

**Hermes Parcelnet Limited's Response to the questions asked by Ofcom in its Consultation document dated 25 May 2016 following its review of the regulation of the Royal Mail**

**3 August 2016**

**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.*

Hermes Parcelnet Limited ("**Hermes**") agrees with Ofcom's view that the current information does **not** show that the financial sustainability of the universal service is threatened. Accordingly it is Hermes' view that:

- (i) the current approach of using the 'financeability EBIT margin' to assess the long-term financial stability should be maintained;
- (ii) the current EBIT margin range of 5-10% is indicative of a financially sustainable universal service; and
- (iii) the current EBIT margin range of 5-10% should continue to be the benchmark and should not be increased as proposed by Royal Mail.

Hermes does not agree with Ofcom's view at paragraph A6.14 that "... Royal Mail's ability to achieve an investment grade credit rating and a reasonable rate of return for equity investors should be pre-requisites for assessment of financial sustainability".

The financial sustainability of the universal service should be Ofcom's concern, and shareholder return should be the concern of the Board of Directors of Royal Mail PLC. These two matters are not as intrinsically linked as Ofcom appears to believe. Hermes makes the obvious point that Royal Mail's shareholder returns could be increased by actions that would threaten the sustainability of the universal service.

Ensuring the financial stability of the universal service by Ofcom should, in and of itself, secure reasonable rates of return for equity investors. If it does not then the Board of Directors of Royal Mail PLC should be wholly accountable for this and Ofcom should not make this position ambiguous by undertaking a level of responsibility for ensuring a reasonable rate of return for Royal Mail's equity investors.

Hermes agrees with Ofcom's view at paragraph 4.103 that "the current regulatory framework and market conditions appropriately incentivise Royal Mail to pursue efficiency improvements rather than excessively raising prices". Therefore Hermes agrees in principle with Ofcom's view in paragraph 4.104 that maintaining the current regulatory framework is the most appropriate option at this time.

However, Hermes expects Ofcom to continue to monitor Royal Mail's efficiency in light of the shortcomings in Royal Mail's practices identified by WIK's review of Royal Mail set out in paragraph 4.62.

Hermes would like Ofcom make it absolutely clear and transparent to the market how it will monitor the effectiveness of its regulation of Royal Mail and the steps it will take if it determines that the current regulation is not meeting its objectives.

**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.*

Hermes agrees in principle to the regulatory framework remaining in place for 5 years following the completion of Ofcom's review by the end of 2016-17 so that there is regulatory certainty for postal operators and their shareholders, however this is subject to the following:

- (i) that Ofcom will do as it intends (as set out in paragraph 5.36) and forms a view on whether there are better ways to ensure that Royal Mail allocates its costs between parcels and letter appropriately;
- (ii) that Ofcom will take appropriate regulatory action in the event that it forms the view that Royal Mail is unfairly leveraging its position in the letter sector into the parcels sector, or where Ofcom believes there is a substantial risk that Royal Mail may do this;
- (iii) that Ofcom will take appropriate regulatory action to ensure that a competitive market for parcels is maintained, in recognition that this is the key objective for a regulatory framework for the parcels sector, as stated in paragraph 4.105; and
- (iv) that Ofcom make it absolutely clear and transparent to the market how it will monitor the effectiveness of its regulation of Royal Mail and the steps it will take if it determines that the current regulation is not meeting its objectives.

Points (ii) and (iii) above are vitally important as we move into an era of technology driven letter and parcel service solutions through the use of big data analytics.

**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.*

Hermes agrees with Ofcom's analysis that Royal Mail is dominant in the single piece parcels market and the market of bulk parcels of 2kg or less in that it has a share of volumes

(and revenues in the case of bulk parcels of 2kg or less) of between 60-80% in these markets.

Hermes makes the point that whilst Royal Mail is facing pricing constraints in single piece parcels above 2kg in weight, the vast majority of single piece parcels (80% of parcels) are under 2kg, to the extent that any price decrease in Royal Mail's 0-2kg single piece parcel rates would, if matched by Hermes, 80% of parcels.

The dominance of Royal Mail in volumes and revenues in the market of bulk parcels of 2kg or less reflects Hermes' recent experience in the market. It is a consequence of Royal Mail purposefully targeting retailers who use bulk parcel services with a view to only taking parcels from those retailers that are 0-2kg. Royal Mail is targeting this parcel market because Royal Mail is able to use its universal service network of post men and women to deliver these parcels at virtually nil cost if Royal Mail does not allocate its costs appropriately for these parcels. This makes the proposed review of Royal Mail's cost allocation (at paragraph 5.36) vitally important.

Hermes does not operate in the single piece and large letter market or the bulk letters and large letter market and so it is unable to give any opinion on Ofcom's analysis of these markets.

**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.*

Hermes agrees with and fully supports Ofcom's 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.

Hermes provides choice to consumers and non VAT registered small businesses (and provides competition to Royal Mail) by offering parcel delivery services, though its 'myHermes' business at a price that is as close as commercially possible to Royal Mail's prices for its standard parcel delivery services.

The myHermes business delivers parcels to all areas of the UK for the same price according to the weight of the parcels. The myHermes business is possible because of its unique selling point of providing a fully tracked service to its customers at a competitive price point and service standard to Royal Mail's standard 2<sup>nd</sup> class parcel service.

Hermes believes that much of what applies to its business would apply to a provider of fully tracked parcel delivery service at competitive price point and service standard to Royal Mail's standard 1<sup>st</sup> class parcel service.

myHermes has [REDACTED] registered customers; of these customers 80% are consumers and 20% are non VAT registered small business. In the past 3 years, Hermes has delivered the following volume of parcels:

[REDACTED]

Whilst we have seen significant growth in the myHermes business it is important to note that, Royal Mail remains overwhelmingly dominant in the C2X market.

The successful growth of the myHermes parcel volume is founded on its ability to provide a fully tracked service, and is sustained by the choice and convenience offered to its customers by a network of 5,000 parcel 'pick up and drop off' points in local convenience stores called 'myHermes ParcelShops'. The cost to Hermes of the myHermes ParcelShop network is financed by myHermes parcel deliveries.

Currently, services carried out by Royal Mail as part of its USO obligation, are exempt from VAT. Therefore any extension of the USO to include tracked standard parcel delivery would create a 20% price distortion in the C2X tracked parcel market. This is because all other businesses providing parcel delivery services to consumers must charge VAT that cannot be recovered, and accordingly prices will be automatically 20% higher than those offered by Royal Mail for the same services.

The appendix to this response document set out:

- (i) the rates charged by the myHermes business in competition to Royal Mail's for parcel delivery through its ParcelShop network in the period up to a short term price discount in the 0 – 1kg weight band; and
- (ii) the rates charged by the myHermes business in competition to Royal Mail for parcel delivery through its courier network.

Parcels with a weight of 0 -2 kg account for [REDACTED] of the total myHermes parcel volume year to date (from 28 February 2016 to 9 July 2016).

Across all weight bands [REDACTED] of myHermes parcel volume year to date has been delivered through ParcelShops (with the remaining [REDACTED] being delivered through self-employed couriers).

myHermes rates for ParcelShop drop-off are lower than the courier rates because of the lower operating costs and also because the ParcelShop service is regarded as being the most similar to the Royal Mail parcel service, where C2X customers have to go to a Post Office to pay their charge and drop the parcel off.

Hermes has no choice but to price match Royal Mail in its 0-1kg rate because of the highly transactional and price sensitive nature of the C2X parcel market. If Hermes dropped its ParcelShop rate for 1-2kg to price match Royal Mail's 0 -2 kg rate, it would result the

myHermes business becoming loss making and unprofitable across all weight bands, across ParcelShops and Couriers.

The effect of the price distortion that would be created by a VAT exemption on a Royal Mail tracked standard product which competes directly with the myHermes tracked product will be that the myHermes business (including ParcelShops) will become financially unsustainable. Therefore, there is a high risk that myHermes (along with other C2X parcel delivery companies) will exit the market. Furthermore, an impenetrable barrier will be created for any future entrants to the market.

The exit of Hermes from the C2X market will damage the UK economy and the interests of consumers. Furthermore it will prevent a properly functioning parcels market.

There is no consumer demand for Royal Mail to cease the provision of a non-tracked parcel delivery service or for the USO to be extended to cover tracked standard parcels. We also make the point that Royal Mail is now a *private* company and as such there is nothing to prevent it from providing a tracked standard parcel product to consumers that is outside of the USO and VATable; and to this end we agree with Ofcom's statement at paragraph 5.13.

Royal Mail's appeal to extend its USO will not make the current USO more secure, but it will reduce and limit competition in the C2X parcel market to the extent that Royal Mail will revert to being a monopolistic service provider across the regulated letters and parcels delivery market.

For the purpose of preserving and promoting competition, innovation and consumer choice in the C2X parcels market, Hermes believes that Royal Mail's USO should remain as is and should not be extended to include a tracked standard parcel service.

***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.***

Hermes agrees with and supports Ofcom's proposal to retain the safeguard cap in its current form for the reasons put forward by Ofcom. Competition in the single piece parcel market is still in the 'emerging' phase of its evolution and as a consequence public awareness of competing services to Royal Mail/Post Office is still comparatively low.

Hermes' experience is that the 0-2kg parcel segment is by far the most used by consumers [X][X][X] of total myHermes volume year to date (28 February 2016 to 9 July 2016)) and so it is right that the safeguard cap applies to this weight band, as well as to letters and large letters.

Hermes makes the point that the current cap remains relevant in the context of a dominant incumbent in the single piece parcel market (as evidenced by paragraph 5.21) that may wish

to reduce competition by reducing prices in the weight segment that has the highest volume to the extent that competitors are forced out. Without the safeguard cap Royal Mail would then be free increase prices in that weight segment without constraint.

Hermes' view therefore is that the safeguard cap also acts indirectly as a deterrent to Royal Mail acting anti-competitively, because it prevents Royal Mail from benefiting from such behavior.

**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?*

Hermes operates its own network for parcel delivery services only and so the USPA Condition is not relevant to Hermes' business and accordingly this question is not applicable to Hermes' business. Hermes will not respond to this question.

**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?*

Hermes agrees with Ofcom's proposal to amend the scope of Essential Condition 1 on the terms set out in this question 7 and the consultation document. Hermes approves of Ofcom's decision not to extend the scope of Essential Condition 1 to cover parcels and believes Ofcom reasons for this as set out in 7.30 are well considered and correct.

**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?*

As Ofcom has decided not to extend the scope of Essential Condition 1 to cover parcels outside of the USO, the proposed streamlining revisions to Essential Condition 1 (including the removal of the Mail Integrity Code of Practice) are not relevant to Hermes' business. On this basis Hermes will not respond to this question except to note that an outcomes based approach to regulation is more appropriate than prescriptive regulatory requirements.

**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?*

As Ofcom has decided not to extend the scope of Essential Condition 1 to cover parcels, the proposed streamlining revisions to Essential Condition 1 (including the removal of the Mail Integrity Code of Practice) are not relevant to Hermes' business. On this basis Hermes will not respond to this question.

**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?*

As the current Consumer Protection Condition 2 does not apply to Hermes' business and Ofcom's proposed revisions will not change this position, Hermes will not respond to this question.

**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?*

As the current Consumer Protection Condition 2 does not apply to Hermes' business and Ofcom's proposed revisions will not change this position, Hermes will not respond to this question.

**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?*

Hermes agrees with Ofcom's proposal to retain the general requirements in CP 3.2 and that these general requirements continue to apply to all providers of postal services.

Hermes is not a 'regulated postal operator' and accordingly the current CP 3.3 does not apply to Hermes' business and as Ofcom's proposed revisions to CP 3.3 will not change this position, Hermes will not respond to whether or not CP 3.3 should only apply to Royal Mail as the universal service provider. Hermes would note that Ofcom's reasons and justification for this appear to Hermes to be well considered and correct.

**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?*

As the current CP 3.3 does not apply to Hermes' business and Ofcom's proposed revisions will not change this position, Hermes will not respond to this question.

***Question 14: Do you agree with our proposal to revoke Consumer Protection Condition 5?***

Consumer Protection Condition 5 does not apply to Hermes and so Hermes will not respond to this question save as say that it does not object to Ofcom's proposal to revoke it.

***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?***

Hermes does not agree with Ofcom's proposal to remove the one-month notification period for price decreases to Royal Mail's universal service products and services. We would remind Ofcom that Royal Mail is a dominant incumbent in an extremely price sensitive market.

Ofcom has been very careful in its review to consider what effect changing the status quo would have on emerging competition in the single piece parcel market. In paragraph 4.105 Ofcom states that "... the maintenance of a competitive market for parcels should be the key objective for a regulatory framework for the parcels sector". Hermes wholeheartedly supports this view, and considers the proposal to remove any notification by Royal Mail of price decreases in universal service parcel products and services to be contrary to Ofcom's stated key objective for the regulation of the parcels sector.

It is right that Royal Mail, as the dominant incumbent of an extremely price sensitive market, should give its competitors time to prepare for and react to price decreases. In the case of myHermes, changes would have to be made to its web-site and marketing materials. This cannot happen overnight, and there is a real risk that myHermes will lose significant market share during the time it takes to react to any Royal Mail price reduction made without notice.

Hermes understands that a 1 month notification period could be seen to be too long as it prevents consumers benefiting from the price reduction for this period, but removing the requirement altogether is disproportionate, and has to weighed up against the detrimental effect it will have on Royal Mail's emerging competitors.

Hermes would support a proposal to reduce the notification period for price decreases to 2 weeks.



**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)?*

Hermes is not a user of post boxes and so will not respond to this question.

**Question 17:** *Do you agree with our proposal to remove the advance notice period for latest delivery times (currently at three months)?*

Hermes is neither a significant user of Royal Mail's services or recipient of Royal Mail deliveries and so will not respond to this question.

**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?*

Designated Universal Service Provider Conditions 1.10.1, 1.10.2 and 1.10.3 are not applicable to Hermes or its customers and so Hermes will not respond to this question.

## Annex

**Myhermes - Parcelshop Rates**

<b>Weight (Up to)</b>	<b>Net</b>	<b>Gross</b>
1kg	2.29	2.75
2kg	3.29	3.95
1kg	2.29	2.75
2kg	3.29	3.95
5kg	4.96	5.95
10kg	6.63	7.95
15kg	8.29	9.95

**MyHermes - Courier Rates**

<b>Weight (Up to)</b>	<b>Net</b>	<b>Gross</b>
1kg	2.58	3.10
2kg	3.58	4.30
1kg	2.58	3.10
2kg	3.58	4.30
5kg	5.25	6.30
10kg	6.92	8.30
15kg	8.58	10.30