Royal Mail plc

Royal Mail's Response to Ofcom's Review of the Second Class Safeguard Caps 2019

October 2018

Public version

Confidential information which has been redacted from this document is indicated by: [✂]

Contents

Executive Summary

Royal Mail is the proud provider of the Universal Postal Service. This role comes with important obligations relating to the affordability of our products and services. We take these seriously. The impact on our customers is central to all our pricing decisions. Our strong track record of fair, reasonable and prudent pricing in letters and parcels demonstrates this. Ofcom's market analysis understates the extent of competition in both letters and parcels. Market-driven pricing pressures mean we are pricing below both caps. Consumer research shows that our products and services are excellent value for money. Prices are affordable, including for the vast majority of vulnerable customers.

Ofcom should focus on securing the financial sustainability of the Universal Service. Royal Mail operates in a fragile ecosystem. Circumstances have changed since the caps were introduced in 2012. We are currently outside the 5-10% EBIT margin range and [✂]. As Ofcom recognised, Royal Mail *"continues to face a number of credible downside scenarios*". Our recent trading statement explained that trading conditions in the UK are challenging. Letter volumes, especially marketing mail, have been impacted by ongoing structural decline, business uncertainty and GDPR. Royal Mail needs commercial freedom and flexibility to respond to changes in market dynamics and threats to the sustainability of the Universal Service. The caps act as constraints to this flexibility.

Ofcom should continue its journey of de-regulation and remove the safeguard caps. If Ofcom chooses to maintain the safeguard caps – as proposed – then:

- **We believe the level of the letters cap should be set higher than currently proposed. A higher cap would still result in affordable prices for vulnerable customers.**
- **We support the proposal to maintain the headroom in the large letters and parcels cap. This will provide flexibility to help manage downside risks and market uncertainty.**

We do not agree with the proposed modifications to the DUSP conditions enabling the caps to remain in place into perpetuity. They should only remain in place for the duration of this current regulatory framework, ie until March 2022.

Royal Mail is the proud provider of the Universal Postal Service. We have a strong track record of pricing prudently.

i. **Royal Mail is the proud provider of the Universal Postal Service**. We provide a six-day-a-week service to more than 30 million addresses. We recognise that this role comes with important obligations relating to the affordability of our products and services. Our customers are front and centre in any pricing decision. Our pricing strategy for both letters and parcels is rooted in our overarching objective to offer a high quality, affordable service to customers.

ii. Prior to the introduction of the safeguard caps in 2012, Royal Mail had been subject to a prescriptive price control regime across the vast majority of our revenues. **We now have a six year track record which demonstrates our measured approach to pricing – we have yet to reach the level of either of the caps**. This demonstrates the constraints placed on us by the market and our prudent approach to pricing. Ofcom itself recognised in March 2017 that "*price increases have been relatively restrained*."[1]

[1] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, page 4, Para 1.13.

iii. Across both letters and parcels, our pricing decisions are influenced by external factors, such as the **impact on our customers**. At the same time, **shareholder scrutiny** acts as a continuous spur to efficiency which again feeds through to pricing.

We do not agree that we face "limited competitive constraints" in letters or have a "significant degree of pricing power" in parcels.

iv. **In letters, e-substitution is a potent form of competition**. Ofcom itself recognises that *"Royal Mail's end-to-end standard letter stamp volumes fell by around 11% per year on average from 2012/13 to 2017/18 (revenues fell by 7% per year on average)."* [2] Addressed letter volumes are expected to continue to experience structural decline of between 4% and 6% per annum over the medium-term.

v. **Ofcom has understated the risk of hitting a 'tipping point' in letters volumes**. Customers could switch away permanently. This risk limits the price increases we can make. Evidence from other countries has shown dramatic reductions in volume can happen quickly. For example, volume in Denmark and Netherlands declined 61% and 47% in six years since 2011.[3,4] We are actively seeking to avoid replicating the experience of other European postal services.

vi. **On the supply side, we are also observing competition developing**. There is a growing trend in Access operators offering services directly to residential consumers and small businesses. For example, in the last two years, Whistl launched two services in partnership with other companies – Parcel2Go and Imprimus – targeting residential customers and small businesses.

vii. **In parcels, Ofcom recognises that "*[t]he UK has one of the most competitive parcels sectors in the world.*"**[5] There is significant competition in single piece parcels - in particular from Hermes and Yodel – which materially constrains our pricing behaviour. Continued investment in the parcels market has led to ongoing annualised spare capacity of c25%. This leads to downward pressure on prices. Competitors have increased their presence in the single piece parcels sector. Since 2013, the number of pick-up and drop-off points have more than doubled to 44,000 points.[6] Customers are also more aware than ever of alternatives, using marketplaces and price comparison websites to obtain better prices. The prices that some of our competitors are able to charge are artificially depressed due to cost advantages associated with lower standard "gig economy" labour models. We were pleased to see both the Taylor Review and the Government's response to it. We believe that better labour standards across the industry should lead to better service standards for consumers.

A range of key indicators demonstrate that prices remain affordable.

viii. **Across a range of key indicators, prices remain affordable for customers, including the vast majority of vulnerable customers**. For example, these include:

- **Spend on mail is low relative to other vital services**. According to the Office of National Statistics, family spending in the UK for 2016-17 showed that those in the lowest income decile only spend 30p per week on average – or 0.1% of their total

[2] Ofcom, Review of the Second Class Safeguard Caps 2019, Page 19, Para 3.7.
[3] PostNord, Annual and Sustainability Report 2017, Page 24.
[4] PostNL, Annual Report 2017, Page 65.
[5] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, Page 1.
[6] Royal Mail analysis.

expenditure - on post. Spending is far higher on other categories, such as telecoms and other communications services at £8.20 (3.9%) and energy at £17.80 (8.6%).[7]

- **Our Second Class Stamp prices are well below the European average**. Out of the 15 countries among the 30 EU and EFTA members to offer a Second Class service, we have the second lowest price. Our price of 58p is well below the 74p European average.
- **According to Ofcom's own research, customers think our products and services are value for money**. In its 2016-17 Annual Monitoring Report, Ofcom noted that "*the majority of residential consumers are satisfied with postal services overall (86%) and Royal Mail (84%), which is broadly similar to figures reported in previous years. Three quarters of residential consumers are satisfied with the value for money of postal services overall.*"[8]

ix. **In terms of the letters cap, Ofcom's conclusion that "*a larger increase should be considered unaffordable*" is not supported by the evidence**.[9] The proposed level – 65p – is predicated on the findings from its affordability research undertaken in 2013, uplifted by 5% in real terms. Ofcom has assumed that these findings still hold today. It has not tested specific prices with the core demographic, vulnerable customers. This is a basic requirement of any affordability research. Instead, Ofcom has simply made a judgement based on research from 2013 and uplifted using basic proxies, such as growth in real disposable incomes.

If the caps are retained, we need sufficient flexibility to respond to changes in market dynamics and threats to the financial sustainability of the Universal Service.

x. **Circumstances have changed since the caps were introduced in 2012.** We recognise we are now in stronger financial position. However, we are outside the 5-10% EBIT margin range and - as Ofcom recognised - Royal Mail *"continues to face a number of credible downside scenarios"*.[10] In 2012, parcel revenue increases were offsetting letters revenue declines. Our recent trading statement explained that trading conditions in the UK are challenging. Letter volumes, especially marketing mail, have been impacted by ongoing structural decline, business uncertainty and GDPR.[11]

xi. Ofcom introduced the caps as it could not be sure how Royal Mail would behave once price controls were removed. We have priced prudently, demonstrated by our prices being below both caps. **In the absence of affordability concerns, we believe Ofcom should place more weight on ensuring Royal Mail has sufficient commercial flexibility to secure the financial sustainability of the Universal Service**. To achieve this, it should continue its journey of de-regulation and remove the safeguard caps. Customers already have sufficient protection through the PSA 2011 and Ofcom's Designated Universal Service Provider Conditions, which require Royal Mail to provide Universal Service products at affordable prices. Ofcom's current monitoring instruments allow it to identify and intervene if there is a problem.

xii. If Ofcom chooses to maintain the safeguard caps - as proposed - we support the proposal to maintain the headroom in the large letters and parcels cap. This will provide flexibility to help manage downside risks and market uncertainty. We do however believe **the level of the letters cap should be set higher than proposed**. We consider a higher cap would still result in affordable prices for vulnerable customers. Moreover the interdependencies across product lines mean that the impact of Ofcom's decision goes much further than simply constraining

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7 ONS Family spending in the UK: financial year ending 2017, Detailed household expenditure by disposable income decile group, UK: Table 3.1.
8 Ofcom, Annual Monitoring Update on the Postal Market, 2016-17, Para 1.8.
9 Ofcom, Review of the Second Class Safeguard Caps 2019, Para 1.15.
10 Ofcom, Review of the Second Class Safeguard Caps 2019, Para 5.25.
11 Royal Mail, Trading update (1 October 2018). See here: https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail-group/trading-update-1-october-2018/

second class prices. It constrains much wider revenue raising options. We also believe the caps should only remain in place for the duration of the regulatory framework. We do not agree with the proposed modifications to the DUSP conditions enabling the caps to remain in place into perpetuity. They should only remain in place for the duration of this current regulatory framework, ie until March 2022.

Question 1: Do you agree with our market analysis?

Across both letters and parcels, our pricing decisions are influenced by other external factors, such as the **impact on our customers**. At the same time, **shareholder scrutiny** acts as continuous spur to efficiency which again feeds through to pricing.

The market constrains our pricing behaviour. Ofcom's analysis understates the extent to which competition restricts our ability to increase prices and revenue across the vast majority of our product portfolio, including Second Class Stamps.

Royal Mail does not agree with the Ofcom analysis underpinning its assessment of letters competition. The letters market is significantly more competitive than Ofcom suggests. E-substitution is a potent form of competition. We estimate that the UK will continue to experience structural decline in addressed letter volumes of between 4% and 6% per annum over the medium-term.

Ofcom has not adequately recognised the significant risk of hitting a 'tipping point' in letters volumes. 'Tipping points' limit the price increases we can make and incentivises us to maintain high quality of service standards. Evidence from other countries has shown dramatic reductions in volume can happen quickly. On the supply side, we are also observing a growing trend in Access operators offering services directly to residential consumers and small businesses.

In parcels, Ofcom rightly recognises that *"[t]he UK has one of the most competitive parcels sectors in the world."* Continued investment in the parcels sector has led to ongoing annualised spare capacity of c25%, resulting in downward pressure on prices. Competition in single piece parcels is characterised by low barriers to entry and expansion. The rollout of pick-up and drop-off points has more than doubled since 2013. Customers are also more aware than ever of alternatives, using marketplaces and price comparison websites to obtain better prices. Moreover, prices are further depressed due to cost advantages associated with lower standard "gig economy" labour models.

We have a strong track record of pricing responsibly.

1.1 **We think carefully about customers when making pricing decisions**. Our pricing strategy for both letters and parcels is rooted in our overarching desire to offer a high quality, affordable product to customers. Prior to the introduction of the safeguard caps in 2012, Royal Mail had been subject to a prescriptive price control regime across the vast majority of our revenues. **We now have a six year track record which demonstrates our measured approach to pricing – we have yet to reach the level of either of the caps.** Ofcom itself recognised in March 2017 that "*price increases have been relatively restrained*."[12]

The competitive postal landscape – not regulation – maintains downward pressure on prices.

1.2 **Our prudent approach has been driven by our customer focus and market dynamics rather than Ofcom's price caps**. These factors act as effective non-regulatory constraints on our pricing behaviour. At the same time, **shareholder scrutiny** acts as a continuous spur to efficiency which again feeds through to pricing.

[12] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, Para 1.13.

1.3 We are aware that increasing letter or parcel prices risks encouraging customers to change their behaviour. **In letters**, this includes e-substitution, the risk of hitting tipping points alongside supply-side constraints. **In parcels**, competition is characterised by low barriers to entry and expansion, significant spare capacity, increasing consumer awareness and switching due to the growth in marketplaces and price comparison websites. The prices that some of our competitors are able to charge are artificially depressed due to cost advantages associated with lower standard "gig economy" labour models. Below we set out our thoughts on these factors in more detail.

Letters

1.4 We believe the letters market is significantly more competitive than Ofcom suggests in its market analysis. Below we set out three key factors we believe demonstrate that we are materially constrained in our pricing.

Factor 1: E-substitution is driving structural decline in letters.

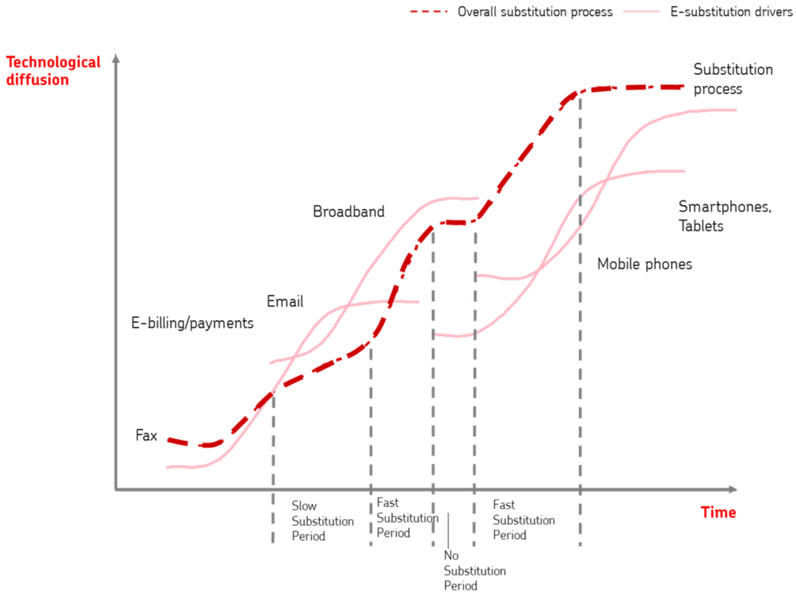
1.5 While Ofcom accepts that Royal Mail faces some constraints from e-substitution in single piece letters, it concludes that in letters, "*there is limited evidence that e-substitution represents a meaningful constraint on Royal Mail's ability to profitably raise prices for single piece letters (particularly with respect to smaller price increases). We therefore remain of the view that Royal Mail faces only limited competitive constraints on its prices for single piece letters.*" **We think Ofcom's market analysis understates the extent to which competition and e-substitution constrain our ability to increase prices** and revenue across the vast majority of our product portfolio, including Second Class Stamps.

1.6 **Letter volumes in the UK are in long term structural decline.** We expect to continue to experience significant levels of decline in addressed letter volumes of between 4% and 6% per annum in the medium term. As noted in our recent trading statement, addressed letter volume was 7% down in the first half of 2018-19. This was primarily due to marketing mail being impacted by ongoing structural decline, business uncertainty and GDPR. On this basis, we anticipate a similar decline for the full year. Since the caps were introduced, **the declines in Stamp volume have been even more marked**. Ofcom itself recognises that *"Royal Mail's end-to-end standard letter stamp volumes fell by around 11% per year on average from 2012/13 to 2017/18 (revenues fell by 7% per year on average)."*[13]

1.7 **E-substitution is a potent form of competition.** There has been a series of technological advances which have led to customers – both consumer and business - using less mail. This constrains our pricing. Since around 2003, e-substitution has driven a wedge between letter volume growth and GDP. Whilst GDP has remained an important driver of volumes, the relationship has become more complex. New technologies mature and their usage evolves over time. As Figure 1 below demonstrates, the evolution of new technologies is an ongoing dynamic process driven by individual technologies overlapping. As an "old technology" starts to plateau a new one emerges.

[13] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 3.7.

Figure 1: E-substitution is a dynamic and evolving process



1.8 The moderate price increases we have implemented in recent years – including for Second Class Stamps - reflect the **risk that customers could switch away permanently, primarily to digital alternatives**. Price increases could be profitable in the short run. However, they may encourage customers to switch to alternative forms of communication, ultimately damaging profitability in the long run and increase the risk of creating a financial sustainability issue for the Universal Service. These constraints show no signs of diminishing. We do not know when the next technological advancement will be. E-substitution creates a powerful incentive for us to maintain our prudent pricing policy and deliver customers a high quality of service.

Factor 2: We are actively trying to avoid 'tipping points' experienced by other European countries

1.9 **Ofcom has not adequately recognised this significant risk of hitting a 'tipping point' in letters volumes which other European postal operators have experienced**. Other countries have shown dramatic reductions in volume can happen quickly. For example, volume in Denmark and Netherlands declined 61% and 47% in six years since 2011.[14, 15] We are actively trying to avoid replicating the experience of other European operators. We believe significant price increases substantially increases the risk of triggering a 'tipping point'. The prudent nature of our pricing policy – demonstrated by us pricing below both caps - reflects the risk that customers could switch away permanently.

Factor 3: Supply-side constraints on our pricing

1.10 **On the supply side, we are also observing a growing trend in Access operators offering services directly to residential consumers and small businesses.** While the majority of Royal Mail's access mail is bulk mail, residential consumers and businesses who post relatively few letters compared to larger organisations are increasingly using Access services. In July 2017, Whistl and Parcel2Go launched a service allowing residential consumers and small businesses to send letters, large letters and parcels via Whistl's access

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14 PostNord, Annual and Sustainability Report 2017, Page 24.
15 PostNL, Annual Report 2017, Page 65.

network for final delivery by Royal Mail.[16] In May 2018, Whistl and Imprimus launched a service "Cornwall Collects" to consolidate mail for small businesses, stating "*small online retailers and ebay sellers will be able to enjoy the cost and service efficiencies currently only experienced by larger companies.*"[17]

Parcels

1.11 Ofcom recognised in the March 2017 decision that ***"[t]he UK has one of the most competitive parcels sectors in the world"***. [18] However, we believe that Ofcom's market analysis has understated the degree of competition in the sector and the extent to which it constrains our pricing for single piece parcels. Alongside this, despite our high market share in single piece parcels[19] competition from Hermes and Yodel in particular mean that contrary to Ofcom's findings, we do not believe we have a *"significant degree of pricing power"*. [20] We therefore disagree with Ofcom that *"there is currently limited competition for Royal Mail in single piece parcels up to 2kg"* and that it *"cannot rely on competitive constraints to prevent Royal Mail from raising prices for the parcel products subject to the safeguard cap"*.[21]

<u>Factor 1:</u> Competitor expansion, overcapacity and an increased focus on the single piece parcels sector.

1.12 Substantial investment in new facilities by parcel competitors has generated **c25% ongoing annualised spare capacity** in the sector. This has placed - and continues to place - downward pressure on Royal Mail's prices, including single piece parcels. We have seen **extensive roll-out of pick up and drop off (PUDO) points by competitors** in recent years. This is primarily aimed at improving their product offering and presence in the single piece parcels sector. It has required little investment. Since 2013, the number of PUDO locations in the UK has more than doubled to over 44,000 points.[22]

1.13 Table 3.2 in Ofcom's Consultation shows that our two biggest single piece parcel competitors - Hermes and Yodel - are pricing below us for some or all of our services.[23] Hermes is increasing its focus on the C2C market. It recently began to re-brand its fleet to "*reflect a change of focus for Hermes from purely B2B towards the end consumer*".[24]

1.14 **Our internal pricing decision papers demonstrate we are acutely aware of competitive environment when making pricing decisions for single piece parcels.** We were required to submit a number of pricing papers to Ofcom as part of the recent RFI. They show our concern with the risk of losing volume to competitors if we increase prices. For example, our Tariff 2017 Consumer and SME Parcel Pricing Strategy Proposal outlined that we would adopt *"limited price changes given the competitive environment – with a small increase on RM's lowest price points, and limited change elsewhere.*" This was influenced by *"on-line resellers are offering competitive pricing across a wide range of carriers."* [25]

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[16] Post & Parcel article, 'Parcel2Go announces Letters and Small Parcels service', 12 July 2017. http://postandparcel.info/81118/news/parcel2go-announces-letters-and-small-parcels-service/

[17] Whistl press release http://www.whistl.co.uk/news/new-collection-service-launches/

[18] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, Page 1.

[19] Which Ofcom estimates to be between 70 to 80%.

[20] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 3.73.

[21] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 3.55.

[22] Royal Mail analysis.

[23] Ofcom, Review of the Second Class Safeguard Caps 2019, Table 3.2.

[24] Matthew Hanson, Head of Marketing and Product, Hermes, September 2018. https://tamebay.com/2018/09/new-livery-myhermes-uk-fleet.html

[25] Royal Mail, Tariff 2017 Consumer and SME Parcel Pricing Strategy Proposal.

Competitive constraints in the single piece parcels sector is causing us to be very cautious about the impact of price increases and materially constrains our pricing behaviour.

Factor 2: Growing use of marketplaces and price comparison websites.

1.15 Consumers are aware of alternatives. They use both marketplaces and price comparison websites to obtain better prices. According to Ofcom's Residential Postal Tracker, in Q2 2013 only 30% and 33% of those surveyed had heard of Hermes and Yodel respectively.[26] In both cases, consumer awareness had more than doubled in the latest Ofcom residential tracker, with 73% of consumers aware of Hermes and 69% of Yodel.[27]

1.16 **Customers use marketplaces to obtain better deals.** ebay has been developing solutions to allow marketplace sellers to buy postage through ebay's own online channel. This is effectively an ebay controlled service. This diverts parcels that would have previously been delivered by Royal Mail. ebay is using its market power to obtain lower prices for its sellers. **Royal Mail's survey data also shows a high awareness of alternatives among consumers who are regular marketplace sellers (Figure 2).** [✂].

Figure 2: Consumers who are regular marketplace sellers' awareness of Royal Mail versus alternatives.[28].

[✂]

1.17 **The growing use of price comparison websites has increased competition.** Online platforms display comparative pricing and service level information across a range of carriers. They enable home collection, and allow consumers to pay postage and print labels from home. Consumers have a much wider choice than in the past, and are able to select a carrier based on lowest cost. We understand that some of these websites also agree specific contracts with parcel operators, acting as an aggregator, and pass on lower prices to customers.

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[26] Ofcom, Residential Consumer Postal Tracker Quarter 2 2013. See Table 120 on Page 133 here: https://www.ofcom.org.uk/__data/assets/pdf_file/0017/41732/trackerq22013.pdf

[27] Ofcom, Residential Postal Tracker Q3 2017 to Q2 2018. See here: https://www.ofcom.org.uk/__data/assets/pdf_file/0034/118996/Residential-Postal-Tracker-Q3-2017-Q2-2018-tables.pdf

[28] Royal Mail, Marketplace Seller survey Q1 2018/19.

Case study: Sized-based pricing

In April 2013, we moved away from pricing Stamp parcels based only on weight to price on both the size and weight of the item. This reflected the evolution of the market and better align our prices with the drivers of cost.

We introduced a new medium parcel format. Following the introduction, we experienced significantly higher volume losses to competitors than anticipated. In response, we changed our small parcel definition mid-year (October 2013). We increased the dimensions which can be sent as a small parcel in an attempt to win back volume.

Since then, competition has continued to constrain our prices. Price increases for Second Class Stamp small and medium parcels have been below CPI inflation. As a result, the headroom in the cap has increased in each of the last four years, as CPI inflation has outstripped our Second Class Stamp small and medium parcel price increases.

Factor 3: The "gig economy" is distorting prices across the sector.

1.18 Royal Mail is proud to be a good corporate citizen, providing our employees good quality jobs and benefits whilst paying our fair share of taxes. The prices that some of our competitors are able to charge are **artificially depressed due to cost advantages associated with lower standard "gig economy" labour models**. Some competitors use owner-drivers or "lifestyle couriers". They are paid on a piece rate (i.e. per item delivered). They also have to provide their own vehicles, and pay for fuel and uniforms from their remuneration. Firms using this labour model avoid the costs of holiday pay, sick pay, pensions and employers' National Insurance. They are also not bound by National Minimum or Living Wage legislation.

1.19 **This presents a significant cost advantage in comparison to businesses that directly employ people, tilting the playing field.** Accordingly, for example, Royal Mail estimates that it has hourly labour costs are c.40% higher than Hermes. This is distorting prices across the parcels sector. We were pleased to see both the Taylor Review and the Government's response to it. We participated in the review process and continue to engage the Government in support of better labour standards across the industry. We believe that better labour standards across the industry should lead to better service standards for consumers.

The caps represent unnecessary regulation and are not in accordance with the principles of better regulation.

Given these ongoing competitive constraints and our track record on pricing, the caps are unnecessary. They should be removed. In addition to market constraints, customers already have significant protection through the PSA 2011 and Ofcom's Designated Universal Service Provider Conditions, which require Royal Mail to provide Universal Service products at affordable prices. Ofcom's current monitoring instruments and one-month notification on Stamp price changes allow it to identify and intervene if there is a problem.

Question 2: Do you agree with our assessment of affordability of Second Class postal services?

If the caps are to be maintained, we support the proposed retention of the current headroom under the large letters and parcels cap. This should provide sufficient flexibility to help manage downside risks and market uncertainty. However, we do not agree with the proposed level of the letters cap. We believe that a higher cap would result in affordable prices for vulnerable customers for the following reasons:

- Spend on mail is low relative to other vital services.
- Our Second Class Stamp prices are well below the European average.
- According to Ofcom's own research, consumers think our products and services are value for money.

Our prudent pricing approach has meant that our prices remain affordable. Ofcom's conclusion that "*a larger increase [than 65p] should be considered unaffordable*" is not supported by evidence:

- The proposed level of the cap is predicated on Ofcom's findings from its affordability research undertaken in 2013, uplifted by 5% in real terms. Ofcom has assumed that these findings still hold today.
- It has failed to test specific prices with the core demographic – vulnerable consumers. This is a basic requirement of any affordability research.
- Instead, Ofcom has simply extrapolated its decision from 2012 (55p letters cap + CPI) based on proxies, such as growth in real disposable incomes.

We firmly believe that prices would remain affordable if the cap was set higher than 65p - including for the vast majority of vulnerable consumers – and at the same time provide vital commercial flexibility to secure the provision of the Universal Service.

We support Ofcom's proposal to retain the headroom in the large letters and parcels cap.

2.1 Given Ofcom's decision to retain both safeguard caps, we support the proposed retention of the current headroom under the large letters and parcels cap. Our response in chapter 1 demonstrates that competition constrains our pricing behaviour in this area, meaning prices will remain affordable. **Our comments in this chapter are restricted to the letters cap**.

The proposed letters cap of 65p is unnecessarily restrictive. A higher cap would remain affordable.

2.2 **Ofcom has recognised our measured approach to pricing.** In its 2016-17 Annual Monitoring Report on the Postal Market, Ofcom noted that *"universal service products are currently affordable for most residential consumers".*[29] As discussed in Chapter 1, the **competitive constraints we face – including a recognition that customers can switch away permanently – has incentivised a prudent pricing strategy**. These constraints show no signs of diminishing. In contrast to other regulated sectors in the UK - including telecoms, rail and airports – we are yet to reach the level of either of the caps. There are a number of key measures that demonstrate that letters remain affordable for customers, including the vast majority of vulnerable customers. We set these out below.

[29] Ofcom, Annual Monitoring Update on the Postal Market, Financial year 2016-17, Para 3.25.

Post accounts for a very small share of consumers' weekly spending.

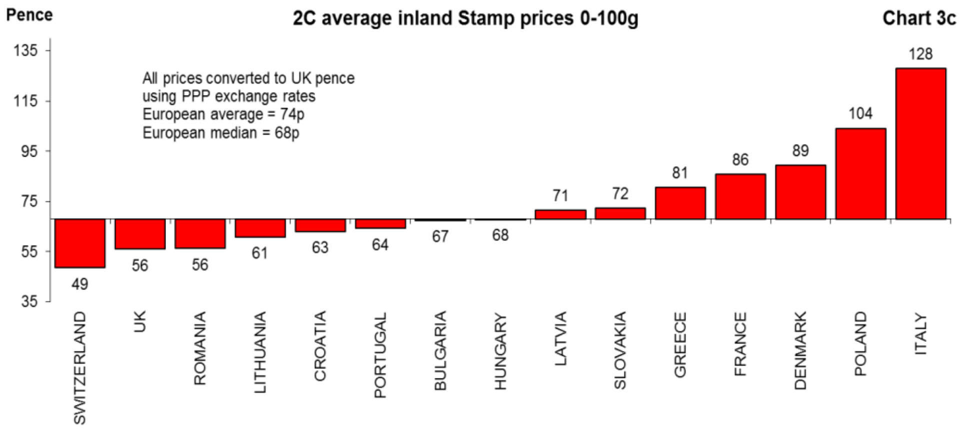
2.3 As Ofcom's Consultation document recognises, post accounts for a very small share of consumers' weekly spending. On average, **consumers' spend c.70p (0.1%) a week on post**, against a total expenditure of £554. By contrast, spend on telecoms and other communications services is £16.50 (3.0%) and energy is £22.20 (4.0%). **Consumers in the lowest income decile spend c.30p (0.1%)** a week on post, against a total expenditure of £213. By contrast, spend on telecoms and other communications services is £8.20 (3.9%) and energy is £17.80 (8.6%).[30]

Our prices are well below the European average.

2.4 Royal Mail is one of only 15 countries among the 30 EU and EFTA members to offer a Second Class service. Ofcom's Consultation document benchmarked Royal Mail's Second Class Stamp letter and large letter prices against four other European countries – France, Sweden, Poland and Italy. The analysis shows that Royal Mail was either the cheapest or second cheapest of the five countries considered. Ofcom judged that ***"Royal Mail's price for Second Class stamp letters was relatively low in comparison to the other European countries* we considered.**"[31]

2.5 This finding aligns with our own internal analysis, which benchmarks our prices to the 15 other EU and EFTA countries who offer a Second Class Stamp service. This research demonstrates Royal Mail's Second Class Stamp prices are the second cheapest. **Our current price of 58p is well below the European average of 74p (Figure 3)**. Ofcom's proposed level for the safeguard cap – 65p – is 12% below the European average Second Class Stamp price. We believe this demonstrates that if Ofcom is to retain the letters safeguard cap, the level should be significantly higher. Prices would remain affordable for customers, including the vast majority of vulnerable customers.

Figure 3: Second Class Stamp prices in EU and EFTA members.[32]



Source: PPP exchange rates taken from the World Bank. Stamp prices are based on information published on operators websites. Average prices calculated using UK volume weights. Calculations by RM Commercial & Economics Finance.

30 ONS Family spending in the UK: financial year ending 2017, Detailed household expenditure by disposable income decile group, UK: Table 3.1.

31 Ofcom, Review of the Second Class Safeguard Caps 2019, Para 4.47.

32 Prices as at January 2018.

Ofcom's consumer research shows satisfaction and value for money are high.

2.6 We are pleased Ofcom's consumer research recognises we are seen to offer value for money. **Ofcom's March 2017 Decision noted that the majority of consumers *"continue to consider that stamps represent fairly or very good value for money"*.** This is supported by consumer satisfaction results from Ofcom's Residential Postal Tracker which found that: [33]

- Over eight in ten residential consumers are satisfied with Royal Mail (86%), with dissatisfaction at 4%.
- 63% were satisfied with the cost of postage.
- Over three quarters (77%) are satisfied with the value for money of postal services overall, with only 7% dissatisfied.

2.7 Ofcom's Residential Postal Tracker also demonstrates the majority of **consumers are also satisfied with features of Royal Mail's service**:

- Items sent reaching their destination (86%),
- Items being delivered intact/undamaged (85%),
- Quality of postal delivery to the home (84%),
- Delivery speed (83%).

2.8 Ofcom's research from 2015 found that **postal services and delivery was the only sector to see an increase in customers' perception of value for money**. By contrast, ratings fell for a range of other services; most markedly banks, gas and electricity providers, and supermarkets.[34]

Royal Mail's consumer research shows a strong record of providing an affordable, high quality service that consumers' value.

2.9 Royal Mail's own consumer research backs up consumer satisfaction and value for money is high. **Consumers are very satisfied with their sending and receiving experience with Royal Mail**, with both over 90% (Figure 4). Our net promoter score has increased significantly over the last three years.

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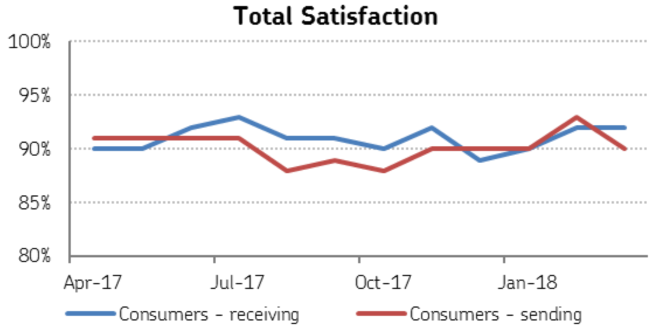
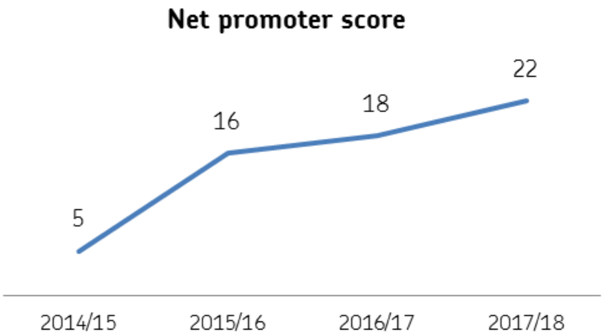
[33] Ofcom, Residential Postal Tracker Q3 2017 to Q2 2018. Questions QG5, QG3_7, QG2, QG3_2, QG3_3, QG3_1 and QG3_4. See here: https://www.ofcom.org.uk/__data/assets/pdf_file/0034/118996/Residential-Postal-Tracker-Q3-2017-Q2-2018-tables.pdf

[34] Ofcom, Customer Experience Report 2015. We note that 2015 was the last time Ofcom carried out this analysis.

Figure 4: Sending and receiving customer satisfaction and net promoter score.[35]





2.10 If Ofcom is to retain the safeguard caps, we believe the level of the letters cap should be higher. Prices would remain affordable for customers. **Our prudent pricing approach has meant that our prices remain affordable. Ofcom's conclusion that "*a larger increase [than 65p] should be considered unaffordable*" is not supported by the evidence.** A cap in excess of 65p would result in affordable prices for customers, including those who are vulnerable. Its proposed level of the cap – 65p – is predicated on the findings from its affordability research undertaken in 2013, uplifted by 5% in real terms. Ofcom should not simply assume the findings from 2013 still hold today. Ofcom would need up-to-date research to ascertain whether pieces above 65p would be unaffordable.

2.11 Ofcom conducted research into consumers' responsiveness to hypothetical 10% and 20% price increases. In its market analysis, Ofcom interpreted the limited responsiveness to hypothetical price increases to mean there is not a strong constraint on Royal Mail's pricing. We interpret the result differently. Namely that **the limited change in consumer behaviour is a result of the prices being affordable and remaining so, even if prices were higher.** Further, Ofcom recognised that the results are likely to overstate the true consumer responsiveness, and – under Royal Mail's interpretation – further supports our conclusion that prices are affordable.

2.12 **Setting the cap higher than 65p would be consistent with Ofcom's four cap objectives**.[36] Prices would remain affordable, including for the vast majority of vulnerable customers. It would reduce the effect of the safeguard cap on Royal Mail's pricing freedom and provide greater flexibility for Royal Mail to respond quickly in the event of financeability concerns, which are discussed in Chapter 3.

[35] Royal Mail Consumer Satisfaction Survey.
[36] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 3.7.

Question 3: Do you agree with our analysis of the commercial flexibility afforded to Royal Mail under the safeguard caps?

Royal Mail operates in a fragile ecosystem. Our market environment is uncertain with the level and pattern of demand unclear. We are not like a traditional utility, which are characterised by relatively stable volumes and steady income streams. Letters are in structural decline and parcel competition is fierce.

Circumstances have changed since the caps were introduced in 2012. We recognise we are in a stronger financial position. However, we are currently outside the 5-10% EBIT margin range and [✂]. As Ofcom recognised, Royal Mail *"continues to face a number of credible downside scenarios"*. **If the caps are maintained, we need sufficient freedom and flexibility to respond to changes in market dynamics to sustain the Universal Service**. In the absence of evidence demonstrating that prices will become unaffordable to vulnerable consumers (see Chapter 2), we believe that Ofcom should place more weight on ensuring Royal Mail has commercial flexibility to secure the provision of the Universal Service.

Given interdependencies exist across product lines, the impact of Ofcom's decision on the future of the caps, however, goes much further. Changes in relative prices impact customer mailing decisions. We cannot simply make pricing decisions on individual products in isolation. If the caps are set too low, these interdependencies limit our ability to respond to changes in market dynamics (eg. a recession, increased business uncertainty or accelerated e-substitution) using our pricing lever. To react effectively to unexpected market conditions, we need commercial flexibility. In its July 2012 Safeguard Cap decision on large letters and packets, Ofcom clearly recognised: *"...the need to provide sufficient pricing flexibility to Royal Mail so that it can respond quickly to customers' needs and market changes."* We have consistently priced below the caps since they came into effect in 2012.

Royal Mail operates in a fragile ecosystem.

3.1 Royal Mail operates in a fragile ecosystem. **Our market environment is subject to business uncertainty**. We are not like traditional utilities, which are characterised by relatively stable volumes and steady income streams. Addressed letter volumes are expected to continue to experience structural decline between 4 and 6 per cent per annum over the medium term. There are high fixed and common costs associated with delivering the USO – a common feature with other utilities - which take time to remove. These high fixed costs coupled with declining letter volumes create upward pressure on unit costs. This means that plausible downside threats to the financial sustainability of the Universal Service can materialise quickly.

3.2 **The wrong regulatory approach can have serious consequences**. The price controls put in place by Postcomm constrained our ability to run our business. We were unable to respond to changing market conditions. The impact was incredibly damaging. By 2011-12, UKPIL was making a £120m operating loss. In its 2012 decision on the regulatory framework, Ofcom also noted that one of the key objectives of removing the substantial majority of price regulation was because *"Royal Mail rather than Ofcom is better placed to determine how and what price increases should be applied."*[37]

3.3 **We believe the time is right for Ofcom to remove both safeguard caps**. We recognise we are now in a stronger financial position. However, we are outside the 5-10% EBIT margin range and - as Ofcom recognised - Royal Mail *"continues to face a number of credible*

[37] Ofcom, Decision on the New Regulatory Framework, March 2012, Para 7.45.

downside scenarios."[38] In 2012, parcel revenue increases were offsetting letters revenue declines. Our recent trading statement explained that trading conditions in the UK are challenging. Letter volumes, especially marketing mail, have been impacted by ongoing structural decline, business uncertainty and GDPR.[39] Furthermore, in 2012, Ofcom also could not be sure how Royal Mail would behave once price controls were removed. It therefore felt it needed to introduce the safeguard caps to act as a backstop to protect vulnerable customers from price increases. We now have six years evidence demonstrating how Royal Mail prices when provided with pricing freedom. We are pricing below both caps. We believe the marked changes in circumstances since 2012 mean Ofcom should remove the safeguard caps. Ofcom recognised our prudent approach to pricing in its March 2017 decision document, stating that "*price increases have been relatively restrained*."[40]

We are currently outside the 5-10% EBIT margin range and [✂]. Ofcom recognises we face "credible downside risks".

3.4 Returns for the **Reported Business have now been below Ofcom's 5-10% EBIT** range - deemed appropriate for securing a financially sustainable Universal Service - for two years. We achieved 4.4% in 2017-18. [✂]. If the caps are maintained, we need sufficient freedom and flexibility to respond to changes in market dynamics to sustain the Universal Service.

Post is a network business, with high levels of fixed and common cost associated with delivering the Universal Service.

3.5 One of Ofcom's four policy objectives for the safeguard caps is to ensure Royal Mail can make a reasonable commercial rate of return on the safeguarded products. As Ofcom recognised in the consultation, **post is a *"network business with many costs that are shared between different services"***.[41] In 2011, Ofcom noted that having a single network delivering both USO and non-USO services is more efficient.[42] This allows the high levels of fixed and common cost associated with delivering the USO to be spread over more products.

3.6 **Ofcom should focus on the returns for the Reported Business when considering a reasonable commercial rate of return**. Product specific margins in isolation are misleading in network businesses. There are a variety of methodologies that could be adopted to allocate fixed and common cost associated with providing the Universal Service network. Royal Mail's Fully Allocated Cost (FAC) allocates the common cost across products using an equi-proportional mark-up approach. It therefore does not reflect the true cost of delivering the Universal Service products. As Ofcom recognised, if we choose to stop providing some non-USO services, under Ofcom's current costing rules, there would be a re-allocation of common cost from non-USO services to USO services, which would reduce the margins of USO products.[43] When considering its policy objective to allow Royal Mail to make a reasonable commercial rate of return, we therefore believe Ofcom should focus on the returns for the Reported Business. This is in line with Ofcom's primary duty to secure the provision of the Universal Service.

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[38] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 5.25.

[39] Royal Mail, Trading update (1 October 2018). See here: https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail-group/trading-update-1-october-2018/

[40] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, page 4, Para 1.13.

[41] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 5.7.

[42] Ofcom, October 2011 Consultation, Para 5.10 and 5.11.

[43] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 5.7.

Shareholder scrutiny is a spur to efficiency and feeds through to pricing.

3.7 As Ofcom recognised, competitive pressure and **shareholder scrutiny strongly incentivises Royal Mail to deliver efficiencies**. Ofcom's March 2017 Decision recognised that *"market conditions and shareholder discipline are more likely to be effective in securing an efficient and financially sustainable universal postal service".* [44]

3.8 Royal Mail must be as low cost as possible to stem letters decline and have a cost competitive proposition in letters and parcels. We delivered c.£642m annualised cumulative cost avoidance over the three financial years to 2017-18, ahead of our target. The deal we agreed with the CWU in early 2018 covers pensions, pay and pipeline. We closed our defined benefit pension scheme without incurring widespread national industrial action. If we did not close our pension scheme we would have seen our annual pension contributions increase from c.£400m to c.£1.2bn per annum. This would have jeopardised the financial viability of the Reported Business. The agreement also provides the basis to progress with operational trials which will help to unlock efficiencies.

Theoretical modelling supports higher price caps in letters to respond to unforeseen circumstances.

3.9 A paper by De Donder et al[45] uses a theoretical model to assess the trade-offs that postal operators face between efficiency gains and pricing when operating in an environment with increasing competition and a regulatory framework with price caps. **The paper shows that increasing competition in the single piece parcels (SPP) sector implies higher price caps need to be set for single piece letters (SPL), even if the Universal Service provider (USP) achieves its efficiency aims.** This result is summarised in Figure 5 which shows the USP's SPL price caps and profit maximising SPP prices for different levels of competition in the SPP market. It shows that as competition in the SPP sector increases – or more precisely, the cost of using competitor SPP services declines - and the USP loses market share, it would need to raise its prices on single piece letters in order to earn a normal rate of return.

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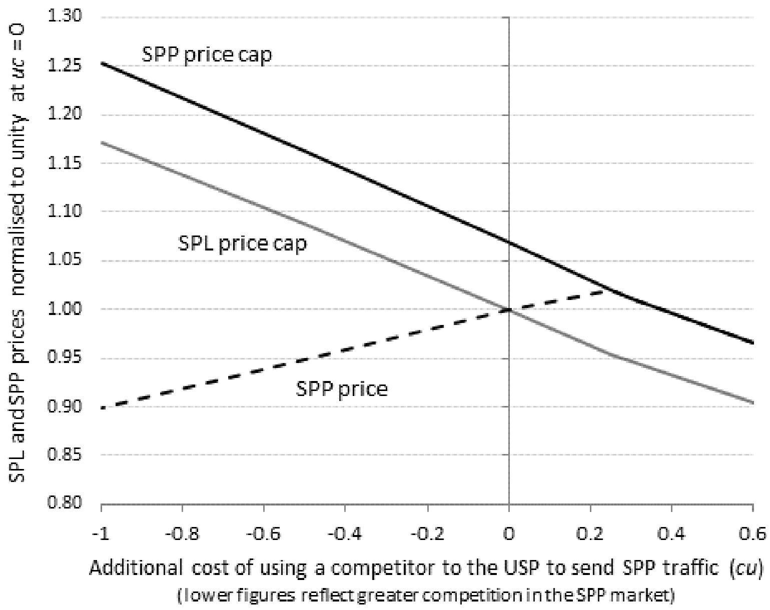
[44] Ofcom, Review of the Regulation of Royal Mail, 2017, Para 1.17.

[45] See *The Impact of Increasing Competition for Non-Contract Parcels on Postal Prices and Efficiency Decisions*, Philippe De Donder, Frank Rodriguez and Soterios Soteri. Presented at the 26th Conference on Postal and Delivery Economics, June 2018 organised by the Florence School of Regulation and Center for Research in Regulated Industries.

Figure 5: USP prices under different degrees of competition in the SPP market



3.10 It therefore follows that **if the regulatory price control on single piece letters is set too low the USP would not be able to meet its Universal Service obligations** and earn a normal rate of return. Given the high level of uncertainty surrounding the evolution of competition within the parcels sector and other wider economic factors, this strongly indicates that the USP needs a high degree of commercial flexibility, within any price control to appropriately respond to unforeseen circumstances.

If the caps are maintained, we need sufficient freedom and flexibility to respond to changes in market dynamics to sustain the Universal Service.

3.11 In 2017-18, Second Class Stamp products contributed over £[✂]m in revenue and £[✂]m in profit (on an FAC basis) - representing [✂]% and [✂]% of total Reported Business revenue and profit respectively. **Given interdependencies exist across product lines, the impact of Ofcom's decision on the future of the caps, however, goes much further**. Changes in relative prices impact customer mailing decisions. We cannot simply make pricing decisions for one product in isolation. For example, changes in Second Class Stamp prices impact customer decisions with respect to First Class Stamp and Meter. Customers have the ability and financial incentive to substitute between them depending on the relative prices. If the price gap between First and Second Class Stamps widens due to cap constraints, customers may downtrade to Second Class Stamps. These pricing interdependencies and chain of substitution effects continue throughout our product portfolio. It can lead to revenue dilution with an attendant impact on the sustainability of the Universal Service. We therefore have to consider revenue raising options in the round.

3.12 **If the caps are set too low, these interdependencies limit our ability to respond to changes in market dynamics (eg a recession, increased business uncertainty or accelerated e-substitution) using our pricing lever.** To react effectively to unexpected market conditions, we need commercial flexibility. In its July 2012 Safeguard Cap decision on large letters and packets, Ofcom clearly recognised: "…*the need to provide sufficient pricing flexibility to Royal Mail so that it can respond quickly to customers' needs and market* *changes*."[46] With this in mind, we believe that the proposed level of the letters cap should be increased to provide this flexibility.

3.13 Market conditions can change quickly. **Ofcom's consultation process takes time**. We are concerned that should Ofcom need to carry out a review of the caps before 2022 - in response to a threat to financial sustainability of the Universal Service - it will take a long time. This emphasises the need for Ofcom to provide commercial flexibility in the safeguard caps. As a minimum, Ofcom should address how it would act quickly in such circumstances.

[46] Ofcom, Safeguard cap for Large Letters and packets, July 2012, Para 3.26.

Question 4: Do you agree with our proposals relating to the standard letter safeguard cap?
Question 5: Do you agree with our proposals relating to the basket safeguard cap?
Question 6: Do you have any comments on our proposed modifications to the DUSP conditions specified in Annex 5?

We believe the time is right for Ofcom to remove both safeguard caps. However, if the caps are maintained – as proposed – we need sufficient freedom and flexibility to respond to changes in market dynamics to sustain the Universal Service. In summary:

- We do not agree with the proposed level of the letters cap. We believe that a higher cap would result in affordable prices for consumers - including the vast majority of vulnerable customers – while providing Royal Mail commercial flexibility to respond to changes in market dynamics.
- We welcome the proposal to maintain the headroom in the large letters and parcels cap. This will provide flexibility to manage downside risks and market uncertainty.

We do not agree with the proposed modifications to the DUSP conditions enabling the caps to remain in place into perpetuity. They should only remain in place for the duration of this current regulatory framework, ie until March 2022.

We believe the time is right to remove the safeguard caps.

4.1 **We think carefully about customers when making pricing decision**. Our pricing strategy for both letters and parcels is rooted in our overarching desire to offer a high quality, affordable service to customers. We believe competition, our track record of reasonable pricing and the marked changes in circumstances facing Royal Mail since the caps were introduced in 2012 **support the removal of the safeguard caps**:

- **Competition in single piece letters and parcels is fierce**. In contrast to the findings in Ofcom's market analysis, we do not believe we face *"limited competitive constraints"* in letters or have a *"significant degree of pricing power"* in parcels. (See Chapter 1 - Market analysis).
- **Our prudent pricing approach has meant that our prices remain affordable, including for the vast majority of vulnerable customers**. We are pricing below both caps. Post accounts for a very small share – just 0.1% - of consumers' weekly spending. (See Chapter 2 – Affordability assessment).
- **Circumstances have changed since the caps were introduced in 2012**. Royal Mail needs flexibility to respond to changes in market dynamics. (See Chapter 3 – Commercial flexibility).

4.2 **If Ofcom is to retain the caps – as proposed – we need commercial flexibility to respond to changes in market dynamics to sustain the Universal Service**. We are currently outside the 5-10% EBIT margin range and [✂]. As Ofcom recognised, Royal Mail *"continues to face a number of credible downside scenarios."*

The letters cap should be set higher than the proposed level of 65p.

4.3 **We do not agree with Ofcom's conclusion that "*a larger increase should be considered unaffordable*".** We believe that a higher cap would result in affordable prices for customers - including the vast majority of vulnerable customers - for the following reasons:

- E-substitution and the threat of tipping points materially constrain our pricing power.
- Spend on mail is low relative to other vital services.
- Our Second Class Stamp prices are well below the European average.
- According to Ofcom's own research, consumers think our products and services are excellent value for money.
- Ofcom has not tested specific prices with the core demographic, vulnerable consumers. The proposed level of the cap – 65p – is predicated on the findings from its affordability research undertaken in 2013, uplifted by 5% in real terms.
- Setting the cap higher than 65p would be consistent with Ofcom's four cap objectives.[47]

The proposed level of headroom in the large letters and parcels cap provides sufficient flexibility to help manage downside risks and market uncertainty.

4.4 **We welcome Ofcom's proposal to maintain the current level of headroom in the large letters and parcels cap**. Ofcom recognises that "*[t]he UK has one of the most competitive parcels sectors in the world*." [48] Competition materially constrains our pricing power. This has placed - and continues to place - downward pressure on Royal Mail's prices, including single piece parcels. A number of factors mean prices will remain affordable:

- Competitor expansion, c.25% ongoing annualised spare capacity and an increased focus on the single piece parcels sector puts downward pressure on prices.
- Consumers are aware of alternatives. They are increasingly using both marketplaces and price comparison websites to obtain better prices.
- We are proud to be a good corporate citizen. The prices some of our competitors are able to charge are artificially depressed due to cost advantages associated with lower standard "gig economy" labour models.

We do not agree with the proposed modifications to the DUSP condition enabling the caps to remain in place into perpetuity.

4.5 **Ofcom's Annual Report explains that it is focused on reducing regulation where appropriate**.[49] In particular, it aims to ensure rules are properly targeted, and do not impose undue burdens on stakeholders. At the moment, we are concerned that Ofcom's inability to increase the level of the cap quickly in response to changes in market conditions creates an undue burden.

4.6 Ofcom has stated it is likely to *"review the levels of the safeguard caps in 2022, when we anticipate that the next review of the regulatory framework for postal services will take place."* [50] The proposed drafting of the caps allows them to remain in place into perpetuity. Regulation should only apply where there is a clear need. Ofcom should continue to remove regulation where it is not necessary. With this in mind, we consider the safeguard caps as set out in **the DUSP condition should only last for the duration of this current regulatory framework, ie until March 2022.** This approach is in line with the approach Ofcom adopted in the 2012 regulatory framework.

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[47] Ofcom, Review of the Second Class Safeguard Caps 2019, Page 19, Para 3.7.
[48] Ofcom, Review of the Regulation of Royal Mail – Statement, March 2017, page 1.
[49] Ofcom, 2017/18 Annual Report and Accounts, Page 41.
[50] Ofcom, Review of the Second Class Safeguard Caps 2019, Para 1.21.