(3) of the PSA 2011 as meaning a person who provides the service of conveying postal packets from one place to another by post, or any of the incidental services of receiving, collecting, sorting and delivering postal packets.
Postal service	Defined in section 27(1) of the PSA 2011 as meaning the service of conveying postal packets from one place to another by post, the incidental services of receiving, collecting, sorting and delivering postal packets, and any other service which relates to, and is provided in conjunction with, any of those services.
Postal network	Defined in section 38(3) of the PSA 2011 as meaning the systems and all the resources used by the provider for the purpose of complying with its universal service obligations (and, accordingly, includes arrangements made with others for the provision of any service)
Postal Packet	According to section 27(2), the expression “postal packet” means a letter, parcel, packet or other article transmissible by post.
POSTRS	The Postal Redress Service
PPA	Professional Publishers Association
Pre-sorted	Describes where the sender has sorted its mailing items to a predetermined level before handing them to the operator.
Price Plans	The respective national and zonal pricing options which Royal Mail offers in relation to its agreements with other persons for D+2 Access. It includes the price plans known as ‘National Price Plan One (SSCs)’, ‘Average/National Price Plan Two (Zones)’ and ‘Zonal Price Plan’, respectively, as well as the price plans for D+2 Access that preceded these price plans from time to time (known as Condition 9 agreements, whether or not they remain in force).
Postcomm	The Postal Services Commissions, which was the regulator responsible for postal services in the UK, until it was merged into Ofcom in 2011
PSA 2000	The Postal Services Act 2000
PSA 2011	The Postal Services Act 2011
The Postal Services Directive (PSD)	Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service (as amended by Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008)

PVEO	Price, Volume, Efficiency and Other
QoS	Quality of Service
RAB	Regulatory Asset Base
Regional Distribution Centre (RDC)	The part of Royal Mail's pipeline used to perform outward processing of predominantly pre-sorted mail items.
Regulatory Accounting Guidelines (RAG)	A document setting out such requirements as Ofcom may direct from time to time relating to the preparation, auditing, reporting and publication, of regulatory financial statements and other regulatory financial reports to be prepared and maintained by Royal Mail under the USPAC Condition.
Regulatory financial reports	The financial reports produced for Ofcom by Royal Mail in relation to the RAG; they include both the regulatory financial statements and additional financial reports produced by the Royal Mail as per the guidance in the RAG.
Regulatory financial statements	The income statements, balance sheet statements and cash flow statements produced by Royal Mail as per the guidance in the RAG.
Relevant Group	Royal Mail PLC and the group of companies it collectively holds.
Reported Business	The part of Royal Mail's UKPIL business that undertakes activities for the purpose of, or in connection with, the provision of universal service and non-universal service products, excluding the activities and products of Parcelforce International and Royal Mail Estates Limited. For the avoidance of doubt, the activities and products of the Reported Business shall be treated to include all the activities and products which fall within the scope of Royal Mail's National Costing Methodology as documented in the Costing Manual from time to time.
RMPP	Royal Mail Pension Plan
ROA	Return on Assets
ROCE	Return on Capital Employed
ROS	Return on Sales
Royal Mail	Royal Mail Group Limited, whose registered company number in England and Wales is 04138203.
Royal Mail Wholesale	A business unit within Royal Mail Group Limited that deals with access to Royal Mail Group Limited's postal network.
RPI	Retail Price Index
SAC	Stand-alone cost

Safeguard cap	In 2012 Ofcom introduced a safeguard cap on Second Class stamped items up to 2kg, with one price for letters, and a separate basket price for stamped parcels and Large Letters.
Single Piece	Single piece is defined in the Universal Service Order as a postal service for the conveyance of an individual postal packet to the addressee, for which the price per postal packet is not subject to any discounts related to (a) the number of postal packets sent in connection with the person who paid for the service; (b) the positioning or formatting of text on the postal packet; (c) the use of markings which facilitate the use of machines to sort postal packets; (d) pre-sortation into geographical areas for delivery; or (e) the purchase of any other conveyance of the same or any other postal packet.
SOC	Standard Occupational Classifications
Sorted	Describes mail that has been sorted into geographical areas prior to being collected by the postal operator. Some postal operators call this type of mail ‘pre-sorted’.
Standard Selection Code (SSC)	A numeric code used by Royal Mail to sequence addresses, identify selection breaks and match items to mailing bag labels.
Statement of Process	A Royal Mail document that outlines the process for postal operators and users of postal services to make requests for access contracts or to make variations to existing contracts
UKPIL	UK Parcels, International and Letters
Universal Service Obligation (USO)	The requirements to provide postal services which are contained in a designated USP condition imposed on the universal service provider by Ofcom under section 36 of the PSA 2011.
Universal Service Order	This refers to the Postal Services (Universal Postal Service) Order 2012 (as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013), which defines the scope of a universal service setting out a description of services that should be provided in the UK as a universal postal service, including a set of required characteristics of those services.
Universal Service Provider (USP)	Any postal operator for the time being designated by Ofcom as the universal service provider under the Postal Services Act 2011.
Unsorted	Describes mailing items handed to an operator which are not pre-sorted.
Upstream	The activities of collection, outward sortation (where necessary – pre-sorted mail may not require further outward sortation) and trunking.
User	Defined in section 65(1) of the PSA 2011 as including addressees and potential users

USP access condition (USPA Condition)	A condition that Ofcom may impose under section 38 of the PSA 2011 that requires the universal service provider to give access to its postal network to other postal operators or users of postal services and/or requires the universal service provider to maintain accounting separation.
USP accounting condition (USPAC Condition)	A condition Ofcom may impose under section 39 of the PSA 2011 that requires the universal service provider to provide regulatory financial statements and information, and may from time to time direct the universal service provider to do one or more of the following: to maintain accounting separation; to comply with rules about the identification of costs and cost orientation; to comply with rules about the use of cost accounting systems; and to secure that compliance with those systems is audited annually.
WACC	Weighted Average Cost of Capital
WIK	WIK-Consult
WLR	Wholesale Line Rental
Y2X	Consumer to Anywhere, when sending via an access point
Zones	The geographical zones into which Royal Mail divides the United Kingdom based on the density of delivery points and the proportion of business delivery points of postcode sectors, currently known as Zone A (Urban), Zone B (Suburban), Zone C (Rural) and Zone D (London).
Zonal tilt	The differential in Zonal charges for downstream services across different Zones.

Annex 11

Sources of evidence

A11.1 This annex presents a non-exhaustive list of the sources of evidence we have used, relied upon and/or referred to throughout this consultation. It is designed to help readers understand and locate the evidence we have used to form our proposals with greater clarity and transparency.

UK legislation

- The Communications Act 2003 (as amended)
- The Equality Act 2010 (as amended)
- The Postal Services Act 2011 (as amended)
- The Postal Services (Universal Postal Service) Order 2012 (S.I. 2012/936), as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, S.I. 2013/3108

European legislation

- Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008 amending Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services - http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997L0067-20080227&from=EN

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Information gathered using our statutory powers

A11.2 During this review, we have issued several notices under Section 55 and Schedule 8 of the Postal Services Act 2011, requiring Royal Mail and other postal operators to provide us with information, as set out in the notice. These information requests, and where relevant, the responses received, are listed below.

- Information from postal operators on their volumes and revenue for letters, large letters and access mail has been monitored on an ongoing basis. The information has been obtained in response to notices issued on a quarterly basis.

- Information request dated 28 May 2015 to a number of postal operators on their quarterly volumes and revenue for parcels.
- Two information requests both dated 2 June 2015 to Royal Mail and Parcelforce Worldwide Mail relating to quarterly volumes and revenue.
  - Response of 29 June 2015 from Royal Mail
  - Response of 29 June 2015 from Parcelforce Worldwide Mail
- Information request dated 11 March 2015 to Royal Mail covering specified information regarding Royal Mail's collections and logistics (e.g. transport routes and transportation methods).
  - Responses of 24 March and 1 April 2015 from Royal Mail
- Information request dated 12 May 2015 to Royal Mail covering specified information regarding Royal Mail's collections and logistics (e.g. transport routes and transportation methods).
  - Responses of 10 June and 24 June 2015 from Royal Mail
- Information request dated 27 May 2015 to Royal Mail covering specified information about the efficiency of Royal Mail's delivery offices, such as their mail volumes, staff hours and costs.
  - Response of 8 July 2015 from Royal Mail
- Information request dated 24 July 2015 to Royal Mail covering specified information regarding pricing, revenue and volumes data for parcels in order to inform our ongoing monitoring regime to track Royal Mail's Performance.
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  - Response of 2 October from Royal Mail
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  - Response 16 October 2015 from Royal Mail
- Information request dated 1 December 2015 to Royal Mail covering specified information about the efficiency of Royal Mail's delivery offices, such as their mail volumes, operating costs and KPIs.
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  - Responses of 3 and 4 September 2015 from Royal Mail.

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- Royal Mail, Size and weight formats for UK mail, *http://www.royalmail.com/personal/help-and-support/Tell-me-about-size-and-weight-formats*
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[432] Formerly TNT Post UK Limited. Documents submitted by TNT Post UK Limited have been included under Whistl's heading.