Review of the Second Class Safeguard Caps 2019

Price caps for Second Class standard letters, large letters and parcels up to 2kg

[✂] Redacted for publication

FINAL STATEMENT:

Publication Date: 17 January 2019

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1. Overview

1.1 **Postal services are essential to the UK economy and are a very important communication method for many people.** Most consumers value postal services. Older people and those without internet access are particularly reliant on the postal service to communicate.[1]

1.2 **Ofcom has legal duties to secure an efficient and financially sustainable universal postal service.** The universal service currently requires Royal Mail, as its provider, to deliver and collect letters six days a week, and parcels five days a week, at an affordable and uniform price throughout the UK.

1.3 **The current regulation for postal services has been in place since March 2012.** At that time, the universal service network was making a loss and Royal Mail's future provision of the universal service was under threat. To help sustain the universal service Ofcom granted Royal Mail greater commercial and operational flexibility to meet these challenges.

1.4 At the same time, **we imposed safeguard caps on Royal Mail's retail prices for the following "Second Class products":**

- a Second Class standard letter safeguard cap; and
- a 'basket' cap, comprising Second Class large letters and small and medium parcels weighing up to 2kg[2].

1.5 **The caps are designed to ensure that a basic, affordable, universal postal service is available** to consumers and small businesses; that users of postal services, especially vulnerable consumers, are protected from ongoing price increases; that Royal Mail can earn a reasonable commercial rate of return on the safeguarded products, and that the effect of the safeguard caps on Royal Mail's pricing freedom is minimised so as to avoid a material effect on wider financeability.

1.6 **The current safeguard caps expire on 31 March 2019.** This document sets out our decisions for regulating the Second Class products for the period 1 April 2019 – 31 March 2024.

What we have decided – in brief

The safeguard caps are still necessary. Royal Mail continues to hold a near-monopoly in delivering letters, and it has a very high share of the small and medium parcels sector. Therefore, we cannot rely on competition alone to protect consumers from significant price increases.

There is scope for some increase, while keeping prices affordable. Our evidence indicates that a 5%, real-terms increase to each of the caps would not make the Second Class products unaffordable, either for consumers generally or for a significant majority of potentially vulnerable consumers. But a larger increase would be unaffordable, because it could harm some vulnerable consumers.

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[1] Ofcom, 2018. *Residential Postal Tracker 2018*, July 2017-June 2018. QC3_1 and QG1. https://www.ofcom.org.uk/__data/assets/pdf_file/0034/118996/Residential-Postal-Tracker-Q3-2017-Q2-2018-tables.pdf.

[2] There is one cap for standard letters and a separate 'basket' cap covering large letters and parcels, and each cap increases in line with the Consumer Prices Index each year.

Raising the level of the standard letter cap will help to minimise the effect of the safeguard caps on Royal Mail's pricing freedom so as to avoid a material effect on wider financeability. Our analysis shows that, if we do not raise the level of the *standard letter* cap, Royal Mail's flexibility to increase prices could be eroded within two to three years. Royal Mail currently prices significantly below the level of the *basket* cap, which still gives it sufficient pricing flexibility over the products in the basket.

We have decided to increase the level of the standard letter cap by 5% in real terms, to 65p[3]; and to maintain the basket cap at its current level. These caps will ensure that the Second Class products remain affordable to consumers, while also giving Royal Mail an appropriate level of commercial flexibility. Each cap will increase by Consumer Prices Index ("CPI") inflation on 1 April each year, until they expire on 31 March 2024 – or earlier, should we decide this is necessary.

This overview is a simplified, high-level summary only. The decisions we have taken, and our reasoning, are set out in the full document.

Royal Mail has a significant share for letters and parcels

1.7 The UK letters market is in decline, with total letter volumes falling by around 17% since the caps were introduced in 2012/13, or 3% per year. Royal Mail's stamped letter volumes have fallen even faster, with volumes and revenues declining by around 11% and 7% per year on average respectively.

1.8 Against this backdrop, our assessment shows that Royal Mail holds a near monopoly in delivering letters. In the small and medium parcels sector, Royal Mail has a very high share and an extensive access network and strong brand awareness. Combined, these give it significant pricing power.

1.9 We cannot rely on competition alone to protect consumers from significant price increases, so the safeguard caps are needed. In addition, we do not consider there has been a change in competitive conditions that might prompt changes to the structure or scope of the caps.

Retaining a safeguard cap to protect vulnerable customers

1.10 In setting the safeguard caps, we must ensure prices are affordable for residential consumers and small businesses. We have particularly focused on the ability of potentially vulnerable consumers[4] to afford the Second Class products.

1.11 Measuring affordability for post is not straightforward. However, our analysis shows that although spending on post is a low proportion of income, affordability issues may still arise in circumstances where consumers either need to cut back on other essentials to send

[3] The precise upper limit of the cap will be set at 65.2p from April 2019, however we note that currently Royal Mail charges in whole pence increments for the Second Class products. Therefore, when describing the level of the cap in this document, we round to the last whole pence (65p).

[4] In assessing affordability we have considered each of the following groups, which we categorise as potentially vulnerable consumers: (i) over 65; (ii) without internet access; (iii) residing in rural areas; and (iv) in socio-economic group C2DE.

post, or choose not to send post they consider essential. We have balanced a range of evidence on affordability, and the likely effects on consumers, to come to a judgment on the appropriate level of the safeguard caps.

1.12 In several areas, little has changed since we conducted our affordability assessment in 2013.[5] Postal services still make up a low proportion of income, and our research suggests most consumers do not experience affordability issues. However, real disposable incomes have increased moderately since 2013, including for the lowest earners. This suggests affordability has improved.

1.13 In our judgment, the evidence suggests that an increase of 5% in real terms above the current level of each of the caps would not make the Second Class products unaffordable for either consumers in general or most of those who are potentially vulnerable. The potential for harm to some vulnerable consumers and evidence of changes since 2013 indicate that a larger increase than 5% should be considered unaffordable at this time.

Any changes to the standard letter cap should ensure Royal Mail has sufficient commercial flexibility to respond to threats to the universal service

1.14 We have found that the current levels of the safeguard caps have not prevented Royal Mail from making a reasonable commercial rate of return on the safeguarded products.

1.15 Since the safeguard caps were introduced, Royal Mail has consistently chosen to price its products below the level of the caps. When the caps were introduced in 2012/13, the maximum permitted price of a Second Class stamp was 55p. Royal Mail chose not to price to the level of the cap, instead pricing a Second Class stamp at 50p. This provided it with pricing 'headroom' of approximately 10%. The current level of the cap now stands at 60p and the price of a Second Class stamp is currently 58p. This means Royal Mail's headroom under the standard letter cap now stands at less than 5%, despite Royal Mail increasing prices by only 1-2p per year on average since 2013. By contrast, Royal Mail currently has headroom of approximately 29% under the cap for large letters and parcels up to 2kg, which gives it considerable commercial flexibility.

1.16 While the level of commercial flexibility afforded by the basket cap is significant and growing, the level of flexibility afforded by the standard letter cap has diminished over time. Since 2013, for standard letters and large letters, Royal Mail has generally implemented annual price increases at or around the Retail Prices Index ("RPI").[6] RPI inflation has generally been above CPI inflation, meaning that prices for Second Class letters have increased slightly each year in real terms (when compared to CPI). Should the level of the standard letter cap remain unchanged, it is likely that Royal Mail's commercial flexibility to increase prices in line with RPI inflation could be eroded within two to three

[5] Ofcom, 2013. *The Affordability of Universal Postal Services.* https://www.ofcom.org.uk/__data/assets/pdf_file/0014/10445/affordability.pdf.
[6] RPI is the inflation measure used by Royal Mail in its analysis of the postal sector.

years. Our analysis shows that raising the level of the standard letter cap by 5% in real terms will grant Royal Mail sufficient headroom and improve its ability to respond to unforeseen market developments which could threaten the sustainability of the universal service.

1.17 As set out in the *Annual Monitoring Update on the Postal Market: Financial Year 2017/18*[7] ("Annual Monitoring Update 2017/18"), we continue to consider that the universal service is likely to remain financially sustainable in the immediate future. However, there are various possible downside scenarios which have the potential negatively affect the financial sustainability of the universal service. We will continue to monitor these closely.

1.18 Taking all of this together, we believe that raising the level of the standard letter cap by 5% in real terms and maintaining the basket cap will give Royal Mail sufficient commercial flexibility to make a reasonable commercial rate of return. This is necessary to avoid a material effect on the universal service.

Our conclusions

1.19 In light of the findings, we have decided to raise the level of the **Second Class standard letter cap** by 5% in real terms, which will take the upper limit of the cap from 60p currently to 65p. This means Royal Mail can price Second Class standard letters up to a maximum of 65p from 1 April 2019 to 31 March 2020. The cap will continue to increase by CPI each year on 1 April until the 31 March 2024.

1.20 This will re-establish a similar degree of pricing flexibility that Royal Mail had under the Second Class standard letter cap in 2012, which will improve Royal Mail's ability to respond to unforeseen market developments. Raising the level of the standard letter cap should ensure that Royal Mail has sufficient pricing flexibility, and that the cap does not have any wider impact on the financial sustainability of the universal postal service.

1.21 We have decided not to adjust the level of the **cap for Second Class large letters and parcels up to 2kg**, which will continue to increase each year by CPI on 1 April. Royal Mail already has considerable pricing flexibility of approximately 29% under this cap, so it is not necessary to increase the cap level further, despite the results of our affordability assessment.

1.22 The caps will come into effect on 1 April 2019 and remain in force until 31 March 2024 – or earlier, should we decide this is necessary.

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[7] Ofcom, 2018. *Annual monitoring update on the postal market, Financial year 2017/18*. https://www.ofcom.org.uk/__data/assets/pdf_file/0027/128268/Annual-monitoring-update-postal-market-2017-18.pdf.

2. Introduction and summary of the regulatory framework

Structure of this statement

2.1 This statement concerns the regulation of the safeguard caps currently imposed in relation to Royal Mail's Second Class products. This follows a consultation we published in July 2018 (the "July 2018 Consultation").[8]

2.2 In this section, we summarise Ofcom's powers and duties relevant for our consideration and assessment in coming to the decisions in this statement. We then summarise the background to the review and the current regulatory framework for postal services, of which the safeguard caps form a part. The remainder of this document sets out stakeholder responses and our final decisions as follows:

- section 3 sets out our market analysis;
- section 4 sets out our assessment of affordability; and
- section 5 sets out our assessment of the commercial flexibility afforded to Royal Mail under the caps.

2.3 Finally, section 6 sets out our final decisions and Annex 1 sets out the legal instruments imposing the safeguard caps on Royal Mail from 1 April 2019.

Our powers and specific duties relevant to our decisions

2.4 The legal framework relating to the regulation of postal services is set out in the Postal Services Act 2011 (the "PSA 2011"), which transposes the EU Postal Services Directive[9] into UK legislation.

2.5 Pursuant to the EU Postal Services Directive, the UK is required to ensure that prices for each of the services forming part of the universal postal service are affordable, cost-orientated and give incentives for an efficient universal services provision. In the UK, the universal postal service is a set of services described in an order made by Ofcom under section 30 of the PSA 2011 (the "Universal Service Order") and it includes the Second Class stamp products subject to the safeguard caps.[10]

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[8] Ofcom, 2018. *Review of the Second Class Safeguard Caps 2019: Proposed price caps for Second Class standard letters, large letters and parcels up to 2kg.* https://www.ofcom.org.uk/__data/assets/pdf_file/0021/116643/Review-Second-Class-Safeguard-Caps-2019.pdf.

[9] *Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service*, as amended in particular by *Directive 2002/39/EC* and *Directive 2008/6/EC*. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997L0067-20080227&from=EN.

[10] *The Postal Services (Universal Postal Service) Order 2012, SI 2012/936*, as amended by *The Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108*. See https://www.ofcom.org.uk/postal-services/information-for-the-postal-industry/upso.

2.6 In 2012, Ofcom designated Royal Mail as the universal service provider and (among other regulation) imposed upon it designated universal service provider ("DUSP") conditions using our powers under section 36 of the PSA 2011. The DUSP conditions are intended to secure the provision in the UK of those services set out in the Universal Service Order. As such, they form part of Royal Mail's universal service obligations.

2.7 When setting tariffs, such as the safeguard caps, in relation to the provision of the universal postal service, under section 36(4) of the PSA 2011, Ofcom must under section 36(5) seek to ensure that the prices of the relevant universal postal services:

- are affordable;
- take account of the costs of providing the service; and
- provide incentives to provide the service efficiently.

2.8 The decisions set out in this statement modify the existing DUSP conditions. In order to impose or modify a regulatory condition, such as the DUSP conditions, we must be satisfied, pursuant to Schedule 6 of the PSA 2011, that the imposition or the modification in question must:

- be objectively justifiable;
- not discriminate unduly against particular persons or a particular description of persons;
- be proportionate to what it is intended to achieve; and
- be transparent in relation to what it is intended to achieve.

2.9 Ofcom is also required to publish a notification setting out its proposals prior to imposing or modifying a regulatory condition. That notification was published at Annex 5 to the July 2018 Consultation. In order to impose or modify a regulatory condition, Ofcom must publish a notification setting out the condition or modification. We therefore set out the effects of our modifications in section 6, and the notification itself is published at Annex 1.

2.10 Our power to impose or modify a regulatory condition is also subject to the specific duty in section 29(1) of the PSA 2011, which provides that Ofcom must carry out its functions in relation to postal services in a way that it considers will secure the provision of a universal postal service.

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

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

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

General duties

2.13 Ofcom's principal duty under section 3(1) of the Communications Act 2003 (the "CA 2003") is to further the interests of citizens and consumers, where appropriate by promoting competition. This duty, in addition to our specific duty under section 29 of the PSA 2011, also applies when we carry out our functions in relation to post. The CA 2003 also requires that Ofcom must, in performing its principal duty, have regard to various factors as appear to us relevant in the circumstances, such as the needs of persons with disabilities, of the elderly and those on low incomes.[11]

2.14 In performing our principal duty, we must also have regard, in particular, to the interests of consumers in respect of choice, price, quality of service and value for money. We must further have regard, in all cases, to regulatory principles which should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice.

2.15 Section 3(6A) of the CA 2003 provides that the duty in section 29(1) of the PSA 2011 takes priority over Ofcom's general duties in the CA 2003 in the case of conflict between the two, where Ofcom is carrying out its functions in relation to postal services.

Securing the Universal Postal Service 2012

2.16 The current regulatory framework for postal services has been in place since March 2012, when we established a new regulatory framework for postal services (the "2012 Statement").[12] We removed the previous price control regime implemented by Postcomm in order to give Royal Mail greater commercial and operational flexibility, in recognition of the major challenges facing the postal sector at that time.

2.17 In making that decision, we also recognised the risks associated with giving Royal Mail greater pricing freedom. In particular, we were concerned that Royal Mail could seek to improve its profitability through price rises alone and avoid tackling the considerable efficiency challenge. There was also a related risk that Royal Mail raised prices to such an extent that there could be affordability concerns for vulnerable consumers.

2.18 For these reasons, we concluded that, together with moving away from a price control-based approach to regulation, vital safeguards needed to be put in place to ensure that Royal Mail delivered on our regulatory objectives. We therefore put in place the following new regulatory regime in 2012:

- **an ongoing monitoring regime** to track Royal Mail's performance in respect of the universal service, efficiency levels, pricing and competition;

[11] CA 2003, section 3(4)(i).

[12] Ofcom, 2012. *Statement on Securing the Universal Postal Service*: *Decision on the New Regulatory Framework*. http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/statement.pdf.

- **safeguard caps** including a cap on the price of Second Class stamps[13] for standard letters, and separately a basket cap for Second Class stamps on large letters and small and medium parcels up to 2kg[14]; and
- **access regulation** to maintain access competition given the benefits it can bring, such as lower prices for consumers.

2.19 This review is concerned with the safeguard caps only.

Introduction of the safeguard caps

2.20 The safeguard caps, introduced in 2012, 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. Both safeguards caps are due to expire on 31 March 2019.[15]

2.21 We considered that, if the safeguard caps ensured that a universal service product was affordable to vulnerable consumers, it would also be affordable to all residential consumers and small and medium businesses ("SMEs") that were reliant on universal services and Royal Mail to provide their postal services.

2.22 To ensure that the safeguard caps did not undermine the financial sustainability of the universal service, we sought to minimise the impact of the caps 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 products.

2.23 We therefore adopted the following policy objectives in determining the appropriate scope, level and duration of the safeguard caps (the "safeguard caps objectives"):

- ensure a basic affordable universal service product is available to all;
- protect vulnerable consumers from ongoing price increases;
- allow Royal Mail to make a reasonable commercial rate of return on the safeguarded product; and
- minimise the effect of the safeguard caps on Royal Mail's pricing freedom so as to avoid a material effect on wider financeability and/or efficiency incentives[16].

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[13] Unless otherwise specified, throughout this statement, references to Second Class stamps are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.

[14] The safeguard cap on Second Class stamp standard letters came into effect on 1 April 2012 and is imposed by DUSP Condition 2, as amended on 18 December 2017 ("DUSP 2"). An unofficial consolidated version of DUSP 2 is available via this link: https://www.ofcom.org.uk/__data/assets/pdf_file/0023/8339/dusp2.pdf. The safeguard cap on Second Class stamp large letters and parcels up to 2kg came into effect on 20 July 2012 and is imposed by DUSP Condition 3, as amended on 28 March 2013 and 18 December 2017 ("DUSP 3"). An unofficial consolidated version of DUSP 3 is available via this link: https://www.ofcom.org.uk/__data/assets/pdf_file/0019/8335/dusp3.pdf. The official legal instruments of DUSP 2 and DUSP 3, including their amendments, are referenced in the recitals to our notification published at Annex 1.

[15] As provided for in DUSP 2 and DUSP 3.

[16] When the safeguard caps were introduced in 2012, Royal Mail was in a weak financial position and the sustainability of the universal service was under severe pressure. The regulatory regime introduced in 2012 sought to address this by moving away from a price control-based approach to regulation towards the introduction of various safeguards, including the Second Class safeguard caps, which would grant Royal Mail greater commercial and operational flexibility. In this

Scope and level of the cap on Second Class standard letters

2.24 In October 2011, we first consulted on whether a safeguard cap should be introduced with respect to First and/or Second Class stamp products.[17] On the basis of research and evidence relating to the usage of stamp products, as well as the need to give Royal Mail more pricing flexibility to secure the provision of the universal service, we proposed limiting the scope of the safeguard caps to Second Class standard letters only.

2.25 In March 2012, we decided to impose a safeguard cap on Second Class standard letters set at 55p for 2012/13.[18] This represented a 53% increase on the stamp price at the time which was 36p (2011/12 prices). The cap was to apply for seven years and is subject to indexation at CPI[19]. As noted above, that safeguard cap is due to expire on 31 March 2019.

Addition of a basket cap for large letters and parcels

2.26 After a consultation in April 2012[20], we decided in July 2012 to extend the scope of the safeguard caps to create an additional, separate basket cap comprising Second Class large letters and small and medium parcels up to 2kg.[21] We set the level of this basket cap to allow for up to a 53% increase in the overall price of products within the cap (thereafter increasing each year by CPI), in line with the level of price increase allowed for under the standard letter cap. As noted above, this basket cap is also due to expire on 31 March 2019.

2.27 We considered that designing such a cap is slightly more complex compared to the cap applied to Second Class standard letters, as Royal Mail offered large letter, packet and standard parcel products at a variety of different weights. We decided to adopt a simple basket cap that would give Royal Mail flexibility to set the structure of individual prices subject to a cap on the maximum overall price increase for Second Class stamp large letters and packet products[22] up to 2kg.[23]

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context, we note that the safeguard caps are not, in and of themselves, solely intended to provide efficiency incentives to Royal Mail.

[17] Ofcom, 2011. *Consultation on Securing the Universal Postal Service: Proposals for the Future Framework for Economic Regulation.* https://www.ofcom.org.uk/__data/assets/pdf_file/0012/63003/Securing-the-Universal-Postal-Service-Proposals-for-the-future-framework-for-economic-regulation.pdf.

[18] 2012 Statement. See footnote 14 for DUSP 2.

[19] In 2012 we decided to use CPI rather than RPI for future increases to the safeguard caps because CPI is considered to be a better measure of the costs incurred by vulnerable consumers, for example CPI is used as the basis for indexing benefits payments.

[20] Ofcom, 2012. *Consultation on Securing the Universal Postal Service: Safeguard Cap for Large Letters and Packets*. https://www.ofcom.org.uk/__data/assets/pdf_file/0024/69063/condoc.pdf.

[21] Ofcom, 2012. *Statement on Securing the Universal Postal Service: Safeguard Cap for Large Letters and Packets.* https://www.ofcom.org.uk/__data/assets/pdf_file/0015/72042/statement.pdf. ("2012 Basket Cap Statement"). See footnote 14 for DUSP 3.

[22] Under Section 27(2) of the PSA 2011, 'postal packet' means a letter, parcel, packet or other article transmissible by post.

[23] We also made some minor amendments to the basket cap on 28 March 2013 and 18 December 2017, respectively.

Review of the Regulation of Royal Mail 2017

2.28 In June 2015, we initiated a *Review of the Regulation of Royal Mail* with the objective of ensuring that the regulation of Royal Mail remained appropriate and sufficient to secure the universal postal service (the "2017 Review"). We published a statement on our final decision in March 2017 (the "2017 Statement").[24]

2.29 In the 2017 Statement, we concluded that it was appropriate to maintain the current regulatory approach for a further five years, until 2022. We considered that the imposition of wholesale or retail price controls and/or efficiency targets on Royal Mail would not be appropriate in order to secure the objectives of the regulatory regime. Rather, we concluded that market conditions and the shareholder discipline which Royal Mail is subject to as a privatised company are more likely to be effective in securing an efficient and financially sustainable universal postal service than the imposition of additional regulation.

2.30 We also concluded that the Second Class safeguard caps should remain in place to ensure vulnerable consumers can access a basic universal service. This was on the basis that Royal Mail continues to be a near monopolist in single piece letters and therefore has the ability to profitably raise prices above the current level of the safeguard caps. In parcels, we noted that Royal Mail's significant share of the single piece parcel sector, combined with its extensive access network and strong brand awareness, provides it with a significant degree of pricing power. We therefore concluded that we could not rely on competitive constraints to prevent Royal Mail from raising prices.

2.31 Data from our monitoring programme showed that Second Class revenue had increased at a time when First Class revenue had fallen, which we considered may indicate that some customers now favour cheaper Second Class products, perhaps due to price rises and the desire to economise.[25] We considered that this highlights the importance of maintaining the safeguard caps as an affordability measure, in order to ensure that consumers, in particular vulnerable consumers, continue to have access to a universal service at affordable prices.

2.32 We concluded that the safeguard caps should be retained to ensure vulnerable consumers can access a basic universal service. However, we also committed to review the level of the safeguard caps during the course of the 2018/19 financial year, so we could take an informed view based on the most up-to-date market information and any changes to the financial sustainability of the universal service and/or the prices vulnerable consumers can afford prior to the expiry of the safeguard caps in March 2019.[26]

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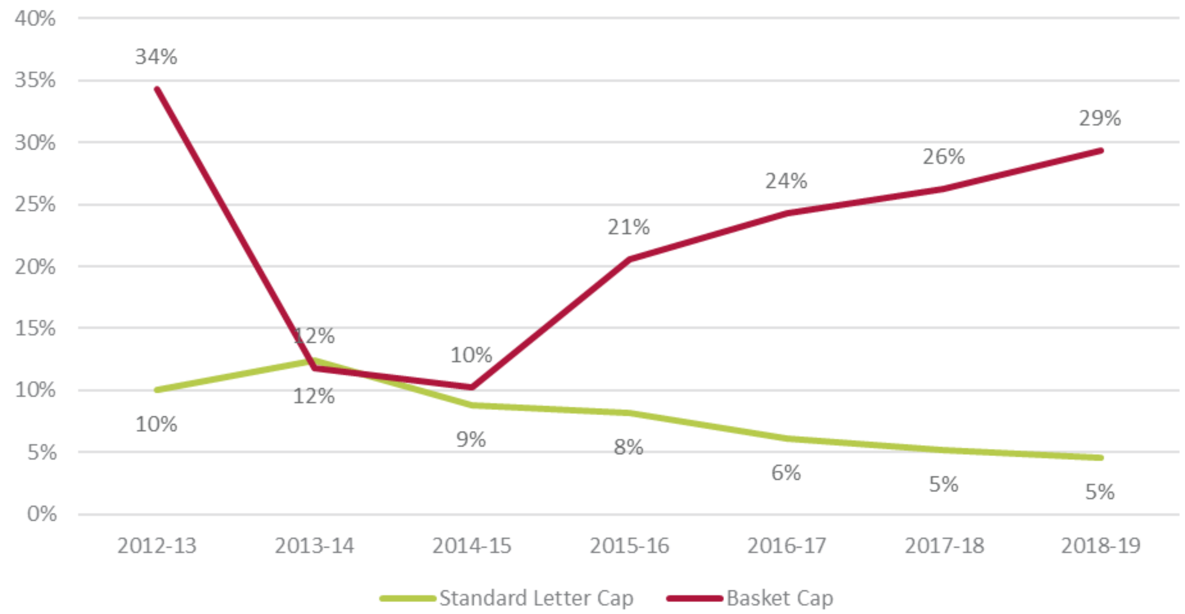
[24] Ofcom, 2017. *Statement on Review of the Regulation of Royal Mail*. https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf.
[25] Ofcom, 2015. *Annual Monitoring Update on the Postal Market: Financial Year 2014/15*, page 56. https://www.ofcom.org.uk/__data/assets/pdf_file/0025/56923/annual_monitoring_update_2014-15.pdf.
[26] 2017 Statement, paragraphs 3.179 and 4.46.

Royal Mail's pricing behaviour since 2012

2.33 Following our change in approach to regulation in 2012, Royal Mail implemented significant price increases (although still below the level of the caps) across its universal service products in 2012 and 2013. Since then, for standard letters and large letters, it has generally implemented smaller annual price increases at or around RPI[27] – meaning that prices for Second Class letters have increased slightly each year in real terms (when compared to CPI). Figure 2.1 shows the percentage headroom under the safeguard caps from 2012/13 to 2018/19. Figure 2.2 shows the prices of Second Class standard letter and large letter products in nominal terms over the period 2011/12 to 2018/19.

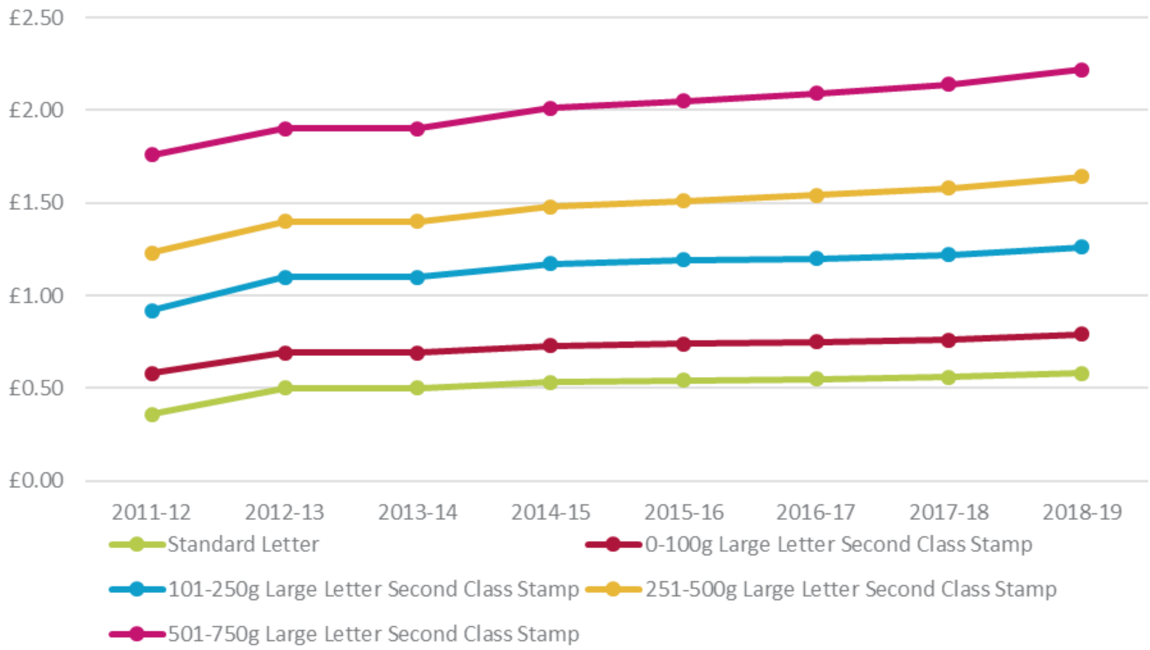
Figure 2.1: Percentage headroom under the safeguard caps, 2012/13 to 2018/19



Source: Second Class safeguard cap compliance submissions as part of Royal Mail Regulatory Financial Reporting Information.

[27] RPI is the inflation measure used by Royal Mail in its analysis of the postal sector.

Figure 2.2: Second Class standard letter and large letter nominal prices, 2011/12 to 2018/19



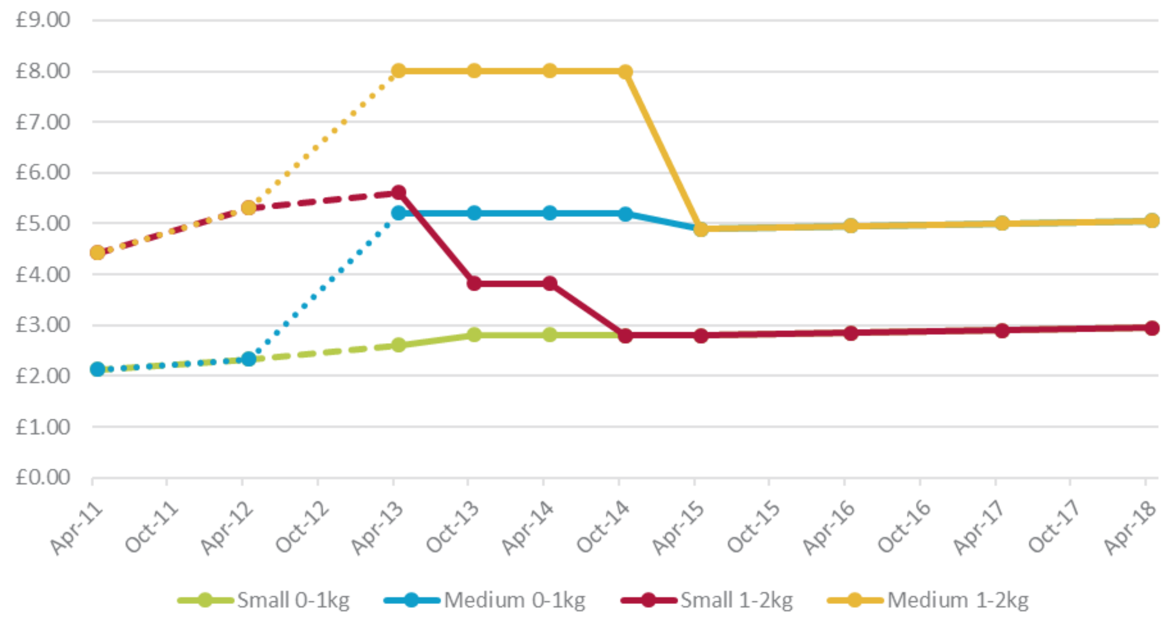
Source: Royal Mail published prices[28]/Ofcom Annual Monitoring Update analysis.[29]

2.34 For parcels, Royal Mail implemented size-based pricing in 2013 so that parcels were no longer priced solely by weight but also by their dimensions. This involved differentiating between small and medium sized parcels and led to substantial price increases for very lightweight and medium format parcels. By consolidating the weight steps, Royal Mail also reduced the price of some small but heavier weight Second Class stamp parcels in relation to 2011/12 prices. In 2015, Royal Mail introduced a single price for 0-2kg for small and medium Second Class parcels, which effectively reversed some of these price increases, as shown in Figure 2.3. Since 2015, Royal Mail has generally implemented price increases for its Second Class parcels products, broadly in line with RPI.

[28] Prices obtained from Royal Mail website, for most recent price list see: https://www.royalmail.com/sites/default/files/Our-prices-2018-effective-26-March-2018.pdf.

[29] For our most recent Annual Monitoring Update see footnote 7.

Figure 2.3: Second Class small and medium parcel <2kg nominal prices, 2011/12 to 2018/19[30]



Source: Royal Mail published prices[31]/Ofcom Annual Monitoring Update analysis.[32]

2.35 Table 2.1 shows the impact of the price changes implemented since 2012 including how the consolidation of prices for parcels weighing up to 2kg has caused the prices of parcels at some weight steps to increase very significantly while others have fallen. For example, medium parcels weighing 0-100g have increased in price by 280%, whereas small parcels weighing 1-2kg have decreased in price by 33%. These changes are reflective of a change in Royal Mail's pricing strategy which now determines the price of sending a parcel by weight rather than size. For example, whereas it used to be cheap to send a large and light parcel, it is now more expensive.

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[30] In 2013, Royal Mail introduced new parcel products and size-based pricing. To enable comparison between the current Second Class parcel products, we use proxies based on Royal Mail's most comparable previous parcel products. The line in this chart is dashed where we rely on these proxies.
For small and medium parcels weighing less than 1kg, we use a proxy of Royal Mail's Second Class packet product, which had a maximum dimension equivalent to a medium parcel. As this product was available at a range of weight steps up to 1kg, we use a weighted average price. Individual component prices were as follows: April 2011: £1.33 (0-100g), £1.72 (101-250g), £2.16 (251-500g), £2.61 (501-750g) and £3.15 (751-1000g); April 2012: £2.20 (0-750g) and £3.50 (751-1000g).
For small and medium parcels weighing 1-2kg, we use of proxy of Royal Mail's Standard Parcel up to 2kg.
[31] Prices obtained from Royal Mail website, for most recent price list see footnote 28.
[32] For our most recent Annual Monitoring Update see footnote 7.

Table 2.1: Second Class stamp parcel prices, 2011/12 to 2018/19

	Medium Second Class 2011/12 Price	Medium Second Class 2018/19 Price	% change to price from 2011/12-2018/19	Small Second Class 2011/12 Price	Small Second Class 2018/19 Price	% change to price from 2011/12-2018/19
0-100g	£1.33	£5.05	**280%**	£1.33	£2.95	**122%**
101-250g	£1.72	£5.05	**194%**	£1.72	£2.95	**72%**
251-500g	£2.16	£5.05	**134%**	£2.16	£2.95	**37%**
501-750g	£2.61	£5.05	**93%**	£2.61	£2.95	**13%**
751-1kg	£3.15	£5.05	**60%**	£3.15	£2.95	**- 6%**
1-2kg	£4.41	£5.05	**15%**	£4.41	£2.95	**-33%**

Source: Ofcom analysis of Royal Mail Second Class stamp parcel prices from 2011 to 2019, as at 17 January 2019.

Review of the Second Class safeguard caps 2019

The July 2018 Consultation

2.36 The July 2018 Consultation set out our proposals with respect to the level and scope of the Second Class safeguard caps. In summary, we proposed to increase the standard letter safeguard cap from its current level by 5% in real terms and to retain the level of the basket cap, allowing each cap to increase by CPI each year thereafter. To give effect to these proposals, in Annex 5 of the July 2018 Consultation, we set out a notification of our suggested modifications to DUSP conditions 2 and 3, the legal instruments which impose the safeguard caps. We considered that our proposals would enable us to achieve the safeguard cap objectives, which we considered remained appropriate for our review.

Stakeholder responses to the July 2018 Consultation

2.37 We received eight responses to our July 2018 Consultation. The stakeholders that responded were: Citizens Advice, Citizens Advice Scotland ("CAS"), the Consumer Council

Northern Ireland ("CCNI")[33], Hermes UK, the Mail Competition Forum ("MCF"), Royal Mail plc, Sterling Technical Services Ltd ("Sterling")[34] and Whistl UK Limited.

2.38 We have considered all submissions made by stakeholders in their responses, and have summarised and addressed these points in the relevant sections of this statement. Non-confidential versions of all the responses received are published on the Ofcom website.[35]

Evidence-gathering process for this review

2.39 In carrying out our analysis for the purposes of this review, we have relied on several sources of evidence, including:

- data from a *Residential Omnibus Survey*[36] commissioned by Ofcom in April 2018 relating to consumers' postal expenditure and sending patterns ("Residential Omnibus Survey");
- data from Ofcom's *Business Postal Tracker 2018* relating to January-December 2017[37] in the July 2018 Consultation and to July 2017-June 2018[38] in this statement, and April 2018[39] on small and medium business' postal expenditure and sending patterns ("Business Postal Tracker");
- data from Ofcom's *Residential Postal Tracker 2018* on usage and affordability relating to January-December 2017[40] in the July 2018 Consultation and to July 2017-June 2018[41] in this statement ("Residential Postal Tracker");
- data on household disposable incomes, expenditure on postal services, expenditure on other comparator items and household expenditure from the Office for National Statistics' ("ONS") *Living Costs and Food Survey*[42];

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[33] In addition to the points raised by CCNI and discussed in this statement, CCNI also submitted that we should monitor the effect of the safeguard caps on consumers. We note that our monitoring regime includes monitoring affordability to ensure services remain affordable.

[34] We understand that the comments submitted by Sterling relate to the provision of stamps by different dominations. As explained in this statement, the level of the safeguard caps is set to address affordability concerns, as well as to allow Royal Mail sufficient commercial flexibility to ensure the provision of a sustainable universal service. We consider that the issue raised by Sterling is a matter for Royal Mail to decide and, on this occasion, it would be disproportionate for us to act in this respect.

[35] Stakeholder responses to the July 2018 Consultation are available at: https://www.ofcom.org.uk/consultations-and-statements/category-1/review-second-class-stamp-safeguard-cap.

[36] Ofcom, 2018. *Residential Omnibus Survey 2018*. https://www.ofcom.org.uk/__data/assets/pdf_file/0028/116596/Residential-omnibus-survey.PDF.

[37] Ofcom, 2018. *Business Postal Tracker 2018*, January-December 2017. https://www.ofcom.org.uk/__data/assets/pdf_file/0023/111695/Business-Postal-Tracker-Q1-Q4-2017-tables.pdf.

[38] Ofcom, 2018. *Business Postal Tracker 2018*, July 2017-June 2018. https://www.ofcom.org.uk/__data/assets/pdf_file/0032/118994/Business-Postal-Tracker-Q3-2017-Q2-2018-weighted-tables.pdf.

[39] Ofcom, 2018. *Business Postal Tracker 2018*, April 2018. https://www.ofcom.org.uk/__data/assets/pdf_file/0029/116597/Business-postal-tracker.PDF.

[40] Ofcom, 2018. *Residential Postal Tracker 2018*, January-December 2017. https://www.ofcom.org.uk/__data/assets/pdf_file/0020/111692/Residential-Postal-Tracker-Q1-Q4-2017-tables.pdf.

[41] Ofcom, 2018. *Residential Postal Tracker 2018*, July 2017-June 2018. See footnote 1.

[42] ONS, 2018. *Living Costs and Food Survey*. See: https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/bulletins/familyspendingintheuk/financialyearending2017 and

- data received from Royal Mail in response to an information notice sent on 15 May 2018, pursuant to our information gathering powers under section 55 of the PSA 2011, relating to Royal Mail's pricing decisions, consumer research, price- and cross-elasticities and costs ("s.55 Notice"); and
- data received from various parcel operators in response to an information notice sent on 13 April 2018, pursuant to our information gathering powers under section 55 of the PSA 2011, relating to volumes and revenues ("s.55 Market Data Notices").

The January 2019 statement

2.40 This statement concludes our review and sets out our decisions for the continued regulation of the Second Class products, taking account of up-to-date market information and our latest assessment of the commercial flexibility afforded to Royal Mail by the safeguard caps and of the prices we consider vulnerable consumers can afford. We continue to believe that the safeguard cap objectives remain appropriate for our review and consider that the decisions set out in this statement secure those objectives.

General impact assessment

2.41 The analysis presented in this statement represents in its entirety an impact assessment, as defined in section 7 of the CA 2003.

2.42 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy making. This is reflected in section 7 of the CA 2003, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see our guidelines, *Better Policy Making: Ofcom's approach to Impact Assessment*.[43]

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

Equality impact assessment

2.44 In carrying out our functions, including with regard to the safeguard caps considered in this review, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:

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https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/theeffectsoftaxesandbenefitsonhouseholdincome/financialyearending2017.

[43] Ofcom, 2005. *Better Policy Making: Ofcom's Approach to Impact Assessment*. For further information see our website: https://www.ofcom.org.uk/consultations-and-statements/better-policy-making-ofcoms-approach-to-impact-assessment.

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

in relation to the following protected characteristics: age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation.

2.45 Such equality impact assessments also assist us in making sure that we are meeting our principal duty under section 3 of the CA 2003 mentioned above.

2.46 We have therefore considered what (if any) impact our decisions in this statement may have on equality. Having carried out this assessment, we are satisfied that our decisions are not detrimental to any group defined by the protected characteristics set out in paragraph 2.44 above.

3. Market analysis

Introduction and summary

3.1 This section assesses the market context and competitive constraints in the segments of the postal market where the safeguard caps apply. We discuss the single piece standard letter, large letter and parcel market segments in turn. We focus on the competitive constraints in each of these market segments, from both the supply and demand side. We also consider interactions between the different products within scope of the caps.[44]

3.2 We last carried out an assessment of competitive dynamics in the letter and parcel sectors in our 2017 Review referred to in section 2 of this statement. The 2017 Review concluded in particular that we could not rely on competitive constraints to prevent Royal Mail from raising prices for single piece letters and parcels. We therefore decided that it would be necessary to retain the safeguard caps to ensure vulnerable consumers can continue to access a basic universal service at an affordable price.

3.3 Our July 2018 Consultation set out our view that competitive constraints had not changed since we concluded our 2017 Review. Having considered stakeholder responses to the July 2018 Consultation, we remain of the view that competitive constraints are insufficient to prevent Royal Mail from raising the prices of the safeguarded products significantly, and that a safeguard cap continues to be necessary. Also, we do not think there has been a change in competitive conditions that would suggest altering the structure or scope of the safeguard caps.

3.4 This section summarises our consultation position and stakeholder responses, and sets out our conclusions on the market analysis having taken responses into account.

Standard letters

Our consultation proposal

3.5 In our July 2018 Consultation, we proposed that Royal Mail remained a near-monopolist in the provision of single piece standard letters. In our view, whilst the risk of accelerating e-substitution may have caused Royal Mail to be cautious in implementing larger price increases, there was limited evidence that e-substitution represented 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 remained of the view

[44] In exercising our powers under section 36 of the PSA 2011 to impose or modify the safeguard caps under the DUSP conditions, we are not required to carry out a market analysis and to assess market power in accordance with the principles of competition law. To conduct this review, we do not consider it necessary to formally define relevant markets or reach findings on the existence of any positions of dominance. We focus instead on an assessment of the extent of competitive constraints in the market segments in question, particularly to inform our understanding of the extent to which market forces might impact on Royal Mail's ability to set its prices for the products covered by the safeguard caps.

that Royal Mail faced only limited competitive constraints on its prices for single piece letters.

Stakeholder responses

3.6 Consumer groups[45] and MCF agreed with our market analysis, and said that competitive constraints were insufficient to prevent Royal Mail from raising prices for standard letters.

3.7 Royal Mail disagreed with our market analysis. It argued that the letters market was significantly more competitive than we had suggested, setting out three key factors that demonstrated it was materially constrained in its pricing:

a) It argued that e-substitution was a potent form of competition. It considered that price increases may be profitable in the short run, but it could encourage consumers to permanently switch away from mail, predominantly to digital alternatives, and so harm long-run profitability. It considered this risk created an incentive for Royal Mail to maintain a prudent pricing policy.

b) It argued that significant price increases substantially increased the risks of triggering a "tipping point", leading to substantial reductions in letter volumes, as experienced in other European countries such as Denmark and the Netherlands. It said the its prudent pricing policy reflected this risk.

c) It argued that a growing trend of access operators offering services directly to residential consumers and small businesses provided an additional constraint.

3.8 We set out our assessment of competitive constraints in standard letters below, taking into account the stakeholder responses we received.

Our assessment

Context

3.9 Within the single piece letters sector, there are two main standard letter products[46] which are available to consumers for domestic services: Royal Mail's First and Second Class universal letters services. Businesses are likely to have access to a wider range of products including meter mail (which is also within the scope of the universal service, but outside the scope of the safeguard cap) or bulk mail, subject to meeting minimum volume thresholds.

3.10 Customers can pay for universal postal services in three main ways: stamps[47], meter and on account. Paying by meter allows customers to access cheaper prices, but is usually only suitable for higher volume users due to the cost of investing in a meter.

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[45] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

[46] Royal Mail specifies that standard letters weigh no more than 100g and have maximum dimensions of: 24cm x 16.5cm x 5mm.

[47] As noted in section 2, this includes postage purchased online, though for standard letters this is priced the same as a stamp purchased in person.

3.11 Overall standard letter volumes have been in decline. 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). This decline was consistent across First Class and Second Class letters, though higher than the volume and revenue decline across all stamp, meter and account letters (which was around 8% and 5% respectively per year on average over the same period).[48]

3.12 A significant contributor to this declining trend is e-substitution – the replacement of communications previously sent by mail with electronic alternatives. This is a structural change occurring as technology has enabled alternative means of communicating. This process of switching from physical mail to electronic communication would be likely to occur to a large extent independently of pricing and competition in the letters sector. Once any initial set up costs are incurred, the incremental cost of electronic communications is very low. However, we note there may be other barriers to the use of e-substitutes, such as internet literacy or access, which may constrain the extent they present viable alternatives for some users. Royal Mail argued that significant price increases could lead to a tipping point or step-change in the rate of e-substitution, particularly for larger users. In our 2017 Review, we concluded that there was limited evidence that e-substitution represented a meaningful constraint on Royal Mail's ability to profitably raise prices, particularly for moderate price increases.

Supply-side constraints

3.13 Royal Mail remains a near-monopolist in Second Class single piece stamped standard letters. It is the only operator offering these end-to-end services on a national scale, although there are a number of smaller scale end-to-end operators delivering in specific geographic areas. We continue to estimate that Royal Mail has a volume share of over 99% in single piece letters. We estimated in 2017/18 that just 0.1% of total addressed letters volumes were delivered by end-to-end operators other than Royal Mail.[49]

3.14 As discussed in our 2017 Review, following Whistl's exit from end-to-end delivery in 2015, we do not consider that there is likely to be another end-to-end entrant of sufficient scale and scope to provide a significant level of letter delivery competition to Royal Mail in the foreseeable future. As the prospect of significant rival entry has diminished, potential constraints on Royal Mail are weaker than when the safeguard caps were introduced in 2012, when the prospect of end-to-end entry and expansion was more credible.

3.15 In its consultation response, Royal Mail pointed out that some access operators have started offering services directly to residential and small business customers, specifically:

a) Royal Mail referenced Whistl offering such a service through parcel2go.com. However, this service requires a minimum spend of £20+VAT and so is only suitable for sending multiple letters at the same time. This means it is unlikely to be a suitable alternative

[48] Royal Mail Regulatory Financial Reporting Information.
[49] Annual Monitoring Update 2017/18, paragraph 3.14.

for many users of single piece letters, as particularly residential consumers are unlikely to reach this minimum spend threshold. Our Residential Omnibus Survey suggests just 1% of consumers spent over £20 on letters in the last month,[50] and our Residential Postal Tracker indicates that just 12% of consumers spent over £20 on postage in total.[51]

b) Royal Mail also gave the example of Cornwall Collects, a partnership between Whistl and Imprimus offering collection services to businesses in Cornwall. However, this service is only available to business users in a limited geographical area.

3.16 These services are only likely to be viable substitutes for a small subset of users of single piece letter services. Therefore, we consider that constraints from these services on the prices of single piece letters are likely to be very limited.

3.17 Accordingly, we continue to consider that neither existing competitors nor the threat of future entry are likely to constrain Royal Mail's pricing for Second Class stamps for standard letters.

Demand-side constraints

3.18 A consumer or business considering sending a Second Class standard letter using a stamp, has, in theory, the following main alternative mail or non-mail options:

- sending the item using a Royal Mail First Class stamp;
- sending the item using a different Royal Mail payment method (for example a meter product) or a competing provider using Royal Mail access products, subject to meeting the necessary volume threshold; and/or
- not sending the item by mail, possibly due to sending it using an alternative electronic form of communication.

Alternative mail products

3.19 Alternative mail products do not provide a direct competitive constraint on Second Class stamps, as Royal Mail is also the only (retail or wholesale) provider of these alternatives.[52] Accordingly, switching between these products does not necessarily affect Royal Mail's overall profitability, and it is able to set prices across products to maximise overall revenues.

3.20 Interdependencies between products could affect Royal Mail's pricing decisions and may lead to some degree of indirect competitive constraint, to the extent that other products are constrained by alternatives (that do not involve Royal Mail at retail or wholesale levels) and there are interlinkages between these products and Second Class stamps.

3.21 Royal Mail's main alternative stamp product to Second Class is its First Class stamp product. This provides a superior service to Second Class (delivery within one working day

[50] Residential Omnibus Survey, Q1.
[51] Residential Postal Tracker 2017/18, QD4.
[52] Except in very limited cases of smaller scale end-to-end operators delivering in specific geographic areas.

compared to three working days) and is priced higher to reflect this. This price differential affects switching between the two products, and Royal Mail has chosen to maintain a price differential of around 9p in recent years.

3.22 Alternative payment methods (such as a meter product) are only likely to be a viable option for businesses, given that customers need to send significant volumes of letters for it to be economic to incur the upfront cost of a meter machine. Again, Royal Mail has historically maintained a differential between stamp and meter prices, and the level of this differential affects switching between the products.

3.23 If managing switching between products is desirable to Royal Mail, this may mean it would not implement a standalone price increase for Second Class stamps. However, this would be unlikely to constrain a general increase in prices across products that maintained differentials. This is how Royal Mail has historically implemented price changes, and evidence from Royal Mail's internal documents shows that broadly maintaining differentials between products is a consideration when setting prices.[53]

3.24 Further, these interlinkages would only provide an indirect competitive constraint if some linked products were constrained by other alternatives that do not involve Royal Mail. For higher volume users, Royal Mail's meter and bulk products may face some competition from operators using access products. If this constrains meter pricing, this may in turn affect the pricing of stamp products to the extent that maintaining differentials between products is important. However, this indirect constraint is not likely to be strong. Only a small subset of customers would send sufficient volumes of mail to make them attractive to a competing access provider.[54] In any case, Royal Mail retains the vast majority of revenues from letters delivered via access products.

E-substitution

3.25 In response to our July 2018 Consultation, Royal Mail argued that our market analysis understated the extent to which e-substitution constrained its ability to raise prices.

3.26 Switching to a digital alternative may have upfront costs for some consumers – for example buying a smart phone or putting in place an electronic customer communications platform (such as a business investing in new systems). However, for consumers who already have the means of using an electronic alternative the incremental cost is very low and would be substantially cheaper than using postal services.

3.27 As we concluded in our 2017 Review, e-substitution has led to a decline in single piece standard letter volumes, including Second Class stamps. Royal Mail argued that technological advances have led to customers using less mail, which constrains its pricing.

3.28 We agree that there is a clear decline in letter volumes, at least in part driven by the use of electronic alternatives. However, Royal Mail has not provided additional evidence to

[53] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[54] As discussed above, Whistl's service offered through parcel2go.com requires a minimum spend greater than typical monthly spend for almost all consumers.

demonstrate that volume decline due to e-substitution would necessarily indicate a pricing constraint. We remain of the view that the structural decline in standard letters means that falling volumes do not necessarily represent responses to price increases. Ongoing volume and revenue decline is not necessarily evidence of constraints on pricing. Once in place electronic alternatives have a substantially lower cost than post at current prices. A further price increase in post would therefore be unlikely to trigger substantial additional switching for those customers that have electronic alternatives in place, as there is already a significant differential between post and electronic alternatives. As 87% of consumers have internet access,[55] this is likely to be the case for the majority of consumers.

3.29 For consumers who would need to incur upfront costs before switching to a digital alternative, this may be more likely in response to a significant stamp price increase that might trigger such an investment. Royal Mail argues that the risk that consumers could switch away permanently has caused it to implement a prudent pricing policy. It notes that it is actively seeking to avoid 'tipping points' experienced by other European postal operators where volumes have fallen dramatically.

3.30 We consider that specific individual circumstances have influenced the rate of e-substitution in the examples cited by Royal Mail. For example, in Denmark, the government implemented a Digital Post Strategy whereby citizens received official correspondence from the public sector digitally. However, we do agree that these risks may lead Royal Mail to act somewhat conservatively, as it may be uncertain about the level of price increase that might contribute to triggering additional e-substitution or 'tipping points'. Royal Mail's internal documents on their pricing decisions demonstrate a consideration that larger price increases may have a greater risk of triggering e-substitution.[56]

3.31 In addition, there may be several factors that affect the likelihood of e-substitution for certain customers or mail types. A lack of e-literacy could be a barrier to some consumers using electronic alternatives, whilst businesses would need to both invest in systems and gain customer consent to switch to communicating electronically. Additionally, it is likely that there will remain a proportion of standard letters for which digital alternatives are not a good alternative. For example, Royal Mail has estimated that e-substitution rates are higher for transactional and advertising mail ([✂]% per annum) than for social mail ([✂]% per annum)[57], suggesting that e-substitution is more likely for certain letter types.

3.32 Absent very significant price increases, it is not clear that Royal Mail's prices have a significant impact on the rate of e-substitution. There is limited evidence that e-substitution represents a meaningful constraint on prices. Royal Mail's price increases have historically been profitable, accounting for structural decline due to ongoing e-

[55] Ofcom, 2018. *Communications Market Report 2018: United Kingdom*, Figure 1.3. https://www.ofcom.org.uk/__data/assets/pdf_file/0022/117256/CMR-2018-narrative-report.pdf.
[56] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[57] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

substitution.[58] Royal Mail's internal documents demonstrate that price increases for stamped letters have generally translated into average unit revenue increases.[59]

Price sensitivity

3.33 In this sub-section, we consider the available evidence on whether mail consumers are sufficiently sensitive to price increases to make it unprofitable for Royal Mail to increase its Second Class stamp price. Initially, we consider responses to consumer surveys, although these tend to overstate the responsiveness to price increases. Then we consider Royal Mail's own estimates of price sensitivity (the elasticity of demand – the ratio of the percentage change in volume to a percentage change in price).

3.34 Our market research suggests that, in general, a small minority of consumers are price sensitive in relation to letters. 10% of residential consumers said they would send fewer standard letters and large letters in response to a 10% price increase and a further 2% said they would not send any letters because the price would be unaffordable. 14% said they would send fewer letters, and 3% said they would not send any, in response to a 20% price increase.[60]

3.35 Amongst businesses, 35% said they would send fewer letters in response to a 10% price increase and 1% said they would not send any letters. 52% said they would send fewer letters in response to a 20% price increase, and 3% said they would not send any.[61] This includes a significant proportion who said they would switch to electronic alternatives where they could (29% and 48% respectively). However, only 4% of businesses said they had responded to recent moderate postage price rises by sending fewer letters.[62] Of businesses that had recently decreased their volume of post, only 12% cited cost as the reason.[63] This supports a view that, for businesses, moderate increases are less likely to trigger a significant reduction in volumes, but significant increases may lead them to consider implementing electronic alternatives.

3.36 These survey responses provide mixed evidence on whether a price increase would be unprofitable. We treat, however, this evidence from market research with a degree of caution, given that survey responses to hypothetical questions, such as the ones mentioned above, have a tendency to overstate actual price responsiveness. In addition, our research does not provide an indication of the extent of volume response envisaged by those who would send fewer letters.

3.37 Royal Mail's own elasticity estimates suggest that social and transactional mail are price inelastic, and transactional mail has a low elasticity for small price changes ([✂]). Royal

[58] 2017 Statement, paragraph 3.118.
[59] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[60] Residential Omnibus Survey, Q9 and Q10. Question concerned letters, so covers both standard and large letters.
[61] Business Postal Tracker, QN7a and QN7b. Question concerned letters, so covers both standard and large letters.
[62] Business Postal Tracker, QN8.
[63] Business Postal Tracker, QS3a.

Mail estimate social and transactional mail make up over 95% of Second Class Stamp letter volumes.[64]

3.38 Our survey results may suggest consumers are more price sensitive than Royal Mail's estimates of price sensitivity. We have noted potential issues in interpreting answers to hypothetical survey questions, whereas Royal Mail's estimates are based on actual consumer behaviour. Accordingly, in this instance, we think Royal Mail's estimates are likely to better reflect the reality in this regard. This evidence suggests that, particularly for residential consumers, few would respond to a significant price increase for a Second Class standard letter by choosing not to send the item. Substantial price increases may increase the likelihood of businesses considering electronic alternatives. Accordingly, we consider that price sensitivity is unlikely to competitively constrain Royal Mail's prices, particularly for price increases in line with those Royal Mail has implemented in recent years.

Royal Mail's pricing behaviour

3.39 Our 2012 Statement introduced a safeguard cap for standard letters at 53% above prevailing prices, with subsequent annual increases by CPI. In 2012, Royal Mail implemented significant increases in standard letter prices in the first year of the new safeguard caps, though not up to the level of the safeguard cap. Since this increase, Royal Mail has implemented price increases for standard letters of around RPI each year. As RPI inflation has generally been above CPI inflation, this has led to a gradual narrowing of the headroom under the safeguard cap. Royal Mail's current prices remain 5% below the cap, though it has effectively used most of the headroom granted in 2012.

3.40 As we concluded in our 2017 Review, Royal Mail's price increases for letters have historically been profitable. Royal Mail's internal documents indicate that it generally expects that moderate price increases for single piece letters would be revenue enhancing.[65] Though the cap for standard letters is not currently binding, there is little evidence that prices are constrained by competition, or that further price increases would not be profitable.

3.41 Royal Mail's response argues that its recent moderate price increases for letters demonstrate that it is materially constrained in its pricing. However, we consider Royal Mail's pricing approach of implementing regular relatively small price increases is consistent with the existence of limited constraints for such price increases. This is also consistent with greater uncertainty about the potential impact of larger price increases, including the potential risk of triggering a step-change in the rate of e-substitution or 'tipping points' due to large, repeated price increases.

3.42 As in our 2017 Review, we continue to consider that political pressure, negative publicity and our monitoring regime act as additional constraints on Royal Mail's pricing of single

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[64] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

[65] For example, documents prepared for the consideration of 2018/19 price changes suggested that [✂]. Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

piece letters to some extent. This is supported by considerations in Royal Mail's internal documents, which highlight the risk of political intervention or negative publicity as part of a range of factors taken into account when considering stamp price increases.[66] This, however, does not mean that Royal Mail would be unable to continue to profitably increase prices, though it may choose to manage uncertainty by implementing changes in a gradual manner.

Conclusion on competitive constraints on standard letters

3.43 Royal Mail remains a near-monopolist in the provision of single piece standard letters. Whilst the risk of accelerating e-substitution may cause Royal Mail to be cautious in implementing larger price increases, 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.

Large letters

Our consultation proposal

3.44 In our July 2018 Consultation, we proposed that Royal Mail remains a near-monopolist in the provision of single piece large letters. In our view, whilst the risk of accelerating e-substitution may have caused Royal Mail to be cautious in implementing significant price increases, there was limited evidence that e-substitution represented a meaningful constraint on Royal Mail's ability to profitably raise prices for single piece large letters (particularly with respect to smaller price increases). We therefore remained of the view that Royal Mail faced only limited competitive constraints on its prices for single piece large letters.

3.45 Our assessment was that Royal Mail continued to have a significant degree of pricing power in single piece large letters. We considered that, absent regulation, Royal Mail would be able to increase its prices materially. However, in our view, uncertainty about e-substitution may act to limit the scale of price increases implemented at one time.

Stakeholder responses

3.46 In relation to competition in large letters, respondents made the same arguments as for standard letters. Consumer groups[67] and MCF agreed that competitive constraints were insufficient to prevent Royal Mail from raising prices for large letters. Royal Mail disagreed, and argued that e-substitution, tipping points and access operators provided material constraints on its pricing.

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[66] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

[67] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

3.47 We set out our assessment of competitive constraints in large letters below, taking into account stakeholder responses we received.

Our assessment

Context

3.48 Products within the large letter[68] sector mirror those described above for standard letters – i.e. there are stamp, meter and online variants although the stamp and online variants are priced identically. Meter products are cheaper by comparison. The prices of large letter products also vary by weight step.[69] As well as being used to deliver larger paper items, large letters are also used for sending other lightweight, flat items.

3.49 Overall, large letter volume trends show a small increase in large letter Second Class stamp volumes and revenues from 2012/13 to 2017/18 – 2% and 4% respectively on average per year. First Class stamp large letter volumes showed a moderate decline (6% in volumes and 4% in revenues on average per year).[70] As residential consumers use large letters relatively infrequently, this trend may be driven by businesses downtrading to Second Class products as the price of both First and Second Class stamps has increased.

3.50 As with single piece standard letters, e-substitution is leading to the decline in some types of large letter volumes, and this is at least somewhat independent of pricing. The increase in Second Class large letter volumes may reflect the use of large letters for fulfilment, and the increase in volume of mail sent for this purpose.

Supply-side constraints

3.51 We consider that supply side constraints for large letters are the same as those for standard letters. Royal Mail remains a near monopolist and the only operator offering these services on a national scale. The prospect of significant rival end-to-end entry has diminished. As discussed for standard letters, Royal Mail highlighted services offered by access operators directly to residential and small business customers. These services would only be suitable for a small subset of uses of single piece letter services and therefore we consider that constraints from these services are likely to be very limited. Accordingly, we remain of the view that neither existing competitors nor the threat of future entry are likely to constrain Royal Mail's pricing for Second Class stamps for large letters.

Demand-side constraints

3.52 A consumer or business considering sending a Second Class large letter using a stamp, has the following main alternative options:

- send using a different Royal Mail First Class stamp product;

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[68] Royal Mail large letters can weigh no more than 750g and maximum dimensions cannot exceed 35.3cm x 25cm x 2.5cm.
[69] These are 0-100g, 101-250g, 251-500g and 501-750g.
[70] Royal Mail Regulatory Financial Reporting Information.

- send using a different Royal Mail payment method (e.g. meter) or a bulk provider, subject to minimum volume thresholds;
- reformat the item so that it can be sent as a standard letter; and/or
- not sending the item by mail, possibly due to sending it using an alternative electronic form of communication.

Alternative mail products

3.53 As discussed above for standard letters, Royal Mail maintains differentials between its Second Class large letter stamp prices and its other large letter products to manage switching between products. As for standard letters, whilst this may constrain standalone price increases in Second Class stamp prices, it would be unlikely to constrain a general increase in prices across products.

Reformatting the item

3.54 Customers sending a large letter-sized item may be able to reformat the item so that it could be sent as a cheaper standard letter. Therefore, standard letter prices may provide some constraint. However, this would only be suitable for some items sent by large letter. Given the current price differentials between these product sets, it is likely that this would have already occurred if it could be done at a low cost, and further moderate widening of the price differential is unlikely to trigger significant additional reformatting. This constraint on large letter pricing is therefore likely to be small.

3.55 In addition, whilst this effect may constrain a standalone increase in price to a limited extent, this would be unlikely to constrain a general increase across standard letters and large letters. Royal Mail's historic pricing behaviour and internal documents indicate that it takes a coordinated approach to pricing its products to avoid this risk.[71]

E-substitution and price sensitivity

3.56 As for standard letters, Royal Mail argued that our market analysis understated the extent to which e-substitution constrained its ability to raise prices. We remain of the view that, whilst e-substitution may be driving some decline in volumes, this is not necessarily a result of price increases. Absent very significant price increases, it is not clear that Royal Mail's prices have a significant impact on the rate of e-substitution. Market research suggests that many residential customers are not very price sensitive. Royal Mail elasticity estimates are also low.[72] This suggests that Royal Mail could implement further price increases without having a significant impact on volumes.

[71] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[72] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

Parcels

Our consultation proposal

3.57 In our July 2018 Consultation, we proposed that Royal Mail's strong market position, widespread access network,[73] VAT exemption[74] and strong brand recognition gave it a significant degree of pricing power for Second Class parcels weighing up to 2kg. In our view, this was greater still for small and lightweight items that can fit through a letter box, as Royal Mail has cost advantages for these items due to its established integrated parcel and letter delivery network. We remained of the view that we could not rely on competitive constraints to prevent Royal Mail from raising prices for the parcel products subject to the safeguard cap. Whilst Royal Mail was not pricing to the cap, it had made use of a significant proportion of the headroom under the cap and had tended to increase prices roughly in line with RPI in recent years. We considered that the risk of unforeseen responses to their pricing strategy may lead Royal Mail to act conservatively.

3.58 Our assessment was that Royal Mail continued to have a significant degree of pricing power in small and medium parcels up to 2kg. We considered that, absent regulation, Royal Mail would be able to increase prices materially. However, in our view, uncertainty about e-substitution (in letters) or competitor responses (in parcels) may have acted to limit the scale of price increases implemented at one time.

Stakeholder responses

3.59 Consumer groups[75] and MCF agreed with our market analysis, and said that competitive constraints were insufficient to prevent Royal Mail from raising prices for small and medium parcels up to 2kg. Consumer groups also highlighted that some consumers may be less able to switch to alternative providers if they live in areas with fewer alternative access points.

3.60 Royal Mail disagreed with our market analysis. It argued that our analysis understated the degree of competition in the parcels sector and the extent to which it constrains Royal Mail's pricing for single piece parcels. It set out three factors that it considered demonstrated that it was materially constrained in its pricing for single piece parcels:

a) It argued that investment in new facilities by parcel competitors had generated spare capacity, which places downward pressure on Royal Mail's prices. It also argued that extensive roll-out of pick up and drop off points by competitors was primarily aimed at improving their product offering and presence in the single piece parcels sector. It argued that competitive constraints in the single piece parcels sector were causing it to

[73] Parcel operators maintain outlets where consumers can drop off (and collect) parcels – in Royal Mail's case this is the Post Office network.
[74] Royal Mail does not pay VAT on universal service products, including First and Second Class services.
[75] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

be very cautious about the impact of price increases and materially constrained its pricing behaviour.

b) It argued that consumers were increasingly aware of alternatives and use of marketplaces and price comparison websites had increased competition.

c) It argued that “gig economy” labour models gave some competitors cost advantages and distorted prices.

3.61 Hermes agreed that Royal Mail had a significant degree of pricing power, due to its significant share of the parcels market, strong brand awareness and exclusive relationship with the Post Office. However, Hermes argued that increased consumer choice of providers plus general requirements on Royal Mail to provide parcel services at an “affordable price” meant that adequate protection was in place for consumers and including parcels in the cap was unnecessary. Hermes also argued that the risk of reputational damage or of losing market share to competitors acted to constrain Royal Mail’s pricing of parcels.

3.62 We set out our assessment of competitive constraints in parcels below, taking into account stakeholder responses.

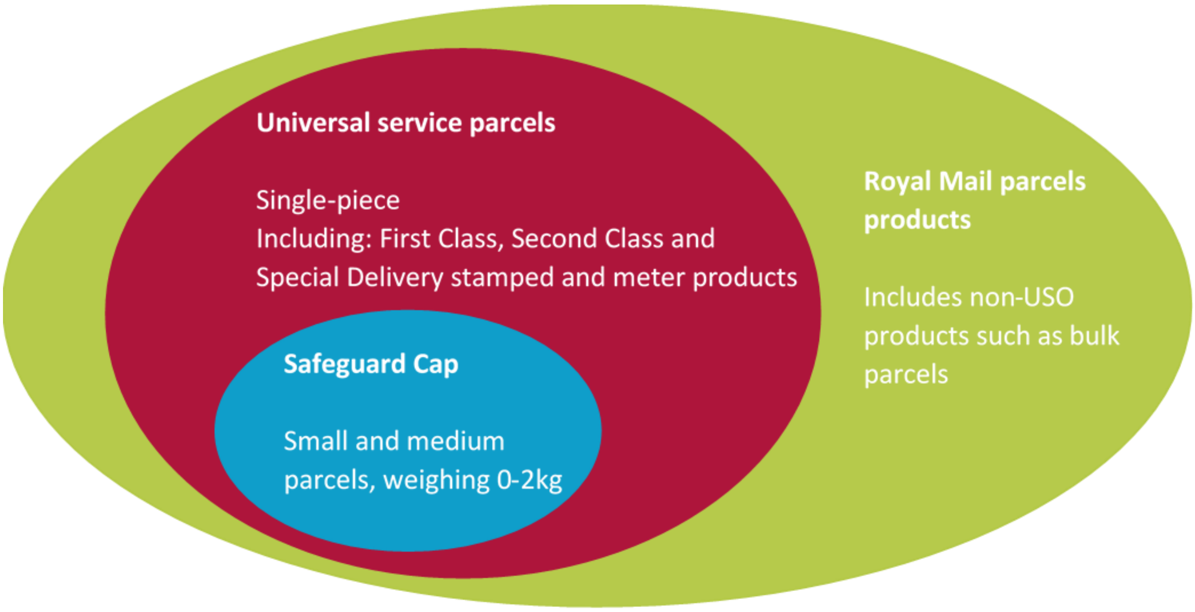
Our assessment

Context

3.63 Parcel products vary by weight and size (dimensions). The safeguard cap applies to Royal Mail’s Second Class stamps for small and medium[76] parcels weighing up to 2kg. Within the single piece parcels sector, there are two main Royal Mail products which are available to consumers for domestic services: First and Second Class universal services. Businesses are likely to have access to a wider range of products including meter mail (which is also within the scope of the USO but outside the scope of the safeguard caps) or bulk mail, subject to meeting minimum volume thresholds. Figure 3.1 below summarises these products.

[76] Maximum dimensions 45cm x 35cm x 16cm and 61cm x 46cm x 46cm respectively.

Figure 3.1: Royal Mail parcel products by category (not to scale)



3.64 In line with our 2017 Review, we refer to single piece parcels as any parcel delivery service which is available for purchase by any member of the public and can be used for sending an individual parcel.[77] We categorise any parcel product that does not fall within the scope of that single piece description as a bulk parcel product. Bulk products are typically used by businesses to deliver large volumes, and usually include negotiated volume discounts. Such products are not generally available to consumers, given that few consumers are likely to meet the minimum volume requirements which are pre-requisites to access these services, and are therefore outside the scope of this review.

3.65 Single piece parcels can be sent from access points or collected from a sender's premises. We group both these types together in this analysis.

3.66 Overall, we estimate that single piece parcel volumes are increasing steadily, at around 2% in 2017/18. We estimate that single piece parcels weighing 2kg or less increased by around 3%.[78]

3.67 Royal Mail has the largest share of all parcel volumes and revenues.[79] However, unlike in letters, competitors have a material presence in downstream delivery and provide competing end-to-end services.

[77] This is intended to include products that are sold through parcel reseller websites, such as Parcels2Go, as well as parcels services that are resold to users at a discounted price through marketplace websites, such as eBay. This definition excludes items sold on Amazon Marketplace that are delivered by Amazon Logistics. This is because Amazon Logistics delivery services are only available to those selling products through the Amazon website and are also required to be purchased in combination with other Amazon services (such as warehousing).
[78] Ofcom calculation using parcel operator responses to s.55 Market Data Notices.
[79] Including services offered through Royal Mail Group's Parcelforce Worldwide arm. Ofcom calculation using parcel operator responses to s.55 Market Data Notices.

3.68 Consumers sending single piece parcels with Royal Mail can either take the item to a Post Office or place it in a pillar box – if the item is small enough and they have applied the correct postage. Royal Mail also offers click and collect services via the Post Office and increasingly via other Royal Mail customer service points such as Delivery Offices. Parcelforce offers a premises collection service as well as allowing customers to drop off parcels via the Post Office.

3.69 Competing operators offer similar products to those within the scope of the safeguard cap, but these may have some differences in delivery timescales, maximum dimensions or other features. For example, most competing providers offer tracking as standard.

Supply-side constraints

3.70 Royal Mail retains a very high share of single piece parcels weighing 2kg or below. We estimate this was between 80-90% of both volumes and revenues ([✂]) in 2017/18. Royal Mail also has a high share of single piece parcels as a whole, which we estimate was between 70-80% of volumes and revenues ([✂]) in 2017/18.[80] These shares have remained broadly constant over the past two years.

Figure 3.2: 2017/18 volume shares of single piece domestic parcels <2kg

[✂]

Source: Ofcom calculation using parcel operator responses to s.55 Market Data Notices.

Figure 3.3: 2017/18 revenue shares of single piece domestic parcels <2kg

[✂]

Source: Ofcom calculation using parcel operator responses to s.55 Market Data Notices.

3.71 Our market research data aligns with these estimates – reported use of Royal Mail for parcels is significantly greater than that of any competitors. In our recent Residential Omnibus Survey, we asked residential consumers which companies they had ever used to send a parcel. Of those that were regular parcel senders (which we measure as those that had sent any small or medium parcels up to 2kg in the past month) 89% said they had used Royal Mail to send a parcel at some point. The next most cited competing postal operators were Hermes (37%) and Yodel (25%).[81] Of respondents to our Residential Postal Tracker who had sent parcels in the previous month, 92% had used Royal Mail at some point in the past month. Hermes, the next most named competitor to Royal Mail, had been used by just 15% of respondents in the past month.[82]

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[80] Ofcom calculation using parcel operator responses to the s.55 Market Data Notices – these shares are higher than reported in our 2017 Statement, as, in the s.55 Market Data Notices some providers have reclassified volumes, previously reported as single piece, as bulk. We lack data to make reliable comparison with earlier years, though we note Royal Mail has generally retained a significant majority of estimated volumes in this segment in previous years (for example, see 2017 Statement, paragraph 3.145).

[81] Residential Omnibus Survey, Q14A.

[82] Residential Postal Tracker, QD5.

3.72 Competing operators have established their own networks of access points, often by partnering with convenience stores and high street retailers to provide a drop-off service. In many cases these networks also provide collection services for e-commerce deliveries. Table 3.1 below summarises the main access point networks available for sending single piece parcels.

Table 3.1: Access points

	Parcel operator	Number of access points	Access points locations
Post Office	Royal Mail / Parcelforce	11,500	Post Office branches/outlets
CollectPlus	Yodel	7,000	Convenience stores (Paypoint network)
MyHermes ParcelShop	Hermes	4,500	Convenience stores
UPS Access Point	UPS	2,800	Convenience stores
DPD Pickup	DPD	2,500	Halfords, Pharmacy chains, Doddle
DHL Service Points	DHL	1,200	Highstreet/retail park shops
InPost parcel lockers	InPost	1,200	Convenience stores, petrol stations, etc…
Parcelforce depots	Parcelforce	54	Parcelforce depots
UK Mail (iPost Parcels)	UK Mail	50	UK Mail depots

Source: Parcel operator websites (correct as of January 2019).

3.73 As noted in our 2017 Review, and mentioned by Royal Mail in its consultation response, alternative access point networks have grown in recent years. In our view, this has been largely driven by operators wishing to expand their pick up and drop off networks to increase first time delivery success rates. Royal Mail argued this has been primarily aimed at improving competitors' product offering and presence in the single piece parcels sector.

3.74 However, as highlighted by consumer groups[83] in their consultation responses, these alternative networks tend to have lower coverage in rural areas compared to urban areas,

[83] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

meaning that the Post Office (and therefore Royal Mail[84]) is likely to still be the primary option available to consumers in many rural areas, and these customers may find it difficult to access services from alternative providers. Third party reports provided by Royal Mail show that the Post Office has a smaller share of outlets in more densely populated areas (such as London), and a greater share in less densely populated areas (such as Scotland, Wales and the South West).[85] However, we do not think that this difference in the availability of alternatives would be likely to lead to a worse outcome for consumers in rural areas. Royal Mail is obliged to offer a geographically uniform price for products falling within the universal service. Where competition is present, even where it is largely limited to urban areas, it will tend to constrain Royal Mail's prices to some extent, which has the potential to benefit all consumers regardless of location.

3.75 In addition, using alternative providers' services often requires customers to access the internet to pay for postage and generate a label. This is not the case for parcels sent via the Post Office.

3.76 Most alternative providers are focused on bulk services (for example, delivering online retail orders) or heavier weight single piece parcels. As demonstrated by the volume and revenue shares above, there is currently limited competition for Royal Mail in single piece parcels up to 2kg. Approaches to pricing suggest only a limited number of operators seek to compete with Royal Mail for parcels weighing up to 2kg, though some of the higher priced operators offer an enhanced service to Royal Mail's Second Class products, such as providing faster delivery or courier pick up.

Table 3.2: Competitor products and pricing

	0-1kg	1-2kg
Royal Mail Second Class Stamp	£2.95 (small); £5.05 (medium)	£2.95 (small); £5.05 (medium)
Hermes parcel shop drop off (up to equivalent of Royal Mail medium parcel size)	£2.79	£3.99
Yodel/Collect+ drop off (up to equivalent of Royal Mail medium parcel size)	£3.99	£3.99
UK Mail/ipostparcels (depot drop off)	£5.09 (small); £6.29 (medium)	£5.09 (small); £6.29 (medium)
APC (courier pick-up)	£13.80	£13.80

[84] Royal Mail and Post Office have an exclusivity agreement that is due to run until 2022, whereby Post Office is Royal Mail's exclusive retail outlet.
[85] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

	0-1kg	1-2kg
DPD local	£7.19	£7.19
Yodel (doorstep collection)	£7.19 (small); £9.59 (medium)	£7.19 (small); £9.59 (medium)

Source: Parcel operator websites (correct as of January 2019), inclusive of VAT where applicable. Where options for delivery timescales offered, prices shown reflect closest comparison to Royal Mail's Second Class service.

3.77 Though alternative operators currently have a limited presence in lightweight single piece services, there remains potential for other operators to expand into this area, especially if they have already established access point and delivery networks for bulk fulfilment or click and collect services. Royal Mail's consultation response notes that investment in new facilities (such as sorting centres) by competitors has generated c.25% ongoing annualised spare capacity in the sector. It argues this has placed - and continues to place - downward pressure on its prices. This excess capacity could potentially lower the cost of expansion for competitors. However, we have seen limited expansion to date in lightweight single piece parcels. As highlighted in our 2017 Statement, other carriers saw a rapid increase in single piece volumes between 2013 and 2015[86], but since then their rate of growth has slowed, as demonstrated by Royal Mail's consistently high share of volumes and revenues.

3.78 Royal Mail and alternative providers are likely to have a variety of differing cost advantages and disadvantages. Royal Mail has a substantial advantage over alternative providers due to its established foot delivery network. This provides it with a cost advantage, particularly for small and lightweight parcels which can fit through a letter box, as these can easily share the letter delivery network (small and lightweight parcels are a sub-set of services in the safeguard cap). This means some of the fixed costs of delivering such parcels are shared with letter products. Further, Royal Mail's universal services are exempt from VAT, whereas competitors' parcel services are not. [✂][87]. Conversely, in its consultation response, Royal Mail argues that some competitors gain cost advantages through "gig economy" labour models. Taken together, we do not consider that competitors have overall cost advantages that would lead to a material increase in the competitive constraints they can place on Royal Mail.

3.79 In summary, whilst competing operators are able to offer equivalent services to Royal Mail's Second Class stamp small and medium parcels, these operators have had limited success to date in terms of gaining a significant share of the services covered by the safeguard cap. They would have to overcome Royal Mail's cost and VAT advantages in lightweight parcels in order to do so. We consider that, given Royal Mail's share of the sector, supply-side constraints are unlikely to prevent Royal Mail from raising prices.

[86] 2017 Statement, paragraph 3.129.
[87] [✂].

Demand-side constraints

3.80 A consumer or business considering sending a single piece parcel (weighing up to 2kg) with Royal Mail's Second Class stamp products has, in theory, the following main alternative options:

- sending the item using Royal Mail's First Class stamp product;
- sending the item using a different Royal Mail payment method (e.g. meter);
- sending the item using a competing parcel operator; and/or
- not sending the item in the mail (potentially due to electronically transferring content instead).

Alternative parcel products offered by Royal Mail

3.81 Royal Mail maintains differentials between its Second Class parcel stamp prices and its other products to manage switching between products. For parcels, this also includes differentials between weight steps and format sizes. As for letters, whilst this may constrain standalone price increases in individual Second Class stamp prices, it would not constrain a general increase in prices across products.

3.82 Whilst meter products can be used for parcels, in practice users of meter services are primarily senders of letters rather than parcels. Just 2% of Royal Mail's total Second Class meter volumes were parcels in 2017/18.[88] Royal Mail's internal documents show that it considers that parcels are posted via a meter for convenience, and thus are relatively inelastic, though may still be targeted by competitors.[89] Royal Mail's modelling of switching between products also illustrates that a proportion of stamp volumes would be expected to switch to meter products in response to a moderate price increase, though in our view this proportion is small.[90]

Send using competing parcel operator

3.83 As discussed above, competing operators account for a relatively small proportion of the single piece parcels sector up to 2kg by both volume and revenue. Whilst many do offer these products, few are price competitive with Royal Mail's Second Class products. Royal Mail's consultation response also highlighted that some consumers are using marketplaces to obtain better deals, such as buying postage through eBay's own online channel. It also mentioned the growing use of price comparison websites facilitating consumer choice between alternatives. Hermes argued that the risk of losing market share to competitors acts to constrain Royal Mail's pricing of parcels.

3.84 The threat of consumer switching to competing providers with similar tariffs may constrain Royal Mail's pricing to some degree. To the extent that marketplaces or price comparison websites facilitate this, the strength of this constraint may have increased to some degree.

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[88] Royal Mail Regulatory Financial Reporting Information.
[89] Royal Mail response dated 6 June 2018 to s.55 Notice, [✄].
[90] Royal Mail response dated 6 June 2018 to s.55 Notice, [✄].

Royal Mail's internal documents indicate that it considers rivals' pricing when setting its own prices, and is concerned about the prospect of entry and expansion of competitors in the single piece parcel sector. Royal Mail considers that overcapacity in the market increases the risk of losing volume to competitors.

3.85 However, Royal Mail has significant brand advantages over its near-competitors in single piece lightweight parcels. Our Residential Omnibus Survey indicates that 95% of respondents were aware of Royal Mail, but just 61% were aware of Hermes.[91] There is a similar picture amongst businesses, with 80% naming Royal Mail when asked to think of postal providers, compared to 12% naming Hermes.[92] Royal Mail's own consumer research also shows this advantage in brand strength. Consumers are significantly more aware of Royal Mail, more likely to consider using Royal Mail and more likely to actually use Royal Mail.[93] In its consultation response, Royal Mail notes that awareness of competitors had increased in recent years, and that marketplace sellers in particular are more aware of competitors. However, this does not change our view that Royal Mail enjoys an advantage in consumer awareness relative to its competitors, including amongst marketplace sellers, even if this advantage may be smaller than in the past.

Price sensitivity

3.86 Our consumer research suggests that price responsiveness is relatively low in parcels. 9% of residential consumers indicated they would send fewer parcels in response to a 10% price increase, and 3% indicated they would not send any parcels. Just 10% said they would send fewer, and 4% said they would not send any, in response to a 20% price increase.[94] Among business users, just 3% said they would send fewer parcels in response to a 10% price increase. In response to a 20% price increase, just 4% said would send fewer parcels and 1% indicated they would not send any.[95]

3.87 As for letters, we treat this evidence from market research with a degree of caution, given that survey responses to hypothetical questions have a tendency to overstate actual price responsiveness. In addition, our research does not provide an indication of the extent of volume response envisaged by those who would send fewer parcels.

3.88 Royal Mail's own elasticity estimates suggest similar or less price responsiveness at a market level. It estimates that demand for small and medium parcels is relatively inelastic (estimated as [✂]).[96]

3.89 This suggests that the risk is low that consumers would respond to a price increase for parcels by choosing not to send the parcel (except perhaps in certain circumstances where digital alternatives are available such as electronically transferring content as opposed to

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[91] Residential Omnibus Survey, Q13 – prompted. This aligns closely with our Residential Postal Tracker, QI1, which shows 96% of consumers are aware of Royal Mail and 73% aware of Hermes.

[92] Business Postal Tracker, 2018, QV3 – unprompted.

[93] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

[94] Residential Omnibus Survey, Q11 and Q12.

[95] Business Postal Tracker, 2018, QN7c and QN7d.

[96] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

sharing content via a physical CD or DVD transmissible by post). Accordingly, we consider that this is not likely to provide a strong constraint on Royal Mail's pricing.

Pricing behaviour for large letters and parcels

3.90 As we regulate large letter and small and medium parcel prices as part of the same basket cap, we consider Royal Mail's pricing behaviour for these products together in this sub-section.

Our consultation proposal

3.91 In our July 2018 Consultation, we proposed that uncertainty around potential market responses to further significant pricing changes, and the risk of unforeseen responses to its pricing strategy may constrain Royal Mail's pricing decisions and discourage it from making radical changes to pricing. However, we did not think that it was clear this risk would constrain more moderate price increases, particularly given the limited price competition that Royal Mail currently faces.

Stakeholder responses

3.92 Royal Mail noted its moderate price increases for letters (including large letters) in recent years, arguing these reflected constraints on its pricing due to risks from e-substitution, 'tipping points' or competition. It also argued that its internal pricing decision papers showed concern with the risks of losing volume to competitors if it increased parcel prices. It also noted the impact of its decision to introduce size-based pricing in 2013, subsequent changes to win back volume and argued that since then competition had continued to constrain its prices.

3.93 Hermes argued that the fact that Royal Mail is pricing significantly below the basket cap, combined with the risk of reputational damage and loss of market share in single piece parcels, meant that the cap, for parcels at least, was redundant. Hermes also notes that Royal Mail's pricing decisions allowed competitors (such as Hermes) to gain a foothold in the single piece parcel market.

3.94 We set out our assessment of Royal Mail's pricing behaviour for large letters and parcels below, taking into account stakeholder responses.

Our assessment

3.95 Our 2012 Basket Cap Statement introduced a basket cap covering large letters and parcels, at 53% above prevailing prices, with subsequent annual increases by CPI. For large letters, Royal Mail's pricing strategy was in line with its approach to standard letters, introducing significant increases in 2012 and smaller regular increases in subsequent years. Although large letter prices have increased substantially, they have remained below the maximum that would be permitted under the basket safeguard cap.

3.96 Royal Mail made changes to its products to introduce size-based pricing for parcels in 2013. This increase in prices reduced the headroom under the basket cap to 10% in 2014/15. These changes meant that some parcel prices effectively increased by more than 100%. This allowed competitors, particularly Hermes, to gain a foothold in this market segment, which resulted in a [✂]% decline in single piece parcel volumes for Royal Mail.[97] In response, Royal Mail made some changes to its pricing structure which resulted in reductions to some parcel prices, including the introduction of a flat 0-2kg rate for small and medium parcels. It has since proceeded in a cautious manner raising prices by around 2% per annum in recent years. Royal Mail internal documents state that this has allowed it to slow volume decline and return to growth in parcels.[98] Royal Mail retains significant headroom under the basket safeguard cap which it could use to increase parcel prices significantly.

3.97 As argued by Royal Mail and Hermes, this may suggest that competitors could constrain Royal Mail's parcel pricing to some degree, but there is little evidence that competitor responses have had a significant impact on Royal Mail, except in the case of very significant price increases such as those that affected some shapes and weights when size-based pricing was introduced in 2013. Whilst uncertainty around the prospect of entry and expansion by competitors may lead Royal Mail to take a cautious approach to price increases for parcels, there is little to suggest that moderate increases would be unprofitable.

3.98 This uncertainty around potential market responses to further significant pricing changes, and the risk of unforeseen responses to its pricing strategy may constrain Royal Mail's pricing decisions and discourage it from making radical changes to pricing. However, it is not clear that this risk would constrain more moderate price increases, particularly given the limited price competition that Royal Mail currently faces. Accordingly, we consider that competitive constraints are not sufficiently strong to constrain prices in the absence of a safeguard cap.

Conclusion on competitive constraints in large letters and parcels

3.99 For large letters services, Royal Mail remains a near-monopolist in the provision of these services. Whilst the risk of accelerating e-substitution may cause Royal Mail to be cautious in implementing significant price increases, there is limited evidence that e-substitution represents a meaningful constraint on Royal Mail's ability to profitably raise prices for single piece large letters (particularly with respect to smaller price increases). We therefore remain of the view expressed in our 2017 Review that Royal Mail faces only limited competitive constraints on its prices for single piece large letters.

3.100 For parcels services, Royal Mail's strong market position, widespread access network, VAT exemption and strong brand recognition gives it a significant degree of pricing power for Second Class parcels weighing up to 2kg. This is greater still for small and lightweight items

[97] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[98] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

that can fit through a letter box, as Royal Mail has cost advantages for these items due to its established integrated parcels and letters delivery network. We remain of the view that we cannot rely on competitive constraints to prevent Royal Mail from raising prices for the parcel products subject to the safeguard cap. Whilst Royal Mail is not currently pricing to the cap, it has made use of a significant proportion of the headroom under the cap, and has tended to increase prices steadily (roughly in line with RPI) in recent years.

3.101 Our assessment is that Royal Mail continues to have a significant degree of pricing power in both single piece large letters and small and medium parcels up to 2kg. We consider that, absent regulation, Royal Mail would be able to increase prices materially. However, uncertainty about e-substitution (in letters) or competitor responses (in parcels) may act to limit the scale of price increases implemented at one time.

Variation in competitive conditions within large letters and parcels

Our consultation proposal

3.102 In our July 2018 consultation, we considered that the evidence did not suggest sufficient differences in competitive conditions such that a different approach to parcels and large letters would be appropriate. We also considered that interactions between products were not sufficiently strong that a control on some products would constrain the prices of other products sufficiently such that they could be removed from the cap. Accordingly, we proposed that both large letters and small and medium parcels up to 2kg should remain within the same basket cap.

Stakeholder responses

3.103 Hermes argued that large letters and parcels should not be part of the same cap as the prices competing parcel operators can charge to remain competitive with Royal Mail could be artificially impacted by the price of large letters, where competition is more limited.

3.104 We set out our assessment of variations in competitive conditions within large letters and parcels below, taking into account stakeholder responses.

Our assessment

3.105 To inform our decision on the scope of the basket, we have considered the extent to which competitive conditions differ between products within the direct scope of the basket cap (i.e. Second Class large letters and small and medium parcels up to 2kg).

3.106 Royal Mail faces some competition in small and medium parcels, but virtually no competition in large letters. However, in both instances, Royal Mail remains by far the largest operator with a significant degree of pricing power.

3.107 If competitive conditions differed materially, and the basket cap was currently ‘biting’ on Royal Mail, retaining the products under the same basket cap could distort competition. This is because it would give Royal Mail a strategic incentive to rebalance prices across the basket products to meet the basket cap constraint by setting higher prices in products where it faces a limited threat of competition, and lower prices where it faces greater competition. This could allow it to foreclose competition, whilst maximising revenues within the constraint of the basket cap.

3.108 We agree with Hermes that there are some differences in competitive conditions between large letters and single piece parcels. As discussed above, Royal Mail is a near-monopolist in large letters but faces some competition in single piece parcels. However, the evidence does not suggest sufficient differences in competitive conditions such that a different approach to parcels and large letters would be appropriate. In both sectors, Royal Mail has a very high share, substantial cost and scale advantages, and limited competitive constraints on its pricing.

3.109 Further, Royal Mail continues to price significantly below the basket cap, meaning the cap is not currently a determining factor in the structure of Royal Mail's prices for products within the basket cap. We recognise there is potential for some segments to experience a growth in competition, such that it may be appropriate in the future to amend the scope of the safeguard caps.

3.110 We have also considered whether interactions between products are sufficiently strong that a control on some products, such as Second Class standard letters, would constrain the prices of other products sufficiently such that these other products can be removed from the cap. There are clear interactions between First and Second Class products and payment types (e.g. stamp or meter) within sectors. Consumers trade off between products based on their requirements and expected volumes. This is demonstrated by Royal Mail's attempts to broadly maintain consistent differentials and their considerations when setting prices (based on its internal documents).[99]

3.111 However, given current differentials between standard letters and large letters and parcels of different weights, it is unlikely that an increase in a smaller or lighter product would be materially constrained by the risk of switching to a larger or heavier product. Current significant differentials also mean that, if switching to a smaller or lighter product was possible, consumers would likely already have done so. A moderate widening of the differential would be unlikely to prompt significant additional switching. Accordingly, we consider that a cap on both standard letters and large letters and parcels remains necessary.

Our conclusions on the market analysis

3.112 Overall, we remain of the view set out in our 2017 Review that competitive constraints are still insufficient to prevent Royal Mail from raising prices for the products under the safeguard caps.

[99] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

3.113 Royal Mail remains a near-monopolist in standard letters and large letters, with little threat of entry. The risk of triggering a step-change in e-substitution may act to constrain very substantial price increases, but is unlikely to provide protection against smaller increases.

3.114 Though there is more competition in the parcels sector, this is limited for small and lightweight single piece items, where Royal Mail retains a very high share of volumes and revenues. Past competitor responses to very large price increases may lead Royal Mail to act cautiously, but this is unlikely to constrain Royal Mail from implementing moderate price increases.

3.115 Finally, there is insufficient evidence of differences in competitive conditions to suggest that a change in the structure or scope of the safeguard caps is necessary.

4. Assessing affordability

Introduction and summary

4.1 As discussed in section 2, when setting tariffs, such as the safeguard caps, in relation to the provision of the universal postal service, we are required under section 36(5) of the PSA 2011 to ensure that the prices of the relevant services are affordable, take account of the costs of providing the service and provide incentives to provide the service efficiently. Assessing affordability is therefore a very important component of our assessment of the safeguard caps.

4.2 This section sets out our assessment of the extent to which consumers, especially potentially vulnerable consumers, are likely to consider the safeguarded products to be affordable both at current prices and at prices above the level of the caps.

4.3 In summary, in the July 2018 Consultation, we found that there is a range of evidence and no single price point emerges as clearly being the limit of affordability. However, determining the appropriate level of the safeguard caps requires us to identify a specific limit. This requires regulatory judgment, balancing different evidence and the likely effects on different groups of consumers. In the July 2018 Consultation, our judgment was that an increase of 5% in real terms above the current level of both the letters and basket caps would not render the letter products unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable. The potential for adverse effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase for either cap should be considered unaffordable. Having considered consultation responses and updated our research, we remain of this view.

4.4 This section summarises our consultation position and stakeholder responses, and sets out our affordability analysis having taken responses into account.

Methodology for assessing affordability

Our consultation proposal

4.5 In the July 2018 Consultation, we set out our proposal to assess affordability using the same approach as we used in *The Affordability of Universal Postal Services*[100] (the "2013 Report"). This report included our findings with respect to better understanding consumers' use of and needs for post and how we intended to monitor the affordability of universal postal services on an ongoing basis.

[100] Ofcom, 2013. *The Affordability of Universal Postal Services.*

Stakeholder responses

4.6 Royal Mail considered that "Ofcom should not simply assume the findings from [the 2013 Report] still hold today". It stated that we should consider up-to-date research to ascertain whether prices above 65p would be unaffordable.[101] As such, Royal Mail stated that our conclusion that a larger increase [than 65p] should be considered unaffordable is not supported by evidence, and that prices would remain affordable if the cap was set above 65p.[102]

4.7 We received no other stakeholder comments on our approach to assessing affordability.

Our assessment

4.8 We have decided to maintain the approach to assessing affordability that we used in the 2013 Report for the purposes of this decision, whilst using the most recently available research (e.g. our 2018 Residential Postal tracker) to inform our decision. We have adopted this methodology, whilst noting that no one approach can be definitive about whether the price of a good or service may be considered unaffordable.

4.9 Following the approach set out in the 2013 Report, we have identified two ways in which postal services might be considered unaffordable for residential consumers, namely where:

- consumers reduce their purchases of postal services due to the price; and/or
- consumers continue to buy postal services, but have to cut back on other essential expenditure.

4.10 We have focused our analysis on certain consumer groups of interest,[103] as follows:

- those with low income;
- those living in rural areas (as they may have a higher reliance on post); and
- other consumers who may be particularly reliant on postal services. For example, those who are aged over 65, or who have a disability, or who have no or limited access to the internet[104], or recent immigrants to the UK.

4.11 We have focused on these groups because we maintain the view that certain consumer groups may be particularly vulnerable with respect to sending post, either because they have a particularly high need to send universal service post products, and/or because they lack the means to do so. We also consider that, if the evidence suggests that vulnerable consumers in general would be able to afford universal postal services, we can be confident that all consumers on average would be able to afford universal postal services.

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[101] Royal Mail's non-confidential response to Ofcom's July 2018 Consultation ("Royal Mail's non-confidential response"), paragraph 2.10.

[102] Royal Mail's non-confidential response, page 13.

[103] We identified the same potentially vulnerable consumer groups in the 2013 Report, paragraph 3.23. We also note that there is a significant degree of overlap between some of these groups.

[104] 'No internet' means consumers that have no broadband access at home.

4.12 For SMEs, we find that postal services may be unaffordable for a business only where the following three conditions are met:

- universal postal services are a critical input to the business' commercial proposition;
- there is a lack of good alternatives to universal postal services available to the business; and
- the cost of universal postal services is important for the business' financial position.

4.13 In order to assess whether these conditions are met, we collected data from our Business Postal Tracker on postal expenditure and sending patterns. Our general approach to assessing affordability for SMEs remains to identify businesses which are potentially (but not necessarily) at risk of finding Second Class postal services unaffordable and to consider the extent to which the prices of universal service postal products might materially harm a business' commercial position.

4.14 This approach to assessing affordability, for both residential consumers and SMEs, is designed to take account of the way in which these consumers use universal postal services, as well as how the affordability of universal postal services has previously been assessed. Furthermore, the assessment is informed by approaches to assessing affordability in other sectors, as well as the way in which regulatory authorities in EU Member States have assessed whether universal postal services are affordable. We consider that such an approach is appropriate for the purposes for our assessment of affordability.

4.15 As noted above, Royal Mail expressed concern that, in following this methodology, we had assumed that findings from our 2013 affordability analysis, uplifted by 5%, still held today. Whilst the methodology we used in 2013 has remained the same, our analysis and thus our assessment itself has been updated to take in to account the most recently available sources of data. We have collected the following data relating to residential consumers (and in particular those belonging to potentially vulnerable groups[105]):

- data from our Residential Omnibus Survey on consumers' postal expenditure and sending patterns, broken down by consumer type;
- data from our Residential Postal Tracker on consumers' postal expenditure, sending patterns and; and
- data on household expenditure and disposable incomes from ONS *Living Costs and Foods Survey*[106], broken down by consumer type and over time.

4.16 Comparisons with the 2013 Report, which we believe represented an accurate analysis of affordability at that time, provide us with further useful information. As an example, when considering real household disposable income as a measure for affordability, we can understand the context of how this has changed over time, and what this means for the current level of affordability. We believe that such an approach to measuring affordability

[105] For the purposes of this assessment we categorise consumers in the following groups as potentially vulnerable, consumers: (i) over 65; (ii) without internet access; (iii) rural areas; and (iv) in socio-economic group C2DE.
[106] Data taken from ONS, 2018. *Living Costs and Food Survey*.

remains appropriate for the purposes of this review, although we note that defining a precise point at which the Second Class products may become unaffordable is challenging.

4.17 The 2013 Report considered the affordability of all universal postal services. Our decision in this statement is, however, focused particularly on the affordability of the Second Class products subject to the safeguard caps. Where possible, we have sought to focus our consumer research and data collection on the Second Class products. To the extent that our research relates to the affordability of the universal postal services more broadly, this is highlighted below. However, we consider that the more general considerations of the affordability of universal services also apply to the affordability of the specific Second Class products subject to the safeguard caps.

4.18 For SMEs, we have collected data from our Business Postal Tracker on postal expenditure and sending patterns. Our general approach to assessing affordability for SMEs remains to identify businesses which are potentially (but not necessarily) at risk of finding Second Class postal services unaffordable.

Affordability for residential consumers

Our consultation proposal

4.19 Assessing affordability for residential consumers requires weighing up a range of evidence. In order to do this, we have split our analysis into three parts:

- use and expenditure for postal services;
- disposable income and comparator spending; and
- market research on affordability.

4.20 In the July 2018 Consultation, we found that post makes up a small proportion of total expenditure, and in absolute terms, only amounts to approximately 70p a week.

4.21 We also found that, compared to 2012/13, real disposable incomes have risen across all households, although for low-income retired households this growth has been moderate, and expenditure on comparable communications services has increased by more in absolute terms than it has for post.

4.22 Finally, when considering the interaction between spending on post and spending on other essentials, we found that post remains affordable for most consumer groups. However, we did recognise that unfortunately some consumers who suffer significant financial difficulty and have a frequent need to send post may find Second Class postal services unaffordable, even at a significantly reduced price.

Stakeholder responses

4.23 Both Citizens Advice[107] and CAS[108] agreed that it is challenging to identify a single price point as the limit of affordability, with CAS also adding that any such decision requires a degree of regulatory judgment.

4.24 Citizens Advice considered that our "analysis of affordability is reasonable given relatively low household spend on post". Nonetheless, it also stated that letters remain "essential for vulnerable consumers who are less able to switch to digital alternatives, and it is vital that they remain affordable to all consumers".[109]

4.25 Citizens Advice also noted an "increase in private rental costs over the last few decades, with low income consumers most impacted", and suggested that "[i]ncluding income 'after housing costs' in any assessment of affordability may be valuable".

4.26 Whistl stated it had "every reason to believe and support the analysis that Ofcom produced on expenditure on services and affordability for vulnerable groups"[110], whilst MCF did not challenge our affordability analysis.[111]

4.27 The CCNI carried out its own research which considered the affordability of Second Class postal services in Northern Ireland.[112] It found that the proposed level of the cap may present affordability issues for vulnerable consumers, particularly those without access to the internet and those with a disability.

4.28 Royal Mail stated that we had "failed to test specific prices with the core demographic - vulnerable consumers".[113]

4.29 Royal Mail interpreted the results of our research into consumers' responsiveness to hypothetical 10% and 20% price increases in our market analysis[114] as consumers finding prices affordable. Specifically, it stated "the limited change in consumer behaviour is a result of the prices being affordable and remaining so, even if prices were higher".[115]

4.30 Royal Mail also commented on the results of our Residential Postal Tracker which suggested that consumers see stamps as representing good value for money and

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[107] Citizens Advice non-confidential response to Ofcom's July 2018 Consultation, page 4. Citizen's Advice also submitted that we should take further measures to address affordability concerns, such as introducing a discount scheme. We consider that setting the caps as described in this statement sufficiently addresses affordability concerns based on our current assessment.

[108] CAS' non-confidential response to Ofcom's July 2018 Consultation, page 2.

[109] On 18 October 2018 Ofcom presented the proposals set out in the July 2018 Consultation to the Communications Consumer Panel ("CCP"). The CCP were concerned that the safeguard caps should remain at an affordable level for consumers who rely on postal services, and noted that Ofcom had undertaken robust research to determine whether the safeguarded products were affordable for residential consumers (particularly vulnerable consumers) and small businesses.

[110] Whistl's non-confidential response to Ofcom's July 2018 Consultation, page 1.

[111] MCF's non-confidential response to Ofcom's July 2018 Consultation, pages 1-2.

[112] CCNI's non-confidential response to Ofcom's July 2018 Consultation ("CCNI's non-confidential response"), pages 17-32.

[113] Royal Mail's non-confidential response, page 13.

[114] See paragraph 3.38

[115] Royal Mail's non-confidential response, paragraph 2.11.

consumers are generally satisfied with features of Royal Mail's service.[116] Royal Mail claimed its own consumer research supported this view, as indicated by year-on-year increases in its net promoter score[117] and consumers reporting a high satisfaction rate with regard to their sending and receiving experience with Royal Mail.[118]

Our assessment

4.31 Since the July 2018 Consultation, we have published the results of our most recent Residential and Business Postal Trackers in August 2018 and have thus updated our analysis where relevant.

Use and expenditure for postal services

4.32 Information on usage of postal services comes from our Residential Postal Tracker, Residential Omnibus Survey and the ONS *Living Costs and Food Survey*.

4.33 Our Residential Omnibus Survey suggests that on average consumers sent 2.3 letters or small and medium parcels in the past month, around two-thirds of which are standard letters, but a majority of respondents said they sent no post in the last month.[119]

4.34 Our Residential Postal Tracker suggests a slight increase in the volume of post sent from 2012/13 to 2017/18, from around 7 to around 8 items of post per month on average.[120] A like-for-like comparison, taking into account a change in methodology in our tracker[121], suggests a small decrease, with an average of 6 items sent per month in 2017/18. 18% of respondents said they had not sent any post in the last month in 2012, compared to 15% in 2017/18.[122] Research carried out by CAS indicates that only 43% of consumers in Scotland send personal letters at least once a month.[123] This is broadly in line with our finding that residential consumer usage of the postal service is relatively low.

[116] Royal Mail's non-confidential, paragraph 2.6 to 2.8.
[117] The net promoter score is an index ranging from -100 to 100 that measures the willingness of customers to recommend a company's products or services to others. It is used as a proxy for gauging the customer's overall satisfaction with a company's product.
[118] Royal Mail's non-confidential response, paragraph 2.6 to 2.9.
[119] Residential Omnibus Survey, Q2 – data from April 2018 fieldwork. As postal use is seasonal this represents a non-peak month rather than an average across the year.
[120] Residential Postal Tracker, QD1.
[121] In 2012/13, tracker data was collected exclusively using face-to-face interviews. We now collect data using a mix of online and face-to-face surveys which is then weighted to the overall UK population. This like-for-like comparison uses only the data collected via face-to-face interviews. Our Residential Postal Tracker appears to show greater levels of usage in 2017 than our Residential Omnibus Survey. The questions on usage in each survey are not directly comparable. Our Residential Omnibus Survey asks simply about use of standard letters, large letters and small and medium parcels. Our Residential Postal Tracker asks about specific items of post (such as postcards or greetings cards), so is likely to generate a different response.
[122] Residential Postal Tracker, QD1.
[123] CAS Consumer Tracker Survey: Wave 2, unpublished, page 28.

4.35 In general, consumer spending on post is also low. ONS data shows on average households spent 70p per week on postal services in 2016/17.[124] This data covers all postal services and is similar in real terms to expenditure in 2012/13.

4.36 Our Residential Omnibus Survey aligns with ONS estimates, and indicates that the sum of average spending on each of standard letters, large letters and small and medium parcels (up to 2kg) was around £3.10 in the last month (or approximately 70p per week).[125] This estimate (and ONS data) also includes First Class mail and other products, so actual expenditure on Second Class services will be lower than these estimates.

4.37 There are significant differences in usage and spending by consumer group, as illustrated in Figures 4.1 and 4.2 below. In relation to those consumer groups which are likely to comprise vulnerable consumers, we observe the following[126]:

- Consumers aged **over 65** and consumers **without internet access** both send more mail items than average, and a greater proportion of these items are standard letters. As a result of their reliance on cheaper, more basic postal services, total spending for these customer groups is below average.
- Consumers **living in rural areas** send slightly more mail items, and report slightly higher average spending.
- Consumers in socio economic groups **C2DE** send fewer items than average, and spend less on postal services than average.

4.38 Some of these trends are in line with our 2013 Report findings, particularly that older consumers tend to send more postal items and lower income consumers tend to send less than average, although we note that research carried out by the CCNI indicates that, for consumers in Northern Ireland, usage is slightly higher than average for those who live in rural areas or those with a disability.[127]

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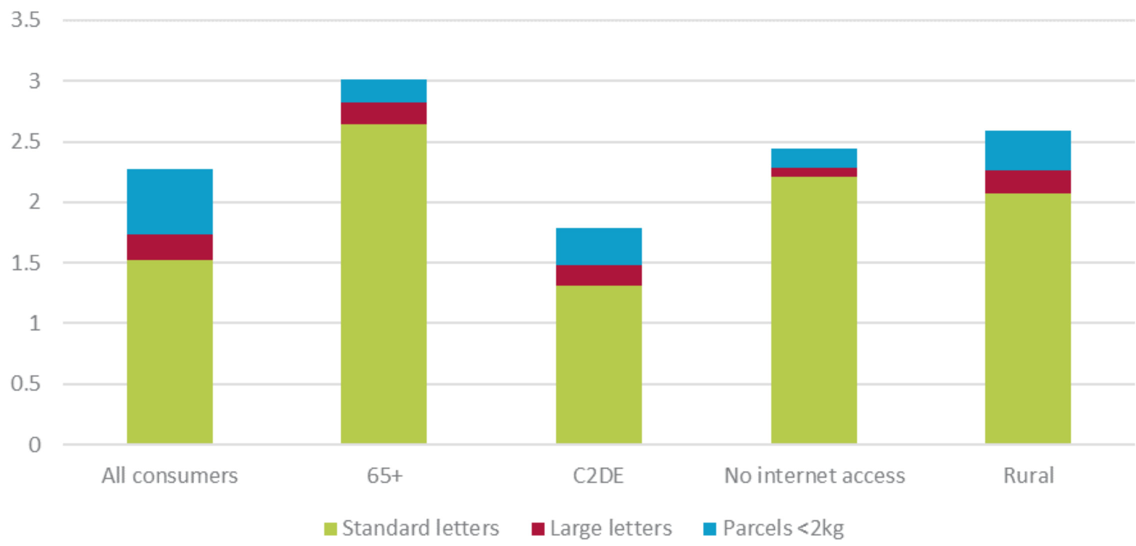
[124] Data taken from *Living Costs and Food Survey*, table 3.2E: 'Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK.' https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditureasapercentageoftotalexpenditurebyequivaliseddisposableincomedecilegroupoecdmodifiedscaleuk32e.

[125] Residential Omnibus Survey, Q1 – includes those that spent nothing on post.

[126] Residential Omnibus Survey, Q1 – includes those that spent nothing on post.

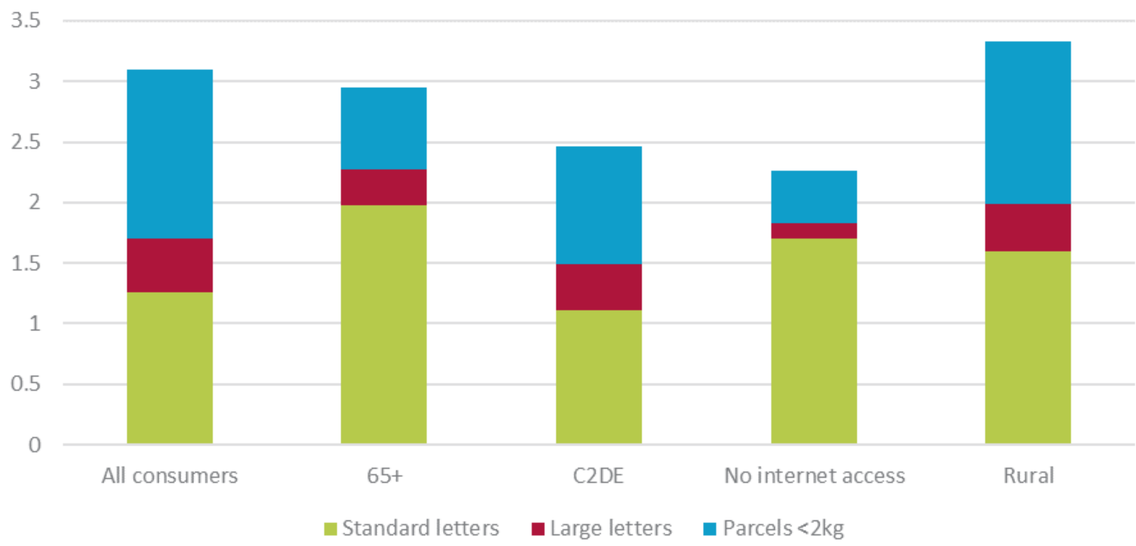
[127] CCNI's non-confidential response, page 22.

Figure 4.1: Average items sent per month, by customer group



Source: Residential Omnibus Survey, Question 2.

Figure 4.2: Average monthly spend on post (£), by customer group



Source: Residential Omnibus Survey, Question 1.

4.39 Use of postal services is seasonal for many consumers, with a significant increase in average use and spending over the Christmas period. For many consumers, there are peaks in postal spending, which could make issues of affordability more acute at these times. For example, on average, consumers surveyed in January 2018 reported spending £13.16 in the last month, compared to an annual average of £9.45 per month in 2017/18.[128]

4.40 ONS data on household expenditure[129] (as shown in Figures 4.3 and 4.4) indicates that expenditure on post for all households and low income households has remained small and largely constant since 2012/13, in both level and share of total expenditure. Spending by consumers aged 65 or over is higher than average and appears to have increased in 2016/17.[130] However, it remains a small share of total expenditure.

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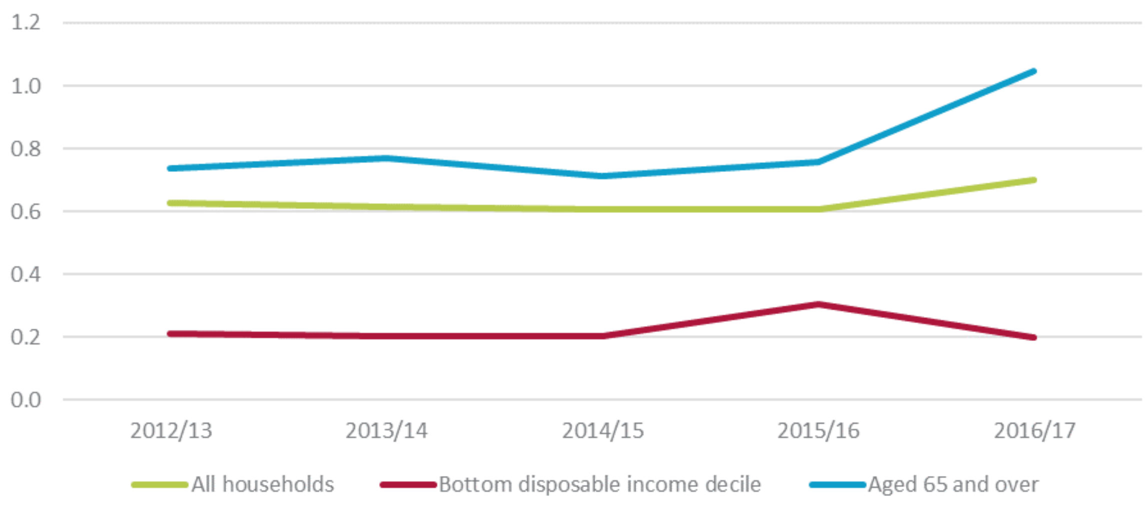
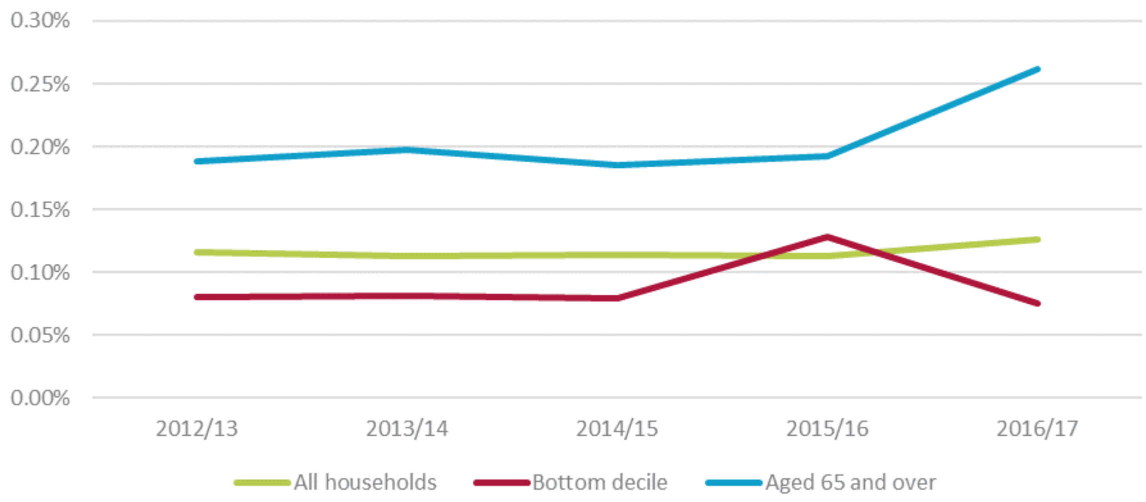
[128] Residential Postal Tracker, QD4. Any responses that stated "I prefer not to say" or "I don't know" were excluded from the calculations of the mean average and the January spend figure.
[129] Data taken from *Living Costs and Food Survey*, table 3.2E: 'Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK.'
[130] Data taken from *Living Costs and Food Survey*, table A11: 'Detailed household expenditure by age of household reference person, UK.'
https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/expenditure/datasets/detailedhouseholdexpenditurebyageofhouseholdreferencepersonuktablea11.

Figures 4.3 and 4.4: Household expenditure on post, level (£/week) and share of total expenditure, by customer group, 2012/13 to 2016/17





Source: Ofcom calculations using ONS Living Costs and Food Survey, 2016/17 prices, adjusted using CPI.

4.41 In general, this evidence indicates that post continues to make up a small share of household expenditure, and that little has changed since 2012/13. There is some indication that some potentially vulnerable consumers may send more items or spend more on postal services than was the case in 2012/13, but overall expenditure by these groups remains broadly in line with 2012/13 levels.

Disposable income and comparator spending

4.42 Assessing changes in household incomes and expenditure since 2012/13 and considering trends in expenditure on comparator products, provides us with an indication of the resources available to households and whether spending on post might be constrained.

4.43 Our calculations, from ONS data[131], summarised in Table 4.1 suggest that real disposable incomes have increased by 8.9% across all households over the period 2012/13 to 2016/17. Real disposable incomes have increased for average retired households at a faster rate than non-retired households. When looking at lower income consumers, who may be more likely to be vulnerable, real disposable incomes have increased by 7.6% for the bottom decile and 9.5% for the bottom quintile. Low income retired households have experienced a slower growth in disposable incomes; 1.9% for the bottom decile and 3.0% for the bottom quintile.

Table 4.1: Cumulative growth in real disposable incomes by group, 2012/13 to 2016/17

	Bottom decile	Bottom quintile	All incomes
All households	7.6%	9.5%	8.9%
Non-retired households	11.9%	12.9%	8.4%
Retired households	1.9%	3.0%	10.6%

Source: Ofcom calculations from ONS Living Costs and Food Survey. We use equivalised household incomes to control for the effect of changes in household size. 2016/17 prices, adjusted using CPI.

4.44 Citizens Advice noted that considering income *after* housing costs may be useful in our assessment of affordability. As the *Living Costs and Food Survey* does not provide any information on this metric, we have used data from the *Households Below Average Income Report (HBAI)* to assess this.[132] The data indicates that real disposable income after housing costs has decreased by 3.7% since 2012/13 for the bottom decile. However, the ON notes that this result must be treated with a degree of caution as small changes in estimates from year-to-year, particularly at the bottom of the income distribution may not be significant in view of data uncertainties. For the bottom quintile, income has grown by 6.8%, whilst across all households income has increased by 7.3%.

4.45 Using the same HBAI dataset, we have also assessed regional trends of growth in real disposable incomes for all households before and after housing costs.[133] The results, summarised in Table 4.2 indicate that, whilst there is some regional variation, on average real incomes have risen for consumers across the country. This dataset does not provide

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[131] Data taken from *Living Costs and Food Survey*, tables 2, 2a, 3, 3a, 4 and 4a: 'Effects of taxes and benefits on household income.' https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/theeffectsoftaxesandbenefitsonhouseholdincomefinancialyearending2014.

[132] Data taken from *Households Below Average Income Report,* table 2_1ts. Equivalised household incomes are used to control for the effect of changes in household size. 2016/17 prices. https://www.gov.uk/government/statistics/hbai-199495-to-201617-incomes-data-tables

[133] Data taken from *Households Below Average Income Report,* tables 2_5ts. The dataset reports incomes as three year averages, so we have calculated the median income growth rates between 2012/13 – 2014/15 to 2014/15 – 2016/17. Equivalised household income is used to control for the effects of changes in household size.

more granular information for the consumer groups which we identified as being potentially vulnerable, but we nevertheless consider the overall regional averages to be useful for this assessment.

Table 4.2 Growth in real disposable incomes for all households by region, 2012/13 – 2014/15 to 2014/15 – 2016/17

	Before housing costs	After housing costs
England	4.5%	5.0%
North East	5.9%	7.5%
North West	3.0%	2.9%
Yorkshire and the Humber	4.6%	5.3%
East Midlands	3.6%	6.5%
West Midlands	5.9%	7.7%
East of England	3.8%	3.7%
London	4.3%	5.1%
South East	2.1%	2.6%
South West	4.0%	6.3%
Wales	3.0%	2.9%
Scotland	3.0%	3.6%
Northern Ireland	5.3%	5.6%

4.46 ONS data[134] also shows that total household expenditure has increased by 2.4% over the same 2012/13 to 2016/17 period, by 2.2% for the bottom income decile and by 2.5% for households where the reference person is aged 65 or over.

4.47 Overall household expenditure and expenditure on comparable communications services (namely, telephone services) has increased by more in absolute terms than spending on

[134] Data taken from *Living Costs and Food Survey*, table 3.2E: 'Detailed household expenditure as a percentage of total expenditure by equivalised disposable income decile group (OECD-modified scale), UK' and table A11: 'Detailed household expenditure by age of household reference person, UK'.

post. This holds for both all households and the bottom income decile. This is summarised in Table 4.3 below.

Table 4.3: Absolute change in real household expenditure, £/week, 2012/13 to 2016/17

	All households	Bottom decile	Aged 65 and over
Expenditure on post	+0.1	0.0	+0.3
Expenditure on telephone services	+1.1	+1.1	+1.2
Total expenditure	+12.9	+5.7	+9.9

Source: Ofcom calculations from ONS Living Costs and Food Survey, 2016/17 prices, adjusted using CPI.

4.48 Taken together, this evidence indicates that households (including potentially vulnerable households) have allocated increased income and expenditure to items other than post. This suggests that spending on postal services was not, and has not become, constrained by income for most households. The increase in household incomes and total expenditure, including for the lowest income decile, since our 2013 Report may suggest that the affordable level of prices for postal services has increased in line with this.

Market research on affordability

4.49 Our 2017/18 Residential Postal Tracker data shows 8% of respondents reported reducing use of post to afford essentials, and 4% had to cut back on essentials to afford post.[135] This proportion does not appear to be significantly greater for potentially vulnerable consumer groups. The equivalent figures for 2012/13 were 3% and 2% respectively[136], however we hypothesise this may be due to a change in methodology.[137] A like-for-like comparison, taking into account this change in methodology gives figures of 2% and 1% for 2017/18, may suggest little actual change once the effect of the change in methodology is removed.

4.50 Royal Mail argued that we had failed to test specific prices with the core demographic – vulnerable consumers. Whilst we have not tested specific prices with consumers due to the difficulty in drawing strong conclusions from hypothetical questions, we have considered the core demographic through various data splits which cover key metrics of affordability for vulnerable groups.

[135] Residential Postal Tracker, QF1.
[136] Residential Postal Tracker 2012/13 (Q3, 2012: https://www.ofcom.org.uk/__data/assets/pdf_file/0008/51011/q32012-tracker-data.pdf); (Q4, 2012: https://www.ofcom.org.uk/__data/assets/pdf_file/0008/51200/q42012-trackerdata.pdf); Q1, 2013: https://www.ofcom.org.uk/__data/assets/pdf_file/0014/41072/trackerq12013.pdf); (Q2, 2013: https://www.ofcom.org.uk/__data/assets/pdf_file/0017/41732/trackerq22013.pdf).
[137] See footnote 121 above.

4.51 For low income consumers, with annual household income below £11,500, 14% reported reducing use of post to afford essentials, and 7% had to cut back on essentials to afford post in 2017/18.[138] There is little difference between older consumers and the general population. This suggests that, for some potentially vulnerable groups, there is an increased risk of affordability issues compared to the general population.

4.52 Our consumer research does not appear to suggest a significant variation in affordability across nations and regions. We note that CCNI has carried out research on potentially vulnerable consumers in Northern Ireland.[139] This research indicates that, on average, at 63p and 67p respectively, consumers with a disability and consumers without access to the internet would find Second Class standard letters unaffordable. Broadly speaking, this research supports our view that a small increase in real terms above the current level of the caps would not render Second Class products unaffordable for either consumers generally or a significant majority of vulnerable consumers, but that a larger increase should be considered unaffordable. However, we do note that as CCNI's research was carried out in 2017, when the cost of sending a letter by 2nd class mail was 55p. There therefore may have been an anchoring effect present, in that consumers are likely to have based their responses on the prevailing price of 55p. Had the research been carried out when the prevailing price was 58p, the average price at which consumers find Second Class stamps unaffordable may have been higher.

4.53 Nonetheless, we treat survey responses to hypothetical questions on pricing with a degree of caution as consumers tend to overstate their responsiveness to changes in price when they do not have to follow through with taking a given action. It is also difficult to rely on survey questions to a great degree of precision (i.e. the nearest pence), which is why we have considered a range of sources instead of solely relying on questionnaires to determine the current level of affordability.

4.54 CCNI also found that, on average, consumers without access to the internet and consumers with a disability would find Second Class small parcels unaffordable at £2.83 and £2.85 respectively. Again, we treat the results from these hypothetical questions with caution.

4.55 As discussed in section 3, our consumer research suggests that postal consumers are generally not particularly price sensitive and demand tends to be relatively inelastic. This means that price increases would generally result in increased spending on post for consumers, especially in circumstances where the consumer has a particular need to send the postal items and does not have access to alternatives (such as email). For consumers at risk of affordability issues, this may reduce income available for other expenditure.

4.56 Royal Mail hypothesised that this inelastic demand may be a result of consumers finding current prices affordable, and prices remaining affordable despite a 10% or 20% increase. We think it is at least equally as likely that the low price sensitivity is due to consumer

[138] Residential Postal Tracker, QF1.

[139] The Consumer Council, 2017. *Postal Consumers in Northern Ireland: Experiences and Attitudes of Vulnerable Consumers and Businesses to the Postal Service*. http://www.consumercouncil.org.uk/sites/default/files/original/Experiences_and_attitudes_of_vulnerable_consumers_and_businesses_to_the_postal_service.pdf.

reliance on post. However, even if Royal Mail's interpretation were to be correct, the purpose of the affordability assessment is to measure whether consumers, especially vulnerable consumers, would stop using the service, or forego spending on other essentials to continue using it. Whilst only 10% of consumers responding that they would send fewer letters in response a 10% price increase might seem small, this group of people may represent the vulnerable consumers that the safeguard caps aims to protect.

4.57 Royal Mail also argued that our research showed that consumer satisfaction and value for money are high. Data from our Residential Postal Tracker suggests that 86% of consumers are satisfied with Royal Mail, with net dissatisfaction at only 4%. However, only 62% of consumers were satisfied with the cost of postage – arguably the metric of greater relevance to affordability.[140] 17% of consumers reported being dissatisfied with the cost, with this figure increasing to 23% when considering only consumers aged over 65. This demonstrates that satisfaction with the cost of postage using Royal Mail's service is lower than overall satisfaction with Royal Mail.

4.58 Overall, our assessment is that our consumer research suggests that postal services are currently affordable for most. However, a minority may face affordability issues at current prices, and this could increase as a result of a significant price increase.

4.59 It is likely that some of these consumers face circumstances where they would unfortunately have concerns about the prices of the Second Class products, even at much lower prices. This limited set of circumstances where a consumer suffers both significant financial difficulty or very low income, and has a frequent need to send post items they consider to be essential, reflects very particular circumstances and severe financial hardship. We recognise that an increase in prices could have negative impacts on these consumers, though unfortunately postal services may be unaffordable for some even if their prices were reduced significantly.

Affordability for SMEs

Our consultation proposal

4.60 In the July 2018 Consultation, we set out that our approach to identifying businesses which are at risk of affordability issues as those that view post as a critical input to their businesses commercial proposition; those that lack a good alternative to stamp products and those that have a high spend on post relative to their turnover. We estimated this only applied to a very small number of SMEs in the UK.

Stakeholder responses

4.61 CCNI broadly agreed with our view that "if the postal service is affordable to residential consumers it is likely to be the same for almost all SME's".[141]

[140] Residential Postal Tracker, QG3_7.
[141] CCNI's non-confidential response, paragraph 6.28.

4.62 There were no other stakeholder comments on the affordability of Second Class postal services for SMEs.

Our assessment

4.63 In general, we consider that, if postal services are affordable for residential consumers, including potentially vulnerable consumers, then they are likely to be affordable for almost all SMEs as well. As in our 2013 Report, our approach to identifying businesses which are potentially at risk from affordability issues is to identify businesses that satisfy the three above-mentioned conditions, which we measure using market research data, namely:

- universal postal services are a critical input to the business' commercial proposition: we measure this condition by reference to businesses that say mail is 'core' to their operations;
- the business lacks good alternatives to stamp products: we measure this condition by reference to businesses with reported mail spend of below £100/month, as below this level a meter mail product is unlikely to be significantly cheaper; and
- the cost of post is important for the business's financial position: we assume this condition is satisfied where postal spending is high relative to turnover; given that condition ii) requires spending to be low, we measure this condition iii) based on businesses with a relatively low annual turnover (of less than £50,000).

4.64 Taken together, we estimate that just 2.3% of UK SMEs would satisfy all three conditions, based on our assessment of responses from our Business Postal Tracker.[142] This equates to around 131,100 SMEs. We estimated this group comprised 2.4% of UK SMEs in 2013. We recognise that there may be some variation within this, for example if post is critical to a greater proportion of SMEs in remote rural areas.[143] However, our evidence does not suggest a significantly greater proportion of SMEs in a given region would be at risk of affordability issues.

4.65 Importantly, this is an estimate of the maximum number of businesses that could be at risk of facing affordability issues. The actual number at risk is likely to be lower still as even for businesses that are dependent on post it is unlikely that the price of Second Class stamp products would be the main determinant of financial viability.

4.66 In 2017, business insolvency rates were around 0.5%[144], indicating that in general relatively few active businesses have faced financial viability issues.

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[142] Business Postal Tracker, QC2a, QC7 and QV1b.

[143] For example, we note CAS research that found that one in five (19%) Scottish SMEs described post as core to their business operations (businesses which state they could not function without it) – this figure is higher (29%) for businesses in remote rural areas (Citizens Advice Scotland/Consumer Futures Unit, 2018. *Delivering for Business: Scottish SMEs use of Postal Services*, paragraph 4.1. https://www.cas.org.uk/system/files/publications/delivering_for_business_-_scottish_smes_use_of_postal_services.pdf).

[144] The Insolvency Service, 2018. *Estimated Company Insolvency Rate in the United Kingdom, January to December 2017*. https://www.gov.uk/government/statistics/estimated-company-insolvency-rate-in-the-united-kingdom-january-to-december-2017. This estimate covers all UK businesses, but as SMEs represent 99.9% of all businesses we consider this is representative of SMEs.

4.67 Based on this assessment, we consider that Second Class postal services are highly likely to be affordable for almost all SMEs. We have not seen evidence to suggest that SMEs currently face affordability issues, or may be likely to do so in future.

International comparisons

Our consultation proposals

4.68 In the July 2018 Consultation, we benchmarked Royal Mail's price for Second Class Stamp letters against the prices of comparable postal services in four other European countries – France, Sweden, Poland and Italy. We noted that variation in the key characteristics of these services made it difficult to make direct comparisons between the prices of each country. Nevertheless, we found that, in 2017, at 56p and £1.22, Royal Mail's prices for Second Class standard and large letters compared relatively favourably in relation to the other countries.

Stakeholder responses

4.69 Royal Mail noted that out of the 15 EU and EFTA countries who offered a Second Class Stamp service in 2018, its price of 58p is the second cheapest.[145] Further, it argued that this price is well below the European mean average of 74p and that the proposed level of the letters cap – 65p – is 12% below the European average. Given this, Royal Mail stated that the level of the safeguard cap should be significantly higher, and that prices would remain affordable for customers, including the vast majority of vulnerable consumers, if it were.

Our assessment

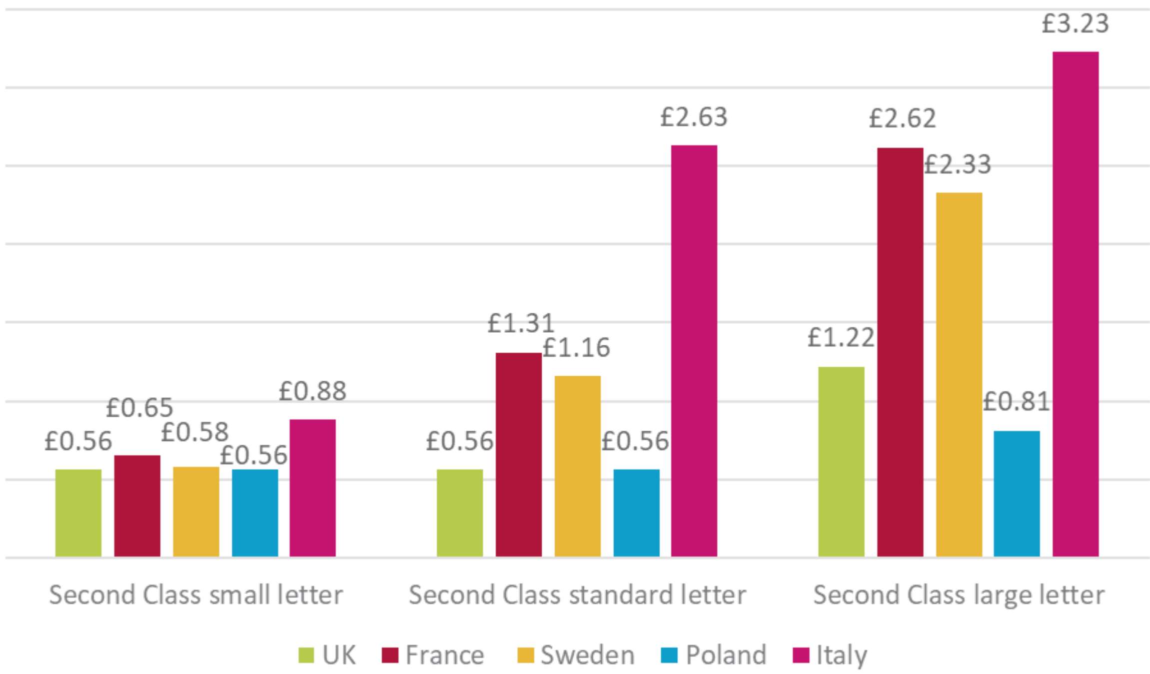
4.70 Although the EU Postal Services Directive requires a degree of harmonisation in postal services across the EU, there remains variation in universal postal services between different European countries, as well as variation in pricing structure and product and delivery specification. For example, many European countries do not offer a Second Class service to consumers, while others (such as France) offer Third Class. In addition, costs vary due to factors such as geography and quality of service standards. However, despite this variation, we consider that observing how Royal Mail's Second Class prices compare to similar services in other countries provides useful context.

4.71 Figure 4.5 shows Second Class stamp prices in 2017 in a number of European countries which offer a Second Class service. Pricing structure varies between the countries included in Figure 4.5. Universal service providers in other comparable countries typically have three sizes of letter products – 'small,' 'standard' and 'large' – whereas Royal Mail has two – 'standard letters' (equivalent to other countries' 'small' and 'standard' letters) and 'large letters.'[146] In effect, this means that consumers in the UK pay a single price to send a

[145] Royal Mail's non-confidential response, page 14.
[146] A small letter is based on a DL envelope, a standard letter a C5 envelope and a large letter a C4 envelope.

standard letter that meets the dimension of 'small' and 'standard' sized letters in other counties.

Figure 4.5: 2017 Second Class stamp prices in selected European countries which offer Second Class services



Source: WIK/Ofcom analysis.[147] *Prices as at September 2017. Conversion to GBP calculated by European Commission Currency Converter.*[148] *Small letter: 110mm x 220mm x 5mm, 20g or less. Standard letter: 229mm x 162mm x 5mm, 100g or less. Large letter: 324mm x 224mm x 25mm, 101g or 150g.*

Note delivery specification varies between country (2016): UK 1C (D+1) 2C (D+3); France 1C (D+1) 2C (D+2); Sweden 1C (D+1) 2C (D+3); Germany 1C (D+1); Netherlands 1C (D+1); Poland 1C (D+1) 2C (D+3); Spain 1C (D+3); Italy 1C (D+1/2/3) 2C (D+4).

4.72 At 56p and £1.22 in 2017, Royal Mail's price for Second Class stamp letters was relatively low in comparison to the other European countries we considered.[149]

4.73 Royal Mail's analysis reported the average price of a second class 0-100g letter as of January 2018 for the 15 EU and EFTA members who offer a second class service. Its price of 58p ranks it as the second cheapest Second Class service in Europe.

4.74 These findings are not dissimilar to ours, although as previously noted, differences in the key characteristics of these services make it difficult to draw strong conclusions from either

[147] Figure 4.5 comprises countries considered in the WIK/Ofcom analysis which offer services broadly comparable to Royal Mail's Second Class standard letter and large letter services.
[148] See: http://ec.europa.eu/budget/contracts_grants/info_contracts/inforeuro/index_en.cfm.
[149] We note that Royal Mail announced price increases for 2018/19 which took effect on 26 March 2018. This does not change our assessment of UK stamp prices compared to other countries. For most recent price list see footnote 28.

piece of analysis. Whilst the European mean price for a Second Class 0-100g letter is 74p, and the European median price is 68p, our cap of 65p is not significantly cheaper than either measure.[150]

Our conclusions on the affordability analysis

4.75 As our analysis shows, it is difficult to measure affordability for post. Given low levels of spending, measures such as a share of income may not show affordability issues that arise where price and the need to send essential post requires consumers to cut back on other essentials or not send post that they consider essential. In addition, there are diverse groups of potentially vulnerable consumers, who have experienced different changes since our last review and may be affected differently by price increases.

4.76 Taking these considerations into account, we recognise that there is a range of evidence and no single price point emerges as clearly being the limit of affordability. However, determining the appropriate level of the safeguard caps requires us to identify a specific limit. This requires regulatory judgment, balancing different evidence and the likely effects on different groups of consumers.

4.77 In several areas, little has changed since 2013. Postal services still make up a low share of income, and the majority of consumers do not report experiencing affordability issues. However, real disposable incomes have increased moderately since 2013, including for the lowest income decile. This suggests an increase in affordability. We have therefore used the level of increase for the lowest income decile (7.6%) as an upper bound for our consideration of an increase in affordability.

4.78 Other evidence suggests a more cautious approach. Disposable incomes for low income retired households have increased at a slower rate (1.9% over 2012/13 to 2016/17). Further, for the lowest income decile, disposable incomes after housing costs have decreased by 3.7% (although the lowest income quintile has experienced an increase of 6.8%). Another measure of household budgets, total household expenditure has increased more moderately over the same time period (2.2% for the bottom income decile). Postal spending is seasonal, meaning that peaks in postal spending could make issues of affordability more acute at certain times of the year. In addition, our consumer research suggests a minority of households face affordability issues at current prices. A substantial increase in prices could increase the proportion of households at risk of affordability issues with respect to postal services.

4.79 In our judgment, the evidence suggests that an increase of 5% in real terms above the current level of the caps would not render the Second Class products unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable. Royal Mail has stated that it believes prices would remain affordable if the cap was increased in real terms by more than 5%. Whilst noting the difficulty in identifying a specific price as the limit of affordability, the potential for adverse

[150] Royal Mail non-confidential response, Figure 3.

effects on some vulnerable consumers and the evidence of changes since 2013 lead us to judge that a larger increase than 5% should be considered unaffordable at this time.

5. Commercial flexibility

Introduction and summary

5.1 We explained in section 2 that, when imposing tariffs on universal postal services, we are required under section 36(5) of the PSA 2011, in addition to ensuring prices are affordable, to take account of the costs of providing the universal service and to ensure the level of the tariff provides Royal Mail (i.e. the designated universal service provider) with incentives to provide the service efficiently. In addition, and consistent with the overall regulatory framework for postal services also discussed in section 2, we consider it important that the level of the safeguard caps allows Royal Mail to make a reasonable commercial rate of return on the safeguarded products.

5.2 The July 2018 Consultation set out our view that the safeguard caps have afforded Royal Mail sufficient pricing flexibility since their inception to ensure that the safeguarded products make a reasonable commercial rate of return.

5.3 Having considered consultation responses as well as recent market developments, we remain of the view that the headroom of approximately 29% under the basket cap affords Royal Mail sufficient commercial flexibility. Whereas, we consider that the remaining headroom under the standard letter cap (of less than 5%) means that, if left unchanged, Royal Mail's commercial flexibility to increase letter prices would be eroded within 2-3 years.

5.4 In this section, we set out our assessment of the commercial flexibility provided by the safeguard caps at their current levels, how this has changed over time and how this will change under our decisions set out in this statement. To provide context to this assessment, we also consider the costs Royal Mail incurs in providing the safeguarded products and consider the financial sustainability of the universal postal service.

5.5 This section summarises our consultation position and stakeholder responses, and sets out our commercial flexibility analysis, having taken those responses into account and having considered the latest view on sustainability.

Pricing headroom under the safeguard caps

Our consultation proposals

5.6 In the July 2018 Consultation, we found that, while we consider that headroom of approximately 29% under the basket cap affords Royal Mail considerable commercial flexibility, the available headroom under the standard letter cap has diminished over time and now stands at less than 5%. We considered it likely that if the standard letter cap were left unchanged Royal Mail's commercial flexibility to increase prices above inflation would be eroded within 2-3 years.

Stakeholder responses

5.7 Royal Mail believes that the level of the standard letter cap should be increased to provide it with more flexibility to allow it to respond to changes in market dynamics. It noted that the impact of the safeguard caps extends beyond the Second Class products; that First Class stamp and meter products are interdependent on the price of the Second Class products, and should the safeguard caps be set too low, Royal Mail would be limited in its ability to respond to market dynamics using its pricing levers. However, Royal Mail did not propose the level at which it would have sufficient pricing flexibility under the standard letter cap. In addition, Royal Mail also asked what action Ofcom would take in the event that market conditions were to change very quickly. Royal Mail did not comment on the level of headroom currently afforded to it under the basket cap.

5.8 Conversely, MCF considers that the standard letter cap should be retained at its current level and the basket cap should be reduced, so that it can act as a mechanism to encourage efficiency.

5.9 Hermes considers that the fact that Royal Mail is pricing so far below the basket cap suggests that the pricing of the products in the basket is not fully reflective of cost and that the basket cap should be removed altogether.

5.10 The consumer groups[151] broadly agreed with our assessment of commercial flexibility, although they did highlight some affordability concerns in relation to the headroom currently afforded to Royal Mail under the basket cap (see paragraphs 4.31 – 4.59 for our assessment). CAS in particular noted that it considered that the level of the caps would not overly restrict Royal Mail's pricing freedom.

Our assessment

5.11 As set out in section 2, Royal Mail increased prices significantly for most of the safeguarded products in 2012/13 after the removal of the previous price control regime. In subsequent years, Royal Mail has chosen to increase the price of standard letters by a relatively constant amount, with annual price increases broadly in line with RPI. For parcels, the introduction of size-based pricing in 2013 led to a very significant increase in the prices of some parcels products, with some products effectively increasing in price by more than 100%. However, subsequent changes to its size-based pricing policy later in 2013 and in 2014 resulted in some of these products reducing in price. Royal Mail has increased prices of products within the basket cap more conservatively since 2015.

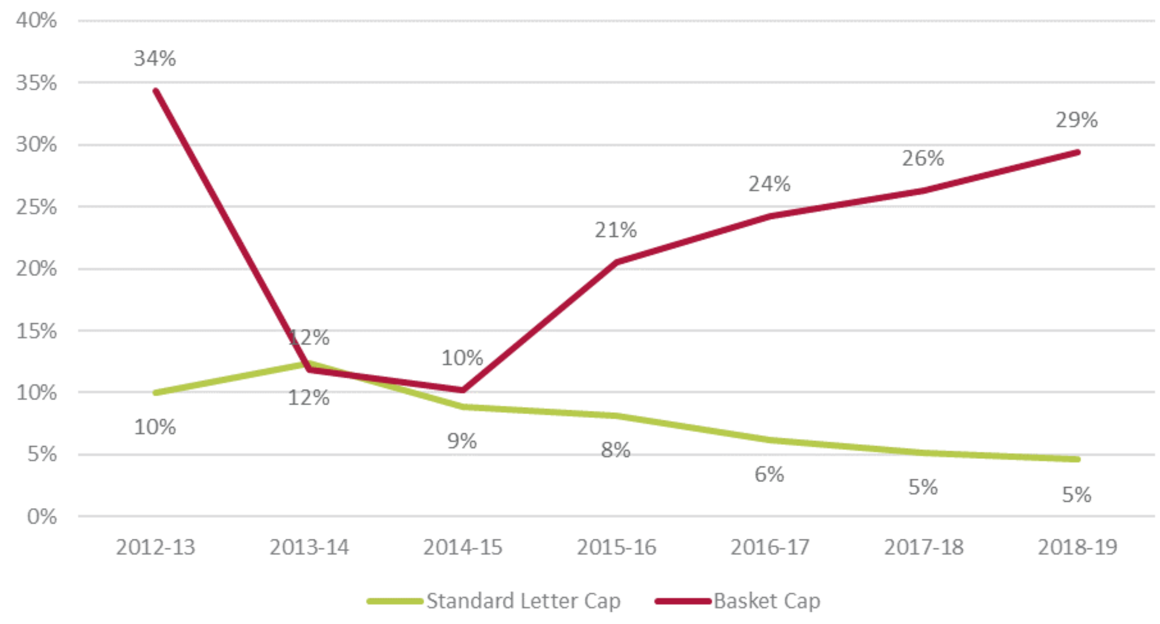
5.12 As a consequence of these pricing decisions, Royal Mail currently has significant headroom under the basket cap. As shown in Figure 5.1, it is currently pricing the products within the basket at approximately 29% below the cap.[152] The amount of headroom afforded by the

[151] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

[152] We note that the safeguard cap is set by reference to our assessment of the affordability of the Second Class products and Royal Mail's commercial flexibility, not by reference to cost, and therefore the level of headroom under the cap is not indicative of the relationship between price and cost.

cap has been increasingly steadily by around 3% year on year due to Royal Mail's pricing policy for these products in recent years. By contrast, the headroom available under the standard letter safeguard cap has reduced each year since 2013/14 as a result of Royal Mail's pricing decisions, with the price of a Second Class stamp now just under 5% below the standard letter cap (58p against a permitted maximum of 60p in 2018/19). This is despite Royal Mail increasing prices by 1-2p per year on average during that period.

Figure 5.1: Percentage headroom under the safeguard caps, 2012/13 to 2018/19



Source: *Second Class safeguard cap compliance submissions as part of Royal Mail Regulatory Financial Reporting Information.*

5.13 Prior to publishing the July 2018 Consultation, we sought information from Royal Mail under our formal powers to understand why it has not chosen to make full use of the flexibility afforded to it under the safeguard caps. Royal Mail's internal documents[153] reveal that political, reputational and regulatory risks are amongst the factors its considers with respect to above inflation price increases for standard letters. This may partly explain why it has chosen to increase prices of standard letters relatively conservatively since 2013/14, rather than pricing to the level of the cap.

5.14 In respect of parcels, there is evidence from Royal Mail's internal documents[154] which suggests it is concerned that overcapacity in the market increases the risk of losing volume to competitors. It is possible that Royal Mail is hesitant to exploit the available headroom under the basket cap given that when it last sought to do this via the introduction of size-

[153] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].
[154] Royal Mail response dated 6 June 2018 to s.55 Notice, [✂].

based pricing in 2013, it resulted in a significantly greater loss of volume than Royal Mail had anticipated.

5.15 As set out in section 3, Royal Mail continues to have a significant degree of pricing power in both single piece large letters and small and medium parcels up to 2kg, and absent regulation, Royal Mail would be able to increase prices materially. We therefore continue to believe that the basket cap is necessary.

5.16 Overall, we believe that the headroom under the basket cap of approximately 29%, which is increasing over time, affords Royal Mail considerable commercial flexibility, which we consider assists in avoiding a material effect on wider financeability. We consider that the significant headroom under the basket safeguard cap ensures that the effect of this cap on Royal Mail's pricing freedom is minimal and does not prevent it from making a reasonable commercial rate of return. Given that the cap works on a volume weighted average basis, Royal Mail has the ability to increase the prices of some products within the cap by even more than 29% should it consider it necessary to do so, provided that price increases are such that the overall level of the cap is not breached. This provides an additional degree of pricing flexibility which a narrower cap might not provide and ensures Royal Mail has the flexibility to change its products to better suit consumer needs as they evolve, should that be necessary. For these reasons, we do not consider there is a need to change the level of the basket cap to allow additional flexibility.

5.17 In response to our consultation, consumer groups[155] expressed concerns that this flexibility could allow Royal Mail to implement substantial price increases for individual products, and that this could create affordability issues. In theory, Royal Mail's pricing power and the structure of the basket cap could give it the ability to make significant price increases for a single product if it left the price of other products unchanged. However, we think it is unlikely that Royal Mail would have the incentive to adopt such a pricing strategy. Royal Mail has commercial incentives to set an efficient structure of prices for products within the basket cap, and its historical pricing behaviour demonstrates the importance it places on maintaining consistent pricing differentials between products. Further, we consider affordability in the round, and a substantial increase in an individual product would be offset by no or little changes in the price of other products in the basket in order to comply with the cap.

5.18 However, the remaining headroom under the standard letter cap is less than 5% and is decreasing over time, despite Royal Mail increasing prices by only 1-2p per year in recent years. If this were left unchanged, and Royal Mail continued to increase prices annually broadly in line with RPI inflation, it is likely that Royal Mail would exhaust the remaining headroom within the next 2-3 years meaning that the cap would have a binding impact on its pricing, and therefore impact Royal Mail's pricing flexibility. We have not seen evidence to suggest that a larger increase to the safeguard cap is required to ensure pricing flexibility, although we do consider that increasing the current standard letter cap as proposed in the July 2018 Consultation may give Royal Mail more flexibility over some

[155] See non-confidential responses to Ofcom's July 2018 Consultation from Citizens Advice, CAS and CCNI.

products in the basket cap, to the extent that Royal Mail maintains price differentials between certain Second Class products, for example by allowing it greater freedom over the level of price increases that could be implemented whilst maintaining a consistent price differential between standard and large letters.

5.19 Overall, we believe that increasing the standard letter cap by 5% affords Royal Mail sufficient commercial flexibility to make a reasonable commercial rate of return, which we consider necessary to avoid a material effect on wider financeability in respect of the universal service. Our analysis shows that raising the level of the standard letter cap will grant Royal Mail sufficient headroom to continue making price increases in line with RPI (the same basis on which it has done over recent years, see paragraph 2.33 above) until 2024. Should market conditions change quickly, nothing in this decision would preclude us from taking prompt action; we consider that in such events we could take steps to respond quickly.

Costs of providing the safeguarded products

Our consultation proposals

5.20 In our July 2018 Consultation, we found that, in general, Second Class standard letters are profitable to Royal Mail, while in aggregate the products within the basket cap have earned a significantly lower return and have been loss making in some years.[156] Taken together however, we observed that the products within the safeguard caps are profitable to Royal Mail, and, in each year, have made a higher rate of return than Royal Mail's Reported Business[157] overall.

Stakeholder responses

5.21 Broadly, stakeholders agree with our analysis of profitability and returns. Royal Mail submitted that, when considering the reasonable commercial rate of return, the analysis should focus on the returns for the Reported Business. It considers that product specific margins in isolation are misleading in network businesses.

Our assessment

5.22 In considering the relationship between Royal Mail's prices for universal services and the costs it incurs in providing these services, we think it is important to take into account the specific features of Royal Mail's network. As the postal industry is a network business with many costs that are shared between different services, the fully allocated costs of individual services depend on the scale and type of other services delivered over the same network. This could cause the costs of providing different services to vary significantly. For

[156] Royal Mail Regulatory Financial Reporting Information.
[157] The Reported Business is part of Royal Mail's business responsible for the universal service, which requires Royal Mail to collect and deliver letters and parcels a minimum number of days a week, at an affordable and uniform price to all UK addresses.

example, if there was a significantly lower volume of business mail (which makes up the majority of items carried over the network), the average cost of all mail products would increase.

5.23 Therefore, in order to ensure that the provision of the universal postal service remains financially sustainable, Royal Mail has incentives to set prices across its different mail products in a manner that maximises overall mail volumes. This, in turn, should help contain costs and prices for all mail users, but it does also mean that the reported accounting margins and profitability across mail services will vary, again possibly significantly.

5.24 We continue to believe that our analysis, which focuses on returns for the Reported Business, whilst also taking into consideration other factors such as product specific margins, is the correct approach. Looking at the profitability of the Reported Business allows us to assess the costs of providing these products, which includes the safeguard products, independently of decisions on cost allocation for individual products. The product specific figures remain relevant because they relate to the profitability of the specific products on which we are imposing regulation.

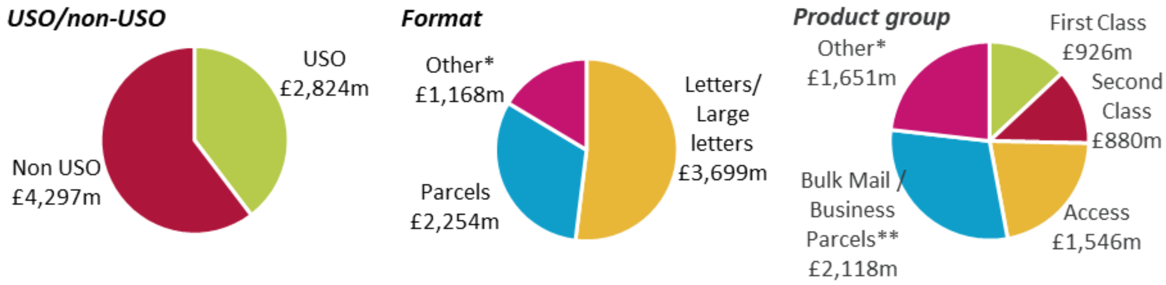
5.25 As set out in the Annual Monitoring Update 2017/18 and in Figure 5.2 below, Royal Mail's Reported Business recorded revenues of £7,121m in 2017/18. £2,824m of this revenue was accounted for by universal services, which equates to approximately 40% of Reported Business revenues. Second Class services accounted for £880m in revenue, including revenue across all payment methods (stamp, meter and account), representing about 12% of revenue. Stamp products which accounted for £[✂] in 2017/18, represent <10% of Reported Business revenue. Within this, Second Class stamp standard letters in scope of the safeguard cap accounted for £[✂][158], or <5% of revenue, and Second Class stamp large letters and parcels in scope of the safeguard cap accounted for £[✂][159], or <5% of revenue.[160]

[158] [✂].

[159] [✂].

[160] On 15 January 2019, Royal Mail submitted that the Second Class stamp large letters and parcels in scope of the safeguard cap accounted for £[✂]rather than £[✂]. We have recalculated that the resulting profit margins set out in paragraph 5.27 below would change from [✂]% to [✂]% for Second Class large letters and small and medium parcels and taken together, the products covered by both of the safeguard caps would make a rate of return of [✂]%, rather than [✂]% in 2017/18. We have considered these revised figures on their face value and do not consider that these changes have an impact on the decisions set out in this statement. We will however, investigate the reasons for the difference in these figures, which were originally submitted to us in the *regulatory financial accounts (confidential) technical appendices for the costing manual (volumes)* and *the Second Class safeguard caps compliance submission (prices)* pursuant to the universal service provider account condition (USPAC) and the Regulatory Accounting Guidelines (RAG).

Figure 5.2: Reported Business revenues split by product group, format and universal service product 2017/18



Source: Royal Mail Regulatory Financial Statements and unaudited submissions from Royal Mail.
**Other mainly consists of unaddressed and international mail.*
*** Includes special delivery.*

5.26 Data provided by Royal Mail as part of its regulatory reporting shows that the costs it incurs in providing the products in scope of the safeguard caps on a Fully Allocated Cost basis in 2017/18 were £[✂], with the cost of standard letters representing £[✂] and £[✂] attributable to large letters and small and medium parcels.

5.27 This resulted in a reported profit margin of [✂]% for Second Class standard letters and [✂]% for Second Class large letters and small and medium parcels. Taken together, the products covered by each of the safeguard caps made a rate of return of [✂]% in 2017/18.

5.28 Royal Mail's Regulatory Financial Reporting Information therefore, in general indicates that Second Class standard letters are profitable to Royal Mail, while in aggregate the products within the basket cap have earned a significantly lower return and have been loss making in some years.[161] Taken together, we observe that the products within the safeguard caps are profitable to Royal Mail, and, in each year, have made a higher rate of return than Royal Mail's Reported Business overall. We consider that our analysis, which focuses on the Reported Business, but which also takes into consideration other factors such as product specific margins is the correct approach as it provides context and allows us to assess the financial position of the safeguarded products in the round.

The financial sustainability of the universal postal service

Our consultation proposals

5.29 In the July 2018 Consultation, we said that the universal postal service is likely to remain financially sustainable in the immediate future, although it faces a number of credible downside scenarios. We also consider that Royal Mail retains incentives to improve efficiency, and we expect Royal Mail's efficiency performance to improve now that it has reached an agreement on pension reform.

[161] Royal Mail Regulatory Financial Reporting Information.

Stakeholder responses

5.30 With the exception of Royal Mail, MCF and Whistl, stakeholders did not make specific comments in relation to the financial sustainability of the universal postal service. In its submission, Royal Mail recognised that it is in a stronger financial position than in 2012 when the safeguard caps were introduced, however noted it is outside the 5-10% EBIT margin range which we consider to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term, it noted that it is [✂]. Royal Mail further notes [✂].

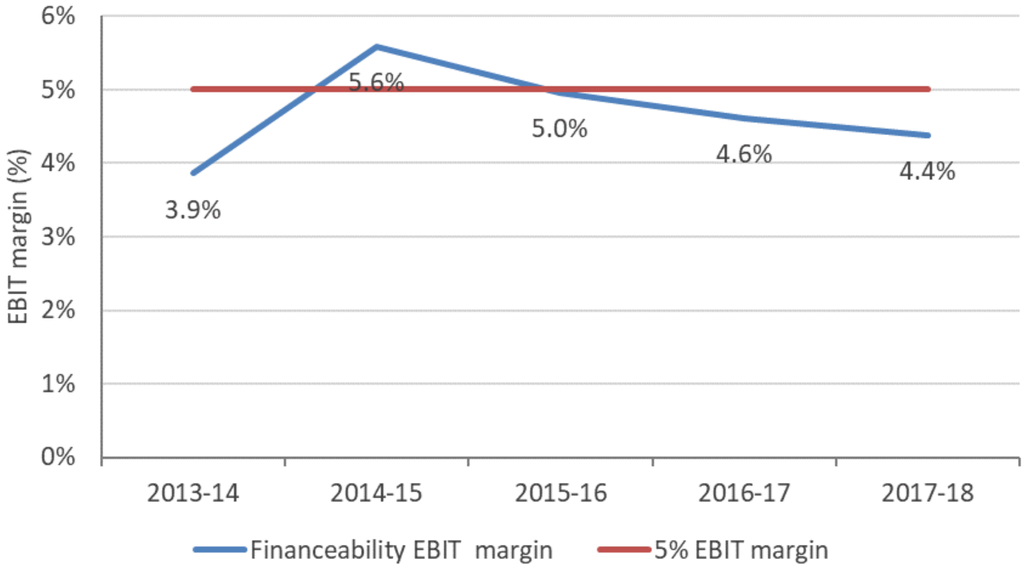
5.31 Whistl raised concerns about Royal Mail's efficiency incentives, believing our proposals do not go far enough. In addition, MCF considers that Ofcom should retain the current level of the standard letter cap and reduce the basket cap in order that the caps become a mechanism for Royal Mail to improve its efficiency. CCNI also stated that Ofcom should monitor the efficiencies made by Royal Mail.

Our assessment

5.32 In our *Annual Monitoring Update on the Postal Market: Financial Year 2016/17 (*"Annual Monitoring Update 2016/17"), we noted that the 2017/18 financeability EBIT margin for Royal Mail's Reported Business fell by 0.2 percentage points from 4.6% in the prior year to 4.4%.[162] This is below the 5% - 10% range that we consider to be consistent with a reasonable commercial rate of return for a financially sustainable universal service in the longer term.[163] Figure 5.3 shows the Reported Business Financeability EBIT margin over the period 2012/13 to 2017/18.

[162] Ofcom, 2017. *Annual Monitoring Update on the Postal Market: Financial Year 2016/17,* paragraph 7.10. https://www.ofcom.org.uk/__data/assets/pdf_file/0019/108082/postal-annual-monitoring-report-2016-2017.pdf.
[163] 2017 Statement, paragraphs 3.54-3.63.

Figure 5.3: Reported Business Financeability EBIT margin, 2013/14 to 2017/18



Source: Royal Mail audited regulatory accounts and unpublished submissions from Royal Mail.

5.33 Despite the fall in EBIT margin to 4.4%, in the Annual Monitoring Update 2017/18, we said that we consider the universal service is likely to remain financially sustainable in the immediate future. Our key reasons are:

- the Reported Business is currently profitable; and
- the financial position and financial health metrics (including credit rating) of Royal Mail Group do not indicate any short-term financial health issues.

5.34 In our Annual Monitoring Update 2016/17[164], we recognised that there are various downside scenarios which have the potential to have a negative impact on the financial sustainability of the universal service. These downside risks included the impact of potential industrial action, affordability of the pension scheme going forward, increased competition for bulk parcels, where Royal Mail competes with other parcel operators for contracts with online retailers, and economic and market downturn.

5.35 Since that time, Royal Mail has concluded a pay and pensions agreement, which we expected would address some of those downside scenarios and result in Royal Mail being better placed to make efficiency improvements in the short to medium term compared to recent years. However, Royal Mail's performance to date in 2018-19, particularly in relation to productivity, has not matched such expectations. In previous years, we considered that continued progress on efficiency was likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service. This is therefore of concern to us, and we will continue to monitor developments closely.

[164] Annual Monitoring Update 2016/17.

5.36 As part of our monitoring programme, we engage regularly with Royal Mail's senior management to understand their perspective on the future on the universal service and plans they have in place to address any performance issues within the part of the business responsible for delivering the universal service.

5.37 Following Royal Mail's trading update in October 2018, in its results for the half year ended 23 September 2018, its CEO stated "it was very disappointing to have to announce in early October our poor UK productivity and cost performance"[165] and that Royal Mail was taking actions to address its current performance issues. In its response to the July 2018 Consultation, Whistl said that market conditions and shareholder discipline do not go far enough to provide efficiency incentives. MCF also argued that we should retain the level of the current standard letter cap and reduce the basket cap in order to encourage efficiencies. In this case, we consider that price regulation is not the best means of incentivising efficiency, and we believe that Royal Mail has strong incentives to improve its efficiency in future to remain financially sustainable. Progress on efficiency is likely to improve the profitability of the Reported Business and help ensure the financial sustainability of the universal service. Further, we believe that market conditions and shareholder discipline continue to provide efficiency incentives.

5.38 With respect to the longer-term sustainability of the universal service, we noted that it is dependent on Royal Mail's ability to grow parcels' revenues sufficiently to offset letters revenue decline and / or remove costs from the business. As part of our monitoring each year, we review Royal Mail's expectations of future performance to form a view of the medium- to long-term outlook of the Reported Business.

Our conclusions on commercial flexibility

5.39 Overall, we observe that the current levels of the safeguard caps have not prevented Royal Mail from making a reasonable commercial rate of return on the safeguarded products. While Royal Mail tends to earn a greater rate of return on standard letters compared to the aggregate rate of return on products within the basket cap, we note that the headroom afforded under the basket cap is such that Royal Mail could have increased the prices of these products in order to improve the profitability of these products.

5.40 We also observe that, while the level of commercial flexibility afforded by the basket cap is significant and growing, the level of flexibility afforded by the standard letter cap has diminished over time and now stands at less than 5%. Should the level of this standard letter cap remain unchanged, it is likely that Royal Mail's commercial flexibility to increase prices in line with RPI inflation (as it has done over recent years) could be eroded within 2-3 years. Our analysis shows that raising the level of the standard letter cap by 5% in real terms will grant Royal Mail sufficient headroom to continue making price increases in line with RPI until 2024.

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[165] Royal Mail, 2018. *Annual Report and Financial Statements 2017-18,* page 4. https://www.royalmailgroup.com/media/10169/royal-mail-group-annual-report-and-accounts-2017-18.pdf.

5.41 As set out in the Annual Monitoring Update 2017/18, we continue to consider that the universal service is likely to remain financially sustainable in the immediate future, given that the Reported Business is currently profitable; and the financial position and financial health metrics (including credit rating) of Royal Mail do not indicate any short-term financial health issues. We do, however, recognise that there are various possible downside scenarios which have the potential to have an adverse impact on the financial sustainability of the universal service, which we will continue to monitor closely.

5.42 Taking all of this together, we believe that our decision on the caps set out in this statement afford Royal Mail sufficient commercial flexibility to make a reasonable commercial rate of return, which we consider is necessary to avoid a material effect on wider financeability in respect of the universal service.

6. Our decision

The case for the retention of the safeguard caps

6.1 As set out in section 2, we concluded in our recent 2017 Statement that it was necessary to retain the safeguard caps on the Second Class products, primarily to ensure vulnerable consumers can access a basic universal service at affordable prices. This was on the basis that Royal Mail is a near monopolist in single piece letters and therefore has the ability to profitably raise prices above the current level of the safeguard caps. In parcels, we noted that Royal Mail's significant share of the single piece parcel sector combined with the extensive Post Office network and strong brand awareness, provides it with a significant degree of pricing power. We therefore concluded that we could not rely on competitive constraints to prevent Royal Mail from raising prices. Our further analysis set out in this statement supports our 2017 Statement conclusion.

6.2 Based on the analysis set out in section 3 (which takes account of all stakeholder comments received in response to the July 2018 Consultation), we remain of the view that competitive constraints are insufficient to prevent Royal Mail from raising the prices of the safeguarded products significantly, and that the safeguard caps continue to be necessary. In addition, we do not consider there has been a change in competitive conditions that would suggest altering the structure or scope of the safeguard caps.

6.3 For these reasons, and in light of our analysis of affordability and commercial flexibility in sections 4 and 5, we continue to believe it is necessary and proportionate to impose safeguard caps on Royal Mail's Second Class stamp products and that the structure and scope of the safeguard caps should remain the same.

Setting the level of the safeguard caps

6.4 We have decided to set the levels of the caps as proposed in our July 2018 Consultation.

6.5 In considering the appropriate level of the safeguard caps, we have taken account of all stakeholder comments received in response to the July 2018 Consultation, and we have been guided, in particular, by our safeguard caps objectives discussed in section 2.

6.6 In summary, we are imposing the following levels:

- **Standard letter safeguard cap:** we propose that this cap should be increased from its current level by 5% in real terms. This would take the effective upper limit of the standard letter cap from 60p currently to 65p, thereafter each year on 1 April, increasing by CPI.
- **Basket safeguard cap:** We do not propose to increase the level of the basket cap, and therefore propose to retain the level of that cap at its current level, thereafter each year on 1 April, increasing by CPI, including on 1 April 2019.

6.7 We consider that these levels are appropriate in meeting our four safeguard caps objectives for the reasons set out in this statement and summarised again below.

6.8 As set out in section 3, we remain of the view set out in our 2017 Statement that competitive constraints are still insufficient to prevent Royal Mail from raising prices for the products under the safeguard caps. Royal Mail remains a near-monopolist in standard letters and large letters, with little threat of new entrants in the market. The risk of triggering a step-change in e-substitution may act to constrain very substantial price increases, but is unlikely to provide protection against smaller price increases, which may nonetheless cause prices of the Second Class products to become unaffordable for some consumers.

6.9 Though there is more competition in the parcels sector, this is limited for small and medium single piece parcels, where Royal Mail retains a very high share of volumes and revenues. Past competitor responses to very large price increases may lead Royal Mail to act cautiously, but this is unlikely to constrain Royal Mail from implementing moderate price increases, which may render the products unaffordable over time.

6.10 As set out in section 4, our judgment is that an increase of 5% in real terms above the current levels of both the letter and the basket caps will not render the price of Second Class services unaffordable for either consumers generally or a significant majority of those we have identified as potentially vulnerable and by extension SMEs. However, as noted above, increases of greater than 5% above the current caps could be considered unaffordable, particularly for some vulnerable consumers.

6.11 Section 5 highlights that we continue to consider the universal service is likely to remain financially sustainable in the immediate future, but that there are various possible downside scenarios which have the potential to impact the financial sustainability of the universal service negatively, which we will continue to monitor closely.

6.12 Taking our analysis together, we believe that increasing the standard letter cap by 5% and maintaining the basket cap at its current level, affords Royal Mail sufficient commercial flexibility to make a reasonable commercial rate of return, which we consider necessary to avoid a material effect on wider financeability in respect of the universal service.

6.13 Increasing the standard letter cap by 5% in real terms takes the effective maximum price that Royal Mail can charge for a Second Class standard letter to 65p from 1 April 2019.[166]

[166] The precise upper limit of the cap will be set at 65.2p from April 2019. This is on the basis that the level of the cap is currently 60.65p. A 5% increase would take the level to 63.7p before inflation, and a further 2.4% increase (representing the rate of inflation for the 12 months ending September 2018) would take the upper limit of the cap to 65.2p (rounded to one decimal place). We note that currently Royal Mail charges in whole pence increments for the Second Class products. Therefore, when describing the level of the cap in this document, we round to the last whole pence (65p).

Modifications to the DUSP conditions

6.14 Under the PSA 2011, Ofcom is under a duty to publish a notification prior to imposing or modifying a regulatory condition such as the DUSP conditions. In the notification relating to our proposed modifications to the safeguard caps we are required to:

- state that we are proposing to modify the condition specified in the notification;
- set out the effect of the modification(s);
- give our reasons for making the proposal; and
- specify the period within which representations may be made to us about our proposal.

6.15 This notification was published in the July 2018 Consultation (see section 6 and Annex 5 to the July 2018 Consultation). We set out below stakeholder comments received on our proposed modifications to the DUSP conditions, together with our assessment and decision on these modifications, which are reflected in our notification published in Annex 1 to this statement.

Our consultation proposals

6.16 In the July 2018 Consultation, we set out our proposed modifications to the DUSP conditions to give effect to our policy proposals. This included amendments to give effect to our proposed changes to the level of the standard letter cap, amendments to the formulae for calculating the basket cap, amending the definition of 'relevant year' to reflect our proposal to introduce the caps without a sunset clause and a clarificatory amendment to make clear that Second Class products captured by the safeguard caps should comprise traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.[167]

Stakeholder comments

6.17 Royal Mail was the only stakeholder that responded to our proposed modifications to the DUSP conditions. Royal Mail submitted that it believes the caps are unnecessary because DUSP Condition 1 ("DUSP 1")[168] already requires the provision of end-to-end services at affordable prices. Further, Royal Mail stated that it did not agree with our proposal to enable the caps to remain in place in perpetuity, rather the caps should remain in place for the duration of the current regulatory framework, until March 2022. Royal Mail also asked what action Ofcom would take in the event that market conditions were to change very quickly.

[167] The notification in Annex 5 of the July 2018 Consultation sets out our proposed modifications to DUSP 2 (the standard letters safeguard cap), which are specified in Schedule 1, and our proposed modifications to DUSP 3 (the basket safeguard cap), which are specified in Schedule 2.
[168] Ofcom, 2013, *DUSP Condition 1,* https://www.ofcom.org.uk/__data/assets/pdf_file/0017/8351/dusp1.pdf.

Our assessment

The safeguard caps continue to be necessary

6.18 We believe that the safeguard caps continue to be necessary, and that the requirement under DUSP 1 to provide end-to-end services at affordable prices is not sufficient to protect vulnerable consumers. DUSP 1 does not contain any measure of what affordability means, nor does it specify how and to whom prices should be affordable.

6.19 Since 2012, we have made clear that it is important to ensure that 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 on-going price increases. To ensure this, we have imposed the safeguard caps on the Second Class products, having regard to our general approach to assessing the affordability of universal postal services for residential consumers and SMEs, as set out in the 2013 Report.

6.20 In our recent 2017 Statement, we found again that the safeguard caps should be maintained in order to ensure that consumers, in particular vulnerable consumers, continue to have access to a universal service at affordable prices. We have also previously found that, if the safeguard caps ensured that a universal service product was affordable to vulnerable consumers, it would be affordable to all residential consumers and SMEs.

6.21 We therefore continue to believe that the safeguard caps remain necessary to provide the necessary protection for vulnerable consumers, and consumers more generally.

Modifications to the standard letter safeguard cap (DUSP 2)

6.22 Currently, the standard letter safeguard cap (DUSP 2) sets the maximum price which Royal Mail (as the designated universal service provider) is permitted to charge for the Second Class standard letter product. For the first year which the cap was in operation (1 April 2012 to 31 March 2013), the maximum price was set at 55p. The cap permits the maximum price to increase by CPI for each subsequent year (from 1 April to 31 March) of the control period, which ends on 31 March 2019. The cap also imposes certain requirements on Royal Mail (as the designated universal service provider) to aid Ofcom's monitoring of the safeguard cap and ensure compliance.

6.23 We continue to believe that this control is appropriate for the Second Class standard letter stamp product. Consumers use significantly more Second Class standard letters than any other Second Class format or price point and consumers tend to have greater awareness of the price of standard letter products compared to large letter and parcel products, reflecting the greater frequency of use of standard letter products. There is therefore benefit in keeping in place a simple cap that allows customers to easily predict future (maximum) prices. We are therefore retaining DUSP 2 as a standalone cap on Second Class standard letters. This has the benefit of being simple to implement and straightforward for all stakeholders to understand.

6.24 Our main modification to the standard letter safeguard cap is to set the new maximum price in relation to Second Class standard letters. The effect of the modification is to introduce the new, increased maximum price of 65.2p in the first year of the control, increasing with CPI thereafter. Additionally, and aside from our new definition of 'Relevant Year' and the addition of a sunset clause (see below), we are implementing some minor textual changes to DUSP 2.[169]

Modifications to the basket cap (DUSP 3)

6.25 The basket cap (DUSP 3) currently imposes on Royal Mail (as the designated universal service provider) a maximum limit on the weighted average increase of the basket of products (large letters and small and medium parcels up to 2kg) falling within the cap by applying the formulae specified in DUSP 3.

6.26 This is on the basis that we consider it appropriate that Royal Mail should have commercial freedom to determine the prices of individual products within this basket, in order to ensure that it has the flexibility to change its products to better suit consumer needs as they evolve, should that be necessary, and to ensure that the impact of the cap on its pricing freedom is minimised subject to prices remaining affordable overall. The maximum price increases by CPI for each year of the control period, until its expiry on 31 March 2019. The cap also imposes certain requirements on Royal Mail (as the designated universal service provider) to aid Ofcom's monitoring of the safeguard cap and ensure compliance.

6.27 We are retaining the level of the basket cap at its current level in real terms, with the maximum price limit increasing by CPI for each year that the cap remains in force. We consider that this sets the basket cap on current prices and products in a transparent way. The main effects of our modifications to the basket cap are:

- The formulae used to calculate the basket cap operate by reference to the 'Base Year', which is currently defined as meaning the period beginning on 1 April 2011 and ending 31 March 2012. We have replaced that definition so that it refers to the period beginning on 1 April 2018 and ending on 31 March 2019.
- We have included a list setting out the base year prices for the products caught by the basket cap. We have amended the formulae to specify that the cap is set at 29.4% above Royal Mail's 2018/19 weighted average prices as at 17 January 2019 (which is the headroom that Royal Mail currently has under the cap) plus the change in CPI between the base year and the relevant year. We have altered the CPI adjustment term in the formulae, to provide for a change to the level of the cap in line with the change in CPI from 2018/19 to 2019/20.

6.28 Additionally, and aside from our new definition of 'Relevant Year' and the addition of a sunset clause (see below), we are implementing some minor textual changes to DUSP 3.[170]

[169] Annex 5 of the July 2018 Consultation contains a marked-up version of our proposed changes to DUSP 2. Our final changes modifying DUSP 2 are found in Schedule 1 to our notification published at Annex 1 to this statement.
[170] Annex 5 of the July 2018 Consultation contains a marked-up version of our proposed changes to DUSP 3. Our final changes modifying DUSP 3 are found in Schedule 2 to our notification published at Annex 1 to this statement.

Modifications to the definition of 'Relevant Year' to introduce a sunset clause in each of the safeguard caps (DUSP 2 and DUSP 3)

6.29 Currently, each of the safeguard caps (DUSP 2 and DUSP 3) define 'Relevant Year' as the period running from 1 April to 31 March for the duration of the control period, which commenced on 1 April 2012 and will expire on 31 March 2019.

6.30 In the July 2018 Consultation, we proposed not to fix an expiration date for each of the caps set out in DUSP 2 and DUSP 3, and we therefore proposed to modify each of the safeguard caps so that neither DUSP condition states a specific date at which the caps will expire. We proposed that the new definition of 'Relevant Year' for each of DUSP 2 and DUSP 3 should refer to any period of 12 consecutive months beginning on 1 April and ending on 31 March.

6.31 In response to the July 2018 Consultation, Royal Mail submitted that it considered that the new regulation should remain in place for the duration of the current regulatory framework, until March 2022.

6.32 In our 2012 Statement, we imposed the regulatory framework for a period of seven years in order to provide a sufficient period of regulatory stability for the management of Royal Mail to fully address the challenges facing the business. We imposed the safeguard caps for the same period, but noted that we would review the level of the cap in two to three years, if required.

6.33 In 2017, we decided to maintain the 2012 approach to regulation for a further five years, on the basis that we thought that a significant change in our regulatory approach would be inappropriate and that maintaining the approach adopted in 2012 would best achieve our duties under the CA 2003 and the PSA 2011.

6.34 Taking account of Royal Mail's submission, we have decided to introduce a sunset clause in each of the safeguard cap conditions (DUSP 2 and DUSP 3) such that they expire on 31 March 2024. As set out in our 2017 Statement, we anticipate reviewing the regulatory regime again in 2022. We did not propose an expiration date for the safeguard caps in the July 2018 Consultation in order to provide flexibility as to the exact timing of reassessing and consulting on any future safeguard caps in light of the anticipated 2022 review. We consider that imposing the safeguard caps until 31 March 2024 will afford us a similar level of flexibility, whilst also giving Royal Mail formal reassurance that the safeguard caps imposed in this statement will expire on 31 March 2024 at the latest.

6.35 However, we note that this introduction of a sunset clause does not preclude us from taking prompt action in the event of material concerns regarding affordability for consumers or Royal Mail's ability to finance the universal postal service; we consider that in such events we could take steps to respond quickly.

Modifications concerning the definition of the stamped products in each of the safeguard caps (DUSP 2 and 3)

6.36 We are modifying each of DUSP 2 and DUSP 3 to clarify that the Second Class products captured by the safeguard caps will comprise traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.

6.37 This clarificatory modification will reflect a practice already taking place; Second Class standard letter and large letter stamps bought online are currently the same price as the same 'traditional' stamp bought over-the-counter at a Post Office and elsewhere, whereas small and medium parcels are currently cheaper to buy online. Moreover, we consider that the safeguard caps should cover both 'traditional' postage stamps and the online variant in order to effectively meet our safeguard caps objectives.

Legal tests

6.38 We consider that our decision (as reflected in our modifications to DUSP 2 and DUSP 3 as set out in Annex 1) satisfies the relevant tests set out in Schedule 6 to the PSA 2011, which must be met where we impose a regulatory condition, namely that it:

- is objectively justifiable;
- does not unduly discriminate against a particular person of a particular description of persons;
- is proportionate; and
- is transparent in relation to what they are intended to achieve.

6.39 We consider that our modifications satisfy these tests. Our reasons are set out throughout this statement. In summary, we consider that those tests are satisfied because:

- **Objectively justifiable** – we believe that our modifications are objectively justifiable, because they seek to ensure that the relevant universal postal services remain affordable, whilst taking account of the costs of providing the service and appropriate incentives for Royal Mail to provide the relevant services efficiently. We also consider that our modifications strike an appropriate balance between our safeguard caps objectives.
- **Not unduly discriminatory** – we believe that our modifications are not unduly discriminatory because they only affect the universal service provider in the UK (i.e. Royal Mail) reflecting its unique position as the sole universal service provider. We also note that the relevant universal postal services captured by the caps are required to be uniformly priced across the UK. In addition, should Royal Mail decide to offer discounts to the price of Second Class stamps (for example, if it chose to offer Christmas discounts for vulnerable consumers), this would not impact the requirement to charge no more than 65p at all other times (between 1 April 2019 to 31 March 2020) and to all other customers.
- **Proportionate** – we believe that our modifications are proportionate because they only impose requirements that we consider are appropriate and necessary to ensure that our safeguard caps objectives (including the requirements set out in section 36(5) of the PSA 2011, as reflected in those objectives) are met, without imposing any undue

burden on Royal Mail in its capacity as the designated universal service provider. In particular, we consider that the safeguard caps are being set at levels which take account of affordability for vulnerable consumers, whilst still ensuring that Royal Mail retains sufficient pricing flexibility to make a reasonable commercial rate of return on the Second Class products.

- **Transparent** – we consider that our modifications are transparent because they clearly set out the obligations we have imposed on Royal Mail in its capacity as the designated universal service provider, particularly by clearly specifying the maximum prices that Royal Mail is permitted to charge for the relevant services captured under the respective caps.

6.40 In reaching our conclusions, we have also addressed in this statement the specific requirements set out in section 36(5) of the PSA 2011 to ensure that, in imposing tariffs on the relevant universal postal services, the prices of these services will be affordable (see section 4). In addition, our conclusion takes account of the costs of providing the universal service, alongside our related policy objective to ensure that Royal Mail is able to make a reasonable commercial rate of return on the safeguarded products (see section 5).

6.41 Our assessment has also considered the extent to which the level of the caps may incentivise efficiency improvements. As we set out in our 2012 Statement, the safeguard caps are not intended, in and of themselves, solely to provide efficiency incentives to Royal Mail. However, we are of the opinion that Royal Mail remains strongly incentivised to pursue efficiency improvements to remain financially sustainable. We believe that Royal Mail would remain incentivised even if it were to choose to immediately make use of all of the additional flexibility afforded by our decisions.

6.42 Finally, in arriving at our decision, we have considered and acted in accordance with our specific duty in section 29 of the PSA 2011 (see section 5 for our assessment of the financial sustainability of the universal postal service) and our general duties in section 3 of the CA 2003. In performing our principal duty under section 3 of the CA 2003, we have had particular regard to those consumers identified as potentially vulnerable and how they may be affected by any decision we may take with respect to the safeguard caps. Taking into account the impact of our conclusions on each of consumers and Royal Mail, we believe that the interests of citizens and consumers will be secured or furthered by our modifications to the safeguard caps.

A1. Statutory notification: Modified Designated USP Conditions 2 and 3

NOTIFICATION OF MODIFICATIONS TO DESIGNATED USP CONDITIONS 2 AND 3 PURSUANT TO SECTION 36 OF, AND IN ACCORDANCE WITH SECTION 53 OF, AND PARAGRAPH 3 OF SCHEDULE 6 TO, THE POSTAL SERVICES ACT 2011

BACKGROUND

(A) On 27 March 2012, following consultation, Ofcom published a statement entitled '*Securing the Universal Postal Service: Decision on the new regulatory framework*'[171] setting out various decisions, including the imposition on Royal Mail of designated USP conditions to make provision for matters set out in sections 36 and 37 of the Act, such as Designated USP Condition 2[172] (the "**initial DUSP 2**").

(B) On 20 July 2012, following consultation, Ofcom published a statement entitled '*Securing the Universal Postal Service: Safeguard cap for Large Letters and packets*'[173] setting out its decision to impose on Royal Mail another designated USP condition to make provision for matters set out in section 36 of the Act, namely Designated USP Condition 3 (the "**initial DUSP 3**")

(C) On 28 March 2013, following consultation, Ofcom published a statement entitled '*Safeguard cap for Second Class Large Letters and packets: Statement on the proposed modifications to the safeguard cap condition (DUSP Condition 3)*'[174] setting out its decision to modify the initial DUSP 3 to correct an error in the drafting to ensure that the condition accurately implemented Ofcom's intended original policy (the "**amended DUSP 3**").

(D) On 18 December 2017, following consultation, Ofcom published a statement entitled '*Regulatory financial reporting for Royal Mail*'[175] setting out its decisions to modify both DUSP 2.2.4 of the initial DUSP 2 (the "**amended DUSP 2**") and DUSP 3.2.4 of the amended DUSP 3 (the "**further amended DUSP 3**"), to require the data necessary to monitor compliance with the Second Class stamp safeguard caps one month after the implementation of any new prices.[176]

(E) On 26 July 2018, Ofcom published a consultation document entitled '*Review of the Second Class Safeguard Caps 2019*'[177] setting out a notification of Ofcom's proposals to modify the amended DUSP 2 and the further amended DUSP 3 contained in Annex 5 to that consultation document (the "**July 2018 Notification**").

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[171] https://www.ofcom.org.uk/__data/assets/pdf_file/0029/74279/Securing-the-Universal-Postal-Service-statement.pdf.
[172] See Schedule 2 to the statutory notification published in Annex 7 of Ofcom's Statement of 27 March 2012: https://www.ofcom.org.uk/__data/assets/pdf_file/0019/71812/annex7.pdf.
[173] https://www.ofcom.org.uk/__data/assets/pdf_file/0015/72042/statement.pdf.
[174] https://www.ofcom.org.uk/__data/assets/pdf_file/0022/50566/statement.pdf.
[175] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/108869/financial-reporting-Royal-Mail.pdf.
[176] See paragraphs 2 and 3 of the statutory notification published in Annex 3 of Ofcom's Statement of 18 December 2017: https://www.ofcom.org.uk/__data/assets/pdf_file/0026/108872/Annex-3.-DUSP-Modification-Notification.pdf.
[177] https://www.ofcom.org.uk/consultations-and-statements/category-1/review-second-class-stamp-safeguard-cap.

(F) A copy of the July 2018 Notification was sent on 26 July 2018 to the Secretary of State in accordance with paragraph 5(1)(a) of Schedule 6 to the Act.

(G) Ofcom invited representations about the proposals set out in the July 2018 Notification by 4 October 2018. Ofcom received responses from eight stakeholders to the July 2018 Notification. Ofcom has considered every such representation. In accordance with paragraph 3(5) of Schedule 6 to the Act, Ofcom has made the decision set out below to give effect, with some modifications (the nature of which are explained in the accompanying statement), to its proposals set out in the July 2018 Notification. The Secretary of State has not notified Ofcom of any international obligation of the United Kingdom for the purpose of Ofcom giving effect to those proposals.

DECISION

1. Ofcom hereby decides, in accordance with section 53 of, and paragraph 3 of Schedule 6 to, the Act and pursuant to its powers under section 36 of the Act, to modify DUSP 2 and DUSP 3 as set out in the July 2018 Notification—and with the modifications that Ofcom has made to the proposals in that Notification—in order to make further provision for matters set out in that section 36 and to impose that DUSP 2 and DUSP 3 on the universal service provider, i.e. Royal Mail.

2. The texts of DUSP 2 and DUSP 3 as modified by our above-mentioned decision are set out in Schedule 1 (for DUSP 2) and in Schedule 2 (for DUSP 3), respectively, to this Notification, which shall take effect on 1 April 2019.

3. The effect of, and Ofcom's reasons for making, this decision are set out in the accompanying statement.

OFCOM'S DUTIES AND LEGAL TESTS

4. Ofcom is satisfied that this decision satisfies the general test in paragraph 1 of Schedule 6 to the Act.

5. In making this decision, Ofcom has considered and acted in accordance with its principal duty in section 29 of the Act and its general duties in section 3 of the Communications Act 2003.

INTERPRETATION

6. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them in this Notification and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Act.

7. In this Notification—

(a) "**Act**" means the Postal Services Act 2011 (c.5);

(b) "**DUSP 2**" means Designated USP Condition 2 referred to in recital (A) to this Notification as amended by the modification referred to in recital (D);

(c) "**DUSP 3**" means Designated USP Condition 3 referred to in recital (B) to this Notification as amended by the modifications referred to in recitals (C) and (D) respectively;

(d) "**Ofcom**" means the Office of Communications; and

(e) "Royal Mail" means Royal Mail Group Ltd, whose registered company number in England and Wales is 04138203.

8. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded;

(b) expressions cognate with those referred to in this Notification shall be construed accordingly; and

(c) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

9. Schedules 1 and 2 to this Notification shall form part of this Notification.

Signed by

M. Gibbs

Marina Gibbs

Competition Policy Director

A person duly authorised by Ofcom under paragraph 18 of the Schedule to the Office of Communications Act 2002

17 January 2019

SCHEDULE 1

DESIGNATED USP CONDITION 2

SAFEGUARD CAP PRICE CONTROL FOR SECOND CLASS STANDARD LETTERS

2.1. Application, Definitions and Interpretation	
DUSP 2.1.1	This designated USP condition ("**DUSP Condition**") shall apply to the universal service provider.
DUSP 2.1.2	In this DUSP Condition— **(a) "First Relevant Year"** means the period beginning on 1 April 2019 and ending on 31 March 2020; **(b) "Consumer Prices Index"** means the index of consumer prices compiled by an agency or a public body on behalf of Her Majesty's Government or a governmental department (which is the Office for National Statistics at the time of publication of this Notification) from time to time in respect of all items; **(c) "CPI amount"** means the amount of the change in the Consumer Prices Index in the period of twelve months ending on 30th September immediately before the beginning of a Relevant Year, expressed as a percentage (rounded to two decimal places) of that Consumer Prices Index as at the beginning of that first mentioned period; **(d) "Relevant Year"** means any period of 12 consecutive months beginning on 1 April and ending on 31 March, the last period of which begins on 1 April 2023 and ends on 31 March 2024; **(e)** "**Second Class Post"** means a service of sending a stamped item by post where the universal service provider aims to deliver the item no later than the third working day after it was posted. For the purposes of this DUSP Condition, it does not include services which are not universal services or which include charges in respect of additional registered, insured, tracked or recorded services; and **(f) "Standard Letter**" means a letter weighing up to 100 grams that is no more than 5 millimetres thick and up to 240 millimetres in length and up to 165 millimetres in width.
DUSP 2.1.3	For the purpose of interpreting this DUSP Condition— **(a)** except in so far as the context otherwise requires, words or expressions shall have the meaning assigned to them in DUSP 2.1.2 above and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose of Part 3 of the Postal Services Act 2011;

	(b) headings and titles shall be disregarded; **(c)** expressions cognate with those referred to in this DUSP Condition shall be construed accordingly; **(d)** the Interpretation Act 1978 (c. 30) shall apply as if this DUSP Condition were an Act of Parliament; and **(e)** references in this DUSP Condition to "stamped" postal items (or mail) are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid, including where the postage has been sold online.
2.2 Maximum price to be charged for specified services	
DUSP 2.2.1	This DUSP Condition specifies the maximum amount that the universal service provider shall be permitted to charge for the service of sending a single Standard Letter by Second Class Post. In the First Relevant Year, the maximum amount that the universal service provider shall be permitted to charge for sending a single Standard Letter by Second Class Post shall be the amount of 65.2 pence.
DUSP 2.2.2	For each Relevant Year after the First Relevant Year the maximum amount that the universal service provider shall be permitted to charge for sending a single Standard Letter by Second Class Post shall be the maximum amount that the universal service provider was permitted to charge for that service in the previous Relevant Year increased by the CPI amount.
DUSP 2.2.3	Where the universal service provider makes a material change (other than to a charge) to any product or service which is subject to this DUSP Condition or there is a material change in the basis of the Consumer Prices Index, DUSP Conditions 2.2.1 and 2.2.2 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For these purposes, a material change to any product or service which is subject to this DUSP Condition includes the introduction of a new product or service wholly or substantially in substitution for that existing product or service.
DUSP 2.2.4	The universal service provider shall record, maintain and supply to OFCOM in writing, within one month of the coming into effect of any price increase, the data necessary for OFCOM to monitor compliance of the universal service provider with the requirements of this DUSP Condition.
DUSP 2.2.5	This DUSP Condition shall not apply to such extent as OFCOM may direct.
DUSP 2.2.6	The universal service provider shall comply with any direction OFCOM may make from time to time under this DUSP Condition.

Table of terms defined in the Postal Services Act 2011

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Defined term	***Section of the Postal Services Act 2011***
OFCOM	*90*
universal service provider	*65(1) and Schedule 9 paragraph 3(3)*

SCHEDULE 2

DESIGNATED USP CONDITION 3

SAFEGUARD CAP PRICE CONTROL FOR SECOND CLASS LARGE LETTERS AND RELEVANT PACKETS

3.1. Application, Definitions and Interpretation	
DUSP 3.1.1	This designated USP condition ("**DUSP Condition**") shall apply to the universal service provider.
DUSP 3.1.2	In this DUSP Condition— **(a) "Base Year"** means the period beginning on 1 April 2018 and ending on 31 March 2019; **(b) "Basket"** means the services of sending Large Letter and Relevant Packet products by Second Class Post that the universal service provider currently provides; **(c) "Consumer Prices Index"** means the index of consumer prices compiled by an agency or a public body on behalf of Her Majesty's Government or a governmental department (which is the Office for National Statistics at the time of publication of this Notification) from time to time in respect of all items; **(d) "Large Letter**" means a letter weighing up to 750 grams that is no more than 25 millimetres thick and up to 353 millimetres in length and up to 250 millimetres in width. **(e)** "**Relevant Packet"** means any item greater than a Large Letter in dimensions but weighing no more than 2kg; **(f) "Relevant Year"** means any period of 12 consecutive months beginning on 1 April and ending on 31 March, the last period of which begins on 1 April 2023 and ends on 31 March 2024; and **(g)** "**Second Class Post"** means a service of sending a stamped item by post where the universal service provider aims to deliver the item no later than the third working day after it was posted. For the purposes of this DUSP Condition, it does not include services which are not universal services or which include charges in respect of additional registered, insured, tracked or recorded services.
DUSP 3.1.3	For the purpose of interpreting this DUSP Condition— **(a)** except in so far as the context otherwise requires, words or expressions shall have the meaning assigned to them in DUSP 3.1.2 above and otherwise any word or expression shall have the same meaning as it has been ascribed for the purpose

	of Part 3 of the Postal Services Act 2011; **(b)** headings and titles shall be disregarded; **(c)** expressions cognate with those referred to in this DUSP Condition shall be construed accordingly; **(d)** the Interpretation Act 1978 (c. 30) shall apply as if this DUSP Condition were an Act of Parliament; and **(e)** references in this DUSP Condition to "stamped" postal items (or mail) are references to traditional postage stamps or other types of labelling affixed to such items to indicate the amount of postage paid including where the postage has been sold online.
3.2 Maximum price to be charged for specified services	
DUSP 3.2.1	This DUSP Condition specifies the maximum prices that the universal service provider shall be permitted to charge for the group of services within the Basket in each Relevant Year.
DUSP 3.2.2	In each Relevant Year (which is represented as "*t*" in the formulas below), the price of services in the Basket shall be set such that— $$\frac{\sum_i P_{i,t} V_{i,t-2}}{\sum_i V_{i,t-2}} \leq \left(\frac{\sum_i P_{i,0} V_{i,t-2}}{\sum_i V_{i,t-2}} \times X_t\right)$$ where— $$X_t = (1 + 29.4\%) \times \frac{CPX_t}{CPX_0}$$ ***Pi,t*** is the maximum price charged for sending a single Large Letter or Relevant Packet by Second Class Post in Relevant Year *t*; ***Vi,t-2*** is the volume delivered by the universal service provider in the twelve months to March in the year *t*-2 for each type of a Large Letter or Relevant Packet by Second Class Post (which is represented as "*i*") as calculated by the universal service provider using a reasonable methodology which has been disclosed to OFCOM; ***Pi,0*** is the price as listed in the Appendix to this DUSP Condition charged for

	sending a single Large Letter or Relevant Packet by Second Class Post as at 17 January 2019 (which is represented as "*0*"); ***CPX0*** is the Consumer Prices Index for the month of September immediately before the beginning of a Base Year (rounded to one decimal place), the figure of which is 104.1; and ***CPXt*** is the Consumer Prices Index for the month of September immediately before the beginning of a Relevant Year (rounded to one decimal place).
DUSP 3.2.3	Where the universal service provider makes a material change (other than to a charge) to any product or service which is subject to this DUSP Condition or there is a material change in the basis of the Consumer Prices Index, DUSP Conditions 3.2.1 and 3.2.2 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For these purposes, a material change to any product or service which is subject to this DUSP Condition includes the introduction of a new product or service wholly or substantially in substitution for that existing product or service listed in the Appendix to this DUSP Condition.
DUSP 3.2.4	The universal service provider shall record, maintain and supply to OFCOM in writing, within one month of the coming into effect of any price increase, the data necessary for OFCOM to monitor compliance of the universal service provider with the requirements of this DUSP Condition.
DUSP 3.2.5	This DUSP Condition shall not apply to such extent as OFCOM may direct.
DUSP 3.2.6	The universal service provider shall comply with any direction OFCOM may make from time to time under this DUSP Condition.

Appendix

	Description of postal item product or service	**Maximum price as at 17 January 2019**
1.	Second Class Post, Large Letter, 0-100 grams	£0.79
2.	Second Class Post, Large Letter, Second Class Post, 101-250 grams	£1.26
3.	Second Class Post, Large Letter, 251-500 grams	£1.64
4.	Second Class Post, Large Letter, 501-750 grams	£2.22
5.	Second Class Post, Relevant Parcel not exceeding length 45cm x width 35cm x depth 16cm (small parcel), 0-2kg	£2.95

6.	Second Class Post, Relevant Parcel not exceeding length 45cm x width 35cm x depth 16cm (small parcel), 0-2kg, (sold online only)	£2.85
7.	Second Class Post, Relevant Parcel not exceeding length 61cm x width 46cm x depth 46cm (medium parcel), 0-2kg	£5.05
8.	Second Class Post, Relevant Parcel not exceeding length 61cm x width 46cm x depth 46cm (medium parcel), 0-2kg, (sold online only)	£4.95

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OFCOM	*90*
universal service provider	*65(1) and Schedule 9 paragraph 3(3)*