Royal Mail

Response to Ofcom's consultation -
Review of Second Class safeguard caps 2024

Royal Mail Submission

1 September 2023

Public Version

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

Contents

Executive Summary

We are very concerned by Ofcom's proposals to continue to impose a price cap on 2c stamp letters and large letters. This will significantly constrain the commercial flexibility that we need. Our concerns relate to both the substance of the proposals and the process Ofcom has followed to arrive at them.

There is no valid, evidence-based justification for Ofcom's proposals. We fundamentally believe that there is no justification for the continuation of any price caps on 2c stamp letters or large letters. **There is no affordability issue caused by 2c stamp prices**. **But there is a real and present threat to the financial sustainability of the Universal Postal Service**. We are facing financial jeopardy – we incurred a £419m loss in 2022/23 caused by significant revenue decline due to Covid-19 unwind and worsened by industrial disruption through 2022/23, as well as the need for urgent and major transformation. Despite considerable efforts taken by Royal Mail to minimise the impact of these issues, we continue to face significant financial jeopardy in 2023/24 and beyond. Ofcom is missing this opportunity to allow Royal Mail greater commercial flexibility, whilst developing more appropriate, targeted strategies to support the most vulnerable postal users.

As Ofcom explains in the opening sections of its consultation, the Postal Services Act 2011 sets out Ofcom's overriding duty to secure the Universal Service, including the duty of having regard to ensuring its financial sustainability, as well as ensuring the Universal Services remain affordable.[1] However, in the body of its consultation document, Ofcom instead characterises the first of these duties as being to *"minimise the impact of any safeguard cap on the financial sustainability of the universal service."*[2] Furthermore, this crucial factor features last in the list of Ofcom's objectives for the review of the safeguard caps.[3] This does not mirror the legal requirement. We are therefore concerned that, in its proposals, Ofcom appears to have adopted an approach that is inconsistent with its statutory duties. It has given greater weight to the affordability consideration (without any robust evidence that there is an affordability issue), than to financial sustainability, where there is clear evidence of a material issue.

Royal Mail does not agree that there is an affordability issue based on the evidence provided by Ofcom. Spend on mail is low relative to other vital services such as utilities. Royal Mail's own analysis suggests that there is no issue with affordability in post. Spending on post represents only 0.1% of spending for households in the lowest income decile. Moreover, our Second Class Stamp prices are well below the European average.

We understand Ofcom has some concerns that there are customers facing affordability issues more broadly, which are caused by the cost of living crisis. However, we believe a blanket price cap is not a proportionate means to address this. Ofcom's current proposal risks penalising Royal Mail, reducing our commercial freedom because of a cost-of-living crisis caused by wider economic factors including the war in Ukraine, and price increases imposed by energy firms and retailers. From a procedural perspective, Ofcom's proposals seem to be in direct conflict with its stated approach for this review, which is that *"any changes* [Ofcom] *make to the safeguard caps must be led by the impact of changes in postal prices on affordability and not by the impact of prices of other items or services on affordability of postal services".*[4]

Ofcom previously asked us to consider what we would be prepared to offer by way of a targeted scheme for vulnerable customers in return for greater commercial flexibility. Despite us putting forward a number of pragmatic suggestions, Ofcom has not worked with us to overcome the practical challenges involved in designing and implementing a targeted scheme and has not explained

1 Sections 29 and 31 PSA 2011, respectively.
2 Paragraph 3.4 of the consultation.
3 Paragraph 3.4 of the consultation.
4 Paragraph 5.14 of the consultation.

sufficiently why it is no longer considering this alternative approach. Ofcom has not even identified which customer groups should be included in a targeted scheme.

We believe that Ofcom's approach is inconsistent with its legal duty to *"have regard to the need for the provision of a universal postal service to be financially sustainable"*[5] as a matter of principle, notwithstanding the absence of evidence demonstrating that prices will become unaffordable to vulnerable consumers.

The impact of Ofcom's decision on the future of the 2c cap has a much wider impact given the interdependencies that exist across product lines. The binding CPI price cap will limit our pricing for many other products as a result of the "*Pricing Ladder*" effect. We have a range of letter and large letter services each tailored to a particular customer base. The prices for these letters and large letters sold via other channels is set at a certain amount lower than the price of stamps, and this gap between prices must be maintained. The prices of these products are in effect price controlled by stamps. Changes in relative prices impact customer mailing decisions. We therefore cannot simply make pricing decisions on individual products in isolation. If the cap is set too low, the interdependencies of our product prices limit our ability to respond to changes in market dynamics (e.g. a recession, increased business uncertainty or accelerated e-substitution) using our pricing levers.

Given our position that all the safeguard caps should be removed, we support Ofcom's proposal to remove parcels from the cap. We agree there is competition which, as demonstrated by our recent pricing decisions, is acting as a constraint on our pricing.

If, despite the concerns Royal Mail raises in this response, Ofcom implement its proposal to cap 2c letters and large letters and combine these into a basket cap, it needs to give us greater commercial flexibility than the current proposals allow. Ofcom should not simply apply a CPI annual uplift to the existing prices at the time when Ofcom publish its decision. Instead, Ofcom should:

Proposal: Allow the combined basket cap to:

- price 2c letters to the EU Median – in the UK, we currently have some of the lowest prices compared to prices in EU countries. We also have higher quality targets than many countries and the joint highest requirement of 6 days in which letters should be delivered under the USO.
- provide an average 10% p.a. uplift on large letters from prevailing market prices[6] – to ensure some degree of commercial flexibility

As a minimum, providing an uplift to the weighted basket price will give us some commercial flexibility which is needed to support the financial sustainability of the Universal Service and without impacting affordability. The price cap is a cap not a floor. Our stamp pricing decisions will continue to be based on a wide range of factors including market conditions, tipping points and financial sustainability in assessing the appropriate price to put in the market. However, we need the ability to change prices if required.

In summary, we believe Ofcom's proposal is inconsistent with its duties. It is denying Royal Mail the commercial flexibility we need to address our current financial situation, without any valid, evidence-based justification. It is putting at risk our ability to provide the Universal Postal Service. Ofcom is driving stress into the regulatory system, which we are not seeing in comparable EU countries, and leaving us with a regulatory outcome which is inherently unfair. It is another example of Ofcom failing to support the Universal Service. On the other hand, Royal Mail's compromise ask of an initial uplift in 2024/25 in the base letter and large letter basket price is fair and reasonable. It provides much needed commercial flexibility to respond to market conditions whilst still offering a service which is affordable for consumers.

[5] Paragraph 2.3 of the consultation, which is referencing Ofcom's statutory duties under s.29 of the PSA 2011.
[6] At time of Ofcom's decision.

Background

1. As Ofcom explains in its consultation, Section 29 (1) of The Postal Services Act 2011 (the 'PSA 2011') sets out Ofcom's regulatory objectives. It states *"OFCOM must carry out their functions in relation to postal services in a way that they consider will secure the provision of a universal postal service".* At the time this was introduced, the intention of Government was to give Ofcom the relevant powers to address the challenges facing Royal Mail. Commentary at the time acknowledged that there were many challenges in regulating a declining postal sector, not least the increasing use of technology and the resulting risk of e-substitution.[7]

2. The Government wanted to minimise regulation wherever possible and to ensure that the Universal Service provider, Royal Mail, was given the necessary financial, operational and commercial flexibility to deliver the Universal Service in what was clearly a declining letters market.[8]

3. Parliamentary intention was clear. The structural decline in the letters market demanded flexibility from operators and the regulator alike. The issues faced by Royal Mail at the time (namely letter volume decline, higher costs and the need to invest in modernisation to achieve a reasonable rate of return) have only intensified, so greater commercial flexibility is needed now like never before.

4. The Universal Service provider needs the flexibility – where appropriate – to react to market dynamics in pricing and product innovation. Any regulatory decisions should include sufficient flexibility and adjustment mechanisms to allow for rapid change to help secure the future of the universal postal service. Ofcom recognised this in its 2012 decision on the regulatory framework, noting that one of the key justifications behind 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."*[9]

[7] Richard Hooper report, Modernise or decline, 2008; and Saving the Royal Mail's Universal Postal Service in the Digital Age, 2010.

[8] As referenced in Letter from Vince Cable to Colette Bowe (Ofcom) and Millie Banerjee (Postcomm) - 15 April 2011.

[9] Ofcom, Decision on the New Regulatory Framework, March 2012, Paragraph 7.45.

Financial Sustainability

There is a real and present threat to the financial sustainability of the USO. Ofcom is well aware of the significant challenges the business faces:

- We are forecasting a further substantial loss in 2023/24 on top of the loss incurred in 2022/23. We announced in May 2023 our intention to dispose of a property in Royal College Street in London to generate proceeds to support our cash position. In our 2023 Business Plan, Royal Mail does **[✂]**.[10]

- The 2023 Business Plan also shows that the Reported Business only achieves **[✂]** by the fifth year of the plan, and this plan comes with high execution risk.

The current cap is one of several factors that impact the financial sustainability of the USO. Significant e-substitution and risk of hitting tipping points means we have to consider very carefully any price increases. Combined with the structural decline in letter volumes and high fixed costs associated with delivering a 6 day letter service to every address in the UK, the safeguard cap puts increasing strain on the financial sustainability of the USO and our ability to maintain a market funded USO.

Ofcom's duty under the PSA 2011 is to secure the provision of the universal postal service. In doing so, Ofcom must have regard to "*the need for the provision of a universal postal service to be financially sustainable.*"[11] However, in Ofcom's consultation, there is scarce consideration of this part of Ofcom's duties. Ofcom cannot "*pick and choose*" its responsibilities. There is insufficient consideration and weight given to one of the few real levers within Ofcom's gift. Ofcom should set out how its decision on the 2c Safeguard Cap is in line with its statutory duties, in our view, its proposal does not.

There is a real and present threat to the financial sustainability of the USO

5. In 2022/23, sharply declining revenues, driven by further post-Covid unwinding of parcel volumes and an acute cost of living crisis that rapidly drove down consumer spending (both external factors that were outside Royal Mail's control) created an urgent and unavoidable need for reform in terms of structural network, delivery and ways of working to give customers what they want (so we can grow) and to radically tackle our high fixed cost base (so we can compete). This was against a backdrop of difficult industrial relations where the Communication Workers Union (CWU) promised its members an unconditional, no strings, inflation-based pay rise, which led to a prolonged and bitter industrial relations dispute that led to 18 days of national strikes, during which 1.1 million working days were lost.

6. By October 2022, Royal Mail's trading position had deteriorated to such an extent that on 14 October 2022 International Distributions Services ('**IDS**') plc issued an unscheduled trading update and revised outlook in respect of Royal Mail, which stated: "*The position of Royal Mail has deteriorated due to a combination of the impact of the industrial dispute, an inability to deliver the joint productivity improvements agreed with CWU under the Pathway to Change agreement, and ongoing macro-economic headwinds. Although action was taken in H1 to lower labour costs, the business was unable to reduce costs quickly enough in line with deteriorating parcel volumes*." At IDS plc's half-year results in November 2022, Royal Mail announced a five-point plan to stabilise the business, focusing on rightsizing the business, tighter cash management and improving operational grip. This plan included reducing capex by £100 million and a reduction of c.5000 Full Time Employees by March 2023. Our

[10] **[✂]**
[11] Postal Services Act 2011, 29 (3) a.

business was having to manage cash in order to address the reduction in revenue. No interim dividend was paid.

7. By the end of 2022/23, Royal Mail's revenue had decreased by 13% to £7,411 million and we were losing over £1 million a day, culminating in an adjusted operating loss of **£419 million (£386 million** excluding voluntary redundancies) for the full financial year. In 2022/23 Royal Mail had cash outflow of £306 million compared with cash inflow of £280 million in the previous year, a swing of £586 million in cash generation. Gross capital expenditure decreased by £186 million to £255 million as we focused on maintaining liquidity and cash conservation given the ongoing industrial action and business performance. The deterioration of Royal Mail's performance was such that Royal Mail's carrying value was written down by £539 million in the impairment review announced in the Annual Results. In part due to the performance of Royal Mail in 2022/23, the IDS plc board decided not to pay a final dividend for 2022/23. Due to the current issues regarding profitability in Royal Mail and, at that time, the unresolved industrial dispute, it was announced that the Group capital allocation framework, including future dividend policy, is currently under review.[12]

Future plans – continued risk of financial jeopardy

8. The outlook for Royal Mail in 2023/24 is expected to be challenging. Royal Mail total revenue was down 4% year in year in Q1 2023-24, with domestic parcel revenue 9% lower (albeit partially supported by 2% increase in letter revenues). The weaker parcel performance was due to price/mix and lower Covid-19 test kit volumes. Addressed letter volumes were more robust than expected for this quarter and, when coupled with pricing actions, led to better revenue performance. However, there is no doubt that letters are in overall structural decline and parcels are the driving force behind our potential for growth. The extent to which progress is made in 2023-24 will be dependent on our ability to improve service quality and the extent to which we are able to make progress on changes in operations. Our target is to offset in-year trading cash outflows with proceeds from real estate disposals in 2023-24 to improve the cash position of Royal Mail. But this is increasingly under strain as wider external market factors have resulted in a less favourable property market.

9. The ongoing UK economic position including low consumer confidence, the legacy of industrial action, and the need to implement efficiency **[✂]**. Royal Mail has taken action to manage cashflow through the reprioritisation of capital expenditure and other working capital initiatives. Royal Mail also intends to use its balance sheet to raise cash **[✂]**.

10. Royal Mail has a very ambitious plan for revenue growth and cost reduction over the next five years. Ofcom has our 2023 Business Plan – the level of ambition included in that plan is evident. Despite this ambition, in the base case scenario, the **[✂]** for the Reported Business over the six-year period from 2022-23 to 2027-28 is **[✂]**.

11. Further, there are significant risks to the 2023 Business Plan from the perspective **[✂]**. We have shared with Ofcom our downside 'execution risk' scenario, including mitigating actions. This results in **[✂]** for the Reported Business over the six-year period from 2022-2023 to 2027-2028. There are two key mitigations, not factored into the above, that would help improve the financial position:

   - Greater commercial flexibility through either removal of or significant uplift to 2c stamp prices; and

   - USO reform.

12. There is no investment or economic case for IDS, our parent company, to keep funding the Royal Mail business in the downside scenario. For IDS to support Royal Mail, like any investor, there needs to be a positive investment case. As set out in the IDS plc 2022-23 Annual Results and Financial Statement "…. *the Board will periodically consider whether providing further access to the Group's resources is*

[12] Royal Mail, Annual Report and Financial Statements 2022-23 Page 68.

appropriate, taking into account relevant circumstances at the time, which may include the progress of Royal Mail's mitigating actions, the availability of other sources of liquidity and management's plan. Should the Board consider it appropriate not to provide further access to the Group's resources this could lead to significant liquidity issues for Royal Mail, though such a decision would only be taken in order to leave the Group liquidity and financial position in a better long term situation."

13. In summary, Royal Mail has a very ambitious plan for revenue growth and cost reduction over the next five years. There are significant risks to successful execution of the 2023 Business Plan. [✂], and medium- to long-term financial sustainability issues. This analysis clearly demonstrates the need for urgent regulatory reform, starting with the removal of, or significant uplift to, the 2c stamp Safeguard caps.

Ofcom has ignored these key considerations in its assessment of whether to retain the 2c caps

14. Ofcom's principal duty under Section 29 of the PSA 2011 is to "*carry out their functions in relation to postal services in a way that they consider will secure the provision of a universal postal service*". Under paragraph 3 of this section "*in performing* [that] *duty … OFCOM must have regard to— (a) the need for the provision of a universal postal service to be financially sustainable, and (b) the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times*". It is also clear that under Section 31 of the PSA 2011, it is a minimum requirement of the Universal Postal Service that the services be provided "*at affordable prices in accordance with uniform public tariff*".

15. In its consultation document, Ofcom, contrary to its principal duty under the PSA 2011, places far more weight on affordability of postal services than whether its proposals are consistent with its duty to have regard to the need for the provision of the Universal Postal Service to be financially sustainable. In particular, in setting out the main objectives of its review and its proposals, it seemingly places factors such as "*ensuring universal services are affordable*" and "*provide protection to consumers*" above financial sustainability.[13] Moreover, Ofcom talks about "*minimising the impact of any safeguard cap on the financial sustainability of the universal service*".[13] However, that is not the relevant consideration – Ofcom must have regard to our financial sustainability overall, not just on minimising the impact. In other words, even if the impact of the proposals on our financial sustainability has been minimised (and there is no evidence or assessment in the Ofcom consultation document as to why that is the case), if the proposals nevertheless still materially undermine our financial sustainability, then they should not be pursued.

16. We set out why we consider Ofcom is wrong on in its conclusions on affordability, and why we consider 2c services are and will continue to be affordable even without any cap, in Section 4 below. But in any event, it is clearly wrong as a matter of law for Ofcom to have so little regard to the impact of its proposals on our financial sustainability. Indeed, the only apparent consideration by Ofcom in the consultation document of Royal Mail's financial position is in Section 6, which is titled Financial Sustainability, but which actually includes very little by way of consideration of the substantive impact of the proposals on our financial position. There is just a brief analysis of the increased revenue we might achieve if we were able to increase our 2c prices and a conclusion that this represents a small proportion of the revenue for the Reported Business. We explain why Ofcom should be considering the impact on profit, rather than revenue, in paragraph 47 below. We also explain why it is necessary to consider the impact of the price cap on our services as a result of the "*Pricing Ladder*" effect in paragraphs 47 and 50. But in any event, it is clear that Ofcom's assessment of the impact of its proposals on our financial sustainability, which for the reasons set out above is under considerable strain, falls woefully short of the standard of assessment which it is required to carry out as a result of its principal duty set out in the PSA 2011.

[13] See, for example, the placement of financial sustainability in the list of factors being considered in paragraph 3.4 of the consultation.

Affordability

There is no issue with affordability in post. Ofcom's own evidence shows this.

There is no robust evidence to suggest that affordability is an issue. Absolute and relative spending on post is very low, representing just £0.70 spend per week for the average household, or 0.1% of weekly expenditure. This is a small fraction both of the amount spent on other vital services such as utilities, and of discretionary spend on items such as restaurants, alcohol and tobacco.

Against this backdrop of household spending, it is not credible to suggest there is an affordability issue in post. Ofcom's own research backs this up. In work undertaken by Jigsaw on behalf of Ofcom, none of the responses mentioned the price of a stamp as having a major impact on them. This despite consumers over-estimating second class stamp prices by 41%. Comparison to other European postal operators demonstrates that Royal Mail has a history of pricing stamps prudently. In the UK, we currently have some of the lowest prices compared to prices in EU countries. We also have higher quality targets than many comparable countries and the joint highest requirement of 6 days in which letters should be delivered under the USO.

Ofcom is choosing to use a safeguard cap as a very blunt tool to protect a very small, putative group of vulnerable consumers. A blanket price cap is not a proportionate means to address Ofcom's concerns. Rather Ofcom should work with us on a targeted scheme aimed at protecting truly vulnerable customers.

Royal Mail has invested significant time and resources in exploring an approach that would better address the affordability concerns of that small proportion of people who genuinely find postal services to be unaffordable. We are very disappointed that Ofcom has chosen not to fully engage in relation to this proposal, or to provide any constructive input prior to publishing its consultation document. Ofcom has not worked with us to overcome the significant practical challenges to identify who should be considered vulnerable with regard to 2c stamps, or with designing and implementing a targeted scheme.

There is no issue with affordability in post. Ofcom's own evidence shows this.

17. **Consumer spending on post is low**, both in absolute terms, and relative to spend on other goods and services. According to the Office for National Statistics ('**ONS**'),[14] the average weekly household spend in the UK is £528.80. At the same time, the average household spend on post is just £0.70[15] per week, or just 0.1% of weekly expenditure. By comparison, weekly spending on other vital services is substantially higher. The average household spends £10.50 (2.0%) on gas, £13.70 (2.6%) on electricity, £10.40 (2.0%) on water and other services.[16] Weekly spend on other forms of communication are also significantly higher – for example £9.90 per week (1.9%) is spent on telecom services.

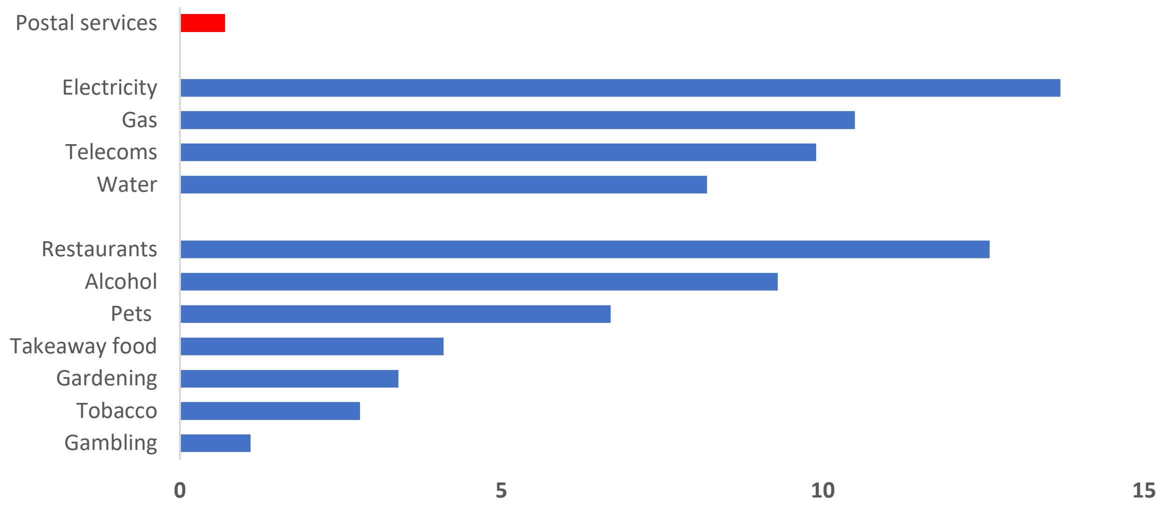
18. The average weekly household spend also includes high levels of discretionary spend, for example £9.30 (1.8%) on alcohol, £2.80 (0.5%) on tobacco, £3.40 (0.6%) on plants and flowers, £6.70 (1.3%) on pets, £1.10 (0.2%) on gambling, £12.60 (2.4%) on restaurants and cafés and £4.10 (£0.8%) on takeaway meals.

[14] ONS, Family spending in the UK: April 2021 to March 2022, May 2023.

[15] Including parcels.

[16] ONS lists 'other services' to include service charges for rent and refuse collection/skip hire.

Figure 1. Average household weekly spend (£)



19. We understand that the purpose of the 2c safeguard cap is to protect those on the lowest incomes. The ONS data shows that weekly expenditure on postal services of those in the lowest income decile stands at just £0.50. This accounts for just 0.2% of their weekly expenditure, while spend on telecoms is £5.90 (2.9%) £7.70 (3.1%) on gas, £11.00 (4.4%) on electricity, £8.20 (1.6%) on water and other services.

20. **In its consultation, Ofcom has recognised that** "*In both absolute terms and as a proportion of total household expenditure, expenditure on postal services remains low*."[17] It has further recognised that "*it is clear that that postal prices at their current level are not a major determinant of consumers' costs of living, and that it is not possible for an adjustment to postal prices to materially redress existing wider cost of living concerns*."[18] Given the extremely low level of household spend on post, it is not clear how consumers meet Ofcom's criteria of suffering "*significant detriment as a result of current prices*".[19]

21. Ofcom is using the safeguard cap as a crude tool to protect a small minority of consumers who may have real concerns about the affordability of postal services. In paragraphs 71 - 75 below we highlight our proposal for a targeted scheme to help those who are genuinely in need of regulatory protection. Even in the bottom income decile, spend on non-essentials such as recreation is 50x greater (and spend on alcohol and tobacco is 16x greater) than the spend on postal services.

22. Against this backdrop of average household spend on different goods and services, it is not credible to suggest there is an affordability issue in post. The price of a second class stamp is negligible in the context of wider household spending, and Ofcom's own research shows that consumers are not raising concerns about the price of stamps. Even within the bottom decile of income, the average spend on post is equivalent to less than one cigarette or a mouthful of a takeaway coffee. For that price it is possible to send a letter from the Scilly Isles off the South-West coast of England to the Shetland Islands off the North coast of Scotland – over 1000km away.

Ofcom's own evidence indicates that the current cost of living crisis is the reason why vulnerable customers need to be protected, not the price of stamps themselves.

23. In paragraph 5.14 of its consultation document Ofcom acknowledge that "*[a]n increase in the proportion of consumers reporting a reduction in their spend on stamps to afford essentials may therefore not indicate an increase in postal affordability issues, but rather broader financial concerns*

[17] Paragraph 5.33 of the consultation.
[18] Paragraph 5.17 of the consultation.
[19] Paragraph 5.104 of the consultation.

arising from the increased cost of living. Similarly, it is difficult to determine whether there is any connection between changes in consumption and increases in postal prices. This is particularly important for us to consider because any changes we make to the safeguard caps must be led by the impact of changes in postal prices on affordability and not by the impact of prices of other items or services on affordability of postal services."

Ofcom's research shows consumers are not concerned about stamp prices

24. Independent affordability research undertaken for Ofcom by the research firm Jigsaw, which was published in June 2023,[20] identified that "*[n]one of the participants mentioned the price of stamps as having a major impact on them*" and that "*[p]articipants' personal circumstances seemed to have a greater impact on perceptions of postal affordability than the price of a stamp*". Ofcom has stated in the consultation that "*concerns about affordability appeared to relate to general economic conditions rather than relating specifically to post*."[21] Whilst consumers are conscious of a cost-of-living crisis, the impact of this squeeze on incomes on affordability of postal services is negligible to consumers, such that it was not mentioned on a single occasion during the research.

25. To inform Ofcom's consultation, it commissioned Jigsaw Research to undertake research "*to understand: (1) the consequences for consumers who report experiencing affordability issues in the postal sector; and (2) how this relates specifically to the current price of stamps*." This qualitative research consisted of a series of hour-long in-depth interviews with consumers from a range of backgrounds and included a specific focus on consumers with lower incomes. It was designed to support, and add context to, Ofcom's ongoing Residential Postal Tracker.

Prices are below the European average

26. Comparing our prices to those across Europe, it is clear that the price of our second class stamp is significantly below the European average. As we set out more fully in paragraphs 79 - 81 below, as of January 2023, the European average 2c Stamp letter price was £1.01, with a median of 94p, compared to 68p in the UK. Even with the increase to 75p in April 2023, the 2c stamp price is still significantly cheaper. Royal Mail has long maintained a prudent pricing policy on letters to avoid "*tipping points*" whereby price increases push customers away from post entirely.

Consumers overestimate stamp prices

27. Ofcom regularly tracks the views of consumers through its Residential Postal tracker. Ofcom's data shows the majority of consumers think that a second class stamp offers value for money[22]. This is despite the majority of consumers overestimating the price of a second class stamp. Consumers, on average, think that the price of a second class stamp is £1.06, which is 41% higher than the actual price of £0.75.[23] We note that the public perception of the current price of a second class stamp being £1.06 is higher than the c.25p uplift in the cap that Royal Mail is asking for in paragraphs 76 - 78. It would be reasonable to conclude that, for the majority of consumers, a maximum increase of c.25p for the price of a second class stamp, out of an average weekly budget of £528.80, would not have a noticeable impact.

Ofcom did not carry out a proper impact assessment

28. As Ofcom notes in paragraph 2.35 of its Consultation Document, impact assessments "*form part of best practice policymaking*" and are a valuable way of assessing different options. However, Ofcom considers only the impact of its proposal (paragraph 2.38). The purpose of an impact assessment is

[20] Jigsaw, Residential Postal Affordability Research, June 2023.
[21] Paragraph 2.46 of the consultation.
[22] Ofcom, Residential Postal Tracker Q3 2021 – Q2 2022, September 2022.
[23] Ofcom, Residential Postal Tracker Jan 2022 – Dec 2022, March 2023.

not to consider only the impact of a specific policy or regulatory proposal but to determine whether that proposal is the best way of achieving its intended objectives. This requires consideration of alternative means to achieve the intended objectives, and an assessment of the impact of each possible approach. While the impact assessment Ofcom refers to in the consultation document is in line with the impact assessment guidelines Ofcom recently consulted on,[24] we do not consider that these guidelines allow for the consideration of whether the proposal is the best way of achieving the intended objectives.

29. Ofcom sets out its regulatory objectives in Section 2 of the Consultation Document**.** These include ensuring regulatory conditions must be "*proportionate to what it is intended to achieve*" (paragraph 2.10). There is significant scope for Ofcom to achieve these objectives in a more effective way. In particular, the proposed price control is a blunt tool that caps 2c prices for all customers to protect a very small putative group of customers that may be impacted by an increase in the price of a second class stamp. This comes at significant cost to Royal Mail, not only given the financial position of the company, but also given the lack of evidence as to the existence of such a group of customers.

[24] Ofcom, Consultation: Draft impact assessment guidance, 17 March 2023.

Structure of Price Cap

We support Ofcom's proposal to remove parcels from the cap. We agree there is competition which, as demonstrated by our recent pricing decisions, is acting as a constraint on our pricing.

There is also evidence to support removing large letters from the cap. Many large letters are used for fulfilment and are more akin to parcels both in their demand characteristics and the way they are handled through our network. However, if Ofcom maintain their proposal to retain caps on letters and large letters, then we need the commercial flexibility of a combined letter / large letter Cap.

We support Ofcom's decision on removing parcels from the price cap. There is growing competition which acts as a constraint on pricing as demonstrated by our pricing over recent years

30. Ofcom acknowledges in its consultation document, competition in the C2X parcels market segment has grown since its last review in 2018-19, particularly in the lighter weight steps. We agree with this assessment. Ofcom recognises that alternative operators have increased their volume shares in lighter C2X segment and whilst we remain the largest in this segment, our volume share is declining.[25]

31. This growth has been facilitated by an expansion in the number of places customers can drop off their parcels. Specifically, a number of operators, including Evri (Hermes), Yodel and DPD, all have substantial logistics and Pick Up Drop Off ('**PUDO**') networks that enable them to offer competitively priced, high-specification, nation-wide, single-piece, addressed parcel delivery services.

32. In addition, two of the largest PUDO networks in the UK, the Post Office Ltd ('**POL**') network and Collect+, are no longer exclusive to Royal Mail and Yodel respectively. It is now easier than it has been historically for any operator to expand its presence quickly, through a contract with POL and/or Collect+. Similarly, the growth in the use of resellers, such as Parcel2Go, make bringing new C2X products to market easier than ever before.

33. Alternative operators have been able to respond to the emergence of more price-sensitive C2X senders (in particular online marketplace sellers) by offering comparable, competitively priced alternatives to Royal Mail at weight steps up to 2kg.

34. Ofcom itself acknowledges that "*Royal Mail's internal documents also show that Royal Mail closely monitors the prospect of expansion of its competitors in the single piece parcels sector and how its prices compare to those of its competitors*"[26]. And that "*Not only have price increases been relatively modest, but Royal Mail has decreased its prices for small and medium sized parcels when the consumer pays online for the service, rather than using stamps*".[27]

35. Given the economics of this market segment, competition is likely to remain strong, and may intensify as operators seek to grow volumes that can make a positive contribution to their network costs. As the largest company currently operating in this space, Royal Mail's C2X parcels volumes are likely to come under further pressure. The evidence demonstrates that there is no need for any safeguard caps on stamp parcels services.

[25] Paragraph 4.62 of the consultation.
[26] Paragraph 4.83 of the consultation.
[27] Paragraph 4.78 of the consultation.

There is also evidence to support removing fulfilment large letters from the cap since they face similar demand characteristics and levels of competition as that faced by small parcels

36. There is growing competition for large letters. Large letters are defined by dimensions - up to 353mm in length, 250 mm in width and 25 mm in thickness, with a maximum weight of 750g. The definition of large letters covers any item which falls within these dimensions, irrespective of content. As we set out in our response to Ofcom's 2022 Regulatory Review, this definition is out of date. It does not reflect the very significant differences in how consumers use paper-based large letters and large letters for fulfilment. Moreover, it does not reflect how we handle these items in our network.

37. Large letters used for fulfilment are in effect small parcels (that may contain phone cases, for example) that typically fit through a letter box. These thick, large letters (e.g. >10mm thick) typically are not sorted through our large letter sorting machines for a number of reasons. In our operation, correspondence large letters are typically sorted through our Tops 2k machines. To ensure efficient throughput, these machines are typically set to process items up to 10 mm. If we set the machines to handle items larger than 10mm, this significantly reduces their throughput rates, introducing inefficiencies into our sortation of paper-based large letters. "*Floppy*" and/or >10mm items are extracted and put through either manual sortation or parcel sort machines.

38. In addition to the way these "*fulfilment*" large letters are handled in Royal Mail's network, the end-customers using these will have different characteristics. For example, customers sending fulfilment items may be more inclined to want tracking and the large letters themselves are likely to be heavier weights. They will also have many more options of supplier than those customers predominantly sending paper-based large letters as we have seen recently with the introduction of Evri's postboxable product.

However, if Ofcom maintain their proposal to retain the caps on letters and large letters, then we need the commercial flexibility of a combined letter / large letter Cap.

39. If Ofcom maintain their proposal to retain the caps on letters and large letters, then we need the commercial flexibility of a combined letter / large letter Cap.

40. Ofcom's consultation document suggests that Royal Mail may already be pricing at the maximum the market would bear for large letters. Indeed, Ofcom's conclusion on large letters appears to contradict statements in its consultation. In paragraph 7.16 of its consultation document, Ofcom states that one of the reasons it has not allowed the existing headroom in the large letter cap is that Royal Mail has not used it to date; stating this may mean we have priced to the maximum the market would accept. As we have explained above, our approach has been to increase prices gradually to test the market rather than using all of the headroom in the cap. Our gradual approach should not be used as a reason for removing all our commercial flexibility going forward. Rather it demonstrates our considered approach to price increases, which takes into account market conditions, the risk of hitting tipping points and the need to ensure a market funded USO.

Ofcom's proposals could undermine our financial sustainability

Ofcom's proposals have the potential to significantly undermine our financial sustainability. They ignore the "*Pricing ladder*" effect. A binding cap on 2c letters and large letters will limit the price increases we can put on our other letters services including 1c letters and wholesale (access) products. This could have a significant impact on our finances by the end of the period included in our Business Plan. By as early as next year we will no longer be able to implement the pricing strategies in our Business Plan.

Our Business Plan assumes price increases in Business Mail of [✂] pa. Ofcom's proposals to constrain prices to CPI mean we will be unable to fulfil that element of the Plan. If we want to maintain the "*Pricing Ladder*" by 2027/28, Ofcom's proposals will have a direct impact on the Plan of a revenue reduction of [✂] over the 5 year Plan period.

However, the impact could be worse than that. Due to market conditions, recent Business Mail price increases have been on average [✂]. If we needed to continue with this approach and maintain the current price gap between services, Ofcom's proposal would have a negative revenue impact of [✂] in 2027/28. This compares to a forecast profit of [✂] in 2027/28 for the Reported Business.

The proposals also create perverse incentives. We have been forced to increase large letter prices more rapidly due to Ofcom's 2c safeguard cap proposals – reducing our commercial flexibility through removal of the headroom on large letters

With all our pricing decisions we are mindful of the impact we may have on customer posting decisions and whether our prices could result in a tipping point. As Ofcom is aware, we have taken the decision to bring forward our tariff and implement a c30% increase to 2c stamp large letters from 1 October 2023. This was not the action we wanted to take. However, Ofcom's proposal to remove the headroom in the current cap for large letters has meant we would not be able to follow our normal commercial approach.

We are having to take a number of very difficult decisions to preserve and generate cash in the short term while needing urgent change to the USO to ensure a financially sustainable business. [28]

The safeguard caps were not intended to limit our commercial freedom

41. We do not agree with Ofcom's decision to maintain the price cap on our 2c letter and large letter prices.

42. In its 2019 review, Ofcom sets out that the safeguard caps, "*seek to ensure a basic universal service is available to all at affordable prices, and to ensure that users of postal services, especially vulnerable consumers, are protected from significant price increases*" as well as to "*allow Royal Mail to make a reasonable commercial rate of return on the safeguarded products; and to minimise the effect on the safeguard caps on Royal Mail's pricing freedom so as to avoid a material effect on wider financeability and/ or efficiency incentives*."[29]

[28] The ask for urgent reform of the USO was set out in the Royal Mail's half-year results for 2022-23, published 17 November 2022.

[29] Ofcom refers to these as "*safeguard caps objectives*" in its decision statement.

43. The original intention of the safeguard cap in 2012 was to ensure that a basic Universal Service remains affordable for vulnerable customers but not that it should be a binding cap. Specifically in its decision document Ofcom stated that its intention was "*…to impose a safeguard price cap on a product to ensure that a basic universal service is available to all and protect vulnerable consumers from ongoing price increases. In addition, to ensure that the wider financeability and/or efficiency incentives are not affected, we looked to minimise the impact of the cap on Royal Mail's wider pricing freedom and considered that Royal Mail should be allowed to make a reasonable commercial rate of return on the safeguarded product*". [30] As set out earlier in the document and in further detail below, market and operating conditions mean that we are now pricing at the letter cap. This means that the original regulatory objectives are at risk.

44. The safeguard cap put in place by Ofcom in 2012 was never intended to restrict Royal Mail's commercial flexibility in the way Ofcom's latest proposal does.

45. Ofcom has limited levers to support Royal Mail. This is one lever – removal of an unjustified price cap to provide us with an opportunity to grow revenue and support the sustainability of the USO. Yet, rather than supporting Royal Mail Ofcom has decided to use this regulatory lever as a stick – retaining a restrictive price cap with no acknowledgement of the impact of the structural decline in letters on unit costs given the high fixed cost of the USO business.

Ofcom has not provided any increase in the headroom

46. This is the first time Ofcom has proposed a new safeguard cap with no uplift to the starting cap level. In fact, it is proposing removing the existing large letter headroom, further reducing our commercial flexibility at a time when Royal Mail is facing one of its worst financial outlooks as set out elsewhere in this response. In 2019, when Ofcom last reviewed the 2c price caps, the standard letters cap was increased by 5% in real terms (going from 60p in 2018/19 to 65p[31], an increase above CPI of 5%), whilst the existing headroom (c.29%) in the basket cap (large letters and parcels) was retained. In 2012, the caps were set to allow an initial increase of 53% across both the standard letter and basket (large letter and parcel) caps. An increase in the cap does not mean we will automatically make use of the headroom. It simply gives us the option to do so if circumstances require. It provides us with the commercial flexibility to respond rapidly to changing market conditions – precisely the objective behind Ofcom's decision on the regulatory framework more than a decade ago.

Profit – and not revenue - is the correct measure in assessing impact on financial sustainability

47. Ofcom states that the 2c stamp revenue impact is small compared to Royal Mail's overall revenue. But this does not acknowledge the significant contribution to profit that is made by 2c stamp services. Further, it ignores the impact that a binding cap will have on other prices we can put into the market. This is commonly referred to as the "*Pricing Ladder*" effect whereby we need to keep the price gaps between services such as bulk letter services and meter mail at specific levels. If, due to the "*Pricing Ladder*" effect, we are constrained from implementing the prices in our Plan or even leveraging our commercial flexibility to increase prices by more if our finances require it, this could have a significant impact on the financial sustainability of the USO. We provide further information on the impact on the "*Pricing Ladder*" in paragraphs 50 to 59 below.

When assessing its objective of taking account of the costs of providing the capped service(s), Ofcom should be using Fully Allocated Costs (FAC) not incremental costs

48. In Section 7 of its consultation document Ofcom sets out how its proposal meets its objectives. One of those is to ensure that "*any safeguard cap takes into account the costs of providing the capped service(s)*". Specifically in paragraph 7.27 its states that "*we [Ofcom] are confident (subject to volumes*

[30] Ofcom, Securing the Universal Postal Service Decision on the new regulatory framework – March 2012, Paragraph 8.4.
[31] Actual value was 65.2p.

remaining broadly aligned with recent historic trends over the past five years) that prices remaining constant in real terms will be sufficient to cover the incremental costs of providing the relevant services." This is the wrong cost standard to use. In short, a network business which prices all of its services at or only just above incremental cost would very soon go out of business.

49. Royal Mail operates across a number of markets, many of which are highly competitive. In these highly competitive markets, prices are driven lower and often we need to price to incremental cost to remain competitive. However, in order to be in a position to provide a market funded financially sustainable USO, we need to be able to cover our total cost base (i.e. Fully Allocated Costs including a reasonable return). Our prices should reflect the costs of the provision of the service and the prices that customers are prepared to pay for the services. If we set too high a price on USO letter services we risk hitting a tipping point leading to an acceleration in e-substitution.

Ofcom has ignored the "*Pricing Ladder*" effect – a binding cap on 2c caps will reduce our commercial flexibility, limiting the price increases we can put on other services

50. Ofcom's proposals have the potential for an even more serious impact on our finances. Unlike previous Ofcom consultations, it ignores the "*Pricing ladder*" effect.

The "Pricing Ladder"

When considering the appropriate price for all letters and large letters we carefully consider the relationship between the different services being offered. Letter and large letters are sold via channels other than just stamp and, for account customers, where the mail is sorted and / or uses a Mailmark barcode. These are set at, and must maintain, a lower price than stamps, so are in effect price controlled by stamps.

Relative prices: Stamp: Meters and USO Account (both USO); Business Mail Unsorted; Business Mail Low Sort Mailmark. The ladder goes all the way down to our lowest prices in Wholesale.

Any price difference between products and channels must be enough to cover the customers' extra costs to meet the extra requirements needed.

51. Price differentials are also key levers to ensuring we drive efficiency in our operation. For example, through our automation strategy, Mailmark products are cheaper than their Manual equivalents. We have consistently increased the prices of manual products by more than the Mailmark equivalents to encourage customers to move to the more efficient products; we need to continue to do this in the future. Mailmark products are also better from a customer perspective as they provide more information at a cheaper price, as well as being better for Royal Mail as they are operationally more efficient and benefit from a unique identifier.

52. See table below:

Table 1. Key examples

Channel / Product	Letter Price	Notes
2c Stamp	75.0p	Service available to consumers and businesses via POL; online, and other outlets
2c Meter	69.0p	Meter customers spend c£40 per month on a meter machine and Royal Mail also saves on stamp commission costs. This is the minimum price difference we need from stamps to make the channel viable
2c USO Account	67.0p	Account customers need to spend a minimum of £5k a year to set up an account
2c Business Mail Manual Unsorted	65.0p	VAT payable version of USO Account and attracts VRDs, as all Business Mail products do
2c Business Mail Mailmark Unsorted	51.2p	Mailmark is more efficient for Royal Mail to process and gives more information to the customer. Min 250 items per posting
Economy Business Mail Mailmark Sorted	45.9p	The lowest priced retail product with sortation required by the customer and a longer delivery spec. Min 4k items
Economy Access 70 Business Mail Mailmark	40.1p	There is a minimum price gap between Retail and Wholesale products to pass Regulatory and Competition Law tests

Note: Prices as at 1 September 2023

53. The 2c cap also has an impact on our 1c stamp prices. Historically, we have kept the gap between our 1c and 2c prices at a specific level in order to minimise the number of consumers who may choose to downgrade. However, if this gap widens, we may see further downgrading than we anticipated. The 2c cap may in effect act as a constraint in our 1c pricing. In both scenarios, this will impact our Business Plan.

54. Ofcom explicitly recognised and considered the impact of the "*Pricing Ladder*" in its 2012 regulatory review. In its 2012 consultation 'Securing the Universal service', Ofcom explicitly acknowledged the important relationship between our different prices stating that "*Our analysis also indicates that setting a ceiling on Second Class stamps at an appropriate level will not unduly constrain Royal Mail's pricing flexibility in relation to other products. In this sense, this approach will not cut across the wider benefits to be gained from pricing freedom*."[32]

55. It has failed to apply the same rigour to its current consultation proposal. It has ignored the fact that it is proposing a binding price control (compared to a c.53% uplift in 2012/13) and has ignored current prices in the market. It has also failed to assess the impact of its current price cap proposal on the "*Pricing Ladder*".

56. Our Business Plan assumes that we increase Business Mail prices by c [✂] pa. If 2c stamp letters and large letter price increases are capped at CPI there will come a point at which we are no longer able to meet our Plan because we simply cannot increase the prices for our other letters services, including Access products, if we maintain the "*Pricing Ladder*". This could have a significant impact on our

[32] Ofcom, Securing the Universal Service, 2012, Paragraph 1.47.

finances by the end of the Plan. We estimate by next year we will no longer be able to implement the pricing strategies in our Plan if Ofcom implements its consultation proposals.

57. Assuming we keep the current price gaps at the same level, Ofcom's proposal starts to have an impact on our plan as early as 2024/25. By 2027/8, this has increased to a revenue impact of **[✂]**.

58. However, in order to support the business, recent Business Mail price increases have been on average **[✂].** If we need to continue with that approach due to our current precarious financial position and we maintain the price gap between services, Ofcom's proposal could have a negative revenue impact of **[✂]** in 2027/28.

59. Table 1 and Figures 2 and 3 below clearly show the potential financial impact on the business if we are unable to increase our business mail prices in line with our pricing strategy.

[✂][✂]

[✂]

We have been forced to increase large letter prices early, and by more, due to Ofcom's consultation proposal of removing the existing large letter headroom and to only allow CPI increases from prevailing prices[33]

60. Whenever we take decisions regarding our prices we carefully consider the impact these decisions are likely to have on customers, and hence on volumes, and whether our prices could result in a tipping point. As Ofcom is aware, we have taken the difficult decision to bring forward our stamp tariff and implemented a c.30% increase to 2c stamp large letters from 1 October 2023. This was not the action we planned to take. However, Ofcom's consultation proposal to strip away the existing headroom on large letters has forced us to consider how we can aim to implement our large letter pricing strategy. This has caused us to accelerate and combine **[✂]** worth of price increases on 2c stamp large letters in our October 2023 tariff decision. Even with this increase, we would need a **[✂]** average uplift on large letters from prevailing market prices to meet our Business Plan.

61. Due to our challenging financial position, we need to retain the ability to increase our prices by more than CPI. Our preferred approach would have been to increase prices gradually, in line with previous pricing decisions, **[✂].** This approach allows us to test the price the market can sustain. However, Ofcom's proposals remove all the existing headroom on large letters and constrains price increases to CPI from the time at which Ofcom publishes its decision. This has resulted in us needing to accelerate our prices on 2c large letters to try and preserve some much needed commercial flexibility.

62. Over the past couple of years we have increased our large letter prices by c.10% pa. Our pricing at the lower weight steps remains lower than our competitors, but we are very conscious of the impact our price increases could have on customer decisions. Under Ofcom's proposals, we could not continue with our measured pricing strategy. The c.30% increase now is simply consolidating in one year what we would otherwise likely have done over a number of years.

63. Figure 4 below clearly shows the impact that Ofcom's proposal has had on 2c large letter prices, with customers experiencing a sharp increase in October 2023, rather than the more gradual increase of **[✂]** as shown in the dotted line.

[✂]

64. We are having to take a number of very difficult decisions to generate cash in the short term. We recognise that our 2c stamp large letter price changes, announced 1 September, increases the risk of hitting tipping points or losing out to competitors. But, due to Ofcom's consultation proposals and our cash position, this is necessary action to help support the finances of the USO.

Other harmful, unintended, consequences of Ofcom's proposal to set a binding price control

65. As with all price controls, and particularly in the context of post, there is a very high risk of regulatory error when setting the price cap given demand and cost uncertainty. This was recognised by Ofcom in its 2011 consultation where it identified the market uncertainty would risk the need to re-open the price control within the price control period. Ofcom noted that this limits certainty and efficiency incentives.[34]

66. It is important that Royal Mail has a flexible pricing strategy to allow us to proactively address the potential adverse consequences stemming from economic downturns. This is crucial in maintaining our commitment to providing the USO even in the face of uncertain economic conditions.

[33] At time of Ofcom's decision – Paragraph 7.32 of the consultation.

[34] Ofcom, Securing the Universal Postal Service Proposals for the future framework for economic regulation, October 2011.

67. Furthermore, it is imperative that Royal Mail has a flexible pricing strategy to enable us to rapidly respond to changing external factors. A carefully monitored and flexible pricing strategy will not only protect Royal Mail's services but also uphold the expectations from our customer base.

68. The current economic outlook is very uncertain. In the event that concerns regarding a potential recession become a reality, the impact on Royal Mail's financial capacity to sustain the Universal Service Obligation (USO) could be significant. Our volume and revenue are highly correlated to GDP. Changes in the UK's economic outlook can therefore have a material impact on our financial position. Ofcom's commitment to periodically assess and review the situation does not provide sufficient flexibility to respond to changing economic conditions. Regulatory reviews, by their very nature, take time, leaving us concerned that Royal Mail will not be well-placed to rapidly respond to emerging challenges. As recognised when the new regulatory framework was introduced in 2012, Royal Mail needs to have commercial flexibility to respond rapidly to changing circumstances.

69. In setting a binding price cap, Ofcom significantly reduces our ability to react rapidly to Government policy changes and increases the risk that potential policy changes may also lead to Ofcom having to re-open the cap. For example, the implementation of the Windsor framework will impact on our cost base and therefore how we need to price.

Alternative proposal

For the reasons set out in this document, there is no justification for a continuation of any price caps on 2c stamp letters, large letters and parcels. As we have set out earlier in the document, there is no affordability issue but there is an urgent need for commercial flexibility to support the financial sustainability of the USO. Our starting point, therefore, is that Ofcom should remove all 2c caps.

If Ofcom does have concerns that, in a very small number of cases, there may be some consumers with genuine affordability issues, then we would urge Ofcom to engage with us further regarding a targeted scheme to protect those consumers. This would be far more appropriate than the blunt tool of a price cap for all our 2c letter and large letter services.

If, contrary to our views, Ofcom continue with its proposed cap on letters and large letters, it needs to give us the commercial flexibility we need to support the USO. For the reasons set out above, we need the commercial flexibility to price 2c stamp letters to a level equivalent to the median price across EU countries. In particular, we would suggest the following proposal:

Proposal: Allow the combined basket cap to:

- price 2c stamp letters to the EU Median – in the UK, we currently have some of the lowest prices compared to EU countries. We also have higher quality targets than many comparable countries and the joint highest requirement of 6 days in which letters should be delivered under the USO; and
- provide an average 10% p.a. uplift on large letters from prevailing market prices[35] – to ensure some degree of commercial flexibility

Using prices at the time of Ofcom publishing its decision (expected November/ December 2023), this would require an uplift in the cap (i.e. the base weighted price or P0) of c.25p to provide commercial flexibility.

This is a fair and reasonable proposal

Remove all the price caps in their entirety

70. Our starting position is that 2c price caps should be removed in their entirety. In particular, we already have very strong incentives to price our services at reasonable and affordable prices, given the extent of competition we face across all our parcel services, and the risk of e-substitution and tipping points for letters. These principles apply equally to our 2c USO consumer parcel and letter services.

Re-engage with us urgently on a targeted scheme to address affordability issues with vulnerable consumers

71. We request that Ofcom re-engages as a matter of urgency, and before reaching any final decision regarding the imposition of binding price caps, on the introduction of a targeted scheme to address affordability issues for vulnerable consumers. As per Ofcom's request, Royal Mail invested significant time and resources in exploring a potential solution that would better address the affordability concerns of that small proportion of people, while ensuring that we would have sufficient commercial flexibility to improve our financial sustainability. In particular, earlier this year Royal Mail:

[35] At time of Ofcom's decision.

- Met with a wide range of stakeholders including Citizens Advice, Consumer Scotland, CCNI, Centrica, Libraries Connected, DCMS, Trussell Trust, Water UK, and DWP to understand how affordability schemes have been designed and implemented in other sectors and to identify which postal customers would require support.

- Carried out extensive benchmarking of affordability schemes in other sectors including telecoms, water and energy to understand delivery mechanisms, eligibility criteria, the level of support provided.

- We also held meetings with Post Office and Libraries Connected to understand how stamps could be distributed in practice.

- Meetings with DWP and utilities companies to understand the extent to which we could use existing data sets and delivery channels to identify and reach eligible consumers.

- Had various discussions with Ofcom. Data protection laws mean that it is difficult to identify eligible customers in the same way that has been done in other sectors (e.g. in water and energy, there are special provisions in the law to do this). We have therefore asked Ofcom to support us in identifying potential eligibility criteria and ways of developing a list of eligible customers and addresses.

72. Based on our work, we identified posting a fixed number of 2c stamps directly to eligible customers as the appropriate way to reach the customers Ofcom is concerned about, since this would allow us to utilise existing Royal Mail capability. This method is more cost effective than other options explored (e.g. using POL or partners such as charities or libraries).

73. We have engaged on a regular basis with the Consumer Advocacy Bodies (CABs) as the statutory consumer bodies for post. We asked the CABs for evidence relating to scale and nature of affordability issues including what an affordable price would be, stamp usage, and spending on post. However, they have not provided this information to us.

74. Ofcom notes that it may be prepared to reconsider any decisions regarding the 2c price cap if in the future we were able to develop a targeted scheme or if actual demand turned out to be significantly different to forecast demand. We are very disappointed, however, that Ofcom has not engaged with us further on this prior to issuing its consultation document.

75. Going forward, we would suggest that as a matter of urgency Ofcom re-engages with us immediately on these proposals and before reaching any final decision regarding a new price cap. Moreover, in order for us to understand what might meet Ofcom's expectations, and help to improve regulatory certainty, Ofcom should provide objective, specific and measurable criteria that would need to be met in order for it to reconsider any decisions it may make as regards the 2c price cap. These should include:

    - By how much would actual and forecast need to differ and over what time period.
    - What proportion of customers would a targeted scheme need to reach.
    - How much support would need to be provided to those customers.
    - Ofcom should also provide the legal mechanism and process for re-opening the price control, including clear timelines for how long it would take Ofcom to review a request to re-open the price control.

Increase the 2c letter cap to the EU Median price. This is a fair and reasonable proposal

76. If Ofcom is not prepared to remove the price caps in their entirety, then, we would ask Ofcom seriously to consider materially increasing the starting level of that cap. In particular, we have previously shared

with Ofcom details of our proposal to price to the EU Median for letters over a gradual three year period to avoid any shocks to the market.[36] For the reasons set out in this paper, we believe Ofcom should remove all 2c price caps. However, if Ofcom disagrees, we believe that an increased 2c letter cap that allows us to achieve this would be fair and reasonable We have some of the lowest prices compared to countries in the EU but the fact that UK prices are cheaper doesn't reflect any lower targets. In fact, they are higher. We have a six-day letters USO and 118 Post Code Area (PCA) targets for quality of service performance which no other comparable country has. We have estimated that an uplift in the order of c.25% is needed based on CPI projections to provide the commercial flexibility. This is equivalent to a c.25p increase based on our estimate of the weighted average basket price. However, this uplift should be based on the prices in the market at the time Ofcom publishes its decision.

77. In its 2012 consultation, Ofcom itself stated that "*In proposing this safeguard, we note, first, that UK stamp prices are currently within the range of EU prices, despite the fact that elements of the UK's universal service are more onerous than those in other countries.*"[37] Our recent proposal of pricing letters to the EU Median still meets that criteria.

78. As we set out below, based on the latest data available, international comparison of stamp prices and quality of service requirements have shown:

- our 2c Stamp letter prices are well below the European average. As of January 2023, the European average 2c Stamp letter price was £1.01, with a median of 94p compared to 68p in the UK. Even with the UK April Tariff increase to 75p, the price is still significantly cheaper.
- the UK has higher quality targets than many countries. A quality of service delivery target of 98.5%, is the second highest requirement in Europe, 0.5% behind France and Spain.
- we also have the joint highest requirement of six days in which letters should be delivered under the USO

Our 2c Stamp letter prices are well below the European average

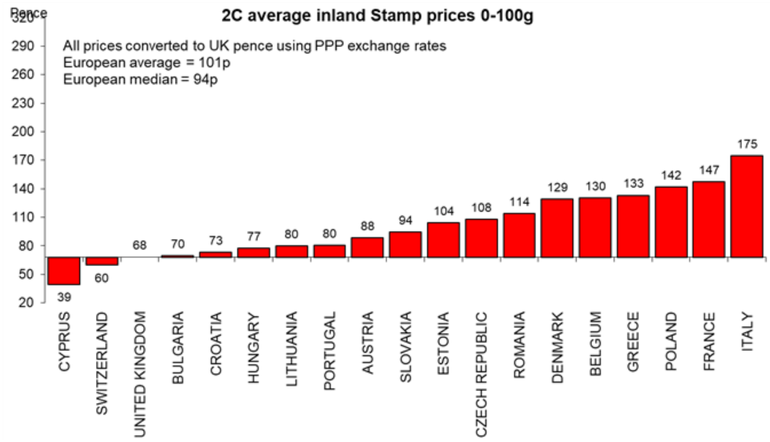
79. We have undertaken analysis which explores Stamp letter price trends in the UK and makes a comparison with European Union (EU) member states and the two European Free Trade Association (EFTA) countries of Norway and Switzerland, where prices can be clearly and publicly identified.

80. Royal Mail charges the same price for letters up to 100g, whilst most other operators in Europe charge two or three different prices in this weight step (0-20g, 21-50g and 51-100g). **UK 1c and 2c Stamp prices, adjusted by Purchasing Power Parity (PPP), remain below the European average in all three weight bands**, despite service standards in the UK being appreciably higher than in many other countries.

81. As Figure 5 below shows, Royal Mail's 2c Stamp letter price of £0.68[38] is below the European average of £1.01 and median of £0.94. A price of £0.68 makes Royal Mails 2c stamps almost half the price of the European average and current prices make Royal Mail 2c stamps the 3rd cheapest in Europe, behind Cyprus and Switzerland.

[36] Letter from Royal Mail to Ofcom, 22 May 2023.
[37] Ofcom, Securing the Universal Postal Service Decision on the new regulatory framework – March 2012, Paragraph 1.48.
[38] Price at time international comparison was made – January 2023. Current price of 2c letter stamp is 75p.

Figure 5. 2c average inland stamp prices 0-100g



82. Royal Mail's UK 2c Stamp letter price of £0.68p for all letters up to 100g is highly competitive and the 3rd cheapest across all three price intervals (0-20g, 21-50g and 51-100g). Royal Mail provides a service for 2C stamp letters that is:

- The 3rd cheapest and below the European average of £0.93 for 0-20g.
- The 3rd cheapest and below the European average of £1.16 and median of £1.04 for 21-50g.
- The 3rd cheapest and below the European average of £1.55 and median of £1.28 for 51-100g.

2c prices in benchmark countries have increased rapidly in recent years

83. Since January 2023, 12 countries have changed their 2c stamp prices with the highest price increases in Hungary (c+21%), Belgium (c+17%), Slovakia (c+15%) and Bulgaria (c+15%). Meanwhile, Royal Mail have had the lowest increase in prices of 2c stamp prices across Europe in the price interval up to 20 grams, the second lowest in the 21-50 grams and third lowest in the 51-100grams price interval.

84. Despite the relatively low price increases since January 2022 and competitive prices that we offer customers in the United Kingdom, we have one of the highest delivery targets in Europe. A quality of service delivery target of 98.5% is the second highest requirement in Europe, 0.5% behind France and Spain. France, however, have the second highest price on 2c stamps across Europe, whilst Spain do not have a price cap in place.

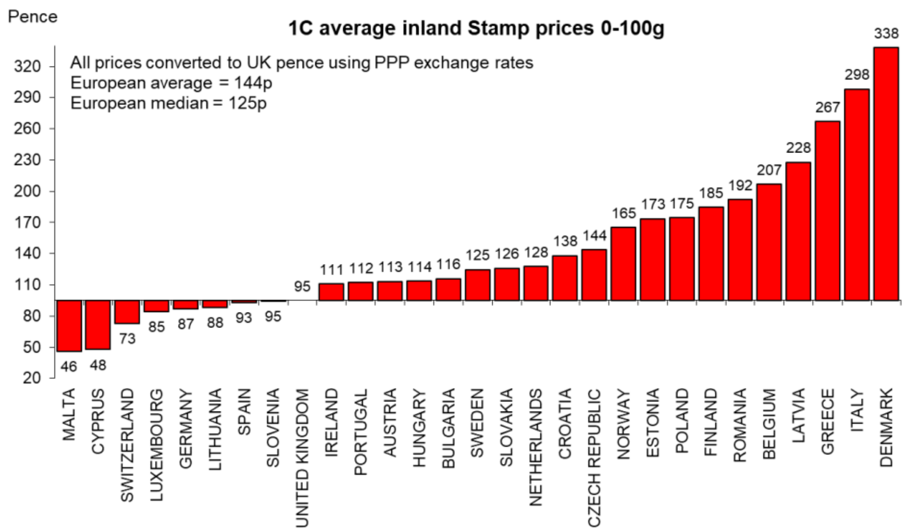
85. Furthermore, Royal Mail have the joint highest requirement of six days in which letters should be delivered under the USO. Countries including Spain, Netherlands, Italy and Denmark have a requirement of 5 days delivery service, whilst others have even lower requirements including Norway, for example, where letters are only delivered twice a week under the USO. In other countries, such as Finland, there are different delivery requirements for letters for both urban and rural areas (three and five days respectively), both of which are lower than the six days expected of Royal Mail. We have asked Government to change to the USO specification to five days a week letter delivery service.[39] However, this request to date has been refused.

[39] The ask for urgent reform of the USO was set out in the Royal Mail's half-year results for 2022-23, published 17 November 2022.

1c prices are lower than in benchmark countries

86. In addition to 2c Stamp letter prices falling below the European average and median, Royal Mail also price 1c Stamps competitively relative to the European market. Using the latest comparison available prices on 1c Stamps were £0.95 compared to an average across Europe of £1.44 and median of £1.25. This makes Royal Mail's 1c stamps 34% cheaper than the European average. Royal Mail's 1c Stamp letter price of £0.95 is below the European 0-100g average of £1.44 and median of £1.25.[40]

Figure 5 – 1c average inland stamp prices 0-100g



Quality of Service (QoS) challenges Royal Mail is facing should not be a barrier to publicly increasing prices

85. Finally, we acknowledge that we are facing quality of service ('**QoS**') challenges. However, this should not be used as any form of justification to continue to constrain our prices or to refuse our request for any price cap to be materially increased. Royal Mail takes USO QoS extremely seriously. USO QoS failure is good for no-one. It is not good for customers, it is not good for Royal Mail, and it is not good for business. We are very disappointed that we did not meet our USO QoS targets in 2022/23, albeit we believe there are clear and compelling reasons why this was unavoidable.

86. 2022/23 was a uniquely challenging year, characterised by rapid revenue loss, an urgent need to radically transform operations, a long running and bitter industrial dispute and high levels of staff absence and attrition, creating a financial cliff edge where Royal Mail faced significant financial jeopardy.

87. To restore USO QoS, we need to achieve vital structural reform in the network and in delivery, restore absence levels to pre-pandemic levels, reduce attrition, remove agency in delivery, reset the mindset of frontline staff to clearing all mail every day and restore morale and trust across the operational workforce so as to provide a stable and more cooperative industrial relations framework.

88. We are working hard to fix these, and it is not appropriate for these current (but fixable) issues to influence a safeguard cap which is being put in place for the next 5 years.

[40] Note: As of 2 October 2023, 1c stamp price in the UK will be £1.25.

Our Asks – (i) removal of all caps; (ii) proposed modernised structure of the cap

There is no justification for a continuation of any price caps on 2c stamp letters, large letters and parcels. As we have set out earlier in the document, there is no affordability issue but there is an urgent need for commercial flexibility to support the financial sustainability of the USO. Ofcom should remove all 2c caps.

Ofcom acknowledge that there is growing competition for consumer parcels. We agree with this and therefore support the removal of 2c parcels from the safeguard cap.

If Ofcom continue with its proposed cap on letters and large letters, it needs to give us the commercial flexibility we need to support the USO. As we set out above, we need the commercial flexibility to price 2c letters to the EU Median.

We believe there are grounds to also remove large letters from the cap due to our prices being constrained by competition and already being close or at the price the market will bear. However, retaining large letters within a combined cap may allow us a degree of commercial freedom.

Our proposal was to be allowed to price letters to the EU Median and to increase large letters by c.10% pa over the duration of the cap. Using prices at the time of Ofcom publishing its decision (November/ December 2023), this would require an uplift in the cap (i.e. the base weighted price or P0) of c.25p to provide commercial flexibility.

Summary of regulatory positions

Below we provide a short summary covering our specific regulatory positions for each of Ofcom's questions in its consultation. We provide more details and evidence to support these positions in the chapters above:

Ofcom's Question	Royal Mail's Response
Question 1: Do you agree with our assessment that our proposals will not discriminate against any groups with protected characteristics? Please state your reasons and provide evidence to support your view.	We agree the proposals in themselves do not discriminate against any groups with protected characteristics. However, as we set out in paras 71 - 75 above, we believe a targeted scheme would have focused help on the most vulnerable of consumers.
Question 2: Do you agree with our assessment under the Welsh Language Policy Marking Standards? Please state your reasons and provide evidence to support your view.	No comment
Question 3: Do you agree with the objectives we propose to use for our review of safeguard caps? Please state your reasons and provide evidence to support your view.	No. As we set out in para 15 above Ofcom has placed far more weight on assessing the affordability of postal services than the weight placed on consideration of whether its proposals are consistent with its duty to have regard to the need for the provision of the Universal Postal Service to be financially sustainable
Question 4: Do you agree with our analysis of the market in relation to Second Class standard letters and large letters? Please state your reasons and provide evidence to support your view.	No. We believe the letters market is significantly more competitive than Ofcom suggests. For standard letters the risk of e-substitution and hitting tipping points is a very real threat that we take very seriously when setting prices. Our own internal pricing documents clearly demonstrate that we take these risks into consideration. We also believe Ofcom has underestimated the extent of competition in the large letter segment, where many of the letters are used for fulfilment as we set out in paragraph 37 above.

Ofcom's Question	Royal Mail's Response
Question 5: Do you agree with our analysis of the market in relation to Second Class parcels up to 2kg? Please state your reasons and provide evidence to support your view.	Yes. As set out in paras 30 - 35 above, we agree that the market for Second Class parcels up to 2kg is becoming increasingly competitive and acts as a significant constraint on our pricing.

Ofcom's Question	**Royal Mail's Response**
Question 6: Do you agree with our approach to assessing affordability of postal services? Please state your reasons and provide evidence to support your view.	No. We do not agree with Ofcom's approach to assessing affordability of postal services. The spend on post is a very small proportion of income. As we set out in paras 17 - 27, we do not consider there is an affordability issue. Even if Ofcom considers there to be an affordability issue, it has not set out why a safeguard cap would be the most appropriate and proportionate way of addressing it.
Question 7: Do you agree with our assessment of the affordability of Second Class postal prices? Please state your reasons and provide evidence to support your view.	No. We do not agree there is an affordability issue for second class postal prices. Absolute and relative spending on post is very low, representing just £0.70 spend per week in the average household, or 0.1% of weekly expenditure. This is a small fraction of the amount spent on other vital services such as utilities, and of discretionary spend on items such as restaurants, alcohol and tobacco. We explain further in paras 17 - 27 above.
Question 8: Do you agree with our analysis of the impact of the caps on the financial sustainability of the Universal Service? Please state your reasons and provide evidence to support your view.	No. We do not agree that Ofcom has given sufficient weight to the financial sustainability of the USO. Ofcom, contrary to its principal duty under the Act, appears to place far more weight on affordability of postal services than whether its proposals are consistent with its duty to secure the Universal Postal Service, and in performing this duty having regard to the need for the provision of the Universal Postal Service to be financially sustainable. In particular, in setting out the main objectives of its review and its proposals, it seemingly places factors such as "*ensuring universal services are affordable*" and "*provide protection to consumers*" above financial sustainability. Moreover, Ofcom talks about "*minimising the impact of any safeguard cap on the financial sustainability of the universal service*". However, that is not the relevant consideration – Ofcom must have regard to our financial sustainability overall, not just on minimising the impact. In other words, even if the impact of the proposals on our financial sustainability has been minimised (and there is no evidence or assessment in the Ofcom consultation document as to why that is the case), if the proposals nevertheless still materially undermine our financial sustainability, then they should not be pursued.

Ofcom's Question	Royal Mail's Response
Question 9: Do you agree with our proposal for the structure of the safeguard cap to be based on a single basket which includes Second Class standard and large letters? Please state your reasons and provide evidence to support your view.	We believe all the safeguard caps on letters and large letters should be removed. However, if the cap remains, we support the proposal for a basket which includes both Second Class standard and large letters since, as set out in paras 39 - 40 above it gives us the greater commercial flexibility we need to support the USO
Question 10: Do you agree with our proposal to set the basket cap for Second Class standard and large letters at current prices plus CPI? Please state your reasons and provide evidence to support your view	If the cap on Second Class standard and large letters is to be retained, we believe there needs to be an initial uplift to the cap in 2024/25 of c.25p. However, this uplift should be based on the prices in the market at the time Ofcom publishes its decision.
Question 11: Do you agree with our proposal to set the cap for five years? Please state your reasons and provide evidence to support your view.	Yes. The proposal to set the cap for 5 years gives certainty. However, Ofcom needs to be prepared to quickly reconsult and amend the cap if market conditions change
Question 12: Do you agree with the structure of the basket set out in Annex 5 in which stamp prices are weighted by volumes of each service type based on the volumes measured two years prior to the control? Please state your reasons and provide evidence to support your view.	Yes. We agree with the structure of the basket. However, as we set out in our response to Question 10, we believe the level of the Cap (i.e. the P0) should be increased from 2024/25.
Question 13: Do you agree with our proposal to remove the safeguard cap from Second Class parcels up to 2kg? Please state your reasons and provide evidence to support your view.	Yes. As we set out above, competition is growing in this market segment and is acting as a constraint on prices. There is no need for any safeguard cap on Second Class parcels up to 2kg.

Ofcom’s Question	Royal Mail’s Response
Question 14: Do you consider that there is value in developing a targeted scheme focusing on vulnerable consumers? If yes, your views on characteristics of such a scheme including target groups, nature of support and delivery options. Please state your reasons and provide evidence to support your view.	Yes. As we set out in our response above, we believe that a targeted scheme is the most appropriate way to help vulnerable customers.
Question 15: Do you have any others comments on the proposed modifications to the relevant DUSP conditions through which we propose to implement our proposals, attached in Annex 5? Please state your reasons and provide evidence to support your view.	No.