# Review of end-to-end competition in the postal sector

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Statement

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# About this document

This document sets out Ofcom's decision that we do not consider there are grounds to impose regulatory conditions on Whistl's end-to-end letter competition. This is because we do not currently consider the evidence shows that end-to-end letter competition by Whistl presents a threat to Royal Mail's ability to provide the universal postal service.

End-to-end letter competition is where letters are collected, processed and delivered directly to the recipient in direct competition with Royal Mail, without the need to use Royal Mail's network.

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## Section 1

# Executive summary

1.1 This document sets out Ofcom's current regulatory position on end-to-end letter competition and its effect on Royal Mail's provision of the universal postal service.[1]

1.2 End-to-end letter competition is where an operator other than Royal Mail (the universal service provider) collects, processes and delivers mail directly to the recipient in direct competition with Royal Mail, without the need to use Royal Mail's network. End-to-end letter competition is also sometimes referred to as direct delivery competition. Royal Mail has also previously referred to it as bypass competition. End-to-end competition is a relatively new form of postal competition in the UK; it is currently small in scale, and provided almost entirely by Whistl (formerly TNT Post UK). The main form of competition to date has been access competition, where the operator collects mail from the customer, transports it to Royal Mail, but relies upon Royal Mail's delivery network in order for it to reach the recipient.

1.3 Ofcom took over responsibility for regulating postal services in 2011. Ofcom's duty under the Postal Services Act 2011 in respect of postal services is to secure the provision of a universal postal service, having regard to the need for such provision to be both financially sustainable and efficient.

1.4 Since 2011, Ofcom has been monitoring the development of end-to-end competition to Royal Mail. In that period, Royal Mail has regularly made representations asking Ofcom to consider the need to impose regulatory obligations on Whistl. In light of these representations and the evidence that Ofcom collects including information contained in Royal Mail and Whistl's forward looking business plans, Ofcom has published a number of statements of its position in the intervening period, as well as guidance on assessing the impact of end-to-end competition on the provision of the universal postal service.[2]

1.5 In June 2014 Royal Mail provided Ofcom with a further submission arguing that end-to-end competition poses a significant threat to the provision of the universal postal service, and again argued that Ofcom should intervene to protect the universal service as a result. In July 2014, Royal Mail provided to Ofcom its latest business plan, on which its submission was based.

1.6 At the heart of Royal Mail's submissions is its claim that unless Ofcom takes regulatory action in relation to end-to-end competition, Royal Mail's ability to finance the universal service will be undermined, and this would be contrary to Ofcom's duty under the Postal Services Act 2011 to secure the provision of a universal postal service.

[1] Throughout this document, where we refer to "end-to-end competition", we mean end-to-end competition in collection, sortation and delivery of letters and large letters.
[2] Securing the Universal Postal Service: Decision on the new regulatory framework (27 March 2012); Update on Ofcom's position on end-to-end competition in the postal sector (25 July 2012); End-to-end competition in the postal sector: Ofcom's assessment of the responses to the draft guidance on end-to-end competition (27 March 2013), Annual monitoring updates on the postal market (20 November 2012 and 22 November 2013) and analyst briefings for the postal sector (18 July 2013 and 24 April 2014).

1.7 In this review we have considered the evidence available to us, including the most recent information from Royal Mail's 2014 Business Plan, the latest results from our ongoing monitoring programme and Whistl's rollout plans. We have also considered the arguments in Royal Mail's June 2014 Submission. We have assessed whether, in light of the evidence, the impact of end-to-end competition from Whistl is likely to pose a threat to the provision by Royal Mail of a financially sustainable and efficient universal postal service. To this end, we have assessed the forecast financial position of the universal service, and the arguments which Royal Mail and other stakeholders have put to us about the likely impact of end-to-end competition on that financial position.

1.8 In light of this assessment we have considered whether the legal tests in the Postal Services Act 2011 for imposing regulatory conditions on end-to-end operators are met, and/or whether we should be undertaking any other work in light of our duty to secure the universal service.

1.9 For the reasons set out in this document, we do not consider it necessary at this time to exercise our regulatory powers under the Postal Services Act 2011 to impose regulatory conditions on Whistl in order to secure the ongoing provision of a universal postal service. We do not consider that the provision of the universal postal service is under threat, and as a result we do not consider that the legal tests for imposing such regulatory conditions are met.

1.10 We continue to consider that competition, including end-to-end letter competition at the delivery end of the network, provides an important degree of choice for users of postal services, and can have an important incentive effect on Royal Mail to provide the universal service in an efficient manner.

1.11 We recognise that there is uncertainty around Royal Mail's future financial position, particularly in the final two years of our analysis (i.e. 2017-18 to 2018-19). However, contrary to the position Royal Mail set out to us in its June 2014 submission, this uncertainty in our view arises to a significant extent from factors other than end-to-end competition.

1.12 Our decision not to intervene at this point does not imply that we are ruling out such a course of action at some point in the future, if circumstances change. As we set out in our March 2013 guidance on end-to-end competition in the postal sector,[3] we consider we could implement general universal service conditions within six to nine months if it was necessary to secure the provision of a universal service. To this end, we will continue to monitor the situation closely.

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

**Section 2**

# Background

## Ofcom's duties

2.1 Regulatory responsibility for postal services was transferred to Ofcom in October 2011 under the Postal Services Act 2011 (PSA 2011).

2.2 Ofcom's principal duty under the Communications Act 2003 (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 a universal postal service, to which we must give priority where it appears to Ofcom that there is a conflict with our CA 2003 duties.

2.3 In performing our duty to secure the provision of a universal postal service, Ofcom must have regard to the need for the provision of a universal postal service to be (i) financially sustainable and (ii) efficient before the end of a reasonable period, and for its provision to continue to be efficient at all subsequent times.

2.4 The reference to the need for the provision of a universal postal service to be financially sustainable includes the need for a reasonable commercial rate of return for any universal service provider (USP) (currently only Royal Mail) on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.

## Regulatory steps taken in March 2012 to secure the provision of a universal postal service

2.5 In 2011, in light of Ofcom's new duty to secure the provision of a universal postal service, we reviewed the regulatory framework for the postal sector in the UK, and in particular the performance and financial position of the universal service. In this review, we noted that the universal service is central to the role that post plays in society, and that developments over the past decade or so, including the increasing substitution of mail for electronic communication methods and the shift to lower value services had resulted in serious challenges to the postal sector and Royal Mail. We observed that Royal Mail's financial position was weak and considered that the financial sustainability of the universal service was under severe pressure. As part of this, we also noted that the provision of the universal service needed to become more efficient.

2.6 To address these issues, in March 2012 we issued a statement which fundamentally changed the regulatory regime to which Royal Mail was subject to provide Royal Mail with a greater opportunity to return the universal service to a financially sustainable position and secure its future provision.[4]

2.7 We recognised that under the PSA 2011 the concept of financial sustainability includes the need for the USP to earn a reasonable commercial rate of return on any expenditure incurred for the purpose of, or in connection with, the provision of a

[4] The "March 2012 Statement", *Securing the Universal Postal Service - Decision on the new regulatory framework,* 27 March 2012, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf

universal postal service. We considered what a reasonable level of return might be given market conditions and the level of risk within the business, and concluded that an indicative EBIT[5] margin range of 5% to 10% was appropriate and consistent with securing a financially sustainable universal service. We have been clear that this was an exercise of judgment and it would not represent a cap on earnings or an automatic right for Royal Mail to earn a return within this range.[6]

2.8 We considered that Royal Mail needed to be given significantly greater pricing and commercial flexibility than it had been afforded under the previous regulatory framework and so removed the vast majority of the previous regulation, retaining only a simple price cap on Second Class stamps (less than 2kg) to protect vulnerable consumers. We acknowledged that it was likely that Royal Mail would need to raise prices, at least in the short term, which duly transpired.[7]

2.9 We noted that beyond short term price rises, Royal Mail must also rely on efficiency improvements and if it did not exercise its new freedoms in ways that supported the regulatory objectives, it was important that we were in a position to intervene as appropriate.

2.10 In order to monitor developments in the postal sector, including to ensure that Royal Mail uses its new pricing and commercial flexibility in a way that accords with our regulatory objectives of achieving a universal service that is both financially sustainable and efficiently delivered, we put in place a detailed monitoring regime.

2.11 We prepare quarterly reports based on data we collect from operators in the postal sector, which are examined internally by our relevant governance bodies, and we have published annual monitoring updates based on these quarterly reports in November 2012 (to set the baseline under the previous regulatory regime), and 2013 (covering the 2012-13 financial year), and our third annual monitoring report for 2013-14 is published today alongside this document. We have also reviewed the position periodically and produced update statements.

2.12 Finally, we recognised the importance of competition (both in the form of access and end-to-end competition) to incentivise Royal Mail to improve its efficiency and protect customers from unreasonable prices. To this end:

i) we required Royal Mail to continue to provide access to its letters network to other postal operators and set certain limits on its pricing of that access; and

ii) to allow us to readily identify any future threat to the universal service that might be posed by end-to-end competition (of which there was virtually none at the time), we imposed a notification condition, requiring end-to-end competitors to tell us in advance of their plans to enter or increase their delivery volumes.[8]

2.13 We said we would review the effect of end-to-end competition on a case by case basis and noted that we have powers to impose conditions where there is a demonstrable threat to the provision of the universal service from such competition.

[5] Earnings Before Interest and Tax.
[6] March 2012 Statement, paragraph 5.34 to 5.43 and March 2013 end-to-end Statement, paragraph 3.9
[7] For details of Royal Mail's price increases since April 2012 see Sections 5 and 6 of the *Annual monitoring update on the postal market – Financial year 2013-14*, published 2 December 2014, http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/.
[8] The Notification Condition only applies to end-to-end competitors who are planning to deliver in excess of 2.5 million items per quarter.

2.14 In order to provide regulatory stability and certainty and to enable Royal Mail to adapt to the challenging circumstances that it and the universal service were facing, we decided that the new regulatory framework should be in place for a period of seven years. We set out our expectation that Royal Mail would use the additional flexibility and commercial freedom within the new regulatory framework to secure the long term sustainability of the universal service in a manner that responded to its customers' needs, and noted that if it did not act as we expected it to (particularly with respect to improving its efficiency) we would, if necessary, be open to reviewing the regulatory framework within the seven year period.

## Developments in end-to-end letter competition since March 2012

2.15 End-to-end competition is where operators other than Royal Mail collect, process and deliver mail direct to the recipient without the need to use Royal Mail's network. Prior to Ofcom taking over regulatory responsibility for the postal industry in October 2011, there had been virtually no end-to-end letter competition in the UK, with Royal Mail delivering 99.9% of total market volumes.[9]

2.16 In April 2012, Whistl (formerly TNT Post UK) started a trial of the end-to-end delivery of letters in West London. Whistl publicly stated in 2013 that it planned to deliver to around 42% of UK addresses by 2017.[10] Following its successful trial of delivery operations in West London, it has extended delivery services to Central, South West and North West London, Manchester and Liverpool.

2.17 Through our ongoing monitoring of the postal sector, formal notifications from Whistl required under the Notification Condition,[11] and general updates provided by Whistl (including provision to Ofcom of its operational and business plans),[12] Ofcom has informed itself of the developing position regarding end-to-end letter competition since Whistl commenced its trial.

2.18 While the significant majority of information provided to Ofcom by Whistl is commercially confidential, it has publicly stated that its rollout plan is behind schedule. By the end of 2014, it had expected to be delivering to around 15% of the country[13] but it is currently only delivering to around 7%[14] (for example, it had planned to also be delivering in Edinburgh, Glasgow, Birmingham and East London by now). [15] As set out in our annual monitoring update, Whistl only delivered around 0.5% of the total addressed letter mail market in 2013-14.[16]

2.19 [✂]

[9] *Annual monitoring update on the postal market, Financial year 2011-12*, Ofcom, 20 November 2012, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf.
[10] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013.
[11] Any operator is required to give three months' notice of its intention to enter or expand its letter delivery service and to provide Ofcom with its future volume forecasts, geographic areas to be entered and timeframe for entry/expansion, subject to minimum additional volume requirements of 2.5 million items per quarter.
[12] [✂]
[13] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013
[14] Whistl presentation to the MarketForce annual conference on The Future of the UK Postal Services, 21 October 2014.
[15] Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013
[16] *Annual monitoring update on the postal market, Financial year 2013-14*, paragraph 3.28.

2.20 Aside from the impact of Whistl's suspension of its rollout plan as a result of Royal Mail's announced access prices, we consider it is likely other factors have impacted its ability to achieve its plan. This includes the time taken to secure the investment required in 2013 and [✂].

2.21 To reflect the suspension of its rollout plan and its actual results, Whistl has recently revised its rollout plan. It provided a new plan to Ofcom on 19 November 2014. This plan was consistent with Whistl's recent public statements that if it secures investment it is intending to deliver to around 42% of the country by 2019.[17] As discussed in Section 3, our modelling of the potential future impact of end-to-end competition on the universal service was based on the plan provided to Ofcom in December 2013 delayed by an additional year. We have reviewed Whistl's new plan against the assumptions used in our modelling and [✂].

2.22 In addition, the High Court has recently determined, in the course of proceedings brought by Whistl, that it is lawful for the UK Government to exempt Royal Mail's access services from VAT.[18] As a consequence, VAT-exempt customers (such as financial institutions and charities) are not likely to find end-to-end services provided by Whistl financially attractive unless it can offer prices including VAT which match (or are lower than) Royal Mail's VAT-exempt access prices.[19] This also impacts Royal Mail's retail services for bulk mail products.

## Ofcom's monitoring of the postal services market

2.23 Ofcom's monitoring of the postal sector analyses:

- actual results from Royal Mail in relation to financial performance, efficiency and quality of service, and volume and revenue data provided by other postal operators; and
- forecasts of future performance from Royal Mail in relation to its strategic business plans and annual budgets, notifications from other postal operators under the Notification Condition and business plans from any end-to-end entrants or updates to existing end-to-end operators' plans.

2.24 We report on key metrics in relation to:

- the financial performance of the universal service;
- Royal Mail's progress on improving the efficiency of the universal service network;
- the impact of changes in prices and achieved quality of service for customers and consumers; and
- the level of competition in the market.

[17] Whistl presentation to the MarketForce annual conference on The Future of the UK Postal Services, 21 October 2014.
[18] *R. (on the application of Whistl UK Limited) v. Her Majesty's Revenue And Customs* [2014] EWHC 3480 (Admin).
[19] All postal operators are required to charge VAT for upstream retail bulk mail products.

2.25 As explained above, these reports are examined internally by our relevant governance bodies on a quarterly basis. In addition, we publish an annual monitoring update on the postal market.[20]

## Ofcom's reviews of the impact of end-to-end competition since March 2012

### July 2012 update

2.26 In July 2012 in response to representations on the impact of end-to-end competition from stakeholders, including Royal Mail, Ofcom reviewed the position and published a statement updating its views on end-to-end competition in the postal sector.[21] We noted that Royal Mail considered that end-to-end competition may severely impact its ability to continue to provide the universal service and as such it had asked Ofcom to consider imposing regulatory conditions on all end-to-end entrants.

2.27 We assessed Whistl's business plans at the time, and its likely impact on Royal Mail's provision of the universal postal service, in light of Royal Mail's business plan at that point in time. We found that Whistl's market share and therefore the financial impact on the universal service were expected to be low in the first few years of its plan. There was also significant uncertainty over Whistl's ability to meet its business plan, Royal Mail's commercial and cost reactions to competition and other key market factors in the longer term.

2.28 We therefore concluded that we did not consider it necessary, at that time, to impose any additional regulatory conditions on Whistl to secure the ongoing provision of the universal service.

2.29 We explained that we would continue to monitor the postal market carefully and carry out further reviews as appropriate. In order to provide regulatory clarity for the future, and in recognition of the ongoing and forward-looking nature of Ofcom's duties, we also committed to publish guidance setting out in more detail a framework against which Ofcom would consider the exercise of its regulatory powers in relation to end-to-end competition.

### March 2013 guidance on assessing the impact of end-to-end competition on the universal postal service

2.30 In March 2013 we published guidance (the "March 2013 end-to-end Guidance") on Ofcom's approach to assessing the impact of end-to-end competition on the provision of the universal postal service.[22] In this guidance we set out the approach and financial analysis we would expect to undertake in establishing the extent to which the finances of the universal service might be affected by the entry or expansion of end-to-end competition. We also set out how, on the basis of this financial analysis, we would form a view as to whether the sustainability of the universal service is likely to be under threat due to end-to-end competition, and whether or not it would be appropriate to intervene. This is the analysis that we have now undertaken and is set out in Section 3 of this document.

[20] Published November 2012, November 2013 and December 2014.
[21] *Update on Ofcom's position on end-to-end competition in the postal sector*, 25 July 2012, http://stakeholders.ofcom.org.uk/binaries/post/update.pdf.
[22] March 2013 end-to-end Guidance, *End-to-end competition in the postal sector – Final guidance on Ofcom's approach to assessing the impact on the universal postal service*, Ofcom, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf

2.31 We also published a further statement in which we confirmed that we did not consider end-to-end competition was a threat to the universal service at the time.[23] In that statement we explained that the following announcements since our July 2012 update suggested to us that our decision in July 2012 on the effect of end-to-end competition remained appropriate. Those announcements were:

- Royal Mail's interim financial report for the first half of 2012-13 (published on 13 November 2012).[24] This showed Royal Mail's best financial results for several years, with its division UKPIL (UK Parcels, International and Letters), which includes the universal service operations, reporting an operating profit (after exceptionals) of £99 million (compared to an operating loss of £41 million for the first half of 2011-12); and

- PostNL's Q4 and full-year 2012 results, (published 25 February 2013). In these results and related presentations, PostNL (Whistl's parent company) published information on the current scale of its end-to-end operations in London and its future intentions. In particular, it said that as of December 2012 Whistl was delivering 345,000 letters per week as part of its London operations. This equated to 0.13% of the relevant market (by volume).[25] PostNL also said that due to its cash constraints it was looking for €50 to €80 million of external investment to complete a full rollout of end-to-end services in the UK.[26]

### Further updates by Ofcom

2.32 In addition to the decisions set out above, we also publicly confirmed in the annual monitoring updates in November 2012 and 2013 and in analyst briefings in July 2013 and April 2014 that, on the basis of the evidence we had seen, we did not consider that end-to-end competition was currently a threat to the universal postal service.

## Royal Mail's submission of June 2014

2.33 In June 2014, Royal Mail submitted a document[27] to us ("Royal Mail's June 2014 Submission") which set out Royal Mail's views on the threat that it considered that end-to-end competition poses to the universal postal service. Further details of this submission are set out in Annex 1. In July 2014, Royal Mail submitted to us its latest business plan. We consider this evidence further in Section 3 below.

2.34 Following Royal Mail's submission, Ofcom received a submission from the Communications Workers Union (CWU) in which it set out its concerns about the

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[23] March 2013 end-to-end Statement.
[24] *Interim Report for the half year ended 23 September 2012*, Royal Mail, published 13 November 2012, http://www.royalmailgroup.com/interim-report-half-year-ended-23-september-2012.
[25] March 2013 end-to-end Statement, paragraph 1.7
[26] PostNL, Q4 & FY 2012 Results including update 2015, 25 February 2013: press release, http://www.postnl.nl/en/Images/20130225-postnl-2012-q4-press-release_tcm9-15846.pdf; PostNL, Q4 & FY 2012 Results including update 2015: Sustainable delivery, 25 February 2013: Analyst presentation https://www.postnl.nl/Images/20130225-postnl-2012-q4-presentation_tcm10-15847.pdf; PostNL Q4 and 2012 full year results: transcript of the analyst presentation, Transcript, 25 February 2013, https://www.postnl.nl/Images/20130225-postnl-2012-q4-analyst-transcript_tcm10-15850.pdf.
[27] Royal Mail's June 2014 Submission entitled *Direct Delivery: A Threat to the Universal Postal Service Regulatory Submission to Ofcom*. A non-confidential version is available at: http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission%20Final%20Version%20for%20Publication.pdf

impact of end-to-end competition on the universal postal service;[28] and a response to Royal Mail's submission from the Mail Competition Forum (MCF).[29] Further details of these submissions are set out in Annex 1.

2.35 In Annex 2, we address points made by stakeholders which are not separately addressed in Section 3 below.

[28] *CWU Submission to Ofcom: The threat to the universal postal service from direct delivery competition*, published on the CWU website on 3 October 2014, available at: http://cwunorthwest.org/pdf/CWUSubmissionToOfcom.pdf

[29] *Text of letter sent to Ofcom in response to letter from Royal Mail regarding a perceived threat to the Universal Service Provision from "Direct Delivery competition"*, Mail Competition Forum, Press release of letter dated 22 August 2014 sent to Ofcom, available at: http://www.mailcompetitionforum.org/wp/press-releases/

**Section 3**

# Analysis of the financial position of the universal postal service and the effects of end-to-end competition

## Background

3.1 This section sets out our current assessment of the financial position of the universal postal service and the possible impact of end-to-end competition. It follows the approach set out in our March 2013 end-to-end Guidance,[30] on how we planned to assess whether the expected scale of end-to-end competition was likely to be sufficient to threaten Royal Mail's financeability to the point where the provision of the universal service would become financially unsustainable.

3.2 The steps proposed in our March 2013 end-to-end Guidance were to:

- determine what the financial position of the universal service would be likely to be in the absence of end-to-end competition;
- assess the expected direct impact of end-to-end competition on the universal service;
- consider the impact of Royal Mail's potential commercial response(s); and
- assess the risk to the universal service, taking into account the uncertainty associated with forecasting.

3.3 To carry out our assessment, we have relied on confidential business plan data obtained from both Royal Mail and Whistl. We have also used data obtained as part of our ongoing monitoring work together with further information provided in response to statutory information requests from Royal Mail, Whistl, UK Mail and Secured Mail. We have also taken account of all the submissions and representations made to us.

3.4 Our analysis is structured as follows:

- first, we set out our base position by taking Royal Mail's most recent business plan for the Reported Business and removing any end-to-end competition assumed within it, to identify Royal Mail's view of its financial position absent end-to-end competition;
- second, we overlay Whistl's business plan onto this adjusted Royal Mail plan;
- third, we identify the possibility for commercial responses by Royal Mail by reference to previous Royal Mail business plans, monitoring results, any relevant submissions by stakeholders, and our own analysis of Royal Mail's efficiency; and

[30] See Section 4 of the March 2013 end-to-end Guidance.

- fourth, we consider the extent to which other factors may affect whether the universal service is sustainable in the longer term.

## Methodology to assess the financial sustainability of the universal postal service

### Introduction

3.5 Our duty to secure the provision of a universal postal service requires us to have regard to the need for the provision of a universal postal service to be financially sustainable, including a commercial rate of return on any expenditure incurred for the purposes of, or in connection with such provision.

3.6 In the March 2012 statement we stated that an approach such as a return on sales would be more relevant than a return on capital, given Royal Mail's universal service network is largely based around people, and its operating costs are significantly higher than the value of its tangible assets. We then determined that the EBIT margin (Earnings before Interest and Taxes, expressed as a percentage of sales), is the most appropriate measure of a commercial rate of return for Royal Mail. This was in part because we were seeking a proxy for operating cash generation and Royal Mail's cash flow and EBIT were projected to become broadly comparable towards the end of the business plan that was in place at that time.[31]

3.7 The treatment of pension costs has a significant impact on any assessment of Royal Mail's profitability. For the financial year ended March 2012, the pension cost reported by Royal Mail in its accounts (17.1% of pensionable salary) was similar to the amount Royal Mail paid into the scheme in cash. Therefore, the reported EBIT provided a reasonable proxy for Royal Mail's ability to generate cash. Since then, however, the rates have diverged; the cash rate remains at 17.1%,[32] while the accounting rate has [✂].[33]

3.8 Royal Mail's current funding agreement with the Trustee of the Royal Mail Pension Plan (its defined benefit pension scheme) covers the period to September 2018. As this plan is currently in surplus (due to the pensions reform agreed with the Trustee that took effect on 1 April 2014), the actuarial surplus is being used to meet part of Royal Mail's on-going defined benefit pension costs. Royal Mail noted in its prospectus dated 25 July 2014[34], that "movements in equity markets, interest rates and life expectancy could materially affect the level of actuarial surpluses and deficits in the schemes" and could result in additional pension costs in the future.

3.9 The next significant review of the Plan's financial position will be the March 2015 actuarial valuation. This may provide a better indication of what the payments might be once the current funding agreement ends in 2018.

3.10 In the short term, the effect is therefore to increase our measure of Royal Mail's EBIT. However, we do not know what the likely cash pension costs will be after September 2018 when a deal must be done with the pension trustee. It is possible that the cash rate will increase. If the cash rate exceeds the accounting rate, the

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[31] March 2012 Statement, paragraphs 5.25 and 5.47.
[32] Royal Mail 2011-12 statutory accounts entitled Annual Report 2012, page 47 http://www.royalmailgroup.com/sites/default/files/Annual_Report_2012.pdf
[33] The July 2014 Business Plan.
[34] Royal Mail plc: Prospectus, http://www.royalmailgroup.com/sites/default/files/Full_Prospectus.pdf.

adjusted EBIT would be lower than the reported EBIT. However, we would not expect Royal Mail would agree to a deal that it could not afford.

3.11 Therefore, we consider that Royal Mail's reported EBIT should be adjusted to restate pension costs on a cash basis. We have called this the "financeability EBIT".

## EBIT Range

3.12 In March 2012 we stated that we considered "An indicative EBIT margin range of 5% to 10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk within the business".[35]

3.13 Consistent with our March 2013 end-to-end Guidance, we consider that the appropriate basis for assessing the financial sustainability of the universal service, in an assessment of the impact of end-to-end competition, is to have regard to whether the expected EBIT margin is likely to be within a range consistent with our view of financeability.[36] We have therefore used this indicative EBIT margin as the starting point for this assessment.[37]

3.14 In addition, the March 2013 end-to-end Guidance also set out our approach to consider whether Royal Mail has sufficient *opportunity* to earn a reasonable commercial rate of return to secure the provision of the universal service. However, we noted that we would not *guarantee* that Royal Mail earns that return. We noted that, as a general rule, "if Royal Mail's poor financial performance was primarily the result of factors that are within its control, then there would be a substantially weaker case for intervention than if its performance was due to factors that are mainly outside its control."[38]

## Timescale

3.15 We have considered the appropriate length of time over which to assess whether the universal service is likely to be financially sustainable. While we did not set out an appropriate timeframe for such an assessment in the March 2013 end-to-end Guidance, we considered that the expected period of relatively low (or negative) EBIT margins would need to be of sufficient duration for us to be confident there was a real threat to the financial sustainability of the universal service.

3.16 For the purposes of this assessment, we have considered a five year timeframe from 2014-15 to 2018-19. We consider that this is a reasonable period to consider, as it would allow sufficient time for Whistl's current planned rollout to be near complete and it is a time period for which we have received forecast data for the Reported Business from Royal Mail [✂].

## Data sources

3.17 We have used a number of data sets to inform our analysis of the impact of Whistl's end-to-end plans on the universal service. Royal Mail provided us with a new

[35] March 2012 Statement, paragraphs 5.47.
[36] March 2013 end-to-end Guidance, pages 20-21.
[37] We note that the 5% to 10% indicative range we identified as being appropriate in 2012 was in the context of a publicly owned Royal Mail and we have not yet re-assessed this range since Royal Mail was privatised.
[38] March 2013 end-to-end Guidance, pages 23-24.

business plan in July 2014 (the “July 2014 Business Plan”) which had been approved by its Board and covers the years [✂]. In addition, so that we were able to estimate the financial position of the universal service from 2014-15 to 2018-19, it also provided high level financial information for [✂], which has not been Board approved. Royal Mail also set out in its June 2014 Submission evidence to show its estimated impact of end-to-end competition to [✂].[39]

3.18 As set out in Section 2, Whistl has provided a number of rollout plans to Ofcom, including prior to its trial of end-to-end competition starting in April 2012. Our analysis is based on the updated rollout plan provided to Ofcom in December 2013 (“December 2013 plan”), delayed by an additional year to take account of Whistl’s suspension of its rollout plan this year.

3.19 To prepare its business plan, Royal Mail made a number of assumptions regarding Whistl’s future roll-out plans, which it has not seen. We therefore have additional, confidential, information that is not available to Royal Mail and is not reflected in its July 2014 Business Plan. The starting point for our assessment is an adjusted version of Royal Mail’s July 2014 Business Plan, which excludes Royal Mail’s estimated impact of end-to-end competition. We have then overlaid our estimate of the impact of end-to-end competition, informed by Whistl’s confidential plans.

3.20 In this section we take Royal Mail’s 2014 Business Plan, replace its assessment of the impact of end-to-end competition with our own (based on Whistl’s plans) and consider the extent to which Royal Mail might be able to convert the reduced volumes into lower costs.

3.21 We then show the effect of restating the pension costs on a cash basis.

## Royal Mail’s financial position absent end-to-end competition

3.22 Royal Mail's July 2014 Business Plan assumed [✂[40, 41]].

3.23 [✂]

3.24 [✂]

### Figure 3.1: Royal Mail’s Actual and Expected EBIT margin 2010-11 to 2018-19

[✂]

*Source: Ofcom analysis of Royal Mail’s July 2014 Business Plan*

3.25 We have considered whether Royal Mail’s results for the first half of 2014-15 might cause it to change its future forecasts. These results have provided an indication of potential performance for 2014-15 against the July 2014 Business Plan. [✂[42, 43].]

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[39] Royal Mail’s June 2014 Submission – confidential version received by Ofcom on 20 June 2014, figures 5.2 to 5.8, pages 48 to 51.
[40] Royal Mail’s June 2014 Submission – confidential version received by Ofcom on 20 June 2014, paragraph 5.2.
[41] [✂]
[42] Ofcom Monthly Return 1415 P6, growth in Letter and Large Letters End-to-End Inland and Access.
[43] Ofcom Monthly Return 1415 P6, growth in Parcels End-to-End Inland and Access.

3.26 However, the Reported Business EBIT margin after transformation costs for the first half of 2014-15 was [✂].[44] We have therefore continued to base our analysis on the July 2014 Business Plan.

### Summary – Royal Mail's financial position absent end-to-end competition

3.27 Royal Mail's latest business plan predicts that it will earn an EBIT margin (including pension costs on an accounting basis) [✂].

3.28 As explained later in this section, the effect of including pension costs on a cash basis is that the estimated financeability EBIT margin is [✂] higher than the EBIT margins set out above.

## Assessing the impact of end-to-end competition

3.29 We have reviewed the current and forecast activities of Whistl and have considered how this might affect Royal Mail's forecast financial position (as calculated by Royal Mail, including pension costs on an accounting basis).

3.30 The development of Whistl's end-to-end operations, current market shares and updated plans are discussed in Section 2. As set out above, we have used Whistl's December 2013 plan delayed by a year in our modelling. Whistl has since provided us with an updated rollout plan on 19 November 2014 which has [✂.[45]]

3.31 Our analysis is shown in Figure 3.2 below and suggests that, absent any commercial or cost response from Royal Mail, its EBIT margin will be likely to [✂].[46] However, this assumes Royal Mail is not able to remove any costs associated with the decline in its volume.

**Figure 3.2: Royal Mail's projected EBIT margin to 2018-19 including Whistl's rollout plan**

[✂]

*Source: Ofcom analysis of Royal Mail and Whistl Business Plans*

3.32 The above graph therefore represents our view of Royal Mail's EBIT forecasts (as reflected in its July 2014 Business Plan and additional high level financials provided to Ofcom) adjusted only to reflect the better information we have on Whistl's roll out plans.

### Cost response to loss of volumes

3.33 In its analysis of the potential impact of end-to-end competition within its regulatory submission (both its assumptions on the likely impact of Whistl's publicly stated plans and its other scenarios of the potential volume of end-to-end competition), [✂].[47]

3.34 The loss of volumes to end-to-end competition will inevitably reduce Royal Mail's workload. The question is therefore whether Royal Mail would be able to reduce its costs as a result.

44 Q2 RB Proxy Income Statement, provided by Royal Mail
45 Whistl's November 2014 Business Plan
46 In our modelling we have assumed that Whistl's end-to-end volumes are converted from Royal Mail's access volumes (rather than its retail bulk mail volumes).
47 [✂]

3.35 Royal Mail argued in its submission that it has strong incentives to reduce its cost base due to declining letter volumes, strong competition in the parcels market and the need to deliver value for its shareholders.[48] It therefore stated that end-to-end competition would not result in any additional savings from those it will make in any event.

3.36 [✂][49]

3.37 It is possible that Royal Mail will not be able to immediately convert reduced volumes and workload into cost savings. However, it seems unlikely that the reduced volumes would have no impact on Royal Mail's ability to cut its costs over the next five years.

3.38 We have therefore attempted to quantify the possible impact on Royal Mail's costs. In its July 2014 Business Plan, Royal Mail set out its assumptions on how costs could vary in line with changes in volume (also known as marginality). We understand that these assumptions already take account of the difficulties in reducing costs, given the high proportion of fixed costs within its network due to the universal service obligation.

3.39 Figure 3.3 illustrates the effect on Royal Mail's EBIT forecasts of assuming that it could reduce costs in response to the reduced volumes in line with Royal Mail's cost volume elasticities for frontline delivery and processing. [✂][50]. Figure 3.3 shows that the assumptions regarding Royal Mail's ability to reduce its costs have relatively little impact in the short term (when the possible reduction in volumes would be relatively low), but a greater impact in the longer term (as the potential loss of volumes increases).

**Figure 3.3: Royal Mail's projected EBIT margin to 2018-19 with Whistl's rollout plan**

[✂]

*Source: Ofcom analysis of Royal Mail and Whistl Business Plans*

3.40 If Royal Mail was able to make the cost savings that its marginality assumptions would suggest were possible, we estimate that [✂].

## Restating pension costs on a cash basis

3.41 Royal Mail's forecasts include pension costs calculated on an accounting basis. As explained above, we consider that EBIT should be calculated including pension costs on a cash basis. We described this measure of EBIT as the financeability EBIT.

3.42 As explained above, in the short term, the effect of including the cash cost of pensions is to increase our measure of Royal Mail's EBIT. We do not know what the likely cash pension costs will be after 2018. It is possible that the cash rate will increase, potentially above the level of the accounting cost. In such circumstances, the financeability EBIT would be lower than the reported EBIT. However, we would not expect Royal Mail would agree to a deal that it could not afford.

3.43 Figure 3.4 shows Royal Mail's EBIT forecasts (as reflected in its July 2014 Business Plan and additional high level financial assumptions adjusted to reflect Whistl's roll

[48] Royal Mail's June 2014 Submission, page 26.
[49] Royal Mail's June 2014 submission – confidential version received by Ofcom on 20 June 2014, page 48.
[50] [✂]

out plans) with pension costs restated on a cash basis. For illustrative purposes, we have assumed that the cash rate continues at the current level beyond 2018.

**Figure 3.4: Royal Mail's projected EBIT margin to 2018-19 with Whistl's rollout plan (Pension costs included on a cash basis)**

[✂]

*Source: Ofcom analysis of Royal Mail and Whistl Business Plans*

3.44 The graph shows that, if Royal Mail could achieve additional cost reductions in response to volume decline, in line with its marginality assumptions for front line processing and delivery, we would expect it to make a financeability EBIT margin of [✂] for the three years [✂] 2014-15 to 2016-17.

3.45 In light of the possible significance of Royal Mail's future pension costs on its longer term financial sustainability, we are intending to do some additional work to better understand the financial position of Royal Mail's pension arrangements and what might happen to pension costs in the longer term.

### Summary – the impact of end-to-end competition

3.46 If Royal Mail is able to respond to reduced volumes by reducing costs in line with its own frontline delivery and processing marginality assumptions, we estimate that the impact of end-to-end competition could be to reduce Royal Mail's EBIT (and the financeability EBIT) by [✂] by 2015-16, [✂] by 2017-18 and [✂] by 2018-19.

3.47 We are not persuaded by Royal Mail's counter-argument that it could not reduce its costs any faster over the next five years if it lost additional volumes to end-to-end competition. However, even if this was the case, we estimate that Royal Mail would still make a financeability EBIT of [✂] from 2014-15 to 2016-17.

3.48 On this basis, there does not appear to be any immediate threat to the sustainability of the universal service.

3.49 In the longer term, there is greater uncertainty.

3.50 The longer term impact of end-to-end competition depends on the scale of the competition and the extent to which Royal Mail reduces its costs in response to the reduced workload caused by the loss of mail volumes.

3.51 However, the profitability of the universal service will also depend on other factors, unrelated to end-to-end competition. We consider some of these, below.

## Royal Mail's potential commercial responses to end-to-end competition and other uncertainties

### Introduction

3.52 Inevitably, if end-to-end competition was to increase in line with Whistl's business plan, Royal Mail's EBIT would be lower than it would have been absent that competition. For example, the above analysis indicates that the effect of competition could be to reduce Royal Mail's margin in 2018-19 by around [✂] when compared to a world without any end-to-end competition if we assume that it is able to reduce its costs in line with its marginality assumptions for front line processing and delivery (or by more, if it was not able to do so).

3.53 Therefore, in the context of Royal Mail's expected single digit percentage EBIT margins, end-to-end competition could potentially have a significant impact on Royal Mail's margins in the longer term.

3.54 However, there are other factors that could have a similar or greater impact on Royal Mail's profitability. Some of these are within Royal Mail's control, such as its ability to reduce its costs. Others may be partly within its control such as its future parcel revenues. Other factors, such as the state of the economy are outside of Royal Mail's control. Therefore a significant level of uncertainty remains around Royal Mail's future profitability.

3.55 The extent of this uncertainty is illustrated to some extent by a comparison between Royal Mail's 2013 and July 2014 business plans.

3.56 The changes made by Royal Mail between the 2013 and July 2014 Business Plans reflect uncertainties largely unrelated to end-to-end competition. [✂][51]

3.57 We have therefore considered how Royal Mail's EBIT forecasts are subject to Royal Mail's ability to reduce its costs and uncertainty regarding its parcels revenue.

## Royal Mail's ability to cut its costs

3.58 We have explained above that it seems likely that the reduced volumes that would follow increased end-to-end competition would give Royal Mail scope to achieve greater cost savings than are reflected in its Business Plan, due to the <u>reduced workload</u> that would result.

3.59 In this section we consider the extent to which Royal Mail might achieve greater cost savings than are reflected in its Business Plan, by achieving <u>greater efficiency</u> savings in response to increased competition.

3.60 As discussed in detail in Annex 5 of the Access Pricing Consultation on the benefits of competition,[52] we consider that end-to-end competition is likely to provide powerful efficiency incentives to Royal Mail in the processing and delivery of business mail. As Royal Mail uses the same network to deliver both universal service products and business mail letters and parcels, we expect that the resulting efficiency benefits will also have a significant impact on the efficient provision of universal services. We therefore consider that, as long as it is compatible with the financial sustainability of the universal service, end-to-end competition in business mail services may be one of the key mechanisms through which we secure the efficient provision of the universal service.

3.61 We acknowledged in the March 2012 Statement that while access competition had resulted in efficiency improvements in the parts of the pipeline subject to competition, such as mail centres, it does not impact the largest portion of the operational cost base, namely delivery. We therefore expect that under normal circumstances end-to-end competition would be likely to result in additional efficiency incentives on an incumbent USP. However, it is conceivable, as Royal Mail has suggested, that its

[51] Royal Mail presentation entitled *2013 Business Plan and 2013/14 Budget,* March 2013, Slide11
[52] *Royal Mail Access Pricing Review: Proposed amendments to the regulatory framework*, Ofcom, 2 December 2014, http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/.

efficiency targets are already sufficiently challenging and it will therefore not be possible to increase the pace at which it is improving its efficiency.

3.62 To this end, we have reviewed the productivity improvements, gross hour reductions and cost savings within Royal Mail's July 2014 Business Plan.

## Productivity

3.63 Royal Mail uses a productivity metric which provides a measure of the operational efficiency of its delivery and processing (mail centre) operations. This measure calculates the ratio between volumes processed and time taken. Volumes are weighted by the time expected to be taken to process them to give a weighted volume (or "workload") which includes the impact of a change in mix of products and volume decline.

3.64 There are some limitations to this type of measure. Firstly, it currently only covers delivery and processing activities and so excludes parts of Royal Mail's operations (although delivery and processing people costs account for a significant proportion of Royal Mail's regulated business costs). In addition, the measure is a productivity measure not a financial measure. This means that although it captures the rate of work, it does not cover the costs involved in achieving that rate of work, for example, how much people are being paid and non-people costs such as accommodation and transport costs.

3.65 Royal Mail has provided us productivity targets in a number of its business plans since we took over regulation of the postal industry in October 2011. [✂]

i) The restructuring plan which informed our analysis and policy proposals for the October 2011 consultation on the new regulatory framework, set a target for productivity improvement [✂]

ii) The next plan [✂]

iii) The 2013 Business Plan set targets of [✂]; and

iv) the 2014 Plan set targets of [✂].

3.66 For example, the effect of the successive business plans in 2014-15 is that efficiency targets were [✂] from [✂] to [✂] to [✂] and finally to [✂].

3.67 As set out in the annual monitoring update,[53] Royal Mail achieved an improvement in productivity of 1.7% in 2013-14. This was lower than its target of 2 to 3%[54] [✂] but matched what it was able to achieve in 2012-13.[55]

3.68 [✂], in the first half of 2014-15 Royal Mail's productivity improvement of 2.1%,[56] was [✂][57] and at the low end of its published target of 2% to 3%.[58]

[53] See Section 4 of http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/.
[54] Royal Mail Annual Report and Accounts 2013-14, Royal Mail, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202013-14_DDA_0.pdf, page 20.
[55] [✂]
[56] *Royal Mail plc: Half Year 2014-15 Results*, Royal Mail, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20H1%202014-15%20Results%20Presentation.pdf, page 10.

3.69 Therefore, for the last year and the first six months of this year, Royal Mail has not achieved its productivity targets and for 2012-13 it [✂].

## Gross Hours

3.70 [✂]

3.71 Actual gross hours reduction for 2013-14 was 2.9% which was [✂[59]]. Similarly, in the first half of 2014, frontline gross hours reduction was 2.3%[60] which is [✂].[61]

## Costs

3.72 An important component of Royal Mail's costs is the wages that it pays its staff. It is therefore important to assess its productivity targets in line with expectations about how labour costs are likely to increase over the same time period. As a result of the agreement signed between Royal Mail and the CWU,[62] frontline staff pay increased by 3.0% in 2014-15 and is expected to increase by 2.8% in 2015-16.[63]

3.73 [✂]

3.74 In addition, while Royal Mail stated in its submission that end-to-end competition would not result in any additional efficiency incentives, in meetings and presentations with Ofcom [✂[64, 65, 66]].

3.75 [✂[67, 68. 69]]

3.76 The employee protections agreed with the CWU in December 2013 may restrict Royal Mail's ability to make its workforce more flexible as it includes, among other things, a commitment to maintain a predominantly full-time workforce, maintenance of existing employment terms and conditions, no additional outsourcing and an objective to manage change without recourse to compulsory redundancy. These

[57] P6 2014-15 monthly cost information submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines.
[58] *Royal Mail plc: Half Year 2014-15 Results*, Royal Mail, 19 November 2014, page 10.
[59] P12 2013-14 monthly cost information submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines.
[60] *Royal Mail plc: Half Year 2014-15 Results*, Royal Mail, 19 November 2014, page 10
[61] P6 2014-15 monthly cost information submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines.
[62] *Agenda for Growth, Stability and Long Term Success*, CWU, January 2014, http://www.cwu.org/assets/_files/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf.
[63] Subject to review if actual inflation (average monthly RPI from January to March 2015) is below 2.3% or above 3.3%.
[64] [✂]
[65] [✂]
[66] P6 2014-15 monthly cost information submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines. Figures based on end-to-end and access parcel volumes but excluding international.
[67] [✂]
[68] Royal Mail report to Ofcom entitled Group Monthly Management Accounts and KPI Performance Pack November (4 weeks to Sunday 1 December 2013) [✂]
[69] *Agenda for Growth, Stability and Long Term Success*, CWU, January 2014, http://www.cwu.org/assets/_files/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf.

undertakings are ongoing and subject to periodic review starting from January 2019.[70, 71]

3.77 Royal Mail's decision to enter into these arrangements may therefore limit its ability to control these costs in the short term and may make it more important for Royal Mail to tightly control its other (non-people) costs. These make up around a third of Royal Mail's UKPIL operating costs,[72] and approximately the same proportion for the Reported Business.[73] In the first half of 2014-15, Royal Mail has reduced its non-people costs for UKPIL by 4%.[74] This compares to a decrease of almost 2% for the 2013-14 financial year (once the £42m one-off VAT rebate is excluded).[75]

## Ofcom's view on Royal Mail's scope for efficiency improvements

3.78 It is not yet clear to us whether Royal Mail's achieved levels and proposed targets for efficiency improvement represent a reasonable rate of improvement, or whether it would be possible and/or necessary for Royal Mail to aim for more ambitious cost savings than those reflected in its current forecasts if it felt the financial sustainability of the business was at risk. It is possible that if Royal Mail's actual results proved to be significantly worse than those shown in its forecasts, that it would look to accelerate or increase its planned cost savings. [✂.[76]]

3.79 Given the importance of improving efficiency with respect to Royal Mail's ability to provide a financially sustainable universal service, we are intending to undertake further analysis on what might represent a reasonable rate of efficiency improvement as part of our wider review of factors that affect the future financial sustainability of the universal service.

3.80 In addition, as discussed in the annual monitoring update, we have commissioned a review into the assumptions Royal Mail has made about how it expects its costs to vary with volume changes i.e. marginality (from Analysys Mason). This is an important component of the workload metric which is used in the productivity and other efficiency metrics we have developed. We expect this work to be completed next year and for it to feed into the efficiency metrics used in the annual monitoring update for 2014-15.

3.81 We note that a number of City analysts have also highlighted the potential for Royal Mail to achieve further efficiency gains, while recognising the difficulties involved in reducing costs. For example, [✂].[77]

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[70] See Royal Mail Group News Release, Royal Mail and CWU reach agreement in principle on an Agenda for Growth, Industrial Stability, Pay and Protections, Royal Mail, 9 December 2013, http://phx.corporate-ir.net/phoenix.zhtml?c=251825&p=irol-newsArticle&ID=1883124&highlight.
[71] In exceptional circumstances Royal Mail can notify the CWU at any time that any or all of the Protections will no longer continue if it believes on reasonable grounds that any part of the business has ceased to be, or is likely to cease being, financially sustainable. See the Agenda for Growth, Stability and Long Term Success, paragraph 7.1.
[72] Royal Mail plc Half Year 2014-15 Results, 19 November 2014, Slide 20.
[73] Ofcom analysis of 2013-14 Regulatory Financial Statements 52 weeks ended 30 March 2014, Royal Mail, page 11.
[74] Royal Mail plc Half Year 2014-15 Results Transcript, 19 November 2014, page 5, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Half%20Year%202014-15%20Results%20Transcript.pdf
[75] Royal Mail 2013-14 Statutory Financial Statement, page 20.
[76] [✂]
[77] [✂]

## Uncertainty around future parcel revenues

3.82 Royal Mail has said that its: “*strategy is to be a successful parcels business. We aim to offset the decline in letters with growth in parcels [and increases in efficiency]*”.[78]

3.83 Online shopping continues to grow and to drive growth in the parcels market. Royal Mail stated recently that it expected medium term annual growth in the UK parcel delivery market to be about 4% but that the UK addressable market growth rate was only c.1% to 2% for the next two years.[79] It also stated that due to the competitive environment average unit revenues were under pressure.[80] PwC estimated, in its report on UK mail volumes, average inland parcel growth of 3.3% between 2013 and 2018.[81]

3.84 As noted by Royal Mail, the parcels market is very competitive and competition has recently intensified, particularly from UK Mail, DPD, Hermes and Amazon's roll-out of its own delivery service, which started in January 2014.[82] Royal Mail estimated that, if Amazon further expanded its delivery network, this could [✂].[83]

3.85 Demand is price sensitive due to high levels of competition and limited barriers to switching for customers. This can be seen from the impact of Royal Mail’s introduction of size-based pricing for single piece stamp and meter parcels in April 2013. This resulted in significant price increases for Royal Mail’s "medium" sized parcels; in some cases over 100%.[84] The introduction of size based pricing led to a decline of [✂] in consumer parcel volumes in 2013-14.[85] [✂]. Royal Mail stated in its 2014-15 half year results that the impact of size based pricing was still “*unwinding*”.[86]

3.86 Parcel operators compete with Royal Mail both on price, and technological and service innovations.[87] Many operators are using digital technology to drive innovation. Royal Mail noted, in its June 2014 submission, that innovation is a key feature of the UK parcels market.[88] For example, earlier this year, Parcelforce launched an interactive service enabling customers to arrange for a parcel to be delivered on a different day or to a different address by SMS or email. In March 2014, parcel operator DPD also announced enhancements to its ‘Predict’ service, which notified recipients of the time of delivery to within a 15 minute window.[89]

3.87 Royal Mail is, however, lagging behind in its implementation of some of the technological and service innovations for its parcels that use the universal service network. For example, it does not currently track the majority of its parcels using this

[78] Royal Mail’s June 2014 Submission, page 16.
[79] Royal Mail plc Half Year 2014-15 Results, 19 November 2014, Slide 4.
[80] Royal Mail plc Half Year 2014-15 Results, 19 November 2014, Slide 4.
[81] PwC July 2013 Report, *The outlook for UK mail volumes to 2023*, slide 10, available at: http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf.
[82] [✂]
[83] [✂]
[84] For example, Royal Mail’s price for a 500g parcel that fell into the “medium parcel” category increased from £2.20 to £5.20. Royal Mail’s published prices for April 2012 and April 2013.
[85] 2013-14 Annual Monitoring Report, 2 December 2012 paragraph 3.31.
[86] Royal Mail plc Half Year 2014-15 Results Slides, 19 November 2014, Slide 7.
[87] Royal Mail’s June 2014 Submission, page 16.
[88] Royal Mail’s June 2014 Submission, page 17.
[89] ‘DPD’s Predict service upgraded and rolled out to all UK customers’, *Post and Parcel*, March 2014, http://postandparcel.info/60569/news/dpds-predict-service-rolled-out-to-all-uk-customers/, [accessed 24 November 2014].

network and although it has put in place a scheme where mail can be delivered to the neighbour this is not interactive with the receiving customer as Parcelforce and DPD are now doing. Royal Mail has outlined its plans to improve customer experience through technological innovations, for example Royal Mail is developing the capability to barcode and track more of its parcels and it said on 19 November 2014 that it expects 80% of its parcels to have a barcode by this time next year.[90] This feature is standard with the significant majority of other parcel operators of significant size.

3.88 Innovation in the types of service offered can pose further risks to Royal Mail. For example, click and collect services, which allow customers to pick up an item bought online from a local shop, have grown rapidly in the UK [✂].[91] Similarly, parcel lockers are being rolled out across the UK by companies including InPost, ByBox and Amazon which allow consumers shopping online to choose to pick up their items from public places such as railway stations rather than delivery to the door. Royal Mail has also extended access to its click and collect service, which allows recipients to collect parcels from the Post Office retail network (and Amazon announced on 25 November 2014[92] that its customers would be able to use this service).[93]

3.89 We outlined in paragraphs 3.25 and 3.26 above, Royal Mail's recent parcels performance which reflects the competitiveness of the market. Royal Mail's parcel volumes and revenues have been affected by its sized based pricing initiative and Amazon's new delivery strategy as well as increased supply-side capacity in the market. Inland parcel volumes in the Reported Business declined by 1.2% in 2013-14[94] and [✂] in the first half of 2014-15.[95] The decline in Reported Business parcel volumes is in contrast to the Reported Business' historic trend of parcel volume growth. It is also in contrast to the overall parcel market growth, thus indicating the Reported Business parcel share of supply declined in 2013-14.[96]

## Ofcom's view on parcel volumes

3.90 We consider that growth in parcels offers an opportunity for Royal Mail. However this is dependent on the success of Royal Mail's commercial strategy and parcels could also pose a threat if it fails to achieve its projections.

3.91 Parcel revenues therefore remain a significant area of uncertainty.

3.92 We are therefore intending to do some additional work to better understand the parcels market and Royal Mail's future parcels revenue in our wider review of other factors that affect the future financial sustainability of the universal service.

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[90] Royal Mail plc Half Year 2014-15 Results Slides, 19 November 2014, Slide 6 and Royal Mail plc, Half Year 2014-15 Results: Management presentation and Q&A transcript, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Half%20Year%202014-15%20Results%20Transcript.pdf, (accessed 1 December 2014).
[91] [✂]
[92] Amazon, Press release, *More Than 16,000 Amazon Pickup Locations Now Available Across The UK With The Introduction Of Collection From Post Office Branches*, 25 November 2014, http://phx.corporate-ir.net/phoenix.zhtml?c=251199&p=irol-newsArticle&ID=1992690.
[93] Royal Mail plc, *Financial Report for the half year ended 28 September 2014*, November 2014, p.6.
[94] 2013-14 Annual Monitoring Report, December 2014, paragraph 3.29
[95] P6 2014-15 monthly volume and revenue submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines. Figure based on end-to-end and access parcel volumes but excluding international.
[96] 2013-14 Annual Monitoring Report, 2 December 2014, paragraph 3.29.

## Impact of our access pricing proposals

3.93 We have today published a consultation on our proposals to amend the access pricing regulation that is currently in place. These proposals include a requirement on Royal Mail to earn equal returns across the different geographic zones. We have therefore considered what the likely impact of these proposals will be on the level and scope of end-to-end competition.

3.94 We find it very difficult to predict with any certainty or accuracy what Royal Mail might do in setting its access prices, if following consultation, the current proposals were imposed. However, London is Royal Mail's most expensive zone to deliver in but is not currently the highest price zone, so it is likely that Royal Mail will need to increase the price in London relative to the national average access price (there are no current or proposed requirements on Royal Mail in relation to setting the level of the national average price). Therefore, on an equivalent basis, this may make entry into London Standard Selection Codes[97] (SSCs) relatively more attractive than the current prices and Royal Mail's proposed prices for April 2014. Urban zonal prices are likely to increase relative to the national average price and Suburban and Rural prices would be likely to decrease relatively.

3.95 However, we do not expect that this will have a significant impact on Whistl's current rollout plan. It is [✂] and most other SSCs will have a mixture of urban, suburban and rural zones so, if Royal Mail maintained its current margin, the impact of these proposals is likely to be mixed depending on the number and type of the different delivery points in the individual SSCs. It is possible under this scenario that Whistl [✂]

## Scope for greater end-to-end competition

3.96 Our modelling of the impact of our revised version of Whistl's December 2013 Business Plan assumed that the maximum share of the total addressed market that it would achieve would be [✂] market share in the areas that it enters.[98]

3.97 In contrast, Royal Mail analysed the contestable market for letters and considered that [✂][99] of UK addressed inland letter mail are contestable by an end-to-end entrant. [✂][100]

3.98 It is possible that an end-to-end entrant could win higher local market shares than the [✂] predicted by Whistl in its business case. We have therefore considered what the maximum market share that an entrant could credibly win in the areas that it entered would be likely to be.

3.99 To do so, we considered the different types of mail volumes that Whistl might be able to win. We consider that access volumes would make up the majority of Whistl's end-to-end volumes and that the share of the access market it could convert to its access operations could be over 85%. We have also assumed in this maximum entry scenario that an entrant could conceivably win some (around 25%) of Royal Mail's retail bulk mail volumes and to a lesser extent some single piece PPI[101] and meter

[97] An SSC is a numeric code used by Royal Mail to sequence addresses, identify selection breaks and match items to mailing bag labels.
[97][✂]
[99]See page ii, section 4.6.2 on page 36, and page 38 of Royal Mail's confidential regulatory submission to Ofcom, *Direct delivery: a threat to the universal service*, 20 June 2014.
[100] [✂]
[101] Printed Postage Impression.

volumes (15% and 10% respectively). We do not consider that end-to-end entrants would be likely to set up First Class networks or to develop the collection points required for targeting residential customers and small businesses.

3.100 Combining these assumptions in our analysis suggests that an entrant could potentially win a maximum share of around 50% to 55% in its delivery areas by 2018-19.

3.101 If this was to happen, we estimate that Royal Mail's EBIT margin could be less than [✂] by 2018-19. It would also be possible that if the entrant's local market share increases, it will be incentivised to enter in additional areas. It is therefore possible that this level of market share would mean the universal service would not be financeable.

3.102 However, we do not consider it is likely that Whistl will win a market share that is even close to the maximum local market share we modelled in this example. The end-to-end volumes under this scenario are [✂] higher than the final rollout volumes assumed by Whistl in both its December 2013 business plan and the November 2014 plan. In addition, Whistl has informed us that [✂].

3.103 The issue of VAT exemption is also relevant to considering the maximum market share that Whistl might be able to achieve. Access is VAT exempt, but Royal Mail retail (excluding universal services) and end-to-end operators have to charge VAT for the total cost of the item. As discussed in Section 2, Whistl recently lost its challenge to the VAT exemption of regulated access in the High Court.[102] We consider that this is likely to mean that Whistl will find it more difficult to compete for customers who cannot reclaim VAT (such as financial institutions and charities) unless it can offer prices including VAT which match (or are lower than) Royal Mail's VAT-exempt access prices. This is likely to mean that the effective maximum possible level of entry for access products is lower than we have modelled.

3.104 As noted above, we do not consider it likely that Whistl will reach a local market share that is close to what we have modelled. In any event, if it did start winning greater market share than implied by its business case, we consider that this would be identified by our monitoring regime sufficiently far in advance to take any necessary action to secure the universal service.

### Summary – potential commercial response and other uncertainties

3.105 Beyond the next few years, our assessment of the sustainability of the universal service becomes less certain.

3.106 However, to a significant extent, this uncertainty is due to factors other than end-to-end competition, including Royal Mail's ability to reduce its costs to reflect the reduced workload and deliver efficiency savings, and the success of its parcels strategy.

3.107 Relatively small changes in parcel volumes, hours worked, pay increases or pension costs could significantly affect its future EBIT margins by as much as, or more than, the impact of end-to-end competition.

[102] *R. (on the application of Whistl UK Limited) v. Her Majesty's Revenue And Customs* [2014] EWHC 3480 (Admin).

3.108 Some of these factors are, to a significant extent, within Royal Mail's control. In this respect, [✂] Royal Mail has found (and may continue to find) it challenging to deliver the savings that may be necessary to secure the universal service in the longer term. Other factors, such as future parcel revenues, while perhaps less within Royal Mail's control are nevertheless affected by decisions taken by Royal Mail and recent results have shown that Royal Mail has found it difficult to forecast the impact of its parcel strategy on its revenues.

## Current assessment of the risk to the universal service

3.109 In the March 2012 Statement we set out our view that an indicative EBIT margin range of 5% to 10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return given the level of risk within its business. In our March 2013 end-to-end Guidance, we were clear that this level of return was not guaranteed and that we would consider whether Royal Mail has sufficient opportunity to earn a reasonable commercial rate of return to secure the provision of the universal service.

3.110 We therefore noted in this guidance, that, as a general rule, if Royal Mail's poor financial performance was primarily the result of factors that are within its control, then there would be a substantially weaker case for intervention than if its performance was due to factors that are mainly outside its control.

3.111 Absent end-to-end competition and using the accounting pension costs, Royal Mail's forecasts indicate that it would expect that its EBIT margin would be [✂]. Adjusting these figures to reflect the cash cost of the pension scheme increases these estimates by around [✂]. As explained above, we have called this measure of EBIT the financeability EBIT.

3.112 After adjusting Royal Mail's forecasts to reflect the expected impact of competition (based on the information provided in Whistl's plans and Royal Mail's marginality assumptions), we estimate that, in the short term (to 2016-17), Royal Mail's financeability EBIT margin would be [✂]. On this basis, there does not appear to be any immediate threat to the sustainability of the universal service.

3.113 Beyond the next few years, our assessment of the sustainability of the universal service becomes less certain. In the longer term, the impact of end-to-end competition depends on the scale of the competition and the extent to which Royal Mail reduces its costs in response to the reduced workload caused by the loss of mail volumes.

3.114 However, when looking at the longer term, the potential impact of end-to-end competition needs to be considered in the context of other uncertainties.

3.115 There may be commercial responses available to Royal Mail that could improve its profitability. Alternatively, Royal Mail may fail to meet its efficiency targets or deliver its parcel strategy. Relatively small changes in parcel volumes, hours worked, pay increases or pension costs could significantly affect Royal Mail's future EBIT margins by as much as, or more than, the impact of end-to-end competition.

3.116 Therefore, it is possible that Royal Mail's profitability could be better or worse than its forecasts. We recognise that in some scenarios it could deteriorate to the point where the universal service is not sustainable. However, at this stage it is far from certain that this will be the case and even less certain, if this was the case, that end-to-end competition would be the decisive factor.

3.117 However, as explained in Section 2 and above, our monitoring regime would ensure that we were aware of this possible outcome sufficiently far in advance to take any necessary action to secure the universal service.

3.118 In light of the above analysis we do not consider that end-to-end competition currently poses a threat to the financial sustainability of the universal postal service over the period covered by Royal Mail's current business plan.

**Section 4**

# Conclusions

4.1 In the preceding sections and associated annexes of this document we have set out:

a) our relevant statutory duties;

b) details of the regulatory steps we have taken to date to meet our duty to secure the provision of a universal postal service that is both financially sustainable and efficient;

c) details of the monitoring we undertake of the postal service sector in general, and the extent of end-to-end competition in particular;

d) a summary of the submissions that we have received from Royal Mail, the CWU and the MCF in relation to the impact of end-to-end competition on the provision of the universal postal service;

e) details of both Royal Mail and Whistl's commercially confidential business plans; and

f) our current assessment, in light of the submissions made to us and the further evidence that we have considered, of the likely future financial sustainability of the universal postal service, including the rate of return that we might expect Royal Mail to be able to make on expenditure incurred for the purpose of, or in connection with, the provision of the universal postal service based on its July 2014 Business Plan and Whistl's business plan.

4.2 Having considered all of the evidence before us, including both Royal Mail and Whistl's latest business plans, we do not consider that end-to-end competition currently poses a threat to the financial sustainability of the universal service over the period covered by Royal Mail's current business plan. While there is greater uncertainty over both the projections for key assumptions (such as future parcel revenues, actual performance on improving efficiency and future cash pension costs) and Royal Mail's EBIT margin in the later years of our analysis, we consider that [✂].

4.3 Consequently, we do not currently consider that it is necessary to impose regulatory conditions on postal operators who compete end-to-end with Royal Mail in order to secure the provision of a universal postal service. As such, the legal tests set out in the PSA 2011 for imposing general universal service conditions (GUSCs) are not in our view currently met.

4.4 Our decision not to intervene at this point does not imply that we are ruling out such a course of action at some point in the future, if circumstances change. As we set out in our March 2013 end-to-end Guidance, we consider we could implement GUSCs within six to nine months if it was necessary to secure the provision of a universal postal service. To this end, we will continue to monitor the situation closely.

4.5 In its engagement on the financial sustainability of the universal service (both with us and externally), Royal Mail has focussed predominantly on the impact of end-to-end competition from Whistl in the letters market, urging us to take action to limit Whistl's activities.

4.6 We consider a range of other factors are likely to have a significant impact on Royal Mail's ability to earn a commercial rate of return. Some of these factors are endogenous, such as Royal Mail's rate of efficiency improvement, and the costs of its pension schemes. Others, such as the effect of competition in parcels and from electronic communication methods are, in part at least, exogenous, albeit capable of being affected by Royal Mail's own behaviour.

4.7 We consider that there is a need to look more closely at some of these key assumptions which could have a larger effect than end-to-end letter competition in the longer term on the financial sustainability of the universal service i.e. Royal Mail's performance in the parcels sector, its progress on efficiency improvements, and pension costs.

4.8 We have therefore today announced that we are going to broaden our review of the factors that could materially impact Royal Mail's ability to continue to provide the universal service in the future, and this review will look at factors including:

- developments in the parcels market and Royal Mail's position within it – to inform our view of future parcels volume and revenue forecasts; and

- what rate of efficiency improvement Royal Mail should reasonably be able to achieve.

4.9 In addition, on the basis that we consider end-to-end competition is not currently a threat to the provision of the universal service, and that competition is an important driver of efficiency which may positively help to secure the provision of the universal service in the long term, we have today separately published a consultation document setting out proposals to modify the regulation of Royal Mail's access charges.

**Annex 1**

# Submissions on end-to-end competition in the UK

A1.1 In this Annex we set out the information and submissions we have received from Royal Mail, the Communications Workers' Union (CWU) and the Mail Competition Forum (MCF) in relation to this issue.

## Royal Mail's submission

A1.2 In June 2014, Royal Mail provided Ofcom with a submission entitled: *Direct Delivery: A Threat to the Universal Postal Service* ("Royal Mail's June 2014 Submission"). It also published a non-confidential version of this document on its website.[103] This set out Royal Mail's views on the threat that it considers that end-to-end competition poses to the universal postal service and provided analysis to support this view.

A1.3 In its June 2014 submission, Royal Mail argued that the threshold for opening a review of end-to-end competition (as set out in Ofcom's March 2013 guidance on end-to-end competition)[104] had been met, and that it was necessary for Ofcom to intervene to protect the universal service, for example by imposing new regulatory conditions which limit the scale of end-to-end competition.

A1.4 Royal Mail considered that urgent action was needed.[105] It asked Ofcom to consider the level of end-to-end competition which would be consistent with the sustainability of the universal service, determine the point at which conditions should be placed on end-to-end competition to secure the provision of the universal service, and assess the most effective forms of intervention.[106]

A1.5 Royal Mail's key arguments were:

a) the structural decline in letter volumes means the provision of the universal service is already challenged;[107]

b) in light of Whistl's publically stated plans and absent regulatory intervention Royal Mail's ability to reach an EBIT margin within the indicative 5% to 10% range (which Ofcom considered in March 2012 was consistent with a commercial rate of return)[108] on a sustainable basis in the future would be undermined;[109]

[103] Royal Mail's June 2014 Submission. A non-confidential version is available at: http://www.royalmailgroup.com/sites/default/files/Direct%20Delivery%20Submission_Final.pdf.
[104] The March 2013 end-to-end Guidance, *End-to-end competition in the postal sector - Final guidance on Ofcom's approach to assessing the impact on the universal postal service*, Ofcom, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf.
[105] Page vi.
[106] Page v.
[107] Page i.
[108] The March 2013 end-to-end statement, *Securing the Universal Service – Decision on the new regulatory framework,* Ofcom, 27 March 2012, http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf, paragraph 5.47.

c) the threat to Royal Mail's provision of the universal service is greater than that suggested by Whistl's publicly stated plans, on the basis of:

i. the UK's uneven population distribution (its "economic geography");[110]

ii. the extent of access competition in the UK, and the proportion of the UK market that is contestable;[111]

iii. the relative costs of end-to-end entrants, compared to the costs faced by Royal Mail due to its obligation to provide the universal service;[112] and

iv. constraints on Royal Mail's ability to respond to competition in terms of price, frequency and product offering;[113] and

d) finally, Royal Mail argued that it already faces significant efficiency incentives, and end-to-end competition would not provide it with any additional efficiency spur.[114]

A1.6 We summarise Royal Mail's arguments in more detail below.

## Potential threat to the universal service

A1.7 Royal Mail provided some analysis that it had undertaken to estimate the impact of Whistl's publicly stated plans. Based on its estimates of Whistl delivering to 42% of addresses by 2017, and gaining a market share of 20%,[115] Royal Mail considered its revenue could reduce by over £200m in 2017-18.[116]

A1.8 In addition, Royal Mail also considered that the impact of end-to-end competition in the UK was likely to be significantly higher than what was implied by Whistl's publicly stated plans. It argued that the underlying structure and economics of the UK postal market meant that, absent regulatory intervention, there are strong incentives and opportunities for Whistl to achieve a wider rollout, and larger market share, than its publicly stated plans suggest. Royal Mail considered that the current nature of the UK postal market is such that entrants into the end-to-end market are able to grow quickly.

A1.9 Royal Mail's argument was based on a number of factors:

a) the extent of access competition in the UK;

b) the proportion of the UK market that is contestable;[117]

c) the relative costs of Whistl and other end-to-end entrants, compared to the costs faced by Royal Mail due to its obligation to provide the universal service;[118] and

d) constraints on Royal Mail's ability to respond to competition in terms of price, frequency and product offering.[119]

[109] Page v.
[110] Pages iii and 27-32.
[111] Pages iii, 5-9 and 32-35.
[112] Pages i-ii.
[113] Page iv.
[114] Page iv.
[115] Page 60.
[116] Page v. Footnote 8.
[117] Page iii, 5-9 and 32-35.
[118] Page i-ii.

## Access competition

A1.10 Royal Mail considered that the extent of access competition in the UK market meant that end-to-end competition poses a greater threat than in other EU countries (as no other EU country has experienced the same degree of mandated and price-controlled access).[120] Royal Mail argued that, because access operators already have direct relationships with mailers, they can easily switch volumes to their own delivery networks. Royal Mail contended that this creates a platform for rapid expansion of end-to-end delivery.[121] It estimated that Whistl has currently converted over 50% of its access volumes to its end-to-end operation in the areas in which it operates.[122]

## Proportion of the UK market that is contestable

A1.11 Royal Mail also considered that that there is not a natural ceiling to the level of market share that entrants could win in the areas in which they choose to enter.[123] It contended that Whistl is likely to be incentivised to grow its market share by more than its publicly stated plans.[124] Royal Mail's analysis suggested that [✂] of the UK addressed inland letter market is contestable.[125]

A1.12 In its submission, Royal Mail also stated that the business letter mail market is highly concentrated, and as such decisions made by a few large business customers could have significant consequences. Royal Mail suggested that this may mean that the growth of end-to-end competition is neither smooth nor predictable.[126]

## Costs of Royal Mail's universal service obligations

A1.13 Royal Mail argued that it already faces challenges in sustaining the provision of the universal service because of the structural decline in addressed letter volumes of around 4-6%per annum.[127] While it acknowledged that it can respond to declining mail volumes (from both the structural decline of the market and end-to-end competition) through cost reductions linked to a reduction in workload (marginality), it considered that these cost reductions are limited and constrained by its universal service obligations.

A1.14 Royal Mail stated that the universal service obligations (such as delivering six days per week to all addresses in the country) defined the majority of its cost base. In particular, it pointed to the collection and delivery parts of its network, which by their nature entail a high degree of fixed costs, which means that a high proportion of Royal Mail's cost base is relatively inflexible to changes in volume.[128]

A1.15 In addition, Royal Mail argued that the economics of the universal service require a series of cross-subsidies to support it. Royal Mail therefore believed that it is necessary for it to be able to use revenues generated from more profitable

[119] Page iv.
[120] Page iii and 7.
[121] Page iii and 8.
[122] Page 34.
[123] Page ii.
[124] Page v, 41 and 42.
[125] Page 35.
[126] Page iii.
[127] Page i.
[128] Pages 3-4.

geographic or product areas to fund the less profitable areas and services. It expressed concern that end-to-end competition would unwind this inherent cross-subsidy.

A1.16 Royal Mail set out three factors that it considered contribute to this:

a) Competitors have cost advantages from not being required to deliver to the whole country. Royal Mail stated that Whistl aims to deliver to around 42% of the country but this would only equate to around 8.5% of the UK's geographical area. It also stated that the geographical areas in which Whistl is delivering are among the cheapest to serve for a new entrant (based on Royal Mail's analysis of population and mail density). Further, Royal Mail argued that the cost of entry is low for access operators, as they can commence operations in urban areas without major capital investment.

b) Competitors do not have to deliver six days per week across the country. Royal Mail stated that Whistl currently offers an every-other-day service, and considered that this confers a cost benefit of around 40% compared with providing a six-day delivery network.

c) Finally competitors are also able to choose the types of mail they deliver. Royal Mail stated that Whistl is only delivering mail from business customers, much of which can be machine-sequenced, and is therefore easier and cheaper to handle. Such mail also provides dependable volumes. Royal Mail stated that the mandatory access regime means that it has to handle any items that an end-to-end entrant does not want to deliver itself (such as difficult to deliver addresses).[129]

A1.17 Royal Mail asserted that the cumulative effect of these cost advantages meant that end-to-end competitors can set lower prices that are difficult for Royal Mail to match.[130] Royal Mail acknowledged that it benefits from the VAT exemption applied to the services it provides in its capacity as a universal service provider (USP) (such as universal service products and access mail). However, it argued that the cost advantages that end-to-end competitors have from not being subject to the universal service obligation more than offset the benefits of the VAT exemption (as evidenced by the fact that Whistl was delivering some mail for financial institutions).[131]

## Constraints on Royal Mail's ability to respond to competition

A1.18 Royal Mail also considered that it is constrained in its ability to respond to competitors on price, frequency of delivery, and product offering (as set out in paragraph A1.16, above, Royal Mail identified three areas in which competitors have a cost advantage – they do not have to deliver to the whole country, six days per week, and can choose to deliver only certain types of mail).[132] Further to this, Royal Mail also argued that its commercial response to competition has been constrained as a result of Ofcom's ongoing Competition Act investigation into Royal Mail's proposed access price changes.[133]

[129] Pages i, ii, and iii.
[130] Page 33.
[131] Page ii.
[132] Page iv.
[133] Page 39.

Royal Mail's modelling of the impact of end-to-end competition

A1.19 Given the factors set out above, Royal Mail has undertaken some modelling using a range of potential scenarios to estimate a range of an entrants potential delivery volumes. [✂]

A1.20 [✂][134]

A1.21 Figure A1.1 below, shows Royal Mail's view of the range of possible impacts on its EBIT margin depending on the future scale of end-to-end competition. [✂]

**Figure A1.1: Royal Mail Reported Business profit margin under a range of different scenarios (after transformation costs)**

[✂]

*Source: Royal Mail's June 2014 submission page 48 (of the confidential version received by Ofcom on 20 June 2014)*

A1.22 Royal Mail has therefore argued that, absent regulatory intervention, its ability to sustainably earn an EBIT margin in the 5% to 10% range (i.e. the indicative range Ofcom considered in March 2012 was consistent with a commercial rate of return) would be undermined. Figure A1.1, replicated from the June 2014 Submission shows that depending on a number of potential scenarios that it has selected, Royal Mail is predicting that [✂][135]

## Other issues raised by Royal Mail

A1.23 Royal Mail raised a number of other issues in relation to end-to-end competition that it argues impact its ability to continue to provide the universal service which we discuss further below.

Economic geography

A1.24 Royal Mail argued that the UK's economic geography makes the universal service challenging to sustain, and, compared to other EU countries, particularly susceptible to the impact of end-to-end competition. It stated that the UK has a high concentration of large, dense, urban areas (which it argued are attractive to end-to-end competitors), coupled with deeply rural areas of the country (which are costly to serve, and therefore less attractive to competitors). Royal Mail considered that this means that comparisons between the UK and other EU countries in which there is end-to-end competition are of limited relevance.[136]

A1.25 Royal Mail's analysis is based on its assessment that the top 15% most densely populated areas cover only 1% of the UK's landmass, and another 15% of the population lives in areas that amount to 63% of the UK's landmass. According to Royal Mail, under these measures, the UK is an outlier compared to other European countries.[137] It therefore argued that is easier for competitors to enter the market in densely populated areas, leaving Royal Mail to serve more costly, less

[134] Pages 46-52 of the confidential version of The June 2014 Submission.
[135] It is important to note that Royal Mail's business plan is based on the accounting rate for the costs related to the defined benefit pension scheme but our analysis set out in Section 3 is based on the cash rate. We have estimated this to equate to an additional [✂] EBIT margin.
[136] Page iii.
[137] Figure 4.4 on page 30.

densely populated areas, and that this exacerbates the impact of end-to-end competition on the universal service.[138]

Efficiency incentives from end-to-end competition

A1.26 Royal Mail argued that it already faces strong efficiency incentives, noting, in particular, competition from e-substitution and the discipline of being a public company. It stated that it is already targeting efficiency levels that have been described by its economic consultants, Oxera, as challenging but plausible.[139]

A1.27 While Royal Mail acknowledged that some cost reduction is possible as a response to volume decline, it stated that the universal service means that, even with fewer items, it still has to deliver to the same number of streets six days per week. Royal Mail therefore considered that end-to-end competition would not provide any additional efficiency spur.[140]

### Royal Mail's assessment of different regulatory interventions

A1.28 Royal Mail provided its assessment of a range of different regulatory interventions that Ofcom could consider introducing:

- reforming access conditions;
- imposing GUSCs; and
- introducing a compensation fund.[141]

A1.29 Royal Mail expressed its preference for Ofcom imposing a GUSC to set a threshold for a level of end-to-end competition that is compatible with an efficiently delivered and financially sustainable universal service.[142] It also stated that Ofcom should determine a framework for how competition under this threshold would operate (e.g. undertaking an auction for this agreed level of competition, potentially operating on a franchise basis).[143]

A1.30 Royal Mail considered that a GUSC requiring coverage of certain geographic areas, or a GUSC requiring delivery on a minimum number of days per week risk damaging the sustainability of the universal service further.[144] Similarly, it stated that imposing a general access condition, or easing Royal Mail's access conditions, risked reducing Royal Mail's volumes and revenues, and that this would not be sufficient to address the impact of end-to-end competition.[145] Finally, Royal Mail considered that a universal service fund, while potentially a viable longer term option, would not provide a solution to the immediate threat.[146]

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138 Page iii.
139 Page iv, 16-25. [✂]
140 Page iv.
141 Page 43.
142 Ibid.
143 Page 46.
144 Page 45.
145 Page 44.
146 Page 48.

A1.31 Royal Mail also stated that it does not favour amending the requirements of the universal service.[147]

### Royal Mail's conclusion

A1.32 Royal Mail concluded that, unless it acts now, Ofcom could find that the provision of the universal service has become unviable before effective actions could be implemented. It believed that Ofcom should undertake a review of end-to-end competition and its impact on the universal service now as a matter of priority, and that is was also necessary to simultaneously look at the regulatory changes that are needed to protect the universal service.

## Other stakeholder comments

A1.33 Following Royal Mail's June 2014 Submission, we also received:

a) a submission from the CWU in which it set out its concerns about the impact of end-to-end competition on the universal postal service[148]; and

b) a response to Royal Mail's submission from the MCF.[149]

### CWU's submission

A1.34 Like Royal Mail, the CWU's submission expressed concern that the universal service is under threat from end-to-end competition as a result of competitors rolling out in profitable city locations. The CWU was also concerned about the impact of end-to-end competition on Royal Mail's ability to achieve an EBIT margin of between 5% and 10%, stating that Whistl's projected growth rate makes this impossible for Royal Mail to achieve. Indeed, the CWU argued that Ofcom underestimates the impact of revenue losses where there is competition in final mile delivery.[150]

A1.35 Of particular concern to the CWU in its submission was Ofcom's assessment of Royal Mail's efficiency, and quality of service.

A1.36 It expressed concern about how Ofcom defines and measures efficiency, arguing in particular that it would be wrong for Ofcom to compare Royal Mail's labour costs with competitors who can choose when and where to deliver.[151] Further, the CWU believed that Royal Mail has sufficient incentives to improve its efficiency without further competition (due to, for example, volume decline, competition in parcels, and privatisation).[152] Nevertheless, the CWU did not believe that Royal Mail has the capacity to make sufficient efficiency improvements to meet the threat of end-to-end

[147] Page 49.
[148] *CWU Submission to Ofcom: The threat to the universal postal service from direct delivery competition*, CWU, published on the CWU website on 3 October 2014, available at: http://cwunorthwest.org/pdf/CWUSubmissionToOfcom.pdf.
[149] *Text of letter sent to Ofcom in response to letter from Royal Mail regarding a perceived threat to the Universal Service Provision from "Direct Delivery competition"*, Mail Competition Forum, Press release of letter dated 22 August 2014, sent to Ofcom, available at: http://www.mailcompetitionforum.org/wp/press-releases/.
[150] Page 2.
[151] Page 9.
[152] Page 11.

competition given its level of fixed costs related to maintaining the universal service.[153]

A1.37 Moreover, the CWU considered that there is a point at which pursuit of efficiency could affect quality of service.[154] It argued that there is a connection between Royal Mail's record on quality of service and the level of pay and conditions that Royal Mail offers.[155] The CWU contrasts this with Whistl's employment model and what it sees as Whistl's poor quality of service.[156] The CWU considered that poor performance on quality of service affects perceptions of the postal industry, and therefore argued that Ofcom should require all end-to-end providers to record and report on performance targets.[157]

A1.38 In summary, the CWU called on Ofcom to impose a cap on competition at its current level, and undertake a full review of end-to-end competition to establish the longer term remedies required to secure the future of the universal service.[158]

## Mail Competition Forum

A1.39 The Mail Competition Forum which is made up of a number of access and end-to-end competitors to Royal Mail, wrote a letter to Ofcom on 22 August 2014, arguing that it would be disproportionate, and contrary to our general duty under the CA 2003, if, as Royal Mail had argued for, we took action to limit end-to-end competition.[159] Indeed, the MCF considered that such an intervention may be illegal under the 3rd EU Postal Services directive.[160]

A1.40 The MCF argued that mail users have benefited from competition, through cost savings for customers (the MCF estimated this to be in the region of £145m annually), a wider range of choice, and innovation.[161] Indeed, the MCF considered that these benefits have mitigated the decline in mail volumes,[162] and that competition in mail had, by 2008, already added more than 3,300 jobs, and £229m, to the UK economy.[163]

A1.41 In its letter, the MCF argued that, rather than competition, Royal Mail's performance on efficiency represents the major threat to the universal service.[164] The MCF therefore considered that Ofcom should provide a statement on whether we consider Royal Mail's provision of the universal service to be efficient, and, if not, over what period we consider it reasonable for its provision to become efficient.[165]

153 Ibid.
154 Ibid.
155 Page 12.
156 Pages 13-14.
157 Pages 14-15.
158 Page 18.
159 Page 1.
160 Page 2.
161 Ibid.
162 Ibid.
163 Page 3.
164 Page 7.
165 Ibid.

A1.42 The MCF also contended that Royal Mail may be misleading or incorrect in its assertion that the geography and demographics of the UK make the universal service uniquely difficult to provide.[166]

[166] Ibid.

## Annex 2

# Ofcom's position on the UK's economic geography and "cherry picking"

A2.1 In this Annex we set out our response to points which Royal Mail has made in its June 2014 Submission and which have not been addressed elsewhere in this Statement.

A2.2 These are that:

- Whistl is "cherry picking" the areas and types of services in which it chooses to compete end-to-end with Royal Mail, thereby undermining the cross-subsidies (between geographic areas and product types) needed to support the universal service;
- Royal Mail's costs are higher than Whistl's due to Royal Mail being obliged to provide the universal service, which constrains its ability to compete in terms of price, frequency and product offering; and
- the extent of access competition in the UK is greater than in other European countries and this, alongside the UK's unique economic geography, provides a platform from which end-to-end competition can rapidly grow.

A2.3 In its June 2014 Submission, Royal Mail also set out its views on the potential remedies which it states Ofcom should consider. We do not address these in light of our overall conclusions on the universal service.

## Ofcom's view

A2.4 We address Royal Mail's concerns about competitors' cherry picking certain geographic areas and types of mail alongside its assertions about the cost advantages that Whistl and other entrants enjoy due to Royal Mail's universal service obligations, the impact of the UK's economic geography and restrictions on its ability to respond to competition.

### Universal service obligation and access regulation

A2.5 Royal Mail is required to deliver universal services six days per week for letters and five days per week for parcels at geographically uniform prices to minimum quality levels. Within this universal service obligation there is an element of cross-subsidy for universal services, which means that items which cost less to deliver (for example, because they are for lower cost delivery areas or the recipient address is close to the sender) are subsidising to some extent the items that cost more to deliver. This is an important part of the universal service obligation as set out in the PSA 2011.

A2.6 It is important to note, however, that these regulatory requirements and inherent cross-subsidies between geographic areas only apply to universal services such as First and Second Class single piece mail. The customers that are being targeted by other operators for both access and end-to-end services overwhelmingly use business mail services (known as bulk mail) which are not subject to any such regulatory requirements.

A2.7 Royal Mail is required to provide access to its inward mail centres to customers and other postal operators for the onward delivery of the mail. However, Royal Mail already has the freedom to set the absolute level of its access prices and the ability to set its zonal access prices so that they cover the cost of delivery for specific geographic areas (both now and under our proposed changes to the access pricing regulation).[167]

## End-to-end entry in specific geographic areas

A2.8 No end-to-end entrant is in our view likely to choose to set up delivery operations that mirror Royal Mail's national network. For example, Whistl has stated publicly that it intends to deliver to 42% of the country in 2019. This approach is consistent with the experience in other European countries where entrants have generally set up delivery services in certain parts of the country only (aside from the Netherlands which covers a small geographic area and has high population density).[168]

A2.9 However in the UK, the majority of bulk mail customers require a national delivery service.[169] As a result, any entrant choosing to roll out its network selectively will need to purchase access services from Royal Mail in order to offer a service to the majority of retail customers. Royal Mail is therefore required to provide access services in areas where Whistl (or any other end-to-end entrant) chooses not to roll out its own network.

A2.10 Royal Mail stated that Whistl is likely to enter in areas that have a high population density which it argued are cheaper to serve.[170] It also considered that cross subsidies from lower-cost areas are needed to fund the more expensive rural network, in order to deliver a uniform price for universal service products.

A2.11 Delivery costs do vary materially between different geographic areas, with urban and suburban areas typically costing less per delivery than rural areas.[171] While it is true that end-to-end entry is in general likely to be in lower-cost to serve areas, it does not follow that this constitutes unfair competition or that Royal Mail is unable to respond to it. In the first instance, it is not necessarily the case that areas which are low cost to an entrant are also low cost to Royal Mail. For example, as London is likely to be largely made up of delivery points that would be classified as urban and suburban in other parts of the country, it would logically follow if this is also a low cost zone. Indeed, this appears to be the case for Whistl, whose initial phases of roll-out included the London area. However, London is Royal Mail's most expensive zone (largely due to its labour costs).

A2.12 In any event, we do not have concerns about entry that happens on a selective basis where this entry reflects genuine competitive advantage rather than arbitrage-even if it focusses on low cost areas. In this context, an entrant can only gain an artificial advantage by entering in selected areas if it is able to obtain access

[167] See the Access Pricing Consultation, 2 December 2014, http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/.
[168] *ERGP report on end-to-end competition and access in European postal markets*, June 2014, case studies on the Netherlands (page 69) and Sweden (page 86).
[169] Paragraph 1.15 on page 3 of the Access Pricing Consultation states that the majority of access mail is carried on national pricing plans, and a small minority on zonal pricing plans.
[170] Royal Mail's June 2014 submission, page 28.
[171] Royal Mail's June 2014 submission, page i.

services in non-entry areas at subsidised prices. For example, if Royal Mail were required to offer access at a uniform price in all areas then an entrant could off-set inefficient self-supply in low cost areas with subsidised access at the uniform price in higher areas. This would not reflect a competitive advantage but would be exploiting an arbitrage opportunity created by the uniform pricing requirement.

A2.13 However, Royal Mail is not subject to a uniform pricing requirement with respect to access mail and is currently able to set zonal charges which reflect the differences in costs it incurs when providing access services in different zones.[172] Our proposals for access regulation on which we are consulting today (2 December 2014) will preserve these features of the regulatory regime (and indeed would require Royal Mail to reflect any differences in the costs it faces in providing access services in different zones in its zonal access charges). As long as zonal access charges reflect underlying differences in the cost of providing access services in different areas, there will be no subsidy to Whistl or other entrant buying access services from Royal Mail in more expensive areas.

A2.14 Under such a system of zonal access charges, entry can only be a profitable strategy if a competitor is able to self-supply in entry areas at a cost below the relevant zonal access charge. This limits entry to those operators who have a genuine source of competitive advantage over Royal Mail in the areas they choose to enter, either in terms of the cost of self-supplying delivery, the mark-up they are prepared to accept on their own delivery services or both. We note this point was recognised by Royal Mail itself when establishing non-uniform access charges in the UK. In particular, it quoted Panzar (2002) as saying that the problem of inefficient entry would not occur in response to mandating access as long as “the prices charged to all services and market segments were subsidy free.”[173]

A2.15 We therefore do not consider that end-to-end competition entering in specific geographic areas represents arbitrage or “cherry picking” in relation to business mail services.

A2.16 We also do not consider that end-to-end entry in selected areas will undermine the cross-subsidies between geographic areas needed to support the universal service. We recognise that the delivery of universal service mail in more expensive areas requires cross-subsidies from universal service mail in lower-cost areas because of the uniform pricing requirement that applies to universal services mail. This creates a theoretical possibility that Whistl or another entrant could target universal service mail customers solely in low-cost areas, undercutting Royal Mail’s uniform price and thereby undermining the implicit cross-subsidy of the universal service. However, we consider end-to-end entry is likely to focus on customers who currently use bulk mail rather than universal service customers and so we do not think the implicit cross-subsidy of the universal service is likely to happen. This is consistent with the position in other European countries with more end-to-end competition where entrants have focussed on bulk mail.[174] We are therefore not concerned about the potential for this kind of arbitrage in relation to universal service mail and have instead focussed on the potential for it to arise in relation to bulk mail.

[172] Albeit Royal Mail chose not to reflect differences in its own delivery costs across different zones in its 2013-14 proposed zonal access charges, proposing that London and Urban areas should be charged at the lowest rate despite London being its highest cost zone.
[173] Hill and Robinson (Royal Mail Group), 2005, Establishing Non-Uniform Access Prices in the UK, p.5.
[174] *ERGP report on end-to-end competition and access in European postal markets*, June 2014, case studies on the Netherlands (page 69) and Sweden (page 85).

A2.17 Nonetheless, we do recognise the potential for end-to-end entry in bulk mail to affect the profitability of the universal service. In particular, we are conscious that Royal Mail's delivery network has a very high proportion of fixed costs, giving rise to significant economies of scale (i.e. average delivery costs are lower when more mail is delivered over the network). As Royal Mail uses the same delivery network for universal service and other types of mail, including bulk mail and parcels, a reduction in the volumes of these other types of mail (including as a result of end-to-end entry) is likely to lead to an increase in Royal Mail's average delivery costs for all mail, including universal service mail.

A2.18 However, this does not challenge the cross-subsidies needed to support the universal service *per se* but rather the economies of scale Royal Mail currently enjoys in delivering other types of mail in addition to universal service mail over its delivery network. We note this effect would occur regardless of where entry occurred- high cost areas, low cost areas or even on a national basis – we therefore do not consider this effect to be a feature of end-to-end entry occurring in selective geographic areas. Instead, it reflects the fact that Royal Mail's delivery network has a very high proportion of fixed costs, making it potentially sensitive to any decline in volume, which could occur for a number of reasons other than end-to-end entry in bulk mail.

### Type of mail

A2.19 As noted above, currently we consider that the only realistic prospect of entry into letter delivery is in relation to bulk mail. However, Royal Mail is free to set retail prices for bulk mail on a separate basis from other mail types (e.g. universal service mail) and is not subject to any retail price regulation when it does so (other than a margin squeeze condition). It is therefore able to adjust the price of its bulk mail delivery services in response to entry without also taking into account the price it charges for delivery of other mail types and any restrictions that may apply to these other mail types. It is not clear therefore where any potential for arbitrage would arise.

A2.20 Within bulk mail delivery, we recognise some types of letters are likely to be easier to handle than others (for example, mail presented in a particular way). It may well be the case that an entrant chooses to focus on easier to handle types of mail and uses Royal Mail's access service for the remainder. However, an entrant will not be able to do this to gain an artificial cost advantage under our proposals as Royal Mail will be free to reflect the higher costs of handling this type of mail by setting higher charges for these services (as it currently is able to do).[175]

A2.21 Royal Mail has stated that cross-subsidies between product types are also needed to finance the universal service, implying that bulk mail provides some element of cross-subsidy to the universal service. We do not consider this is currently the case as universal service mail is profitable in its own right, and more so than many other types of mail. As Royal Mail's regulatory accounts for 2013-14[176] show, the return Royal Mail makes on the universal service products is higher in comparison with many of its other products including access. The EBIT after transformation costs for universal service products was 15.4% in 2013-14, while the EBIT after

[175] In particular, Royal Mail will be able to designate these types of mail as distinct 'services' and apply a higher mark-up over the relevant format level FAC than it applies to easier-to-handle services.
[177] Royal Mail Regulatory Financial Statements 2013-14: http://www.royalmailgroup.com/sites/default/files/Regulatory_financial_statements_2013-14_1.pdf

transformation costs for the whole of the Reported Business and access was respectively 3.0% and 1.1% in that year.[177]

A2.22 However, we recognise that the development of end-to-end competition in bulk mail could potentially impact the future financeability of the universal service as it removes revenue from Royal Mail. While bulk mail is a low-margin service, this loss of revenue could still have some effect on the overall profitability of the Reported Business.

A2.23 Royal Mail has estimated that the revenue impact could be £200m on the basis of Whistl's publicly stated plans. The actual impact on EBIT would be lower (if its estimates of Whistl's plans were accurate) as Royal Mail would be able to reduce some of its costs due to the lower resulting volumes. We have assessed the impact of Whistl's entry plans on Royal Mail's July 2014 Business Plan in Section 3 above.

## Cost advantages and disadvantages of the universal service obligation

A2.24 While Royal Mail is required to provide collection and delivery services for universal service mail six days per week to a minimum service quality, there is no such requirement for the frequency of delivery or level of service of bulk mail. Whistl is offering a less frequent service, with the intention of generating economies of scale by consolidating volumes over fewer deliveries. Royal Mail stated that the costs incurred by Whistl and any other end-to-end competitor would be 40% less than its own as a result.

A2.25 However, this argument disregards the significant economies of scale and scope from which Royal Mail benefits given its role as the designated universal service provider – it is currently delivering over 99% of all letter mail. In the areas that Whistl is delivering, Royal Mail it is still currently delivering the vast majority, [✂], of letter volumes.[178] Royal Mail has recognised this in its June 2014 Submission, noting that increased volumes lead to lower unit costs and greater volumes. While it uses a diagram to illustrate the virtuous circle this creates – for end-to-end entrants[179] – the same is of course true of Royal Mail.

A2.26 Royal Mail's scale economies are far greater than those of Whistl. Put together, operators other than Royal Mail delivered 80 million letters in 2013-14, around 0.6% of the addressed letter mail market. While this is increasing it is from a very low base. In contrast, Royal Mail delivered 14.5 billion addressed letters (including access and end-to-end letters) in the same year.[180] Even after accounting for Whistl's ability to consolidate deliveries over a fewer number of days, Royal Mail is likely to retain a considerable scale advantage over Whistl.

A2.27 In this respect, we note there is no requirement on Royal Mail to deliver bulk mail at a minimum frequency or quality. Nonetheless, Royal Mail chooses to deliver bulk mail six days per week, presumably because there are significant economies of scope in using the same delivery network for both bulk mail and universal service mail. This suggests that the cost advantages Royal Mail enjoys from using its universal service network for the delivery of bulk mail exceed the cost advantages

[177] Royal Mail Regulatory Financial Statements 2013-14, pages 15 and 29.
[178] Royal Mail's June 2014 Submission, pages iii and iv of the confidential version, referencing an Ipsos MORI survey conducted on behalf of Royal Mail, February 2014.
[179] Figure 6.4: Dynamics for a new entrant, page 38, Royal Mail's June 2014 Submission.
[180] Figure 6.1: Total letters volume by type of operator, *Annual monitoring report on the postal market: 2013-14*, Ofcom, 2 December 2014, http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/.

from operating a bulk mail delivery service on a less frequent basis. The universal service requirement is therefore likely to confer a net cost advantage on Royal Mail when competing with an entrant in bulk mail delivery (at least while the entrant volumes in the areas entered are low) rather than placing Royal Mail at a competitive disadvantage.

A2.28 The universal service is also likely to confer an additional source of cost advantage on Royal Mail when competing with an end-to-end entrant in bulk mail delivery. In particular, Royal Mail, as the universal service provider, also benefits from an exemption from Value Added Tax (VAT). This applies to Royal Mail's access services as well as its universal postal services. This means that Royal Mail's delivery network has a 20% cost advantage over its competitors – including Whistl – in respect of customers who are unable to reclaim VAT, such as financial institutions. Whistl has sought to close this gap by bringing a court action challenging this tax exemption. It recently lost its case in the High Court.[181]

### Greater access competition and unique economic geography in the UK provide a platform for swift end-to-end market penetration

A2.29 Royal Mail stated that the extent of access competition and unique economic geography in the UK is likely to give an advantage to Whistl and any other end-to-end operators, enabling them to quickly grow market share.

A2.30 We have not seen evidence that suggests to us that the either the pre-existence or extent of access competition or population density impacts upon the speed of growth or eventual market share of end-to-end entrants.[182] Whistl started trialling end-to-end delivery services in April 2012 and in the intervening two and a half years it is only delivering to around 7% of addresses[183] with less than 1% market share.[184]

A2.31 Whistl's position in the bulk mail market may better enable it to convert customers from its access to end-to-end business than if it was starting from scratch. However, we have seen no evidence of this accelerating the pace of entry or extending the scope of entry beyond the position we have modelled using Whistl's plans. [✂] However, as set out in Section 3 above, we have modelled our view of a maximum entry scenario to allow for the possibility that entry may occur on a greater scale than set out in Whistl's business plans. We have taken this maximum entry scenario into account in our assessment of the potential impact of end-to-end competition on the universal service.

[181] *R. (on the application of Whistl UK Limited) v. Her Majesty's Revenue And Customs* [2014] EWHC 3480 (Admin).
[182] A report published by June 2014 by ERGP: *ERGP report on end-to-end competition and access in European postal markets*, June 2014, considered whether it was possible to identify factors that encouraged competition. It did not find a relationship between either the pre-existence or extent of access competition, or the level of urbanisation or population density and the development of end-to-end competition in those European countries whose postal markets had been open to competition before 2012. This is partially because some markets have only recently been opened to end-to-end competition, and in part because it is difficult to draw direct comparisons between different European states. See pages 13 and 20 of the ERGP report, http://ec.europa.eu/internal_market/ergp/docs/documentation/2014/ergp-13-38rev1-report-on-end-2-end-competition-clean-adopted_en.pdf.
[183] Whistl presentation to the MarketForce annual conference on The Future of the UK Postal Services, 21 October 2014.
[184] *Annual monitoring update on the postal market, Financial year 2013-14*, paragraph 3.28.

A2.32 Royal Mail argued that the UK's economic geography makes the universal service particularly susceptible to harm from end-to-end entry. It argued the UK has the highest concentration in the EU of large dense urban areas which are attractive to cherry-picking end-to-end competition, noting that 15% of the population lives in very high density areas comprising just 1% of the landmass. On the other hand, it noted the UK also has large parts of the country that are deeply rural and costly to serve, with 15% of the population living in lower density areas comprising c.63% of the landmass.[185]

A2.33 We disagree with Royal Mail that the UK's economic geography makes the universal service particularly susceptible to harm from end-to-end competition. We do not consider the UK has particularly unique economic geography and, in any event, we have not seen any evidence that population density has any relationship with the scale of end-to-end entry. As discussed above, we also do not consider end-to-end entry in bulk mail has any direct impact on the internal subsidies of the universal service.

A2.34 Furthermore, Royal Mail's finding that the UK has the highest concentration of urban areas in the European Union is sensitive to the population density threshold used. For example, when a 10% threshold is used instead of a 15% threshold, this result no longer holds. Royal Mail argued that at a 10% threshold the results are distorted by the inclusion of Paris. However, we see no reason to exclude Paris, particularly given that Royal Mail noted itself that Paris is the closest comparator to London in terms of areas with high population density.[186] We therefore do not consider Royal Mail's analysis of the UK's economic geography to be particularly robust.

A2.35 In any event, we do not consider population density to be a good indicator for the scale of end-to-end competition likely to emerge in a particular country. Therefore, even to the extent the UK does have a relatively high concentration of urban areas, we do not think this necessarily has any implications for the likelihood and scale of end-to-end entry. As noted above, the ERGP recently looked at whether the level of urbanisation or population density correlated to the development of end-to-end competition in those European countries whose postal markets had been open to competition before 2012, and did not find a relationship.

A2.36 Finally, we set out above our reasons as to why we do not consider that end-to-end entry in bulk mail in selected geographic areas has any direct impact on the internal subsidies of the universal service.

## Summary of Ofcom's position

A2.37 We do not consider that Whistl's entry into selected geographic areas and product types will represent an arbitrage of the universal service or access regulation. In summary, this is because:

- Royal Mail is currently able (and under our proposals would be required) to set zonal charges that reflect the costs it incurs when providing access services in different zones. This would prevent Whistl and any other entrants from gaining an artificial cost advantage by rolling out a competing end-to-end network selectively; and

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185 Royal Mail's June 2014 Submission, page iii.
186 Royal Mail's June 2014 Submission, page 28.

- Royal Mail can and does price bulk mail services independently of other mail types, and will continue to be able to set charges for different types of bulk mail on a different basis under our access proposals – not allowing for the potential for arbitrage between different types of mail in future.

A2.38 We also do not agree that Whistl's selective entry into certain areas and product types undermines the cross-subsidies needed to finance the universal service. Whistl and any other end-to-end letter operator is unlikely to target universal service customers and so this type of competition will not have any direct impact on the internal cross-subsidies between different geographic areas. In addition, universal service mail is currently more profitable than many other types of mail, including bulk mail.

A2.39 We also do not agree with Royal Mail's cost assumptions relating to the ability of Whistl to undercut Royal Mail due to the universal service requirements Royal Mail is subject to, in particular on price, frequency or type of service. There is no requirement on Royal Mail to deliver bulk mail at a particular frequency or level of service – so the fact Royal Mail chooses to deliver bulk mail six days per week is likely to reflect the fact there are significant economies of scale and scope from delivering bulk mail and universal service mail over the same network which outweigh the cost advantages from consolidating volumes over less frequent deliveries. We also note that the VAT exemption confers a significant cost advantage on Royal Mail when competing with an end-to-end entrant in bulk mail.

A2.40 Finally we do not consider the extent of access competition in the UK necessarily means end-to-end competition is likely to occur on a greater scale in the UK than it has elsewhere. In any event, we have modelled the maximum entry scenario we consider possible and included this scenario in our assessment set out in Section 3.

### Annex 3

# Sources of evidence

## Introduction

We have noted throughout this Statement the evidence we have relied upon in making the decision and how we have relied upon that evidence. This Annex lists:

- the key legislation and other documents to which we have referred; and
- the main sources of that evidence.

While this Annex lists the main sources we have relied upon, the list is for convenience only and it is not intended to be exhaustive.

## UK legislation

- The Communications Act 2003
- The Postal Services Act 2011

## Ofcom documents (excluding research)

- *Notification Condition 1*, as at July 2013, http://stakeholders.ofcom.org.uk/binaries/post120713/un.pdf
- *Securing the Universal Postal Service - Decision on the new regulatory framework: Statement*, 27 March 2012, http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/
- *Update on Ofcom's position on end-to-end competition in the postal sector*, 25 July 2012, http://stakeholders.ofcom.org.uk/binaries/post/update.pdf
- *End-to-end competition in the postal sector - Draft guidance on Ofcom's approach – Consultation*, 31 October 2012, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/summary/e2e-guidance.pdf
- *Annual monitoring report on the postal market: 2011-12*, 20 November 2012, http://stakeholders.ofcom.org.uk/binaries/post/monitoring-update2011-12.pdf
- *Review: Mail Integrity and Postal Common Operational Procedures: Call for inputs, Ofcom,* 28 February 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/mail-integrity/summary/condoc.pdf
- *End-to-end competition in the postal sector: Ofcom's assessment of the responses to the draft guidance on end-to-end competition – Statement*, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/statement.pdf

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

- *Annual monitoring report on the postal market: 2012-13, published 22 November 2013*, http://stakeholders.ofcom.org.uk/post/monitoring-report-12-13

- [✂]

A3.1 *Annual monitoring report on the postal market: 2013-14*, 2 December 2014, [http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/]

A3.2 *Royal Mail Access Pricing Review - Proposed amendments to the regulatory framework: Consultation*, 2 December 2014 http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/

## Ofcom information requests

We have issued a series of statutory notices under section 55 and Schedule 8 of the Postal Services Act 2011, requiring various persons to provide specified information as set out in the notices. For the purposes of this work, we have also reused some information that was originally obtained for other purposes, including the review of Royal Mail's Access pricing. These have been recorded as such in the list below. These information requests and the responses we received are listed below.

- Information request dated 2 June 2014 covering specified information about D+2 access mail to Royal Mail as part of the Access pricing review.
  - [✂]
  - [✂]
  - [✂]
  - [✂]

- Information request of dated July 2014 covering specified information about mail volumes and revenues to Whistl as part of the Access pricing review.
  - Response dated 31 July 2014 from Whistl.
  - Response dated 10 September 2014 from Whistl.

- Information request dated 31 July 2014 October 2014 covering specified information about its mail volumes, customers and activities among other things to Secured Mail
  - [✂]

- Information request dated 31 July 2014 October 2014 covering specified information about its mail volumes, customers and activities among other things to UK Mail
  - [✂]

## Royal Mail documents


- Royal Mail plc, Half Year 2014-15 Results: Management presentation and Q&A transcript, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Half%20Year%202014-15%20Results%20Transcript.pdf, (accessed 1 December 2014)

- Monthly volume and revenue data provided by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines

- Royal Mail September 2012 Business Plan

- *Interim Report for the half year ended 23 September 2012*, 13 November 2012, http://www.royalmailgroup.com/interim-report-half-year-ended-23-september-2012

- Royal Mail Reported Business Plan – March 2013

- *Royal Mail plc - Annual Report and Financial Statements: 2013-14*, 2014, http://www.royalmailgroup.com/sites/default/files/Annual%20Report%20and%20Accounts%202013-14_DDA_0.pdf

- P12 2013-14 monthly volume and revenue submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines

- 2013-14 Regulatory Financial Statements 52 weeks ended 30 March 2014

- Royal Mail's 2014 Business Plan, Royal Mail Board presentation, 17 June 2014

- *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

- [✂]

- Royal Mail Reported Business Plan – July 2014

- Operations 2014 Business Plan, presented to Ofcom on 10 July 2014.

- *Royal Mail plc: Financial Report for the half year ended 28 September 2014*, November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Financial%20Report%20for%20the%20half%20year%20ended%2028%20September%202014.pdf

- P6 2014-15 monthly volume and revenue submission by Royal Mail to Ofcom as per the USP Accounting Conditions and Regulatory Accounting Guidelines

- Ofcom Monthly Return 1415 P6, growth in Parcels End-to-end Inland and Parcels Access

- Ofcom Monthly Return 1415 P6, growth in Letter and Large Letters End-to-end Inland and Parcels Access

- *Royal Mail plc: Half Year 2014-15 Results*, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20H1%202014-15%20Results%20Presentation.pdf

- *Royal Mail plc: Half Year 2014-15 Results*, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20H1%202014-15%20Results%20Presentation.pdf

- Royal Mail plc Half Year 2014-15 Results: Management presentation and Q&A transcript, 19 November 2014, http://www.royalmailgroup.com/sites/default/files/Royal%20Mail%20plc%20Half%20Year%202014-15%20Results%20Transcript.pdf

- Q2 RB Proxy Income Statement, provided by Royal Mail.

## Other stakeholder documents

- Whistl Business Plan

- Whistl Business Plan Model

- PostNL, *Q4 & FY 2012 Results including update 2015*, 25 February 2013: press release, http://www.postnl.nl/en/Images/20130225-postnl-2012-q4-press-release_tcm9-15846.pdf

- PostNL, *Q4 & FY 2012 Results including update 2015: Sustainable delivery*, 25 February 2013: Analyst presentation https://www.postnl.nl/Images/20130225-postnl-2012-q4-presentation_tcm10-15847.pdf

- PostNL Q4 and 2012 full year results: transcript of the analyst presentation, *Transcript*, 25 February 2013, https://www.postnl.nl/Images/20130225-postnl-2012-q4-analyst-transcript_tcm10-15850.pdf

- Whistl presentation to the MarketForce annual conference: The Future of UK Postal Services, 30 September 2013.

- CWU, *Agenda For Growth, Stability & Long Term Success*, January 2014, http://www.cwu.org/assets/_files/documents/jan_14/cwu__1389094257_04273_Agenda_For_Growth_Stabil.pdf

- Email from [✂]

- CWU, *CWU Submission to Ofcom – The threat to the universal postal service from direct delivery competition*, 3 October 2014, http://cwunorthwest.org/pdf/CWUSubmissionToOfcom.pdf

- 'DPD's Predict service upgraded and rolled out to all UK customers', Post and Parcel, March 2014, http://postandparcel.info/60569/news/dpds-predict-service-rolled-out-to-all-uk-customers/, (accessed on 24 November 2014)

- Whistl presentation to the MarketForce conference: The Future of UK Postal Services, 21 October 2014.

- Submissions to the Department for Business, Innovation and Skills (BIS) Select Committee inquiry into competition in the UK postal sector, October 2014, http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/inquiries/parliament-2010/competition-in-the-uk-postal-sector-/?type=Written#pnlPublicationFilter

- Amazon, Press release, *More Than 16,000 Amazon Pickup Locations Now Available Across The UK With The Introduction Of Collection From Post Office Branches*, 25 November 2014, http://phx.corporate-ir.net/phoenix.zhtml?c=251199&p=irol-newsArticle&ID=1992690

- Whistl's November 2014 Business Plan


## Other information


- Hill and Robinson (Royal Mail Group), 2005, Establishing Non-Uniform Access Prices in the UK

- ERGP, ERGP Report on end-to-end competition and access in European postal markets, June 2014, http://ec.europa.eu/internal_market/ergp/docs/documentation/2014/ergp-13-38rev1-report-on-end-2-end-competition-clean-adopted_en.pdf

- PricewaterhouseCoopers LLP, The outlook for mail volumes to 2023, 15 July 2013, http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf

## Annex 4

# Glossary and defined terms

| Term | Definition |
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| March 2013 end-to-end Guidance | Ofcom's Guidance dated 27 March 2013 entitled *End-to-end competition in the postal sector – Final guidance on Ofcom's approach to assessing the impact on the universal postal service*. |
| March 2013 end-to-end Statement | Ofcom's Statement dated 27 March 2013 entitled *End-to-end competition in the postal sector – Ofcom's assessment of the responses to the draft guidance on end-to-end competition*. |
| Access | Allowing other companies operating in the postal market, or other users of postal services, to use Royal Mail's facilities for the partial provision of a postal service. Access to Royal Mail's postal facilities could in principle be at any point in the pipeline. |
| CA 2003 | The Communications Act 2003 |
| Competition Act | The Competition Act 1998 |
| CWU | Communications Workers' Union |
| December 2013 plan | Whistl's Business Plan which was submitted to Ofcom in December 2013. |
| Downstream | The activities of sortation in the Inward Mail Centre and delivery of mail items from the Inward Mail Centre to the final destination. |
| Downstream access | Access to Royal Mail's postal network at the point of entry to an Inward Mail Centre or at any point in the postal chain after that. |
| EBIT | Earnings Before Interest and Tax. |
| End-to-end operators | Operators other than Royal Mail that provide a postal service from collection to delivery without using Royal Mail's postal network (usually only in some parts of the country). |
| Financeability EBIT | EBIT of the Reported Business used for assessing financeability of the universal service |
| General access condition | A regulatory condition that Ofcom may impose under section 50 of the PSA 2011, which requires a postal operator to give access to the operator's postal infrastructure or any service within the scope of the universal service that it provides, and/or to maintain accounting separation. |

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| GUSCs | General universal service conditions |
| Inward Mail Centre | The part of a Royal Mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre's catchment area) of mail received from the upstream part of Royal Mail's network, or from other postal operators etc., to the final addresses take place. |
| July 2014 Business Plan | Royal Mail's Strategic Business Plan which was submitted to Ofcom in July 2014 in accordance with the requirements of the USP Accounting Condition. |
| March 2012 Statement | Ofcom's Statement dated 27 March 2012 entitled *Securing the Universal Postal Service – Decision on the new regulatory framework.* |
| MCF | Mail Competition Forum |
| MICOP | Mail Integrity Code of Practice |
| October 2012 Consultation | Ofcom's Consultation dated 31 October 2012 entitled *Securing the Universal Postal Service – Proposals for the future framework for economic regulation*. |
| PCOP | Postal Common Operational Procedures Code of Practice |
| Pipeline | Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item. |
| PPI (Printed Postage Impressions) | An indication on the envelope that the postage has been paid and can be used by customers with an account with Royal Mail. It offers a pre-printed alternative to stamps and franking machines. |
| PSA 2011 | The Postal Services Act 2011 |
| Regional Distribution Centre (RDC) | The part of Royal Mail's pipeline used to perform outward processing of predominantly pre-sorted mail items. |
| Regulatory Accounting Guidelines (RAG) | Means the document so entitled and published by Ofcom (as amended from time to time) setting out such requirements as Ofcom may direct from time to time relating to the preparation, auditing, reporting and publication, of regulatory financial statements and other regulatory financial reports to be prepared and maintained by Royal Mail under the USP Accounting Condition. |
| Reported Business | The part of Royal Mail's UKPIL business that undertakes activities for the purpose of, or in connection with, the provision of USO and non-USO products, excluding the activities and products of ParcelForce International and Royal Mail Estates |

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| | Limited. For the avoidance of doubt, the activities and products of the Reported Business shall be treated to include all the activities and products which fall within the scope of Royal Mail's National Costing Methodology as documented in the Costing Manual from time to time. |
| Royal Mail | Royal Mail Group Limited, whose registered company number in England and Wales is 04138203. |
| Royal Mail's June 2014 submission | Royal Mail's regulatory submission to Ofcom entitled *Direct Delivery: A Threat to the Universal Postal Service: Regulatory Submission to Ofcom*. This document was received by Ofcom on 19 June 2014. A non-confidential version was published on Royal Mail's website. |
| Standard Selection Code (SSC) | A numeric code used by Royal Mail to sequence addresses, identify selection breaks and match items to mailing bag labels. |
| Universal Service Obligation (USO) | The requirements to provide postal services which are contained in a designated USP condition imposed on the universal service provider by Ofcom under section 36 of the PSA 2011. |
| Universal Service Provider (USP) | Any postal operator for the time being designated by Ofcom as the universal service provider under the Postal Services Act 2011. |
| Upstream | The activities of collection, outward sortation where necessary (pre-sorted mail may not require further outward sortation) and trunking. |
| USP Accounting Condition | A condition Ofcom may impose under section 39 of the PSA 2011 that requires the universal service provider to provide regulatory financial statements and information, and may from time to time direct the universal service provider to do one or more of the following: to maintain accounting separation; to comply with rules about the identification of costs and cost orientation; to comply with rules about the use of cost accounting systems; and to secure that compliance with those systems is audited annually. |
| Weighted Volume Drivers | Has the meaning given to it by National Costing Rule 10 as per Ofcom's Regulatory Accounting Guidelines. |
| Whistl | Whistl Limited (formerly TNT Post UK Ltd). |
| Zones | The geographical zones into which Royal Mail divides the United Kingdom based on the density of delivery points and the proportion of business delivery points of postcode sectors, currently known as Zone A (Urban), Zone B (Suburban), Zone C (Rural) and Zone D (London). |