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# Parcels market analysis and implications for the scope of the access regime

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## Executive summary

Royal Mail (RM) has commissioned Oxera to undertake a market analysis of the parcels delivery industry in the UK. The report is intended as an input into Ofcom's 2021 Call For Inputs as part of its review of postal regulation.<sup>1</sup> The report also covers the implications for any access regime for parcels and fulfilment large letters (FLLs).

The analysis focuses on bulk B2X<sup>2</sup> deliveries, as access operators would be unlikely to use access services for anything other than bulk contracts. However, the analysis also touches on wider developments within the parcels industry, where appropriate, to fully understand competitive dynamics and trends. The analysis also includes fulfilment items that are small enough to fit within the large letter dimensions—a departure to an extent from Ofcom's definition of a parcel.<sup>3</sup> We find that there are no substantial demand- or supply-side differences between a FLL and a parcel that is small enough to fit through the letterbox.

While the analysis focuses on developments since the last time Ofcom reviewed regulation in the postal industry (2016–17), we also take a longer-term view where appropriate. As the implications of the COVID-19 pandemic will take time to be fully understood, the analysis focuses primarily on the period up to 2019. However, while recognising the uncertainty, evidence on the impact of the pandemic is also presented and used to inform our forward-looking view of the sector.

### Market context

There has been a rapid increase in demand for fulfilment services, turbo-charged by the COVID-19 pandemic. While this acceleration has been driven by the extensive lockdown periods of mandated closures of brick-and-mortar retail outlets, demand is not expected to return to pre-pandemic levels, as indicated by a number of permanent exits from the retail environment.<sup>4</sup>

A range of consumers have discovered the ease and convenience of online shopping and home delivery, and demand has increased across the board, including across all types of delivery. According to survey evidence from McKinsey and Forrester, during the lockdown period:

- 10% of consumers have tried grocery delivery, 10% have tried curbside pickup, and 6% have tried BOPIS<sup>5</sup> for the first time;<sup>6</sup>
- 40% of customers said that they are buying more things than they normally do online;<sup>7</sup>
- 33% do not plan to resume normal shopping habits immediately, and 55% say they plan to slowly return to shopping in stores.<sup>8</sup>

This demand has given entry and expansion opportunities to providers of delivery services, including RM. Investment levels are high and carriers can

<sup>1</sup> Ofcom (2021), 'Review of postal regulation', Call for inputs, 11 March.

<sup>2</sup> Business to consumer (B2C) and business to business (B2B).

<sup>3</sup> In its Annual Monitoring Report on the Postal industry.

<sup>4</sup> For example, Debenhams, Arcadia Group.

<sup>5</sup> Buy Online Pick-up In-store.

<sup>6</sup> McKinsey UK Consumer Sentiment Survey, April/May 2020.

<sup>7</sup> Forrester Analytics Consumer Technographics® COVID-19 Survey.

<sup>8</sup> Forrester Analytics Consumer Technographics® COVID-19 Survey.

see the opportunity to expand across segments. As the market has become more competitive over time and customers' expectations have increased, carriers have been innovating to remain competitive, and products that were initially viewed as premium have become the norm, resulting in ever-increasing service quality and falling prices.

### **Assessment of competition for bulk B2X deliveries**

This analysis applies the standard tools and criteria used by competition authorities for defining relevant markets and for assessing the level of competition, taking into account industry-specific factors to adapt the approach.

The report presents evidence of a highly competitive industry where numerous end-to-end operators have challenged and continue to challenge RM across the full spectrum of segments, including premium B2C services (where DPD is the among the strongest contenders), economy B2C services (where Hermes and Yodel are prominent players alongside RM), B2B (where RM has not been traditionally as strong) and C2X, including returns (where competition is primarily driven by RM, Hermes and Yodel). In addition, the recent entry of Amazon Logistics has been highly disruptive and poses a direct challenge to RM and the other traditional parcel operators.

### **Market shares**

Market shares are part of the standard toolbox to assess competitive conditions. However, market shares alone are not informative of whether competition is working to the benefit of consumers. An operator can have high shares and still not be able to exercise significant market power if senders have countervailing buyer power and/or barriers to entry or expansion across segments are low.

In such situations, even if a player retains high market share, it would be the result of competing strongly against other (current and potential) competitors. If that is the case, one would typically also find evidence of positive 'outcomes' for consumers, in the form of good-value products. The parcels industry is indeed an industry in which all of these conditions are observed.

Nonetheless, the evidence also shows that RM has lost significant share in B2C deliveries over 2016–19 ([<]pp), both as a direct result of Amazon's insourcing of volumes as well as competitors' ability to outpace RM in capturing market growth in B2C deliveries. As at 2019, it is estimated that RM (excluding Parcellforce and RM Access) had a share of [<]% of volumes (and just [<]% of revenues) in overall B2X deliveries.

### **Countervailing buyer power**

There is significant evidence to show that the parcels industry features many large senders who hold and are able to exercise significant buyer power.

- The prevalence of multi-sourcing among large retailers indicates that their procurement strategies are sophisticated and that they take full advantage of the wide range of options available for the best overall deal. There are opportunities for both existing and new carriers to win volumes by either offering clients a full range of products and delivery methods or by specialising in specific types of delivery, products, types of items, and so on.
- Switching is a common occurrence, particularly for B2C deliveries, with churn rates of 20% or more. 81% of senders report having switched at least

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once within three years, and 25% report having switched in the last year. Customer retention is therefore a significant challenge which requires carriers to ensure they are offering competitive rates and high standards of service.

- Data on RM customers from a range of sources indicates that deliveries on behalf of larger-volume senders correlate with lower prices, which indicates that retailers are able to exercise significant buyer power. This is evident from an analysis of volumes delivered by RM on behalf of Amazon and other top UK retailers, as well as data on ongoing and past negotiations with bulk B2X senders.

### **Barriers to entry and expansion**

Parcels delivery is a network business, which implies that a supplier's facilities are shared across its customers and therefore the marginal cost of adding new customers is generally low.

While this means that a minimum scale is required to have an efficient end-to-end network, there are ways to achieve such scale in a relatively capital-light way. Indeed, there are currently 13 carriers that operate national networks in the UK, with sophisticated operations covering the full spectrum of deliveries (B2X and C2X, Next day (ND) and later than next day (LTND), premium vs economy, small/light vs large/heavy).

Crucially for these carriers, barriers to expansion are low. Indeed, we observe significant expansion and supply-side substitution across segments as carriers look to offer a more complete range and are constantly on the lookout for profitable opportunities to increase utilisation of their shared facilities.

In addition, many operators have adopted flexible employment models, which implies that capacity (particularly in delivery) can be scaled up or down to accommodate demand relatively quickly and easily. Although automatic sortation capacity can create bottlenecks, the COVID-19 pandemic demonstrates how responsive carriers have been to an unexpected surge in demand (e.g. by setting up manual sortation processes).

The evidence also shows that parcel operators have invested heavily to keep up with growth in the industry and to improve their position against competitors, increasing their sortation and delivery capacity and significantly expanding the network of pick-up and drop-off (PUDO) points (e.g. parcel shops). This is consistent with an industry where incentives to expand are high and barriers are relatively low.

These findings are also consistent with evidence that many parcel operators are active across all segments (B2X and C2X, ND and LTND, premium and economy) and that movements across these have been significant. Such mobility was facilitated historically by significant levels of spare capacity, which, all else equal, is expected to strengthen competition and put downward pressure on prices.

As a result of the COVID-19 pandemic, utilisation levels are higher than in the past and are expected to remain high in the short term. However, despite uncertainty on the level of post-pandemic demand, it is reasonable to expect, and current evidence indicates, that in the medium term, operators will invest in permanent and efficient capacity to meet the demand and improve their competitive position. This is because this is an industry where a degree of

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spare capacity is necessary to operate at high standards of service during peak periods.

### **Amazon Logistics' entry**

The recent experience of Amazon starting its own parcel delivery operations through Amazon Logistics exemplifies the vibrancy and challenge of the competitive environment to which RM and other carriers are exposed.

Since 2013, Amazon Logistics' entry has disrupted the industry dramatically. The total volume of parcels delivered by Amazon Logistics has increased at a rate of [X]% year-on-year, making it the second largest B2X carrier within a short span, achieving a volume share of [X]% in 2019.

This achievement is a result of Amazon's unique combination of a flexible and highly efficient operating structure, its position of leadership in technology and innovation (AI, optimisation software, use of robotics) and economies of scale and density facilitated by vertical integration with the largest online retailer in the UK (estimated to represent at least a third of all e-commerce volumes). This means that Amazon is likely to be one of the most efficient parcel carriers, all the while championing the highest standards of service for consumers (e.g. in terms of speed and convenience).

This combination of strengths has enabled Amazon to deliver all types of parcel for its own retail business and on behalf of its marketplace sellers, diverting significant volumes away from RM and other carriers. Its recent launch of 'Shipping with Amazon' signals a new stage in its development as it starts to compete head-to-head with RM and other UK carriers for profitable opportunities to deliver parcels and FLLs on behalf of third-party sellers.

### **Outcomes**

The evidence on outcomes indicates that operators are constantly improving and innovating to differentiate themselves and win share, offering a growing range of high-quality delivery options at increasingly affordable prices. This is consistent with the view that the parcels industry is dynamic and effectively competitive, working to the benefit of consumers. Specifically, we find that:

- all carriers have been innovating their processes to reduce unit costs and be able to deliver any type of parcel to the final consumer at competitive prices. This has resulted in increasing sortation efficiency and innovative strategies to reduce the cost of the final mile (e.g. route optimisation software, use of apps to reduce the risk of failed deliveries);
- new business models have emerged, such as those of aggregators, and a growing network of parcel shops and lockers has sprung up, offering ever-more convenient alternatives to home deliveries, enabling volume consolidation and lower unit costs and providing an increasing range of options;
- as the large retailers have become more sophisticated and demanding, with Amazon leading the way, parcel senders have required carriers to guarantee increasing levels of flexibility, speed and choice to their customers. The result is that all parcel operators offer a wide range of options for delivery and that products that were traditionally viewed as premium have now become the norm (e.g. ND, sophisticated tracking);

- at the same time, there is consistent evidence from a range of sources pointing to long-running and persistent pricing falls in the industry, as well as modest (and declining) levels of profitability. This applies to both RM and its competitors. For example, RM [X] in recent years,<sup>9</sup> with [X]. At the same time, [X] despite a significant shift to higher-value tracked products. This indicates strong pricing pressures driven by competition and that efficiency gains were passed onto consumers in the form of lower prices.

There is also evidence of competitive pressure and contestability affecting all types of B2X deliveries, including for the lightest and smallest letter-boxable items.

### Evidence on 'lightweight' items

In its Call for Inputs, in relation to access in parcels, Ofcom reports that some access operators have suggested that RM should be required to provide a lightweight parcels access service 'given its market position in the lightweight bulk segment of the market'. End-to-end parcel operators on the other hand argue that access in parcels would harm competition and innovation in the parcels sector.<sup>10</sup>

Ofcom commented that:

We are mindful of these potential harmful effects that a mandated parcels access service could have on competition and innovation in the parcels market. [...]. Unless we find clear evidence suggesting that it is appropriate to mandate a parcels access service in order to promote efficiency, promote effective competition, and confer significant benefits on postal users, we are not currently minded to intervene in the parcels market. **However, we would be particularly interested in any stakeholder evidence which supports or opposes the mandation of a lightweight access parcels service** [emphasis added]

Within this context, we report the evidence from the market analysis specifically relating to lightweight items, showing that there are no market failures that would justify mandating access for these items.

### Assessment of competition for 'lightweight' items

As discussed earlier in this summary, this report presents evidence of a highly competitive industry in which many end-to-end operators have challenged and continue to challenge RM across the full spectrum of segments.

In a competitive industry, we expect to find that operators have specific strengths that are reflected in their relative positions within different segments. Indeed, our analysis of cost drivers indicates that there are a variety of factors that are capable of influencing the unit costs of delivery for different providers, with differences in business and operating models resulting in areas of relative strength and weakness.

While RM relies on its foot delivery network to deliver small parcels cost-effectively, other operators have other advantages over RM. For example, Amazon Logistics benefits from its upstream integration with the largest UK retailer as well as from its leadership in information and data technology; while Hermes relies, among others, on its cheaper and more flexible employment model.

<sup>9</sup> Domestic account parcels.

<sup>10</sup> Ofcom (2021), 'Review of postal regulation', Call for inputs, 11 March, para. 7.39.

In addition, as discussed above, parcel carriers have been highly innovative and have made significant investments to strengthen their overall position and reduce costs across the pipeline, with a focus on innovations to improve their ability to deliver any type of parcel to the door. Market growth and the associated increase in scale is also supporting better economies of density for collection and delivery, broadening the types of customers that carriers are able to serve (e.g. going beyond the bulk senders).

As a result, competition and contestability in the parcels industry is increasingly broad, and discontinuities in competitive conditions delineating distinct market segments are blurred. This dynamic has had an appreciable impact on competition for delivery of all types of parcels, including the lightest/smallest items.

Notwithstanding the above, we find that, to the extent that bulk B2X deliveries can be segmented across different types of items, volumetrics rather than weight, would be a more appropriate segmentation. This is because [REDACTED]:

- letter-boxable parcels (including large letters), [REDACTED];
- non-letter-boxable foot-deliverable parcels, [REDACTED]; and
- non-letter-boxable van-deliverable items, [REDACTED].

While costs can also differ by customer size, with the largest senders requiring lower unit costs to serve, we have not found sufficient evidence of a clear cost break to conclude that there are separate economic markets for bulk senders of different sizes.

Also, our analysis of cost drivers demonstrates that segmenting the market by weight steps such as 0–1kg or 1–2kg would be artificial. This is because, to the extent that supply conditions vary across these segments, this is a function of the proportion of small letter-boxable parcels and FLLs within those weight segments (which is significant for items weighing less than 1kg, while there are fewer letter-boxable items that weigh more than 1kg).

In relation to competition within each volumetrics segment, we find as follows.

### **Foot-deliverable parcels**

RM does not appear to have an appreciable cost advantage for foot-deliverable items against its closest competitors, particularly for bulk B2X senders, and irrespective of weight ([REDACTED]).

This is confirmed by a cost comparison exercise between Hermes and RM and evidence from bulk 0–1kg consignments under negotiation indicating that RM would [REDACTED] if it agreed to deliver the items at the price solicited by the client (in competition with providers such as Hermes, Yodel and DPD).

Foot-deliverable items represented [REDACTED]% of RM's total parcels as at 2019 and we estimate that RM's total share for delivery of these items was [REDACTED]% in 2019, [REDACTED] from [REDACTED]% in 2016.

### **Van-deliverable parcels**

RM is likely to be at a cost disadvantage against its competitors for delivery of larger van-deliverable items. This is a direct result of its business model, which

requires splitting deliveries between the foot delivery network and a network of van delivery, reducing capacity utilisation of the latter.

These items represented [X]% of RM's total parcels as at 2019 and are [X]kg in weight. We estimate that RM's total share for delivery of these items was [X]% in 2019, slightly [X] from [X]% in 2016.

### Letter-boxable parcels

While RM is likely to have a degree of cost advantage over Hermes for letter-boxable parcels and FLLs, we find no evidence that RM is able to exercise significant pricing power for bulk delivery of these items, given the constraints imposed by countervailing buyer power, contestability and low barriers to expansion.

- Countervailing buyer power—there is evidence that a significant proportion of senders hold buyer power. These operators will use RM to access the lowest available rates for specific products without RM being able to exercise pricing power. For example, in 2019–20, [X].
- Contestability and low barriers to expansion—as discussed above, the marginal costs of sending additional parcels are low if capacity is not constrained. As a result, while items that can fit within the large letter dimensions will give senders access to an affordable market-leading product, the evidence indicates that RM faces competition and growing pressures in this segment.
  - other operators deliver small fulfilment items as small parcels as part of bulk B2X contracts, and their ability to do so at attractive prices is improving. Hermes, for example, has recently introduced affordable bulk 'postable' rates for business customers.
  - Amazon Logistics has been able to in-source delivery of a large number of light and letter-boxable items, taking volumes directly away from RM, and increasingly so over time. This means that, in these cases, [X] and that the segment is highly contestable.
  - RM does not have a clear cost advantage if items are delivered and procured as baskets (as they often are), even where the proportion of FLLs in those baskets is relatively high. This implies that bulk retailers could find equally affordable alternatives in the market for such baskets.

As a result, while RM currently delivers the majority of letter-boxable items (estimated at [X]% in 2019, including an estimate of Amazon Logistics' volumes), we estimate that its share has declined by over [X] since 2016. When measured in weight (0–1kg), RM retains a larger proportion of deliveries (estimated at [X]% in 2019), but its share has also declined by around [X] over the same period.

Finally, the evidence on outcomes for consumers is consistent with the view that RM is facing significant competitive pressure, constraining its pricing and margins. In particular:

- at the product level, over the last four years, there have been [X] for RM's ND and LTND tracked parcels (RM Tracked 24 and RM Tracked 48) across the board, including the lowest weight steps. At the same time, [X], with overall FAC margins for these products being [X].

- ND and LTND untracked parcels (RM 24 and RM 48 parcels) have seen some [X]. At the same time, [X] and overall margins were [X];
- while RM is able [X] for FLLs than for any other bulk product, these only represent [X] of its bulk B2X volumes and only [X]% of its revenues. RM's relative position is consistent with it having a comparative advantage in the context of a diversified competitive environment. Crucially, [X] since 2017–18 and there is no evidence of material pricing power, as average revenues for FLLs have [X];
- finally, aggregating all ND and LTND bulk B2X products (including FLLs) by weight step shows that, although RM's [X], the evidence overall confirms that RM has limited to no pricing power across the board. In particular:
  - for ND products, RM makes [X];
  - for LTND products, [X].

### **Overall conclusion on market analysis**

Collectively, the evidence presented above strongly indicates that the parcels industry is working well for consumers, as carriers innovate and deliver increasing quality and range, with efficiency gains passed on in the form of affordable and declining prices.

The evidence also confirms that, despite having a delivery cost advantage for the smallest letter-boxable items, RM is facing competition and growing pressure in this segment, with no evidence of significant market power. On the contrary, RM's offering of a good-value market-leading product for items that can fit within the large letter dimensions adds to the range of options available to senders. This is part of the virtuous dynamics, whereby at the same time as different carriers specialise in their respective areas of strength, competitive pressures, driven by contestability and supplier mobility, increasingly affect all segments, acting to drive innovation and constrain carriers' pricing behaviour.

From a forward-looking perspective, despite short-term capacity constraints due to the uncertainty of the ongoing pandemic, competition is expected to intensify further in the letter-boxable segment (and the wider industry) over the medium term, as online retail sales continue to grow and RM's competitors increase in scale/density, further innovate to reduce delivery costs (as they have done historically), and continue to look for opportunities for profitable expansion. Operators such as Hermes, for example, are constantly improving their offerings and contesting all types of B2C contracts as a result.

In addition, in this context, Amazon is likely to find it cheaper and easier to deliver an increasing number of items of all sizes, including small and letter-boxable ones. Amazon has a very efficient operational and sortation model with resulting high capacity and standards of service. Therefore, it has the incentive and ability to further expand at a rapid pace, as it looks to go beyond in-sourcing of its own deliveries to capture profitable third-party volumes and establish its Shipping with Amazon service. As a result, Amazon represents a continued and tangible competitive threat to RM's offerings.

### **Implications for the appropriate scope of access**

The evidence from the market analysis presented in this report suggests that there are no market failures that would justify:

- mandating access for lightweight parcels services;
- retaining access conditions for FLLs. In light of the current market environment and future prospects for more intense competition in this segment, retaining current regulation would be equivalent to imposing an access condition on small letter-boxable parcels.

Specifically, the evidence indicates that mandating access to parcels, including small letter-boxable parcels (falling within the dimension of a large letter) is not needed to promote either effective competition or efficiency, or to confer significant benefits on users of postal services.

As noted by Ofcom in the Call for Inputs, at the time of the last review, Ofcom had already concluded that there was no evidence to suggest that it should review whether it would be appropriate to impose any additional forms of access, noting that the bulk parcels sector overall was becoming increasingly competitive.<sup>11</sup>

At the time, Ofcom also concluded that: ‘the challenges Royal Mail faces in the letter and parcel sectors mean that it has strong incentives to improve its efficiency in future to remain financially sustainable. [...] we consider that the market conditions it faces incentivises it to pursue these efficiencies’.

Competition has intensified further since then, and the arguments against parcel access mandation are therefore all the more compelling now.

Specifically, the evidence indicates that current end-to-end competition already provides alternative and effectively competitive services to RM’s delivery of all types of parcels and FLLs, and no access requirements are therefore needed to promote competition.

Competition as it stands also provides sufficient incentives for RM to pursue cost efficiencies within a reasonable time frame and such incentives are likely to become even stronger in the future as competition further intensifies and Amazon continues to disrupt the market.

Indeed, pressure on RM has resulted in a number of programmes and initiatives designed to improve efficiencies of its sortation activities, via investments in new and automated super hubs. In this context, requiring RM to provide access risks undermining the investment case for the super hubs, due to the risk of stranded assets in case RM were to lose significant volumes upstream while this investment programme was underway.

Finally, end-to-end competition provides powerful incentives to RM and other carriers to offer customers the level of quality and service that they require. Ofcom itself considers end-to-end competition to be a more effective form of competition compared to access, and access competition plays a limited role in the parcels industry; therefore, additional mandation requirements (or continuing with mandation for FLLs) would not be expected to confer significant additional benefits to users.

On the contrary, access could have detrimental consequences for users of postal services due to the adverse effects on:

- innovation in the market—to the extent that access increases reliance on RM’s model of delivery, this will reduce incentives for other carriers to further invest and improve on alternative solutions and operating models for

<sup>11</sup> Ofcom (2021), ‘Review of Postal Regulation. Call for Inputs’, 11 March, p. 40.

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last-mile delivery, setting back end-to-end competition and undermining the significant consumer benefits that have resulted from it;

- future sustainability of the USO network—as acknowledged by Ofcom in the previous review, as letter volumes decline, the future sustainability of the USO increasingly depends on RM’s ability to drive sufficient revenues and margins from its parcels business. At the same time, the evidence indicates that RM has been and will continue to be under increasing pressure from competition in this area. Therefore, an access regime targeted precisely at those products where RM is still able to retain a position of relative (albeit declining) strength risks structurally worsening RM’s financial position, and could fundamentally undermine its ability to recover the fixed costs of the USO network.

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