Review of the Regulation of Royal Mail

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Consultation

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About this document

On 16 June 2015 we announced a fundamental review of the regulation of Royal Mail. The review is to ensure regulation remains appropriate and sufficient to secure the efficient and financially sustainable provision of the universal postal service.

Following the publication of a discussion document in July 2015, we now set out the findings of our review. This includes our assessment of Royal Mail's efficiency, analysis of its position within the letter and parcel sectors, and consideration of the company's potential ability to set wholesale prices in a way that might harm competition. The document set outs proposals for a future framework for post focussing on five key areas:

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

We seek the views of stakeholders by 3 August 2016 and plan to issue a statement before the end of 2016-17.

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Section 1

Executive Summary

Securing an efficient and financially sustainable universal postal service that meets the reasonable needs of users

1.1 This fundamental review into the regulation of Royal Mail sets out Ofcom's approach to regulating the postal sector. It sets out how we will continue to fulfil our duties under the Postal Services Act 2011 (the "**PSA 2011**") to secure the provision of an efficient and financially sustainable universal postal service which meets the reasonable needs of users.

1.2 The review has been comprehensive, covering a wide range of areas, including Royal Mail's financial sustainability and efficiency; competition in the parcels and letters sectors; and the appropriateness of regulatory conditions.

Key proposals

Maintaining the current regulatory approach for a further five years: We are proposing to maintain the approach to regulation we established in 2012. Given Royal Mail's reasonable efficiency improvements, its moderate profitability, the increase in parcels competition and increasing consumer satisfaction with postal services, we consider that a significant change in our regulatory approach – for example, the re-introduction of price controls – would be inappropriate. We also propose that the three key safeguards we established in 2012 (monitoring, affordability and competition) should be retained.

Supporting competition and innovation in the parcels sector: We believe that consumers' interests are best served by competition. The UK has one of the most competitive parcels markets in the world. However, Royal Mail retains high revenue and volume shares for single piece and light-weight bulk parcels. We propose to protect consumers by retaining the safeguard cap on Second Class parcel prices. We also propose to retain the current position on standard universal service parcels, i.e. that tracking is not included. This reflects how consumers are actually using the universal service and supports competition by not granting Royal Mail an unfair competitive advantage.

Tightening rules on access competition: Generally access competition continues to perform well (accounting for 56% of all letter volumes) and meets the needs of large senders of mail. However, there are a small number of areas such as regulatory notification periods and new product development where customers have raised concerns and where we therefore propose to tighten the rules. In particular, we propose to clarify the circumstances in which a shorter notification period may be agreed to so as to prevent Royal Mail from circumventing the regulatory notification period. We also propose to require Royal Mail to respond to a request for mandated access within a six week time period, where it already offers an equivalent retail product.

Focusing mail integrity rules: We are amending the current mail integrity regulation to ensure that postal items which do not have protections such as proof of delivery or tracking but which may contain personal or confidential information are adequately protected from loss, theft or damage. We propose to amend the regulation to focus on untracked letters, large letters and universal service parcels, and to ensure that postal operators have the incentive to concentrate on good consumer outcomes rather than process.

Ensuring regulations remain appropriate and fit-for-purpose: We are proposing various changes to ensure that regulations do not impose an undue burden on postal operators, while ensuring consumers remain protected. These include reducing the advance notice period for specified collection times to one month, removing the advance notice period for latest delivery times and removing the Postal Common Operational Procedures (PCOP) code and agreement.

Background

1.3 In March 2012, Ofcom published a statement putting in place a new seven-year regulatory framework for the postal sector (the "**March 2012 Statement**"). This gave Royal Mail greater commercial and operational flexibility so that it could return the universal service to financial sustainability and adapt to the changing market environment. At the same time, we put in place three key safeguards. These are:

- **Monitoring**: an effective and on-going monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels and pricing and competition;
- **Affordability**: a cap on the price of Second Class stamps for letters and parcels up to 2kg so vulnerable consumers can access a basic universal service; and
- **Competition**: we require Royal Mail to continue to provide access to its network for letter competitors.

1.4 However, the market has since witnessed some significant changes. In particular, Royal Mail's only significant direct competitor for the delivery of letters, Whistl, announced in June 2015 that it was closing down its end-to-end letter delivery operations. End-to-end competition is where an operator collects, sorts, and delivers mail entirely using its own network (and so not using any part of Royal Mail's postal network).

1.5 At the point that it exited the market, Whistl was delivering to around 7% of addresses and had a maximum share in total addressed letters of 1.3%. On average this represented around 20% of the total letter volumes in the areas that Whistl was delivering. Whistl's exit leaves Royal Mail without any competition of significant scale for letters, although competition is stronger in relation to other postal products such as parcels and 'access mail' – where operators collect and sort mail before handing it over to Royal Mail for delivery.

1.6 There have also been a number of other significant developments since March 2012. These include:

- a significant improvement in the financial position of the universal service; and
- an increase in competition and innovation in parcel services, which could have implications for the future financial sustainability of the universal service network.

1.7 As a consequence, in June 2015 we announced a fundamental review to examine whether the current regulation of Royal Mail remains appropriate and sufficient to secure the universal postal service. In July 2015 we published a discussion paper (the "**July 2015 Discussion Document**") which set out our intention to examine the incentives and constraints on Royal Mail's behaviour regarding efficiency and pricing.

In particular, we wanted to establish whether there would need to be changes to the regulation to ensure it continued to protect and promote the interests of consumers.

Maintaining the current regulatory approach for a further five years

1.8 In assessing the current regulation we have analysed Royal Mail's financial sustainability and efficiency, the competitive conditions in letters and parcels, and the consumer experience of postal services.

We consider Royal Mail is financially sustainable

1.9 We consider Royal Mail is currently financially sustainable and likely to remain so in the immediate future. We are proposing to retain the current approach to measuring financial sustainability based on Royal Mail's return on sales, and consider that the 5-10% EBIT (Earnings Before Interest and Tax) margin range we identified in 2012 remains an appropriate benchmark. Royal Mail is currently making returns at the lower end of the 5-10% range.

Royal Mail has made some efficiency improvements in recent years, but there is potential for it to do more

1.10 Royal Mail has made some progress on efficiency in recent years. As part of our efficiency review, we examined whether its projected efficiency plans represent a reasonable rate of improvement. Specifically, we commissioned analysis of Royal Mail's business plan, the relative performance of its delivery offices and mail centres, and to identify the level to which Royal Mail's costs vary with changes in volume. Our analysis suggests that Royal Mail's proposed efficiency initiatives and levels of cost reduction are reasonable. However, we consider them to be at the lower end of a reasonable range for improvement. While its future plans are more ambitious than its past achievements, we believe there is potential for Royal Mail to make greater efficiency gains than those it is currently forecasting. For example, our analysis suggests there is scope for Royal Mail to improve the efficiency of its Delivery Offices by about 10% from increasing the performance of lower performing units to match their higher performing peers.

Since 2012 Royal Mail has increased prices conservatively

1.11 We consider that the constraints Royal Mail faces are unlikely to be sufficient to prevent it from raising prices in many sectors of the postal market. In particular, Royal Mail continues to deliver the vast majority of letters and may therefore face few constraints on its prices. However, we also note that it has not raised prices as much it could have done. Following the significant price rises introduced in 2011-12 and 2012-13 in order to return to profitability, its price increases have been roughly in line with RPI.

1.12 Some parts of the parcel sector are competitive, particularly heavier parcels (above 2kg) and those requiring fast delivery. However, despite increasing competition, we consider Royal Mail retains an advantage for single piece parcels used by consumers and small and medium enterprises (SMEs) and small, lightweight bulk parcels.

Consumers and businesses are satisfied with the postal market

1.13 Our on-going research shows that consumer and SME satisfaction is reasonably high and improving. Nine out of ten residential consumers are satisfied or very satisfied

with postal services, and six out of ten consider the price of a First Class stamp to be good or very good value for money. Eight out of ten businesses are satisfied or very satisfied with Royal Mail's services and nine out of ten with the services of other postal operators.

We think the current regulatory approach remains appropriate

1.14 Some respondents to our July 2015 Discussion Document advocated the re-introduction of price controls on Royal Mail before the end of the seven-year regulatory framework in 2019. However, we consider that this would not be appropriate.

1.15 While Royal Mail may have the ability and incentive to increase prices and profitability at the expense of efficiency savings, it has not done so. On the contrary, our analysis shows Royal Mail is making returns at the lower end of the 5-10% EBIT margin range, some progress on efficiency and not raising prices as much it could, against a backdrop of increasing customer satisfaction.

1.16 Therefore, we consider that both the provision of a financially sustainable universal postal service and the interests of consumers are best achieved by continuing to afford Royal Mail pricing flexibility, subject to certain safeguards.

We propose to extend the current regulatory approach for five years

1.17 In 2012 we said that the new regulations should remain in place for seven years (unless fundamental concerns arose through the monitoring regime). Having carried out this fundamental review, we propose that the regulatory framework should remain settled for a further five years from the date we close the review, i.e. from 2017 to 2022.

1.18 We will continue to closely monitor the market and retain the right to intervene. While it is not possible to identify all of the circumstances in which we might step back in, examples might include:

- The emergence of threats to the financial sustainability of the universal postal service, which Royal Mail could not deal with through commercial action alone.
- Negative outcomes for consumers, such as significant price increases or poor quality of service, where there is no or very little competition.
- Failure on Royal Mail's part to make sufficient progress on improving its efficiency, exposing consumers to higher prices and/or a lower quality of service than might be the case in a competitive market.

1.19 In addition, we will continue to measure and gather information about the reasonable needs of postal users. This is particularly important given changing consumer preferences for some postal services, particularly parcels. It is likely that Ofcom will conduct a review of postal users' needs during the course of the five year period.

Supporting competition and innovation in the parcels sector

1.20 In response to our July 2015 Discussion Document, Royal Mail said that regulation unfairly prevents it from offering full tracking of standard parcels within the universal service. It argued that this prevents it from responding to customer demand and keeping its universal service products relevant.

1.21 We propose to retain the current position on standard universal service parcels, i.e. that tracking is not included. We are not opposed to the principle of including tracking on such parcels in future if that would help consumer needs to be met, However, there is a risk that allowing Royal Mail to offer tracking in the universal service could give it an advantage over its competitors since universal service products are currently exempt from VAT. Royal Mail would therefore benefit from a price advantage for tracked parcels which could harm competition in the parcels market. In addition, the vast majority of single piece parcels sent by consumers are not tracked, despite the wide availability of similarly priced tracked services from competitors. We also understand that Royal Mail is not currently in the position to offer tracked services universally to its customers.

1.22 We have also considered whether the safeguard cap on Second Class parcels up to 2kg remains necessary given the emergence of competition in the parcels sector. We consider that competition has not yet developed to a sufficient degree to constrain Royal Mail's pricing on single piece parcels and we therefore propose to retain the safeguard cap.

1.23 Our analysis of the parcels sector has identified a risk that Royal Mail could unfairly leverage its strong position in the letters sector into parcels. Therefore, to address this risk we propose to review our regulatory accounting guidelines and build a costing model to help develop our own view of how Royal Mail allocates costs.

Tightening rules on access competition

1.24 In response to stakeholders' concerns we have reviewed whether access regulation remains appropriate both in relation to price and non-price elements of the existing regulatory framework. In general we propose that it is appropriate to retain access regulation largely in its current form.

1.25 However, we propose to make two amendments to the existing framework for access in order to strengthen protections for customers of Royal Mail's access services. We propose to:

- clarify the circumstances in which a shorter notification period may be agreed to so as to prevent Royal Mail from circumventing the regulatory notification period in respect of all future changes to terms and conditions relating to new access products; and

- require Royal Mail to respond to a request for mandated access within a six week time period, where it already offers an equivalent retail product.

1.26 Some stakeholders suggested Ofcom should require Royal Mail to provide other forms of access, e.g. First Class services, small parcels up to 2kg, unaddressed mail, and access to the collections network (post boxes, Post Offices and business collections) via the Outward Mail Centres. However, we do not consider that the evidence put forward by stakeholders is sufficient to warrant an extension of access obligations at this time.

1.27 We have also decided not to implement the proposals in our 2014 Access Pricing Consultation at this point in time. However, we will continue to closely monitor Royal Mail's changes to its access prices and zonal pricing structure, with particular reference to the principles set out in this document.

Focusing mail integrity regulation

1.28 Mail integrity is about ensuring postal items are protected from loss, theft or damage. Postal items that are most vulnerable include those items which do not have additional protections (e.g. proof of delivery, tracking) but may contain personal or confidential information, such as bank or credit card details, tax information or medical appointments.

1.29 We are amending the current mail integrity regulations to focus on untracked letters, large letters and universal service parcels, and to ensure that postal operators have the incentive to concentrate on good consumer outcomes rather than process.

Ensuring regulations remain appropriate and fit-for-purpose

1.30 With the exception of those regulatory conditions which implement the universal postal service obligation, we have reviewed all the regulations applying to Royal Mail and other postal operators to ensure they remain appropriate and fit-for-purpose. As a result we propose to:

- simplify the rules around the treatment of mis-collected and mis-directed mail to maintain adequate protection for postal users on a proportionate basis, reflecting the relatively low volume of affected items;
- reduce the unnecessarily long notification periods for changes to collection and delivery times; and
- remove requirements on Royal Mail to notify price decreases while retaining the requirement for consumers to be given advance warning of price increases.

Next steps

1.31 Ofcom invites responses to this consultation, to reach us by 3 August 2016. The time period for this consultation is 10 weeks, consistent with Ofcom's Consultation Guidelines.[1] We anticipate issuing a final statement before the end of the 2016-17 financial year.

1.32 Separately, we expect to undertake the following work later in 2016:

- consult on proposals for amending the USP Accounting Condition and Regulatory Accounting Guidelines to ensure they remain fit for purpose and make some technical changes to the detailed workings of the margin squeeze control; and
- review whether the regulation in relation to Royal Mail's quality of service remains appropriate in light of market developments.

[1] See http://stakeholders.ofcom.org.uk/consultations/how-will-ofcom-consult.

Section 2

Introduction & Summary of the Regulatory Framework

2.1 In this section, we set out the legal framework and Ofcom's duties relevant for our consideration and assessment of the proposals set out in this consultation in the context of our review of the regulation of Royal Mail. We then summarise the current regulatory framework for postal services and the background to the review.

Ofcom's duties are to further the interests of citizens and consumers and to secure the provision of a universal postal service

2.2 The legal framework relating to the regulation of postal services is set out in the Postal Services Act 2011 (the "**PSA 2011**").

2.3 Ofcom's principal duty under the Communications Act 2003 (the "**CA 2003**") is to further the interests of citizens and of consumers, where appropriate by promoting competition. For postal services, we also have a duty under the PSA 2011 to secure the provision of the universal postal service, to which we must give priority if we consider that there is any conflict with our principal duty. We explain in more detail below how these duties fit together.

2.4 Section 29(1) of the PSA 2011 provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service. Section 29(2) provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1).

2.5 Section 29(3) provides that, in performing its duty under section 29(1), Ofcom must have regard to the need for the provision of a universal postal service to be:

- financially sustainable; and
- efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.

2.6 Section 29 does not require that Ofcom gives more weight to one of those considerations over the other. We must take them both into account in arriving at a judgment as to how we ought to carry out our functions, including when considering imposing or modifying regulatory conditions.

2.7 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom's general duties in the CA 2003 in the case of conflict between the two where Ofcom is carrying out its functions in relation to postal services. However, if we consider that no conflict arises, Ofcom must carry out our functions in accordance with these general duties and so must further the interests of citizens and of consumers, where appropriate by promoting competition.

2.8 For the reasons set out in this consultation, Ofcom does not consider that there is any conflict between its duty to secure the provision of the universal postal service and its general duties.

2.9 In performing its general duties, Ofcom is also required under section 3(4) of the CA 2003 to have regard to a range of other considerations, which appear to Ofcom to be relevant in the circumstances. In this context, a number of such considerations appear relevant, including:

- the desirability of promoting competition in relevant markets;
- the desirability of encouraging investment and innovation in relevant markets;
- the needs of persons with disabilities, of the elderly and of those on low incomes;
- the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas; and
- the extent to which, in the circumstances of the case, the furthering or securing of the matters mentioned in section 3(1) is reasonably practicable. Section 3(5) of the CA 2003 provides that, in performing its duty to further the interests of consumers, Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.

2.10 Additionally, pursuant to section 3(3) of the CA 2003, in performing its general duties, Ofcom must have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice. In this regard, we also note Ofcom's general regulatory principles.[2]

2.11 Finally, we have an on-going duty under section 6 of the CA 2003 to keep the carrying out of our functions under review with a view to ensuring that regulation by Ofcom does not involve the imposition of burdens which are unnecessary or the maintenance of burdens which have become unnecessary.

The universal postal service

2.12 The universal postal service is a set of services described in an order made by Ofcom under section 30 of the PSA 2011 (the "**Universal Service Order**").[3] In addition, the EU Postal Services Directive (PSD) sets out certain minimum requirements that all member states must ensure are provided.[4]

2.13 Section 31 of the PSA 2011 sets out the services that must, as a minimum, be included in a universal postal service,[5] subject to exceptions to those minimum requirements set out in section 33 of the PSA 2011.

[2] See Ofcom's website, http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/.
[3] The Postal Services (Universal Postal Service) Order 2012, SI 2012/936, as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108, see http://stakeholders.ofcom.org.uk/post/upso/.
[4] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997L0067-20080227&from=EN
[5] These implement the requirements of the EU Postal Services Directive (Directive 97/67/EC as amended).

2.14 In making the Universal Service Order in 2012, we sought to describe the essential features of the universal service, without substantively changing the scope of the universal service as it had existed up until that time. In summary, the Universal Service Order stipulates that the universal postal service shall comprise:

- At least one delivery of letters every Monday to Saturday and of other postal packets every Monday to Friday to the home or premises of every individual in the UK and to such delivery points as approved by Ofcom;
- At least one collection of letters every Monday to Saturday and of other postal packets every Monday to Friday;
- The provision of certain 'end-to-end services at affordable prices', which are defined in Schedule 1 to the Universal Service Order;
- The provision of certain 'free end-to-end services', which are defined in Schedule 2 to the Universal Service Order; and
- The provision of certain 'addressee services', which are defined in Schedule 3 to the Universal Service Order.

2.15 The scope of the universal service as described in the Universal Service Order is reflected in Designated Universal Service Provider (DUSP) Condition 1, which requires Royal Mail, as the designated universal service provider, to provide services matching those described in the Universal Service Order.[6]

2.16 With the exception of the first universal postal service order,[7] before making or modifying a universal postal service order, Ofcom is required under section 30(3) of the PSA 2011 to carry out an assessment of the extent to which the market for the provision of postal services in the United Kingdom is meeting the reasonable needs of the users of those services.

The postal sector was facing major challenges

2.17 In March 2012, Ofcom published a statement putting in place a new regulatory framework for the postal sector (the "**March 2012 Statement**").[8] The new regulatory framework gave Royal Mail greater commercial and operational flexibility in recognition of the major challenges facing the postal sector at that time.[9]

2.18 In particular, the volume of mail in the UK had fallen by over a quarter between 2006 and 2012 and, due to substitution to electronic alternatives such as email, total market volumes were expected to continue to decline in the medium term. In

[6] Ofcom may impose a DUSP condition on a universal service provider under section 36 of the PSA 2011 where we consider it necessary to do so in order to secure the provision of a service of a description set out in the universal postal service order in accordance with the standards set out there.
[7] Section 30(4) of the PSA 2011 provides that in respect of the first universal postal service order Ofcom must carry out an assessment of user needs before the end of the period of 18 months from the date the relevant provisions of the Act came into force.
[8] Ofcom, *Securing the Universal Postal Service, Decision on the new regulatory framework*, Ofcom, 27 March 2012: http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/.
[9] For example, see March 2012 Statement, paragraphs 1.5 to 1.12.

addition, customers had moved away from higher value traditional products towards lower value services.

2.19 These factors had a negative impact on Royal Mail's revenues, which put the financial sustainability of the universal service under severe pressure. The changes in mail volume and mix led to a decline in Royal Mail's revenues by more than 35% between 2006 and 2012.[10] In addition, as Royal Mail had been unable to reduce its costs in line with the falling volumes, this had resulted in increasing unit costs.[11]

2.20 The universal service network was making a loss (and had been for a number of years) and Royal Mail's future provision of the universal service was under threat. Its financial results for 2010-11 showed a loss of over £100 million on revenues of about £7 billion and a significantly worse cash flow position as Royal Mail continued to invest in modernisation.[12]

2.21 In light of these challenges, the new regulatory framework gave Royal Mail greater commercial and operational flexibility so that it could return the universal service to financial sustainability and adapt to the changing market environment.

2.22 We decided to put the regulatory framework in place for a period of seven years in order to provide an appropriate degree of certainty as to the regulatory framework for Royal Mail, potential investors and other stakeholders. We considered that this would better encourage efficiency incentives and allow the benefits of a financially sustainable universal service to be shared with customers.

2.23 However, we recognised that there might be circumstances in which we could decide to re-open the regulatory framework earlier than seven years.[13] These included if Royal Mail used its commercial freedom to act in a way that did not support our regulatory objectives and so might undermine the provision of the universal service, or in the event of significant unanticipated market challenges.

The March 2012 Statement gave Royal Mail greater commercial flexibility with key safeguards

2.24 Given Royal Mail's financial position in 2012, there was an immediate risk to the universal service. We considered that in all likelihood Royal Mail would need to increase prices in the short term. However, beyond that, it was clear that unless Royal Mail could deliver efficiency gains that at least offset the effect of volume decline, it was likely that there would be a need for further price increases. We were concerned that this could send the postal sector into a spiral of decline as price rises were likely to exacerbate the decline in demand, further increasing unit costs, and put additional upward pressure on prices.

2.25 Since 2006, Royal Mail had been subject to a price control on the majority of its services. The price control had fixed the margin between Royal Mail's access services and its corresponding retail services. In the March 2012 Statement, we set out our concerns that a price control-based approach would not be effective in the

[10] See the March 2012 Statement, paragraph 1.7.
[11] See the March 2012 Statement, paragraph 1.11.
[12] See the March 2012 Statement, paragraph 1.8.
[13] For example, see March 2012 Statement, paragraphs 7.77-7.91.

specific circumstances facing Royal Mail and the postal market at that point in time.[14] This was due to:

- in a highly uncertain market environment, where the level and pattern of demand is unclear, it was not likely to be feasible to predict accurately whether a given price trajectory would be adequate to ensure the provision of the universal service was financially sustainable;

- the mechanism for instilling efficiency incentives under an RPI - X formula did not work effectively in circumstances where Royal Mail was struggling financially and Ofcom had a duty to secure the continued provision of the universal service; and

- a price control reduced Royal Mail's flexibility to adapt to changes in the market and its operating environment.

2.26 Given the challenges facing Royal Mail at that time and the risks involved with imposing a price control described above, we decided it was appropriate to allow Royal Mail the flexibility to determine the best way to meet the significant financial challenges facing it.[15] This included:[16]

- pricing flexibility, by moving away from a price control based approach for a period of seven years, subject to future review; and

- operational flexibility, by reducing the notification, publication and pre-approval requirements for product changes and new services.

2.27 We considered that, absent price regulation, Royal Mail had inherent efficiency incentives, given its financial position and the ongoing decline in market volumes. We acknowledged that while prices were likely to rise in the short-term, Royal Mail had a commercial incentive to ensure that such price rises did not significantly accelerate market decline and therefore threaten the viability of the universal service.

2.28 However, we recognised that pricing flexibility may give rise to a number of risks:[17]

- Royal Mail might have the incentive and ability to increase prices instead of taking on the efficiency challenge, and might do so in a way that resulted in a detriment to the universal service in the longer term;

- vulnerable consumers in particular might potentially be adversely affected by price increases; and

- Royal Mail would have the incentive and ability to make competition more difficult.

2.29 Therefore, in granting Royal Mail pricing flexibility, it was essential to ensure it would use this in a way that accorded with our regulatory objectives in respect of the universal service. Given this, we put in place three key safeguards in order to

[14] For example, see March 2012 Statement, paragraph 1.19.
[15] For a full discussion of our regulatory decisions around Royal Mail's commercial flexibility, see March 2012 Statement, sections 6-10.
[16] For example, see March 2012 Statement, paragraph 6.3.
[17] For example, see March 2012 Statement, paragraph 6.157.

mitigate and monitor the impact of the removal of traditional price controls. Those were:[18]

- **a monitoring regime**: an effective and ongoing monitoring regime to track Royal Mail's performance in respect of the universal service, efficiency levels, pricing and competition;
- **a cap on the price of Second Class stamps up to 2kg**: to ensure that vulnerable consumers remained able to access a basic universal service; and
- **access regulation**: we put in place regulation to maintain access competition given the benefits it could bring such as lower prices to consumers.[19]

2.30 After putting the regulatory framework in place, in accordance with section 30(4) of the PSA 2011, we undertook a review of the reasonable needs of users in relation to the market for the provision of postal services in the UK.[20] In March 2013, we concluded that the postal market was meeting the reasonable needs of users and was highly valued by residential users and businesses across the UK. Therefore, we decided not to change the scope of the universal service.[21]

2.31 However, our research also indicated that while users generally were satisfied with the current services available, different users relied on post to varying degrees, and users' needs and preferences were evolving.

The market has witnessed some significant changes since the regulatory framework was put in place in March 2012

2.32 In our March 2012 Statement we recognised the prospect of end-to-end competition developing in the future as well as its potential benefits and risks to the universal service. End-to-end competition in post is where an operator collects, sorts, and delivers mail entirely using its own network (and so not using any part of Royal Mail's postal network). We decided to assess these benefits and risks on a case-by-case basis.

2.33 However, in the interests of providing greater regulatory certainty to the market in 2013 we published guidance on how we would approach such an assessment in the future.[22]

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[18] For example, see March 2012 Statement, paragraph 6.158.

[19] In accordance with the USP access condition Royal Mail has to grant access at Inward Mail Centres for the provision of retail D+2 and later than D+2 letter and large letter services. While we do not directly regulate the price of access, we ensure, by means of an ex-ante margin squeeze test, that the difference between its access price and the equivalent retail price is consistent with principles that will provide for effective competition between Royal Mail and access operators.

[20] See our 2013 Review of Users' Needs: http://stakeholders.ofcom.org.uk/consultations/review-of-user-needs/.

[21] In December 2013 we made some technical and other minor amendments to the Universal Service Order, but these were intended to clarify the drafting of the Universal Service Order and the scope of the regulatory obligations on Royal Mail to reflect current provision rather than making any changes to the scope of the universal service in practice. See Ofcom's Statement *Technical and other minor amendments in postal regulation*, 10 December 2013, http://stakeholders.ofcom.org.uk/consultations/post/.

[22] See our guidance on assessing the impact of end-to-end competition in the postal sector: http://stakeholders.ofcom.org.uk/consultations/e2e-guidance/statement/.

2.34 In April 2012, Whistl (formerly TNT Post UK) started a trial of the end-to-end delivery of letters in West London.

2.35 Whistl publicly stated in 2013 that it planned to deliver to around 42% of UK addresses by 2017.[23] Following its successful trial of delivery operations in West London, by 2014 Whistl had extended its delivery services to Central, South West and North West London, Manchester and Liverpool.

2.36 In June 2014, Royal Mail provided us with a submission arguing that end-to-end competition by Whistl posed a significant threat to the provision of the universal postal service.[24] Royal Mail argued that we should intervene to protect the universal service as a result.

2.37 In December 2014, we published a review of the impact of end-to-end competition on Royal Mail's ability to provide the universal postal service (the "**2014 End-to-end Statement**").[25] Our review concluded that it was not necessary at that time to exercise our regulatory powers under the PSA 2011 to impose regulatory conditions on Whistl in order to secure the ongoing provision of a universal postal service. We concluded that the provision of the universal postal service was not under threat from end-to-end competition, and as a result the legal tests for imposing such regulatory conditions were not met.

2.38 However, we recognised that there was uncertainty around Royal Mail's future financial position. Contrary to the position Royal Mail set out to us in its June 2014 submission, we concluded that this uncertainty arose from factors other than end-to-end competition. These factors included Royal Mail's ability to execute its commercial strategy in relation to parcels, and its ability to make efficiency improvements. On this basis, we announced that we would undertake a wider assessment of factors that affect the future financial sustainability of the universal service.

2.39 Alongside our review of end-to-end competition in the postal sector, in December 2014 we consulted on proposed amendments to the regulatory framework relating to access pricing (the "**2014 Access Pricing Consultation**") in response to Royal Mail's notified price increases in January 2014.[26] In essence, we were concerned that Royal Mail's behaviour could discourage or even prevent competition in bulk mail letter delivery, leading to reduced pressure on Royal Mail to deliver efficiency improvements and a risk of excessive prices.

2.40 We therefore consulted on proposals designed to promote entry by end-to-end letter delivery operators who would put downward pressure on Royal Mail's retail prices and access charges. We argued that this kind of entry would prevent Royal Mail from

[23] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013.
[24] See Royal Mail's submission, *Direct Delivery: A Threat to the Universal Postal Service: Regulatory Submission to Ofcom*, 20 June 2014, non-confidential version available at: http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission%20Final%20Version%20for%20Publication.pdf.
[25] *Review of end-to-end competition in the postal sector, Ofcom, 2 December 2014,* http://stakeholders.ofcom.org.uk/binaries/post/end-to-end-statement/end-to-end.pdf.
[26] See Ofcom's *Royal Mail Access Pricing Review - Proposed amendments to the regulatory framework*, 2 December 2014, http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/.

charging excessive prices, encourage Royal Mail to reduce its costs and to invest in improving its products and processes, leading to net benefits for postal users.[27]

Changing market circumstances led us to announce our review of the regulation of Royal Mail

2.41 On 10 June 2015, Whistl announced that it was closing down its end-to-end delivery operations. At this point Whistl was delivering to around 7% of addresses[28] and had a maximum share in total addressed letters of 1.3% for the 2014-15 financial year.[29] On average this represented around 20% of the total letter volumes in the areas that Whistl was delivering.

2.42 Whistl's exit means Royal Mail no longer faces any end-to-end competition of significant scale for letters, although competition is stronger in relation to other postal products such as parcels and 'access mail' – where operators collect, sort and transport mail before handing it over to Royal Mail for delivery.

2.43 Whistl's exit occurred against the backdrop of the provisional view set out in our 2014 Access Pricing Consultation[30] that Royal Mail has, in successive years, proposed or notified changes to its contract terms and conditions which could discourage and potentially prevent entry and expansion into bulk mail letter delivery.[31]

2.44 There have also been a number of other significant developments in the postal market since we put the new regulatory framework in place in March 2012. These include:

- a significant improvement in the financial position of the universal service; and
- an intensification in the level of competition and innovation in parcel services, which could have implications for the future financial sustainability of the universal service network.

2.45 As a consequence of these changes, we announced a fundamental review of the regulation of Royal Mail on 16 June 2015.[32] The objective of the review was to ensure that regulation remains appropriate and sufficient to secure the universal postal service, given recent market changes.

2.46 On 17 July 2015 we published a discussion paper (the "**July 2015 Discussion Document**") setting out the proposed scope of the review.[33] The paper sought stakeholder views and evidence to assist our analysis.

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[27] See paragraph 1.9 of the 2014 Access Pricing Consultation.
[28] Whistl presentation to the MarketForce annual conference on The Future of the UK Postal Services, 21 October 2014
[29] See Ofcom's *Annual monitoring update on the postal market – financial year 2014-15*, 27 November 2015, paragraph 4.29 http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.
[30] See paragraph 4.8 of the 2014 Access Pricing Consultation.
[31] Separately, we are conducting an investigation into whether Royal Mail's pricing and other contractual changes have infringed the prohibition against the abuse of a dominant position under the Competition Act 1998. The latest position on that investigation can be found on our website.
[32] See http://media.ofcom.org.uk/news/2015/royal-mail-regulation-review/.
[33] See http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

We have considered a range of relevant factors as part of our review

2.47 When we announced our fundamental review of the regulation of Royal Mail in 2015, our ongoing work included:

- a review of Royal Mail's ability to set wholesale prices in a way that might have an adverse effect on competition;
- a review of factors which may have an impact on Royal Mail's ability to provide the universal service sustainably in the longer term, including:
  - the rate of efficiency improvement Royal Mail should reasonably be able to achieve; and
  - a review of developments in the parcels sector and Royal Mail's position within it.

2.48 Since announcing our review, we have broadened our work to consider a number of other relevant factors:

- whether any changes to the overall postal regulatory framework might be appropriate to secure the universal postal service;
- how best to ensure Royal Mail continues to become more efficient in the absence of significant end-to-end competition for letters (helping the universal postal service to remain sustainable);
- whether Royal Mail's commercial flexibility remains appropriate in the changing market; and, if not, whether wholesale or retail charge controls might be appropriate.

2.49 We have also supplemented our existing work programme by broadening our parcels work to look at the market structures in the letter and parcel sectors. This is in order to assess Royal Mail's position within these sectors and whether there have been any changes in its position which might justify a change in approach.

2.50 Our findings have been informed by our ongoing monitoring of Royal Mail's financial position (including its 2015 Business Plan and potential future pension costs).[34]

2.51 This review also addresses the concerns we provisionally identified in the 2014 Access Pricing Consultation in relation to competition and efficiency, taking account of the pricing and non-pricing issues that stakeholders have raised with us.

2.52 As noted above, prior to changing the scope of the universal service we would first have to conduct a review of users' needs. While we continue to monitor the preferences of postal users through our postal tracker surveys[35] and other means,

[34] Our view of a financially sustainable universal service was an EBIT margin of between 5 and 10%. EBIT margin means earnings before interest and tax as a proportion of total sales (see paragraph 5.47 of the March 2012 Statement).

[35] See our Residential Consumer Postal Tracker 2015 and our Business Postal Tracker 2015 for example: http://stakeholders.ofcom.org.uk/binaries/research/statistics/2016Feb-Apr/Residential_Postal_Tracker_2015_data_tables_tbp.pdf and:

we have not at this stage carried out a review of users' needs with a view to determining whether the current market for the provision of postal services is meeting the reasonable needs of postal users. Therefore, we are not proposing in the context of this review to make any changes to the scope or characteristics of the universal service.

2.53 However, we will continue to measure and gather information about the reasonable needs of postal users. This is particularly important given changing consumer preferences for some postal services, particularly parcels. It is likely that Ofcom will conduct a review of postal user's needs during the course of the five year period for which the regulatory framework is expected to remain in place.

General impact assessment

2.54 The analysis presented in the whole of this consultation represents an impact assessment, as defined in section 7 of the CA 2003.

2.55 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the CA 2003, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see our guidelines, '*Better policy-making: Ofcom's approach to impact assessment*'.[36]

2.56 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the CA 2003) is secured or furthered by or in relation to what we propose.

Equality impact assessment

2.57 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to

- eliminate unlawful discrimination, harassment and victimisation;
- advance equality of opportunity between different groups; and
- foster good relations between different groups.

2.58 In relation to the following protected characteristics: age; disability; gender re-assignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation. Such equality impact assessments (EIAs) also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 discussed above.

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http://stakeholders.ofcom.org.uk/binaries/research/statistics/2016April/Ofcom_Business_Postal_Tracker_2015_tables_weighted.pdf

[36] See Ofcom's website, http://www.ofcom.org.uk/about/policies-and-guidelines/better-policy-making-ofcoms-approach-to-impact-assessment/.

2.59 We have therefore considered what (if any) impact the proposals in this Consultation may have on equality. Having carried out this assessment, we are satisfied that our proposals are not detrimental to any group defined by the protected characteristics set out in paragraph 2.58.

Purpose and structure of this document

2.60 The purpose of this consultation is to seek input from stakeholders and any other interested parties on our proposals following our review. The deadline for responding to this consultation is 3 August 2016 and information on how to respond, including our consultation questions, is found in Annexes 1 to 4.

2.61 The rest of this document is structured as follows:

- Section 3 provides a summary of the responses we received to the July 2015 Discussion Document;
- Section 4 describes the findings from our review and sets out proposals relating to the overall regulatory framework;
- Section 5 sets out our proposals relating to the regulation of parcels;
- Section 6 explains our proposals in relation to access price and non-price issues;
- Section 7 sets our proposals for deregulation;
- Annexes 1 to 3 set out the process for responding to this consultation document and Ofcom's consultation principles;
- Annex 4 is a list of the consultation questions;
- Annexes 5 to 8 provide an in-depth analysis of Royal Mail's efficiency, financial sustainability and the postal market for letters and parcels respectively;
- Annex 9 lists respondents to our July 2015 Discussion Document;
- Annex 10 is a non-exhaustive glossary of acronyms and defined terms used throughout this consultation;
- Annex 11 is a non-exhaustive list of the sources of evidence we have relied upon for our review; and
- Annexes 12 to 17 set out the legal notifications of the proposed modifications to the regulatory conditions.

2.62 Separately we have also published today a review by WIK of the projected costs within Royal Mail's business plan, a report on econometric benchmarking in the UK postal sector by Deloitte and a report by CEPA on the relevance of a margin based approach to measuring financial sustainability. We will shortly be publishing a review by Analysys Mason of Royal Mail's short-run marginality.

Section 3

Summary of responses to Discussion Document

Stakeholder responses to the July 2015 Discussion Document

3.1 We received responses from 39 stakeholders to the July 2015 Discussion Document. These stakeholders came from a wide variety of industries related to the postal sector, representing postal operators, consumer groups and large scale customers. Royal Mail provided a response that included a series of reports produced by FTI Consulting.

3.2 A full list of respondents is included at Annex 9. All non-confidential responses to the July 2015 Discussion Document are published on our website.[37]

3.3 Most respondents provided views on the proposed scope of our review and how the regulatory framework should be amended. We received many responses and there were several themes that emerged from respondents' feedback. We discuss these themes below, which we have broadly grouped along the lines of the questions we asked in the July 2015 Discussion Document. Where respondents made comments relating to specific aspects of the review, these are discussed in greater detail in the relevant section or annex below.

The need for a review of the existing regulatory structure

3.4 A number of stakeholders argued that the current regulation was not working as effectively as it could be and that the framework should be amended. Of these:

- some stakeholders (e.g. DMA, Secured Mail, Whistl) said the framework should be revised to apply more effective regulatory constraints on Royal Mail's pricing and non-pricing behaviour, for both retail and access products;[38]
- some stakeholders (e.g. First Post, The Postal Group) said that the framework should be revised to reduce the focus on encouraging end-to-end competition and to apply greater focus on promoting competition in downstream access services;[39] and
- Hermes said regulatory action should be taken to prevent Royal Mail from adopting anti-competitive behaviour in the growing parcels sector.[40]

3.5 Royal Mail also considered that a review of the framework was necessary but that the review should focus on enabling Royal Mail to grow its revenues to further secure the financial sustainability of the universal service and argued in favour of giving it

[37] See http://stakeholders.ofcom.org.uk/consultations/royal-mail-regulation-review/?showResponses=true.
[38] See page 1 of DMA, page 2 of Secured Mail and pages 11-14 of Whistl's responses to the July 2015 Discussion Document.
[39] See page 1 of First Post and page 3 of The Postal Group's responses to the July 2015 Discussion Document.
[40] See Hermes' response to the July 2015 Discussion Document, page 1.

greater flexibility in this regard.[41] CWU and Unite expressed similar views and RNIB also stressed the importance of maintaining the financial sustainability of the universal service.[42]

3.6 The Countryside Alliance, The General Consumer Council for Northern Ireland ("**The Consumer Council**") and The Convention of Scottish Local Authorities (COSLA) emphasised the importance of taking into account the interests of consumers in reviewing the regulatory framework. Citizens Advice said that the current approach to regulation leant towards ensuring Royal Mail's interests are safeguarded, as a provider of the service, rather than promoting those of customers and consumers.[43]

3.7 TechUK was in favour of maintaining a light touch regime and suggested that there was no need to fundamentally revisit the regulatory framework at this time; for example, by imposing tighter regulation such as a price cap.[44]

3.8 A number of respondents, for example UK Mail, Secured Mail and Whistl, argued that imposing price controls on Royal Mail was necessary and justified in order to limit future price rises and improve Royal Mail's efficiency.[45]

Constraints on Royal Mail's pricing behaviour

Letters Pricing

3.9 Some respondents (e.g. BBC Licence Fee Unit and The Consumer Council) considered that the constraints on Royal Mail's pricing had been significantly diminished following Whistl's exit.[46]

3.10 As we discuss in further detail below, some respondents said that it was too easy for Royal Mail to maintain or increase its profitability through price increases and that it therefore had little incentive to improve its efficiency. For example, [✂] suggested that Royal Mail's above inflation price rises provided evidence that it could profitably raise prices, at the expense of making efficiency gains.[47]

3.11 However, Royal Mail argued that the price elasticity for letters was high which acted as a constraint on its pricing. Royal Mail further argued that e-substitution and the presence of other operators provided sufficient constraint on its pricing. In particular, Royal Mail said that its pricing is constrained by the fact that customers could switch away permanently, primarily to digital alternatives.[48]

[41] See Royal Mail's response to the July 2015 Discussion Document, page 3.
[42] See page 17 of CWU, pages 11-14 of Unite and page 2 of RNIB's responses to the July 2015 Discussion Document.
[43] See page 2 of The Countryside Alliance, page 4 of The Consumer Council and page 1 of COSLA's responses to the July 2015 Discussion Document.
[44] See TechUK's response to the July 2015 Discussion Document, page 2.
[45] See page 3 of UK Mail, page 3 of Secured Mail and page 8 of Whistl's responses to the July 2015 Discussion Document.
[46] See page 2 of BBC Licence Fee Unit and page 6 of The Consumer Council's responses to the July 2015 Discussion Document.
[47] See 'Name Withheld 5' [✂] response to the July 2015 Discussion Document, page 1.
[48] See Royal Mail's response to the July 2015 Discussion Document, page 4.

Access Pricing

3.12 A number of respondents (e.g. DMA, Whistl and [✂]) argued that Royal Mail was not subject to any competition from other postal operators and as a result faces no constraints on its access pricing behaviour.[49]

3.13 Some respondents argued that Royal Mail had the ability to introduce significant access price increases. For example, UK Mail and CFH Docmail (CFH) suggested that Royal Mail had been able "to impose large access price increases" which were significantly above inflation.[50] Both said this provided evidence that Royal Mail did not face sufficient pricing constraints.

3.14 Royal Mail argued that its approach to access price increases has been fair and reasonable.[51]

3.15 We discuss stakeholder comments relating to access pricing in more detail in Section 6.

Constraints on Royal Mail's non-pricing behaviour

3.16 Most stakeholders who responded to this question did so in the context of Royal Mail's non-pricing behaviour in relation to access mail.

3.17 A number of access mail operators (e.g. UK Mail, Whistl and MUA) said that the terms and conditions of Royal Mail's access products were neither fair nor reasonable.[52] They argued that this constituted evidence that Royal Mail's non-pricing behaviour was not sufficiently constrained. In particular, these respondents argued that:

- contracts are subject to change as and when Royal Mail decides and are non-negotiable;[53]
- Royal Mail strongly resists product development which removes the scope for market innovation;[54]
- there is significant non-equivalence between access and retail products and new product introductions;[55]
- service specifications, additional features and pricing options and/or promotions offered by Royal Mail to its retail and access customers are not sufficiently similar;[56]
- Royal Mail does not collaborate or consult effectively with the industry on matters of strategy;[57] and

[49] See page 1 of DMA, page 2 of 'Name Withheld 5' [✂] and pages 11-14 of Whistl's responses to the July 2015 Discussion Document.
[50] Page 4 of CFH and page 4 of UK Mail's responses to the July 2015 Discussion Document.
[51] See Royal Mail's response to the July 2015 Discussion Document, page 6.
[52] See page 5 of MUA, page 3 of UK Mail and pages 12-14 of Whistl's responses to the July 2015 Discussion Document.
[53] See 'Name Withheld 5' [✂] response to the July 2015 Discussion Document, page 4.
[54] See UK Mail's response to the July 2015 Discussion Document, page 4.
[55] See 'Name Withheld 4' [✂] response to the July 2015 Discussion Document, page 2.
[56] See MUA's response to the July 2015 Discussion Document, page 9.

- Royal Mail imposes a series of unnecessary requirements on its customers, for example the prohibition of using Royal Mail trays for other operators' mail.[58]

3.18 Royal Mail said that the declining letters market and intense competition in the parcels market provide sufficient constraints on its non-pricing behaviour. Royal Mail argued it had worked with access operators to ensure that both sending and receiving customers enjoy a great service. It believed that its non-pricing behaviour had been fair and reasonable.[59]

3.19 Royal Mail further argued that it did not engage in non-pricing behaviour intended to prejudice any of its access customers. It said it had valid operational and commercial rationales for its actions, and that it had acted within set guidelines. It also noted that its relationship with its access customers was a supervised one, and that any proposals that it makes to change terms and conditions can be challenged by access customers.[60]

3.20 We consider stakeholders' views on non-price issues relating to access mail in further detail in Section 6.

Competitive constraints across different mail types

3.21 Royal Mail and CWU argued that Royal Mail faces competition and volume decline in all bulk mail segments and that this provides constraints on its price and non-price behaviour.[61]

3.22 In relation to bulk mail, the majority of respondents suggested that all mail types faced competition from e-substitution. However, some respondents considered that there may be differing competitive constraints in relation to different segments, namely advertising mail, transactional mail and publishing mail.

3.23 The DMA, DX, The Mail Competition Forum (MCF), Secured Mail, UK Mail and a confidential respondent all said that competition was strongest in advertising mail due to substitutability with digital media advertising products.[62] However, the same respondents argued that despite this they did not consider that the existence of potential pricing constraints had been reflected in Royal Mail's pricing behaviour.

3.24 In relation to parcels, some stakeholders (e.g. GI Solutions, UK Mail, Secured Mail and a confidential respondent) argued that there were limited constraints at lower weights and for single piece parcels but that competition existed among higher weights and for bulk parcels.[63]

3.25 Stakeholder comments in relation to the competitive constraints within the letters and parcels sectors are discussed in more detail in Annexes 7 and 8.

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[57] See Chris Williams' response to the July 2015 Discussion Document, page 2.
[58] See Whistl's response to the July 2015 Discussion Document, pages 12-14.
[59] See Royal Mail's response to the July 2015 Discussion Document, page 25.
[60] See Royal Mail's response to the July 2015 Discussion Document, page 25.
[61] Pages 10-14 of CWU and pages 32-40 of Royal Mail's responses to the July 2015 Discussion Document.
[62] Page 2 of DMA, page 2 of 'Name Withheld 5' [✂], page 8 of UK Mail and page 7 of Secured Mail's responses to the July 2015 Discussion Document.
[63] Page 2 of GI solutions', page 8 of UK Mail, page 7 of Secured Mail and page 3 of 'Name Withheld 5' [✂] responses to the July 2015 Discussion Document.

Efficiency incentives

3.26 Royal Mail argued that the presence of e-substitution and competition in the parcels sector means it is crucial that Royal Mail improve its efficiency and pointed at the efficiency gains that it has already made as evidence of its commitment to making efficiency savings.[64]

3.27 Royal Mail considered that it faces strong and growing market based incentives to deliver efficiency improvements despite the lack of end-to-end competition. It pointed to its record of improving efficiency as evidence of this and suggested that it was committed to making even further improvements in the future.[65]

3.28 Royal Mail further suggested that shareholder pressure would only add to the need for efficiency improvements and as a result no further regulation aimed at improving its efficiency was required.[66]

3.29 Other respondents were largely split on whether Royal Mail had sufficient incentives to improve its efficiency.

3.30 On the one hand, some stakeholders, for example, The Consumer Council, CWU, RBS and Unite, argued that Royal Mail faced sufficient efficiency incentives due to its status as a Public Limited Company and the presence of shareholders to encourage efficiency improvement.[67]

3.31 On the other hand, other stakeholders, for example, CFH, Whistl and a confidential respondent, argued that although pressure from shareholders did exist, it was limited. Furthermore some stakeholders argued that to the extent that this pressure exists, it is aimed towards profitability rather than increasing efficiency, and that Royal Mail preferred to increase profitability through price rises rather than efficiency improvements.[68]

3.32 RBS suggested that if Royal Mail were to publish its performance against its efficiency targets, this could provide greater incentive for it to increase its efficiency.[69]

3.33 Secured Mail said that the most effective efficiency incentive is direct competition, but with the withdrawal of Whistl from the end-to-end delivery of letters this incentive had been removed.[70] MUA and Whistl also suggested that greater competition in end-to-end letter delivery would act as an efficiency incentive on Royal Mail.[71]

3.34 Finally, CFH, GI Solutions and Whistl cited the presence of a highly unionised workforce as potentially reducing the potential for efficiency gains to be achieved.[72]

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[64] See Royal Mail's response to the July 2015 Discussion Document, page 41.
[65] See Royal Mail's response to the July 2015 Discussion Document, page 41.
[66] See Royal Mail's response to the July 2015 Discussion Document, page 42.
[67] Page 14 of CWU, page 10 of The Consumer Council, page 6 of RBS and page 5 of Unite's responses to the July 2015 Discussion Document.
[68] Page 7 of CFH, page 16 of Whistl and page 3 of 'Name Withheld 5' [✂] responses to the July 2015 Discussion Document.
[69] See RBS' response to the July 2015 Discussion Document, Page 6.
[70] See Secured Mail's response to the July 2015 Discussion Document, Page 7.
[71] See responses to the July 2015 Discussion Document: MUA, pages 11-12 and Whistl, page 16.
[72] See responses to the July 2015 Discussion Document: CFH, page 7; GI Solutions, page 2; Whistl, page 16.

3.35 Stakeholder comments on efficiency are discussed in more detail in Annex 5.

Potential areas for deregulation

3.36 Royal Mail argued that there was a need to reduce the length and volume of regulatory notification and consultation periods, and streamline burdensome reporting requirements.[73]

3.37 Many other respondents however saw only limited scope for deregulation, for example:

- BBC Licence Fee Unit, The Consumer Council, MUA and a confidential respondent suggested that no deregulation was necessary at this time and that important parts of the existing framework such as the price cap should be retained.[74]

- First Post, The Postal Group and Whistl argued that there was a need for further regulation rather than any additional movement towards deregulation.[75]

3.38 Of those respondents who argued that there was scope for deregulation, CFH, DX Group and MCF all proposed the removal of metered mail from the universal service.[76] GI Solutions suggested that there was scope for deregulation in First Class mail.[77]

3.39 We discuss stakeholder comments on areas for potential deregulation in more detail in Section 7.

[73] See Royal Mail's response to the July 2015 Discussion Document, page 55.
[74] See responses to the July 2015 Discussion Document: BBC Licence Fee Unit, page 5; the Consumer Council, page 11; MUA, page 12; 'Name Withheld 5' [✂], page 3.
[75] See responses to the July 2015 Discussion Document, First Post, page 3; The Postal Group, page 3; Whistl, page 18.
[76] See responses to the July 2015 Discussion Document: CFH, page 8; DX Group, page 6; MCF, page 9.
[77] See GI Solutions' response to the July 2015 Discussion Document, page 2.

Section 4

Findings from our Review of the Regulatory Framework

4.1 In the March 2012 Statement we decided to remove certain regulation to give Royal Mail greater commercial flexibility to meet the significant challenges it faced then and in the future. We acknowledged the risks inherent in this approach and attempted to address these with three key safeguards: effective monitoring; an affordability cap on Second Class stamps for letters, large letters and parcels up to 2kg; and competition.

4.2 In the March 2012 Statement, we said that this framework should remain in place for a period of seven years (i.e. to 2019) unless we considered that Royal Mail was not making sufficient progress on improving its efficiency or that it had relied on price rises alone to return to profitability.[78] In particular we said:

> "6.57 We nevertheless recognise, and were also clear in our proposals, that there is a risk that Royal Mail will seek to increase prices and improve its profitability without making appreciable efficiency improvements. While profits would be lower than in the scenario where Royal Mail achieves significant efficiency improvements, they could be sufficient to reward investment and the risks for the shareholder of achieving those profits could be lower, particularly if volumes decline at a slower rate than expected (or there is a longer than expected lag in volume decline).
>
> 6.58 We have concluded that to ensure that this is not the case we will need to implement safeguards that are robust to this risk. The ability to operate the network efficiently, combined with appropriate pricing flexibility, is what will secure the provision of the universal service in the medium term. We are proposing that a thorough monitoring regime […] will be in place through the regulatory period, including an assessment of the pace of cost reduction, and that this will provide strong incentives on Royal Mail.
>
> 6.59 If Royal Mail does not respond to those incentives, we will consider the need to reregulate, and if it shows a track record of consistently increasing prices and not improving efficiency, it is likely that more intrusive regulation will have to be considered."[79]

4.3 We recognise that some of the circumstances that we observed in March 2012 no longer apply. For example, we do not consider the current information indicates that the financial sustainability of the universal service is threatened. In addition, the threat of end-to-end entry and expansion is significantly diminished following Whistl's exit such that significant end-to-end letter delivery competition appears unlikely to emerge again in the foreseeable future.

4.4 As explained in the July 2015 Discussion Document, the objective of the current review is to ensure that regulation remains appropriate and sufficient to secure the

[78] See the March 2012 Statement.
[79] See the March 2012 Statement, paragraphs 6.57-6.59.

universal postal service, given the recent market changes. In this section, we describe our analytical approach in carrying out this review. We also set out our views on the effectiveness of the regulatory framework overall and our proposals as to whether there is a need for any fundamental changes, in light of our findings in relation to Royal Mail's efficiency, financial sustainability and its position in the letters and parcels markets, and having considered stakeholder comments and the experience of users.[80] Finally, we set our proposals for the future regulatory framework.

The experience of users

4.5 The universal postal service is important because of the service it provides to its users – both businesses and residential consumers; senders and recipients. As part of our monitoring programme, we have measured Royal Mail's delivery of the universal postal service, its quality of service performance, and users' satisfaction with value for money and the postal services.

Quality of service and delivery of the universal postal service

4.6 Royal Mail's requirement to provide universal services to a high standard is an essential part of the regulatory framework. Royal Mail is required to meet a series of quality of service targets. The main targets are:

- 93% of First Class letters and parcels to be delivered the next day after posting nationally;
- in each Postcode Area (PCA) 91.5% of First Class letters and parcels to be delivered the next day after posting; and
- 98.5% of Second Class letters and parcels to be delivered within three days of posting.[81]

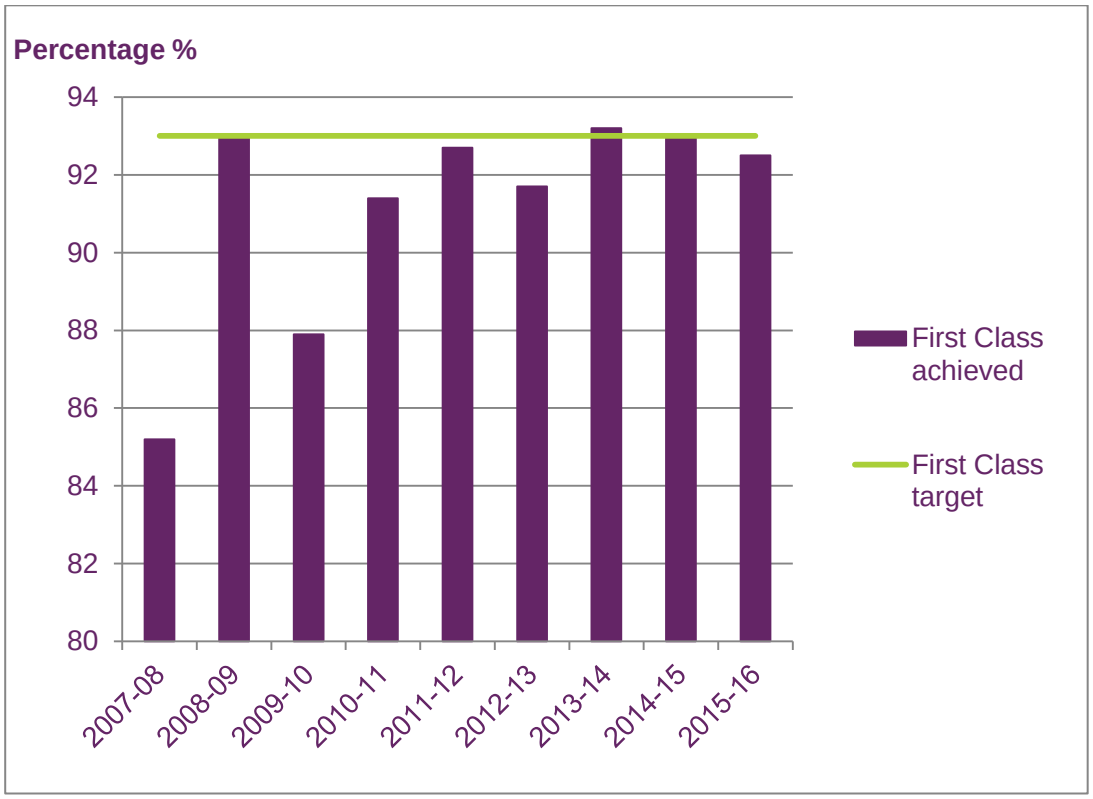
4.7 Figures 4.1, 4.2 and 4.3 below set out Royal Mail's quality of service performance since 2007-8. In particular, Royal Mail has met the Second Class quality of service target every year from 2011-12.

4.8 The First Class quality of service target has been more challenging, and Royal Mail has met the target only twice in the past five years. In May 2013, we told Royal Mail to improve its compliance with its quality of service obligations. We said we would continue to monitor Royal Mail's progress on quality of service performance closely and would consider investigating and potentially taking enforcement action if it failed to meet quality of service targets in the future.[82] In 2013-14 and 2014-15 Royal Mail achieved its national quality of service targets for First and Second Class, and significantly improved its regional performance. However, in 2015-16 it missed the First Class target and its regional performance was worse. Therefore, on 13 May 2016, Ofcom announced that it would be investigating whether there are reasonable

[80] Annexes 5, 6, 7, and 8 contain detailed analysis in relation to efficiency, the financial sustainability of the universal postal service, and competitive dynamics in the letter and parcel sectors respectively.
[81] As set out in DUSP 1.9.
[82] Ofcom, *Annual monitoring update on the postal market – financial year 2012-13*, 22 November 2015, paragraph 1.5 (http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2012-13.pdf).

grounds for believing that Royal Mail has failed to comply with its obligations under DUSP condition 1.9.1 in respect of the financial year 2015-16.[83]

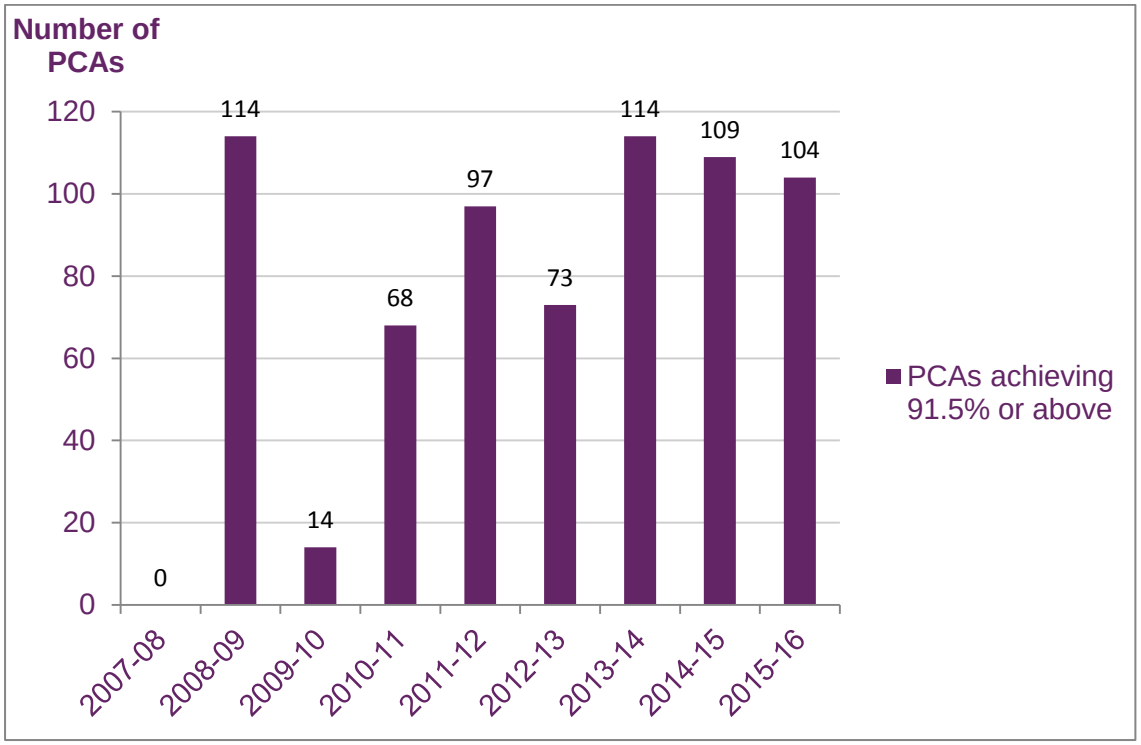
Figure 4.1: Royal Mail's national First Class quality of service



Source: Royal Mail's Quarterly Quality of Service and Complaints Reports

[83] Ofcom, Own-initiative investigation into Royal Mail concerning compliance with Designated USP Condition 1.9.1 regarding the quality of service performance of D+1 universal service mail, 13 May 2016, http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01183/?utm_source=updates&utm_medium=email&utm_campaign=cw_01183.

Figure 4.2: Royal Mail's local First Class quality of service[84]



Note: The full year total for 2007-8 was zero. Royal Mail noted that this was because "performance in Quarter 2 and Quarter 3 was severely disrupted by a series of national strikes and local official and unofficial industrial action".[85]
Source: Royal Mail's Quarterly Quality of Service and Complaints Reports

[84] This measure is based on Royal Mail's performance in 118 of the 121 Postcode Areas (PCAs).
[85] Royal Mail's 2007-8 Quality of Service report, *National Report to Postcomm and Postwatch - 2007/08 Quarter 4 Report*, http://www.royalmailgroup.com/sites/default/files/Quarterly_Quality_of_Service_Report_Q4_2007-08.pdf.

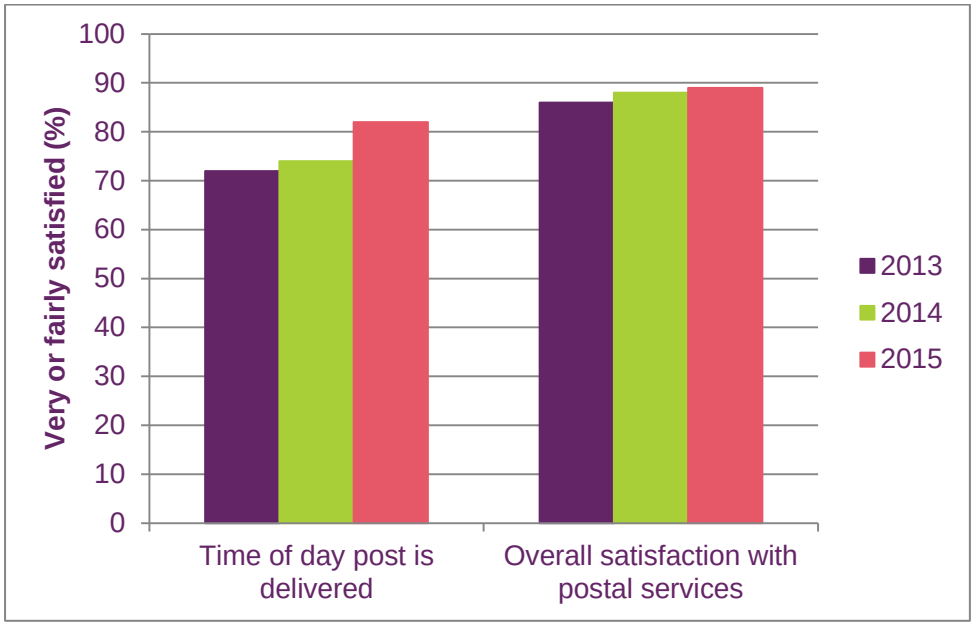
Figure 4.3: Royal Mail's national Second Class quality of service

Source: Royal Mail's Quarterly Quality of Service and Complaints Reports

Consumer satisfaction

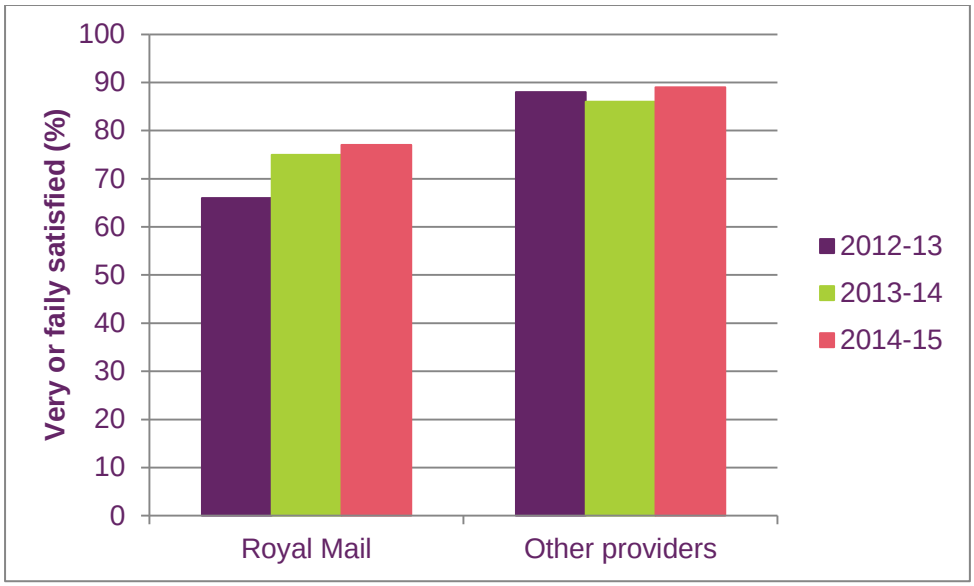
4.9 As can be seen from Figures 4.4 and 4.5 below, general satisfaction with postal services is very high and improving among both residential consumers (89% satisfied or very satisfied in 2015) and SMEs (77% satisfied or very satisfied with Royal Mail and 89% with other postal operators in 2015).

Figure 4.4: Residential consumers' views on delivery times and overall satisfaction with post



Source: Ofcom Annual Monitoring reports

Figure 4.5: Satisfaction levels among businesses for Royal Mail and other postal operators



Source: Ofcom Annual Monitoring reports

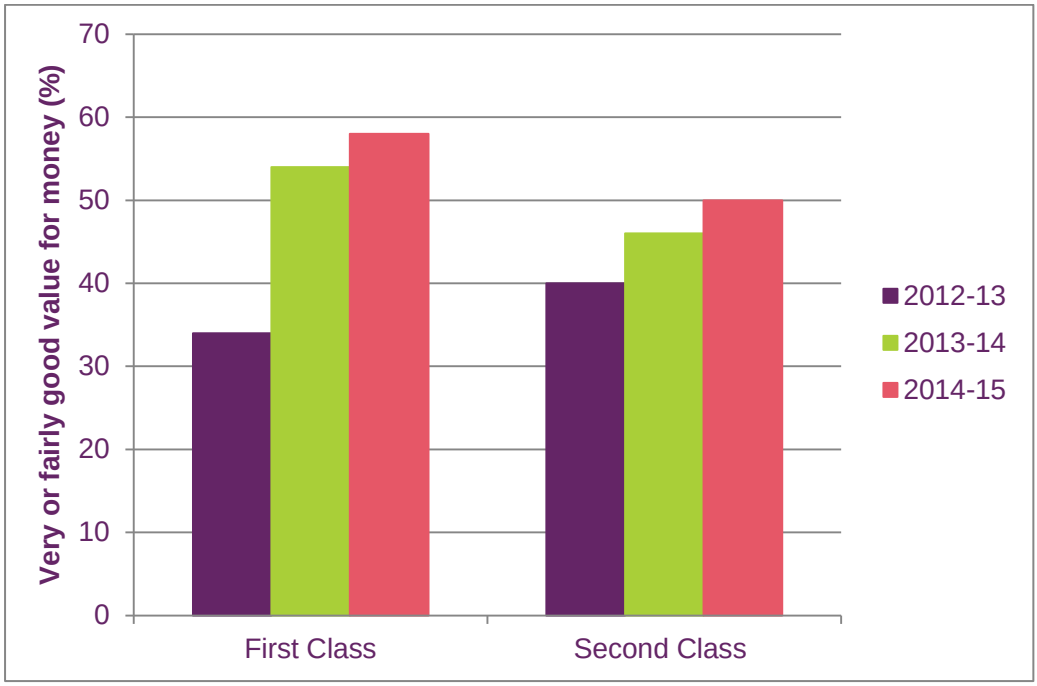
Value for money

4.10 The price of a First Class stamp for a standard letter has increased by 39% under the 2012 regulatory framework (from 46p in 2011 to 64p in 2016), and the price of Second Class stamp for a standard letter has increased by 53% (from 36p in 2011 to 55p in 2016).

4.11 However, six out of ten consumers are satisfied or very satisfied with the cost of postage, and a similar number consider the price of a First Class stamp to be good or

very good value for money. While perceived value for money of Second Class stamps has increased since 2012-13, fewer consumers (five out of ten) considered it good or very good value for money.

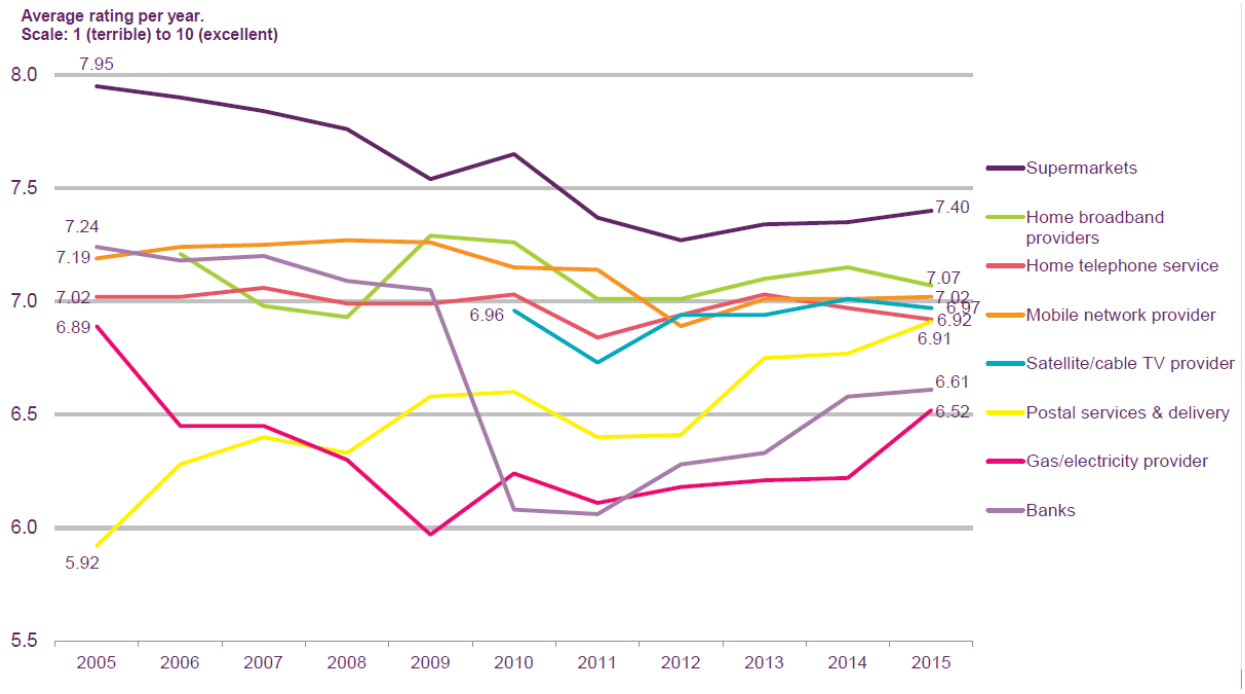
Figure 4.6: Perceived Value for Money of First and Second Class stamps among residential consumers



Source: Ofcom Annual Monitoring reports

4.12 In addition, since 2005, we have tracked consumer ratings of value for money in eight sectors. For many sectors, value-for-money ratings have fallen over this time; most markedly banks, gas and electricity providers, and supermarkets. Postal services and delivery is the only sector to see an increase in customers' perception of value for money; from 5.92 in 2005 to 6.91 in 2015.

Figure 4.7: Customers' attitudes towards value for money across sectors: 2005-2015



Source: Ofcom Consumer Experience Report 2015;[86] Customers in Britain 2015, Firebrand Insight
Base: All adults (2015, 1,007)
Q6a: Please give a rating for the value for money you receive from your main provider in each category, over the last 12 months.

The changing needs of users

4.13 It is clear that the needs of postal users are changing. In our "**2013 Review of Users' Needs**"[87] we found that the postal market was meeting the reasonable needs of users and was highly valued by residential users and businesses across the UK. We also acknowledged that different users rely on post to varying degrees and users' needs and preferences are evolving. In particular, we found:

- some users indicated that there may be less need for next-day delivery and others were less reliant on collections and deliveries six days a week; and
- users wanted more convenient options for the delivery of parcels.

4.14 As a result we decided to make no changes to the scope of the universal postal service. We also noted that the changes users wanted regarding parcel delivery were more likely to be delivered through competition and innovation by Royal Mail and other parcel operators.[88]

[86] Ofcom's *The Consumer Experience Report 2015 – Research Annex*, http://stakeholders.ofcom.org.uk/market-data-research/market-data/consumer-experience-reports/consumer-experience-15/.
[87] The "2013 Review of Users' Needs", Ofcom's *Review of postal users' needs*, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf.
[88] *Review of postal users' needs*, 27 March 2013 (http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf).

4.15 As set out in our Annual Monitoring Reports and other research publications, including the Communications Market Review and Consumer Experience Report, our research since the publication of this review supports these findings.[89]

4.16 Overall letter volumes continue to decline. In particular, residential consumers are both sending and receiving fewer letters, and as such volumes of universal service items are falling faster than the average decline, with First Class items fastest of all.[90]

4.17 Developments in the parcels sector since 2013 also support our view set out in our 2013 Review of Users' Needs that consumer improvements were more likely to be delivered through competition and innovation, than regulation. Parcel volumes have continued to grow, largely as a result of online shopping.

4.18 There has also been significant innovation by Royal Mail's competitors in relation to both the sending and receiving of parcels in recent years, including:

- The launch of new 'parcelshop' networks for consumer parcels by Hermes and Yodel (through its CollectPlus venture with Paypoint).
- The extension of retailers into delivery, e.g. the launch and expansion of Amazon Logistics; eBay establishing its own pick-up and drop-off network in partnership with Argos and Sainsbury's; and the growth of click and collect services, such as Waitrose / John Lewis, Marks & Spencer and Tesco.
- In January 2015 DPD launched 'Last Mile Labs' – a programme designed to help start-ups develop innovations which could "improve the delivery business",[91] and its 'Predict' and 'Follow my parcel' services provides recipients with a 15 minute delivery window.

4.19 In our 2014 End-to-end Statement, we considered that Royal Mail was lagging behind in its implementation of some of the technological and service innovations for its parcels that are carried via the universal service network.[92] In its response to the July 2015 Discussion Document, Royal Mail noted that it is investing in its parcels business to improve efficiency and foster innovation, and stated that it has introduced 30 product and service innovations for customers[93], including:

- Sunday opening hours at 100 enquiry offices across the UK, and relaunched its click and collect service (Local Collect);[94]

[89] See Ofcom's annual monitoring reports on the postal market: http://stakeholders.ofcom.org.uk/post/monitoring_reports/, Ofcom's Communications Market reports: http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/ and Ofcom's consumer experience reports: http://stakeholders.ofcom.org.uk/market-data-research/market-data/consumer-experience-reports/.
[90] Ofcom's Annual monitoring update on the postal market, Financial year 2014-15, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf, paragraphs 6.20 to 6.23.
[91] See Post&Parcel, 'DPD launches innovation accelerator programme in UK', 12 January 2015, http://postandparcel.info/63741/news/it/dpd-launches-innovation-accelerator-programme-in-uk/.
[92] Ofcom, 2014 End-to-end Statement, paragraph 3.87.
[93] See Royal Mail's response to the July 2015 Discussion Document - *Appendix: Royal Mail innovation and improvements*, page12.
[94] See Royal Mail's response to the July 2015 Discussion Document - *Appendix: Royal Mail innovation and improvements,* paragraphs 1.12 and 1.15.

- working with the Post Office to offer extended opening hours,[95] which has occurred in the context of growth in the number of alternatives to the Post Office (see paragraphs 5.21 and A8.25 – A8.30) which often have longer opening hours than those traditionally offered by the Post Office;[96] and

- increased use of delivery to neighbour and SMS updates.

4.20 In addition, Royal Mail has acquired a number of companies during 2015 and 2016 with the intention of strengthening its position and expertise in e-commerce and parcel delivery. For example, since September 2015 it has acquired Storefeeder eCourier, NetDespatch, and Intersoft Systems and Programming Ltd.[97]

Financial sustainability of the universal postal service

4.21 A key safeguard of the regulatory framework we put in place in 2012 was the establishment of a monitoring regime which, among other things, allows us to assess the financial sustainability of the universal service network on an on-going basis.[98]

4.22 We set out in the July 2015 Discussion Document that we would continue with our ongoing monitoring of Royal Mail's financial sustainability (including Royal Mail's current business plan and potential future pension costs) and noted that our findings would inform the fundamental review of the regulation of Royal Mail. In addition, we said we would also consider whether our view of the commercial rate of return that is likely to be consistent with securing a financially sustainable universal service, as set out in the March 2012 Statement,[99] remained appropriate in light of prevailing financial market conditions, postal market developments and changes in Royal Mail's ownership and funding structure since privatisation.[100]

4.23 As part of this review we have therefore:

- assessed whether the current approach to measuring financial sustainability remains appropriate;

- analysed Royal Mail's 2015 Business Plan to better understand what Royal Mail expects the future financial position of the universal service to be;

- gained a better understanding of Royal Mail's future pension costs; and

- assessed the financial sustainability of the universal service network.

4.24 Royal Mail was the only stakeholder that directly responded on our current approach to assessing the financial sustainability of the universal postal service.[101] This

[95] See Royal Mail's response to the July 2015 Discussion Document, page 39.
[96] Royal Mail suggested that competitors' shops are open, on average, for 50% more hours – see Royal Mail's response to the July 2015 Discussion Document, paragraph 3.30.
[97] http://www.royalmailgroup.com/financial-and-media-media-centre/finance-media-press-releases
[98] See the March 2012 Statement, paragraphs 1.28 to 1.56.
[99] Our view was an EBIT margin of between 5 and 10%. EBIT margin means earnings before interest and tax as a proportion of total sales (see paragraph 5.47 of the March 2012 Statement).
[100] See the July 2015 Discussion Document, paragraph 4.13.
[101] FTI Consulting was commissioned by Royal Mail to provide advice on how the financial sustainability of the universal service provider, Royal Mail, should be assessed as part of Royal Mail's response to the July 2015 Discussion Document. See 'Financial Sustainability of the USO, FTI Consulting response to the Fundamental Regulatory Review', FTI Consulting, September 2015:

response is set out in more detail in Annex 6, but in brief, Royal Mail considered that we should confirm our use of the EBIT margin as the metric to assess whether it is achieving a commercial rate of return. It also argued that the 5-10% EBIT margin range we considered in March 2012 was consistent with a commercial rate of return for the universal service network is at the lower end of the appropriate range.

4.25 After conducting a detailed review of potential alternatives, we have concluded that it is appropriate to continue to apply the current approach to monitoring financial sustainability. This approach involves looking at a particular measure of the commercial rate of return, namely the "**financeability EBIT**" margin[102] of the Reported Business,[103] to see whether it lies within a range we consider consistent with the long-term financial sustainability of the universal service.

4.26 We have also considered whether the current EBIT margin range of 5-10% remains an appropriate indicative benchmark for these purposes and we continue to believe it is. However, in future we intend to supplement the existing approach with monitoring of some of the new financial information which has come to be relied on by lenders and investors following the privatisation and listing of Royal Mail PLC on the London Stock Exchange. In Annex 6 we explain the analysis and reasoning behind this in full.

4.27 Applying this approach, we do not consider the current information indicates that the financial sustainability of the universal service is threatened. However, as we explain below, we do recognise that there are some downside risks to the forecasts underpinning that view, and that the financeability EBIT margin achieved by the Reported Business in the past has been at the lower end of the 5-10% EBIT margin range. We now set out a summary of the analysis underlying these findings.

4.28 As can be seen from Figure 4.8 below, the financeability EBIT margin has increased steadily since 2010-11 to 5.6% in 2014-15 which is within the indicative 5% to 10% EBIT margin range.

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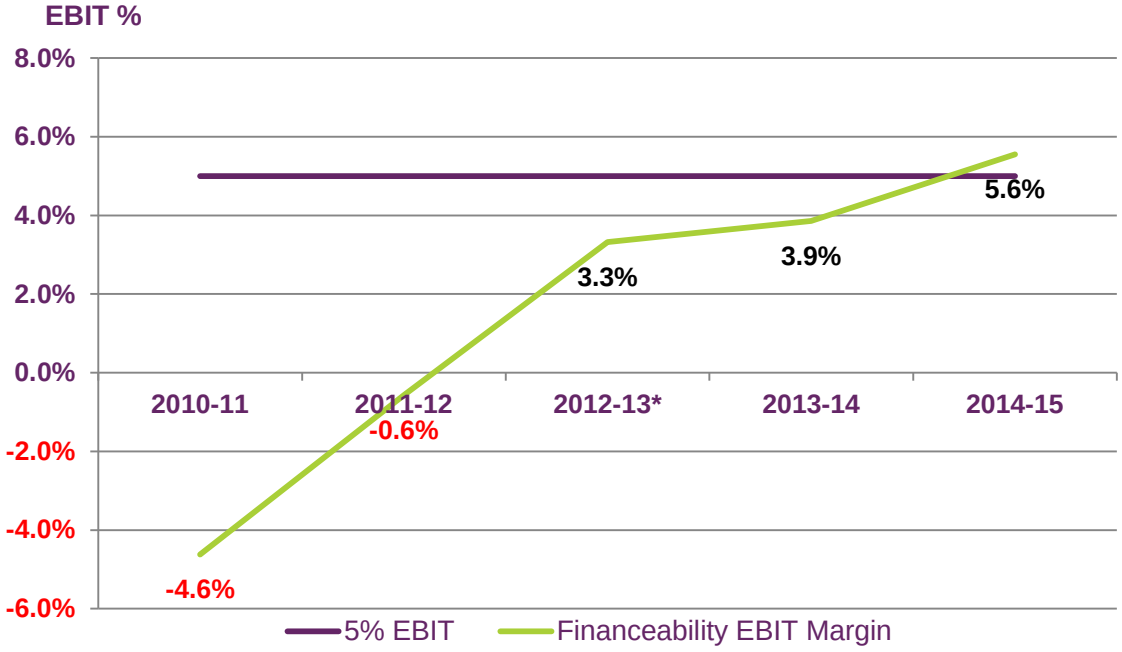
http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/responses/Royal_Mail_FTI_report_on_financial_sustainability_of_the_USO.pdf.
See also Chapter 6 of Royal Mail's response to the July 2015 Discussion Document.

[102] In the 2014 End-to-end Statement, we considered it was appropriate to adjust Royal Mail's reported EBIT margin to restate pension costs on a cash basis (i.e. at the rate the contributions are actually paid which currently stands at 17.1%), rather than the rate calculated using the accounting standards. We considered this methodology takes account of the true cost of pensions and we refer to this EBIT margin measure as the 'financeability EBIT margin'.

[103] 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. This is discussed further in Annexes 5 and 6.

Figure 4.8 – Reported Business financeability EBIT Margin



Source: Ofcom's Annual monitoring update on the postal market, financial year 2014-15[104]

4.29 We have estimated the financeability EBIT margin to be around [✂] for 2015-16. The final 2015-16 results for the Reported Business, which are part of the annual audited regulatory accounts, will be submitted to us in July 2016. The financeability EBIT margin is forecast to be [✂] in 2016-17 and [✂] in 2017-18, based on the projections in Royal Mail's 2015 Business Plan.[105] Royal Mail's annual budget for 2016-17, updated in March 2016, forecasted the financeability EBIT margin for 2016-17 to be [✂]. We understand Royal Mail will provide a full updated Business Plan to Ofcom in June 2016.

4.30 We therefore expect the Reported Business to make returns, in the next two financial years that are within the 5-10% range that is indicative of a financially sustainable universal service.

4.31 As an indicator of financial health, we have also looked at the cash which Royal Mail is likely to have available for contingencies over the next few years. We have therefore looked at the current and forecast cash headroom for the next six quarters following March 2016.[106] This analysis shows there is considerable headroom[107] in both the most likely base case scenario and an indicative downside scenario considered by Royal Mail [✂]). Our review of the current and projected values over the next two financial years of other financial health metrics – in particular the metrics that the credit rating agencies and Royal Mail's lenders use – indicate no short to

[104] Ofcom's Annual monitoring update on the postal market, Financial year 2014-15, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf, page 3.
[105] We have made necessary adjustments to the Business Plan, one of which is the effect of end-to-end competition which ceased in June 2015 with Whistl's closure of its end-to-end letter delivery operations.
[106] Royal Mail provides us, in accordance with the USP Accounting Condition, with quarterly cash flow forecasts which cover the following six quarters.
[107] Cash headroom is defined as cash balances plus undrawn available borrowing facilities.

medium-term financial health issues (see Annex 6 for an explanation of the additional new metrics we intend to monitor going forward).

4.32 We have also considered the Viability and Principal risks statements included in Royal Mail's Financial report for the full year ended 27 March 2016. The Viability Statement confirmed 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."[108]

4.33 In light of all of the above considerations, we do not consider that the financial sustainability of the universal service is currently threatened. However, we recognise that there are various downside risks to the forecasts that underpin this view.

4.34 One of the key downside risks is in relation to future pension costs. Pension costs are a significant component of the costs which are taken into account in calculating the financeability EBIT margin, and as such changes in these costs have the potential to have a large effect on this measure of financial sustainability. The largest component of Royal Mail's pension costs by far relates to its defined benefit pension scheme, the Royal Mail Pension Plan (RMPP). Royal Mail's current funding agreement with the Trustee of the RMPP set a 17.1% contributory pay rate which may increase in certain circumstances[109] before the completion of the 2015 actuarial valuation.[110]

4.35 When this agreement expires, it is possible that Royal Mail could face significantly greater pension costs. This would have the potential to significantly undermine its future financial sustainability. In its November 2015 half year report, under the heading of 'Principal risks and uncertainties', Royal Mail stated: "Our on-going ability to maintain the Royal Mail Pension Plan in its current form is subject to financial market conditions, or other factors. Current economic conditions would suggest that keeping the defined benefits scheme open to accrual beyond 2018 will not be affordable." [111]

4.36 As discussed in the July 2015 Discussion Document, we have undertaken some work to gain a better understanding of Royal Mail's future pension costs. We contracted Punter Southall, a pension consultancy, to assist us. Punter Southall has provided its findings and conclusions to us in a confidential report.

4.37 Having reviewed Royal Mail's pension costs, we have now developed our understanding of the RMPP's present financial position and the range of possible scenarios that could arise in the future and following any pension negotiations. There

[108] Royal Mail plc, Financial report for the full year ended 27 March 2016, Thursday 19 May 2016 http://www.royalmailgroup.com/sites/default/files/Financial%20report%20for%20the%20full%20year%20ended%2027%20March%202016.PDF, page 26.

[109] Up to £50m per annum of further contributions to the extent, if any, that these are required to maintain a projected technical provisions funding level as at 31 March 2019 of at least 100%. See Royal Mail plc 2014-15 Annual Report and Financial Statements, page 35, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.

[110] Royal Mail plc 2014-15 Annual Report and Financial Statements, pages 93-98, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.

[111] See Royal Mail's Half-Year Results 2015-16, 19 November 2015, page 16, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Financial%20Report%20for%20the%20half%20year%20ended%2027%20September%202015.pdf.

remains a significant amount of uncertainty as to the terms that will be agreed, however we would not expect Royal Mail to agree a level of future contributions which are unaffordable and could jeopardise its financial sustainability.

4.38 In summary, we consider that the EBIT margin with an indicative range of 5-10% continues to be the most appropriate metric and range for assessing whether Royal Mail's expected financial performance is consistent with a commercial rate of return and the financially sustainable provision of the universal service. We intend to supplement our current approach, which also includes assessing the cash flow of the whole of Royal Mail group with consideration of a range of financial health metrics assessed at that level. The current information indicates that there is no reason to consider that the financial sustainability of the universal service is threatened.

4.39 A key downside risk is Royal Mail's future pension costs but, as explained above, we would not expect Royal Mail to agree a level of contributions that could jeopardise its financial sustainability. Other key downside risks to financial sustainability we have identified as part of this review include economic downturn, efficiency improvement challenges (such as the new pay deal under negotiation), and downward pressure on Royal Mail's parcel volumes and revenues from competition. We have conducted a detailed analysis of these latter risks as part of this review, and set out our findings on each below.

Efficiency

4.40 Ofcom has a duty to have regard to the need for the provision of the universal service to become and remain efficient. Given that efficiency can play an important role in ensuring that Royal Mail is able to continue providing a financially sustainable universal service, it is essential that the regulatory framework continues to provide appropriate incentives for Royal Mail to realise its potential to become more efficient.

4.41 We have considered whether Royal Mail has sufficient incentives on it to improve its efficiency and whether the rate of efficiency improvement assumed in its 2015 Business Plan is reasonable.

Incentives

4.42 In the July 2015 Discussion Document, we asked stakeholders for their views on whether Royal Mail faces appropriate incentives to deliver efficiency improvements. Stakeholder responses to this question are summarised in Section 3 above and discussed in more detail in Annex 5.

4.43 In brief, Royal Mail and the unions representing postal workers considered that Royal Mail faces sufficient incentives to improve its efficiency. They argued that the recent privatisation of Royal Mail meant that shareholders would be exerting pressure on it to realise efficiency improvements. Further, they suggested that the decline in letter volumes would also incentivise Royal Mail to reduce its costs.

4.44 The stakeholders who believed that Royal Mail faces insufficient incentives to improve its efficiency suggested that Royal Mail had the ability to increase prices to meet shareholder requirements for higher profits rather than driving through efficiency savings. They pointed to the absence of competition to constrain prices as a key factor in this.

4.45 We consider that privatisation should offer incentives for efficiency. We believe that shareholders will expect to see Royal Mail achieving greater cost savings (see

paragraph A5.113). We agree with stakeholders that competition would be expected to provide additional efficiency incentives and note that there are some constraints on prices offered by e-substitution, access and parcel competition.

4.46 Some stakeholders suggested that we should consider additional measures to incentivise efficiency such as charge controls or setting an efficiency target. These responses are outlined in more detail in paragraphs A5.11 to A 5.21.

4.47 In considering whether additional measures to incentivise efficiency are required we have looked at recent efficiency initiatives undertaken by Royal Mail together with the factors that might influence its ability to realise efficiencies (the background to our efficiency assessment). In this context we then consider its projected future efficiencies which we summarise here but outline in more detail in Annex 5.

Relevant context to our efficiency assessment

4.48 We discuss the market context in more detail below (from paragraph 4.78 onwards and in Annexes 7 and 8). In brief, Royal Mail is facing volume decline in its letter business. At the same time Royal Mail is actively pursuing growth in its parcels business. This is likely to give rise to higher average unit costs due to the longer time it takes to process parcels and the fact that Royal Mail is currently reliant on manual processing for parcels whereas the majority of its letters are machine processed into delivery order.

4.49 In response to these developments, Royal Mail began a modernisation programme in 2008 to adapt its processes so that they are better suited to the evolving needs of the postal market. As part of this programme it introduced automated walk sequencing,[112] deployment of new delivery methods including trolleys and vans, improved office layouts and equipment for manual preparation and extended delivery spans.[113] It has also rationalised its mail centre estate significantly, reducing the total number of mail centres in operation from 69 in 2007-08 to 39 in 2014-15.[114]

4.50 Royal Mail's people costs represent a high proportion of the total costs of the universal service (around 68%), reflecting the labour intensive nature of the postal sector.[115] In January 2014, Royal Mail reached a pay agreement with the CWU (the union representing frontline postal workers) to cover the three financial years from 2013-14 to 2015-16.[116]

[112] Automated walk sequencing is the machine sortation of letters into the sequence in which they are delivered by a postman/woman during the course of a delivery round.
[113] Delivery span means the proportion of daily work hours a full-time postman/postwoman is engaged in the physical delivery of mail (i.e. outdoor delivery).
[114] See Royal Mail's regulatory financial statement, 2014-15, page 5, http://www.royalmailgroup.com/sites/default/files/Regulatory%20financial%20statements%202014-15%20-%2011.12.15_0.pdf.
[115] 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.
[116] 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.

Rate of improvement

4.51 The rate of efficiency improvement that Royal Mail is able to achieve was highlighted in our 2014 End-to-end Statement as a factor which could materially affect Royal Mail's ability to continue to provide the universal service in the future.[117] As a result, we were already conducting a review of efficiency when we announced our fundamental review of the regulation of Royal Mail. In the July 2015 Discussion Document, we noted that the outcome of this work was also relevant to determining the best approach to regulating Royal Mail.[118]

4.52 As part of this review, we have therefore considered whether Royal Mail's efficiency plans as set out in its 2015 Business Plan represent a reasonable rate of improvement. Understanding what Royal Mail could potentially achieve in relation to efficiency and how it expects to perform relative to this potential is an important aspect of our review of the regulatory framework.

4.53 Our analysis was informed by consideration of data both internal and external to Royal Mail and used a number of methods recommended to Ofcom by NERA.[119]

- **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 pipeline areas.

- **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.

[117] See our 2014 End-to-end Statement, paragraphs 3.105 to 3.118, http://stakeholders.ofcom.org.uk/binaries/post/end-to-end-statement/end-to-end.pdf .
[118] See the July 2015 Discussion Document, paragraph 4.5.
[119] See "Approaches to Measuring the Efficiency of Postal Operators: Final Report for Ofcom", published August 2013, http://stakeholders.ofcom.org.uk/post/report-postal-efficiency/.

Key Findings

Internal Review of Royal Mail's Business Plan

4.54 Our own analysis of Royal Mail's 2015 Business Plan indicates that the Reported Business is expected to achieve average annual efficiency savings of around [✂] per annum from 2015-16 to 2017-18.[120] Applying the same method for identifying efficiency improvements to Royal Mail's recent cost data, Royal Mail achieved actual efficiency savings in the Reported Business of around [✂] per annum over the previous three years. In our annual monitoring report we reported PVEO efficiency improvements of 0.7% in 2013-14 and 2.6% in 2014-15.[121] We also observed increases in projected efficiencies when compared to recent historic performance across a range of metrics used to consider efficiency. These are described in more detail in Annex 5. Royal Mail's 2015 Business Plan targets therefore represent an improvement on its performance in recent years.

Econometric Analysis

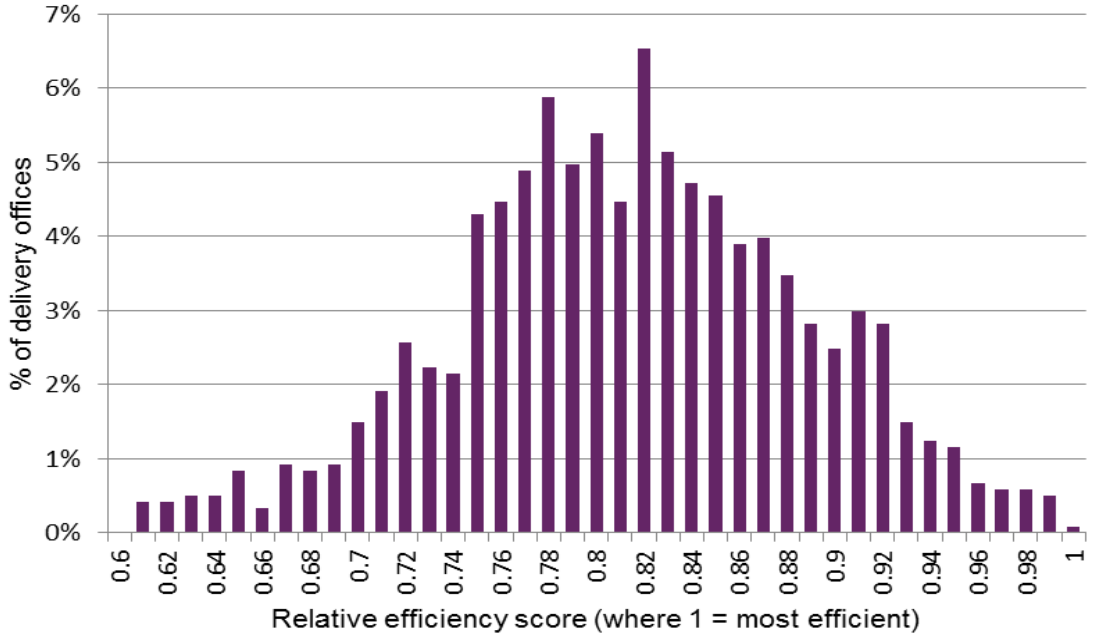
4.55 In addition, we asked Deloitte to undertake econometric benchmarking analysis of Royal Mail's delivery offices and mail centres. This analysis used statistical techniques to look at how efficiency varies across different delivery offices and mail centres. The results of the econometric analysis suggested that there is scope for greater efficiency improvements than those set out in Royal Mail's 2015 Business Plan.

4.56 The econometric analysis identified that Royal Mail has recently improved its efficiency in gross hours (i.e. paid time). The analysis estimated that average operational efficiency for delivery offices has improved by 5.8% in terms of gross hours since 2010-11 (equivalent to approximately 1.9% per annum). For mail centres, the average operational efficiency in terms of gross hours is estimated to have improved by 8.8% since 2012-13 (equivalent to approximately 2.9% per annum).

4.57 The econometric results show that some individual Royal Mail delivery offices and mail centres perform considerably better than others. Figures 4.9 and 4.10 below illustrate the distribution of efficiency across delivery offices and mail centres respectively. For example, our analysis suggests there is scope for Royal Mail to improve the efficiency of its Delivery Offices by about 10% from increasing the performance of lower performing units to match their higher performing peers.[122] In these diagrams, the most efficient delivery offices or mail centres appear furthest to the right.

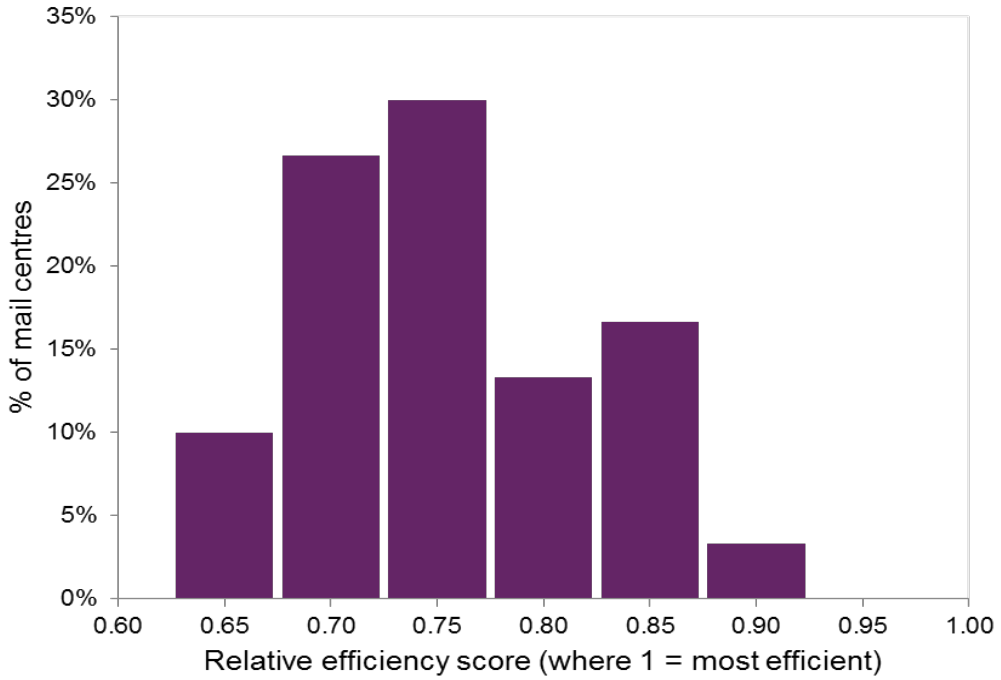
[120] As calculated using PVEO approach outlined in Annex 5.
[121] Ofcom, Annual Monitoring update on the postal market, Financial Year 2014-15.
[122] Increasing the performance of Delivery Offices to match the performance of the top 10% of Delivery Offices would reduce Frontline Delivery hours by up to c.10%. See Deloitte for Ofcom, *Econometric benchmarking in the UK postal sector: Final report*, 24 May 2016.

Figure 4.9 Delivery office efficiency distribution



Source: Deloitte for Ofcom, Econometric benchmarking in the UK postal sector: Final report, 24 May 2016.

Figure 4.10: Mail centre efficiency distribution



Source: Deloitte for Ofcom, Econometric benchmarking in the UK postal sector: Final report, 24 May 2016.

4.58 This divergence in efficiency suggests there is scope for Royal Mail to increase its overall efficiency by improving the performance of the less efficient delivery offices and mail centres to catch up with their higher performing peers.

4.59 By narrowing this efficiency gap, and by completing the efficiency initiatives it has already started as part of its modernisation programme, our econometric analysis suggests that Royal Mail could achieve efficiency improvements in its delivery operations in terms of hours of up to 2.5% per annum over the next three years (see paragraph A5.164). [✂]. Our analysis suggests Royal Mail expects to make efficiency savings of [✂] per annum in its delivery frontline hours, after taking volume effects into account.[123]

4.60 We are not able to compare Royal Mail's expected efficiency savings in its mail centre operations with the results of our econometric analysis due to data limitations. Nonetheless, our econometric analysis indicates that there remains potential for Royal Mail to improve the efficiency of its mail centre estate, particularly by reducing the difference in performance between mail centres.

WIK review of Royal Mail's 2015 Business Plan

4.61 WIK's review of Royal Mail's 2015 Business Plan provides further evidence that there is greater scope for efficiency improvements than those set out in Royal Mail's plan. WIK reviewed the 2015 Business Plan and benchmarked it against a selection of six international postal operators.[124]

4.62 WIK's review found that Royal Mail is not targeting enough cost savings in delivery, particularly given the importance of this element of its business. WIK considered 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 on outdoor delivery activities (known as the delivery span) than its international peers. Royal Mail's delivery span is around 60% compared to 80% or above at the benchmarked international operators.[125] This means that Royal Mail's frontline employees spend a greater proportion of their time indoors compared to the frontline employees of other operators. WIK also identified a number of initiatives in delivery not currently deployed by Royal Mail which have been put in place by other comparable postal operators. These include:

- implementing initiatives to realise the potential efficiency benefits of greater automation (such as increasing the level of walk sequencing);
- moving to a more innovative delivery model (e.g. having peak/off-peak delivery days);
- separating the tasks of indoor and outdoor delivery, and then assigning them to different employees; and
- introducing practices to increase flexibility in working time (such as 'flextime' schedules and flexible route re-designs).

4.63 WIK's review recognised that Royal Mail has undertaken a large transformation process in rationalising its mail centre estate, but nonetheless identified areas where Royal Mail could be more ambitious in the scope of its initiatives or current

[123] CAGR from 2014-15 to 2017-18).
[124] France, Germany, the Netherlands, USA, Sweden and Denmark.
[125] Having a longer delivery span is beneficial because each employee can deliver to more addresses which will reduce the number of routes required and therefore overall delivery costs. See WIK report on the Projected Costs in Royal Mail's Business Plan.

operational practices in processing mail. In particular, WIK identified that Royal Mail has not yet maximised the automation potential of its current machines [✂]. WIK also identified a number of initiatives available to Royal Mail which could further improve its efficiency including moving towards more innovative delivery methods, the way it deals with the bundling of unaddressed items, and the potential for greater centralisation of sequence sorting.

Marginality Review

4.64 We sought to understand the extent to which Royal Mail's costs vary in the short term in response to volume changes (referred to as marginality). We consider Royal Mail's flexibility in reducing costs to be relevant to its efficient provision of the universal service, particularly in the context of enduring letter volume decline. We also observed the challenges in estimating this effect. We have concluded that it is relevant to consider two types of efficiency metrics; those that adjusted for the impact of volume changes on costs as well as those that did not. We engaged Analysys Mason to inform our view on marginality.

4.65 Analysys Mason's marginality review found that recent changes to delivery methods have reduced Royal Mail's ability to remove delivery costs in the short term in response to volume decline. This means that Royal Mail's delivery operation is now less flexible than it was previously, i.e. costs are less responsive to reductions in volume. This is largely a result of Royal Mail's decision to adapt its delivery methods to deliver more parcels over its foot network, necessitating different, more fixed methods of delivery, involving a greater investment in vans and trolleys. As discussed in more detail in paragraph 5.34, in addition to making delivery operations less flexible, this means that the whole of Royal Mail's delivery network is exposed to competitive pressures from parcel operators which could act as an additional spur on its efficiency. On the other hand, if parcels continue to grow this should mean that Royal Mail is better able to absorb the growth without incurring further costs.

4.66 We also observe that the pay deal agreed with the CWU in January 2014, limits Royal Mail's ability to increase the proportion of part-time employees; provided that staff will be employed on permanent contracts except in exceptional circumstances; and included an objective for Royal Mail to achieve all future change without recourse to compulsory redundancy.[126] This is likely to have further limited Royal Mail's flexibility to respond to volume decline.

4.67 In summary, the ability of Royal Mail to reduce costs in response to volume decline in the short term is relevant to the efficient provision of the universal service. We observe that Royal Mail's recent changes have reduced this flexibility. This is in contrast to WIK's findings that other operators are observed to have increased the flexibility of their operators to better respond to short term fluctuations in mail volumes.

Other Assessments

4.68 Royal Mail has made some public statements as to its future plans for efficiency improvement including a statement in its 2015-16 half year results that it expects to

[126] 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.

avoid a greater level of costs by 2017-18 than it has over the past three years[127] (see paragraph A5.117 and A5.118).

4.69 In addition, analysts have highlighted the potential for Royal Mail to achieve further efficiency gains. However they also observed that Royal Mail faces challenges in realising these gains. In particular analysts have cited the importance of the current pay deal negotiations and talks on the future of Royal Mail's pension plan (see paragraph A5.113 to A5.116).

Other Considerations

4.70 Despite the potential for further improvement, we consider that there are a number of factors that might constrain Royal Mail's ability to achieve efficiency savings.

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

- 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."[128] 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.

- 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.

Summary

4.71 Overall, our analysis shows that Royal Mail has made progress on efficiency in recent years, and that its future plans (if successfully executed) would result in greater efficiency improvements than its historic achievement. However, our analysis indicates that there remains potential for Royal Mail to make greater efficiency gains than those forecast in its 2015 Business Plan.

4.72 Specifically, our econometric analysis indicates that Royal Mail can further increase its efficiency by raising the performance of poorer performing delivery offices and mail centres to match their higher performing peers, and from fully realising the

[127] See Royal Mail's 2015-15 Half Year Results Announcement, page 2 http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Financial%20Report%20for%20the%20half%20year%20ended%2027%20September%202015.pdf.
[128] See CWU website, *CWU 'drive for 35'*, 24 March 2016, http://www.cwu.org/media/news/2016/march/24/cwu-drive-for-35/.

efficiency gains from the initiatives already implemented as part of the modernisation programme. In addition, WIK identified a number of initiatives available to Royal Mail which it has not yet implemented but which have improved the efficiency of some other postal operators.

4.73 Despite this, we observe a number of factors which might limit Royal Mail's ability to realise further efficiency gains including the need for Royal Mail to reach a new labour agreement and pension settlement.

4.74 Further, we note that the flexibility of its frontline operations in delivery and processing has reduced which may make it more difficult to remove costs in response to short term fluctuations in volume.

4.75 Taking all of this into account, we conclude that Royal Mail's proposed efficiency initiatives and levels of cost reduction are reasonable. However we consider them to be at the lower end of a reasonable range for improvement.

4.76 We therefore consider that Royal Mail should be capable of achieving the efficiency targets set out in its 2015 Business Plan at a minimum. We further consider that it should be capable of meeting these targets without any adverse impact on its quality of service performance given that its business plan must assume compliance with its regulatory obligations.

4.77 In summary, given our analysis indicates that Royal Mail's efficiency plans are reasonable (notwithstanding the challenges it will need to overcome to achieve its plans), we consider that the regulatory framework does appropriately incentivise Royal Mail to pursue efficiency gains.

Postal Market Analysis

4.78 We have considered how the competitive dynamics in the letter and parcel sectors 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.[129] Our findings are summarised in the following paragraphs and are set out in more detail in Annexes 7 and 8.

4.79 Increasing parcel volumes have helped to mitigate the impact of declining letter volumes on Royal Mail's revenues in recent years, making parcel revenues an important component of the financial position of the universal service.[130] We had already begun work to better understand developments in the parcels sector at the time we announced the fundamental review as we recognised its potential to materially affect Royal Mail's ability to provide a universal service in the future.[131]

4.80 In the July 2015 Discussion Document, we said we would supplement this work by looking also at market structures in the letter and parcel sectors. This was with a view to exploring the competitive constraints faced by Royal Mail in these sectors and assessing whether there had been any changes in the level of these constraints that

[129] See paragraph 4.10 of Ofcom's July 2015 Discussion Document.
[130] In 2014-15, parcel revenue accounted for 51 per cent of Royal Mail revenue: http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202014-15_0.pdf.
[131] See the July 2015 Discussion Document, paragraphs 3.27 to 3.29 http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

might require a change in the regulatory framework. We said this work would enable us to determine whether amending the regulatory framework may be necessary in order to supplement the efficiency, innovation and quality incentives provided by market forces in the different market segments. We also said it would allow us to determine whether existing regulation on Royal Mail in bulk access and parcels should be modified or potentially removed.[132]

4.81 We set out our analysis of the letter and parcel sectors in detail in Annexes 7 and 8, respectively and we have summarised our key findings below.

Letters

4.82 The letters sector includes a large number of products used by different types of customers to meet a diverse range of needs. To reflect potential differences in the competitive constraints Royal Mail may face in providing different letter products, we have grouped the letters sector into two categories: (1) single piece letters and large letters and (2) bulk letters and large letters.

4.83 In line with the definition of 'single piece service' in the Universal Service Order, we have defined single piece letters and large letters as those where the price per item is not discounted on the basis of volume, sender, format or pre-sortation. Single piece products are typically used by small businesses and consumers, although it is likely that all businesses use single piece products at times. Bulk letters and large letters are subject to discounts relating to volume, format and pre-sortation. Royal Mail offers separate access and retail bulk products for sending transactional and advertising mail. In addition, it has a retail bulk mail publications product. These services are not included in the universal service and are used by businesses which send large volumes of mail.

4.84 Overall, we find that Royal Mail remains a near monopolist facing relatively limited competitive constraints in relation to both single piece and bulk letters and large letters. At first glance there does not appear to be a material change in the actual level of competition that Royal Mail has faced since 2012 (as even at the peak of Whistl's delivery operations, Royal Mail was delivering over 98% of all letter volumes).[133] However, following Whistl's exit from end-to-end letter delivery in 2015, we consider the prospect of a significant rival operator to Royal Mail starting end-to-end letter delivery operations in the future has diminished. In this sense, we consider the constraints on Royal Mail in letters and large letters are weaker than they were in 2012 when the prospect of end-to-end entry and expansion was more credible.

Single piece letters and large letters

4.85 Royal Mail continues to be a near monopolist in the provision of single piece letters and large letters. It remains the only operator offering these services on a national scale and we estimate that it delivers greater than 99% of end-to-end single piece letter volumes.[134] There are a number of other operators offering limited end-to-end

[132] See the July 2015 Discussion Document, paragraphs 4.10 and 4.11.
[133] See Ofcom's *Annual monitoring update on the postal market – financial year 2014-15*, 27 November 2015, paragraph 4.29, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.
[134] End-to-end competition only accounted for the delivery of 1.3% of letters in 2014-15 (see paragraph 4.28 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.

single piece services in restricted geographical areas but they handle much lower volumes than Royal Mail. At this point in time, the emergence of a national end-to-end entrant for single piece services in the foreseeable future appears unlikely.

4.86 It is likely that Royal Mail does face some constraints, particularly given the on-going decline in single piece volumes due to e-substitution. However, the competitive constraints it faces are unlikely to prevent it from profitably raising prices for single piece letters and large letters. Nevertheless, following the significant price increases in 2012 (for example, stamp letter prices increased by circa. 30% and 40% for First and Second Class respectively), Royal Mail has not raised prices as much as our analysis suggests it could have profitably sustained.[135] There may, however, be factors other than competitive constraints such as political pressure, concern about negative publicity and our monitoring regime which have limited Royal Mail's incentives to raise prices further. While that may be the case, it does not affect our assessment of the competitive constraints which Royal Mail faces in respect of single piece letters and large letters.

Bulk letters and large letters

4.87 Royal Mail provides the overwhelming majority of bulk letter mail delivery.[136] The main change in competitive constraints for bulk mail since 2012 has been the entry and subsequent exit of Whistl from end-to-end letter delivery. As discussed above (in paragraph 4.84), the constraints on Royal Mail in relation to bulk mail letter and large letter pricing have weakened following Whistl's withdrawal of delivery services. Although Royal Mail has increased access letter prices on average slightly above RPI since 2012, it has not raised prices by as much as our analysis suggests it could have profitably sustained.[137]

4.88 As with single piece letters, Royal Mail faces some constraint on its pricing behaviour from the threat of e-substitution for bulk letter mail. Transactional mail volumes (such as invoices, bank statements etc.) in particular are susceptible to e-substitution and the impact of volumes switching is higher as customers are unlikely to switch back to using mail for these transactions once they have moved to online platforms. However, it is not clear to what extent this threat of permanent switching to electronic alternatives significantly constrains Royal Mail's pricing behaviour. Royal Mail has increased business mail access prices by more than RPI between 2012 and 2016, whereas price increases for access advertising mail have been more in line with RPI over the same period, suggesting that Royal Mail may consider advertising mail has a higher elasticity than other mail applications.

4.89 Despite the lack of competition in the delivery of letters, Royal Mail faces significant competition for retail bulk mail services. Royal Mail is required to offer access to its network to other operators, who undertake the collection, sortation and transportation of letters (i.e. the upstream parts of the supply chain) before handing the mail over to Royal Mail at the relevant Inward Mail Centre. Access mail accounted for around 70% of bulk mail letter volumes[138] and 56% of total letter volumes in 2014-15,[139] and

[135] Excluding the price freeze for stamp products in 2013, Royal Mail's overall single piece price increases have been slightly above RPI since 2012.
[136] See footnote 134.
[137] RPI is the inflation measure used by Royal Mail and formerly by Postcomm in their respective analysis of the postal sector.
[138] See Figure A7.1 in Annex 7.

has also provided greater choice and innovation in the sector. Access competition may provide some constraint on Royal Mail's retail prices.[140] However, Royal Mail sets the wholesale price for access operators, and the significant majority of revenues from bulk mail are retained by Royal Mail. For example, access operators only received £164 million in revenues in 2014-15 which equates to approximately 4% of total letter market revenues. Consequently, Royal Mail retained nearly 95% of all bulk letter revenues across the whole sector.[141]

4.90 We therefore do not consider that there are significant competitive constraints on Royal Mail's pricing of bulk letter mail overall. Access operators provide some constraint over a small proportion of the value chain and there is likely to be some constraint from the threat of e-substitution. Following the more significant price increases in 2011 and 2012, access price increases have been relatively modest (although overall greater then RPI).[142] Similar to our conclusion in relation to single piece letters above, we consider this is likely to be due to other factors such as our monitoring regime or that further significant price increases could trigger greater e-substitution (following the significant increases in 2011 and 2012).

Parcels

4.91 In looking at the constraints faced by Royal Mail in the parcels sector, we were interested primarily in assessing the potential risks to Royal Mail's parcels revenue from increased competition. As a result, our analysis of the parcels sector focuses on the two segments where in 2010 Postcomm considered Royal Mail had market power and where any increase in competitive constraints may therefore be expected to have a larger potential revenue impact.[143] These two segments are:

- single piece parcels (i.e. parcels sent by consumers and small businesses, that are posted at access points[144] or collected from the sender, where the price per item is not discounted on the basis of volume, sender, format or pre-sortation); and

- Small/lightweight deferred bulk parcels[145] weighing 2kg or less (although Postcomm found competition to be emerging at least for high volume parcels between 1-2kg[146]).

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[139] Ofcom, *Annual monitoring update on the postal market – financial year 2014-15*, 27 November 2015, paragraph 4.14 - http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.

[140] Royal Mail is also subject to an ex ante margin squeeze control that seeks to ensure the upstream element of the revenues of these bulk mail services is sufficient to cover the costs of the relevant upstream activities carried out by Royal Mail to provide the services.

[141] Ofcom, *Annual monitoring update on the postal market – financial year 2014-15*, 27 November 2015, calculated based on Figure 4.3.

[142] However, we note that from Jan 2015 onwards Royal Mail has offered an additional discount off the CBC price for access letters using its Mailmark service.

[143] 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).

[144] For example, Post Offices and other retail outlets used by operators such as CollectPlus.

[145] Deferred bulk parcels was defined by Postcomm in its 2010 analysis as non-guaranteed services and included all next day and later than next day services but did not include express time guaranteed and Sameday services. We have treated bulk parcels as those 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

4.92 Our analysis suggests that the parcels sector is becoming more competitive generally, but that 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 finding).

Single piece parcels

4.93 When we put the current regulatory framework in place in March 2012, we decided to put a safeguard cap on Second Class stamp items up to 2kg,[147] with one price for letters, and a separate basket price for large letters[148] and stamp parcels (up to 2kg). As part of this review, we have considered whether this safeguard cap remains appropriate (which draws on the analysis of the constraints on Royal Mail in single piece parcels) and we discuss this in paragraphs 5.15 to 5.32 below.

4.94 Our analysis suggests that Royal Mail may retain a strong position in single piece parcels. Royal Mail remains the most widely used operator, and has a share of single piece parcel volumes of between 60-80% ([✂]). There are reasons why Royal Mail may continue to retain a strong position in single piece parcels: it has by far the largest single network of access points,[149] and alternatives to the Post Office are overwhelmingly located in urban areas. Nevertheless, we have observed that competition has begun to emerge – for example, volumes of single piece parcels carried by competitors to Royal Mail increased by 34% between 2013-14 and 2014-15, and competitors have invested in their own range of access points to compete with Post Offices. As a result, Royal Mail faces some pricing constraints in single piece parcels (particularly for parcels over 2kg).

Bulk parcels weighing 2kg or less

4.95 As noted in Section 2, our approach to the regulation of Royal Mail in March 2012, was as far as possible to give Royal Mail greater commercial and operational freedom so that it could return the universal service to financial sustainability. In addition, as bulk parcels are outside of the universal service they are therefore not subject to the same regulation as universal services.

4.96 We have considered how competition has developed in relation to bulk parcels weighing less than 2kg and in particular:

- Royal Mail's share of volumes and revenues: from the information we have collected, Royal Mail has a share of volumes and revenues for bulk parcels that weigh less than 2kg of between 60-80% ([✂]). In addition, Royal Mail's own

negotiated contract. Bulk parcels are typically sent by businesses (either to other businesses, or to consumers).

[146] Postcomm's *Laying the foundations for a sustainable postal service – Annex 1: Analysis of Markets – Decision document*, November 2010, page iii.

[147] The details of the safeguard cap for Second Class stamp large letters and packets were consulted on separately see: Ofcom, *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets*, 20 July 2012 - http://stakeholders.ofcom.org.uk/binaries/consultations/postal-service-letters-packets/statement/statement.pdf.

[148] A letter weighing up to 750g that is no more than 25mm thick, and up to 353mm in length and up to 250mm in width.

[149] There are roughly 11,500 Post Offices, and the second largest (CollectPlus) has around half that number (5,800).

internal estimates suggest that it has a large volume share of parcels that weigh less than 1kg but that its share of parcel volumes above 1kg is much lower.[150]

- Royal Mail's network configuration: Royal Mail's foot delivery network gives it an advantage for small, lightweight parcels, and gives Royal Mail a cost advantage for parcels that fit through a letterbox.[151]

4.97 Taking into account the factors set out above, in our view Royal Mail continues to retain an advantage for small, lightweight bulk parcels (particularly for those weighing less than 1kg, and specifically for parcels that can fit through the letterbox).

Assessment of the current regulatory framework against the 2012 tests

Should we impose retail and/or wholesale price controls on Royal Mail?

4.98 One of the key elements of the 2012 regulatory framework was the removal of nearly all price controls from Royal Mail. As set out at paragraph 4.2 above, the key test we set in 2012 was that if Royal Mail "shows a track record of consistently increasing prices and not improving efficiency, it is likely that more intrusive regulation will have to be considered." Several respondents to our July 2015 Discussion Document argued that price controls on Royal Mail should be reintroduced or that we should set efficiency targets.[152]

4.99 One of our key concerns in launching our current review was that in the absence of end-to-end letter delivery competition from Whistl, Royal Mail may have weakened incentives to deliver efficiency improvements and an increased ability to charge excessive prices.[153] This would be a concern in particular if we considered that Royal Mail was earning (or was likely to earn) excessive profits, through subjecting consumers to excessive prices.

4.100 Therefore, we have considered whether more stringent controls on Royal Mail's pricing flexibility, such as the potential re-introduction of price controls, could be required in order to ensure that Royal Mail has sufficient incentives to improve its efficiency, rather than relying on price rises to remain profitable. Our objective in doing so is to secure the provision of an efficient and financially sustainable universal service at affordable prices.

4.101 On the basis of the evidence set out in relation to Royal Mail's efficiency, its financial sustainability and its position in the letters and parcels sectors, we do not consider that the imposition of further retail or wholesale price controls on Royal Mail is justified at this time. In particular:

[150] Royal Mail's response dated 11 September to Q2 of Ofcom's information request under s.55 PSA 2011 (issued 24 July 2015) [✂].
[151] See FTI Consulting, Competitive constraints on pricing faced by Royal Mail, September 2015, paragraph 2.18.
[152] DX, CFH, UK Mail, The Consumer Council, the BBC Licence Fee Unity, Secured Mail, the MUA, and Whistl all proposed price controls being re-introduced.
[153] Review of Royal Mail Regulation discussion document, July 2015, paragraph 3.17, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-regulation-review/summary/Review_of_RM_regulation.pdf.

- consumer and SME satisfaction is reasonably high and improving with the majority of residential and business consumers satisfied or very satisfied with postal services.

- Royal Mail is now financially sustainable and is making profits in line with what we have described as a reasonable commercial rate of return;

- despite occupying a very strong position in the letters sector, retaining a strong position in certain segments of the parcels sector and other constraints being relatively limited, Royal Mail has not exercised its ability to raise prices to the extent that it could have done; and

- although there remains scope for further improvement, Royal Mail's future efficiency plans demonstrate greater ambition than its past performance and are within a reasonable range.

4.102 While Royal Mail may have the ability and incentive to increase prices and profitability at the expense of efficiency savings, it has not done so under the current regulatory framework. On the contrary, our analysis shows Royal Mail is making returns at the lower end of the 5-10% EBIT margin range, some progress on efficiency and not raising prices as much it could, against a backdrop of increasing customer satisfaction.

4.103 In light of this evidence, we consider that the current regulatory framework and market conditions appropriately incentivise Royal Mail to pursue efficiency improvements rather than excessively raising prices. As such, and having regard to the principles of regulatory certainty and predictability, we do not consider that it would be appropriate to amend the regulatory framework to set efficiency targets for Royal Mail or to impose price controls to drive efficiency.

4.104 We therefore believe that maintaining the current regulatory framework including the safeguard cap (giving Royal Mail pricing freedom, alongside safeguards for consumers and effective monitoring) is the most appropriate option at this time.

Do the changes in the parcels sector require us to change the regulatory framework?

4.105 As described above, consumers (both residential and business) are making different demands of the letters and parcels sectors in the postal market. In the letters sector, the best outcomes for consumers require the maintenance of a financially sustainable universal postal service for letters that can adapt to structural volume decline, including sustaining the current competitive arrangements for bulk mail, i.e. the access arrangements and remaining end-to-end delivery operators. By contrast, in the parcels sector, competitive pressures are more likely to provide the outcomes desired by consumers – both as senders and recipients, and residential and business users. Therefore, the maintenance of a competitive market for parcels should be the key objective for a regulatory framework for the parcels sector.

Providing future certainty and clarity

4.106 As noted in Section 2, in our March 2012 Statement, we decided to put the regulatory framework in place for a period of seven years, i.e. until March 2019.

4.107 We considered that a period of seven years, supported by monitoring the effectiveness of the regime, would provide an appropriate degree of certainty as to

the regulatory framework for Royal Mail, potential investors and other stakeholders. We considered that this would better encourage efficiency incentives and allow the benefits of a financially sustainable universal service to be shared with customers.

4.108 However, we recognised that there might be circumstances in which we would decide to re-open the regulatory framework earlier than seven years. These included if Royal Mail used the commercial freedom that we were giving it, to act in a way that did not support our regulatory objectives and so might undermine the provision of the universal service, or in the event of significant unanticipated market challenges.

4.109 In light of our current review, we do not consider that it is necessary to review the framework again within the next two years. When we established the regulatory framework in 2012 we had not envisaged undertaking another fundamental review by this point. However, changes in the market have led us to undertake this review at what was anticipated to be the mid-point of the seven year framework established in 2012. Therefore, while retaining the same discretion to re-open the regulatory framework if necessary, another fundamental review is not likely to be required in the near future and we therefore consider that the regulatory framework should remain in place for a further five years from the completion of the current review so as to provide sufficient certainty to market participants. Therefore, if we complete the review as currently planned by the end of 2016-17, the regulatory framework would run until March 2022.

Monitoring

4.110 Our on-going monitoring of the postal market remains a very important component of our regulatory framework, representing one of the three safeguards on which the framework rests. In order to ensure that the regulatory framework continues to work effectively in furthering the regulatory objectives we will continue to monitor a range of factors including Royal Mail's performance on efficiency, quality of service, the financial performance of the universal service network, and competition in parcels and letters. We will also continue to publish our view of Royal Mail's efficiency in the annual monitoring updates, based on the metrics discussed in Annex 5. In addition, we intend to work with Royal Mail to get better insight into its performance against its efficiency initiatives.

4.111 We retain the discretion to review the regulatory framework at any time should the results of our monitoring programme indicate that there is a need to do so. In interpreting the findings of our monitoring work, we will continue to consider metrics and indicators across the range of factors that we monitor.

4.112 We also intend to continue to monitor consumers' experiences in the postal sector. In our 2013 Review of Users' Needs, we said it is important for Ofcom to continue to understand the needs of users of postal services and how these needs may change in the future.[154] Although we already gather some information in relation to user needs, we intend in future to place greater emphasis on monitoring the evolution of postal user needs and preferences as part of our overall monitoring programme. This is to ensure that more information on user needs and opinions is captured to help us assess if and when we need to carry out a further review of users' needs. The results of our monitoring will help us assess the appropriate time to carry out such a review.

[154] See Ofcom's 2013 Review of Users' Needs, paragraph 1.4, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf.

Question 1: *Do you agree that the evidence summarised in Section 4 and set out in more detail in the annexes to this consultation does not support the imposition of (i) further price controls on parts of Royal Mail's business or (ii) efficiency targets? Please state your reasons and provide evidence to support your view.*

Question 2: *Do you agree that the regulatory framework should remain in place until March 2022 following the anticipated completion of Ofcom's review by the end of 2016-17? Please state your reasons and provide evidence to support your view.*

Question 3: *Do you agree that the analysis summarised in Section 4 and set out in more detail in the annexes to this consultation accurately reflects the UK postal market? Please state your reasons and provide evidence to support your view.*

Section 5

Regulation of parcels

Introduction

5.1 In Section 4, we summarised developments in relation to the parcels sector. Despite these developments, Royal Mail continues to have the largest volume and revenue share of the parcels sector overall and particularly in relation to small/lightweight bulk parcels and single piece parcels (although we have seen competition begin to emerge in single piece parcels in the past few years, and, based on the information we collected, Royal Mail's share of volumes declined between 2013-14 and 2014-15). Our assessment of Royal Mail's position in single piece parcels and small/lightweight bulk parcels is set out in Annex 8.

5.2 This chapter considers whether existing parcels regulation remains fit for purpose in light of developments over the past few years. In particular, we have considered:

- Royal Mail's proposal to include tracked parcels in the universal service;
- whether there is still a need to protect vulnerable consumers through the safeguard cap on Second Class stamped parcels; and
- the risk of Royal Mail unfairly leveraging its position in the letters sector into parcels.

5.3 These are discussed in turn below.

Regulation of parcels

5.4 There are currently two main areas of regulation that apply to parcels:

- the universal service obligation; and
- the safeguard cap on Second Class stamped parcels products weighing less than 2kg.

5.5 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.

5.6 DUSP Condition 3 puts a safeguard cap price control on Royal Mail's Second Class stamp large letter and parcels up to 2kg. 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.

Tracking of parcels in the universal service

5.7 In making the Universal Service Order in 2012, we sought to describe the essential characteristics of the universal service, without substantively changing the scope of the universal service as it had existed up until that time.[155] At its most fundamental, the universal service provides for the delivery and collection of mail everywhere in the UK at affordable and uniform prices. When we introduced the Universal Service Order, we considered that tracking was a premium feature and therefore specified that priority and standard single piece parcels within the universal service should not include tracking services.[156]

5.8 We are not opposed to the principle of including tracking on standard universal service parcels in future if that would help consumer needs to be met. However, in the context of emerging competition, we have concerns that the VAT exemption on universal service products[157] could result in a competitive distortion which could risk damaging the growing but relatively recent competition in single piece parcels. We understand that some rival firms e.g. Hermes and Yodel have sought to differentiate themselves from Royal Mail by offering tracking as standard in response to the 20% VAT exemption on Royal Mail's universal service products. [✂][158].

5.9 In addition, including tracking services as a standard feature on priority and standard single piece parcels within the universal service would entail a change to DUSP 1, which does not permit tracked First and Second Class parcels to be provided as part of the universal service.

5.10 Under section 30(3) of the PSA 2011, in order to make changes to the universal service, we would need to "carry out an assessment of the extent to which the market for the provision of postal services in the United Kingdom is meeting the reasonable needs of the users of those services". We consider that any material change to the current universal service is only appropriate after a process of gathering evidence as to whether users' needs are met. Therefore, we would only change the Universal Service Order to include tracked parcels as a standard feature, if we had evidence to suggest that user's needs have changed such that tracking should be a core feature of a universal postal service. If we decided that tracking of parcels was a core feature and should be included in the universal service, we would then have to consider whether Royal Mail should be required to provide this service (which would consequentially mean that Royal Mail's services would be exempt from VAT), or whether there are suitable alternatives provided by the wider postal market, which meant that user needs are being met.

5.11 While tracking is a standard offering for parcel services among Royal Mail's competitors, it is not clear whether users (i.e. single piece customers such as consumers and SMEs) currently require tracking as a core feature of parcel services.

[155] See Ofcom, *Securing the Universal Postal Service – Decision on the new regulatory framework*, 27 March 2012, paragraph 4.25.
[156] See Ofcom, *Securing the Universal Postal Service – Decision on the new regulatory framework,* 27 March 2012, paragraphs 4.39 to 4.43 and 8.135. As noted below, the Universal Service Order was later amended to remove the exclusion of tracking for standard and priority services from the scope of the universal service.
[157] VAT (levied at 20%) is not applied to universal service products – http://www.hmrc.gov.uk/manuals/vpostmanual/VPOST4250.htm. Competitors to Royal Mail, however, have to charge VAT to their customers (as does Royal Mail on its non-universal service products). The application of VAT to postal services is a matter for HMRC.
[158] [✂].

Based on the information we collected from operators (see Annex 8 for more details), the large majority of UK single piece parcels are sent via Royal Mail (between 60%-80%), and, apart from its Special Delivery Guaranteed service, all Royal Mail single piece parcels are untracked. We estimate, therefore, that the majority ([✂]) of single piece parcels were untracked in 2014-15), despite the fact that tracked options are available from both Royal Mail and competitors. Consequently, consumer behaviour does not currently appear to support the proposition that tracking is a basic characteristic of single piece parcel services. We have not received representations from consumers or consumer groups asking for tracked parcels to be included on standard parcels in the universal service.

5.12 There does not, therefore, seem to be an urgent need to review user needs in relation to the tracking of parcels. However, it is important that consumers are able to benefit from innovative developments such as tracking. We propose to monitor user needs as part of our on-going monitoring programme and we will consider the requirements of users with respect to tracking as part of this. As we have discussed elsewhere, competition is emerging in single piece parcels, and our monitoring programme will observe how user needs are changing in relation to parcels. Royal Mail also currently does not have the capability to track the majority of its parcels, though it is investing in this.[159]

5.13 It is also worth noting that there is nothing preventing Royal Mail from offering tracked First and Second Class parcels outside of the universal service. Indeed, it currently offers both tracked and untracked variants of certain parcel products.

Our proposal

5.14 We therefore propose not to amend the DUSP conditions to include tracking as standard on First and Second Class single piece parcels. We have not carried out a review of user needs recently, and based on the current evidence available, it is not clear that consumers currently require tracking as a standard feature of a universal service. In addition, suitable tracked single piece alternatives are available in the wider postal market and it is therefore not necessary to require Royal Mail to provide such a service (particularly as consumers currently have the option to use tracked services offered by both Royal Mail and its competitors). We also note that the VAT exemption associated with universal service products means that allowing tracked parcels within the universal service could have a negative impact on emerging competition in the parcels sector.

Question 4: *Do you agree with our proposal not to amend the Universal Service Order or the DUSP conditions to include tracking as standard on First and Second Class single piece parcels? Please state your reasons and provide evidence to support your view.*

Safeguard cap on Second Class stamp parcels under 2kg

5.15 As noted in section 2, in 2012 we introduced a safeguard cap on Second Class stamp prices, for items weighing up to 2kg. As set out in paragraph 4.104, we do not consider that there is a case for removing the safeguard cap insofar as it applies to

[159] Royal Mail's response to the July 2015 Discussion Document – Appendix: Royal Mail innovation and improvements, paragraph 1.19.

letters and large letters.[160] Here, we consider in more detail whether competition in single piece parcels under 2kg has developed to such an extent that there is a case for modifying the safeguard cap to remove parcels from its scope (i.e. limiting the cap to letters and large letters).

5.16 When we introduced the cap, we provided three broad reasons for including large letters and parcels:

- Large letters and parcel prices were likely to be important factors in ensuring an affordable basic universal service was available to all as large letters and parcels accounted for around half of total household postal expenditure.[161]
- Consumers lacked sufficient competitive alternatives to Royal Mail's services, and awareness and use of services offered by competitors was low.[162]
- The cap would not have a material impact on Royal Mail's flexibility as it would still only apply to a small proportion of its revenues, and would not materially constrain the prices of Royal Mail's meter and PPI Second Class large letters and parcels, which are priced significantly below the stamp price.[163]

5.17 We restricted the cap to Second Class parcels under 2kg because we considered that usage of parcels weighing more than 2kg was low, and that there was a wider range of competitive alternatives available for these types of parcels.[164] This continues to be the case and Royal Mail's universal services are also in general not the cheapest services for consumers to use when sending parcels above this weight.[165]

5.18 In 2012, large letters and parcels accounted for around half of total household postal expenditure. While we do not have detailed information about how much parcels contribute to total household postal expenditure in 2016 a significant number of respondents to our consumer postal tracker reported sending more parcels than they did two years ago.[166] This suggests that large letters and parcels are likely to continue to be a significant proportion of overall consumer postal expenditure and their prices remain an important factor in ensuring an affordable basic universal service is available to all.

[160] The details of these safeguard caps are set out in DUSP 2 (second class letters) and DUSP 3 (large letters and relevant packets), http://stakeholders.ofcom.org.uk/post/conditions/.
[161] Ofcom, *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets,* 20 July 2012, paragraph 3.2 http://stakeholders.ofcom.org.uk/binaries/consultations/postal-service-letters-packets/statement/statement.pdf.
[162] Ofcom, *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets,* 20 July 2012, paragraphs 3.2 and 3.11.
[163] Ofcom, *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets,* 20 July 2012, paragraphs 3.3, 3.13, 3.14, and 3.54.
[164] Ofcom, *Securing the Universal Postal Service – Safeguard cap for Large Letters and packets,* 20 July 2012, paragraphs 3.2 and 3.9.
[165] See operator websites or www.parcels2go.com.
[166] 63% said that they send larger parcels more often compared to two years ago, and 39% that they send smaller parcels more often than two years ago. By comparison, 28% said that they are sending larger parcels less often, and 18% smaller parcels. Ofcom Residential Postal Tracker 2015, *QC11 – Which of these types of mail would you say you are sending more often by post?* and *QC12 – of these types of mail would you say you are sending less often by post?*

5.19 As set out in more detail in paragraphs 5.26 to 5.30 below, Royal Mail is currently pricing below the safeguard cap, which suggests that the cap is not currently unduly constraining its ability to set prices. Royal Mail has also not proposed that the safeguard cap be removed.

5.20 We consider below whether the safeguard cap remains fit for purpose, with particular focus on whether there are competitive alternatives to Royal Mail's services (and the extent to which any competitive alternatives may exert a constraint on Royal Mail's prices).

How competition is developing

5.21 There has been some market entry in the provision of lightweight (i.e. less than 2kg) single piece parcels in the last few years. Since 2012, a number of operators have launched their own parcel shop networks (see paragraph A8.26), and websites that aggregate offers from different delivery firms (for example, www.parcels2go.com). The two largest alternative networks combined have nearly as many outlets as Post Offices (which Royal Mail uses to offer its single piece services) – see Annex 8 for more details. As we noted above (see paragraph 4.94), the volume of single piece parcels carried by the combination of Royal Mail's competitors has increased (by 34% between 2013-14 and 2014-15), although Royal Mail still accounts for the large majority: based on the information we collected, Royal Mail's share of single piece parcel volumes in 2014-15 was between 60%-80% (in 2013-14 its share of volumes was [✂], compared to [✂] in 2014-15). While Royal Mail's prices for parcels below 2kg in general continue to be lower than those of most of its single piece competitors, there are some lower prices available, as well as operators offering services for prices that consumers may see as competitive with Royal Mail's products.[167]

5.22 Figure 5.1 sets out the prices for Royal Mail's later than next day parcel services under 2kg, and compares these against alternative single piece services that (based largely on price) consumers are likely to see as alternatives to Royal Mail.[168]

Figure 5.1 – Single piece parcel services and prices 0-2kg

	Speed of delivery	Tracked?	Retail prices (including VAT where applicable)	
			0-1kg	1-2kg
Royal Mail D+2 or later				
Second Class[169]	2-3 days	No	Small: £2.80/£2.85[170] Medium: £4.89/£4.95	
Second Class Signed For[171]	2-3 days	Recorded	Small: £3.90/£3.95 Medium: £5.99/£6.05	
Parcelforce Express48	2 days	Yes	£4.80-£10.10[172]	

[167] Consumers' decisions are likely to include considerations not just of price, but also other factors such as ease of sending (e.g. how close to competitor access points they are), and how much they trust the operator.
[168] For a more complete list of single piece parcel prices, see Figure A8.7.
[169] VAT is not applicable for this product.
[170] Royal Mail charges a cheaper price if the postage is purchased online.
[171] VAT is not applicable for this product.
[172] 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.

Examples of other single piece services				
CollectPlus (Yodel)	3-5 days	Yes	£4.99	
myHermes (Hermes)	2-4 days	Yes	£2.70	£3.78
iPostParcels (UK Mail)	2-3 days	Yes	£2.39-£4.79[173]	
InPost (locker service)	2-3 days	Yes	Small: £3.59 Medium: £5.82	

Source: operator websites. Correct as of April 2016.

5.23 As Figure 5.1 above shows, Royal Mail's standard Second Class service (which benefits from the VAT exemption) is typically cheaper than the services offered by other operators. However, other operators' services offer features that Royal Mail's service may not (e.g. tracking as standard); for customers who require tracking, these operators' services are often cheaper than Royal Mail's recorded services,[174] as well as certain operators being cheaper at certain weights and/or sizes.

5.24 However, as we have noted above (paragraph 5.21), Royal Mail remains by far the most widely used operator for single piece parcels, and we consider this is likely to remain the case:

- Royal Mail (through its relationship with the Post Office) has the largest network of access points (see Figure A8.5), and the Post Office is likely to be the most easily available access point for large parts of the country (see paragraph A8.35);

- Some consumers may find new entrants' services less convenient – for example, in order to use parcel shops like myHermes and CollectPlus, you typically need access to a printer, having paid for postage online (unlike at the Post Office, where you can purchase postage in store); and

- Royal Mail and the Post Office have strong and universally known brands, whereas we have some evidence that levels of awareness of alternative parcel services are currently comparatively low. For instance, when we asked consumers which of certain listed parcel or letter service providers they had heard of, 99% said they had heard of Royal Mail, compared to 61% for Yodel, 52% for Hermes, and 27% for CollectPlus.[175] These levels of awareness may also overstate the importance of those companies as alternative providers of single piece parcel services to consumers. For instance, consumers may be aware of Hermes and Yodel from receiving parcels delivered by these companies but may not be aware of their single piece parcel services for consumers which they can use to send parcels. This may be reflected in the fact that awareness of CollectPlus is lower than for Yodel. CollectPlus is a joint venture between Yodel and PayPoint and effectively functions as Yodel's equivalent to the Post Office

[173] 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.
[174] Their prices are also cheaper than Royal Mail's tracked service, which is only available as a next day product (Special Delivery Guaranteed by 9am/1pm).
[175] Ofcom Residential Postal Tracker 2015, *QI1- Which, if any, of these companies that can be used to send parcels or letters have you heard of before today?,* http://stakeholders.ofcom.org.uk/binaries/research/statistics/2016Feb-Apr/Residential_Postal_Tracker_2015_data_tables_tbp.pdf.

(i.e. consumers can send parcels from CollectPlus stores, which are typically newsagents and convenience stores).

5.25 These factors may therefore limit the take up of alternative services, at least in the short term.

Royal Mail's pricing behaviour

5.26 In light of this emerging competition, we consider below whether Royal Mail's pricing behaviour suggests that it has the ability to implement significant price rises for Second Class stamped parcels under 2kg.

5.27 In April 2013 (following consultation[176]), Royal Mail changed its single piece pricing structure to differentiate between small and medium parcels[177] within the 0–1kg and 1–2kg weight ranges. Prices for medium parcels (shown as dashed lines in Figure 5.2 below) rose by around £2 – £3 (which in some cases represented an increase of over 100%), while price changes for small parcels were more limited. This change in the structure of single piece prices also followed the simplification of weight steps Royal Mail introduced in 2012 (which is more similar to how other operators price their parcels). The impact of these changes has meant significant price increases for very lightweight (i.e. less than 250g) and in particular larger parcels.

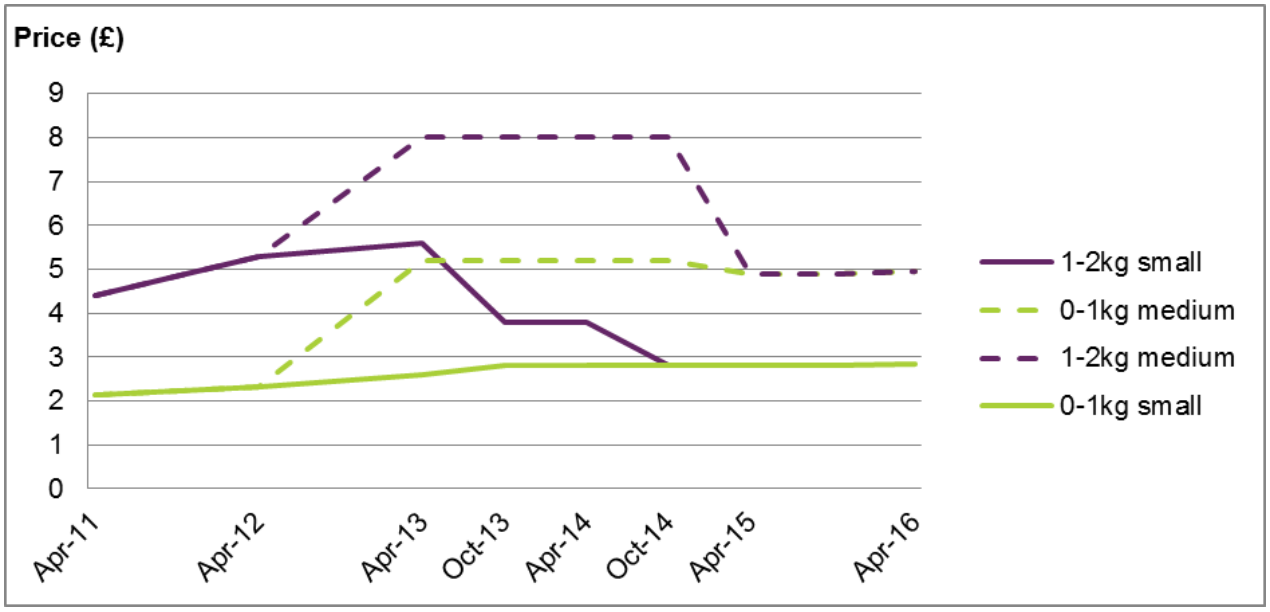
5.28 However, following these more structural changes to parcel prices in 2012 and 2013, Royal Mail has reduced prices for all Second Class parcels apart from small parcels weighing between 0-1kg (which increased by 25p (10%) between 2013 and 2016), and no longer charges a different price for 0-1kg and 1-2kg.[178]

[176] See *Royal Mail announces proposals to change its parcels range*, 7 December 2012, http://www.royalmailgroup.com/royal-mail-announces-proposals-change-its-parcels-range.

[177] Royal Mail's small parcels currently have following maximum dimensions: 45cm x 35cm x 16cm. Royal Mail's medium parcels currently have the following maximum dimensions: 61cm x 46cm x 46cm. Royal Mail has changed the dimensions of its small parcel since it was first introduced in 2013 - for more details, see Ofcom, *Annual monitoring update on the postal market: Financial year 2014-15*, paragraphs 3.20-3.23.

[178] For its 2016-17 parcel prices, Royal Mail introduced a price difference between postage purchased at a Post Office and postage purchased online (the latter not shown in the chart). For postage purchased at a Post Office, Royal Mail's Second Class parcel prices increased by 5p for small parcels under 2kg, and 6p for medium parcels under 2kg. When postage is purchased online, prices remained the same as the previous year. It appears that the introduction of a separate online price targets customers who would consider using myHermes and CollectPlus, as these require postage to be purchased online.

Figure 5.2 – Weighted average price for Second class stamp parcels 2011-12 to 2016-17[179]



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

5.29 Royal Mail has said that the introduction of size-based pricing contributed to greater than expected volume decline in Royal Mail's consumer parcels.[180] This suggests there is some pricing constraint on Royal Mail for these types of parcels.

5.30 In addition, Royal Mail is currently pricing below the level of the cap: in 2014-15, the cap was set at £2.47 and the level of Royal Mail's basket of large letter and parcel prices was £2.24. Royal Mail could, therefore, have increased its prices by an additional 10% on average under the cap.[181] The fact that Royal Mail is currently pricing below the level allowed by the safeguard cap may indicate that there are some pricing constraints on Second Class stamp parcels under 2kg. However, Royal Mail has increased basket prices by 45.6% (against a permitted increase of 60.5%) since 2011-12, including increasing weighted average parcel prices in excess of 50%, which indicates a limited risk that Royal Mail has the potential to introduce large price rises in the coming years, above the existing safeguard cap.

Proposal

5.31 We have observed some emerging competition in single piece parcels that was not present when we put the regulatory framework in place in 2012. There is also a prospect that competition in single piece parcels will continue to grow in the next few years.

[179] Royal Mail typically updates its prices annually in April, but the chart also shows changes that Royal Mail made to prices in October 2013 and October 2014.
[180] Royal Mail, *Annual Report and Financial Statements 2013-14*, 6 June 2014, page 9, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202013-14_DDA_0.pdf.
[181] In addition, we note that Royal Mail decreased some of its parcel prices in 2015-16 and 2016-17. It is therefore likely that current Second Class stamp large letter and parcel prices could increase by greater than 10% on average.

5.32 However, there are risks associated with removing the safeguard cap. Competitors' share of volumes and revenues is currently relatively low, and it is not yet clear how competition will develop in this segment. Consequently, we consider it possible that circumstances will arise in which Royal Mail would have the ability to profitably raise prices above the safeguard cap. We note that Royal Mail is not currently choosing to price up to the level of the safeguard cap and therefore it does not appear to unduly constrain Royal Mail's pricing flexibility. We therefore propose to retain the safeguard cap in its current form. Depending on how competition develops in single piece parcels (which we will actively monitor), we will reconsider the need for the safeguard cap in relation to parcels in the future.

Question 5: *Do you agree with our proposal to retain the safeguard cap in its current form? Please state your reasons and provide evidence to support your view.*

Risk of Royal Mail unfairly leveraging its position in the letter sector into parcels

5.33 As part of our analysis of whether the safeguard cap is still required, we provisionally concluded that Royal Mail could have the ability to profitably raise prices above the level of the cap. In the context of emerging competition in single piece parcels, and competitive pressures in the parcels sector more generally, there is a risk that Royal Mail could unfairly leverage its strong position in the letter sector into parcels.

5.34 As noted in paragraph A8.51, Royal Mail has configured its network in such a way that it can utilise its foot-delivery network for letters to deliver small/lightweight parcels alongside letters. This approach means that all of Royal Mail's delivery network (i.e. including letters) will to some extent be exposed to the competitive pressures it faces in the parcels market. Given that parcels competition is national while competition in end-to-end letters is confined to specific geographic areas, this could increase the efficiency incentives on the delivery network on a national basis, and to a greater extent than Whistl's end-to-end rollout plans might have done. However, it may also provide a mechanism for Royal Mail to leverage its strong position in the letters sector into parcels. For example, it may have an incentive to use revenues from letters to provide below cost parcel services, or to allocate costs associated with parcel deliveries to letter deliveries thus enabling it to set higher prices for letters and lower prices for parcels. This incentive may be stronger given the increase in the proportion of fixed costs which are common to both letters and parcels delivery following the implementation of Royal Mail's new delivery methods as discussed in paragraph 4.65.

5.35 Some stakeholders have also expressed concerns about unfair pricing by Royal Mail in lightweight bulk parcels (although we have not yet received evidence in support of these concerns). For instance, as noted in paragraph A8.22, 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.[182]

Next steps

5.36 In light of this risk, we intend to consider whether, as part of our forthcoming review of the USP Accounting Condition and Regulatory Accounting Guidelines (see

[182] Hermes' response to the July 2015 Discussion Document, page1.

paragraph 1.32), there are ways to better ensure that Royal Mail is appropriately allocating costs between parcels and letters. We also propose to build a costing model to help develop our own view of how Royal Mail allocates costs.

Section 6

Access Framework

6.1 This section sets out the issues raised by stakeholders in relation to the regulation of access, our analysis of these issues and, where appropriate, proposals for changes to the access condition. This section also takes account of our 2014 Access Pricing Consultation, including where relevant, the responses to that consultation.

Background

6.2 Prior to the 2012 regulatory framework, Royal Mail was required to offer access to any point in its network (if requested) at prices that reflected a reasonable allocation of costs. The majority of national access prices were further restricted through controls on the overall price and a requirement to maintain minimum margins between retail and wholesale prices to protect against margin squeeze.

6.3 In addition, there were restrictions on the charges for different types of geographical areas to protect access operators who did not post nationally or delivered mail in some geographic areas themselves and used Royal Mail to deliver in others. These zonal prices were intended to be cost reflective (on a fully allocated cost (FAC) basis), linked to the national average price (i.e. the national price was equal to the weighted average of zonal prices) and changes to the make-up and number of zones were limited.

6.4 Royal Mail was also prohibited from unduly discriminating between operators using its network (including its own retail division) and obtaining any unfair commercial advantage in relation to its provision of access services.

6.5 The terms and conditions of access were set out in the access contracts between Royal Mail and access users. Royal Mail was only able to change many of these terms and conditions if the users agreed to the change.

2012 Regulatory Framework

6.6 In developing the March 2012 regulatory framework, we considered that access competition was beneficial and should be retained. We considered it would help to incentivise the financially sustainable and efficient provision of the universal service, without threatening its sustainability (provided access prices reflect Royal Mail's costs).[183]

6.7 We also considered that access was likely to be an important component in facilitating the development of end-to-end letter competition, as it allowed potential end-to-end entrants to develop a customer base and offer a national delivery service without the prohibitive expense of delivering to all addresses.[184] This was likely to be particularly important as delivery operators enter the market and gradually roll-out to additional geographic areas.

[183] See the March 2012 Statement, paragraphs 10.7 to 10.31.
[184] See the March 2012 Statement, paragraphs 10.15 to 10.18.

6.8 Therefore, we required Royal Mail to provide access to its Inward Mail Centres (IMC) for letter and large letter D+2 or later services,[185] which at the time represented over 99% of all access items and 97% of all access revenue.[186] However, we also made some changes to the regulation of access to give Royal Mail greater commercial and operational flexibility to respond to market changes.

6.9 The Universal Service Provider Access Condition (USPA Condition) required Royal Mail to:

- provide D+2 Access as soon as reasonably practicable and on fair and reasonable terms, conditions and charges and on any terms, conditions and charges that Ofcom directs;[187]
- not unduly discriminate in relation to D+2 Access, including in relation to its own retail operations;[188]
- use all reasonable endeavours to ensure that information it has obtained pursuant to its provision of access is not disclosed for its own benefit;[189]
- meet an ex ante margin squeeze control requiring it to recover upstream FAC across a basket of retail products (including quarterly information provision to Ofcom for monitoring purposes);[190]
- adopt a reasonable, transparent and timely process for users to make requests for D+2 Access;[191]
- give a minimum of ten weeks' notice for changes to access charges and changes to non-price terms (unless otherwise agreed) and, in respect of changes to non-price terms for which prior consent of the access operators is not required, the relevant notice period should be sufficient to meet the reasonable needs of access users;[192] and
- publish all such information as is reasonably necessary for the purposes of securing transparency as to the quality of service for D+2 Access.[193]

6.10 We also decided for the purposes of resolving access disputes, referred to Ofcom in accordance with Schedule 3 of the PSA 2011, to adopt a dispute resolution process for access.

[185] "D+2" means a postal service that aims to deliver two working days after collection, also known as a day C service. Therefore "D+2 Access" means access to Royal Mail's postal network at the IMC for the purposes of providing D+2 and later than D+2 Letter and Large Letter services.
[186] See the March 2012 statement, paragraph 10.21.
[187] USPA Condition 2.1, 2.2 and 3.1.
[188] USPA Condition 5.1 and 5.2.
[189] USPA Condition 5.3.
[190] USPA Condition 6.
[191] USPA Condition 4.1 requires Royal Mail to publish a Statement of Process for requests for D+2 access or variations to the current D+2 contract which must include (a) the form in which such a request should be made; (b) the information Royal Mail requires to consider a request and (c) the reasonable time-scales in which such requests will be handled and USPA Condition 4.2 requires Royal Mail to keep the Statement of Process under review and consult with access operators and Ofcom before making changes to it.
[192] USPA Condition 7.
[193] USPA Condition 8.

6.11 We considered that these requirements would better facilitate commercial negotiations between Royal Mail and access operators and would provide greater flexibility to meet the changing needs of the market.

6.12 In relation to zonal access pricing, we considered that the requirement to set fair and reasonable terms and conditions was a more flexible approach while maintaining sufficient protection for customers and competition. However, we also set out three principles that we considered would be important when considering whether terms, conditions and charges (or proposed terms, conditions and charges) were fair and reasonable. These were that Royal Mail should:

- take into account the alignment of zonal prices with Royal Mail's costs. Furthermore, in moving geographic areas (e.g. postcode sectors, postcode areas) between zones, Royal Mail should take into account the alignment of prices and costs. Zonal costs should be derived in accordance with Royal Mail's Regulatory Financial Reporting obligations;

- seek to ensure that the weighted average of zonal access prices is broadly comparable to the national access price; and

- take into account the frequency of implementing changes to the terms of zonal access (including moving geographic areas between zones and revising the zonal structure) as well as the transactional costs for access users (and customers) of implementing the changes. Regard should be given to minimising such transactional costs for access users.[194]

Royal Mail's access agreements under the new regulations

6.13 Following a consultation in October 2012, Royal Mail offered access customers a revised standard access agreement in March 2013 (the "**Access Letters Contract**"). Access users were not forced to move to this new contract; however Royal Mail offered a price discount relative to the old contract. The significant majority of access customers and volumes have now switched. The new contract provides Royal Mail with increased flexibility, including greater ability to make changes to the contract without the consent of access operators. However, it also includes additional procedural requirements requested by access operators. In particular, the contract requires the suspension of any change that becomes the subject of an investigation or dispute resolution process carried out by a regulatory body (including Ofcom). The Access Letters Contract is a standard form bi-lateral contract which enables customers to procure products using one of four price plans. The price plans are:

a) **National Price Plan 1 (NPP1)** offers access operators a uniform wholesale price for delivery to any UK address. To use this plan operators must agree to meet certain requirements associated with the geographic distribution of mail at a national level across the country using Standard Selection Codes (SSCs).

b) **Averaged Price Plan 2 (APP2)** also offers a uniform price for delivery to any UK address if certain geographic requirements are met. However, this plan is measured against the proportion of Royal Mail's mail that is delivered to the four zones (i.e. Urban, Suburban, Rural and London) rather than the proportion of mail delivered in the 86 SSCs.

[194] See the March 2012 Statement, paragraph 10.153.

c) **Zonal Price Plan 3 (ZPP3)** offers four separate prices for delivery depending on the zone in which the address is located.

d) **Regional Price Plan 4 (RPP4)** offers a uniform price for delivery to each of the UK's regions: England and Wales (excluding London), Scotland and Northern Ireland. As with APP2 operators must agree to meet certain requirements associated with the distribution of mail according to Royal Mail's zones however in this case the benchmark distribution is related to each region.

6.14 The Access Letters Contract is supported by a number of schedules which set out operational processes and detailed requirements and specifications for different access products. Schedules 1 to 5 are mandatory whereas schedules 6 to 21 relate to services which the access operators are not required to take under the main body of the contract (although in order to use the relevant services/operational practices access operators do need to agree to the terms and conditions in these schedules). Schedules 6 to 21 include terms and conditions associated with specific products (such as advertising mail, Mailmark[195] and Business Mail large letters[196]) or specific operational practices (such as the use of trays).

Stakeholder concerns

6.15 Stakeholders – in particular, access operators and senders of bulk mail – raised concerns regarding the regulation and provision of access services. These concerns have been raised informally, at industry fora and in response to the 2014 Access Pricing Consultation and July 2015 Discussion Document. We address these issues below in three categories:

- Access pricing;
- Non-price issues:
  - Contractual power to impose terms and conditions; and
  - Non-equivalence; and
- Scope of access regulation.

Access pricing

6.16 In this section we examine whether the proposals we made in the 2014 Access Pricing Consultation to restrict Royal Mail's ability to set access prices in a way that might harm competition remain appropriate given recent market developments.

Background

6.17 In January 2014 Royal Mail notified access operators of price changes that it intended to implement on 31 March 2014. These changes included:

[195] Mailmark is a new product specification offered by Royal Mail at both the retail and wholesale (access) levels. Mailmark is based on a new barcode system which can be scanned at various stages of the delivery process enabling improved tracking and reporting. See: https://www.royalmailwholesale.com/royal-mail-mailmark.

[196] See Royal Mail's website, http://www.royalmail.com/business/services/sending/letters-uk/business-mail.

- Introducing a 1.2% price differential between the NPP1 and APP2/ZPP3 prices which Royal Mail argued was to reflect the cost benefit to it from receiving forecast volumes which it intended to require under NPP1 but not APP2 or ZPP3; and

- Modifications to the price differentials between the zones (see Table 6.1 below). This would have had the impact of reducing Urban and London and increasing Suburban and Rural zonal prices significantly (i.e. it changed the zonal tilt).

Table 6.1 Royal Mail's notified Letter zonal price changes[197]

	Urban zone	Suburban zone	Rural zone	London zone
2013 access contract charge[198]	-12.9%	+0.3%	+13.9%	+9.9%
2014 notified contract charge[199]	-25%	+10.4%	+44.1%	-25%

6.18 In addition, in November 2013 and January 2014 Royal Mail notified reductions to the NPP1 and APP2 'tolerances' which relate to the extent to which operators may diverge from the specified profiles. These changes would have had the effect of reducing the allowed difference between the profiles of access operators and Royal Mail that would not have been subject to surcharges. Changes to APP2 were intended to come into effect at the same time as the price and zonal tilt changes discussed above whereas non-price changes to NPP1 were intended to come into effect in August 2014.

6.19 Whistl launched end-to-end letter delivery operations in April 2012. In early 2014 it was in the process of expanding to cover additional parts of London as well as Manchester and Liverpool. It had publicly stated that it intended to expand its letter delivery operations to around 40% of households by 2017.[200] Whistl was still reliant on access for the delivery of the majority of its items, principally using the APP2 price plan.

6.20 Following a complaint from Whistl, we opened a Competition Act investigation into Royal Mail's January 2014 and November 2013 notified changes.[201] This triggered the suspension clause in the access contract and in March 2014 Royal Mail suspended the new access prices. In March 2015, Royal Mail withdrew the January 2014 and November 2013 notifications. On 28 July 2015, we issued a statement of objections to Royal Mail in respect of the Competition Act investigation. That investigation remains ongoing.

6.21 In December 2014, we published a consultation on proposed changes to the regulation of access (the 2014 Access Pricing Consultation). This set out our concern that Royal Mail had the ability and incentive to set access prices in a way that could undermine confidence in investment and deter or potentially prevent beneficial localised entry in relation to the delivery of letters. To address these concerns, we

[197] Percentage change is from the APP2 access charges.
[198] Royal Mail, *Letter to customers*, undated, see https://www.royalmailwholesale.com/mint-project/uploads/507938298.pdf.
[199] Royal Mail, *Letter to customers containing Contract Change Notices 003 - 005*, 10 January 2014.
[200] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services 2014, 21 October 2014.
[201] See http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01122/.

proposed some changes to the USPA Condition that were intended to remove Royal Mail's ability to set charges in a way that could undermine beneficial entry into letter delivery, but retain Royal Mail's freedom to determine the overall level of charges.

6.22 Our proposals included the following requirements:

- A rule requiring that, for every service, the ratio of zonal charges equal the ratio of zonal costs (on a fully allocated (FAC) basis);
- A zonally priced service must be offered for every access service available priced on a national basis;
- The weighted average of the zonal prices for each service must be equal to any national charge;
- Access prices must be national or zonal (thereby prohibiting sub-national price plans); and
- The relevant zones would be specified in the condition (including rules on how geographic areas should be allocated to the different zones) and therefore the zonal structure could not be amended by Royal Mail (although it could propose new zones to Ofcom).

6.23 As explained at paragraph 1.4, Whistl announced in June 2015 that it was closing down its delivery operations following the withdrawal of potential investors and a review of the viability of its end-to-end delivery operations.[202] Following this, we opened a review of the regulation of Royal Mail and in the July 2015 Discussion Document we announced that we would incorporate our work on access pricing regulation into this review.

Stakeholder concerns

6.24 In response to both the 2014 Access Pricing Consultation and the July 2015 Discussion Document, stakeholders raised the following concerns about access pricing and our 2014 proposals.[203]

6.25 A number of stakeholders, including Whistl, the MCF, Secured Mail, MUA, Onepost and BBC TV Licensing, agreed with our argument that there was a need to intervene in relation to access prices. They all shared our concerns that Royal Mail possessed both the ability and incentive to introduce price changes that would cause uncertainty for competitors and foreclose competitive entry into the end-to-end market, to the detriment of consumers.[204] First Post considered that Royal Mail had tried to use its zonal prices to make alternative end-to-end delivery operations less viable and this would also have damaged rural mail services.[205]

[202] See http://www.whistl.co.uk/news/update-on-e2e-review/.
[203] Stakeholders' responses to the 2014 Access Pricing Consultation are published here: http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/?showResponses=true.
[204] See responses to the 2014 Access Pricing Consultation: BBC TV Licensing, page 3; Mail Competition Forum, page 1; Mail Users' Association, page 2; ONEPOST, page 1; Secured Mail, page 2; Whistl, page13.
[205] See response to the July 2015 Discussion Document: First Post, page 1-2.

6.26 Conversely Royal Mail, CWU and Unite disagreed with our approach. Royal Mail argued that its actual and notified prices for access and contract letters were fair, reasonable and cost oriented. It considered that its access pricing proposals were cost oriented, compliant with competition law and would not have put an efficient end-to-end operator at a competitive disadvantage.[206] Royal Mail also believed that our access pricing proposals would severely restrict its ability to compete and would encourage inefficient entry into the end-to-end delivery market. It claimed that the proposals would accelerate the threat it perceived to the future financial sustainability of the universal service from end-to-end competition. In addition, Royal Mail considered that restricting it to maintain the current four zones removed its ability to respond to market changes and emerging customer needs.[207]

6.27 Royal Mail and CWU considered that Royal Mail's access pricing proposals were merely using the commercial freedom given to it by Ofcom in the 2012 regulatory framework to respond to changes in the market and address the threat of end-to-end competition.[208] CWU also argued that a more thorough review by Ofcom was necessary before altering the regulation around access pricing.[209] Critiqom believed that Ofcom's approach would undermine the universal service.[210]

6.28 UK Mail argued that if Royal Mail could demonstrate it benefits from cost savings from access operators meeting certain geographic profiles or forecasting requirements then it should be able to share these benefits with access users (in terms of lower prices or contract variations).[211]

6.29 In addition, there were a number of other concerns raised by stakeholders about Ofcom's proposals:

- The MCF and Whistl considered that Royal Mail should not be able to price access services below FAC;[212]
- Whistl also expressed concern that our proposals would still allow Royal Mail some freedom to change its zonal boundaries (particularly with respect to London) which could undermine the structure of the access charges.[213] On the other hand, Critiqom and Regional Mail Services suggested there should be a greater number of zones to reflect different geographic and demographic conditions (suggesting between 5 and 12 zones);[214]
- ONEPOST was concerned about the lack of an explicit restriction on how often Royal Mail could change the zonal ratios and weighted average national access charges; [215]

[206] See Royal Mail's response to the July 2015 Discussion Document, pages 24-25.
[207] See Royal Mail's response to the 2014 Access Pricing Consultation, page 2.
[208] See responses to the July 2015 Discussion Document: Royal Mail, page 25, Communications Workers Union, paragraph 23.
[209] See Communications Workers Union's response to the 2014 Access Pricing Consultation, page 2.
[210] See Critiqom's response to the 2014 Access Pricing Consultation, page 1.
[211] See UK Mail's response to the July 2015 Discussion Document, paragraph 3.47.
[212] See responses to the 2014 Access Pricing Consultation: Mail Competition Forum, page 2; and Whistl, pages 3 to 4.
[213] See Whistl's response to the 2014 Access Pricing Consultation, pages 5 to 6.
[214] See responses to the 2014 Access Pricing Consultation: Critiqom, page 2; and Regional Mail Services, page 1.
[215] See ONEPOST's response to the 2014 Access Pricing Consultation, page 2.

- Whistl was concerned that our proposals would not prohibit Royal Mail from offering discriminatory national access terms, i.e. terms that favour those that use Royal Mail to deliver all of their mail;[216] and

- Critiqom, DX (Group) plc, MUA and UK Mail argued for Ofcom to impose a wholesale charge control on access prices.[217]

6.30 In its response to the July 2015 Discussion Document, DX (Group) plc said it was concerned that Ofcom now appeared to have concluded that widespread end-to-end competition was unlikely. It considered we should be careful not to foreclose market entry.[218]

Ofcom's assessment

6.31 The current USPA Conditions require Royal Mail to provide access on fair and reasonable terms, conditions and charges but allow Royal Mail a degree of freedom within those boundaries as to how it chooses to provide access. As set out in paragraph 6.21, the 2014 Access Pricing Consultation proposed to extend the USPA Conditions to ensure that Royal Mail was not able to set access prices in a way that could undermine confidence in investment and deter, or potentially prevent, entry in relation to the end-to-end delivery of letters. However, as set out in paragraph 6.23, market conditions have changed since we published our 2014 Access Pricing Consultation. In particular, Whistl has now ceased its end-to-end letter delivery operations and we do not consider there is likely to be another end-to-end entrant of sufficient scale and scope to provide a significant level of letter delivery competition to Royal Mail in the foreseeable future 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.[219]

6.32 Given that there is little prospect of significant entry in end-to-end letter delivery, the concerns identified in the 2014 Access Pricing Consultation are no longer relevant. We are not therefore pursuing the proposals set out in that consultation. Given that we are not proposing to implement the 2014 proposals, we have not set out our assessment of the comments we received from stakeholders about the detail of these proposals.

6.33 Nevertheless, we remain of the view that the principles of zonal pricing set out in the March 2012 Statement (discussed in paragraph 6.12) remain fundamental to protecting consumers and competition. In particular.

a) Alignment of zonal prices with costs – i.e. that the ratio of zonal prices should be broadly equivalent to the ratio of zonal costs on a FAC basis. We do not consider it is appropriate that Royal Mail recovers its fixed costs differentially depending on the type of area that recipients live in. Royal Mail should take into account the alignment of prices and costs when changing geographic areas (such as postcode sectors or SSCs). For the avoidance of doubt this should be done on

[216] See Whistl's response to the 2014 Access Pricing Consultation, page 7 and 8.
[217] See responses to the 2014 Access Pricing Consultation: Critiqom, page 2; DX, page 2; MUA, page 2; and UK Mail page 2.
[218] See DX's response to the July 2015 Discussion Document, page 3.
[219] Other operators delivered just over 1% of letters in 2014-15, however as this included a full year of Whistl's delivery volumes we are expecting this volume to significantly reduce in 2015-16. See the Annual monitoring update on the postal market, Financial year 2014-15, Figure 4.2.

the basis of FAC costs and zonal costs should be derived in accordance with Royal Mail's Regulatory Financial Reporting obligations.

b) All national (or sub-national) access prices should equal the weighted average of zonal access prices – this would mean that there is no price disadvantage for access users on the zonal price plans compared to any national (or sub-national) price plan.

c) Stability and cost justification for changes to the zonal structure – we also consider that there should be a reasonable level of stability in relation to zonal structures (i.e. the number and make-up of zones) and/or how geographic areas are allocated to zones. Any changes should be cost justified to minimise the potential for manipulation to disadvantage end-to-end competitors. Royal Mail should consider how it can minimise the transaction costs for users if cost justified changes are made.

6.34 We will continue to closely monitor Royal Mail's changes to its access prices and zonal pricing structure, in particular whether Royal Mail's prices are in accordance with the principles set out in paragraph 6.12 above.

Non-price access issues

6.35 Stakeholders – particularly access operators and bulk mail customers – have raised a number of concerns relating to non-price issues regarding Royal Mail's access services. A significant number of respondents to the July 2015 Discussion Document raised concerns about Royal Mail's contractual power and, in particular its ability to impose potentially unfair non-price terms and conditions or to offer non-equivalent services which may favour its own retail business.

6.36 These concerns appear to fall into the following categories:

- Royal Mail's power as the virtual monopoly supplier of letter delivery to impose contractual terms in a way which may be unfair, in particular:
  - its ability to make unilateral changes to the terms and conditions for access;
  - concerns that it may be offering new products and services by way of optional contractual schedules which are conditional on accepting reduced procedural protections; and
  - concerns that specific terms and conditions may be unfair, e.g. use of trays and bags.
- Access operators being treated on a non-equivalent basis to Royal Mail's retail bulk mail operations, in particular in relation to:
  - the development of new access products, in particular new products that enable access operators to compete with Royal Mail's retail products;
  - differences in operational processes used to process access mail compared with those used for Royal Mail's retail products;
  - potential for Royal Mail to misuse confidential information obtained from access operators for its own benefit; and

- whether the risk of discrimination is such that Royal Mail should be functionally or structurally separated to resolve these issues.

Contractual power to impose terms and conditions

Unilateral changes to the terms and conditions of access

Stakeholder concerns

6.37 Many access operators expressed concern about Royal Mail's power to make changes to the terms and conditions of access without their consent. Access operators considered that this had resulted in the imposition of changes without sufficient consultation.

6.38 A number of respondents specifically pointed to Royal Mail's announcement of its January 2015 price changes as an example of a change imposed without sufficient consultation. In that case, Royal Mail announced that its annual price increase would take place in January 2015 rather than April 2015 as had been Royal Mail's practice. Respondents commented that this unexpected change had implications for the budget cycles of their customers and had resulted in confusion and additional costs.[220]

6.39 Stakeholders also expressed concerns about Royal Mail's January 2015 consultation on proposed contract changes which included a proposal to remove the contractual requirement for Royal Mail to suspend changes that are investigated by a regulatory authority and to increase the frequency with which it could implement price changes.[221] Several stakeholders appeared to consider that Royal Mail adopts a 'take it or leave it approach' to changes in terms and conditions while avoiding collaboration.[222]

6.40 Royal Mail argued that it has well-established processes for consulting with customers, and emphasised that it cannot make certain material changes to its access contracts without consulting with its customers in advance. Royal Mail stated that there are many contractual and regulatory provisions in place that provide significant protections for customers against changes with which they disagree, including complaining to Ofcom.[223]

6.41 Royal Mail provided an example of the introduction of its Mailmark product, where it argued that it has undertaken a lengthy engagement process with industry from 2011 onwards. It said that this engagement had led to various improvements which were based on customer feedback.[224] Royal Mail also noted that its January 2015

[220] See response to the July 2015 Discussion Document: GI Solutions, page 2; and other confidential submissions 'Name Withheld 5', page 1.
[221] See responses to the July 2015 Discussion Document: BBC License Fee Unit, page 3; and UK Mail, page 9 and 10.
[222] See responses to the July 2015 Discussion Document: MCF, page 4; 'Name Withheld' 5, page 1; RBS, page 4; and Whistl, page 3.
[223] Royal Mail, *Clarifications in response to stakeholder submissions to the Ofcom Fundamental Review of the Regulation of Royal Mail*, 19 November 2015, page 4 (non-confidential version).
[224] Royal Mail, *Clarifications in response to stakeholder submissions to the Ofcom Fundamental Review of the Regulation of Royal Mail*, 19 November 2015, pages 12 to 13 (non-confidential version).

consultation was part of an engagement process and as a result of this it had listened to customers and acted on their feedback.[225]

Ofcom's assessment

6.42 Ofcom's approach to access regulation in March 2012 was to give Royal Mail greater commercial and operational flexibility while retaining sufficient protection for access operators. While we removed the some of the more prescriptive arrangements that had been in place previously, we imposed clear over-arching obligations on Royal Mail to offer access services on terms and conditions that were fair, reasonable and non-discriminatory.

6.43 We have carefully considered stakeholder concerns that Royal Mail has too much contractual flexibility as demonstrated by its ability to impose unilateral changes. As a starting point we continue to believe that it is preferable that access terms and conditions are based on commercial negotiation rather than being imposed through regulation. This reflects the complexity of the industry and highly detailed contractual framework that is currently in place for the provision of access services.

6.44 Since the regulatory framework was put in place in March 2012, Royal Mail has made many changes to the terms and conditions of access. A number of these, which are referred to above from paragraph 6.17, were suspended as a result of the investigation Ofcom announced in February 2014 and have since been withdrawn. With one important exception, which we consider further below, we have not however received formal complaints, or identified material concerns, regarding any other changes implemented by Royal Mail.

6.45 We consider that it continues to be appropriate that Royal Mail has commercial flexibility to make changes to its access and retail products provided those changes are fair and reasonable. This includes, for example, determining when (and how) it intends to implement price changes. We would expect that Royal Mail would take account of the needs of its customers when implementing price changes, which we believe is also in its own best interests.

6.46 In our view there is evidence that Royal Mail has undertaken a genuine consultation process with its customers. For example in January 2015 Royal Mail consulted on changing or removing certain contractual features[226] including a number of procedural protections, such as the suspension clause. Subsequently, some of these proposals were altered or dropped with Royal Mail citing strong customer feedback in relation to the proposed changes.[227] We would expect that Royal Mail will continue to proceed in this consultative way.

6.47 We would also expect that stakeholders would engage with Royal Mail and use any consultation processes to attempt to resolve concerns they had with any of Royal Mail's proposals. We note that where stakeholders are unable to reach agreement they could refer a dispute to Ofcom. To the extent Royal Mail sought to impose terms and conditions which access operators regarded as not fair and reasonable in the future, we would need to carefully consider whether those terms and conditions were consistent with Royal Mail's regulatory obligations. To that end we would encourage

[225] Royal Mail, *Clarifications in response to stakeholder submissions to the Ofcom Fundamental Review of the Regulation of Royal Mail, 19 November 2015*, page 5 (non-confidential version).
[226] Royal Mail, Change Proposals for Access Contracts – A Discussion Document, 16 January 2015.
[227] Royal Mail, Change Proposals for Access Contracts – A Decision Document, 30 June 2015.

stakeholders to bring complaints to us in accordance with the Enforcement Guidelines, if concerns arise in the future.

6.48 We note that several stakeholders expressed concern that the current requirement for Royal Mail to provide terms and conditions which are fair and reasonable is too imprecise or presented with insufficient clarity on what is required from Royal Mail. We have considered whether it would be appropriate to issue further guidance as to how we would assess whether the terms and conditions of access are fair and reasonable.

6.49 In the March 2012 Statement, we said that it may be appropriate to provide guidance once the regulatory framework had time to become established. Although the framework is now fully established, it is not clear that there remains a case to issue a separate guidance document on how we would assess whether the terms and conditions of access are fair and reasonable. We have reached this view given the complexity of the arrangements that have evolved and continue to evolve with innovation in product design, the specific procedural protections that have been included, by industry negotiation, in the access framework and the nature of the highly specific concerns raised by stakeholders in recent months. In view of this, it is unlikely that a guidance document which is general in nature and scope would make a useful contribution to the functioning of the access market.

Notification periods for changes to new/optional contractual schedules

6.50 USPA Condition 7 sets out the notification periods which Royal Mail is required to provide before introducing changes to its standard terms and conditions for access. In particular, USPA Conditions 7.3 and 7.4 require Royal Mail to provide notice of, and publish, changes to standard terms and conditions, including charges, at least 10 weeks before the date on which those changes are due to take effect. Shorter periods of notice may, however, be agreed between Royal Mail and the access operators under both USPA Conditions.

6.51 Since 2012 Royal Mail has introduced a number of changes to the overall structure of its access product range including the introduction of a number of new product classes. Royal Mail's practice has been to introduce the terms and conditions associated with these new products by way of an additional contractual schedule separate to the general terms and conditions of the Access Letters Contract. As it is possible to procure some access products without agreeing to these schedules they are presented by Royal Mail as optional.

6.52 Royal Mail has used this approach to introduce the Mailmark and Digital Stamp products[228] and to establish a differentiated large letter product for business mail.[229] These schedules provide for a shorter notice period for certain contractual changes than that required by USPA Condition 7.

6.53 Each of the schedules contains terms which specify how quickly Royal Mail can change the terms and conditions associated with the relevant product:

[228] See Royal Mail's website, https://www.royalmailwholesale.com/digital-stamp/.
[229] Respectively Schedules 19, 20 and 21 of the Access Letters Contract.

i) The Business Mail large letter schedule states that "[r]egardless of any other term of this Contract, we may change or withdraw the Business Mail Large Letter service on at least 30 days' written notice."[230]

ii) The Mailmark schedule states that "[r]egardless of any other term of this Contract, except 13.2.3. [pricing changes] we may change the terms of this Schedule by giving you at least thirty (30) days' written notice."[231] This schedule also has a surcharge mechanism for which the surcharge is defined as "an adjustment charge payable in relation to non-compliant Mailmark Mailing Items, as published on our Website and as may be amended from time to time." [232]

iii) The Digital Stamp schedule states that "[r]egardless of any other term of this Contract, except 13.2.3. [pricing changes] we may change the terms of this Schedule by giving you at least thirty (30) days' written notice."[233]

6.54 The obligations set out in USPA Conditions 7.3 and 7.4 would ordinarily require at least 10 weeks' notice to be given for those changes. We understand that Royal Mail considers that the schedules provide agreement by access operators to the shorter periods of notice set out above.

Stakeholder concerns

6.55 Stakeholders have expressed concerns that these schedules enable Royal Mail to make material changes to these new products more quickly than the minimum notification requirements provided for by the access contract and as required by USPA 7 (see paragraph 6.9). Stakeholders emphasised that notice periods were important to ensure operators could implement the changes and that, if there is an objection to the change, this can be challenged.[234] UK Mail noted that "*in practice customers have no option but to accept [the schedules] in order to be able to use or offer the new services and so maintain their market position*."[235]

6.56 Royal Mail has stated that these schedules are optional and that no customer is obliged to include them in their contract. Where customers do agree, Royal Mail considers that they have "*consented to the terms of the new schedule, including any revised notice periods*."[236]

Ofcom's assessment

6.57 We have considered the concerns raised by stakeholders about Royal Mail's apparent ability to impose shorter notification periods. As set out in paragraph 6.50, current regulation imposes a series of requirements on Royal Mail to provide minimum notification prior to the commencement of any changes which are made to the terms and conditions of access.

[230] Royal Mail, Access Letters Contract: Schedule 19 Royal Mail Business Mail large letter, paragraph 9.1.
[231] Royal Mail, Access Letters Contract: Schedule 20 Royal Mail Mailmark (version 2), paragraph 10.1.
[232] Royal Mail, Access Letters Contract: Schedule 20 Royal Mail Mailmark (version 2), page 2.
[233] Royal Mail, Access Letters Contract: Schedule 21 Digital Stamps (version 2), paragraph 7.1.
[234] [✂].
[235] See UK Mail's responses to the July 2015 Discussion Document, page 6.
[236] Royal Mail, Letter of 27 February 2015.

6.58 Royal Mail has said that it considers that certain contractual schedules are optional and accordingly customers who agree to the schedule also consent to any shorter notification periods provided for by that schedule. It appears that Royal Mail is relying on the exception built into USPA 7 which enables changes to be implemented more quickly in circumstances where Royal Mail and access operators agree to a shorter notification period than ten weeks.

6.59 This creates a situation where the requirements of the notification condition may not apply to certain key access services. The relevant services covered by these schedules – including the use of Mailmark services and Business Mail large letters – are important services used by the majority of access operators. Although it is possible for operators to function in the access market without using these services the need to compete with other operators who do use these services may mean operators have little option but to accept the schedules.

6.60 For example, Royal Mail plans for Mailmark to replace the current barcode-based sortation product CBC for access by January 2018. In addition, Royal Mail is currently pricing Mailmark at a 2.5% discount to the equivalent CBC product, and intends to increase the differential to 4% from 1 July 2016. Royal Mail stated that these "*price changes further recognise those customers that have already switched to Mailmark and are designed to encourage further switching*".[237] In addition, the Digital Stamp product[238] also requires customers to use Mailmark products.

6.61 The schedules are complex and there appears to some uncertainty over the extent of changes which may be possible under the shorter notification periods. However it is clear that all parties consider that these schedules purport to allow Royal Mail to make certain unilateral changes with a shorter notification period than the minimum 10 week period required by USPA 7.

6.62 We consider that it may not be clear from the current wording of USPA 7.3 and USPA 7.4 about whether this is permitted in accordance with the flexibility accorded under those conditions for Royal Mail and access operators to agree to a shorter notice period.

6.63 We imposed the minimum notification requirements under USPA 7 in order to ensure that Royal Mail provides access operators and customers sufficient notice of changes to terms and conditions. We believe that such a requirement is necessary so that access operators are able to manage appropriately any changes to the terms of access with their own customers and maintain a sufficient level of transparency to the access regime.

6.64 We do not consider that it is appropriate that the terms and conditions relating to the use of a D+2 Access product should make it a requirement that, in order to take the product, an access operator must agree generally to a shorter notification period for changes to those terms and conditions than the minimum period required under USPA 7. We are concerned that this could undermine the regulatory protection which is intended to be offered under USPA 7.3 and 7.4, particularly where the access operators have no real choice but to agree to that or not to take the relevant D+2 Access product. Although USPA 7.3 and 7.4 permit Royal Mail and access operators to agree to shorter notice periods, this should be limited to cases where Royal Mail and access operators choose to exercise commercial flexibility to agree to implement

[237] See Royal Mail's website, https://www.royalmailwholesale.com/royal-mail-mailmark/.
[238] See Royal Mail's website, https://www.royalmailwholesale.com/digital-stamp/.

specific changes in a shorter notice period – for example, because this would be of benefit both to Royal Mail and access operators alike.

6.65 We therefore propose to amend USPA 7 to make it clear that Royal Mail may not embed shorter notification periods in the standard terms and conditions for its products and/or operational processes.

Question 6: *Do you agree that we should amend the USPA Condition so that it is clear that access operators cannot be required to accept general terms and conditions that include shorter notification periods than those provided for under USPA 7?*

6.66 More detail on the precise drafting of the proposed changes to USPA 7 is set out in the Notification included at Annex 12.

6.67 We consider that this will satisfy the relevant legal test for modifying USPA 7 (as set out in paragraph 1 of Schedule 6 to the PSA 2011) in that:

- It is objectively justifiable because it strengthens safeguards that we consider to be important in the regulation of access (specifically by ensuring that changes to terms, conditions and charges cannot be introduced unduly quickly such that access operators cannot adequately prepare and/or object to the change prior to its commencement);
- It does not unduly discriminate against Royal Mail because it reflects Royal Mail's position as the only postal operator with a downstream delivery network capable of facilitating participation by access operators in the relevant markets;
- It is proportionate in what it is intended to achieve because we consider the protections associated with the notification requirements are the minimum necessary to safeguard the provision of access and ensure the benefits of access competition can be achieved;
- Our proposals transparently set out a clarification to the existing notification requirements in a way which should give greater certainty as to the circumstances in which Royal Mail and access operators may agree to a shorter time period for notification of changes to the terms and conditions of access.

Specific terms and conditions

Stakeholder concerns

6.68 Stakeholders also raised concerns that some existing terms and conditions may not be fair and reasonable. They argued that in some cases they had found Royal Mail to be unwilling or slow to engage with industry on discussions to collectively address and improve these areas.

6.69 For example, a number of stakeholders suggested that Royal Mail adopts an unnecessarily burdensome approach to dealing with 'consumables' – which are ancillary products such as trays and bags that are required by access operators to process and hand over mail to Royal Mail. Stakeholders considered that Royal Mail's

approach has pushed costs from Royal Mail onto the access operators and that a more flexible approach could be more efficient. [239]

6.70 Other stakeholders raised concerns that surcharges and other financial penalties associated with the access agreement may not be fair and reasonable. They argued that surcharges were insufficiently precise or a result of arbitrary and unnecessarily high specifications. [240]

6.71 Stakeholders maintained that surcharges should be limited to the additional cost to Royal Mail resulting from the non-compliance that gave rise to the surcharge.[241] The recent 50% reduction in the level of surcharges associated with Mailmark was offered as an example of the lack of cost reflectivity in Royal Mail's surcharges.[242]

Ofcom's assessment

6.72 We have reviewed the issues associated with consumables and surcharges and considered whether additional regulation is required. In both cases, we consider that the issues involve complex operational matters and that, although there is evidence of friction between Royal Mail and its customers, there is no evidence to suggest that these terms and conditions are unfair and unreasonable at this point. There is also evidence that industry discussion is progressing towards a solution in some of these areas. For example, Royal Mail has informed us that a Tray Supply Industry Forum has been set up to address the concerns associated with consumables. In our view this is an appropriate way to seek to resolve these issues.[243]

6.73 To the extent that there is evidence that Royal Mail is seeking to impose unfair or unreasonable terms and conditions relating to surcharges or consumables, we consider this would be covered by existing regulation. The USPA Conditions require Royal Mail to provide access services on fair and reasonable terms and we could therefore intervene if Royal Mail was failing to meet this requirement. We note that in the March 2012 Statement, Ofcom provided guidance which indicated that in considering whether a surcharge was fair and reasonable it would have regard to issues of transparency and proportionality, including whether the surcharges "*have regard to the additional costs incurred by Royal Mail*."[244]

Non-price issues – equivalence

6.74 A number of stakeholders have raised concerns about differences in the wholesale terms offered to third parties compared to those offered to Royal Mail's own retail business. We have reviewed the specific issues raised and identified a number of key concerns which are considered in more detail below:

- the new access product request system and, in particular, concerns that access customers are unable to access wholesale inputs used by Royal Mail's retail products;

[239] See responses to the July 2015 Discussion Document: UK Mail, page 10; Whistl, page 12.
[240] See responses to the July 2015 Discussion Document: RBS, page 4; Secured Mail, page 6.
[241] See responses to the July 2015 Discussion Document: UK Mail, page 6; Secured Mail, page 6.
[242] See UK Mail's response to the July 2015 Discussion Document, page 10.
[243] Letter from Royal Mail to Ofcom dated 11 March 2016.
[244] March 2012 Statement, page 151, paragraph 10.67.

- a lack of equivalence in basic operational matters which gives Royal Mail's retail products an inherent advantage; and
- concerns about recent moves by Royal Mail to gather more information about the retail customers of wholesale operators and potentially to use this information for its own commercial ends.

New access product request process

Stakeholder concerns

6.75 Stakeholders have suggested that Royal Mail's process for considering requests for new product development is difficult and that there are inconsistencies with Royal Mail's approach to developing new wholesale inputs for its own retail products. Stakeholders noted that in their experience Royal Mail had demonstrated a reluctant or slow approach in responding to wholesale customer requests.[245]

6.76 These concerns were particularly acute where there appeared to be a difference in approach between new access products and new retail offerings from Royal Mail. In one example associated with the Scottish Independence Referendum we understand that Royal Mail launched a new retail election mail product which involved a new wholesale input that was not at the time offered through access. Upon enquiry, wholesale customers were advised to go through the new product request process which would be conducted as a standard request, including a requirement to provide an indemnity associated with the costs of operating the new service. We understand that, as a result of the timing and costs associated with this process, the stakeholder elected not to proceed.[246]

6.77 Royal Mail argued that its own success is directly linked to the success of access operators and its product development activity is very much driven by customer needs through both formal and informal means. Royal Mail noted that it sets out its formal process for responding to customer requests and that it is well understood and well used, and has resulted in a number of new products. Royal Mail also outlined informal development of products and services via industry representative groups. For example a change to the information included in Mailmark customer reports was a result of discussions with industry.[247]

Ofcom's assessment

6.78 A number of stakeholders expressed concerns about Royal Mail's engagement in discussions about new access products.

6.79 To the extent that there are concerns Royal Mail has favoured in its own retail business in the development of new products compared with the development of new access products and that this was found to be unduly discriminatory, we consider this would be covered by USPA Condition 5 which requires Royal Mail not to unduly discriminate in the provision of access.

[245] See responses to the July 2015 Discussion Document: MCF, page 7; Whistl, page 9.
[246] [✂].
[247] Royal Mail, *Clarifications in response to stakeholders submissions to the Ofcom Fundamental Review of the Regulation of Royal Mail* (non-confidential version), 19 November 2015, pages 8-10.

6.80 Under USPA 2, Royal Mail is obliged to offer D+2 Access services upon reasonable request and as soon as is reasonably practicable. This may include requests for D+2 Access associated with particular features of wholesale inputs that are used by Royal Mail to provide retail products. Under USPA 4, Royal Mail is required to publish a Statement of Process which it must apply in considering new requests for access and changes to the current access terms and conditions. This process sets out the terms on which Royal Mail will design and implement new wholesale access products.

6.81 The present regulation provides Royal Mail with flexibility on the design of the Statement of Process and in particular the time scales in which requests must be handled. Royal Mail's current processes require it to aim to handle requests within three months.[248] In 2012 we said that we would "*expect that the Statement of Process would have regard to the complexity of the access request when setting timings for offering the terms of access*".[249] In our view an important factor associated with the complexity of a request is whether Royal Mail already offers an equivalent retail product.

6.82 In these circumstances, the evidence presented to us suggests that there may be cases where Royal Mail is handling requests for some access products in a manner which is not sufficiently responsive to the needs of access operators due to the timescales involved in processing the requests. We consider that it should be possible for Royal Mail to process access requests more quickly where it already offers an equivalent retail product. This would be more responsive to the needs of access customers and would help ensure that they are not disadvantaged in seeking to offer their own retail services to their customers (particularly as there is no requirement on Royal Mail to provide access equivalents for its relevant retail bulk mail products).

6.83 Royal Mail is required to apply its statement of process to all new access product requests and it is important that this statement provides a transparent and effective platform for all such requests. The development of new wholesale products is clearly a complex operational matter. We said in March 2012 when we introduced the relevant condition that Royal Mail's statement should specify details of the process such as the timings of the different stages and the information required from access operators. We remain of the view that it is important for Royal Mail and the industry to determine how best to deal with new access requests. We therefore do not consider that it is appropriate to impose a revised Statement of Process on the industry, nor to specify in detail how the process should apply.

6.84 However, we are concerned that Royal Mail does not currently face sufficient incentives to process requests for access in as timely a manner as possible in order to meet the reasonable needs of access operators, particularly in circumstances where it may be possible to process requests more quickly. We therefore propose to amend USPA 4 to require Royal Mail to process a request for D+2 Access in relation to which it already offers an equivalent retail product within a six week time period. In our view, this strikes an appropriate balance between ensuring that Royal Mail has sufficient time to process a request for D+2 Access while also ensuring that the process is sufficiently timely and responsive to the needs of access customers, particularly where they wish to introduce a time-sensitive product that Royal Mail is already offering through its retail services.

[248] See Royal Mail's website, https://www.royalmailwholesale.com/new-service-development/.
[249] See the March 2012 Statement, paragraph 10.71.

6.85 Further details on the drafting of the proposed amendments to USPA 4 are set out in the Notification at Annex 12.

6.86 We consider that this will satisfy the relevant legal test for modifying USPA 4 (as set out in paragraph 1 of Schedule 6 to the PSA 2011) in that:

- it is objectively justifiable because it strengthens safeguards that we consider to be important in the regulation of access (specifically by ensuring that access operators can request D+2 Access in a reasonable timescale that reflects the circumstances of the request thereby advancing the objective of equivalence);
- it does not unduly discriminate against Royal Mail because it reflects Royal Mail's position as the only postal operator with a downstream delivery network capable of facilitating participation by access operators in the relevant markets;
- it is proportionate in what it is intended to achieve because we consider the regulation associated with the D+2 Access request process is the minimum necessary to safeguard the provision of access and ensure the benefits of access competition can be achieved;
- our proposals transparently set out a requirement for Royal Mail to process a request for D+2 Access where it already offers an equivalent retail product within a six week time period.

Non-equivalence in operational practice

Stakeholder concerns

6.87 A number of stakeholders identified areas of non-equivalence in some of the key operational interfaces with Royal Mail. One example identified a difference in approach to testing mail items for compliance with it bulk mail and access specifications – specifically Royal Mail tested its own retail customers at its regional distribution centres whereas access operators were tested at the IMC (which occurs later in the process and after the contents of a packet may have moved in transit). This means that the same item could potentially pass Royal Mail's retail compliance test but fail its access compliance test. This may give rise to additional reversion costs for access operators and their customers.[250]

6.88 Other examples included limits imposed on access operators' use of facilities at the IMC. This includes access operators having specific limited arrival timeslots at which to handover mailing items with a requirement to pre-advise details of vehicle, driver, and contents, whereas Royal Mail's retail products are not subject to such restrictions. There was also a suggestion that superior facilities were in some cases provided to Royal Mail's retail business that enabled it to use larger and more efficient vehicles.[251]

6.89 Several stakeholders stated that access to Royal Mail's network needs to be transparent, non-discriminatory and on equal terms. In order to achieve this it was suggested that all customers, including Royal Mail's retail business, should access the network on the same arm's length published terms.[252] Stakeholders also

[250] [✂].
[251] [✂].
[252] See Whistl's response to the July 2015 Discussion Document, page 2.

suggested that it may be necessary to structurally separate Royal Mail's retail activities or its mail centre and delivery office network.[253]

Ofcom's assessment

6.90 In the March 2012 Statement, our approach to concerns about equivalence was to align those concerns to the concept of requiring Royal Mail to not unduly discriminate in the provision of access services. This approach enabled us to focus on areas of difference in treatment which could give rise to harmful outcomes. The no undue discrimination obligations are currently set out in USPA 5.

6.91 A number of stakeholders proposed structural remedies to separate Royal Mail's bulk retail business from its wholesale access business. In the present circumstances, we consider current regulation to be suitable to address the risks of non-equivalence; we do not consider that it is necessary to consider vertical separation further. In our view it continues to be appropriate to pursue the objective of equivalence by maintaining regulation to prevent undue discrimination by Royal Mail.

6.92 With regards to concerns over different operational access facilities and processes to test compliance with product specifications, both of these issues concern detailed operational matters and reflect what may be to some degree unavoidable operational friction. We have however not seen any evidence to suggest that Royal Mail is presently acting in an unduly discriminatory manner or in a way so as to cause access operators harm as a result. However, in our view, in the event there was evidence that non-equivalence in Royal Mail's operational practices was causing harm to access operators, this could be addressed by existing regulation. We do not consider that it would be necessary, proportionate or effective for Ofcom to introduce any more detailed regulation relating to such operational issues.

Concerns about misuse of data

Stakeholder concerns

6.93 Stakeholders expressed concerns about the additional confidential information that Royal Mail will have access to as a result of its Mailmark product, which includes more granular information on mail use by retail customers. Wholesale operators were also concerned that every end-user of Mailmark (i.e. the sender) must sign up to Royal Mail's Participant terms and conditions and provide a contact point for Royal Mail in the end-user company. There is concern that this means access operators cannot maintain confidentiality of their customer base and that Royal Mail is seeking inappropriately to build relationships with the retail customers of access operators.[254]

Ofcom's assessment

6.94 USPA 5.3 requires Royal Mail to use all reasonable endeavours to secure that no information it possesses as a result of providing access is disclosed to, or used by, any trading business of Royal Mail or associated with Royal Mail. This includes both Royal Mail's retail business and its wholesale business. This means, for example, that use of information gathered through its access services to attract the retail

[253] See responses to the July 2015 Discussion Document: Whistl, page 2; UK Mail, page 6; CFH, page 9.
[254] See UK Mail's response to the July 2015 Discussion Document, page 10 (informed by further discussions with UK Mail).

customers of access operators directly as wholesale or retail customers is not allowed. Any misuse of such information would be a serious matter. However, there is no evidence that Royal Mail has misused information although it appears that as a result of product innovation, in particular as a result of Mailmark, it is gathering more extensive and potentially higher risk information. In our view, however, concerns over the use of such information to Royal Mail's commercial advantage are already addressed by the existing regulation.

Scope of access

Stakeholder concerns

6.95 The current access regulation under the USPA Condition obliges Royal Mail to offer access to its network for D+2 and later letter and large letter services. In the July 2015 Discussion Document, some operators requested that additional forms of access be mandated. Stakeholders requested for access to be extended to include, among other suggestions:

- D+1;[255]
- large letters over 750g and tracked and untracked small parcels and packets at least up to 2kg;[256]
- unaddressed mail;[257] and
- access at more points of Royal Mail's network than the IMC, including upstream collection through the post box network, Post Office counters network[258] and access to the Outward Mail Centres (OMC).[259]

6.96 Whistl considered that the scope of access should be extended to create upstream competition in products where it argued Royal Mail does not face any constraint on its pricing and non-pricing behaviour. For example, Whistl believed there is no competition below 1.5kg for tracked parcel services and no competition below 2kg for untracked parcel delivery.[260] Whistl further argued that access to a tracked parcel service would provide greater choice for customers, better customer service and service innovation in a growing area of the market.[261]

6.97 The MCF similarly called for access requirements to be extended to items up to 2kg, arguing that extending the scope of mandated access would allow access operators (and other competitors) to offer consumers more choice while maintaining the financing of the universal postal service.[262]

[255] See responses to the July 2015 Discussion Document: CFH, page 9; Secured Mail, page 6; Whistl, page 1.
[256] See responses to the July 2015 Discussion Document: MCF, page 7; Mail Users Association, page 2; Whistl, pages 1 and 12.
[257] See Whistl's response to the July 2015 Discussion Document, page 1.
[258] See Whistl's response to the July 2015 Discussion Document, page 13.
[259] See responses to the July 2015 Discussion Document: MUA, page 2; Secured Mail, page 6; Whistl, page 15.
[260] See Whistl's response to the July 2015 Discussion Document, page 13.
[261] See Whistl's response to the July 2015 Discussion Document, page 13.
[262] See MCF's response to the July 2015 Discussion Document, page 7.

6.98 Whistl specifically mentioned that Royal Mail had been slow and obstructive in offering terms for new parcel services in access. Whistl expressed concern that Royal Mail has an inherent preference to secure parcels only through its own retail – rather than the wholesale – channel. Whistl argued that this is why regulatory intervention in the form of mandating and regulating parcel access is needed.[263]

Ofcom's assessment

6.99 Under the PSA 2011, we cannot impose a condition requiring access to the universal service provider's network unless it appears that a condition is appropriate for each of the following purposes:

- promoting efficiency;
- promoting effective competition; and
- conferring significant benefits on the users of postal services.[264]

6.100 In assessing the need for a USP access condition requiring Royal Mail to offer access in relation to additional services or at a different point in its network, these legal tests will need to be satisfied in each case. We have previously explained that, before Ofcom undertakes an assessment of whether the tests are met, we would expect to receive detailed evidence from access seekers supporting the case for imposing a USP access condition,[265] including the following information:

a) the access seeker's business case for the proposed form of access;

b) a description of the perceived operational requirements of the proposed form of access; and

c) an assessment of how the form of access meets the tests set out in the Act. In addition, an assessment of how this form of access will be consistent with Ofcom's primary duty to secure the provision of the universal postal service.

6.101 We would also take into account the impact on competition in the relevant market when assessing a request for additional forms of access.

6.102 We have not currently received from stakeholders sufficient information on these points in order to progress an assessment of whether the tests in the PSA 2011 are met in relation to imposing additional forms for access other than D+2 Access letters and large letters. Ofcom remains open to considering requests to expand access however we would emphasise that this requires a sufficient degree of evidence to meet the legal threshold for imposing an access condition.

[263] See Whistl's response to the July 2015 Discussion Document, page 9.
[264] Section 38(4).
[265] See the October 2011 Consultation, Annex 7, paragraph 2.5 and the March 2012 Statement, paragraph 10.212.

Section 7

Options for Deregulation

Introduction

7.1 Under section 6 of the CA 2003, we have a duty to keep our functions under review with a view to securing that regulation does not impose or maintain unnecessary burdens. We have therefore considered whether the regulatory conditions imposed under the PSA 2011[266] remain relevant and appropriate.

7.2 We have aimed to ensure that our regulation is focused on the most relevant postal operators and postal items by considering whether the scope of the conditions remains appropriate, and we have set out proposals for removing regulatory burdens where we no longer consider that they are necessary in order to achieve our regulatory objectives. Following our review, we are proposing changes to the following conditions:

- Consumer Protection Conditions 2, 3, and 5;
- Essential Condition 1; and
- DUSP 1.10.[267]

Background to the regulatory conditions

7.3 We have imposed a total of 12 regulatory conditions on the postal industry. These are set out in Figure 7.1 below.

Figure 7.1: Brief description of regulatory conditions imposed by Ofcom on the postal sector

Condition	Overview of purpose
Designated Universal Service Provider (DUSP) Condition 1	Requires the universal service provider (USP) to provide the universal service as set out in the Universal Service Order, including quality of service and notification obligations.
DUSP 2	Sets a safeguard cap on Second Class stamp prices for 'standard letters'.[268]
DUSP 3	Sets a safeguard cap in relation to a basket of Second Class stamp 'large letters'[269] and parcels up to 2kg.
USP Access Condition (USPA)	Requires the USP to offer access to its network at its Inward Mail Centres (IMCs) for D+2 or later letters and large letters.

[266] All of the current regulatory conditions imposed by Ofcom can be found at: http://stakeholders.ofcom.org.uk/post/conditions/.
[267] DUSP 1 requires the universal service provider to provide the services included in the Universal Service Order. The changes we are proposing do not relate to those services, but relate instead to notification requirements. See paragraph 7.94 onwards for the full discussion.
[268] As defined in DUSP 2.1.2(f).
[269] As defined in DUSP 3.1.2(c).

USP Accounting Condition (USPAC)	Requires the USP to maintain accounting separation, costing methodologies and regulatory financial reporting.[270]
Notification Condition	Requires any postal operator to notify Ofcom three months in advance if they are intending to enter or expand end-to-end letter delivery operations (by a minimum of 2.5m items per quarter).
Essential Condition 1	Requires 'regulated postal operators'[271] to put in place processes that protect the integrity of mail, with regards to minimising its exposure to interference, damage, theft or loss.
Consumer Protection Condition (CP) 1	Requires regulated postal operators to make payments relating to qualifying consumer expenses[272] incurred by the Consumer Advocacy Bodies (i.e. Citizens Advice, Citizens Advice Scotland and The Consumer Council) with regards to their functions relating to postal services.
CP 2	Requires regulated postal operators to comply with rules (called Postal Common Operational Procedures, or PCOP) that aim to ensure there are processes in place to return mis-directed or mis-collected mail to the intended operator.
CP 3	Requires all postal operators to have a complaints handling procedure in place, and imposes additional requirements on regulated postal operators, including the need to be a member of a redress scheme.
CP 4	Requires the USP to offer compensation for universal service products.
CP 5	Requires a regulated postal operator to deliver mail it receives in the course of operating its business as a postal operator.

Summary of current review

7.4 Following our review of regulatory conditions, we are proposing changes to CP 2, CP 3, Essential Condition 1 and DUSP 1.10. We also propose to revoke CP 5 as we no longer consider this obligation is required.

7.5 We do not discuss DUSP 2 or 3 because, as set out in Sections 4 and 5, we consider these conditions remain appropriate. Our proposals to amend the USPA Condition are set out in Section 6 above and we also do not discuss this further here. We also do not propose any amendments to the other conditions for the following reasons:

[270] In addition, we have also imposed Regulatory Accounting Guidelines (RAG) through a direction under the USPAC condition in accordance with section 53 of, and paragraph 4 of Schedule 6 to the PSA 2011. See http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex11.pdf.
[271] See discussion on definition of regulated postal operator below from paragraph 7.7 onwards.
[272] As defined in section 51(4) of the PSA 2011.

- **CP 1** – we intend to reconsider this condition alongside a review of our Statement of Charging Principles for Postal Services[273] to ensure that there is greater alignment between the two.

- **CP 4** – we did not receive any stakeholder comments suggesting changes to this condition were required and continue to consider the scope of this condition remains appropriate.

- **Notification Condition 1** – we were directed by the Secretary of State to impose this condition on all postal operators and therefore unless this direction ceases to apply, we are required to retain this condition.

- **USPAC** – we intend to consider possible amendments to this condition in a separate consultation, which we currently expect to publish later in 2016.

7.6 In carrying out this review, we have taken into account stakeholder comments concerning the regulatory conditions in response to the July 2015 Discussion Document. In addition, we have also taken into account the comments received in response to our call for inputs in 2013 (the "**2013 Codes of Practice CFI**").[274] This call for inputs asked for stakeholders' views on the Mail Integrity Code of Practice (MICOP) set under Essential Condition 1 and PCOP set under CP 2.

Review of the regulatory conditions

Current scope of CP 2, CP 3 and Essential Condition 1

7.7 The scope of application of CP 2, CP 3 and Essential Condition 1 is currently defined by reference to a definition of "regulated postal operator", which is intended to limit their scope to a specific set of postal operators and postal services.

7.8 At the time these conditions were introduced in March 2012, the definition was intended to capture those postal operators who were already subject to similar requirements under the previous Postcomm licensing regime.

7.9 Consequently, in each of these conditions,[275] a "Regulated Postal Operator" is defined as:

> "a postal operator which provides services in relation to which, had those services been carried out prior to the Appointed Day,[276] it would have been required to hold a licence under the Postal Services Act 2000."

7.10 Furthermore, the scope of the licensing regime under the PSA 2000 was defined in relation to price and weight thresholds which no longer relate to the relevant products in the current market. Under the PSA 2000 licences were required only for postal operators delivering postal items that (i) cost less than £1 to deliver and (ii) weighed

[273] See Ofcom's *Statement of Charging Principles - Postal Services*, 28 March 2012, http://stakeholders.ofcom.org.uk/binaries/consultations/post-socp/statement/socp-post-statement.pdf.
[274] See Ofcom's *Review: Mail Integrity and Postal Common Operational Procedures Call for inputs*, 28 February 2013, http://stakeholders.ofcom.org.uk/consultations/mail-integrity/.
[275] We note that the same definition of "regulated postal operator" is also used in CP 1. We are not however proposing any changes to CP 1 at this time for the reasons set out in paragraph 7.5 above.
[276] 1 October 2011.

less than 350g. As can be seen from Figure 7.2, the "regulated postal operator" definition would only capture Royal Mail's letters and large letters up to 100g on the price threshold, and the weight threshold of 350g does not match any of Royal Mail's weight-steps.

Figure 7.2: Royal Mail letter and large letter prices and weights (from 29 March 2016)

	Weight	1st Class	2nd Class
Letter[277]	Up to 100g	64p	55p
Large Letter[278]	Up to 100g	96p	75p
	Up to 250g	£1.27	£1.20
	Up to 500g	£1.71	£1.54
	Up to 750g	£2.46	£2.09

Note: The cells highlighted in red show products which do not fall within the scope of the current definition of a regulated postal operator.
Source: Royal Mail website, http://www.royalmail.com/sites/default/files/RoyalMail_2016_Prices.pdf, accessed 29 February 2016.

7.11 In response to the July 2015 Discussion Document, some stakeholders argued that this definition and the scope of those conditions should be updated:

- In their joint response, the Communications Consumer Panel (CCP) and the Advisory Committee on Older and Disabled People (ACOD) suggested that Ofcom should review the definition of a regulated postal operator. They said that "clearer, more meaningful terminology will make it easier for consumers to understand their rights and how to assert them".[279]

- Royal Mail said that Ofcom should update the definition of a regulated postal operator to "reflect market realities." It said "Ofcom should apply the same minimum set of consumer protections to all items posted – letters and parcels – to ensure all consumers receive a consistent service in which they can have confidence."[280] Royal Mail also said that there were varying levels of regulatory burden for different operators;[281] and that Ofcom should consider "reducing the length and volume of regulatory notification and consultation periods and streamlining burdensome regulatory reporting requirements."[282]

- CWU said that regulation on consumer protection "should be levelled up across the postal sector as a whole, but particularly in the parcels sector", although it also said that "any move towards deregulation must not compromise protection for postal users in terms of the scope or the quality of postal services".[283]

7.12 In relation to Essential Condition 1 and the Mail Integrity Code of Practice (MICOP) specifically:

[277] "Letter" means any item up to length 240mm, width 165mm, thickness 5mm, and weighing no more than 100g.
[278] "Large letter" means any item larger than a letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.
[279] See The Communications Consumer Panel (CCP) and the Advisory Committee on Older and Disabled People (ACOD)'s response to the July 2015 Discussion Document, page 1.
[280] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.17.
[281] For example, see Royal Mail's response to the July 2015 Discussion Document, paragraph 5.18.
[282] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.40.
[283] See CWU's response to the July 2015 Discussion Document, paragraph 77.

- In response to the 2013 Codes of Practice CFI, Royal Mail,[284] CWU,[285] [✂][286] and Consumer Futures[287] (formerly known as Consumer Focus)[288] said that the scope of the regulation should cover access mail as well as end-to-end delivered items. However, DX,[289] Whistl[290] (formerly TNT Post UK) and UK Mail[291] disagreed, saying that access operators operate to appropriate standards, are accountable to their customers, and there was no evidence of a mail integrity problem with access mail.

- In response to the July 2015 Discussion Document, Royal Mail and CWU called for Essential Condition 1 to be extended to all postal operators, including parcel operators. Royal Mail said "the Mail Integrity Code of Practice does not apply to most parcel operators. We believe it should. Consumers need a service they can rely on, whichever operator they choose."[292] CWU said "Ofcom should also extend the Mails Integrity Code so that it applies to parcels as well as letters in order to ensure the same basic standards apply to the whole parcels industry and to protect all consumers."[293]

7.13 In relation to CP 2 and the Postal Common Operational Procedures (PCOP) Code of Practice, both Royal Mail and CWU stated in response to the 2013 Codes of Practice CFI that the requirements should be extended to a wider range of postal operators,[294, 295] although Royal Mail considered that it would be unnecessary to cover parcel operators.[296]

7.14 We agree with stakeholders that there needs to be greater clarity as to the scope of Essential Condition 1, CP 2 and CP 3. We consider that it is not appropriate to refer to the scope of the obsolete Postcomm licensing regime, and we consider that it would be preferable to more clearly define the scope of these conditions by reference to the categories of postal operators and postal services which we think should be captured in order to meet the relevant regulatory objectives of the conditions.

7.15 Below we consider the scope of each condition in turn, and where we have identified a potential for change, we also considered whether there is the potential for a removal of or reduction in regulatory burden. We also set out our proposals for change below.

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[284] See Royal Mail's response to the MICOP section of 2013 Codes of Practice CFI, paragraph 6.
[285] See CWU's response to the 2013 Codes of Practice CFI, paragraph 5.
[286] [✂].
[287] See Consumer Futures (formerly Consumer Focus)'s response to the 2013 Codes of Practice CFI, page 2.
[288] Consumer Futures was a Non-Departmental Public Body that represented consumers in a number of essential markets subject to economic regulation, including postal services, among others. Consumer Futures was abolished on 1 April 2014, with all of its functions transferred to other bodies including Citizens Advice, Citizens Advice Scotland and General Consumer Council for Northern Ireland.
[289] For example, see DX's response to the 2013 Codes of Practice CFI, page 2.
[290] See Whistl (formerly TNT Post UK)'s response to the 2013 Codes of Practice CFI, page 2.
[291] For example, see UK Mail's response to the 2013 Codes of Practice CFI, pages 1 and 3.
[292] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.39.
[293] See CWU's response to the 2015 Discussion Document, paragraph 18.
[294] See CWU's response to the 2013 Codes of Practice CFI, paragraph 7.
[295] For example, see Royal Mail's PCOP response to the 2013 Codes of Practice CFI, paragraph 7.
[296] For example, see Royal Mail's PCOP response to the 2013 Codes of Practice CFI, paragraph 26 and page 13.

Essential Condition 1

7.16 Essential Condition 1 is intended to ensure regulated postal operators take appropriate steps to protect the integrity of mail. This means minimising the exposure of the relevant mail items to loss, damage, theft or interference.

7.17 Currently, Essential Condition 1 (imposed by Ofcom in March 2012) requires regulated postal operators to comply with the Mail Integrity Code of Practice (MICOP) which is annexed to the condition.[297] As explained above, this obligation currently applies to postal items conveyed by regulated postal operators that (i) cost less than £1 to deliver and (ii) weigh less than 350g. In practice, this means that it applies to letter and most large letters services, but does not capture access operators (as they were not required to be licensed by Postcomm) and does not capture express or secured services (by which we mean those which have a tracking facility or which guarantee delivery by a particular time or date, such as those sent by courier companies).[298] It also applies to Royal Mail's universal service products, including its universal service parcel products.

7.18 We have reviewed whether Essential Condition 1 and the related MICOP remain proportionate and fit-for-purpose, including whether it applies to the most appropriate types of mail and operators, i.e. the scope of Essential Condition 1.

7.19 There may be strong incentives for postal operators to take mail integrity seriously. Under the PSA 2000, it is a criminal offence for any postal operator (section 83) or person (section 84) to interfere with the mail. However the threshold for prosecuting such cases is high, and therefore the possibility of such action may not, of itself, provide a sufficient incentive to put in place appropriate preventative steps to minimise the risk of mail integrity events occurring in the first place, which is the objective of Essential Condition 1.

7.20 Users should be able to expect their mail to arrive without it being lost, stolen or interfered with, and should therefore in turn, have confidence in using those postal services. We continue to consider that Essential Condition 1 is necessary as it provides an incentive to relevant postal operators to safeguard mail in their care and to ensure preventative measures are in place, as non-compliance can potentially result in enforcement, including a financial penalty from Ofcom. No stakeholder has suggested that Essential Condition 1 should be removed altogether.

7.21 The key purpose of the mail integrity obligations contained in Essential Condition 1 is to protect those items which do not have additional protection (such as tracking which allows postal users to monitor the location of their mail) or where operators are not incentivised to protect the integrity of the mail (i.e. where the threat of losing customers to other operators means that operators are incentivised to ensure they provide a high quality of service and low level of mail integrity issues to ensure customer retention and/or attraction). While these postal items may not have contents that justify the additional cost of tracking or insurance, they can contain personal and confidential information, for example, bank or credit card details,

[297] Essential Condition 1 and the MICOP can be found at: http://stakeholders.ofcom.org.uk/binaries/post120713/essential.pdf.

[298] Express and secured service means a service involving the conveyance of postal packets and any incidental services of collecting, sorting and delivering those postal packets which have at least one of the following features: (i) a guarantee for delivery by a certain time or date; (ii) a facility enabling the sender and the recipient to monitor the progress of a postal packet through the postal operator's network, including confirmation of delivery.

medical appointments, tax information, etc. It is essential that consumers feel confident in using the postal service for such items and the purpose of Essential Condition 1 is to provide such confidence.

7.22 We therefore consider that it is important that Essential Condition 1 continues to include letter and large letter mail. In order to accurately capture letter and large letter mail, we propose to remove the definition of 'regulated postal operator' and 'regulated postal service' and replace them with the new terms 'relevant postal operator' and 'relevant postal service'.

7.23 We propose to use the weights and dimensions of Royal Mail's large letters products to define the type of mail which would be captured by the mail integrity obligations – in other words, it would capture all postal packets up to the maximum dimensions and weight of Royal Mail's large letter products.[299] We recognise that by using definitions which refer to the dimensions employed by only one operator (in this case, Royal Mail), there is a risk that these may not directly map onto the products offered by all operators. However, the dimensions of letters and large letters are used commonly among postal operators in order to ensure consistency for postal users and postal networks and are the most appropriate dimensions and weights in order to capture the letter and large letter items which we consider should be in scope for the reasons set out above.

7.24 Where consumers want to send valuable items, there are various options above and beyond basic letter services. For example, even within the universal service, consumers can use Royal Mail's Special Delivery Next Day service which includes tracking and insurance; or request proof of sending and delivery (Certificate of Posting and Royal Mail Signed For). Express and secured mail companies also offer tracked services. For closed user group networks and document exchange mail,[300] as it is sent through a private network between two or more places, it is unlikely that the mail being handled will go missing. The risk of mail integrity issues arising in these networks is therefore minimal. Consequently, we do not consider it necessary for the mail integrity regulations to cover express and secured mail, closed user group network mail or document exchange mail, and have therefore excluded these services from the definition of relevant postal service for the purposes of this condition.

7.25 There are also a number of other types of mail, which are currently excluded from scope of the definition of a 'regulated postal operator' (on the basis that a licence for conveyance of these items was not required under the PSA 2000), which may otherwise fall within the proposed scope of the revised Essential Condition 1 which we continue to consider should be excluded from its scope. These include, for example, Christmas cards delivered by charities. We have therefore included specific exclusions of these items from the scope of the proposed definition of a 'relevant postal service'.

[299] "Large letter" means any item larger than a letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.

[300] Closed user group network means a system providing for the conveyance of postal packets (and the incidental services of receiving, collecting, sorting and delivering postal packets) between: (i) the premises of one firm and another firm: (ii) a government department and a third party firm; (iii) branches and/or units in the same firm; or (iv) government departments, where both the sender and the recipient of the postal packets have entered into specific arrangements with the postal operator for the conveyance of postal packets to or from other members of that system, which, for the avoidance of doubt, includes a document exchange.

7.26 Further, we do not consider that it is necessary for the mail integrity obligations to cover access mail. Since taking responsibility for postal regulation in 2011, we have received very low numbers of mail integrity complaints relating to access mail,[301] despite the fact that access operators handle over half (56%) of all letter volumes.[302] Furthermore, there are a number of reasons to believe that mail integrity issues are less likely to arise in respect of access mail:

- the contractual requirements of bulk senders (and the threat of that contract being terminated due to poor quality of service or reputation concerns if there were any mail integrity issues);
- the level of competition in the bulk mail market between access operators and Royal Mail; and
- the fact that access operators do not deliver mail to end recipients, which is where mail integrity issues are more likely to occur compared to the collection and sortation process (where mail is more closely monitored within a contained environment).

7.27 Taking all of those factors into account, we do not consider that it would be proportionate to extend the scope of the mail integrity obligations to cover access operators and have drafted the amended condition so as to continue to exclude access mail from the definition of relevant postal service.

Should Essential Condition 1 be extended to cover parcels?

7.28 In their responses to the July 2015 Discussion Document Royal Mail and CWU suggested that the mail integrity regulations should be extended to cover parcels.[303] However, neither Royal Mail nor CWU provided evidence to identify a consumer need for further regulation.

7.29 In 2015, we gathered information on mail integrity complaints from six of the largest parcel operators.[304] We found that during 2014 the mean level of mail integrity complaints was 0.087% of total items conveyed[305] (see Figure 7.3). This represents a very low percentage.

[301] Between April 2015 and April 2016, we received 26 complaints in relation to mail integrity, of which one related to an access operator. No complaints were received in relation to regulated postal operators other than Royal Mail.
[302] Annual Monitoring Update on the Postal Market 2014-15, Ofcom, paragraph 4.36 http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.
[303] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.39; and CWU's response to the 2015 Discussion Document, paragraph 18.
[304] We asked parcel operators with a revenue market share of more than 4% to provide us with total number of items conveyed between 1 January – 31 December 2014, and the total number of mail integrity complaints received during that time. We considered that operators with shares above this level would provide a sufficient and usefully representative sample for our analysis.
[305] We asked postal operators to provide details on postal items defined as "an individual postal item that can be delivered by a single employee without the aid of specialist equipment such as a lift truck, pallet truck or truck with hydraulic lift and which weighs no more than 35kg".

Figure 7.3: Total mail integrity complaints per item conveyed (January – December 2014)

Overall	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	Total
Total number of items conveyed	[✂]	[✂][306]	[✂]	[✂]	[✂]	[✂]	660.2m
Total number of complaints received in relation to mail integrity issues	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	574,212
Percentage of items generating complaints	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	0.087%

Note: Figures have been rounded in the row entitled 'Total number of items conveyed'.

7.30 In addition, we note that:

- given the increasingly competitive nature of all parts of the parcels sector, consumers (including major online retailers) have a choice of supplier and parcel operators an incentive to maintain all aspects of quality of service;
- parcels are often tracked and are therefore less at risk of being lost or stolen;
- parcels are often expected by the recipient and, therefore, non-arrival is more likely to be noticed than, for example, transactional letter mail (such as bank statements) or advertising mail; and
- where the parcel delivery is fulfilling an online order, the receiving consumer is protected by consumer legislation and the retailer is liable until the parcel is safely in the recipients' hands.

7.31 Taking all of the above factors into account, we do not consider it necessary to extend Essential Condition 1 to cover parcel operators. The factors set out above should ensure that parcel operators are sufficiently incentivised to ensure that mail integrity issues do not arise and, where they do, to provide suitable redress for their customers.

7.32 We note, however, that Royal Mail's universal service parcels are currently covered by the mail integrity regulation. We have therefore considered whether it would be appropriate to exclude Royal Mail's single piece universal service parcels from the scope of the mail integrity obligations.

7.33 We consider that there are some important differences between Royal Mail's single piece universal service parcels and the parcel services of other operators and Royal Mail's and Parcelforce's non-universal service parcel products. In particular, the

[306] [✂].

significant majority of Royal Mail's universal service parcels are untracked and, as discussed in Sections 4 and 5 above, these parcels are not currently subject to a high level of competition (although competition is beginning to emerge in this area). At this point in time, however, the incentives we have identified in relation to parcel operators more generally would not appear to apply in respect of the universal service parcels products. On balance, we therefore consider that it remains appropriate to include Royal Mail's untracked single piece universal service parcels within the scope of Essential Condition 1 to ensure that the mail integrity objectives are fulfilled in relation to these products. We note in this regard that Royal Mail delivers its untracked single piece universal service parcels over the same network as its untracked letters and large letters which would be subject to the mail integrity obligations in any event and do not therefore consider that this approach would result in any significant additional burden for Royal Mail.

7.34 As a result, we propose that the scope of the Essential Condition should be amended so that it includes end-to-end letter and large letter delivery services and universal service, untracked single piece parcels.

Giving relevant postal operators more flexibility

7.35 We note that, in response to the 2013 Codes of Practice CFI, some stakeholders considered that the current regulation is too prescriptive and potentially overly burdensome. Specifically:

- Around half of respondents to the CFI (DX, Whistl, UK Mail, and Consumer Focus) said that the current level of detail included in MICOP was appropriate. However, Royal Mail [✂] considered that the existing code is too prescriptive, stating that operators should be able to determine their own framework for ensuring that the integrity of mail is upheld.[307, 308]

- In terms of reporting, DX, Consumer Focus and CWU each considered the current reporting requirements appropriate. Whistl recommended that some of the requirements should be removed,[309] and Royal Mail [✂] considered the reporting requirements disproportionate and unfit for purpose.[310, 311]

7.36 We also note that in its response to the July 2015 Discussion Document, Royal Mail highlighted the large number of regulatory reports it is required to submit under the regulatory conditions, and called on Ofcom to reduce its "significant reporting burden".[312] It argued that Ofcom should consider "reducing the length and volume of regulatory notification and consultation periods and streamlining burdensome regulatory reporting requirements."[313]

7.37 We agree that it is appropriate to allow postal operators more flexibility in putting in place procedures to meet the mail integrity objectives given that we expect the postal industry to have a better understanding of how to tailor these procedures to suit the needs of their business. Therefore, we propose to amend the mail integrity

[307] See Royal Mail's response to the MICOP section of the 2013 Codes of Practice CFI, paragraph 10.
[308] [✂].
[309] See TNT Post UK's response to the 2013 Codes of Practice CFI, page 3.
[310] See Royal Mail's response to the MICOP section of the 2013 Codes of Practice CFI, page 6.
[311] [✂].
[312] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.15.
[313] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.40.

obligations to remove the obligation to comply with the prescriptive procedures set out in MICOP. Instead, we propose to amend Essential Condition 1 to include only the following obligations:

- a clear obligation on relevant postal operators to take all necessary steps to minimise the exposure of relevant postal packets to the risk of loss, theft, damage and/or interference and address mail integrity issues promptly when they arise (the "Mail Integrity Objectives");

- an obligation to implement and adhere to appropriate policies and procedures (and review those policies and procedures) to meet those objectives. In designing those policies and procedures a relevant postal operator would need to have regard to the need to ensure that they are proportionate to the scale of the relevant postal services undertaken by the relevant postal operator and the level of risk to mail integrity in relation to the activities concerned. These would need to include procedures/policies relating to:

    - the recruitment of employees;

    - training of relevant employees;

    - staff disciplinary procedures; and

    - ensuring the safe conveyance and security of the mail (in particular relating to the security of relevant premises and delivery vehicles and equipment);

- a streamlined recording and reporting regime that would enable Ofcom to monitor mail integrity performance for all relevant postal operators. This would require all relevant postal operators to:

    - record separately each incident of loss or theft of, damage to, or interference with relevant postal packets as soon as reasonably practicable after becoming aware of the occurrence of such incident, and keep such records for a minimum of three years from the date on which the incident occurred;

    - provide copies of any of those records to Ofcom on request;

    - submit annual reports to Ofcom and the Consumer Advocacy Bodies about the number of mail integrity incidents which occurred during that period, broken down as to whether they were lost, stolen, damaged or interfered with; the total number of prosecutions in connection with mail integrity during that period and a statement of measures the operator intends to take to remedy those failures to achieve the Mail Integrity Objectives and reduce the number of mail integrity incidents. For this requirement, a relevant postal operator is a postal operator which has handled more than 250,000 relevant postal packets in the most recent 12 month period;

- an obligation to ensure, so far as is reasonably possible, that franchisees, agents or sub-contractors involved in handling their mail, comply with the relevant obligations outlined above.

7.38 This approach represents a move away from specifying particular processes in detail, but instead sets out the key elements which we consider necessary for postal operators to incorporate into their own procedures in order to meet the objectives of Essential Condition 1.

7.39 As noted above, we propose to streamline the reporting requirements by removing the requirement to report on serious incidents, moving to annual reports (rather than quarterly reports), and ensuring that only those operators of scale (i.e. those delivering more than 250,000 relevant postal packets) are covered. This should ensure that the condition is not unduly burdensome.

7.40 We also propose that Ofcom would have the ability to direct a relevant postal operator to adopt such policies and procedures or take such steps as we consider necessary for the purposes of facilitating the achievement of the Mail Integrity Objectives. This is in order to ensure that if we identified significant problems with a relevant postal operator's mail integrity policies and procedures, we could intervene as necessary to ensure that relevant steps are taken to address these concerns.

7.41 We consider that the proposals set out above will strengthen the incentives on relevant postal operators to focus on good consumer outcomes for mail integrity, while also providing postal operators with greater flexibility to develop mail integrity processes that are appropriate to their business and particular customers. In our view, the proposals strike the right balance between ensuring the needs of postal users are met and ensuring that regulation is not unduly burdensome on the postal operators.

7.42 In order to make the amendments set out above, we propose to revoke Essential Condition 1 and the annexed MICOP, and to replace it with a new Essential Condition 1 as set out in the statutory notification set out at Annex 13. The detailed drafting of this condition is as set out in the Notification.

Question 7: *Do you agree with our proposal to amend the scope of Essential Condition 1 to cover untracked letter and large letter mail, and single piece universal service parcels, and to remove the remaining universal service products from the scope of the Essential Condition 1?*

Question 8: *Do you agree with the proposed streamlining revisions to Essential Condition 1, including the removal of the Mail Integrity Code of Practice, as drafted in Annex 13?*

Question 9: *Do you agree that the proposed drafting of Essential Condition 1 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?*

Consumer Protection Condition 2

7.43 The purpose of CP 2 is to deal with circumstances where postal items end up in the wrong postal operator's network, and to minimise the risk of mis-posted, misdirected and mis-collected mail not getting to the correct postal operator, sending customer or addressee. Without some form of regulation on operators to co-operate on mis-posted, misdirected and mis-collected mail, there is a risk that such postal items will either be discarded or delayed to the detriment of consumers and recipients.

7.44 Postal items can be mis-posted, misdirected or mis-collected in a number of ways. Mis-collection can occur when a postal operator unintentionally collects postal items that are intended for another operator. Misdirected mail encompasses all mail that ends up in the wrong operators' network (aside from mis-collected mail) including where the receiving customer has posted items that are not for a recipient at their address (i.e. previous occupants) or have been wrongly delivered, into an access point such as a post box (typically entering Royal Mail's network). In addition, mail

can be misdirected by sending customers accidentally mis-posting mail items into the wrong operators' network. This commonly occurs in businesses that use more than one postal operator to send their mail (such as law firms who use a document exchange network as well as sending some mail with Royal Mail). Mis-posted mail can end up in other operators' networks as well as Royal Mail's network.

7.45 The Postal Common Operational Procedures (PCOP) are currently set out in:

- CP 2;
- the Postal Common Operational Procedures Code (the "**PCOP Code**") – a code of practice which is set out at section 3 of CP 2; and
- the Postal Common Operational Procedures Agreement (the "**PCOP Agreement**").[314]

7.46 CP 2 currently requires regulated postal operators to comply with the PCOP Code and to sign up to the PCOP Agreement. The PCOP Agreement, while not part of the regulatory conditions, can only be amended through a direction by Ofcom, and among other things, sets out charges for various elements of the repatriation process.

7.47 We understand from responses to the 2013 Codes of Practice CFI, that some stakeholders believe that the current regulation is inflexible and may not be the most effective way to deal with the issue.[315]

7.48 The majority of respondents to the 2013 Codes of Practice CFI considered that the PCOP Code should remain part of CP 2, as set by Ofcom, rather than be owned and managed by industry operators. For example, DX and Consumer Focus noted that the current arrangements function well and change is not necessary.[316] Whistl said that it was important for Ofcom to remain in charge because the industry did not have a good track record for self-regulation.[317] CWU said that both the PCOP Code and the MICOP should be kept independent of the industry, but did not provide further reasoning to support its view.[318] However, Royal Mail suggested an industry-managed Code and Agreement would be more flexible and more effective, stating that the "one-size-fits-all" approach was not able to keep pace with the rate of change in the postal market.[319]

7.49 With regard to the costs of complying with the PCOP Code, DX expressed concern that the PCOP Code Identifier requirements cause unnecessary costs,[320] and UK Mail suggested that extending the reporting requirements onto access providers

[314] See Consumer Protection Condition 2 and the Postal Common Operational Procedures Code at http://stakeholders.ofcom.org.uk/binaries/post120713/con2.pdf, and the PCOP Agreement at http://stakeholders.ofcom.org.uk/binaries/post120713/Amended_PCOPA_as_at_1_June1.pdf.
[315] See paragraph 7.13 above regarding responses to the 2013 Codes of Practice CFI above.
[316] See DX's response to the 2013 Codes of Practice CFI, page 2; and Consumer Focus' response to the 2013 Codes of Practice CFI, page 2.
[317] See Whistl's response to the 2013 Codes of Practice CFI, page 2.
[318] See CWU's response to the 2013 Codes of Practice CFI, paragraph 4.
[319] See Royal Mail's response to the PCOP section of the 2013 Codes of Practice CFI, page 12.
[320] See DX's response to the 2013 Codes of Practice CFI, page 3.

would result in excessive costs.[321] Royal Mail argued that its compliance costs are disproportionate and that operators should be able to recover handling costs.[322]

7.50 As noted above, Royal Mail also argued that the requirements should be extended to a wider range of postal operators, but considered that it would be unnecessary to extend to them to parcel operators.

7.51 We note that the level of PCOP mail received by Royal Mail is very low, and has decreased recently due to the exit of Whistl from end-to-end letter delivery. The volume of PCOP mail fell by 95% (albeit from a low base) for the six month period between July and December 2015 compared to the same period in 2014-15.[323]

7.52 In light of the fact that the volume of PCOP mail is low, we consider that the current procedures set out in CP 2 may be unduly prescriptive and burdensome. We therefore consider that a more streamlined form of regulation may be equally effective and more proportionate in addressing our objectives.

7.53 We therefore propose to move to a more 'principle-based' approach for CP 2 which would give industry the freedom to put in place arrangements which are most effective for them (which is ultimately a matter best understood by postal operators rather than Ofcom). While we acknowledge the concerns of our stakeholders about having an industry-managed code (see paragraph 7.48 above), we consider that our proposed approach would strike the balance between ensuring that our consumer protection objectives are met, with some oversight from Ofcom in terms of monitoring and enforcement, but allowing industry to put in place practices and procedures which best meet their needs.

7.54 We have considered which postal items and which postal operators need to be subject to the regulatory conditions in order to ensure that the objectives of CP 2 are met.

7.55 As discussed above in paragraph 7.44, the most common way that postal items end up in the wrong network is via an access point (e.g. a post box),[324] or by mistakes at the point of collection (e.g. from a business that uses multiple postal operators). Therefore, we believe CP 2 should apply to those postal items whose size allows them to be put into a post box by a consumer when it has been misdirected, i.e. "letterboxable" items. We consider "letterboxable" items to be letters[325] and large letters.[326]

7.56 Parcels are highly unlikely to end up in the wrong network on the basis that they cannot physically be posted into a post box and therefore cannot enter the wrong network by this route. This view was supported by Royal Mail in response to the 2013

[321] See UK Mail's response to the 2013 Codes of Practice CFI, page 7.
[322] See Royal Mail's PCOP response to the 2013 Codes of Practice CFI, paragraphs 1 and 9.
[323] Ofcom analysis of data provided by Royal Mail dated 12 February 2016 in response to an information request dated 9 February 2016 covering specified information about PCOP letter volumes.
[324] For example, when a person receives mail for a recipient who does not reside at the premises where the mail was delivered and then that mail is put into a post box for redelivery.
[325] "Letters" means any item up to length 240mm, width 165mm, thickness 5mm, and weighing no more than 100g.
[326] "Large letters" means any item larger than a letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.

Codes of Practice CFI.[327] In addition, express and secured mail (both parcels and letters) are also highly unlikely to end up in the wrong network. This is because such services generally include a tracking facility which allows both the sender and recipient to monitor the progress of the mail item across the postal operator's network to the point of delivery (such as Royal Mail's Special Delivery items) or, because they guarantee delivery by a specific time or date. Therefore mis-posting and mis-collection are far less likely to happen. In addition, in the rare occasions that parcel or tracked items do end up in the wrong network, parcel and express operators have said that they have processes in place to ensure the items are returned to the intended operator.

7.57 We therefore propose that the focus of CP 2 should be on untracked letters and large letters, as these are the items which are most likely to enter the wrong network and need to be returned to the intended operator.

7.58 Royal Mail is the universal service provider and the only postal operator with an access point network for letters and large letters (i.e. the post box network). We therefore consider that it is likely that mis-posted letters and large letters which are the responsibility of other postal operators will continue to enter Royal Mail's network on an ongoing basis. In practice, this means that Royal Mail is the most likely to receive mis-directed mail due to its large post box and collection network. Indeed, in 2014-15, Royal Mail received [✂] PCOP items from other regulated postal operators, although as noted at paragraph 7.51 above, this fell considerably in the early part of 2015-16 following Whistl's exit from end-to-end letter delivery.[328] Hence the remaining smaller regulated postal operators[329] appear to generate a very low volume of PCOP mail. Furthermore, as these smaller regulated postal operators do not generally have significant numbers of access points for letters and large letters, they are unlikely to receive a significant amount of PCOP items, if any at all.

7.59 The one exception to this is closed user groups and in particular document exchanges. This mail generally enters Royal Mail's network due to sending customers' mis-posting mail. These errors are reciprocal so that document exchanges also receive mail that was intended for Royal Mail.

7.60 In view of the fact that Royal Mail is currently, and is likely to remain, overwhelmingly the largest recipient of mis-directed mail which needs to be returned to the intended operator, we consider that Royal Mail should be required to put in place appropriate arrangements with other relevant postal operators to ensure that mis-directed and mis-collected untracked letters and large letters are returned to the intended operator or otherwise appropriately dealt with.

[327] Royal Mail for example suggested that as parcels are not "open access" (i.e. cannot be posted into a post box), that they are therefore less likely to enter the network of parcel carriers. Royal Mail therefore argued that CP 2 should not be extended to parcels. See Royal Mail's response to the PCOP section of the 2013 Codes of Practice CFI, paragraph 26.

[328] The figure excludes mail from [✂] because it does not fall under the current definition of a regulated postal operator. Ofcom analysis of data provided in Royal Mail's response of 12 February 2016 to an information request dated 9 February 2016 covering specified information about PCOP letter volumes.

[329] Following Whistl's exit from the end-to-end letter delivery market, the remaining regulated postal operators tend to be smaller, operate in limited geographic areas, and tend to deliver mail for business customers. They include (but are not limited to) Citipost Ltd, CMS, Velopost, Yellow Jersey Delivery and City Cycle Couriers.

7.61 We have also considered whether it is necessary to require other postal operators to enter into specific arrangements to meet the objectives of CP 2. In doing so, we considered two options:

- Imposing a condition which required both Royal Mail and other operators offering untracked letter and large letter services to enter into arrangements to ensure that mis-directed and mis-collected mail is appropriately repatriated (current scope of the condition). We considered that such a condition would be appropriate if there were unlikely to be incentives on other postal operators to enter into arrangements with Royal Mail on a reciprocal basis providing for the repatriation of their mail, such that it would be necessary to require this through a regulatory condition; or

- Imposing a condition which required only Royal Mail to use all reasonable endeavours to enter into arrangements to ensure that mis-directed and mis-collected mail is appropriately repatriated. We considered that such a condition might be appropriate if there were sufficient incentives on other postal operators to enter into arrangements with Royal Mail on a reciprocal basis.

7.62 While access mail largely comprises letters and large letters and is therefore "letterboxable", access operators do not deliver the mail to the end recipient, which is the responsibility of Royal Mail. Therefore, any mis-posted access mail arriving in Royal Mail's network would be intended to be handed to Royal Mail anyway for redelivery (because Royal Mail is responsible for this part of the letter and large letter service). Furthermore, access operators have separate contractual arrangements with Royal Mail for the return of misdirected items.[330]

7.63 It is possible that other postal operators delivering untracked letters and large letters, including end-to-end operators who are currently within the scope of the definition of 'regulated postal operator' (and therefore caught by CP 2), as well as postal operators delivering document exchange mail or closed user group network mail[331] (all of which could be letter and large letter mail) could refuse to enter into arrangements with Royal Mail for the repatriation of mis-directed or mis-collected mail. However, we consider this to be unlikely. This is because these other postal operators will be incentivised to enter into arrangements with Royal Mail to ensure the repatriation of their own letter and large letter items back to them in a timely manner so as to ensure they provide a good quality of service for their customers.

7.64 Indeed, currently, DX, one of the largest document exchange operators, has arrangements in place with Royal Mail similar in nature to those which regulated postal operators are required to put in place under the current scope of CP 2. This is

[330] For example, see Royal Mail's *Access Letters User Guide for Inward Mail Centres*, page 16, https://www.royalmailwholesale.com/mint-project/uploads/844318746.pdf (requires login).

[331] Closed user group network means a system providing for the conveyance of postal packets (and the incidental services of receiving, collecting, sorting and delivering postal packets) between: (i) the premises of one firm and another firm: (ii) a government department and a third party firm; (iii) branches and/or units in the same firm; or (iv) government departments, where both the sender and the recipient of the postal packets have entered into specific arrangements with the postal operator for the conveyance of postal packets to or from other members of that system, which, for the avoidance of doubt, includes a document exchange.

despite document exchange mail or document exchange operators not falling within the current scope of the condition.[332]

7.65 Consequently, we do not consider it is necessary or appropriate to require postal operators, other than Royal Mail, to enter into arrangements for the repatriation of letter and large letter mail under CP 2.

7.66 As with Essential Condition 1 above, we propose to use the weights and dimensions of Royal Mail's letter and large letters products as the basis for our definition of PCOP mail.[333] We also propose to exclude a number of specific types of letter and large letter mail, which are currently excluded from scope of the definition of a 'regulated postal operator' (on the basis that a licence of these items was not required under the PSA 2000), and which we continue to consider should be excluded from the scope of CP 2. These include, for example, Christmas cards delivered by charities. However, given the likelihood of closed user group and document exchange mail in particular ending up in Royal Mail's network we intend to include these operators in the definition of 'relevant postal service' for this condition. The detailed drafting is set out in the draft condition at Annex 14.

7.67 We also propose to revise the scope of CP 2 to require Royal Mail to use all reasonable endeavours to enter into arrangements for dealing with mis-collected or misdirected mail from other relevant postal operators. However, we do not propose to be prescriptive as to the precise terms of those arrangements, subject to certain minimum requirements, which we discuss below.

7.68 We consider that it remains important that the arrangements which Royal Mail has in place to deal with mis-collected and mis-directed letters are on fair and reasonable terms and conditions. Given Royal Mail's scale and the fact that it is likely to receive the majority of mail under CP 2, we are concerned that it may be able to refuse or delay the return of items to other postal operators, which could have an impact on these smaller scale operators. We therefore propose to include a requirement that those arrangements must be on fair and reasonable terms and conditions.

7.69 We note that Royal Mail argued in its response to the 2013 Codes of Practice CFI that it should be permitted to recover its actual costs incurred, and earn a commercial rate of return, on processing items for repatriation under the PCOP Code.[334] While we propose to give freedom to Royal Mail to set the charges for the return or handling of misdirected letters (including mis-posted letters), we consider that it is important that charges for handling mis-directed letters are fair and reasonable, and we would expect them to be based on the costs fairly and reasonably incurred in the repatriation of relevant letters.

7.70 We also propose that Ofcom will retain a power to direct amendments to terms and conditions, including charges, if necessary to ensure that they meet the proposed requirement to be fair and reasonable.

[332] As noted above, the current definition of 'regulated postal operator' is defined by way of reference to those operators which would have been required to hold a licence under the PSA 2000. Under the PSA 2000, it was not necessary to hold a licence for the purposes of the conveyance of letters as part of a document exchange (defined as "a system involving at least three members for the exchange of letters between members of the system").

[333] "Large letter" means any item larger than a letter and up to length 353mm, width 250mm, thickness 25mm, and weighing no more than 750g.

[334] For example, see Royal Mail's PCOP response to the 2013 Codes of Practice CFI, paragraph 28.

7.71 As under the current CP 2, we continue to consider that there should be no charge for the return of mis-collected letters, as we do not consider it reasonable to expect the intended operator to pay for the return of items which were collected in error by another operator.

7.72 We propose to remove the annual reporting requirements which we consider to be unnecessary and overly burdensome. However, we propose to include an obligation on Royal Mail, as the universal service provider, to retain records of the number of mis-directed letters and mis-collected letters that it handles in accordance with CP 2, and the charges made to other relevant postal operators, for a minimum of three years. This will assist Ofcom in identifying any concerns we may have, for example, regarding the possibility of unfair or unreasonable charges.

7.73 We propose to keep a requirement for Royal Mail to handle customer service enquiries it receives which should have been directed to other relevant postal operators. This will ensure that those complainants are informed of the correct operator they should contact in order to ensure that their complaint can be dealt with appropriately.

7.74 Given the proposed change in approach to CP 2, we do not propose to include any requirements in relation to Code Identifiers[335] in the revised condition as we believe it is more appropriate for industry to determine how best to identify the relevant postal operator on the mail piece. However, we recognise that, in practice, some form of identification will be necessary to ensure that other operators' mail can be easily identified. We consider that this could be part of the arrangements agreed between Royal Mail and other operators.

7.75 In order to make these amendments, we propose to revoke the current CP 2 (including the PCOP Code of Practice), and to replace it with a new CP 2. We set out at Annex 14 the statutory notification which specifies our proposed modifications of CP 2. The detailed drafting is set out in the draft condition at Annex 14.

Question 10: *Do you agree with the proposed revisions to Consumer Protection 2, including the removal of the PCOP code and agreement, as drafted in Annex 14?*

Question 11: *Do you agree that the proposed drafting of CP 2 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?*

Consumer Protection Condition 3

7.76 Under CP 3, there are currently, broadly speaking, three sets of regulatory obligations that apply in relation to complaints handling procedures for dealing with complaints made by consumers[336] of postal services.

[335] Code identifiers are codes which are printed onto Code Letters so that the intended operator can be identified. Under the current CP 2, all regulated postal operators are required to put the CL code on the mail so that regulated postal operators can identify mail that is subject to the PCOP code and the intended operator. Ofcom is currently in charge on managing and distributing the code identifiers. These can be found here: http://stakeholders.ofcom.org.uk/binaries/post120713/register_of_code_identifiers.pdf.

[336] For the purposes of CP 3, a "consumer" is a "person who uses postal services either as a sender or an addressee".

7.77 Firstly, CP 3.2 sets out a general requirement for all postal operators to establish, make available, and comply with transparent, simple and inexpensive procedures for dealing with complaints of consumers of postal services, which facilitate the fair and prompt settlement of disputes. CP 3.2 seeks to ensure that the EU obligations in Article 19(1) of the Postal Services Directive[337] are implemented in the UK.

7.78 Secondly, CP 3.3 sets out further requirements for 'regulated postal operators' (as described above) relating to 'consumer complaints'.[338] These include:

- a requirement for regulated postal operators to be a member of a 'qualifying redress scheme', i.e. an Alternative Dispute Resolution scheme which has been approved by Ofcom;[339]
- requirements to establish, maintain and comply with a procedure which satisfies the detailed requirements set out in CP 3.3.2;
- requirements to review the procedure once every three years to ensure that it meets the needs of relevant consumers (CP 3.3.3);
- requirements to give complainants certain information about how their complaints are being handled and what their rights are and to process complaints in a particular way (CP 3.3.7-CP 3.3.13);
- record keeping requirements (CP 3.3.4-3.3.6); and
- annual reporting requirements (CP 3.3.14-CP 3.3.15).

7.79 Finally, Royal Mail, as the universal service provider, is additionally required to publish and submit to Ofcom and the Consumer Advocacy Bodies quarterly reports (CP 3.3.16).[340]

7.80 In March 2015, we commenced a review of the appropriateness and effectiveness of CP 3.[341] Following a period of initial information gathering,[342] we found no indication that there were any major issues relating to complaint handling and redress that

[337] Directive 97/67/EC (as amended). The Directives are available from this page: http://ec.europa.eu/growth/sectors/postal-services/legislation/index_en.htm.
[338] A 'consumer complaint' means a complaint which is made against a regulated postal operator or the universal service provider by or on behalf of a 'relevant consumer'. 'Relevant consumer' means a consumer of a regulated postal service who is not a 'contract customer', meaning circumstances in which the provision of the regulated postal service is governed by a contract between that consumer and the regulated postal operator or universal service provider.
[339] Ofcom approved IDRS Limited to administer the Postal Redress Service under s.52 and Schedule 5 of the PSA 2011 on 1 October 2011. The redress scheme is called POSTRS – see http://www.cedr.com/postrs/ for more information.
[340] In accordance with section 52(7) of the PSA 2011, Ofcom must ensure that a consumer protection condition imposed on a universal service provider requires the universal service provider to publish information about the number of complaints made to them and the way in which the complaints have been dealt with.
[341] Letter to industry - post complaint handling and redress, 10 March 2015, http://stakeholders.ofcom.org.uk/post/letter-post-complaint-handling-redress/.
[342] Including an open letter to stakeholders, additional questions to consumers in the Ofcom postal tracker, Ofcom's own complaints data, and data from the postal dispute resolution scheme (POSTRS).

needed to be addressed by Ofcom at that time.[343] We note that POSTRS, the redress scheme for regulated postal services, handled 391 complaints in 2014.[344] However, in our March 2015 review, we also said that we would look at the scope of this condition by reviewing the definition of "regulated postal operator" which is currently used to set the scope of CP 3.

7.81 We consider that it remains appropriate to retain the general complaints handling obligation which is imposed on all postal operators under CP 3.2, and which is designed to ensure a minimum level of protection to consumers of all types of mail, in accordance with the requirements of the Postal Services Directive. In relation to CP 3 therefore, we have considered whether the remaining, more detailed requirements of CP 3 (from CP 3.3 onwards) should apply in any other situation.

7.82 We think that it is important to ensure that there is sufficient consumer protection in place for users of universal services, including both senders and recipients. We note that the majority of Royal Mail's universal service products are offered to mail users under a Scheme,[345] rather than a contract. As such, there are no contractual remedies available to Royal Mail's universal service customers if they have a complaint relating to these services. In this case, we consider it appropriate to ensure that these customers are able to access a robust complaints handling procedure, and redress scheme where appropriate. We therefore consider it appropriate to apply CP 3.3 to Royal Mail's universal service products, as set out in DUSP 1.

7.83 We have further considered whether it is appropriate to retain the more detailed complaints handling requirements of CP 3.3 for 'regulated postal operators' other than Royal Mail, particularly in light of their limited scale (with a combined market share of only around 1%[346]) and coverage (as they operate in specific geographical areas). As noted above, currently all 'regulated postal operators' are required to be members of a redress scheme under CP 3.3.17, as well as complying with the more detailed complaints handling requirements set out in the remainder of CP 3.3. In assessing this issue, we have considered the following factors:

- Other regulated postal operators are already required to have simple, transparent and inexpensive complaints handling procedures in place as a minimum requirement under CP 3.2 for complaints from their sending customers as well as recipients of mail they handle. There is therefore a minimum level of protection already in place for customers of these postal operators.

- Other regulated postal operators tend to be focused on bulk mail sent by businesses under commercial arrangements rather than individual consumers. As such, any complaints raised by these mail users fall outside the scope of CP 3.3 currently as it is likely that disputes could be resolved through other means (e.g. contractual remedies, alternative dispute resolution where appropriate, or even, the termination of the contract so that the customer could switch to another

[343] For more details, see Ofcom's website, http://stakeholders.ofcom.org.uk/post/review-complaint-handling-redress/.
[344] See POSTRS 2014 Annual Report, page 10, http://www.cedr.com/docslib/POSTRS_Annual_Report_2014.pdf.
[345] A 'Scheme' is a document where a postal operator publicly sets out the charges, terms and conditions it has for its products and services. These allow customers to purchase services under specific terms without the need for individual contracts.
[346] For example, see Ofcom's *Annual monitoring update on the postal market – financial year 2014-15*, paragraph 1.9, 27 November 2015, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-reports/Annual_monitoring_update_2014-15.pdf.

bulk mail operator). This is also true of Royal Mail's non-universal service products.

- It is unclear whether the recipients of such bulk mail need to have a right to recourse to a specific post-related redress scheme to resolve disputes which cannot be resolved through the complaints handling procedure (required to be put in place under CP 3.2). However given that the delivery of almost all bulk mail letters is carried out by Royal Mail,[347] and that other regulated postal operators are of a very small scale, it appears disproportionate to apply the requirements of CP 3.3 to other regulated postal operators.

7.84 Given the above, we do not consider it appropriate or proportionate to impose more onerous and detailed complaints handling procedures on these operators. We therefore consider that the scope of CP 3.3 should be amended such that it no longer applies to 'regulated postal operators' other than Royal Mail.

7.85 In summary therefore, we propose to amend the scope of CP 3 to limit the obligations set out in CP 3.3 to Royal Mail as the universal service provider in respect of complaints relating to its universal service products. However, all other postal operators, including those which were formerly captured under the definition of 'regulated postal operators' will still have to comply with the obligations under CP 3.2 to establish, maintain and comply with transparent, simple and inexpensive procedures for dealing with complaints from users of postal services.

7.86 While we propose to no longer require regulated postal operators other than Royal Mail to be a member of a redress scheme, we note that it would remain open to those operators to be members of such a scheme on a voluntary basis.

7.87 Our proposed drafting of CP 3 as a result of our proposal to change the scope of this condition can therefore be found at Annex 15.

Question 12: *Do you agree with our proposal to amend the scope of Consumer Protection Condition 3 so that it retains a minimum requirement for all postal operators, and that additional requirements in relation to redress and reporting would apply to Royal Mail as the universal service provider only?*

Question 13: *Do you agree with our proposed drafting of Consumer Protection Condition 3 given our proposal to only apply the additional requirements set out in CP 3.3 in relation to redress and reporting to Royal Mail as the universal service provider?*

Consumer Protection Condition 5

7.88 CP 5 provides that:

> "A regulated postal operator, in relation to a regulated postal service or a USO service, shall use reasonable endeavours to deliver appropriately, or procure the delivery of, any postal packets it receives in the course of its business as a postal operator, within a reasonable time."

[347] End-to-end competition only accounted for the delivery of 1.3% of letters in 2014-15 (see paragraph 4.28 of Ofcom's Annual monitoring update 2014-15). Following the exit of Whistl, we expect that the volume of mail delivered by other operators to have significantly reduced.

7.89 Previously, CP 5 was part of the former transitional consumer protection condition CP 1.2, [348] which in turn was based on Royal Mail's licence issued under the PSA 2000. The former condition included two parts: collections and delivery.

7.90 In the March 2012 Statement, we decided to remove the obligation on collection because it would have been met through the contractual arrangements between the sender and the regulated postal operator.[349] However, the section of the condition regarding delivery, which forms CP 5 today, was retained subject to a review of the Mail Integrity and PCOP Codes.[350]

7.91 We have now carried out a review of both Codes of Practice (see our proposed amendments above at paragraph 7.37 for MICOP and paragraph 7.74 for PCOP). We are therefore in a position to reconsider the need for CP 5.

7.92 We consider that CP 5 is unnecessary on the basis that postal operators have sufficient incentives to deliver mail on behalf of their customers – either as a result of requirements set out in other regulatory conditions or through contractual arrangements – without a specific regulatory obligation requiring them to do so. For example:

- In relation to its universal service products, Royal Mail is required to provide end-to-end services under the DUSP conditions set out in DUSP 1.6 and is also subject to delivery performance targets set out in DUSP 1.9.

- Postal operators, including Royal Mail for its non-universal service products, will have contractual arrangements in place with the sender under which they agree to deliver the relevant postal items. If they failed to do so in accordance with their contractual obligations, it is likely that their customers would have contractual remedies available.

- Furthermore, relevant postal operators, including Royal Mail, have additional incentives arising from Essential Condition 1 under which a failure to deliver relevant mail would be considered a mail integrity issue (i.e. items which are not delivered within 15 working days of the due date of delivery are treated as 'lost').

7.93 We are not aware to date of any evidence to suggest that there have been any significant failures on the part of postal operators to deliver mail. We therefore consider that the objectives of CP 5 are likely to be met without the need for a regulatory condition. We therefore propose to revoke CP 5 in its entirety, as set out in the Notification at Annex 16.

Question 14: *Do you agree with our proposal to revoke Consumer Protection Condition 5?*

[348] See transitional CP1.2 on Ofcom's statement *Postal regulation: Transition to the new regulatory framework*, page 34, 29 September 2011, http://stakeholders.ofcom.org.uk/binaries/consultations/postal-regulation/statement/statement.pdf.
[349] See the March 2012 Statement, paragraphs 12.113 to 12.116.
[350] See the March 2012 Statement, paragraphs 12.97 to 12.116.

DUSP 1.10 (Obligations on the USP to provide prior notification)

7.94 DUSP 1 requires the USP (i.e. Royal Mail) to provide the universal service, as set out in Universal Service Order. It contains a number of sections which can be summarised as follows:

- conditions related to the characteristics, products and services of the universal postal service (DUSP 1.1 to DUSP 1.8);
- quality of service targets and measures (DUSP 1.9);
- information publication, notification and reporting requirements (DUSP 1.10); and
- requirements to put in place contingency plans (DUSP 1.11).

7.95 As discussed above (see paragraph 2.52), we have not considered or proposed any changes to the scope of the universal postal service in the course of this review, including the quality of service measures. We also believe that the obligations relating to contingency plans are appropriate.

7.96 However, we noted that in response to the July 2015 Discussion Document, Royal Mail said that it is subject to "slow and burdensome" and "unnecessary regulation" which slows down its processes. Royal Mail said that Ofcom should consider "reducing the length and volume of regulatory notification and consultation periods and streamlining burdensome regulatory reporting requirements."[351]

7.97 In particular, with regard to its consultation and notification requirements, it noted:

- it is the only postal operator which is required to have notification periods for changes to its products;[352]
- the requirements for prior notification and/or consultation to introduce changes to universal services "prevent[ed] Royal Mail from moving quickly and innovating, especially in the fast paced parcels sector"; For example, Royal said that in March 2014, myHermes dropped its prices to 2p below Royal Mail, five days before Royal Mail's new reduced parcel prices came into effect;[353]
- the three-month advance notification for changes to collection and delivery times lead to a "protracted process" to introduce its Collection on Delivery[354] initiative;[355] and
- the combined impact of the mandated one-month notification period and the consultation periods means that there are delays to changes that would be

[351] See Royal Mail's response to the July 2015 Discussion Document, paragraph 1.40. We have addressed the issue of regulatory reporting requirements in the discussions on Essential Condition 1 and CP 2 above.
[352] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.14.
[353] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.14.
[354] Collection on Delivery refers to when a postman/postwoman empties post boxes on their delivery round, instead of having a dedicated collection by van. Royal Mail began introducing this initiative in September 2014 for low-volume post boxes – see http://www.royalmail.com/personal/help-and-support/postboxes-faqs.
[355] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.14, [✂].

beneficial to customers, e.g. the reduction in the number of days before which a customer could claim compensation.[356]

7.98 After considering the current requirements in DUSP 1.10, we have decided to propose amendments to the following conditions:

- **DUSP 1.10.1(c)** – one-month notification period for changes to universal service terms and conditions (including prices); and
- **DUSP 1.10.2 (b) and DUSP 1.10.3** – notification period for changes to latest delivery times and specified collection times of access points.

7.99 We discuss each of these conditions in turn, and our proposed amendments, in the following paragraphs.

Changes to terms and conditions (including prices) notification

7.100 Under DUSP 1.10.1(c), Royal Mail is required to notify Ofcom and the Consumer Advocacy Bodies of, and publish (in such manner as will ensure reasonable publicity), proposed changes to the terms and conditions (including prices) of its universal service products at least one month in advance of implementing the proposed change.

7.101 Prior to the March 2012 Statement, the advance notice period was three months; however we reduced this to one month.[357] At the time, we said that, given the low average household spend on postal services, residential customers are unlikely to need significant notice of price changes and one month is often used in other industries as the minimum notice period to protect consumers.[358]

7.102 In the March 2012 Statement we also recognised that both price and non-price changes can have more of an impact on SMEs that use Royal Mail's universal services. We considered that, as most businesses operate on a one month billing cycle, they would also require a minimum of one month's notice to pass any price increase or non-price changes on to their customers. We proposed that one month would be an appropriate balance between the need to give additional commercial flexibility to Royal Mail and allow SMEs time to change their prices and/or budgets. We also noted that we would expect Royal Mail to give more notice for changes that would have a significant impact on its customers (particularly non-price changes).[359]

7.103 As a result of our review of DUSP 1.10.2(b), we believe that the price notification obligation represents an important safeguard for consumers, in that they are notified in advance of any proposed increases to stamp prices or changes to other terms and conditions for universal service products. However we also recognise that the notification obligations on Royal Mail do not apply to its competitors, who can 'price follow'[360] and may restrict Royal Mail's freedom to introduce changes which may be beneficial to postal users such as a price decrease.

[356] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.14.
[357] See the March 2012 Statement, paragraphs 6.87 to 6.113.
[358] See the March 2012 Statement, paragraph 6.88.
[359] See the March 2012 Statement, paragraph 6.89.
[360] By 'price follow', we mean that a competitor introduces a price similar or less than Royal Mail before Royal Mail has implemented said change.

7.104 We believe that the needs of consumers in relation to the notification of price and non-price changes to universal service products has not changed significantly since our 2013 Review of Users' Needs, and therefore, we consider that the notification of changes to price and non-price terms remains important.

7.105 Given the evidence from our 2013 Review of Users' Needs, we consider that non-price changes to terms and conditions may be more problematic for postal users than price changes. For example, if Royal Mail were to change the dimensions of its parcel products, it would be harder to react to on the day if, for example, you had purchased packaging that conformed to the old dimensions. This is particularly a concern for small businesses who may buy such materials in bulk in advance.

7.106 However, even if we were to remove the notification period for changes to terms and conditions, Royal Mail would still have to consult on potential changes to its non-price terms and conditions when it changes its Schemes.[361] Under Section 89A of the PSA 2000, where Royal Mail is proposing to make or amend its Schemes, it must notify Ofcom and carry out a consultation exercise in accordance with requirements contained in a notification published by Ofcom. In the March 2012 Statement, Ofcom explained that any postal operator intending to make a Scheme should consult for a period of not less than one month with those customers or users likely to be affected by the Scheme and with any relevant groups representing such customers or users.[362] Although this is a different obligation to the advance notification period required under DUSP 1.10.1(c) before *implementation* of changes, this obligation would still mean that Royal Mail would be unable to change its non-price terms and conditions (which, in respect of its universal service products, are set out in its Schemes) from one day to the next without any form of prior notification of the proposed change.

7.107 The question of whether or not to reduce the notification period is therefore finely balanced and there are a number of options we could choose which could strike the appropriate balance between the need for flexibility in pricing and terms and conditions, while ensuring that consumers are adequately protected. These are:

- **Option 1** – Retain the one month notification obligation for changes to terms and conditions, including prices, except where a price decrease is proposed, in which case no advance notification would be required;
- **Option 2** – Reduce the notification obligation to one week for changes to prices and non-price changes; or
- **Option 3** – Remove the notification period altogether for both price changes and non-price changes to terms and conditions.

7.108 We discuss each of these options in more detail below.

7.109 **Option 1** – Retaining the notification obligation for price increases and non-price changes, but removing it for price decreases, may provide Royal Mail with the flexibility it needs to compete on price, while ensuring safeguards for consumers remain in place. It would also mean that we could retain the one month notification

[361] A 'Scheme' is a document where a postal operator publicly sets out the charges, terms and conditions it has for its products and services. These allow customers to purchase services under specific terms without the need for individual contracts.
[362] See the March 2012 Statement, paragraph 12.139.

for changes to terms and conditions which are more problematic for customers than price changes. However, it may not address Royal Mail's concerns about introducing changes to terms and conditions which are beneficial to consumers in a shorter period than is currently required.

7.110 **Option 2** – Moving to a week-long notification period for price changes would ensure that consumers would still get advance notice of changes to prices; however it would be more difficult for Royal Mail's competitors to 'price follow'. This option would give Royal Mail additional flexibility, without disadvantaging the majority of individual consumers who are likely to be able to respond to or mitigate the impact from the changes more easily. However, we note that a week's notice of both price and non-price changes may not be sufficiently long for other individual consumers (i.e. those who do not use the postal service regularly), or businesses, particularly SMEs, especially in relation to non-price changes.

7.111 **Option 3** – This option would address Royal Mail's concerns around suggested lack of flexibility to introduce changes to its price and non-price terms and conditions which may benefit postal users. It would also mean that residential consumers would be unable to purchase stamps in advance of a price rise, although we note that this is not an option open to consumers for many other non-postal products. However, it would mean that Royal Mail would be able to introduce changes to its terms and conditions, including prices, without giving any prior notice to its customers. This may have a negative impact on postal users, particularly SMEs, who would not be able to pass on the cost of any increases in price changes to their customers immediately (especially as most businesses operate on a one-month billing cycle). We consider this would not give sufficient protection to consumers, in particular in relation to changes to non-price terms and conditions, such as dimensions, which could have a large impact on customers, particularly SMEs.

7.112 Based on the considerations set out above, our provisional view is that Option 1 strikes the most appropriate balance between providing Royal Mail with the flexibility to lower its prices in a similar fashion to its competitors and ensuring that postal users are given advance notice of price increases and changes to terms and conditions.

7.113 We therefore propose to amend DUSP 1.10.1 to remove the requirement for advance notification for price decreases. We would also stress that the one month notification period would remain as the minimum requirement and that Royal Mail should consider the likely impact of the changes it intends to make when deciding on the appropriate notification period needed, particularly in relation to certain types of users (e.g. non-smart meter franking customers where the price decrease may not be automatically applied).[363]

Question 15: *Do you agree with our proposal to remove the one-month notification period for price decreases to Royal Mail's universal service products and services?*

[363] We note that certain organisations are likely to need advance notification of price changes (e.g. meter manufacturers) so that the prices can be changed in their systems and rolled out to users. We expect these arrangements will be met through commercial contracts as is currently the case.

DUSP 1.10.2(b) and DUSP 1.10.3 – Delivery and collection times notifications

7.114 Under DUSP 1.10.2(b), Royal Mail is required to notify Ofcom and the Consumer Advocacy Bodies[364] and publish any changes it intends to make to its latest delivery times and its specified collection times not less than three months in advance of those changes coming into effect. DUSP 1.10.3 requires Royal Mail to publish its latest delivery times and its specified collection times and to ensure any changes to them are published within one month of the change in such a manner as will ensure reasonable publicity for them.

7.115 In our December 2011 consultation on the Review of Regulatory Conditions,[365] we explained that we imposed, as a transitional condition, a requirement on Royal Mail to notify us of the specified delivery and collection times from post boxes, any changes they intend to make to those times, and any reclassification which results in the collection time moving earlier, and that we proposed to keep this notification requirement. At that time evidence suggested that times of delivery and collection, and in particular consistency of delivery times, were important to postal users.[366] We retained these requirements in the March 2012 Statement.[367]

7.116 The requirement focuses on notification and publication of times with an aim of ensuring transparency and clarity to postal users, and does not specify what those times should be. The decision about the times for delivery and collection are a matter for Royal Mail to decide.

7.117 We note that there have been a number of changes to collection and delivery times over the past few decades, including the removal of the second daily delivery in 2004-5, the cessation of Sunday collections in 2007 and the move to collection on delivery for between 45,000 and 50,000 low-volume post boxes in 2014-15 (which has effectively moved the collection time to between 9am and 4pm depending on its location on the delivery route).[368] Royal Mail has made such changes to ensure that its delivery and collection operations are more flexible and efficient, which should help to ensure the financial sustainability of the universal service.[369]

7.118 As a result, we have considered whether it remains necessary to require advance notification of changes to latest delivery times and specified collection times and if so, whether three months remains the appropriate notice period. In that sense, we have considered why an advance notification period of changes to said times would be important for postal users.

7.119 As regards collection times, in order to ensure prompt, same-day collection of their item(s), postal users must be aware of the latest collection. A change to the latest collection time to an earlier time would therefore require a change in the posting behaviour of the postal user; i.e. the postal user would have to ensure that they post

[364] Citizens Advice, Citizens Advice Scotland and The Consumer Council.
[365] See Ofcom's *Review of Regulatory Conditions - Postal Regulation*, 13 December 2011, http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/.
[366] See Ofcom's *Review of Regulatory Conditions – Postal Regulation*, 13 December 2011, paragraph 4.26 http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/.
[367] See the March 2012 Statement, paragraph 4.14.
[368] See Royal Mail's website, http://www.royalmail.com/personal/help-and-support/postboxes-faqs. Royal Mail will move those post boxes with a low average volume threshold where there is an alternative late posting facility within half a mile to Collection on Delivery. [✂]
[369] See for example Royal Mail's website, http://www.royalmail.com/personal/help-and-support/postboxes-faqs.

their item earlier. In our 2013 Review of Users' Needs[370], we found that consumers placed relatively low importance on collection and delivery times. We therefore do not consider that individual consumers are likely to find it problematic to adapt to earlier collection times. However, we consider that businesses (particularly SMEs) may find it more difficult to adapt their practices to adjust to earlier collection times. This was also our finding in the 2013 Review of Users' Needs.[371] Therefore, we consider that advance notification of changes to the latest collection times remains important in particular to meet the interests of businesses and SMEs.

7.120 Regarding the length of the notification period required, we believe that this needs to strike a balance between allowing Royal Mail flexibility to change its collection times to meet its operational needs and to ensure that our regulation does not cause any unnecessary burden on Royal Mail, while also ensuring that postal users are sufficiently protected from the potential harm caused by missing the latest collection time due to insufficient notification.

7.121 We therefore consider that businesses would require advance notice of collection times in order to implement changes to their business. We consider that a notice period of one month would be likely to meet the needs of small businesses in relation to changes in collection times.

7.122 Individual consumers are likely to be able to react more quickly to changes to collection times than businesses, as long as they are aware of the change in time. We therefore consider that a one month notice period would provide consumers with more than enough notification of changes in collection times.

7.123 We therefore propose that the advance notification period for changes to specified collection times should be reduced from the current three months (as set out in DUSP 1.10.2 and DUSP 1.10.3) to one month.

7.124 In terms of delivery times, postal users are, in effect, passive for the act of delivery. In that sense, postal users do not require advance notification of changes to the latest possible delivery times because there is no need for a change in their behaviour. Also as noted at paragraph 4.9 above, despite the significant changes to delivery in the past several years, eight out of ten residential consumers are very satisfied or fairly satisfied with the time of day post is delivered.

7.125 Some stakeholders raised concerns in our 2013 Review of Users' Needs about the combination of earlier collection times combined with later deliveries making it harder for businesses to respond to correspondence on the same day (particularly a concern for rural businesses).[372] However, we note that Royal Mail does offer a number of services to businesses which could address the concerns of a later delivery time (e.g. Early Collect, Mail Collect and Timed Delivery).[373] Also, where

[370] The research for the 2013 Review of Users' Needs found that individual consumers said that the collection times did not affect their posting decisions. The location of access points was a more important concern (although the location of access points (or post boxes) is subject to separate regulation under DUSP 1.8). See paragraphs 9.6 to 9.14 of Ofcom's *Review of Users' Needs* (2013), http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-user-needs/statement/statement1.pdf.
[371] See for example paragraph 9.37 of Ofcom's *Review of User Needs* (2013).
[372] See paragraph 9.39 Ofcom's *Review of Users' Needs* (2013).
[373] See for example Royal Mail's website, http://www.royalmail.com/corporate/mail-management.

Royal Mail has extended collections on delivery it has only done so for post boxes where there is an alternative late posting facility within half a mile.[374]

7.126 We therefore propose to remove the advance notification period for changes to latest delivery times altogether (as set out in DUSP 1.10.2 and DUSP 1.10.3). In order to ensure consistency and clarity, we also propose to remove the advance notification period for when a re-classification of addresses leads to a change in delivery time (as set out in DUSP 1.10.2(c)).

7.127 Separately, we note that there is an inconsistency between the length of the advance notification in DUSP 1.10.2(b) and DUSP 1.10.3 (three months and one month respectively). We propose to address this inconsistency by removing DUSP 1.10.3 and restructuring DUSP 1.10.1 and DUSP 1.10.2.

7.128 In conclusion, we propose to:

- Reduce the advance notification period for changes to specified collection times from three months to one month; and
- Remove the requirement for an advance notification period for changes to the latest delivery times.

Question 16: *Do you agree with our proposal to reduce the advance notice period for specified collection times to one month (reduced from three months)?*

Question 17: *Do you agree with our proposal to remove the advance notice period for latest delivery times (currently at three months)?*

Summary of proposals on DUSP Conditions

7.129 Given our proposals for changes to DUSP1.10.1, DUSP1.10.2 and DUSP1.10.3, we propose to restructure the conditions and consolidate them into two conditions: one which sets out what information Royal Mail should publish and maintain-up-to-date; and one which sets out the requirements for advance notifications both publically and to Ofcom and the Consumer Advocacy Bodies.[375] Our proposed revised conditions can be found at Annex 17.

7.130 Our proposed new DUSP 1.10.1 will set out all the information that the USP should publish and keep up-to-date to ensure that consumers have access to clear information. We propose this will include:

- the brand names of the services it provides with a view to meeting its obligations under DUSP 1.6 and 1.7;
- the terms and conditions of those services (including prices); and
- its latest delivery times and its specified collection times.

7.131 Our proposed new DUSP 1.10.2 sets out all the types of changes to that information which require advance notification to both the public and to Ofcom and the Consumer

[374] See Royal Mail's website, http://www.royalmail.com/personal/help-and-support/postboxes-faqs.
[375] The Consumer Advocacy Bodies are Citizens Advice, Citizens Advice Scotland, and The Consumer Council.

Advocacy Bodies. As discussed above, we propose that the notification period should be a minimum of one month. We propose this condition will include:

- the brand names of the services it provides with a view to meeting its obligations under DUSP 1.6 and 1.7;
- the terms and conditions of those services, including prices, with the exception of any reduction in prices;
- its specified collection times; and
- every re-classification of access points that will result in an access point's specified collection time starting earlier.

7.132 The proposed drafting amendments will make it clearer and more transparent to both postal users and Royal Mail about which information needs to be published and kept-up-date, and which changes require advance notification.

7.133 More detail on the precise drafting proposed is set out in the Notification included at Annex 17.

Question 18: *Do you agree with our proposed restructuring and drafting of Designated Universal Service Provider Conditions 1.10.1 and 1.10.2, and the removal of Designated Universal Service Provider Conditions 1.10.3?*

Legal tests

7.134 In the above section on the scope of the regulatory conditions, we have proposed a number of amendments to CP 2, CP 3, Essential Condition 1 and DUSP 1.10. We explain below why we consider our proposals would satisfy the relevant tests set out in Schedule 6 of the PSA 2011 which must be met where we impose or modify a regulatory condition, namely that they:

- are objectively justifiable;
- do not unduly discriminate against a particular person of a particular description of persons;
- are proportionate; and
- are transparent in relation to what it is intended to achieve.

7.135 As we have not proposed any modification to CP 1, we do not consider it below. As we are proposing to revoke CP 5 completely, we do not consider it below, but have explained above at paragraphs 7.91 why we think it is appropriate to revoke that condition on the basis that it is no longer necessary.[376]

[376] Schedule 6 to the PSA 2011 requires us to ensure that are proposals to impose or modify a regulatory condition meet the four criteria listed, however it does not require us to do in the case of revocation.

Objectively justifiable

7.136 We believe that our proposed amendments to the scope of CP 2, CP 3, and Essential Condition 1 are objectively justifiable because they would ensure, for the reasons discussed above, that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives.

7.137 We further consider that the proposed amendments to CP 2 and Essential Condition 1 are justified, for the reasons set out in paragraphs 7.43 to 7.75 and 7.16 to 7.42 respectively, in order to ensure that the obligations which are imposed under those conditions are no more onerous than necessary to meet the objectives of ensuring, respectively: that mis-collected and mis-directed mail items are returned to the correct postal operator or otherwise handled appropriately (such as being delivered to the relevant addressee) and ensuring that relevant postal operators protect the integrity of the mail they carry, meaning that postal users can have confidence in the postal services they use.

7.138 We consider that the requirements relating to complaints handling as set out in CP 3 remain appropriate to ensure appropriate protection for consumers as to how their complaints are dealt with, but we no longer consider that it is necessary for the additional requirements set out under CP 3.3 to be imposed on any postal operators other than the universal service provider (i.e. Royal Mail) in respect of complaints relating to its universal service products for the reasons set out in paragraphs 7.76 to 7.87 above. We consider this is justified because in respect of all other postal operators, CP 3.2 will require that consumers should have access to a simple, transparent an inexpensive complaints procedure which we consider is appropriate to ensure a sufficient level of consumer protection. In respect of the universal service, we consider that it remains appropriate to retain more detailed complaints handling procedures and that consumers should be entitled to have access to an independent redress scheme because they either have no contractual remedies available, or if there is a contract, are not able to switch to another postal service provider.

7.139 We consider our proposed amendments to DUSP 1.10 are justified because they would ensure an appropriate balance is achieved between protecting postal users and removing unnecessary regulatory burden in that they would allow Royal Mail flexibility to lower prices more quickly, but would ensure consumers have appropriate notification of other relevant changes to its universal services.

Not unduly discriminatory

7.140 We consider that our proposed changes to CP 2, CP 3, Essential Condition 1 and DUSP 1.10 are not unduly discriminatory because they would ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives.

7.141 For CP 2, we consider that it is not unduly discriminatory to apply the condition only to Royal Mail, because Royal Mail is the only postal operator with a network of access points (i.e. post boxes and other relevant approved access points) for letters and large letters.

7.142 For CP 3, we consider that it is not unduly discriminatory to apply the additional requirements set out in the condition to Royal Mail for its universal service products only, because for those products, mail users either have no contractual remedies available, or if there is a contract, are not able to switch to another postal service provider.

7.143 For Essential Condition 1, we consider that it is not unduly discriminatory to apply the requirements to Royal Mail's untracked universal service parcel products because these are not covered by the protections of tracking, unlike other parcel operators' services.

7.144 For DUSP 1.10, these continue to apply to Royal Mail as the USP.

Proportionate

7.145 We believe that our proposed changes to CP 2, CP 3, Essential Condition 1 and DUSP 1.10 are proportionate because they would ensure that our regulation is targeted at the most appropriate postal operators and postal items in order to meet our regulatory objectives. They also would only impose requirements that we consider are necessary to meet our regulatory objectives, without imposing undue burden on the relevant postal operators which would be subject to these obligations.

Transparent

7.146 We consider that our proposed changes to the revised scope of CP 2, CP 3, and Essential Condition 1 are transparent because the proposed revised conditions would set out clearly and transparently the postal operators and postal items which would be within scope of those conditions. In respect of the other proposed changes to CP 2 and Essential Condition 1 and the proposed changes to DUSP 1.10, we consider our proposed changes would also clearly and transparently set out the revised obligations which would apply under those conditions. We are also consulting now on their precise wording, as set out in the Notifications in Annexes 13 to 17.

Other stakeholder comments on scope of the universal postal service

7.147 As noted above in paragraph 2.52 above, we are not considering the scope of the universal postal service as part of this review. Furthermore, in order to make a change to the Universal Service Order we would be required to first carry out a review of postal users' needs which, as discussed above, we aim to conduct within the next five years. We therefore do not propose any modifications to the universal service below.

7.148 However, we received a number of comments from stakeholders concerning potential changes to it, relating to:

- meter mail; and
- volume discounts for universal service products.

7.149 We set out our current thinking in response to those stakeholder comments below.

Meter mail

7.150 Meter or franked mail is a method of payment or payment channel for Royal Mail services where customers pre-pay for postage and apply an impression to the envelope, label or wrapper using a franking machine licensed by Royal Mail, but usually supplied by a third party. Meters can be used to pay for a range of postal services, including both universal services (such as First and Second Class letters and parcels) and non-universal services (such as Special Delivery Next Day 9am).

7.151 DUSP 1.6.1 requires Royal Mail to provide priority and standard domestic single piece services. Those services are expressly stated to include postal packets which "are capable of purchase by postage stamp and by meter and may be capable of purchase by other reasonable methods". Other payment methods offered by Royal Mail for universal services include stamps, online postage, postage paid impression (PPI) and account.

7.152 In the March 2012 Statement, we said that the franking impression on the envelope, used to show the postage value, was not a presentation discount[377] (because it did not aid in the sortation of mail);[378] and that meter was not a channel for a volume discount for single piece items because there is no minimum volume requirement to send a meter standard tariff item.[379]. We therefore considered that it was appropriate to continue to include meter and franked single piece mail within the universal service.

Stakeholder views

7.153 Three of our stakeholders, DX, MCF and CFH suggested that meter mail should be removed from the universal service in their responses to the July 2015 Discussion Document. In summary, they argue that meter mail does not meet the characteristics of a universal service product. Specifically, they said that:

- meter mail was aimed at businesses, particularly when considering the combined cost of the franking machine and the postage price, not all consumers so is not a universal service (MCF[380], CFH[381] and DX[382]);
- the collection of meter mail is not the same as stamp universal service products which can be posted in 'standard' access points[383] (CFH);
- [✂][384]; and
- Royal Mail does in fact impose presentational requirements on meter mail users such as: restrictions on the geographical area in which the mail may be posted;

[377] In August 2011, Postcomm clarified its definition of "presentation of mail" as including pre-sortation by geographic zones for delivery; and/or the positioning of text on the envelope, font or bar codes using approved Optical Character Recognition (OCR) fonts, or machine readable barcodes (Customer Bar Code, CBC), so that it is easier for sorting machines to read. See Postcomm's *The building blocks for a sustainable postal service, Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document,* August 2011, paragraph 4.11, http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf.
[378] See the March 2012 Statement, paragraph 4.35.
[379] See the March 2012 Statement, paragraph 4.36.
[380] See MCF's response to the July 2015 Discussion Document, page 9.
[381] See CFH's response to the July 2015 Discussion Document, page 8.
[382] See DX's response to the July 2015 Discussion Document, page 6.
[383] In its response to the July 2015 Discussion Document, CFH said that meter mail is often collected from the sender's premises (sometimes for an additional charge). It noted that if it is not collected by Royal Mail, then meter mail is posted into a 'Franked Mail' post box (which is often not collected on a Saturday) or must be posted via a Post Office. There are fewer of these access points than 'standard' access points. See CFH's response to the July 2015 Discussion Document, page 8.
[384] [✂].

the use of particular pouches, trays and bags, and; segregation of class and service (DX[385]).

7.154 MCF, DX and CFH also highlighted that, due to the inclusion of meter mail in the universal service, Royal Mail benefits from a 20% price advantage on this product (because universal service products are VAT exempt – see discussion on VAT in paragraph 5.8). According to those stakeholders, this allows Royal Mail to charge lower prices and is a barrier to effective competition, particularly for customers who cannot recover VAT (such as small customers with an annual turnover of £83k, charities or financial services). CFH believed that this was a distortion of competition.[386]

Ofcom view

7.155 We consider that none of the issues presented by the stakeholders identify any characteristic of meter payment that has either substantially changed since 2012 or is inconsistent with Ofcom's understanding of the universal postal service. Therefore, we are not proposing to amend the universal postal service with regard to meter services. We consider the points raised by stakeholders in turn below.

7.156 We consider that meter services are clearly aimed at businesses (particularly SMEs); however, this does not disqualify meter services from being a payment method for universal postal service products. Businesses are important users of the universal postal service, and meters are an important payment method. Our market research shows that meter services are used as the standard way of sending mail by 10% of all small businesses, and 43% of those businesses that send between 100 and 500 items.[387]

7.157 Items paid for using meters can be posted in standard access points (albeit using a franking outer envelope). In addition, meter items can be posted at Post Offices, business mail post boxes, mail centres and delivery offices.[388]

7.158 The issue of presentational requirements is relevant because Postcomm defined single piece services as "not being subject to any discounts related to requirements regarding volume of mail per mail or presentation of mail".[389] However, at the same time Postcomm defined "presentation of mail" as "not referring or relating to not refer or relate to the location at which the mail is posted, whether the mail is posted in pouches or, when preparing the mail for posting, whether the mail is posted face up, or posted by class of products (i.e. priority or non-priority)".[390] While Ofcom has not used exactly the same definition of single piece services in the universal postal service order, we consider that the above considerations remain valid today.

[385] See DX's response to the July 2015 Discussion Document, page 6.
[386] See CFH's response to the July 2015 Discussion Document, page 8.
[387] Ofcom Business tracker, 2014-15, page 433, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2015May/Business_postal_tracker_Year_3_Data_Tables.pdf.
[388] https://business.help.royalmail.com/app/answers/detail/a_id/980/related/1.
[389] See paragraph 4.14 of Postcomm's *The building blocks for a sustainable postal service, Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document,* August 2011, http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf.
[390] See paragraph 4.11 of Postcomm's *The building blocks for a sustainable postal service, Removing bulk products from the universal service and clarifying the status of other universal service products – a decision document,* August 2011, http://stakeholders.ofcom.org.uk/binaries/post/2005.pdf.

7.159 Finally, in Section 5 above (on single piece parcels) we have noted the potentially distortive effect on competition of the VAT exemption for public postal services. While the VAT exemption may have an adverse effect regarding competition against meter services, this is not something we should address regarding the definition of the universal services. It is a matter for central government.

Permitting volume discounts on universal service products

7.160 In order to distinguish single piece products from bulk products, the Universal Service Order defines a single piece service as one where the price per postal packet is not subject to any discounts related to (among other things) the number of postal packets sent. This means that Royal Mail is not permitted to offer volume-related discounts on universal service products (although it may do so on non-universal service single piece products).

7.161 In its response to the July 2015 Discussion Document, Royal Mail said that it should be able to offer such discounts to members of the public, for example by offering loyalty cards to customers posting several parcels at Christmas. It argued that the current approach limits its ability to offer innovative promotions and that its competitors offer discounts for every additional parcel posted. It points to the example of Yodel, which offers an incremental discount for every additional parcel posted at the same time.[391]

7.162 As noted above, we are not proposing to amend the scope of the Universal Service Order at this time, which we would only do after carrying out a review of users' needs (in accordance with section 30 of the PSA 2011). We do not believe this is an issue that needs to be addressed at this stage in order to ensure the financial sustainability of the universal service. We also do not see evidence of a clear and urgent user need for such a discount to be included as part of the universal service at this time. In addition, prior to doing so, we would need to consider whether making such changes to the scope of the universal serve could potentially have an adverse effect on competition in relevant sectors.

[391] See Royal Mail's response to the July 2015 Discussion Document, paragraph 5.12.

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on Wednesday 3 August 2016**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://stakeholders.ofcom.org.uk/consultations/royal-mail-review2016/howtorespond/form as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email postal.regulation@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Richard Orpin
Floor 4
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Richard Orpin on 020 7981 3000.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your

response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/terms-of-use/.

Next steps

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in by the end of the 2016-17 financial year.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/email-updates/

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Steve Gettings, Secretary to the Corporation, who is Ofcom's consultation champion:

Steve Gettings
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email: steve.gettings@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at http://stakeholders.ofcom.org.uk/consultations/consultation-response-coversheet/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing ☐

Whole response ☐

Part of the response ☐

Name/contact details/job title ☐

Organisation ☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 Below is a list of the questions in this consultation document:

Question 1: *Do you agree that the evidence summarised in Section 4 and set out in more detail in the annexes to this consultation does not support the imposition of (i) further price controls on parts of Royal Mail's business or (ii) efficiency targets? Please state your reasons and provide evidence to support your view.*

Question 2: *Do you agree that the regulatory framework should remain in place until March 2022 following the anticipated completion of Ofcom's review by the end of 2016-17? Please state your reasons and provide evidence to support your view.*

Question 3: *Do you agree that the analysis summarised in Section 4 and set out in more detail in the annexes to this consultation accurately reflects the UK postal market? Please state your reasons and provide evidence to support your view.*

Question 4: *Do you agree with our proposal not to amend the Universal Service Order or the DUSP conditions to include tracking as standard on First and Second Class single piece parcels? Please state your reasons and provide evidence to support your view.*

Question 5: *Do you agree with our proposal to retain the safeguard cap in its current form? Please state your reasons and provide evidence to support your view.*

Question 6: *Do you agree that we should amend the USPA Condition so that it is clear that access operators cannot be required to accept general terms and conditions that include shorter notification periods than those provided for under USPA 7?*

Question 7: *Do you agree with our proposal to amend the scope of Essential Condition 1 to cover untracked letter and large letter mail, and single piece universal service parcels, and to remove the remaining universal service products from the scope of the Essential Condition 1?*

Question 8: *Do you agree with the proposed streamlining revisions to Essential Condition 1, including the removal of the Mail Integrity Code of Practice, as drafted in Annex 12?*

Question 9: *Do you agree that the proposed drafting of Essential Condition 1 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?*

Question 10: *Do you agree with the proposed revisions to Consumer Protection 2, including the removal of the PCOP code and agreement, as drafted in Annex 13?*

Question 11: *Do you agree that the proposed drafting of CP 2 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?*

Question 12: *Do you agree with our proposal to amend the scope of Consumer Protection Condition 3 so that it retains a minimum requirement for all postal*

operators, and that additional requirements in relation to redress and reporting would apply to Royal Mail as the universal service provider only?

Question 13: *Do you agree with our proposed drafting of Consumer Protection Condition 3 given our proposal to only apply the additional requirements set out in CP 3.3 in relation to redress and reporting to Royal Mail as the universal service provider?*

Question 14: *Do you agree with our proposal to revoke Consumer Protection Condition 5?*

Question 15: *Do you agree with our proposal to remove the one-month notification period for price decreases to Royal Mail's universal service products and services?*

Question 16: *Do you agree with our proposal to reduce the advance notice period for specified collection times to one month (reduced from three months)?*

Question 17: *Do you agree with our proposal to remove the advance notice period for latest delivery times (currently at three months)?*

Question 18: *Do you agree with our proposed restructuring and drafting of Designated Universal Service Provider Conditions 1.10.1 and 1.10.2, and the removal of Designated Universal Service Provider Conditions 1.10.3?*